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DISCUSSION PAPER

Can the eurozone's economic governance combine political accountability, legitimacy and effectiveness?[1]

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After years of economic crisis, resulting in significant changes to economic governance at EU level, especially for the eurozone, the time has come to consider the longer term political and economic implications of this new situation for the economic integration process. Not only to determine how well the system is likely to function but also what more needs to be done to ensure long-term stability and to provide the EU institutions with sufficient political legitimacy to carry out this new role.

This article does not consider abolishing the euro, based on the conviction that introducing the euro created a path dependency that makes trying to unpick the seams of the process extremely costly. While, economically, the exit of one eurozone member state might conceivably be manageable (but costly, especially for that country), the long term political costs might end up unravelling the whole European integration process, with the potential for a bankrupt and politically unstable state outside the euro but still within the EU. However, the *status quo* situation is still unstable, politically and economically, and needs further policy reforms.

Governing reluctant member states

The crisis has shown that the EMU has created an even higher degree of interdependence, with imbalances and lack of convergence – partially inflicted by countries themselves – threatening the stability of the EMU as a whole and thus driving the need for (politically controversial) support for economically weaker member states. The key policy levers to influence these imbalances are at member state level rather than being controlled by the EU institutions. It follows that one of the key features of the post-crisis eurozone governance framework is the need to directly influence the behaviour of member states, in particular in terms of fiscal policy choices and structural reforms.

To address this need, the new governance framework mostly relies on a legalistic, rules-based approach, i.e. an EU legal framework with sanctions for non-compliance. In many ways, this represents a halfway house between market forces and 'federalisation', i.e. pooling sovereignty at EU level in an executive that can enforce common policy decisions. Not only is a rules-based system the EU's traditional response (its backbone is legislative, after all), but both market-based and federalised solutions were seen as undesirable: market-based solutions might lead to sovereign defaults and banking system troubles, while federalisation was seen as an undesirable transfer of sovereignty that would be constitutionally tricky, as fiscal policy touches on some of the most fundamental functions of the nation state, and would be politically impossible to sell to northern European electorates, as it would have to include the mutualisation of public debt.

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However, the new EMU governance framework is not purely rules-based: it also contains new provisions that are more akin to the open method of coordination. In the new European Semester process, the main driver behind member state compliance is 'peer group' pressure, i.e. being monitored by fellow heads of state and government. However, in the past these methods have not worked successfully and this seems to be the case once again for the implementation of the Country-specific Recommendations (CSRs). Studies suggest that implementation of the CSRs is patchy at best. In essence, those member states that want to implement the CSRs do so, while the rest can safely ignore them without the fear of sanctions.[2] While the European Semester process could be improved, for example, by putting a stronger focus on a smaller number of key recommendations, this structural deficit of a lack of enforcement mechanisms will continue to limit the effectiveness of CSR implementation.

In one area of the new governance, enforcement mechanisms had been ever present: the programmes introduced by countries requiring public finance support, with implementation monitored by the troika of European Commission, ECB and IMF. However, the troika mechanism has been highly controversial, because of the loss of sovereignty it implies. Consequently, many have criticised the troika and the recent developments in Greece can, in part, be interpreted as a backlash against the perceived lack of legitimacy of the troika's actions, which is reinforced by the exclusion of the support and implementation systems in programme countries from the community method.

The limitations of rules-based systems

For the foreseeable future, it therefore appears likely that the EU will rely on the tried-and-tested method of rules-based governance. But the effectiveness of the system is still questionable, as rules-based systems suffer from a number of limitations, including:

- questions about how to pick appropriate rules/targets, adapted to both the economic environment and country-specific conditions;
- the way that rules suffer from low anticipatory powers: they often address past crises rather than coming ones. To deal with emerging risks, it is necessary to have significant instruments that can be employed quickly (or even automatically) rather than having a set of inflexible rules;
- the perennial question of enforcement mechanisms, especially since, at EU level, enforcement is often reliant on the willingness of the heads of member states to censor or even fine their peers;
- whether a country's failure to meet a target is down to willingness or capacity to deliver and under what circumstances there needs to be flexibility, and who decides on it;
- and that the available instruments, both old and new, are too complex and therefore difficult to understand for policy-makers that need to quickly apply and comply with the rules. This complexity is an additional factor that leads to low automaticity that obstructs the necessary degree of *ex ante* support for the prevention of new economic and financial crises.

The rules-based system is further complicated by the need to interpret rules which always opens up potential disagreement. While the system offers the opportunity of taking the legal enforcement route, this requires the political will to take countries to court, as well as patience, as rulings take time to be delivered. In addition, there are questions over whether a court with legal rather than economic competence is well-placed to rule on matters of economic governance. Furthermore, the reliability of monitoring information is critical to ensure consistent implementation of the rules. If there is a degree of interpretation – in conditional rules, for example, which are based on some form of relative concept rather than a simple, absolute target – it can be difficult to reach agreement on how the data should be interpreted.

Given the difficulties in changing the EU's strategic direction, it is also very challenging to change any of the rules that have been written into the EU treaties. Furthermore, it is nearly impossible to take into account country-specific conditions and circumstances, or changes in the broader macro-environment. This raises a number of crucial questions: Is the same inflation target still appropriate in a situation where deflation is threatening? Is it right to focus strongly on public debt? Is a deficit target of 3% the right one for all countries, given divergent growth performances and debt financing costs? Again, if, for any of these rules, there is a need to consider more flexibility, who is empowered to make such a decision?

For some countries, it seems that the main objection to any economic governance arrangement is more the fact of attempting to impose rules at European level than disagreement with the content of the rules themselves or how flexibly they are applied. In essence, under the guise of flexibility or reductions in austerity, countries may aim for a repatriation of fiscal powers, which would undermine effective fiscal coordination at eurozone level, as well as undermining the underlying political bargain: debt financing support only with attached conditionality.

Another key challenge is to ensure compliance with the rules by both small and big countries to safeguard the long-term credibility of the new governance system. Previous experience with the Stability and Growth Pact shows that if large, powerful countries do not comply with the rules, the remaining countries will soon follow suit. Recent debates already seem to show that some member states think the rules apply less to them than to others, as illustrated by the debates about the flexibility of sticking to the 3% deficit limit (prompted by large countries with public finance problems) and recent discussions on export surpluses, which provoked highly negative reactions in Germany, despite being fully in line with the recently-created governance instruments. Any exceptions to the rules, for example regarding flexibility, should only be decided at the eurozone level and be equally applied to all member states.

But the lack of a *priori* flexibility in rules-based systems is a particular challenge in times of crisis and uncertainty. It raises the question of who makes the decision on whether rules can be suspended or eased in such instances. In the case of fiscal governance, any such decision (or the decision to enforce the rules) by the Commission is likely to be challenged, especially by the bigger countries. However, if it is down to the Council, it is difficult to see heads of state and government holding their peers strictly to account.

In the current situation, the rules need to be adapted to encourage more private and public/social investment. But this needs to be done while still maintaining the integrity of the governance framework as a whole. The only way to do this consistently in a rules-based system is to amend the rules. In this case some form of Golden Rule, excluding productive investment from the deficit criterion, would be a feasible, if politically contentious, option. This would need to be accompanied by a framework to define what falls under social/public investment for the purpose of such a Golden Rule. But, yet again, significant hurdles need to be overcome, such as how to define what falls under the rule, determining who makes the final decision on it, and ensuring its implementation relies on objective, independent evidence.

But the difficulties with a rules-based, legalistic system go further than this. In the policy areas which the EU now needs to cover which are close to the heart of national decision-making systems, the reliance on a rules-based approach is unlikely to function well. While, at times, adhering to European rules in politically sensitive areas can be politically useful in order to shift responsibility for unpopular measures, at other times the political cost of compliance outweighs the consequences of breaking the rules, especially for the more powerful countries.

A game-theory view of economic governance

The challenge of implementing rules in a dynamic and uncertain environment should not, thus, be seen as a legal problem. It is, in reality, a political economy problem and here it can be useful to borrow some concepts from game theory, political economy theory and transition economics to highlight some of the fundamental political conflicts that limit the further development of eurozone governance.

Political feasibility: The crisis management strategy chosen by the EU to deal with the euro-crisis has not taken political feasibility sufficiently into account, as is clearly demonstrated by the election victory of Syriza in Greece. This should not have been unexpected. After all, in a situation with rapidly falling living standards and few positive economic prospects, the messages of populists will gain traction. A crisis management strategy must thus build in the need to create constituencies for reform, as well as providing populations with realistic prospects of future improvement.

Time inconsistency and moral hazard: Agreements based on the commitments of member states suffer from moral hazard problems, i.e. the tendency of countries, once they have received the support they need, to backtrack on the more difficult reforms and commitments they have previously made. This can be especially difficult when governments change. As a result, any support becomes time inconsistent and the result is sub-optimal, with no support and no reform.

Bounded rationality and asymmetric information: There are a number of information limitations which arise in such complex governance frameworks. This is aggravated by information asymmetry, where national governments hold more information than the institutions or the other member states, for example, on whether reforms are implemented or whether there is only on-paper compliance.

These issues, in combination with the distrust between member states which arose from the euro-crisis, imply that there is a prisoner's dilemma at the heart of EU policy: without support, there is no reform, but without reform there will be no support. In the EU, traditionally, Germany has been able to overcome the prisoner's dilemma by making the first move, with a focus on the longer-term national interest, but Germany no longer takes this role, having become more 'normalised', i.e. looking out for more narrowly-perceived national interests.

The final result is inertia. Member states try to muddle through without having a long-term agreed-upon vision, necessitating ongoing ECB action to prop the system up. Given the continuing structural challenges within the EMU, these periods of muddling through will be accentuated by an acute crisis for which short term responses are found without addressing fundamental governance reform. In the long run, this may well threaten the European integration process if a particularly acute crisis runs out of control or when the long-term imbalances lead to a build-up of political frustration in the countries providing and the countries receiving support.

The role of the Commission

To overcome these issues, the literature suggests that a 3rd party could take the role of arbitrator, acting as an honest broker. The member states (the principles) could delegate some common functions to an independent body (the agent), which acts in the common interest. This could be (and arguably was in the past), a function fulfilled by the Commission. But the member states no longer trust the Commission to act in the common interest, in part because the Commission has become more politicised. There is a fundamental conflict between the political function of the Commission, taking a role in the overall political direction of the EU, and its role as an independent monitoring/assessment agency, regulator and arbitrator in the application of EU law, for example in areas such as competition policy or in the assessment of member states' budgetary policies. With an increasingly 'political Commission', potentially further reinforced by the link to the EP elections made through the Lisbon treaty and the *Spitzenkandidaten* process, maintaining credibility as an independent and objective arbitrator might be severely challenged in the future.

One way to address this would be to outsource some of the functions that call for impartial arbitration or objective advice and recommendations. Independent bodies could be set-up such as, for example, a separate competition authority, as well as bodies to monitor fiscal policies, a statistics agency and a council of wise men and women to provide advice on the economic strategy and position of the EU. Undoubtedly, this would be a longer term process, but thinking about a fundamental reform of the Commission along these lines should start now, including clear provisions to reinforce the political accountability of such bodies.

But the fundamental issue is that, at member state level, many have had enough of 'more Europe' due to the crisis and think that it is now time for 'less Europe'. In many countries, there are also signs of the 'British disease', namely that any further integration is seen as undesirable and that further integration steps are blocked, with the argument that this might raise strong objections in the electorate. This will be a significant challenge for the EU. There are already a number of areas where a process of 'inverse subsidiarity' can be observed. These are areas where member states want to retain control but EU solutions are now needed as it is no longer possible to deal effectively with the issue at national level, such as energy security or migration. In addition, further integration is also becoming necessary for the eurozone due to a process of 'spill-in', i.e. further integration within a policy area with the aim of avoiding negative consequences, here driven by the necessity to correct the flaws of the EMU (these contrast with positive reasons for integration, such as a wish to move towards a federal Europe or the pull of positive spill-over effects). Increasingly, we will see that what is politically possible diverges further and further from what is required to effectively deal with the challenges the EU faces. Clearly, to have effective decision-making, there first needs to be agreement on what the EU should be doing. At the moment we are nowhere near such agreement.

More government than governance

Ultimately, there is a need for more executive powers at EU level, especially so as to be able to react swiftly to any emerging crisis. In addition, an effective system also needs to have accountability mechanisms. In national systems, this is usually performed by the legislative. But with co-legislators, the Council cannot hold itself to account if it also has an executive role. There is also now a greater role for national parliaments, which can create additional uncertainty: who, in the end, holds the executive to account? The Council, the EP, the national parliaments, or a combination of these?

Currently, most member state governments are unwilling to relinquish control of executive powers in politically highly sensitive areas to the Commission, insisting that the final decision-making power should be retained at national level or, at the very least, in the Council. But there is no effective way in which two bodies can share this kind of executive power. While co-legislation can work due to its sequential nature and the absence of acute time pressure, co-executive power shared by Council and Commission is likely to create uncertainty and delay that can be very costly in a crisis. The only way out is to vest powers in a supranational body, whether it be the Commission or another construction. There is thus a need to construct a grand political bargain based on the wishes of the population that provides an acceptable deal, including institutional and treaty change. But further far-reaching steps seem highly unlikely at the moment, so at the very least it will take time until the political environment is right. So, what can be done in the meantime, in addition to preparing for such a bargain?

Improving output legitimacy[3]

One short-term measure may be to improve the effectiveness of the EU institutions, especially the Commission, in delivering their policy priorities, thereby improving so-called output legitimacy. But the Commission is not necessarily structured efficiently: a long-standing issue, aggravated by the recent enlargements of the EU, is the number of commissioners. While the EU treaties have provided for a reduction in the number of commissioners to enable the EU to cope with successive enlargements, it has proven to be impossible to get the political agreement for countries to give up the principle of one commissioner (at least) per country. Equally, having 'junior' and 'senior' commissioners, in line with similar arrangements in many national governments, does not seem to be acceptable to many member states, with some of the smaller states worried they would perpetually end up with junior posts.

The number of commissioners increasingly leads to a strong 'silo' mentality, with each member of the College virtually autonomous when it comes to their own portfolio's competences, and where inter-service consultations and infrequent top-down direction from the Commission president is insufficient to break the overall pattern. Eventually this leads to a lack of coherence and focus, and in the worst cases can give rise to uncertainty about the overall direction and may even create outright contradictions. There is, however, a way of potentially overcoming these difficulties. This would be through building on the existing structure: creating clusters of commissioners around vice-presidents.

In previous publications[4], we have suggested a possible distribution of priorities for vice-presidents and clusters of commissioners to ensure that the structure of the Commission mirrors the overarching challenges of the EU. The new structure of the Juncker Commission does partially reflect these suggestions, with seven vice-presidents covering broad thematic areas without a specific portfolio. However, there is one crucial difference: in an attempt to maintain flexibility (and possibly to assuage the member states' fears that this would create 'junior' commissioners), the clusters of commissioners differ for each broad policy area, with many commissioners contributing to more than one area. In other words, there is no clear cluster structure but a matrix, as well as numerous overlaps between the vice-presidents themselves and between vice-presidents and commissioners, both in terms of portfolio content and in terms of the supporting bureaucracy. At the very least, this will require the clear definition of which commissioner is ultimately responsible for what and who reports to whom at the outset of the Commission, but even so, the structure might well prove ineffective without a clear hierarchy. This new way of working will also require effective coordination between the president and the vice-presidents, guided by a common purpose and vision.

A more political Commission

If, in the end, this works, it will improve output legitimacy and, at the same time, will turn the Commission into a more political instrument, with clear-cut political priorities and the ability to better deliver and implement them, which raises fears over the politicisation of the Commission as discussed earlier on.

But politicisation should not be seen as a negative process. For a long time, many convinced Europeans have lamented that the EU is remote from its citizens, that democracy is not functioning as it should at EU level and that there is no engagement with EU policy debates. While current governance/political developments certainly do not answer all the questions posed of EU democracy, at least it is a starting point to get citizens more interested in EU policy decisions.

Even if it were desirable, it seems unlikely that we could go back to a 'golden age' where the Commission does not get involved in politics. The Commission is already highly politicised and, increasingly, the EU needs a Commission able to make executive decisions that can be implemented across the EU. This means a move from governance to government, from a rules-based legalistic system to one driven by political preferences, underpinned by mechanisms of legitimacy and direct accountability.

But to do this, democracy at EU level also needs to be further developed to facilitate engagement. In addition to the existing mechanisms of representative democracy, which are still struggling with low engagement and participation, there is a need to develop a more accessible, informed participatory democracy by utilising new technologies and building bespoke mechanisms for citizens to have input on EU decision-making, such as developing an EU version of 'liquid democracy', where citizens can be involved directly in EU policy. In addition, there needs to be a clear mechanism to hold the Commission to account for its executive/political decisions, a role the EP could increasingly play. Improving democracy at EU level will also require the finding of a solution to deal with the differences between member states, especially the Euro *ins* and *outs*, with a need to find a way of re-invigorating differentiated integration. While progress is certainly possible, in the end, decision-making and accountability at EU level will only be as effective as member states allow it to be.

By and large, the EU could start to introduce some of the changes proposed here in the near future, without major changes to the institutions or the EU treaties. However, the elephant in the room is the question of what member states want the EU to do and how far they are willing to make the necessary changes, especially if they require the further pooling of sovereignty in some areas.

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2 Theoretically, the lack of implementation of CSRs might have some consequences, for example in terms of EU structural and investment funds. But it is difficult to envisage this being implemented strictly.

3 The following sections draw on Zuleeg (7 March 2014).

4 See Zuleeg (9 September 2014).

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