

EUROPEAN

# POLICYBRIEF

## EMU CHOICES

### Searching for EMU reform consensus

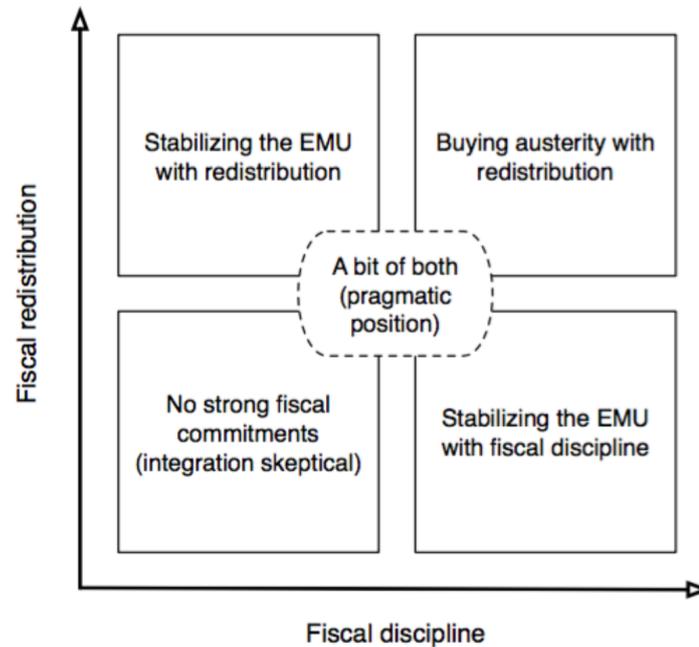
New data on member states preferences confirm a North-South divide on various aspects of EMU reform. This implies that the more politically feasible reform scenarios are likely to be based on mutual concessions, whereby the 'South' accepts more supranational governance while the 'Norths' concedes to some form of fiscal easing.

#### INTRODUCTION

There is no shortage of EMU reform proposals, however political consensus necessary for the implementation of any of them is elusive. The Five presidents' report, Commission's blueprints as well as myriad of scholarly and practitioners' proposals outline viable solutions, but without reference to their political feasibility. Hence, there is a need for a systematic study of political economy cleavages within the EU, which could indicate what reform designs increase the likelihood of consensus among member state governments.

The experience from the Euro crisis suggests that preferences of member state governments on EMU reform designs differ. Some member states prefer Keynesian macroeconomic policies for the stabilization and completion of the EMU that rely on fiscal expansion on national level in combination with some elements of fiscal redistribution or risk-sharing within the single currency area. In contrast, other governments prefer fiscal discipline and prevention of fiscal deficits instead of any form of redistribution. Finally, governments may also opt for pragmatic positions that vary from one policy proposal to the next and do not reflect any consistent set of underlying preferences (see Chart 1 for schematic depiction of this policy trade-off). The knowledge of policy preference is thus important for the EMU reforms proposals that strive to accommodate constraints imposed by preference constellations among member states in order to increase the feasibility of their adoption and implementation.

Chart 1: Schematic distribution of preferences on EMU reforms in 2010 to 2015

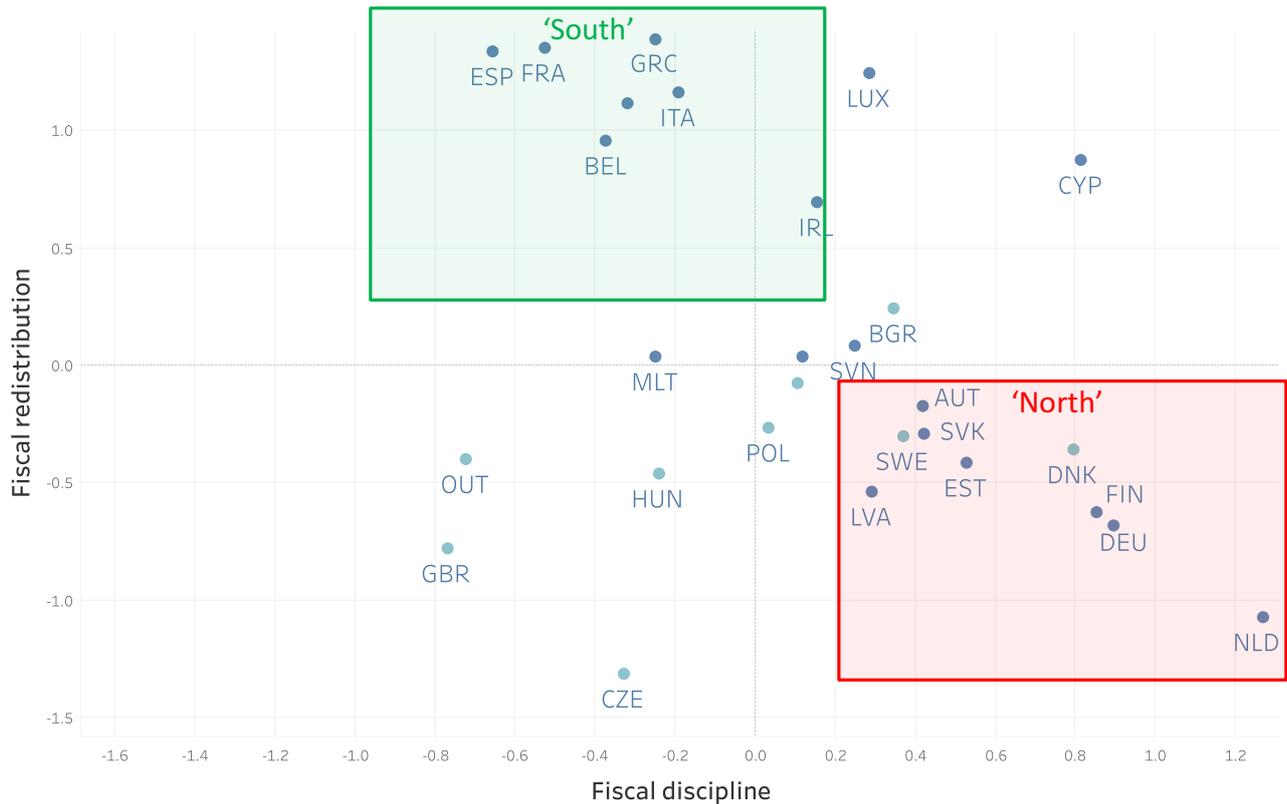


## EVIDENCE AND ANALYSIS

Our new dataset of member states preferences on economic and fiscal integration covers 47 contested policy issues that were adopted or discussed during the 2010 to 2015 period. These reforms include the introduction of the support packages for Greece, set up of the European Financial Stability Facility, European Stability Mechanism, Fiscal Compact, Six-Pack and Two-Pack, three pillars of the Banking union as well as proposals for future integration involving Eurobonds, financial transaction tax as well as some aspects of the fiscal union and political union outlined in the Five Presidents' report (see Table 1 below). Consequently, the dataset facilitates a systematic study of preferences across many issues that can reveal some more surprising preference constellations that are not readily observable even to participants in individual negotiations.

Our estimations of the policy ideal-points of all EU member states confirm the 'North-South' divide as most member governments consistently prefer either more fiscal redistribution or more fiscal discipline (Chart 2). Their preferences cluster into three groups. The 'Southern' countries like France, Spain, Italy, Greece or Belgium, consistently supported proposals easing fiscal discipline and introducing elements of fiscal redistribution. On the other hand, 'Northern' governments of the Netherlands, Germany Finland, Denmark and others argued in favor of fiscal discipline and no redistribution. The third group of countries is formed primarily by the UK and new member states, whose preferences were more varied as they sided with either of the two groups on individual policy issues.

Chart 2: Policy ideal-points on fiscal redistribution/discipline trade-off

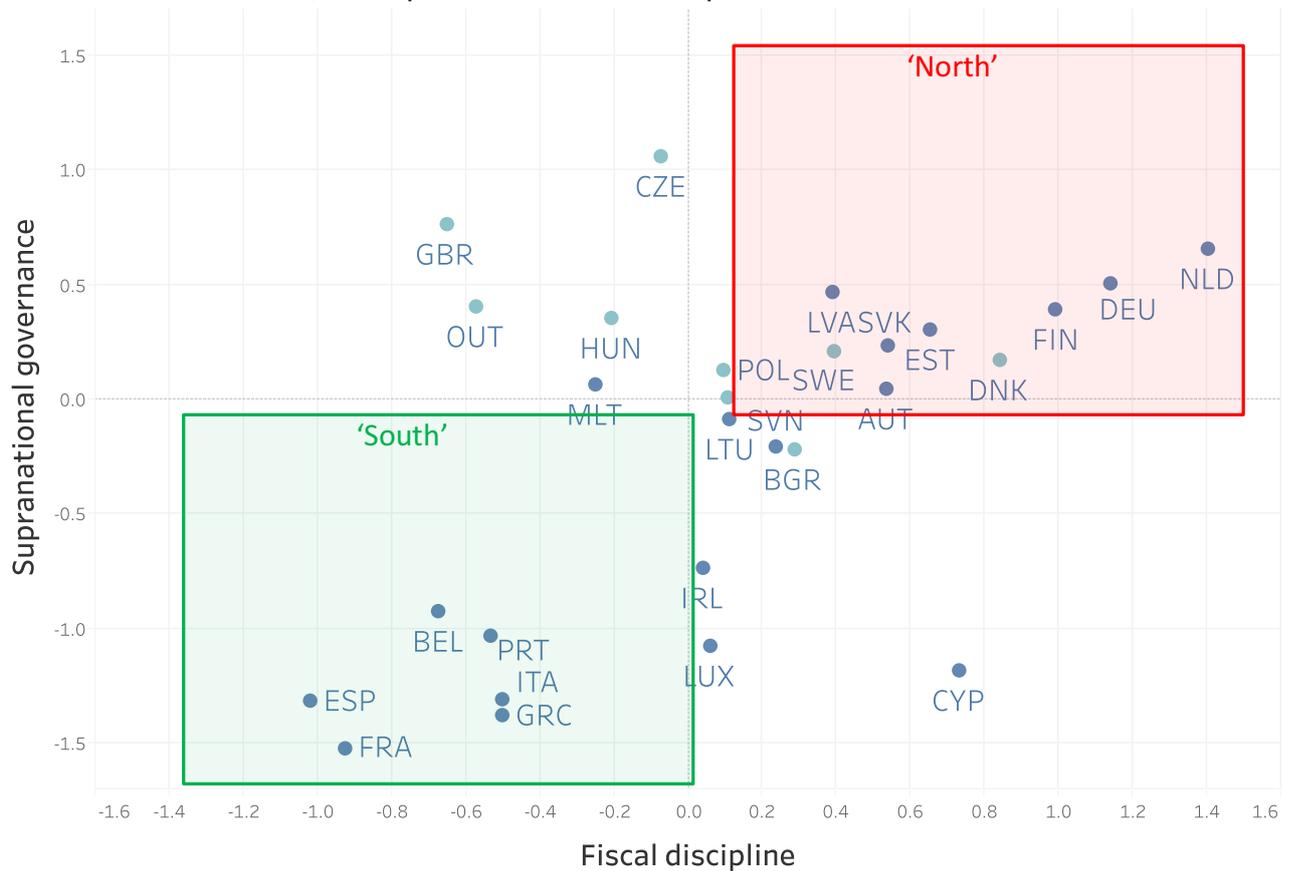


The 'North-South' divide is a common knowledge to any observer of the Euro crisis. Still it provides a useful reality-check for our dataset, suggesting that our data are not divorced from the underlying political economy. However, the dataset allows for systematic analysis on additional dimensions of member preferences that indicate less obvious patterns. One of such cases is the 'North-South' divide on EMU reforms introducing various elements of supranational governance (Chart 3).

Somewhat surprisingly the 'Southern' group of member states is not particularly supportive of further supranationalization. Given its sustained support for EMU reforms that include some elements of fiscal redistribution, the absent backing for institutions with the mandate and capacity to manage fiscal integration is not necessarily expected. This contrasts with the indicated preferences of 'Northern' group of countries that insist on maintaining the fiscal discipline, while also supporting supranationalization. This constellation of preferences only confirms deep divisions that represent a constant challenge to the search for politically feasible reform scenarios.

At the same time, these divides also provide some elementary hints about the structure of the more feasible reform proposals. These are not likely to be based on some joint proposals satisfying all member governments, because there is little evidence that such designs exist, given the prevailing cleavages. Similarly, it is not likely that the preferences of either of the groups could prevail, given the high consensual requirement for any EMU reforms. Ultimately, the more feasible proposals are likely to be based on mutual concessions.

Chart 3: Policy ideal-points on EMU reform policies in 2010 to 2016



## POLICY IMPLICATIONS AND RECOMMENDATIONS

Our ideal-point estimates indicate that the two groups of Euro Area member states are divided by a deep and consistent cleavage about the design of EMU reforms. This would imply that no reforms could have taken place during the 2010 to 2015 period that our dataset covers. However, this is far from being the case since the EU and Euro Area members agreed on major breakthroughs including the ESM, Six- and Two-Packs or banking union. This experience makes it clear that under the pressure of acute crisis, member states can overcome the bifurcated preferences. At the same time, this observation confirms the long-held notion that EMU reforms can be agreed upon only under the pressure of the exogenous crisis.

Our project will test this assumption by extending the dataset on member states preferences all the way back to 1992 and analyzing the political and economic circumstances that enabled agreements on EMU reforms in the absence of exogenous crisis. Given the current state of our research project, we can only reiterate the limits imposed on consensual reforms by divided preferences.

The division also implies that reform packages more likely to garner support are those balancing ‘dislikes’ of both sets of countries and building on the common concern for the Eurozone stability and long-term success. Their design is likely to be similar to the case of the banking union, which demonstrated that the ‘Southern’ group can – despite initial opposition – accept deepening of the supranational governance (introduction of the Single Supervisory Mechanism), if the reform also provides some element that eases fiscal pressures at least under some circumstances (such as the Single Resolution Fund in case of failure of the large bank). The package deal on the banking union was construed as a combination of both aspects, which facilitated the compromise based on mutual concessions.

Consequently, the key policy recommendation emerging at the current stage of our research, is for the Commission to try to design policy proposals that respond to divided preferences of member states by asking them to accept balanced set of measures for the sake of stabilizing and completing the EMU. At the same time, as our work progresses beyond the initial data collection, we focus on the analysis of political and economic mechanisms that enabled member states to overcome their divisions and agree on economic and fiscal integration, even in the absence of immediate crisis. This is based on the hypothesis that certain constellations – such as the type of government in power or prevailing economic climate – make adoption of reforms more likely, despite underlying divisions across the EMU.

## RESEARCH PARAMETERS

In order to ensure a strong validity and reliability of the data, our strategy combines different methodologies and includes a number of control steps that build on one another. The data collection process follows these steps:

- identification and selection of policy packages to be included into the dataset (see Table 1);
- identification and selection of the relevant policy issues of the selected proposals on the basis of extensive analysis of primary and secondary documents ranging from official EU statements to media reports,
- definition of the policy space and the coding of positions of both EU member states and EU institutions for the selected policy issue based on document analysis,
- validation and completion of the dataset through 26 interviews with experts who were personally involved in the negotiation of the given policy package,
- and the aggregation of the data from the document analysis and the interviews for constructing a unified dataset.

This approach facilitated the collection of 71% of member state positions on the 47 contested issues (78% for EA members).

**Table 1: Policy packages and contested issue in the dataset**

Policy package	Initiatives	Year of decisions	Number of contested issues
Support for Greece	First Greek program	2010	4
European Financial Stability Facility	EFSF and EFSM	2010, 2011	4
European Stability Mechanism	ESM	2012	7
Fiscal Compact	Fiscal Compact (TSCG)	2012	9
Six-Pack and Two-Pack	Six Pack Two Pack	2011 2013	8
Banking union	CRD IV SSM SRM	2013 2013 2014	9
Proposals for future fiscal integration	Eurobonds, Five presidents' report, Tax on Financial Transactions	2011 2015 2011/2013	6
Total dataset			47

The estimation of policy ideal-points in Charts 1 and 2 relies on the Bayesian Item Response Theory (IRT) that reduces the 47 issue into 2 dimensions, whereby each dimension is calibrated by the contested issue that best captures the dimension of interest. The IRT is used in political science mainly to estimate the ideal points of members of parliament as it generates particularly robust results for datasets with some proportion of unavailable data. For our purposes it measures a latent preference for EMU integration identified by a series of answers to test items – in this case positions on contested issues. The member government indicates its preference by choosing a position on contested issue that shows underlying preference for either less or more integration. This is used to calculate the IRT 'difficulty-parameter'. The contested issues also differ in their 'discrimination parameter', i.e. the extent to which they can identify the different underlying preference for more or less integration. The ideal-point for each member state is jointly estimated with the difficulty and discrimination parameters by the MCMCpack in R statistical software.

An example of a contested issue included in the dataset is "Withholding EU Funds to deficit countries" discussed during the Six-pack negotiations, where the member state position was coded 100 (the government initially supported the notion), or 0 (when it opposed). This issue was used to calibrate the fiscal discipline dimension in Charts 1 and 2 in the IRT model. The fiscal redistribution dimension in Chart 1 was calibrated by the "Preparedness to issue EFSF loan guarantees", coded 0 (member government were not initially prepared to back European Financial Stability Facility) or 100 (supported the proposal from the onset). Finally, the 'supranational governance' dimension in Chart 2 was calibrated by the issue of "Gaining political legitimacy", which was coded on the basis of Sherpa's documents for the Five presidents' report (100: support for Euro treasury, 50: support for Euro committee in EP, or 0: minor adjustments in interaction of EP and national parliaments).

<b>PROJECT NAME</b>	The Choice for Europe since Maastricht. Member States' Preferences for Economic and Financial Integration (EMU_SCEUS; see <a href="http://www.EMUchoices.eu">www.EMUchoices.eu</a> ). Horizon 2020 funded project - Grant number 649532.
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