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Economic and social policies under EMU

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Abstract

The coordination of economic policies is seen as a requirement of EMU, although there is no strong economic rationale for it. After the 2008-2010 crises a complex surveillance mechanism was implemented where the European Semester had the role to coordinate economic and social policies in order to obtain real convergence between countries and prevent further instability. However, it has been ineffective in helping Southern countries to converge, deepening existing divisions and threatening further exits after the UK. This ineffectiveness and a democratically flawed decision-making process ask for a change in the framework of policy coordination. The proposed solution mixes an idle approach based on fiscal transfers with an engaged one where coordination over significant spillover effects between countries and cooperation based on Pareto improvements are the rules. It reinvigorates the governance of the single market, focuses on the spatial distribution of economic activity and it is a decentralized answer to the common threat of division. Moreover, it complies with the two core ideas of the EU project: democracy, from which peace depends, and development within a market economy where countries are free to choose their way of development.

Keywords: EMU, European Semester, Policy coordination, Efficiency, Cohesion.

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1. Introduction

The completion of the European and Monetary Union (EMU) was said to require *coordination and guidance* for economic and social policies, in the words of the European Commission (EC). Article 119 of the EU treaty calls for a *close coordination* of Member States' economic policies as a necessary way to achieve the purpose of a single monetary policy, although it does not provide a meaningful explanation of what does that mean in practical terms and which policies are included. This policy coordination is supposedly in accordance with the Optimum Currency Area (OCA) theory in order to better protect participating countries from asymmetric shocks that can destabilize the single currency (Mundell, 1961).

The instability caused by the financial and the sovereign debt crises of 2008-2010 led to the creation of a complex surveillance mechanism of coordination with possible sanctions, where the European Semester (ES) was included. Despite the focus on fiscal policies and EMU, the ES was supposed to be the framework for the coordination of economic and social policies, linking EMU with the single market.

One of the aims of the ES is to solve the trend for economic divergence that peripheral countries in the South of the EU are experiencing. This trend, and EMU itself, are a cause of division between countries, which became more evident with the exit of the UK. Furthermore, it may endanger the core ideas of the EU project: democracy, from which peace depends, and development within a market economy.

However, not only the evaluation of the ES shows that it is not an effective framework of policy coordination but it also has shifted governance responsibilities away from parliaments into the hands of unelected and unaccountable bureaucrats (Crum, 2018; Papadopoulos and Piattoni, 2019), thus further undermining the democratic base of the EU institutions.

This chapter offers an alternative solution to the governance of economic and social policies in the EU that answers to the common threat of division and complies with those two core ideas. It goes beyond OCA theory to consider the economic geography approach to the spatial distribution of economic activity (Krugman, 1991; Fujita et al, 1999; Baldwin and Krugman, 2004) and it moves the focus from non-consensual fiscal goals, and more so in a Covid-19 setting, to social and economic policies[2].

It starts by considering the effectiveness of the European Semester as a guide and a surveillance mechanism for the coordination of economic and social policies under EMU. Then it discusses the options to address the current trend of economic divergence in the Southern part of the EU to heal the existing division between member states. It ends by proposing a *back to the basics* solution, where the ES is replaced by a decentralized option that re-discovers the centrality of democracy and of the accountability of governments, and promotes a politically sustainable economic development.

[2] By economic and social policies is meant all areas except fiscal policy: transport, energy, communications, labour and product markets, R&D or innovation and so on, where the focus is on firms, workers and consumers and not on the state and budget deficits.

2. The European Semester: feigned policy coordination

The coordination of member states' economic policies is often seen as a necessary way to achieve the purpose of a well-designed single monetary policy, under what economists usually refer to a theory of optimum currency areas. The lack of coordination can compromise the foundations of the European Monetary Union (EMU), risking jeopardizing its operability.

An implicit reference to policy coordination can be found on the work of Kenen (1969) on the desirability of fiscal transfers to help countries to diversify their productive structure to deal with sector-specific shocks, and by Frankel and Rose (1997) on the endogeneity of the OCA criteria leading to an increasing correlation of national business cycles. This would better prepare countries to participate in a monetary union. In essence, the intuition is that the closer the economic characteristics of participants in a single currency the lower the probability of asymmetric shocks to occur and the smaller the difference in their economic effects.

But the question of how far should economic policy coordination go was never explicitly stated. In EMU, a so-called multilateral surveillance mechanism was established in an attempt to ensure that countries comply with fiscal goals and correct macroeconomic imbalances[3]. But economic policy also comprehends a diversified set of areas, from energy and transports to communications, firm financing, innovation, labour and product markets or foreign investment, and is equally important to both Euro and non-Euro members.

An answer to what is economic policy coordination in these areas is absent from the EU legal paraphernalia. The Article 119 of the EU treaty calls for *close coordination* of Member States' economic policies as a necessary way to achieve the purpose of a single monetary policy. However, and except for the public finance dimension, these legal requirements are vague are only generically met under the so-called Macroeconomic Imbalance Procedures, where the need to coordinate economic policies is not explicit and is open to very different interpretations.

Even if it is assumed that economic and social policy coordination is required, a better understanding of the meaning of *close coordination of economic policies* is needed to ensure an EMU that operates with clearer rules.

In practical terms, however, the idea of economic policy coordination in the first decade of EMU was mainly theoretical. Even the goals for the deficit and debt and the Stability and Growth Pact were continuously disregarded for many years without any meaningful consequences and despite the penalties

[3] Regulation (EU) No 1175 and 1176/2011 of the European Parliament and of the Council, of 16 November 2011; Council Regulation (EC) No 1467/97 of 7 July 1997.

considered in the EU legislation. It was only after the crises of 2008 and 2010 that fiscal policies started to be monitored in a more serious way and Eurozone countries felt the pressure to comply with fiscal criteria[4]. The European Semester (ES[5]) and the six pack legislation were established after 2010 and aimed to improve the coordination of economic policies through an aggregation of different processes of control and surveillance of fiscal, economic and social policies. The main goal was to stabilize the Euro area after two successive crises, but it did also include the aim of implementing a governance framework for thematic coordination of member state policies towards the 'smart, sustainable and inclusive growth' objectives of the EU 2020 Strategy.

Under the ES each state receives a set of Country Specific Recommendations (CSR) covering a wide range of policy fields – fiscal, competitiveness, labour market, innovation, R&D, education, health, etc. These areas fall mostly under national competence but through the ES the European Commission tries to monitor, scrutinize and guide national economic, fiscal and social policies, in a way that enhances policy coordination among countries. The expected outcome of these CSR is their adoption by national parliaments.

This is a multilateral surveillance mechanism that implicitly assumes EU institutions to know better than elected governments what should be the national policies, which is not true and it raises legitimacy concerns. The economic basis to support it is unknown but the countries who approved the ES often do not comply with it. The assessment of the European Semester is that of a weak and declining effectiveness in the implementation of CSR, lower than the recommendations made by the OECD (Darvas and Leandro, 2015; EP, 2018 – Figure 1). That is, countries approve the general direction for growth policies at an EU level (the Annual Sustainable Growth Strategy) but choose which ones to implement without considering the recommendations of the EC.

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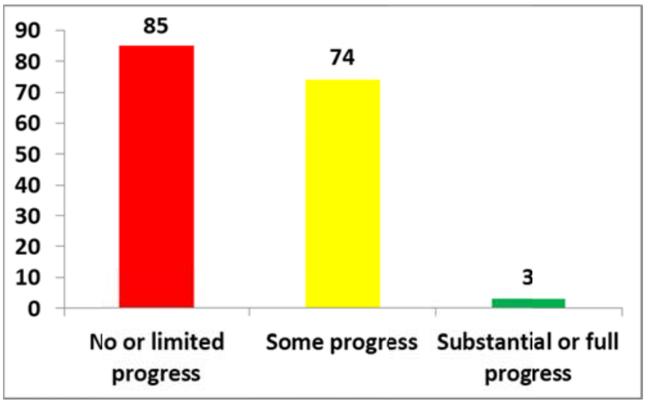
[4] The implementation of the European Semester, the two pack, six pack and the Treaty on Stability, Coordination and Governance.

5 The European semester is a yearly cycle of policy cooperation among the EU Member States, running from November to June. It includes several steps: A common growth strategy for all member states, individual country reports, National Reform and Stability and Convergence programmes, bilateral meetings (formally not on the menu) and, in the end, country specific recommendations (CSR) by the European Commission and approved by the Council. In the remaining six months countries are supposed to implement the guiding reforms of the EC. Its main objectives are to ensure convergence and stability in the EU; to contribute to ensuring sound public finances; to foster economic growth; to prevent excessive macroeconomic imbalances in the EU.

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/european-semester-timeline_en.

Figure 1.X – Number of CSR in 2016 and 2017. Source: European Parliament (2018)



More recently, and in order to increase the low level of implementation of CSR, the EC has been using individual country reports, National Reform Programmes and bilateral meetings with each state to better understand the respective policy orientation and to define CSR in accordance with it. Given the past failure in CSR implementations, it is now the EC that is adjusting its CSR to the policies of the countries and not the other way around, meaning that there is no effective policy coordination.

Whether the ES did represent a fundamental shift in EU socioeconomic governance, as some would say, or is an administrative and complex process abundant in EU jargon where a too diversified range of instruments make it opaque for everyone not involved in it[6], may be an open discussion. A clear conclusion, however, is that it is not effective in promoting economic and social policy coordination among EU member states (Crum, 2018). And given that it is a process whose competences are not objectively defined under EU law (except for fiscal and, in a more tenuous way, macroeconomic imbalances) member states do not have any legal obligation to comply with its recommendations[7].

Baldwin and Martin (2006) show that there is no advantage in the coordination of industrial policies between EU countries and that there are costs in terms of time, information, and political goodwill. Alcidi and Gros (2017) refer to a loss of effectiveness in the coordination of economic policies in normal times, when spillover effects and the incentives for coordination are smaller, and a stronger national ownership is needed because it changes the perception that policies are undemocratically imposed.

Finally, and despite the failure of the ES, there are two other mechanisms through which the EC can coordinate economic and social policies: EU funds and the level playing field of the single market. They will be addressed below.

[6] A proof that it is a bureaucratic process may be seen from the writing and publication of an in-depth report for the UK under the ES in 2020, when the country is leaving the EU.

[7] For social and economic policies there is mainly peer pressure from other member states and vague EC warnings through public means (newspapers, etc.).

3. Idle and engaged solutions

EMU is now more than 20 years old and has been working properly without economic policy coordination in what concerns its core countries (e.g. Germany, The Netherlands, Belgium, Luxembourg, Austria or France). This confirms that the evidence for the need to coordinate social and economic policies in a monetary union and for the economic usefulness of the ES, is too feeble.

But although the Euro area was known not to be an OCA back in 1999, the theory is based on a cost perspective and one of resilience in the face of economic shocks but it is not concerned about the rate of growth of the different economies that share a single currency. The original work by Mundell (1961) and McKinnon (1963) was concerned with the mobility of workers, inputs and prices and the openness of the economies as necessary conditions for an OCA, but not with how different countries would develop.

Despite the inclusion of economic growth and convergence in the objectives of EMU, peripheral countries in the South such as Portugal, Italy or Greece have been lagging in terms of development since the beginning of the Euro, showing that there is, undoubtedly, an economic problem in the Southern periphery

Economic data shows that these Southern countries diverged from the EU average between 2000 and 2018 (Figure 2 and del Hoyo et al, 2017). BdP (2020) shows that after a real convergence in the period 1960-1995, Portugal diverged in 1996-2018, coinciding with the inception of the financial external unbalance. The growth of GDP *per capita* (measured at purchasing power parities by the OECD) in this period was lower in Portugal than in 25 of the remaining 27 member states (the two exceptions were Greece and Italy).

In the case of Portugal, interest rates decreased during the 1990s, when a nominal convergence was achieved in preparation for EMU due to appropriated economic policies. This reduction shows that low interest rates require, first of all, good economic policies and that they can be achieved without a single currency.

However, the main advantage of EMU - access to finance at low interest rates - was a curse for the Portuguese economy. Not only it was not able to take full economic advantage from it but it also led to an excessive level of indebtedness that was hidden by EMU and that became a much more serious problem, of a greater magnitude than it would ever be possible outside the single currency. The consequence was a near-bankruptcy ten years after the beginning of the Euro. Furthermore, the expected positive effect on investment in the Portuguese economy was far from extraordinary. Indeed, there was a significant reduction in relative terms in the levels of investment since the beginning of EMU (Figure 3).

Moreover, the single monetary policy since the inception of EMU was not adequate for Portugal because higher interest rates were needed to prevent the accumulation of debt after 2000. But monetary policy in the Euro zone did ignore this economic problem, in effect exposing the costs of monetary integration.

Figure 2.X – GDP *per capita* in PPP – EU = 100 (Source: AMECO)

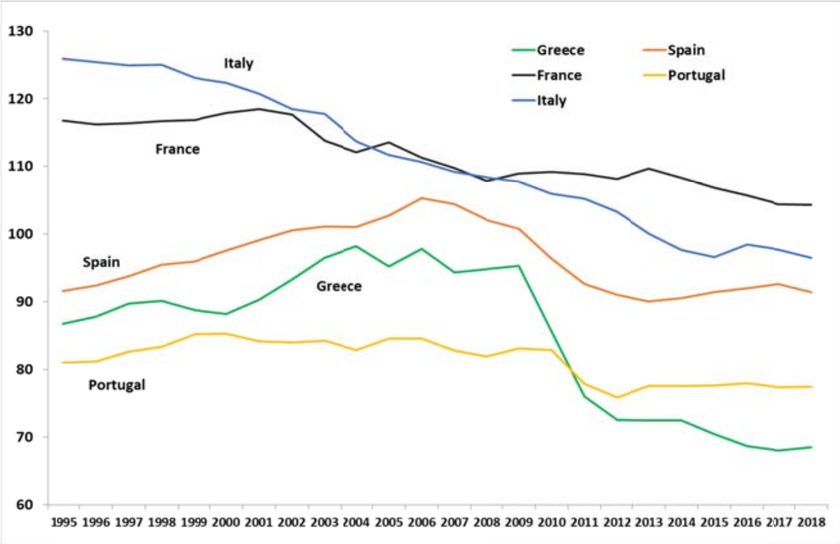
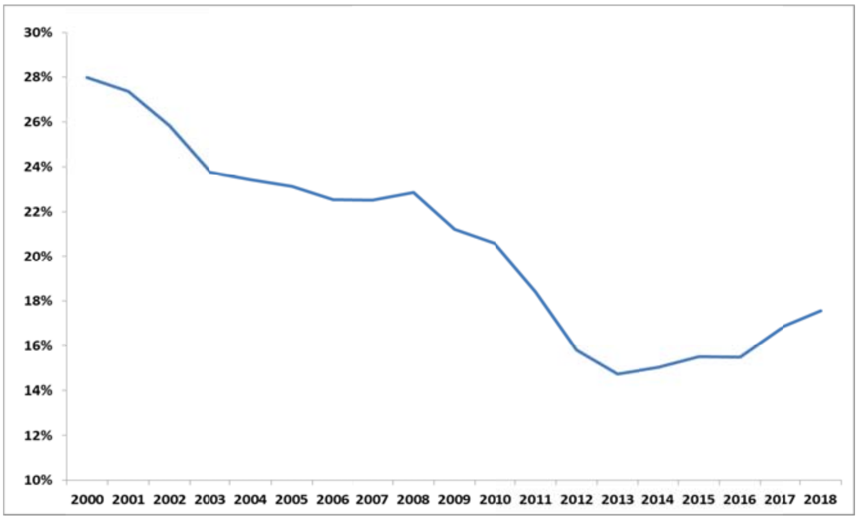


Figure 3.X – Gross Fixed Capital Formation in % of GDP (Source: INE)



The crisis in 2010-2011 affected mostly peripheral countries and was related with strong macroeconomic imbalances, not with the lack of coordination in economic or social policies. But the problems with peripheral economies started earlier, when the Single Act and the single market were inaugurated, back in 1992. It makes sense to go back to the beginning of the single market if one remembers that its economic effects for firms and consumers are much more important than those of the single currency (e.g. del Hoyo et al, 2017).

This statement is arguable because it is not easy to separate the single currency from the dynamic effects of market integration. The single currency was always presented as needed because it would maximize the benefits of the single market. But evidence shows trade gains from EMU to be exaggerated and that both Euro and non-Euro countries benefited similarly from trade creation (Baldwin, 2006).

The intuition behind it is that the currency is only one factor in economic activity. There are other that are also important, such as labour and total factor productivity, administrative rules, standards, social and behavioural phenomena, geography and natural resources, human capital and infrastructure, R&D and innovation, local competition and the business environment, marketing, cultural and information differences and so on.

Then, if one goes beyond OCA theory and considers that the economic effects of the Single Market, namely on trade, investment and competition are much more relevant, a different perspective becomes necessary. When the Single Market started there was a concern about its effects on the spatial distribution of economic activity from the liberalization of trade and investment, namely if a convergence or divergence in the level of economic development would occur between the core and the peripheral EU member states.

This was exposed firstly by the economic geography literature started by Krugman (1991) and Fujta et al (1999), essentially based on international trade models with imperfect competition, and was later reinforced when the unwanted consequence of a deeper centre-periphery relationship (Baldwin and Krugman, 2004) could result from a higher divergence in economic development within the Euro zone.

The idea was based on a purely transactional costs approach where production was concentrated in a single location in order to benefit from scale economies. The peripheral countries such as Portugal had lower production costs (wages, infrastructures, and so on) but higher transport costs to supply the bulk of the market located in the centre of EU. The central countries had higher production costs but lower transport costs. This trade-off between transport and production costs would determine the location of production and convergence (if the main location was the periphery) or divergence (if the chosen location was the centre) in economic development.

These simplified models did not consider the opening of the European market to emerging economies that happened during the 1990s and the growth in the number of peripheral countries with the EU enlargement to Eastern Europe in 2004. In both cases, there was an increase in the competition to firms in peripheral countries like Portugal, Italy or Greece and the cost advantages quickly evaporated. For example, the EC recognized that Portugal was strongly and negatively affected by the enlargement to the East (European Commission, 2008 and 2009).

Generally speaking, a consequence of the single market and of EMU was a growing economic divergence in the South of the EU in the last 20 years. This divergence did not necessarily occur at a regional level inside the Southern countries, but the case of Portugal is a warning. The mobility of the population praised by Mundell (1961) led to the abandonment of poorer areas by people looking for job opportunities in richer regions.

This migration was the way to avoid an economic divergence inside the country. Alentejo, a desertified region, would have hugely diverged from the richest regions of Portugal without it. The growth in GDP *per capita* in Alentejo between 2001 and 2018 was 13%, but it was mostly explained by the exodus of 9% of its inhabitants, further depressing the region. If Alentejo had kept its population her GDP *per capita* growth would have been much lower than richer regions (2.8% growth since 2001, compared with 7.1% in Lisbon or 30% in Algarve – Table 1), thus deepening divergence in wellbeing. This scenario of depression and desertification is a nightmare for any country in the EU and some peripheral countries seem to be heading in that direction.

Table 1.X – Regional disparity in Portugal (source: OECD)

2001-2018 (%)	**2018**	**GDP per capita growth**	**GDP per capita growth**	**Population growth**
	(USD per head, constant PPP)	**(Population in 2018)**	**(Population in 2001)**	
Portugal	**32,326**	**10%**	**9%**	**-1%**
Norte	**27,478**	**15%**	**12%**	**-3%**
Algarve	**35,900**	**17%**	**30%**	**11%**
Centro	**28,037**	**12%**	**6%**	**-5%**
Lisboa Area	**42,100**	**1%**	**7%**	**7%**
Alentejo	**30,141**	**13%**	**3%**	**-9%**
Azores	**28,555**	**16%**	**17%**	**1%**
Madeira	**31,374**	**22%**	**27%**	**3%**

How to address these disparities in economic development is a key question to the future of the EU because they are a source of division between member states. There are two possible ways to address them, being the most reasonable solution a mix of the two. But it exposes a trade-off between efficiency and equity-oriented policies.

The first is the *idle* one: richer countries should put more money and increase the cohesion funds. It is the equity-oriented solidarity pillar that is usually compared with the size of fiscal transfers available in the USA to help depressed states and said to be needed to complete EMU (following Kenen, 1969).

The case of Alentejo shows that cohesion policies are surely needed but the *idle* approach has several risks. First, it depends on the generosity of other countries and their populations. Second, it assumes that these extra solidarity funds would be applied in a rational and productive way. The deficient application of EU funds in Portugal over the last 33 years is a warning about it. And third, the factor mobility presented by Mundell (1961) and existing in the USA, may lead to a permanent desertification of some areas, even with generous transfers. The higher the mobility the easier for workers and capital to *vote with their feet*, thus deepening and accelerating a permanent shock and a trend for depression in the affected region (Krugman, 1993).

In the EU case, and given the lower labour cross-border mobility due to cultural reasons, the risk of desertification is lower than on the USA but, nevertheless, is real because obstacles to mobility are less significant inside a country, as the case of Alentejo shows. The alternative to mobility in this setting is to live on a growing dependence of subsidies from richer countries or regions. This is the *idle* perspective.

The second solution is an efficiency-oriented *engaged* one. It requires a different type of organization at the EU level where policy integration should only exist when there are significant - i.e. real and not only theoretical and vague – spillover effects among countries (*common collective interests* in the words of Amaral, 2002). There are three areas where the nature of these interests is more evident: free trade, requiring no internal barriers and a common external tariff to facilitate operations within the single market; environmental policies, where the EU is already doing something by using money as a carrot; and defence, where there is the NATO alliance.

The remaining economic and social areas do not comply with this criterion and thus should be solely developed on the basis of cooperation between countries, without any economic or social policy coordination. Nevertheless, cohesion policies which are at the core of the *idle* approach should not be discarded given the need to ensure that equity concerns are addressed in the EU. Then, a mix of the two solutions should apply.

4. Economic disparities and democratic legitimacy

The EU has evolved since its inception based on two core ideas: the promotion of democracy in its member states, a necessary condition for peace to be kept, and economic development through a market economy. Its main goals are to foster development and to ensure economic growth and stability for all member states.

In spite of those two core ideas, some countries see the EU as a way to enlarge markets and to provide economic growth based on higher efficiency in the allocation of resources. Others see it as the only way to develop by demanding for more cohesion, that is, more money from the richest group. There are those that defend the union based on an illusory idea that a region that used to be the *centre of the world* and is now slowly leaving it and losing economic weight, can maintain that *status* through bureaucratic ways and others that, nostalgic of the European empires, see the EU as a new empire despite its growing geopolitical irrelevance. Countries became members with different preferences and aims and, thus, the expected outcome of a process based on preferences that differ is a multifaceted EU.

However, and despite these different views, the trend in EU since 1992 was to harmonize the most and to discard the preferences of populations in member states. This is true for all EU countries and not only for those that participate in EMU. The achievement of those two core ideas is much more important than that of a monetary union. However, the single currency was not an economic but a political project since its beginning. The economic advantages of EMU were overvalued in order to justify it but its main aim was not to promote democracy or economic and social development. It was a further step to build an *European* identity in order to create the conditions for a political union.

This was done even knowing that a political union is not a shared objective in the EU and its pursuance is dividing member states, and led to the exit of one of them, the United Kingdom. The democratic deficit of the EU institutions is an old problem still waiting to be addressed in a serious way. Dahrendorf (2002) was clear about it when he charged the EU institutions of betraying its very own democratic principles[8]. Since this statement there were some institutional changes such as the reinforcement of the role of the European Parliament. But as Dahrendorf also stated, an institutional reform preserving the *status quo* would not solve the systemic problem of the EU. The paradox between democratic legitimacy at a national level and policy decisions at an EU level is still a barrier for further political integration.

In the case of EMU, there were no democratic legitimacy concerns in the decision for Portugal and other countries to participate. This is clearer in Portugal, where there was no strong economic rationale for the participation in EMU, as the last twenty years have shown.

Furthermore, economic disparities in Portugal, Italy or Greece led to the idea that some countries are not benefiting from EMU. This division caused by EMU is in itself becoming a risk to the future of the two core ideas of the EU.

Therefore, in the same way as the governance changes made after 2010 aimed to stabilize EMU, the discussion on the future of Europe that is now under way should also aim to mitigate the division between member states. In other words, EU countries should concentrate on what is more important, a *back to the basics* to those two core ideas. This requires democratic legitimacy to play a central role in the future so that the sustainability of the EU project is not destroyed.

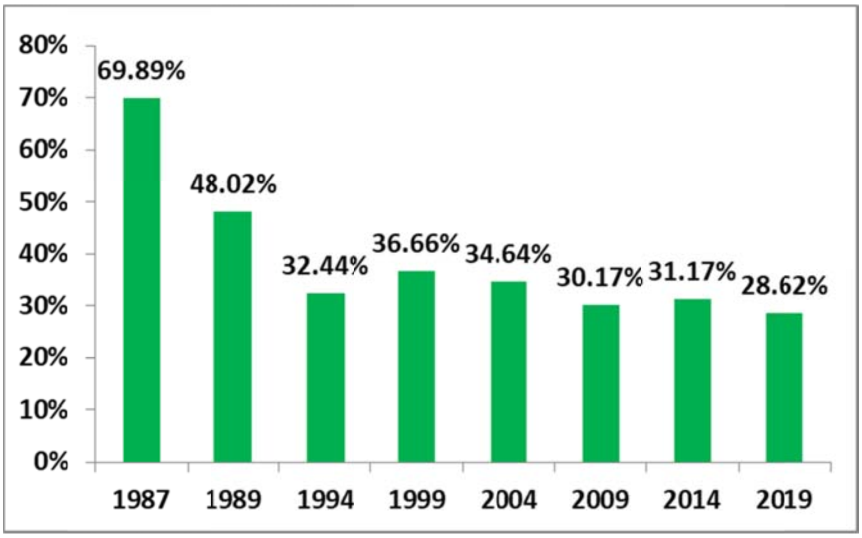
If democracy must be at the centre of the EU, does it make sense to have economic and social policy guidance and coordination by the European Commission through the ES? This question is valid both for Eurozone and non-Euro countries. The answer must be *no* because (i) the ES does not work, (ii) there is no economic rationale for it and (iii) economic and social policy decisions should be accountable to the national parliaments and cannot and should not be based on an institution that lacks democratic legitimacy.

It was shown that the ES is not effective in dealing with the coordination of economic and social policies and that this solution is in reality not needed for a stable and operative single currency. Moreover, the democratic requirement precludes the ES reinforcement to become the expected guidance tool and driver of policy coordination because the EC is unelected and the ES governance is undemocratic.

The central role of democratic legitimacy would be strengthened by the level of participation on European elections. But in Portugal, in a trend similar to what is happening in other countries, this level has been continuously decreasing, showing that something is wrong with the popular basis of the EU project (Figure 4).

[8] He stated that the EU itself would fail any application for membership if it wished to join the Union and considered the EU institutions that negotiate behind closed doors as ‘an insult for democracy’ (Dahrendorf, 2002).

Figure 4.X – European elections in Portugal: voters in political parties (% of electors – National Electoral Commission)



Given the ineffectiveness and the limited democratic legitimacy of the ES governance system, one would expect for the current conference on the future of the EU to present an alternative solution. The *White paper on the Future of Europe* (European Commission, 2017) presents five scenarios, from a realistic *carry-on* and a free choice *do it as you want* to an optimistic *all together*.

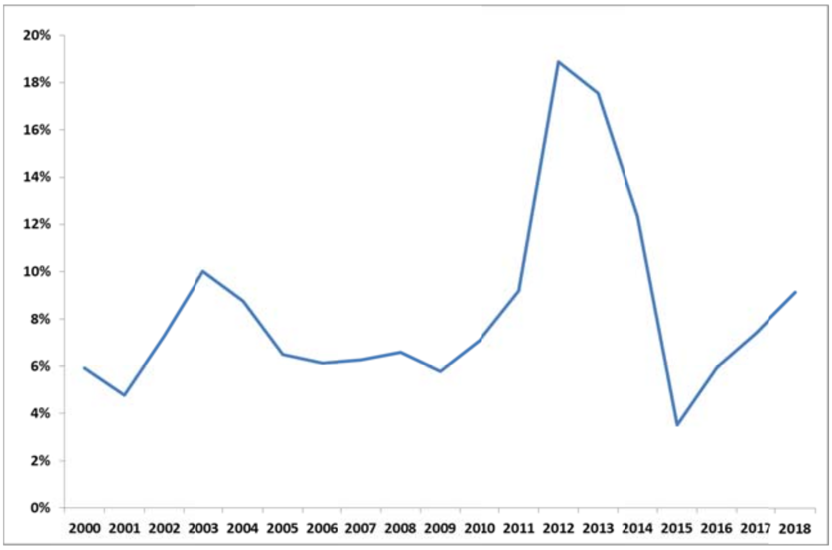
Then, which way to go? A purely *idle* solution for economic disparities, where rich countries are supposed to make permanent and growing fiscal transfers to prevent poorer states from being left behind, do not seem to have sufficient legitimacy and it is always dependent on the electorate of those rich countries.

Recent economic history shows that an increase in *solidarity funds*, as it is now advocated to complete EMU, is not necessarily a solution. Portugal has had access to a growing and significant amount of funds without preventing a bankruptcy and the occurrence of economic divergence in the last twenty years (Figure 5). The cohesion policy and structural funds, enacted to prevent the divergence between member states inside the EU, were significant in size but not effective in solving economic disparities.

This may be related with one of the levers available to the EC too coordinate economic policies. The bilateral negotiations on where to apply the structural funds try to align the priorities of all countries in an attempt to coordinate social and economic policies. But this may be in reality a barrier for less advanced countries to converge because they are oriented and tend to imitate what more developed economies, with more and better resources, do, instead of promoting complimentary patterns of specialization based on their own means and capabilities. It is true that through this specialization countries would become more prone to asymmetric shocks. But the root of the problem is not specialization as a way of development, which does not prevent convergence, but the participation on a monetary union when a country is economically not ready for it, as it happened with Portugal or Greece.

As a result, and although the cohesion policy is an essential part of EU, its reinforcement could end up in an unhealthy situation of permanent dependency, as it can be observed now in the case of Alentejo.

Figure 5.X – EU funds received by Portugal in % of total Gross Fixed Capital Formation (sources: INE and Eurostat). EU funds correspond to the operating balance between incoming funds and Portuguese contributions.



Even considering this *idle* solution together with the functioning of the single market, as it is today, it would be difficult to believe that a different outcome would arise. The governance of the single market has its problems too. It was built on the assumption that more harmonization would lead to an optimal outcome because a full level playing field was needed in order to allow for free and *fair* competition between firms. This assumption led to an excessive harmonization of laws, rules and standards, fully ignoring local realities and achieved in total disregard to the principles of democratic legitimacy and subsidiarity because there was never a real and independent effort to proof that a full level playing field was necessary[9].

Harmonization was achieved while ignoring very small firms, which are more than 90% of the total in the EU, that act locally and do not compete with corporations in other countries. That is, all the legal harmonization that was forced since 1992 applied to less than 10% of the firms.

Furthermore, investment and trade grow not because there is a full level playing field, as it is usually assumed, but due to the differences existing between countries and firms. The single market relies on these differences, not on similarities and harmonization, as long as they are not used to protect domestic suppliers[10]. This is more important because most of the trade is based on comparative advantages and regional value chains have created interdependence but have also augmented inter-industry exchanges.

[9] Structural funds are, themselves, a discriminatory distortion to the level playing field rule. But money and the associated conditionality are the only carrot that makes economic policy *go round* in the EU. Both are under the control of the EC and are the only real, although limited, lever at the EU level to force countries to partially coordinate social and economic policies (currently, sustainable and digital policies are the main examples).

[10] The simplification of the rules would benefit trade and investment much more than full harmonization.

And these differences are also important because they represent the preferences of the population in each country highlighted through the democratic system.

An example of undesirable harmonization that is usually considered in an erroneous way is corporate taxation. Simple tax competition models say that it is more efficient to have the same corporate tax rate in all countries in order to avoid a *run to the bottom* and a sub-optimal provision of public goods. This was a *hot* issue in the EC for many years, based on the need for a full level playing field. But this is an oversimplification of reality in a model. The reality is rather different. Cities and countries with higher agglomeration economies can levy higher tax rates without seeing capital flow to other locations and without losing tax receipts, meaning that from an efficiency perspective the optimal is to have different tax rates and preferably those that answer to the preferences of the voters (Pinheiro Alves, 2010).

Therefore, excessive policy harmonization has been more of a problem than of a solution to the divergence in economic development that is presently occurring in the EU. The costs of harmonization are there. An excessive legal harmonization led to the constraining of policy tools for countries to deal with economic development[11]. And a single monetary policy was inadequate due to the different needs of core and peripheral countries that were more strongly affected by the liberalization of trade and capital flows. The problem is both economic and political. The monetary policy axis of EMU is concentrated on the ECB, but the fact that the ECB president goes often to the European Parliament is not a sign of democratic legitimacy, is only a sign of very limited accountability.

To sum up, there are three features of EC governance - the ineffectiveness of the ES and of cohesion policy, and an unnecessary harmonization of laws – that together with different rhythms of growth from unequal entrepreneurial and work abilities among countries are preventing economic and social convergence. A further feature is the democratic deficit in the EU. All together, they are endangering the two core ideas that led to the creation of the EU.

This asks for a change in how policy decisions are made at the EU level, even considering that the single market and a targeted cohesion policy are essential to economic and social development and to reinstate convergence. The single market is the great achievement in pursuing the two core ideas of EU because it promotes economic development (it would be even better without the excessive harmonization of laws) and as a decentralized institution compatible with the democratic requirement. Therefore, an *engaged* solution, where economic and social problems are dealt with under the aegis of the single market, is a feasible one as long as its governance is changed.

This *engaged* solution acknowledges that free trade requires some multilateral coordination and that a duly evaluation of costs and benefits of policy harmonization should be done by independent entities (e.g. OECD). Moreover, previously agreed and deepened WTO-type rules could be useful to protect trade, investment and competition in the single market, and to replace the current level of excessive EU rules

[11] An example is Banco de Fomento, which is still not operating 8 years after its inception in Portugal mainly due to limiting requirements from the European Commission. Nevertheless, it should be also stated that countries still possess fiscal instruments such as tax credits to foster economic growth.

and standards. In this case, a multilateral competition authority could intervene *ex-post* in case of protectionist practices, thus replacing the current need of a prior notification to the EC under competition rules of the single market.

For those areas that are based on cooperation and are not under a multilateral authority –digitalization, innovation, R&D, training and so on - a complimentary criterion based on a Pareto improvement should be considered, that is, policy decisions at an EU level can only be approved if all countries are benefited by it, meaning that all countries can veto them (Amaral, 2002). This is compatible with the possibility of a country to choose to participate in a policy without having to negotiate it on a case-by-case basis, as it happened with the single currency where Denmark and the UK opted-out, or the Schengen agreement where Ireland has an opt-out clause. That is, it is compatible with all countries having opt-in or opt-out clauses by default.

There are two advantages from this *engaged* process. First, the decisions have to be negotiated between countries given the risk of a veto. It can be said that this procedure will make policy decisions much more difficult, but it will also make decisions against the interests of each country also less likely. Second, decisions will have to be made within the formal democratic process in each country, with direct participation of national parliaments, and thus would be more responsive to the wishes of voters. The possibility of opting-in or opting-out would also help to mitigate the divisions between countries by allocating the responsibility to the democratically elected governments, thus preventing the *blame game* with EU institutions.

This would be a more transparent way than a purely *idle* solution based on permanent fiscal transfers, where a *close coordination* of social and economic areas would mean that elected governments could not make their choices in accordance with the proposals voted by electors. Many authors have confirmed this concern about the European Semester, but mainly at the fiscal policy level. Crum (2018) exposes a loss in parliamentary powers of scrutiny and control due to the reinforcement of the system of surveillance after the crises. Papadopoulos and Piattoni (2019) confirm the low credibility and effectiveness of the ES to be associated with a democratic deficit resulting from executive dominance, the relative marginalization of parliaments and the public, limiting learning to government and bureaucrats.

The evaluation of the ES shows that this lack of democratic legitimacy has been circumvented by enlarging the focus on social issues, where the EU can reinforce its visibility due to the direct relevance for populations (Verdun and Zeitlin, 2018). This was in accordance with the Europe 2020 Strategy, which was explicitly designed to have a stronger social dimension than the preceding Lisbon Strategy, and included specific guidelines and targets on poverty and social inclusion. Social partners (employers, unions) also saw the ES as a way to become more directly involved in the design of EU policies and to achieve their objectives without being too dependent on national governments. But none of these have democratic legitimacy.

In practical terms, the reinforcement of the ES to achieve greater social and economic policy coordination through sanctions for non-compliance with the CSR, the strengthening of conditionality in accessing structural funds or even the *idle* option of increasing cohesion funds via fiscal transfers would be a threat to the democratic system that is at the core of the EU idea.

5. The way ahead

The coordination of social and economic policies has been presented as a necessary requirement for a complete EMU. However, there is no evidence that this is really necessary and there is no economic basis for it. Nevertheless, after the crises of 2008-2010, a multilateral mechanism and a set of new legal instruments were implemented to reinforce the governance of EMU even when a clear understanding about the meaning of a *close coordination of economic policies* was absent.

Furthermore, the European Semester, the framework for policy coordination, has shown not to be a proper instrument and it did not comply with the requirements that economic and social policy decisions should be accountable to national parliaments and cannot and should not be based on a non-democratic body.

Strangely enough, given these important flaws, the European Semester is being considered as the monitoring framework for the coordination of the new EU recovery fund currently under discussion to be an answer to the economic turmoil brought about Covid-19 and the confining policy measures.

Moreover, the focus on fiscal policies under EMU has relegated economic and social policies associated with the single market to a secondary status. Although EMU was presented as a deepening of the economic effects of the single market, the spatial distribution of economic activity within the Euro area has been neglected as a policy concern.

But countries such as Italy, Portugal or Greece have been diverging from the centre of the EU since the inception of the Euro despite the significant cohesion and structural funds allocated, thus creating a division between member states and questioning its governance model. This division was also exacerbated by the enforcement of a political vision of EMU without popular legitimacy that facilitated the exit of the UK.

This ineffectiveness of the ES and of the cohesion policy and the unnecessary harmonization of laws constraining policy instruments at a national level require a change in how the EC participates in policy decisions. Furthermore, these inefficiencies together with different rhythms of growth from unequal entrepreneurial and work abilities among countries and a democratic deficit in the EU institutional framework are endangering the two core ideas and greatest achievements of the EU: the spreading of democracy, as a necessary condition for peace, and development within a market economy.

The way ahead is to find a solution build on those two core ideas of the EU and based on efficiency and equity concerns. Contrary to EMU, it should focus on households and firms and not on the state, and should concern economic development and sustainable employment and not budget deficits and public debt. This solution can be found between two poles: an *idle* one purely based on fiscal transfers and an *engaged* one where policy coordination is based on real and significant spillover effects between countries (e.g. environmental policies) and cooperation based on *Pareto improvements* is the rule.

The intermediate solution is an *engaged* one based on a reinvigorated focus on the single market, where its governance is relaxed and the aim for a full legal harmonization is abandoned. This means to scrap-up the full level playing field utopia and that the current EU centralized project for an industrial strategy is undesirable. It keeps cohesion and coordination with neighbouring countries for issues related with e.g. security concerns or the environment to answer for common threats. In the remaining areas the role of EC should recede given the low effectiveness of coordination and the reduced national ownership of policy-making at an EU level.

An *engaged* single market, with a reinforced WTO-type of coordination and equity-targeted cohesion policies, is a decentralized process where firms and households have freedom of choice and economic and social policy decisions are more transparent and can be negotiated between countries, allowing for a veto and opt-in or opt-out clauses by default. It is also a solution where the wishes of electors are better respected through the participation and accountability before national parliaments, the pillars of democracy, and where countries are free to choose their way to development.

This is a solution that discards the European semester, reinforcing the ideas of democracy and economic development and an EU that operates with clearer rules and on a more solid basis. It does not aim to achieve a political union or to feed the ego of elected politicians wanting to be part of history, but it is worried about the well-being of people, the current divisions between countries and it aims to prevent other members from leaving after the UK. It does not ensure economic convergence, because that is not possible in a world of freedom and liberty where it always depends on economic agents and on adequate incentives from good economic policies, but it also does not prevent it as the single market rules presently do.

It is simply a contribution to the future of the EU based on the idea that the essence of self-government, democracy and freedom are much more important than the promise of an ever-closer union in Europe.

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