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Economic Guidelines for a Better Union

**Facilitating Policies that enhance
not constrain economic policy**

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Foreword

This report on EU and national guidelines for fiscal balances, commissioned by the Rosa Luxemburg Stiftung Brussels Office, is written at a time when the EU and member state national governments appear determined to make the present highly constrictive fiscal rules, which have heavily contributed to an overall poor economic performance, even tighter. Despite the fact that the global financial crisis was a crisis brought on by excessive private debt, the EU and its most powerful member states insisted that the answer was to bear down ever more strongly on public debt, imposing rigid austerity and – even worse for the long run – imposing new, ever-more restrictive legal and constitutional limits on governments’ deficits and their public debt.

Thus in the midst of the private debt crisis, and urged on by the German government and its friends in European People’s Party – but also supported by social democrats – and for no good economic reason at all, in 2012 all EU member states bar the Czech Republic and (for its own reasons) the UK signed up to the “Treaty of Stability, Coordination and Governance in the Economic and Monetary Union” with its neoliberal dogma of requiring (by law) that budgets always be in virtual balance or in surplus. And worse, governments signed up to an obligation to impose this perverse rule into their own *national* legislation or constitution. This is a fine example of what the historian Quinn Slobodian, in his recent (2018) study on the neoliberal “Globalists” calls the “encasement” of the economy through binding legal norms:

“The normative neoliberal word is not a borderless market without states but a doubled world kept safe from mass demands for social justice and redistributive equality by the guardians of the economic constitution.”

The EU’s institutions are now in the process of re-integrating the key ‘balanced budget’ provisions of the 2012 Treaty into the EU’s own legal regime, which if successful will represent yet another ratcheting-up of the legally binding fiscal rules, requiring for the future still more austerity when the next serious downturn or recession occurs. Curiously, the Commission’s proposals here are the subject of criticism not just from progressives, but also (for opposite reasons) from the right in the form of the European Central Bank, whose recent opinion argues that the Commission has not gone far enough in imposing the 2012 Treaty’s legal straitjacket!

Against this austere backdrop, our own proposals may appear utopian, since they argue almost the precise opposite to the standard prescriptions. For us, the key word is “guidelines”, which by definition means that a lot of discretion is given to member states, as against rigid “rules” embedded in law.

We accept the need for member states to cooperate and be mindful of the potential consequences of their fiscal policy for others, but the reality is that there is much more room than official economic dogma allows for national discretion, and a strong common interest in allowing states (with their own strong identities and traditions) to look after their citizens through democratically using the levers of fiscal policy. For this to happen, however, (a) there need to be broad guidelines setting out a shared and rational fiscal policy framework, and (b) Europe needs a fully empowered central bank that can and will respond to protect governments and their peoples from aggressive bond market speculation.

The ‘balanced budget’ requirement, we can predict with full confidence, will break down as soon as the next serious recession hits Europe as a whole, or major areas of the continent.

Since 2008, nothing fundamental has changed in the international financial system, which remains vulnerable – not least since private debt as a share of global GDP continues to rise.

We therefore offer our fiscal policy guidelines as a basis for reflecting now on what will prove helpful, or even necessary, when the present ideologically-driven present break down under their own contradictions.

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Executive Summary

A previous report by the same authors identified problematical aspects of the economic rules written into the major EU treaties. Because of these problems the existing economic rules do not protect the EU economies or the Union as a whole against systemic instability. They undermine stability and have a bias towards low growth and stagnant employment.

Stability-enhancing and growth-fostering policies would include a new approach to fiscal balances, based on guidelines not inflexible rules.

The first principle of the national fiscal balance guideline is that its design should not derive from the impact on either the EU as a whole or the eurozone.

The second principle of the fiscal balance guideline is that it should facilitate the stabilizing function of the fiscal balance. To achieve this, the fiscal guideline should not specify numerical targets.

The third principle of fiscal balances is that capital expenditure creates assets and should or may normally be funded by borrowing.

The following principles should guide the design of constraints on national fiscal balances.

- 1. To prevent speculation and ensure stability of deficit financing, the ECB would pledge to purchase national public bonds at a pre-announced interest rate in the range of two to two-and-one-half percent (explained in text).**
- 2. National fiscal balances would be assessed by whether they are sustainable. The appropriate measure would be the balance without interest payments, i.e. the primary balance.**
- 3. Public investment, like private investment, should as accepted standard practice be substantially financed by borrowing. This implies that the appropriate fiscal balance to target is current expenditure minus interest payments (the current primary balance).**
- 4. The sustainability guideline would be that over the average maturity of the public debt, the average current primary fiscal balance in GDP for that time period should not exceed the nominal rate of economic growth.**
- 5. Increasing the rate of economic growth is the most effective way to reduce the deficit-GDP ratio, and policy should work to this end, subject to sustainability.**
- 6. Deficit reduction policy would be consistent with GDP growth by (i) policies that increase the income elasticity of tax revenue, and (ii) phasing adjustment over several years.**

We can state the reformed guidelines succinctly:

National governments would maintain the ‘primary current budget deficit to GDP ratio’ equal to or less than the rate of GDP growth. When this deficit ratio is

greater than the growth rate, policies of adjustment should not reduce the rate of GDP growth. To facilitate adjustment, the ECB would prevent speculation on public bonds.

The excessive deficit and convergence criteria definition for public debt uses the gross government debt, which covers all levels of government (See Protocol No.12 to TFEU, on the Excessive Deficit Procedure). This definition has two major problems that render it inappropriate. First, it includes public liabilities but excludes liquid assets held by governments. Including assets with liabilities measures the net public debt, used by most governments in the world. Second, the gross measure includes public bonds held by government institutions. For some EU countries the difference between gross and net debt is quite substantial.

The appropriate measure for public debt management is the net debt excluding bonds held by government institutions.

Businesses and households assess their debt capacity by the cost of servicing debt, which is interest payments plus repayment of maturing debt. The same principle should apply to the public debts of EU national governments. The general guideline for public debt management can be stated simply:

The net debt of EU governments should be sustainable. The net government public debt is sustainable if its fiscal cost over an appropriate debt management period is stable as a proportion of GDP that is less than the share of public investment in GDP.

This guideline therefore has four elements: 1) the appropriate debt measure, 2) the appropriate debt management period, 3) fiscal cost, and 4) the share of public investment as the upper limit to fiscal cost.

The present deficit rule suffers from the fundamental mistake of treating fiscal deficits as problems. The fiscal balance of governments is an automatic stabilizer that reduces the volatility of the national economy. The reformed approach would provide guidelines that allow the fiscal balance to fulfil its stabilizing role. To fulfil its stabilizing role the fiscal balance varies to compensate for fluctuations in private sector demand.

The fiscal management procedure would be as follows:

- 1. The distinction between the overall and primary balances allows for the automatic stabilizing function of fiscal policy.**
- 2. The sale of public bonds funds public investment. National government can sell the bonds to private buyers or to public institutions (including central banks).**
- 3. Public investment spending is relatively inflexible in the short term, and essential for the long term. Current expenditure is normally the appropriate instrument to reduce the cyclical instability that characterizes capitalist economies.**
- 4. The fiscal guideline implies that national governments can vary current spending for counter-cyclical intervention by an amount equal to interest payments above and below the current primary balance.**

The European Central Bank is a public sector institution and under the proposed new framework it would facilitate the welfare of the peoples of the European Union. In order to facilitate an effective framework for public fiscal balances and public debt, we propose the following formalized policy change:

The ECB shall maintain a maximum interest rate on national public bonds.

It will maintain a maximum rate by serving as the reserve buyer of national public bonds. The ECB would announce the maximum interest rate on public bonds, chosen to lie in the 2.0-2.5% range. In the event of financial market offers to purchase bonds at a higher rate, the issuing government sells its new bonds to the ECB at the fixed rate.

Statement of Purpose

International solidarity and opposition to chauvinistic nationalism have been central principles of progressive politics for 150 years. On the basis of these principles progressives support a united Europe. This support is conditional on the practical form that unity takes. The practical form that facilitates the goals of united Europe includes cooperation across countries to foster peaceful relations; decline in the politics of nationalism; and prosperity for working people.

In the second decade of the 21st century the European Union has not achieved these goals. In place of cooperation the EU treaties explicitly institutionalize economic competition which fosters political tension. The politics of nationalism have grown stronger, assuming sinister far-right forms including fascism. In place of general prosperity, inequality has grown and in most member countries the share of national income accruing to the working class has fallen. (For example, in Germany the bottom 50%’s share of income has fallen dramatically from around 33% in 1965 (West Germany) to around 23% in 1990, and falling almost each year since a peak in 1995, down to 17% in 2013, according to the [World Inequality Database](#). In France, the position has rather stagnated in recent decades; the bottom 50% ‘share’ was around 23% in 1980, falling back slightly to 22% in 2013).

These failures result in great part from the economic framework embodied in the two major treaties that form the *de facto* constitution of the Union, the Treaty on European Union and the Treaty on the Functioning of the European Union (EU 2007a & 2007b). Central to this economic framework is a set of dysfunctional economic rules and regulations that come from an ideology preaching that capitalist economies are inherently stable and governments are the fundamental cause of instability (Smith & Weeks 2017, Introduction).

In our previous study we demonstrated the dysfunctional nature of the rules and regulations, especially the excessive deficit procedure and the mandate of the European Central Bank. We proposed specific changes in the wording of the two major treaties that would eliminate those ideologically based flaws. We specifically recommended that certain rules and regulations now embodied so inflexibly in the treaties - to the extent they are necessary - would become the responsibility of the European and national parliaments through legislation, rather than being set in ‘constitutional concrete’ in the Treaties, which are so brutally hard to amend.

As in almost every country of the world, the guidelines for EU economic governance should take the flexible form of legislation, not constitutional imperatives. The great advantages of a legislative framework rather than constitutional constraints are flexibility and democracy. Legislation allows the flexibility to alter the economic framework when conjunctural circumstances demand this. Legislation provides the vehicle for an electorate through its representatives to implement democratically changes in political consensus and political priorities.

Anxieties about trusting the democratic process may be one motivation for the placement of hard economic rules into treaties. Some of the EU policy makers, especially in the largest countries, believe that inflexible rules are necessary to prevent both the European and national parliaments from acting irresponsibly in response to pressures from their electorates. This is a profoundly anti-democratic and implicitly authoritarian approach to governance, as well as contradicting the basic values of the European Union as stated in the [Charter of Fundamental Rights](#) of the European Union:

Conscious of its spiritual and moral heritage, the Union is founded on the indivisible, universal values of human dignity, freedom, equality and solidarity; it is based on the principles of democracy and the rule of law. It places the individual at the heart of its activities, by establishing the citizenship of the Union and by creating an area of freedom, security and justice.

By any reasonable interpretation, the statement pledges that those decisions affecting the livelihoods and rights of the individual shall be made through the democratic process. The purpose of EU treaties should be to facilitate democracy, not to restrict it. It is in that democratic spirit that we propose new economic guidelines for the European Union.

The Context

As this report is being written the European Union has twenty-eight members. Should the current or a future British government not reverse the decision to withdraw membership, by April 2019 twenty-seven will be left, of which 19 use the euro as national currency. Of the remaining eight countries, the governments of all but one (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Sweden) are committed by treaty to join the euro zone upon meeting the conditions for convergence. The exception country is Denmark, which has a formal “opt-out” from the treaty obligation (as does the British government).

It is possible that the official position of the European Union may at some point in future (and in particular following the departure of the UK) harden on enforcing the requirement for the seven countries to enter the euro zone. In his State of the Union speech on in September 2017, European Commission president Jean-Claude Juncker underlined that all EU countries (save UK and Denmark) are “required and entitled to join the euro once they fulfil all conditions”, and proposed a “Euro-accession Instrument” to offer “technical and even financial assistance” to the current non-euro countries.

However, the current positions of non-euro governments strongly suggest that for the foreseeable future the European Union will continue to have several members that do not – and do not wish to - adopt the euro. While this arrangement may contradict treaty obligation, it is unlikely that the European Commission would take action against any member for not joining, though officials in Brussels may repeatedly issue complaints about delay. This contrast between the treaty requirement and the position of some governments suggests that the treaty imperative could or should be made discretionary.

The simultaneous existence of these two groups, the euro countries and the non-euro countries, has implications for the design of effective economic guidelines. Member governments designed and created the so-called Maastricht criteria as pre-conditions for a common currency, i.e. the convergence and the excessive deficit criteria. The justification for these criteria arose from the reasonable inference that all members of a currency union should, as well as bringing their economies into reasonable alignment in order to join in the first place, behave in a manner that does not destabilize that union, once they have joined.

The primary flaw of the convergence and excessive deficit criteria, and the subsequent Treaty on Stability, Cooperation and Governance, in relation to fiscal policy is that in pursuit of a reasonable goal they impose unreasonable means. Their secondary flaw is that to use the same set of rules for euro members and non-euro members is inappropriate. A rational reformulation of EU economic guidelines would specify clearly those guidelines that should apply to all members and those binding on euro zone members.¹

¹ This differentiation is currently made only to a very limited extent. Thus, for example, Article 139.2 provides that the “coercive means of remedying excessive deficits” under Article 126.9 shall not apply to “Member States with a derogation”, i.e. states that have not adopted the euro. But the actual rules on deficits and debt are the same for euro and non-euro states.

The Story so Far – the EU’s Ever-Tightening Fiscal Rules

When the European Economic Community was formed by the Treaty of Rome in 1957, there were no fiscal rules laid down for member states to adhere to. Article 6 simply required members “in close co-operation with the institutions of the Community, [to] co-ordinate their respective economic policies to the extent necessary to attain the objectives of this Treaty.”

By Article 104, “Each Member State shall pursue the economic policy needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while taking care to ensure a high level of employment and a stable level of prices.” And to help meet those objectives, “Member States shall co-ordinate their economic policies.” (Art. 105).

All changed with the Maastricht Treaty of 1992. The drafters, many of whom were inspired by Hayek’s extreme neoliberalism, aimed to reduce the economic role and discretion of governments, and the new single currency was crafted with this objective at its heart. For the first time, constitutionally imposed fiscal rules (via the EU Treaties) were imposed on member states. The same rules were used for two purposes: (a) for a new “excessive deficit procedure”, and (b) as part of the convergence criteria for states joining the new common currency.

What is now Article 126 TFEU provides that “Member States shall avoid excessive government deficits”, and requires the Commission to check on compliance with “budgetary discipline” i.e. whether the government budget deficit to GDP ratio, and its debt to GDP ratio, exceed the “reference values” of 3% and 60% respectively, as set out in Protocol 12.

There follows a long and detailed Article 126 “procedure”, which for euro zone member states, can lead ultimately to severe penalties being imposed.

The same fiscal rule is applied as part of the convergence criteria, with the “excessive deficit” test being the sole one applied to the question of “the sustainability of the government financial position”.

In 1997, new Regulations laid down the reporting and supervision processes under the rubric of the “Stability and Growth Pact”, and in particular for countries aiming to join the euro. These included (Regulation (EC) No 1466/97) which required member states to submit a “stability programme” with

“the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio”

Therefore, while the excessive deficit rules set out the intended outer limits for deficits and public debt, member states were supposed to have a continuing *medium-term objective* of an overall budgetary position (including investment expenditure) of *close to balance or surplus*. When the 2007/8 global financial crisis struck, some of the worst affected states did not have a high level of public (general government) debt. Spain, for example, had in 2008 a ratio of around 40%, while Germany’s was then 67%. The key issue was the amount and structure of private debt, which the Treaty rules scarcely deal with. The bizarre (but highly ideological) EU institutional response to the crisis, however, was to focus ever more closely on the rules and procedure in relation to public debt. To this end, two sets of EU legislation were adopted

– the “Six Pack” of 2011, followed by the “Two Pack” of 2013, almost as if sheer quantity of detailed intrusive legislation was the main panacea.

But more far-reaching by far was the political initiative to create a Treaty-driven obligation on Member States to move towards a legal obligation of permanent (near) balanced budgets, a move driven in particular by the German government which had already adopted the so-called “debt-brake” amendment into the country’s Basic Law. Because the UK and Czech Republic would not accept this as an EU Treaty, the (so-called) Treaty on Stability, Coordination and Governance in the Economic and Monetary Union was signed in 2012, and came into effect in January 2013 as an inter-governmental Treaty yet using and involving the EU institutions. While open to all EU member states to sign it, the key provisions only affect members whose currency is the euro, except to the extent that other signatory states voluntarily agree to be bound.

In December 2017, the European Commission announced its intention to “incorporate” or “integrate” the Treaty on Stability, Coordination and Governance – at least its “core” elements - into European Union law, and published a draft Directive for the purpose ([COM\(2017\) 824 final](#)). This draft Directive is said by the Commission to implement the main substantive provisions of the Treaty, to be found in Article 3; these would apply compulsorily to all euro zone members, and to other member states if they choose to be so bound.

However, in the course of consultation to date, the Commission has recently (May 2018) received some contradictory feedback. On the one hand, the European Central Bank [in its Opinion argued](#) that the draft Directive was too loose, and weaker than the actual provisions of Article 3 of the Treaty:

“The provisions of the proposed directive deviate substantially from those of the fiscal compact, which may lead to a weakening of the rules of the fiscal compact and increase uncertainty as a result of the coexistence of multiple fiscal frameworks. In particular, the fiscal compact rules are weakened due to the fact that the proposed directive does not contain any reference to **the Member States' obligation under the fiscal compact to have their budgetary position in balance or in surplus, or to keep the structural deficit to an upper limit of 0,5 % of gross domestic product**, which can become 1,0 % of gross domestic product in cases where the debt level is significantly below 60 % of gross domestic product and where there are low risks to sustainability... The ECB considers that these obligations need to be clearly reflected in the proposed directive.” [Our emphasis].

The ECB therefore supported the concept of the Directive, but wants to “toughen” its provisions in line with the Treaty, and contrary to the Commission’s wish to maintain a little more discretion.

On the other hand, the Economic and Social Committee (EESC), representing both sides of industry and civil society, considered that more fiscal space is required for public investment:

“While acknowledging the flexible interpretation given to the Stability and Growth Pact (SGP), the EESC considers that it is not enough and recommends that discussions should be opened at EU level on excluding value-adding strategic public investment from the scope of application of the SGP. This should be seen not as a cost, but rather as a source of future revenue, making for a smooth business cycle and ensuring both the creation of quality jobs and the reduction of inequalities, in line with calls made in

previous EESC opinions and with the United Nations Sustainable Development Goals (SDGs).

Public investment — including social investment — would indeed deliver stronger demand in the short term but also expand growth potential in the long term, thus also addressing the question of public debt sustainability.”

We may be pessimistically confident, however, that the austere voice of the ECB is more likely to win through than the more sensible advice of the EESC.

So for the time being, we need to wait and see if the provisions of Article 3 of the 2012 Treaty are to be “integrated”, or not.² The Treaty’s provisions therefore remain binding as mutual international obligations upon signatory states, rather than as EU law, i.e. for all member states except the Czech Republic and UK. The Treaty provisions are even tighter than the current EU Treaty and legislative rules, and moreover require signatories to embed the Treaty fiscal rules in their own national legislation.

The provisions of Article 3 are therefore highly significant, now and for the future. They in particular provide:

“The Contracting Parties shall apply the following rules, in addition and without prejudice to the obligations derived from European Union law:

(a) The budgetary position of the general government shall be balanced or in surplus.

(b) The rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective as defined in the revised Stability and Growth Pact with a lower limit of a structural deficit of 0.5 % of the gross domestic product at market prices. The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time frame for such convergence will be proposed by the Commission taking into consideration country-specific sustainability risks.”

To conclude this brief account of the EU’s fiscal rules, we may note that they demonstrate an ever-tightening framework. In contrast to the simple (pre-EMU) duty to coordinate economic policies, since 1993 the (now TFEU) Treaty-defined limits on deficits and debt have been legally in force, supplemented soon after in law (but not Treaty) by an obligation to seek, as a Medium Term objective, a budget in near balance or surplus. In 2012, for euro-using countries, the new Stability etc. Treaty turned this Medium term objective into a permanent ongoing obligation – and one to be set in concrete not only in international law, but also in national legislation.

And all based on a specific – but highly contested - economic ideology in which budget deficits and public debt are seen as the sole issue or problem in relation to government financial sustainability, and for which the sole remedy is ever-tighter rules and limits.

² In the authors’ view, the legal justification and proposed basis for this new draft Council Directive are extremely dubious, since the claimed legal basis, Article 126(14), expressly limits the legislative power to steps needed to “lay down detailed rules and definitions for the application of the provisions of the [Excessive Deficit] Protocol.” In fact, the Protocol is hardly referred to in the draft directive or the Commission’s covering justification, and the actual proposals go well beyond application of the provisions of the Protocol. Moreover, if the Directive were tightened further to reproduce the “balanced budget” provisions of Article 3, it is even more strongly arguable that this goes beyond the application of the – somewhat less restrictive - provisions of the Protocol.

Why Economic Guidelines are Necessary

The European Union is an association of countries mediated by national governments and supra-national institutions. The most important of the latter are the European Council, the European Parliament, the Council of Ministers, the European Commission, the European Central Bank and the European Court of Justice. A major goal of the association is economic integration that 1) prohibits trade restrictions among countries, 2) permits cross-border mobility of people, and 3) allows for unrestricted movement of financial capital among countries. The fourth is the “freedom of establishment and freedom to provide services”. It is the orthodox view that together these provide the basis for a common internal market among members. One journalist characterised them as the “very essence” of the European Union (Münchau 2017).

These four are frequently summarized as the “four freedoms”, a misleading and unfortunate phrase. It is misleading because the four are not freedoms in the usual sense of that word. The right to migrate among member countries for residence and employment assures a relatively unrestricted personal freedom. However, the absence of trade restrictions is not a personal freedom. Products can move among EU countries only on condition that they comply with quality and labelling regulations as well as many others. In the case of capital movement, this is in practice irrelevant to the behaviour of the vast majority of EU citizens. The fourth, freedom to provide services, is not a classical personal freedom, but more akin to a commercial relationship.

The EU use of the term “four freedoms” is inappropriate because the first and most famous use of the term was by US President Franklin D. Roosevelt in January 1941 to characterise the nature of the war raging in Europe and Asia. He referred to “four essential human freedoms”, freedom of speech, freedom to worship, freedom from want, and freedom from fear. Freedom of people to move among countries could qualify alongside these. The absence of tariffs, capital restrictions and (for example) establishment of a private healthcare business or open bidding for government contracts do not qualify alongside these fundamental human rights. A more appropriate and less ideological term for these four economic policies would improve public understanding of them, such as “the four rules of market access and integration”.³

By whatever name, these four aspects of multi-country market integration imply that economic policies applied by a member government may potentially impact on the economies of the other member countries, and do so to a greater extent than on non-member countries. The transmission of policy effects can have both positive and negative consequences across countries. Rules on economic behaviour can be preventative, designed to discourage policies that create or worsen cross-border economic problems. Rules can also be facilitating, encouraging policies that foster positive cross-border benefits.

The economic EU treaties tend to be preventative, specifying what member governments should not do. These preventative policies are non-symmetrical, which is a serious failing. The non-symmetric nature of EU rules highlights the difference between policies and outcomes. A policy is an action taken by a government with the purpose of achieving a specific goal. An outcome is the result of the policy and may differ from the goal.

³ In similar vein, Quinn Slobodian in his “Globalists - the End of Empire and the Birth of Neoliberalism” (2018) argues (p.136) that “the so-called market rights enshrined in the European Economic Community treaty were central to the neoliberal vision of Europe. Against Roosevelt’s Four Freedoms... neoliberals posed the four freedoms of capital, goods, services and labor”.

An example shows this distinction and its importance. An “excessive deficit” rule sets a target for the balance between public expenditure and revenue, the fiscal balance. This target specifies a required outcome that results from a policy, the size of the fiscal balance. Requiring a government to raise the VAT rate specifies a policy. Specifying outcomes allows for greater diversity and flexibility in economic frameworks among member countries than instructing adoption of specific policies. An outcome rule can leave member governments to choose the policies to achieve that outcome. If a government anticipates a potentially unsustainable fiscal deficit, there exist different policies to correct that problem.

The International Monetary Fund sets both outcome rules (also called “target conditionalities”) and instructs adoption or termination of specific policies (“policy conditionalities”). Attempting to enforce both on borrowing governments has resulted in loan agreements with so many requirements that they prove dysfunctional and frequently inconsistent. As a result an IMF Policy paper in 2005 assessed outcome conditions as being preferable to detailed policy rules (Lombardi 2005).

Though outcome conditionalities are more effective than specifying policies, the numerical outcomes specified in the Maastricht Treaty create two major difficulties. First, governments do not control all of the influences that determine the convergence criteria outcomes. In the case of the fiscal balance, policies cannot precisely determine actual expenditure. If unemployment proves larger than anticipated, social protection spending will be larger than specified in the budget. The unexpectedly high unemployment, implying unexpectedly low employment and incomes, will bring less revenue than predicted in the budget. Every finance minister is aware of these uncertainties, that random economic “shocks” can prevent even the most carefully planned fiscal programme from achieving its predicted outcome.

The impact of specific policies and the shocks that disrupt them will vary across countries because causality is not the same in every country. Because the impact of shocks varies, policies that are effective in achieving a specified outcome in one country may prove ineffective in another country. It is also possible that the same policy measure, such as an increase in the VAT rate to reduce a fiscal deficit, may have a different impact in the future than it had in the past.

These complications, the limited control that governments actually have over major economic influences, and the extent of variability across countries and through time, should have major lessons for designing the European Union’s economic guidelines. The most obvious are:

- 1) changes over which EU governments have limited control in the domestic economy or in international markets may render outcome rules or specific policy rules unachievable or irrelevant;
- 2) the appropriateness of an outcome or policy rule may change over time; and
- 3) an outcome or policy rule may be appropriate for some member governments but not others.

These lessons prompt a generalization that should guide the design of economic guidelines among EU countries. With regard to procedure, the EU-wide guidelines would be enacted through legislation by the European Parliament. These guidelines should have the following characteristics:

First, because institutions and economic conditions vary among countries, if an outcome is specified for a member government to achieve, the government should be allowed to design the policies to achieve that outcome.

Second, the time allowed for achieving a specified outcome should be subject to discussion between the Commission as the monitoring body and the government seeking to achieve that outcome.

To summarize, EU economic guidelines should be explicit that choice of policies and policy tools should be the decision of each national government; and allow flexibility across countries in adjustment to the desired outcome.

If the economies of EU members were approximately the same size and level of development, it might be justified to specify numerical targets for all countries, subject to random variation. We stress “might” because changes in the world economy could render some rules out-of-date or require additional ones. For example, the current treaties provide little policy guidance to country level dangers arising from the globalization of finance. This omission is potentially dangerous because treaties specify unregulated movement of financial capital.

The economies of member states are vastly different in size. As a direct result of differences in size the rules first codified in the Maastricht Treaty are dysfunctional. They literally suffer from the “one size fits all” fallacy. The inflation rule set by the ECB⁴ provides a clear example of an inappropriate uniform rule. A major concern prompting the inflation rule is that an excessive inflation rate in one country might spread to other countries and perhaps destabilize the entire euro area economy. The likelihood of one country’s inflation affecting the euro zone or EU economy depends on the size of the country. A transmission danger is credible for Germany (accounting for 22% of EU GDP) or Spain (7.5%), and absurd for Malta (less than 0.1%) or Greece (1.2%).

Also important if less obvious are differences in level of development. Even after a decade of rapid growth, Poland’s per capita GDP is one-third of France’s and less than a third of Germany’s. Large differences in output per head imply differences in infrastructure, efficiency of financial markets, and workforce skills. These structural differences strongly influence economic dynamics in each country. Less developed physical and financial infrastructure results in markets being slower to adjust to local, national and cross-border changes in economic variables. To use the technical term, markets in less advanced economies tend to be less “efficient”. Differences in economic structure across the European Union might result in the ECB target inflation rate of 2% having strong growth-depressing effects on the economies of lower-income countries such as Poland (if it were to join the euro) because of less efficient goods and financial markets.

The size and structural characteristics of each economy, as well as its level of development, affect the impact of exogenous shocks. While capital inflow or outflow is unlikely to destabilize a large country such as Germany or France, these flows can and do frequently destabilize small economies.

The most significant rules, perhaps, are those set out in the excessive deficit and debt provisions of the Treaty (Article 127 and Protocol 12 on the Excessive Deficit Procedure) which set the limit for budget “deficits” at 3%, and total government debt at 60%. If these are exceeded, the Commission has to write a report which while giving some leeway for minor or diminishing breaches, if it considers an excessive deficit is arising, require it to make specific recommendations. In this way, the policy outcome is in effect to be achieved by a more rigid

⁴ “The Governing Council clarified in 2003 that in the pursuit of price stability it aims to maintain inflation rates below, but close to, 2% over the medium term.” See ECB website <https://www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html>

policy framework of measures to be taken, since ultimately these are coercive rules, at least for euro area states. And as we have noted above, the current set of rules are due to be supplemented and toughened by the incorporation into EU legislation of the main provisions of the 2012 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union which go further and require annual balanced budgets, as defined.

An association or union of countries requires mutually agreed economic guidelines to coordinate across governments. The guidelines should prevent public and private sector actions that destabilize the economies of member states and undermine cooperation among them. Guidelines should facilitate public and private sector actions that foster stability and cooperation among member states.

To put our argument simply, guidelines among member states should be both positive (what a government can do) and negative (what it cannot do), with the purpose of deepening cooperation among member states. This approach is in contrast to rules currently in treaties that tend to be negative, prohibitive and limiting, with the purpose of fostering competition rather than cooperation.⁵

Cooperation not competition is central to designing appropriate economic guidelines for member governments. To ensure cooperation, economic guidelines should as far as possible maintain consistency between the welfare of the Union and that of national economies. Necessary - but not sufficient - to achieve this consistency, the guidelines should be flexible to country circumstances. The sufficient condition is that when the guidelines are breached by national governments, the “correction mechanism” should not depress economic wellbeing of the vast majority of the national population.

⁵ As exemplified by the inclusion, in Article 3.3 of the Treaty on European Union of “a highly competitive social market economy” as a key element of the EU’s economic objectives.

BOX: Probability of Achieving a Specified Fiscal Balance

The difference between predicted (specified or targeted) and actual fiscal outcomes can be stated rigorously using probability analysis.

1. If all factors influencing the government's fiscal balance are known, and the exact causality is known, then it is possible to make an accurate prediction of the fiscal balance. This is the "formal model" of the fiscal balance.
2. Unanticipated, random events (sometimes called "shocks") can occur causing the actual outcome to differ from the predicted outcome. An example of a random event is an unexpected increase in international petroleum prices. This will impact on public expenditure directly and indirectly through its effect on the private economy, private incomes and tax revenue.
3. If the formal model is correct, the predicted outcome will most frequently be the actual outcome. But because each prediction is a unique event, there is only one actual outcome. The process is not an experiment that can be repeated under identical conditions.
4. Except in rare cases, the actual outcome will differ from the predicted outcome due to random events ("shocks"). If the formal model is correct, the outcomes will be normally distributed with the predicted outcome the most frequent. The difference between the actual and predicted outcome is determined by the size of the "shock". The standard deviation of the outcomes determines the width of the distribution. The formal model determines standard deviation, which can be large or small. It is reasonable to expect the standard deviation to vary across countries.

In summary, a government's fiscal balance is in part the result of random events beyond the government's control. An "excessively negative" fiscal balance can occur even when governments plan an outcome consistent with the rules in the Treaty on Stability, Coordination and Governance. The "excessive" outcome is consistent with following those rules. It is a random derivation from the planned outcome and requires no corrective measures.

The Great Financial Crisis of 2008 was an example of a random, unexpected event that had a major impact on fiscal balances of EU governments. Return to historically typical rates of economic growth would have restored fiscal balances in almost every EU country. Austerity policies prevented a return to historically typical growth rates.

EU Economic Performance

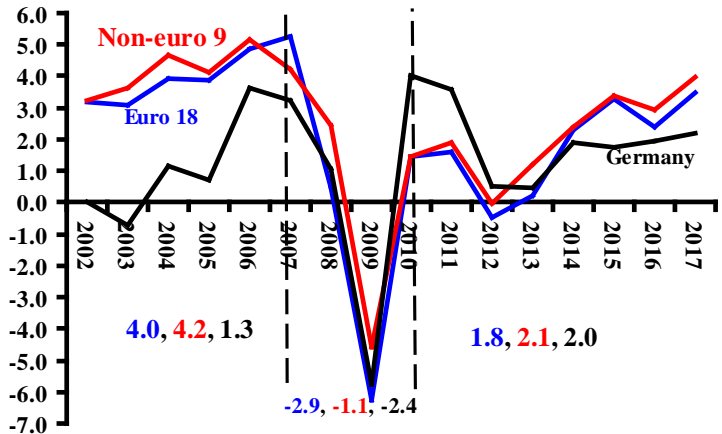
Economic Growth

Were it the case that under current economic rules EU countries have enjoyed strong economic indicators, those rules might be justified by the pragmatic defence that “they work”. Economic indicators have not had satisfactory outcomes, much less strong ones. Few if any of the major economic goals integration sought to achieve have been realized: stable growth, convergence in living standards and more balanced trade. Of great concern is the evidence that by most economic indicators euro zone countries have performed worse than countries whose national governments have not adopted the common currency, as well as non-European broadly comparable countries. This evidence suggests that the euro zone suffered more from the dysfunctional rules in treaties than non-euro countries.

Chart 1 begins the analysis of economic indicators. This and subsequent tables include all countries that made up the membership of the European Union at the end of the years covered by the statistics.⁶ The long period during which government policies were constrained by EU accession procedures justifies inclusion of the late-comers, ie., those adopting the euro after 2000. The euro zone countries also include those that used the common currency at the end of the period.⁷ The post-2000 members of the euro zone are included in the group whatever their joining dates. This grouping is justified because the governments of the countries were required to link their currencies closely to the euro well before formal membership.

The first chart shows that in the years immediately before the financial crisis, the euro zone group of 18 (excluding Germany) and the non-euro countries grew at similar rates, and the German economy at a much slower rate. During the three crisis years, the contraction of the non-euro countries appears substantially less than for euro countries. To an extent this might be explained by the non-euro countries (save UK), having financial sectors that were less developed or played a smaller role in their economies. It is also possible that the common currency provided a mechanism to facilitate the spread of the global financial collapse.

Chart 1: GDP Growth Rates: Germany (black), Eurozone 18 (blue) & Non-euro 9 (red), 2002-2017 (constant prices)



.Note: Eurozone 18 excludes Germany.

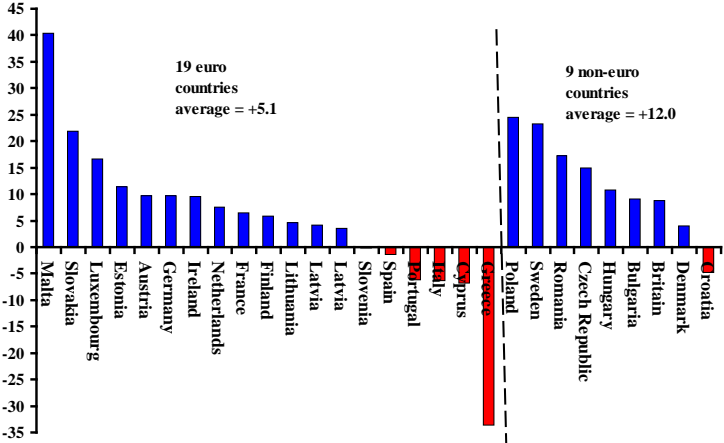
⁶ Ten countries joined in 2004 (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia). Bulgaria and Romania acceded in 2007, and Croatia in 2013.

⁷ Founding members were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxemburg, Netherlands, Portugal and Spain (11). Other current members are Greece (2001), Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011), Latvia (2014), and Lithuania (2015). Source: [Eurostat](#).

In terms of the welfare of residents, the appropriate test for an economic recovery is its impact on goods and services available to people to purchase and use. The relevant measure is not GDP but domestic expenditure, by households, businesses and the public sector. If domestic expenditure falls, the welfare of the population has declined. It may seem obvious that an increase in domestic production results in more goods and services for the population, but that is not true. Recovery characterized by a declining deficit in external trade or an increasing surplus means goods and services available to a country’s population increase less than total production. The critique of mercantilism by Adam Smith in the 18th century focused on this negative welfare effect of trade surpluses (Adam Smith 1998, Chapter 22).

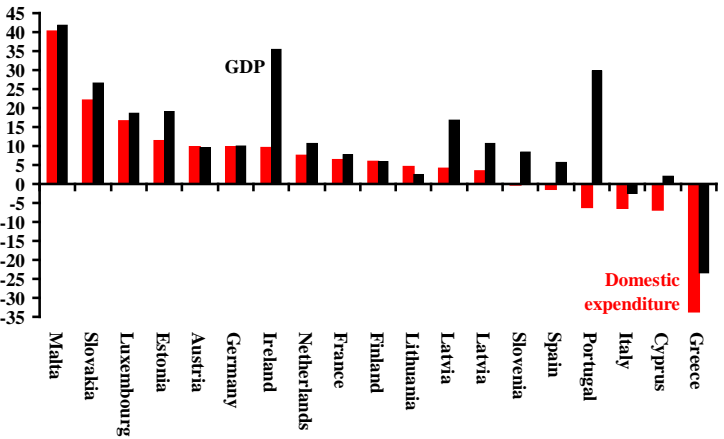
Chart 2 shows the change in domestic goods and services, those available to the population of each country, from the beginning of 2008 through the second quarter of 2017. Over these ten years (41 quarters), for only four euro zone countries was the average increase as much as one percent a year (cumulative 10% percent). These four are among the smallest countries of the 19 member euro zone (Malta with the lowest population, Luxemburg second lowest, Estonia fourth and Slovakia 11th). At the other end, the change was negative for five countries, two of which are among the largest members (Spain and Italy). By contrast only one of nine non-euro countries showed a negative change (Croatia).

Chart 2: Percentage change in Domestic Expenditure, 19 euro zone countries & 9 non-euro countries, 2008Q1-2017Q2



Source: [Eurostat](#).

Chart 3: Percentage Change in GDP and Domestic Expenditure, 19 euro zone countries, 2008Q1-2017Q2



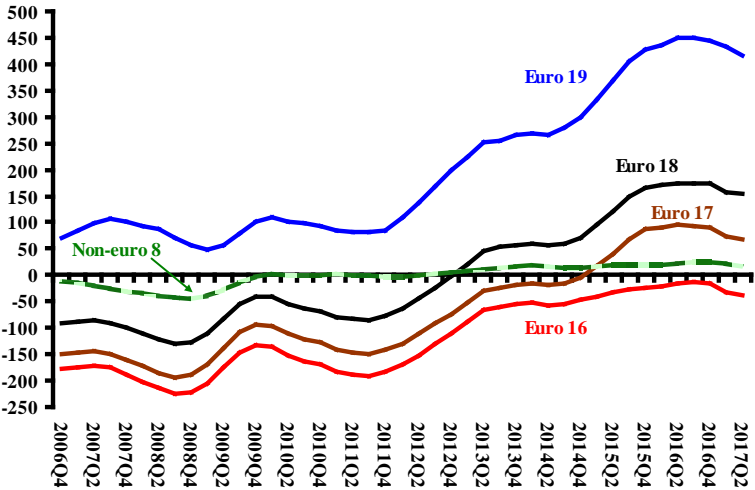
Source: [Eurostat](#).

This is a dismal outcome by any assessment, real domestic expenditure improvement of 0.5% per year across the euro zone, and barely above one percent for non-euro countries. The result is all the more dismal when we focus on the euro zone countries (Chart 3). In every country but one, rising trade surpluses left the increase in domestic goods and services well below the increase in gross domestic production. To put it simply, the mercantilist drive for “competitiveness”, a trade surplus, has substantially reduced the benefits of growth. During the period 2008 to 2017, Irish GDP increased by 35% while the domestic availability of goods and services rose by less than 10%. More extreme was Portugal, where the export boom left residents worse off. GDP increased by 30%, yet domestic goods and services fell by over 5%.

External & Intra-EU Trade

Chart 4 shows that the extraordinary expansion of EU trade surpluses was concentrated in just a few countries. When the UK is excluded,⁸ the non-euro countries show little change over time, from a small trade deficit before the crisis to an equally small surplus in the latest years. In contrast, the change for the Euro 19 is striking, from a surplus of about €100 billion during 2006-2010 to well over €400 billion in 2017. Three countries account for this massive surplus, Germany and two much smaller countries, Ireland and Netherlands. When these three are excluded, the remaining Euro 16 show a continuous though declining trade deficit. In the four quarters ending 2017Q2, the German goods surplus was €264 billion, for Ireland €103 billion and Netherlands €87 billion, to leave the other 16 at minus €36 billion. The dismal performance of EU countries in raising the welfare of their populations, with export surpluses generating “immiserizing growth”, has a clear cause, the policies of fiscal austerity, which is discussed below.

Chart 4: Balance on Trade in Goods, Euro zone countries, 2006Q1-2017Q2 (billions of euros)



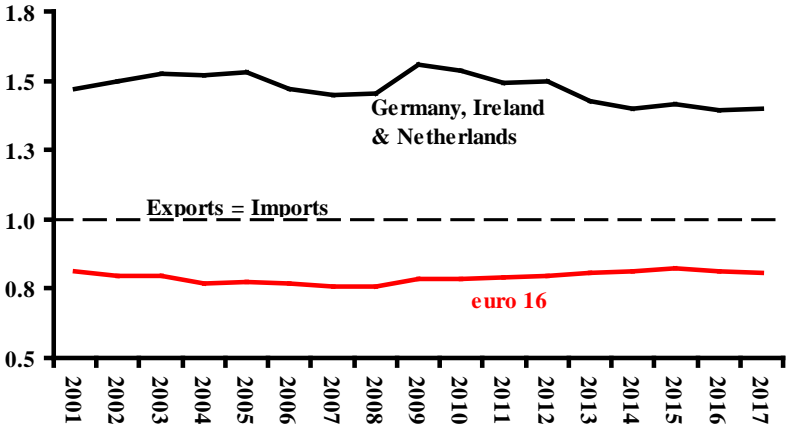
Notes: Euro 19 includes all euro zone countries. Euro 18 excludes Germany, Euro 17 omits Germany & Netherlands, and Euro 16 omits Germany, Ireland & Netherlands. Non-euro 8 are Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland, Romania & Sweden. The trade balance is annualized. Each quarter is the sum of the current and previous three quarters.

Source: [Eurostat](#).

⁸ Inclusion of the UK would be distorting because the British trade balance on goods is quite large and negative with an off-setting surplus on services, especially from the financial sector.

One might expect that the adoption of the euro would reduce trade imbalances within the currency zone, if not for *total* trade (i.e. with the rest of EU and the world). This did not occur, as **Chart 5** demonstrates. Over the 17 years of common currency trade, the euro zone has been sharply divided between three surplus countries, again Germany, Ireland and Netherlands, and the deficit Euro 16. For the three trade surplus countries the ratio of exports to imports changed relatively little over the 17 years, rising from 1.40 to 1.56.⁹ For the other 16 the variation was even less, from 0.76 to 0.82. Adoption of the common currency has not reduced trade imbalances.

Chart 5: Intra-EU Trade, Ratio of Exports to Imports, 2001-2017



Source: Eurostat.

Notes: Ratios for 2017 cover the first nine months. Euro 16 excludes Germany, Ireland and Netherlands. The trade balance is annualized.

Convergence & Divergence

Convergence in levels of development has been an important goal of the European Union since its inception in the late 1940s. It was anticipated that the elimination of internal tariffs, of restrictions on flows of financial capital, and on barriers to movement by workers would generate convergence in living standards. Though it is not ideal, GDP per capita serves as the most common indicator of this convergence, and the simplest measure is its coefficient of variation across countries.¹⁰

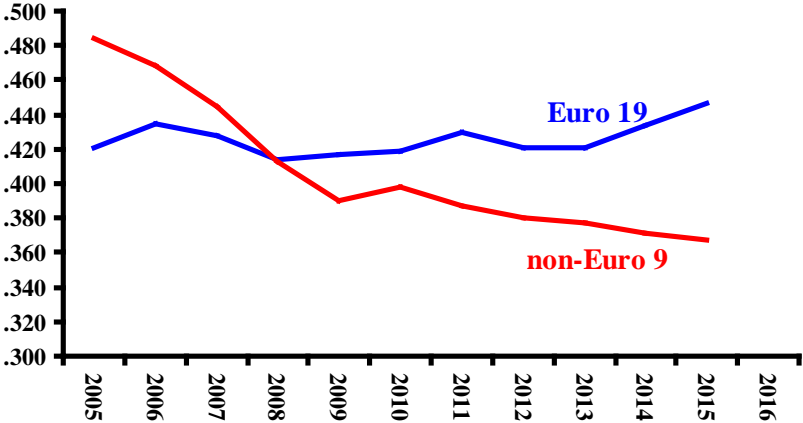
Chart 6 reports this statistic for the 19 euro zone member and the 9 non-euro countries. In 2005 the divergence among the latter was considerably greater than for the former. One would expect this because six of the nine non-euro countries were in transition from central planning, while only 5 of the 19 euro zone members fall into that category (the three Baltic states, Slovenia and the Slovak Republic). During the 11 years 2006-2016 divergence among the non-euro countries declined almost continuously. In contrast, divergence among the euro-zone countries steadily rose, surpassing the other group in 2008, with the gap between the groups steadily increasing.

While the substantial divergence among the euro zone countries occurs after the financial crisis of 2008-2010, that was not a reversal from a trend to convergence. During the previous three years, 2005-2008, the level of divergence hardly changed. The comparison of the two groups strongly suggests that *use of the common currency increases rather than decreases divergence among countries*. Mainstream neoclassical trade theory would predict the

⁹ Any value greater than one indicates a surplus.
¹⁰ The coefficient of variation is the standard deviation divided by the mean.

opposite, convergence.¹¹ Convergence should result because the common currency facilitates cross-country capital flows. Neoclassical theory predicts that financial capital will flow from the higher income countries to the lower income countries, generating higher investment and growth in the latter.

Chart 6: Divergence and Convergence for Euro and Non-Euro Countries, 2005-2016 (coefficient of variation of GDP per capita)



Notes: GDP per capita is measured adjusting for consumption patterns and price across countries (purchasing power standards, PPS). The coefficient of variation is the standard deviation across countries divided by the mean. A higher coefficient represents a greater degree of divergence, and vice versa.

Source: [Eurostat](#).

This simplistic analysis suffers from many defects. It derives from a framework that explains levels of development across countries by each country’s “endowment” of means of production, “capital”, compared to labour. Though deeply entrenched in mainstream analysis with its famous “comparative advantage” cliché,¹² the theory suffers from the fundamental problem that no satisfactory method exists to aggregate means of production.¹³ Therefore, the so-called capital-labour ratio cannot be directly measured.

The argument that facilitating financial capital flows among countries reduces divergence among countries encounters two obvious practical objections. First, while a common currency facilitates capital inflow, it also facilitates outflow. The net movement of financial capital is not determined exclusively or even primarily by levels of national development. Second, inflow of financial capital need not result in productive investment or more rapid and/or sustainable growth. Prior to the global financial crisis, capital flowed from Germany and other surplus states towards Spain and Ireland, for example, but only to pump up unsustainable construction “bubbles” which swiftly burst. The evidence is clear. Membership in the euro zone does not facilitate convergence.

¹¹ Mainstream trade theory is frequently called Heckscher-Ohlin theory after two Swedish economists who developed an early version, Eli Heckscher and Bertil Ohlin.

¹² Though frequently cited as the basis for trade among countries, “comparative advantage” analysis is based on faulty theory. See Shaikh (1979).

¹³ The practical problem is that means of production can only be aggregated by their market value. To use this message through time it must be corrected for inflation and technical change that renders some means of production partially or totally obsolete. The most basic conceptual problems were famously revealed by Joan Robinson (1953-1954) and are explained in Weeks (2012, Chapter 12).

Fiscal Austerity

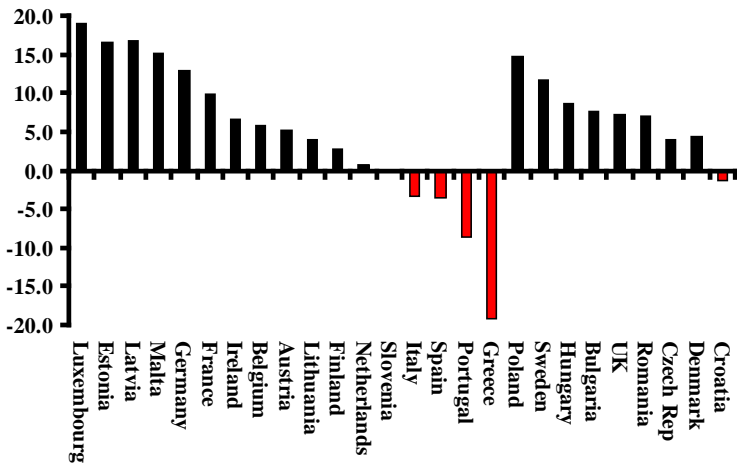
As recalled above, the national governments of the European Union in February 1992 signed the Maastricht Treaty which first specified the rules on fiscal balances (“excessive deficits”). Twenty years later the Treaty on Coordination, Stability and Governance (TCSG) restated these in stricter form, in effect aiming to move to the still tighter framework of permanent “balanced budgets”. Two governments (UK, Czech Republic) declined to sign this treaty, preventing unanimous adoption as an EU Treaty.

The final Article of the 2012 Treaty (article 16) committed the signatories to take the “necessary steps” within five years of its coming into force (in 2013) to incorporate “the substance of this Treaty into the legal framework of the European Union.” The Commission has with its draft Directive begun this process of incorporation, in relation to Article 3, but it has not yet been adopted, and its contents are contested. Article 3, as we have noted, turns the goal of a near balanced or in surplus budget from a Medium Term Objective into a permanent duty.

The formal basis for restrictive fiscal policy, “austerity”, has therefore been in place for over 25 years. The EU’s policy response to the global financial crisis has perversely been to tighten the rules still further, despite the clear evidence of their failure.

Chart 7 shows the percentage change in government current expenditure in constant euros by country for the second quarter of 2017 compared to the first quarter of 2010. The comparison to early 2010 is appropriate because that marks the beginning of concerted pressure on governments, first the Greek government, to reduce fiscal deficits. The statistics cover all nine non-euro countries, and 17 from the euro zone (no data from Cyprus and the Slovak Republic). Current expenditure excludes investment. With few exceptions, current expenditure accounts for 95% or more of public expenditure. Wages and salaries are its largest component.

Chart 7: Government Current Expenditure, 17 Eurozone & 9 non-euro countries, 2017Q2 compared to 2010Q1 (% change, constant euros 2010)



Source: [Eurostat](#).
 Note: No statistics for Cyprus and the Slovak Republic.

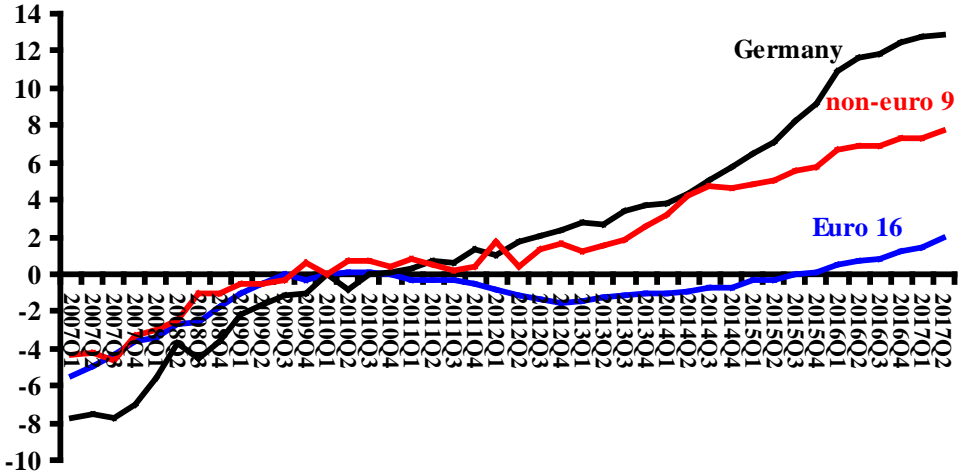
Over the seven years, in 12 euro zone countries inflation-adjusted current expenditure increased and in five it declined. The four countries with the largest increases include the two smallest members (Luxembourg and Malta), that have less than 1.5% of the euro zone

population. At the other end, the five countries with declining expenditure include two of the largest members (Italy and Spain), with 38% of the zone’s residents. By contrast only one of the non-euro countries shows a decline, Croatia.

A useful benchmark for public expenditure is whether it keeps pace with population growth. Failing to do this means that public provision of services declines per capita. In 10 of the 17 euro zone countries public services per capita increased, in six it declined, and in one there was no change.¹⁴ Again, the contrast to non-euro countries is clear. In all nine non-euro countries expenditure rose more than population, though in Croatia this was due to contracting population.

Chart 8 emphasizes the difference in public expenditure growth for the two groups over a slightly longer period. In mid-2017 German public current expenditure was over ten percent above its level in early 2010. For the non-euro nine the increase was lower, about 8%. For the other 16 euro countries the increase was a meagre 2%. These statistics demonstrate the greater fiscal austerity in the euro zone, either due to commitment by national governments or greater effectiveness of EC enforcement of fiscal rules on common currency countries, or a combination of both.

Chart 8: Government Current Expenditure for Germany, 16 Eurozone & 9 non-euro countries, percentages compared to 2010Q1 (constant euros of 2010)



Source: Eurostat.

Notes: No statistics for Cyprus & Slovak Republic. Expenditure is the annual equivalent, sum of current and previous three quarters.

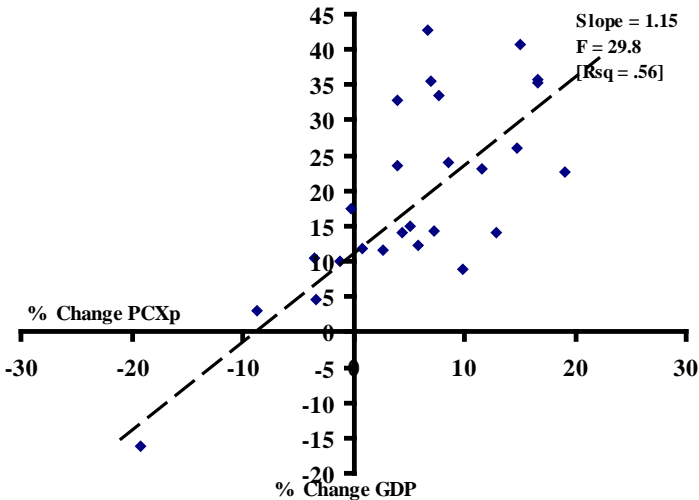
We conclude the discussion of fiscal austerity by inspecting its probable impact on economic growth. In the long term increases in capacity determine the growth of an economy. In the short term demand drives growth because it determines how much of available capacity is used. Economies have four sources of demand - consumer expenditure, private domestic investment, export sales and public expenditure. If governments constrain the growth of public expenditure, one of the other sources of demand must replace it. Restraining public spending, austerity, is by its nature growth-reducing.

Chart 9 verifies that general conclusion. The vertical axis measures, for 26 euro and non-euro countries, the percentage change in constant gross domestic product from the first quarter of 2010 compared to the second quarter of 2017. The horizontal axis shows the percentage

¹⁴ The countries with decreases were, from least to most, Netherlands, Ireland, Italy, Spain, Portugal and Greece. No change occurred in Finland. In Slovenia population fell by more than expenditure.

change in constant price government expenditure over the same period. The dashed line indicates the statistical relationship between the two variables. A ten percent increase in government spending is associated with an increase in growth by 11 percent (for example, from 2.0 to 2.2 percent).¹⁵

Chart 9: Percentage Change Public current Expenditure (PCXp, horizontal) and GDP (vertical), 2010Q1-2017Q2 (constant prices of 2010)



Source: Eurostat.

Notes: In a two variable regression the F-statistic, t-statistic and R-square are the same measure. Sample size (number of countries) is 26. Government spending is the annual equivalent, measured in each quarter as the sum of the current and previous three quarters.

Summary of empirical findings

From the above, the empirical findings are the following.

1. GDP growth of EU countries overstates the performance of economies on the welfare of residents. As noted above, in almost every euro zone country recovery driven by exports led to very slow growth, stagnation or decline of domestically consumed goods and services. Euro zone populations have suffered from “immiserizing growth”, growth that leaves people worse off.
2. Among the euro zone members, export surpluses are concentrated in three countries, Germany, Netherlands and Ireland. This imbalance in trade among euro zone countries is in contrast to the non-euro countries where the trade balance across countries has not shown a substantial change.
3. Substantial imbalances in intra-euro trade have not changed over the 17 years of the common currency.

¹⁵ The values of the test statistics, F and R-square, report that the probability that the relationship is accidental and random is less than one in 100.

4. Since the introduction of the common currency levels of per capita income among euro zone countries have diverged, while among non-euro countries they have converged.
5. Austerity fiscal policies depressed growth in the EU, more so in the euro zone than for countries with national currencies.
6. Evidence is strong that the current institutional and regulatory framework of the European Union, and notably of economic and monetary union as constituted, does not achieve the basic goals of economic prosperity, stability, and convergence.

Specifying New Guidelines: Fiscal Balance

The Stabilizing Role of Fiscal Balances

Professional opinion on fiscal policy is not favourable to setting a specific number for fiscal deficits.¹⁶ Technically respectable approaches employ the dynamic and flexible concept of fiscal sustainability. Redesign of EU fiscal guidelines begins with understanding the fundamental problem of the existing rule, which is that it requires governments to implement policies that increase economic instability. The economic term for this flaw is that the existing rule is “pro-cyclical”. Adhering to the rule aggravates rather than moderates tendencies toward recessionary contraction.

As explained in the discussion of austerity, in a capitalist economy demand determines production in the short run. We now elaborate that analysis to understand the flaws in EU fiscal rules. The output (GDP) of a capitalist economy stabilizes when total demand for goods and services equals the production of goods and services. If total demand exceeds production, shortages of goods and services result and private producers increase their outputs causing the economy to expand.

If the production of goods and services exceeds the demand for them, private producers cannot sell all they produce. In response they produce less, hire fewer workers and the economy contracts. These quantity adjustments in private production result in the cyclical pattern typical of capitalist economies, a rise and fall of production in response to fluctuations in total demand for goods and services. In most cases when the economy briefly stabilizes, when total demand and production are equal, this tends to occur at less than full capacity. Market economies have an inherent tendency to under-utilization of capacity, especially labour.

The central problem of the capitalist economy is insufficient demand to achieve full capacity and provide work for all who seek it, “persistent demand failure”. A major responsibility of a progressive government is to implement policies that counteract private sector demand failures. These policies fall into two categories 1) automatic stabilizers and 2) discretionary interventions.

As the name suggests, automatic stabilizers come into effect automatically without the need for policy interventions. The full definition of an automatic stabilizer helps explain why the EU deficit rule is dysfunctional:

Automatic stabilizers reduce the volatility of a capitalist economy. An automatic stabilizer is a structural relationship in the private or public sector

¹⁶ In a 2001 IMF policy paper, Kopit writes,

“Skepticism about the usefulness or effectiveness of fiscal rules is grounded on several arguments, ranging from theoretical to practical ones. From a theoretical perspective, neither traditional macroeconomic analysis, nor any principles of public finance are predicated on a rules-based fiscal policy. Indeed, a discretionary approach has been widely viewed as instrumental for the achievement of conventional fiscal goals or functions—namely, stabilization, distributional fairness, and allocative efficiency. Likewise, monetary rules were not deemed to be superior to discretionary monetary policy. In all, the main virtue of discretionary demand management was that it afforded short-run flexibility to offset large exogenous disturbances, especially those that could lead to a prolonged and significant unemployment. In the postwar period very few authors...questioned this conventional wisdom.” (Kopit 2001, 4).

that causes personal incomes to change at a slower rate than national income (GDP).¹⁷

An example of a private sector automatic stabilizer is the short run tendency for households to maintain their level of expenditure when their incomes decline. Households do this by drawing down – spending from – their savings. This helps temporarily stabilize the economy because the fall in GDP does not immediately lead to an equal fall in household consumption spending.

More important than private automatic stabilizers are automatic stabilizers created by government policy. The quantitatively most important automatic stabilizers are a progressive personal tax structure and social benefits. Among social benefits the most effective in many European countries is the automatic payments to newly unemployed workers. When a capitalist economy falls into recession, these structural relationships automatically moderate the recessionary decline (explained in box “Automatic Stabilization” and diagram “Recessionary Dynamics”).

Automatic stabilizers cause a decline in the fiscal balance. If when the recession begins the central government has a budget surplus, the surplus declines, perhaps becoming a deficit. If when the recession begins the central government has a budget deficit, the deficit grows larger (more negative). The deficits that result from a recession are not a problem. They are a solution, slowing the decline and making subsequent recovery easier and faster. Attempts to reduce or eliminate the recession-generated deficit by cutting expenditure or increasing taxation make the recession worse and postpone recovery.

The sequence described is not “Keynesian economics”. It is a generally recognized and statistically verified empirical reality. John Maynard Keynes was one, and the most famous, of many economists and non-economists to offer theoretical explanation for this empirical relationship.

The fundamental flaw in the EU deficit rule – and a fortiori a “balanced budget” rule - is that it eliminates the most important automatic stabilizers protecting capitalist economies from extreme volatility. It does not protect the EU economy or national economies from instability. It does the opposite, eliminating stabilizing mechanisms and undermining the health of national economies and the EU economy. The concept is whole.

This flaw is not reduced by use of the EU concept, “structural deficit”. This is no more than an alternative measure of the overall deficit that takes no account of automatic stabilizers (see annex, “Structural Deficit” Theory and Measurement”).

¹⁷ A clear discussion of automatic stabilizers is found on the Tax Policy Center website, though it does not consider private sector stabilizers. <https://www.taxpolicycenter.org/briefing-book/what-are-automatic-stabilizers-and-how-do-they-work>. The definitive work on private sector automatic stabilizer, now over 50 years old, is Ruggles and Ruggles (1956).

How capitalist economies automatically stabilize

Imagine one of European countries enjoying strong growth with a low level of unemployment. A shock to the economy, such as those that occurred in 2008, causes a sudden drop in business optimism. This drop in optimism leads businesses to reduce their investments (as occurred during 2008-2010). The following empirical sequence unfolds (see diagram “Recessionary Dynamics”).

Private sector contraction:

1. The reduction in business investment causes a decline in business purchases of equipment, construction materials and employment in construction of new factories and offices.
2. The fall in employment results in a contraction of household incomes.
3. The contraction in household incomes induces less consumption expenditure.

Automatic counteracting mechanisms

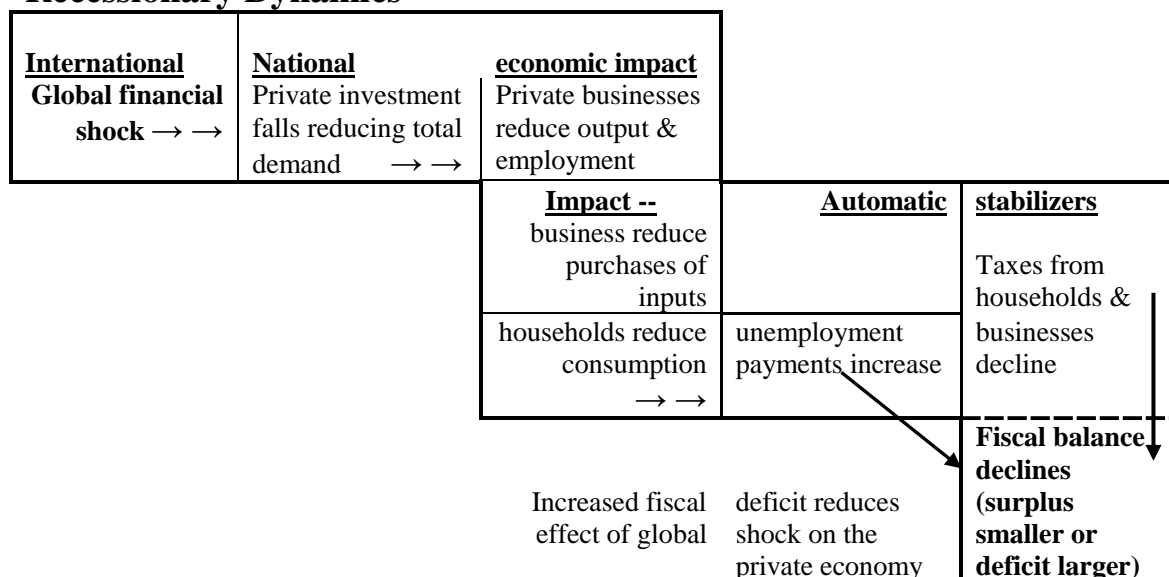
1. Because the personal taxation structure is progressive, aggregate household income after taxes (“disposable income”) declines less than income before tax (“personal income”). *Public income has fallen more than private income.* As a result household consumption declines less because income losses have been redistributed from households to government via the tax system.

2. When employment declines, support payments to workers who lose their jobs automatically increase, partly replacing income lost through unemployment. This automatic increase stabilizes household consumption spending.

When an EU country suffers a shock such as the global financial crisis the immediate contraction of the economy (including more unemployment) is *counteracted* by a progressive tax system and payments of unemployment support. This counteracting mechanism results in an increased fiscal deficit. The increase in the fiscal deficit signals that the economy is automatically healing itself.

The larger deficit is part of the solution to recession. A requirement that fiscal deficits should not exceed a specific share of GDP prevents the economy from counteracting recessionary decline.

Recessionary Dynamics



Functional Fiscal Guidelines

The role played by the fiscal balance in protecting the private economy against economic shocks is essential to the stability of national economies and the EU economy in the aggregate. The current rules undermine the ability of fiscal policy to achieve that stabilizing role.

The new approach to fiscal balances should use guidelines not rules.

The first principle of the national fiscal balance guideline is that its design should not derive from the impact on the EU as a whole.

The second principle of the fiscal balance guideline is that it should facilitate the stabilizing function of the fiscal balance. To achieve this, the fiscal guideline should not specify numerical targets.

The third principle of fiscal balances is that capital expenditure creates assets and should or may normally be funded by borrowing.

The first principle rejects the justification for the excessive deficit and convergence criteria fiscal rule. This justification utilises a favourite neoliberal cliché, “moral hazard”. National governments with budget deficits create a “moral hazard” because the instability that results from deficit finance spreads to other EU states. The purpose of the convergence criteria 3% of GDP limit to an overall fiscal deficit is to prevent a form of “moral hazard”.

That a national fiscal balance could be so negative that it would destabilise the EU economy as a whole is a fiction without analytical or empirical basis. The majority of member states are so small that no fiscal deficit or surplus could have a substantial impact on the stability of other states in the aggregate. The few EU countries that are large enough to affect the others have not had histories of large deficits, outside recessions when the automatic stabilizers kicked in (early 1990s recession, global financial crisis). While contingency measures for improbable events are needed, such events should not dictate guidelines for all policy.

To demonstrate the lack of validity we assume that the moral hazards feared are that deficits 1) fuel inflation, 2) provoke a rise in the interest rate on sovereign bonds, and/or 3) cause ‘bankruptcy’ of a national government because it cannot service its debt, causing knock-on impacts on creditors elsewhere, or requiring financial support or bail-out. We treat the last in the discussion of the convergence criteria public debt rule.

To be meaningful the alleged link between deficit finance and inflation requires a theoretical mechanism. The simplest version of neoliberal inflation theory is the Quantity Theory of Money. It is also the version that produces the largest inflation effect. In this simple causality an increase in the fiscal deficit is funded by money creation. The increase in the availability of money leads to greater private expenditure (no money is held idle). If the economy is at full capacity the greater expenditure causes inflationary pressure. The algebra for this simplistic model is itself simple, leading to the extreme special case in which all deficit finance results in inflation.¹⁸

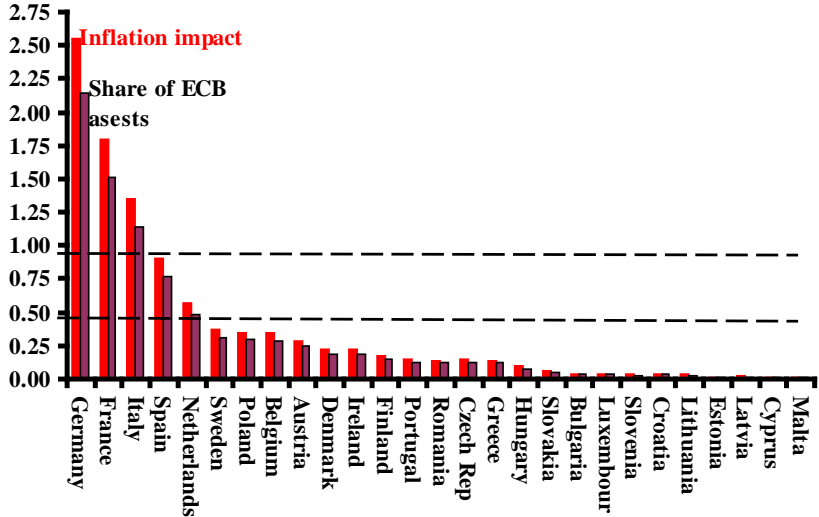
¹⁸ This is a special case because it is only true if 1) the economy is at full capacity, and 2) the increase in the fiscal deficit increases money in circulation by the same amount. In order for the second condition to hold a government must “monetise” the deficit. A deficit is monetised if a government borrows from its own central bank or the ECB, or literally prints money. Both actions are prohibited at the national level by EU law. Under EU rules a national government must sell its bonds in financial markets to finance a deficit. That method of

In Chart 10 the red columns show the hypothetical inflation consequence of each EU government increasing its fiscal deficit by the convergence criteria three percentage points of GDP. The exercise calculates the answer to the question, what if a government went from a balanced budget to the convergence criteria limit in one year, or if beginning at that limit the government were to double the deficit? By recent experience a 3 percentage point increase in deficits within a year is rare. During 2001-2017 across 27 EU countries, a year-to-year increase in the fiscal deficit greater than three percentage points occurred 34 times, or in 7.9% of the cases. Of these 34 increases greater than three percentage points, 26 happened in two years, 2007 to 2008 and 2008-2009.

All but eight (1.9% of cases) resulted from the global financial crisis, which caused GDP and tax revenue to contract across all EU economies. Other than during 2007-2009, countries with more than a three percentage point increase in their fiscal deficits in no year accounted for as much as 2.5% of EU total GDP. In summary, the calculation of inflationary impact refers to rare fiscal events in small countries, which when they occur would have had no measurable impact on the European Union as a whole.¹⁹

The calculations show that for only three of the 27 EU member states (UK excluded) would an increase in the fiscal deficit by 3 percentage points result in inflation of more than one percent (Germany 2.55, France 1.79, and Italy 1.35). In only two more countries would the inflation impact exceed 0.5% (Spain 0.91 and the Netherlands 0.57). If the 14 other euro zone governments suddenly and simultaneously increased their fiscal deficits by 3 percentage points, the accumulative inflationary impact would be about 1.5 percentage points; for example, from 2% to 3.5% inflation.

Chart 10: Inflationary impact of a deficit increase of 3% of GDP & its share of ECB assets, by country (percentages)



Notes: Inflation calculation assumes full capacity and velocity of circulation of money (M2 measure) of 4, using 2016-2017 GDP for each country. See text footnote for further explanation. Source: [ECB](#).

finance leaves the amount of money unchanged. When selling a €100 bond the government takes €100 out of private circulation. When the government spends the €100 the money goes back into private circulation. The net effect is zero.

¹⁹ Statistics on fiscal balances across EU countries are from Eurostat, <http://appsso.eurostat.ec.europa.eu/nui/submitViewTableAction.do>.

In summary, the theoretical and empirical likelihood is tiny that any EU country would increase its fiscal deficit by enough to provoke enough inflationary pressure to create a problem for the EU economy. We unambiguously conclude that the treaty-based 3% limit on fiscal deficits plays no important role in protecting the EU economy against inflation.

The second and third of our proposed principles of fiscal balances allow for countercyclical demand management and rational financing of investment. With regard to the second, investment by definition creates an asset. If investments are selected on a sound technical assessment, they generate a rate of return equal to or in excess of the cost of borrowing the funds to finance the investment. For that reason businesses and households borrow to invest.²⁰

The practical problem is that circumstances arise when national governments have unsustainable negative fiscal balances. The serious problem created by large national fiscal deficits is their tendency to fuel speculation on the bonds sold to finance the deficit. The EU “sovereign debt crisis” during 2010-2014 resulted from financial speculation that generated unsustainable debt service.

Fiscal deficits do not cause the speculation-driven high interest rates. That problem results from treaty restrictions on national central banks and the European Central Bank. These public institutions are prohibited from lending directly to national governments or even from purchasing government bonds in the secondary market if the purpose is to enable public expenditure rather than to “maintain price stability”. These Treaty restrictions are based on ideological grounds, not on sensible economic principle. The problem would be simply solved by allowing the ECB to be the “buyer of first resort” for national public bonds. This would require a change in the treaty-based ECB mandate and ‘tasks’ (Smith & Weeks 2017).

The ECB would prevent speculation by a pledge to purchase public bonds of any EU member government at a pre-announced interest rate. Subject to the approval of the European Parliament, the ECB would set its bond-buying interest rate by the so-called Golden Rule, equal to the sustainable rate of growth of per capita income (Solow 1956).²¹ The Golden Rule GDP growth rate equals the rate of population growth plus the rate of productivity growth. The latter is by definition the rate of growth of technical change.

Functioning as “first resort buyer” of national public bonds would be well within the asset capacity of the ECB. In Table 10 the black columns show the increase in ECB assets or liabilities as a result of purchasing the bonds²² for a three percentage point increase in the fiscal deficit for each EU country. For only three countries would this purchase increase ECB liabilities and assets by more than 1%, Germany (2.2), France (1.4) and Italy (1.1). For 23 of the 27 countries the increase would be less than 0.5%, and for 11 less than 0.1%.

In the event of the fiscal deficit of a government increasing in one year by 3 percentage points, the ECB could avoid sovereign bond speculation by financing the deficit increase.

²⁰ In the case of households almost all investments are for residential mortgages.

²¹ The rate of growth of population varies across EU countries. Because a substantial proportion of country level growth results from migration among countries, the weighted EU average would be the appropriate rate. Since goods and capital can move freely among countries, the EU average for productivity growth or technical change is also appropriate. An ECB working paper in 2002 estimated overall productivity growth in the 1.5-2% range (ECB 2017, 48-49). Average population growth since 2000 has been about 0.5%. These statistics imply a Golden Rule inflation-adjusted interest rate in the 2-2.5% range.

²² The ECB adds a liability or debt when it creates the funds to purchase the national public bond. The bond itself is the off-setting asset.

The following principles should guide the design of constraints on national fiscal balances:

- 1. To prevent speculation and ensure stability of deficit financing, the ECB would pledge to purchase national public bonds at a pre-announced interest rate in the range of two to two-and-one-half percent.**
- 2. National fiscal balances would be assessed by whether they are sustainable. The appropriate measure would be the balance without interest payments, the primary balance.**
- 3. Public investment, like private investment, should as accepted standard practice be substantially financed by borrowing. This implies that the appropriate fiscal balance to target is current expenditure minus interest payments (the current primary balance).**
- 4. The sustainability guideline would be that over the average maturity of the public debt, the average current primary fiscal balance in GDP for that time period should not exceed the nominal rate of economic growth.²³**
- 5. Increasing the rate of economic growth is the most effective way to reduce the deficit-GDP ratio, and policy should work to this end, subject to sustainability.**
- 6. Deficit reduction policy would be consistent with GDP growth by (i) policies that increase the income elasticity of tax revenue (a shift from VAT to income taxes, and greater progressivity of the latter), and (ii) phasing adjustment over several years.**

The most effective policy for increasing the income elasticity of tax revenue would be to increase direct taxes on household and business incomes to replace indirect taxes (VAT being the most important).

We can state the reformed guidelines succinctly:

National governments would maintain the primary current budget deficit²⁴ to GDP ratio equal to or less than the rate of GDP growth. When this deficit ratio is greater than the growth rate, policies of adjustment should not reduce the rate of GDP growth. To facilitate adjustment, the ECB would prevent speculation on public bonds.

The present deficit rule suffers from the fundamental mistake of treating fiscal deficits as problems. The fiscal balance of governments is an automatic stabilizer that reduces the volatility of the national economy. The reformed approach would provide guidelines that allow the fiscal balance to fulfil its stabilizing role. To fulfil its stabilizing role the fiscal balance varies to compensate for fluctuations in private sector demand.

The fiscal management procedure would be as follows:

- 1. The distinction between the overall and primary balances allows for the automatic stabilizing function of fiscal policy.**

²³ For example, if GDP grows at an average of 2.5% for six years, the average primary current fiscal balance over that time period should not exceed minus 2.5% of GDP.

²⁴ i.e. excluding investment

2. The sale of public bonds funds public investment. National government can sell the bonds to private buyers or to public institutions (including central banks).

3. Public investment spending is relatively inflexible in the short term, and essential for the long term. Current expenditure is normally the appropriate instrument to reduce the cyclical instability that characterizes capitalist economies.

4. The fiscal guideline implies that national governments can vary current spending for counter-cyclical intervention by an amount equal to interest payments above and below the current primary balance (see Annex 1).

To state the guideline succinctly, over the average maturity period of the privately held public debt, the actual current primary balance should not fall below the current primary balance minus interest payments, or rise above the actual current primary balance plus interest payments. Using statistics for [public investment in recent years](#) the guidelines implies an overall fiscal deficit as defined by the convergence criteria in the range of minus 6 to plus 6 percent of GDP. See Annex for elaboration.

This guideline is subject to a fundamental caveat, that fiscal policy should maintain full employment without excessive inflationary pressure. The guideline does not prescribe what a fiscal balance should be. It sets reasonable upper and lower boundaries to allow for effective countercyclical fiscal management. In order to achieve that balance, national governments may find it necessary to exceed the limits.

Functional Public Debt Framework

Rational management of the public debt derives directly from the fiscal management procedure. The proposed new framework 1) uses the correct technical definition and measurement of debt, 2) recognizes the public debt as both asset and liability, and 3) employs debt management as a regulating mechanism for financial markets.

The excessive deficit/convergence criteria definition of public debt, reiterated in subsequent treaties, is the gross debt of the public sector, which covers all levels of government.²⁵ This definition has two major problems that render it inappropriate. First, it includes public liabilities but excludes liquid assets held by governments. Including assets with liabilities measures the net public debt, the measure used by most governments.²⁶ For example, a national central bank may hold the securities issued by other central banks. These are assets which by standard accounting practice balance against liabilities. Second, the gross measure includes public bonds held by public institutions. As shown in our previous study, for some

²⁵ General government gross debt according to the convergence criteria set out in the Maastricht Treaty comprises currency, bills and short- term bonds, other short- term loans and other medium- and long- term loans and bonds, defined according to ESA 95. ESA 95 is the abbreviation of the European System of regional and national accounts, which is almost identical to the System of National Accounts of the United Nations.

²⁶ The UK government has used the net measure since 1986, which it defines as follows:
Public Sector Net Debt records most financial liabilities issued by the public sector less its holdings of liquid financial assets, such as bank deposits. The financial liabilities usually have an explicit monetary value but are measured using their nominal values i.e., not at market prices. The majority of debt financing is through central government issues of government securities (gilts) and treasury bills.

<https://www.ons.gov.uk/ons/guide-method/method-quality/specific/economy/public-sector-statistics/government-and-public-sector-debt-measures.pdf>

EU countries the difference between gross and net debt is quite substantial (Smith & Weeks 2017, 53).²⁷

The appropriate measure for public debt management is the net debt excluding bonds held by public sector institutions.

Businesses and households assess their debt capacity by the cost of servicing debt, which is interest payments plus repayment of maturing debt. The same principle should apply to the public debts of EU national governments. The general guideline for public debt management can be stated simply.

The net debt of the public sector of an EU country should be sustainable. The net government public debt is sustainable if its fiscal cost over an appropriate debt management period is stable as a proportion of GDP that is less than the share of public investment in GDP.

This guideline has four elements 1) the appropriate debt measure, explained above, 2) the appropriate debt management period, 3) fiscal cost, and 4) the share of public investment as the upper limit to fiscal cost. Like businesses and households, governments contract debt over long periods. The assessment of the sustainability of a business or household debt is also done for an extended period.

Perhaps the single most important variable determining the sustainability of private debt is its time structure, when outstanding debt matures. If a household or business takes out a 100 year loan, it would be foolish to assess sustainability monthly. Because the future is uncertain, it would be equally foolish not to reassess sustainability every few years. The shorter the maturity period the shorter must be the assessment period.

Similar considerations apply to governments. The shorter is the maturity of public debt, the shorter must be the assessment period for sustainability. In 2010 when the global financial crisis struck, the average maturity period for public debt varied among 19 EU governments from 4.16 years (Hungary) to 8.30 (Austria) with an average of 6.28.²⁸ We recommend that the assessment of the sustainability of public debt be made by the country using the average maturity of the debt.

Concretely, that assessment would calculate the fiscal cost over the average maturity period, which would require projection of key macroeconomic variables such as growth in GDP, overall public expenditure and public revenue. We can now consider the calculation of fiscal cost and the justification for using public investment as the upper limit to debt service.

An EU government can repay maturing debt by replacing it with new debt that it sells in financial markets or to its central bank or other public institution. The interest paid by the central government on public debt held by public institutions may or may not return to the central government as revenue depending on the practice in each EU non-euro country. Country specific practice does not change a general rule that the fiscal cost of servicing public debt held by the public sector is zero.

²⁷ The gross debt of Finland in 2016 was over 70% of GDP. Liquid assets held by the Finnish government far exceeded outstanding debt paper, yielding a negative net debt of the public sector of minus 50% of GDP (Smith & Weeks 2017, Chart 3).

²⁸ For six governments the average exceeded seven years (Austria, Denmark, France, Greece, Italy and the Netherlands). For only two countries was the average less than five (Hungary and Finland). Source: <http://stats.oecd.org/Index.aspx?QueryId=53#>.

In the case of a government with a national currency, effective cost of debt service equals the interest paid to non-government bond holders, but not the repayment of principal. Control of a national currency provides the permanent option of replacing privately held debt with debt internal to the public sector. Debt that a government owes itself need never be repaid. In effect it has an infinite maturity.

The case of a euro zone country is not different if the ECB serves as buyer of national bonds at a fixed interest rate. Stated simply, euro zone governments cannot create money (euros). That privilege is limited to the European Central Bank. We do not object to the ECB monopoly over management of the common currency. That monopoly is essential to the orderly management of a common currency. It implies that national governments cannot replace maturing bonds held in the private sector with bonds held by public institutions, but the ECB can. Thus, as for governments with national currencies, the fiscal cost of debt service to euro one governments would be interest only.

In the discussion of fiscal deficits we recommended that treaties be changed to allow the ECB to purchase national public bonds at a fixed interest rate. This policy by the ECB would prevent public bond rates from rising above the fixed rate, for example 2.5%. The *maximum* debt service for every government is easily calculated as the fixed interest rate times the value of debt held by the private sector. The components of the calculation are both known to policy makers. Converting the debt service to its proportion of GDP requires projection of the national growth rate over a period equal to the average maturity of the public debt. GDP is perhaps the most commonly projected economic aggregate, involving well-established calculation methods.

The framework proposes that interest-only debt service as a share of GDP be equal to or less than the share of public investment in GDP. This guideline has a straightforward justification. If governments (directly or through public sector investment banks) choose public investments appropriately, these investments will produce a rate of return at least equal to the long run growth potential of each natural economy. Whether the return on these investments generates a cash flow is a policy decision.²⁹ Therefore, technically sound public investments generate a return, which over many years pay for the original investment outlays.

Constraining debt service to be equal to or less than public investment implies that the latter is the balancing item for the former. In effect, this guideline treats debt service as the cost of financing public investment, and instructs governments to equal public revenue to current primary expenditure. See Annex for elaboration.

ECB Mandate on Bond Rates

The European Central Bank is a public sector institution and under the proposed new framework it would facilitate the welfare of the peoples of the European Union. In our previous report we made detailed recommendations for changes in the ECB mandate, including changes for greater transparency and accountability. In this report we focus on the change that would facilitate an effective framework for public fiscal balances and public debt.

We have stated the policy change previously and now formalize it:

²⁹ A motorway with toll charges, as in Italy, is a public investment with an explicit cash flow. Construction of public sector schools generates a flow of productive services, education, funded in most countries by taxation.

The ECB shall maintain a maximum interest rate on national public bonds.

It will maintain a maximum rate by serving as the reserve buyer of national public bonds. To be specific, the ECB shall announce the maximum interest rate on public bonds, chosen to lie in the 2.0-2.5% range. In the event of any financial market offer to purchase bonds at a higher rate, the issuing government sells its new bonds to the ECB at the fixed rate.

Variants of this policy were implemented in the post-WWII years in the United States³⁰ and in Western European countries.³¹ The policies reflected Keynes's argument that full employment economic growth requires low and stable long run interest rates (Tily 2015).

³⁰ See Eichengreen and Garber (1991).

³¹ The argument for interest rate regulation in Britain is found in the famous Radcliffe Report (1959), which is discussed in a Bank of England article. <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/1969/the-operation-of-monetary-policy-since-the-radcliffe-report>.

Annex 1: Debt and Deficit Guidelines

The algebra of our debt and deficit guidelines is quite simple. First, we define the symbols.

b is the overall fiscal balance divided by GDP

t is public revenue divided by GDP

α is current expenditure less interest payments divided by GDP

β is public investment divided by GDP

$g = (\alpha + \beta)$

δ is interest payments on the privately held public debt divided by GDP

r^* is the maximum bond rate, set by the ECB

n is the net public debt, divided by GDP

The overall fiscal balance is

$$b = t - g = t - (\alpha + \beta)$$

Primary balance is $b^P = b - \alpha$

$$b^P = b - \delta$$

Maximum interest payments equal the ECB maximum interest rate times the net privately held public debt.

$$\delta = r^*n$$

When we substitute, the primary balance is

$$b^P = b - r^*n$$

Current expenditure balance is

$$b^C = \alpha + r^*n$$

The fiscal guideline is

$$[\alpha - r^*n] < \alpha < [\alpha + r^*n]$$

This is subject to the constraint that r^*n not exceed β . When at the upper limit, $r^*n = \beta$ the fiscal guideline becomes

$$[\alpha - \beta] < \alpha < [\alpha + \beta]$$

The guideline instructs governments to set revenue to equal current primary expenditure over the maturity period of the privately held public debt. During 2015-2017 the share of public investment in GDP for all EU countries was about 3% and slightly lower for euro zone countries. That average implies that the overall fiscal deficit by the excessive deficit/convergence criteria definition could vary (according to circumstances at given times) from minus 6 to plus 6 percent of GDP.

Annex 2: Structural Deficits, Theory and Measurement

Pro-cyclical nature of the Excessive Deficit Procedure

As noted in this report, the member states of the euro zone have, by ratifying the 2012 Treaty on Stability etc., undertaken international legal obligations to comply with its provisions, which include the duty to achieve a balanced or in surplus budget, as defined. Some form of this obligation (which is already a Medium Term Objective under EU legislation) is likely to be integrated into EU law in the not-too-distant future.

The provisions of Article 3 of the Treaty are therefore highly significant, now and for the future, and in particular provide:

“The Contracting Parties shall apply the following rules, in addition and without prejudice to the obligations derived from European Union law:

(a) The budgetary position of the general government shall be balanced or in surplus.

(b) The rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective as defined in the revised Stability and Growth Pact with a lower limit of a structural deficit of 0.5 % of the gross domestic product at market prices. The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time frame for such convergence will be proposed by the Commission taking into consideration country-specific sustainability risks.”

This text itself is sufficient to establish the pro-cyclical nature of EU budgetary rules, no matter how one defines and measures the “structural deficit”. The Excessive Deficit Procedure (EDP) under Article 3 thus effectively requires that the first principle of every EU national government’s policy is to achieve a fiscal outcome in which the budget is “balanced or in surplus”. To use a technical term, this makes the budget balance “endogenous” to the level of national income (GDP).

In the following algebra, $Y = \text{GDP}$, $T = \text{total public revenue}$, $G = \text{total public expenditure}$, and $B = T - G$. For simplicity, again we assume that public revenue is a constant proportion of GDP. This would be the case if 1) rates do not change, 2) all tax revenue comes from fixed rate levies on expenditure (eg. VAT), personal incomes and corporate profits; and 4) either the personal income tax is flat-rate or the distribution of income does not change.

Using the same notation as in Annex 1,

$$B = T - G$$

$$T = tY$$

$$B = tY - G$$

In the simplest case, the EU budget rule requires that

$$0 = tY - G$$

Therefore,

$$G = tY$$

The level of GDP and the tax rate determine the level of government spending. In the “medium term” a national government has no scope for countercyclical fiscal policy. If national income suffers a decline, as in 2008-2009, tY (average tax share times national

income) falls. When tY falls, G must fall or t must rise to maintain a zero budget balance. Both policy measures, less G and more T , will depress national income.

However one measures the deficit, the requirement that it conform to a specified share of GDP is pro-cyclical, deepening recessions. Because the EDP does not specify an upper limit to a surplus, it need not add to inflationary pressures during booms.

Measurement of the Structural Deficit

The EDP defines the structural deficit as “‘annual structural balance of the general government’ refers to the annual cyclically-adjusted balance net of one-off and temporary measures”. The document explaining the measurement of the structural deficit, we read (emphasis in original),

The structural budget balance is a **nominal budget balance adjusted by the cyclical component and net of one-off and temporary measures**. In line with the methodology used in the SGP [Stability and Growth Pact], the cyclical component of the budget is subtracted from the actual budget balance. The cyclical component is calculated as the product of the output gap (difference between actual and potential GDP as percent of potential GDP) and a parameter reflecting the automatic reaction of the government balance to an output gap change.

This cyclically adjusted budget balance corresponds to a budget balance prevailing if the economy was running at its full potential.

As it is based on estimates of the potential output, the structural balance is vulnerable to uncertainty and revisions. (Angerer, Hagelstam & Minkina 2017, 1)³²

Despite proposals for more sophisticated measures,³³ this quotation indicates clearly that the so-called structural deficit involves simple multiplicative or exponential adjustment that transforms the actual budget balance to what would be the balance at a hypothetical “potential GDP”. In very simple algebra, the structural deficit is some number (z) times potential GDP (Y_{ptl}) minus actual GDP (Y_{act}).

$$d_{str} = z[Y_{ptl} - Y_{act}]$$

A blog post on the website of the (strongly pro-EU) Bruegel Institute summarizes the problems succinctly,

“However simple is the intuition [behind the concept], the structural balance is not observable and its estimation implicates difficulties, uncertainties and controversies” .

They add that estimating “potential output” is the most dubious part of the calculation.³⁴

³² The technical version of the calculation is in [Economic Papers](#) 420 (2010).

³³ For example, Arjoca and donca (2015) propose decomposing both taxes and revenue and estimating the behaviour of each over the business cycle. Kuusi (2015) proposes several alternatives to the simplistic method used by the European commission.

³⁴ The potential output methodology used in the EU is based in a “production function”, in which quantities of undifferentiated labour and homogeneous machinery (“capital”) combine in an equation to generate a number for output. Over sixty years ago Joan Robinson discredited this methodology (Robinson 1953-54). Its return indicates a resurgence of right wing ideology in economics. The basic problem is that there is no theoretically or

Structural Deficit in Practice

In addition to these problems of estimation, the structural deficit suffers from faulty conceptualization, a problem that requires no knowledge of economics to understand. Let us suppose that we solve the insolvable problem of calculating a methodologically sound “potential output”. Suppose that our economy is at 90% of potential, with a fiscal balance of minus 8 percent of actual GDP. Our estimation method tells us that at potential output (100%), the deficit would be 6% of (potential) GDP.

This calculation does not tell us how we might achieve that potential; it does not even tell us if we could reach that potential. All the EDP calculation of “structural deficit” tells us that it is necessary to reduce public expenditure and/or increase public revenue *in order to achieve an appropriate calculation that is hypothetical*. Yet, we know that both expenditure cuts and tax increases depress the economy.

The structural balance calculation sets in process an Excessive Deficit Procedure that makes it impossible to achieve potential output. The “structural balance” is in practice a pseudo-technocratic cover for pro-cyclical fiscal policy. To disguise the pro-cyclical nature of the concept various diversionary words are used, “one-off and temporary”, “cyclical component”, and “medium-term target”. These do not change the essential role, to enforce balanced budgets through pro-cyclical tax increases and expenditure cuts.

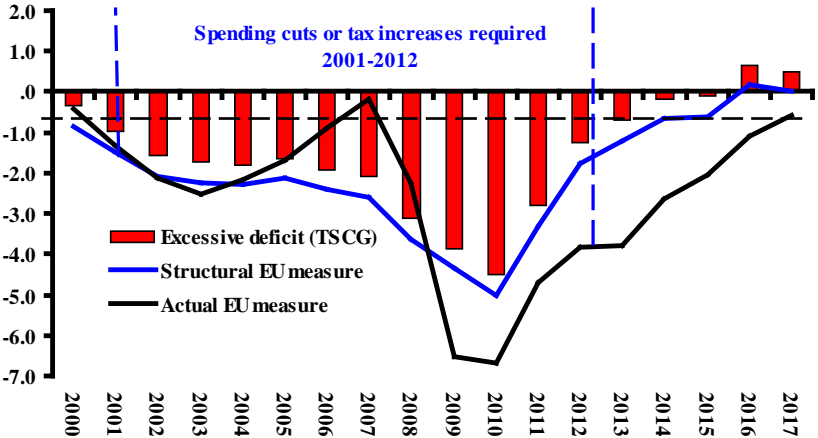
The policy requirement in the Article 3 Excessive Deficit Procedure is clear. To repeat the quotation from the Article and set out earlier in this annex,

The [balanced budget] rule...shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective as defined in the revised Stability and Growth Pact with a lower limit of a structural deficit of 0.5 % of the gross domestic product at market prices. The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective.

Chart A2.1 demonstrates the pro-cyclical implications of the structural budget concept. The EU countries (see notes to chart for details). During the 18 years, 2000-2017, the average structural deficit failed to meet the 0.5% target in 13. If we treat these 21 countries as one, and had the EDP been in effect for the entire period, the European Commission would have been legally bound to enforce fiscal austerity, spending cuts or tax increases, for 15 consecutive years.

practically sound method to measure either the total labour force, due to skill differences, or capital, because of differences in quality and problems of obsolescence. See Weeks (2010, Chapter 10).

Chart A2.1
Actual and Structural General Government Fiscal Balances,
Average for 21 EU Members, 2000-2017 (percentage of GP)

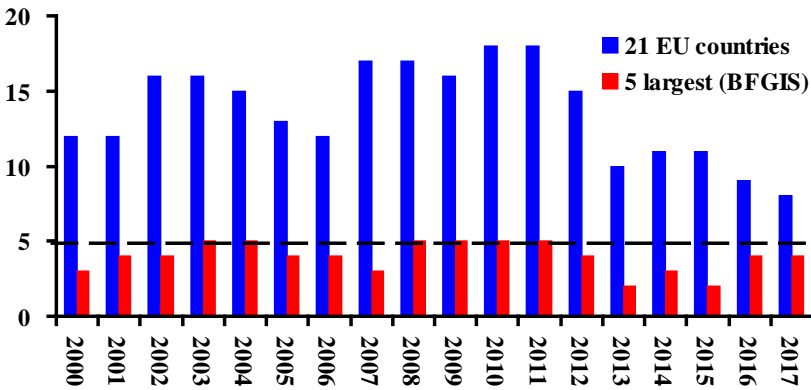


Note: the red columns are the structural deficit minus 0.5. See text. For some countries the structural balance statistic is not available. Countries included are: Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Luxembourg, Netherlands, Poland, Portugal, Slovenia, Spain, Sweden and United Kingdom.
 Source: [Eurostat](#) and [OECD](#).

Chart A2.2 shows the pro-cyclical implications at the country level, which counts the number of governments which would have been in breach of the EDP rule had it been in effect for the 18 years. In only two years was less than a majority of governments above minus 0.5% of GDP (2016 and 2017). In 14 of 18 years at least four of the EU’s largest economies were in breach of the minus 0.5% (2000, 2013, 2014 and 2015).

In summary, if enforced the structural deficit target will have a substantial growth depressing impact on EU members countries and the EU economy as a whole. It institutionalizes pro-cyclical fiscal austerity.

Chart A2.2
Number of Countries in Breach of Structural Balance Rule,
2000-2017



Note: Same 21 countries as in previous Chart, “5 Largest (BFGIS) refers to Britain (United Kingdom), France, Germany, Italy and Spain.
 Source: [Eurostat](#) and [OECD](#).

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