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BEYOND AUSTERITY
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A EUROPEAN RECOVERY POLICY IS FEASIBLE

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ABSTRACT – The European Council of 8 February 2013, with its decision to cut the EU budget to 1% of GDP, made a great mistake: it aggravated the recession of the European economy and, tacitly, admitted that a European recovery policy is impossible. In this paper the Authors show that with an annual EU budget of only 1.19% of GDP, a recovery plan of 2% of GDP is possible, in order to fill the gap in European aggregate demand for investment and consumption. The twofold aim of this exercise is to show that European parties and leaders can put forward an alternative economic policy to austerity and that European fiscal imbalance is one of the major causes of the crisis of democracy in Europe.

Keywords: Recovery, European Union, Federalism. **JEL classification**: E62, F42, F55

> "The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. … It shall promote economic, social and territorial cohesion, and solidarity among Member States …"
>
> Article 3.3 of the *Lisbon Treaty*

1. Aims and means of European economic policy

Anyone who reads the first articles of the *Lisbon Treaty,* particularly Article 3 cited above, cannot but be struck by the gap that exists between the ambitious aims proclaimed and the deplorable state of the Union's economy. This remark does not refer only to the Union after the financial and the sovereign debt crisis. The reasons for the failure of the Union's economic policy need to be looked for much further back in time. In 1957, a Common Market was set up but at the end of the 1960s only commodities were circulating freely in Europe. In 1986, the Single European Market Treaty established that all internal physical barriers hindering the free circulation of people, commodities, capital and services were to be abolished by 1992. 90% of the original aims were achieved, but today a single market for services has yet to be created; many industrial sectors have their own "national champions" but no "European champion" has come forth; each national government maintains its own energy sector and deals directly with foreign suppliers; national governments compete for low company taxation, since harmonisation of tax laws requires an unlikely unanimity. In 2000, the EU launched the Lisbon strategy in order to "make Europe, by 2010, the most competitive and dynamic knowledge-based economy in the world." Today this claim sounds utterly empty. Rates of productivity, competitiveness and employment – as before the financial crisis – are still much lower than in the US. In environment policy, the EU managed to establish a market for tradable permits, but the price of CO_2 is kept so low that the declared goal for 2020 is unlikely to be achieved. Finally, we should not forget how the sovereign debt crisis demonstrated a pitiful degree of economic, social and territorial cohesion among member states, divided into "surplus" and "deficit" countries, not to speak of the lack of "solidarity", absent from

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any agenda. The expulsion of Greece from the EMU was taken into serious consideration by some governments.

Many of the existing gaps between aims and achievements should be looked for in the Maastricht Treaty, which set up a Monetary Union without an Economic Union, despite the acronym adopted (EMU). The establishment of a monetary union whilst preserving all the main fiscal powers at the national level was an unhappy compromise. The European Commission could rely on a very limited EU budget – a little more than 1% of EU GDP – insufficient for carrying out the main goals entrusted to the EU by the Treaty. The illusion is that EU aims can be achieved without a government: in fact, governance, not government, was the terminology used for the feeble political system.

At the end of 2012, the European Commission presented *A Blueprint for a Deep and Genuine EMU* (EC, 2012a), outlining the creation of a European fiscal union, endowed with its own fiscal resources and fiscal capacity. At last, this suggested a change for the future of Europe. But the decision of the European Council (2013) to reduce the EU budget by 3.5% (compared to the previous MFF and 8% if compared to the EC proposal) for the Multiannual Financial Framework 2014-20 dashed all such hope. After four years of European recession, cutting European expenditure – a pro-cycle policy – can only be considered an act of economic recklessness. How was this decision possible? The first and simplest answer is the internal logic of the inter-governmental decision-making process. When 27 heads of state and government sit around a table, each thinks of his or her own national interest and, since fiscal consolidation is today the predominant economic policy, the EU budget is thought of as a safe that has been left open and unguarded for anyone to filch what they want. But there is a second and more structural explanation. Europe's political parties are unable to view the EU budget as an instrument of economic policy. Even at the height of the crisis, the European Parliament was unable to put forward effective proposals to mitigate unemployment and social distress via the implementation of extraordinary EU policies. The EU budget – established for seven years in the MFF – is considered a fund for day-to-day business, not an instrument of EU economic policy.

In the current public debate on the future of the EU economy, two conflicting points of view can be seen. One the one hand: austerity, based on a policy of fiscal consolidation in the belief that this will lead to growth in the future (when?); and, the opposing side, supporting the view that, since austerity is not the road to recovery, it is time to end the most severe austerity measures or, at least, postpon them. In this paper we attempt to show that both sides are wrong, because they are geared to national recovery, ignoring the role of the EU budget for long term European prosperity. In this paper, we present an alternative European recovery policy based on a EU budget of 1.19% of GDP. This modest amount has been chosen in order to indicate that the European Council of February 8 2013 could have taken a different decision, whilst maintaining the ceiling of the EU budget below 1.23% of annual appropriations. Unfortunately, an alternative MFF was not even discussed: nobody, not even the European Parliament, proposed increasing the EU budget a little in order to combat the economic downturn. Initially, we will attempt to clarify the ideological basis of this inexplicable blindness.

2. Neoliberalism, Keynesianism and the nation state

Economic theory does not only establish itself in the forefront of thinking through logical consistency, but also through its ability to explain and lead social forces. Social facts are very different from physical facts. The height of a mountain can be measured and does not depend on our convictions: nature involves the observation of brute facts, as John Searle (2010) calls them. Not so social reality: civilization is founded on institutions whose functioning can be explained and, if necessary, changed by human understanding and will. Institutions – such as the family, the sports club, the Church, the Trade Union and the State – are the glue that holds human societies together.

Human institutions evolve, have a history and work effectively on the basis of systems of thought, called culture or, in some cases, ideology.

The history of economics, as a social science, started in the modern age when classical economists discovered the market system and its relations with the state. Adam Smith's *Wealth of Nations* is considered not only a landmark of economics, but also of political science, since Smith accurately defines the limits of sovereign power in private activities. Since then, inevitably, every serious economic theory has also been a theory of the state. In recent times, one fierce debate over the relationship between the state and the market was the Hayek vs Keynes argument (Wapshot, 2011), the former being regarded as the champion of the free market and the latter the advocate of state intervention. Of course, Hayek and Keynes were much more nuanced economists than this suggests and the history of economic thought includes other influential thinkers such as Milton Friedman, and a whole range of positions on monetarism and post-Keynesian economics.

Even this picture is oversimplified, however, because it disregards the international system. Keynes and Hayek worked out a theoretical framework concerning the role of the national government vis-à-vis its home market; rarely were they obliged to consider the international order too (this statement is certainly correct for Keynes's *General Theory*, but it can be considered unfair for Keynes's proposals in view of the Bretton Woods conference). Indeed, it is impossible to study the role of the state in the economy in an international vacuum. The fate of liberalism, socialism and nationalism (autarchy) are closely related to the evolution of the international balance of power. For instance, during the cold war, and the ideological clash between free market and planned economies, in Western Europe and the United States several left-wing economists criticized the capitalist system on the basis of Marxist theory. But after the fall of the Berlin Wall and the breakdown of the Soviet Union, Marxist thinking is either fading away or trying to shape new frameworks of critical thinking.

The years of the Bretton Woods agreement are considered the heyday of Keynesianism. US hegemony ensured the smooth working of the system of fixed exchange rates, international monetary and financial stability, a free market economy and a remarkable post-war recovery in Europe and Japan. The Bretton Woods system was based on the prohibition of the free movement of capital internationally and, at least in this sense, was Keynesian; therefore national governments had a certain national margin of manoeuvre for fiscal policy and control over effective demand, output and employment. But when the Bretton Woods system collapsed, the new dollar standard – a system based on floating exchange rates – opened the way for an unstoppable world-wide movement of capital, the rise of multinationals and the flow of cheap labour towards the most affluent nations: in a word, globalization. This international framework is crucial to understand the demise of Keynesian economics, the political success of Thatcherite and Reaganite economic policy and the intellectual dominance of monetarism, supply-side economics and neoliberalism. Globalization is also crucial to understand the increasing dominance of the world market over the nation state, whose power to control the economy has become inadequate. Neoliberalism calls for a minimum state (a night-watchman) and praises, sometimes groundlessly, the virtues of the free market over public policies: as Tzvetan Todorov says, neoliberalism leads to a paradox: "individual liberty – in whose name all state intervention is rejected – is hampered by the unrestricted liberty afforded to the market and companies." (Todorov, 2012: 126)

European integration is at odds with the neoliberal model of international relations. It originated in the political desire to overcome bloody divisions among national peoples; to prevent further wars in Europe. Therefore, the founding fathers of European unity sought to build a federal union or, more precisely, a supranational federal union. Of course, European integration is not free of the defects of Keynesianism and neoliberalism but, as we shall see in the following sections, the European Union has the potential to overcome Todorov's paradox: with appropriate supranational policies, public and private wellbeing are not necessarily at odds with one another, but can become complementary.

3. The European Union: from negative to positive integration

European integration was not founded on a fully-fledged federation, but on a compromise: supranational European institutions were endowed with sovereign power in some sectors of the economy. To understand this new kind of institution, which is more a political process than a state, Jean Tinbergen (1954: Ch. 8) suggested distinguishing between negative and positive integration. Negative integration involved abolishing the barriers between the six economies of the founder members. After WWII integration was hampered by high customs duties and tight national controls over the free movement of people, services and capital. In order to build a common market, it was more important to remove barriers than to build a top-heavy system of supranational government. Moreover, during the first phase of European integration, the Bretton Woods system provided a stable international monetary system within which the Common Market could build and develop. Indeed, the dollar was the real European currency. Within this framework, for national governments, it was also possible to benefit from sound public finance, since in the Common Market the free movement of capital was forbidden.

The amazing rate of growth in the European economy during the Bretton Woods era – the European miracle – required only a light supranational system of government, because it was founded on the pillar of international monetary stability, provided by US hegemony. When the Bretton Woods system collapsed, the Common Market came crashing down with it. During the Seventies, two oil crises and uncontrolled floating exchange rates convinced European governments that, a further step toward positive integration was necessary in order to save the European economy. The core of the positive integration strategy was the project for monetary union. More than twenty years were needed, from the Werner plan (1970) to the Maastricht Treaty (1992), to establish Economic and Monetary Union.

Here, our task does not include giving a broad historical explanation of the events leading up to the Maastricht Treaty, such as German reunification and French fears of a German Europe. Our aim is merely to point out two internal inconsistencies of the EMU set up by Maastricht. The first concerns the relationship between the monetary union and the growth of the European economy. The Werner plan clearly warned that the creation of a monetary union would require a substantial increase of the European budget, because the coordination of national policies was not sufficient to provide anti-cyclical policies, regional cohesion and growth. The McDougall Report (1977), prepared for the European Commission, recommended a European budget of 2-2.5% of GDP for a pre-federal phase and 5-7% for the federal phase. Moreover, in 1981, the French President, Mitterrand, launched a plan called "Socialism with French colours," whose aim was to increase wages and public investments to stimulate domestic demand. Very soon it was clear that the plan was doomed to fail: the increase in public expenditure and demand caused an untenable external deficit, internal inflation and the devaluation of the French franc. The French government was obliged to choose between autarchy and European integration. As Eichengreen says, after this Keynesian experiment: "Mitterrand obligingly cut public spending and raised taxes. He abandoned the strategy of expansionary fiscal policy: … This was a turning point for France and for Europe. The Socialists had learned that unilateral expansionism was not possible" (Eichengreen, 2007: 290). Therefore, in view of Maastricht, the political leaders were aware of the shortcomings of light European supranational government, but they preferred to leave the problem to their successors. Growth policies were delegated to national governments.

The second inconsistency concerns the relationship between monetary and financial stability. In the Maastricht Treaty, monetary policy is entrusted to the ECB, whose main goal is price stability. The independence of the ECB from government interference is enshrined in the "no bail-out" clause and the Stability and Growth Pact (SGP) of 1997. However, some "large" countries – Germany and France in 2002-3 - failed to keep to the parameters of the SGP (3% ratio of budget deficit/GDP and 60% for debt/GDP). The decision to maintain, within a monetary union, national fiscal sovereignty was clearly inconsistent. This second inconsistency is tightly connected to the first. In Europe, the living standards of society – roughly epitomized in the "European welfare state" formula – enables every citizen to benefit from a certain level of social services and protection against risks. If the European system of government, or governance, fails to provide a minimum standard of living, citizens perceive monetary union as an unbearable constraint: national governments are pushed to break the parameters of the SGP, placing the monetary and financial stability of the EMU at risk.

As stated above, these two inconsistencies were not unfamiliar to the architects of the Maastricht Treaty. The Treaty had only just been signed, when the President of the Commission, Jacques Delors, in 1993, launched a plan for *Growth, Competitiveness and Employment. The Challenges and Ways forward into the 21st Century* (EC, 1993). Trade unions and the business community welcomed the plan. But the Council of financial ministers refused to finance it, saying that the political priority was national structural reforms (perhaps the real reason was that Delors had proposed financing the plan by issuing EU bonds). The unsettettled problem was European growth. Later on, in 2000, the European Council launched the Lisbon Strategy, based on the notion that European growth could be achieved by spontaneous cooperation between national governments. More than twenty years after the Maastricht Treaty, the only growth policies carried out within the EMU are so-called structural reforms: rendering the labour market more flexible, lowering labour costs, curtailing social rights, making environmental business more attractive and consolidating national public finances, eventually increasing consumer taxation (VAT). The agreement on supply-side economics and neoliberalism was not a choice; there was no serious alternative; it was the only way for national governments to increase the productivity of their economies and to create more jobs.

After the financial crisis, sovereign debt crisis and European recession brought on by austerity policies, the time has come to propose a supranational macroeconomic approach to European recovery and to the global challenges facing the EU. Today a set of policies for positive integration is not being discussed by EU leaders. In this paper, we struggle against a deeply rooted conviction in economic theory and virtually a taboo for policy makers: that is the belief that in Europe it is not possible to adopt policies to stimulate supranational effective demand. However, in economics, both supply and demand must be taken into consideration; these are the crucial forces determining economic variables. In macroeconomic textbooks the aggregate supply and aggregate demand (AS-AD) model is commonly adopted to understand the forces determining prices and output in national economies. But aggregate supply and aggregate demand do not depend on pure market forces; public institutions also play a part. After analyzing the current state of the European economy, in this paper we put forward: a) a policy to stimulate aggregate demand and aggregate income in the EU by means of more public and private investment, without causing European deficit spending; b) a set of policies to reinforce national welfare systems under a common European roof, because new jobs today are not created only by the market but also by public institutions, from municipalities right up to the European government.

4. Crisis, debt and austerity

Government deficits and debts did not cause the financial crisis. In the period 2003-2007, in the EU the deficit/GDP ratio was on a decreasing path with a generalized movement toward balanced public finance (Table 1). In the same period (Table 2), on average, the debt/GDP ratio slightly exceeded 60% but in 2007, just before the crisis, it reached the satisfactory value of 59%. It is also interesting to observe that before 2008, among the countries hit by the sovereign debt crisis, Spain was running a government surplus, Ireland had always comfortably met the Maastricht parameters, and Italy was running a primary surplus which enabled the country in a few years to cut the deficit/GDP ratio to 1.6% (in 2007). In the so-called PIIGS group, only two countries, Portugal and to a larger extent Greece, had evident problems in public finances before the crisis.

Table 1: Government deficit/GDP ratios

	2003	2004	2005	2006	2007	2008	2009	2010	2011
EU (27)	-3.2	-2.9	-2.5	-1.5	-0.9	-2.4	-6.9	-6.5	-4.4
Germany	-4.2	-3.8	-3.3	-1.6	0.2	-0.1	-3.1	-4.1	-0.8
France	-4.1	-3.6	-2.9	-2.3	-2.7	-3.3	-7.5	-7.1	-5.2
UK	-3.4	-3.5	-3.4	-2.7	-2.8	-5.1	-11.5	-10.2	-7.8
Italy	-3.6	-3.5	-4.4	-3.4	-1.6	-2.7	-5.4	-4.5	-3.9
Ireland	0.4	1.4	1.7	2.9	0.1	-7.4	-13.9	-30.9	-13.4
Portugal	-3.7	-4	-6.5	-4.6	-3.1	-3.6	-10.2	-9.8	-4.4
Spain	-0.3	-0.1	1.3	2.4	1.9	-4.5	-11.2	-9.7	-9.4
Greece	-5.6	-7.5	-5.2	-5.7	-6.5	-9.8	-15.6	-10.7	-9.4

Source: Eurostat

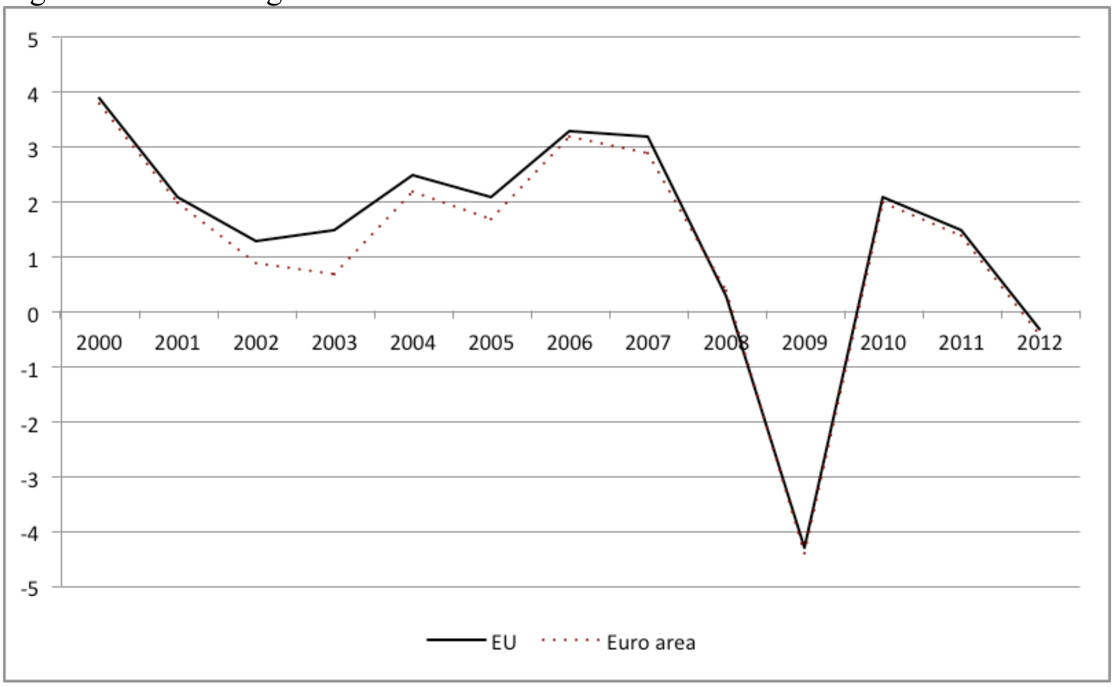
Table 2 : Government debt/GDP ratios

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
EU (27)	61.9	61	60.5	61.9	62.3	62.8	61.6	59	62.2	74.6	80	82.5
Germany	60.2	59.1	60.7	64.4	66.2	68.5	68	65.2	66.8	74.5	82.5	80.5
France	57.3	56.9	58.8	62.9	64.9	66.4	63.7	64.2	68.2	79.2	82.3	86
UK	41	37.7	37.7	39.1	41	42.2	43.3	44.2	52.3	67.8	79.4	85
Italy	108.5	108.2	105.1	103.9	103.4	105.7	106.3	103.3	106.1	116.4	119.2	120.7
Ireland	35.1	35.2	32	30.7	29.5	27.3	24.6	25.1	44.5	64.9	92.2	106.4
Portugal	50.7	53.8	56.8	59.4	61.9	67.7	69.4	68.4	71.7	83.2	93.5	108.1
Spain	59.4	55.6	52.6	48.8	46.3	43.2	39.7	36.3	40.2	53.9	61.5	69.3
Greece	103.4	103.7	101.7	97.4	98.6	100	106.1	107.4	112.9	129.7	148.3	170.6

Source: Eurostat

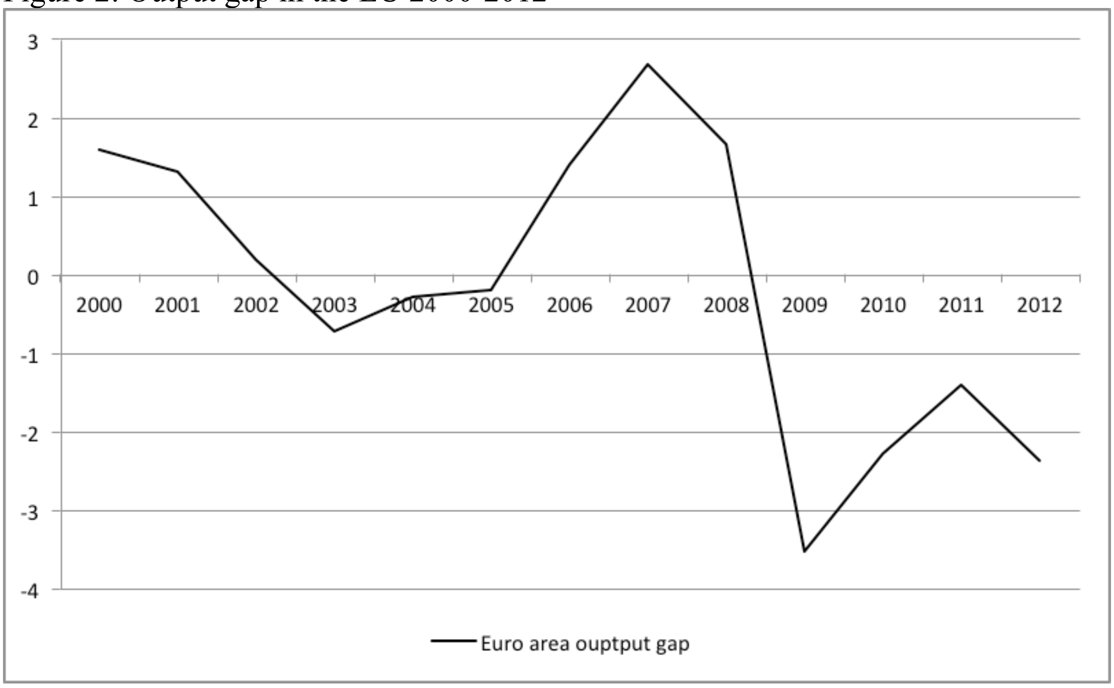
After 2007, public finance parameters rapidly deteriorated in the whole EU area, primarily as a consequence of the fall in GDP due to the international financial crisis and subsequent global recession. Figure 1 shows real GDP growth rates in the EU and euro area. After 2007, a sharp reversal of the previous positive trend is evident. In two years, the EU annual growth rate fell from 3.2% in 2007 to -4.3% in 2009. In 2010, the growth rate rebounded (2.1%) but soon fell again leading the EU and the euro area into a new recession in 2012. Comparing pre and post crisis period data it can be seen that, notwithstanding the recovery of 2010-2011, after 2008 the average rate of growth has been negative (-0.14% in the EU overall and -0.2% in the euro area) while it was above 2% (2.48% in the EU and 2.18% in the euro area) until 2007. This data suggests that the EU has not been able to recover output lost through the crisis. A look at output gap statistics makes this point even clearer. The output gap measures the percentage difference between potential output, i.e. the output which can be produced by utilizing the productive resources of an economy at their "normal" non-inflationary level, and actual output. Figure 2 shows that from 2000 to 2007, the output gap was cyclical, but on average it had a positive deviation of 0.75. Whereas, after 2008 the output gap became negative, with an average value of -1.58. This means that over the last four years, the EU economy has been working steadily below full capacity, and did so even when growth rates were positive, as in 2010 and 2011. In our opinion, this is a clear sign of domestic demand shortage in the EU economy. Table 3 supports this conclusion. The EU has not been able to recover the dramatic drop in domestic demand that occurred in 2009 and at the end of 2012, the accumulated percentage loss in domestic demand compared to 2007 was -3.1%. In terms of individual components, investment (gross fixed capital formation) made the largest negative contribution to aggregate demand, followed by private consumption, which at the end of 2011 was slightly below the 2007 level. The slowdown in Government consumption is also evident, while, with the exception of 2009, net exports have been giving a positive contribution to EU aggregate demand. A demand shortage rather than a supply shortage is at work.

Figure 1: Real GDP growth rates in the EU and euro area 2000-2012



Source: Eurostat

Figure 2: Output gap in the EU 2000-2012



Source: Eurostat

Table 3: EU Real aggregate demand components – yearly percentage change 2007-2012

	2007	2008	2009	2010	2011	2012
Domestic demand	3,3	0,2	-4,2	1,6	0,6	-1,3
Private consumption	2,2	0,3	-1,8	1,0	0,1	
Government consumption	0,9	2,2	1,4	0,0	-1,4	
Gross fixed capital formation	6,3	-1,2	-13,0	0,2	1,4	-2,2
Net export	-0,3	0,5	-0,1	1,0	2,3	2,1
Exports	5,6	1,6	-11,7	10,7	6,4	2,2
Imports	5,9	1,1	-11,6	9,7	4,1	0,1

Source: Eurostat, GDP and main components – volumes (nama_gdp_k tables)

Lack of demand has also exacerbated the problem of unemployment, particularly for young people. In the first half of the 2000s, unemployment in the EU was around 20 million. From 2005 to 2007 that number fell, reaching a minimum of 16 million. After 2007, in five years the number of unemployed people rose by 10 million, reaching 26 million at the end of 2012. In the same period, the EU aggregate unemployment rate rose from 7.2% to 11.8% (November 2012). Even more dramatic is the situation of young workers under 25 years of age, where unemployment was slowly decreasing before the crisis, and then jumped from 15.7% in 2007 to 21.4% in 2011, with their share of total unemployment increasing to above 9% (Eurostat).

The drop in GDP explains why, in 2009, the deficit/GDP ratio in the EU stood at a record negative value of -6.9% (Table 1) and the debt/GDP ratio started to rise, passing 90% in 2012. It is well-known that during a recession GDP losses automatically cause both deficit and debt/GDP ratios to rise. In addition, the bailout of the private banking system by several Governments adversely affected public budgets further worsening these two fiscal ratios. Ireland is a striking example: the massive bailout of the entire banking sector by the Irish Government caused the deficit/GDP ratio to move from balance in 2007 to a huge deficit (-30.9%) in 2009! As a consequence, in a few years, the debt/GDP ratio skyrocketed from the very low value of 25.1% in 2007 to an unprecedented 106.4% in 2011. A private debt and banking crisis became a sovereign debt crisis.

The political response by European authorities to the sovereign debt crisis has so far been that of "country by country" fiscal consolidation along the lines of the new Fiscal Compact: government budgets must be balanced and any country exceeding a 60% debt/GDP ratio must reduce it at the steady pace of 5% each year. This strategy is based on two main assumptions: the first is that "sound" public finance is necessary to foster economic growth and that fiscal consolidation has negligible effects on GDP or, under some conditions, may positively affect consumer and entrepreneurial confidence fostering demand and investments, as in the "expansionary fiscal contraction" hypothesis (Alesina and Ardagna, 2012; Alesina and Perotti, 1997; Giavazzi and Pagano, 1996). The proponents of this view usually assume that the fiscal multiplier is smaller than 1 (typically around 0.5) or even zero, so that the negative impact of restrictive fiscal policy on GDP is relatively small. The second assumption is that the logic of the "house in order" perfectly fits the current EU situation. If each individual country correctly implements "structural reform" and keeps its public finances under control, than the entire EU will benefit without the need for explicit supranational economic policies. In our view, both assumptions are questionable.

The actual value of the fiscal multiplier is a long debated question. In standard Keynesian theory, a restrictive fiscal policy has a negative impact on GDP, both in the case of tax increases and of expenditure cuts. The reason is simply that fiscal restriction cuts aggregate demand and therefore output. Only simultaneous monetary expansion with sufficiently low real interest rates can counteract the negative impact of fiscal policy. Proponents of "expansionary fiscal contraction" add two new elements to the traditional Keynesian picture: a confidence channel and Ricardian equivalence. In their view, rational agents know that today's government expenditure cuts imply lower taxes tomorrow. The expectation of higher disposable income in turn increases consumption, offsetting the government expenditure cuts so aggregate demand remains constant. Furthermore, the expectations of lower taxes and interest rates should increase confidence in a future “pro-business” environment fostering private investment (the “crowding in” effect of fiscal restraint). The bottom line is that fiscal consolidation is either “neutral” or “positive” in relation to GDP. The assumption of full rationality by agents and the empirical validity of the Ricardian equivalence hypothesis are highly debatable, and recently Perotti (2011), an early proponent of the approach, has raised doubts about the validity of the policy prescriptions suggested. However, the “expansionary fiscal contraction” view is not necessary to justify the usefulness of countries in the EU simultaneously implementing fiscal consolidation programmes. What matters is that the fiscal multiplier is actually very small. In this event, the long run benefits of balanced government budgets and low debt should outweigh the small short run negative effects of fiscal restriction. But recent empirical literature on fiscal multipliers contradicts this idea (Auerbach and Gorodnichenko, 2012; Barrel et al., 2012; Batini et al., 2012; Blanchard and Leigh, 2013; Cristiano et al., 2011; Coenen et al., 2012; Holland and Portes, 2012; IMF, 2012). The main findings about the fiscal multiplier can be summarized as follows:

1. the value of the fiscal multiplier differs from country to country and with economic conditions;
2. in “normal” times, when the economy works around full capacity, the fiscal multiplier is smaller than one and often very often close to zero;
3. In periods of recession and stagnation, when the interest rate has bottomed out the fiscal multiplier is greater than one, sometimes even above 2.

Coenen et al. (2012) use seven different structural models to compute the value of the fiscal multiplier in the USA and the EU with and without an accommodating monetary policy. In the case of no monetary accommodation, their first year istantaneous government consumption multiplier ranges between 0.7 and 1 for the US and between 0.8-0.9 for the EU. In the case of accommodating monetary policy the multiplier increases to 1.55 (US) and 1.52 (EU). They also estimate the government investment multiplier as 1.59 in the US and 1.48 in the EU. According to these results, in a period such as now, fiscal policy has strong (positive and negative) effects on economic activity and GDP. In standard Keynesian textbook terms, statement 3 describes a liquidity trap where fiscal policy exerts the maximum effect on output. In a liquidity trap, the interest rate cannot further decrease so monetary policy cannot offset the negative impact of a restrictive fiscal policy. On the positive side, an expansionary fiscal policy does not crowd out private investments. Woodford (2011) obtains similar theoretical result in the context of a new-Keynesian macro model.

The practical implications of the recent empirical and theoretical findings about the dimension of the fiscal multiplier are quite clear: the rapid adoption of fiscal consolidation plans (“shock therapy”) in countries affected by economic recession is bound to quickly became self defeating, particularly when the political target is set in terms of debt and deficit/GDP ratios and when the adoption of such plans simultaneously occurs in highly integrated economies, as in the EU. Any fiscal consolidation plan simultaneously reduces both the numerator and the denominator of the deficit/GDP ratio and since in the current situation the fiscal multiplier is quite high, the final result may actually be an increase, rather than a decrease of the deficit/GDP ratio, calling for another round of fiscal consolidation and so on. Two other effects are at work here making the situation even worse: negative international repercussions or “coordination failure” effects and sustainability effects. On the one hand, when fiscal restraint is simultaneously adopted in integrated economies, recessive stimuli are transmitted from one country to the others, worsening everyone’s economy. In this regard, it is worth noting that according to Eurostat data (nama_gdp_k tables), in 2009, government expenditure decreased in eight countries, most of them quite small (Bulgaria, Estonia, Ireland, Latvia, Lithuania, Malta and Poland and the UK). In the subsequent year, sixteen EU countries reduced their government expenditure and in 2011 just six out of twenty-seven countries managed to increase government expenditure. Among the major EU economies, Germany was the only one to hike public expenditure, albeit to a small degree (0.5%) and along a decreasing path. This data indisputably establishes the rapid dissemination of simultaneous recessive fiscal impulses in the EU.

On the other hand, investors in international financial markets may judge that a drastic effort to reduce government deficits is unsustainable if the impact of that policy on GDP is over-recessive. Paradoxically, in this case interest rate spreads rise rather than fall, making the fiscal consolidation aim impossible to reach and also increasing the likelihood of sovereign debt default (Tamborini, 2012). The experience of Greece is emblematic in this sense. As stated above, Greece was having problems with its budget well before the start of the international financial crisis. When the crisis hit the weak Greek economy, the government was forced to ask for international help. The response of the EU and IMF was to impose severe fiscal policy restrictions in exchange for granting financial facilities. So far, this "austerity" recipe has been a failure. The Greek Government has not been able to reach annual targets in terms of deficit/GDP ratio, the debt/GDP ratio has risen sharply and Greece has been in deep recession since 2008 (Table 4).

In one official publication (IMF, 2012) and two unofficially supported reports (Batini et al., 2012; Blanchard and Leigh, 2013) the IMF itself has recognized that the economic forecasts concerning the consequences of fiscal consolidation plans in Europe were too optimistic and based on too low a multiplier. We add that the "coordination failure" aspect of the "country by country" approach is part of the problem and that only a supranational approach can overcome it.

Table 4: Growth rates of selected EU countries

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
EU	3,9	2,1	1,3	1,5	2,5	2,1	3,3	3,2	0,3	-4,3	2,1	1,5	-0,3
Euro area	3,8	2	0,9	0,7	2,2	1,7	3,2	2,9	0,4	-4,4	2	1,4	-0,4
Germany	3,1	1,5	0	-0,4	1,2	0,7	3,7	3,3	1,1	-5,1	4,2	3	0,8
France	3,7	1,8	0,9	0,9	2,5	1,8	2,5	2,3	-0,1	-3,1	1,7	1,7	0,2
UK	4,2	2,9	2,4	3,8	2,9	2,8	2,6	3,6	-1	-4	1,8	0,9	-0,3
Italy	3,7	1,9	0,5	0	1,7	0,9	2,2	1,7	-1,2	-5,5	1,8	0,4	-2,3
Ireland	10,7	5,3	5,6	3,9	4,4	5,9	5,4	5,4	-2,1	-5,5	-0,8	1,4	0,4
Portugal	3,9	2	0,8	-0,9	1,6	0,8	1,4	2,4	0	-2,9	1,9	-1,6	-3
Spain	5	3,7	2,7	3,1	3,3	3,6	4,1	3,5	0,9	-3,7	-0,3	0,4	-1,4
Greece	3,5	4,2	3,4	5,9	4,4	2,3	5,5	3,5	-0,2	-3,1	-4,9	-7,1	-6

Source: Eurostat

5. Supranational aggregate demand

Since the Lisbon Strategy, the employment policy of the European Commission has boiled down to nothing more than a set of recommendations to national governments to reform their labour market (for instance, EC, 2012b). The tacit assumption is that European aggregate demand is a given or, to be more explicit, that it lies beyond the power of the Commission to change. Moreover, as Mitterrand's experiment showed, within member states the wiggle room to change aggregate demand is practically zero outside Germany (whose aggregate demand depends substantially on exports), In the European Union, supply-side economic policy prevails because there is no alternative: European institutions have no power to act and national governments can act only on the supply-side of the economic scoreboard.

We do not mean to say that supply-side policies are wrong. If it is possible to increase labour productivity and get rid of red tape and vested interests, reform is necessary and welcome. But if the economy is depressed, if investment and consumption are below trend (see section 4), as was the case in the EU in 2012, with 26 million people unemployed and 120 million people risking poverty, a policy to spur aggregate demand should be considered with due seriousness. When this problem is raised, two interdependent stumbling blocks present themselves and must be got over, the first institutional and the second theoretical. The institutional problem lies in the fact that the European Commission is not a government in the ordinary meaning, because it has no budgetary power to implement an aggregate demand policy. But a discussion of the institutional reforms required to transform the Commission into a European federal government is beyond the scope of this paper; we aim only to show that a supranational aggregate demand policy is possible.

European institutional reform is necessary for economic and political reasons. As Keynes says in the *General Theory*, "the *state of confidence*, as they term it, is a matter to which practical men always pay the closest and most anxious attention. … There are not two separate factors affecting the rate of investment, namely, the schedule of the marginal efficiency of capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former, which is the same thing as the investment demand-schedule" (Keynes, 1973: 148-9). The cultural framework of the inducement to invest is usually considered the horizon of the national economy. This assumption is rooted in a fundamental ambiguity in the *General Theory*, which can be considered both the theory of the world capitalist system and the theory of closed nation states. Only in the last chapters of his work, does Keynes take side openly with the mercantilist (national) point of view (on this ambiguity, see Montani, 1996: 151-191). Today a more accurate analysis of the state of confidence would recognize a distinction between national and international states of confidence. For the European Union this distinction is crucial: the state of confidence of national businesses is a function of what investors can do in the national economy, in the EU single market and in the global market, insofar as their foreign activities are supported by active national policies (for instance bilateral or multilateral agreements between governments). Here a political factor enters the picture. Confidence is more than expectation, the term usually used in economics. Confidence also has a political meaning, as in the wording: "vote of confidence or no confidence". If we consider the state of confidence of US businesses, since the end of WWII, the USA has not only been an economy of continental size but also the leading political power of the Western hemisphere. The stability of the international economy depended on US monetary, commercial and military strength. All these factors influenced the propensity to invest of US businesses, as Keynes accurately explained with his distinction, concerning the inducement to invest, between risk and uncertainty, i.e. events for which no scientific basis exists for calculating the probability. Now it should be clear that there is a difference concerning the uncertainty an American and a European businessman must face. These factors include the capability of the US federal government to react to an international crisis (for instance, in the Middle East, during the oil crisis of the last century, or the recent financial crisis). Therefore, an American business has much stronger inducements to invest than a European business.

The second stumbling block concerns the Keynesian multiplier. Usually, when a proposal for a European investment plan is put forward, someone objects that the EU economy is very different from that of the US: in the US almost half of public expenditures is carried out by the federal (national) government and the other half by individual states. Whereas in the EU almost all public expenditure is carried out by national governments and only 2% by the EU. The conclusion is that a policy of effective demand based on the EU budget is impossible. This conclusion is inaccurate. The European economy is not the arithmetic sum of national economies. It comprises several national economies plus a supranational government, whose power is not used to the full. Consider the value of the Keynesian multiplier: $k = 1/(s + m)$, where s is the propensity to save and m is the propensity to import. If we assume provisionally that the EU economy is closed to the rest of the world and that s is the same in every member state, a single national government must consider that the value of m (i.e. the propensity to import commodities and services from other member states) in its multiplier is positive. If a certain national government finances an expansionary budget, it cannot expect that the other 26 governments do the same. Perfect coordination among national governments is tantamount an expense of a European government. But in national investment plans some public investments – such as Galileo or the European supergrid of renewable energy sources – cannot be taken into consideration, because they are public European goods out of the reach of national budgets: a national investment plan must take external diseconomies and leakages into account. On the contrary, a European investment plan (amounting to the same total of national expenditures) cannot only provide public European goods, but can also yield spillovers into national economies. European public investment has a multiplier $k = 1/s$ because it impacts all European national economies and kick starts some national public investment programmes, which are of interesting to national governments only as part of a European plan (such as hooking up to the European supergrid). Therefore, if the European investment plan concerns public goods provided at the European level, the impact of the multiplier is greater, perhaps markedly greater, than the sum of national expenses. This supranational effect is generally neglected in European debate and – worst still – in its policies.

Of course, the European economy is not closed, but open to international trade and the movement of international capital. A policy to spur aggregate demand should therefore take into consideration that 15% of EU GDP is imported (the US economy has more or less the same percentage of foreign trade). Hence, a European investment plan can have a sizeable impact on European income and employment. Moreover if it were possible in the future to coordinate the European recovery plan with American recovery and that of other countries, the real impact on growth would increase. In a previous book (Fiorentini and Montani, 2012) we showed how the creation of a World Eco-Monetary Union – initially among a group of industrialized countries, but open to other members – could contribute to a fairer distribution of income and improve the stability and growth potential of the world economy.

The second crucial constituent part of aggregate demand, after investment, is consumption. Consumption is a function of disposable income. Here we remark only that the present crisis of the European economy, exacerbated by austerity policies, has caused a serious drop in income and high rates of unemployment and poverty, because of long running trends in income distribution, which has weakened employees' incomes and consumer demand. In the past 30 years, public and private investment has fallen steadily, but corporate profits (or return on capital) has increased. The burden of taxation has shifted from capital to labour, thanks partly to indirect tax increases and the fact that since 1999 labour productivity has increased faster than average wages (ILO, 2013: 48). As a consequence, labour's share in national income has diminished (ILO, 2013: 41-49), effective demand is weak and recovery is difficult. "Weak demand is not the result of a lack of competitiveness brought on by onerous labour regulation or excessive business taxes. Businesses will not invest unless they are confident that there will be demand for whatever it is they produce" (Tilford, 2012: 3). This short remark on consumer demand is enough to show that this problem cannot be tackled only by quick reforms, but requires a new approach to taxation, which should become a EU concern. In short, the structure of the national welfare state, within which a modern wage policy is worked out, should be reconsidered (see section 7).

Before concluding this section, we need to clarify three questions: the first is the relationship between the short and long run; the second is the ill-grounded opinion that the core of Keynesian policy is deficit spending and the third is the relationship between aggregate demand and employment.

In 1923, Keynes said that "in the long run we are all dead," but Chapter XII of the *General Theory* is devoted to long run expectations, because a theory of investment cannot be built on the short-term. Later on we will take the "Europe 2020" plan of the European Commission as the framework for proposing a policy for supranational investment. The Commission Plan is of course founded on the long-term view, because Europe – like every continent – faces challenges that require coherent policy measures over decades. Consider the threat of climate change. We need to prevent the average global temperature rising to 2° C above nineteenth-century levels. To achieve this goal, we should be aware that "less action to reduce emission now will require faster cuts in the future at rates of reduction that may be very costly and disruptive because of the structural changes entailed … Cutting emissions on this scale will require strong action across all sectors of the economy, with a focus on energy efficiency, new low-carbon technologies … and reversal of deforestation … any economic analysis must be about risk and uncertainty, it must be global in scope and it must consider long time horizons." (Bowen and Rydge, 2011: 71). We are already living in the long run. It is impossible to launch a judicious plan of public and private investment without considering long term horizons. But this is not a rejection of short term and anti-cyclical policies. The government can always decide to advance or delay a certain investment project, in response to unexpected events.

The second problem concerns the disputed question of deficit spending. It is certainly true that, after the breakdown of the Bretton Woods system, many national governments misused Keynesianism for electoral reasons, causing an outburst of national debt. After the sovereign debt crisis, fiscal consolidation is necessary. But fiscal consolidation does not mean austerity forever. Fostering aggregate demand does not necessarily require a deficit spending policy. The core of Keynesianism is not deficit spending policy. Keynes himself in *How to Pay for the War* (1940) put forward proposals to avoid inflation in the UK during wartime. In the Thirties and after WWII, the broad support of national governments for Keynesian policies – in USA, Europe and Japan –was based on the consensus for a policy able to bring together the interests of capital and labour. In democratic capitalist countries, Keynesian policies for growth and employment worked well during the Bretton Woods era. In this century, after a worldwide financial crisis, it is necessary and possible to propose policies bringing together the interests not only of capital and labour, but also of public and private finance in order to spur sustainable development within a supranational framework. The global economy is the comprehensive framework in which a new economic policy is to be designed. In this paper, we put forward some proposals to allow the European Commission (or, rather, the future European federal government) to raise money in private financial markets in order to finance its "Europe 2020" plan, preferably without deficit spending.

The last problem concerns the relationship between effective demand and employment. Of course, this relationship is crucial for a policy of investment, growth and employment. Unfortunately, the relationship is much less clear today than in the age of Keynes, when Fordism was the main industrial model of production and management. Today, employment is much less dependent on effective demand for the following reasons: a) a large share of the modern economic system consists of services, a sector employing around 75% of the labour force; the service sector is less sensitive than manufacturing to changes in output (deindustrialization and jobless growth are, in some way, connected with this problem); b) labour-capital ratios depend on the kind of investments included in the proposed plan: it is likely that the same quantity of money will mobilize fewer workers in scientific research than in the construction industry or a local public service, and today we need to foster both kinds of investment; c) in the EU the relationship between output and employment various greatly between member states; according to the ECB (2012: 70), during recent years: "employment and unemployment elasticities to GDP differed remarkably across the euro area countries over the period." Nevertheless, an investment plan can certainly have a positive impact on the state of confidence of the business community and foster further investment, consumption and employment.

6. An investment policy for recovery and sustainable development

European recovery could be brought about by an external stimulus such as growth in international trade. Or it could occur because one or more national government is able to reverse the trend. During recent decades sluggish growth, fast in some countries with stagnation in others, has been considered the hallmark of Europe. But some national growth is not European growth. Sluggish European growth is the side effect of the lack of a European federal government. Here, we propose a recovery policy, in the short run, as a first step towards sustainable development in the long run.

The first problem a European federal government has to take into consideration is the depressed state of confidence of the business community, social partners and citizens. In order to change this bleak view, the federal government must propose a bold recovery plan, whose size and new contents show that the European economy can compete on a level playing field with other leading world economies: China, USA, Russia, India, Brazil, etc. The European Union must show its will to become a global player by, for example, taking a single seat in the IMF, in the UN security council and setting up a rapid reaction military force. The state of confidence of "practical men", as Keynes says, has a political aspect.

Today the political will and a European economic plan do not exist, but the "Europe 2020" plan of the European Commission (EC, 2010) can be considered a useful starting point for a recovery policy. The main targets of the plan are: 75% of the population aged 20-64 should be employed (the rate in 2010 was 69%); 3% of EU GDP should be invested in R&D (less than 2% in 2010); "20/20/20" climate/energy targets should be met; the share of early school leavers should be under 10% and at least 40% of the younger generation should have tertiary education; 20 million less people should be at risk of poverty (80 million people in 2010). In order to achieve these general targets seven flagship initiatives are planned: "Innovative Union" to improve research and innovation; "Youth on the move" to enhance the performance of education systems and to facilitate the entry of young people into the European labour market; "A digital agenda for Europe" for a digital single market; "Resource-efficient Europe" to help decouple economic growth from the use of resources; "An industrial policy" to face the challenge of the global market; "An agenda for new skills and jobs" to modernize the labour market; "A European platform against poverty" to ensure social and territorial cohesion.

We do not intend to discuss the entire "Europe 2020" plan, but only to point out some of its shortcomings and suggest an alternative. The first shortcoming is that the European Council is considered "the focal point" for implementing the proposed strategy. In other words, the error of the "open method of coordination" adopted for the Lisbon strategy rears its ugly head again. On the basis of this method, which allows "free rider" countries to do as they please , the plan is sure to fail, as the Lisbon strategy did. Of course, a certain degree of coordination between national economic policies in the European Union is necessary, owing to the size of national budgets compared to the EU budget. But the European Commission should try to play its role fully as a "catalyst" of national economies; without a strong coordinator, coordination fails.

To highlight the problem, we focus on the "Connecting Europe Facility" (EC, 2011a), a crucial part of the "Europe 2020" plan and included in the MFF for 2014-2020. The Connecting Europe Facility (CEF) sets out a policy framework for investment in three sectors: transport, energy and telecommunications (digital networks). These are necessary to complete the single market. Moreover, investments in key infrastructures can boost Europe's competiveness and sustainable development. The Commission says: "the crisis has shown that infrastructures are crucial for Europe's economic future." (EC, 2011a: 1).

Let us turn to the cost of the original CEF project. The energy sector (electricity highways, gas transportation, smart grids, cross-border carbon dioxide networks) requires an investment of one trillion euro by 2020. The transport sector needs the completion of missing links to alleviate bottlenecks and spur the use of more efficient services in multimodal combination. Its cost is estimated at over 1.5 trillion euro for 2010-2030. For telecommunications networks, the removal of digital bottlenecks is a key objective. The estimated cost is 270 billion euro, 50 billion from private sources. Therefore the total cost of the CEF is 2.72 trillion euro, if the horizon of 2030 for the transport sector is maintained (or 2 trillion by 2020).

The CEF project is crucial for European recovery, reversing a long-running trend of decreasing public investment. An EIB study says: "Total governments investment as a ratio to GDP fell from almost 5% in the 1970s to less than 2.5% at the turn of the century" (Wagenvoort *et al.*, 2010: 27) and is continuing to decrease after the crisis. Moreover, it should be noted that: "public finance declined while private project finance increased. These two major events suggest that over the last forty years, at least qualitatively, the decline in government finance has been partly offset by an increase in the relative importance of private finance. Quantitatively, however, the increase in private finance remains relatively small because the share of project finance in infrastructure is so far relatively small. Overall, there has thus been a decline in infrastructure investment" (Wagenvoort *et al*, 2010: 28). The relationship between public investment in infrastructure and growth is another fact which deserves to be underlined, even though growth does not depend only on public investment. As noted in a study sponsored by members of the European Parliament, there is "a strong correlation between the declining government investment ratios and declining rates of economic growth during the last three decades. The eurozone has now become a low-growth zone, no doubt caused in a significant way by the decision of its member governments to cut back on public investment" (Haug et al, 2011: 60).

Now let's face the problem of the size of the recovery plan. Our assumption is that the plan must have a shock effect on the state of confidence of European public opinion: its size must reveal the political will of the federal government to reverse the declining trend and to provide a long term policy for the sustainable development of the European economy in the global market. Moreover the size of the recovery plan should be enough to fill the effective demand gap caused by the crisis, which we have evaluated at 3.1% of EU GDP. To achieve this target, however, it is not necessary to invest all this amount. Two related effects should be taken into consideration. The first is the Keynesian income multiplier, which according to the estimates reported in section 4 should currently be greater than one. As stated earlier, the investment in European public goods has a greater multiplier effect than national multipliers and monetary policy in Europe today provides more liquidity than the business demand of credit so that a crowding-out effect, caused by increased interest rates, has to be ruled out. Finally we can relay on a positive crowding-in effect, namely the possibility that public investment may induce private investment. According to one study: "the likelihood of the crowding-in effects of productive public investments is higher in countries with a more stable macro environment, high availability of domestic credit, low foreign debt burden, and more checks and balances in the political system, and good rule of law and property rights protection" (Romp and de Haan, 2007: 27-8). Here it is not possible to provide an econometric evaluation of the crowding-in effect because until now all research has been devoted to national economies and not to the European economy as an integrated market with European public investments (for instance Afonso and St. Aubyn, 2008). Nevertheless, some further observations can be made. The recovery plan should comprise not only the CEF investment, but also investment in research and innovation for the long-term challenges Europe is facing in the global market, as outlined in the *Global Europe 2050* study (EC, 2012c). For instance, investment in projects such as *Copernicus* (Global Monitoring for Environment and Security), a joint satellite system sponsored by the European Commission and European Space Agency, costing about €5.9 billion, or Graphene research on a new multipurpose material, are supported by the European Commission in order to push the European economy to the technological frontier. In the USA, after intensive public research, in some cases begun during WWII, it was in a similar cultural environment that private entrepreneurs came up with new computer technologies and the digital communications system. Today, Schumpeter's entrepreneur does not need only a good credit system and a competitive market, but also a solid public system of innovative research as fertilized ground to plant a business in.

Generally, in the light of the above considerations, one objection is immediately raised: how is a European recovery plan of this size possible when the EU budget is only 1% of EU GDP? In the past, the answer was usually the easy, but illusory, coordination of national plans with the Commission in the role of advisor. Here we suggest an alternative. The bulk of the finance should come from the European budget, with only a minor share from national contributions, if any, so the Commission can fully act as a catalyst for national investment plans. Suppose, say, the Commission asks national governments to finance 0.5% of EU GDP with national government contributions, with investment of national interest, and the Commission finances the plan with 1.5% of EU GDP from Europe's own resources. This is possible if innovative financial instruments made available by Public Private Partnership (PPP) are used cleverly (EC, 2011b). Of these innovative financial instruments, project bonds are probably the most interesting and are especially suited to finance the CEF investment project, which has a private and a public dimension. The investments are profitable only in the very long run (20-30 years) and are risky, especially in the first phase of their life. Therefore it is difficult for private companies to find finance in the credit market at a convenient rate of interest. Moreover the bond market in Europe is not used to financing infrastructure projects. Nevertheless some institutional investors, such as pension funds and insurance companies, need long-term assets to match their long-term liabilities. Therefore, European infrastructure can be financed with project bonds, if they are considered safe and cost-effective. Project bonds "are issued neither by the European Union nor by Member States governments. They are private debt, issued by the project company. The Europe 2020 Project Bond instrument would enhance the credit standing of private entities that need to raise private funds for infrastructure projects they promote. By addressing capital market investors, the Project Bonds Initiative opens up a further avenue for project sponsors to attract funds. The EU budget contribution will be capped ex ante" (EC, 2011c: 5). An example shows how the financial mechanism works. The Commission provides a certain amount of money in the EU budget to cover the risk of the EIB while the EIB covers the remaining risk, which should not be higher than 20% of the investment. In this way, there is a multiplier effect of around 15-20. The aim of this mechanism is to upgrade private investment, whose share of 80% is considered senior in case of default. The guarantee of EU institutions allows the company to raise funds in the capital market at a lower rate of interest than bank loan interest rates.

In theory, project bonds could finance the recovery plan: in effect 10% of the present EU budget could finance 1.5% of GDP for infrastructure investments. However, this simple calculation cannot work in practice, for two reasons. The first is that, according to a study sponsored by the EIB (Dhéret et al, 2012: 8-10): "While the EU Project Bond Initiative can succeed in opening up additional capital markets for PPPs and delivering higher private-sector infrastructure investment, it is unlikely that they can deliver the scale of investment identified by the Commission … they are not the silver bullet and are not necessarily suitable for all sectors and every type of project. Galileo is a case in point. The EU originally planned for a consortium of companies to bear two thirds of the €3.4 billion development cost. But … the Commission had to admit that a PPP was not the best solution for this project, given that the high level of technological risk was liable to produce significant cost overruns with little potential to generate revenue from commercial exploitation. Therefore, the programme is now entirely owned, sponsored and funded by the EU." Following this advice, the European plan should include not only the CEF, research and innovation projects, but also social initiatives to boost employment in the short run. The financial effort of the EU will be justified and supported by its citizens if it produces more jobs rapidly.

7. More solidarity for a supranational community of citizens

Since the budget of the European Union is considered more as a supplementary fund for national budgets than a budget for providing public goods to citizens, during the European election nobody speaks about future European policies and taxation. The only European policy known to the citizens is the common agricultural policy (CAP), where the amount and impact are decided more by bargaining between national governments than by democratic elections. This does not mean that the Commission has not tried to foster policies in favour of citizens' rights and welfare. On the contrary, anyone who looks at the EU website cannot be but amazed by the variety of policies for social and territorial cohesion and for citizens' rights. These initiatives were made possible through the Lisbon Treaty and the Charter of Fundamental Rights (CFR), which clearly states the values upon which the Union is based. The *Preamble* of the Charter says: "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."

Yet, in the European Union, more solidarity between states and among citizens is necessary. That does not mean more transfers of money between nation states. The question of the transfer Union was hotly debated during the sovereign debt crisis and is now enshrined in institutions (the ESM) and rules (the Fiscal Compact), while comprehensive reform for the creation of a Fiscal Union is under way. This reform could lead to a new model of fiscal federalism (Montani, 2013) if the proposals discussed in this paper become an integral part of the new Union. In the European monetary union (EMU), fiscal policy cannot be left only to national governments: if the EU budget is not able to provide the services and the public goods required for the social and territorial cohesion of the Union, a severe crisis (as shown by the sovereign debt crisis) could jeopardize monetary union (should Greece and Italy, for example, abandon the EMU?). The EU budget should provide for more solidarity among states and citizens.

The degree of solidarity within a supranational community of citizens is different from the degree of solidarity within a nation state. In Europe, the basis for the modern welfare state was created in the nineteenth century. Today it is considered a specifically European identity, although a form of welfare state exists in every developed country (for a comparison between USA and Europe, see Streissler, 2008). The welfare state guarantees basic services to citizens, such as health, pensions and education for children. In this way the welfare state creates a system of equal opportunities for every citizen, removing differences of wealth, gender and culture. Of course, the welfare state has a cost, which is covered by national taxation: it is a system that ensures solidarity among citizens within the same nation. But the same degree of solidarity does not exist among citizens of different nations, even European nations, as the debate during the sovereign debt crisis made plain. Hence, studies concerning the reform of the European welfare state usually fail to take into consideration the role of the EU budget (for instance, Plihon, 2009). Here, we show that a common European umbrella – for European public goods – over the national welfare state is necessary and feasible.

A common home is required for at least two reasons. The first is that globalization places the very survival of the national welfare state in Europe at risk. The main threat is the erosion of the fiscal base through the mobility of international capital. Year after year, national fiscal sovereignty is weakening, but closing the European frontier to capital mobility would mean isolating the EU from the global market. The only reasonable way out is to pool a share of national fiscal sovereignty at the European level. The second reason is that the very notion of wealth is changing. While in the past century the idea of social progress corresponded roughly with stronger welfare institutions, today social progress is more and more a quality concept, which can be measured not only by a quantitative index (such as GNP), but also by qualitative markers. As a Report (Stiglitz et al., 2009: 14) on social progress says: "Increasing 'output' is more a matter of an increase in the quality of goods produced and consumed than in the quantity." Therefore, wellbeing is a multi-dimensional concept. Its definition is based on: "material living standards (income, consumption and wealth); health; education; personal activities including work; political voice and governance; social connections and relationships; environment (present and future conditions); insecurity, of an economic as well as a physical nature." The search of individuals for a new-found wellbeing necessarily has a European dimension. Consider the environment: in practice EU institutions establish almost all environmental regulation and for the protection of consumer health. European wellbeing has a multicultural and multinational aspect, which can be better administered at the European level.

Our proposal is to change the allocation in the MFF 2014-20 under two headings: the European globalisation adjustment fund (EGF) and the Economic, social and territorial cohesion policy. The first heading we would like to change is the European Globalisation Adjustment Fund (EGF), created in 2006 to provide personal support to workers made redundant as a result of trade liberalization. The aim of the EGF is to reintegrate workers into the labour market providing services such as assistance in job-searching, careers guidance, outplacement assistance, tailor-made training and the promotion of entrepreneurship. But the EGF does not finance passive social protection measures, such as pensions, invalid or unemployment benefits, which are the responsibility of member states. The EGF adds the solidarity of the EU to the support provided by member states at national, regional and local levels.

One of the problems of the EGF is its shortage of financing. In 2011, in the middle of the crisis, with 25 million unemployed, a total of € 77.5 million was paid to redundant workers for 16,870 workers targeted for assistance. The average aid per worker was € 4,597 (EC, 2012d). Our proposal is to exploit the legal framework of the EGF, but to transform it into a European Stabilisation Fund in order to face emergencies, which the member states of the Union are not able to handle through their economic stability mechanisms. This European Stabilization Fund would provide aid to redundant workers more automatically and more generally than the present EGF. The macroeconomic function of stabilisation should not be confused with the distribution function: if the displaced worker finds a new job the Fund can be refinanced. The macroeconomic function of stabilizing the economy should be centralized at the European level because of the existence of externalities. "In an open economy, some proportion of the net local government expenditure will flow through into higher net imports, so the benefit of such expenditure will partly benefit non-residents, whereas the local government will in general have to impose the higher future taxes (to service the higher debt) solely on residents. The consequence is likely to be that governments in small, open economies are likely to feel incapable of undertaking as much stabilization as would be optimal if all externalities were to be internalized" (Goodhart and Smith, 1993: 423).

Considering this general theoretical framework, and the fact that the economic crisis, from 2008 to 2012, caused about 5 million people to lose their jobs, the amount of the new European Stabilization Fund could be € 75 billion for the MFF 2014-20, based on average aid of € 5 thousand (instead of € 4,597) per person, for 5 million people for 3 years, assuming that the unemployment emergency will be over after three years. The European Stabilization Fund should provide European solidarity in cases of an extraordinary economic downturn and leave ordinary anti-cycle policy to national welfare systems.

The second heading we would like to change is the Economic, social and territorial cohesion policy. The allocation of the European Commission was € 336 billion, reduced by the European Council to € 325.1 billion; we propose an increase to € 360 billion. This money is used to finance the European Social Fund (ESF), the European Regional Development Fund (ERDF), the Cohesion Fund (CF), the Youth Employment Initiative and Aid for the most deprived. All these funds are crucial for fostering employment, new jobs and new investment. The Commission says: "cohesion policy is an important expression of solidarity with the poorer and weakest regions of the EU, but is more than that." After the recent crisis, unemployment and persistently high rates of poverty call for effective EU action. It is essential "to accompany growth enhancing investments in infrastructure, regional competitiveness and business development with measures related to labour market policy, education, training, social inclusion, adaptability of workers, enterprises and entrepreneurs and administration capacity." (EC, 2011e: 11).

We propose a substantial increase for four reasons. The first is that the aid for the most deprived of € 2.5 billion should be substantially increased in the wake of the crisis. At the time of the Commission's proposal, there were 80 million people at risk of poverty; in 2012 the total was 120 million. The second reason is that the Youth Employment Initiative – € 6 billion for the MFF – is likely to be insufficient, though the EU contribution is a supplementary aid to national contributions and to EU structural funds. According to the *Annual growth survey 2013*, in the EU there are 5.52 million unemployed young people: in a depressed economy this supplement is not enough for creating million of jobs. The third reason is to strengthen territorial cohesion, essential for environmental, cultural and social initiatives. For instance, most air and environmental pollution comes from the poor administration of cities and regions. New technologies for a resource-efficient economy are often a source of new jobs: potential renewable energy sources could create an estimated three million jobs. Local communities are also crucial for the expansion of social services and improvement of the quality of life. There is a "rising demand for personalised care and professional social services. The size and fast growth of these sectors (twice the employment growth overall) suggests they will remain a key driver in providing jobs in the years to come." (EC, 2012a: 6). Local communities also play an important role in fighting social exclusion and poverty, often with the aid of volunteers. "Some 100 million EU citizens make a positive contribution to their community offering their time, talent and money too. Volunteering empowers individuals and helps create stronger communities, providing services to the excluded. It also fosters new skills, civic responsibility and enhanced employability" (EC, 2011f: 28). The European Commission should support these volunteers with the creation of a civilian service, especially for young people. The fourth and last reason is the urgent need for a minimum income, as requested by the European Parliament (Resolutions of 20 October 2010 and 15 November 2011). Excluding Italy and Greece, a minimum income exists in every state of the Union, albeit often at a very low and uncoordinated level. A European legal framework could represent a strong bulwark against the widening gap between the rich and poor, caused by globalization and the financial crisis. The fear of a minimum guaranteed income – most commonly expressed is its negative effect on employment – according to *The Economist* (2012: 74) is groundless: "Bastions of orthodoxy, such as OECD, a rich-country think-tank, and the IMF, now assert that a moderate minimum wage probably does not do much harm and may do some good. Their definition of moderate is 30-40% of the median wage. Britain's experience suggests it might even be a bit higher." A minimum wage pushes up pay for workers at the bottom and reduces wage inequality. Moreover a minimum wage should go with a European citizen's basic income, a more inclusive policy. The Union should effectively "ensure a decent existence for all those who lack sufficient resources" (CFR, 34, 3). The European basic income should be based on three components: a policy to fight poverty and social exclusion, supported by social impact bonds (Liebman, 2011); a minimum wage (or aid to unemployment) and a European civilian service. A comprehensive reform for the creation of a society based on fundamental rights would create more solidarity among European citizens.

8. The EU fiscal gap and the EU budget

Before taking into consideration the EU budget as a means of economic policy we need to understand its place in the European Union system of public finance. Indeed, the European Union is a very peculiar system of multilevel finance, i.e. a system of fiscal federalism. If we compare the EU fiscal system with the other multilevel system of public finance the peculiarity of the EU becomes clear: in all federal states the bulk of financial revenues is raised by the federal government, while exactly the opposite happens in the EU, where the bulk (practically all) of financial revenues are raised by national governments. In the jargon of fiscal federalism this abnormality is called Vertical Fiscal Imbalances (VFI). Whereas the EU budget receives 85% of its revenues from national governments and the EU is unable to provide enough services and public goods (as it should do according to the Treaty) to European citizens. In Europe there is a negative VFI (see Appendix A). The negative fiscal imbalance has a very important political consequence: the subordination of EU budget management and budget policies to the will of national governments, and the subordination of the European interest to national interests.

To measure negative VFI in the EU would require an in-depth study. Here we merely observe that there is a double imbalance, one concerning expenses and the other revenues. On the expense side, past studies give a rough idea of the problem. The MacDougall Report (1977) stated that the size of the EU budget should have been 2-2.5% of GDP in a pre-federal phase, excluding European defence expenditure. A subsequent Report, by an independent group of economists (1993), sponsored by the European Commission, stated that the size of the EU budget should have been at least 2% of GDP, without European defence. Therefore our provisional conclusion is that the negative VFI of the EU is at least 1% of GDP. The EU should double its budget to provide more public goods and services to the citizens because too many unproductive and inefficient expenses are located within national budgets. The VFI for expenses is of course a consequence of the lack of European revenues, notwithstanding the European Parliament several times demanded genuine European resources. National governments prefer to maintain all fiscal revenues within their jurisdiction (for instance, contrary to what happens in a federal system, the profits of the ECB – €998 billion in 2012, seven times the EU budget – are reassigned to national banks).

Returning to our attempt to show that a European recovery policy of 2% of GDP is feasible, as already stated, 0.5% should comprise national expenses. The bulk of the recovery plan, 1.5% of GDP, can be financed by the EU budget, provided that our alternative MFF is taken into account (see Appendix B). For this calculation we consider the average income (of the MFF) to be 137.1 billion: 1% of GDP at 2011 prices. Broadly the alternative proposal includes two headings: public investment and social expenses. The first heading – CEF investment – is the most important, due to the project bond multiplier of 15-20. In effect, with an annual disposable amount of 8.57 billion for the CEF in the EU budget, 171.4 billion of investments can be financed, i.e 1.25% of GDP, if the multiplier is 20. If the multiplier has only an average value of 16-17, an investment plan of a little more than 1% of GDP can be financed. The remainder can be financed under the heading for social expenses, i.e. the Economic, social and territorial cohesion funds and the Stabilisation fund, which total 0.45% of GDP. In case of need, some finance can be advanced by the European Stabilisation Fund, functioning as a buffer.

Of course, these calculations exclude political and administrative difficulties in changing the MFF and the inevitable time required for the experimental phase (EIB 2012): a serious fiscal reform of European public finance would take years. Therefore, in the transition phase, a federal bond issue of at least 1% of GDP might be necessary. The federal bonds would find underwriters without difficulty in years in which national governments are committed to reducing national debt. It should be clear by now that a federal bond issue does not mean deficit spending: it is an emergency measure to overcome negative VFI. With a suitably sized budget, the EU does not need deficit spending policies to launch a recovery plan.

9. Conclusion: public finance and democracy in Europe

Public finance is one of the pillars of a democratic community. Virtually in every EU country people's discontent with exorbitant taxation and inefficient public services – including a policy for full employment – is not the fantasy of populist leaders and eurosceptics. European democratic parties and leaders must understand that some public goods and services can be provided better at the European level whilst others are best provided at the regional and local level. The EU could collapse either because of a split between Northern and Southern Europe or because of people's dissatisfaction in Catalonia, Northern Italy, Belgium, Scotland and, even in some regions of France and Germany. In the long run, if Monetary Union is not consolidated into a genuine fiscal union – with a federal budget – the balkanisation of Europe is a real possibility.

Year after year, European political parties and leaders postpone the overhaul and reform of European public finances because they fear abandoning national fiscal sovereignty and ceding too much power to the EU. At the same time, they conceal from their citizens that year after year global finance wears away the power to tax of nation states. Thriving tax havens and decreasing trends in the corporate tax rate are a significant index (OECD, 2013; Fiorentini and Montani, 2012: 201-2) of a reality beyond the reach of national governments. Merely by assigning the power to tax to the European federal government, European citizens could recover some of the money disappearing from national accounts and flowing away offshore. By postponing the creation of a European government and a federal budget, European parties and leaders are causing the most severe economic recession in Europe after WWI and imposing unnecessary pain on their citizens.

Appendix A – **Fiscal federalism and European imbalances**

The aim of this Appendix is to briefly show the central problem of fiscal federalism and to outline the main fiscal imbalances in the European Union.

Hamilton's Problem

Alexander Hamilton was the first federalist to face in theory and practice the constitutional problem of establishing a multilevel system of public finance. In modern times, Hamilton's problem can be restated on the basis of the classic wording of Kenneth Wheare: "The federal principle requires that the general and regional governments of a country shall be independent each of the other within its sphere, shall be not subordinate one to another but co-ordinate with each other. Now if this principle is to operate not merely as a matter of strict law but also in practice, it follows that both general and regional governments must each have under its own independent control financial resources sufficient to perform its exclusive functions" (Wheare 1967: 93). This principle is the cornerstone of fiscal federalism because the other side of the coin of Hamilton's problem is federal democracy: each government should be accountable to its citizens (or their representatives in Parliament) and that is possible only if the government's budget clearly indicates where the money comes from and how it is spent (principles of financial transparency).

Now, to restate Hamilton's problem in a slightly more technical fashion, in a multilevel system of government, a government – at the federal or regional/state level – may be unable to raise sufficient fiscal revenues to finance its expenditure. In such a case there is an imbalance (Bird, 2006). Two kinds of imbalances are possible: a vertical fiscal imbalance (VFI) and a horizontal fiscal imbalance (HFI). If, for instance, the federal government is able to collect more taxes than regional/state governments and the regional/state governments are responsible for more expenditure than the revenues they can collect the result is VFI. This is the general case in today's federations, where federalism is considered a decentralized system of central government because most of the fiscal power and monetary policy are at the federal level (Anderson, 2010: 20); Watts, 2008: 103). At the same time, in a situation with a sub-federal government, some regions/states might be able to finance their expenses from their own resources, whilst others are unable to do so: in this case the result is HFI.

The experience of existing federations shows that it is very difficult to remove these two kinds of imbalance, because they are interlinked. Consider a federation with rich and poor regions/states. Federal regions/states could find an agreement to overcome VFI. But the agreement is shaped in such a way that rich regions/states achieve a balance quite easily while poor regions/states find that their fiscal revenues are not sufficient to provide the same per-capita services other citizens receive. The lesson is that, in practice, in a multilevel system of public finance some form of vertical transfer from the federal government towards regions/states and some form of horizontal transfer from rich to poor regions/states is unavoidable.

However these transfers of revenue between governments should be conceived as a transitory measure on the way to attaining the ideal state without fiscal imbalances, as described by Wheare. The transfer of funds between governments is a transitory policy to avoid major social, economic and political problems, which can jeopardize the cohesion of the federal union. Generally the transfer of funds causes quarrels and complaints. Cohesion policies are necessary only to attain a more perfect union, where every government can be fully accountable for the utilization of the taxes paid by its citizens and for the quantity and quality of the services it provides.

The European fiscal problem

If we look at VFI, we can say that all existing federations suffer from an excess of centralization: some fiscal transfer from the federal government to region/state government is necessary to allow them to provide the services and public goods required by their citizens. Sub-federal governments undergo a fiscal gap. The existing situation of the European Union is exactly the opposite: a fiscal gap and an excess of decentralization of revenues and expenditure at the national level. The proposal of the Commission for the next MFF 2014-2020 (EC, 2011e) states that the budget should provide "programmes which can deliver results that individual Member States cannot deliver on their own". But when you consider the crucial programme "Connecting Europe Facility" the Commission says that the total amount of investment could be up to € 2 trillion, but the budget provides funds for less than half this amount. Moreover, the Commission admits that 85% of Europe's own resources come from national budgets. Wheare would say that the European government is not independent, but subordinate to national governments.

The European fiscal deficit (or gap) is one of the features of the lack of democracy in the EU. One cannot be solved without the other. This means that overcoming European fiscal deficit is a political issue. The fiscal deficit is not a novelty: it blew up during the last two decades but the European Parliament and European parties felt that it was unfortunately unavoidable. The recent report on the shortcomings of the EU budget by Haug, Lamassoure and Verhofstadt (2011) deals openly with the "own resource" problem but postpones the debate on the crucial issue of the size of the Union budget. The Union will have a federal budget only if the European parties and their leaders are able to convince citizens that some public goods (balanced growth, full employment, a green economy, security) can be provided by the federal government at a lower cost than they pay for the same public goods (or the illusion of them) to their national governments. Such a federal fiscal system, without imbalances, would reduce the average fiscal burden on citizens.

Real federal reform of the Union cannot be obtained by fiddling with some articles in a new treaty. A judicious treaty amendment would remove the main bottlenecks in the way of a substantial increase of Europe's own resources, but a European federal budget can only come from a struggle by political parties and European citizens for a better future.

Appendix B – **Proposals for an alternative MFF 2014-2020**

ALTERNATIVE MULTIANNUAL FINANCIAL FRAMEWORK 2014-2020
(Commitment Appropriations in billions of euro – 2011 prices)

Heading	EC MFF 2014-20 (2011 proposals)	Council MFF (2013 proposals)	Authors' proposals 2014-2020	Difference from Council proposals
Connecting Europe Facility[1]	50	29.3	60	30.7
Horizon[2]	80	80	120	40.0
GMES[3] (Copernicus)	5.9	3.8	5.9	5.9
Galileo[4]	7	6.3	7	0.7
Economic. Social and Territorial Cohesion[5]	336	325.1	360	34.9
EGEF (or Euro-pean Stabilization Fund)[6]	3	1.0	75	74
			Total	186.2
			as % of EU GDP	0.19

Notes

[1] Investment in infrastructure to complete the trans-European energy networks, the trans-European transport network and pan-European ICT services.
[2] Horizon 2020 will closely link key sector policy priorities such as health, food security and bio-economy, energy and climate change. The European Institute for Technology will be part of Horizon 2020, bringing together the three sides of the knowledge triangle – education, innovation and research.
[3] Copernicus comprises a set of services, which collect data and provide information using satellites and terrestrial sensors to observe the environment and natural phenomena occurring on the planet. Copernicus improves citizen security and is a driver for economic growth and employment.
[4] Galileo is a system of 30 satellites, replacing the American GPS.
[5] The heading includes funds for regional convergence, transition regions, economic competitiveness, territorial cooperation, social cohesion and outer, sparsely populated regions.
[6] The Authors' proposal is to use the legal framework of the European Globalisation Adjustment Fund (EGF) for the creation of a new European Stabilisation Fund.

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