STUDY

Alternatives to Austerity

Progressive Growth Strategies for Europe

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- Before the crisis there were different growth models in Europe: property bubbles in Spain and Ireland, state spending in Greece, hypertrophied financial sectors in the United Kingdom and Cyprus. All of these were based on growing, mostly private debt. They caused large current account deficits, and imploded in the financial crisis. State-led bank rescues to stabilise the financial sector massively increased state debt.

- The Greek state debt problems and the mistaken response of Europe and Germany transformed the financial crisis into a state debt crisis. This offered an excuse to force austerity on the crisis countries with cuts in wages and social spending. Growth collapsed, unemployment and poverty increased, but no amelioration of state debt ensued.

- The ECB's belated low-interest policy ended the state debt panic in the financial markets but obviously cannot create new growth. That would require new investment, presupposing a banking sector recapitalised through a banking union and coordinated European growth initiatives. It also implies improving business competitiveness in the crisis countries and more equitable income distribution.

Content

Foreword: Beyond Austerity

Michael Dauderstädt and Ernst Hillebrand

Europe's response to the economic and growth crisis has been two-staged. After anti-cyclical stabilisation measures dominated in the first phase after 2008, the pendulum swung back in the aftermath of the Greek and Euro crisis. Austerity and budget consolidation became the touchstones of economic policy response. Criticism of this turn, referred to as a »fiscal suicide pact« by one of the contributors to this volume, concentrated from the outset on its crisis-deepening deflationary consequences. But at the same time, the critics have not succeeded in explaining to an unnerved public what the alternatives to austerity are and what an all-European crisis strategy could look like. In this situation the Friedrich Ebert Foundation invited economists from a range of OECD countries to outline concrete alternative strategies for their countries. The main interest was to explore the specific challenges and potential solutions in the individual states, moving above and beyond well-meaning but unspecific appeals to »European solidarity« and calls for growth initiatives. That said, the authors were also asked to identify possible European contributions to overcoming the crisis.

The studies on the alternatives to austerity presented in this collection show one thing relatively clearly: just as the crisis has no single cause, nor is there a single perfect solution for overcoming the growth weakness of Western economies (above all those of the Euro zone). In reality we are dealing not with one single economic crisis, but many different national crises with different causes and solutions. That does not, however, mean that looking for basic guiding principles for European growth strategies would be meaningless. As the contributions collected here clearly show, the effect of pure austerity has been to exacerbate crisis and stifle growth. Complementing the analyses of European economies, the volume also includes contributions on two important non-European economies, the United States and Japan. Both pursued expansive budget policies following the collapse of Lehman Brothers, but both are also debating the longer-term usefulness of deficit-funded growth strategies.

The Causes of Crisis

Ultimately it is obvious that we cannot speak of a single unified crisis diagnosis. The dip in growth in Germany after the collapse of Lehman Brothers and the subsequent »great recession« were of a different nature than events in Spain or the United Kingdom, for example. Nonetheless, certain common features can be identified in the worst-affected countries: The crisis revealed the limits of the growth strategies – fuelled by an influx of cheap money within the Euro zone – pursued during the preceding years. This applies to the overemphasis of the property sector in Spain (and Ireland), and the passive acceptance of eroding industrial competitiveness in Italy as well as France under the conservative governments of Chirac and Sarkozy. The United Kingdom also experienced the vengeance of a lop-sided growth strategy focusing too strongly on a successful financial sector. However, without the external shock of the financial crisis more gradual corrections of the chosen growth paths (in the sense of a »soft landing«) would have been possible.

Instead, the crisis has brutally exposed the limits and weaknesses of economic policies. What began as a crisis of banking and finance mutated, via socialisation of credit risk, the fiscal repercussions of recession, and growing doubts in the financial markets concerning the long-term solvency of the crisis states, into a crisis of state borrowing. It would, however, be naive to attribute the political response solely to a mistaken fixation on budget deficits and an unhealthy belief in the virtues of austerity. Instead, that response also reflects the consensus of conservative economic policy-makers (in the individual states as well as Brussels) and the so-called financial markets. It was they who made support for state borrowing conditional upon restrictive budget policies and cuts in social spending. In these matters, politicians and civil servants were more than just victims of forces outside their control. They likely also saw a historic »window of opportunity« to force through changes in social policy that would have been politically out of the question under normal circumstances. The list of cuts in social spending implemented in the crisis states in the course of the financial crisis makes previous welfare state reforms look positively benign.[1]

Responses to the Crisis

The analyses presented in this volume – leaving to one side the special situation of the United States – do, however, reveal a certain common theme, in the sense that supply-side reforms are treated as inevitable. This applies especially to the crisis nations of the Euro zone, which have no option of boosting international competitiveness with monetary strategies of the kind adopted by Japan and Poland, for example. But the thrust of proposed reforms is ultimately always very specific to the particular national circumstances. The point of reform proposals here must be first of all to do the homework. This means to address the specific deficits of the respective economies, from the weakness of French small and medium-sized enterprises, through the productivity gap of the »crumbling« Italian industry to the hypertrophy of the Spanish construction sector.

At the same time, almost all the contributions emphasise the necessity of shifting the long-term social perspective: more investment in infrastructure, productivity, education and training, a more equitable distribution of income, and a fairer sharing of the burden of funding state budgets by higher taxation of high incomes and profits. Especially in the United States, energetic measures to counteract the distributional effects of the neo-liberal epoch are being proposed as a route to achieving stable economic growth. In the United Kingdom and Poland, too, fairer distribution is advised as a central element of economic dynamisation.

Herein lies one of the biggest differences to the Euro zone. Here, economic debates are strongly dominated by questions of trade deficits and a focus on international competitiveness. The question of stabilising domestic demand tends to play a subsidiary role.[2] This is where the lack of monetary policy alternatives is conspicuous: the common currency forces policy makers in the deficit countries to pursue real term adjustment strategies via cost-cutting, exacerbating the deflationary dynamic.

At the same time, the authors of the European studies agree that the EU level has a major role to play in overcoming the crisis. They demand an abandoning the myopic austerity logic, giving the surplus countries an active role in fighting the crisis and advocate for a strengthening the European institutions through banking and fiscal union. Yet, while the deficits of the social dimension of the Union and the ensuing beggar-thy-neighbour logic inside the EU are mentioned in the paper from France, the contributions also show that the social dimension of the EU seems not to be a central aspect in the current phases of crisis management.

A European Answer?

The question that arises is what the contours of a European growth strategy could be. In the following, a number of fundamental ideas are outlined from the perspective of the editors. The first commandment for a growth-oriented European economic policy should be »do no harm!« The EU massively violated that rule in 2010. After answering the financial crisis with a successful comprehensive programme that averted a severe depression, the European response to the sovereign debt panic of spring 2010 was devastating. Hesitant, breathless rescue initiatives further heightened the panic, while the austerity programmes imposed on debtor countries caused growth to collapse and hampered rather than enabled debt reduction. As the International Monetary Fund has now conceded, the estimated multipliers (for the magnitude of growth and employment effects triggered by changes in government spending) were utterly unrealistic.

The second aspect of the reform programs – internal devaluation by means of wage cuts to substitute for currency devaluation (the latter being impossible because of the lack of independent currencies in the Euro zone) – is also likely to have caused more harm than good. Although unit labour costs in the peripheral countries increased faster than the EU average between 2000 and 2007, it is questionable whether that actually caused a real competitiveness problem for those economies. After all, their exports grew quite strongly during this period.

1. Philippe Pochet and Christophe Degryse, »The Programmed Dismantling of the ›European Social Model‹«, *Intereconomics,* 4/2012, pp. 212–217; Avram et al., *The Distributional Effects of Fiscal Consolidation in Nine Countries,* EUROMOD Working Paper No. EM 2/13, January 2013.

2. Georg Feigl and Josef Zuckerstätter, *Europäische Wettbewerbsdesorientierung,* WISO direkt (Bonn: Friedrich-Ebert-Stiftung, 2013).

Their large current account and balance of payments deficits at that time were caused not simply by price effects, but above all by their lower propensity to save (vis-à-vis investment) and the higher economic growth that resulted. The reductions in current account and balance of payments deficits that we are now observing in the crisis countries (and which are in principle welcome) are probably caused more by the collapse of domestic demand than by any regained competitiveness.

Stop the Balance-Sheet Recession

The decisive turn to a more strongly growth-promoting policy was finally accomplished in summer 2012 by the European Central Bank under its new President Mario Draghi – two years too late. In the meantime the death spiral of falling growth rates, rising state debt, spending cuts and problems at the banks (which had on their books the sovereign debt of their governments and loans to businesses and households suffering collapsing revenues) continued in the crisis countries. European economic policy recognised too late – if at all – that a balance-sheet recession cannot be defeated with spending cuts.

The enormous growth of debt and wealth, with the ratios of debt and assets to income (GDP) doubling over two decades, certainly dangerously increased the risks in the global financial system. In 2008, in the wake of the financial crisis, states began accumulating high levels of public debt, which had previously been largely the preserve of households and businesses. But, as already indicated above, this increase in government debt was necessary to avoid an even deeper depression. That would have been the outcome if the governments had accompanied the private-sector deleveraging with inactivity or worse with own spending cuts. Government debt can only be reduced without growth risks if other sectors such as households or businesses are willing to borrow (and invest) at the same time. Because this process also depends on a functioning financial sector, the banks must be restored to a position where they (are able to) issue loans. This may necessitate temporarily or permanently relieving them of non-performing assets and/or recapitalising them. The United States successfully pursued this route in the current crisis (as did Sweden in the 1990s), refraining from seeking rapid reductions in the budget deficit and supplying the financial system with generous liquidity. The government has in fact been able to sell certain emergency investments made during the crisis at a profit. Europe, on the other hand, has for too long left its interdependent banking system to the often inadequate rescue systems of EU member-states, setting in motion the aforementioned vicious circle. The very hesitant expansion of the Euro rescue measures to permit bank rescues was not enough to restore confidence and restart lending in the crisis countries. Europe (or the Euro zone) needs a banking union that, while limiting moral hazard, effectively combines deposit insurance, liquidity supply, insolvency processes and regulation.

Far-sighted Investment Programmes

Our growth analysis has concentrated thus far on the cyclical factors – if one can call the balance-sheet recession triggered by euphoric expansion of credit followed by financial panic »cyclical«. But the financial shock has also exposed real structural problems in these economies and exacerbated them to crisis point. These include property bubbles in Spain and Ireland, the collapse of Portuguese light industry, and the inability of the Greek state to collect adequate taxes or exert control over clientelist personnel policies in the public sector. The recession to date may at least have had one positive side-effect in reducing above all the less viable economic activities. Spain's construction sector can shrink without endangering the supply of housing or public infrastructure.

But correcting these mistakes will be a long-term affair. In the short term it will create little or no growth stimulus and in fact further slow the recovery. In view of the planning procedures involved, even sensible long-term investments like new power grids, expansion of renewable energy sources or European transport infrastructures (rail rather than road), as reflected in calls for a European investment programme, will tend to create employment only in the medium term. The contribution that such programmes could make to short-term social stabilisation in the crisis states should therefore not be overestimated. Fundamentally, the question that a European structural policy must answer is this: In which sectors do we need greater output? The idea that the answer could sensibly be left to the markets is unconvincing, given the crisis and the market failures that preceded it. But the foresight of state bureaucrats is also limited. Even the popular idea that one should look to the world market forgets that the bulk of demand stems from the internal market. Exports create prosperity only to the extent that they permit imports of desired goods. For this reason import substitution would be one possible waymark for European investment programmes, for example in the area of energy where imports contribute heavily to negative trade figures, especially in the deficit countries.

Attempts to strengthen the tradable sector in the deficit countries – an obvious move given that earlier growth models were largely defined by non-tradables – must involve integration into transnational value chains rather than merely relying on the export chances of domestic products. Nor should such a strategy forget that growth in the non-tradable sector can naturally also create prosperity, growth and employment (and has done so in the past). Europe as a whole cannot rely on export surpluses to drive growth, but must strategically seek a balance of supply and demand within the continent. That means systematically reducing imbalances and reaching a consensus about the structural orientation of the European economy. This is a process that certainly demands painful adjustments but also opens up new opportunities for growth.[3] If sectors like housing construction or the car industry suffer overcapacity, we must examine where the real needs lie.

In a debt crisis all chances for growth ultimately depend on creditors buying more from debtors than they sell to them, thus permitting them to generate revenue surpluses. Germany is doing the opposite with its growing export surpluses. The demand that debtor countries should orientate their production ever more strongly on the preferences of their creditors has dangerous repercussions. In the sphere of consumption the luxury sector would be expanded; in the investment sector the owners of wealth expect bountiful returns. In the ideal case such returns signalise chances for innovation and increasing productivity and demand. But they often arise only if either costs are cut – which often means that income falls elsewhere, especially in wages – or investors expect to be able to realise high prices. But high prices, except where they are paid for luxury goods, mean consumers having to accept falling real incomes.

If the owners of wealth do not wish to dispense voluntarily with their financial assets through investment or consumption (which would be necessary in order to reduce the corresponding mountain of debt) then political intervention is required. This could occur through a phase – of which signs are already being seen – of financial repression (with negative real interest rates) or through a wealth tax or levy used to fund necessary public goods and services.

3. Karl Aiginger, *Dreimal Regimewechsel für Europa: im Süden, in Brüssel, in Deutschland – Überlegungen zum Junigipfel 2013,* WISO direkt (Bonn: Friedrich-Ebert-Stiftung, 2013).

A Progressive Growth Strategy for the United Kingdom

Jonathan Portes

The Macroeconomic Position

The economic history of the United Kingdom over the past 30 years can be summarised as a period of fairly successful microeconomic reform, leading to relatively high productivity growth, interspersed with episodes of disastrous macroeconomic and financial mismanagement. Unfortunately, we are living through such an episode at present. Although growth has now returned this remains the slowest recovery in the United Kingdom's recorded economic history. The National Institute of Economic and Social Research (NIESR) forecasts that real per capita gross domestic product, the simplest measure of how prosperous we are as a country, will not return to its 2008 for several more years.

How did we get into this mess? The financial crisis of 2007–2009, and the ensuing Great Recession, was global. However, UK policymakers, especially those in power in the 1990s and 2000s, contributed as much as anyone to a prevailing philosophy that the only appropriate intervention in markets was to deal with specific, identified cases of market failure.

When it came to financial markets, that approach proved to be wholly inadequate. The direct result was a combination of perverse incentives, failures of corporate governance and unanticipated systemic risk in the financial sector that helped spark the crisis. Indirectly, it increased inequality at the top end of the income distribution (at the same time as, thanks to the introduction of the national minimum wage and tax credits, it was falling at the bottom end for the first time in decades). And it meant that the United Kingdom was far too reliant on one volatile sector for both growth and tax revenues, which in turn left the public finances extremely vulnerable to a severe downturn in that sector. All this meant that the crisis hit the United Kingdom particularly hard.

By contrast, the initial policy response in 2008–2009 – bank recapitalisation and fiscal stimulus – was relatively successful. Unfortunately, however, emergency bank recapitalisation was not followed up by proper restructuring. And, in mid-2010, leading the way in the G20, the Coalition Government reversed course on fiscal policy in mid-2010, with the Prime Minister David Cameron describing the new approach as »fiscal conservatism and monetary activism«. This was justified by sustained attacks on those calling for a more balanced approach. The Prime Minister suggested that the »the only way out of a debt crisis is to deal with your debts. That means households – all of us – paying off the credit card bills.« The Deputy Prime Minister claimed that the government will »wipe the slate clean of debt« for the sake of our children.

While, fortunately, the reality has not been nearly as extreme as the rhetoric, as the government has by and large allowed the automatic stabilisers to operate, it is still the case that »fiscal conservatism« – described by the International Monetary Fund as a »large and front-loaded« fiscal consolidation plan – had a substantial and negative impact on growth. The halving of public sector net investment (a cut of more than 1.5 per cent of GDP), planned by the previous administration and implemented by this one is now almost universally recognised as a major policy error.

But the impact of »monetary activism« is far less clear. Although the Bank of England did indeed expand its quantitative easing programme, this has become subject to diminishing marginal returns. Meanwhile, the financial sector remains dysfunctional. It is manifestly failing to fulfil its primary function of channelling credit to the real economy, particularly small businesses, while larger businesses, many of whom have ample cash reserves, are reluctant to invest given the continued uncertainty about future demand, both in the United Kingdom and elsewhere.

The result, combined with even worse policy failure in the Eurozone – where the pursuit of misguided fiscal policy has been far more dogmatic, and hence damaging – has been two years of stagnation. Perhaps even more serious is the long-term impact of underinvestment, both public and private, on future growth.

Of course this applies with even more force to the European Union as a whole; we have seen the creation of a death spiral of deficit cutting, leading to reduced growth – which in turn leads to reduced revenues and pressure to cut deficits faster. Paradoxically, the EU was set up in part to avoid such problems by allowing members to cooperate to secure better outcomes. But, instead of economic policy coordination, what we've actually had is a fiscal suicide pact.

Fortunately, with fiscal consolidation having slowed, financial conditions easing, and, at least for the moment, apparent stability in the eurozone, the UK economy has returned to growth – although the fact that even in current conditions this has been accompanied by house price rises, concentrated in London and the South East, gives cause for concern. With unemployed workers and plenty of spare capacity, there is plenty of scope for improvement in the short term. The United Kingdom suffers from both creaking infrastructure and a chronic lack of housing supply, and long-term interest rates remain very low by historic standards.

It would be sensible and realistic to target an increase in public investment spending of perhaps 2 per cent of GDP, focused particularly on housing, until macroeconomic conditions have normalised, with growth above trend and unemployment heading back down towards the pre-crisis rate. Ideally, such an approach should be coordinated at a European level – all EU countries, especially those in severe and prolonged recessions, would currently benefit from a coordinated boost in demand.

Sustainable Growth in the Medium Term

But getting short-term macroeconomic policy right can only limit the damage – it cannot in itself generate sustainable growth. A progressive growth strategy needs to reorient the UK economy towards equitable long-term growth that is less reliant on the financial sector and more oriented towards investment and exports. This means both building on some of the successes of the past thirty years – and they were real – as well as addressing areas in which we have underperformed. I would identify three main challenges; first, our people; second, our welfare state and public services; and third, economic dynamism.

(a) People: the forgotten 50 per cent

The United Kingdom has seen a remarkable, and remarkably successful, expansion of higher education over the past three decades. But that has been accompanied by a growing socio-economic gradient of educational and hence labour market attainment. The result is that a large proportion of those who don't go on to higher education end up without the skills that are useful in today's labour market – let alone that of the future.

Three policies are needed to deal with this:

- *Schools*. Here we have a clear model: the remarkable, unexpected and unprecedented success of London's schools over the past decade, both in improving average attainment and in narrowing the attainment gap. At its best, this success reflects a number of factors: strong political commitment at both central and local levels, extra resources and embedding high expectations for all pupils in the system.

- *School to work transition*. For those going to university, the path from school to career is clear, if not always easy; for the rest, it is a minefield. We need to set out a clear vision of how young people move from school into apprenticeships, skilled jobs and then careers.

- *A guaranteed (and compulsory) employment scheme* for the young unemployed people who fail to make that transition successfully – not after one or two years on the dole, but after three months. Long-term youth unemployment does long-term damage, both economic and social.

The UK labour market has performed remarkably well during the recession; both workers and employers have been much more flexible than in previous downturns. Jobs haven't been cut – but wages and hours have. It has been painful for many, particularly as it has reinforced a growing trend towards the casualisation of some previously permanent full-time jobs, but is far better than the alternative. In the United Kingdom, the answer is not more labour market regulation, but we should seek to influence the ways that employers behave, and how they value and invest in their workforce.

(b) Public services, welfare, pensions, and housing

The UK public remains committed to high quality public services – education, health and social care – provided largely free at point of use. But it also remains reluctant to pay the taxes necessary to fund them. This contradiction will intensify: over time, an increasingly affluent society (as, on the whole, we will become) is likely to want to spend more on improving the lives of its citizens, and an older society is likely to want to spend more on the priorities of older people. This has to mean, one way or another, better off older people – especially those who benefited from the long house-price boom – paying more. There are lots of ways this could be done – higher property or inheritance taxes, or charges for services, all payable only after death – but we need to end the expectation among relatively well-off people that they are entitled both to depend on publicly financed services in their old age and to leave their houses to their children.

The long-term future and financing of public services and the welfare state cannot be divorced from the operation of the UK housing market, which has done a tremendous amount of economic and social damage over the past half century. The combination of restrictive planning rules, high population growth, social trends towards smaller households, the fetishisation of home ownership and a dysfunctional mortgage market has led to a very large increase in house prices. This has substantially increased the inequality of wealth, probably reduced labour mobility and certainly contributed to the severity of the past two recessions. And it has pushed up the cost of the least effective part of the benefit system, housing benefit.

A progressive government would say that house prices in the United Kingdom should be more affordable, not less; and implement policies – on planning, social housing, the private rented sector and the mortgage market – designed to achieve that.

(c) Economic dynamism

The tragedy of the past 20 years is that so much of the inherent dynamism of the UK economy has been misdirected into rent-seeking in the financial sector rather than value-creating activities. That does not mean that we don't need a healthy financial sector – on the contrary, it is a sector in which long-term global growth prospects are good and we have a clear comparative advantage. But there are huge distortions in the way the sector currently operates. We need to reshape it so that, domestically, it performs its central task of channelling money from savings to investment in the real economy; and internationally so that it delivers real value to customers; or it will not ultimately be sustainable or successful.

That will require changes not just in regulation, but in corporate governance, market structure and ethical standards. Transparency on pay would be a start – perhaps with, as in Switzerland, obligations to secure affirmative consent from shareholders (and indeed, especially in financial institutions, other stakeholders).

The dominance of the financial sector, and its focus on short-term rent-seeking behaviour, has also contributed to the weakness of the UK economy in turning its generally good performance in primary research into innovative businesses. Getting innovation policy right is notoriously tricky and is certainly not about throwing public money at private business; but there is a strong case for redirecting money from the wasteful and ineffective »patent box« (essentially a government subsidy to large pharmaceutical companies) to co-financing riskier, long-term investments.

A real challenge to restoring UK economic dynamism is the current pressure for restrictive immigration policies. Government needs to make clear that immigration, like trade, is indeed central to making the United Kingdom open for business, and hence to our growth strategy. The next step would be to examine each aspect of immigration policy – but in particular those relating to students, skilled workers and settlement – with a view towards reorienting them towards growth. Greater coordination of policy at EU level – in particular, aimed at facilitating mobility of skilled workers – would also help.

Beyond »Growth«

Growth matters. But it matters as a means to an end, not an end in itself. Whether we phrase it in the traditional economic language of »utility functions«, or the more fashionable concept of »subjective well-being«, it is human welfare that we should ultimately be concerned about. That's not just about equity, redistribution or the provision of decent minimum standards for all, although all these are important; it is about giving everyone a chance to succeed; and, if they fail, another chance.

There is no magic formula, either for the United Kingdom or for other developed countries struggling with similar issues. We should be optimistic – taking a medium term view, our countries have never been so prosperous, our people never so educated, technological and scientific progress never so rapid and potentially liberating, and the scope for continuing to improve human welfare never so great. If »progressive« means anything, it should represent a belief in the potential for government and society to fulfil that potential for human progress.

A Progressive Growth Strategy for Spain

Emilio Ontiveros

The Most Important Economic Challenges

The Spanish economy is a good example of the vicious circle in which the economies on the periphery of the Eurozone have been immersed since the start of the crisis in the summer of 2007. This circle consists of three elements: an economy in recession, a vulnerable banking system and a public sector deficit and debt expanding in parallel with the other two elements. The fiscal consolidation policies implemented since May 2010 have contributed to the further deterioration of economic activity and this in turn damages the quality of bank assets.

Besides the commonalities with other economies in the Eurozone, Spain presents specific features that should not be overlooked. These have emerged from the situation that characterized the Spanish economy at the onset of the crisis. It may be useful to recall its main features at the end of 2007:

- With the onset of the financial crisis in the United States in the summer of 2007, a long period of growth and job creation ended in the Spanish economy. The average pace of economic growth during the decade previous to the crisis was above 3.5 per cent in annual terms, well above the EU average. In 2007, Spanish GDP growth was 3.6 per cent.

- At the end of 2007 the unemployment rate in Spain was equal to the European Union average of 8.5 per cent.

- In 2007, Spain did not register a public sector deficit. On the contrary, Spain enjoyed a surplus of just over 2 per cent of GDP, while public debt represented only 36 per cent of GDP.

However, alongside these positive indicators the Spanish economy exhibited some significant private-sector imbalances, in particular the very high concentration of economic and financial activity in residential construction and real estate, which accounted for more than 12 per cent of GDP and employment. The main players in this sector had very high levels of indebtedness, and so did households, which had made significant investments in housing.

One of the main reasons why the Spanish economy was growing at such a high rate, and with a large concentration in real estate, was the cost of financing – low in historical terms – since the inception of EMU. This factor was also the main reason behind the rise in private debt during the 2000s. That is now Spain's main problem, and one of the most important constraints on GDP growth. Spanish private debt as a percentage of GDP is one of the largest in the Eurozone and the pace of deleveraging is very slow. It is important to underline the private nature of the Spanish economy's problems when the crisis began. There is a strong correlation between growth in private debt and the fall in private consumption after the crisis. It is also a key factor in the lack of stability in the Spanish banking system.

The collapse of economic activity led by residential construction led quickly to a very high rate of unemployment and the weakening of domestic demand. Tax collection fell strongly and the fiscal deficit rose. The Spanish banking system began to show solvency problems arising from the erosion of the quality of its assets linked to the real estate sector.

Since May 2010, the implementation of fiscal austerity policies has compounded the weakness of domestic demand, accelerating the rise in unemployment and rapid deterioration in the quality of bank assets. The situation in the banking sector was so severe that, in the summer of 2012, the Spanish government demanded the provision of a credit line from European institutions to recapitalize the weakest Spanish banks. The tensions in government bond markets have also contributed to the weakness of Spanish banks, traditionally major investors in Spanish government debt.

The most expressive and distinctive Spanish economic indicator is the unemployment rate, the highest in the Eurozone, particularly among young people. As a result, wages are decreasing, both in the private and in the public sector. This evolution helps us to understand the vicious circle: the weakening of private demand and the consequent deterioration of public revenues.

In this context, it is clear that the main challenge for the Spanish economy is to reduce unemployment. A significant stimulus to aggregate demand is needed and, given the restrictions imposed by fiscal austerity, this can come only from the European institutions.

If both internal and external demand could count on a more growth-oriented European context, it would be possible to reduce the vulnerability of the banking system and Spanish public finances would stabilize. However, since the onset of the crisis, external financing to the private sector of the Spanish economy has practically disappeared: with a few exceptions there was a sudden halt in the capacity to obtain foreign financing.

Requirements for a Progressive Economic Policy

The main priority should be to re-establish the necessary conditions for job creation, above all, a return to growth of aggregate demand in the economy. Despite the dynamism of Spanish exports in recent years, its contribution to economic growth is insufficient to offset the still very weak domestic demand. Despite the easing in the pace of fiscal consolidation to be approved by the European Commission, it is absolutely necessary to receive some stimulus to aggregate demand from the European Union.

Assuming this orientation as a priority, the Spanish authorities should continue to implement reforms aimed at improving the supply side of the economy, promoting a change in the growth pattern toward a less vulnerable and more competitive economy.

Besides improving labour market reform, now in force for one year, it is necessary to prioritize the following:

- Reform of public administration towards greater efficiency. Without diminishing the constitutional powers of regional and local administrations, this would require a review of administrative procedures. It is also necessary to review all the measures involved in the joint provision of common services for smaller municipalities.

- Reform of the public pension system, in order to ensure its sustainability in the medium and long term. The extension of the retirement age and the increase in contribution periods are also necessary. Because the previous policy measures would have higher costs for people with low incomes and wealth, it would be necessary to secure social cohesion by adopting programmes to mitigate the negative effects of fiscal adjustment in essential welfare services and equality, especially with regard to education and health care. These two areas, together with public investment, have been the biggest losers in the process of fiscal consolidation which has been taking place in the Spanish economy since May 2010.

- Reform of the energy sector in order to achieve more internationally competitive prices. The high cost of electricity hinders business competitiveness. This is influenced by the so-called ›tariff deficit‹. A credible plan is needed to eliminate this financial imbalance to bring about the necessary convergence of electricity prices with those in more competitive economies in Europe.

- Reforms designed to facilitate the creation of enterprises. Removal of bureaucratic barriers to business creation and support for the creation of specific mechanisms of non-bank financing for new businesses.

Is There an International – or European – Dimension?

The recession in the Eurozone provides the clearest proof of the failure of the policies adopted to overcome a crisis that was not genuinely European, but that in the Eurozone has generated the most severe damage: in the real economy (with lower growth and high unemployment rates), in the financial economy (hindering the transmission of monetary policy and producing a severe sovereign debt crisis) and the erosion of the quality of common institutions.

The Spanish economy has a significant share – with others in the Eurozone – of the problems, especially those countries considered peripheral. The most prominent is the absence of growth, but also the lack of acceptable results from the implementation of policies aimed solely at fiscal consolidation imposed by the European institutions. The implementation of fiscal austerity has provided enough evidence: the recession has become stronger and the imbalances in public finances have not been addressed sufficiently. Some of the structural reforms implemented in recent months have not provided for a re-start of growth, but rather the opposite.

This is the case with regard to labour market reform: providing greater flexibility to companies has significantly facilitated the dismissal of workers, driving unemployment to historically high levels. More than 57 per cent of young people in Spain are unemployed. Nearly 2 million families have all their members unemployed. Among the employed, the temporary rate is close to 30 per cent.

It is time, therefore, to implement measures aimed specifically at offsetting the depressing effects of the policies applied so far. These should be defined by the European institutions. Indeed, in the absence of measures to boost growth – through stimulus implemented by the European institutions, the Spanish economy will be unable to achieve any meaningful recovery. Moreover, continuation of the current recession will significantly erode potential economic growth.

Urgent decisions

The EU faces depression in some Eurozone economies, thereby increasing the threat of fragmentation. To stimulate economic growth, curbing the rise in unemployment is the most urgent task. To do this, the EU has the following options, all of them complementary:

- A more flexible approach to fiscal consolidation. The consolidation of public finances is important, but as the IMF said »it is not a sprint but a long distance race«. In any case, it has to be reconciled with the appropriate expansionary measures to offset the contractionary effects of extreme austerity.

- Pan-European investment programmes aimed at reducing unemployment, particularly among young people, as well as measures aimed at strengthening the European single market.

- Support for the ECB to carry out specific financing programmes to small and medium-sized enterprises in order to alleviate the obvious problems of monetary policy transmission in the peripheral economies. In Spain, SMEs are responsible for almost 70 per cent of employment. Strengthening programmes of aggregated loans to SMEs by the ECB or direct funding must be possible courses of action to be explored by the ECB. These decisions are necessary to avoid additional financial fragmentation in the Eurozone.

- Expansionary policies, mainly through income policies applied in those economies in the Eurozone with lower unemployment, higher rates of labour productivity and less severe scrutiny by bond markets.

- It is necessary to develop and present a detailed timetable leading to banking union, at least in the Eurozone.

- The requirements and steps to fiscal union must be defined, at least in the Eurozone.

A New Formula for Pro-growth Policies

The duration and severity of this crisis is endangering the political, economic and social integration of Europe.

At present, progressive policies must prioritize the rapid overcoming of the recession in the Eurozone, stimulus of economic growth and a return to employment growth. By doing so, they would also neutralize the risks of fragmentation of the Eurozone and the growing disaffection of European citizens towards its institutions, particularly those belonging to the Eurozone.

The four sets of policies highlighted in the previous section are necessary conditions for any policy of progress. Next to them, strengthening Community institutions and their democratic legitimacy should be part of any progressive agenda. The role of the European Parliament is particularly important.

Beyond the necessary institutional strengthening of the EU, any progressive orientation should take into consideration the unprecedented inequality that is taking place in the distribution of income, both at the EU level and within the Member States. Inequality is expanding as a result of the crisis. The situation is particularly bad in peripheral economies.

Fiscal consolidation decisions proposed by the European institutions should take into account the effectiveness of taxation to ensure compliance with tax obligations by all economic agents and to reduce fraud. This is one of the preconditions of social cohesion in the European Union. To this end, EU structural funds should be increased and used more efficiently.

A Progressive Growth Strategy for Italy

Paolo Guerrieri

Introduction

There must be a return to growth in the Italian economy, as only sustained growth will enable Italy to eliminate the high level of public debt steadily accumulated over the years (the 2013 figure is about 130 per cent of GDP). To achieve this, as we shall see below, important domestic reforms must be introduced to remove structural obstacles that have hampered the economy (more in Italy than in other European countries), preventing it from adjusting positively, from the late 1990s onwards, to new dynamic and revolutionary IT technologies and changes in global equilibrium caused by development in emerging countries.

There must also be a significant improvement in both the European and the international economic situation if Italy is to enhance its exports, traditionally a strong point of the country's growth pattern. Clearly, what is needed is an overall growth strategy for the entire euro zone; domestic measures and even important reforms introduced by individual countries are not sufficient in an area in which there is a high level of interdependence. Each state must take action to bring about economic reconstruction, but this alone will not be sufficient to produce economic recovery. Without a concerted effort towards growth, countries in difficulty will have no chance of effectively adjusting their economies, irrespective of the austerity imposed.

The Challenges Facing the Italian Economy

The onset of the euro-zone crisis that subsequently spiralled into a deeper economic downturn hit the Italian economy harder than most other countries in Europe. It was already ailing prior to the crisis, having lost ground in terms of growth compared to the more advanced countries, starting from the mid-1990s and in the following 15-year period. Even during the short-lived economic respite (2010–2011), recovery in Italy was slight, and below the European mean. The economy then fell into a period of economic recession that was more prolonged and severe than anything witnessed since the end of the Second World War. Proof of this can be seen in the constant stream of enterprises that have been forced to cease their activities, partly due to a powerful credit crunch that shows no signs of easing. The repercussions for employment have been particularly severe: the current unemployment rate exceeds 12 per cent, rising to around 40 per cent for the young.

However, all this must not prevent us from acknowledging the incisive action that has been taken to adjust fiscal issues since November 2011, when the financial crisis deepened. This intervention has led to a significant improvement in the structural deficit of public finance. Thanks to the positive results achieved, in June 2013 the procedure imposed on Italy for breaching the deficit level, which commenced immediately after the onset of the slump in 2008–2009, was lifted.

Of the numerous factors that contribute to the severe and lasting Italian recession, many are longstanding as they are linked to structural issues that have long afflicted the Italian economy. The most important of these include weaknesses in the production system and research, the lack of infrastructure, the inefficiency of the welfare system and public administration, and territorial rivalry between north and south. To some extent, all these weaknesses are reflected and summed up in one problem: the stagnation of productivity in Italy, particularly so-called total factor productivity. This highly significant and concise indicator sums up the capacity of an economy to efficiently combine overall capital and labour endowments and represents the prime ingredient for a nation's economic growth. In Italy, this indicator has shown a particularly negative trend, especially over the past decade. Although there has been only a small increase in nominal salaries, in the past decade, stagnating productivity has led to a widening gap in competitiveness, thus penalising the Italian economy. Although the export trade has suffered, compared to other European countries such as France and Spain, Italy has succeeded to some degree in maintaining its position by managing to contain deficits in the trade and current balance. The past two years have witnessed an initially limited inversion of the negative trend, with the trade balance once more registering a surplus, although this is largely due to the period of recession and subsequent reduction in domestic demand and imports that began at the end of 2011.

Remedies for Promoting Growth

There must be a return to growth in the Italian economy. Since there is (as we well know) a very close positive correlation between growth in productivity and GDP which, compared to the past decade, has become even stronger during these years of economic crisis, it follows that only a significant increase in Italian productivity over the next few years will enable the country to raise its future growth trend. Achieving this objective will depend on two factors: important domestic reforms to eliminate the aforementioned structural obstacles and a marked improvement in the European and international economic scene capable of enhancing exports, traditionally a strong point of Italy's growth pattern. On the domestic front, tough policies and intervention are needed to counter the current recessionary spiral and help the Italian economy to link up to an international recovery that could start to become visible at the end of the current year. In this respect, there are three fundamental macro-areas to be taken into consideration.

First, there is the question of public finance, an area where it is vital to keep public accounts under control. Italy is back among the virtuous countries as regards the deficit-GDP ratio, but it remains at the top of the list of countries with the largest debt. To avoid the sanctions envisaged under the new Fiscal Compact, the government must include in its budget policy a balanced medium-term path that avoids stifling the economy and gives more opportunity for public investment to return after years of heavy penalisation. Policies involving a spending review and the sale of publicly-owned assets must contribute to this process.

A global outlook is needed to counter the sharp reduction in domestic demand which, in the past two years, has more than offset the positive contribution made by growth in exports. In this case, the key problems are, on one hand, how to ensure greater liquidity and credit for businesses, the victims of the credit crunch, and on the other hand, how to significantly reduce the »tax wedge« (income tax and social security contributions) so as to benefit both workers and employers. As regards the latter, the main obstacle stems from restrictions on national expenditure, whereas for the former, there are two possible effective solutions: the first is the rapid payment not only of the sum already allocated, but also of all the arrears owed to enterprises by public administration, currently estimated at approximately 100–120 billion euros. This can be done through careful management of state insurance systems and the consequent increase in national debt. The second solution is to re-introduce loans to enterprises (and families) by reactivating banking channels and/or alternative means of financial support.

There is no time to lose. The country's industrial foundations are steadily crumbling. The third essential step is to prevent this erosion so that Italy can link up to economic recovery in Europe. Although many Italian enterprises have reacted well to the economic downturn by modernising and becoming more international, this number remains small and, at an optimistic estimate, represents no more than a quarter of the entire productive system. The remaining, or what amounts to the majority of enterprises, are still in great difficulty. In fact, since the beginning of the recession, Italy has lost 15 per cent of its manufacturing strength and 25 per cent of its industrial production. What is needed are far-reaching processes of reconversion and large-scale productive reorganisation. Clearly, there are numerous ways of promoting these changes, but it is essential to introduce industrial policies focused on production and research that help enterprises to group together, innovate and become more international.

The Need for a European Outlook

Although a return to economic growth means that Italy must pursue a reform path that will require a long-term effort, it is clear that positive domestic intervention will not suffice. In order to get back on a path of sustained and lasting economic growth, Italy must interact with Europe, and particularly the euro zone. This Europe will, however, be different from the one we have known in recent times: today's Europe is an area of deep economic crisis, increasingly divided between creditor countries and indebted nations, and where unemployment, inequality and poverty are on the increase.

Obviously the European crisis is part of a much broader, global crisis, but it is principally the result of the wrong remedy – austerity packages – introduced after an equally erroneous diagnosis – the fiscal irresponsibility of indebted nations. Principally on account of such policies, indebted countries, Italy included, have found themselves spiralling in a vicious circle, in which tax hikes and spending cuts depress income and prevent a reduction in the debt/GDP ratio. Growth is out of the question, and the most realistic prospect – assuming that the European Central Bank manages to avert a disastrous end to the euro – is a long period of stagnation, with an immediate effect on the Italian economy. If this situation continues, stagnation could last for most of the current decade.

Another scenario could emerge, although its creation is currently meeting strong political opposition. No one has a magic formula for producing economic growth, but what is clearly needed is a strategy that encompasses the whole of the euro zone.

A return to economic growth in Europe will depend not only on enhanced competitiveness and the full implementation of structural reforms in each individual country, but also on the capacity to exploit the European domestic market that must become a new hub for European development. The euro zone is not a small open economy; on a world scale, it is the second largest economic area in terms of income produced and wealth accumulation. Germany's export-led growth formula cannot therefore be extended to the whole European zone. In fact, foreign demand and exports to the rest of the world cannot compensate for a lasting weakness in the European domestic market which is too large and wealthy to be sustained by the American and/or Chinese consumer.

Achieving a return to growth will involve the use of made-to-measure methods and policies. Two of these are worth mentioning: symmetric adjustment mechanisms for indebted and creditor countries that, contrary to what has occurred thus far, oblige countries with a deficit as well as those with a surplus to adopt reciprocally compatible adjustment measures prescribed by the new European governance. Moreover, the domestic market must be promoted. This will mean liberalisations within Europe, the creation of a joint area of research and innovation and also European investment to jointly finance services and strategic areas (focusing on research, alternative forms of energy, eco-friendly technologies, education and communications).

Ensuring growth throughout the euro zone will make it easier to pursue a path of greater economic integration, a prerequisite for guaranteeing the stability of the single currency. Steps to be taken by European governments in this direction should include important measures such as banking union under the central control of the ECB. This would interrupt the vicious circle created by the banking sector and sovereign debt crises, a combination that has been largely responsible for fuelling the economic crisis over the past two years. Another step would be to take action to govern finance which must be used to support the real economy. Finally, intervention is needed to share debt risks and eventually build a fiscal Union entailing distribution of European debt and the emission of eurobonds.

New Growth Engines

The policies adopted in Europe by mainly centre-right governments, led by the German Chancellor Angela Merkel, are not working. These are the so-called structural reforms based on austerity and the restructuring of supply, and are designed to open up markets and make them more competitive. However, they are unable to trigger and promote a new lasting cycle of expansion on account of the vicious circle into which European countries have spiralled and from which they are unable to escape. What is needed are structural reforms in individual states accompanied by medium- and long-term public and private investment in all the above sectors that could become new growth engines.

For example, the golden rule could be applied to agreements on strict budgetary policies, such as the fiscal compact, and alterations could be made to European and international financial rules that oppress medium- and long-term investments but reward short-term financial speculation. Moreover, use could be made of policies to reorganise national budgets by restructuring public expenditure; this would mean a reduction in current spending and more capital expenditure.

These proposals involve the re-establishment of a correct and subtle balance between markets and the supply of collective goods, essential for the efficient functioning of a growth-oriented market economy. In the past few decades, this equilibrium has been lost due to a period of ideologically driven free trade and undisciplined globalisation that has given rise to increasing instability, inequality and an inordinate concentration of economic and financial power in the hands of an élite. It is important to restore this balance, not by returning to the government activism characteristic of the 1960s and 1970s, but by promoting new methods of intervention such as those mentioned earlier. Only by introducing these new strategies can we begin to reduce inequality and restore global growth and thus comply with the ever more stringent restrictions arising from the need to consolidate public debt.

A Progressive Growth Strategy for France

Pierre-Alain Muet

By electing François Hollande President of the Republic and then giving the Left a large majority in the Parliament, French voters were expressing a desire for a new kind of politics. In order to exit a crisis that has hit Europe particularly hard fundamental change is needed on a European level to establish the solidarity that at present is largely lacking.

The Situation in France

For the past five years, there has been null growth in France and when the Ayrault government took office GDP per capita was still 3 per cent below its 2008 level. The brief upturn that followed the 2009 recession did not, indeed, overcome that recession, the euro zone crisis having plunged Europe into a new recession before the economy was able to recover from the first. Unemployment had been growing continuously since 2008, as a consequence of null growth giving rise to the usual vicious circle: weak growth – job losses – falling purchasing power – a further fall in growth.

Added to this situation, due in large part to the crisis, were two characteristics that can be ascribed more to previous policies than to the crisis: debt that had doubled over ten years of right-wing government and which rocketed as a result of five years of massive structural deficit in public finances; an external deficit without precedent in recent history resulting from industrial decline and a deterioration of competitiveness that has been ongoing since 2003.

In June 2012 France thus combined four deficits: an employment deficit, a demand deficit, a lack of competitiveness and a structural deficit afflicting the public finances. Confluence of both a supply problem and a demand problem is rare. Even rarer is having to solve them when debt reduction calls for a rapid decrease of the public deficit, thus depriving the government of the usual methods of economic stimulus, which necessarily have a budgetary cost. Sorting out the French economy required that all four deficits be addressed, but it had to be done in order and based on social justice, giving priority to debt reduction and jobs before tackling competitiveness.

François Hollande's Economic Policy

Since July's supplementary budget the Ayrault government's three policy priorities have asserted themselves and are to become the main strands of the 2013 budget: debt reduction, maintaining jobs and fair taxation.

In July 2012 three important measures were adopted in a bid to rectify previous economic policy: abolition of subsidies for overtime, which made no sense in a context of massive unemployment; cancelling the previous government's decision to drop the introduction of so-called social VAT, whose implementation – scheduled for autumn 2012 – would have depended strongly on growth that was already very weak; and, finally, the re-establishment of the solidarity tax on wealth abolished by Nicolas Sarkozy at the end of his term of office.

These urgent measures corrected the trajectory, while the 2013 budget aims to decisively influence the direction of deficit reduction, fair taxation and the priorities announced during the presidential campaign: jobs, education, housing and justice.

The 2013 Budget: Reducing the Deficit without Imposing »Too Much« of a Drag on Growth

During François Hollande's presidential campaign it was proclaimed that France's public finance deficit had to be brought back to 3 per cent in 2013. This aim enabled the left-wing government to make deficit reduction one of the priorities of its first year in office, while, at the same time, not making this nominal deficit a taboo in order not to have to sign up to austerity policy if growth did not meet expectations.

Throughout the debate on the organic law transposing the European Treaty the Socialist Group had, indeed, insisted on the fact that the relevant objective for public finances was the structural deficit, since it enabled the budget to reflect the current economic situation by letting the »automatic stabilisers« operate and, furthermore, respecting the policy choices embodied in the adopted budget.

The preoccupation that dominated the run-up to the 2013 budget was twofold: reduce the deficit rapidly while minimising the negative impact on growth and on the lowest incomes. This was reinforced because fair taxation, leading to the abolition of unfair and inefficient loopholes and putting the onus on the wealthiest French citizens, was not supposed to encroach upon consumption. In the situation likely in 2013, in which growth would be limited by demand, any further dampening of already subdued consumption had to be avoided.

The budgetary effort was in the amount of 30 billion euros: 20 billion in revenues and 10 billion in spending cuts. This two-thirds, one-third option was judicious. In the short term, spending cuts have a more depressive effect than increasing revenues (in the long term it is generally the other way round). Furthermore, the choice of measures has been extremely selective on both the spending and the revenue sides in order to impinge as little as possible on growth.

On the spending side the cuts in the amount of 10 billion euros resulted neither in cuts across the board nor in brutal spending cuts. Instead, a selective policy was applied, eliminating inefficient spending, while pursuing three priorities: jobs, education and housing.

Not only were the employment-policy outlays maintained, but the creation of 100,000 future-oriented jobs in 2013 was an apt response to current economic needs: creating future-oriented jobs gives young people a sustainable income and restores their confidence, along with that of their families.

On the revenue side, the 2013 budget did not entail any general tax increases, either on households or on companies. On the contrary, it abolishes unfair and inefficient loopholes. It re-establishes progressive income taxation. It corrects the major tax-related inequalities characteristic of the French tax system: those between large and small enterprises and between labour and capital. By focusing more on the highest incomes it re-establishes fair taxation, while maintaining consumption and growth.

An Important Fiscal Reform

The major income tax-related reform is undoubtedly the abolition of levy at source *(prélèvements libératoires)* on interest and dividends and of flat-rate levy *(prélèvements forfaitaire)* on capital gains on the sale of securities. The 2013 Finance Act will result, for the first time in France, in capital income finally being taxed like labour income at the income tax rate. Progressive taxation is being enhanced with the establishment of a marginal rate of 45 per cent on incomes above 150,000 euros and the ceiling on the »*quotient familial*« (factor applied during calculation of the income tax due by a French household), which benefits in particular the highest incomes, has been reduced from 2,300 to 2,000 euros.

With regard to enterprises, three arrangements that had enabled in particular large companies to significantly reduce their taxes have been reformed. First of all, the difference in treatment between dividends (included in taxable profits) and interest on loans (which were tax deductible in their entirety). Large and multinational companies have made extensive use of this discrepancy to reduce their taxable profits. The Finance Act thus reduces the deductibility of interest on loans to 85 per cent in 2013 and to 75 per cent in 2014. The advantage accruing from the exemption of long-term capital gains realised on the sale of securities is also being reduced significantly. Finally, the deferral of previous losses will be limited to 50 per cent of income.

Revision of Prospective Growth and Nominal Deficit

At the start of 2013 it became evident that the growth prediction for 2013 would not be met. The government made it clear that it would not apply an austerity programme in pursuit of the 3 per cent target because this would only drive the economy deeper into the recession that is already under way in Europe. As part of the stability programme already discussed in the Parliament in April 2013 and submitted to the European Commission, the predicted deficit for 2013 was revised to 3.7 per cent as a result of the worsening economic situation. The structural effort would remain unchanged – at 1.9 per cent – in conformity with the adopted budget.

After negotiating with the European Commission France obtained a two-year respite to achieve a headline deficit of 3 per cent of GDP, giving it room to manoeuvre in which to prioritise restoration of growth.

The Importance Attributed to Social Dialogue

The most fundamental structural reform implemented by the Ayrault government, the importance attributed to social dialogue, will assert itself in two areas: competitiveness and employment.

Since 2003, France's external deficit has steadily deteriorated, reaching 75 billion euros in 2012, having achieved surpluses of between 20 and 30 billion euros between 1995 and 2002. The lack of industrial policy over the past 10 years has exposed the two major weaknesses of French industry. First, the excessively wide gap between large enterprises – which globalisation suits perfectly – and small and medium-sized enterprises, whose presence in external markets is limited. Secondly, a product range that lacks sophistication and relies insufficiently on innovation, which makes French exporters more vulnerable than others to price variations – and thus the euro exchange rate – and the development of wage costs. The sole measure taken by the Right in the past ten years was the vote held before the presidential election on reducing social security contributions to be financed by a rise in VAT, due to come into effect after the election, in autumn 2012.

After abolishing it in July 2012 the government replaced it with a tax credit for competitiveness and employment (*Crédit d'impôt pour la compétitivité et l'emploi* or CICE) corresponding to a reduction in employers' contributions of 20 billion euros from 2013, funded fifty-fifty from 2014 by a further reduction in the deficit and through taxation (VAT and environmental tax). This measure was part of a Pact for growth, jobs and competitiveness, which included many structural measures intended to restore competitiveness.

This pact gave a pivotal role to social dialogue, highlighting its role in a nation's competitiveness. But bargaining will clearly take its proper place in the area of employment, illustrated especially by the conclusion of negotiations on inter-generational contracts as well as by safeguarding career paths.

The first measure taken by the government was direct job creation in the non-profit sector (subsidised jobs and future-oriented jobs for young people). This is the measure best adapted to the current economic situation, characterised by weak demand and declining purchasing power. By increasing the income of workers who find or are reinstated in a job it increases national income and quickly enhances economic activity.

The second measure, inter-generational contracts, is more structural. It encourages enterprises to hire young people and, at the same time, to retain older workers, thus responding to weak participation rates at both ends of working life.

The third is the conclusion of negotiations on safeguarding careers. It involves a major change: for example, one of the elements in these negotiations and the law that transposes it – the development of short-time working – has enabled Germany to get through the crisis by reducing unemployment.

However, growth is not possible solely on the basis of national policies.

Towards a Progressive European Growth Policy

The sovereign debt crisis affecting the euro zone, although Europe is much less encumbered with debt than the United States or Japan, illustrates Europe's main failing: the lack of solidarity. By raising doubts concerning the solidarity which brought them together European states have managed to transform the rescue of Greece, a country responsible for only 3 per cent of European GDP, into a general crisis of the euro zone.

Europe is currently dominated by conservative parties applying the same recipes that plunged the world into crisis: free trade as the horizon of external relations and austerity to the exclusion of any other policy. It is time to restore its original meaning to the European construction: an area of solidarity.

Social and fiscal dumping run counter to the European project. Solidarity has been replaced by confrontation between countries, competition between employees, reduction of social standards, exploitation of resources and depletion of biodiversity. After decades of rivalry, what makes Europe strong must be restored: cooperation, which has made possible the upward convergence of living standards and social protection. This cooperation must apply in all areas: in the macroeconomic domain to implement deficit-reduction policies that do not sacrifice growth; in the fiscal and social domains to avoid uncooperative behaviour; and in the domain of innovation in order to benefit from economies of scale.

Combating unemployment and inequalities must constitute the main objective of the next stage of European construction: this is how the European project will once more inspire popular confidence and hope. We must aim at introducing a »European social treaty«, advocated in particular by the European Trade Union Confederation (ETUC). Such a treaty must guarantee such fundamental rights as labour rights, the level of social protection, trade union rights and favourability clauses. The European Commission should also call on the ETUC when it comes to working out any text concerning the rights of employees and labour regulations. Finally, youth employment must be a priority.

Single currency, the Schengen area, Airbus, the financial transactions tax backed jointly by the French PS and the German SPD in their respective parliaments before becoming the object of closer cooperation, many achievements of the EU have been negotiated and supported by a limited number of member states, going out on a limb, before being joined by others and sometimes by all. This approach must be extended to other areas in order to make progress in social and fiscal harmonisation (common corporate tax base) and the launching of major projects in infrastructure, industry, technology, science and energy. A policy of future-oriented investments funded by the European Investment Bank is indispensible for developing Europe's long-term competitiveness, making Europe the first eco-continent on the planet and compensating for the depressive impact of budget consolidation policies. The first step must be the rapid implementation of the growth pact.

In contrast to liberal free trade we propose fair trade, based on respect for human rights, democracy, social progress and protection of the environment, including the implementation of a carbon tax at the borders of the European Union.

A Progressive Growth Strategy for Poland

Marcin Piatkowski

Introduction

Poland, the largest economy among eleven post-socialist EU member states, with almost a 40 per cent share of the region's GDP, has just experienced probably the best twenty years in the more than one thousand years of its history. Since 1989, when the Solidarity-led social movement spearheaded the collapse of communism, Poland has been the fastest growing economy in Europe and one of the fastest in the world, beating most Asian Tigers and other rapidly growing emerging markets. Poland was also the only European economy to avoid a recession during the current global crisis. In 2012, Poland's GDP was almost 20 per cent higher than in 2007, a peerless performance among all EU27 countries.

In 2013, Poland has achieved levels of income, social well-being and happiness never experienced before.[4] Its GDP per capita (PPP) has reached 61 per cent of that in Western Europe (EU17), an income level last seen in the year 1500, according to historical income statistics.[5]

Poland is also well placed to continue to converge with Western Europe. Long-term projections by the European Commission, the OECD and independent think-tanks suggest that Poland will likely reach up to 80 per cent of the EU15 level of income by 2030. In doing so, Poland will have moved from the economic periphery of Europe, where it languished for centuries, to Europe's economic centre. This achievement would mark the arrival of a new Golden Age for Poland.

However, if this convergence process is to be successful it will need to be supported by adequate policymaking and an adjusted growth model. While cautioning against overconfidence about the ability of economics to precisely pinpoint the future drivers of growth, this paper discusses what a new growth model should look like, reflecting the lessons of long centuries of Polish economic history, the transition period and the most recent global crisis.

The New Growth Model

Despite an impressive economic performance since 1989, especially during the global crisis, and overall fairly optimistic growth projections that suggest that Poland's convergence with Western Europe will continue at least until 2030, the prospects for continued growth are far from certain.

First of all, the projections may simply prove to be wrong: despite many strengths and upside risks,[6] Poland's growth and the speed of convergence may decline much faster than anticipated. This might occur largely because of the slowing labour productivity growth as the easy post-transformation reserves become exhausted[7] and as Poland continues to lag behind in innovation.[8] In addition, growth may be undermined by low saving and investment rates, which place Poland at the bottom of the EU28, a still largely unfriendly business environment, with Poland placed only fifty-fifth in the World Bank's Doing Business ranking, an inefficient public sector, faster demographic decline driven by continued emigration and low levels of social trust.[9] What, then, would a new growth model that could help ensure Poland's full income convergence with the West look like?

In the short term, the main focus should be on accelerating growth (projected at only around 1 per cent in

4. Well-being is defined in this paper in a narrow sense of living standards to contrast it with wider definitions of well-being, which include subjective assessments and emotional reactions.

5. Piatkowski (2009): The Coming Golden Age of New Europe, Center for European Policy Analysis Report No. 26.

6. Piatkowski (2011): Post-Crisis Prospects and a New Growth Model for the EU-10, Center for European Policy Analysis Report No. 33; Piatkowski 2009.

7. Van Ark and Piatkowski (2009): Productivity, Innovation and ICT in Old and New Europe, in: D. W. Jorgenson (ed.) The Economics of Productivity.

8. World Bank (2012): Poland. Enterprise Innovation Support Review.

9. Social Diagnosis (2013): Social Diagnosis. Objective and Subjective Quality of Life in Poland, The Council for Social Monitoring. Available at: http://www.diagnoza.com/.

2013, the lowest in 20 years), which is now suffering mainly from subdued domestic demand. This could be done (i) by changing the distribution of GDP towards the poorer segments of society with a high marginal propensity to consume, especially locally produced products and services, (ii) by increasing public and private investment and (iii) by further expanding exports.

Specifically, a change in income distribution to bolster effective demand could be achieved by, inter alia, increasing the progressiveness of the personal income tax (which declined following the introduction of two lower tax rates in 2009, 32 and 18 per cent), including by restricting child tax credits to families with three or more children (thus at the same time supporting demographic policy and reducing the incidence of poverty, which is most prevalent among large families); introducing a tax based on the market value of real estate; and raising social assistance thresholds, including for welfare programmes in which payments would be contingent on job search and additional training.

With regard to increasing investment, given the current fiscal constraints, with current public debt close to debt limit of 55 per cent of GDP laid down in the Public Finance Act (and also to the 60 per cent constitutional debt limit), there is only limited room for increased public investment. That said, the existing limit should be used to the maximum, benefiting from the lowest cost of public debt on record. In addition, the government should increase the flexibility of fiscal rules for local governments to ensure that they can use all of the available EU funds to support investment. The major growth boost, however, would come from higher private investment. This could be achieved by introducing a time-bound investment tax credit, fundamentally simplifying the investment process, especially as regards construction permits (on which Poland ranks only in one hundred and sixtieth place in the Doing Business ranking, one of the worst in the world), and expanding the use of public-private partnerships, including expanded use of state guarantees. In addition, the government should promote investment through BGK, the state-development bank, and the recently established Polish Developmental Investment, a state-owned special investment vehicle.

Lastly, but most importantly, the government should focus on further increasing exports, which still represent only about 40 per cent of GDP, below the EU average. The time to promote exports is especially opportune given the super competitive level of the real exchange rate (which turns Poland into the »China of Europe« in terms of price competitiveness) and the ongoing eurozone crisis, which keeps the Polish zloty weak despite its strong fundamentals. The main action should concentrate on strengthening export financing and export insurance, subsidising costs of foreign market entry for SMEs and fundamentally reforming diplomatic services to focus on promoting exports and investment (and performance-based assessment).

The savings ratio has to rise

Poland does not save enough to support high investment rates and to insulate the economy from future crises by lessening reliance on import of foreign capital, especially of the fickle portfolio capital, which can come in and out of the country at the least opportune moments. Countries that have successfully caught up with developed countries, mostly in Asia, saved and invested on average more than 30 per cent of GDP.[10] However, Poland's saving and investment rate is much lower: during 2004–2011, the average saving rate amounted to only 17 per cent of GDP, with investment at only 21 per cent of GDP, below the EU average and most regional peers.

The solution is to raise private and public saving through further pension reforms (reforming the second pension pillar and enhancing the attractiveness of the third, voluntary pillar), imposing stricter long-term fiscal policy to increase public saving (decrease public dissaving),[11] introducing pan-European tax harmonization, starting from a corporate income tax base and a minimum CIT tax rate among the EU11 countries and eliminating tax havens in Europe and elsewhere. In addition, adoption of the euro at a competitive exchange rate in around 2020 would help to increase macroeconomic stability and thus saving (the current problems of the euro zone notwithstanding). The target should be for the domestic savings rate to amount to at least 25 per cent of GDP, up from around

10. World Bank (2008): The Growth Report: Strategies for Sustained Growth and Inclusive Development.

11. In the long term, the ultimate objective should be to decrease public debt to below 40 per cent of GDP. This would not only help to boost public saving, but also further insulate the country from the vagaries of international financial markets and thus allow Poland to conduct its own, sovereign economic policy in line with the wishes of its population rather than the myopic and often counterproductive demands of the bond markets.

20 per cent currently. Together with imported savings of up to 5 per cent of GDP, ideally all in the form of FDI, this should allow domestic investment to amount to at least 30 per cent of GDP, in line with the high investment ratios experienced in the past by successful catch-up countries such as Japan, Korea and Taiwan.

Increase of work productivity

As regards labour productivity, the issue is the slowing growth of total factor productivity (TFP), the overall efficiency of the use of the available capital and labour, driven by low spending on R&D and innovation and exhaustion of simple growth reserves. The major part of the solution is to increase the efficiency of the 10 billion euros that will be spent on supporting enterprise innovation in the 2014–2020 EU financial perspective.[12] In addition, it will be crucial to fully open up domestic and EU markets to competition, particularly in the utilities and services sectors, promote high-skilled labour immigration, improve the business climate and promote R&D-intensive FDI. Finally, it will be important to continue to enhance human capital and labour skills through further education reforms.[13]

Fighting social inequality

Finally, Poland needs to keep social inequality in check, as it is a crucial ingredient of both short-term (by supporting effective demand) and long-term economic growth, as well as overall well-being. The issue in Poland is that inequality has risen substantially in the past 20 years and is now above the EU average, as measured by the Gini coefficient (0.34 for Poland relative to the 0.30 average for the EU). The plight of the bottom 10 per cent of society is especially worrying: during 2008–2011 their incomes increased less than those of all other segments of society and much less than the richest 10 per cent. The solution should be to introduce measures – including more progressive taxation, smarter social assistance and an improved system of vocational training – to ensure that the incomes of the bottom 10 per cent and 40 per cent rise more than the incomes of the rest of society and that the Gini coefficient falls below 0.30 (monitored with the same frequency as GDP).

12. World Bank 2012.

13. World Bank (2011): Europe 2020. *Fueling* Growth and Competitiveness in Poland Through Employment, Skills and Innovation.

Conclusions and Policy Recommendations

Poland has never had it so good. Its income, quality of life and level of happiness have not been closer to those of the developed countries in Western Europe since the sixteenth century. However, Poland's convergence with the West may slow and then halt altogether as the current model of growth based on imports of technology, non-technological improvements and use of simple post-transition reserves comes to an end. This year's economic slowdown to the slowest pace in the past 20 years and ever weaker economic rebounds suggest that the economic fundamentals may be weakening.

However, a new growth model is needed. Specifically, the government ought to take steps to increase domestic savings to lessen reliance on imported foreign capital and boost investment, further raise labour participation, promote immigration, enhance innovation, maintain strong supervision over the banking sector, improve skills and keep the real exchange rate at a competitive level. In addition, it should also aim to further improve the business environment, with the objective of putting Poland in the top 30 countries worldwide in the Doing Business ranking. Finally, while working to increase the returns on EU-financed investments, Poland should continue to promote further integration of the EU's internal markets, especially in e-commerce and services, and support further enlargement, including by first expanding free trade agreements to countries such as Ukraine and Turkey.

Contrary to the current practice, all specific policies proposed under the new growth model should be assessed against their impact not only on GDP growth, but also on social well-being and happiness. Only policies that improve (or at least do not undermine) all three indicators should be implemented.

In the longer term, while the convergence gap between Poland and Western Europe continues to diminish, economic policy should focus increasingly on social well-being and happiness. This should particularly include expanded leisure time, especially if used productively. After all, the whole point of economic growth is to become productive enough to be able to work less and less and have more and more free time. Poles should learn in time that enough is enough and there is life beyond work.

A Progressive Growth Strategy for the USA

Josh Bivens and Hilary Wething

The US economy faces pressing challenges in the short, medium and long term. For the short term, the key policy intervention should be a large increase in public spending. While targeted income transfers can be useful for stabilization, large-scale public investment projects to boost jobs and growth in the near-term have the added advantage of boosting long-term productivity as well.

For the medium term, the key policy intervention should be the aggressive maintenance of full employment, a significant increase in top marginal tax rates and the bolstering of labor market institutions that enhance the bargaining power of low- and middle-income workers (particularly a large increase in the minimum wage and labour law reform that allows willing workers to form unions).

For the long term, the key policy interventions should be to raise the cost of GHG pollution faced by emitters, a reduction in average working hours and efforts – both regulatory and through direct spending – to increase investment in efficiency and carbon mitigation.

The Short-term Challenge: Full Recovery from the Great Recession

June of 2013 marked four full years since the Great Recession officially *ended,* yet full recovery from the Great Recession had not yet happened and it is assuredly *not* guaranteed. Many economic indicators are better than they were two or three years ago: the unemployment rate in May 2013, for example, was a full 2.4 percentage points lower than its peak in October 2009. However, most of the reduction over this time period has not been driven by a jobs boom, but by a reduction in the labor force participation rate.

The 81.8 per cent peak in this measure reached in 2000 was never reached again. At the four-year mark of recovery it had recovered less than a percentage point and sat at 75.9 per cent.

Given how much further the economy still has to grow to get the labour market back to full health, it is distressing that policymakers in both parties have turned far too quickly away from addressing the crisis of joblessness and towards addressing the purely hypothetical menace of large budget deficits. The clearest signal that deficits do *not* pose a pressing danger is that interest rates remained at historic lows even as deficits rose and even as the Great Recession officially ended. What this clearly indicates is that the US economy remains severely demand-constrained, and that extraordinarily accommodative monetary policy will not spur a full recovery on its own.

The freedom from speculative attack enjoyed by the United States means that fiscal policy has been nowhere near as contractionary in the past three years as it has been throughout the Eurozone. Nevertheless, it still clearly fails to meet the need to fill the »output gap« between actual output and what could be produced if all idle resources (including workers) were employed. Government spending has also fallen far behind even the more modest benchmark set by the historical record of past recoveries which needed government spending much less than the current one. If the average trajectory of government spending during the previous three recoveries had been sustained in the past four years, the output gap would nearly be closed today and the unemployment rate would be much closer to 5 per cent than today's 7.6 per cent.[14]

The economics of using fiscal stimulus to secure a full recovery are quite clear. Unfortunately, it is equally as clear that current US politics will not let this happen. This raises a number of issues concerning whether or not other policy levers can help secure such a recovery.

The Federal Reserve has been by far the most aggressive major macroeconomic policymaking institution in the world in addressing the Great Recession and

14. For more details on public spending in the current recovery relative to historical trends see Josh Bivens and Heidi Shierholz (2013): How Much Has Austerity Held Back Recovery So Far? Economic Policy Institute.

its aftermath. By the middle of 2008 its conventional short-term interest rates were set to essentially zero to boost spending, and by the end of that year it was engaged in unconventional »quantitative easing«, long-term asset purchases to drive down interest rates. These measures have clearly aided recovery; researchers at the San Francisco Federal Reserve Bank have estimated that the unemployment rate would have been roughly 1 to 1.5 percentage points higher at the end of 2010 had these long-term asset purchases not occurred.[15] However, it seems unlikely that such aggressive monetary policy can by itself secure a full recovery, and the beneficial effect of the Fed's programme is fairly fragile.

The most sweeping financial regulatory reform in years – the Dodd-Frank Act – was passed in 2010 in response to the financial crisis that accompanied the Great Recession. How it will succeed in preventing future crises remains extremely uncertain. Key details of implementation remain unresolved even today and the real test of counter-cyclical financial policy will come when asset markets boom again. Since the crash of 2008, there has been little evidence that financial markets are making excessively risky bets; the extraordinarily high prices of US treasuries, for example, is a clear sign that these markets continue to remain fairly risk-averse.

Regardless of how Dodd-Frank performs in restraining future excess, it does very little to boost economic activity in the near-term. Housing policy that allows for substantial restructuring of mortgages to boost potential consumer spending could help boost recovery. The inability of many American homeowners to take advantage of historically low interest rates and refinance their mortgages, however, has hamstrung the effectiveness of monetary policy. But even an extraordinarily aggressive programme of mortgage refinancing was estimated to potentially boost GDP by about 50 billion dollars.[16]

15. For this estimate, see Hess Chung, Jean-Philippe Laforte, David Reifschneider and John C. Williams (2011): Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events? Working Paper 2011-01, Federal Reserve Bank of San Francisco.

16. For this estimate, see Alec Philips (2011): Revisiting the Potential for Large Scale Mortgage Refinancing, *US Daily,* 26 August, New York, N.Y.: Goldman Sachs.

The Medium-term Challenge: Reversing the Generation-long Rise in Inequality

For the first three decades following the end of the Second World War economic growth was rapid and broadly shared across the income distribution. Between 1979 and 2007, growth has been slower, much more concentrated at the very top of the income distribution and, except for the late 1990s, has left low- and middle-income households' living standards barely creeping upwards.

The implications of this difference in growth rates between the very top and low- and moderate-income Americans are startling. Between 1979 and 2007, 38.3 per cent of total income growth in the American economy was attributable to growth of the highest 1 per cent of households. The bottom 80 per cent of households saw barely a quarter of overall income growth over this period (25.5 per cent).[17]

On the whole, policy makers' decisions – including decisions *not* to act – over the past generation have tilted the balance of economic power away from low and middle-income families towards the already-affluent. For example, tax rates faced by the richest American households have plummeted in the past generation.[18] The deregulation of financial markets opened up a much wider range of activities for financial institutions and most of this activity hid risk and increased rents in the sector rather than boosting overall growth.[19]

At the same time, domestic labour law has failed to keep pace with rising employer hostility and with aggressive tactics against attempts to organize unions.[20] This has had powerful effects on inequality as the direct benefits of unionization for workers are progressive, with wages and benefits being larger for low-wage workers

17. For more on the growth of income and wage inequality over the past generation see Lawrence Mishel, Josh Bivens, Elise Gould and Heidi Shierholz (2012): The State of Working America, 12th Edition. Ithaca. ILR Press, Cornell University and Economic Policy Institute.

18. For the influence of lower top marginal tax rates on inequality see Andrew Fieldhouse (2013): Rising Income Inequality and the Role of Shifting Market-Income Distribution, Tax Burdens, and Tax Rates. Economic Policy Institute Briefing Paper No. 365.

19. See Andrew Haldane (2010): The Contribution of the Financial Sector – Miracle or Mirage? Speech by Mr Andrew Haldane at the Future of Finance conference, London, 14 July 2010.

20. On the gap between unionization rates and the share of American workers who say they would like to be in a union see Richard Freeman (2007): Do Workers Still Want Unions? More than Ever. Agenda for Shared Prosperity Briefing Paper. Washington, DC. Economic Policy Institute.

than higher-wage workers. Research further shows that unions actually provide a needed check on excessive executive pay.

Most striking, perhaps, is the tendency for federal policymakers to allow the real value of the minimum wage to be eroded by inflation for nearly a decade at a stretch over much of the past generation. Modest increases in the minimum wage are politically popular and state-of-the-art empirical microeconomics argues they cause no detectable disemployment effect. Nevertheless, they are incredibly hard to actually make happen.

There is no single silver bullet that will reverse the past generation's growing inequality of incomes and wages. Instead, policymakers should look at the whole portfolio of economic policymaking – labour market standards, monetary policy, tax policy, regulatory policy and trade policy, among others – to see where opportunities arise for boosting the bargaining power of low- and middle-wage workers. The past generation's enormous rise in inequality has been driven by a steady accumulation of policy decisions that boosted bargaining power at the top, and reversing it will similarly require a steady accumulation of decisions that reverse this.

The Long-run Challenge: Global Climate Change

Experts agree that anthropogenic climate change has already begun. The clearest policy lever for mitigating carbon emissions is to price the currently free externality imposed by these emissions. A carbon tax and a hard cap on emissions accompanied by the rights to emit below the cap to be traded are two of the most-often mentioned mechanisms for raising the cost of emissions. Direct government regulation of carbon emissions is another possibility.

Lastly, a comparison of economic and emissions histories in the United States and its advanced-country peers is interesting. Because many of the latter have made the social decision to take some portion of productivity increases in the form of increased leisure rather than increased consumption, this means that the pace of carbon emissions in the non-US developed world has been much slower.[21] If succeeding decades sees the United States move closer to its global peers in shortening average annual hours worked – devoting a portion of coming productivity gains to increased leisure rather than increased consumption – then the challenge of slowing and reversing carbon emissions would be much less daunting.

Synergy in Policy Solutions for the Short, Medium and Long Terms

Each of the problems identified in various time-horizons so far seem extremely daunting, particularly given the dysfunctional state of American politics. However, from an economic perspective all of these problems are solvable. And while political constraints bind tight, they are nothing compared to genuine economic constraints.

Many of the proposed solutions addressing challenges within each time horizon dovetail and can lead to genuine synergy in addressing challenges across time horizons. Take, for example, using policy to reduce average annual hours worked. If undertaken in the near-term, it could reduce the gap between potential and actual GDP, which is the primary barrier to restoring the labour market to pre-Great Recession health. And in the longer term, getting American workers used to allocating productivity gains to increased leisure could reduce carbon emissions relative to the »business as usual« base-case that currently makes climate change look so dangerous.

A key barrier to selling Americans on reducing working hours in the longer-term is the simple fact that increasing working hours was one of the key coping mechanisms households used to achieve higher living standards in the face of nearly-stagnant hourly wages. Giving American households confidence that they will see substantial living standards gains as overall productivity rises would be key to convincing them that some of these gains should go to increased leisure.

Or take measures either providing a market price for carbon or directly regulating (and hence increasing the costs

21. See David Rosnick and Mark Weisbrot (2006): Are Shorter Work Hours Good for the Environment? A Comparison of U.S. and European Energy Consumption. Washington, DC. Center for Economic and Policy Research.

of) carbon emissions. These obviously are laser-focused on reducing carbon emissions. But if they are done while substantial output gaps remain (and to be clear – this could well be half a decade or more), the investments in carbon abatement they spur will provide a Keynesian boost to the economy and close output gaps in the short term.

Federal Budget Deficits are Not the Main Problem

We should finish by acknowledging that we have not identified large federal budget deficits as a pressing economic challenge, over any time horizon. This is because they are not. Before 2008, even with the deeply unwise fiscal policy decisions made in the 2000s, these deficits were small and manageable. After the Great Recession, cyclical factors made these deficits rise significantly – but these large deficits were useful shock absorbers. In the long term, projected deficits are driven mainly by rapidly rising health care costs. But these costs have slowed in recent years, and major new reforms to American health care have been passed and have already begun to take effect. In short, the source of these long-term budget problems may well already have been solved; and at the very least it would make sense to wait and see their long-term effect before rushing to lock-in policies that could reduce the deficit only by inflicting widespread pain through cutting valuable social insurance programmes.

The economic challenges identified in this paper are much more serious and potentially harmful than budget deficits. As such, they should claim a much larger share of policymakers' attention than they currently do, and much of this attention should be diverted from the misguided obsession with reducing federal budget deficits.

Abenomics and Japan's Growth Prospects

Risaburo Nezu

Mr Abe's Inheritance: Two Lost Decades

Prior to Mr Abe's appointment as Prime Minister of Japan in December 2012, Japan had suffered two decades of economic stagnation and deflation. This economic malaise came immediately after the housing and stock price bubble collapses of the 1990s. In November 2012, the Tokyo Stock Exchange sat at around 8,000, less than a quarter of its peak in 1989, and land prices in urban commercial sectors were at one-fifth of their high water mark. Throughout these two decades, the real economic growth rate was less than 1 per cent per annum and the rate of inflation fell into the negative after the global financial crisis of 2008. What was particularly frustrating to the Japanese business community was the rampant appreciation of the yen, which accelerated despite such poor growth and the earthquake and tsunami of March 2011. After his election, Abe pressed the Bank of Japan to embark on a bold policy of monetary easing, succeeding in achieving both a weaker yen and a rising stock market.

Short-lived Excitement over »Abenomics«

The new economic policies of the Shinzo Abe administration produced two immediate results that surpassed expectations: a sharp rebound of stock prices and a fall in the yen's exchange rate. This was achieved by pressing the Bank of Japan to embark on a bold policy of monetary easing. In just six months from the autumn of 2012, when it seemed likely that Abe would become the next prime minister, the dollar appreciated by 25 per cent against the yen, moving. The Nikkei Stock Index rose from 8,600 to over 15,000 in May. Replacing Bank of Japan Governor Masaaki Shirakawa, who was reluctant to engage in aggressive monetary easing, with Haruhiko Kuroda, who had been arguing for quantitative expansion for some time, ensured the desired policy. This was a relief to Japanese export industries, which had struggled through years of a strong yen, and seemed likely to improve corporate profits. Rising stock prices brought a surge in consumption. In May 2013, it looked like a virtuous cycle was finally beginning to take hold.

From 23 May, however, everything started to move backwards. Stock prices fell to 13,000 yen in less than a month. The yen soared again to 93 yen/dollar from 103. More surprisingly, despite quantitative easing, long-term interest rates rose from 0.3 per cent to 0.8 per cent during this period. Following ultra-easy monetary policy and fiscal stimulus, Abe released his third arrow in June. But this third arrow – the structural reform programme – failed to convince the market of the long-term growth viability of the Japanese economy, since it stopped short of the most desired reforms, such as liberalisation of farm land, labour regulation and strict control over the medical service industry. Tokyo stock prices tumbled even further. Abe hastily announced that there would be more reform initiatives to come in the second half of 2013 and indicated that further corporate tax cuts and investment incentives were likely.

Risk Factors of Abenomics

Seen from an economic perspective, Abenomics is characterised by a number of serious risk factors. The first concerns whether the Japanese economy will really be that much improved by a weaker yen and rising stock prices alone. Certainly a weaker yen means profits for export businesses, but what about imports? The prices of the gasoline and food that Japan imports are already beginning to rise. In fiscal year 2012, Japanese exports totalled 64 trillion yen and imports 72 trillion yen. With exports exceeding imports by 8 trillion yen, a weaker yen is a negative for the Japanese economy. Conversely, because the balance on income – the sum of dividends and interest on financial assets, such as stocks and bonds and overseas factories and offices owned by Japanese companies – is denominated in foreign currency, it increases in yen terms when converted into a weaker yen. When all these factors are combined, the weaker yen has almost no overall effect. Over a longer period of time, it may well be that a weaker yen would boost Japanese exports and eventually the entire economy. However, to what extent this would happen is far from clear. Japanese manufacturing now prefers to produce locally rather than produce at home and export. The benefit of a cheap yen thus may be much less than expected.

No End of Deflation in Sight

The second risk factor is that a weaker yen and rising stock prices may not necessarily beat deflation on their own. A weaker yen results in higher prices for imported goods that, to some degree, are probably shifted to consumers. The degree to which they shift depends on how far prices can rise without impacting sales. The income of ordinary workers, which makes up 60 per cent of Japan's GDP, has fallen consistently for the past 15 years, declining by 13 per cent from 1998 levels. Whether imported or made at home, if the prices of products rise, consumers simply cut back further on their spending; the inability to raise prices will make it impossible to do away with deflation.

Wages Not Increasing

The third risk factor is wages. In order to compensate for deflation, it is essential that the incomes of ordinary consumers – that is, their wages – rise. This is why Prime Minister Abe and his principal cabinet ministers called upon the leaders of the business community to raise wages. This appears to have led a number of large corporations to increase their bonuses, but they remain reluctant to raise base wages. With conditions still difficult for small and medium-sized companies, the overall increase in wages this year is negligible and the outlook for next year and beyond is uncertain. If prices rise in the absence of an increase in wages, people will have a harder time getting by and the economy is likely to slow down once again.

Abenomics Is Silent on Fiscal Issues!

In January 2013, Abe's government decided the supplementary budget for fiscal year 2012, which included 10 trillion yen of public infrastructure building and other spending to boost local economies. This action, the so-called second arrow of Abenomics, was made possible by issuing 5 trillion yen of Japanese government bonds. The interest rate on these bonds rose in March and April. For fiscal year 2013, the size of the general budget is 93 trillion yen, of which 43 trillion yen – or 46 per cent – is financed by debt. This is equivalent to 9 per cent of GDP.

Abe must present a credible plan to rein in government debt, which is already twice as large as GDP. The official position of the Japanese government is that it will stick to the plan to eliminate the deficit in the primary balance and to reach a positive primary balance by 2020. This plan was drawn up by the previous government and already Abe's administration has strayed from the course by spending an additional 5 trillion yen to finance Abenomics' second arrow. Abe promised to present his own fiscal plan in the autumn of 2013. In October, he announced that consumption tax is to be raised from 5 per cent to 8 per cent in April 2014. It remains open, however, whether the tax will be raised further to 10 per cent in October 2015, as the consumption tax law assumes. As a result, there may be greater scope for cutting back the deficit. Still, restoring the primary balance in six years' time is a challenge.

To accomplish this, greater tax increases would be necessary, coupled with spending cuts. These spending cuts would come from streamlining and cutting back social welfare programmes. On the revenue side, a further increase of consumption tax from 10 per cent to 15 or 20 per cent is an option. Other increases in inheritance tax and income tax are under consideration. All these tax increases and spending cuts will probably have a depressive effect on the economy and thus they should be implemented only when the economy is strong enough to bear the burden.

Will Japan Replicate the Fates of Greece and Portugal?

Given this gloomy prospect, some economists and experts in the Japanese government argue that Japan will become like Greece and Portugal, unless it takes bold measures to reduce the deficit very soon. Two of Abe's predecessors, former Prime Ministers Naoto Kan and Yoshihiko Noda of the Democratic Party of Japan (DPJ), share this view. They had both been finance minister before becoming prime minister.

For a long time, there have been two sharply opposed views of the Japanese fiscal deficit, which is the largest in the world both in absolute volume and relative to GDP. One school of thought contends that such a large deficit poses an immediate threat to the Japanese economy. Proponents of this view, most notably finance ministry officials, believe in a balanced budget and have called for tax increases and spending cuts in social welfare programmes as soon as possible. They fear that unless Japan takes action immediately to cut the fiscal deficit, the country will soon follow in the footsteps of Greece and Portugal.

The other school argues that, although the current fiscal deficit may be unsustainable in the long run, there is not much to worry about at present. This is because the Japanese fiscal deficit is fully financed by domestic savings. The fact is that the Japanese private sector, households and corporations generate savings equivalent to 10 per cent of Japanese GDP, while the government of Japan borrows 8 per cent. The remaining 2 per cent is funnelled into foreign countries as current surplus. This is the complete opposite of Southern European nations such as Greece or Portugal, which borrow heavily from abroad to finance their fiscal deficit. The interest rate on Japanese government bonds is the lowest in the world. It is difficult to argue that Japan's situation is similar to those of Southern European countries.

This debate on fiscal discipline versus economic growth seems to be identical to the discussion under way in Europe. While many economists take the view that consumption tax should be increased as planned, some of Abe's most trusted advisors are more cautious. Both Japan and European countries must carefully calculate the effects of aging populations on public expenditure. Many social welfare programmes, including pensions and medical insurance, must be streamlined and cut back or taxes will need to be raised unbearably high.

The Surplus in the Current Account Is Dwindling

Japan has been running a current account surplus for the past four decades. The composition of such a surplus, however, has evolved greatly. Until the middle of the 1990s, the trade surplus – that is, exports minus imports – was the major component of the current surplus, but since then it has tapered off and begun to decrease slowly. In its place, income revenue from the assets Japan holds overseas has generated an increasing amount of dividends and interest revenue.

Since the earthquake and tsunami of 11 March 2011, Japan has been forced to import huge volumes of gas to offset the closure of its nuclear power plants. Consequently, since 2011 the trade balance has fallen into the red, cutting into the income surplus. Now, Japan's current account surplus is about 1 per cent of GDP, down from 5 per cent in 2007. Economists and policymakers are beginning to worry that, sooner or later, Japan will become unable to finance its fiscal deficit with domestic savings. It is imperative for Japan to reduce the level of its fiscal debt to a manageable level before its current account is wiped out.

Problem for Japanese Banks

A massive injection of money by the Bank of Japan was supposed to lower the interest rate, increase borrowings and stimulate investment and personal spending. The primary goal of Abenomics is to stop deflation and create modest inflation of around 2 per cent per annum. With overall price levels going up, interest rates must go up, too, which means that bond holders will suffer losses. Given that banks and other financial institutions have a high ratio of Japanese government bonds to total assets, rising interest rates may drive them into a banking crisis similar to those seen in Southern Europe recently.

In Europe, what began as a fiscal problem developed into a banking crisis because many European banks held a substantial amount of sovereign bonds of peripheral countries. Will the same banking crisis occur in Japan? Perhaps not. The Japanese government can always pay the interest on Japanese government bonds and the principal when due. They can print the money, if necessary, since all Japanese government bonds are denominated in Japanese yen, including those held by overseas buyers.

However, this does not mean that there will not be a problem for the Japanese banking sector. It is plain that the lion's share of Japanese government bonds is held by Japanese banks, pension funds and other institutional investors. There is a lot to suggest that the price of Japanese government bonds is likely to fall and the holders will suffer losses. Already, the so-called mega-banks are cutting back on their holdings of long-term Japanese government bonds, but small, local banks remain exposed to much greater risk, as they still hold a large amount of the bonds.

No Exit Strategy in Sight

At present, there is no clear vision of how these swollen assets can be scaled back to a normal level. Mr Kuroda has said publicly that it is still premature to discuss an exit strategy. It is widely feared that the Japanese government bond market may collapse under its own. This might happen if holders were to sell their Japanese government bonds in a rush due to fears of sudden interest rate hikes.

Given the basic principles of Abenomics, which purports to cause inflation of 2 per cent, it is inevitable that sooner or later interest rates will rise. The only questions are if and how to avoid a massive sell-off of Japanese government bonds. It is absolutely necessary for the Bank of Japan to present a credible plan to reduce its asset level in an orderly manner.

Success of Abenomics Depends on Structural Reform

While views are divided on the effectiveness of monetary easing and additional spending on public works, economists are in unanimous agreement that the most important part of Abenomics is its third arrow, namely, structural reform. This includes bold initiatives that should cut into the staunch vested interests of labour unions, medical doctor associations, farmers' associations and the like. Abe has yet to disclose the details of his reform programme.

At present, Japan is conducting a series of trade negotiations with the EU, Canada, Australia and neighbouring Asian countries. But by far the most important is the Trans Pacific Partnership (TPP). Abe's decision to join the TPP negotiations has been much welcomed by business leaders and economists, but vehemently opposed within his own party. Trade liberalization negotiations will enter a critical stage this fall, when he must decide on liberalization of imports of products that have been protected by high tariffs or other forms of barriers in the past. This includes such items as rice, beef, pork, wheat and sugar. Traditionally, these products have been regarded as sacrosanct and no prime minister has ever dared to touch them. But more and more people, including farmers, are beginning to realize that Japanese agriculture cannot survive under the current regime anyway. If Abe can bring these reform-minded farmers onto his side, he has a chance of winning enough support to see the negotiations through. Such liberalization will bring in more competition in the Japanese agricultural industry and create an environment for innovative farmers to take a greater slice of the market and even venture into the export business.

Medical and care services is a sector in which bold reform is urgently needed. This is a much larger industry than agriculture and a growing industry due to Japan's aging population. This industry is heavily regulated by cumbersome rules and regulations, which today work to the detriment of new technology and services. While Japan's technology and equipment are internationally competitive, very few products have been allowed into the domestic market. The resistance to reform in this field comes not only from government agencies, but also from medical practitioners and pharmaceutical companies that enjoy dominant positions under the present system. They have the money and political connections to mobilize strong opposition, if they wish to do so.

Another area which deserves a lot of attention is the labour market. In Japan, although it is legally possible, historically it has been very difficult to lay off workers. The law considers lay-offs to be an absolute last resort. In fact, mid-career lay-offs are almost unheard of. If a case is brought to court, the employer must prove that the company has exhausted all other options to avoid a lay-off. This is an impossible task. A proposal is being made by employers to amend labour law to pave the way for lay-offs with monetary compensation. This is being met by fierce opposition from labour unions.

The electricity industry will also see major changes over the next decade. A law has already been passed that will split the current vertically integrated nine regional monopolies into electricity generating companies and transmission companies. New companies are allowed to generate and sell electricity, opening up the entire electricity market for competition. There will be more supply from renewable sources such as solar, wind, biomass and geo-thermal. This will be particularly beneficial to Japan, as it must find alternative energy sources to fill the gap left by the closure of its nuclear power plants.

Following through with all of these reforms will take a much greater effort than the first and second arrows. We will have to wait and see how Mr Abe spends his political capital to that end.

Qualitative Growth, Full Employment and Social Security

A summarising commentary by Dierk Hirschel

The euro zone remains in the midst of the worst crisis since its founding. From Athens to Paris its economies are shrinking for the second year in succession. Unemployment has hit a historic 12.2 per cent, with almost 20 million out of work. Southern Europe is worst affected. In Spain and Greece one in four are unemployed. Youth unemployment has reached around 60 per cent. A lost generation is coming through in Madrid, Lisbon, Rome and Athens. The economic crisis is leading to falling tax revenues and an ever-growing mountain of debt.

But the professional soothsayers claim to see light at the end of the tunnel. The economy of the euro zone is shrinking rather more slowly, the number of unemployed rising rather more gradually. After four years of permanent crisis the worst-affected countries might have bottomed out. Spain and Portugal have been able to increase their exports and reduce their current account deficits. Free-market economists celebrate this as the success of austerity. Yet the improvements in southern European trade and current account balances are due primarily to a fall in imports provoked by the crisis. After the deep recession comes stagnation, although next year the euro club is predicted to see slight growth.

But the risks of relapse remain high. Prices are tumbling in southern Europe; fear of deflation led the European Central Bank to reduce its key interest rate to a historic low of 0.25 per cent. If prices fall across Europe the euro zone faces a depression. The vicious circle of shrinking economy, troubled banks and high state debt has yet to be broken. Europe's banks are sitting on bad loans to the tune of a trillion euros.

Causes of crisis

The euro crisis was caused by flaws in the design of the Economic and Monetary Union (EMU) and unrestrained financial markets.[22] The architects of the EMU created a united currency zone without a political, economic and social union. This gave rise to a system of competing states. Nations and businesses competed for the lowest wages, social spending and taxes. Since the birth of the euro the imbalances have grown across the common currency area. The economically strong countries became stronger and the weak nations weaker. Germany, Finland, the Netherlands and Austria kept their unit wage costs low and thus improved their price competitiveness. In Germany this reflected in the first place a chronic weakness of wages.

Because of their enhanced price competitiveness, the northern countries of the euro zone were able to export more goods each year than they imported. As a consequence their trade and current account balances grew. Greece, Spain, Italy and Portugal, on the other hand, imported more goods every year than they exported. Consequently southern deficits grew. In short: the Maastricht Treaty led straight to the present crisis.

But that is not all. Before the crisis bankers and fund managers were able to speculate with borrowed money. In the great economic and financial crisis the bubble burst. Then the state rescued casino capitalism from its doom. Private debts were suddenly transformed into public debts. Stimulus packages and bank rescues caused state debt to explode. The euro zone debt ratio (state debt to GDP) rose from 66 per cent in 2007 to 84 in 2010.

In other words, these high levels of state debt cannot be blamed on treasury profligacy. The public spending ratios of the crisis countries (state expenditure to GDP) have not increased since before the great financial meltdown. In fact, Spain and Ireland ran budget surpluses and reduced their debt ratios. But Merkel, Barroso and co. have succeeded in establishing their interpretation of the crisis. Today state debt is the root of all evil. Cause and effect are reversed. This is what prepared the ideological ground for austerity. Now the debtors are to blame.

22. Klaus Busch and Dierk Hirschel, *Europa am Scheideweg,* FES Internationale Politikanalyse (Berlin, 2011).

Debt ratio

	2007	2010	2013
Eurozone	66.4	85.6	95.5
Germany	65.2	82.5	79.6
Greece	107.2	148.3	176.2
Spain	36.3	61.7	94.8
Italy	103.3	119.3	133.0
Portugal	68.4	94.0	127.8
Ireland	25.0	91.2	124.4
France	64.2	82.4	93.5

Source: European Commission 2013

2013: Projection
Debt ratio: Public debt in % of GDP

Swingeing cuts and neoliberal shock therapy

Merkel, Barroso and Lagarde responded to the euro crisis with drastic spending cuts. New loans were only granted against promises of cutbacks. The troika of EU Commission, European Central Bank and International Monetary Fund sought to balance state budgets by means of public service redundancies, wage cuts, cuts in social spending and higher indirect taxes – poisonous medicine that has chained the European patient to the sickbed.

These short-sighted austerity policies were economically harmful and socially inequitable. They stifled growth in the crisis countries and caused unemployment to rise. As a consequence tax revenues collapsed and state debt continued to increase. The troika has saved Europe to death. Despite drastic cuts, France, Spain and Portugal naturally failed to meet their consolidation targets. In Greece the situation is so dire that a second haircut must be expected next year. And that would mean asking the German taxpayer to contribute for the first time.

In the meantime, even the troika has had to concede the failure of its policies. The International Monetary Fund recently admitted that it had underestimated the risks and side-effects of the European austerity regime. The spending cuts caused the economies of the over-indebted countries to shrink at least two or three times more strongly than expected. Individual criticisms have even been heard from within the ranks of the European Commission. In the end the cutback requirements were relaxed somewhat.

The troika, national employers' organisations and conservative free-market politicians seized the opportunity offered by the crisis in southern Europe to overturn wage agreements, curtail trade union bargaining rights, slash the welfare state and sell off public property, all under the cover of so-called structural reforms. The deep economic crisis threw large parts of the population into a daily struggle for survival. The trade unions remain severely weakened by the level of unemployment. For the neoliberal shock strategy, crisis is the best time for a radical change of politics. Such a turn would not be possible in normal times, as Angela Merkel quite openly admitted in her speech at the World Economic Forum in Davos.[23]

The central target of neoliberal shock strategy was the labour market. Wage-setting has been shifted to workplaces or individualised. National agreements have been undermined, with company agreements given precedence. Exemption clauses have been written into law.[24] The favourability principle under which workers have the right to the best alternative offered by labour law has been abandoned. The post-expiry validity of collective agreements has been truncated. Moreover, the state dictates wages in the public sector. In Greece civil servants' salaries have been cut by 30 per cent, in Spain and Italy public sector pay has been frozen. Athens cut the minimum wage by more than one fifth, Madrid and Lisbon ceased raising the minimum wage.

The neoliberal shock strategy was also deployed to destroy public pension systems. Across southern Europe the level of pensions has been cut and the legal retirement age increased. Anyone who wishes to draw a pension in future will have to demonstrate more years of contributions. One-off payments have been abolished and it is increasingly difficult for disabled people to obtain benefits at all. Here old-age poverty is decreed by law.

23. »Experience teaches, however, that often structural reforms are tackled only when the political pressure to act becomes irresistible. In Germany, for example, it wasn't until unemployment reached the 5-million mark that policy-makers were willing to take decisive action. So as I see it, the reality of the difficult situation Europe is now in means that we must take action now on the structural reforms needed to ensure a brighter future.« Angela Merkel at the World Economic Forum in Davos on 24 January 2013, http://www.bundesregierung.de/Content/EN/Reden/2013/2013-01-24-merkel-davos.html.

24. Klaus Busch, Christoph Hermann, Karl Hinrichs, and Thorsten Schulten, *Eurokrise, Austeritätspolitik und das Europäische Sozialmodell,* FES Internationale Politikanalyse (Berlin, 2012).

But that is not all. The crisis set in motion a new wave of privatisations in southern Europe. Loans to Athens and Lisbon from the European Financial Stability Facility were made conditional on far-reaching privatisations. Spain and Italy also initiated huge privatisation programmes under pressure from the ECB. These sell-offs of public goods and services occur to the detriment of workers and consumers and restrict the possibilities for state economic and structural policy.

The neoliberal structural reforms represent nothing other than a frontal assault on the rights and achievements of workers and their trade unions. Wages and so-called ancillary wage costs have been reduced in the service of global competitiveness. Over the past two years Greek real wages have fallen by one fifth, Spanish and Portuguese by six and ten per cent respectively. These neoliberal policies exacerbate the economic and social crisis of the euro zone. The economy continues to shrink, unemployment and debt increase. The race to the bottom for the lowest labour costs squeezes prices.

The triumph of failed ideas

After the failure of Merkel's attempt to overcome the euro crisis through national anti-crisis policies, free-market conservative forces also began looking for a sustainable European solution. Since then the European institutions have been expanded and reconfigured according to neoliberal designs (Sixpack, Euro Plus Pact, Fiscal Compact, Twopack, European Financial Stability Facility, and European Stability Mechanism).

Now concrete steps towards a deepened European Monetary Union are even being mooted. The German version of a European economic government is close intergovernmental cooperation between the EU member-states: Larger national economic reforms would be coordinated in advance, with individual states reporting their political proposals to the EU Commission. Brussels would then examine the repercussions on competitiveness. Beyond that, such proposals also posit contractual agreements about structural reforms between the European institutions and the member-states. In other words, they seek to generalise the condition-imposing policies of the troika. National governments would negotiate individual structural reform agreements with the Commission. Under such a competitiveness pact, national financial, labour market and social policies would be permanently neoliberal. If this planned institutionalisation of neoliberalism succeeded, Europe would be even more deeply divided.

A European Marshall Plan for qualitative growth and jobs

The permanent European crisis can only be overcome through a change of political course. A relaxation of austerity will not be enough; austerity must be stopped. Successful budget consolidation is only possible through growth.

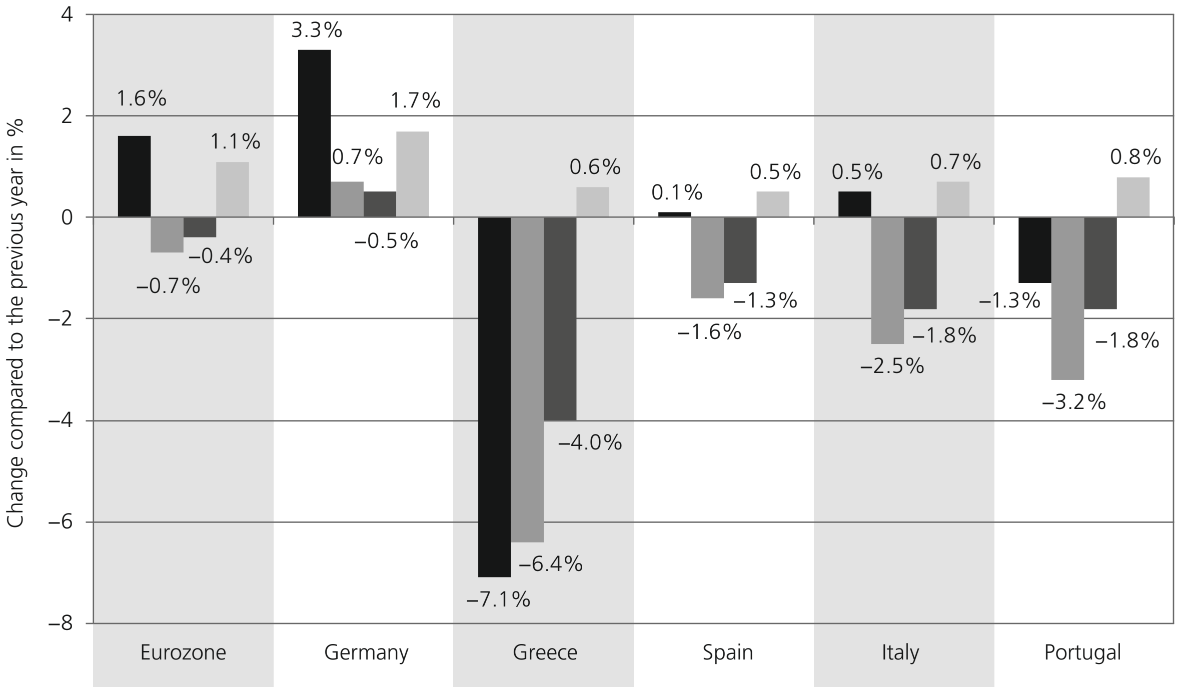
The cash-strapped crisis countries cannot kick-start their growth themselves. They are dependent on the solidarity of their stronger neighbours. The domestic market in the countries running trade surpluses should therefore be stimulated by means of higher wages and state spending. This would represent an important contribution to reducing imbalances. Germany, as the biggest euro-zone economy, bears a special responsibility.

What we now need above all is a European strategy for qualitative growth and employment. Europe needs an investment and reconstruction programme to enhance its infrastructure, environment and energy supply.[25] The investment and reconstruction programme should comprise institutional measures, direct public investment, investment subsidies and growth-stabilising consumer incentives. The growth strategy would need to be designed to run for ten years, spending 260 billion euros every year across the continent. That corresponds to two per cent of European GDP. Of this, 160 billion euros would fall to direct investment and investment subsidies, while a further 100 billion euros would have to be found for credit subsidies.

Qualitative growth demands increased private and public investment. The heart of this new Marshall Plan is investment in the ecological conversion and modernisation of the European economies. A networked Europe system of centralised and decentralised renewable energy sources would reduce consumption of fossil fuels dependency on energy imports. Such a European energy transformation

25. *Ein Marshallplan für Europa, Vorschlag des Deutschen Gewerkschaftsbundes für ein Konjunktur-, Investitions- und Aufbauprogramm für Europa* (Berlin, 2012), http://www.dgb.de/themen/++co++985b632e-407e-11e2-b652-00188b4dc422.

Crisis in the Eurozone
Real Growth Rates of GDP



Source: European Commission 2013
2013: Projection

would demand annual investment of 150 billion euros – but save 200 billion euros annually in fuel imports. Annual investment of 10 billion euros should also be channelled into the expansion and consolidation of a modern multi- and intermodal trans-European transport network. Furthermore, the expansion of broadband internet should also be promoted across Europe, 20 billion euros invested annually in social services (nursing care, nurseries, schools, universities, services for the elderly, etc.), plus 30 billion euros annually to flow into education and training.

Such an investment and reconstruction programme could be funded by a European Future Fund issuing ten-year »New Deal Bonds«. Total private cash assets in Western Europe amount to 27,000 billion euros. This financial capital is looking for secure investment opportunities. A European Future Fund could and should divert a proportion of this private wealth into real investment. The interest on the bonds could be paid out of the revenues of the financial transaction tax. In order to be able to operate as a prime creditor in the capital markets the Future Fund requires adequate equity. This capital – 200 to 250 billion euros – should be procured through a one-off Europe-wide wealth surcharge.

The new Marshall Plan could kick-start European growth. An additional stimulus of 400 billion euros is expected. That corresponds to annual growth of three per cent. Such a European investment and reconstruction programme would probably create between nine and eleven million new jobs.

More Europe but different

Pumping billions into an investment and reconstruction programme will not, however, be enough on its own. A European growth strategy will need to be integrated into a comprehensive alternative programme. First of all, the euro zone needs joint debt management. Shared eurobonds would immediately reduce the interest burden of the over-indebted countries and an important step towards formalising European solidarity.

National wage, social and tax policies would also need to be coordinated across Europe. Coordinated European wage policy should ensure that national wage growth at least exhausts the distribution-neutral possibilities (inflation plus productivity growth). This would avoid market distortions and go some way towards balancing current accounts. National social and tax policies should be better coordinated in order to avoid social and tax dumping. Spending on social security systems should be coupled to national economic performance using a corridor model, to avoid social dumping and shore up the process of social recovery in the weaker member-states. Tax havens should be shut down, while agreed assessment standards and minimum rates of company tax could put an end to tax dumping.

In a wider perspective, the financial markets require new rules and the financial sector must urgently be redimensioned. A mix of demanding capital requirements (Basel III plus), strict limits on proprietary trading, tight regulation of the shadow banking sector (hedge funds, money market funds, etc.) and financial certification would be sensible and useful. The sources of risk production must be sealed. A properly designed banking union would also serve this purpose.

A Marshall Plan, joint debt management, coordinated European welfare and tax policies and a European regulatory framework for the financial markets would be tasks for a democratically elected supranational economic government. But the latter must also be democratically legitimated. This would presuppose a further democratisation of the European Union.

Such a political sea-change will not appear by magic. If we want a Europe with qualitative growth, full employment and social security social democrats, socialists, trade unions and social movements must mobilise collectively.

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