

The crisis and the European social model

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If you merge 16 small open economies, you get a large closed economy. But here is the catch. If you assemble the leaders of the 16 small open economies, you get a roomful of 16 small-economy politicians (Muenchau, 2010)

As further rounds of economic crisis unfold, Europe's social democrats seem frozen like frightened rabbits in a car's headlights. They have nothing new to say about how to deal with fiscal deficits, except that the cuts must not occur too quickly and that the most vulnerable citizens must be shielded where possible. Otherwise, politicians on all sides appear to accept that public deficits must be slashed, failing which we will all face a massive sovereign debt crisis. Nor, fearing inflation, do they favour monetising the deficits. As for dealing with the crisis of the bond markets, Eurozone politicians cannot agree on the need for a common Eurobond backed by the combined economic weight of all its members. However, further sovereign debt crises and further deficit reduction almost certainly mean further economic slowdown and privatisations, at the cost of education, health, pensions and other building blocks of the European social model.

There is a way out. Europe can grow its way out of crisis. More growth means both a fall in government spending and a dramatic increase in tax receipts; it also means greater confidence in the Eurozone, a key element in stopping the ongoing sovereign debt crisis. Growth can provide the renewed infrastructure, energy saving technology and alternatives to fossil fuel so badly needed. But launching a growth-based strategy requires political courage. If Europe's social model is to survive, social democrats will need to find the courage to challenge the conventional orthodoxy of public sector cuts. A common Eurobond would be an important first step; ultimately, though, social democrats must press for fiscal integration; ie, a European Treasury.

1. How we got here

The current crisis in Europe has two components: first, it is in part a private banking crisis in which governments (such as the Irish) have taken on the debts of their private banks, turning these into 'sovereign' debt; ie, debt guaranteed by government. In order to save the private banks, Irish sovereign debt doubled overnight. It became so large relative to the country's output that international financial markets took fright and charged a hefty risk premium to refinance it, thus driving up the interest payments on the debt and raising the risk of default even more.

Secondly, the financial crisis of 2008 led to the most serious economic recession since the 1930s throughout the Eurozone. In a recession, tax receipts fall, social spending rises and the budget goes into deficit; such a cyclical deficit is at the heart of the 'automatic stabiliser' mechanism which prevents output and employment from contracting disastrously. But any serious recession may also result in a fall in the growth potential of the economy, in turn increasing the 'structural' component of the deficit. Without pursuing the matter in detail, suffice to say that in most OECD economies, both the cyclical and structural components grew in 2009-10; hence, the so-called 'black hole' in public finances. In a country like Greece, where the public current deficit was already large, tax collection was weak and the stock of debt was of short maturity and needed to be funded abroad, international bond markets panicked.

Such panic leads to the 'contagion' which lies at the heart of the current problem. Financial markets have reacted to countries' budgetary problems by demanding ever-higher annual rewards for buying their bonds (6-8% yields are not uncommon). Equally, since such bond purchases are typically 'insured' through the purchase of Credit Default Swaps (CDSs), the perceived risk of a country going broke caused the cost of CDSs to rise as well, thus adding further fuel to the sovereign debt crisis.

Even the US is worried about the deficit hysteria sweeping the EU and its deflationary impact, not just in Europe but for the world economy¹. In Ireland, where the collapse of the housing bubble in 2007 led the government to underwrite the entire banking system and thus greatly increase its own indebtedness, self-imposed spending cuts contributed to an estimated 9% annual fall in GDP in 2009, a widening budget deficit and a dramatic 'bailout' by the EU/IMF. By 2010, its GDP had fallen by well over 10% – the official definition of a depression – and is forecast to fall a further 5% in 2011 as a result of the EU/IMF imposed cuts. In Greece, an EU-IMF imposed deficit reduction plan of 10 percentage points over two years has led to a forecast fall in GDP of 20%.

By late 2010, Spain and Italy had announced €15bn and €25bn respectively in austerity measures. Portugal had accelerated its budget reduction programme to get from 9% in 2009 to below 3% by 2013, or by about 2.5% a year². In France, where the budget deficit is much smaller than in Britain, President Sarkozy was under pressure to follow Ms Merkel's budget balancing act. Lest anybody forget, in 2009 the CDU-SPD coalition led by Ms Merkel committed Germany constitutionally to a permanently balanced annual budget after 2016, the so-called 'debt-brake' law, which means extra budgetary cuts amounting to €10bn per year starting in 2011³.

As though all this fiscal tightening were not bad enough, the OECD recommended monetary tightening as a precaution against inflation⁴. Both the Bank of England (BoE) and the ECB are considering raising interest rates in early 2011, despite the ECB's warning that the Eurozone might have contracted by nearly 5% at the end of 2010 and that the core inflation rate has been near zero.

What does all this mean for growth? Take the Eurozone-16 countries; their average current deficit in 2010 is about 7% of GDP, and it will probably be 8% in 2011. The current aim is to bring this figure within

1. See <http://www.nytimes.com/2010/05/31/business/global/31deflation.html?scp=3&sq=europe&st=cse>.

2. See <http://www.ibtimes.com/articles/22922/20100509/portugal-promises-eu-to-cut-budget-deficit-more-in-2010.htm>.

3. See <http://www.spiegel.de/international/germany/0,1518,696760,00.html>.

4. See <http://www.guardian.co.uk/business/2010/may/26/oecd-backs-coalition-spending-cuts>.

the 3% limit by 2013; i.e. to make budgetary savings of 5% of GDP over two years. If we assume a (small) government multiplier of 1.5 and that its impact is distributed evenly over the three years following 2013, this would mean a 2.5% annual loss in growth until 2016. But average Eurozone growth in the decade since 2001 has only been just above 1% per annum, so we can expect deficit cutting to lower future growth.

Even more contradictory is what this does to the stock of debt. Recall that the Maastricht rules require the ratio of the stock of government debt to a country's GDP not to exceed 60%. A simple rule used by economists to forecast how the debt/GDP ratio will move is the following: the debt/GDP ratio will fall as long as the rate of interest paid on the debt is smaller than the rate of growth of GDP. If growth prospects are good and interests costs low, the debt burden will shrink. Per contra, high interest rates on government bonds and poor growth prospects will raise the debt burden, thus causing international financial markets to worry even more about the future 'sustainability' of the debt . So when the EU/IMF insists that Ireland, Greece or whoever should cut public spending, it reduces the country's future growth prospects and makes bond markets even more reluctant to refinance future debt maturities.

To assuage bond markets in the short term, the ECB has tried to pump short-term liquidity into the system by buying distressed countries' eurobonds. As a longer term solution, Germany and France agreed in May 2010 to operating a permanent bailout facility after 2013:the European Financial Stability Facility (EFSF). But because of the terms demanded by Germany, namely that bond holders take 'haircuts', the €440bn supplied by the EU, rather than promoting stability, has actually made the crisis worse (De Grauwe, 2010).

Moreover, since the Facility must be over-collateralised, only about €250bn of the €440bn total can be lent out (Muenchau, 2011). Indeed, having just lived through the Irish crisis, the ECB warned in December 2010 that the total cost of refinancing Eurozone sovereign debt over the next two years could reach a staggering €1tr. Unless this sum can be financed, there will be defaults and restructuring. Markets know this and, when they re-opened in January 2011, became even more worried about contagion. Eurozone ministers are now bickering about whether (and how) to raise the effective size of the EFSF (Wyplosz, 2010).

All this is happening while Europe pursues pro-cyclical budget cutting policies. Such policies make things worse. Not only will Europe suffer, but because the combined EU economy is so large, so too could growth elsewhere in the world. Prolonged unemployment means that a whole generation will remain jobless, and even when recovery takes place, they will enter the labour market without the skills they would otherwise have acquired and with little bargaining power⁵. Industries will decline, and some will disappear altogether, as will the wider communities which they helped support. Income and wealth inequalities will grow.

Perhaps most disturbing is that Europe's 'social model' will be so deeply damaged by lack of public finance that it will in effect cease to exist, or else become a patchwork of support programmes for the 'deserving poor' (i.e. tax-related benefits for the employed) as in the Anglo-Saxon countries. The deficit cutters are killing Social Europe.

2. Why Eurozone countries cannot all be like Germany

In its simplest form, the argument used by the deficit hawks relies on treating the budget of a national economy as analogous to that of a business or a household. Mrs Merkel today, like Margaret Thatcher in the 1980s, pretends that she is acting like any prudent housewife, restoring order to the national finances by balancing the family budget on a weekly, monthly or annual basis.

Unfortunately, a national economy doesn't work like that. Unlike households, economies are subject to long term ups and downs or 'business cycles'. The length of the full cycle varies, but it is typically 8-10 years; when we examine the historical record for large market economies, this cyclical pattern emerges quite clearly. The deepest cycle of the 20th century started in the USA just before the Wall Street Crash of 1929. Moreover, because of the writings of Keynes and many others who followed him, we know that governments can do a great deal to reduce the negative impact of an economic downturn.

5. On Britain, for example, see: <http://www.guardian.co.uk/business/2011/jan/19/youth-unemployment-heads-towards-1-million>

In a slump, as firms go out of business and unemployment increases, consumers spend less and save more while firms, aware that sales are falling, stop investing in new machines and buildings; these reactions by the private sector cause even more belt-tightening which in turn causes the economy to contract further. Moreover, as the economy turns downward, the accumulation of bad debts in the banking system can lead to a financial crisis, adding fuel to the flames as it did in 1929.

To prevent this from happening, governments must offset the fall in private sector demand by loosening both monetary policy and fiscal policy; ie, by keeping interest rates low and by spending more. To a degree, automatic fiscal stabilisers help; i.e. governments pay unemployment benefit and cease taxing those who lose their jobs. But in a serious slump such as that which we have experienced, governments must do more. It may need to 'bail out' failing banks and to design a large stimulus package to get people back to work.

Germany was one of the first EU countries to come out of recession, and its recovery was largely driven by an export boom (with stronger domestic demand primed by government playing a role too). Indeed, Germany experienced buoyant growth in the second half of 2010, with the end-of-year GDP growth forecast to be nearly 3%, well above the 1.4% forecast for the Eurozone-17 and bringing it back to nearly its pre-2008 level⁶. It is expected that growth will slow in 2011, mainly because stimulus programmes will ease and fiscal stringency will start to bite. One must bear in mind that Germany sells about half its total exports to the Eurozone with which it traditionally runs a trade surplus.

But Germany's export dominance has become a source of friction for its trading partners, particularly those in the Eurozone. For one thing, German exports have been helped by a relatively cheap euro; were the DM still in use, it would doubtless have appreciated strongly. For another thing, Germany's exports are by definition someone else's imports, and for one country to be in surplus, another country must run a deficit. This is precisely what happened to the so-called 'Club Med' countries (Greece, Portugal, Spain and Ireland). As shown by Lapavitsas *et al.* (2010), Germany's trade surplus is mirrored by the Club-Med deficit.

6. See <http://www.spiegel.de/international/germany/0,1518,711679,00.htm>.

Crucially important, too, is that fact that a budget deficit cannot always be eliminated simply by ‘balancing the budget’, mainly because of the way in which the budget balance relates to the other savings balances in the economy. We know from simple national income accounting definitions that the sum of private and public sector ‘savings’ must equal the external current account balance. If there are no net savings in the private sector and the external current account is in deficit, the government account must be in deficit – there is no causality implied, rather this statement is true by definition. Germany can ‘balance the books’ precisely because it runs a large external surplus.

More generally, where private savings and investment are in balance for all Eurozone countries, these same countries could only run balanced or surplus budgets if each eliminated its trade deficit and went into surplus with the rest of the world. However, as Whyte (2010) has shown, the Eurozone is simply too big for the rest of the world to be in deficit with all Eurozone members. In short, the position of the deficit hawks is not just empirically misleading, it is logically untenable (see also Wolf, 2010).

In short, in order for some Eurozone countries to run surpluses, others must run deficits; this is true whether for the Eurozone or for the world as a whole. Nor can deficit countries ‘balance the books’ and ‘regain productivity’ merely by cutting expenditure; rather, expenditure cutting can only balance the books if national income falls, in some cases with the brunt of the cuts borne by the poor as is currently happening in Greece and Ireland. Moreover, the race to the bottom this entails may have negative secondary repercussions on other trading partners; witness fears in the US that European contraction will hurt US growth.

A further problem with ‘balanced budget’ orthodoxy is that it ignores growing private sector indebtedness. Indeed, what distinguishes countries like Ireland and Spain is that it is the private sector which has accumulated debt. In the Irish case, as soon as the housing bubble burst, the burden of debt was transferred to the public sector, doubling public indebtedness at a stroke and precipitating a sovereign debt crisis and the subsequent EU/IMF ‘bailout’. As Paul De Grauwe (2010) writes: ‘From 1999 until 2008, when the financial crises erupted, private households in the eurozone increased their debt levels from

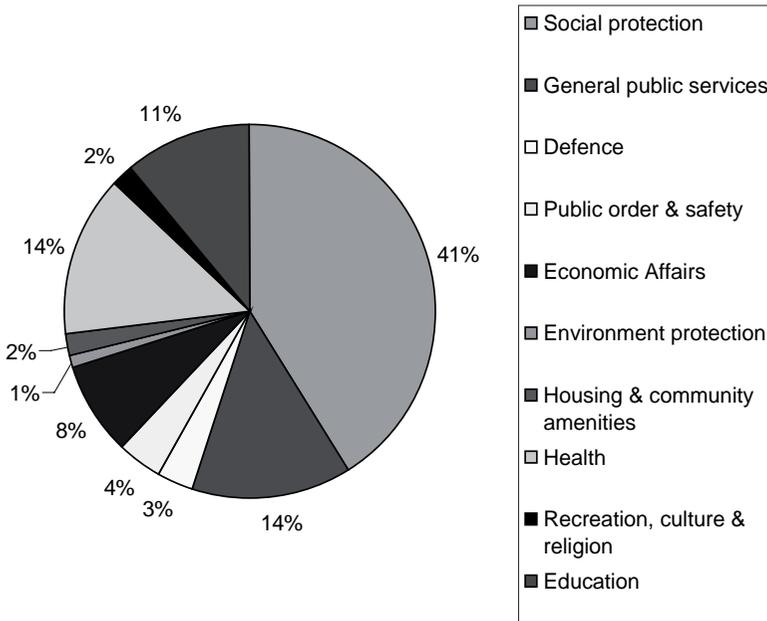
about 50% of GDP to 70%. The explosion of bank debt in the eurozone was even more spectacular and reached more than 250% of GDP in 2008. Surprisingly, the only sector that did not experience an increase in its debt level during that period was the government sector, which saw its debt decline from 72 to 68% of GDP. Ireland and Spain, two of the countries with the severest government debt problems today, experienced the strongest declines of their government debt ratios prior to the crisis. These are also the countries where the private debt accumulation was the strongest'.

3. Who pays for the crisis?

It should be clear that the general public, not the banks, will pay for the crisis. Payment in most EU countries will predominantly take the form of spending cuts rather than tax increases (still less tax increases for the very rich). The deficit hawk argument is that the state is large and inefficient and so must be cut back. In the EU-27, state spending as a proportion of GDP ranges from just under 40% in Spain to over 50% in Sweden, and hawks like to compare this to a figure of about 25% in the USA. In contrast to the USA, European countries generally spend a higher proportion of their budget on 'transfer payments'; i.e. on items such as universal medical cover and pensions for which citizens save by means of taxes and other transfers, but which they receive back in the form of entitlements.

The breakdown of government spending for the EU-27 in 2008 reveals that social transfers, including payments 'in kind', amount to about 30% of GDP, and that the public sector wage bill is about 10% of GDP. Everything else is much smaller: investment and interest payments 2.7% each, and subsidies 1.2%. So any major cuts in public spending are almost certainly going to hit welfare payments (financial transfers and in-kind service provisions) and public sector wages. As a matter of simple logic, the lion's share of any meaningful cuts on the spending side will have to come from these sources, simply because of their size. The other categories are simply too small (Watt, 2010).

Figure 1 Average share of public expenditure for EU-27 by category (2003)

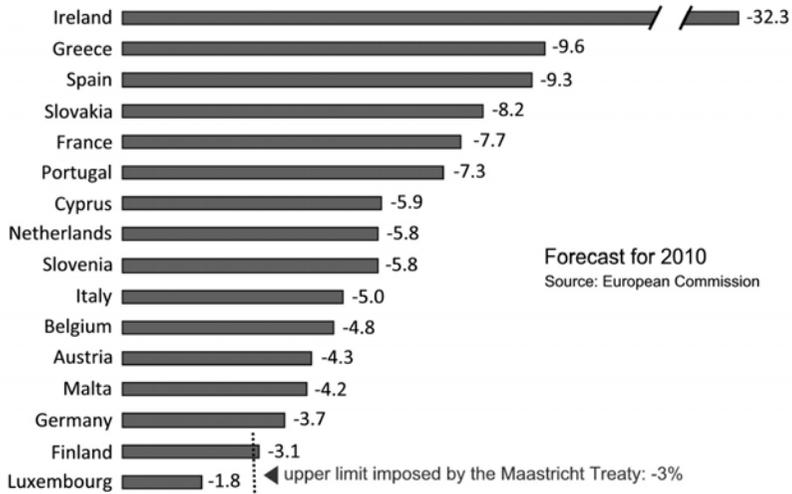


Source: CEC (2008: Figure 4).

Figure 1 shows the breakdown by policy area of national governments' spending as an average for the EU27 in 2003; the figures were published in 2008 and the pattern has been relatively stable. Social protection is about 40% of government spending while health, education and general public services each account for between 10 and 15%. Spending on social protection tends to rise as populations age. Equally, spending on the environment is likely to rise, although from a very low base. With the exception of 'economic affairs', all other items represent a negligible share of spending. In theory, scrapping the armed services of all EU countries would reduce public spending by only 3%. It is clear that meaningful cuts in public spending will almost inevitably involve 'soft targets' – social and welfare services in a broad sense. These are EU averages and, of course, there are some national differences. Spending on social protection varies from 9.5% in Ireland to 23.8% in Sweden. In the area of defence, spending on the British armed forces is

ten times higher as a share of GDP than in Luxembourg. Still, the basic point is that meaningful cuts must come from spending categories of a meaningful size.

Figure 2 Eurozone budget deficits as percentage of GDP (2010)



Source: Spiegel on line, 13 January 2011.

Figure 2 shows the size of government current deficits for eurozone countries. With the EU expecting all Member States to have met the budget deficit target of 3% of GDP by the financial year 2014-15, what belt-tightening measures are the countries taking?⁷

Ireland

The huge cost of bailing out the banks increased the government's current deficit to an astronomical 32% of GDP in 2010, while the stringent bailout conditions imposed by the EU/IMF rescue package require this figure to fall to 2.9% by 2015. To this end, Ireland has pledged

7. See <http://www.bbc.co.uk/news/10162176>.

to make €15bn worth of savings by 2014 of which €6bn in cuts are 'frontloaded'; i.e. they will occur in 2011. Government spending has been slashed by €4bn, with all public servants' pay cut by at least 5%, social welfare reduced, and the cutting of nearly 25,000 public sector jobs. The government also plans: €2.8bn of further savings in social welfare spending, €1.9bn to be raised from income tax changes, a reduction in the minimum wage to €7.65 an hour and a VAT rise from 21% to 22% in 2013, then to 24% in 2014. Needless to say, these changes will hit the most vulnerable hardest.

France

In order to meet the target of reducing the budget deficit from 7.7% of GDP (2010) to 3%, France has announced plans to cut spending by €45bn by the end of 2013. Some of this money is to be saved through closing tax loopholes, the withdrawing temporary economic stimulus measures and a 1% increase in tax on the highest income band. In addition, some 97,000 public sector jobs are to be axed in the period 2011-13, according to the French Prime Minister, Francois Fillon⁸.

The most politically controversial measure, though, has been President Sarkozy's plans to raise the initial retirement age from 60 to 62 and the full state pension age from 65 to 67. This is seen as a direct attack on France's traditionally generous system of social provision.

The Netherlands

The centre-right coalition formed in The Netherlands on 8 October 2010 said it wanted to cut the 2010 budget deficit, estimated at 5.8% of GDP, by €18bn between 2011 and 2015. But the new government will have to rely on the radical Freedom Party to enact legislation and there are doubts about its long-term viability. Nevertheless, the government

8. See <http://www.guardian.co.uk/world/2011/jan/13/french-pm-francois-fillon-euro>.

expects to narrow the 2011 budget shortfall to 4 percent of GDP, still slightly above the EU's 3 percent ceiling⁹.

Spain

At the end of 2010, Spain's deficit stood at just over 9% of GDP. The Spanish government has approved an austerity budget for 2011 which includes a tax rise for the rich and 8% spending cuts.

Madrid has promised European counterparts to cut its deficit to 6% of its gross domestic product (GDP) by the end of 2011. Government workers have had their pay cut by 5% since June, and salaries will be frozen for 2011. The tax on tobacco is to rise 28%, and Madrid also plans to sell off 30% of the Spanish national lottery and a minority stake in the country's airport authority. A tax rise of 1% will be applied to personal income above €120,000. Smaller savings include an end to a €2,500 cash payout for new mothers, known as 'baby cheques'. Madrid will also stop paying a monthly subsidy of €426 to the long-term unemployed who are no longer eligible for the dole. Unemployment has more than doubled, to about 20% of the workforce, since 2007.

Italy

The Italian budget deficit was an estimated 5% of GDP in 2010. The Italian government has approved austerity measures worth €24bn for the years 2011-12. The cuts amount to about 1.6% of Italian GDP. Italy also aims to cut public sector pay and freeze new recruitment. Public sector pensions and local government spending are also being targeted, and there are plans to crack down on tax evasion.

Funding to city and regional authorities is expected to be cut by more than €13bn. For the next three years there will be a freeze on public sector pay rises and cuts in public sector hiring, replacing only one employee for every five who leave. Progressive pay cuts of up to 10% are

9. See <http://www.bloomberg.com/news/2010-09-24/netherlands-reduces-2010-2011-borrowing-plans-as-budget-deficit-narrows.html>

planned for high earners in the public sector, including ministers and parliamentarians. Retirement will be delayed by up to six months for those who reach retirement age in 2011. Provincial governments serving fewer than 220,000 inhabitants are to be scrapped.

Germany

Germany's federal deficit in 2010 was an estimated 3.7%, lower than originally forecast because of the country's relatively strong growth performance over the year. The German government has proposed plans to cut the budget deficit by a record €80bn, or 3% of GDP, by the end of 2014 and to achieve a fully balanced budget by January 2016. The plans include a cut in subsidies to parents, 10,000 government job cuts over four years, and higher taxes on nuclear power. 'Germany has an outstanding chance to set a good example', said German Chancellor Angela Merkel. What Mrs Merkel did not say is that German regional (Länder) and municipal governments have been starved of finance and are suffering gravely¹⁰.

At the heart of the deficit reduction plan is the 'debt-brake' law, introduced by Chancellor Merkel and Finance Minister Per Steinbrück, incorporated into Germany's constitution in June 2009 and taking effect in January 2011. The federal government is expected to adhere fully to the new law by January 2016. Deep recessions and natural disasters would, however, permit higher borrowing, provided there is a 2/3 majority in the parliament. The law sets a zero limit on net borrowing for the Länder (regions) and limits the federal budget deficit to 0.35 percent of GDP. The Bund (Federal Government) and the Länder have a number of years to adjust their fiscal position. In addition, in the coming years, the richer Länder and the Bund will assist the poorer Länder to cut back their stock of debt by providing an annual amount of €800 million to them. The zero net borrowing limit for the Länder will become effective in 2020.

10. See <http://www.reuters.com/article/idUSTRE67K1QM20100821>.

Figure 3 Debt-to-GDP ratio of selected EU countries (2010)



Source: Spiegel on line, 13 January 2011.

Portugal

At the end of 2010, the Portuguese deficit stood at an estimated 7.3% of GDP and its debt-to-GDP ratio at 84.6%. Portugal's borrowing costs have risen as investors regard it as one of the weakest links in the eurozone, like the Irish Republic and Greece, and currently stand at just under 7% for its 10-year Eurobonds; nevertheless, in January 2011 it successfully raised €1.25bn from the international financial market. But that has not halted speculation that Portugal will need some form of bailout in the course of the year.

The social-democratic government of José Socrates has announced a range of austerity measures aimed at cutting the 2011 deficit to 4.6%. Public services, including flights and rubbish collection, were paralysed by a general strike on 24 November 2010. It was the first such joint protest by the main unions for 22 years. In the austerity drive top earners in the public sector, including politicians, will see a 5% pay cut. VAT will rise by 1% and there will be income tax hikes for those earning more than 150,000 euros. By 2013 they will face a 45% tax rate. By 2013 military spending will have been cut by 40% and the government is delaying the launch of two high-speed rail links: the Lisbon-Porto and Porto-Vigo routes.

Greece

Greece aims to slash the budget deficit from an estimated 13.6% of GDP in mid-2010 and 9.6% at the end of the year to below 3% by the end of 2014. To do this it must take nearly 2% out of GDP per annum. The Greek government has pledged to make drastic spending cuts and boost tax revenue in return for a €110bn bail-out from the EU and IMF approved in mid-2010. It is now drawing on the bail-out money because a sharp downgrade of its sovereign debt rating resulted in borrowing costs of 7.7%.

Greece received a €20bn tranche in May 2010 and €9bn in September. The lenders consider that Greece has made solid progress enabling a further €9bn to be disbursed in early 2011, despite missing its 2010 deficit target by an expected 1.5%. The country has started cracking down on tax evasion, and on corruption within the tax and customs service. It will also curb its widespread early retirement schemes. The average retirement age is set to rise from 61.4 to 63.5.

Under the plan to slash the budget by €30bn over three years, Greece has been forced to scrap bonus payments for public sector workers, to freeze public sector salaries and pensions for at least three years, to increase VAT from 19% to 23% and to raise taxes on fuel, alcohol and tobacco by 10%. Nevertheless, Greece will pay a heavy price for these cuts: quite apart from repeated political protests, Greek GDP contracted by 4% in 2010 and is expected to contract by a further 2% in 2011. In consequence, its debt-to-GDP ratio is forecast to rise to as high as 150% and unemployment to peak at nearly 15% in 2011.

United Kingdom

Although the UK's public deficit was high in 2010 at over 11% of GDP, public sector net debt (excluding financial interventions) was equivalent to only 58% of GDP at the end of November 2010; ie, less than the Maastricht 60% target figure¹¹.

11. See http://www.hm-treasury.gov.uk/d/junebudget_chapter1.pdf

Nevertheless, the Con-Dem coalition government aims at reducing the budget deficit to about 1% of GDP by 2014-15. Savings of about €100bn are to be made over four years. The Chancellor, George Osborne, told parliament that 490,000 public sector jobs would be cut over four years because the country had 'run out of money'. It is predicted that there will be a similar number of job losses in the private sector. Most Whitehall departments face budget cuts of 20% on average while the defence budget will be cut by 8%. The retirement age is to rise from 65 to 66 by 2020. Some incapacity benefits will be time-limited and other money will be clawed back through changes to tax credits and housing benefit. On the revenue side, at the beginning of January 2011, VAT rose from 17.5% to 20%.

5. The distributional impact of budget cutting

To my knowledge, there is no comprehensive study of the distributional impact of budget contraction for the whole EU. However, there is some evidence to suggest that if budget contraction increases inequality, this can have an adverse effect on fiscal discipline and adjustment. In the words of one commentator: 'income inequality seems to dampen the effect of economic growth on the budget. As a result, income inequality can hamper fiscal discipline and adjustment' (Larch, 2010: 6). In short, the more egalitarian the distribution of income, the more likely it is that governments will be able to keep structural deficits in hand.

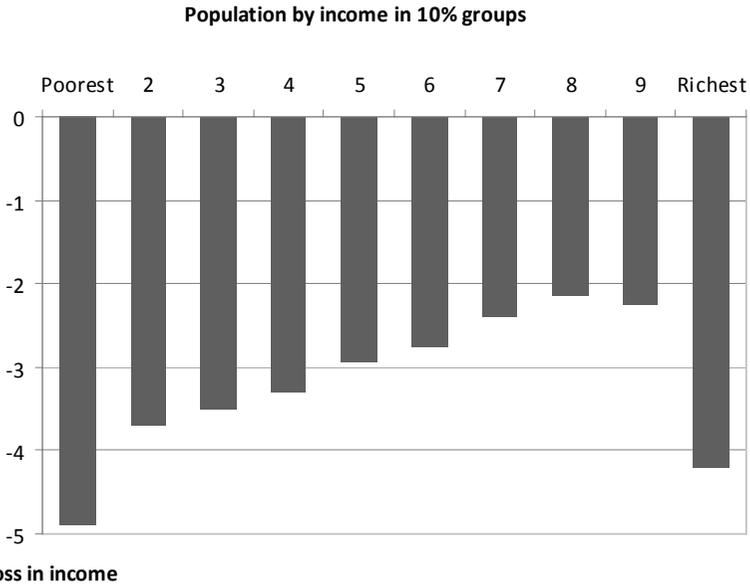
In the absence of an all-encompassing EU study, it will be useful to draw on the UK debate where there is now considerable evidence that attaining budget balance through drastic spending cuts can have adverse distributional consequences.

Figure 6 shows the distributional impact by household income decile group as reported by London's Institute for Fiscal Studies (IFS) in August 2010. Clearly, the impact of fiscal retrenchment for the period 2010-14 is regressive, hitting the poorest income group hardest and richer groups increasingly less until arriving at the richest (10th) decile group. However, there are a number of caveats.

The first, pointed out by Tim Horton and Howard Reed (2010), is that the above distributional effects include the progressive elements of tax

and benefit changes introduced or pre-announced by Labour in its March 2010 budget; e.g. the increase in the top rate of tax to 50% for incomes above £150,000 per annum and the withdrawal of personal allowances above £100,000.

Figure 4 The long-term effects of tax and benefit reforms announced in the UK June 2010 budget by household income decile group



Source: Institute of Fiscal Studies (2010).

The second and third points have to do with the claim by the UK Treasury that the overall incidence of the coalition government’s emergency budget (EB), together with the measures announced in Comprehensive Spending Review (CSR) in late November 2010, was in fact progressive¹². For those who followed the debate, it will be recalled that the Deputy Prime Minister, Nick Clegg, dismissed the IFS analysis which claimed the incidence was regressive as ‘complete nonsense’. But the Treasury’s progressive assessment depended on considering only

12. See Cm 7942, Spending Review 2010, HM Treasury, London.

those aspects of the EB and CSR which took effect in 2011-13 while ignoring important benefit cuts due to take hold in the period 2014-15.

An even more debatable point is the claim by the government that raising VAT to 20% is progressive, not regressive. The simplest version of this argument is that, in absolute terms, VAT falls most heavily on the rich because they spend more than the poor. This version can be dismissed on definitional grounds: all flat-rate taxes (like VAT) are regressive since they take a smaller share of the income of the rich than of the poor. However, since in the UK some 'essential' items (children's clothes, food, rent) are not VAT rated, one might make the case that UK VAT is mildly progressive. Unfortunately, this argument misses the fact that most of the things bought by the poor are VAT-rated (eg, clothes, fuel, tobacco, or even a drink at the local pub) while many of the things that the rich do with their money (buying property, for example) do not incur VAT.

The more serious point, made by the government and echoed by the IFS, is that although a VAT rise may be regressive when measured as a proportion of each decile group's income, it is progressive as a proportion of expenditure. This is because the rich generally spend a lower share of their income than the poor (and the poor may indeed be spending more than their net income at any point in time; i.e. dis-saving).

However, there is no good reason for looking at VAT or any other tax as a proportion of expenditure since what we are interested in is people's ability to pay; i.e. their net income. A slight variant of this argument is that since over a person's lifetime income must roughly equal expenditure, then VAT must be progressive when 'lifetime income' is considered rather than income at a point in time. As argued elsewhere, 'a proportional VAT on all goods and no benefit system at all (including pensions) might be highly progressive in a lifetime incomes context, but it would also leave a lot of low-income people dependent on charities, or dead in the streets'¹³.

13. See <http://blogs.euobserver.com/irvin/2011/01/05/vat-and-vooodoo-economics/>.

6. Accelerating privatisation

One of the most discouraging aspects of budgetary rectitude is that it is accelerating the privatisation of Europe's public services. Some will argue that there is nothing new here. Privatisation was central to the Reagan-Thatcher agenda, just as it has been a key part of the agenda of Europe's centre-right since the 1980s.

The centre-right argues that privatisation and liberalisation are the only way to meet the needs of consumers, improve the efficiency of public finances and create a common European market allowing enterprises, professionals and workers to move freely. By contrast, the centre-left highlights the risks of privatising services that have been historically guaranteed and protected by the state, thereby depriving the public of democratic control over the way that their taxes are spent. But here is the rub: the growing fiscal-financial crisis of the EU has given the neoliberals the upper hand.

In Italy, privatisation began with the state-owned industrial conglomerates, the best-known example being that of ENI in 1955, and was then extended to essential local public services. Germany has been selling off its infrastructure since the 1980s: energy, railways, telecoms and so on. Everywhere, the views that emerged during the Thatcher and Reagan years in conservative parties have been adopted by the centre-left too.

It is in the UK that privatisation has gone furthest. The sell-off of industrial corporations such as steel and coal is today a distant historical memory. Subsequently, Britain under New Labour opened up local government, health, education and part of the criminal justice system to private business. Public bodies became 'commissioning organisations', purchasing services from public, private and voluntary sector organisations. They were also required, as in the case of health, to create pseudo-markets of competing providers where these did not already exist.

In theory at least, neoliberals claim to use liberalisation to stimulate competition and to make it difficult for monopolies or oligopolies to fix prices. Hence liberalisation of services is said to benefit the consumer. Privatisation, on the other hand, is the partial or complete transfer of public industries to the private sector. It was used by Margaret Thatcher in its purest form – the outright sale of those industries – to defeat the

trade unions. It has since extended to include the substitution of public delivery of services with private delivery through the process of competition and marketisation.

The way that postal services and telephone companies now operate is instructive. Eurobarometer, in a survey carried out for the European Commission, found privatised telecommunications customers to be the most dissatisfied in Europe, both in terms of services and value for money. The most favourable consumer feedback came from countries where public ownership of phone companies is still prevalent. Another classic example is the high costs and inefficient operation of public highways, which in Italy were privatised in 1999 (with most of the shares bought by Benetton).

The end of state monopoly has not translated into the realisation of a competitive market. Instead it has produced private oligarchies and massive profits for private companies, with very little going to public authorities, which continue to face dire problems of underfunding and debt. Financial institutions have been the main beneficiaries of the privatisation of infrastructure in Europe. Across the continent, privatisation has resulted in the deterioration of 'liberalised' services, job cuts, the weakening of trade unions and the casualisation of labour.

Another Europe-wide consequence of privatisation and liberalisation concerns the massive conflicts of interest within major telephone, media, electricity and gas networks. For example, the European Commission has separated the ownership of energy producing companies from those administering energy supply networks. It has pursued the same sort of logic in the telecoms sector.

Privatisation in Europe of industries, infrastructure and public utilities has amply demonstrated the increasing influence of financial markets in setting the direction of the economy. In many European countries, privatisation has been directly linked to 'wider' shareholding and 'popular capitalism', whereby shares in what were public industries and services are sold on the financial market and bought up partly by private citizens – but mostly by international investors such as insurance companies.

France provides a good example of this phenomenon. Here the government, after years of resisting privatisation, decided to go down the route of selling shares to the public. 'Under the pretext of controlling the public sector, both left-wing and right-wing governments gave birth to a real transformation of public industries into industrial multinationals, with a growing quota of private capital,' says Nicola Galepides, of France's main telecoms union. 'State industries like France Telecom or EDF-GDF have often bought up public companies in emerging countries,' says Galepides, and their involvement globally will only increase with privatisation (Andruccioli, 2007). Note that Electricité de France (EDF) was part-privatised in 2005, largely to comply with EU market liberalisation laws, while privatisation of Gaz de France (GDF) followed by stages in the period 2006-08. This step-by-step privatisation strategy has previously been adopted for France Telecom (1997), for motorways (2005) and most recently for postal services (2010).

In Spain, privatisation began in 1986, when both industrial and public service sectors were privatised. The INI (National Institute of Industry) sold Seat and Puralator to foreign private companies, while 38% and 98% respectively of two important state-owned companies in the energy sector, Gesa and Endesa, were sold on the financial market. In further waves of privatisation, banks, food production companies and tobacco industries were all subject to the same treatment.

Similar examples can be cited for most other EU countries. There is little doubt that the main impulse has come from the European Commission. Below is an extract from a Commission Green Paper on telecommunications, although the broader intent of the conclusion is clear: 'In general, an open, competitive market for new service providers ... can make a substantial contribution to the rapid spread of new services, under the current condition of rapid development of technology and market opportunities ... Given the complexity and multiplicity of the emerging ... services, only the market can efficiently link the producer with the consumer. *Economics knows of no other means of fulfilling this purpose and all attempts to replace it by something else have so far failed* [my italics]' (CEC, 1987: 52) [quoted from Parker, 1998: 30]

There are two strategic questions which must be addressed. The first is how to define in judicial terms 'services for the general interest' and 'services for the general economic interest'; the second is the question of participatory democracy.

In relation to the first, the literature is vast, but at EU level there is no agreement. Various researchers have found that EU legislation shows 'no awareness of the notion of public service' but only acknowledges 'services for the general economic interest' (Andruccioli, 2007). One of the most urgent political tasks for opponents of privatisation in Europe, therefore, is to secure a clear and definitive directive on services for the general interest.

Democracy is another fundamental problem that needs to be addressed. Privatisation has gone hand in hand with 'individualistic' and authoritarian political ideologies. The EU is witnessing a disastrous lack of civic participation in its policy-making. This has been highlighted in research by Greenwich University's Public Services International Research Unit, on behalf of the European Federation of Public Service Unions, that is highly critical of the official report of the European Commission on services and liberalisation¹⁴.

Another problem facing Europe has been the Bolkenstein directive on the liberalisation of services and the application of 'country of origin' labour legislation to service workers in the EU; hence the implication that 'Polish plumbers' working in the EU would be subject to (weak) labour law extant in Poland. Originally presented in 2000, this was probably the best-known of a series of directives that flowed from the European single market. The earlier directives were aimed at specific sectors – telecoms, energy, rail transport, waste and postal services – and required all EU Member States to commit to a deregulation timetable to open up public networks to private operators. In its 2006 version, the 'country of origin principle' was dropped from the directive, which otherwise would have involved a race to the bottom in protecting service sector workers. Nevertheless, the Commission insisted on reminding Member States of the importance of the free movement of labour and the applicability of the EU Posted Workers Directive which

14. See www.psiru.org; also <http://www.psiru.org/reports/2006-03-EU-EPNICrit.doc>.

provides that a 'hard core' of rules of the host country (country of destination) needs to be observed.

At present, a key area of privatisation is that of health services. Britain provides an excellent example of 'privatisation from the inside', a process by which health provision, while retaining the outward appearance of a publicly funded service, is gradually turned over to private sector firms from any member-state to be run on a 'for profit' basis. New Labour (1997-2010), far from reversing John Major's introduction of a pseudo-market in health care (the so-called internal market), speeded up the process, decentralising the National Health Service (NHS) and reorganising hospitals into regionally based 'primary care trusts' (PCTs) while contracting in everything from managers to cleaning services. At present, the Con-Dem coalition in Britain is in the process of abolishing the PCTs and handing over their funds to general practitioners (GPs), who in turn will be free to hand on management operations to private conglomerates, often headed by US-style Health Maintenance Organisations (HMOs). In the words of the Guardian columnist, Polly Toynbee: 'GPs are camouflage for the true Cameron revolution. Consortiums must now commission services from 'any willing provider'. Naive GPs who fondly imagine they can choose where to send patients may get a nasty shock. Monitor, whose role was limited to scrutinising foundation hospitals, has been re-born as a regulator whose first task is 'to promote competition'. For the first time the NHS is opened to EU competition law. If a consortium keeps a relationship with a trusted local hospital, it may find itself challenged in court by any private company claiming the right to outbid. Neither GPs nor patients will control who is treated where: the law will decide'¹⁵.

Much the same can be said of the financial services industry. When, famously, Northern Rock was taken under UK government control in 2008 after the housing bubble burst, the new publicly owned-company was prevented from offering cheap mortgages to stricken households on the grounds that to do so would constitute 'unfair competition' with the private sector.

15. See <http://www.guardian.co.uk/commentisfree/2011/jan/17/free-market-bill-blow-nhs-apart?>

Or again, one can cite the example of state pensions in which the squeeze on government budgets has been used as a reason either for reducing pension provision, increasing the pensionable age, or both. French street protests in 2010 provide a good example of just how volatile an issue pension entitlement has become. But neoliberal logic dictates that Europe can 'no longer afford' generous pensions, and thus that entitlements must be reduced – or more precisely, that individual responsibility must replace state responsibility as far as possible.

Another example is that of higher education. In Britain, budgetary austerity has been cited as the reason for raising the cap on university fees from £3000 per annum to £9000 per annum. It is argued that such increased fees, particularly when repaid over a number of years, are justified because university education provides access to higher future income for graduates. What is notable is that the notion of 'public good' – ie, that access to higher education should be available to all as a matter of principle – has been replaced by the instrumental notion of education as a means of promoting economic efficiency and faster growth.

7. Neoliberal ideology

Why has it come to this? In part the answer lies in the growing power of the financial sector, a key force in contributing to the near-universal acceptance of neoliberal economic ideology.

Like Britain and America, Europe has poured vast sums (in excess of a trillion euros) into bailing out its banking sector. Doubtless this was needed to avoid complete financial collapse. But as the recent sovereign debt crisis has shown very clearly, the very same financial markets that governments bailed out have raised sovereign borrowing costs to exorbitant levels for Greece and others while making fistfuls of money short-selling the weaker countries' Eurobonds.

Although there has been fresh impetus for greater regulation of financial markets – led to their credit by France and Germany – there has been little corresponding change in ideology. The orthodox ideology is not so much monetarist or even Austrian; it is quite simply the 'common sense' notion of bankers and shopkeepers alike that an economy's budget is no different from the family budget. They assert

that a sound budget, whether private or national, must balance¹⁶. As the US economist Bradford DeLong has noted about the orthodoxy prevalent in the 1920s: 'the hard-money lobby [ruled]: a substantial number of rich, socially influential, and politically powerful people whose investments were overwhelmingly in bonds. They had little personally at stake in high capacity utilization and low unemployment, but a great deal at stake in stable prices. They wanted hard money above everything'¹⁷.

Both Friedman and Keynes would have agreed that the financial crisis required the banks to be bailed out, which the EU has done generously. Where Keynes disagreed with the prevailing orthodoxy during the Great Depression was on the question of balancing the budget. Keynes argued famously that when the private sector was rebuilding its savings, government must spend more; otherwise, aggregate demand would fall leading to falling output, employment and tax revenue.

Some of Ms Merkel's slightly more economically literate followers (eg, George Osborne in the UK) would argue that more state spending leads, via inflation or increased borrowing, to higher interest rates which 'crowd out' private sector investment. Unfortunately, for this argument to be true, one would need to show that 'full' crowding out takes place, something which according to this theory can only happen at the 'natural' rate of unemployment. Since the 'natural' unemployment is unknowable, the argument fails. Indeed, even if it were 'knowable', since real wages are stagnant or falling, it would surely be lower than the current unemployment level.

As for 'Keynesian economics', despite the Great Recession of 2008-09, many of Europe's finance ministers appear blissfully ignorant of the subject. As Keynes explained in his 'paradox of thrift', although saving may be a good thing for individuals and businesses, the more a country tries to save, the more income falls and the less it can actually save. A good example of economic illiteracy is the oxymoronic title of a recent piece published by two journalists in the influential magazine, *Der*

16. See <http://blogs.euobserver.com/irvin/2010/04/13/why-sound-money-is-unsound/>.

17. See <http://www.project-syndicate.org/commentary/delong108/>.

Spiegel, 'European austerity is the first step to recovery'¹⁸. As the *Berliner Zeitung* put it, the end result of this sort of nonsense is that: 'Europe will save its way into the next recession'¹⁹.

8. Growing out of the crisis

There are three components to avoiding further euro meltdown: growth, funding and dealing with financial services.

Take growth: as Keynes warned, when aggregate demand is depressed over many years, private capitalists lose their 'animal spirits', their will to invest, so the state must 'socialise' investment – at least for a time. What and where to build is hardly a problem: everything from social housing to a new, green infrastructure is needed. Nor is there anything very radical about doing so: the two main 'Keynesian' countries driving the world economy at the moment are the United States and China. The US 'fiscal stimulus' package – cumulatively some 4% of GDP since 2008 – is far greater than anything the EU has done.

How is a further EU stimulus to be funded? First, progressive tax reform is needed; most urgently, in the most unequal countries such as Greece, Portugal and the UK. It has been shown, for example, that Britain's structural deficit could be largely plugged by redistributive tax measures designed to rebalance the growing gap between the highest and lowest income deciles²⁰. Moreover, there is now ample evidence that inequality carries high social costs (see for example Wilkinson and Pickett, 2009; see also Irvin, 2008).

Secondly, while awaiting reform of the Eurozone's fiscal and monetary arrangements, the European Bank for Reconstruction and Development (EBRD) could be used much more actively to fund infrastructure and energy projects. After all, the EBRD (unlike the ECB or non-existent Euro-Treasury) can borrow actively on international markets (see for example Irvin, 2006).

18. See <http://www.spiegel.de/international/europe/0,1518,697098,00.html>.

19. See <http://www.spiegel.de/international/europe/0,1518,697098,00.html>.

20. See 'In place of cuts'; <http://www.compassonline.org.uk/news/item.asp?n=6164>.

Crucially, Mr Juncker's proposal that a new European agency be empowered to issue a commonly backed eurobond, so far dismissed by the German government, makes good sense. It does not remedy the problem of the Eurozone trade balances discussed in section 2 above, but it does constitute an important further step towards developing institutions and policies that reflect solidarity amongst Eurozone Member States.

The term 'eurobond' is currently used in a confusing manner since it also describes bonds denominated in a currency not native to the country where it is issued; eg, a Eurodollar or Euroyen bond sold (primarily) on the London market. In our discussion, the term 'eurobond' refers to a fixed income security denominated in euro to be issued by a new European debt agency and backed by all the Member States together.

Mr Juncker has proposed the following. At present, Eurozone countries raise money in the international market by selling euro-denominated bonds issued by their own central banks; the more indebted a country, the more difficult it will be to raise money this way.

The proposed new eurobond would remedy this problem since the instrument would be backed collectively by Europe. Initially, EU countries could borrow up to half their required capital or more from the new agency, the total not to exceed 40% of a Member State's GDP. Mrs Merkel's objection is that while this might lower borrowing costs for indebted nations, it might raise them for ultra-prudent Germany.

A further tool for reducing pressure on Eurozone member-states is for the ECB to make greater use of quantitative easing (QE): the ECB has already used this means to finance bank bailouts. The typical objection that unsterilised QE would be inflationary simply doesn't stand up to scrutiny. With core inflation below 1% in 2010 (and actually negative in some Eurozone Member States), the danger facing Europe is deflation, not inflation.

As Daniel Pfaendler, former head of economics at Kleinwort Benson, has noted: 'Eurozone break-up remains highly unlikely. Rather, the current path will continue to be taken up until a large country (probably Spain) needs a bail-out and the capacity of the EFSF is being used up.

At that stage the political will to start with joint Eurobond issuance or the consensus within the ECB to engage in massive quantitative easing are likely to form, i.e. I think that the most likely scenario is the one of ECB QE (done in conjunction with a topping up in the EFSF), followed by joint Eurobond issuance. Together, I would assign these scenarios a probability of around 60-70%. Up to that point we can continue to watch the dominos fall²¹.

Happily, at the time of writing, no further dominos have fallen, although the omens for 2011 are not promising; in particular, both candidates currently thought likely to succeed Monsieur Trichet at the ECB are considered hardliners²².

On the fiscal side, there is no longer any reason why the EU should not introduce a Tobin Tax. A 0.1% tax on euro forex transactions (€1 per €1000) would bring in €220bn per annum, just over twice the value of the EU budget, and would lay the basis for funding a European Treasury²³.

In summary, I have argued in this paper that pro-cyclical 'budgetary retrenchment' policies being pursued in Europe are neither necessary nor likely to prove efficient. Indeed, their most lasting impact will be raising unemployment and further undermining Europe's social model. This model has already been badly compromised by the European Commission's pursuit of 'competition' policies designed to deregulate and privatise state-owned firms, utilities and services throughout the EU. Informed by neoliberal economics, the European centre-right (and part of the centre left) denies the distinction between public and private goods and services, thus enabling a growing share of the public sector either to be privatised outright (as has been the case with telecoms, public transport, utilities, and in some cases even pensions and prisons) or, as with the National Health Service in Britain and now with higher education, privatised from the inside. In this respect, one might recall the warning of the late Tony Judt, perhaps the pre-eminent historian of

21. See <http://researchahead.blogspot.com/2010/11/watching-dominos-fall.html>.

22. See <http://www.telegraph.co.uk/finance/economics/7139512/Axel-Weber-and-Mario-Draghi-in-pole-positions-as-fight-for-ECB-succession-starts.html>.

23. See <http://blogs.euobserver.com/irvin/2010/02/20/the-eu-must-act-on-a-tobin-tax/>.

post-war Europe. 'This is the second generation of people who can't imagine change except in their own lives, who have no sense of social collective public goods or services, who are just isolated individuals desperately striving to better themselves above everybody else'²⁴.

The major beneficiary of this process has been the private sector where a new class of large conglomerate has been formed, largely with the aid of private capital injections from the financial services sector. But we are coming to a stage when the breakdown of social cohesion associated with the disappearance of social protection is proving deeply damaging. If one includes the opportunity cost of bailing out the banks to this, what emerges is a picture of Europe run for the benefit of a narrow business and financial elite at the expense of ordinary citizens.

Today, the financial sector is simply too big and too unstable to be left to its own devices. The main points which social democrats need to make clearly are two. First, the dismantling of Social Europe must be halted and reversed. Secondly, finance has become a public good and it is time to say so clearly.

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24. Tony Judt, quoted in Ed Pilkington, 'A bunch of dead muscles, thinking', *The Guardian*, 9 January 2010 (<http://www.guardian.co.uk/theguardian/2010/jan/09/tony-judt-motor-neurone-disease>).

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