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European Economists for an Alternative Economic Policy in Europe
– EuroMemo Group –

The deepening crisis in the European Union: The need for a fundamental change

EuroMemorandum 2013

To the memory of Tadeusz Kowalik (1925-2012), distinguished Polish political economist and indefatigable advocate of the welfare and democratic rights of workers and their families.

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Editorial

Dear reader,

Contrary to overly optimistic proclamations in mainstream media, Europe is not coming to terms with the crisis. Rather, the austerity programmes devised by the 'Troika', i.e. European Commission, European Central Bank and International Monetary Fund, do not only lead to a dramatic decrease of the living standards of major parts of the populations in the countries on which they are imposed, they also threaten to plunge large parts of the European South into a social and human disaster. This obviously would affect all the states, also the seemingly stable ones, which the crisis even seems to have strengthened.

Before the generally still sombre economic background a clear trend takes shape towards centralizing the decision-making processes in the European Union and organizing them in an authoritarian way. The Fiscal Pact agreed on in December 2011 by 26 out of 27 heads of government by which national budgets are put under control of the European Commission, as well as the further accumulation of power by the European Central Bank which still lacks democratic control and public accountability can only lead to an exacerbation of political contradictions, among others between a 'core Europe' around the most powerful economies, and a European periphery created that way.

Related to that, there are further political risks: the crisis and its disastrous social consequences delegitimize the European integration in the eyes of large parts of the populations. They provoke and intensify the growth of nationalist and right-wing populist parties all across the continent. Thus, Europe finds itself at a crossroads which is also addressed in the title of this year's Memorandum, 'The Deepening Crisis in the European Union: The Need for a Fundamental Change'.

However, 2012 has also been a year of broad resistance movements in various European countries, amongst them the first transnational strike on 14 November, initiated by big Southern European trade unions and resonating in a broad solidarity in other parts of Europe.

Like last year, transform! europe has taken on the responsibility for the production of the printed versions of EuroMemorandum in English, French, Greek and German – the latter in co-operation with the German magazine 'Sozialismus'.

Thus we hope not only to provide a useful contribution to the European debate on social, economic and ecological alternatives but also to help the development of a broad political movement towards another Europe epitomized in the Alter-Summit of the European people, which will take place in Athens on 7-9 June.

Walter Baier
Co-ordinator of transform!europe
January 2013

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This EuroMemorandum draws on discussions and papers presented at the 18th Workshop on Alternative Economic Policy in Europe, organised by the EuroMemo Group, from 28-30 September 2012 in Poznan, Poland. The text is based on written contributions from Örjan Appelqvist, Joachim Becker, Hermann Bömer, Tanja Cesen, Judith Dellheim, Wlodzimierz Dymarski, Giovanni Esposito, Trevor Evans, Fintan Farrell, Marica Frangakis, John Grahl, Peter Herrmann, Manuela Kropp, Karin Küblböck, Erkki Laukkanen, Jeremy Leaman, Mahmood Messkoub, Dominique Plihon, Werner Raza, Suleika Reiners, Malcolm Sawyer, Catherine Sifakis, Achim Truger, Diana Wehlau and Frieder Otto Wolf.

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Summary

Introduction

The crisis which began in 2007 and deepened dramatically in 2008 has exposed deep rifts in the architecture of the European monetary union. Harsh austerity policies which were first imposed on countries in Eastern Europe, and subsequently on the countries in the euro area periphery, are now beginning to be implemented in countries of the European core. The crisis is highlighting the deeply undemocratic construction of the EU, as the Commission assumes ever greater powers to control national budgets, without any serious oversight by the European Parliament. At the same time, the position of the core countries of the North, and in particular Germany, has been strengthened in relation to the countries of the periphery. But Germany's economy, which has depended on stagnant wages and a rising export surplus, cannot be a model for the whole EU. In the face of global climate change, the EU's approach to the Rio+20 conference in July 2012 contributed to its failure to reach any serious agreement.

1 Economic and financial policy

Economic expansion came to an end in the EU in 2012 with output still below that in 2008. There were recessions throughout the euro area periphery, and output fell during the year by a further 3% in Portugal and 6% in Greece. In Eastern Europe most countries registered some growth in 2012, but output is still down on pre-crisis levels, except in Poland and Slovakia. Countries in the euro area core registered some growth but it was low, and even Germany, which grew strongly in 2010 and 2011, was affected as many of its trading partners in Europe were subjected to austerity programmes.

In early 2012, 25 member states acted, primarily at German insistence, to introduce the so-called Fiscal Compact, a legal limit restricting each country's structural budget deficit to 0.5% of GDP, a measure which will effectively prevent countries pursuing an active fiscal policy in the future. Meanwhile, as the interaction of the debt crisis and the banking crisis threatened to deepen dangerously, the European Central bank (ECB) launched its Long Term Refinancing Operation. It provided commercial banks with some €1tn of three-year loans at 1% interest between December 2011 and February 2012; despite this, bank lending to households and firms actually declined slightly in the course of 2012. After speculation against Spanish and Italian bonds intensified in mid-2012, the ECB also announced its programme of Outright Monetary Transactions. This promises unlimited central bank intervention to support government bonds in the secondary market – but only if countries first agree to an approved programme of policies with the EU's rescue fund, the European Stability Mechanism. Although the ECB has yet to act,

the announcement secured a fragile financial stability in the second half of the year.

Estimates of the combined impact of the various fiscal rules being introduced in the euro area suggest that between 2013 and 2016 GDP could decline by as much as 3.5% in the euro area as a whole, some 5-8% in Italy, Portugal and Spain and 10% in Greece and Ireland. The European Summit in July 2012 proposed to create a European Banking Union, which will involve a common supervision by the ECB; a common deposit insurance; and a common resolution authority. But with some 6,000 banks there are unresolved issues about which banks the ECB will supervise directly, and some Northern countries have indicated an unwillingness to proceed with the common deposit insurance and resolution authority.

Fiscal policy should, in place of austerity, focus on reducing unemployment. Public spending should promote socially and environmentally desirable investment projects. A European currency requires a European fiscal policy, with expenditure in the order of 10% so as to cushion downturns and to ensure an effective transfer of resources between richer and poorer regions. Regional and industrial policies should be strengthened and the European Investment Bank, which is empowered to issue euro bonds, should facilitate a major programme of investments, especially in the most crisis stricken countries in Southern and Eastern Europe. In order to eliminate the large current account imbalances, surplus countries should also be required to expand demand. Employment policy should seek to promote skilled, well paid jobs since competition based on low pay will always be undercut elsewhere in the world. The normal working week should be reduced to 30 hours, both in order to combat unemployment and as part of a shift to a society where people's lives are not dominated by waged work.

The overexpansion of the financial sector should be radically reversed. Commercial and investment banking should be completely separated, and public and cooperative commercial banks should be promoted to provide finance for sustainable investment projects. Investment banks, hedge funds and private equity funds should be tightly curtailed. All securities should be traded on approved public platforms, new securities should be subject to strict testing, and a public European ratings agency should be established. All financial transactions should be subject to a transactions tax. The ECB should be brought under effective democratic control, and its main focus should be on ensuring financial stability through the establishment of a comprehensive, anti-cyclical, system-wide European stability framework.

2 Governance in the EU

A wide range of governance changes have been introduced in the EU in response to the crisis of government debt: new legislation, such as the 'six-pack', which tightens the rules of the stability and growth pact; new treaties and intergovernmental agreements, such as the Treaty on Coordination and Governance, involving tighter constraints on member state budgets; and new procedures, such as the 'European Semester' which reinforces the annual cycle in which the Commission and Council inspect member state macroeconomic policies and 'reform programmes.' The common theme of these changes is to subject the economically weaker countries to a comprehensive system of tutelage with unremitting pressure for expenditure cuts, erosion of labour standards and privatisation of public assets. For those member states which have received 'bailout' funds the controls and restraints are even more oppressive, amounting, in the case of Greece, to a virtually colonial system.

The unavoidable consequence of these developments is to intensify the long-standing legitimacy crisis of the EU. The democratic deficit widens as key decisions are shielded from democratic pressures; as the big corporations dictate EU policies and the content of EU legislation; as the powerful European Central Bank takes critical decisions for which it is not democratically accountable and as national social models are disorganised and dismantled in the name of the single market or of fiscal consolidation.

Although detailed proposals could be put forward to change present governance procedures, they will be futile without a complete change in the direction of EU policy with priority for decent employment and social justice. It has to be recognised that the EU's legitimacy crisis is now so severe that potential challenges to the existing regime at member state level will increasingly be seen as legitimate.

3 Restructuring the social agenda

Austerity policies are also blighting the lives of millions of Europeans, most especially in the Southern and Eastern countries of the periphery. In the EU the official unemployment rate in 2012 was 10.6% but in Spain and Greece it was to 25%, and while the youth unemployment rate for the EU was 22.7%, in Spain and Greece it was over 50%. In place of closing tax loopholes, austerity policies have focussed on expenditure cuts, resulting in the postponement or cancellation of infrastructure projects as well as reductions in recurrent expenditure in healthcare, education, social provision and welfare benefits. Public employment has been reduced significantly in many countries and, due to the recession and the impact of austerity policies, there has been a significant increase in the proportion of the population at risk of poverty. The poorest sectors have been hit worst but, in the crisis stricken countries, many middle-class citizens have also been affected.

Historically, social policies in Europe have been provided by managing or removing the market in the provision of services, through food subsidies or the free provision of health services and certain levels of education. Now the de-

commodification of public services is being reversed through the introduction of vouchers and user fees for health and education services. At the same time, the EU Commission advocates increasing the flexibility of labour markets, but pay freezes, cuts in pensions and increased retirement ages, together with an easing of restrictions on layoffs and limits on unemployment benefits all represent a further weakening of the provisions of Europe's vaunted social model.

The failure of the EU and leading member states to achieve any significant harmonisation of direct taxation has allowed tax competition to flourish, as states offer favourable rates to existing or potential investors, and exposed the vulnerabilities of states with low taxation. All member states should commit themselves to the principal of progressive taxation and an approximate harmonisation of scales. Corporation and other tax rates should be close to avoid profit shifting, and all member states should commit themselves to transparency and a full exchange of information about incomes. Tax avoidance facilities in Europe and the use of tax havens must be eliminated, and there should be a greater taxation of wealth. The shift from direct taxes towards more regressive indirect taxes should be reversed and the destructive dynamic of tax competition must be eliminated.

4 A development strategy for the European periphery

The centre-periphery divide pre-dates the European integration process, but the neo-liberal design of the integration process has widened the divide. In the Mediterranean countries (Greece, Spain and Portugal), accession to the EU was followed by a partial de-industrialisation as governments lost the ability to pursue national industrial policies and, upon entry to the euro, also lost their ability to protect domestic industry through devaluations. Exacerbated by wage deflation in Germany and other Northern European countries, current account deficits grew strongly. In the Baltic and South-East European countries, growth was strongly dependent on an expansion of loans, largely in foreign currencies. Inflows of foreign capital fuelled real estate booms, but overvalued exchange rates were detrimental to industrial development, leading to current account deficits even larger than in the Mediterranean countries. In the Visegrád countries (The Czech Republic, Hungary, Poland and Slovakia) industrial sectors became closely linked to German export industries and, except in the case of Hungary, their current account deficits were smaller.

The Baltic and South-East European countries were affected by the crisis in autumn 2008 as a dwindling or even reversal of capital inflows hit the heart of their growth models. Hungary, Latvia and Romania were the first countries to apply for rescue programmes to the International Monetary Fund and the EU; the programmes' main aim was to stabilise exchange rates, which was the priority of the West European banks that had lent extensively to the countries. The impact of the programmes led to a plummeting of living standards, especially in Latvia. The Mediterranean countries faced the full weight of dwindling capital flows, capital flight and speculative attack in 2010, beginning in Greece. The reaction of the core euro area governments was very slow, and strict austerity programmes focussed on cutting the government deficits, but also aimed at reducing current account deficits. These programmes have bought time for West European banks to disengage from the Mediterranean countries, but austerity policies have not addressed the problem of de-industrialisation and these countries are in a developmental cul-de-sac. The East European countries were primarily affected by a severe contraction of exports in late 2008 and early 2009, and their subsequent recovery was linked to the recovery of German exports – prospects for which dimmed in 2012 due to the impact of austerity policies in Europe and the growth slowdown in key markets such as China.

EU regional policies have focussed on infrastructural development, and not on building viable productive structures. The new EU budget for 2014-2020, due to be agreed in early 2013, is proposing to reduce spending on cohesion policies by some 5% from the current level, and to redistribute its allocation to the benefit of richer and middling ('transition') countries at the expense of poorer countries. The so-called 'Friends of Better Spending' in Northern Europe are also calling for macroeconomic conditions to be attached to cohesion spending, and this appears likely to be agreed. EU peripheral countries have succeeded in reducing their current account deficits, but this has been the result of suppressing domestic demand through strict austerity programmes, and has had disastrous social consequences. EU leaders claim that the structural reforms required by EU/IMF programmes – privatisation and the deregulation of labour markets – will enhance competitiveness, but pro-active industrial policies are completely absent from the programmes. EU policies also fail to address the current account surpluses generated by Germany and other Northern countries as a result of pursuing neo-mercantilist policies.

The current level of public debt in Greece and other peripheral countries is clearly unsustainable. Such debt should be subject to a debt audit to determine which parts are legitimate, and remaining debt should be written down to a sustainable level. The ECB's role as lender of last resort in the government bond market should be extended, and decoupled from demands for strict austerity policies. The EU budget should be raised from the current 1% of EU GDP towards 10%, in order to facilitate macroeconomic stabilisation, and in order to facilitate a major investment and development programme in the southern and eastern periphery of the EU. Active industrial and regional policies are required to promote the process of development in the peripheral countries, since development does not occur only as a result of market processes. Current EU regional and cohesion policy has mainly promoted metropolitan areas, but support for poorer areas is important to increase employment and output. Regional policy has focussed on the regional and urban level, but this is to the detriment of the national level, which is often more appropriate for promoting

development. The full use of resources requires democratic participation and not elite planning. In particular, the 'Smart Specialisation' proposed by the EU whereby every region should be a world leader in some area cannot work as there are not sufficient products to go round and over-specialisation is likely. Furthermore while intra-regional trade is important, there should be greater attention to promoting more ecologically sustainable forms of production by using local resources for local consumption, for example in the case of food or energy generation. Economic policy in the EU must be rebalanced, and whereas the newly instituted procedure in the EU applies to countries with external deficits, countries with external surpluses should also be required to adopt more expansionary policies so as to increase their imports.

5 The crisis in global governance

Two overwhelming failures characterise the field of global governance in 2012. Firstly, no substantial progress has been made on financial reform or economic coordination. The unresolved euro area crisis represents a growing threat to the global economy which is slowing down. Despite numerous declarations about the need to address global challenges, the root causes of the global financial crisis – massive current account imbalances, inequality of income and wealth and unregulated and volatile financial markets – still remain unsolved. Current account imbalances remain well above sustainable levels. The implementation of new financial regulation has lagged far behind declarations of intent. The too-big-to-fail problem is far from being resolved and financial institutions are becoming even larger and more concentrated; risky activities are still being transferred, perhaps on an increasing scale, to the non-regulated shadow banking system.

Secondly, the environmental dimension of global governance combines situations of extreme and growing urgency – e.g. climate change and biodiversity destruction – with a decreasing political capacity to act. The Rio+20 summit in 2012 proved incapable of renewing the global agenda of sustainability politics. Environmental governance has been pushed to the side-lines, reduced to lip-service in the main fields of economic development, and to fragmented and inadequate measures in the field of nature protection.

Currently, there is no global institution or set of institutions effectively overseeing and controlling global and systemic risks, such as global current account imbalances, asset bubbles, excessive exchange rates fluctuations, large swings in capital flows, levels of international reserves or harmful tax competition and tax evasion. Institutions that are currently supposed to assume (part of) these tasks – the International Monetary Fund (IMF), the Group of 20 (G20), the Financial Stability Forum, the Bank of International Settlements, the Organisation for Economic Cooperation and Development (OECD) – are currently not effective in carrying them out in practice. In the field of global environmental governance, the EU's official policy seems to have retreated since the onset of the financial and economic crisis and, in so far as it exists, it is woefully deficient.

Reform of global financial governance must be based on the imperatives of equity and of economic and financial stability and must be organised in a representative and transparent manner. Instead of the G20, a self-appointed group of countries, objective and explicit selection criteria should be employed to establish a 'Global Economic Council', as proposed by the UN Commission chaired by Joseph Stiglitz. The IMF needs to be subjected to substantial reforms in its governance, mandate and policy recommendations. If there is the political will more transparency in tax issues is quite achievable. As the UN is currently the most representative coordination forum, the EU and other OECD members should transfer resources and the mandate from the OECD to a high-level UN tax institution and provide it with sufficient expertise and power to effectively combat tax evasion and tax avoidance, and to reduce tax competition.

Any meaningful alternative political strategy in the field of global environmental governance must reject the privatisation of water, energy and, generally speaking, of the Commons, must contest the monetisation of nature, and refuse the weakening or replacement of binding regulation by mere market mechanisms. The EU could promote its own capacity to develop long-term sustainability by engaging in a new type of multilateralism. Instead of trying to always claim the leading role for itself – or for its leading member countries – and instead of addressing all the others as subordinates that need to be led, the EU and its member states should practise a kind of open diplomacy, in which those who are most advanced in a specific field take the lead.

Introduction

The European Union (EU) is facing a complex crisis. The financial crisis which began in the US in 2007, and which deepened dramatically in 2008, has exposed deep rifts in the architecture of the EU's most ambitious project, the economic and monetary union. As European governments sought to counter the danger of financial collapse and the impact of the deepest recession since the 1930s, government deficits soared. The debt crisis which broke in 2010 in Greece, spread rapidly, first to Ireland and Portugal, and then to Spain and Italy.

Austerity policies were first imposed on the countries of Eastern Europe and then on the peripheral euro area countries as a condition of financial support from the EU and the International Monetary Fund. But austerity policies are now also being implemented in more and more of the rich countries that make up the euro area core. Under the impact of the deeply conservative policies being adopted by European and national authorities in response to the crisis, unemployment and social hardship are rising across much of Europe.

The development of the European Union has, since its inception, been driven by a powerful capitalist dynamic. The initial years, however, were characterised by full employment and it was possible to attain a significant degree of social advance for the great majority of the EU's citizens. This began to change in the 1980s. Major capitalist enterprises adopted a more aggressive stance in relation to employees; financial capital came to play an increasingly dominant role; and the EU and the member states moved towards a neo-liberal set of policies, including de-regulation, privatisation and the promotion of competition, which involved a significant shift in favour of the interests of private capital.

The expansion of the EU to the East opened up a whole new region for investment, production and sales by big West European companies while the creation of the euro area permitted a further marked deepening in the division of labour within Western Europe, enabling Germany and other Northern states to achieve a striking expansion of their exports. Now, under the aegis of the crisis, a wide-ranging process of restructuring is under way. The largest and most successful companies are strengthening their position; the social agenda is being reorganised with especially serious cuts in wages and welfare benefits in the most crisis stricken countries; and the position of the core countries is being strengthened as that of the periphery is weakened.

The crisis has highlighted the deeply undemocratic construction of the European Union. The European Commission is assuming ever greater authority in overseeing national budgets, imposing the doctrinaire rules enshrined in the Stability and Growth Pact, now due to be yet further intensified with the adoption of the so-called Fiscal Compact. While national parliaments are effectively stripped of such fiscal oversight as they might have had, the European Parliament – despite a limited accretion in its competences – is still woefully unable to exercise any meaningful democratic control over economic policy at a European level. The proposal for a banking union could be an important step to achieving an effective European supervision of banks, but the way in which it is planned to do this will strengthen yet further the position of the European Central Bank, an institution that is at present completely outside any process of democratic accountability. This is a Europe of the elites, where powerful lobby organisations are able to exercise wide-ranging influence behind the closed doors of the Brussels administration, well hidden from the prying eyes of Europe's citizens.

The relation between the member states has also been significantly accentuated. The German government, together with its close allies, in particular the governments of Netherlands and Finland, has assumed an ever stronger position, sometimes inside the official structures, at other times through so-called 'coalitions of the willing'. Any hopes that the election of a Socialist Party president in France might result in a challenge to the EU's over-weaning emphasis on austerity policies have been disappointed. For many European heads of government, the path to a decision in Brussels now appears to pass through Berlin.

The idea that the German economy can in some sense be a model for the EU is quite mistaken. Germany's economic development since the introduction of the euro has been dependent on an aggressive export-led strategy where stagnant wage growth and weak domestic demand were compensated by a rising trade surplus. While profits increased, a low-paid sector has been created that now encompasses some 20% of the workforce. At the same time, with the EU's international trade roughly in balance, other European countries have been faced with a rising trade deficit.

Inflows of capital to peripheral EU countries were supposed to promote a process of economic convergence but in many countries they merely fuelled consumption and the growth of unsustainable bubbles in asset prices. Since the onset of the crisis, the inflows have been abruptly reversed and the divergence between member states has widened. Only a major programme of investment in sustainable projects that create skilled, well-paid jobs can reverse this process.

At a global level, the EU has been following a strongly neo-mercantilist global role, pushing for an extension of free trade in manufactured goods at the World Trade Organisation's stalled negotiations. Meanwhile, developing countries that wish to maintain access to European markets have been required to sign up for so-called Economic Partnership Agreements which oblige them to open their economies to European multinational companies in a way that goes far beyond what is required by the WTO.

Perhaps the most far-reaching feature of the complex crisis facing Europe is the challenge of global climate change. The United Nations Rio+20 international conference on sustainable development in July 2012 failed to reach

any significant agreement. Meanwhile, aerial photographs map the retreat of polar ice caps and storms of unprecedented intensity pummel the globe from Pakistan to New York. Europe, as one of the richest regions in the world, must give the highest priority towards promoting an economic transformation that will achieve a fundamental reduction in the consumption of energy and other non-renewable resources, and in the emission of green house gasses.

In the last year there have been impressive mobilisations by trade unions and social movements, above all in the peripheral euro area countries that are facing the cutting edge of austerity programmes, where the first ever coordinated general strike was organised on 14 November 2012. There have also been several important initiatives to promote greater coordination amongst movements at a European level. This EuroMemorandum is intended as a contribution to developing these initiatives and in promoting a different Europe that is based on the principles of democratic participation, social justice and environmental sustainability. In contrast to previous years, the chapters in this EuroMemorandum are organised by theme. In each we attempt to outline key developments in the past year; to identify some of the main problems with the policies adopted by European and national authorities; and to sketch the basis for an alternative approach.

1 Economic and financial policy

1.1 Key economic developments in 2012

Economic expansion in the European Union (EU) came to a standstill in 2012, with output still below the level of 2008 (see Table1).[1] In most member states the official unemployment rate continued to rise in 2012, while real wages either stagnated or declined. As in previous years, however, there are important regional variations.

In the peripheral euro area countries, the impact of strict austerity policies has resulted in recessions in Italy and Spain, and especially deep recessions in Portugal and above all Greece, where output has now fallen by 17% since 2007. Serious hardship is increasingly widespread: unemployment is very high in all these countries, with official rates of 25% in Spain and Greece; real wages continue to decline and, compared with pre-crisis levels, are down by 9% in Portugal and 19% in Greece; meanwhile public services are deteriorating sharply under the impact of severe spending cuts.

In Eastern Europe, most countries registered some growth in 2012 although, in every country except Poland and Slovakia, output is still below pre-crisis levels. In the Baltic countries, which suffered the deepest downturns in 2008-09, output is still around 6% down on pre-crisis levels in Estonia and Lithuania and 13% down in Latvia. Although unemployment has declined slightly in the Baltic countries – partly because of rapid emigration – it remains high and real wages have fallen since the onset of the crisis by 9% in Latvia and 16% in Lithuania. In Poland by contrast, output has risen by 13% since the onset of the crisis, although unemployment has risen slightly and real wages have declined by 1% from their peak.

In the euro area core, most countries also registered some growth in 2012, but this was subdued as austerity policies depressed demand in other euro area markets. Core countries were also affected by a slowdown in international growth, most notably in the US and China. In Germany, where exports had helped fuel a strong expansion in 2010-11, growth in 2012 was expected to be less than 1%. Although the German unemployment rate in 2012 declined to 5.4% and real wages increased by around 1%, this will now prove difficult to sustain unless there is a major shift away from the reliance on export-led growth.

The economic situation in Europe has been exacerbated by the policies pursued by the EU and national governments in response to the euro area debt crisis which broke out in Greece in 2010 and subsequently spread to Ireland and Portugal. These policies have focussed on promoting austerity and failed to respond adequately to the highly precarious financial situation.

1 Many institutions, including the IMF and the OECD, revised their expected figures for 2012 and 2013 downwards towards the end of 2012, so the outcome could well be worse than indicated in the text.

The expectation that governments would have to rescue further banks, most notably in Spain and Italy, led to an intensified selling of government bonds in the second half of 2011; at the same time the fall in bond prices deepened the losses faced by banks, due to their large holdings of government bonds. As the interaction of the debt crisis and the banking crisis intensified, the European Central Bank (ECB) became increasingly alarmed at the precarious position of the banking sector and in December 2011 it launched the Long Term Refinancing Operation, lending the banks a total of €493 billion, followed in February 2012 by a further €529 billion. The loans were for a period of 3 years at an interest rate of 1%, and – in marked contrast to the loans provided by the EU to struggling governments – there were no conditions attached. This huge injection of funds temporarily relieved the immediate pressure on the banks. Some €150 billion was used by the banks to buy government bonds, providing a degree of support for bond prices – and substantial profits for the banks as a result of the wide interest differential. But the bulk of the funds were re-deposited at the ECB, and total bank lending to businesses and households in the euro area actually declined slightly in the first nine months of 2012.

Table 1: Indicators of EU output, unemployment and wage growth

		GDP growth 2011-12, %*	GDP growth peak- 2012, %*	Unemployment rate Sep 2012, %*	Real wage growth 2011-12, %**	Real wage growth peak-2012, %**
	Euro area (17)	-0.4	-1.5	11.6	-0.1	-0.4
	European Union (27)	-0.3	-1.1	10.6	-0.1	-0.8
Euro area core	Austria	0.8	1.6	4.4	0.5	-1.4
	Belgium	-0.2	1.1	7.4	0.5	-0.2
	Finland	0.1	-2.8	7.9	0.2	-0.1
	France	0.2	0.2	10.8	0.2	2.4
	Germany	0.8	2.7	5.4	1.0	1.9
	Luxemburg	0.4	-0.0	5.2	-0.4	-1.0
	Netherlands	-0.3	-1.4	5.4	-0.3	-0.8
Euro area periphery	Greece	-6.0	-19.8	25.4	-7.8	--19.3
	Ireland	0.4	-6.4	15.1	-1.2	-3.4
	Italy	-2.3	-6.7	10.8	-1.4	-2.9
	Portugal	-3.0	-6.1	15.7	-5.1	-9.2
	Spain	-1.4	-5.0	25.8	-1.8	-5.8

Table 1: Indicators of EU output, unemployment and wage growth

New euro area	Cyprus	-2.3	-2.4	12.2	-3.7	-3.7
	Estonia	2.5	-5.5	10.0	0.9	-6.7
	Malta	1.0	3.9	6.4	-1.3	-4.8
	Slovakia	2.6	5.1	13.9	-2.1	-4.8
	Slovenia	-2.3	-8.3	8.4	-2.2	-2.3
Northern non-euro	Denmark	0.6	-3.3	8.3	-0.5	-1.3
	Sweden	1.1	5.7	7.8	1.9	1.5
	United Kingdom	-0.3	-2.6	7.8	-0.2	-3.2
Eastern non-euro	Bulgaria	0.8	-2.8	12.4	2.1	5.6
	Croatia	-1.9	-10.0	15.2	-1.9	-1.3
	Czech Republic	-1.3	-1.5	6.8	-0.5	1.7
	Hungary	-1.2	-5.1	10.6	-1.2	-11.6
	Latvia	4.3	-13.2	15.9	0.5	-9.3
	Lithuania	2.9	-5.8	12.9	0.1	-15.7
	Poland	2.4	12.8	10.1	0.3	-1.1
	Romania	0.8	-5.1	7.1	0.9	-6.6

Source: * Eurostat (November 2012), Peak GDP is highest of 2007 or 2008.
** Ameco (November 2012), Peak real wage is highest for 2007-2010.

As the economic situation deteriorated in the first half of 2012, euro area governments focussed on passing into national law the so-called Fiscal Compact. This had been agreed, in many cases reluctantly, by 25 countries at the end of 2011, primarily at German insistence. It requires states to introduce a constitutional rule that will restrict a government's structural budget deficit to not more than 0.5% of GDP in the future. The measure completely fails to recognise that, in most countries, budget deficits were not the *cause* of the current malaise but rather the *result* of the financial crisis which began in the US in 2007-08. The Compact will seriously restrict the ability of governments to conduct an active fiscal policy in the future; it has also been widely criticised for the ambiguity about what constitutes a structural deficit, and when it is due to take effect. The emphasis on fiscal consolidation also signalled that the EU authorities had no effective policy to counter the recessionary tendencies in Europe and, as it became clear that countries such as Spain would continue to face difficulties servicing their debts, speculation against the countries' government bonds intensified.

At the end of July 2012, the ECB President, Mario Draghi, announced that the ECB would do 'whatever it took' to preserve the euro and this led to an immediate rise in the price of Spanish and Italian government bonds. In September, the ECB agreed on the details of a programme, known as Outright Monetary Transactions, to undertake large, unlimited intervention in government bond markets to stabilise the price of bonds that were under threat – as the central banks in the US and Britain have been doing since the onset of the crisis. (Previous ECB intervention in bond markets had been small scale, and limited in time.) However, it was also announced that this would only be undertaken if governments first reached agreement on the terms for a loan from the euro area's rescue fund, a condition which is likely to imply an intensification of the austerity policies which have been driving the downturn in many countries. But even this was too much for the head of the German Bundesbank, who publicly criticised the proposal; significantly, however, the German premier, Angela Merkel, expressed her support for Draghi's proposal.

The original euro area rescue fund, the temporary €440 billion European Financial Stability Facility set up in 2010, was due to be replaced by the permanent European Stability Mechanism (ESM) in July 2012. In the event its launch was delayed until September 2012 as a result of an unsuccessful attempt to block it at the German constitutional court by a group of dissident parliamentarians. The ESM will be able to make loans totalling €500 billion, financed mainly by issuing bonds. However, this is equal to only one-sixth of Italy and Spain's outstanding debt and by sending a clear signal of the limits of EU intervention, could actually encourage speculation in the future.[2]

EU heads of government met at the end of June 2012 for their 19th summit since the outbreak of the crisis, and appeared to agree on several significant measures. First, it was agreed to create a European Banking Union. This is a major institutional innovation in the architecture of the European Union, and will involve the creation of a single European supervisory mechanism for banks in the euro area. Second, in order to break the vicious circle between bank losses and government bonds, it was agreed that the ESM would be able to recapitalise countries' banks directly, thereby avoiding weighing down national governments with yet further debt. This would have relieved the pressure on Spain and similar treatment was held out for Ireland. Such assistance was, however, made dependent on first establishing the single European supervisory mechanism for banks. The third measure agreed at the June summit was to provide €120 billion to promote growth through infrastructure investment. This is a positive step but it is equal to barely 1% of euro area GDP and will be spread over several years. It is also partly illusory, since it draws on existing structural funds that have not been spent because austerity-strapped national governments have been unable to raise the necessary counterpart financing, and such rules will have to be relaxed if hard-pressed countries are to benefit.

2 See Paul de Grauwe, 'Only a more active ECB policy can solve the euro crisis', *CEPS Policy Brief*, August 2012.

Proposals to make the ECB the single supervisor for all euro area banks were officially unveiled by the Commission President, José Manuel Barroso, in his annual 'state of the union' address in September 2012. However, after a meeting at the end of September, German, Dutch and Finnish finance ministers stated that ESM funds should not be used to help deal with pre-existing bank debts, as Spain and Ireland had been led to expect; questions were also raised about the plan for a banking union, including whether it would be possible to establish a common bank supervisor by January 2013 (a pre-condition for using ESM funds to recapitalise banks). France has supported moving ahead rapidly on the creation of a single supervisory mechanism for banks, but Germany has stressed the complicated nature of the task. At the summit in October 2012, heads of government declared that proposals for a single supervisor were a matter of urgency, but the target of January 2013 is not binding. A further source of tension arose because Eastern European countries that are obliged to join the euro in the future are angry at their restricted rights under the Commission's proposals for the banking union.

The ECBs willingness to intervene in bond markets temporarily stabilised speculative pressures against peripheral euro area bonds in the second half of 2012. Furthermore, the German government has now recognised that a Greek exit from the euro area would be massively destabilising. However, the banking systems of the peripheral euro area countries are haemorrhaging as capital is shifted abroad, in particular to Germany. In October 2012, the President of the European Council, Herman Van Rompuy, presented proposals for moving forward on economic union, including the creation of a European finance ministry.[3] But this is to be subject to the same strict budget rules that apply to national governments, and is principally envisaged as an instrument for establishing yet firmer centralised control over national fiscal policies. By October 2012, even the notoriously conservative International Monetary Fund was questioning whether the EU's focus on fiscal austerity was adequate.[4] As the European economy stagnates and increasing numbers of citizens face unemployment, rising poverty and cuts in essential public services, the European Union's principal proposal for promoting economic reactivation rests primarily on repeating its insistence on establishing fiscal discipline.

3 European Council President, Towards a genuine economic and monetary union: Interim Report, 12 October 2012.

4 International Monetary Funds, World Economic Outlook, October 2012. In particular, it demonstrates that the negative impact on output of cuts in government expenditure could be much larger than had been assumed previously (pp. 41-53).

1.2 The EU's erroneous response

Fiscal policy in the EU seems set to continue and even reinforce the course of austerity that is implied in the current institutional setting of the revised Stability and Growth Pact (SGP), the Fiscal Compact and the conditions attached to EFSF/ESM loans. If pursued further, this strategy will lead to years of stagnation for the euro area as a whole and to a protracted depression with severe economic, social and political consequences for the most troubled economies in the periphery.

After the numerous hasty amendments it is difficult to disentangle which of the constraints on government deficits and debt will be most binding on member states over the next few years. Under plausible assumptions the most binding rules for the majority of countries will be the current excessive deficit procedures (EDP) and the adjustment programmes under the EFSF/ESM which will over the medium term be followed by the Fiscal Compact's limit of 0.5% of GDP for the cyclically adjusted budget deficit. For the countries with very high public debt levels (namely Ireland, Greece, Italy and Portugal) the new debt related aspect of the EDP, which calls for debt in excess of 60% of GDP to be reduced by 1/20th each year, will require further substantial fiscal contraction.

A rough estimate of the ensuing negative cumulative fiscal stance from 2013 to 2016 leads to the alarming figure of 3.5% of GDP for the euro area as a whole, of between 5% and 8% for Italy, Portugal, Slovenia, Spain and Cyprus, and of more than 10% of GDP for Ireland and Greece.[5] Under the current circumstances (simultaneous consolidation efforts mainly on the expenditure side everywhere, monetary policy at the lower bound) the fiscal multiplier is bound to be large. Even using a modest fiscal multiplier of around one, however, is sufficient to show the destructive potential inherent in the current regime of austerity. In this case the negative fiscal stance would be transformed into GDP losses of exactly the same size with millions of jobs being destroyed. There is absolutely no evidence that this consolidation will engender any beneficial confidence effects, as claimed by some mainstream economists. In fact, a look at the economic performance of the euro area economies in recent years shows that the countries with the largest negative fiscal stance are also those countries which are currently in recession. It is also clear that austerity has not led to any improvement in the risk premiums on government bonds.

The negative output and employment effects caused by austerity will result in higher government deficits (and debt levels) that will – under the current institutional and political regime – in turn increase the necessary fiscal restriction in order to reach the very low target values. The emergence of a vicious circle

5 See Achim Truger and Christoph Paetz, 'The economic effects of austerity policies in Europe: Some back of the envelope calculations', Paper presented at the 18th Conference on Alternative Economic Policies in Europe, University of Poznan, 28-30 September 2012 (available at www.euromemo.eu).

of consolidation efforts leading to higher deficits and debt levels and, in turn, to yet greater consolidation efforts is a dangerous possibility that can already be observed in several countries.

In order to avoid such a vicious circle developing, all the three relevant institutional constraints for fiscal policy need to be reformed at the same time. If the Council decides to provide more leeway by shifting the EDP deadline, the adjustment that is necessary under the Fiscal Compact will become larger. And if the transition path to the almost balanced structural government balance is extended, then the adjustment required under the EDP-debt criterion will rise. What is presented as a tight three-layer procedure for achieving fiscal sustainability is, in reality, likely to be a three-step procedure for strangling growth in the euro area economy.

The banking union

Governments in the euro area and the EU are beginning to understand that previous reforms of the financial system have been insufficient to cope with the depth of the problems. New steps have been envisaged in 2012. Attempts were made to limit the negative effects of the European Stability Mechanism (ESM), the ECB decided to enlarge its role as a lender of last resort, and it was decided to create the Banking Union in order to get the euro crisis under control.[6] In spite of these decisions, the logic of 'too little, too late' persists and the muddling through will continue.

There is growing consensus that the establishment of the euro suffered from the beginning from the lack of homogeneity with respect to its regulatory framework. The proposal for a European Banking Union consists of the following elements:

- A regulation that appoints the ECB as the common supervisory structure for the 6,000 banks in the euro area;
- Common rules for capital requirements and other reforms to implement Basel III Accords at EU level;
- A common deposit guarantee scheme;
- A common resolution or recovery mechanism for failing banks.

According to the draft proposal, the ECB will have the right to authorise a bank or to withdraw the authorisation, to remove a bank's management, to require any information, to undertake on-site inspections and to impose pecuniary sanctions. In order to give the impression of democratic accountability, the ECB will have to answer questions before the European Parliament and report regularly. However, the leadership of the new institution will be appointed by the Council.

6 For a more detailed analysis, see the Newsletter on EU Financial Reforms, edited by Somo and Weed, Special Issue 13, July 2012.

At first glance the project might appear reasonable. But when the details of the proposals are examined, it is clear that the Banking Union creates new problems which are not settled. It is doubtful whether the proposed scheme will be really able to get the crisis under control.

First, there is the problem of the linkage of the new institution under the roof of the ECB to the already existing European Banking Authority (EBA), which was established in 2011. The EBA is responsible for the 27 EU countries while the new supervisory structure by the ECB will only be responsible for the euro area. This will deepen fragmentation in the EU.

There is, furthermore, the issue of internal conflicts of interests. What happens, for instance, if the ECB in its capacity as supervisor has to close a bank which is indebted towards the ECB, which then would have to incur losses?

And of course, as in all European projects, there is the tension between the national and the supranational level. It is impossible to supervise 6,000 banks with one single institution. Consequently, the new body will largely depend on national state administrations and thereby lose a great deal of efficiency.

A common deposit guarantee scheme is still too politically sensitive for many countries and national interests will be even stronger, as this concerns money and its distribution. There is, for example, the case of Savings Banks, which were not engaged in widespread speculation prior to the onset of the crisis, and which do not wish to be responsible for guaranteeing the losses incurred by the speculative business models of investment banks. At the same time, the Finnish government does not want to participate in guarantees for Greek banks while the German government does not want to stand behind Italian banks. However, a common supervision, the deposit guarantee scheme and the resolution mechanism are like a tripod. If one leg is missing, the whole structure will fall down.

1.3 Promoting full employment and financial stability

Economic policy in the EU has been obsessed with the budget deficit for the past few years, but the two deficits which need to be addressed most urgently are the jobs deficit and the democratic deficit. Macroeconomic policies must be put to work to reduce the jobs deficit and the setting of macroeconomic policies changed in ways which make a contribution to the reduction of the European Union's democratic deficit.

Fiscal policy should be re-focused on reducing the jobs deficit. Enhanced public expenditure should be used to promote socially and environmentally desirable investment projects that will contribute to establishing full employment with good work. There should be an end to the attack on social welfare spending and tax policies should be re-oriented towards a more progressive system, something which would itself tend to reduce budget deficits. High incomes (say over €250,000) should be taxed at a high marginal rate (perhaps 75%).

For the euro area countries, national governments should be released from the constraints of the Fiscal Compact. A co-ordinated reflation rather than generalised austerity should be the order of the day. It is important that the European Central Bank and, for countries outside the euro area, the national central banks, give full support to fiscal policies for prosperity and do not persist with their continual calls for fiscal consolidation.

A single currency requires a Federal level fiscal policy with tax raising powers, substantial levels of public expenditure, and the ability to run deficits and surpluses. A Federal fiscal policy would, if properly applied and not subject to balanced budget stipulations, act to cushion downturns at both the Federal level and at the national and regional levels. It would also ensure that effective fiscal transfers occurred between the richer regions and the poorer regions. Federal taxation would replace some elements of national taxation, and must be designed in a progressive way which would aid its stabilisation properties. The precise scale of the Federal budget which would be needed for stabilisation purposes is difficult to estimate with certainly, but is likely to be in the order of 10% of EU GDP rather than the current 1%. The construction of a Federal fiscal policy is a long term project but one which is essential for the successful functioning of a single currency.

Current account imbalances in the euro area ranged in 2011 from a surplus of 9.2% of GDP in the Netherlands and 5.7% in Germany through to deficits of 6.4% in Portugal and 9.8% in Greece.[7] The resolution of current account imbalances in a fixed exchange rate system (which the single currency is par excellence) is difficult and liable to subject the deficit countries to adjustment through deflation. A current account deficit can only continue through borrowing from outside the country, and a current account surplus only if other countries are willing to borrow. The severe current account imbalances in the euro area must be eliminated and this must be done without resorting to ever more austerity. The euro area authorities must recognise that surplus countries have as much responsibility as the deficit countries for resolving the imbalances, and that surplus countries can aid that resolution by adopting policies of internal reflation. This will help expand export demand for the deficit countries and faster wage increases in the surplus countries will reduce their export competitiveness.

Germany in particular should raise wages along its international supply chains into Eastern Europe, tackle the growing problem of a low wage sector, and consider a permanent reduction in working time. It should also reverse its recent aggressive switch from social security contributions to higher sales taxes, which acted like a devaluation and aggravated the problems of those countries with current account deficits.

Employment policy in the EU should focus on promoting secure jobs based on high skills. The growth of precarious forms of employment, especially for

7 OECD, *Economic Outlook*, June 2012.

young people, and the more general decline in wages as a share of national income in the last decade must be reversed. A strategy of making Europe more competitive on the basis of lower wages is socially undesirable; it also will not succeed since there are always other countries that can compete with even lower wages. In order to promote full employment, and also as part of a progressive long-term transformation towards a society in which life is not dominated by waged work, the normal working week should be reduced towards 30 hours.

In place of the policies of privatisation and deregulation advocated under the Fiscal Compact, regional and industrial policies must be strengthened to ensure that deficit countries can restructure their economies on a sustainable basis. To this end, the European Investment Bank (EIB) should play an immediate role in facilitating a major programme of public and private investments, especially in those peripheral countries in Southern and Eastern Europe which have been most hard-hit by the crisis, and where unemployment is most acute. The EIB is already empowered to issue euro bonds, and by financing long-term investment can play a key role in overcoming the widening divergences within the EU.

A global framework for financial stability

The major expansion of financial institutions, financial markets and financial instruments in Europe since the 1990s must be decisively reversed.[8] Commercial and investment banking should be completely separated. Commercial banks should provide finance for major expenditure by households, and for socially and environmentally desirable investment projects by firms. Public and cooperative forms of commercial banks should be promoted and there should be strict limits on the size of private banks so that they can fail without threatening financial stability.

Investment banks, together with hedge funds, private equity funds and all other so-called 'shadow banking institutions' should be tightly curtailed. They should not be allowed to operate with borrowed money, and all their activities should be open to public scrutiny.

The spread of complex financial innovations has increased the opacity of the financial system and has been driven by an attempt to circumvent regulation. While banks use multi-layered securitisation to shift risks from their balance sheets and to avoid complying with minimum capital requirements, there has been a decline in the provision of credit for productive investments. All new financial instruments should therefore be subject to testing, and financial institutions should have to prove that a new financial instrument is of benefit for the non-financial sectors of the economy before it is approved. Most derivatives, while appearing to provide cover for specific risks, have actually led to an

8 This was spelled out a little more fully in *EuroMemorandum 2012*, section 3.1.

increase in systemic risk. Any derivatives that are approved should therefore be standardised and tightly controlled.

All securities should be traded on approved public platforms and a publicly owned European ratings agency should be established. To reduce short-term speculative trading, a financial transactions tax should be levied on all transactions.

The European Central Bank is constructed so as to be independent of political authorities but it has clearly not been ideologically independent or free from representing the interests of the financial sector. The ECB should be reconstructed to ensure full democratic accountability. This would involve requirements for the President of the ECB and others to regularly appear before the European Parliament for detailed scrutiny and for the decision-making bodies of the ECB to be drawn from a wide range of stakeholders and not limited, as at present, to central bankers. The ECB must also be integrated into the decision-making processes of the Economic and Monetary Union and to enable policy co-ordination.

A new framework for financial stability is required.[9] It should be based on an alternative paradigm of financial regulation and involve profound institutional changes. It should be recognised that, because of the fundamental instability of capitalism and the pro-cyclicality of finance, market discipline does not work.

A financial stability framework in the euro area should be based on four principles:

- The framework needs to be *comprehensive*. It should be based on all policy instruments so that prudential, monetary and fiscal policies are combined. The separation between monetary stability and financial stability must be overcome. Instead of a focus on price stability, the focus should be on promoting full employment and general prosperity in the euro area. The central concerns of the ECB should shift from price stability to financial stability. This should occur within a framework of policy co-ordination where it is recognised that fiscal and other policies have an impact on financial stability.
- Policies must be *countercyclical.* They should aim to reduce the pro-cyclicality of financial markets and, by using fiscal stabilizers, to dampen business cycles. Macroeconomic and prudential policies need to lean against the build-up of financial imbalances during the boom. It is not sufficient to wait and clean up during the bust phase of the cycle.
- The framework has to be *system wide.* It must take into account the mutually reinforcing interactions between the financial system and the rest of the economy. It needs to include both the supervision of individual financial institutions and the macro-prudential supervision of the financial system.

9 See the proposals in Hervé Hannoun, *Towards a global financial stability framework,* Bank for International Settlements, 2010.

- The framework has to be *Europe wide.* Monetary, prudential and fiscal policies should be designed at the European level, taking into account both the heterogeneity and the interactions among countries in the euro area and the EU as a whole.

2 Governance in the EU

2.1 The Surveillance Union

In response to the crisis of sovereign debt there have been major changes in the functioning of EU institutions and in the relationship between the EU and member states. These have taken the form of increased powers for the Commission, with behind it the power of dominant states in the Council, in the surveillance and control of member states and of reinforced sanctions against those judged to be in violation of the rules.

Firstly, the 'six-pack' of new legislation tightens the constraints of the Stability Pact:

- Sanctions (compulsory deposits first and then fines) now cover not only breaches of the deficit limit of 3% of GDP but also 'excessive' debt levels, that is, public sector debt in excess of 60% of GDP; the latter have to be reduced by one twentieth in each year;
- Judicial proceedings against delinquent member states become more automatic – where before a qualified majority in the Council was needed for the continuation of litigation against a member state, such a majority will now typically be needed to halt it;
- The Commission has been given the right to examine the administrative structures and practices supporting fiscal policy in the member states;
- Sanctions now apply not only to 'excessive' debts and deficits but also to a wide range of 'excessive macroeconomic imbalances'. The macro variables to be used are listed in a 'scorecard' and for the most part relate to external competitiveness.

Secondly, the 'two-pack', two further legislative measures currently in process, requires euro area governments to submit draft budgets to the Commission prior to their presentation to national parliaments. Although 'National Parliaments remain fully sovereign in voting the Budget Law', the Commission is accorded the right to 'require a revised draft'.[10] For member states which have accepted credits from an emergency fund – the European Financial Stability Facility (EFSF) or its successor, the European Stability Mechanism (ESM), 'enhanced surveillance', on a quarterly basis is introduced.[11] These states have 'an obligation on Member States to adopt measures to address the sources of instability'. Failure to comply may lead to the cancellation of disbursements from the EFSF or ESM.

Even before the two-pack, a special supervisory regime for these states was already in place. The troika (composed of representatives of the European Commission, the European Central Bank and the International Monetary Fund) which disbursed emergency funds (so far to Greece, Ireland and Portugal within the euro area and Romania outside it) has used the power

10 http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.
11 ibid.

of these institutions as creditors to demand policy changes and 'structural reforms' which would certainly not be in the competence of the Commission if it was acting simply as an institution of the EU. For example, the troika has demanded that Greece make drastic changes to its collective bargaining system (including a 32% reduction in minimum wages for adults and 22% for youth), that it reorganise its public pension system and that it privatise specified state assets. In any case, these three states, together with Romania, are now subject to a comprehensive system of tutelage by the Commission. Because the ECB president, Mario Draghi, has made support for their bond issues dependent on the acceptance of EFSF/ESM credits, Italy, Spain and other states (both Cyprus and Slovenia are in the firing line) may find themselves compelled to accept a similar surveillance regime.

Thirdly, the Treaty on Stability, Coordination and Governance, agreed in December 2011 and signed by 25 EU member states repeats the rules of the amended Stability Pact and in key respects makes them more stringent. In the Fiscal Compact which is the main part of the Treaty an additional norm for public sector borrowing is introduced – the 'structural' deficit (that is, corrected for the effect of cyclical fluctuations) is not to exceed 0.5% of GDP. Member states with higher figures have to prepare and implement correction plans under the supervision both of the Commission and of 'independent' institutions to be established in each member state. Signatory states are required to introduce these requirements, including 'automatic' fiscal corrections, into national law, preferably with constitutional force. The European Court of Justice is empowered to impose fines for non-compliance. The essential characteristic of the Fiscal Compact is to take the economic constitutionalism which began with the Maastricht Treaty to an extreme point by promulgating new rules and constraints which tend to put national economic policies on automatic pilot, with no room for manoeuvre. The Treaty allows member states to litigate against each other if its rules are deemed to have been broken and this can only make for suspicion and distrust among the member states.

The Council has played a leading role in these measures, with certain of the economically stronger member states, especially Germany, proposing very tight constraints on the weaker ones. The right-wing majority in the Parliament has endorsed them while the centre-left, in spite of some specific criticisms has failed to mount a principled opposition to them.

2.2 Austerity and legitimacy

The surveillance regime briefly described above can only work to aggravate further the longstanding and deepening legitimacy problems of the European Union. These have several, closely related aspects:

- The *democratic deficit* which shields EU decision-making from democratic forces. This relates both to the structural weakness of the European Parliament and to the dominant role of the Council, behind the Commission, in formulating policy and enacting legislation. It is clear that in the Council and especially the European Council, power relations among member states shape the key decisions. Note that the European Parliament has no decision-making power over the 'European Semester', the procedures in the first half of every year, by which national macroeconomic and 'reform' policies are reported to, and corrected by, the Commission and the Council.
- The absence of a strong democracy has as a corollary the *excessive influence of corporate lobbies* which dominate the technical committees of the EU and are able to shape policy and legislation in their own interests.
- The *anomalous status of the ECB* which, unlike all other central banks, is not just independent in operational terms but beyond the control of any elected bodies. This prevents the very necessary redefinition of the ECB's mandate in response to financial instability, the sovereign debt crisis and the deepening unemployment crisis.
- The *social deficit* which results from the absolute priority accorded by EU institutions to the single market and to the freedom of movement of goods, services and capital. This has not only meant that the EU has failed to develop significant social programmes at European level; in recent years the assertion of single market priorities and more recently the 'six-pack' and the 'two pack' legislation has led to increasingly aggressive moves against the social models in member states, whether by deregulatory legislation such as the directive on the cross-border provision of services, through decisions of the European Court of Justice (ECJ)[12] or now through macroeconomic adjustment programs imposed by the troika.[13]

The loss of legitimacy of the EU arising from these factors can be seen in the growth of political forces hostile to the EU, in the falling participation in European elections and in the disillusion and scepticism of many who once supported European integration.

Through the Lisbon Treaty an attempt was made to mitigate legitimacy problems by involving national parliaments in EU decision-making. However, the new procedures are insignificant because they do not enhance the role of national parliaments and do not transfer any decisional power from core European institutions to national peripheral ones.[14] The value of the new

12 For the impact of recent ECJ judgements on trade union rights see Keith D. Ewing and John Hendy (eds), *The New Spectre Haunting Europe: the ECJ, Trade Union Rights and the British Government*, Institute for Employment Rights, Liverpool, 2009.

13 It should be recognised, however, that many national governments are themselves eroding their own social models. In particular there has been a wave of legislation in member states to reduce employment protection. See Isabelle Schömann and Stefan Clauwaert, 'The crisis and national labour law reforms: a mapping exercise', *ETUI Working Paper*, 2012.04.

14 Philipp Kiiver, ‚The Treaty of Lisbon, the National Parliaments and the Principle of Subsidiarity', *Maastricht Journal of European and Comparative Law*, 2008, n.1, pp. 77-83.

procedures is merely formal without any substantial power transfer to national parliaments.

The surveillance structures put into place in recent years can only aggravate the legitimacy crisis of the EU. The reinforcement of the Stability Pact is only on formal terms applicable to all member states. In practice the focus on competitiveness and on public sector borrowing means that it applies to the member states with the weakest economies – to the Eastern and Central European members, to the southern periphery and to Ireland. In practice, also, the demands placed upon the weaker states are heavily influenced by the stronger states acting through the Council – and it should be borne in mind that even a strong state (such as France for example) can lose a relevant amount of competitiveness in comparison with Germany, the Netherlands and so on and thus become a weaker one. As a result, the whole regime imposes the rule of the strong on the less strong and the weak. It is a hegemonic, almost a colonial, system. The massive economic dysfunctions which have followed are discussed elsewhere in this Memorandum: austerity programmes have aggravated public debt problems by reducing income and output; in response the troika and the Commission chase these policy-induced effects downwards in a vicious circle. From the point of view of governance, there is a usurpation of political power: huge changes are being enforced in employment law, in social security and pension systems and in the regulation of services; privatisations of state assets are demanded even though only fire-sale prices can be obtained in present circumstances.

Notice that the troika is demanding changes to bargaining practices, for instance in Greece, although they are found, and accepted, in many other EU member states, including Germany – such as the extension of collective agreements to non-participating enterprises.[15] 'The Memorandum of Understanding' imposed on Greece by the 'troika' as a condition for very limited refinance, permitting the government just to service its debts, is a totalitarian document which shames the EU.[16] It not only imposes impossible targets for public finance, it deprives the Greeks of any choice at all in how they endeavour to meet the targets and it does so in a humiliating way. It strikes at the essence of the Greek employment system and at Greece's (very inadequate) systems of social provision.

European leaderships are aware of the legitimacy crisis facing the EU but usually seek to suppress or bypass democratic pressures rather than respond to them with genuine policy changes. One case in point is the pressure put on Greece to avoid a referendum on the conditions attached to finance from the troika. Another is the recent report from EU foreign ministers (the Westerwelle

15 Maria Karamessini, ‚Sovereign debt crisis: an opportunity to complete the neoliberal project and dismantle the Greek employment model,' in Steffen Lehndorff (ed), *A Triumph of Failed Ideas: European models of capitalism in the crisis*, ETUI, Brussels, 2012.

16 *Memorandum of Understanding on Specific Economic Policy Conditionality*, 9 February 2012.

Report) which proposes various reforms in the hope of reversing the deepening disillusionment of European citizens with the structures and policies of the EU.[17] Some of the Westerwelle proposals may be valid. Others are crudely populist, such as the notion of directly electing the head of the Commission and then permitting her or him to appoint the other Commissioners. However, the report is completely vitiated by its endorsement of the present approach to the crisis of the periphery. The report declares: 'We believe that once the Euro crisis has been overcome, we must also improve the overall functioning of the European Union.' But if current policies towards the populations of the weaker states continue, the damage to the economic fabric and the political status of the Union will be enormous, and perhaps irreparable.

The recent report from the President of the European Council, Herman van Rompuy, takes a completely technical approach to reform in the euro area.[18] The main proposals are for an integrated supervisory regime for banks and for the EU to acquire a certain 'fiscal capacity'. These could be useful developments in the context of debt cancellation, expansion and employment recovery – as an endorsement of the surveillance regime and the drive for austerity they only add to the dysfunctionality of present policies. No meaningful procedures for the accountability of the new fiscal and banking authorities are put forward – there is merely a call to 'involve' the European Parliament and the national parliaments.

The absolute priority given to the four freedoms, the single market and the rules of competition means that the only model of democracy compatible with the present paradigm of integration is a formal democracy, whose ultimate target is to neutralise opposition and legitimise the political choices of the institutionalised centre rather than represent the people. A critical survey of the current EU system of governance suggests that the construction of a democratic Europe requires not only procedural reforms but also the adoption of a different model of integration compatible with the needs and interests of the community.

2.3 Reconstructing EU governance

The most urgent change in EU governance concerns the response to the crisis in the peripheral countries. The present, hegemonic, system must be replaced by a solidaristic approach which makes economic recovery and the elimination of imbalances joint responsibilities of all member states and of the EU. This in turn will require the mutualisation and/or cancellation of much of the debt of the weakest states.

17 Final Report of the Future of Europe Group, www.cer.org.uk/sites/default/files/westerwelle_report_sep12.pdf.

18 European Council, *Towards a Genuine Economic and Monetary Union: interim report*. Octobre 2012, Brussels.

Interference with the social models, bargaining systems and public services of the weakest states must cease as must the involvement of the IMF in the determination of economic policies within the EU. The macroeconomic policy process, currently devoted to surveillance of the weak by the strong, has to be given an entirely different content, centred on a coordinated drive to reduce unemployment and to correct imbalances in productivity, with responsibility equally shared among stronger and weaker states.

The mandate of the ECB must be widened to include crisis management, financial stability and the promotion of employment and it must be required to support unconditionally the agreed macroeconomic stance of the EU, including, where necessary, the direct financing of member state governments. It must at the same time lose its present, quasi-judicial status and be subordinated to the democratic instances of the EU. In order to make the ECB more independent from the financial sector, the circulation of top officials between the ECB and the private financial sector should be stopped. Former top managers of private financial business should, therefore, be made ineligible for top ECB positions and top ECB officials should be barred from seeking employment in the private banking sector after the end of their ECB mandate.

It is certainly possible to develop specific procedural proposals to address the democratic deficit in European institutions. One possibility would be an elected body to oversee the ECB; another could be a decision-making role for the European Parliament in the development of EU economic policies. But such reforms would mean very little, and might make policy decisions even less transparent, unless they related to a complete change of policy direction which alone could begin to restore the legitimacy of the EU. As the EU loses legitimacy, challenges to the regime it is imposing on European citizens and a refusal to comply with its dysfunctional and unjust rules, will correspondingly assume ever greater legitimacy.[19]

19 See Bernard Cassen, ‚Désobeissance civique pour une Europe de gauche,' *Le Monde Diplomatique*, Octobre 2012.

3 Restructuring the social agenda: economic, social and fiscal preconditions

3.1 Unemployment, social deprivation and poverty

Nowhere have the effects of Europe's rolling multiple crisis been felt so directly and so profoundly as in the lives of the region's citizens. The deep recessions of 2009 followed by, at best, weak recoveries in most member states and, at worst, by further severe contractions (in Greece, Portugal, Spain, Italy and Slovenia) have been reinforced by a crisis-management strategy at both EU and member state level which focuses on only one dimension of the crisis – sovereign debt – and accords all other dimensions secondary status. The imperative of a rapid reduction of state budget deficits and overall indebtedness throughout Europe is seen – at Commission level and at the level of key states (Germany, Netherlands, Austria, Finland, UK) – as the primary pre-condition for achieving the region's recovery. However, the austerity 'cure' is not just counterproductive, choking off the already weak recovery; it is above all blighting the lives and the life-chances of millions of Europeans, most notably in the southern and eastern peripheries of the region.

Austerity represents an immediate and specific threat to the survival of the systems of social protection and public provision in Greece, Portugal and Spain, and a general threat to the 'essential objective' of the signatories of the *Rome Treaty*, namely to improve 'the living and working conditions of their peoples' (Preamble, Para 4) and to the promise of 'social Europe' invoked in the late 1980s by the European Commission under Jacques Delors' leadership and others. Mario Draghi's declaration that the 'European social model has already gone',[20] while exaggerated, implies a clear desire to inform a US audience that the supposedly high costs of European welfare regimes for potential investors are falling and, critically, that the supply-side 'reforms' of recent years are being accelerated.

The social policy landscape in Europe is looking increasingly bleak. Average rates of unemployment are rising in the region, reaching 11.4% in the euro area in August 2012 and 10.5% in the European Union as a whole. In Greece and Spain adult unemployment rates are around one quarter of the working population; rates of youth unemployment are double the adult rate and currently stand at 22.7% for the European Union, with catastrophic levels in Greece (55.4%), Spain (52.9%), Italy (39.3%) and Portugal (35.9%). Youth unemployment, according to the EU's own *Eurofound* research agency, is costing the region €152bn annually in lost output and welfare payments. The 'wage scar' effect – which condemns young citizens with extended periods of unemployment to significant losses in lifetime earnings, compared to the rest

20 *Wall Street Journal*, 24 February 2012.

of the cohort in work – carries with it real dangers of political disillusion, social fragmentation and despair, and thus represents a long-term macro-economic and macro-social 'scar' for the region as a whole.[21]

An immediate and direct consequence of the economic crisis, reinforced by the simultaneous deleveraging of enterprises, households and states, has been a significant rise in suicide rates, in particular in Greece and Italy. In 2011 suicides in Greece rose by 45% to around 450, according to the Greek daily newspaper *Ta Nea*.[22] In the same year suicides among young people in Italy rose by 36%.[23]

The thrust of austerity policy is directed primarily at the reduction of state expenditure rather than at the closing of revenue loopholes. The resulting budget cutbacks are producing reductions of both public investment through the cancellation or postponement of infrastructural projects, and key areas of recurrent expenditure in healthcare, education, social provision and welfare benefits. Significant reductions in public sector employment have already been implemented or are being planned in Greece, Spain, the UK, Ireland, Italy, Lithuania, Latvia, Hungary and Romania through redundancies or so-called 'natural wastage' (non-replacement of leavers and retirees). The conditions of employment are worsening as a result of a combination of reductions in nominal and real wages in the public sector, by reduced minimum wage rates, by the weakening of employment protection, by a further liberalisation of short-term contracts, by the raising of weekly working hours, the weakening of centralised pay-bargaining, the raising of retirement age and – in the case of Greece and Spain – with already completed or planned cutbacks in monthly state pension payments.[24]

The cumulative effect of recession, stagnation and austerity measures is both a rise in the proportion of the population in EU member states that are at risk of poverty – as a relative indicator measured against median incomes – and also a marked rise in the levels of absolute poverty, hunger, homelessness and mortality among marginalised groups. Thus in 2011, while Bulgaria manifested an already high ratio of 22% of the population 'at risk of poverty', a full 48% of the population were suffering real material deprivation.[25] As the European Commission itself has acknowledged, homelessness has risen since 2008 across the whole of Europe, as a result of bank foreclosures, repossessions and evictions.[26]

21 Long-term unemployment is affecting an increasing proportion of people of working age. For detailed Eurostat figures by region see http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language.

22 *Ta Nea*, http://www.imerisia.gr/article.asp?catid=26510&subid=2&pubid=112846138.

23 *Der Spiegel,* 15 April 2012.

24 See Christoph Hermann, Karl Hinrichs and Magnus Brosig, 'The Financial Crisis and its Effects on Social States', *FORBA Working Paper*, Vienna, 2012.

25 *Employment and Social Developments in Europe*, 2011, p. 115.

26 Nicole Fondeville and Terry Ward, 'Homelessness during the Crisis', *Research Note 8, Social Europe,* European Commission, 2011.

In Greece and Spain, shortages of medicines in the public health systems are being increasingly reported,[27] a phenomenon that was unheard-of in the advanced economies of Europe before the current crisis, while Spain, Lithuania and Latvia are enacting major cutbacks in employment in the public health sector.

There is overwhelming evidence that the burden of austerity is not being borne equally by all citizens in individual member states or indeed across the whole of the EU. Critically, weaker, marginalised groups – the unemployed, the 'working poor', pensioners, the sick and the homeless – particularly in the peripheral southern and eastern member states that are subject to the severe conditionality of the Commission, the European Central Bank and International Monetary Fund, are bearing a high cost. But, at the same time, a new and worrying development is that certain sectors of the middle class are also facing a process of impoverishment as a result of the crisis.

3.2 Re-commodification at the cost of the welfare state

The EU's failure to either diagnose the breadth and depth of the region's crisis, or to coordinate a balanced and realistic programme of crisis-management as a long-haul operation, represents a fundamental obstacle to both recovery and the consensual rebuilding of a European project that is socially just and ecologically sustainable. Whether by design or by default, Europe risks losing the social cohesion and political solidarity that have been the foundation of almost seven decades of peace and civilisation based on the respect for human rights. Reversing the current trend and restoring the foundations for a transformative social agenda in Europe represents a considerable and multidimensional challenge to its peoples. A critical dimension in such a process is the restoration of a shared belief in the central role played by public goods and the fiscal state in ensuring civilized norms and social equity within Europe. To ensure the adequate provision of public goods – in the shape of universal rights to education, health, social protection and welfare – an integrated Union of 27 or more member states requires policies that seek to achieve both the relative convergence of economic performance (including external balances) and the norms of democratic fiscal governance, as outlined above.

Since the onset of the crisis, decades of achievements in collective action and social provisioning have been increasingly questioned and, in many cases, ruthlessly dismantled. Historically the most important common denominator of social policies practised across the EU countries has been managing or removing the market in the provision of public services such as health and education. This was the so called de-commodification of goods and services that were con-

27 BBC, ‚Greeks queue as pharmacies run out of medicines', 6 June 2012, http://www.bbc.co.uk/news/world-europe-18343048.

sidered essential for maintaining a basic livelihood. Food subsidies (a partial de-commodification) and a free health service and certain levels of education (de-commodification) are the most common examples. Social policies have also been deployed to intervene in the labour market, for example by limiting child labour, setting a minimum wage or legislating against discrimination on the basis of gender, race and creed.

EU countries have employed various combinations of the above elements, making social policy an instrument not only for the redistribution of market incomes but also for a publicly guaranteed legal right to a minimum standard of living independent of the market.[28]

There are also sound economic reasons for state intervention in the social arena. Examples of the logic of public action include externalities in health-provisioning and education, poor planning and lack of foresight when it comes to arranging for pensions and the breakdown of insurance markets when risks co-vary.

Whilst social policies have been a matter for the member states, the EU directives on social issues such as gender equality in pay and conditions set the agenda for the member states, which are required to enshrine them in their national legal systems. Unlike the rules for budget deficits that can lead to automatic fines, however, no sanctions are imposed on member states if they ignore social policy directives, unless the national laws are tested in the European Court. This is the most important difference between budgetary rules and social directives.

It is against this backdrop that the financial crisis has hit the social sector across EU member states. The uniformity of public expenditure cuts and their focus on the social sector is especially striking, given that countries display such large variations in their economic structure and in such key indicators as unemployment rates, debt-ratios and deficit-ratios. The forecast debt to GDP ratio for 2012, for example, varies between 21.3% for Luxembourg and 176.7% for Greece, while budget deficit ratios range from 0.2% of GDP for Germany to 8.4% for Ireland. And yet Luxembourg has also initiated cuts in its public spending and educational subsidies. Disturbingly, a medium-sized but economically diversified country like the Netherlands, with a debt equal to 63% of GDP and a budget deficit of 5.1% of GDP, was nevertheless planning major cuts in public expenditure until the coalition government collapsed in April 2012.

Effectively a one-size-fits-all policy of expenditure cuts is being pushed through in the great majority of EU countries with total disregard for their economic structure and the vulnerability of their populations. In some cases this involves general cuts in public expenditure; in others it implies more specific measures, such as cuts in health and education budgets, a reduction in the

28 Birgit Mahnkopf, 'Das Sozialmodell noch einer aggressiven Handelsmacht: Zur Funktionalisierung von Sozialpolitik für die Außenwirtschaftsstrategie der EU', 2007, quoted in Christoph Hermann and Ines Hofbauer, 'The European social model: between competitive modernisation and neoliberal resistance' *Capital and Class*, 2007, No. 97, pp. 125-139.

minimum wage, reductions in pension payments and an increase in the retirement age, and salary freezes.

The restructuring is not limited to cuts in public expenditure, but extends to questioning, and in several cases, ruthlessly reversing the social model of de-commodification. The introduction of voucher schemes and user-charges in education and health have led to a *re-commodification* of these services, even in countries that could afford to provide their citizens with free health and education services and which could have addressed any concerns about waste and efficiency in more effective ways.

Increasing the 'flexibility' of labour markets is a central feature of the EU Commission's response to the crisis. It is seen as a key means of ensuring Europe's long-term economic competitiveness. The measures proposed by the Commission towards this end include pay freezes and a reduction of holiday pay; cuts in pensions and an increased retirement age; a reduction of severance pay; a reduction in vacation days; an easing of restrictions on layoffs; a reduction in the duration and amount of unemployment benefits; limiting collective bargaining agreements to sectors or companies rather than the whole economy; reduction in welfare benefits; and expansion of part-time and temporary work.[29] Such proposals are highly dubious on grounds of economic logic while they threaten the model of social policy that was based on work as the primary source of a household's livelihood, and the protection of that livelihood through a de-commodification of public services and state intervention in the labour market.

3.3 Fiscal preconditions for solidarity and social cohesion

The record of the European Union in fiscal affairs has been severely hindered by the emergence of the 'competition state', whereby EU member states seek competitive advantages over each other by offering more favourable tax and regulatory regimes to existing or potential investors. Despite regular attempts to harmonise the taxation of the business sector and of cross-border investment income, all European states have been caught in a competitive spiral, lowering their rates of corporation tax and, in the case of many newer member states, abandoning the principle of progressive income taxation in favour of 'flat taxes'. The erosion of progressivity and the subsequent dependence on (more regressive) indirect taxation within the EU, weakens the ability of states to reduce absolute and relative poverty through fiscal welfare measures.

The failure of the Commission and leading member states to achieve any significant harmonisation of direct taxation has not simply allowed tax competition to weaken the fiscal robustness of member states; it has also exposed

29 Zachary Laven and Federico Santi, *EU Austerity and Reform: a Country by Country Table,* 2012, http://www.europeaninstitute.org/April-2012/eu-austerity-and-reform-a-country-by-country-table-updated-may-3.html.

the very particular vulnerabilities of states with low tax ratios and chronic external deficits. In the case of the euro area, it has revealed the cost of the EU's inability to address the problems of both tax disparities and the divergence of external balances between member states. It is no coincidence that the west European states with the lowest tax ratios and severe external deficits – namely Greece, Ireland and Portugal – were the first to seek assistance from the other members of the currency union. In all three cases, the catastrophic exposure to bank collapse (Ireland) and deep recessions (Greece, Portugal and Ireland), combined with chronic current account deficits neutralised any hope of either the structural or the cyclical crisis being managed through the automatic stabiliser mechanism. All three states were immediately dependent on the import of capital in the form of sovereign debt. In the context of the political architecture of the euro area and the dominance of the deflationary imperative, and in the absence of any control of speculative betting on bond spreads, intra-euro area transfers became inevitable.

Without fiscal convergence and strengthened public finances, based not on austerity but on the pursuit of full employment, the European project is doomed and, along with it, the chance of a genuinely transformative social agenda. The measures that are required to achieve the fiscal foundations of social progress and genuine civilisation in Europe can thus be summarised as follows:

1. All EU member states should commit themselves to the principle of progressive taxation as the foundation for an effective Union which seeks the economic convergence of its member states and a fairer distribution of income both within states and between states.
2. There should be an approximate harmonisation of the scales of progression, basic allowances and marginal rates both at the bottom and the top of the scales for personal income tax.
3. There should be a closer correspondence between rates of corporation tax and the rates applying to assessed income tax for non-incorporated businesses. This is necessary to avoid income- and profit-shifting and to ensure a fair contribution of capital to the provision of public goods (physical, social and educational infrastructures) which benefit all economic agents.
4. There should be shared standards for calculating all tax bases, but most notably the mobile/ portable tax bases which, through political neglect, have too frequently avoided paying tax in the jurisdiction in which an enterprise's income and profits have been generated.
5. All member states should commit themselves to transparency and an automatic exchange of information on both personal and corporate incomes, notably of persons/ legal persons whose income is generated in more than one jurisdiction. The legislative initiatives already approved by the European Parliament (on the Savings Tax Directive and a Common Consolidated Corporate Tax Base (CCCTB)) should be accelerated. The bi-lateral deals (Britain-Switzerland, Germany-Switzerland), which undermine both the spirit and the feasibility of the Savings Tax Directive, should be repealed. The CCCTB should be deployed in conjunction with Country-by-Country-Reporting, administered by the EU.
6. The availability of tax-avoidance facilities in European and overseas tax havens must be eliminated, along with the widespread use of 'brass-plate' shell companies by the financial services sector. The Financial Secrecy Index[30] is a considerably more accurate indicator of potential tax haven abuse than the Black/ White Lists complied by the OECD, and which is currently used by the Commission in its (predictably weak) programme against 'harmful tax competition'.
7. EU member states should engage in an active discussion around the introduction and/or extension of the taxation of wealth, with partial allocation of wealth tax revenue to European level.
8. There should be an EU-wide introduction of aircraft fuel tax to remove the anomaly which favours air transport against its terrestrial transport competitors, together with a harmonisation and extension of existing carbon taxes, again with partial allocation of revenues to European level.
9. The trend towards a greater dependence on regressive indirect taxation should be halted and a better balance achieved between progressive direct taxation and taxes on consumption.
10. The destructive dynamic of European tax competition needs to be eliminated in the interests of solidarity and sustainable frameworks of governance. A community of shared interests and values cannot tolerate the existence of fiscal 'free riders' that either poach the tax bases of other jurisdictions or fail to police compliance with agreed standards of taxation; the exceptionally low levels of corporation tax in Ireland, Latvia, Bulgaria and Romania and in many of the Balkan states and the eastern Neighbourhood, defy the principles of solidarity required of a closely integrated group of nations.
11. Some flexibility can be left to individual member states to vary tax rates to meet differing demand conditions and levels of unemployment. But such variation must be negotiated with other member states in order to avoid the competitive erosion of the overall EU tax base.

Within advanced capitalist societies, taxation – most notably progressive income taxation – is a key vehicle for rectifying the disparities of income and wealth distribution and for ensuring the social security of all its citizens. It is also the foundation for a culture of social solidarity, which acknowledges both the need for the collective funding and maintenance of public goods and the desirability of social equity, equality of opportunity, shared burdens and shared rewards. The threat to Europe's long vaunted institutions of solidarity and welfare, represented by pan-European austerity, is far greater than the current elites of Europe realise.

30 See http://www.financialsecrecyindex.com.

The fiscal issues that have been discussed above incorporate a solidarity model based on asymmetrical mutuality, rather than market fundamentalism. In this solidarity model contributions through tax are based on the resources (wealth and income) of individuals, while assistance is based on their needs. In contrast to the solidarity model of asymmetrical mutuality, the social policy ambitions laid out in the Europe 2020 programme are both limited and, with the current trajectory of region-wide cutbacks, contradictory. Even the modest objectives set out in *Europe 2020* of a 75% labour market participation ratio for 20-64 year-olds, the reduction in school drop-out rates to below 10%, raising the proportion of school leavers in tertiary education to 40% and reducing by 20 million the number of those in poverty or at risk of poverty, look increasingly unobtainable.[31] The Commission's own surveys show 40 million people within the EU with severe levels of deprivation; 80 million are below the poverty threshold of 60% of median income; in 2010 already 115 million were adjudged to be at risk of poverty, including 27 million children.[32] The EU 2020 'vision' of removing 20 million from the risk of poverty would still leave 95 million in that category; this is an unacceptable level of social deprivation in the world's most affluent region, presided over by a community of integrated nation states. Moreover, the current pro-cyclical macro-economic policies look set to ensure that levels of deprivation will increase rather than recede. What is required is a radical and differentiated approach to state finances and the strengthening of social programmes to prevent further fragmentation and re-commodification in the supply of public services through part-privatisation or voucher schemes.

31 European Commission, *Europe 2020 Targets*, 2011.
32 Eurostat, 'Population and Social Conditions', *Statistics in Focus*, 9/2012.

4 A development strategy for the European periphery

Today, the division of the EU into 'several Europes' is more manifest than ever.[33] One such division is between the 'core' and the 'peripheral' countries of the euro area; another equally important division is that between the 'old' and the 'new' members of the EU, i.e. those before and after the enlargement of the EU to include the Central and Eastern European countries. The current economic crisis has amply brought to the fore the structural elements which are inherent in the process of European integration – competition, deregulation, non-existence of countervailing policies, lack of vision.[34]

Without a development strategy for the periphery, a catching up process will not occur on any significant scale. The euro area was supposed to have this effect according to the dominant thinking behind it; capital would flow from the centre where it was abundant to the periphery which had less capital but abundant labour, and raise productivity there relative to the centre. Very large amounts of capital did flow to peripheral countries, but much of it contributed to the emergence of asset-price bubbles, especially in Spain and Ireland. An alternative approach which privileges development is essential. This is at its core a qualitative process and not simply a quantitative one, and requires the building of structures and institutions which make possible a dynamic and continuous process of capabilities building and learning.

In this section we will analyse these divisions from a structural point of view; we will further examine the official policy agenda and its deficiencies and put forward alternative proposals for the overcoming of such divisions both in the medium and in the long term.

4.1 Neo-liberal integration has aggravated centre-periphery divisions

The European centre-periphery divide pre-dates the European integration process. However, the neo-liberal design of the integration project has widened the divide. In the Mediterranean countries – Greece, Spain and Portugal – accession to the EU was followed by a partial de-industrialisation. These countries gave up their industrial policy sovereignty without being compensated by an EU pro-industrial regional development policy agenda. Instead, debt-financed economic growth has been driven by two sectors which are extremely vulnerable to financial crises: tourism and construction. The governments of industrially more advanced countries, the most prominent of

33 Ernst & Young, *European Attractiveness Survey*, 2012; the expression was used by Mark Otty, Area Managing Partner for Europe, http://www.ey.com/GL/en/Newsroom.
34 The Memorandum produced by the EuroMemo Group in 2000 – in the aftermath of the establishment of the Single Market and on the eve of the introduction of the single currency – actually discussed these elements which were evident more than ten years ago.

which was Germany, were obviously not interested in pro-industrial policies for the EU periphery, while industrial interests were not particularly strong in the Mediterranean countries. As a result, the latter have become a market for the industrial products of the EU core countries.

Upon entering the euro area, the Mediterranean countries lost their last protective instrument for their domestic industries: the possibility of devaluing their currency. In fact, they adopted an overvalued conversion rate vis-à-vis the euro, often as a means of fighting inflation, a course encouraged by the Maastricht Treaty. Further, wage deflation policies in Germany, as well as in other Northern European countries, placed their industries under additional pressure. As a result, current account deficits grew strongly: in Greece from 7.2% of the GDP in 2001 to 14.9% in 2008, in Portugal from 10.3% to 12.6% of GDP in the same period, and in Spain from 3.9% of GDP in 2001 to 10% in 2007. The exploding current account deficits were financed by capital inflows, particularly loans from German and French banks, made easier by the deregulation of the EU financial services sector. The external borrowing made for relatively strong growth rates in Greece and Spain, largely based on a boom in real estate. The relatively weaker Portuguese growth rate was not based on the productive sectors either.

In parts of Eastern Europe, development prior to the crisis has shown similar traits. The initial transformation years – the early 1990s – were characterised by significant de-industrialisation, particularly in the Baltic countries. Since the late 1990s, growth has been to a significant extent credit-led in the East European periphery as well.

In the Baltic and South-East European countries, financialisation – based on the rapid expansion of loans, largely denominated in foreign currency – was the main pillar of the growth models. Policies of over-valued exchange rates facilitated huge capital inflows that fuelled real estate and import booms. Private debt has been predominantly in foreign currency. Through their foreign currency debts, the middle class was tied to the then prevailing exchange rate. However, the exchange rates proved to be detrimental to industrial development. Current account deficits were generally even larger than in the Mediterranean countries. In Latvia and Bulgaria, they surpassed 20% of GDP in the pre-crisis years.

In the Visegrád countries (the Czech Republic, Hungary, Poland and Slovakia) as well as in Slovenia, by contrast, industrial sectors which were closely linked to German export industries provided a second pillar for the growth model. In the immediate pre-crisis years, their current account deficits tended to hover around the critical limit of 5% of GDP. With the exception of Hungary, their domestic debt was denominated in their national currency. Thus, their vulnerability to the crisis was (with the exception of Hungary) lower than in the Baltic and Southeast European countries.

The economic crisis revealed the asymmetries building up across the EU. The Mediterranean, Baltic, and South-East European countries were mainly

affected through financial channels. Dwindling or reversed capital flows hit the very heart of their growth models. The Baltic countries, Hungary, Romania and Bulgaria were heavily affected by the crisis as early as autumn 2008.

Hungary, Latvia and Romania were the first countries to apply for rescue programmes from the International Monetary Fund (IMF) and the EU in order to ease their external financing constraints. These programmes were primarily aimed at stabilising the exchange rate. This was the priority of the West European banks (particularly those from Austria and Sweden) which were heavily involved in these countries. In fact, the European Commission and some EU member states, such as Sweden, were even more dogmatic than the IMF in their insistence on stabilising the exchange rate, as the Latvian case has shown. The indebted domestic middle classes were equally in favour of this priority. The austerity policies applied as a result aggravated the on-going recession. In Latvia, GDP declined by 18% in 2009 alone. As a result of the recession, current accounts improved temporarily, particularly in the Baltic states. This reduced the pressure of declining capital inflows. By 2011, the current accounts of Latvia and Lithuania had returned to a deficit.

Whereas the prevailing fixed exchange rate regimes could be maintained in the Baltic countries and in Bulgaria, there was a limited deprecation of the currencies in Hungary and Romania. Due to the sharp economic contraction, the share of non-performing loans tended to increase significantly. The already shaky productive base suffered from the recession. Unemployment and/or emigration soared. Living standards plummeted for several years. The underlying structural problems were not resolved. Following a deep recession in 2009, GDP has recovered more strongly in the Baltic states than in Bulgaria and Romania. But in Latvia and Lithuania, the growth of consumption has again outstripped the rise of incomes and the recovery is therefore based on shaky foundations.

The Mediterranean euro area countries were at first not hit by the crisis as heavily as the Baltic and Southeast European countries. They began to face the full weight of dwindling capital inflows, capital flight and speculative attacks only in 2010. Greece was the first Southern euro area country to be exposed to speculative attacks which were amplified by the systematic downgrading of government bonds by the rating agencies.

The reaction to the dire Greek situation by the core euro area governments, particularly by the German government, was slow. In the end, policy prescriptions were imposed on the Mediterranean euro area countries that followed the East European examples of the preceding years and those of Latin America in the 1990s – in spite of the extremely poor outcome of such policies. Although the central aim of the programmes appears to be the reduction of the budget deficit, following the prevailing logic of fiscal contraction, another significant goal is the reduction of the current account deficit and the relevant external finance requirements. Whereas the debt to GDP ratios have risen due to the

austerity induced recession, the current account deficits have declined – though very slowly in heavily de-industrialised Greece. In practice, the IMF/EU programmes have bought time for the West European banks to disengage from Southern Europe. They have not addressed the problems of de-industrialisation and relatively narrow industrial sectors. The Mediterranean euro area countries – Greece, Portugal and Spain – and the Baltic and the South-Eastern European countries are clearly in a developmental cul-de-sac. Their socio-economic situation is particularly disastrous.

The impact of the crisis was rather different in the East European countries. Their development model is characterised by a combination of export industrialisation and financialisation, mainly based on the rapid expansion of credit, especially to private households.

With the exception of Slovenia and Hungary, which face severe problems due to a short-lived, but strong real estate boom (Slovenia), and a high share of debt denominated in other currencies notably Swiss franc (Hungary), the countries of this group were primarily affected by a severe contraction of exports in late 2008 and early 2009. Slovenia and Slovakia, which had adopted the euro, were more heavily affected than the Czech Republic and Poland. As the crisis unfolded, economic policies were generally not strongly pro-cyclical and in Poland they were actually rather anti-cyclical.

In the Czech Republic and Slovakia, and to a slightly lesser extent in Poland, the recovery was in part dependent on the recovery of German exports, while domestic demand had proved to be more resilient than in the other peripheral EU countries. In many cases, private household debt continued to increase even after the onset of the crisis, thereby sustaining consumption, albeit on a dubious base. In 2012, German export prospects became clouded by generalised austerity policies in Europe and a slowing down of growth in countries like China and Brazil. These developments will also affect the export industries in the Visegrád countries. Partially EU-induced, partially home grown (particularly in the Czech Republic) austerity policies have had a negative impact on domestic demand, resulting in slower growth in the Visegrád countries in 2012. Due to the extreme austerity policies of the Czech right-wing government, which aims at dismantling the welfare state, the GDP of the Czech Republic contracted strongly in the second quarter of 2012. The development model of the Visegrád countries has reached its limits.

4.2 Structural problems of the centre-periphery divisions

Neither the regional and cohesion policies nor the allegedly anti-crisis policies of the EU address the fundamental problem of the divergent productive structures in the core and peripheral economies. Regional policies have focused only on infrastructural development, and not on building productive structures and establishing the appropriate institutional environment.

The funding allocated for regional and cohesion policy for the years 2007-13 amounts to **€347bn, or 35.7% of the total EU budget** for that period. In spite of the deepening divisions and the present social, economic and ecological challenges, the European Commission is planning a reduction of finance for cohesion policy in the new funding period 2014-2020 by about 5%, and further reductions cannot be precluded in the protracted and intensely fought negotiations over the new budget.

The new architecture also establishes a redistribution of cohesion funding in favour of rich and transitional regions. In particular, poor regions (with per capita GDP under 75% of the EU-average) currently receive 57.5% of cohesion funding. In 2014-2020 this will be reduced to 48%. By contrast, ~~rich regions~~ (with per capita GDP above 90% of the EU-average) which currently receive 12.6% of cohesion funding are to receive 16% in the next funding period. Similarly, regions which are in between the poorest and the ~~richest regions~~ ('transitional' regions) at present receive 7.4% of such funding, but in the coming funding period are to receive 11%.

The group known as 'Friends of better Spending' (Austria, Germany, Finland, France, Italy, the Netherlands and Sweden) demands the establishment of so-called 'macro-economic conditionality'. That is, when a member state fails to take 'corrective action' in the context of economic governance procedures, the Commission should impose sanctions. So some or all the payments and commitments for the programmes under cohesion policy would be blocked. This would create additional problems for member states which already have difficulties in meeting the requirements of the Stability and Growth Pact. This new sanctioning mechanism contradicts the objectives of cohesion policy, and it is opposed by the majority of the Committee of Regional Development in the European Parliament. The new Multiannual Financial Framework for the EU which is due to be adopted by early 2013 is likely that 'macro-economic conditionality' will be a significant part of this framework.

The reduction in the current account deficits of the EU peripheral countries was not attained through import substitution or sustained export growth, but primarily by suppressing domestic demand through the implementation of extreme austerity policies. Such a strong GDP contraction not only has disastrous social consequences, it also weakens the productive structures in the long term, a phenomenon known as 'hysteresis', i.e. the fact that 'the recession will cause long-term damage that will not be reversed in the ensuing recovery'.[35]

35 Wolfgang Münchau, *Financial Times*, 14 October 2012.

Box 1: The need to reverse the privatisation drive

Public services have been privatised in many EU countries in recent decades.[36] This has affected natural monopolies, such as energy and water utilities, transport networks and hubs, and more recently health, education and care. This has been strongly promoted by the EU, and the crisis is being used to advance privatisation further, thereby removing activities from the possibility of democratic control and putting them under the control of the market, a process often promoted by financial institutions.

The EU is required by its treaties to be neutral between public or private ownership (Art. 345). Yet privatisation is a key part of the 'structural reforms' being imposed by the EU on member states, especially those southern countries subject, whether formally or informally, to the troika. Recently, water privatisation has been pushed strongly in these countries by the EU, despite the 2011 Italian referendum which voted by 96% to reject this. Greece is the most extreme case where almost all state assets are to be privatised, though other countries may follow, especially if austerity and ECB policies make them unable to service their debts. Privatisation results in a loss of the strategic capacity of the state to formulate structural policies, since it becomes increasingly dependent on the private sector for detailed knowledge of what is happening in the economy, leading to a further weakening of the state's interventionist capacity.

Infrastructure finance is seen as a major area for future expansion by the financial sector and public-private partnerships (PPPs) are being enthusiastically promoted by the EU. However, PPP contractors are essentially funded by borrowing (90% in the UK), and the public sector can almost always borrow at lower interest rates. Privatised services often end up costing more, notably due to higher financing costs, large profit margins, and contract management fees.

No consistent difference in efficiency has been found in studies of privatisation, and the experience with privatisation is leading many to question or turn away from it.[37] There have been moves to re-municipalise local public services that had previously been privatised in Germany, France, Britain, Finland and Hungary, involving a wide range of services including water, energy supply, local transport, and housing management. This has usually been undertaken on grounds of efficiency and cost, as well as quality, often by municipalities under budget pressure. EU policy needs to take account of the actual experience of privatisation and reverse the destructive diversion of capital from productive, innovative, welfare-enhancing investment to parasitic forms of capitalism associated with privatisation.

36 See Marica Frangakis, Christoph Hermann, Jörg Huffschmid and Karoly Lorant (eds.), *Privatisation against the European Social Model – A Critique of European Policies and Proposals for Alternatives,* Macmillan, 2010.

37 See David Hall, *Re-municipalising municipal services in Europe*, EPSU, 2012; Martin Pigeon, David A. McDonald, Olivier Hoedeman and Satoko Kishimoto, *Remunicipalisation: Putting Water Back in Public Hands*, Transnational Institute, 2012; Anne Le Strat, *Paris: local authorities regain control of water management*, Transnational Institute, 2012; Water Remunicipalisation Tracker, http://www.remunicipalisation.org.

Leading EU politicians proclaim that the so-called 'structural reforms' of the EU/IMF programmes, including the privatisation of public assets and the deregulation of the labour market, amongst others, will enhance competitiveness and growth prospects in the longer run. Pro-active industrial policies are absent from these programmes. Comparable structural adjustment programmes in the global South have not produced such effects. On the contrary, socially more inclusive and sustained development strategies point to the need to break with key features of the EU/IMF programmes.

In addition, the EU does not seriously address the issue of the current account surpluses of Germany, the Netherlands, Austria and the Scandinavian countries. The governments of these countries have promoted neo-mercantilist strategies that beggared first their workers and then their neighbours.

4.3 Proposals for an efficient, social and ecological development of the periphery

The fabric of many peripheral countries is in danger of being destroyed. For example, in Greece and Spain the healthcare system is collapsing, as is education and social security provision. In Spain even the question of state unity, of a long historical trajectory, is being revisited. In order to counteract these tendencies, to maintain and reinforce the social fabric, a comprehensive recovery plan is urgently required. Such a plan would include the following policy fields.

- *Monetary regime/currency*: As already discussed in previous sections, the euro area rules need to be radically reformulated. In addition, to the extent that the current levels of public debt are clearly unsustainable – as is the case of Greece, as well as other IMF/EU programme countries – debt relief must be seriously considered. Initiatives in various countries to conduct debt audits which asses the legitimacy of the various components of a country's debt, and whether they should continue to be serviced, are to be strongly supported. Extending the role of the ECB as a lender-of- last resort to include government debt would considerably ease the present financial pressures. Further enlargement of the euro area should be avoided until its present structural dysfunction is resolved. Exiting the euro may appear to function as a protective wall for the indebted member states on

which harsh austerity measures have been imposed, but the difficulties of re-introducing national currencies should not be underestimated. Thus, such a course of action could be seen only as a last resort, while any long-term solution would require the fundamental restructuring of EU economic and social policy.

- *Fiscal transfers*: The enhancement of the EU fiscal transfer systems, already discussed above in section 1, is especially significant for the periphery. The EU budget, which is currently less than 1% of GDP, should be raised towards 10%, partly in order to facilitate macroeconomic stabilisation in the EU, and also as a means of implementing a major investment and development programme in the southern and eastern periphery of the EU. Such investment should involve not only the social and physical infrastructure sectors, but also the productive and scientific ones.
- *Industrial and regional policy*: This needs to allow, encourage and facilitate the peripheral countries to follow the paths that the current core countries used when they were the lagging ones, i.e. the development of structures and institutions, including networks, and firms of sufficient strength and scale that can engage with and survive in a wider geographical context. For this to happen on a wide basis, it will require state intervention. Development does not take place from market processes alone. The market barriers to entry facing peripheral regions are such that public involvement is essential in this process. This requires policy space to be able to build up these resources over time. While cohesion appears strongly in the Treaty, it also needs to be applied to the Single Market and Competition rules to allow the space for peripheral countries to build up the necessary structures and institutions, including firms of the kind mentioned above. Policies which seek to attract firms through lower taxes and subsidies as the basis for quantitative growth may appear to work in specific instances, but cannot succeed as a generalised response since countries are competing for the same external investment.

  EU regional policy is conducted through the Cohesion Fund and the Regional Fund. According to the general neo-liberal trend in the field of spatial and regional policies, it is usual to promote and subsidise metropolitan areas with the well-known but nevertheless weak argument that the trickle-down effect will benefit poorer regions. The theory of equalisation, by contrast, argues that financial flows into the poorer regions will increase the regional and national rate of employment as well as output. Such financial flows are also necessary in the fight against environmental disasters, resulting from over-agglomerated metropolitan areas.

  The main emphasis of the EU's regional policy on the regional and urban level with a corresponding downgrading of the national level acts strongly against the possibilities for peripheral countries to develop. Regions or cities are, in effect, left alone and the vast majority of peripheral areas cannot cope. The national level is often much more appropriate for building many of the institutions and resources required, though regions and local areas may be more suitable where they can realistically do so. And it is especially important that the full use of the resources of an area requires democratic participation and not elite-planning systems. In particular, the 'Smart Specialisation' approach now put forward by the EU for Cohesion policy in 2014-2020 period, where each region is to be a world leader in a particular area and to supply the world, cannot work. There are not enough product areas to go round, over-specialisation is likely to result in corresponding risks, while maximising transport across the world with disastrous consequences for climate change.

  While trade by regions and localities with the outside is essential, maximising this is not the solution. One part of an alternative that is ecologically more sustainable and which enables local resources to be better mobilised is for regions or local areas to produce for their own use where there is a good case for doing so, as for example with many food products, or with locally based renewable energy provision.
- *Rebalancing the EU*: The cumulative costs of 'non-development' of the periphery are enormous. Any public expenditure used to create a different dynamic would have a very high return, especially if done in an environmentally and socially sustainable fashion, so as to contribute to high employment. Further, the newly instituted EU imbalances procedure applies strictly to the deficit member states. As Keynes proposed for the world economy at the Bretton Woods conference in 1944, imbalances between states should be reduced not only through the efforts of the deficit countries, but also through those of countries with surpluses, which should expand domestic demand so as to increase their imports. The same principle holds today for the EU and especially the euro area. This is the only way to reduce the disparities between countries and regions without deepening the on-going recession even further.

5 The crisis in global governance

5.1 Key developments in 2012

At the end of 2012, more than four years after the collapse of Lehman brothers, the global economic and financial situation remains fragile, and the unsolved euro area-crisis represents a major threat to the global economy. During 2012 forecasts for international economic growth were revised further downwards.[38] Developing countries are still better off than before the crisis, but growth in major emerging economies is also slowing because of generalised uncertainty and the adverse economic situation in developed countries. Despite numerous declarations about the need to address global challenges, the root causes of the global financial crisis – massive current account imbalances, inequality of income and wealth and unregulated and volatile financial markets – still remain unsolved.

Even though the slowdown in global economic activity has been accompanied by a narrowing of global current account imbalances, these are still well above sustainable levels. The narrowing mostly reflects a reduction in domestic demand from crisis-stricken economies (except resilient domestic demand in China and more social spending by oil exporters), especially in Europe where austerity has hit hard and measures to increase internal demand in surplus countries like Germany are far from sufficient. The inequality of income and wealth remains a key obstacle for inclusive development and a threat to democracy and it risks increasing even more as the costs of current austerity programs are borne in particular by vulnerable households. Financial markets are still very volatile and unstable, and the implementation of new regulation has lagged far behind declarations of intent. The too-big-to-fail problem is far from being resolved and financial institutions are becoming even larger and more concentrated; risky activities are still being transferred, perhaps on an increasing scale, to the non-regulated shadow banking system.[39]

The environmental dimension of global governance combines situations of extreme and growing urgency – e.g. climate change and biodiversity destruction – with a decreasing political capacity to act. From the hopes for a new planetary agenda of sustainable development raised at Rio in 1992, global environmental politics has regressed. From the half-hearted Millennium Development Goals formulated by the UN at the end of the old millennium, via the failures of the Copenhagen summit in 2009 and the ensuing attempts to overcome the blockade of a new and more ambitious agreement coping with the challenges of the climate crisis, the Rio+20 summit in 2012 proved incapable of renewing the global agenda of sustainability politics.

38 IMF, World Economic Outlook, October 2012; UN, World Economic Situation and Prospects 2012, update as of mid-2012.

39 See IMF, Global Financial Stability Report, October 2012.

Faced with a global weakness in economic development, environmental governance has been pushed to the side-lines, reduced to lip-service in the main fields of economic development, and to fragmented and inadequate measures in the field of nature protection. A main factor in this blockade has been the inability of the main global agencies to specify an overall orientation, including a workable perspective for sustainable development which would redefine the pattern of development which is needed, focussed on human well-being and basic needs. This has not been helped by the notions of a green economy dominant among economic experts who tend to avoid all questions of central human needs or of when these needs are adequately met, as well as all qualitative aspects of the interaction of human cultures and communities with natural systems and processes. Instead, they tend to concentrate on the project of monetising nature as a collection of assets – an approach which completely ignores these qualitative aspects as well as the cultural and social conditions and dimensions of economic processes.

The relative failure of the Rio+20 summit has clearly disappointed hopes for a co-ordinated global turn towards 'developing sustainability' in an equitable and agreed way. Some people put forward the notion that the EU and its leading members would play a leading role in the movement for sustainability. The EU's weakness in the summit has shown that this was an illusion. In the environmental discussions held since then, the idea of an active role for the EU in global environmental governance has been sidelined by a narrowing focus on 'green' technologies, as well as by a growing concern with internal issues, especially the implementation (and watering down) of the ambitious natural protection plans of the EU.

5.2 A critique of official policies

In official policy documents, there seems to be a widespread consensus that the current international monetary and financial system is dysfunctional and that only decisive action in those fields will be able to contribute to a resolution of the current crisis. Currently, there is no global institution or set of institutions effectively overseeing and controlling global and systemic risks, such as global current account imbalances, asset bubbles, excessive exchange rates fluctuations, large swings in capital flows, levels of international reserves or harmful tax competition and tax evasion. Institutions that are currently supposed to assume (part of) these tasks – the International Monetary Fund (IMF), the Group of 20 (G20), the Financial Stability Forum, the Bank of International Settlements, the Organisation for Economic Cooperation and Development (OECD) – are currently not effective in carrying them out in practice.

At the outbreak of the financial crisis, the IMF was suffering from a major crisis of legitimacy. This crisis was on the one hand due to its ill-received advice during the Asian financial crisis which resulted in many middle-income

countries paying back their loans prematurely and building up international reserves in order to avoid being subjected to conditionality in the future. On the other hand, the rapidly expanding emerging economies did not feel represented within the IMF as their respective voting power was, and is still, far from reflecting the strong increase of their economic and financial importance in the global system. The outbreak of the global financial crisis brought the IMF back to the international policy agenda and its lending increased dramatically. For the first time in decades, the IMF stepped in as a lender for developed countries, first in Eastern Europe, and later also in euro area countries.

In theory, based on its original mandate, the IMF would be the appropriate candidate for global financial governance. However its historical record gives reason to doubt that under present conditions it is capable of fulfilling this mandate. It was criticised – even by its own **Independent** Evaluation Office (IEO) for its analytical weakness, its insufficient attention to money and asset markets and its dogmatic belief in the efficiency of private markets and self regulation. Moreover, its current governance structure led to an unequal treatment of member countries in the surveillance process, where some countries had to follow its advice while others could ignore them.

In recent years, however, the IMF has changed its discourse significantly, recognising that more heterodox policy measures might be necessary to overcome the crisis and shifting towards somewhat more flexible policy recommendations. The IMF, for instance, gradually changed its positions with regard to the management of capital flows. After strongly advocating full capital account liberalisation in the 1990s, it now recognises the potential usefulness of measures aiming at a change in the composition of capital inflows.[40] However, the implementation of the IMF 'rethinking' into concrete policy advice is apparently lagging behind. In 2010 its policy recommendations did not correspond to its official discourse: even in those countries, such as Brazil, which had obvious problems with a massive inflow of speculative capital, IMF policy recommendations did not include capital controls or measures to change the composition of those inflows.[41]

The IMF itself advocates the need for an enlargement of its mandate and power to properly put into practice its surveillance function. However this aspiration is met with substantial scepticism in most developing countries, as they still consider the IMF as an institution which acts mainly in the interest of industrialised countries. This position is not likely to change in the near future, as the quota and governance reform which would increase the voting power of developing and emerging countries once again failed to achieve the required majority at the IMF Annual Meeting in October 2012.[42]

40 See IMF, Consolidated Multilateral Surveillance Report, September 2011.

41 See Roy Rathin and Raquel Ramos, 'An analysis of IMF policy recommendations', IPC-IG Working Paper 86. Brasília: International Policy Centre for Inclusive Growth, 2012.

42 See G24, Intergovernmental Group of Twenty-Four on International Monetary Affairs And Development Communiqué, http://www.imf.org/external/np/cm/2012/101112.htm, October 2012.

After having served for three decades as the most important informal coordinating body for global economic issues, the G8 was officially replaced in this function by the self-appointed G20 in September 2009. This can be seen both as a response to the global financial crisis and as a recognition that key emerging countries had not been adequately included in global economic governance. At their first summit meeting in November 2008, the G20 leaders admitted that inconsistent and insufficiently coordinated policies had led to the crisis, and in subsequent summits the attention of the G20 focused largely on reform of financial systems and macroeconomic policy coordination.

The G20 initially appeared to provide a common platform for more international cooperation to mitigate spill-overs and to reduce the risks of liberalised financial markets. G20 statements highlighted a lack of surveillance and coordination, weak standards, unsound risk management, increasingly complex financial products, the shadow banking system and excessive leverage as root causes of the crisis. However, by 2010 the pledges for international coordination of financial reforms had diminished significantly, if not disappeared altogether.[43] Moreover, even though the G20 is more inclusive than the G8, representing about 85% of global output and trade and two-thirds of the global population, it still excludes 173 countries and the selection criteria (self-appointment) as well as the skewed regional representation are not adequate. It should also be noted that the EU and others have sought to minimise the role of UN institutions in dealing with the crisis.

Although international tax policies remain one of the main areas where global coordination is desperately needed, there currently exists no single entity with the global legitimacy, resources and expertise to serve as a coordinating body for international tax cooperation. Currently international tax policies are not able to guarantee an effective information exchange and to prevent tax evasion, not to mention tax competition and the race to the bottom of taxes on capital and wealth. This has resulted in a globally mobile class paying little or no taxes and is a major contributing factor to inequality and instability.

The OECD has invested considerable resources in tax cooperation issues in recent years, with a view to establishing global leadership in this area despite its limited membership, which currently encompasses only 34 countries, nearly all of which are developed economies. The OECD has, among other issues, played a central role in establishing a model for taxing multinational companies (in particular as regards transfer pricing) and its model for Tax Information Exchange Agreements (TIEA) serves currently as the basis for most of those agreements. However, the OECD has been subject to considerable criticism concerning its role and legitimacy in relation to those issues. It has been widely criticised for promoting flawed standards which serve dominant economic interests instead

43 See Peter Wahl, 'The G20 – Overestimated and Underperforming', Weed Discussion Paper, June 2012.

of the interests of developing country governments. TIEAs could, for instance, be the main instrument for exchanging information about revenues generated abroad by local citizens and firms. However, the OECD TIEA only contains information exchange 'on request' instead of providing an automatic information exchange, and on various occasions the OECD has argued against an automatic information exchange. In addition, the legitimacy of the OECD to set international standards has been questioned by most developing countries. They claim that the UN is the logical organisation to play a leadership role in international tax cooperation but that it has never been sufficiently resourced to meet that responsibility. In March 2012, the OECD and the EU again opposed a proposal by the G77 and China to upgrade the UN Tax Committee to a more powerful intergovernmental commission.[44]

In the field of global environmental governance, the EU's official policy seems to have retreated since the onset of the financial and economic crisis and, in so far as it exists, it is woefully deficient. Its trade policy continues to remain beyond the reach even of the very superficial coordination of the EU's Sustainable Development Strategy (SDS) and its coordinated foreign policy remains centred on issues of 'security', i.e. of the use (and pre-emptive deployment) of military force. In the present crisis the question of global environmental governance is not only 'crowded out' of public awareness – and thereby deprived of political resources – it is also directly perverted by short term overriding concerns: as in the case of land-grabbing as a reaction to the growing shortage of arable land, or in strategies for securing a privileged access to resources, in the event that access is threatened, by the use of military means.

5.3 Alternative Policy Proposals

Global financial governance is characterised currently by institutional arrangements which are insufficient and unrepresentative, and there is a lack of political will to implement obviously necessary reforms. Any reform of institutional settings must be based on the objectives of equity and of economic and financial stability, and must be organised in a representative and transparent manner. Essential first steps within this agenda should be a reform of the major institutions currently shaping global economic policy.

A Global Economic Council instead of the G20

Instead of a self-appointed group of countries, objective and explicit selection criteria should be employed to establish a 'Global Economic Council', as

44 See David Spencer, *Rifts between the OECD and United Nations on international tax*, http://taxjustice.blogspot.co.at/2012/03/guest-blog-on-rifts-between-oecd-and.html, 2012.

proposed by the UN Commission chaired by Joseph Stiglitz.[45] Criteria should be based on representativeness in terms of population, economic weight and regional representation. Currently 16 countries would meet the condition of accounting for 2% or more of either world GDP or population. In addition, each region could select one other state to represent the region in the GEC.

IMF Reform

If the IMF is to effectively fulfil a role in the surveillance of global imbalances, it needs to be subjected to substantial reforms in its governance, mandate and policy recommendations. In order to become representative, the restoration of the weight of basic votes and the introduction of double majority voting (meaning that decisions need a majority of votes weighted according to both a country's shares and the number of member countries) would be important steps. Policy recommendations should focus on inclusive and equitable development and leave room for countercyclical macroeconomic policies. Controls on international capital movements should be seen as an essential part of the macroeconomic policy toolkit. The IMF is currently the only institution able to issue an international currency – the Special Drawing Rights (SDR). SDR issuance should be increased and used for financing global public goods such as the fight against climate change.[46] More fundamentally, SDRs should be developed as the basis for a truly international monetary system that is not based on any one country's currency, as proposed by the Stiglitz Commission.

Global Tax Coordination

Measures after the terror attack on the New York World Trade Centre in September 2001 to control illegal flows to tax havens have shown that if there is the political will more transparency in tax issues is quite achievable. As the UN is currently the most representative coordination forum, the EU and other OECD members should give up their resistance and transfer resources and the mandate from the OECD to a high-level UN tax institution and provide it with sufficient expertise and power to effectively combat tax evasion and tax avoidance, and to reduce tax competition. In combination with a substantial increase in co-operation among national fiscal authorities, harmful tax practices could

45 See UN, Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, 2009; Robert Wade and Jakob Vestergaard, 'Overhaul the G20 for the sake of the G172', Financial Times, 21 October 2010; Enrique Rueda-Sabeter et al, 'Rethinking Fundamental Principles of Global Governance: How to Represent States and Populations in Multilateral Institutions', Governance, July 2009.

46 See Matthias Kroll, 'The lack of $100 billion for climate finance and the possibility to create new global reserve money in form of the Special Drawing Rights (SDRs) from the IMF', Paper presented at the 18th Conference on Alternative Economic Policies in Europe, University of Poznan, 28-30 September 2012 (available at www.euromemo.eu).

soon belong to the past. This would mobilise an unprecedented volume of resources which could be used to eliminate global poverty and to contribute to an equitable and sustainable transformation of the global economy.

Global environmental governance

Any meaningful alternative political strategy in the field of global environmental governance will have to start from a big No. A No to the privatisation of water, energy and, generally speaking, of the Commons. A No to the monetisation of nature, and a No to the weakening or replacement of binding regulation of human-nature-relations by mere market mechanisms. On the other hand, such a strategy can successfully begin to implement a profound positive change of orientation, by giving priority to the public sphere as the main support of common political deliberation – in terms of new forums in which to debate, as well as in terms of technical and organisational instruments. This will have to start from areas of communal self-organisation, integrating municipal and regional institutions before becoming capable of decisively changing the balance of power within central state institutions and governments. The alternative strategy should also appeal to the potential of civil society organisations and social movements in order to build political alliances and integrated networks which provide needed services on a not-for-profit basis. In order to open the scope for sustainable change, energy and water provision should be taken out of the hands of existing corporate monopolies, assisting and reinforcing decentralised forms of energy generation and sustainable water administration, while making them central issues for participatory and decentralising political processes.

The EU could help to promote its own capacity to develop long-term sustainability by engaging in a new type of multilateralism. Instead of trying to always claim the leading role for itself – or for its leading member countries – and instead of addressing all the others as subordinates that need to be led, the EU and its member states should practise a kind of open diplomacy, in which those who are most advanced in a specific field take the lead,. Such a willingness to look towards and listen to others could strengthen EU internal political practices and processes so that they responded more effectively to the actual problems of the EU and to the real potential for overcoming them.

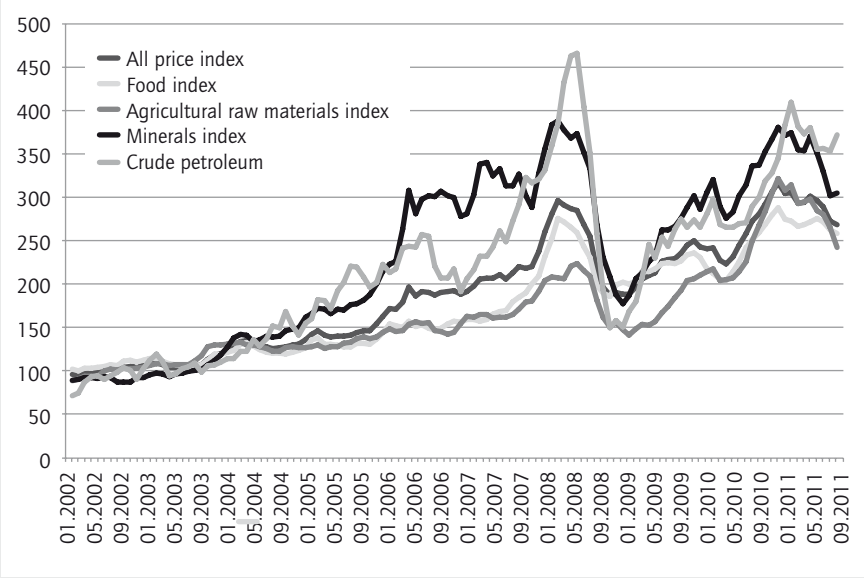
Box 2: The commodity price boom and the problematic renaissance of extractivism[47]

The current commodity price boom in combination with high price volatility is unprecedented in recent history. After two decades of low commodity prices in the 1980s and 1990s, many commodities registered steep price increases from 2002, reaching a peak in mid-2008. In the second half of 2008 prices fell sharply across a wide range of commodities but they began to rise again in the first half of 2009 and non-fuel prices reached an all time high during early 2011. Thus, despite large fluctuations in recent years, commodity prices remain well above their average historical levels. While the timing varied for different types of commodities, the surge in prices, the sharp correction and the subsequent rebound affected all major commodity categories, including agricultural, metallic and energy commodities.

The persistence of commodity dependency remains an important characteristic of many developing countries, in particular in Sub-Saharan Africa. The commodity price boom has benefited some low-income countries as well as resource-rich middle-income countries where growth rates in the last decade have been driven by commodity exports and increased investment in resource extraction, in particular from emerging countries, with China playing a key role. Besides the direct impact of high commodity prices on export earnings and public revenues that to some degree have been used in development-enhancing ways, notably in some Latin-American countries such as Bolivia, Ecuador or Venezuela, a crucial factor that determines the broader development impact of commodity-based exports is the extent of local value-added and the linkages to the local economy. Despite these new opportunities, there remain significant dangers of commodity based development related to often very problematic labour conditions as well as to the severe environmental impact of mining projects. In addition, the capital-intensive nature of many commodity sectors limits employment creation and the distribution of gains and facilitates the development of enclave economies. For this reason, the prioritisation of extractive sector development has in many countries met strong resistance from the communities affected.

47 The following discussion is mainly based on Cornelia Staritz, ‚Financial Markets and the Commodity Price Boom: Causes and Implications for Developing Countries', *ÖFSE Working Paper No. 30*, 2012.

Figure 1: Monthly nominal commodity price indices by commodity group (2002-2011)



Source: UNCTAD Stat 2012.

Note: Free market commodity price indices; Monthly; January 2002-November 2011; Prices are in current US$; 2000=100; Crude petroleum price is the equally weighted average of UK Brent (light), Dubai (medium) and Texas (heavy).

To stabilise commodity prices and mitigate the negative impact of the commodity price boom on developing countries, strict reforms are required. It is necessary to secure the functioning of commodity derivative markets so that they fulfil their role of providing reliable price signals and risk-hedging functions to producers and consumers of physical commodities and contribute to a stable global environment for economic development. For this a major re-regulation of commodity derivative markets is necessary. Regulation has to effectively reduce speculation and the role of financial investors on commodity derivative markets.

Extractive activities must also fully respect the economic, social and cultural rights of affected communities, as well as fully assess the effects on the natural environment. Comprehensive ex-ante assessments of the full impact need to be undertaken and appropriate preventive and mitigating measures

elaborated. The informed consent of the affected local population, in particular indigenous populations, must be obtained prior to the start of project implementation. The responsibility of the state to protect human rights does not only extend to the host state of an extractive activity, but also to the state where the transnational company involved in a project has its headquarters. Following the Maastricht Principles on Extra-Territorial Obligations (ETOs) of States in the area of Economic, Social and Cultural Rights, the EU and its member states should therefore endorse legislation that makes it possible to bring to court transnational corporations residing in the EU for any breaches of human rights in their overseas operations.[48]

48 For detailed information, see http://www.ciel.org/Publications/Maastricht_ETO_Principles_21Oct11.pdf.

European Economists for an Alternative Economic Policy in Europe
– EuroMemo Group –

The deepening crisis in the European Union:

The need for a fundamental change

– EuroMemorandum 2013 –

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