BRINGING DEMOCRATIC CHOICE TO EUROPE'S ECONOMIC GOVERNANCE

The EU Treaty changes we need, and why we need them

This study is a joint publication of the
Rosa-Luxemburg-Stiftung Brussels Office
and Policy Research in Macroeconomics (PRIME).

It is authored by **Jeremy Smith** (Parts 1 and 2)
and **John Weeks** (Part 3), and is the product
of the discussions and ideas of a working
group comprising:

John Weeks, Professor Emeritus of Development
Economics, SOAS, University of London

Antonella Stirati, Professor of Economics,
Roma Tre University

Engelbert Stockhammer, Professor of Economics,
Politics & History, Kingston University, London

Jeremy Smith, Co-Director, Policy Research
in Macroeconomics (PRIME), barrister

The authors, and the working group, would like
to warmly thank the German Federal Foreign Office
and the Rosa Luxemburg Stiftung Brussels Office,
which have provided financial support for this
project. The responsibility for the content
is entirely that of the authors.

March 2017

This study is funded by the German Federal Foreign Office

ROSA LUXEMBURG STIFTUNG
BRUSSELS OFFICE

Prime

Rosa-Luxemburg-Stiftung, Brussels Office
11 avenue Michel-Ange
B-1000, Brussels, Belgium
www.rosalux.eu

Policy Research in Macroeconomics (PRIME)
51 Clarence Gate Gardens, Glentworth Street,
London NW1 6QS, UK
www.primeeconomics.org

CONTENTS

PREFACE 04

PART I — THE DEMOCRATIC CASE FOR CHANGE 05

PART II — OUR TREATY AMENDMENT PROPOSALS

Issue 1: The economic, employment and social protection objectives 11

Issue 2: General economic policy provisions 15

Issue 3: Reforming the European Central Bank's role and mandate 22

Issue 4: Ensuring that trade is beneficial 29

Issue 5: Managing capital mobility 31

Issue 6: Rebalancing the over-emphasis on liberalisation of services 33

Issue 7: Restoring some "State Aid" discretion to Member States 35

Issue 8: Harmonising corporate profits taxation, and action against tax havens, base erosion and profit shifting 37

Issue 9: Strengthening industrial and investment policies 38

Issue 10: Protecting and strengthening public services 41

PART III — THE CASE FOR CHANGE: REDUCING BIAS IN ECONOMIC POLICIES

Democracy, accountability and flexibility 44

Guidelines for Sound Economic Management 45

Changes to Eliminate Bias 47

Smmary 59

References to Part III 60

PREFACE

Brussels, 7 March 2017

Dear colleagues, comrades and friends,

The European Office of the Rosa-Luxemburg-Stiftung in Brussels has taken the opportunity of the debate on the European Union's future to carry out a joint project with the London-based Policy Research in Macroeconomics (PRIME) that looks in detail at the European treaties.

It is often said — and correctly in our view — that the treaties, which in effect serve as a constitution, have forced the EU to develop in a certain direction owing to their political and ideological slant. That dominant constitutional order revolves around primacy of the market, liberalisation, unchecked freedom of capital, debt caps as brakes on investment, lack of democracy and lack of transparency.

We realise this provides very little scope for alternative approaches that would allow for the development of a socially and economically open society that leaves turbo-charged capitalism behind. We are also aware that reform of the existing EU treaties is extremely difficult in view of the existing political majorities and the rules on amending the treaties that are in force, since the unanimous agreement of the Member States would be required.

Nevertheless, we believe it is worth asking what shape specific amendments to the treaties would need to take to allow for other forms of social development in order to escape the non-social stranglehold of neoliberalism and to lay the politically and economically neutral (!) groundwork for the EU, which would make a social EU and perhaps even democratic socialism possible?

This study, which is published by the Rosa Luxemburg Foundation in Brussels, is an invitation to engage in dialogue for all those who are interested in an alternative development of the European Union and its integration. The content of the document, however, chiefly expresses the views of the authors, with whom we are in full agreement on most points. We have also had very interesting discussions with the authors on topics such as international trade, the mandate of the European Central Bank and the question of controls on the movement of capital within the euro area. In some respects we would have drawn further-reaching conclusions from the failure of the EU's integration approach than the authors have done, but like them we hope that this study will be widely read and look forward to a broad-based discussion on the future of the EU. We believe this PRIME study serves as an excellent basis for that.

We hope that the study will encourage our readers to engage in discussion and that talk will result in action.

Martin Schirdewan
Roland Kulke

Rosa-Luxemburg-Stiftung

PART I — THE DEMOCRATIC CASE FOR CHANGE

In principle, the European Union should be a force for peace, prosperity and social progress. It has many positive achievements to its credit, and positive general democratic values to defend and uphold, especially in this world of "post-truth" media and politics. But in recent years, a number of crucial negative developments have taken place, and the global financial crisis, followed swiftly by the ongoing Eurozone crisis, have highlighted the problems caused by the current EU Treaties in so far as they relate to economic and related issues. The structure and operation of the Euro, especially when confronted with financial and economic crisis, have given rise to the most severe difficulties.

Despite its commitment to democratic values, in one key area the European Union does not permit legitimate democratic choice, and that is the economic sphere. Because so much of the economic policy of the EU is embedded in its Treaties, which can normally only be changed if all member states agree, there is a growing frustration that the democratic will of Europe's people simply cannot be expressed if on any point it differs from that set out in the Treaties. We are convinced that much of the recent popular discontent, leading for example to the Brexit Referendum decision, is based on the refusal of the Union to accept that its economic philosophy and policies are in many respects harmful, and its determination to reject out of hand any alternative.

The Treaties' narrow economic dogma

The Treaties impose a very specific - and highly contested — economic ideology, which has been described as "ordoliberal". In a paper [1] published by the European Council on Foreign Relations in 2102, the economist Sebastian Dullien and political scientist Ulrike Guérot describe this ideology:

> "The central tenet of ordoliberalism is that governments should regulate markets in such a way that market outcomes approximate the theoretical outcome in a perfectly competitive market. Inflation is seen as distorting valuable price signals, hence creating high economic costs.
>
> Ordoliberalism differs from other schools of liberalism in that it places a greater emphasis on preventing cartels and monopolies, but it keeps a number of beliefs central to other strands of economic liberalism. For example, it shares a neoliberal opposition to activist monetary and fiscal policies…"

Many who share this philosophy [2] would go still further. Harold James, in his book "Making the European Monetary Union" [3], says

[1] The Long Shadow of Ordoliberalism, July 2012, ECFR

[2] Or indeed its (in many respects) close cognates, neoclassical economics, and neoliberalism

[3] Making the European Monetary Union, Harvard University Press, 2012;
the book was commissioned by the European Central Bank and the Bank for International Settlements.

> "Tommaso Padoa-Schioppa[4] saw this emphasis on the independent central bank as part of a more general acceptance of 'minimum government' that made a new stage of European integration possible. As he implied, the discussion of central banking was part of a broader trend that prepared the way for what was later dismissively referred to as 'market fundamentalism'".

And again,

> "The European Central Bank was designed as a non-state actor whose primary purpose was to issue money — the kind of institution that had basically only been imagined before the 1990s by antistatist liberal economist and philosopher Friedrich Hayek and some of his wilder disciples. By the time of the monetary union, some influential interpreters saw Hayek as one of the inspirations. As Otmar Issing, the first chief economist of the European Central Bank, put it, 'many strands in Hayek's thinking… may have influenced the course of events leading to Monetary Union in subtle ways.'"

Of course, to hold ordoliberal or similar views, and try to win support for them, is a perfectly legitimate part of a democratic society. But many economists and others, the authors of this report included, believe this ideology is based on profoundly mistaken premises, leading to substandard economic results and to adverse social consequences. The great financial crisis demonstrated the falsity of many of the assumptions that underlie the theories embedded in the EU's Treaties and policy-making.

The EU's economic ideology bites deepest in relation to the Eurozone; the Treaty-based rules and policies have imposed austerity, excessive levels of unemployment, and poor economic outcomes, over many years. In October 2016, Eurozone unemployment fell below 10% (to 9.8%) — until October, and with the exception of a single month in 2011, unemployment in the Eurozone had been over 10% for more than seven years. This is a sign of failure in economic policy and theory.

The authors of this study believe that to achieve economic prosperity, the active deployment of fiscal as well as monetary policy is often required. The EU policy to reduce government spending when unemployment is high and the economy is operating way below full capacity is self-defeating and prolongs depression or recession. Fiscal and monetary policy should be coordinated, which means more interaction between the different authorities than current theory and law permit.

For present purposes, it is not even necessary to decide finally which school of thought is right and which wrong (though the economic failings of the Eurozone tell their own tale). The whole purpose of democracy is to allow not only the free exchange of ideas, which can and does take place, but also *to enable different democratic choices to be made*.

Fundamentally, the European Union's Treaties today forbid the peoples of Europe to choose a different economic path. The Treaty-based rules, ultimately given penal effect, require contractionary austerity in a downturn, and now (through "balanced budget" Treaties and constitutional means) prevent an activist fiscal policy. Instead, it is assumed — wrongly — that supply-side measures are the only answer.

[4] One of the "founding fathers" of the single currency, and board member of the ECB 1998-2005

Because so much of the economic policy of the EU is embedded in its Treaties, which can normally only be changed if all member states agree, there is a growing awareness and frustration that Europe's peoples are structurally barred from making legitimate democratic choices in relation to economic policy.

The EU Treaties have created "a constitutional order"

While the Treaty of Rome, which established the original European Economic Community, the modern European Union was created by the Treaty of Maastricht (1993), and since December 2009 its legal existence is provided for by the Treaty of Lisbon. The Lisbon Treaty in turn

a. amends and renames the Maastricht Treaty as the Treaty on European Union, or TEU for short;

b. also amends and renames the Treaty of Rome (1957), now called the Treaty on the Functioning of the European Union (2007) or TFEU.

As the EEC and later the EU developed, a mismatch was increasingly apparent between the inter-governmental *Treaty form,* and the *apparently sovereign substance* of this new transnational entity — with its own European citizenship, as well as a common currency, Charter of Fundamental Rights, and Court with overriding jurisdiction. This led to the decision to draw up a new European Constitution, which was rejected in national referenda in France and the Netherlands in 2005. However, its actual contents were effectively maintained (almost unchanged in substance) and redistributed as amendments into the newly named TEU and TFEU Treaties.

Despite the failure of the European Constitution, the European Union today has all or most of the attributes of a "constitutional order". Its Treaties are to be seen as providing a constitutional framework. That is, they have to a large degree the functional equivalence and force of a written Constitution of a state - or of a 'sui generis'[5] body with many or most of the attributes of a state, even if it has other attributes. This is recognized generally in academic circles; Professor Robert Schütze[6] indeed goes further:

> "Indeed the real problem of the European Union is not whether there is a European Constitution, but that there is '[t]oo much constitutional law'.... For in comparison to the 34 articles and amendments that make up the written constitution of the United States, the European Treaties alone contain 413 articles. The European Treaties are therefore, with regard to their length, 'bad' constitutional law. For it is the task of constitutions to define the very principles on which societies are based."

[5] Meaning "of its own unique kind"

[6] "European Constitutional Law" 2nd edition, Cambridge University Press, 2015.

Nor is this idea that the Treaties form a constitutional order confined to academics. The European Court of Justice had itself, in a formal Opinion delivered as long ago as 1991, affirmed as much in respect of the EEC, i.e. even before the EU was created:

> "The European Economic Area is to be established on the basis of an international treaty which merely creates rights and obligations as between the Contracting Parties and provides for no transfer of sovereign rights to the inter-governmental institutions which it sets up. In contrast, the EEC Treaty, **albeit concluded in the form of an international agreement, none the less constitutes the constitutional charter of a Community based on the rule of law."**

More recently, in its judgment in the case of Kadi (ECJ C402-05) of 2008, the ECJ pronounced that:

> "The obligations imposed by an international agreement cannot have the effect of prejudicing **the constitutional principles of the EC Treaty**..." (our emphasis in each quote).

In sum, the Treaties perform a function that is so analogous to a Constitution — and in particular to a liberal-democratic state constitution — that it is wholly justifiable to assess its provisions against the norms of such states.

A Constitution in general terms sets out the institutional relationship between the different parts and levels of government, and allocates competences between the different parts and levels of government. It may often set out the founders' general values and aspirations. It frequently lays down the principal rights which the state's citizens are to enjoy. The provisions of the Constitution are almost always entrenched, i.e. are harder to amend than ordinary laws.

All Constitutions are the product of their own time and history, and they vary greatly in length. But for all their variation, the European Union is extremely unusual and prescriptive in laying down both a specific economic philosophy (or ideology) and detailed rules based on that ideology to govern economic policy-making.

If one studies the Constitutions of democratic states, one notable feature is that, with very few exceptions, the content and details of economic and monetary policy are absent; the Constitution may set out the society's broad goals and the procedures to be followed, but the content of the policies is left to the product of democratic debate through Parliamentary law-making (as well as day-to-day operational management).

A very few modest exceptions to this general rule are found in a few EU countries' recent constitutions, which have taken in one or two rules of the EU post-Maastricht Treaties[7]. A few Eurozone countries have very recently adopted so-called "debt-brake" or balanced budget amendments to their national Constitutions.

[7] The Polish constitution of 1997 for example requires government debt to be below 60% of GDP, as per the Maastricht criterion

In general terms, we note that while national constitutions often include provisions laying down the *procedural rules* for annual budget-making, taxation or incurring government debt, they never seek to lay down the *policy content*. Moreover, while in a few cases the central bank is created by the Constitution, its mandate is almost invariably left to Parliamentary legislation and can therefore be changed.

In short, the EU is unique in rigidly embedding economic ideology and immutable policy rules within its constitutional order.

The aim of this study

This study offers a short set of essential amendments which would make the terms of the EU Treaties more policy-neutral in the economic domain, and enable the EU and member states, within their remits, to define and implement economic policies that are democratically chosen and appropriate to the circumstances and needs of their citizens.

We have not sought to change the basic structure of the Treaties or their foundational principles. For the purpose of this paper, therefore, we have taken as 'given' the general framework of the internal market, and the 'four freedoms' within that market (goods, services, workers, capital), but provide for some modest democratic discretionary space, e.g. in relation to state aid. We believe, however, that the internal market and the single currency are not ends in themselves, but must always be seen as means to the end, the prosperity and welfare of the peoples of Europe.

We have not included proposals to increase the EU's budget (currently around 1% of EU GDP) to a level that would enable meaningful transfers of resources (as any single currency requires) and help the Eurozone to succeed, as this does not in theory require Treaty changes. Nor have we sought to propose new democratic political structures for the Eurozone, however necessary these may be, as this goes well beyond our present terms of reference. Finally, in this list of issues not treated, our study does *not* address the gross failure of international and domestic financial systems; this is a topic of immense importance, but beyond the scope of the present exercise, and indeed beyond the scope of the EU alone to reform.

We propose major changes to the monetary and fiscal rules set out in the Treaties. The current fiscal rules are inappropriate and counter-productive, and the monetary policy priority on price stability alone stands as a monument to an outdated theory. As the Financial Times' Martin Wolf has recently put it, rather despairingly:

> "The combination of weak aggregate demand with huge post-crisis divergences in economic performance has turned the eurozone into an accident waiting to happen... What the eurozone needs most is a shift away from the politics of austerity..." [8]

[8] Financial Times, 6 December 2016

We have divided our proposed amendments into ten categories, some of which are much more extensive than others, depending on the subject-matter. We have not had the opportunity to consult widely on these beyond the members of our working group, but almost all the proposed changes reflect well-known and widely supported economic policy perspectives. In the interests of space, we have not included every amendment we have drafted — but we have drafted an "amendments working paper" from which we have taken what appear to be the most significant.

In some areas our suggested wording may not capture all the technical problems involved. The Treaties and Protocols cover any enormous range of issues and at enormous length, often with opaque and arcane language reflecting negotiations from long ago! And others who share our broad perspective on economic issues may feel there are other issues to tackle, or that our approach can be improved upon. We would be delighted to receive these ideas and proposals, and aim to engage in a broader dialogue in the coming months.

We are aware how hard it is to change the Treaties, but a sustained, broad-based and widely-supported campaign across Europe in support of a specific set of well-targeted changes to the Treaties can help to change the political atmosphere and lead in due course to the necessary "paradigm shift" in economic thinking. Above all, we need to persuade progressive Europeans, working in different political groupings or none, not only that There Is A Real Alternative (TIARA not TINA!), but that the present Treaty rules and policies on economic issues are leading Europe into danger.

The structure of our study

Following this introduction (which forms Part I), in the following part (Part II) the main Treaty changes are set out, with a brief explanation for each, which we propose are necessary for the EU Treaties to provide a proper basis for more democratic decision-making on economic and related policy issues. Part 3 then offers a fuller explanation of the economic rationale for the key changes proposed, notably in relation to EU and Eurozone fiscal policy, and of how many of the crucial existing Treaty provisions are flawed and ideologically biased.

PART II — OUR TREATY AMENDMENT PROPOSALS

Issue 1: The economic, employment and social protection objectives

(a) The Article 3 objectives

Like many national constitutions, the Treaty on European Union (TEU) begins with an affirmation of the Union's values, in Article 2, and sets out its broad aim and objectives in Article 3. These objectives include economic objectives, amongst some broader objectives.

The values are positive — they include respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. The "Union's aim" in Article 3.1 is likewise one that we can all share: "to promote peace, its values and the well-being of its peoples", while 3.2 offers citizens "an area of freedom, security and justice without internal frontiers, in which the free movement of persons is ensured…"

The economic objectives, which should therefore be in line with the values and aim of the Union, are set out in **Articles 3.3 and 3.4** which are as follows:

Existing text:

> **3.** The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance.
> It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child. It shall promote economic, social and territorial cohesion, and solidarity among Member States…
>
> **4.** The Union shall establish an economic and monetary union whose currency is the euro.

We propose that Article 3.3 be revised. For us, the internal market is a means to an end — prosperity and progress — and not an end in itself. Yet it is placed first in the list of objectives. Thereafter, the present draft expresses a strange hierarchy of values; Europe is to be based on a "social market economy", and it is this economy which "aims at a high level of employment and social progress", i.e. these are highly indirect aims of the Union. Thus, in the existing text, price stability is given far more importance than a high level of employment. This is wrong. Europe has been plagued by high unemployment for far too long — and employment should be at the forefront, at the least co-equal with price stability.

We also contest the notion of a "social market economy" as an objective, at least as expressed here. We of course have no objection to people advocating the concept, but it should not be in the objectives of the Union. In the English language, it is ambiguous whether the adjective "social" attaches to the market or to the economy (in French, it is to the economy), but this does not express the very different vision which many citizens have — which is of a market economy embedded within and subject to the overall society (and not vice versa).

The current wording implies that the "social" is an attribute of the "market economy". It is wrong, or at least, wrong as an objective. Moreover the concept "social market economy" is not to be found (we believe) in any national constitution[9], not even Germany's Basic Law[10]. Moreover, the present text does not touch on what is to us a cornerstone of the European social model — effective social protection, and public services.

Our proposal, therefore, is to keep most of the substance of the present text but reorder it, so that the establishment of the internal market follows, rather than precedes, the objectives.

Proposed change

> **3. The Union shall work for the sustainable development of Europe based on balanced economic growth and prosperity, full and good quality employment, reasonable price stability, social progress and a high level of protection and improvement of the quality of the environment, within the framework of a society based on a dynamic mixed economy and which ensures effective social protection and public services. It shall promote scientific and technological advance.**
>
> **To further the achievement of these objectives, the Union shall establish an internal market.**
>
> It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child.
>
> It shall promote economic, social and territorial cohesion, and solidarity among Member States…
>
> **4. To further the achievement of its objectives**, the Union shall establish an economic and monetary union whose currency is the euro.

[9] Slovakia's Constitution states that "the economy in the Slovak Republic shall be based on the principles of a socially and ecologically orientated market economy" but this makes clear that it defines the economy, not the society.

[10] Though it does appear in the wording of Article 1 of the Treaty between the Federal Republic of Germany and the German Democratic Republic establishing a Monetary, Economic and Social Union (18 May 1990) which provided in Article 1 that "The basis of the Economic Union shall be the social market economy as the common economic system of the two Contracting Parties."

> **5.** In its relations with the wider world, the Union shall uphold and promote its values and contribute to the protection of its citizens. It shall contribute to peace, security, the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights, in particular the rights of the child, as well as to the strict observance and the development of international law, including respect for the principles of the United Nations Charter. **The Union shall work to combat and protect against harmful climate change.**

(b) The specific employment and social protection priorities

In the Treaty on the Functioning of the European Union (TFEU), there are specific Articles dealing with employment and social protection, and which we propose be amended to reflect our new Article 3 objective for full and good quality employment and effective social protection. For example, Article 9 of TFEU requires the Union in defining policies and actions to "take into account" requirements linked to the promotion of a high level of employment and "adequate" social protection. "Take into account" is a weak duty as it stands, so we propose the following:

Article 9

Existing text

> In defining and implementing its policies and actions, the Union shall take into account requirements linked to the promotion of a high level of employment, the guarantee of adequate social protection, the fight against social exclusion, and a high level of education, training and protection of human health.

Proposed changes

> In defining and implementing its policies and actions, the Union shall take into account **and prioritise** requirements linked to the promotion of **full and good quality employment**, the guarantee of **effective social protection**, the fight against social exclusion, and a high level of education, training and protection of human health.

A very similar point arises in relation to Article 147 (cooperation on employment policies), and we propose similar changes to refer to **"full and good quality employment".**

(c) General objectives for environmental protection and climate change

This paper is focused on the economic policies of the Union that are embedded in the Treaties, and does no generally seek to deal with other issues. However, the issue of climate change is of fundamental importance to the future of the economy, as we move to a post-carbon economy. Yet the provisions in the Treaty referring to climate change are few indeed; the only one we have noted is in Article 191 TFEU on environment policy, but limited to

> “promoting measures at international level to deal with regional or worldwide environmental problems, and in particular combating climate change.”

Going back to the overall objectives of the Union in **Article 3**, there is currently no mention of climate change. We recommend that this should be a transversal objective of the Union, which should have economic and non-economic policy consequences. It could be added to **Article 3.5** as follows:

Proposed change

> **5.** In its relations with the wider world, the Union shall uphold and promote its values and contribute to the protection of its citizens. It shall contribute to peace, security, the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights, in particular the rights of the child, as well as to the strict observance and the development of international law, including respect for the principles of the United Nations Charter. **The Union shall work to combat and protect against harmful climate change.**

In similar vein, we propose that the general environmental protection duty under Article 11 should make express reference to climate change, as follows:

Existing text

> Environmental protection requirements must be integrated into the definition and implementation of the Union policies and activities, in particular with a view to promoting sustainable development.

Proposed changes

> Environmental protection requirements **(including those related to climate change)** must be integrated into the definition and implementation of the Union policies and activities, in particular with a view to promoting sustainable development.

Issue 2: General economic policy provisions

(a) The principles of economic policy

Article 119 TFEU requires close coordination of Member States' economic policies, based on the definition of common policies, and compliance with a set of principles. The Article also sets out as an 'activity' the setting of single monetary policy of price stability alone, which we propose below to change to include other factors and have therefore deleted here. Since it has already been made clear in Article 3 (objectives) that the EU has a market economy, we propose not to repeat this time and again as is done in the TFEU. We propose amendments to the principles under 119.3, to align them more closely with the Union's economic objectives (as proposed under Article 3) and to make clear that a sustainable balance of payments avoids excess trade etc. surpluses as well as deficits.

Proposed changes:

1. For the purposes set out in Article 3 of the Treaty on European Union, the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives. **[Delete "and conducted in accordance with the principle of an open market economy with free competition"]**

2. Concurrently with the foregoing, and as provided in the Treaties and in accordance with the procedures set out therein, these activities shall include a single currency, the euro, and the definition and conduct of a **[delete 'single']** monetary policy and exchange-rate policy. **[last part deleted as in 1.]**

3. These activities of the Member States and the Union shall entail compliance with the following guiding principles: **balanced economic growth, full and high quality employment, reasonable price stability, [delete "sound"] well-managed** public finances and monetary conditions and a sustainable balance of payments without excessive surpluses or deficits.

Similar changes are required in **Article 120**, as regards the references to "open market economy" etc.

(b) The economic policy guidelines

Under Article 121, Member States must regard their economic policies as a matter of common concern, and the Council of Ministers draws up a set of broad guidelines. If it is considered that the economic policies of a Member State "are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned."

We believe that this removes more discretion in economic policy from Member States than is necessary, and propose that warnings should only be given if both aspects are met, i.e. the policies are not consistent with the guidelines, **and** they risk jeopardising the proper functioning of economic and monetary union.

(c) Reforming the Maastricht criteria for government deficits and debt

We have now reached one of the two most disputed and debated areas of economic policy — the rules on excessive budget deficits and gross government debt. The other area relates to the monetary policy of the Union, which we deal with below.

For Member States of the European Union — and in particular for Member States who have adopted the euro as their currency — do the current rules set out in Article 126 TFEU make any economic sense? And what if any common rules *should* apply?

Our working group is unanimous in answering the first question — the existing excess deficit rules not only make no sense, but from an economic perspective are completely counter-productive. The reasoning for reaching this conclusion is set out in Part 3 of this Paper.

The rules are set out in **Article 126.1** and **126.2**:

Existing text

1. Member States shall avoid excessive government deficits.

2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

a. whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:
— either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
— or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

b. whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the **Protocol on the excessive deficit procedure** annexed to the Treaties. [3% for the ratio of the planned or actual government deficit to gross domestic product at market prices; 60% for the ratio of gross government debt to gross domestic product at market prices.]

If a Member State does not met these requirements, a long procedure set out in the Article is set in train, and which the Article sets out in detail. It can lead to recommendations being made to the State concerned, and if not followed, can lead to sanctions including fines being levied.

In our long *Treaty amendments working paper* we have set out the existing procedure in full, and made a long series of proposed amendments. But in essence, we recognize that — especially in the case of a common currency — there is a common interest in not having individual Member States put the proper functioning of economic and monetary union at risk.

One possibility — which would be more in line with most constitutions — would be to leave the whole issue to be dealt with by legislation, not in the Treaty itself. That is our Option 1, though on balance our working group favours Option 2, which is to broaden the assessment to include a range of indicators, not a narrow focus on one partial (and in our view incorrect) indicator. The reason for this is that, in the absence of a federal system, Member States can be affected by their neighbours' economic and fiscal policy. But the issue is not "to avoid excessive government deficits" but to avoid a negative spill-over from gross economic mismanagement, which also includes dangers arising from private sector behaviour. We therefore favour a broader overall assessment based on a "dashboard" of economic indicators. We propose that

a. there should be a broader set of budget indicators against which the assessment is made of which budget deficits or surpluses are just one factor; and that the policies should in general terms promote achievement of the economic objectives and the dangers of, for example, *private* debt becoming unsustainable. Focusing on raising employment is beneficial to the government budget; for example, lowering unemployment reduces government payments on unemployment and other welfare payments; and long-term investment will normally pay for itself over time, as well as create good quality employment, if well targeted.

b. The test for whether to take further steps should be an assessment of whether the budgetary policies of a Member State jeopardise or are likely to jeopardise the proper functioning of economic and monetary union

c. When looking at government debt, we propose that it should be net debt, i.e. (i.e. deducting assets from liabilities) that is mainly focused on, and exclusive of internally owed public debt, e.g. debt 'owed' by a government to the country's central bank, which is by definition not a matter of concern to others.

d. When looking at budget deficits, we propose that it should be the primary deficit (i.e. after allowing for debt interest payments) that is mainly considered.

Proposed text

Article 126 — Option I

Delete all and insert:

The European Parliament and the Council, acting in accordance with the ordinary legislative procedure, may adopt measures setting out procedures for the reporting by Member States of their budgetary policies, and for the monitoring thereof by the Commission and Council, in order (a) to assess the impact of such policies on the achievement of the economic objectives and policies of the Union, and (b) to address any budgetary policies of a Member State that might seriously and directly jeopardise the proper functioning of economic and monetary union.

Article 126 — Option II

1. Member States shall **ensure that the government's and public finances are effectively managed. They shall endeavour in particular, and having regard to all the circumstances and in particular to the present and foreseen state of the economy at national, EU and international levels, to**

a. develop budgetary policies that promote the achievement of the Union's economic objectives, including full employment;

b. avoid excessive government surpluses or deficits, taking into account public investment;

c. redress excessive surpluses or deficits on their current account; prevent the build-up of excessive private debt or net government debt;

The Member States shall report promptly and regularly to the Commission on the statistics and proposed policies and measures in relation to the above factors

2. The Commission shall monitor the development of the budgetary situation in the Member States, **having regard to the matters set out in paragraph 1 above**, with a view to identifying gross errors **and to identifying factors in respect of any Member State's budgetary policies which risk jeopardising the proper functioning of economic and monetary union.**

3. **If the Commission identifies, in relation to the budgetary policies of a Member State, what it considers to be such errors or factors**, the Commission shall prepare a report. The report of the Commission shall take into account all relevant factors, including the medium term economic and budgetary position of the Member State, **and shall set out the matter or matters giving rise to concern.**

The remainder of our detailed proposals for amending Article 126 are set out and are available in our working paper. They include a proposal that the European Parliament as well as the Economic and Financial Committee be consulted by the Commission in relation to any such report.

It follows from the above that the provisions of **Protocol No.12 on the Excessive Deficit Procedure** would no longer be relevant, since we do not envisage detailed definitions in relation to budget deficits and government debt — or else these can be dealt with by legislation. Our proposal is therefore for the **repeal of Protocol No.12.**

Although the **Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (2012)** is not strictly part of the EU Treaties, its terms are additional to the EU Treaties, and require the signatory states — in particular all euro zone states — to ensure that "the budgetary position of the general government shall be balanced or in surplus", as defined in the Treaty. We consider this to run counter to sensible and reasonable economic policy, for example since the rule requires public investment expenditure to be covered by current income, but in any event, it is quite undemocratic to impose balanced budget dogma into the form of Treaties or constitutions.

The Treaty was adopted at the peak of the Eurozone crisis, and was in effect forced through for ideological reasons by the German Chancellor and government; it was initially intended to be an amendment to the EU Treaties but the UK for once wisely, if not for the right reason, refused, so recourse was had to a separate Treaty. It effectively duplicates other EU requirements, but was intended to pressurize states to adopt constitutional "debt brake" provisions "of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes" (Article 3.2). In the event, only a few countries have to date amended their constitutions.

The Treaty's principles and rules thus provide yet another obstacle to the exercise of a free democratic choice by the peoples of Europe — based on completely sound economic principles — to decide on a different budgetary policy. The Treaty should be terminated, and proper budgetary discretion and autonomy restored to the Member States, unless their exercise truly poses a significant risk to the functioning of the single currency.

Article 136 TFEU provides for a potentially stronger and more intrusive form of "surveillance" of the "budgetary discipline" of Member States whose currency is the euro, with the Council of Ministers being given power to set out specific policy guidelines for Eurozone states. Our proposal is that the guidelines should broadly cover the same issues as under Article 126, with the addition of macroprudential steps [11] to manage financial risk. We suggest changing the language from "surveillance", with its intrusive and authoritarian overtones and air of distrust, by the term "oversight".

[11] In essence, targeted requirements imposed by government or central bank on financial institutions aimed to protect financial stability e.g. counter-cyclical buffers such as caps on loan-to-value ratio for house purchase loans, caps on debt-to-income ratio etc.

An addition to Article 136 was made in 2012 to provide a stronger legal base for the European Stability Mechanism, which provides a potential €500 billion financial assistance to Member States that hit grave economic difficulties. The second sentence Article 136.3 states that "The granting of any required financial assistance under the mechanism will be made subject to strict conditionality", which runs against the spirit of solidarity and mutual interest. We recommend that Article 136.3 might read:

> **3.** The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism **may** be made subject to **[delete "strict"]** conditionality, **but any conditions must be aimed at the rapid recovery of the financial or economic situation of the beneficiary State or States, take full account of the social consequences, and be proportional to the situation.**

(d) Improving the convergence criteria for Member States to adopt the euro as their currency

Strictly speaking, every Member State that joins the European Union is under an obligation to take steps to meet the "convergence criteria" for adopting the euro — unless (like Denmark and the UK, though in different forms) they have negotiated a Treaty opt-out from this obligation. Member States that have not yet joined the Eurozone are defined in Article 139 TFEU as "Member States with a derogation". We have not tried to amend this point, although it would be an option for the European Union, going forward, to decide that joining the euro was a voluntary act (provided the criteria for joining were met) and not a legal obligation. The position is a little farcical in that a state like Sweden deliberately, year after year, breaches some technical provisions for joining, in order not to be deemed to have met the convergence criteria — and is never held to account!

But in any event it is necessary to look at the "sustainable convergence criteria" which date back to the Maastricht Treaty, since the Commission and ECB report every two years on how far non-euro states meet the criteria. At present, there are four overriding tests, plus other factors that may be considered, which are set out in **Article 140**:

> **a.** the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability,
>
> **b.** the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6),
>
> **c.** the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro,

d. the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

These criteria mentioned are "developed further" in Protocol No.13 on the Convergence Criteria. The reports of the Commission and the European Central Bank also look at "the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices."

Once again, we consider some of the criteria to be wrongly based; the inflation criterion is perversely interpreted since the Commission and Bank consider the "best performing" states to include those in actual price deflation (when these exist) rather than those nearest to the actual target. Moreover, the budget deficit is surely of lesser importance than the current account and trade balance position, for example. So here is our proposed set of amendments to Article 140 on the convergence criteria for joining the euro, which again focus on the strength of the economy, the state of the current account and of private debt, as well as variants of the Maastricht criteria :

Proposed change

1. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union...

2. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

– **The sustainability and strength of the economy; this will be apparent from the development of GDP and the level and trend of employment and unemployment and real wages and household income;**

– **The sustainability of the current account and trade balance which avoids excessive surpluses or deficits, having regard to the results over the previous 5 years;**

– the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to **that established in relation to the monetary policy objectives of the European Central Bank,**

– the sustainability of the government financial position, **having regard to all relevant factors, including the extent to which the Member State has avoided excessive government surpluses or deficits, taking into account public investment and the level of net public and government debt;**

– **the sustainability of private debt, having regard to its level, trend and nature,**

– the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro,

– the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

The European Parliament and the Council, acting in accordance with the ordinary legislative procedure, may develop or amend the criteria mentioned in this paragraph, and may add new criteria for sustainable convergence. The reports of the Commission and the European Central Bank shall also take account of the results of the integration of markets [...] and an examination of the development of unit labour costs and other price indices.

We also propose that **Protocol No. 13 on the Convergence Criteria** be repealed, in consequence, with the Parliament and Council being able to legislate if more detail is required in defining any criteria.

Issue 3: Reforming the European Central Bank's role and mandate

(a) Broadening the mandate and tasks of the European Central Bank and ESCB

If there is one message that the current Treaties hammer home relentlessly, it is this:

The primary objective of the European Central Bank is to maintain price stability. All other matters are secondary to this objective.

It is to be found in Article 127 on the European System of Central Banks, in Article 282 (on the ECB) and in Protocol No.4 on the Statute of the ESCB and ECB, as well as in numerous other places, such as Article 119 (see above).

The fullest version of the mandate in the Treaty is set out in Article 127.1, which is followed by 127.2 which defines the "basic tasks" of the ESCB.

The mandate is based on the theory, which has not proven correct in practice, that a focus on inflation alone is liable to give better economic results. In fact, since the single currency was created, and especially since the global financial crisis, other "advanced economy" states whose central banks have broader mandates have had on average better economic results than the Eurozone, as measured by annual increases in GDP and unemployment.

The US Federal Reserve, as is well known, has a broader mandate — it is in fact a triple mandate, not just a dual one. The 1977 Federal Reserve Act states that the Fed should

> "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."

The Bank of Canada has an even broader mandate, set out in the Preamble to the Bank of Canada Act 1985:

> "...to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada".

In practice Governor Draghi of the ECB has acted in a way that, though arguably lawful, has in reality aimed at achieving broader economic goals than "price stability" through QE. What is also extraordinary is that the ECB is permitted to define for itself what it deems to be price stability — close to but below 2%.

The narrow mandate of the ECB is in effect a left-over from a bygone age when the mythology of the wholly unaccountable (i.e. independent) central bank, with a single goal of price stability, was at its fashionable but misguided peak. Harold James puts it well in his 2012 history of the ECB:

> "The intellectual shift toward central bank independence, which characterised the late twentieth century, and which brought a considerable degree of price stability, was possible only on the assumption that there was a clear rule or principle that the central bank should follow. When that rule or principle became muddied, and discretion in policy-making returned in the aftermath of the financial crisis, the case for central bank independence began to look more problematic... The new post-crisis vision of the central bank is often of a very different sort of institution from the 1990s vision of a mechanism for guaranteeing price stability."

Here then is what **Article 127** provides now (in paragraphs 1 and 2), followed by our proposals to broaden both the mandate (to include balanced growth, full employment and reasonable price stability), and also the tasks - by adding financial stability, and if required, as "lender of last resort." We also add, for avoidance of doubt, the power to purchase government bonds on the secondary market (i.e. not directly from governments) in order to further its objectives and perform its tasks.

We should note, too that currently, the definition of "price stability" is left to the ECB itself to determine — and it has set itself the inflation target of "close to but below 2%", which is lower than the target set by the US Federal Reserve or by the UK government for the Bank of England, which is 2%. We have not at this stage made an explicit proposal on which body should define the meaning in the context of the Eurozone, but we propose below (Article 130) that the European Commission give guidance to the ECB on the definition of the main economic policies of the Union, as from time to time determined by the Parliament and Council, which would probably cover the inflation rate 'target'.

Existing text

1. The primary objective of the European System of Central Banks, hereinafter referred to as "ESCB", shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119.

2. The basic tasks to be carried out through the ESCB shall be:

- to define and implement the monetary policy of the Union,
- to conduct foreign-exchange operations consistent with the provisions of Article 219;
- to hold and manage the official foreign reserves of the Member States,
- to promote the smooth operation of payment system

Proposed change

1. **In relation to monetary policy,** the primary **objectives** of the European System of Central Banks, hereinafter referred to as "ESCB", shall be to **promote balanced economic growth and full employment, and to** maintain **reasonable** price stability. Without prejudice to these objectives, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.

2. The basic tasks to be carried out through the ESCB shall be:

- to define and implement the monetary policy of the Union,
- to conduct foreign-exchange operations consistent with the provisions of Article 219;
- to hold and manage the official foreign reserves of the Member States,
- to promote the smooth operation of payment system
- **to enhance and contribute to the protection of the stability of the financial system**
- **in the event of severe financial or economic crisis, to act if required as "lender of last resort**

In order to further the achievement of its objectives and perform its above tasks, the ESCB may inter alia purchase and sell government bonds of member states on the secondary market.

Article 282 makes a similar but shorter provision as to the mandate ("primary objective"), and we have made a similar amendment, which can be seen in the full amendments working paper.

Protocol No. 4 on the Statute of the ESCB and ECB, in its own Articles 2 and 3, almost replicates the terms of Article 127.1 and 2, and we have drafted almost identical amendments (on both mandate and tasks) to those set out above, also available in our amendments working paper.

Article 219 provides for the possibility of international agreements on an exchange rate system for the euro in relation to the currencies of third states. Such agreements are limited to meeting the objective of price stability. We consider that the purpose of such agreements could or should be broader, and therefore propose amendments to state that the purpose is to reach a consensus **"consistent with the Union's economic and monetary objectives".**

(b) A Statute for the ECB which may be democratically amended

The existing Statute of the ESCB and ECB, in Protocol no.4, can under **Article 129** be amended in many respects by EU legislation. We have extended this power to cover all aspects of the Statute, save for any matters in the Treaties themselves, which of course cannot be contradicted by legislation. This also involves repealing **Article 40 of the Statute**, which replicates Article 129.

Article 10 of the present Statute provides that the membership of the Governing Council of the ECB shall comprise "the members of the Executive Board of the ECB and the governors of the national central banks of the Member States whose currency is the euro." The Executive Board consists **(Article 11)** of the President, the Vice-President and four other members who are "appointed by the European Council…from among persons of recognised standing and professional experience in monetary or banking matters…".

This provides an extraordinarily narrow social and professional base of experience for the Governing Council, unlike the statutes of many other central banks which require non-banking representatives to be included. We propose that the Parliament and Council have the power to appoint a number of other representatives from the social partners and civil society to the membership of the Governing Council. This will require an amendment to **Article 283** TFEU as well as to the Statute of the ESCB and ECB.

(c) Ensuring the operational independence and reporting accountability of the ECB

The Treaty provides for an extraordinary degree of independence, or if you will, lack of accountability, in relation to the ECB and the ESCB. In the case of most central banks, there is a form of accountability built in, and most are ultimately subject to political direction, at least in a severe emergency. Once again, the Treaty provision reflects the ideology of the period in the late 1980s and early 1990s when total independence of the central bank was seen as a desirable matter.

We prefer to see the independence in terms of operational independence — the members of the ECB (and other central banks) should be free from interference in the way they carry out their tasks, but should have to report more regularly to the European Parliament (twice a year instead of once) not only on their conduct of monetary policy, but on the economic developments and prospects for the future. Here is the existing **Article 130**, together with our proposed changes

Existing text

> When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.

Proposed change

> **1.** When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, **the European Central Bank, and the national central banks, shall have full operational independence. [Delete remaining text]**
>
> **2. The Commission shall inform the ECB and the national central banks of the general economic policies in the Union, as determined by the Parliament and Council, which are of principal importance to enable the ECB to contribute to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union, and shall update this information as required.**
>
> **3. The European Central Bank shall report twice yearly on the activities of the ESCB, including an annual report, on the conduct of monetary policy and on economic developments and prospects for the future, to the European Parliament, the Council and the Commission, and also to the European Council. The President of the European Central Bank shall present these reports to the Council and to the European Parliament, which shall hold a general debate on that basis. The President of the European Central Bank and the other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent committees of the European Parliament. The ECB shall publish the minutes of its governing council meetings in relation to monetary policy as soon as reasonably practicable after each session.**

Article 284.3 (which presently provides for an annual report) should be amended to be in like form. We believe it is appropriate to locate operational independence and the reporting accountability in the same Article.

Protocol No. 4 on the Statute of the ESCB and ECB again almost duplicate Article 130 (in its Article 7), and we have accordingly proposed an amendment in similar terms to that to Article 130.

(d) European Central Bank — ending the constitutional prohibition on credit facilities

Article 123 TFEU places an absolute prohibition on the provision of "overdraft facilities or any other type of credit facility" with the ECB or with a national central bank on the part of any governmental or public body. In other words, the ECB may not lend to any governmental body, for any purpose at any time. We do not see the need for such a restrictive provision, in particular not in a constitutional document. Central banks in mature economies do not normally lend to governments as a matter of routine course, but central banks need to be able to react flexibly in particular in difficult times, and an absolute bar of this kind is not required. In any event, we underline that — so far as we are aware — no national State constitution includes this kind of provision or detail.

We propose that **Article 123 be deleted.** While central banks do not normally extend credit to governments, there is absolutely no reason why this provision should appear in a constitution (it is not, for example, in Article 88 of the German Basic Law which provides for the establishment of the Bundesbank), and in particular cases, there may be good reason for providing a credit facility.

The terms of Article 123 are replicated almost exactly in Article 21.1 of the Protocol no.4 on the Statute of the ESCB and ECB. For the same reason, we propose that **Article 21.1 of the Protocol be deleted.**

(e) Reforming the alleged 'no bail-out' Article

We have grouped Article 125 under the set of issues relating to the ECB, as that has been its main focus in recent years. In June 2015, the ECJ upheld the legality of the ECB's proposed "Open Market Transactions" (OMT) policy under which it proposed to purchase government bonds on the secondary market as part of its monetary policy (in effect, but not in law, a plan to stabilise the euro). One of the main arguments by the challengers to the policy was that this would breach Article 125, by providing in effect a form of monetary financing of member states.

But the wording of Article 125 is broader in that it does not refer specifically to the ECB, but to the "Union" as a whole. The debate around Article 125 in recent years has been curious — most people seem to see it as intending to be a "no bail-out" clause, whereas in reality what it says is that neither the EU nor Member States shall be liable for or assume the commitments of another Member State. This does not preclude (but nor does it authorise) the provision of financial assistance that does not take the form of assuming another's liabilities.

We firmly believe that if the Union is to survive, it needs to be constructed more in a spirit of solidarity than in perpetual punishment of those who are deemed to have gone wrong. Therefore, there should be the possibility in some instances of financial burden-sharing, including via the ECB if that is required to meet its objectives. We also cannot see why one Member State should not be able to support another if it so chooses. Therefore, here is the existing text of Article 125.1, and our proposed amendment.

Existing text

1. The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

Proposed text

Subject to the provision of financial assistance under Article 122[12], which may if appropriate involve financial burden-sharing (in such form as may be decided having regard to the circumstances) by the Union and by Member States, and to any measures taken by the European Central Bank in fulfilment of its tasks under the Treaties:

a. the Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project, **and**

b. a Member State shall not, **without its express agreement**, be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

[12] In our working paper we suggest an amendment to Article 122.2 which would make explicit the legal base used initially to support Greece in 2010: "2. Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, **or is confronted with a severe economic or financial crisis,** the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken."

Issue 4: Ensuring that trade is beneficial

For a long time, there had been a consensus among neoclassical economists that increasing trade was always beneficial, whatever it consisted of, and whatever the short-term consequences, based on the theory (which has major weaknesses) of "comparative advantage". This consensus has now broken down, and recent events (the UK Referendum, the election of Donald Trump etc.) — as well as the strong opposition in Europe to new trade agreements that appear to benefit multinational corporations more than citizens — are leading to a major reappraisal.

Of course, since the dawn of time, humans have traded with each other, and will continue to do so. Much trade is of undoubted and enormous benefit to society. But the EU's Treaties were drafted to embed an apparent commitment to do away with all restrictions on trade. This approach is now clearly unsustainable.

Leaving aside all more radical critiques of "comparative advantage", as well as the damage to climate and the environment that flow from the endless shipping of parts of products around the globe, we now see many more orthodox economists questioning the traditional view. Dani Rodrik points out that economists have long under-played the downside of free trade (see e.g. his recent **"Straight Talk on Trade"** in Project Syndicate).

In the IMF's December 2016 edition of **Finance and Development**, Paul Krugman also argues that there is little advantage in promoting further free trade for its own sake:

> "The crucial point… is that there has always been significant dissonance between the rhetorical commitment of economists and elites to free trade and the message that actually emerges from economic models. Yes, textbook trade theory says that international trade makes countries richer, while restricting it makes them poorer. But it also suggests both that there are relatively limited costs from anything short of extreme protectionism and that trade can have strong effects on income distribution within nations, creating losers as well as winners…. Trade is already remarkably free by historical standards, and proposed new agreements like TPP are more about intellectual property and dispute settlement than trade per se."

Returning to the EU's Treaties, our aim is simply to change present wording that implies that any restrictions on trade should be abolished, and to insert a requirement that trade should be beneficial and/or justified.

Thus in **Article 21** of the TEU (foreign and security policy), the present text states:

> **2.** The Union shall define and pursue common policies and actions, and shall work for a high degree of cooperation in all fields of international relations, in order to:
> …
>
> **d.** foster the sustainable economic, social and environmental development of developing countries, with the primary aim of eradicating poverty;

> **e.** encourage the integration of all countries into the world economy, including through the progressive abolition of restrictions on international trade;

...

Proposed change

> **e.** encourage the integration of all countries into the world economy, including through the progressive abolition of **unjustified** restrictions on international trade;

Similarly, in the **Preamble to the TFEU**, one of the recitals refers to the need for concerted action to guarantee "balanced trade and fair competition" — balanced trade (if this means no excessive trade surpluses or deficits) seems to be a positive aim, but only deals with one side of the issue. And another recital states:

> DESIRING to contribute, by means of a common commercial policy, to the progressive abolition of restrictions on international trade,

Proposed changes

> RECOGNISING that the removal of existing obstacles calls for concerted action in order to guarantee steady expansion, **beneficial and** balanced trade and fair competition,
>
> DESIRING to contribute, by means of a common commercial policy, to the progressive abolition of **unjustified** restrictions on international trade, **while maintaining environmental, social and health-related standards**

Under the chapter of the TFEU on the Customs Union, **Article 32**, we find another similar provision, expressed as an unqualified duty to promote trade:

Existing text

> In carrying out the tasks entrusted to it under this chapter the Commission shall be guided by:
>
> **a.** the need to promote trade between Member States and third countries; ...

Proposed changes

> In carrying out the tasks entrusted to it under this chapter the Commission shall be guided by:
>
> **a.** the need to promote trade, **where this is beneficial,** between Member States and third countries, **while ensuring that environmental, social and health-related standards are maintained;**

While dealing with **Article 32**, we also note that it includes a duty ensure "an expansion of consumption within the Union." We argue that the EU should not support an expansion of all forms of consumption:

> **d.** the need to avoid serious disturbances in the economies of Member States and to ensure rational **and beneficial** development of production and **[delete "an expansion of"] sustainable** consumption within the Union.

Issue 5: Managing capital mobility

(a) Power to control mobility with third countries

The Treaties include a progressive requirement to remove restrictions on the free movement of capital (with a few limitations) within the single market, and we have not sought to change this, since it is a fairly natural consequence of the concept of a single market.

However, since the original Treaty of Rome, the Treaties also include a duty, which is expressed in almost absolute terms, to guarantee the total free movement of capital between EU Member States and third countries. This is another area where traditional liberal or neoclassical theory — which was never universally agreed among economists — has been taken into the EU Treaties, but where reality in the form of (for example) the Asian crisis of the late 1990s and the great financial crisis of 2007-09 has demonstrated that absolute free capital mobility can be extremely destabilising and damaging to economies. The IMF has started to rethink its position; see for example the 2015 Working Paper by Anton Korinek and Damiano Sandri, "Capital Controls or Macroprudential Regulation?" [13]

We consider that whilst some forms of capital mobility for longer-term productive investment can have a positive impact, the power to manage capital flows is an essential part of sovereignty and protection of society. Sudden movements of short term capital, in particular, can be extremely damaging, and much mobility is solely for speculative purposes devoid of social benefit. We therefore propose that the prohibition on the movement of capital between Member States and third countries should be removed from the Treaty. We know of no national constitution which contains such a clause.

Article 63

Existing text

> **1.** Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

[13] See also the article **"Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence"** by Hélène Rey, 2013.

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

Proposed changes

1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States shall be prohibited **[delete rest of sentence].**

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States shall be prohibited **[delete rest of sentence].**

Article 64 goes on to allow the Parliament and Council to legislate for certain limited constraints on the free movement of capital with third countries, but within the objective of freeing capital mobility "to the greatest extent possible". We propose to amend this, in particular to remove this objective. The detailed amendment is in our amendments working paper.

(b) Capital mobility — intra-EU capital movement, including power to take emergency safeguard action

Article 66 TFEU provides a limited power for the Council to take safeguard measures for up to 6 months where "in exceptional circumstances, movements of capital to or from third countries cause or threaten to cause serious difficulties for the operation of economic and monetary union". We consider this too limited. We also consider that there should be a power for the Council to take safeguard action (without fixed time limit) if the movement of capital from whatever source — i.e. including movement to or from other states within the Union — is causing serious difficulties for economic and monetary union, or for the economy of a Member State. Finally, we propose that a Member State itself should be able to take safeguard action for a limited period (we propose 3 months), and to report and refer the issue to the Council. The detailed amendments are available in our amendments working paper.

There is an important debate to be had over the means to protect member states in particular within the Eurozone from the negative effects of speculative and/or imbalanced capital flows (See e.g. Heine and Sablowski 2016[14] and Lane 2013[15]). The logic of an internal market is to permit capital movements within its area, but the experience of the global and Eurozone financial crises has clearly demonstrated the need for some means to regulate capital flows in a context of unbalanced economic development between member states. We would wish to consult further over the means best adapted to safeguard economic progress and stability, with a view to deciding whether Treaty changes are required in relation to intra-EU or intra-eurozone capital flows. The current EU macroeconomic imbalance procedure (MIP), which covers excessive current account surpluses as well as deficits, has its legal base in Article 121 and 136 at present; but unlike the Treaty provisions for excessive debt and deficits (Article 126), there is no "punishment" regime.

[14] Frederic Heine & Thomas Sablowski, "Monetary Union Unravelling?", Rosa Luxemburg Foundation, 2016

[15] Philip Lane, "Capital Flows in the Euro Area", European Commission, 2013

Issue 6: Rebalancing the over-emphasis on liberalisation of services

The Treaties refer to liberalisation of services in several places, but do not define the term, which in our view leads to confusion. Within the concept of a single market, it is natural that there should be a process of "liberalisation" in the sense of the removal of artificial or unjustifiable limitations on the rights of people or companies to provide a service. On the other hand, we would argue that there cannot be an absolute freedom to provide services, without regard to genuine public interest concerns and regulation. The fact that this is ideological territory is evidenced for us by the fact that, in the French version of the Treaty, the term used is not "libéralisation" but "libération"!

There is of course another meaning of liberalisation, meaning in effect the ending of what are seen as monopolies, leading to the privatisation of what were state managed or owned undertakings, notably in the network industries. It is often argued that the EU is neutral in terms of public or private ownership of such undertakings, relying on Article 345 TFEU:

> The Treaties shall in no way prejudice the rules in Member States governing the system of property ownership.

However, the reality of the current provisions is that any reversal of ownership is exceptionally difficult, and e.g. in dealing with public transport undertakings, may not be possible (the language is exceptionally opaque). There is a need for a broader debate on the EU and liberalisation, but in this paper we do not yet propose any radical change. For present purposes, we propose simply to reverse the assumption that all liberalisation is necessarily positive in all respects, and to return some power to the Union and Member States to regulate in the public interest.

(a) Liberalisation of banking and financial services — general interest limitation

Article 58.2 links the "liberalisation" of banking and insurance to the liberalisation of movements of capital. This covers capital mobility within the Union (i.e. the single market) and with third countries. Since in the last section we propose to separate these issues, given that it is essential to manage capital flows in the general interest, the current text need also to be qualified. We propose to add a sentence that

> **This shall be without prejudice to all such restrictions on and regulation in respect of such liberalisation as are required in the general interest.**

(b) Liberalisation of services — adding some Member State discretion

Article 59 provides the legislative means to achieve the liberalisation of a service, with priority to services which directly affect production costs or where liberalisation helps to promote trade in goods. **Article 60** requires Member States to endeavour to go further in liberalising services than required by the directives, if their economic situation permits, and requires the Commission to make recommendations. This goes well beyond what a constitutional text should require. It should be for the Member States to decide.

We propose to restore much more discretion to both the Parliament and to the Member States in this field. We have also drafted an amendment to Article 59 to clarify that it does not impose an obligation to liberalise. We propose to delete Article 60, since there is no sound reason for a constitutional text to impose in effect a duty to liberalise. Alternatively, we propose an amendment to Article 60 which permits the amendment, qualification or reversal of a liberalisation if the disadvantages prove to outweigh the benefits.

Existing text

Article 59

1. In order to achieve the liberalisation of a specific service, the European Parliament and the Council, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, shall issue directives.

2. As regards the directives referred to in paragraph 1, priority shall as a general rule be given to those services which directly affect production costs or the liberalisation of which helps to promote trade in goods.

Article 60

The Member States shall endeavour to undertake the liberalisation of services beyond the extent required by the directives issued pursuant to Article 59(1), if their general economic situation and the situation of the economic sector concerned so permit. To this end, the Commission shall make recommendations to the Member States concerned.

Proposed changes

Article 59

1. **If it is considered that the liberalisation (in whole or in part) of a specific service would be beneficial to the general interest,** the European Parliament and the Council, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, **may** issue directives.

2. **[Delete all]**

Article 60

Option I

[Delete the Article]

Option II

1. The Member States **may, if deemed beneficial by them,** endeavour to undertake the liberalisation of services beyond the extent required by the directives issued pursuant to Article 59(1), if their general economic **and social** situation and the situation of the economic sector concerned permit. **[Final sentence deleted]**

2. If it appears subsequently that the liberalisation of a service has led to serious disadvantages that can be mitigated, or that outweigh the benefits of such liberalisation, the European Parliament and the Council, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, may issue directives in order to amend, qualify, or reverse, in whole or in part, the liberalisation of that service.

Issue 7: Restoring some "State Aid" discretion to Member States

The EU has a unique system of controlling — and generally prohibiting — state aid, meaning any form of subsidy or financial assistance (direct or indirect) to undertakings, whether in the public or private sector. The gaping hole in the present system is that states remain able to offer enticements through undercutting other states on corporate profit tax rates, which we return to below.

The state aid policy is seen as a key part of the EU's own model of a competitive economy, and this fits in with the general lines of ordoliberal philosophy, but we should note that it is in no way an essential feature of a capitalist society. The United States, for example, does not have a federal state aid policy, and both states and municipalities frequently offer tax or other financial advantages to attract inward investment.

A system of state aid potentially has advantages. It can reduce the chances of corporations benefiting from a competitive race between governments for inward investment, for example, though the use of ever-lower corporate tax rates partly negates this perceived advantage. For present purposes, we have not sought to propose the more radical option of abolition of the whole state aid structure in the Treaties, but to restore some discretion and power to Member States — independent of the European Commission's permission — to provide some support to regions or industries in difficult economic circumstances. We propose however that such support should be time-limited to (for example) 5 years, after which it could only continue if part of an EU-permitted scheme.

Our proposal is not in principle new, but builds on an existing exemption. To recall, the Treaties provide (a) for state aid that is automatically permitted, and (b) for aid that must be approved by the Commission. Most aid today falls under the second head, and we do not propose any changes to the latter in this study. However, under the current Treaty, Article 107 TFEU, the aids deemed automatically compatible with the internal market include all aid provided by the Federal Republic of Germany to the economy of areas affected by the division of Germany to compensate for that division. No time limit is imposed by the Treaty, and there is no need to obtain the Commission's permission. The exemption was of course both understandable and realistic; but Germany was not and will not be the only Member State with deep economic disadvantages in parts of its territory.

We consider that the logic of this exemption can and should be available to other Member States parts of whose economies are adversely affected by the impact of globalisation, and our proposed change, based on the Germany exception, is set out below. In our view, such a provision will strengthen the EU itself, by making citizens feel that their governments have a degree of local discretion, and that the balance between the European and other levels is better provided for. This would be an example of the principle of subsidiarity at work. The national discretion would be limited to 5 years (the exact limit is open for debate and could be longer), unlike the German exemption which was not time-limited.

We have not at this stage gone further in our draft amendments, for example to permit state aid for the purpose of development of a nascent industry which might be of strategic importance. We would prefer at this stage to consult more widely on the issues.

Article 107

Existing text

1. Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

2. The following shall be compatible with the internal market:

a. aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;

b. aid to make good the damage caused by natural disasters or exceptional occurrences;

c. aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division. Five years after the entry into force of the Treaty of Lisbon, the Council, acting on a proposal from the Commission, may adopt a decision repealing this point.

Proposed change

2. The following shall be compatible with the internal market:

a. aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;

b. aid to make good the damage caused by natural disasters or exceptional occurrences;

c. aid granted to the economy of certain areas of a **Member State**, in so far as such aid is required in order to compensate for **severe economic disadvantages or impacts caused by industrial, sectoral or other major structural change or by sharp economic fluctuations or disturbances (including those resulting from any impact of trade with third countries). Any aid under this paragraph must be proportionate to the economic disadvantages or impacts confronted, and may not continue for more than [five] years.**

Issue 8: Harmonising corporate profits taxation, and action against tax havens, base erosion and profit shifting

As stated above, the existing state aid scheme has a gaping hole in it, since a Member State such as Ireland is presently allowed to engage in a race to the bottom when it comes to corporate taxation. This has a knock-on effect, of course, in putting pressure on other Member States to lower their rates. The whole game mainly serves to benefit large multinational corporations who can play states off against each other. It is hard to see the logic of a system that bans one type of subsidy, but allows or encourages another (via the tax system). This downward pressure on corporate taxation is of course exacerbated by the wider recourse for tax avoidance or evasion to tax havens, a process called (e.g. by the OECD) "base erosion and profit shifting".

We recognize that tackling the latter is complex, but for present purposes have drafted two indicative amendments to the Treaties, which would add new Articles 113A and 113B to the TFEU. The first would provide for the harmonisation of legislation for the minimum tax rates on corporate profits — this could involve a full harmonisation at a given EU rate, or at least require legislation to set a minimum rate to prevent the infra-EU tax competition hurtling further towards zero. The second proposed addition requires EU legislation to tackle the issues of use of tax havens to reduce tax payments otherwise duly payable in a Member State, and to generally to coordinate and strengthen action against tax base erosion.

Proposed change

Add new Articles 113A and 113B:

Article 113A

In order to further the Union's objectives, to avoid distortion of competition, and for the purpose of ensuring the more effective functioning of the internal market, the European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning the minimum rates of tax upon corporate profits to be applied by each Member State.

Article 113B

The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt provisions, including as appropriate for the harmonisation of legislation,

a. **to regulate or prevent recourse to the use of tax havens (as defined in those provisions) by corporations or undertakings established or trading in the Union to artificially reduce the amount of taxation otherwise duly payable within one or more Member States; and**

b. **to coordinate and strengthen action to counter tax base erosion and profit shifting.**

Consequential amendments (including to **Article 114.2**) will also be needed.

Issue 9: Strengthening industrial and investment policies

(a) Promoting a stronger industrial policy

The present Treaty has just a single article dealing with "industry" (Article 173), and this is in our view offers an inadequate and again economically narrow framework; it certainly falls far short of setting either an industrial policy or strategy. But without trying to rewrite this part of the Treaty more radically, we propose some amendments to broaden the approach and (e.g.) focus more on the workforce and on helping to develop the new 'green' technologies that contribute to the transition to a non-fossil fuel intensive European economy. A focus on 'competitiveness' alone offers only a very partial approach to the need to ensure that Europe maintains and develops a strong industrial foundation.

Existing text

1. The Union and the Member States shall ensure that the conditions necessary for the competitiveness of the Union's industry exist.

For that purpose, in accordance with a system of open and competitive markets, their action shall be aimed at:

– speeding up the adjustment of industry to structural changes,
– encouraging an environment favourable to initiative and to the development of undertakings throughout the Union, particularly small and medium-sized undertakings,
– encouraging an environment favourable to cooperation between undertakings,
– fostering better exploitation of the industrial potential of policies of innovation, research and technological development.

...

Proposed amendment

1. The Union and the Member States **recognize that a strong industrial base is an essential foundation for a prosperous European society and economy.** They shall ensure that the conditions necessary for the **sustainable success and** competitiveness of the Union's industry exist.

For that purpose, **[...]** their action shall be aimed at:

– **helping** the adjustment of industry to structural changes,
– encouraging an environment favourable to initiative and to the development of undertakings throughout the Union, particularly small and medium-sized undertakings,
– encouraging an environment favourable to cooperation between undertakings,
– fostering better exploitation of the industrial potential of policies of innovation, research and technological development,
– **developing the skills and capacities of the present and potential industrial workforce**
– **encouraging the development and implementation of 'green' technologies that contribute to the transition to a non-fossil fuel intensive European economy**
– **promoting the productivity of Europe's industry.**

(b) Strengthening investment via the European Investment Bank

The European Investment Bank plays a significant but not sufficient role in helping to ensure that capital investment in Europe's economy and industry is sufficient to meet its objectives. Once again, the Treaty's definition of its role and mandate is limited by an economic dogma that excludes recognition of the potential need to enhance aggregate demand, using investment as a main vehicle. The role of public investment should in particular come into play when the private sector's investment is insufficient.

The EIB's "task", in **Article 309**, is wrongly framed. It is "to contribute to the balanced and steady development of the internal market in the interest of the Union". Yet as we have said before, the internal market is a means to an end, not the end in itself. The task of the EIB should surely be to contribute to the socio-economic policies and objectives of the Union, which of course include the internal market. This too-limited "task" is reflected in too-limited definitions of the kinds of projects the Bank may support.

Existing text

The task of the European Investment Bank shall be to contribute, by having recourse to the capital market and utilising its own resources, to the balanced and steady development of the internal market in the interest of the Union. For this purpose the Bank shall, operating on a non-profit-making basis, grant loans and give guarantees which facilitate the financing of the following projects in all sectors of the economy:

a. projects for developing less-developed regions;

b. projects for modernising or converting undertakings or for developing fresh activities called for by the establishment or functioning of the internal market, where these projects are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States;

c. projects of common interest to several Member States which are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States.

...

Proposed change

The task of the European Investment Bank shall be to contribute, by having recourse to the capital market and utilising its own resources, to **the achievement of the socio-economic objectives and policies of the Union, including** the internal market [...] For this purpose the Bank shall, operating on a non-profit-making basis, grant loans and give guarantees which facilitate the financing of the following projects in all sectors of the economy:

a. projects for developing less-developed regions;

b. projects for modernising or converting undertakings or for developing fresh activities called for **in the interests of the Union's economy [...]**, where these projects are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States;

c. projects of common interest to several Member States which are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States.

d. investment projects that are in the interests of the economy of the Union, or of one or more of its Member States, in particular in case of significant unemployment and/or when the level of private investment is less than is desirable in the general interest;

e. projects involving investment in innovative technologies, including those aimed at contributing to the transition to a non-fossil fuel intensive European economy

...

A similar amendment is proposed in relation to **Protocol No.5** on the European Investment Bank; **Article 18** lays down the principles of its financing operations — we propose that the principle of promotion of the attainment of the internal market should be changed to **the achievement of the economic objectives and policies of the Union, including the internal market.**

(c) Promoting Trans-European Networks

The trans-European networks in the areas of transport, telecommunications and energy infrastructures are an important part of our overall European economic including industrial framework, and under **Article 170**, the Union is required to contribute to their establishment and development. True to the Treaties' excess of ordoliberal economic ideology, this contribution is required in **170.2** to be made **"within the framework of a system of open and competitive markets"**, which in this context is quite inappropriate — in the sense that the task may best be carried out by the state itself, at whatever level, or via the private sector through open markets. The phrase should be deleted.

Proposed change

> **2.** **[delete the initial "within the framework" phrase]** Action by the Union shall aim at promoting the interconnection and interoperability of national networks as well as access to such networks. It shall take account in particular of the need to link island, landlocked and peripheral regions with the central regions of the Union.

Issue 10: Protecting and strengthening public services

(a) Ensuring that non-commercial public services are outside the Treaties' scope

The position of public services under the Treaties and indeed under European law generally is another hotly debated area. The EU legal and jurisprudential framework for public services is a conceptual mess, which flows from a profound bias in economic perspective. In effect, the European Commission (and others) often view the existence of ordinary public services as flowing from "market failure" rather than as an essential component of a democratic society in their own right. With more and more contracting out, or full privatisation, of public services, there is often increasing uncertainty as to which services are to be considered as "market services", therefore covered by competition and internal market rules, and which are to be considered as "non-market" services.

The Treaties do not mention *public* services; the only reference (and this is minimal) is to "services of general economic interest" (SGEIs), which initially mainly referred to the big privatised network industries on which public service obligations (PSOs) are imposed. However, the EU institutions increasingly use the generic term "Services of General Interest" to cover public services as well as these private sector bodies with PSOs. The dividing line between SGEIs and so-called non-economic (public) services is extremely unclear, with the jurisprudence failing to provide clarity. In essence, if a public service is an SGEI, it is subject to the Treaties' internal market and competition rules. If it is deemed to be a non-economic (which broadly means non-commercial or non-market) Service of General Interest (SGI), it is not.

Most state-owned (or controlled) enterprises — e.g. water management services would be seen as SGEIs, while social security is seen as a non-economic service. Compulsory public education services have thus far been generally treated by the courts as not being "economic" in character (therefore so far not SGEIs, but the courts could change their approach), but the legal treatment of health services is more complex. To protect public services further, public procurement laws will also need to be changed, but this is a matter of legislation not of Treaty provisions.

Leading academic writers in the field are highly critical of the current legal position for public services which has been described by one as "a conceptual disaster" [16] , while another refers to "a hollowing out of public services and of the welfare state itself due to unrestricted liberalization by means of negative integration by directly effective EU law". [17]

If a public service enterprise is in operating in a market on a competitive basis, then it is fair to require it to operate on equal terms with other market operators. But with non-commercial, not-for-profit services, such as public health services, social services, educational services, environmental public services etc., we believe their activities must fall completely outside the Treaties' scope, and left to Member States to look after. This needs however to be given explicit recognition in the Treaty, and we have drafted a new Article 106A to reflect this, which gives Member States the right to define which services are SGEIs, and thus fall within the Treaties' scope, and which are non-commercial public services which we here call "Services of General Interest of a non-commercial or non-economic character". This also avoids the legal complexity (from EU case law) of whether the public funding of such services is state aid.

Proposed change

Add new Article 106A:

Services of General Interest and public services

1. A Member State may define, at the relevant level, which public services provided or wholly or mainly financed by it are to be considered as (a) Services of General Interest of a non-commercial or non-economic character, or (b) Services of General Economic Interest. Such decision shall not be open to legal challenge except in case of manifest error, with the burden of proof of such error falling on the complainant. The fact that there are or may be market-based providers of services of the same or similar character as those involved in a Service of General Interest shall not affect the issue of such definition.

2. Services of General Interest of a non-commercial or non-economic character designated under 1(a) above, including local and regional public services, and in particular those having a social, health-related, educational, cultural or

[16] Ulla Neergaard, co-editor of "The Changing Legal Framework for Services of General Economic Interest", TMC Asser Press, 2009, p.49

[17] Professor Wolf Sauter, "Public Services in EU Law", Cambridge University Press, 2015, p.77

> **environmental purpose, shall not be considered as Services of General Economic Interest, nor subject to any provisions of this Treaty relating to competition, state aid or the internal market.**

A few consequential changes will be required, in particular to Article 14 — which provides a general duty in relation to SGEIs, and to Article 106, which also relates to SGEIs, in order to make both subject to the Article 106A.

(b) Ensuring that publicly-owned public transport is a legitimate democratic choice

There is a separate part of the TFEU providing for a common transport policy. These provisions give rise to some uncertainty as to whether Member States may decide that types of public transport should be operated within its territory by its publicly-owned transport undertakings. We consider that the choice of provider of such services is a basic democratic one, and that the Treaties should clearly affirm the neutrality of the EU as to the nature of the provider. We propose a short addition to Article 90 to make this clear, and also reflecting the subsidiarity principle at work.

Proposed change

> The objectives of the Treaties shall, in matters governed by this Title, be pursued within the framework of a common transport policy. **The provisions of the common transport policy shall in no respect preclude or impede a Member State, at the relevant level, from freely choosing to operate public transport services within its territory via its publicly-owned transport undertakings, nor shall Articles 18 or 106 be construed so as to preclude or impede such choice of means of operation.**

PART III — THE CASE FOR CHANGE: REDUCING BIAS IN ECONOMIC POLICIES

1. Democracy, accountability and flexibility

National governments largely determine the economic policies affecting citizens of the European Union. Especially for members of the euro zone, treaty-based conditions constrain these policies. These constraints have two problematical aspects. These are their relationship to the democratic principles professed in the Union's founding values, and their appropriateness.

Prior to discussing the latter it is necessary to consider the former. With few exceptions, national economic policy making rises from representative democracy; i.e. through debate and voting in legislative bodies. The basis of the EU level constraints on policy is not representative democracy, but a restricted form of "democratic accountability" based on post-decision reporting. No representative democratic institution approves the specific application by the EU executive of the rules in the Treaty on Coordination, Stability and Governance (for example).

EU treaties do not require the European Commission to seek approval of the European Parliament before it initiates a "macroeconomic imbalance procedure" for a country (Juncker et al., 2014, 8). The Commission is required by treaty to report to the European Parliament on all its activities. In this specific sense, EU level policy making is "accountable". Because the form of accountability involves an elected body, the adjective "democratic" can be used.

We stress the difference between representative democracy and post-decision reporting "accountability" in EU processes. The first involves a clear division between democratic policy making and implementation of policy by the executive. In the case of the latter, the executive takes on both discretionary policy making and policy execution, with the legislative body left to the role of judging executive action, after the event, as appropriate or inappropriate. In practice a negative assessment of executive action is functionally equivalent to censuring the Commission, and in any event the Parliament too is bound by the Treaties' rules. It comes as no surprise that cases of the EU Parliament disapproving Commission actions is rare.

In practice expanding the decisions subject to ex post reporting rather than to national or EU legislatures brings a reduction in democratic governance. Should the recommendations of the **"Five Presidents' Report"** be implemented, this limited form of "accountability" would further displace representative democracy[18]. Such a shift makes assessment of the rules of economic governance all the more important.

The nature of the rules on economic policy in the EU treaties makes the change in economic governance problematical. As explained earlier in this report, treaties combine to be de facto the EU constitution with the specific characteristic that for national governments they are legally binding and cannot be altered by national legislatures. Unlike many if not most constitutions, the

[18] Of especial importance is the report's recommendation for enhancing the role of the group of euro zone finance ministers, "eurogroup" (Juncker, et. al. 2014, 14). Elected governments appoint these ministers, but they do not constitute a directly elected group.

EU treaties compel member governments to adhere to specific conditions. The fiscal rules discussed below provide obvious examples, treaty based numerical targets. Another example is the prohibition against subsidies (state aid).

Placing detailed rules in a constitutional document is unwise for at least three reasons. First, the rules may be incorrectly specified, containing technical errors that require changes for logical and internal consistency. As explained below, the fiscal rules and inflation guideline incorporate technical measurement errors. Simple wording changes would eliminate these errors, but any such change now requires approval by every government that is a party to a treaty.

Second, some rules may be appropriate for some economic conditions but not others. If the wording of treaties does not allow for changes in economic conditions they can be dysfunctional. However, attempting to specify the conditions when a rule such as deficit limits applies risks making treaties unmanageably complex.

Third, assigning the implementation of detailed rules to a non-elected institution such as the European Commission exacerbates the problems of the misspecification of rules. Assigning decision-making responsibility for implementation to the European Parliament would result in public debate. Granting the Commission that role makes the process non-transparent.

2. Guidelines for Sound Economic Management

Economic policy explicitly or implicitly derives from an underlying analytical framework. As shown in our detailed analysis of the treaty documents, the economic rules and constraints quite explicitly specify their underlying framework. The EU treaties presume that market economies have an inherent tendency to adjust automatically to full utilization of resources. Within that framework the implicit policy objective is an export surplus for all members.

This combination of faith in automatic adjustment and the goal of export surpluses we label "neoclassical mercantilism". The major elements of this framework are as follows[19]:

1. an economy at less than full capacity output results from inappropriate government policies not malfunctioning market processes;

2. a trade deficit indicates a lack of "competitiveness" of the national economy;

3. "national competitiveness" increases as a result of "structural reforms", the reduction of public regulation of markets, most importantly for the labour market;

4. public sector deficits result from the inherent tendency of governments to indulge in excessive expenditure;

[19] The neoclassical mercantilist framework is explained in non-technical language in Stockhammer (2016) and Reissl & Stockhammer (2016), though they do not use our term.

5. the appropriate role of government is to maintain internal and external economic stability through balanced budgets; and

6. very low inflation is the necessary condition for economic stability and export surpluses; to this end the central bank should be insulated from all political influence and focus only on the goal of price "stability".

Prior to considering these points analytically, we stress their antipathy to democratic decision making. The treaty rules on policy derive from a framework in which economic difficulties result from the misbehaviour of governments, especially tendencies to excessive expenditure. Governments are induced into such misbehaviour by a desire to please electorates that fall prey to the promises of "populist" politicians. Therefore, rules constraining behaviour by governments are necessary to prevent some member countries from undermining the stability of the entire Union. The combination of a belief in universal economic laws and the inherent faults of government require clear rules to constrain representative democracy in the interest of a stable Union.

This rather Hobbesian justification of a "rules-based" European Union suffers from a fatal flaw. Theoretic work casts doubt on the argument that market economies automatically adjust to full utilization of resources (summarized in Weeks 2012, Chapters 8-10). If the automatic adjustment hypothesis were true in theory, in practice it would occur so slowly that unemployment would be persistent.

Labour market adjustment requires that the money wage decline more than prices decline. However, in a smoothly adjusting market economy wages and prices move up or down in equal proportion. From the principles of the theory that informs the EU economic framework it follows that falling money wages cannot bring about falling real wages. If the labour market cannot adjust, an economy has no tendency to move automatically to full utilization of resources[20]. If this cannot be demonstrated in abstract theory, the full utilization presumption cannot be a rational basis for policy rules.

Though market economies do not automatically adjust to full capacity they are remarkably stable. Except in rare moments such as the late 2000s, annual fluctuations in output stay in the range of +3 and -3%. These fluctuations typically result from so-called shocks that temporarily undermine private investment or exports. In this context the role of governments is to compensate for inadequate or excessive private demand with fiscal policy. As explained below, the fiscal rules in the various EU treaties undermine the ability at both the national and EU level to implement "counter-cyclical" fiscal policy.

The EU policy framework has several secondary flaws that reinforce the dysfunctional nature of the automatic adjustment assumption. Treating a country's trade balance as indicator of competitiveness is mercantilist ideology. Taken to its logical conclusion this judgement implies that a trade deficit is always a sign of economic weakness. Even if the rule is formulated in terms

[20] The argument made here is developed in technical terms in Weeks (2012). It is not a "Keynesian" argument, though Keynes made a version of it in The General Theory of Employment, Interest and Money (1936). The inability of money wage adjustment to eliminate unemployment comes from Walrasian general equilibrium theory (Patinkin 1933).

of the balance on current account rather than trade only, it is false. Countries can have end-of-year trade deficits for many reasons that do not reflect on competitiveness however defined. A surplus on the capital account can finance a current account deficit, which is typical of foreign direct investment flows.

Since every country cannot have a trade surplus, why should every euro zone country have a surplus? Fostering trade among members is the basic justification for a customs union, a justification inconsistent with every member seeking a surplus. A trade surplus implies that private domestic consumption plus private investment is less than private income. A trade surplus (exports exceed imports) makes domestic spending lower; either households spend less (less consumption) or domestic capital accumulation is less (lower business investment), or both. To restate this principle very simply, what a country exports it cannot use domestically and what it imports adds to domestic goods and services; if a country imports less than it exports, the people in that country have fewer goods and services to enjoy.

The total supply of goods and services is one of the determinants of national welfare, thus a trade surplus reduces national welfare. The rational policy goal is to maintain a sustainable balance of payments, not a trade surplus.

Every government must implement policies to achieve a sustainable balance of payments. Treating the trade or current account balance as an indicator of national competitiveness perverts that general rule. If the European Union becomes more integrated the absurdity of equating competitiveness with trade surpluses will become increasingly obvious. In a successful customs union governments would assess competitiveness and external sustainability at the level of the Union not member countries.

It is also important to recognize that in some countries trade deficits may signal a process of de-industrialization and impoverishment of peripheral regions as production concentrates in a few centres. If this is the case national government should be allowed to carry out specific industrial policies to favour development of the impoverished areas.

3. Changes to Eliminate Bias

(a) Purpose of the Changes

The changes in economic rules and guidelines have a common purpose, to facilitate policy flexibility at the national and Union levels while maintaining internal and external sustainability. The principle elements of internal balance are manageable inflation, sustainable public debt and countercyclical fiscal policy for maximum employment. External balance implies a sustainable balance of payments.

Achieving and sustaining external and internal balance requires re-writing the treaty-based economic rules, from the Maastricht "convergence criteria" to the Treaty on Stability, Coordination and Governance ("Fiscal Compact"), including the mandate and guidelines for the European Central Bank.

The current rules generate macroeconomic instability not stability. They are technically flawed, unsupported by economic theory, and contrary to generally accepted policy guidelines, for example, as recommended by the International Monetary Fund.

(b) Fiscal Policy

Basic Flaw in Treaty Rules

The fiscal rules in EU treaties create a tendency to macroeconomic instability because they are pro-cyclical. They tend to turn recessions into depressions and in prosperous times enhance inflationary pressures. Recessions result in falling public revenue due to the income elastic nature of personal and business taxes, while some expenditures automatically rise (for example, unemployment payments). The Fiscal Pact's deficit rules require national governments to depress demand, lower expenditure or raise tax rates, when the economic problem is insufficient demand.

The necessary changes to the fiscal rules are simple and straightforward: 1) make the rules counter-cyclical; 2) apply technically appropriate measures and definitions for deficits and debt; and 3) restate them to be ideologically neutral. The only serious difficulty that will arise in the reformulated countercyclical fiscal rules is how to facilitate adjustment in countries with unsustainable deficits. This is the final issue we treat.

Fiscal balance

The current EU rules on fiscal policy of member countries derive from the Treaty of Maastricht. The most important of these are 1) the rule that a country's fiscal deficit should not exceed three percent of GDP, 2) the public debt as a proportion of GDP ratio should not exceed 60%, and 3) conditionality on inflation subsequently superseded by creation the common currency and the price stability mandate of the European Central Bank. The last is treated under monetary policy.

The Maastricht Treaty defines "annual government deficit" as total revenue minus total expenditure. Numerous EU documents define the purpose of the deficit rule is to ensure "sound" fiscal policy. However, the policy literature on public finance shows that this is the wrong measure to achieve that purpose.

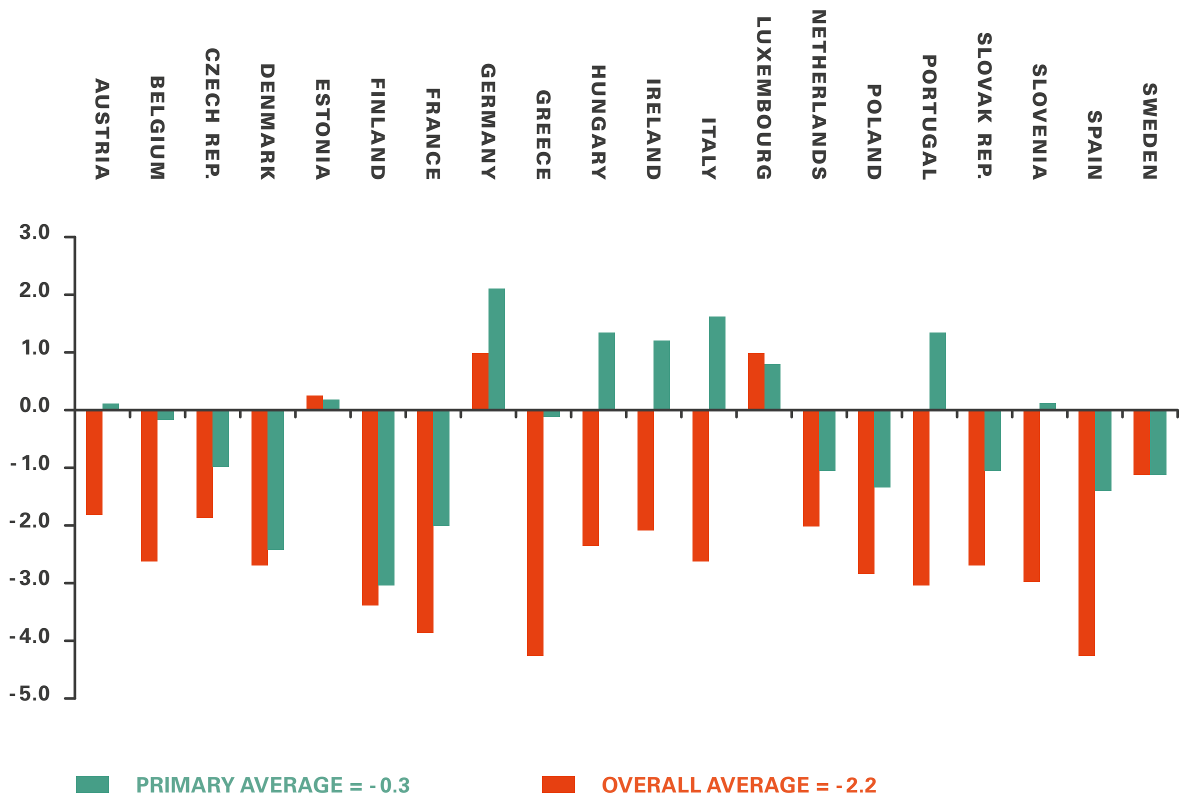
The management of the public budget involves adjusting expenditures and revenues. Interest payments are legal obligations; reducing them implies debt default. Thus, legal obligations mean that governments cannot adjust interest payments. In addition, concern about deficits comes from fears that they could cause inflationary pressures by increasing aggregate demand. An increase in aggregate demand will result if the expenditure results in the purchase of a good or service, which interest payments do not.

The Maastricht Treaty has specified an incorrect measure of sound fiscal policy because it includes a component — debt interest payments — that cannot be changed by policy decision. To assess success or failure, governments require an appropriate measure of the budget balance. A measure that includes items a government cannot change is inappropriate.

Chart 1 compares overall fiscal balances to primary balances for 20 EU countries in calendar year 2015. The overall deficit averaged -2.2% of GDP, with four countries exceeding the Maastricht rule of -3 percent. Using the technically correct primary balance (i.e. excluding interest payments), only Finland broke that rule and only marginally at -3.1%. The Treaty on Coordination, Stability and Governance (TCSG) established an additional and stricter condition, that something called the structural deficit should not exceed -0.5% of GDP.

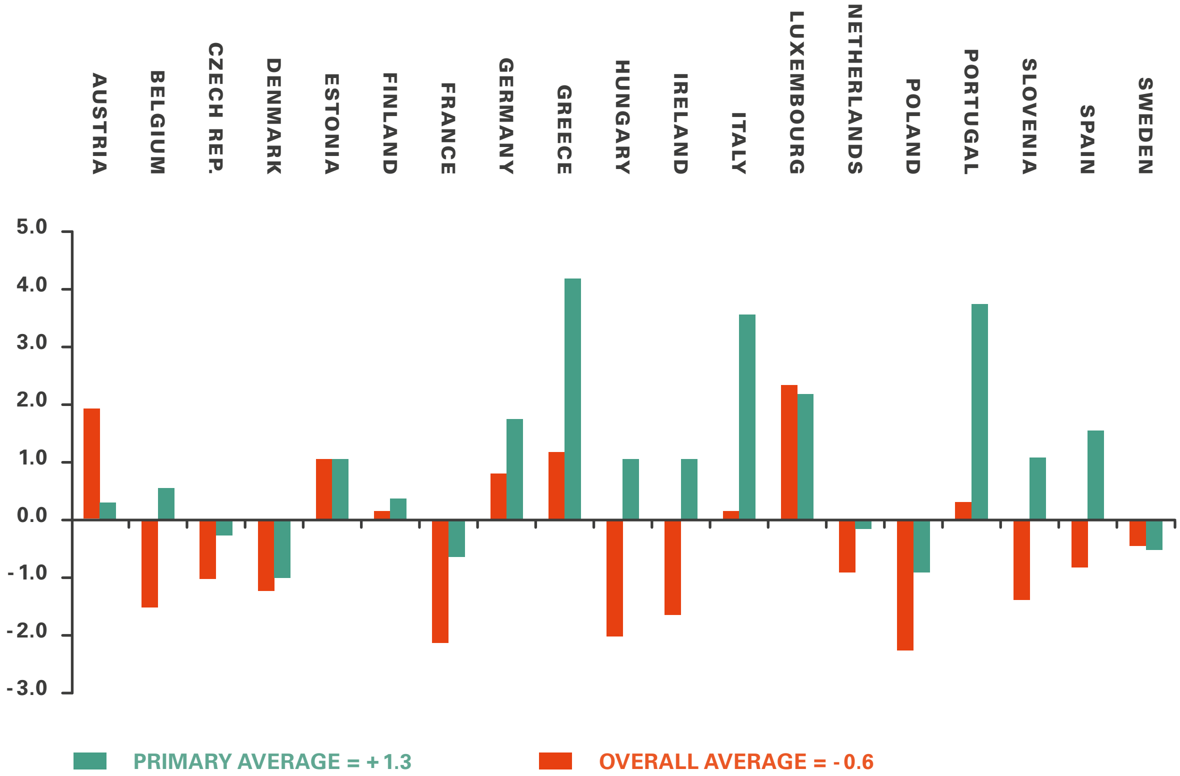
Chart 2 shows this measure, allegedly what the fiscal balance would be if an economy were at normal output (identified by the more accurate name, "cyclically adjusted" balance). Using the inappropriate overall deficit, ten of the 19 countries breach the mandated -0.5% of GDP. Using the primary balance, the number of countries in excess of -0.5% falls to three, only one in the euro zone (France).

Chart 1: General government fiscal balances, 20 EU member countries 2015, percentage of GDP



Sources: OECD and Eurostat.

Chart 2: General government fiscal balances "cyclically adjusted", 19 EU member countries 2015, percentage of GDP



Notes: Balances also exclude "one-off" revenues and expenditures. *Sources: OECD and Eurostat.*

By specifying the 0.5% as a "structural deficit" limit, the TCSG goes from the arbitrary to the inconsistent. The Commission as well as the usually competent OECD define "structural deficit" as the deficit that would appear by eliminating cyclical effects; i.e., the deficit when an economy operates at normal capacity.

Making this concept operational requires an analytically valid method of eliminating cyclical effects, then a clear and consistent measure of normal capacity. The EU structural deficit fails on both criteria. In practice the EC statisticians make no attempt to eliminate cyclical effects. The method of calculation of normal capacity ignores the cycle altogether by defining normal capacity as the level of output at which the rate of unemployment implies stable inflation; i.e., the "non-accelerating inflation rate of unemployment", NAIRU.

Use of the NAIRU concept reveals the underlying ideology of the structural deficit. It identifies inflation as the appropriate measure of economic health rather than output or employment. Implicit is the dogma that inflation results from excess demand. It follows that reducing inflation requires reductions in public expenditure or increases in taxes, which is the austerity doctrine.

The NAIRU would be theoretically problematical even if attempts were made to adapt it to the specific institutional characteristics of each country at specific time periods.[21] For example, if the

[21] The NAIRU concept has proved extremely weak empirically. Since the 1990s evidence has shown that stable inflation may occur in association with many different unemployment rates (see for example Blanchard et al 2015, discussed in Stirati 2016).

concept has operational validity it is extremely unlikely that it would assume the same value before and after the 2008-10 global recession. An inspection of the Eurostat tables for the actual and "structural" deficits shows no evidence of adjustments for country specific characteristics.

The theoretically dubious nature of the NAIRU is indicated by its earlier name, "the natural rate of unemployment". This phrase betrays the belief that 1) unemployment is a natural phenomenon to which all economies automatically adjust; and 2) inflation always results from excess domestic demand. If the first were true the global recession would not have occurred. The second ignores price pressures arising from traded goods and services, petroleum being the most obvious and price-volatile.

The possibility of calculating country and time specific normal capacity would not save the 0.5% rule from theoretical inconsistency. We can show this with a simple example. Assume that an economy operating 10% below normal capacity has a fiscal balance of -2% of GDP. Also assume that if output instantaneously rose to normal capacity the balance would contract to the specified -0.5%. The deficit would decline because as output increased public revenue from direct and indirect taxes would rise. By the rules of the TCSG this economy has the appropriate fiscal balances.

There is a contradiction in this logic. By definition tax revenue is non-spending. A lack of demand caused the initially low level of output, and rising revenue makes that problem worse. In this example the initial combination of private expenditure, public expenditure and public revenue generates insufficient demand to achieve normal capacity. The counterfactual calculation of -0.5 at normal capacity is irrelevant, unachievable in both theory and practice. The economy is stuck in under-utilization of capacity because with the depressed level of private demand the initial public deficit of 2% is too low. Complying with the -0.5% rule prevents the economy from reaching normal capacity.

For countries with a structural deficit calculation greater than 0.5% enforcing the "normal capacity" rule results in the extended recession suffered by the Greek population. Assume in the previous example that the structural balance calculation is minus 1.0%. The TCSG requires the government of the country to either increase tax revenue or reduce expenditure. These changes would decrease output even further below normal capacity, in a multiple of the size of the fiscal adjustment.

The EU treaties specify the wrong measure of the fiscal balance that has a recessionary bias. This recessionary bias is severely reinforced by the rules limiting the fiscal balance. Abandoning numerical rules that apply to all countries would go far to eliminate the recessionary bias. Commonly used calculations of sustainability of fiscal deficits should replace of the arbitrary limits in the TCSG (IMF 2000, 3-5).

The rational reform of existing fiscal rules is to eliminate the excessive deficit target. If member governments cannot reach a consensus to eliminate such targets, the following changes should be made:

1. The fiscal rule should refer to primary balance to not the overall balance.

2. The concept "structural deficit" is theoretically unsound. No consensus exists on how to measure it. It should be abandoned.

3. Application of the same fiscal balance target to all countries is theoretically unsound. The fiscal balance of each country should be evaluated separately taking into account current conditions.

Public Sector Debt

The Maastricht convergence criterion specifies that the general government debt should not exceed 60% of GDP. As with the fiscal balance setting a specific ratio for debt is arbitrary. The concern should be sustainability, not absolute size. Replacing the Maastricht 60% with the simply calculated IMF formula measuring debt sustainability would provide greater rationality to EU economic policy (IMF 1995, 2000).

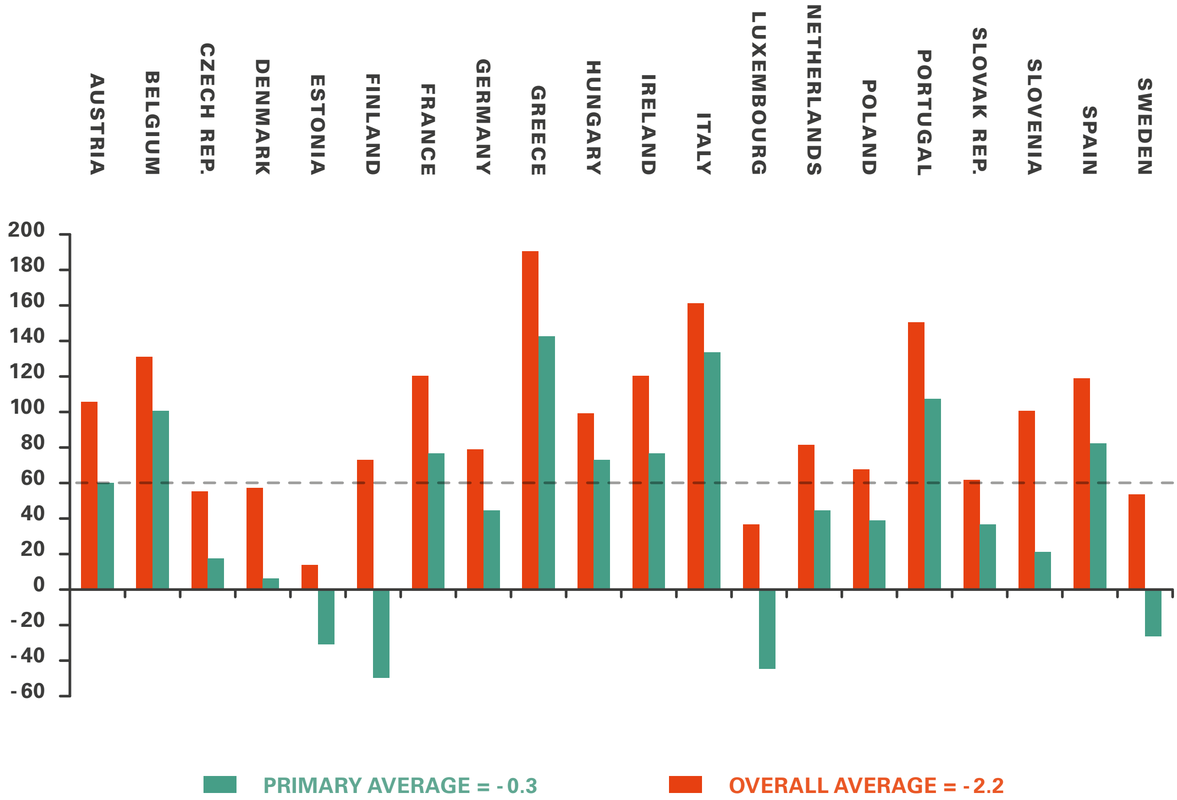
The IMF approach explicitly considers the sustainability of government debt, which is determined by its size and also 1) the interest rate on the government bonds, 2) the repayment schedule, 3) anticipated fiscal balances, and 4) projected growth of GDP. A given debt le el is more sustainable the lower the interest rate, the longer the repayment period, smaller the primary balance and faster the rate of growth.

As for the fiscal balance, the EU treaties apply the wrong general government debt measure, specifying the gross debt, not the net debt. The latter, used by the UK Treasury and in many other countries, subtracts public sector liquid assets, such as cash balances of public institutions and foreign exchange holdings by the central bank. By definition debt, public or private, is the net value of liabilities. Assessing liabilities but ignoring assets betrays ignorance of basic accounting principles.

Chart 3 shows the substantial difference between the gross and net debt. At the end of 2015 fourteen of 20 EU countries were above the Maastricht gross debt rule. Using the net debt, actual liabilities, that number falls to eight, and four countries had negative debt. The most absurd cases are Finland and Slovenia, over the mark for the Maastricht calculation, but on the correct net measure at minus 50% (Finland) and plus 21% (Slovenia). Both countries applied growth-depressing austerity programmes, in part justified as necessary for a debt problem that did not exist. The case of Finland takes the Maastricht debt measure to its reductio ad absurdum. A government that is a net creditor — its assets exceed its liabilities — is required to adopt policies to increase its net assets, which in practice could result in an increase in the net liabilities (net debt) of another euro zone country.

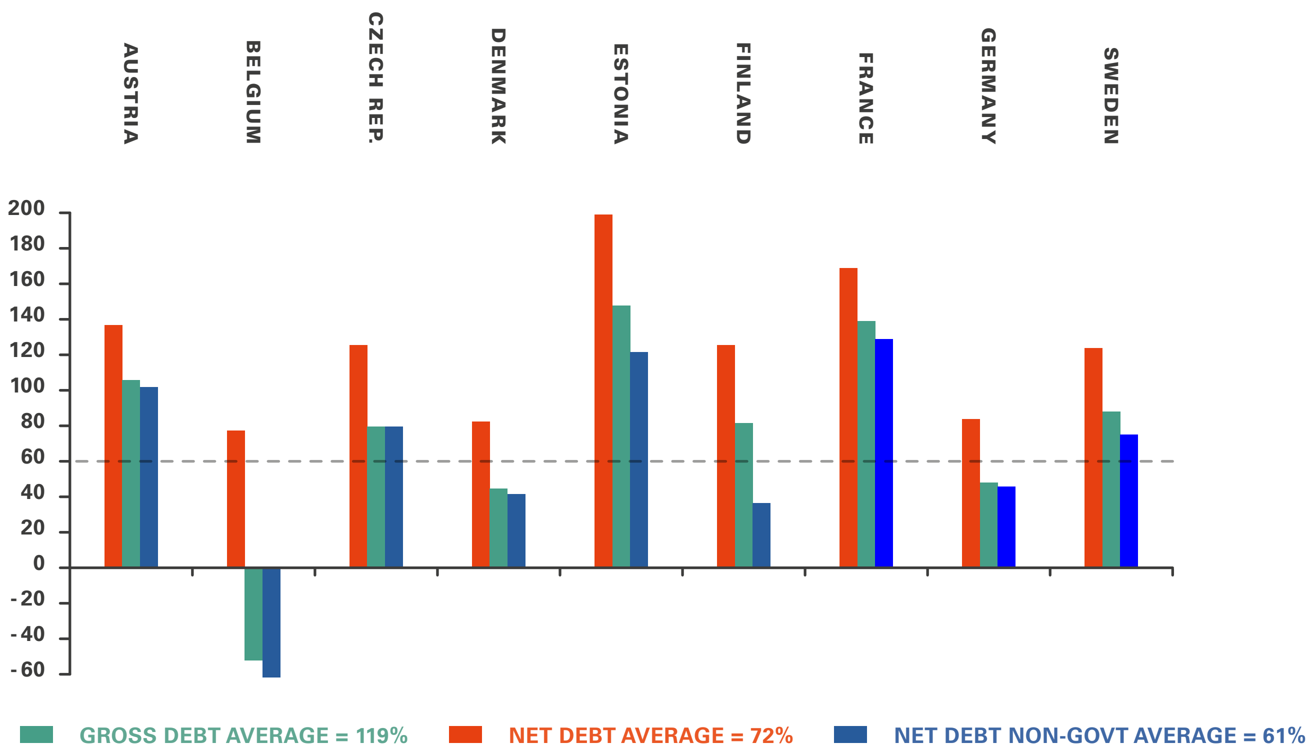
In some EU countries, the net debt measure overstates the size of the general government debt because of borrowing between public sector institutions. Such debts have a corresponding asset that cancels it out. The most common examples involve central banks holding public bonds as assets. Chart 4 shows gross, net and net non-government debt of nine EU countries, based on a study by the Bruegel group. Across the nine countries the Maastricht measure of general government debt gives a value of 119% of GDP and the net measure 72%, and the latter falls to 61% excluding intra-governmental debts.

**Chart 3: General government gross and net debt,
20 EU member countries 2015, percentage of GDP**



Source: OECD.

**Chart 4: General government gross, net & net non-government debt,
9 EU member countries 2015, percentage of GDP**



Notes: "Net debt non-govt" excludes debt held by the government itself.

Source: Bruegel database of sovereign bond holdings developed in Merler and Pisani-Ferry (2012).

Specifying a numerical constraint on the size of the general government debt has no economic justification. However, if EU leaders wish to maintain this irrational policy they should use the correct accounting measure of general government debt. Current practice compounds the recessionary bias of the fiscal balance rule by grossly over-estimating the public indebtedness of all member countries.

The rational reform of public debt rules is to eliminate them and use the guidelines suggested in the next section in their place. If member governments cannot reach a consensus to eliminate public debt targets, the following changes should be made:

1. The definition of the general government debt should be the net debt minus debt held by the government itself.

2. EU economic policy should explicitly recognize that public sector debts are an asset as well as a liability. Viewing debt as a problem is one sided, a misunderstanding of both economics and accounting.

Politically Neutral Imbalance Procedure

A legal process named the Macroeconomic Imbalance Procedure (MIP) provides the enforcement mechanism for the technically flawed rules on fiscal policy. The MIP is a component of the Stability and Growth Pact, derivative from Article 121 of the Treaty on the Functioning of the European Union (TFEU), discussed in Section 2 above. The fundamental problem with the MIP becomes clear in the European Commission document of late 2016 that seeks to explain and justify its application, "The MIP surveillance endeavours to avoid unsustainable booms in good times and unsustainable trends leading to losses of competitiveness" (European Commission 2016, 16-17).

This one sentence demonstrates two basic faults with the imbalance procedure: 1) it is pro-cyclical with a deflationary bias, and 2) its intent is punitive rather than remedial. In macroeconomic analysis the opposite of an expansion (sustainable or unsustainable) is a *contraction* (recession). The MIP betrays its deflationary bias by defining "losses of competitiveness" as the opposite of "unsustainable booms". Thus, the legal mandate of the Commission is to prevent excessive expansion, but not to prevent recession.

The procedure is pro-cyclical because (a) the containment of booms and (b) prevention of loss of competitiveness each involve the same policies - reduction in aggregate demand. For the former, restricting demand has the intention of preventing inflation as the economy approaches full capacity. For the latter, depressing real wages is the function of restricting demand. This approach to achieving sustainable public finances is dysfunctional.

It is important to note that the imbalance procedure is established by the European Parliament not by treaty, "The European Parliament and the Council, acting by means of regulations in accordance with the ordinary legislative procedure, may adopt detailed rules for the multilateral surveillance procedure" (Treaty on the Functioning of the European Union, Article 121.6).

Rational guidelines for the technical solution to unsustainable deficits are 1) to treat fiscal deficits as a cyclical imbalance not as policy failure; and 2) to recognize that deficit reduction is more effective in a growing economy that in a stagnant or contracting one. To enhance accountability and democratic oversight, all programmes to adjust imbalances should be debated and approved by the European Parliament prior to their implementation.

(c) Monetary Policy

ECB Mandate

The European Central Bank is the instrument of monetary policy for the Union. As for fiscal policy, the rules of monetary policy have a recessionary bias. Three changes are necessary to eliminate that bias: 1) altering the ECB mandate, 2) enhancing democratic accountability, and 3) changing the guidelines for price stability.

The **current ECB mandate** identifies maintaining "price stability" as its "overriding" task:

> The Treaty establishes a clear hierarchy of objectives for the Eurosystem. It assigns overriding importance to price stability. The Treaty makes clear that ensuring price stability is the most important contribution that monetary policy can make to achieve a favourable economic environment and a high level of employment.

The second sentence is correct with regard to the wording in the treaty establishing the ECB. As an analytical statement it is false, because price stability has an ambiguous impact on employment. The European Central Bank's Governing Council **defines price stability** "as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". As explained below, under most conditions this target rate implies a recessionary bias. Use of the words "overriding importance" means that all other economic objectives are subject to or constrained by the inflation target. Should the inflation target prove inconsistent with "a high level of employment", the former takes precedent over the latter.

By contrast to the ECB mandate, the operating guidelines of the **US Federal Reserve System** are much broader, "The Congress established the statutory objectives for monetary policy--maximum employment, stable prices, and moderate long-term interest rates". The FRS leadership take responsibility for the emphasis placed on each of the three objectives. The flexibility in the mandate has allowed US monetary policy to shift with changing economic conditions and the prevailing political ideology.

Changing the ECB mandate is essential to facilitating rational macroeconomic policy for the European Union as a whole and each member country. Because of its exclusive focus on price stability ECB policies have an inherent tendency to undermine effective fiscal policy. A simple change in the wording of the mandate, in particular to include promoting full employment, would allow the ECB to operate more in the interest of citizens of the Union.

Governance and Accountability

The membership of the decision-making body of the European Central Bank, the Governing Council, consists of 19 central banks and six full-time employees of the ECB itself, all of whom had professional careers in banking.[22] This narrow base for membership is inconsistent with effective monetary policy and inconsistent with democratic oversight.

Over the last thirty years there has been little consensus on the technical analysis of monetary policy. To take but one example, "monetarism" was the accepted wisdom in the 1980s, which asserted that control of the money supply should be the principle task of central banks. By the 1990s both academic economists and policy makers recognized that achieving this task was impossible (Congdon 2007). Similarly, inflation targeting, practiced by the ECB, has come under theoretical and empirical attack (Epstein and Yeldan 2007).

This policy uncertainty justifies expanding the Governing Council to members outside banking and finance. The reformulation of the Governing Council could follow the example of the US Federal Reserve system. In addition to three members from commercial banks, the Federal Reserve Act specifies that for each regional Federal Reserve bank three "class B [directors] shall consist of three members, who shall represent the public and shall be elected without discrimination on the basis of race, creed, color, sex, or national origin, and with due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor, and consumers".

The addition of these "representatives of the public" in no way violates central bank independence, because elected officials are explicitly excluded. Greater inclusiveness for the Governing Council would in increase ECB credibility as a result of greater public transparency.

A stronger form of ECB accountability should accompany greater transparency in governance. The "Consolidated Version of the Treaty on the Functioning of the European Union" (Article 284) sets the following accountability procedures:

> The European Central Bank shall address an annual report on the activities of the ESCB and on the monetary policy of both the previous and current year to the European Parliament, the Council and the Commission, and also to the European Council. The President of the European Central Bank shall present this report to the Council and to the European Parliament, which may hold a general debate on that basis.
>
> The President of the European Central Bank and the other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent committees of the European Parliament.

A minimum reform would replace the permissive verb "may" with "shall". To complement this change, the wording of Article 130 of the Treaty on European Union would be changed. The current wording appears to prohibit any contact between ECB officials and any government official national

[22] The ECB website gives the membership of the Governing Council and information on the professional background of every member.

or regional: the "European Central Bank...nor any member of [its] decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body."

This passage suffers from several problems. First, it is unnecessary because a separate clause enshrines the ECB "independence", and no clause grants any government or institution access to ECB operations. Second, it is impossible to enforce. ECB officials frequently meet formally and informally with politicians and civil servants. Trying to monitor those encounters for inappropriate discussions is absurd.

Third, by any reasonable judgement, ECB officials, politicians and civil servants sharing ideas is good for policy making. The treaties and protocols establish ECB independence of decision-making on monetary policy. Encumbering that operational independence with unenforceable and nonsensical rules does nothing to support ECB operations.

Inflation Targeting

The inflation guideline is bad policy and technically flawed. The European Central Bank aims for a **target rate** less than 2% of a measure named the **Harmonized Index of Consumer Prices.** The measure itself is seriously flawed because it includes prices of internationally traded commodities over which the ECB has no significant influence.

By definition the rate of inflation equals the sum of price changes for internationally traded goods and services, price changes in constrained markets, and changes of domestic ("non-traded") goods and services in unregulated prices. The first category includes all those goods and services whose domestic price is determined in international markets. The most obvious example is petroleum, as well as almost all producer inputs. Airline fares and shipping charges are services whose domestic prices closely reflect international prices.

The second category includes all prices set by contract or public sector regulation. The importance of this category will vary across countries. Examples are public utility pricing (water and gas), public services and some modes of transport (e.g. railroad and bus fares). In the third category fall all goods and services relatively unaffected by international markets, public regulation or private contracts.

The ECB inflation target rule requires the sum of the price changes for these three categories be close to but below 2%. A rise in internationally determined prices above 2%, for example an oil price increase, is beyond the control of the ECB. Therefore, price increase in one or both of the other categories must rise less than 2% in order to meet the inflation target. Many goods and services in the second category have prices relatively inflexible in the short run because of public regulation and private contracts.

As a result all the greatest adjustment must occur for domestic goods and services in unregulated markets. The lowest-paid tend to find their employment in these market precisely because they are unregulated — employees not in trade unions and many self-employed such as care workers. The nature of the three types of markets implies that meeting an inflation target tends to reinforce and increase inequalities.

The market structure of every economy also undermines the effectiveness of targeting as an example shows. If half of all goods and services fall into the first two categories and these prices rise by 3%, then prices in unregulated domestic markets can only rise 1% to meet the ‘less than 2%’ target. It is likely that the first two categories take a considerably larger share than half, requiring no increase or even deflation in unregulated markets. Even if international prices transfer only slowly into domestic prices, the principle remains, that the unregulated markets must bear the weight of adjustment.

More serious is that less than 2% is an unsound target, for another reason. Twenty years ago the **Boskin Commission** in the US estimated that new products and quality change account for between 0.8 and 1.6 percentage points in the US cost of living index, taking 1.1 as “best estimate”. In a world of globalized markets and production, the EU statistic is unlikely to be very different. Therefore, an inflation target below 2% de facto aims for an effective rate of less than 1%.

The benefits of a capitalist economy come from its dynamism, the continuous reallocation of resources in response to technical change and shifts in consumer preferences. This allocation occurs through price adjustment. For example, workers move between sectors in response to wage changes. Some wage inflation and therefore price inflation are inherent in the efficient operation of a market economy. The (less than) 2% inflation target is in theory and practice deflationary, achieved by suppressing the price adjustments essential to economic growth.

Reform of the ECB and Monetary Policy

The European Central Bank and its monetary policy require a range of changes for accountability and effectiveness.

1. The current ECB mandate gives all economic policy a deflationary bias. It should be altered to set employment and growth as the same priority as price stability. The ECB should review the likely impact of its policies across member states and household inequality and to make this review public prior to policy action. Doing so would increase the credibility of the ECB as an institutional for all member states.

2. Greater openness and transparency is required of ECB activities. A step in this directly would be increasing requirements for reporting to the European Parliament.

3. The ECB should add “representatives of the public” on its Governing Council, including trade unionists and spokespersons for civil society.

4. The ECB should not set an inflation target. If no consensus can be reached to end this policy, the target should be flexible, by raising the numerical target, changing the measurement of inflation, and allowing for discretion when economic conditions vary.

4. Summary

The articles in the EU treaties that address key economic policy issues suffer from fundamental flaws. They are also ideologically motivated. While they refer to a "social market economy" as the goal of the Union, in practice the treaties embody an ideology in which "market forces" are benign and governments are causes of instability. This ideology extols, without analytical support, 1) balanced budgets, 2) trade surpluses and 3) near zero inflation.

These three policies are in our view technically unsound, with little support in economic theory or practice. It is unfortunate that a new treaty or treaties will be necessary to alter the dysfunctional nature of EU economic policy. Recognizing why the existing treaties block rational policy is a step in the long process of treaty reform.

References to Part III

Blanchard, O, E Cerutti and L Summers 2015. "Inflation and Activity — Two Explorations and their Monetary Implications," *IMF Working Paper* WP/15/230

Congdon, Tim 2007. *Keynes, the Keynesians and Monetarism*. Cheltenham, UK: Edward Elgar.

European Commission 2016. *The Macroeconomic Imbalance Procedure, Rationale, Process, Application: A Compendium*, Institutional Paper 039. Brussels: European Commission.

Epstein, Gerald, and A Erinc Yeldan 2009. *Beyond Inflation Targeting: Assessing the Impacts and Policy Alternatives*. Cheltenham, UK: Edward Elgar.

Fatás, Antonio and Lawrence H. Summers 2016. "The Permanent Effects of Fiscal Consolidations," *NBER Working Paper* No. 22374. June 2016

International Monetary Fund, Fiscal Affairs Department 1995. *Guidelines for Fiscal Adjustment.* Pamphlet Series No. 49. Washington: IMF.

International Monetary Fund, Fiscal Affairs Department 2000. Assessing Fiscal Sustainability in Theory and Practice. WP/00/81

Juncker, Jean-Claude (in close cooperation with), Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz 2014. *Completing Europe's Economic and Monetary Union*. Brussels, European Commission.

Nuti, Mario 2013. "Perverse Fiscal Consolidation"
https://dmarionuti.blogspot.co.uk/2013/09/perverse-fiscal-consolidation.html

Reissl, Severin and Stockhammer, Engelbert 2016. "The Euro Crisis and the Neoliberal EU Policy Regime: Signs of Change or More of the Same?" *Near Futures Online* 1 "Europe at a Crossroads" (March).

Stockhammer, Engelbert 2016. "The Five Presidents' Report." Social Europe, July
https://www.socialeurope.eu/2016/07/five-presidents-report-one-year/#

Stirati, Antonella 2016. "Blanchard, the NAIRU and Economic Policy in the Eurozone," Perspectives, Institute for New Economic Thinking,
https://www.ineteconomics.org/perspectives/blog/blanchard-the-nairu-and-economic-policy-in-the-eurozone

Weeks, John 2012. *The Irreconcilable Inconsistencies of Neoclassical Economics: False Paradigm.* Oxford: Routledge.

ROSA LUXEMBURG STIFTUNG
BRUSSELS OFFICE

Prime

Rosa-Luxemburg-Stiftung, Brussels Office
11 avenue Michel-Ange
B - 1000, Brussels, Belgium
www.rosalux.eu

Policy Research in Macroeconomics (PRIME)
51 Clarence Gate Gardens, Glentworth Street,
London NW1 6QS, UK
www.primeeconomics.org