



DISCIPLINE AND PUNISH

End of the road for the EU's
Stability and Growth Pact?

Published by Martin Schirdewan MEP

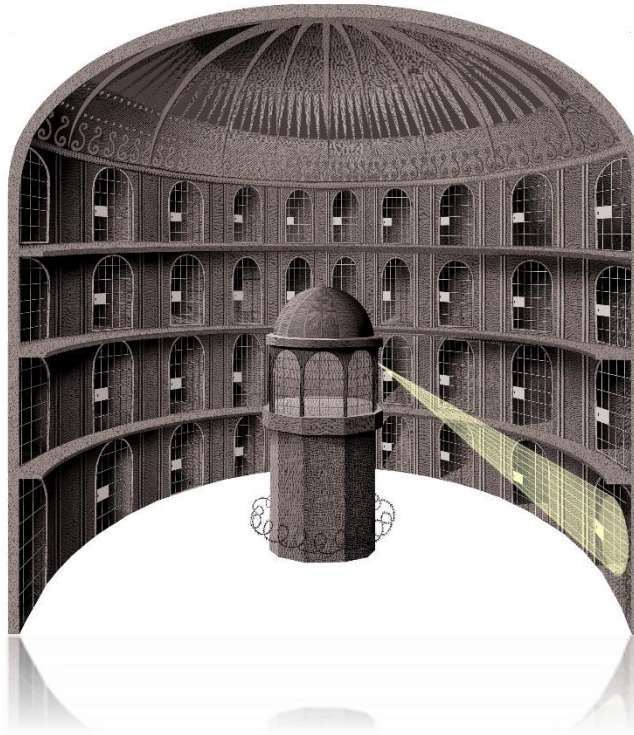
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DISCIPLINE AND PUNISH:

End of the road for the EU's Stability and Growth Pact?



A report commissioned by Martin Schirdewan MEP
Die Linke Member of the European Parliament (GUE/NGL)
Contact: Martin.Schirdewan@europarl.europa.eu

Author: Emma Clancy
Researcher in the office of Martin Schirdewan
Contact: Emma.Clancy@europarl.europa.eu

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Foreword by Martin Schirdewan



A green and social future means the Stability and Growth Pact must go

I commissioned this report in order to examine the precise ways in which the European Union's Stability and Growth Pact has harmed the people and the economy of Europe, and what we can do to change it.

The forthcoming revision of the SGP provides an important opportunity for progressives across the EU to demand an end to the austerity framework that has proven to be so harmful to the climate, economic recovery, communities, jobs and public services.

At a moment when climate change is posing an existential threat to the planet, and to the future of human civilisation itself, we need to radically transform our economies and societies. This historic task cannot be left to "market mechanisms". Such a transformation requires a major, coordinated and sustained public investment effort.

Maintaining the failed Stability and Growth Pact in this context is to fail before we have even begun.

In the current context – of prolonged stagnation and low growth, ultra-low interest rates, rapid digitalisation, rising social inequality, and a desperate need for massive public investment in the climate transition – placing arbitrary restrictions on the borrowing and spending abilities of EU governments is nothing short of absurd.

The SGP rules are based on outdated conditions, conservative ideology and deeply flawed economics. In a monetary union there are many spillover effects one economy can have on the others. A sovereign debt crisis is one – but the SGP clearly failed in preventing this. A massive trade surplus, such as that which Germany has run for many years, is another such spillover effect. Germany's biggest export to Europe is stagnation – but there are no consequences from the Commission for this damaging policy.

It is crucial to understand that the SGP and its surrounding framework has made a major contribution to the increasing inequality in the EU by enabling the European Commission to aggressively demand austerity policies at every opportunity. The European Semester process reveals the Commission's single-minded focus on attacking wages, reducing workers' rights, increasing the pension age, and privatising public services.

I welcome the widespread public debate about the future of the Stability and Growth Pact. Proposals made from varying quarters for exclusions from the rules for green investment, for public investment generally, or relaxing the rules are welcome.

However, progressives need to be more ambitious than simply asking for the austerity shackles to be loosened. They must be cast off.

Europe needs a massive and coordinated public investment effort that can achieve the systematic transformation of our economy that we so urgently need in order to meet the challenges posed by climate change, digitalisation and growing social inequality.

1. Key findings and recommendations

Crisis and contraction

Against a backdrop of prolonged stagnation and low growth, ultra-low interest rates, rising income and wealth inequality, and a desperate need for massive public investment in the climate transition, placing arbitrary restrictions on the borrowing and spending abilities of European governments cannot be economically or socially justified.

It is almost universally acknowledged that the Stability and Growth Pact (SGP) has failed to ensure either economic stability or growth in the European Union (EU) since its introduction in 1997. It has in fact demonstrably acted to stifle growth, and it has deepened and prolonged the double-dip recession in the EU. The strict fiscal rules have acted as a direct barrier to the recovery of economic growth to pre-crisis levels, and they contribute to the ongoing sluggish growth in the EU.

While the SGP was loosened due to political opposition to the rules from powerful member states in 2005, the post-crisis reforms of 2011 (the Six-Pack) and 2013 (the Two-Pack and the Fiscal Compact inter-governmental treaty) dramatically increased the power of the European Commission over the budgetary decisions of member states. These changes strengthened the fiscal rules but weakened the democratic decision-making process.

The content of the SGP, and the Maastricht Treaty (1992) convergence criteria it was based on, reflect the dominant economic ideology of the 1990s, as well as reflecting the general economic conditions that prevailed at the time. The numerical ceilings of the SGP – that EU member states must keep their budget deficits below 3 per cent of GDP, and public debt to GDP ratios below 60 per cent – may have been based on the prevailing

standards of 1997 in the EU, but neither threshold has any sound economic basis.

Fiscal rules promote transfer of wealth from labour to capital

Fiscal policy is one of the most important ways a state has to redistribute wealth and contain or reduce income and wealth inequality. The constraints imposed by the SGP have directly limited states' ability to redistribute wealth. While moves have been made to exempt certain forms of investment from the rules (i.e, national contributions to European Fund for Strategic Investment projects) on the grounds that such investments will generate GDP growth, direct transfers of resources through expenditure on welfare programmes and public services are threatened by the SGP.

The SGP actively promotes the transfer of wealth from labour to capital, a process that has intensified through the Macroeconomic Imbalance Procedure introduced as part of the Six-Pack. The specific policy measures demanded by the Commission focus on limiting wage growth; increasing the threshold age for receiving a pension; privatising state-owned enterprises and healthcare; promoting longer working hours; demanding a reduction in job security; and cutting funds to social services.

An analysis of the country-specific recommendations under the SGP and the Macroeconomic Imbalance Procedure since 2011 finds that in addition to consistent demands for reductions in public spending, the Commission has specifically singled out pensions, healthcare provision, wage growth, job security and unemployment benefits for attack.

The content of Country-Specific Recommendations from the Commission under the Stability and Growth Pact and the Macroeconomic Imbalance Procedure 2011-2018

NUMBER OF EU28 MEMBER STATES RECEIVING INSTRUCTION FROM COMMISSION

YEAR	Increasing pension age/ cuts to pension funding	Spending cuts on healthcare/ privatisation of healthcare	Suppression of wage growth	Reducing job security/workers' bargaining rights	Reducing support for unemployed, vulnerable or people with disabilities
2011	14	2	7	5	8
2012	13	3	6	7	10
2013	15	10	6	9	6
2014	17	16	13	10	9
2015	13	9	8	3	3
2016	10	8	4	2	3
2017	10	5	4	2	3
2018	13	10	2	0	3
TOTAL:	105	63	50	38	45

Source: Author's estimation based on Commission CSR data 2011-2018

The SGP's flawed ideology and methodology

The architects of the euro were aware of the many “spillover” effects that imbalances in one economy can have on others in a currency union. However, the EU institutions have focused single-mindedly on pursuing internal devaluation and reducing “wage rigidities”. The deflationary impact of a state or states running a large current account surplus has been largely ignored.

The economic justification for the EU's pre- and post-crisis austerity policies is based on the fringe theory of "expansionary austerity" that has been decisively disproved.

The calculation of the structural deficit (the discretionary spending by a government minus cyclical factors) that is used to determine whether a state is breaching the 3 per cent deficit target since the introduction of the Six-Pack is highly contested. The fact that the structural deficit is "unobservable" has led to bizarre situations such as the Excessive Deficit Procedure the Commission opened against Italy in 2018 in fear that the stagnant Italian economy was at risk of overheating.

The question of public debt

The average public debt to GDP ratio in the EU has expanded from an average of around 65-70 per cent in 1997 to 80.4 per cent in 2018. Eurozone debt was lower than the EU average in 1997, but this trend has now been reversed. Eurozone public debt peaked at 93.0 per cent in 2014 and declined to 86.1 per cent in 2018.

Public debt is not inherently "good" or "bad". The literature claiming that once a certain threshold of public debt has been reached (90-100 per cent of GDP), the GDP growth rate will decline, is inconclusive and disputed. The level of debt is not as important so long as the state is able to continue rolling over and servicing its debt. In the current context of prolonged ultra-low interest rates, there is little to no cost to borrowing.

The precise scenario the SGP was supposed to prevent – a contagious sovereign debt crisis within the economic and monetary union – unfolded following the global financial crisis.

The key factors behind the surge in the public debt levels in the "peripheral" member states after 2008 were: (1) the policies of the EU institutions and

member states in organising a coordinated rescue of the financial sector, socialising massive levels of private debt; (2) the ECB's actions in failing to intervene to provide credit to the crisis-affected states for an extended period of time, causing the market borrowing costs for these states to surge; and (3) the contractionary austerity programmes imposed by the Troika.

At the same time as limiting public investment and expenditure, the EU facilitates massive levels of tax avoidance by multinational corporations that further deny governments' access to vitally needed revenue. The system whereby individual member states of the EU, several of which are recognised internationally as tax havens, are allowed to veto proposals for effective action to combat tax avoidance enables this situation.

Politicised enforcement of the fiscal rules

Almost all EU member states have breached the rules at some point – during the Great Recession only Luxembourg did not go over the 3 per cent deficit benchmark. Only Estonia and Sweden have escaped the Excessive Deficit Procedure under the SGP.

The examples of the high-profile clashes between member states and the Commission regarding the application of the Excessive Deficit Procedure under the SGP demonstrate the arbitrary, biased and highly political enforcement of the rules in practice. The powerful and compliant are rewarded, while the weaker member states and dissenters are punished. The cases of Germany, France, Spain, Portugal and Italy are used here to demonstrate the disparity in the application of the rules.

The inconsistent, biased and secretive decision-making process under the SGP is perhaps the most glaring symbol of the EU's democratic deficit, significantly undermining public confidence in the EU.

A Left perspective on fiscal strategy

The SGP is currently facing unprecedented criticism from member states, EU institutions such as the European Central Bank, European Court of auditors and European Fiscal Board, and international institutions including the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD). The forthcoming review of the SGP by the Commission that will take place throughout 2020 is an important opportunity to put forward political demands regarding the fiscal rules.

Proposals for reform such as excluding green investment or public investment in general, and simplifying the rules, are welcome, but insufficient. The necessary climate transition is impossible under the SGP. Decisions on borrowing and spending must be decentralised to accountable national parliaments.

The EU needs a major, coordinated public investment effort in order to radically transform our economies and societies to meet the challenges of climate change, digitalisation and growing inequality.



2. Introduction

The Stability and Growth Pact (SGP), first enacted in 1997, has proven to be one of the most contested and controversial features of the Economic and Monetary Union, and the broader European Union (EU). The SGP imposes two numerical ceilings on government expenditure: (1) the government debt-to-GDP ratio must be below 60 per cent; and (2) the annual deficit of member states must be limited to 3 per cent of GDP or less¹.

The power of the European Commission to surveil and control the national budgets of EU member states was significantly strengthened in 2011 by the

¹ European Commission. 2020. Stability and Growth Pact. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact_en

adoption of the Six-Pack and in 2013 by the adoption of the Two-Pack, as well as the signing of the Fiscal Compact, an inter-governmental treaty.

In practice, the SGP has proved to achieve the opposite effects it claims to aim for. It is economic common sense that cuts to government spending will have a contractionary effect and cause the economy to shrink. When the national income shrinks, spending on unemployment benefits must rise, and the situation gets worse. This is exactly what happened in the aftermath of the recessions in Greece, Ireland, Spain and Portugal². Almost all EU member states have breached the rules at some point – during the Great Recession only Luxembourg did not go over the 3 per cent deficit benchmark³.

This report finds that the fiscal rules played a key role in prolonging and deepening the economic crisis in the EU, and in contributing to the long stretch of stagnation and grindingly slow economic growth that it is still experiencing. While the United States had a GDP almost 10 per cent higher in 2015 than in 2007, the Eurozone's GDP grew by just 0.6 per cent over the same period. US GDP per capita (an indicator commonly used to measure living standards) increased by more than 3 per cent from 2007-2015, while over the same period in the Eurozone it actually declined by 1.8 per cent⁴. As living standards have declined – devastatingly in crisis countries, and especially in Greece – income inequality has also risen drastically.

The structural adjustment programmes imposed by the International Monetary Fund (IMF) from the 1970s-1990s in Latin America, Asia and Africa are often described as having caused these continents “a lost

² Stiglitz, Joseph. 2016. *The Euro: And Its Threat to the Future of Europe*, Allen Lane, USA.

³ European Commission, 2020. Excessive deficit procedures - overview.

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/excessive-deficit-procedures-overview_en.

⁴ Stiglitz, J. 2016. (Above, note 1.)

decade” or “lost decades”. Europe has lost a decade but there is a danger that it may lose several more due to its self-imposed constraints on growth.

The SGP has been called a lot of names since its creation – the “Instability Pact”, the “Stupidity Pact”, a “Suicide Pact”, and more. In 2002, then-President of the European Commission Romano Prodi declared that the pact was “stupid”, while French Commissioner for Trade Pascal Lamy called it “crude and medieval”⁵. It has been widely criticised by economists, EU member states and international institutions, particularly in the aftermath of the global financial crisis and the European sovereign debt crisis. This criticism has now reached unprecedented levels.

These criticisms can generally be summarised as follows:

- The SGP has failed to limit or reduce public debt in the EU;
- Enforcement of the rules has been biased and politicised;
- The application of the SGP has had a contractionary impact on GDP growth;
- The debt and deficit targets are arbitrary and economically unsound;
- Member states’ budgets are legally a national competence;
- The rules and calculations used are too complex.

All of these criticisms are valid, factually correct and well-documented. This report examines the evolution and operation of the SGP since its creation, including an examination of the flaws in the economic ideology and methodology underpinning the rules. It takes stock of the extent and causes of public debt in the EU. It also outlines the highly politicised enforcement of SGP.

⁵ Osborn, Andrew. 18 October 2002. ‘Prodi disowns “stupid” stability pact’, *The Guardian*. <https://www.theguardian.com/business/2002/oct/18/theeuro.europeanunion>.

However, this report goes beyond these common criticisms to additionally examine the role of the SGP in intensifying the transfer of wealth from labour to capital in the EU, in particular since the global financial crisis. It examines the precise ways in which the SGP achieves this transfer by examining the content of the country-specific recommendations made by the European Commission to EU member states on the basis of the SGP and the Macroeconomic Imbalance Procedure. It also examines the deeply corrosive impact of the SGP and its enabling framework, on democracy in the EU, and the implications of this.

There is a wide-ranging and ongoing discussion taking place within economic and public policy circles in the EU regarding the future of the SGP. On February 5 the Commission produced a Communication⁶ regarding proposals for change to the fiscal rules as part of a scheduled revision of the so-called Six-Pack and Two-Pack legislative amendments to the SGP that were enacted in 2011 and 2013 respectively.

Among the most common proposals for amendments to the SGP are that:

- Qualifying “green” investment should be exempt from the calculation of the deficit;
- There should be a “golden rule” exempting productive public investment from the calculation of the deficit;
- The headline debt and deficit ceilings should be revised;
- Only the debt-to-GDP ratio should be used;
- The rules should be simplified in general.

At the institutional level, it is significant that the European Parliament’s Economic and Monetary Affairs Committee voted in November 2018 to

⁶ European Commission. ‘Economic governance review.’ Press release. 5 February 2020. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/economic-governance-review_en

reject the incorporation of the inter-governmental Fiscal Compact treaty into the primary law of the EU. Even more significant is the indication by the Commission led by Ursula Von Der Leyen that as part of the forthcoming revision of the SGP, qualifying “green” investments may be excluded from the rules⁷.

However, this report concludes that, due to the dramatic constraints imposed by the SGP on the necessary rapid climate transition, economic growth, the redistribution of wealth, and democratic decision-making, the proposed reforms listed above are insufficient. Of course, the decentralisation of fiscal powers to the national level will not in and of itself be sufficient to resolve the problems of transitioning to a carbon-free society or economic stagnation. But what is certain is that the resolution of these problems will be impossible within the framework of the SGP rules.

(Note: It is beyond the scope of this report to examine in detail the institutional set-up and policies of the European Central Bank and the full interaction between monetary and fiscal policy; however, the ECB's role in contributing to the accumulation of public debt during the sovereign debt crisis will be examined.)

⁷ Smith-Meyer, Bjarke. ‘Pro Morning Exchange: Swedish heat — Green stability pact — More Greek debt’. Politico Pro. 28 January 2020. <https://www.politico.eu/pro/politico-pro-morning-exchange-swedish-heat-green-stability-pact-more-greek-debt/>.



3. Overview of the fiscal rules

3.1. The creation of the Stability and Growth Pact

The Stability and Growth Pact is a product of its time – the 1990s. Previously fringe neoliberal economic theories were on the rise from the 1970s onwards, and dominant by the 1990s. The content of the Maastricht Treaty (1992) establishing the economic governance framework of the common currency reflected these ideas. The treaty enshrined the so-called ‘convergence criteria’ – a set of rules members and potential members of the common currency were obliged to follow.

The Treaty on the Functioning of the European Union (TFEU) states that national budgets are an exclusive competence of member states. However, contradictorily it also states that national budgets are “of common interest”

(Article 121-1)⁸. To join the euro, states had to pledge to control inflation, limit government debt and budget deficits, and commit to exchange rate stability and the convergence of interest rates.

Monetary policy was to be transferred from national central banks to the European Central Bank (ECB), tasked with keeping inflation stable – and low. The SGP was then adopted in 1997, including by non-eurozone member states, in order to enshrine the fiscal control aspects of Maastricht in EU law, and more generally to increase Commission surveillance and control over member states' national budgets.

The blanket, one-size-fits-all fiscal rules in the convergence criteria – that member states must keep public debt limited to 60 per cent of GDP and annual budget deficits to below 3 per cent of GDP – were proposed by Germany, based on its own national SGP structure. The Pact consisted of a preventive arm and a corrective arm, and an Excessive Deficit Procedure (EDP) protocol was established under which the Commission was empowered to follow a corrective process that could result in sanctions against member states in breach of the deficit target.

3.2. Challenges from member states

There was, and remains, no convincing economic rationale behind either the debt ceiling of 60 per cent, or the deficit limit of 3 per cent. The economic ideas in vogue at this time were not the only era-specific influence on the SGP. The debt and deficit benchmarks were based on the prevailing economic conditions – the interest rates, GDP growth rates, inflation rates and public debt levels – of the day.

⁸ EUR-lex. *Consolidated version of the Treaty on the Functioning of the European Union*. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A12012E%2FTXT>.

In 1997 interest rates were approximately 5 per cent for long-term borrowing by European governments⁹. The average public debt to GDP ratio in the EU was between 65 and 70 per cent of GDP, while the median public debt among the 11 initial eurozone members was around 60 per cent of GDP. The forecast GDP growth rate was 3 per cent annually, while inflation was forecast at 2 per cent. According to these economic conditions, maintaining the public debt to GDP ratio at or below 60 per cent would require governments to keep budget deficits limited to 3 per cent of GDP.

The SGP as initially enacted in 1997 included sanctions for member states that breached the deficit limit of 3 per cent, but the debt benchmark was not enforced. Following the dot-com crash in 2002, member states were forced by the deficit rules to engage in cuts to expenditure that, predictably, had a pro-cyclical, contractionary impact on the economy.

France and Germany repeatedly refused to limit their spending to the SGP rules between 2001 and 2005, with no penalties resulting for the two powerful states. This standoff with the Commission led to the eventual weakening of the SGP through amendments in 2005, and the addition of the problematic “structural deficit” measure.

3.3. Exploiting the crisis to toughen the rules

Since the global financial crisis in 2007-2008, there has been a push to implant strict budgetary control ever more firmly in the structure of the EU's economic governance framework – by creating new mechanisms to surveil and structurally reform the economies of member states, and to surveil and control their spending, taxation and borrowing. There have been three main developments since the crisis: the introduction of the Six-Pack in 2011,

⁹ Pisani-Ferry, Jean. ‘When Facts Change, Change the Pact’. *Project Syndicate*. April 29, 2019. <https://www.project-syndicate.org/commentary/europe-stability-pact-reform-investment-by-jean-pisani-ferry-2019-04?barrier=accesspaylog>.

followed by the Two-Pack in 2013 (applicable only to eurozone members), and the signing of the inter-governmental treaty known as the Fiscal Compact, also in 2013.

The Six-Pack significantly strengthened the power of the Commission over the member states and the Council. It introduced the obligation to keep the “structural deficit” (the discretionary spending by member states separate from automatic stabilisers) close to zero. The structural deficit limits are set by the Commission on a country-by-country basis and must not exceed 0.5 per cent of GDP for states with debt-to-GDP ratios of more than the 60 per cent limit, and must not exceed one per cent of GDP for states within the debt levels.

The Six-Pack also introduces fines against member states for failing to reduce their debt ratio above 60 per cent of GDP by at least 5 per cent per year through applying the Excessive Deficit Procedure applicable previously only to deficits. It is forbidden for public expenditure to rise faster than medium-term potential GDP growth, unless it is matched by adequate revenue increases. It also introduced a new macroeconomic surveillance tool, the Macroeconomic Imbalance Procedure, aimed at identifying a broader range of macroeconomic balances than only debt, and applying similar preventive and corrective procedures to combat these.

Significantly, the Six-Pack introduced reverse qualified majority voting in the Council, meaning that fines under the Excessive Deficit Procedure were considered adopted unless a qualified majority of member states voted against this.

The Two-Pack (2013) introduced new “enhanced surveillance” measures for eurozone members experiencing budgetary risks, and obliged eurozone members to submit Draft Budgetary Plans (DBPs) to the Commission annually, as well as establishing independent fiscal bodies at the national level. Member states in receipt of financial assistance from the European

Stability Mechanism can expect regular visits from the Commission and ECB.

The Fiscal Compact (2013), signed by all EU member states with the exception of the Czech Republic and Croatia (former member state Britain also did not sign it), enshrines the rule that members in excess of the limit are obliged to reduce their debt level above 60 per cent at an average of at least 5 per cent per year. It is officially known as the Treaty on Stability, Coordination and Governance (TSCG).

The structural deficit rule – called the “balanced budget rule” – must be incorporated into the national law of signatory states under the Fiscal Compact and aims to limit the structural deficit to close to zero. The text of the TSCG states that the Treaty is to be incorporated into EU law. The Commission made a legislative proposal to achieve this; however, the European Parliament voted in November 2018 to reject the incorporation of the Fiscal Compact into EU law. (The Commission has indicated that it intends to reintroduce this legislative proposal in 2020¹⁰.)

In January 2015, the Commission published a Communication issuing guidance on the fiscal rules, which it called, “Making the best use of the flexibility within the existing rules of the Stability and Growth Pact”¹¹. In fact the “guidance” introduced several new features to the rules, but the Commission declared it was unnecessary to go through a legislative procedure in order to begin implementing its new system.

Specifically, the changes included permitting member states in the preventive arm of the SGP to exempt from the deficit calculations their

¹⁰ European Commission. 2020. Commission Work Programme 2020. https://ec.europa.eu/info/sites/info/files/cwp-2020-publication_en.pdf.

¹¹ European Commission. 2015. *Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank: Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=ES>.

national contributions to the European Fund for Strategic Investments¹², the central instrument of the Juncker Investment Plan. Launched in 2014, this plan aimed to mobilise hundreds of billions of euros in private capital by providing a guarantee for the private sector using public EU funds in a plan that the European Trade Union Confederation likened to an economic miracle similar to the “loaves and fishes”¹³. The other key reform made through the 2015 Communication was allowing member states – in either the preventive or corrective arms of the SGP – to temporarily deviate by up to 0.5 per cent of GDP from the deficit target in exchange for committing to engage in approved major structural reforms¹⁴.

¹² Ibid.

¹³ ETUC. ‘Investment: Commission relying on a financial miracle’. Press release, November 26, 2014. <https://www.etuc.org/press/investment-commission-relying-financial-miracle#.WfLWoIZx1E4>

¹⁴ European Commission. 2015. (Above note 11).

THE SIX PACK (2011)

The Six-Pack consists of four pieces of legislation (one Directive and three Regulations) on fiscal policy, and two Regulations on macroeconomic imbalances.

1) National budgetary framework rules

A Directive on new specific requirements for budgetary frameworks, including standardised national account statistics and data.

2) Detection and correction of macroeconomic imbalances in EU

A Regulation to detect and correct macroeconomic imbalances. This includes the publication of an Alert Mechanism Report, the conducting of an In-Depth Review for member states at risk, and the introduction of an Excessive Imbalance Procedure for member states found to be experiencing an “excessive imbalance”.

3) Sanctions for failing to correct macroeconomic balance (eurozone only)

A Regulation to introduce a sanction mechanism for eurozone member states that fail to implement corrective measures regarding excessive imbalances, namely by imposing an “interest-bearing deposit” (a fine) of 0.1 per cent of the state’s GDP. The imposition of the deposit or fine for repeated failure to take corrective action is automatically approved unless a qualified majority of Eurogroup members objects (reverse qualified majority voting).

4) Strengthening the preventive arm of the SGP

A Regulation that requires eurozone members to submit Stability Programmes (or Convergence Programmes for non-eurozone member states) (SCPs) to the Commission that outline a Medium-Term Budgetary Objective (MTO). The Commission makes Country Specific Recommendations (CSRs) in response, then monitors the implementation of the SCPs. Members that deviate from their MTOs trigger an Early Warning Mechanism from the Commission.

5) Strengthening the corrective arm of the SGP for the debt ceiling (eurozone only)

A Regulation to “speed up” and “clarify” the implementation of the EDP. The corrective arm is made “operational” for breaching the debt ceiling – i.e, sanctions are to be applied. Eurozone members with public debt to GDP ratios of more than 60 per cent are required to reduce this debt by at least five per cent per year.

6) Sanctions for failure to take corrective measures on structural deficit (eurozone only)

A Regulation to introduce sanctions for eurozone members that deviate from the structural deficit required to meet their MTOs. Eurozone members in excessive deficit, or those that fail to take corrective action to correct an excessive deficit, may be fined (by an interest-bearing deposit) 0.2 per cent of their GDP.

THE TWO PACK (2013)

1) Enhanced surveillance for eurozone members in budgetary difficulties

A Regulation to monitor and surveil certain eurozone members. Three categories are established: Enhanced surveillance for eurozone members experiencing difficulties meeting the SGP targets; Macroeconomic Adjustment Programmes for states that have received loans from the European Stability Mechanism; and Post-Programme surveillance for states that have received financial assistance.

2) Rules on excessive deficit correction in the eurozone

A Regulation that inserts more requirements into the European Semester process, requiring the Commission assessment of eurozone members' Draft Budgetary Plans in autumn each year, and requiring each eurozone member to establish an independent national fiscal councils.

Source: Explanations of the SixPack and Two Pack procedures adapted and abridged from: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/framework/eu-economic-governance-explained_en.

3.4. The European Semester process

The European Semester is the annual programme of coordinated economic policy across the EU, introduced by the Commission in 2011¹⁵. It essentially aims to make the national budgets of member states subject to the scrutiny, alteration and approval of the Commission and the Council before the final budget plan is finally put to a vote in the national parliament. The European Semester incorporates the requirements of the SGP and the Macroeconomic Imbalance Procedure, as well as broader structural reforms under the Europe 2020 strategy¹⁶. In response to the draft budgetary plans submitted by member states, the Commission produces “country-specific recommendations” to individual states.

¹⁵ European Commission. 2020. The EU's economic governance explained. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/framework/eu-economic-governance-explained_en.

¹⁶ Hradiský, M. and M. Ciucci. 2018. *Country-specific recommendations: An overview*. Economic Governance Support Unit (EGOV). Directorate-General for Internal Policies.

Annual cycle of the European Semester

November

- Communications from the Commission on Annual Growth Survey (AGS) and Alert Mechanism Report (AMR).

March

- EU priorities endorsed by European Council based on the Commission proposals and Council preparations.

April

- Submission of National Reform Programmes (NRP) and Stability or Convergence Programmes (SCP).

May

- Assessment by the Commission and Council of the NRPs and SCPs.

May-June

- Commission proposals for Country Specific Recommendations (draft CSRs).

June

- European Council endorsement and Council adoption of the CSRs

June-September

- Economic Dialogue with the Commission, the Eurogroup and the Council on the CSRs.
- Implementation of the CSRs in Member States.

October

- Submission of national Draft Budgetary Plans (DBPs) (eurozone states).

November

- Assessment of DBPs and of the implementation of the Semester Cycle as a whole.

Source: European Commission. 2020. European Semester timeline.

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/european-semester-timeline_en.

Timeline: Evolution of the Stability and Growth Pact

1992: Maastricht Treaty

EU Member States sign the Maastricht Treaty, paving the way for the creation of the euro as the common currency of the EU.

1997: Stability and Growth Pact

The Stability and Growth Pact takes effect.

1998: Preventive rules

The SGP's preventive rules enter into force.

1999: Corrective rules

The SGP's corrective rules enter into force.

2005: SGP relaxed

The SGP is amended to allow it to better consider individual national circumstances and to add more economic rationale to the rules to be complied with.

2011: Six Pack

The 'Six Pack' of six new laws toughen the SGP significantly. The monitoring of both budgetary and economic policies is organised under the European Semester'.

2013: Two Pack (eurozone)

The 'Two Pack' reinforces economic coordination between eurozone Member States and introduces new

monitoring tools.

2013: Fiscal Compact

The budgetary targets set by the SGP's Preventive Arm (the Medium-Term Objectives), are strengthened by 'Fiscal Compact', which is part of an inter-governmental treaty, the Treaty on Stability, Coordination and Governance (TSCG).

2014: SGP review

A review of the 'Six Pack' and 'Two Pack' rules, which was called for in the legislation, found that the legislation had contributed to the progress of fiscal consolidation in the EU.

2015: SGP Flexibility

The Commission issues guidance on how it will apply the SGP rules to strengthen the link between structural reforms, investment and fiscal responsibility.

2018: Parliament votes against Fiscal Compact

The European Parliament's Economic and Monetary Affairs committee voted in November 2018 against incorporating the Fiscal Compact (the TSCG) into EU law.

2020: SGP review (forthcoming)

Source: Adapted from European Commission



4. The fiscal rules and the concentration of wealth in the EU

4.1. Redistribution of wealth

Fiscal policy is one of the most important ways a state has to redistribute wealth and contain or reduce income and wealth inequality¹⁷. The constraints imposed by the Stability and Growth Pact have directly limited member states' ability to redistribute wealth. While moves have been made to exempt certain forms of investment from the rules (i.e, national contributions to European Fund for Strategic Investment projects)¹⁸ on the grounds that such investments will generate GDP growth, direct transfers of resources through expenditure on welfare programmes and public services are reduced and constrained by the SGP.

¹⁷ Zucman, Gabriel. 2015. *The Hidden Wealth of Nations*. University of Chicago Press, Chicago.

¹⁸ European Commission. 2015. (Above note 11).

The SGP actively promotes the transfer of wealth from labour to capital, in particular through the Macroeconomic Imbalance Procedure introduced as part of the Six-Pack. The specific policy measures demanded by the Commission focus on limiting wage growth; increasing the threshold age for receiving a pension; privatising state-owned enterprises, cutting public spending on healthcare provision; promoting longer working hours; demanding a reduction in job security; and cutting funds to social services.

This report analyses the content of all country-specific recommendations made under the SGP and the Macroeconomic Imbalance Procedure from 2011 to 2018¹⁹. It finds that in addition to consistent demands for reductions in public spending, the Commission has specifically singled out pensions, healthcare provision, wage growth, job security and unemployment benefits²⁰.

From the introduction of the European Semester in 2011 to 2018, the Commission made 105 separate demands of individual member states to raise the statutory retirement age and/or reduce public spending on pensions and aged care. It made 63 demands that governments cut spending on healthcare and/or outsource or privatise health services. Demands aimed at suppressing wage growth were put to member states on 50 occasions, while instructions aimed at reducing job security, employment protections against dismissal, and the collective bargaining rights of workers and trade unions were made 38 times.

In addition to routine demands to cut government expenditure on social services generally, the Commission also made 45 specific demands aimed at reducing or removing benefits for the unemployed, vulnerable people and

¹⁹ European Commission. 2020. EU country-specific recommendations. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/european-semester-timeline/eu-country-specific-recommendations_en.

²⁰ Ibid.

people with disabilities, including by enacting punitive measures to force these individuals into the labour market - or, at least into becoming jobseekers.

The content of Country-Specific Recommendations from the Commission under the Stability and Growth Pact and the Macroeconomic Imbalance Procedure 2011-2018

NUMBER OF MEMBER STATES RECEIVING INSTRUCTION FROM COMMISSION

YEAR	Increasing pension age/ cuts to pension funding	Spending cuts on healthcare/ privatisation of healthcare	Suppression of wage growth	Reducing job security/workers' bargaining rights	Reducing support for unemployed, vulnerable or people with disabilities
2011	14	2	7	5	8
2012	13	3	6	7	10
2013	15	10	6	9	6
2014	17	16	13	10	9
2015	13	9	8	3	3
2016	10	8	4	2	3
2017	10	5	4	2	3
2018	13	10	2	0	3
TOTAL:	105	63	50	38	45

Source: Author's calculations based on European Commission (Above note 19).

4.2. Concentration of wealth in the EU

In its 2016 Opinion on the labour-capital wealth split in the EU, the European Economic and Social Committee (EESC) stated: "The most important tool at the disposal of Member States for promoting fair redistribution of added value for society as a whole is fiscal policy."²¹ Income and wealth inequality

²¹ Dimitrov, Plamen. 2017. European Economic and Social Committee (own-initiative opinion). *Wealth inequality in Europe: the profit-labour split between Member States*. Adopted on

has been on the rise globally since around 1980, including in the EU, and this dynamic has intensified in the aftermath of the global financial crisis.

Piketty²² has demonstrated the tendency of the rate of return on capital to grow faster than the economy as a whole, meaning inherited wealth grows faster than income and output. “In slowly growing economies, past wealth naturally takes on disproportionate importance, because it takes only a small flow of new savings to increase the stock of wealth steadily and substantially... If the rate of return on capital remains significantly above the growth rate for an extended period of time (which is more likely when the growth rate is low, though not automatic), then the risk of divergence in the distribution of wealth is very high.” Inequality will continue rising sharply unless significant redistributive measures are taken by governments.

The EESC identifies tax competition among EU member states as having fundamentally altered the redistributive nature of fiscal policy²³. The SGP is often criticised for restraining productive investment that can prompt economic growth, and rightly so. But the social transfers made through government expenditure are also vital for redistribution of wealth and preventing inequality from rising. Access to free or affordable, high-quality public services also plays a crucial role in addressing existing inequalities²⁴.

According to the OECD²⁵, income inequality in the EU is at an all-time high, with the average income of the richest 10 per cent now at 9.5 times that of the poorest 10 per cent. Wealth inequality is significantly higher, with Germany and Austria having the highest levels of wealth concentration. The top 10 per cent own at least 50 per cent of the total wealth in the EU, while

06/12/2017. <https://www.eesc.europa.eu/en/agenda/our-events/events/wealth-inequality-europe-profit-labour-split/opinions>.

²² Piketty, Thomas. 2013. *Capital in the 21st Century*. Harvard University Press, USA.

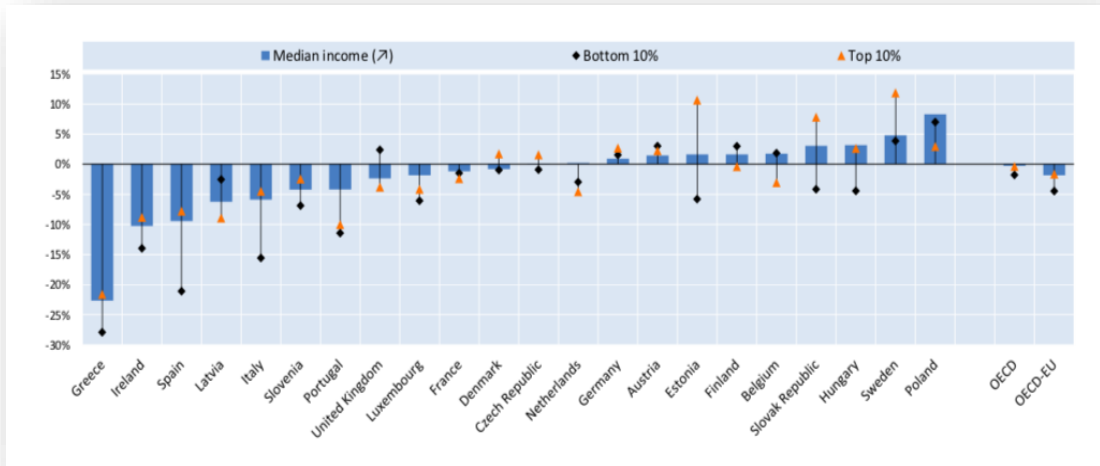
²³ EESC. 2017. (Above note 21). See also Zucman, G. 2015 (Above note 17).

²⁴ Stiglitz, Joseph. 2012. *The Price of Inequality*. W.W.Norton and Company, USA.

²⁵ OECD. 2017. *Understanding the Economic Divide in Europe*. Background Report. <https://www.oecd.org/els/soc/cope-divide-europe-2017-background-report.pdf>.

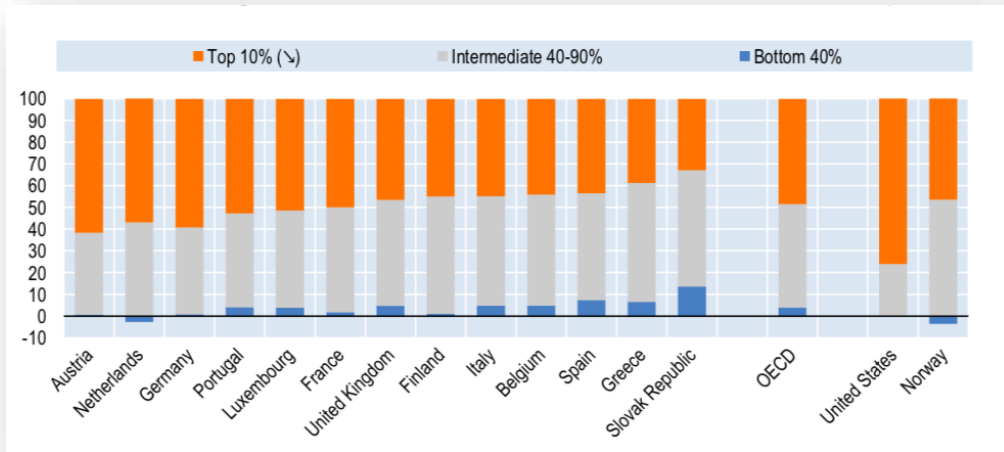
the bottom 40 per cent own just 3 per cent of total wealth. Such a concentration of wealth inevitably leads to the concentration power and the corrosion of democracy.

Income inequality: Real disposable income growth from 2007-2014



Source: OECD Income Distribution Database

Wealth inequality in Europe, 2014



Source: OECD Income Distribution Database

5. Implementation of the fiscal rules

5.1. Political bias and inconsistency

When it comes to implementation of the Stability and Growth Pact and Macroeconomic Imbalance Procedure through the European Semester, the Commission has repeatedly decided against proceeding with the Excessive Deficit Procedure, or imposing fines, for overtly political reasons. As described above, when Germany and France repeatedly breached the rules from 2001-2005, there were no consequences.

In 2016 Spain and Portugal faced Excessive Deficit Procedures. Spain's deficit in 2015 was 5.1 per cent of GDP, and Portugal's was 4.4 per cent. However, the Commission decided to recommend to the Council to cancel the planned fine of up to 0.2 per cent of the member states' GDP²⁶. The media reported that it was then German finance minister, Wolfgang Schäuble, who lobbied the other finance ministers to agree to cancel the fines because he wanted to support the electoral chances of his conservative Spanish ally, then-President Mariano Rajoy²⁷. Earlier that year, then Commission President Jean-Claude Juncker had stated that France should not face an Excessive Deficit Procedure, "because it is France"²⁸.

Another example of the open politicisation of the implementation of the rules took place in 2018-2019 in the standoff between the Italian government and

²⁶ Smith-Meyer, Bjarke. 'Brussels decides against fining Portugal, Spain'. *Politico*. July 27, 2016. <https://www.politico.eu/article/no-fines-for-portugal-spain-over-budget-failures-european-commission-deficit/>.

²⁷ Elder, Florian. 'Wolfgang Schäuble bails out Spain, Portugal'. *Politico*. July 27, 2016. <https://www.politico.eu/article/wolfgang-schauble-bails-out-spain-portugal-sanctions-juncker-german-finance-minister>.

²⁸ Ibid.

the Commission. When the Italian government presented its draft budget for 2019, including a 2.4 per cent deficit, the Commission rejected it and threatened to enact the Excessive Deficit Procedure under the SGP. The proposed deficit did not even cross the SGP's 3 per cent limit. But using dubious mathematics to measure the structural deficit – what the deficit would be if the economy was at full employment – the Commission argued that the Italian economy, in recession, would be at risk of overheating if a fiscal deficit of 2.4 per cent was reached²⁹.

When French President Emmanuel Macron announced €10 billion in additional spending in December 2018 to defuse the *gilets jaunes* protests, taking France's projected deficit for 2019 up to 3.4 per cent, EU economic commissioner Pierre Moscovici gave the thumbs-up.

“The comparison with Italy is tempting but wrong,” he said³⁰. “The situations are totally different. The European Commission has been monitoring the Italian debt for several years; we have never done that for France.” This is despite the fact that it was only in 2017 that France emerged from a long period with a deficit breaching the SGP rules. A French treasury official agreed with Moscovici: “The situations are not comparable. Contrary to Italy, we do not question European rules. We agree that having public finances in order and reducing public debt are the right thing to do.”³¹

A study by Transparency International, which includes a case study on the Italian standoff, concludes that “By using their political weight to exert pressure on the Commission and to form coalitions in the Ecofin Council

²⁹ For a detailed account of the politicised process surround the Excessive Deficit Procedure opened against Italy in 2018, see Braun, Benjamin and M. Hübner. 2019. *Vanishing Act: The Eurogroup's accountability*. A report for Transparency International EU.

<https://transparency.eu/wp-content/uploads/2019/02/TI-EU-Eurogroup-report.pdf>

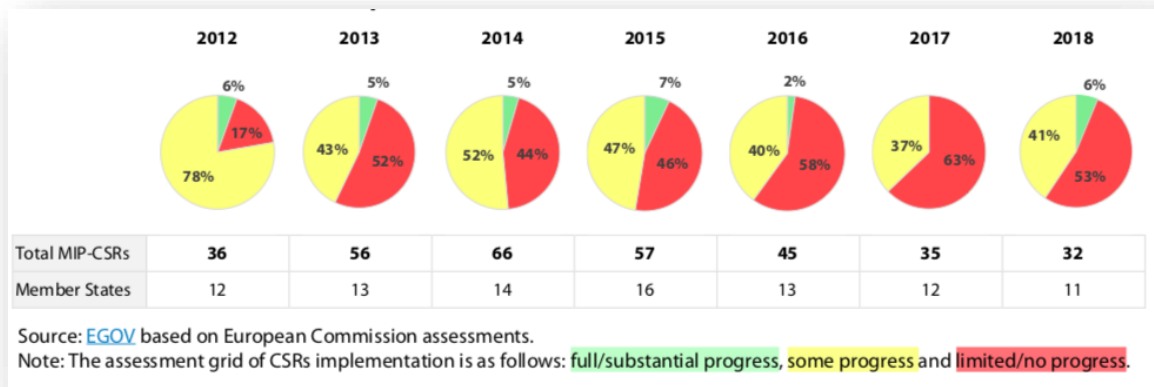
³⁰ Keohane, David and H. Agnew. ‘French budget position not like Italy’s, Brussels says’.

Financial Times. December 12, 2018. <https://www.ft.com/content/bac53c30-fe25-11e8-aebf-99e208d3e521>.

³¹ Ibid.

and the Eurogroup, [large] Member States regularly avoid Excessive Deficit Procedures being launched against them.”³²

Implementation of country-specific recommendations based on MIP, 2012-2018³³



5.2 A corrosive impact on democracy

A common criticism of the SGP from across the political spectrum is that it is unenforceable. However, despite the lack of concluded sanction procedures, the pressure placed on member states – particularly the smaller member states – by the Commission has certainly had a demonstrable impact on their fiscal and public policy. The indicators under the SGP, MIP and ‘structural reform’ framework have enabled the Commission to engage in significant overreach when it comes to public policy areas that legally fall under the competence of the member states under the TFEU, such as pensions and the provision of healthcare.

³² Braun, Benjamin and M. Hübner. 2019. (Above note 28.)

³³ Reproduced from Zoppè, Alice. 2020. Implementation of the Macroeconomic Imbalance Procedure: State of play - January 2020’. In-Depth Analysis by Economic Governance Support Unit (EGOV). [https://www.europarl.europa.eu/RegData/etudes/IDAN/2016/497739/IPOL_IDA\(2016\)497739_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/IDAN/2016/497739/IPOL_IDA(2016)497739_EN.pdf).

In a special report on the operation of the Stability and Growth Pact in 2018³⁴, the European Court of Auditors (ECA) found that, in relation to the Macroeconomic Imbalances Procedure, the way in which the Commission classifies member states with imbalances “lacks transparency”. Further, the ECA found that the country-specific recommendations issued by the Commission under the Macroeconomic Imbalance Procedure do not actually stem from identified imbalances; and that, in general, there is a lack of public awareness, visibility and understanding of the procedure and its implications.

³⁴ European Court of Auditors. 2018. *Is the main objective of the preventive arm of the Stability and Growth Pact delivered?* Special report no 18/2018.
<https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=46430>



6. Flawed economics, ideology and methodology

6.1. Expansionary austerity?

The Stability and Growth Pact is based on conservative ideology and disproven economic theory. The current level of public debt in the EU was not caused by reckless government spending, but rather by the socialisation of private debt and dramatic increases in the costs of borrowing due to “market discipline”. The ensuing austerity severely exacerbated the economic downturn in the EU, worsening and prolonging its effect.

The member states are prevented from engaging in fiscal stimulus policies by the SGP, and the Commission lacks the capacity to do so, with an EU budget of only one per cent of EU GDP. At the same time as limiting public investment and expenditure, the EU facilitates massive levels of tax avoidance by multinational corporations that further deny governments’ access to vitally needed revenue. Individual member states of the EU, several of which are recognised internationally as tax havens, are allowed

to veto proposals for effective action to combat tax avoidance in the Council through the process of unanimous voting on taxation matters³⁵.

The economic “confidence theory” holds that an economy with high unemployment can return to full employment through market forces alone. Instead of boosting public spending, the government should do the reverse. By cutting government spending and increasing taxes, the government deficit would be reduced, which would restore market confidence. This restoration of confidence would lead to increased private investment, and the market would adjust itself to return to full employment.

The confidence theory was demonstrated back in the aftermath of the 1929 crash to be incredibly damaging and to achieve precisely the opposite effect of what it aimed to achieve. The actual effect of implementing austerity in a period of economic downturn was to cause a contraction in the economy, thus weakening the economy further, causing tax revenues and national income to fall, and the deficit to increase. The contractionary impact of austerity policies during a downturn was explained by Keynes during the 1930s, and Keynesian models have proved to be a reliable predictor of growth (or lack thereof) in the wake of the 2007-2008 crisis³⁶.

Evidence abounds of how the programmes imposed by the Troika – the Commission, the ECB and the IMF – on the EU's peripheral economies since 2008 have exacerbated the crisis. In the decades before the global financial crisis, these same policies had caused the exact same devastating contractionary effects when imposed under the guise of “structural adjustment programs” by the IMF across Africa, Asia and Latin America.

³⁵ Langerock, Johan. 2019. *Off the Hook*. Oxfam report.
<https://oxfamlibrary.openrepository.com/bitstream/handle/10546/620625/bn-off-the-hook-eu-tax-havens-070319-en.pdf>

³⁶ Stiglitz, Joseph. 2016. (Above note 2).

A slightly recalibrated confidence theory – of an expansionary fiscal contraction – has been proposed by a small number of economists associated with the neoliberal school of thought since the 1990s. Harvard's Alberto Alesina and Goldman Sachs's Silvia Ardagna have led the charge in reviving this theory since the crisis³⁷. Despite strong criticism of the methodology and findings of these “expansionary austerity” studies, the Commission has heavily depended on their work since 2009.

A wide body of counter-evidence shows that austerity routinely results in lower GDP growth, higher unemployment and depressed demand – effects that only decline if interest rates are reduced by the central bank and if the exchange rate is depreciated.

Then-IMF chief economist Olivier Blanchard admitted in 2013 that the IMF had got its forecasts for growth in response to post-crisis austerity policies drastically wrong by significantly over-estimating the fiscal multiplier effect³⁸. [The fiscal multiplier measures the effect that increases in fiscal spending will have on GDP.] The IMF had forecast that for every dollar of fiscal consolidation, economic activity would decline by \$0.50. Blanchard found that in reality, every dollar that governments had cut from their budgets in fact reduced economic output by \$1.50.

6.2. Fiscal multipliers at the zero lower bound

Further IMF research by Jorda and Taylor in 2013 examined how fiscal consolidation has different effects if the economy is in a downturn. They show that “austerity is always a drag on growth”, but the cumulative impact

³⁷ See, for example, Alesina, Alberto and S. Ardagna. 2009. *Large Changes in Fiscal Policy: Taxes Versus Spending*. National Bureau of Economic Research Working Paper No. w15438. Alesina's publications making this argument began in the 1990s: see, for example Alesina, Alberto and R. Perotti. 1996. *Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects*, NBER Working Papers 5730.

³⁸ Blanchard, Olivier, and D. Leigh. 2013. ‘Growth Forecast Errors and Fiscal Multipliers’. *American Economic Review*, Vol. 103, No. 3, pp. 117–20.

of cut to spending of one per cent of GDP results in a contraction of around 2.5 per cent of GDP after four years in a downturn, compared to GDP only contracting by 0.9 per cent in a boom³⁹. Research shows that fiscal multipliers are bigger in a slump in general, and particularly so when the impact of monetary policy is weakened, such as in the zero lower bound. [The zero lower bound is a problem that arises when interest rates are at or close to zero, limiting the capacity of monetary policy to stimulate growth.]

Significantly, recent research⁴⁰ has shown that public investment also has a much larger impact in the context of the zero lower bound. If the short-term interest rates are low or at zero, the fiscal multiplier for spending is stronger.

6.3. Calculating the structural deficit in the SGP – the output gap debate

Related to the debate over expansionary austerity is a strong strand of criticism of the Commission's model to determine the output gap, used to calculate the structural deficit in the SGP process. The output gap is an estimate of what an economy's real GDP would be if it was at normal capacity. [The "gap" refers to the difference between actual output and potential output. "Structural" deficit or surplus means that which is at the discretion of the government and not attributable to cyclical changes]. It is unobservable – a guess based on the experience and data of the recent past.

The Commission has linked the size of the output gap and the fiscal adjustment requirements it imposes. If the output gap is small, it is assumed

³⁹ Jordà, Òscar, and A. M. Taylor. 2013. 'The Time for Austerity: Estimating the Average Treatment Effect of Fiscal Policy'. NBER Working Paper No. 19414.

⁴⁰ Batini, Nicoletta, L. Eyraud, L. Forni, and A. Weber. 2014. 'Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections.' IMF fiscal Affairs Department Technical Notes and Manuals. <https://www.imf.org/external/pubs/ft/tnm/2014/tnm1404.pdf>.

that the production factors are operating at normal capacity and the state's fiscal space is reduced under the SGP, whether or not the economy is in a downturn. If the output gap is larger, then the member state is given more space for discretionary spending⁴¹.

The “truly perverse”⁴² effects of basing the fiscal space on this model was illustrated clearly in the standoff between Italy and the Commission in 2018-2019, which largely focused on the Commission's calculation of Italy's structural deficit. In a period of strong economic growth, the potential output of an economy will increase, meaning that its fiscal stance will appear to be well-balanced. The EU's double-dip recession has led to the opposite effect, causing the gap between real output and potential output to shrink. This method resulted in the bizarre situation where the Commission demanded that Italy, in a recession and with a GDP 8 per cent smaller than in 2007, cut public spending – lest its economy overheat.

⁴¹ For more on this see research for the Institute for New Economic Thinking, for example: Heimberger, Phillip, and J Kapeller. ‘How economic policy drives European (dis)integration’. Article, September 22, 2016. <https://www.ineteconomics.org/perspectives/blog/how-economic-policy-drives-european-disintegration>. And Costantini, Orsola. ‘Why Hysteria Over the Italian Budget Is Wrong-Headed’. Article, October 10, 2018. <https://www.ineteconomics.org/perspectives/blog/why-hysteria-over-the-italian-budget-is-wrong-headed>.

⁴² Tooze, A. ‘Output gap nonsense’. Social Europe, April 30, 2019. <https://www.socialeurope.eu/output-gap-nonsense>.

7. The question of public debt

7.1. Overview of public debt in the EU

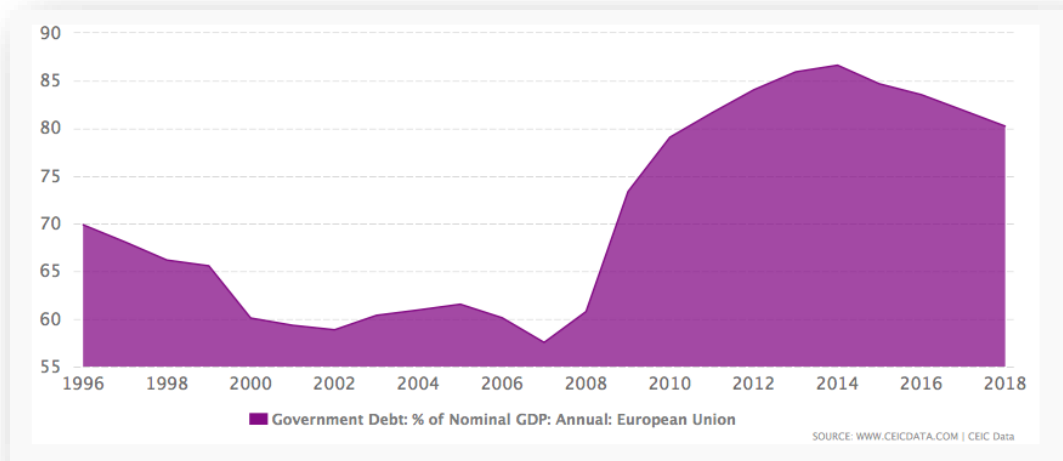
Governments fund public spending and debt-servicing by issuing new bonds (debt) to be purchased by the private sector (or central bank), and the collection of taxes. In the eurozone, however, direct monetary financing of government spending is prohibited by the Treaty on the Functioning of the EU (TFEU), meaning taxation and borrowing are the only options under the current set-up.

The public debt-to-GDP ratio is dependent on the real GDP growth rate, the annual primary budget balance (excluding debt servicing costs), and on the real interest rate to be paid on the state's debt stock. As a result, there are two main ways in which this ratio can be reduced: (1) the growth rate is higher than the interest that must be paid on the existing debt, which will result in a surplus; or (2) as a result of rising inflation. In general higher inflation results in a lower interest rate, helping a government to reduce its debt. Put simply, economic growth and inflation help reduce the public debt⁴³.

The EU is now faced with long-term stagnation and prolonged low inflation, which means that a reduction of the debt to GDP ratio in this context requires direct cuts to regular government expenditure and investment levels.

⁴³ Theodoropoulou, Sotiria. 2018. *Managing public debt in Europe*. European Trade Union Institute report. <https://www.etui.org/Publications2/Guides/Managing-public-debt-in-Europe-an-introductory-guide>.

Nominal government debt to GDP ratio in the EU 1996-2018



Source: ceicdata.com.

The average public debt to GDP ratio in the EU has expanded from an average of around 70 per cent in 1997 to 80.4 per cent in 2018. Eurozone debt was lower than the EU average in 1997, but this trend has now been reversed. Eurozone public debt peaked at 93.0 per cent in 2014 and declined to 86.1 per cent in 2018⁴⁴.

Public debt is not inherently “good” or “bad”. The level of debt is not so important as long as the state is able to roll over its debt (by borrowing more) and continue servicing it (paying the interest owed)⁴⁵. In the current context of prolonged ultra-low interest rates, there is little to no cost to borrowing. Former IMF chief economist Olivier Blanchard argued in 2018 that in a period where interest rates are lower than the growth rate, “public debt may have no fiscal cost”⁴⁶.

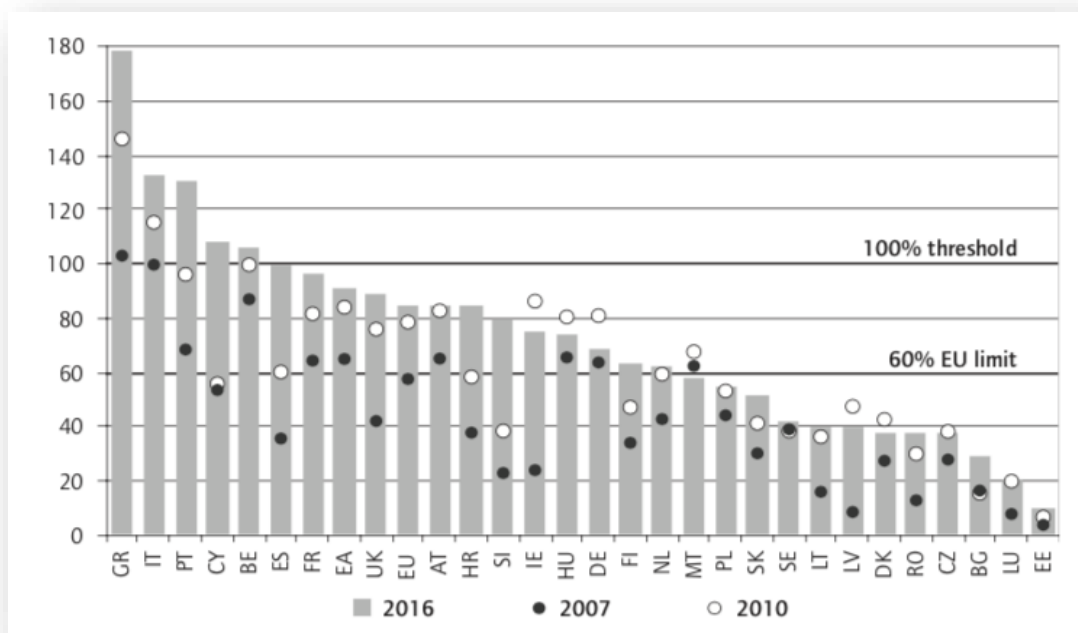
⁴⁴ Eurostat. 2018. <https://ec.europa.eu/eurostat/documents/2995521/9984123/2-19072019-AP-EN.pdf/437bbb45-7db5-4841-b104-296a0dfc2f1c>.

⁴⁵ Theodoropoulou, Sotiria. 2018. (Above note 41.)

⁴⁶ Blanchard, Olivier. ‘Public Debt and Low Interest Rates’. AEA Presidential Lecture, given in January 2019. September 24, 2018.

<https://economics.virginia.edu/sites/economics.virginia.edu/files/macro/Blanchard.pdf>.

Gross general government debt to GDP ratio by EU member state, 2007, 2010 and 2016



Source: AMECO

7.2. Did reckless public spending cause the sovereign debt crisis?

The precise scenario the SGP was supposed to prevent – a contagious sovereign debt crisis within the economic and monetary union – unfolded following the global financial crisis. One of the justifications behind the SGP was that member states required strict budgetary discipline to be imposed by the EU institutions because the discipline imposed by the market may not be quick and tough enough.

De Grauwe has described the widespread acceptance of the narrative that the EU's sovereign debt crisis was caused by the "profligacy of

governments” in the peripheral member states as “one of the most surprising intellectual developments” in the EU⁴⁷.

In reality the public debt levels in the crisis-hit countries, with the exception of Greece, were generally low before the global financial crisis, while Ireland and Spain were running budget surpluses. At the end of 2007 the eurozone debt to GDP ratio was 66.6 per cent, and 58.7 per cent for the EU27. The eurozone debt had declined from 72 per cent in 1999. The EU deficit was at 0.6 per cent of GDP in 2007. During the same period, private debt and financial debt ballooned. By 2009, the public debt to GDP ratio was 78.7 per cent in the eurozone and 73.6 per cent in the EU27, while the deficit reached 6.3 per cent of GDP in the eurozone and 6.8 per cent in the EU27⁴⁸.

The key factors behind the surge in the public debt levels in the peripheral member states after 2008 were: (1) the policies of the EU institutions and member states in organising a coordinated rescue of the financial sector, socialising massive levels of private debt; (2) the ECB's actions in failing to intervene to provide credit to the crisis-affected states for an extended period of time, causing the market borrowing costs for these states to surge; and (3) the pro-cyclical impact of the austerity programmes imposed by the Troika.

7.3. Risk premium on interest rates

While there is a single interest rate across the eurozone set by the ECB, the risk premium on government bonds and bank debt in different countries means the real interest rate differs significantly across the common currency area. The perceived risk in lending to a weaker country is reflected in the spread of interest rates. Where economies are viewed as strong (and

⁴⁷ De Grauwe, Paul. ‘Why a tougher Stability and Growth Pact is a bad idea’. VoxEU article. October 4, 2010. <https://voxeu.org/article/why-tougher-stability-and-growth-pact-bad-idea>.

⁴⁸ Eurostat, various dates.

governments viewed as being capable of bailing out their banks), their banks will benefit from lower interest rates. Weaker countries and their companies have to pay a higher interest rate. During a crisis, capital flees to the “safe” countries’ banks. Since 2008 capital has flowed from the poorer countries to the rich – not only in the eurozone but across the global economy – with a large proportion of global capital fleeing to the US. Inside the Eurozone, the trend has been for capital flight from banks in the periphery to the core, particularly to Germany.

The “foreign currency” nature of the euro – the fact that countries could not create the money they were borrowing in – meant that the belief by investors in the years following the creation of the common currency that all eurozone government bonds were equal was short-lived. From 2007-2009 the spreads between government bonds in Greece and government bonds in Germany (bunds) increased tenfold up to 2.8 percentage points, with the market giving its verdict on the creditworthiness of the Eurozone’s deficit countries. This increased again to a differential of almost 4 percentage points by April 2010, when the Greek government found itself unable to keep funding itself from international money markets.

Former Greek finance minister Yanis Varoufakis described this “market verdict” of risk strikingly: “Suddenly [in 2009-2010] hedge funds and banks alike had an epiphany. Why not use some of the public money they had been given [in the mass bank bailouts] to bet that, sooner or later, the strain on public finances (caused by the recession on one hand, which depressed the governments’ tax take, and the huge increase in public debt on the other, for which the banks were themselves responsible) would cause one or more of the Eurozone’s states to default?”⁴⁹

The most common way to place these bets was through credit default swaps (CDS), which are basically insurance policies that pay out in the case of a

⁴⁹ Varoufakis, Yanis. 2016. *And the Weak Suffer What They Must?* Vintage, London.

default by a third party. As the CDS casino on sovereign debt in the eurozone grew – instead of this capital being directed towards productive investment or economic recovery – the rising value of CDSs in the peripheral economies caused these countries' interest rates to surge. Ireland defaulted in December 2010, followed by Portugal and Cyprus. The existential crisis of the Eurozone began in 2011 when the CDS bets on Spain and Italy defaulting caused the spreads in the government bonds of these two countries to diverge from bunds by between 3 and 6 percentage points, yield rates that had pushed Greece, Ireland and Portugal over the edge.

The ECB refused to intervene for a prolonged period, contributing to (arguably manufacturing) the sovereign debt crisis of 2009-2012. Tooze refers to the “bond market vigilantes” behind the massive capital flight from the periphery to the core during this period, and adds: “The role of bond markets in relation to the ECB and the dominant German government was less that of a freewheeling vigilante, than of state-sanctioned paramilitaries delivering a punishment beating whilst the police looked on.”⁵⁰ When the ECB finally intervened, it attached strict conditions of spending cuts and structural reforms to the lifeline of credit.

⁵⁰ Tooze, Adam. Notes on the Global Condition: Of Bond Vigilantes, Central Bankers and the crisis 2008-2017. Blog post. November 7, 2017. <https://adamtooze.com/2017/11/07/notes-global-condition-bond-vigilantes-central-bankers-crisis-2008-2017/>



8. Behind the 'structural reform' agenda

8.1. Spillovers in a monetary union

There are many spillover effects that one economy can have on another in a monetary union – for example, the deflationary impact of running an intra-union current account surplus – but the only spillover effect that the architects of the Maastricht Treaty focused on was member states' fiscal policy. Stiglitz commented: "Somehow they seemed to believe that, in the absence of excessive government deficits and debts, these disparities would miraculously not arise and there would be growth and stability throughout the eurozone; somehow they believed that trade imbalances

would not be a problem so long as there were not government imbalances.”⁵¹

Of the various adjustment mechanisms identified by optimum currency area theorists, the eurozone's founders have clearly focused single-mindedly on attempting to achieve “flexibility” of wages. Countries inside a common currency area cannot engage in competitive devaluations by devaluing their currency to make their exports more competitive. But they can implement policies domestically to bring about an internal devaluation – lowering their real exchange rate vis-à-vis their neighbours. The main way this takes place is by compressing or reducing wages, which causes prices to fall. Germany has consciously implemented this policy for several decades, at the expense of German workers, millions of who are working but living in poverty. This long-term strategy was intensified in 2003 under the then Social- Democrats/Green coalition government, which carried out a radical reform of the labour and welfare systems entitled Agenda 2010.

8.2. Unit labour costs and competition

The competitiveness of prices largely determines the performance of a country's exports, and the key factor determining prices is the nominal unit labour cost (the nominal unit labour cost is the ratio of labour cost per employee to productivity - the value added per worker). Unit labour costs in Germany stopped growing in the mid-1990s. Between 1998 and 2007, the rise in unit labour costs in Germany was zero. But in the rest of the Eurozone over the same period, average wage costs mainly increased with inflation, of around 2 per cent per year. This difference greatly increased the competitiveness of German exports and reduced it for the exports of other Eurozone members. So the success of Germany's economic model is at the expense of the rights and living standards of its workers. The Agenda 2010

⁵¹ Stiglitz, Joseph. 2016. (Above note 2.)

strategy has been deepened under successive governments and by 2015, more than 12.5 million Germans, out of a population of 80 million, were living in poverty in Europe's economic powerhouse.

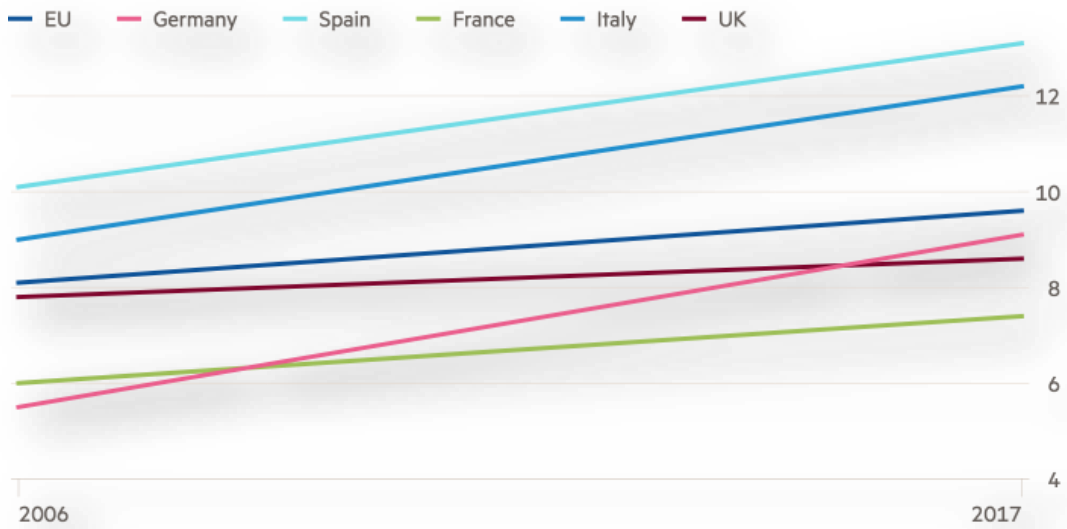
The EU's focus on structural reform, particularly labour market reform, with a view to achieving increased "flexibility" has been a constant feature of its agenda since Maastricht. This was a major element of the Jobs Strategy of 1994, and the Lisbon 2010 Agenda adopted in 2000. The Lisbon Agenda originally set out to make the EU "the most competitive and dynamic knowledge-based economy in the world" by 2010. It included an economic pillar, a social pillar and an environmental pillar.

In 2005, the Lisbon Agenda was revised by the European Council and Commission. Their verdict was that the agenda was failing to achieve its goal, and so they decided to drop the social and environmental pillars and focus on the economic pillar. In 2010 the Lisbon Agenda was relaunched as a new 10-year plan, the Europe 2020 strategy – "an agenda for new skills and jobs: to modernise labour markets by facilitating labour mobility and the development of skills throughout the lifecycle with a view to increasing labour participation and better matching labour supply and demand"⁵² .

The impact of this deregulation of the labour market can be observed in the growth in the proportion of EU workers at risk of poverty, the fall in the labour share of profit and through other indicators.

⁵² European Commission, 2010. 'Europe 2020 Strategy', https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/framework/europe-2020-strategy_en

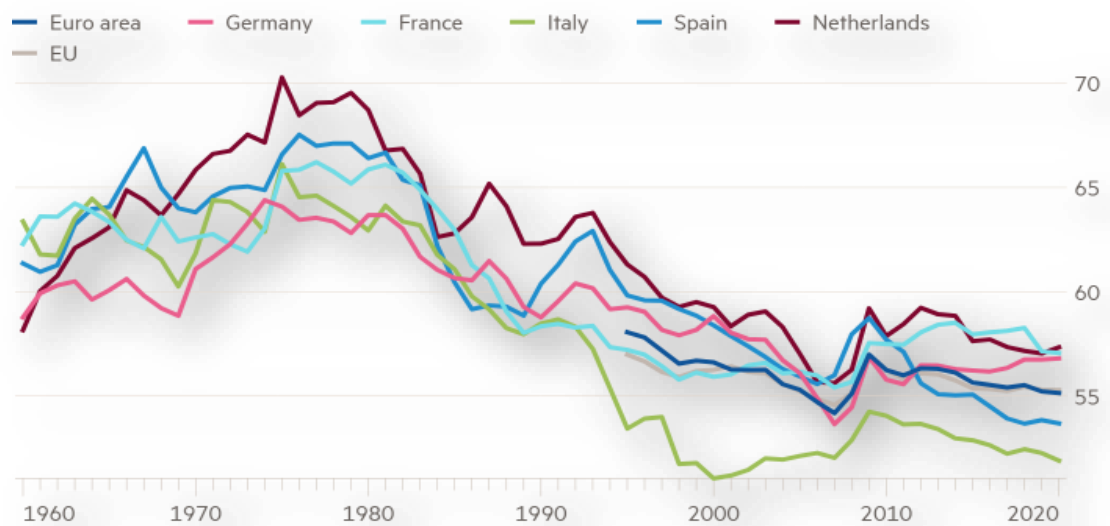
Share of employed people at risk of poverty %



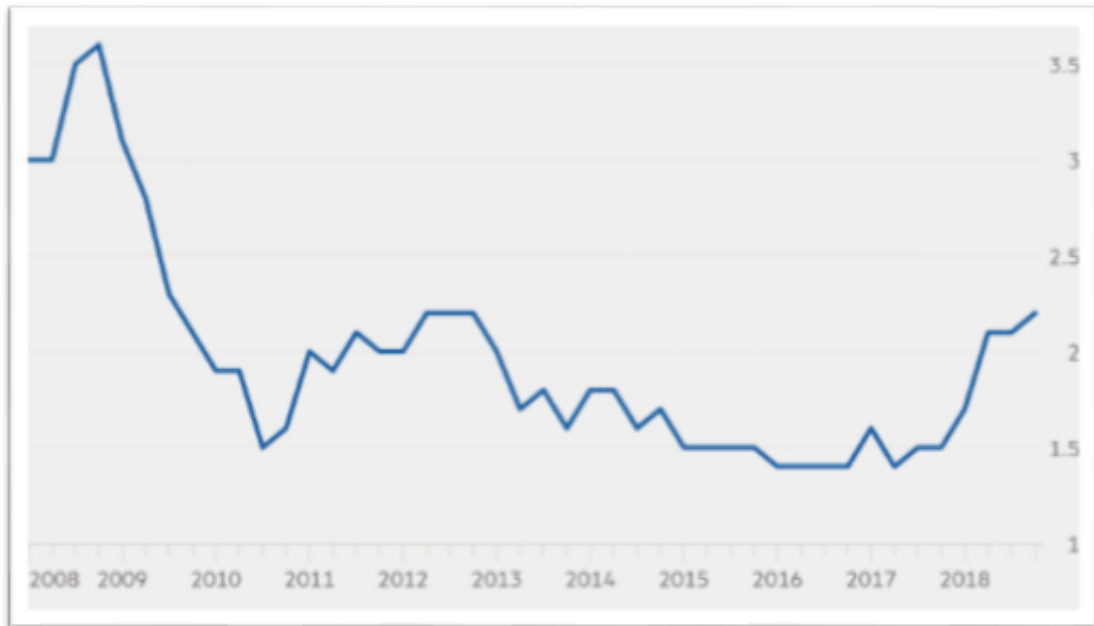
Workers in a household with an income below 60% of the national average income

Source: Eurostat, compiled by Valentina Romei for the *Financial Times*.

EU wages have shrunk: Wages to GDP ratio %



Source: AMECO, compiled by Valentina Romei for the *Financial Times*.

Negotiated wage growth in the EU: Annual % change

Source: AMECO, compiled by Valentina Romei for the *Financial Times*.

8.3. Structural reforms

The “progress” of member states in implementing structural reforms that can facilitate downward movement on wages is monitored through the European Semester process, as outlined above. The Commission technocrats believe (or claim to believe) that if only “wage rigidities” in the member states were overcome, both unemployment and trade imbalances would disappear. If only a country’s population could be forced to work for poverty wages, there would be a job for everyone; and the resulting stagnation in domestic demand would mean prices would fall and this country’s real exchange rate, which had become misaligned and risen too high, could regain its balance. This view underpins the drive to enforce structural reforms in order to increase productivity and competitiveness – and profit. The austerity imposed by the Troika was not only designed to regain market “confidence”

in peripheral governments, but also to facilitate internal devaluations in member states by a form of shock therapy.

University of London Professor George Irvin has described the insistence by the Commission that government profligacy is at the root of the Eurozone crisis as betraying “near-total ignorance of how economies work”. “Budget balance for a national economy is fundamentally different from that of the household or the firm. Why? Because budgetary (or fiscal) balance is one of three interconnected savings balances for the national economy. The other two fundamental economic balances are the current external account balance... and the private sector savings-investment balance. If any one account is out of balance, an equal and opposite imbalance must exist for one or both of the remaining accounts.”⁵³

It will come as little surprise that a system designed to promote the mercantilist model of wage suppression, low inflation and export-led growth, propped up by a currency modelled on the Deutschmark, has benefited one country more than all other members of the eurozone. In February, a German ordoliberal think tank affiliated with the ruling Christian Democrats, the Centre for European Policy, published an empirical study of the “winners and losers” from the euro twenty years after its introduction⁵⁴. It found that Germany was the big winner, having benefited by €1.9 trillion from the euro between 1999 and 2017, or around €23,000 per person. The Netherlands was the only other state that gained substantial benefits from the common currency. France had lost €3.6 trillion or €56,000 per person; while Italy had lost more than any other state, at €4.3 trillion or €74,000 per person⁵⁵.

⁵³ Irvin, George. ‘Why Europe's fiscal compact is bound to fail’, *The Guardian*, May 11, 2012. <https://www.theguardian.com/commentisfree/2012/may/11/europe-fiscal-compact-fail>.

⁵⁴ Gasparotti, Alessandro, and M. Kullas. 2019. *20 Years of the Euro: Winners and Losers An empirical study*. CEP study.

https://www.cep.eu/fileadmin/user_upload/cep.eu/Studien/20_Jahre_Euro_-_Gewinner_und_Verlierer/cepStudy_20_years_Euro_-_Winners_and_Losers.pdf

⁵⁵ Ibid.

Germany's massive and consistent trade surplus – whereby the country's exports have for many years exceeded its imports by nearly €300 billion – has meant that its biggest export to the rest of the eurozone has been stagnation. Around two-thirds of this surplus is generated by intra-EU trade, sapping demand from the economies of other member states. But as a result of the harsh fiscal discipline applied in the wake of the recession, there is not enough internal demand in the eurozone to sustain German industry. Now that a global slowdown has taken hold, and growth is slowing in China due to US trade tariffs and a debt crisis, the dangers of this economic model are exposed.

9. A grim economic outlook

9.1. A long period of stagnation

Addressing a bankers' convention in Frankfurt in November 2018, then ECB President Mario Draghi outlined the weak and fragile nature of the eurozone's recovery: "Since 1975 there have been five periods of rising GDP in the euro area. The average duration from trough to peak is 31 quarters, with GDP increasing by 21 per cent over that period. The current expansion in the euro area, however, has lasted just 22 quarters and GDP is only around 10 per cent above the trough. In contrast, the expansion in the United States has lasted 37 quarters, and GDP has risen by 21 per cent."⁵⁶

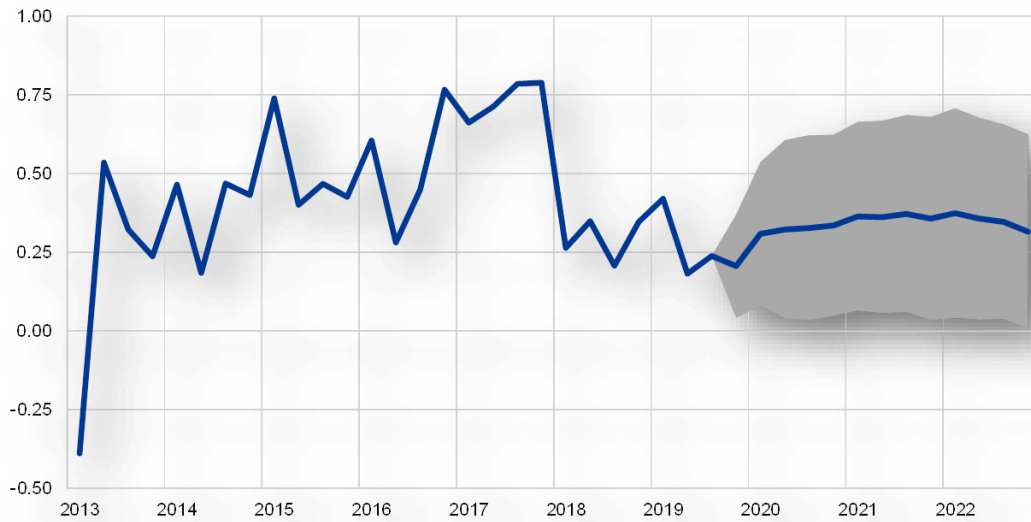
Following a decade of recession and grindingly slow growth, eurozone growth peaked at 2.4 per cent in 2017. This can be explained by a massive fiscal expansion. But the expansion did not take place in the eurozone; it was a result of the fiscal policies implemented in the US, Japan and China, in the latter two cases funded by their respective central banks. Such an expansion could not possibly have taken place in the EU under the stifling and arbitrary debt and deficit ceilings of Stability and Growth Pact.

The long stagnation in the eurozone can be partially explained by the post-crisis austerity shock treatment applied to the periphery by the Troika, but the architecture of the common currency has acted as a brake on sustainable growth and convergence - and investment - since day one. The euro has been built on an enduring effort to constitutionalise austerity, an

⁵⁶ Draghi, Mario. 'The outlook for the euro area economy.' Speech by Mario Draghi, President of the ECB, Frankfurt European Banking Congress. Frankfurt. November 16, 2018. <https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp181116.en.html>

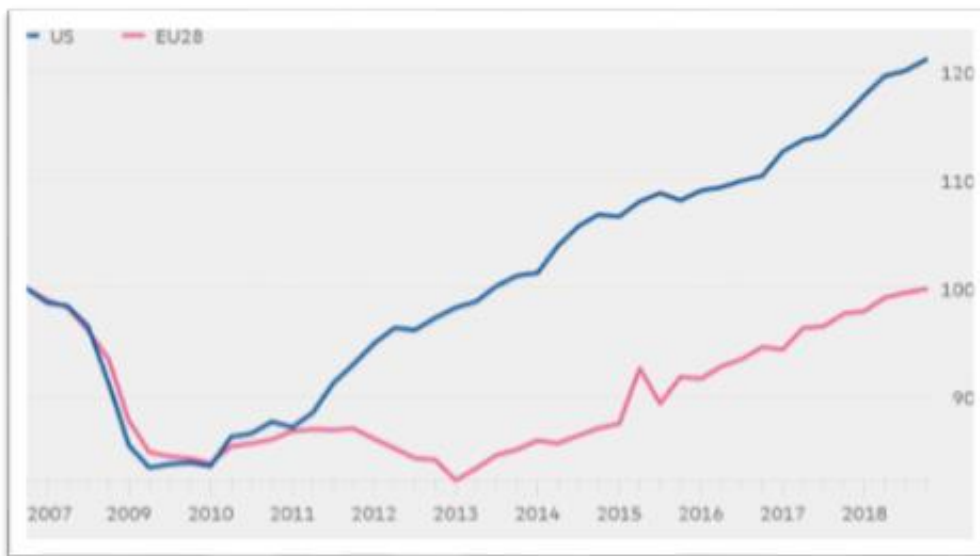
effort that continues today despite all of the evidence demonstrating that it causes economic contraction.

Real GDP growth in the Euro area, 2013 - 2022 (projected)



Source: ECB

Gross fixed capital formation in the EU (investment growth)



Source: OECD and Eurostat, compiled by the *Financial Times*.



10. Conclusion

The Stability and Growth Pact has failed to promote stability or growth. It has failed to prevent a sovereign debt crisis in the EU and it has failed to ensure an economic recovery. It has instead resulted in a massive transfer of wealth to the richest segment of society, while dismantling employment rights, punishing working people and those who rely on public services.

It was always intended to do so.

International institutions such as the IMF and OECD have repeatedly called for increased investment by EU member states and a relaxation of the SGP. Even EU institutions such as the European Fiscal Board are calling for public investment to be excluded from the fiscal rules. The revision of the SGP that is to take place this year presents an important opportunity to shape the future of European fiscal policy.

This report has largely focused on analysing the problems inherent in the SGP and the European Semester process as opposed to outlining detailed proposals for change. Left-wing representatives and activists will participate in the formal consultation process on the revision of the SGP as well as joining and mobilising social movements to demand change.

However, we outline some principles that should inform Left efforts to shape the future of fiscal policy below:

- All discussions about economic and fiscal policy need to begin by acknowledging the enormous challenges we face collectively in navigating a future threatened by climate disaster; planning for the major changes already unfolding as a result of automation and digitalisation; and dealing with the political crisis stemming from rampant and rising inequality.
- The fiscal rules and the European Semester process that enforces them should not merely be loosened but dismantled. The historic task of transforming our societies and economies cannot be left to the market. This transformation needs to let by coordinated, massive and sustained public investment. Proposals to exempt qualifying green investments or even public investment in general are welcome, but they are not sufficient. Investment in a socially just climate transition cannot be restrained by faceless technocrats and arbitrary numbers.
- While economists and international institutions argue that productive investment should be excluded from the debt and deficit rules in order to promote economic growth – correctly – the Left needs to also call for an end to restrictions on expenditure on social services and an adequate level of direct social transfers.

- In the EU, and particularly in the eurozone, fiscal policy is the central mechanism available to carry out the redistribution of wealth. Tax evasion and tax avoidance need to be dealt with decisively, in particular by ensuring multinational corporations are taxed as a single entity under a system of unitary taxation. This will require an end to qualified majority voting on taxation matters in the Council. New direct taxes on wealth need to be placed firmly on the public policy agenda, while regressive consumption taxes should be opposed.
- The wage suppression and labour “flexibility” strategies being pursued under the SGP and the European Semester process should be opposed at every opportunity.
- The Left should reject the surplus cult promoted by neoliberal ideology. A budgetary surplus or a budgetary deficit is the means to achieving an end, not an end in and of itself.
- The SGP has had a deeply corrosive impact on democracy in the EU. Decisions about public spending in particular economies should be shaped by the people living in those economies and by accountable representatives acting on their behalf. European decision-making regarding economic plans to deal collectively with climate change, digitalisation and inequality should be fully inclusive of communities, workers, trade unions and young people.
- Cooperation in the EU and monetary union should be on the basis of partners acting together to promote a green and social future, economic wellbeing and convergence.

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