Fostering Economic Growth through a "European" Debt

Maria Teresa Salvemini

There is a general consensus that the long period of stagnation that has afflicted the European economy is a symptom of more profound structural problems that cannot be solved with expansionary macroeconomic demand policies, much less left up to market forces or financial rigour. The most important problem is the low productivity of European economies, which has now been recorded for many years. This low productivity can be explained in a number of ways, including inadequate public investment in both physical and human capital.[1] Although the link between public investment and productivity and efficiency in the private sector is indirect, and therefore cannot always be precisely quantified, there can be no doubt that the effect of market failures are being felt in numerous sectors of the economy: advanced and applied research, training in information technologies, environmentally compatible infrastructure, low-yield and capital-intensive investments, to mention just a few. Thus, there is room for new development policies based on building the public capital – material and immaterial – which is needed to stimulate that growth of productivity in the private sector that economic theory and historical experience have found to be important.

The problem is that, given the rigidity of national budgets in Union countries and the constraints put on deficit by the Stability Pact, the resources available to the individual states for modernising and strengthening intervention in the fields of education and research, for improving infrastructure in information and communication technologies and for solving the general shortcomings in infrastructure that curb labour mobility and the growth of entrepreneurial services, are just not enough. What is needed is community co-financing. Such resources would of course be subject to regulation, the principles of which, unlike those underlying the creation of the single market, still have to be defined. Regulations could be used to reduce the areas of inefficiency and unproductive rents arising from national spending in those areas. Moreover, community resources could favour national

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[1] Illustrated in a number of empirical studies, European Commission, "Public Finances in EMU", 80–2.

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policies that deploy the complete array of instruments available for sectoral development policies (incentives, tax regulations, etc.).

In some sectors there is also a coordination problem when it comes to policies adopted by national governments. In these sectors, effective Union intervention based on "the power of the purse" could be useful. In general, the principle of subsidiarity in the field of development policy can be taken to mean that the highest level of government is entrusted with interventions that create a network. The reference here is above all to trans-border physical infrastructure, which can only be used fully if it extends or is completed in all interested countries. But now that modern communication technologies have enhanced the value of exchanges of experience and synergic work, it also refers – and here the field of action still has to be thoroughly explored – to investments, even immaterial ones, that are made more effective if they are contemporaneously present in a number of European countries. Today, large research centres communicate at great distances and there is no longer any need to concentrate researchers in one place. Instead it is important to ensure that there are numerous research centres – linked together and able to cross-fertilise each other – in the more advanced fields with high growth potential. The Union could favour the process of selection of these research fields and plan their network-like growth. This is a task that requires planning and regulatory ability, but also financial resources.

Other important examples can be found in the field of technological transfer: a network of European "incubators" or of innovative financial structures able to allocate resources to businesses operating in technologically advanced sectors could be organised so as to ensure that all the scientific input existing on European territory is fully used and widely accessible.

It is certainly not with the resources allocated in the 2007-2013 Financial Perspectives, however, that these development policies can be carried out.[2] Other resources have to be found, even if it is obvious that the resources in themselves cannot guarantee that the objective of higher growth in the long term will be achieved. It is the attentive selection of the areas of spending that guarantees success.

The limits to an increase in EU revenue

Increasing the revenues of the Union budget is a difficult – if not impossible – goal. The revenue issue is at the root of the most evident shortcomings of the current European budget system. This explains the rigidity of choices that are based on multi-year decisions concerning, above all, the size of transfers from national

[2] See the Interinstitutional Agreement between the European Parliament, the Council and the Commission on budget discipline and healthy financial management, *Official Journal of the European Union*, 14 June 2006.

budgets or economies to the community budget and, simultaneously, the distribution of those resources as a function of an acceptable sharing of the net balances between credit and debit in each country. Yet Europe has no real taxation power. Repeatedly tabled, the problem has never been solved. On the contrary, it has become worse over time because the Union's own resources, which pursuant to the Treaty establishing the European Community (art. 269) are meant to finance Union spending, barely cover a quarter of it.

Increasing spendable resources by increasing transfers has also been impossible to date because, with the member states' budgets dangerously close to the deficit limit, an increase in transfers to the Union is seen as an alternative to other kinds of spending and has therefore been rejected. The 2004 reform of the Stability Pact made it possible to take transfers to the Union budget into account, but only as a part of the procedure on excessive deficit. Indeed, the toughness of the negotiations for the 2007–2013 Financial Perspectives can be explained by the importance attributed by each country to its "net balance" towards the Union in a situation of general fiscal stress and slow growth which generates budget gaps and makes it difficult to increase taxes.

But is it equally hard to envisage new "own resources" that would not *de facto* detract from states' tax base or that would not translate, in the end, into increased fiscal pressure at a time when this is seen as undesirable because of the Union's sluggish growth. As in all budgets, the question of revenue is not linked only to the need to finance spending; it is also a self-standing issue related to such matters as the distribution of the fiscal burden among various types of income or its effect on the dynamics of the economic system.

One criterion that could be introduced is subsidiarity, in the sense that some kinds of levies come up against greater opposition at the state level than at the Union level. One example are the customs duties that already exist on goods coming into the area from abroad. One could also consider the issue of taxation of financial yields as it represents the most important case of a levy made difficult by the fear that it would distort competition in the distribution of savings among national financial systems.

Other areas of possible optimisation of levies could be the taxation of polluting activities and productions, since there can be no doubt that more environmental protection would have positive externalities for the entire area. More generally, the link has to be made clearer between the tax or levy devised and the benefits that the very existence of the Union or the Union's activity generates which can, therefore, be considered a kind of dividend.

Another – perhaps easier – track might be value-added tax (VAT). In 1994, the European Parliament (Langes Report[3]) suggested introducing a VAT rate, separate

[3] Draft report on a new system of own resources for the European Union.

from the national rate but not additional to it, in favour of the EU budget. Another idea is to apply a very low (1 or 2 percent) VAT rate in favour of the Union to intermediate stages of production, leaving to the states the freedom to choose the overall level of taxation. The states could also choose whether or not to use the same rate for the last stage, that is sale to consumers, but there would be no EU levy there. This system could be used either simply to change the percentage composition of Union revenues or to increase them moderately. The advantage in both cases would be a clear perception on the part of EU citizens of the charges being levied, and therefore a much stronger democratic involvement in decision-making.

These are merely proposals and it does not look like there are any concrete plans for an increase in Union budget revenues in the near future, let alone increases large enough to make it possible to undertake the spending policies needed to bring Europe's long-term growth rate up to desirable levels.[4] If this is the case, then it might be better to look at the matter from a wholly different angle and explore whether it is absolutely necessary to find new revenues to deal with these spending needs. Perhaps another solution can be found.

Constraints on EU spending reductions

Today, most commentators consider the Union budget totally inadequate.[5] Criticism is directed at both its size (1.048 percent of European GDP) and the way it is spent. The rigidity of the budget is also criticized, as its multi-year focus prevents it from taking new needs into account.

Some critics, however, feel that it is not necessary to increase the EU's budget resources. This position reflects an idea of Europe substantially limited to the construction of the single market and which bases economic policy on the coordination of national budget policies, essentially to be achieved through the Stability Pact's constraints. Thus, these critics are in favour of a shift in resources within the budget. In particular, they underline that the common agricultural policy (CAP) is a serious burden for the Union in international trade negotiations, which prevents Europe from concentrating on other sectors such as services or the environment. They therefore seek a serious reduction in CAP funds – much more than was decided during the recent reform measures taken in the sector – and a substantial renationalisation of this area of expenditure.[6]

However, the obstacles to a mere change in the structure of the budget are obvious. The CAP is an extremely complex system which has been the object, over time, of continuous adjustments aimed at bringing its quantitative dynamics under control and making it less protectionist. Its initial goal of making Europe

[4] Cattoir, *Tax-based EU own resources*, 2004.
[5] See Sapir *et al.*, *Agenda for a growing Europe*, 2003.
[6] Gros and Micossi, *Better Budget for European Union* and *Confronting Crisis in European Union*.

self-sufficient in the food sector has been lost along the way; but it is precisely because it has become an income support policy that it can only be changed very gradually. Furthermore, it would not be very useful to shift this support action to national budgets, which are notoriously much less resilient to the pressure of strong lobbies.

The structural fund policy could also be improved. The new rules on structural funds recently approved establish a strong link to the objectives and instruments set down in the Lisbon Agreements as being crucial to the Union's growth. They reiterate that cohesion is the flipside of competitiveness and confirm the need to allocate resources to this policy without radical changes. But concentrating resources on the diffusion and transfer of knowledge and technologies is not enough to solve the broader and well known problem of the inadequacy of funds for research, education, large infrastructural networks, logistics needed to combat international trafficking, etc. On the other hand, it has become clear since the Union's last enlargement that there will not be enough political will in the coming years to change the Union's spending structure radically to make room for other policies. In any case, it is worth wondering whether the resources that could have been set free in this way would have been sufficient to finance the tasks that have to be tackled by the Union budget anyway, or whether it would simply have resulted in a shift from one kind of beneficiary to another without achieving any structural effects.

Another solution has to be found. It is advocated here that the rule calling for a balanced EU budget has to be eliminated.

The balanced budget rule

The Union's annual budget is based on a few principles set down in the Treaty establishing the European Community. Of them, the most important from the point of view of budget policy is the obligation to balance the budget: revenues have to equal spending, debt cannot be incurred to balance the budget.

Not only has the balanced budget rule not been modified in successive treaties, but no one has ever even seriously considered doing so – neither when Delors revived the European project nor when the contents of all the treaties were re-examined in view of drafting the Constitution. Not even during the most difficult times of disputes over the distribution of resources and burdens among member countries, has revision of this rule been tabled.

The rule was initially conceived in a historical context still dominated by the idea that, in order to ensure the financing of current expenses, public budgets had to be balanced. It was clear from the start, however, that a significant public investment policy was also required. The decision was taken not to intervene directly by giving power and resources to administrative bodies, but to act indirectly, creating an *ad hoc* agency, the European Investment Bank (EIB) – a bank modelled on various

well-tested public financial institutions operating in Europe. The characteristic common to these institutions being the fact that funds were not gathered from deposits but by issuing bonds. The bank had the advantage of being able to go into debt to the extent required to finance select investment projects, with the only limit being its statute and the will of the states and those taking up loans to enter into debt with the bank. This institutional arrangement made a balanced community budget possible by allowing matters of growth to be handled without strong constraints on resources, as would have been the case with either a deficit budget (because rules would have had to be introduced on the size of the debt or deficit) or with fixed resources, whether administered by an agency (a Fund) or directly by the community administration.

During its activity, the EIB has been extremely cautious about credit grants, adopting bankability criteria that are more suited to a private bank than a development institution, and giving priority to loans backed by state guarantees. Much attention has been given to defending the bank's independence, so that it has been enough for an industry seeking – and obtaining – financing to be located in a certain area or to provide a public service or even simply for a business to be small, for the bank to consider its statutory mission fulfilled.

Instead, the link to Union policies should be more instrumental. What is needed is an institutional arrangement allowing the Union's governmental bodies to have a stronger voice in setting the objectives and defining the measures needed to achieve them, leaving it up to the bank to find the resources and make the necessary transfers to the beneficiaries. Obviously, adequate subsequent checks on such interventions would be required.[7]

If the role of the EIB as a public agency is not defined more precisely, the institution's existence could be put into question at a time when there can be no talk of the failure of financial markets in this area, given the innumerable private banks and institutions ready to enter the sector and the many instruments developed to manage related risks.

It nevertheless seems hard to imagine that the EIB could take on the role of providing investment resources without any obligation of repayment, as is the case when resources come from a public budget. It is equally hard to imagine that projects would be selected applying the criteria used by public authorities. In other words, a renewed EIB would still not be enough for a Union that wants to take charge of its growth processes. Another look will have to be taken at the Union budget and the balanced budget rule.

[7] CEE Bankwatch Network, *Comments to EIB Public Disclosure Policy*. The European Parliament has also repeatedly complained that, while there are close relations between the EIB and the Commission, political control of the Union's loan and credit activity through the bank and other agencies is insufficient. In 1994, the Zavvos Report called for more checks and in 1995 the Blak Report called for more parliamentary supervision of "non budgetary finances in the Union".

Financing investments with debt

In 2004, when the Stability and Growth Pact was being revised, the proposal to introduce the golden rule, that is the rule that allows for debt financing of investment spending, was put forward once again. It was rejected at the time, however, because it was felt that the Pact was only supposed to be reinterpreted, not rewritten. But it seems perfectly legitimate to table the proposal for the EU budget again now. For example, in the case of the EU budget there is no risk that the financially more "virtuous" countries will be harmed in terms of savings and interest rates by the permissive budget policies of other countries. Moreover, theoretical support for policies based solely on budget balances is more tenuous than it used to be in the past. Therefore, in the presence of strong demand for infrastructure connected with the recent enlargement but also with the strengthening of the Union, a budget deficit in capital accounts could be justifiable.

The proposal put forward here is to allow for a spending deficit to a maximum of 1 percent of GDP every year. This could fuel spending of around €80–100 billion per year, a substantial figure that is nevertheless completely sustainable from the point of view of the euro financial markets, which are already much larger and growing, and that would not "crowd out" private investment. On the contrary, since a "European" debt would be attractive for investors, it would enhance the quality of the assets negotiated on these markets.

Some aspects of the proposal require clarification. First, the concept of investment spending. According to European statistics rules, public administrations' capital accounts include spending that increases fixed social capital (taken to include investments for information and communication technologies) and transfers to subjects outside the public administration when they are destined to increase or enhance the capital, whether public or private. Think of railway networks, which are generally owned and run by agencies or companies that are separate from the public administration. EU subsidies to these companies would obviously be considered investments to be included under capital accounts and could, therefore, be debt-financed by the Union.

There is also the question of whether the development of human capital could be included here. This question has already been debated for some time and many scholars advocate a "spending for development" concept that takes account of the Lisbon objectives. The European statistics rules already allow for research spending to be classified under capital accounts and this concept could be elaborated upon.

The Council itself could be asked to formulate the golden rule. What is important is to strip the balanced budget rule of its constitutional status – a status it does not have in any single country – and to bring it back into the sphere of the Council's political decisions. In that context, it could be left up to the Council to decide whether the interest on the debt would be paid or set aside every year or

whether the servicing burden could be shifted onto future fiscal years, allowing for temporary payment by recourse to debt.

Considering that the servicing of a debt of about €600 billion, for a multi-year development support programme, could come to about €25 billion annually, it is easy to see how this could be a problem for a budget of the size and rigidity of the Union's.

If the Council were to have the power to decide whether or not and to what extent to finance with debt its development interventions, it could also be free to decide on how to service the debt over time. Such decisions would be guided by the Council's assessment of the economic effects of public debt and the calculations and assumptions it would make with regard to inter-temporal constraints on the budget. It must not be forgotten that not only an estimation of the level of interest and the elasticity of income, but also a correct assessment of the long-term effects on growth of the debt-financed spending would have to be included in those calculations.

Finally, there would be no rule calling for a target for reduction of the stock of accumulated debt. Such a reduction would have to be decided explicitly by the Council. When the bonds mature, new ones would have to be issued. This would be essential to keeping the volume of debt on the market large enough to make it desirable for inclusion in private and public portfolios, as will be argued later. The debt stock would naturally have to be properly managed, responding to the variations in market demand with variations in duration, structure and composition. Ensuring that the market for these bonds is large and resilient would be a fundamental target for the Union's financial management.

At the moment, there is reason to believe that an EU debt of up to 6–7 percent over a few years would be enough to finance an investment plan to relaunch the European economy. At the same time, this would also be totally compatible with the aim of keeping European public debt at the level needed to make it an investment instrument, upholding savers' and markets' trust in the seriousness of the EU's financial management.

Nevertheless, to remove the obligation of a balanced budget, the Treaty of Rome would have to be revised. This is no small obstacle, even if it is not as difficult to overcome as it would have been had the Constitutional Treaty passed. Revision involves a complex procedure – a Council decision, approval by the national parliaments or by referendum. It could take a long time, perhaps too long given the urgency of relaunching the European economy.

But a favourable factor seems to be emerging. The question of what to do with the Constitutional Treaty was addressed at the June 2007 summit: a new text should be agreed by the Intergovernmental Conference by the end of the year. The timeframe for this operation is set by the fact that there will be new European Parliament elections in 2009 and it would be desirable to have completed

ratification by then. That is why this reflection on the EU budget and on the relaunching of the EU economy seems important – it takes time to shape consensus around a new idea.

Union debt and the international role of the euro

The implications of allowing the EU budget to go into deficit could extend far beyond the financing of a plan for public spending for investment and development. The decision would be in keeping with the idea that Europe has a more important role to play in the world economy, that it can compete with the United States in the field of monetary policy and that it can take advantage of the growth of the dynamic Asian and South American economies thanks also to the fact that it issues a reserve currency.

There has been a sharp increase in euro-denominated bonds (they now account for 31.5 percent of the total on the international market), as well as a marked increase in the use of the euro as the currency of denomination and payment in trade. It is remarkable that in important countries like Russia and China the euro is one of the main components of the basket of currencies used to set their exchange rate and that in 40 other countries the euro is used as the anchor for the exchange policy.[8]

But this is not enough to make the euro an international reserve currency. A reserve currency is not only a unit of account, it has to provide the international system of payments with the necessary liquid assets. Therefore, it has to be present to a significant degree in the official foreign exchange reserves of the major countries, especially those with a balance of payments surplus, and in the monetary reserves of banks operating on international markets. International Monetary Fund figures (which do not cover some important Asian countries) indicate that 25 percent of official reserves are now in euro, which is a good starting point. Large official reserves in euro are required if a country intends to use it as a currency for intervention on the exchange market (as Russia already seems to have done).

If the euro were to have real reserve currency status, like the dollar, and not only the – albeit important – role of a currency in which bonds and trade are denominated on the international market, this would have one important consequence. It would in itself put a sizable quantity of goods at the disposal of the Europeans. This is what happens in the United States. As Robert Triffin clarified in the sixties, holding a reserve currency is the same as selling one's goods to a country on credit. The country that issues the reserve currency can pursue a policy of increasing domestic demand without coming up against the limit of having to pay for an

[8] European Central Bank, "International role of the euro", 31–53; ECB, *Review of International Role of Euro*.

import surplus. It is felt that the bonds issued directly by the European Union could aspire to a very high rating and a strong demand for reserve purposes. But there would have to be enough liquid assets and a sufficient volume to allow for regular and significant trade. This would make it possible to relaunch growth on the basis of an innovative and adequately sized spending programme.

The efficiency achieved by euro financial markets contributes to making the prospect of placing a European debt on foreign portfolios possible. It should nevertheless be considered that, given the high propensity towards savings of European families and the high rating of the debt to be financed, the debt could actually be financed from inside the EU area itself.

A budget for the Eurogroup

After the stop to ratification of the Constitutional Treaty brought about by the two referenda and the ensuing period of uncertainty, the European Union will surely start out on its path again – soon. But there can be no doubt that in order for this recovery to take place, and in order for it to be strong, it will have to take account of two factors: the first is the acknowledged difficulty in moving ahead in a Union of 27 with a project of which some important institutional aspects have still not been defined; the second is the evident aversion of much of the European public opinion to an enlargement carried out in a way that exacerbates old problems and creates new ones.

Therefore, of considerable interest are the suggestions of authoritative and convinced Europeanists, that the way out of the current impasse is with a "flexible" Europe, in which groups of countries of different sizes move ahead in a consensual manner with specific integration projects, open to the participation of all those who wish and have the characteristics required to participate.[9]

Could this concept be applied to the field in question? It could take a long time to reach agreement among 27 countries for the institutional reforms required to remove the constraint of a balanced budget and to define new rules to manage growth. Nor can we wait for majority voting to be introduced.[10] In this situation, a transitory or alternative solution could be to solve the problem in a more restricted circle.

The natural candidate is the Eurogroup, the group of 13 countries that have the euro as a currency. The Eurogroup has its own Council, a stable president, a Central Bank, a common currency, a common monetary policy and common budget regulations. These elements undoubtedly create a closer interdependence among the euro states. It is a widespread conviction that the euro countries should

[9] Tosato, "How to Relaunch Europe".
[10] Postponed till 2014 at the most recent Brussels European Council, June 2007.

strengthen their institutional arrangements and extend their sphere of influence to economic policy action.

Thus, there is already a strong nucleus of common policies. This could provide a solid foundation for enhancing Economic and Monetary Union with a plan, an agreement, that involves a budget for the Eurozone, from which to move ahead towards a stronger institutional plan.

The countries of the Eurogroup could create an Authority for budget policy modelled on the European central bank system and the European Central Bank (ECB). An agreement would establish that the Authority's main objective is the economic growth of the participating countries and that that growth must be in conformity with the characteristics of development as defined in art. 2 of the Rome Treaty. It should also state that the tasks of the Authority are of a regulatory and a financial nature. Among its financial powers would be to manage resources for financing development programmes and to issue bonds to raise those resources. It would also ensure efficient management of the debt issued.

An Authority like this, set within the institutional framework of the Eurogroup, could be a counterpart to the ECB and the hub of policies aimed at turning the euro into a solid and reliable international currency, as well as the guarantor of effective coordination of development policies in the euro area.

The debt issued by this Authority would have the characteristics needed to make it suitable for use as an official reserve and in private portfolios of countries outside the Eurozone. It would, in fact, be backed by the economically most solid European countries and its management criteria would be particularly rigorous for the very fact that they are consensual.

Conclusion

In conclusion, in order to finance development and achieve the Lisbon objectives, the proposal put forward here is to eliminate the EU Treaty provision that requires a balanced EU budget. This would shift the authority over the size and financing of the EU budget into the realm of Council prerogatives. The latter could set a general rule on the maximum annual deficit allowed and the kind of expenditure to be financed by deficit spending. The Multi-year Financial Perspectives would then set the amount of debt to be issued over that period.

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