

The Prince('s) Rules: Economic Theories and Political Struggle in Europe.

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The Cyclically Adjusted Budget (CAB) is the estimated size of the public budget at some previously defined level of output which may represent the 'normal' output or a policy target and that usually is considered to be unaffected by business fluctuations or cycles. Such an estimate is supposed to isolate the automatic movements of revenues and expenditures, given the current structure of tax and transfers, from discretionary fiscal interventions and indicate the “impact” and sustainability of fiscal action¹.

But this definition hardly does justice to the long and contentious history of this fateful estimate, which has been differently named, interpreted and calculated over the years and played a crucial role in many of the most important controversies in macroeconomics and public policy.

This paper traces the evolution of the concept through time, tying it to the history of economic thought as well as economic history and policymaking. The reconstruction illustrates the important role the distribution of power plays in the evolution of economic theory and policy as the historical forms of the state-market relationship evolve. Here, however, we will focus mainly on the case of the European Union and Eurozone.

In the process, we will show there has always been – right down to the present day – little agreement among the different schools of economic thought over whether, for example, it is appropriate to anchor fiscal policy to a fixed automatic rule or rather use the CAB for purely informative purposes. In addition, the debates over different methods of calculating the CAB, far from being squabbles over minor technicalities, frequently involve major theoretical issues, such as the impact of wages, employment and aggregate demand on the public budget balance, and lead to substantially different policy conclusions.

Despite the conflicts that punctuate the concept's history, some common threads can be identified through the ways the notion links to broader macroeconomic theories debated in public in each epoch. The CAB was first conceived in Sweden in the 1930s as a mechanism to induce and keep record of budget imbalances across accounting periods, in line with the views of the Stockholm School at the time. Between the 1940s and the mid-seventies, the CAB, under the name of the “High” or “Full Employment Budget,” developed in several stages as a tool supporting counter-cyclical fiscal policies on the basis of what was held to be a theoretically well-established functional relationship between aggregate demand and employment.

From the late seventies, however, the CAB changed yet again, this time for the purpose of limiting the use that governments could make of fiscal tools, at least in public rhetoric. (In fact, while the doctrine of fiscal austerity was strictly imposed on many third world countries, developed economies allowed themselves greater freedom of action.) In parallel with this change in direction, methods of calculation shifted toward so-called “purely statistical” methods. These, such as the Hodrick-Prescott filter, air brushed away possible effects of fiscal policy on output by simply suppressing functional explanations of the cycle on the basis of the strong prior assumption that actual output oscillates symmetrically

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around a natural and satisfactory level.

As the Cyclically Adjusted Budget completed its metamorphosis from being a tool for ensuring high employment into an instrument of budgetary surveillance, policymakers within the European Union were developing an acute need for precisely such a device. The problem they were grappling with arose from the unique nature of the macroeconomic policy framework of the Union, which reflected political compromises at the heart of the 1992 Maastricht Treaty.

Brief history of the CAB

The Great Depression challenged traditional Liberal (in the European, not American, sense) views of the role of the state in favor of a progressive expansion of its economic weight and functions. With this perforce came a redefinition of fiscal practices and their theoretical foundations: in particular, the principle of balancing the government budget.

The process was not linear and stressless: old ideas were questioned, rejected, or radically transformed and new ones struggled to gain credibility, in midst of deep social conflicts. In many countries, powerful working class movements bid for political power either on their own – as in France, with the Front Populaire, or Spain, with the Frente Popular – or, as in the U.S. New Deal, by forging tense alliances with progressive business groups against more conservative political forces. In all cases, their efforts met with bitter opposition from conservative industrial and financial groups, which feared abandoning ideas that had for so long been associated with social order and institutional discipline.

The idea of a cyclical budget balance was first proposed by Gunnar Myrdal, one of the most influential economists of the Stockholm School, in the Appendix to the Swedish government's fiscal program of January 1933 (Lundberg, 1985, p. 7).

Myrdal's proposal was for a rule that would allow (and force) the government to balance the budget over the entire economic cycle, rather than on a year to year basis. At that time, the Stockholm School was concerned with the definition of a fiscal policy able to smooth economic fluctuations: they believed that the government should provide fiscal stimulus during depressions and, symmetrically, implement restrictive measures during expansions, thereby constraining inflationary pressures and ensuring a smooth transition to the downward part of the cycle.

Its deepest rationale relied on Myrdal's specific theoretical explanation of the cyclical crises. In the Myrdalian world, a cyclical disequilibrium originates from a change in the structure of prices, that affects expectations and the ex ante balance between savings and investment. Such an imbalance, in turn, triggers a Wicksellian cumulative effect on prices. Because 'change' and 'uncertainty' are the primary determining factors of equilibrium, stability is enhanced when a government's behaviour is predictable (Myrdal, 1939b; Seccareccia, 1992).

The Swedish government started incorporating these ideas into its budget structure in the late 1930s, the agreed formula being that “a deficit in the running budget shall never disappear from the deficit before it is again made good. The deficit is transferred as a negative item to a special budget equalization fund which represents the continuity in public finances [...] A budget surplus is not allowed to appear on the running budget before all deficits are paid” (Ibid., p.192).

The rule did not apply to capital investment expenditures, which were accounted for in a separate

budget (Ibid., 190). Although this latter idea superficially resembles Keynes' proposal for a Capital Budget, Myrdal, in the 1930s, saw public investments simply as a line of defense against cyclical fluctuations, to be activated only when the circumstances required them. In fact, he thought that the government had to “[...] take precautions in order to avoid delay in setting the spending program in motion. [...] The state production enterprises – railroads, power plants, post office system, mines, forest preserves, etc. – are urged to prepare yearly building programs for ten years in advance”(Ibid., p. 185). Keynes' idea, by contrast, was presented as an integral part of a long term project of the “socialization of investment” to offset what he held to be a chronic tendency of aggregate demand to stagnate as a result of the progressive rentierization of the economy (Myrdal, 1972; Kregel, 1985; Seccareccia, 1995; Smithin, 2013)².

But it is in the United States, in the forties, that the fate of the CAB took a dramatic turn: undaunted by or perhaps, largely unaware of differences between Keynes and the Scandinavians, a major new business organization, the Committee on Economic Development (CED), selectively embraced important parts of Keynes' message and embarked on an effort to integrate a cyclical budget rule with an explicit output target connected to the level of employment.

The Committee for Economic Development was born in 1942 bringing together many business figures associated with the earlier Business Advisory Council, along with other executives from firms that either had supported the New Deal or wished to avoid associating themselves with the deep conservatism of the traditional business groups.

Fiscal policy inevitably became a major focus of its research activity. The group published two statements that won broad attention. The first was “A Post-War Federal Tax Plan for High Employment” issued in 1944 (CED, 1944). Three years later, in a far more contentious political environment marked by a wave of strikes, the CED put out “Taxes and the Budget: A Program for Prosperity in a Free Economy” (CED, 1947). Both stood out for the degree to which they reflected Keynesian influences (Ruml and Sonne, 1944; Twin Cities Group, 1944)³.

Both reports attempt to define a budget plan (and rule) that could yield a surplus at a level of income consistent with high employment of labor. They argue that budget balance could be achieved at any level of national income, but that if the target were fixed at levels much below high employment: “[...] the budget would exert a repressive force upon the economy in depressed conditions, as it did in the 1930s, and would itself contribute to unemployment and a low level of income. While such a program is conceivable, it is certainly not a satisfactory solution to the problem of the debt, and it is unlikely that such a program could survive the pressures that mass unemployment would create, as past experience has shown” (CED 1947, 32). In other words, while acknowledging the importance of reducing public debt, both reports recognize the priority of an employment target. According to the CED, governments have the right and the duty to maintain aggregate demand at a level that allows for high employment, since “ability to buy does not alone create demand” (CED, 1947, 10).

Both CED fiscal statements settled on the high employment surplus as the proper tool for stabilizing budget policy, which: “[...] is [...] advocated as the most practical method of achieving all the objectives of budgetary policy. Its basic principle is to set tax rates to balance the budget and provide a surplus at agreed high levels of employment and national income and thereafter to leave them alone unless there is some major change in national policy or condition of national life” (CED 1947, 20).

This way, when the level of output is below the agreed high level of employment, the budget would be in a deficit, thus supporting the recovery. When it reached the designated level, the budget would be in

small surplus, so to pay off accumulated debt. Symmetrically, when the economy is over expanding, the building surplus would have an anti-inflationary, restrictive effect.

The CED wanted the structure of the budget to be such that its stabilizing properties were most effective. That is, the tax rates and the spending programs should be determined by considering their effect on output carefully. To this end, in contrast to other business groups at the time (Musgrave, 1944), the CED saw merit in progressive personal income taxes and was critical of excise taxes⁴. It also endorsed some social programs such as unemployment compensation that, similar to progressive taxation, operate as automatic stabilizers. Because Ruml and other members were convinced that construction swings broadly influenced the whole economy, the CED also accepted a compensatory program of public investments in that sector.

Proposals like these gave the CED a distinctly different profile from other big business organizations. But the CED, however, was still a big business organization, not an echo chamber of the New Deal – Fair Deal political coalition. Save for the cases already mentioned, neither Ruml nor many other members favored large scale social spending. Committee acceptance of the principle of progressive income taxation was counterbalanced by insistence on lowering tax rates on corporate profits (especially retained corporate income) as incentives to private investment⁵.

Similarly, the Committee believed that the government should take responsibility for unemployment and seek to provide the conditions for jobs to be abundant, but, as will become clearer below, it did not agree with suggestions of a positive right to employment such as then widely held view that the State should guarantee full employment by creating “specific jobs for specific people” (CED Meeting Minutes, 1945)⁶.

The Committee also rejected Keynes’ view that investment should be extensively socialized to prevent stagnation. Neither did it sympathize with Myrdal’s idea, not unknown in the U.S. at the time and championed by some New Deal officials, of a capital investment budget. On the contrary, the Committee’s preferred accounting system and rules “[...] seek [...] to present a unified picture of the transactions that have important economic effects, without regard to financial or functional differences” (CED, 1947, 19 footnote 2).

What the Committee favored were stable tax rates set to balance the budget at a high level of employment. In its view automatic stabilizers and steady programs of public construction should then suffice to keep the economy on an even keel. Save in deep depression, it opposed other forms of discretionary fiscal policies.

But the CED was not a granitic unity: different degrees of enthusiasm existed within its ranks for deficit spending and for tolerance of workers’ claims. The urgent need to coalesce in support of “less acceptable”⁷ policies was often the cement of bonds inside the group. The CED’s budget position reflected precisely such imperatives. Its preference for putting taxes and spending on automatic pilot did not reflect deep theoretical convictions within the group as a whole, rather, it was the result of a compromise, whose rationale traced back to the political climate of their times.

Ultimately, for the CED, relying on a stable budget structure, based on technical, professional, objective reasoning, was a way to reduce the risk of political confrontation over fiscal policy and thus reduce the risk of adverse political outcomes. By liberating high employment policies from the stigma of socialism and, at the same time, defanging them from their socialist potential, the CED contributed to setting the conditions for the automatic rules to be redundant, as soon as the political situation

stabilized.

By the end of the fifties, the High Employment Budget had exhausted its historical function as a fiscal policy target and constraint to become the Full Employment Surplus, a simple fiscal indicator but still charged with economic and political bearings. At that point, when the political climate was becoming more favourable to the CED's understanding of a balanced relation between government and private sector to guarantee prosperity; when even Eisenhower, the Republican successor to Truman, approved a CED-like program of deficit spending during the 1953-54 recession; when the Cold War allowed a political cleansing of the sectors of education, research and mass communication, the CED began to soften its position and became more open toward discretionary interventions.

The shift accompanied the progressive success of the Keynesian discourse on growth and how to achieve it. This discourse had developed in a public campaign during the fifties and eventually turned into the official reference theory of the Democratic governments of the sixties. It appeared as a rupture with the compensatory policy and automatic fiscal adjustments praised by the CED in the forties.

But the customary reconstruction of events underplays important elements of continuity that link the CED's original program, Kennedy's New Frontier, and the broader evolution of American Keynesianism. A closer look at these changes the picture considerably.

The evolution of the High Employment Budget into the Full Employment Surplus traces back to three mutually related factors: the stabilization of the political climate during the Eisenhower era, American elites' impatience with the economy's relatively slow and fitful growth in the 1950s, and the formulation of a consensus version of Keynesianism acceptable to major parts – though far from all – of the business community and policymakers.

These themes echoed in John F. Kennedy's political project. He recreated a coalition that spanned from the civil rights movement to big business. And so it was that a far more business oriented Democrat than Roosevelt won the 1960 election with a promise to "get America moving again." Once elected, Kennedy chose his Council of Economic Advisers from among the most prominent Keynesian economists of the time.

It is then that our estimate began to enjoy its period of largest fame. Although it played a less compelling role in the new context than in the CED's proposals of the forties, it became a symbol and a major instrument of the popularization of the Keynesian thinking in fiscal policy (Canterbery, 1968). This explains why still to this day, the economic Vulgata associates the cyclically adjusted budget with that period and often, in a further hazardous step, with Keynes.

In the *Report* of Kennedy's Council of Economic Advisers for 1962, which can be seen as a manifesto of the New Economics, the full employment surplus is presented as a "convenient method of comparing alternative budget programs" (Council of Economic Advisers 1962, 80) that allows distinction between discretionary and built in budget movements and measurement of the restrictive or expansionary impact of fiscal policy on overall demand.

The estimation follows a procedure that, with important changes discussed later, is maintained to this day. First, full employment receipts are calculated: this involves a definition of full employment, of full employment output, or potential output, and its major components such as tax bases (personal income, corporate profits, wages...) ⁸. The appropriate tax rates are then applied to those components. Second, unemployment compensation is the only expenditure considered to vary with the level of output.

Therefore, all other outlays and the unemployment compensation that would be spent for a 4% unemployed correspond to the full employment expenditures. There is, however, a trend growth of expenditures, as output grows, that is taken into account. Subtracting full employment expenditures from full employment revenues returns the full employment budget surplus (deficit) that is the component of the actual surplus (deficit) that does not depend on the action of the automatic stabilizers.

The definition of the concept of potential output, whose construction and estimation were due to Arthur Okun, played a pivotal role. The notion responded to the felt need to display a quantitative link between full employment and output in the short run. As Okun wrote, potential output and the consequent measure of the output gap point up the “enormous social cost of idle resources” (Okun 1962, 1). In contrast to analyses of cyclical fluctuations, it tells the distance from output and employment targets. It is a short-run calculation: technological knowledge, the capital stock, natural resources, the skills and education of the labor force are all assumed to be given. Assuming that idle labor is a satisfactory measure of all idle resources, potential output is the level of output at which aggregate demand exactly yields a rate of unemployment equal to 4% of the civilian labor force. Okun's well known result was that “[i]n the postwar period, on the average, each extra percentage point in the unemployment rate above 4 percent has been associated with about a three percent decrement in real GNP” (Okun 1962, 3). Although, he specifies, “[i]t is at best an uncertain estimate and not a firm, precise measure” (Okun 1962, 2). Finally, Okun shows that the path of potential output from 1954 to 1962 could be substituted by a trend, an exponential curve, corresponding to a 3.5% annual growth rate.

Accordingly, the Council of Economic Advisers set the full employment output to grow at a 3.5% annual rate in constant 1954 dollars starting at mid-point of 1955 (Teeters, 1965). The 4% goal incorporated both the non inflationary and the full employment targets.

Keynesians thus believed that the challenges of managing a growing economy were too complex to rely on a mechanical application of a budget rule. They used the FES as a simplified instrument of comprehension and advertising. The idea in fact perfectly illustrated the Keynesian aspiration to show that different interests (full employment and fiscal soundness) were not contradictory. Such efforts gave legitimacy to the social demand for full-employment, its justification deriving from (and therefore being conditional on) compatibility with the maintenance of debt and price stability.

As far as the budget composition is concerned, the actual policy enacted by Kennedy and, later on, by Johnson failed at accomplishing the revolution for which Keynes and many others had hoped and worked (Hansen, 1960; Canterbury, 1968; Burch, 1980)⁹. Nevertheless, actual output came to be very close and even superior to potential between mid-1965 to the end of 1969. In that period, “the full employment and actual surpluses told very similar stories” though after 1966, “the concept retreated in the background [...], when fiscal policy became excessively stimulative during the Vietnam buildup”(Okun and Teeters, 1970), said Okun who, at the time, was president of the CEA.

For a long time, however, the risk of inflationary pressures and, ultimately, the price-wage issue remained just an abstract concern (Robinson, 1972; Bator, 1987)¹⁰. But the matter was bound to become increasingly compelling in the late sixties, along with a revival of public fears that they might be caused by the excessive government deficits. By then, however, the Keynesians theoretical orientation had converged toward a consensus that implied the construction of neoclassical models as systems of simultaneous equations, with no consideration of historical time, and the transformation of the concept of expectations into exogenous assumptions about agents' behavior.

The Consensus theory struggled to support the validity of some of the Keynesian policy conclusions in the face of its own ever deepening tropism toward the quantity theory of money. This effort led, eventually, to the concept of Non Accelerating Inflation Rate of Unemployment, which was designed to replicate the concept of the natural rate of unemployment, while maintaining its status as a target for cautious demand-side policies.

Unsurprisingly, these attempts were impotent in the face of the swelling Monetarist tide. Without the support of a theory that seriously questioned the concept of neoclassical equilibrium, the NAIRU was nothing but the optimum, equilibrium-level, unemployment rate and could all too easily be identified as the natural rate of unemployment. To this day, its definition varies, depending on how analysts integrate it into newer neoclassical versions of the theory.

The shift from one doctrine to the other, however, was a process, not an event. Accordingly, the seventies were not marked by clear political or theoretical formulas. They were rather a decade of transition, with both Democratic and Republican parties competing to find and represent a new political equilibrium and its analogue in economic theory. Monetarists and Keynesians were both caught up in this quest, and so was the Full Employment Surplus estimate.

As the new decade started, firms were left with an obfuscated and weakened perception of the advantages related to a state-guaranteed long term growth and employment – the main cement of the New Deal Coalition. Several factors contributed to curbing it: public spending reductions and the tight monetary policy imposed since the late seventies forced American firms to a paradigm shift, to increase international competitiveness; released international capital flows, new IC technologies and rising financial concentration favored productive de-centralization, weakened organized labor and collective bargaining, and emphasized short-termism, flexibility and under-utilization of productive plants. Inflation became widespread, with price shocks raising concerns far beyond financial circles.

A new approach, called New Classical Macroeconomics (Barro, 1976; Lucas, 1977, 1975) and developed from the late seventies, progressively gained ground. It proclaimed the total ineffectiveness of announced monetary or fiscal policies and only very short-term effects for non-announced ones. It aimed to renew macroeconomics by going back to the neoclassical microfoundations¹¹. By the end of the 1980s it was the new mainstream.

The new view assumed that people have rational expectations and anticipate the price consequences of fiscal policy. This implies that deficit spending or monetary expansions cannot cause an increase in output even in the short-term. Rather, expansionary fiscal policy has a negative effect because agents immediately discount the future cost of current deficits in terms of heavier tax burdens, according to the Ricardian Equivalence Theorem.

The new definition of the cycle had important implications for the study of fiscal policy. In so-called Real Business Cycle models (Hodrick and Prescott, 1981; Kydland and Prescott, 1982; Prescott, 1986), output fluctuations do not have any relation to monetary variables or the level of aggregate demand. They represent the optimal path of the economy in the face of exogenous, supply-side market influences or random shocks, including unannounced policy changes. In such a world, there is no place for built in stabilizers.

These were the intellectual foundations of the methodological move that developed toward defining output trends via statistical filters that included a stochastic component along with partially incorporated oscillations of actual output, while rejecting the idea that differences between actual and

trend output defined any output gap (Hodrick and Prescott, 1981). Everything that Keynesians took as policy targets were now taken to be necessary characteristics of a well-organized economic system.

The lesson drawn for policy was that public institutions should concentrate on reducing the uncertainty connected to their actions, by enhancing transparency and credibility relative to their commitments. But the derived political recommendations also included strict fiscal discipline and public debt reduction, as well as deregulation of labor markets and central bank independence. In effect, this approach extended the scope of economic theory to regulation of the whole political process, spurring a literature regarding best practice in public policy, which declared that governments should only rely on a “policy by the rule” while engaging in structural reforms to enhance flexibility of prices and wages, thus setting the best environment for agents to formulate correct expectations.

The rhetoric accompanying the implementation of these ideas in the various national and supra-national contexts painted an extremely simplistic picture of the relation between government and private business. It was almost as if theorists and policymakers had returned to a pre-New Deal regime style, leaving no room for the government to counteract – or reinforce – impulses arising from markets.

However, a more accurate look at those policies implemented in U.S., Europe and many other countries under the direction of the IMF suggests that what was presented as a reduction of the scope of the government in the economy, such as the privatization of social services and public goods, would be more appropriately characterized as an active reallocation of public resources, carried out by the state, with major social and economic consequences.

To focus just on the U.S., for instance, it was in the late seventies and early eighties that income inequality started a still ongoing rising path, similar trend applies household indebtedness (Picketty and Saez, 2001), that just recently reached finally unsustainable levels. Indicators of both market concentration and financialization show continuous rise.

In this new regime, the CAB took on a new life as a tool for budget reduction surveillance. Differences internal to the neoclassical school largely disappear in the empirical literature as methods for calculating the CAB reduce to two options that differ in the way they treat potential output: statistical univariate methods and the “production function” method. Both are more complex than Okun's formulation and include elements of uncertainty and arbitrariness that many economists consider seriously flawed (Blanchard, 1993; Mohr and Morris, 2007; Fatàs and Mihov, 2010; Sawyer, 2012; Les économistes atterrés, 2012; Truger, 2014).

The methodology, in both cases, follows a two stage procedure: a cyclical component of the budget balance CC is first estimated and subsequently subtracted from the nominal budget BB , so that $CAB = BB - CC$. The cyclical component is obtained by applying a budgetary sensitivity parameter ε to the estimate of the output gap OG , which is simply the difference between potential output and actual output: $CC = OG \times \varepsilon$.

The sensitivity parameter estimates the weighted elasticity of both revenues (by different sources) and expenditures to changes in output. Though less symbolically relevant than potential output, which bears an immediately recognizable political content, this parameter heavily affects the estimate of the CAB. Mostly because of the difficulty of obtaining relevant data, however, institutions rarely update it. In practice it thus often fails to take account of changes in legislation and, most importantly, of changes in income distribution due to the cycle (Girouard and André, 2005; Mourre et al., 2014).

The estimate of potential output itself begins with a choice among statistical filters. Those all reduce to methods for calculating some sort of moving average. All avoid identifying politically dangerous employment targets and are claimed to be apolitical. But as Antonella Palumbo observes, the potential output estimates based on various averaging/de-trending filters of actual output fundamentally reduce to an ex post average of the actual output (Palumbo 2013). In other words, once normality becomes the target, estimates of potential output become ex-post ways of justifying the attained levels of growth and employment.

The resulting CAB fails at immediately recognizing government's efforts to enhance the economy's potential with demand-side policies – such as public investment – and it validates measures that have the opposite effect: movements downwards of output due to budget cuts are incorporated into the estimate of potential output, and thus are not recognized as policy failures.

The definition of fiscal policy sustainability produced from these CABs escapes from tautology only if the assumption of direct relation between output gaps and changes in inflation is true. However, as a large literature testifies, no empirical support can be provided to for those claims (see for instance Galbraith, 1997; Palumbo, 2013). Instead, if productive resources and productivity are recognized as affected by the level of activity and by aggregate demand, one can show that restrictive fiscal policy may instead have a perverse effect on public deficit and that, contrarily, expansionary fiscal policy can reduce the ratio of public debt to output (Storm and Naastepad, 2012; Ciccone, 2013).

Various versions of the purely statistical methods proliferated (Baxter and King, 1999; Beveridge and Nelson, 1981; Kålmån, 1960). Especially common today is the use of the Hodrick-Prescott filter (Hodrick and Prescott, 1981), a technique that was first proposed by a mathematician in 1923 (Whittaker 1923), but gained widespread implementation in economics only in the late 1990s. This filter minimizes deviations of actual from potential output and of the potential rate of growth from a regular trend and contains a stochastic component, so that it follows quite closely the actual path economy. This means that the corresponding CAB cannot accurately distinguish between automatic and discretionary movements of the budget, and becomes just a tool for budgetary trend surveillance.

But its use as a fixed target and policy guideline is complicated by the fact that deviations from trend are designed to have an average of zero over the sample. This property is responsible for an *end of sample bias*, where the level of the trend tends to be over or under estimated to compensate for the asymmetric behavior of the deviations in the rest of the sample. The estimates are therefore inaccurate where it matters the most, i.e. at the end of the sample, and require repeated revision.

The HP filter and similar tools became popular in part because their application has the advantage of being simple and time saving, thanks to the now available statistical software and because they did not require the collection of large amount of data. But they are insensitive to structural breaks and other country-specific institutional characteristics.

This is where the so-called production function approach comes to the rescue. This method emerged around the same time of the purely statistical ones but spread more slowly. The IMF seems to have pioneered the method; the first attempt goes back to 1977 (De Masi, 1997).

But numerous versions of this approach exist. Virtually all begin by describing potential output in terms of a Cobb-Douglas production function. They are thus subject to all the problems that attend this celebrated construction, especially the concept of Total Factor Productivity (Sylos Labini, 1995; Pasinetti, 2000; Felipe and McCombie, 2007, 2013). Moreover, the variables entering the production

function are often themselves estimates, obtained by applying the usual filters. Therefore, they are not exempt from the end of sample bias and zero sample mean restrictions that make the previously described method so inappropriate.

Foremost among these, perhaps, is the way the approach estimates NAIRU. Put simply, efforts to estimate it empirically beg all the important questions and in practice break down. The long list of failed attempts has gradually led to changes in its definition: from being considered a fixed rate it became a variable moving with the rest of the economy. The rationale behind the new interpretation is that if a negative shock occurs, the unemployment rate will likely rise, changing its relation to inflation. Thus it is most commonly estimated by statistical filtering. However, this does not solve the crucial problem that the data do not reveal a reliable correlation between unemployment gaps and changes in inflation (or in real unit labor costs, in the variant of the Non Accelerating Wages Rate of Unemployment (Havik et al., 2014)). For this reason, most econometricians employ multivariate instead of univariate filters, because they permit the imposition of some constraints on the form of the estimate, namely a Phillips curve type of relation, that otherwise would not emerge. The triviality of these exercises is discussed by many authors such as Cross, 1988; Galbraith, 1997; Gordon, 1997; Storm and Naastepad, 2012; Stirati, 2015. “Even if there is no such explicit hypothesis [...], the estimated NAIRU is built so to absorb all the changes in the average level of the actual unemployment rate, automatically attributing them to supposed changes in the supply factors determining the NAIRU” (Palumbo, 2013, p. 103). Figure 1 shows the extent to which the NAWRU estimates for the European Union countries followed closely the actual rates (see also Gordon, 1997; Havik et al., 2014; Truger, 2014).

Theoretically speaking, both purely statistical and production function approaches share the logic that economic growth is supply-driven. The production function method, however, permits explicit consideration of those supply-side aspects in the estimate rather than implicitly, as the filters do.

Especially in the forecasting extensions (see for instance the T+5 and T+10 methods of EU Ecofin, (Havik et al., 2014)), the production function method tries to integrate into the estimate parameters that reflect the institutional aspects of a country, such as the rules defining the various markets conditions and even those shaping the political process, such as the union density and labor market taxation and policies.

This, paradoxically, opens up the possibility of an even more arbitrary and flexible use of fiscal policy, because the relationship of the latter with output is mediated by the allegedly technical interpretation of the institutional framework of the economy.

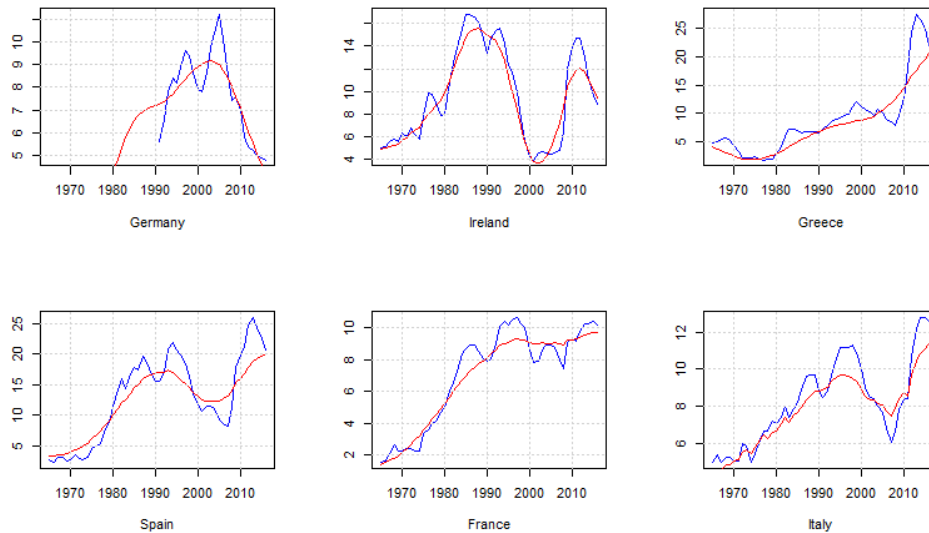
In many formulations, in fact, the only way that governments can affect potential output estimates upward is to adapt the institutions to rules specified by the forecaster. Typically, so-called market deregulations are considered to increase the output gap and thus create more room for actual deficit tolerance. Thus the CAB, instead of indicating how fiscal policy can best obtain the economic objective that a community prefers, becomes a tool for constraining the community's political choices to the demands of a theory on which no consensus exists and which yields sharply different results depending on when and where it is applied.

In fact, from the original models and methodology of the New Classical Macroeconomics a whole literature has developed, that include even some partial deviations from mere austerity. This *corpus* consists in many slightly different versions of the same models, whose basic assumptions are each time transformed by adding a limited range of exceptions. Those are often seen as factors that might partially embroil the perfect machine and make room for selected public intervention. It is interesting to

notice that no endogenous explanation for those embroiling factors is provided. They are, in fact, just exogenously determined exceptions (Tcherneva, 2008; Stirati, 2015)¹².

The literature includes new Keynesian models that allow, like the older monetarist model (Kriesler and Lavoie, 2007), for some short term fluctuations away from potential output that can be addressed by means of supply side policies, monetary policy and just recently also some coordinated fiscal and monetary policy.

Fig. 1 NAWRU (red line) and Actual Unemployment Rate (blue line) in E.U.



Source: AMECO

The CAB in the E.U.

The 1992 Maastricht Treaty, that created the European Union, incarnated a strongly Neoliberal vision of European governance that chiefly reflected accords between France and Germany, with Italy at a second remove. It aimed to liberalize markets, encourage privatization, make it easier for firms to compete across national boundaries, and remove obstacles to the movement of goods and, far more equivocally, people within Europe. Though it did little to strengthen representative institutions – such as the European Parliament, which still lacks the formal power of legislative initiative – the Treaty set the convergence criteria and the step-path toward the creation of the Economic and Monetary Union, informally called the Eurozone. This path included the creation in 1998 of a powerful, independent monetary institution, the European Central Bank and its European System of Central Banks¹³, that was charged by statute with guaranteeing price stability (as well as the other objectives of the E.U., without prejudice for price stability¹⁴ – a clause that would become crucial later to justify unconventional emergency measures).

The architects of Maastricht respected the power of traditional national and bureaucratic forces and were allergic to anything resembling true political union. As a result, the Union's governance mechanisms were (and to a large extent still are) more a space for negotiation between political representatives of member countries and other well organized, powerful groups than expressions of popular political sentiments or pressures. In combination with the commitment to Neoliberalism, budgetary fears and nationalistic interests¹⁵ doomed the long series of efforts by Keynesian economists

and some policymakers to build in robust fiscal recycling mechanisms at the Union level (Holland, 2014; Holland and Varoufakis, 2011). Fiscal policy coordination as well as monetary policy efficacy in the Eurozone thus came to depend crucially on harmonizing individual country budgets, because they were the only form of common economic policy institutionally possible.

The imperative to coordinate, however, set in motion dynamics that potentially threaten the whole edifice, as we are witnessing now. Economic integration initiated a process of market entanglement, restructuring and increasing concentration that tended in the medium run to overthrow traditional national structures. The creation of the European central bank as an institution independent of governments and substituting for national central banks also created new hazards. The prohibition against purchases of national bonds by the European Central Bank in particular left the member countries exposed to the possibility insolvency and subjected their public debts to the whims of financial markets. Over time the combination of financial deregulation cum fiscal austerity further eroded national sovereignty, as national public debts expanded in Italy and many peripheral countries in the decade that followed. This problem was not unexpected, as the members of the preparatory commission for the Maastricht Treaty, the so-called Delors Commission, discussed and ruled out the possibility of issuing Euro bonds that would have made national public debts equivalent liabilities in the markets (Holland, 2014).

But the absence of active convergence policies, coupled with a *one size fits all* monetary policy encouraged divergent economic dynamics among countries. Over time these crystallized a core-periphery equilibrium within the system. The French project of making the Union an international financial center needed a guarantee of price stability, which only Germany could provide (Parguez, n.d.). In exchange, Germany benefited from a relatively under-valued currency, which weakened Italy's competitive position (Halevi, n.d.; O'Connell, 2011). The presence in the EMU of countries less competitive than Italy and France was in turn necessary to persuade French and Italian industrial sectors to give up the possibility of competitive devaluation against German exports. Many industrial sectors appear to have counted on recessions for opportunities to roll back wage demands and unionization as they restructured and out-sourced.

The illusions of industries in the peripheral countries that this process would also work for them failed when European labor costs began their race to the bottom. That is, when German unions responded hyper-cautiously to industry's threats to move plants to the newly included Eastern countries. Germany's real depreciation put its competitors in other countries in a hopeless position. With the option of devaluation foreclosed and the absence of any industrial policy aimed at structural import substitution, technological dependency and over-indebtedness became inevitable. A solution to these asymmetries and resulting fragility implied an assumption of responsibility by the more competitive countries for the less competitive ones. Its absence, on the contrary, allowed the more competitive countries to apply different standards of budget surveillance and remediation to their own cases even as they imposed much harsher conditions on their solidarity towards the others.

The CAB's ability to throw a cloak of spurious statistical precision over this mix of cross-pressures and interests made it a near perfect instrument for negotiating the conflicts that arose as the European Commission bulldozed through conflicting national legislation and regulations. As the conflicts multiplied with the formal advent of the Euro and the collapse of stock markets in the US and Germany early in the new century, the concept's rise in the EU bureaucratic hierarchy was dazzling: from one of several complementary analytical tools, the notion rapidly emerged as a cornerstone of the Union's fiscal framework enshrined in less than a decade in the famous Stability and Growth Pact.

Its ascent in the E.U. took place in three stages, reflecting the Pact's key role in the Eurozone's search for an appropriate and flexible European architecture, that is, a stable power configuration, as well as the varying degrees of control the Commission has exerted over national decisions and policies.

It entered the scene on the margins of the discussion initiated by German finance minister Theo Waigel to codify the rules and procedures of EU fiscal sovereignty in 1995. At that time, what was then referred to simply as the Stability Pact formulated the fiscal rule in terms of actual budget balance leaving the composition of the budget to each individual country, as long as the difference between total expenditures and total outlays conformed to the guideposts. The CAB's role in the new scheme was as a tool for surveillance, without any real teeth or explicit mention in legislation. The agreement defined limits for both budget imbalances and individual country total debt loads (3% and 60% of GDP respectively). The accord also committed member states to an official Medium Term Objective of sustaining a fiscal position close to balance or in surplus (CTBOIS) and set up a formal procedure to enforce this.

The process required individual countries to submit their fiscal plans to the European Commission (expression of the Parliament of the European Union) for advance approval. If the European Commission disapproved, it was empowered to issue official preventive warnings. If these proved unavailing, the European Commission could propose initiating a formal Excessive Deficit Procedure (EDP). But the latter could only be authorized by the Economic and Financial Affairs Council (Ecofin, the council of finance ministers of all the member states of EU). Within the Procedure, scofflaws were afforded a certain amount of time (originally one year, later up to five years) to adjust and only in extreme cases could incur in monetary fines.

In 1996 the French prime minister, Dominique Strauss-Khan succeeded in adding the word "Growth" to the name of the Pact, setting the semantic premises for its wishful reinterpretation in more expansionary terms. The Stability and Growth Pact was finally approved at the 1997 Amsterdam European Council. But the conditions for such reinterpretation came about in 2002. That was the year that the Euro, which had existed in the virtual markets since 1998, finally became available to ordinary citizens. Just at this moment, however, fallout from the 2001 U.S. crisis and the collapse of Germany's much hyped Neuer Markt made it harder for many European countries to comply with the official constraints.

The Ecofin and the Commission quickly broke ranks, as ministers proved reluctant to follow up on the Commission's recommendations for warnings. Ecofin was also far more amenable than the Commission to winding down infraction proceedings on the basis of mere promises to do better. The conflict went so far that the Commission, in 2004, brought suit against Ecofin at the European Court of Justice for suspending Pact rules in the cases of Germany and France¹⁶.

As EDPs proliferated, member countries facing official or unofficial reprimands sought to justify their positions. Not surprisingly, many appealed for adjustments recognizing special circumstances. For example, the rule made no distinctions among types of spending; it did not distinguish between outlays for investment or consumption. Countries also justified expansionary fiscal measures by asserting that their previous CAB estimates had not envisaged the sudden stop in their economy and the consequent fall in tax revenues. They claimed to be following fiscal plans projecting that the high growth rates experienced up to 2001 would continue. Consequently they disavowed responsibility for excessive deficits and insisted that they should be allowed to spend more to fight the unexpected recession.

Detailed analyses of the various country national budgets based on actual balance sheet entries indicate

that many CAB projections were indeed of poor quality (Larch and Turrini, 2009; Truger, 2014). The reasons for bad performance were diverse and not all were favorable to the countries' cases. But they should have been foreseeable from the econometric debates of the nineteen nineties: potential output turned out to be lower than expected when fiscal plans were formulated; postulated tax elasticities failed to reflect recent changes in the law, etc.

Many countries also embraced short term fixes such as sales of public assets and even more elaborate forms of financial engineering (European Commission, 2004). At the time, most of these received little publicity. "Instruments developed by Goldman Sachs, JP Morgan Chase and a wide range of other banks enabled politicians to mask additional borrowing in Greece, Italy and possibly elsewhere. In dozens of deals across the Continent, banks provided cash upfront in return for government payments in the future, with those liabilities then left off the books. [...] Critics say that such deals, because they are not recorded as loans, mislead investors and regulators about the depth of a country's liabilities" (Story et al., 2010). In Italy, such deals were pursued extensively during the period when Mario Draghi was Director-General of the Italian Treasury (1991-2001) (Lucarelli, 2015)¹⁷. The effects of this heavy reliance on external speculative finance would dramatically emerge some years later.

The CAB played a major role in resolving the new crisis of the European fiscal framework. In November, 2002, the CAB made a triumphal entrance onstage as the EU institutions agreed to re-express the Stability and Growth Pact's provisions in its terms (European Commission, 2002). Simultaneously the Commission dramatically altered the estimation method: the "statistical" approach relying on an HP based filter gave way to calculations relying on production functions (Larch and Turrini, 2009). The short and the Medium Term Objectives of the SGP came to be assessed in cyclically-adjusted terms, net of one-offs and temporary measures, that is in "structural" terms (Ecofin, 2003). As a result, after 2003, budget rules for the Stability and Growth Pact concerned not merely the size of the budget balance, but the composition of the budget itself, since these affected production function estimates. The step reflected the insistence of member states that the rules discriminate among different types of spending.

German Chancellor Gerhard Schroeder, however, wanted more. The crumbling of the Neuer Markt piled financial collapse on top of the recession, but Germany still faced large expenditures stemming from reunification. Schroeder accordingly sought to eliminate the power of the Commission altogether and to include in the Pact a list of allowed exceptions that would be considered in the CAB estimate, while leaving enforcement in the hands of Ecofin. Because this group, unlike the Commission, is formally an inter-governmental institution, in which votes are weighted by the size of member countries, Germany would (and has) easily gained support for its budget decisions, avoiding the Commission's stick.

Against revision of the Pact were the Commission and several national members, including the Netherlands, Austria, and Luxembourg, whose prime minister at the time happened to be one Jean Claude Juncker. Schroeder also faced determined opponents within his own government, notably Finance Minister Hans Eichel. As a leaked German government memo from the end of August, 2004, revealed, the Chancellor and his allies "found fault with Eichel for being 'critical of increasing the flexibility' of the Pact. Eichel, the memo indicated, wanted to preserve the pact 'as a disciplinary tool against individual ministries' - the idea being that he could force budgetary responsibility by claiming that his hands were tied by Brussels" (Reiermann and Wiegrefe, 2012).

The 2005 reform of the Stability and Growth Pact (European Commission, 2005) resolved these clashing viewpoints through yet another political compromise. Time for adjustment was prolonged; but

Schroeder's effort to terminate the Commission's role failed. A complete list of exceptions was not drafted, but there was explicit mention of various factors that might permit Medium Term Objectives to diverge from narrow bounds in the Stability and Growth Pact. These included the need for public investments, the necessity for member states to pursue their efforts to implement structural reforms related to the aging of their populations as well as increasing employment and labor force participation ratios; prevailing cyclical conditions, implementation of policies related to the Lisbon agenda, and fostering R&D and innovation¹⁸. Special consideration was given to budgetary efforts towards pension reforms and "increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe if it has a detrimental effect on the growth and fiscal burden of a Member State" (European Council, 2005). This last specification was a contorted way to include – or rather exclude from CAB computation – German fiscal transfers to its new eastern territories.

Finally, the new Stability and Growth Pact confirmed and extended the redefinition of all the fiscal targets in structural terms and added a principle of conditionality allowing excessive deficit procedures to be contingent on the retroactive re-calculation of potential output as well as on country-specific structural aspects (European Council, 2005)¹⁹.

The impression of enhanced statistical precision captured the imaginations of many observers, while the multitude of possible adjustments and exceptions satisfied truly attentive elites. The new procedures widened the scope for "technical" judgments by the Commission, while allowing national governments to continue palming off responsibility for austerity on the EU rules. As a consequence the European political establishment mostly lauded the new compromise.

But the new machinery depended critically on forecasts that were inherently flimsy, that rarely took account of ongoing budget changes, and on tools for detecting "creative accounting" that lagged far behind the realities of contemporary financial engineering. Hence, the new fiscal framework extended the room for flexible, ad hoc political strategies. The system, however, remained fragile and structurally unequal: countries with different productivity levels faced the same currency value, leading to a steady stream of Excessive Deficit Procedures

(http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm).

The Pact reform was perceived by many as a device for formally maintaining the constraints while at the same time substantially eroding them. It thus absorbed dissent from the policy via the creation of an open ended solution that, in dire cases in the future, would be handled by still more *ad hoc* exceptions. As the former Deputy Finance Minister for Greece, Peter Doukas, told the BBC News "The view was that, ok, if the big boys won't adhere and impose discipline on themselves, they're going to be more relaxed in enforcing the treaty [on us]" (Little, 2012).

But, paradoxically the promise of escape hatches in emergencies pointed up the degree to which the call for austerity reflected shared elite convictions, rather than representing simply an imposition of one country on the others (for example: Germany) or dictates of technocrats. Portugal, with Prime Minister Barroso and Spain, with Prime Minister Aznar, as well as Belgium and the Netherlands, were in a position to refuse the austerity reforms suggested by the Commission – simply by taking advantage of the opportunity opened by the bigger countries.

They did not. Instead, some of the smaller countries persuaded themselves that maintaining the Commission's powers would provide a long run guarantee of equal and symmetric implementation of the rules across the Union, neglecting the effects that the policies they were implementing and the framework they were validating would have on the real distribution of power within (and on) the E.U.

The fact that many peripheral countries (Spain and Ireland above all) were booming, fueled by relatively cheap incoming financial flows from France and Germany, likely facilitated this misjudgment. The positive economic numbers made it easy for these governments to brush off objections to full throated de-regulation of the labor market, privatization and social spending cuts – always in the name of Europe.

By the time economic pressures forced the question of further reform on the agenda in 2011, the political equilibrium was entirely different, reflecting yet another stage of the search for appropriate institutional form for a stable power configuration. By then the revival of German mercantilism and the banking crisis had created a new situation, with the Eurozone peripheral countries victims of a speculative storm after interest rates on their public bonds rocketed upward after they were forced to bail out private banks and financial institutions in exchange for remaining in the Eurozone.

On its face the 2011 reform of the Pact, the so-called Six Pack Agreement, looks like a stricter framework than the 2005 Pact (ECFIN, 2013). In fact, it is – for weaker countries. Countries exceeding the debt to income limit must continuously reduce their debts by an amount equal to 0.5% of GDP each year. The agreement also envisages the possibility of early sanctions (interest and non-interest bearing deposits) for repeated non-compliance with the Commission’s rules, in cases of “significant deviation from Medium Term Objectives,” and it fixes the structural budget constraint at 0.5% of GDP. However, as we will see, what the recent reforms have made stricter is rather the explicit control of the supranational institutions on a comprehensive range of macroeconomic and institutional practices of member countries, while maintaining flexible and asymmetric implementation of the rules.

In fact, the exceptions included in the 2005 Pact still hold with even some additions, including the “case of unusual events outside the control of the country with a major impact on the financial position of the general government” and the “case of severe economic downturn in the euro area or the union as a whole.” Neither has heavy reliance on statistical estimates changed. Not only are most constraints expressed in structural budget terms, but the Six Pack has also created a new Expenditures Benchmark to “ensure[s] that expenditure, net of discretionary revenue measures, should grow in line with medium term potential output.” The folly of all this is well illustrated by the potential output and NAWRU figures for several peripheral countries as shown in figure 1 above.

Nor do the reliance on structural budget and potential output estimate exhaust the new macroeconomic supervisory aspirations of the European institutions. The 2011 reforms have explicitly transformed the European fiscal framework into a wider system of Economic Governance (European Commission, 2014), that applies asymmetrically to member countries, depending on their financial fragility. This shift started with the definition of the European Semester that sets up a common timeline for the Commission's macroeconomic evaluation and recommendations, based on an Annual Growth Survey published by the same institution, which requires the countries to report and comply with indications.

The Six Pack also established a new Macroeconomic Imbalance Procedure, running alongside the provisions of the Growth and Stability Pact and relying on similar mechanisms (European Commission, 2012). The indicators used in the macroeconomic evaluations apply less mechanically than the GSP constraints and take account of several external and internal dimensions: current account position (between +6% and -4% of GDP), net investment position, nominal unit labor costs, real effective interest rates, private sector debt (160% of GDP), private sector credit flow, house prices, public sector debt (60% of GDP), unemployment rate (10% three years average), and total financial liabilities of the financial sector.

The dizzying stream of numbers clashes with all attempts to plan intelligently, while the degree of interference with national plans can be very high. For instance, the rescue programs (the temporary European Financial Stability Facility, the permanent European Stability Mechanism, and the smaller Commission's European Financial Stabilization Mechanism²⁰) depend on a strict conditionality, with the IMF playing a crucial role²¹. According to the Two Pack regulation, countries within a program of the European Stability Mechanism are subject to an enhanced surveillance status and to formal post-program surveillance. The latter concerns countries emerging from adjustment programs as well as precautionary assistance and lasts until they have paid back at least 75% of the assistance received²².

Furthermore, countries “whose difficulties could have ‘significant adverse effects’ on the rest of the Euro area can be asked to prepare full macroeconomic adjustment programs. These programs are subject to quarterly review missions and strict conditions in exchange for financial assistance” (European Commission, 2014).

Overall, European economic governance is now a complicated entanglement of rules and schedules that forces countries to continuously justify their position in the face of often conflicting and even contradictory objectives. It is ironic that 2005 played a pivotal role in accelerating this process, given that so many countries supported it believing they would gain more room of maneuver.

Like the smile of the Cheshire Cat, the inter-governmental character of the EU’s framework is gradually fading away. The Commission's suggestions now have a more imperative character now, thanks to the reversed qualified majority requirements (qualified majority is required to reject the Commission's suggestions) for the Ecofin to reject some of its proposals as well as because of the tighter schedules for countries to communicate their plans and react to prescriptions. The Fiscal Compact (Treaty on Stability, Coordination and Governance, TSCG) requires countries in the Eurozone to incorporate the GSP guidelines and procedures into their national Constitutional law. But the new Pact also attempts to ensure that macroeconomic evaluations are made by independent institutions as a guarantee of effectiveness. Some commentators have seen this as a first attempt that foresees the formal establishment of an independent European authority.

In this new European fiscal and macroeconomic framework, the relevance of the CAB tends to diminish, as more direct and intrusive methods of control supplant it. Just as it did in the US, the CAB may eventually become obsolete as a rule and increasingly assume a mere symbolic, rhetorical function once, and if, the process of political unification is accomplished.

On the other hand, if austerity measures and deregulation have enhanced power disparities among sectors and geographical areas, a clear and firm leadership in Europe has so far failed to emerge. Many point the finger toward the inability of Germany to assume a positive leading position (Halevi, trezzini).

Nevertheless, the new framework, by enhancing the capacity of the common institutions to override national decision making processes, represents a qualitative change from the original Ordo-liberal framework of the E.U.

From this point of view, the crisis has uncovered the need of European capitalism for a stronger central power, able to undertake rapid reactions to economic and financial down-swings with temporary discretionary interventions: a practice that allows responses to major crises that inevitably arise from the pro-cyclical structure of the government budget. The current European crisis can be seen as the

price that the EMU is paying for its delays and institutional barriers in responding to speculative attacks and credit market confidence failures. It can also be seen as the trigger that may lead to a conclusion of the remaining European institutional rigidity. Regardless of the political form and content of this solution the CAB would lend itself to rhetorically support it.

We might therefore be beyond what some authors have defined as an attack to the European Social Model. We might in fact be witnessing a redefinition of the locus of power and decision making in the E.U. National Charters and Parliaments, crucial to the post-war European democracies, are becoming increasingly useless. Those represented the attempt, after the totalitarian experiences of the previous twenty years, to build institutional guarantees for the maintenance of well-balanced democratic representation and resolution of political and economic interests.

It is telling that the main critiques of the fiscal framework today concern the introduction of one or another variants of the CAB estimate, rather than reconsideration of the underlying political framework. In other words, once again, the recognition of how circumstantial and theoretically weak the estimate is does not lead to a rejection of how it cloaks political preferences but tends rather to subtly push those preferences in a particular direction.

- ¹ Similar or equivalent definitions can be found in Sawyer (2012) and in Les Economistes Atterrés (2012).
- ² Myrdal may have changed his mind over time and even retroactively: in a speech of 1972 at the American Economic Association Conference, Myrdal states that his 1933 definition of the cyclical budget mechanism reflected Keynesian theory. Indeed, he appears to have a very pragmatic approach and political understanding of the discipline: “In the depression and under the changed institutional and political conditions in the United States in the early 1930s, the Keynesian revolution had to come as a theoretical rationalization of changed policy inclinations” (Myrdal, 1972). Moreover, the Scandinavian policy practices, especially in the forties, often did not differ much from what could be defined as a reformist left-wing interpretation of Keynes' work: especially as far as the investment planning and the focus on income distribution are concerned (Caffè, 1978, 1990).
- ³ In 1944, other two similar proposals were presented: B. Ruml and H. C. Sonne, “Fiscal and Monetary Policy”, Planning Pamphlet No. 35, National Planning Association, and the Twin Cities' “The Twin Cities Plan for Post-War Taxes – A Realistic Approach to the Problem of Federal Taxation”, St. Paul, June 1944.
- ⁴ Musgrave compares the Twin Cities (TC) group program with the CED's and the Ruml-Sonne's (R-S). He finds “CED and R-S plans to be very similar. Both place great emphasis upon the personal income tax, sharply reduce the importance of excises, and pretty much eliminate the corporation tax. The TC plan, however, provides for a substantial yield from the corporation tax and places less emphasis upon the individual income tax, in both relative and absolute terms. It is the only plan which proposes a general sales tax as well as the retention of all other excises” (Musgrave 1944, p. 1164). Overall, however, “[i]f the combined tax liabilities under both the personal income and corporation taxes are compared, the effective rate schedules under the CED and TC plans are in effect quite similar” (Ibid., p. 1174), in terms of progressivity. In fact, “retained corporate income under the CED and R-S plans would be taxed at a substantially lower rate than other income which is subject to the personal income tax” (Ibid., p. 1168).
- ⁵ Musgrave notes that “As a matter of economic policy, the lower tax rate on retained income tends to encourage the withholding of corporate profits even when these are not needed for reinvestment in new assets, a practice which operates against a high level of employment because *it* withholds funds from the expenditure stream. No concern about this basic difficulty is expressed in the CED plan but it is recognized by the authors of the R-S plan. They condition the case for a reduced corporate rate upon concurrent provisions to prevent the corporate form from being used as a refuge from personal income tax or for purposes of retaining nonessential corporate surpluses” (Ibid., p. 1168).
- ⁶ It was indeed a widely held view in Europe, as the post-War period reforms would prove, at least in theory. About this issue Ruml says: “Unemployment and fear of it is a very vicious thing. You can take any of several positions on unemployment: (1) Ignore the problem of unemployment which was the earliest view. (2) Give relief to the unemployed, which was the next view. (3) Take the attitude that demand should be supported to assure enough work if business operated effectively. (4) the state must provide specific jobs to specific people. [...] (3) is our best protection against (4), which represents straight totalitarianism”. Saturday Morning – February 24, 1945, CED meeting minutes, Donald David papers, box 23, folder 6.
- ⁷ This expression can be found in the CED meeting minutes and in my opinion describes the point quite vividly: “Mr. Fennelly remarked that a difference in point of view existed among the committee, some being concerned with stating what is known and what is not known and others being interested in the making the Murray bill *more acceptable* (Italics of the author)”, CED Meeting Minutes April 8, 1945, box 23, folder 7.
- ⁸ Until 1962, corporate profits at full employment were assumed to be 10%, then 9.5%. Personal income 78.5%, wages and salaries 53.5% (Teeters 1965).
- ⁹ “Together with Henry Ford II, David Rockefeller, and the Committee for Economic Development, Kennedy cosponsored the famous 'supply side' investment tax credit [...] in 1962, and laid the foundations for the Revenue Act of 1964, which would cut individual income tax rates an average of 20 percent (dropping the top rate from 91 to 70 percent), and cut the general corporation tax rate 8 percent” (Ferguson and Rogers 1986, p. 53). “First, while Kennedy, Johnson, and their multinational supporters had no intention of moving directly against the income tax, they also had no desire to pay for the social programs they were supporting. Accordingly, they arranged to have most of the benefits financed by a rise in the social security tax – the most regressive of all American federal taxes. Especially when combined with the cuts in corporate tax rates, and the proliferation of corporate credits, this step made the tax system significantly less progressive than it had been, while sharply increasing tax burdens on those who least could afford it. Between 1965 and 1975, corporation income taxes declined as a percentage of gross federal receipts from 21.8 to 14.6 percent. Over the same period, social security taxes and contributions rose from 19 to 30.3 percent. The effects were felt most keenly at the bottom (first) decile, the effective rate of payroll taxes nearly tripled between 1966 and 1975; for those in the second decile it more than doubled” (Ibid., p.67).
- ¹⁰ An influential MIT Keynesian, Francis Bator, says in this regard: “The second classical charge is that in the neo-Keynesian models wage and price stickiness is simply assumed, not modeled as the consequence of choices made by rational agents. [...] The optimization paradigm, when combined with interesting hypothesis on tastes, technology and other perceived constraints (without such hypothesis it is quite empty), has produced a fruitful research program, no more, no less. [...] And it is right to be cautious when relying on coefficients that reflect decision rules that may be

environment-specific and thus change as a result of actual or anticipated changes in policy regimes, as in a game in which government is one of the players. That part of the Lucas critique, reinterpreted as *empirical question* is valuable” (Bator 1987, p. 34). Similarly, Joan Robinson points against the same Keynesian rigidity in understanding the movements of prices, although she traces that problem back to misunderstanding of Keynes' ideas on the matter. Moreover, the progressive opening toward neoclassicism finds a rather different interpretation in her words: “The advocates of 'Keynesian' policies accepted only half of Keynes' diagnosis of the instability of capitalism. He described how the level of output is determined (in given technical conditions) by investment and consumption. He described how the level of prices is determined by the level of money-wage rates. It was sufficiently obvious that if continuous near-full employment was maintained without any change in traditional institutions and attitudes in industrial relations, there would be an irresistible pressure to inflation. I think that in the United States this element in Keynes was somehow swept under the carpet. It seems that the extraordinary vogue in recent years of an argument so implausible as the Quantity Theory of Money was due to a refusal to accept the fact that the main influence on the general price level in money terms is the level of money-wage [which] at any moment is more or less an historical accident, depending on conditions in the labour market over a long past. This was such a serious blow to the notions of equilibrium and the rationality of a market economy, that any theory was better, even a theory that consisted of nothing but a set of incantations” (Robinson 1972, p. 5-6).

¹¹ Bator (1987) summarizes the new-classical standard approach à la Lucas (1973, 1977) as follows: “1) price cleared markets to assure continuous Walrasian equilibrium; 2) strict-form rational expectations to replace Arrow-Debreu futures markets and this make room for money; and 3) to generate business cycles, a capricious monetary authority, and agents one-sidedly misinformed about prices (in the original version they know their selling prices but are confused about the prices they face as buyers). [...] The forcing assumption that produces the characteristic new-classical, Say's Law-like result is the assumption that prices keep all markets continuously in balance. That is the assumption that makes money neutral and policy ineffective” (pp. 36-7). There is a rather large literature of critiques of the new-classical model, to some of which this paper refers in the following sections.

¹² “The attempts to reconcile the facts with traditional theory have led to the continuous introduction of specific and arguably ad hoc hypotheses, in sharp contrast with the search for greater theoretical rigor that had been claimed to be the inspiration for the development of all the various streams of macroeconomic modeling subsequent to the neo-classical synthesis. Thus, in this respect the judgment expressed by Romer about the New-Keynesian models, that is, ‘they are so flexible that they are extremely difficult to refute’ (2005, p 338), appears well suited to all streams in macroeconomic modeling, with the exception of those versions that we might define as the base-models which closely reflect the neoclassical foundations without (many) additional assumptions, such as the monetarist and RBC models.” (Stirati, 2015).

¹³ The ECB and the ESCB were preceded by the European Monetary Institute, active from 1994 to 1998.

¹⁴ “Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union” (art. 127(1) of the Treaty on the Functioning of the European Union)

¹⁵ Some call it neo-mercantilist (Bellofiore et al. , 2011)

¹⁶ The Commission won the trial and an Excessive Deficit procedure was opened for France and Germany, only to be rapidly closed by the Commission itself.

¹⁷ Mario Draghi also “led the National Committee for Privatization. In February 1998, the Consolidated Act on Financial Intermediation weakened shareholders’ syndicates and voting agreements, relaxed conditions for takeover bids, and introduced several provisions designed to protect minority shareholders.” “Draghi’s reform of Italy’s economic institutions has recently been sharply criticized by the Italian Court of Auditors: according to the Court’s resolution 19/2012/G, the privatization of Telecom, Enel, Autostrade, and Ente Tabacchi could yield greater benefits to Italy, and the Committee chaired by Draghi played a more formal than substantial role (Corte dei Conti, 2012), giving too much power to Goldman Sachs, among other consultants. Some journalists gathered a possible conflict of interest in this regard. Indeed, Draghi was a vice-chairman and managing director at London-based Goldman Sachs International from 2002 to 2005” (Lucarelli, 2015, p.150-51)

¹⁸ New and mainly due to Italy's role in the negotiations was the reference to the structural reforms and, namely, pension reforms as “other relevant factors”.

¹⁹ The new Pact revealed acknowledgment of the importance of public investments and expansionary fiscal policy for potential growth, those remained expressed as exceptions to the rule. A rule, it must be remembered, that is expressed in terms of an estimate that only makes sense if there is no such acknowledgment.

²⁰ Under the EFSM the Commission is allowed to borrow up to a total of 60 billion euro from the financial market on behalf of the Union, under an implicit EU budget guarantee.

²¹ The Council established the permanent Stability Mechanism in March 2011 as an international financial institution. It is an inter-governmental organization operating under public international law which acts on the basis of qualified majority. The member country needs to formally request financial assistance after the ESF and is also expected to

address similar request to the IMF. The IMF assistance is sought on a technical and financial level. The ECB is also expected to provide technical assistance.

²² Art. 14 of the Two Pack reform of the Growth and Stability Pact.