MACRON'S EURO–VISION: MORE BRUSSELS AND MORE DEBT

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President Macron wants the EU to reform budget

rules to increase public-sector investments, which, he hopes, would lead to stronger economic growth and higher levels of employment. Macron's vision is understandable, but his reforms are likely to defeat their own purpose.

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On January 1st, when France takes over the presidency of the European Union, President Macron intends to hit the ground running. With broad strokes and high ambitions, he has outlined how he wants to reimagine Europe and put her in charge of her own destiny.

Macron's ambitions come with a common theme: more Europe. He wants a European military, strong enough to be "complementary to NATO" and capable enough to make Europe less reliant on America.

The French president also wants a common European response to migration crises, a stronger enforcement of the EU's borders, a European civil service for young people, and a new, more active economic role for the EU.

If there was one word that could sum up Macron's vision, it would be 'Euro-nationalism.' All his ideas point to a stronger European Union at the expense of the nation states.

Given Brexit, the recent controversy over a centralized EU immigration policy and the growth of Euro-skeptic parties in the last EU election, it is questionable how much support there could be for "more" Europe and "less" member states. It is also important to remember that politics is just as much about bold rhetoric as it is about substance: some of Macron's Euro-vision may just be strategic positioning for the French presidential election in April.

That being said, if Macron wins another five-year term, and if his vision of Europe is a substantive and successful one, he may very well materially influence the continent's future. With such stakes in place, he better tread carefully: his vision of more military independence is likely to run at odds with the NATO-focused foreign-policy doctrines in Washington. Is Europe really capable of standing on its own two feet and assume the responsibilities that American support has provided since the start of the Cold War?

In due course, President Macron and the EU will have to answer that question. In the meantime, his vision of a more centralized Europe is going to run into a much more pressing hurdle than military expansion. According to One America News, Macron is unhappy with how the EU Constitution puts a fiscal straightjacket on the member states. By means of the Stability and Growth Pact, the Treaty of the European Union caps government debt levels at 60% of Gross domestic Product and deficits at 3% of GDP.

President Macron wants the EU to rethink these rules and discuss how they can be reformed. He sees the reform of the budget rules as instrumental to increased public-sector investments, which in turn would lead to stronger economic growth and higher levels of employment.

Macron's vision is understandable. For the past 14 years, the combined economic growth of the current 27 EU member states has been below 3%. From 2014 to 2019, the last year before the pandemic-related economic shutdown, the EU economy averaged only 2.1% growth. The euro zone is doing even worse, not even reaching 1.9% during that same period of time.

At the same time, Macron's envisioned budget-rule reforms are likely to defeat their own purpose. Both economic theory and economic reality speak against allowing Europe's governments to assume more debt and grow government spending.

The argument that government can grow the economy by means of debt is founded in a conventional-wisdom version of Keynesian economic theory. It suggests that when government spends money in a recession, the economy recovers more quickly than it otherwise would, producing tax revenue increases so that government trades a budget deficit for a budget surplus. Over time, public finances balance out.

While conventional Keynesianism has strong support among both European and American legislators, it is less successful in the real world. There are many reasons for its failure, one being that every new deficit-funded spending package tends to permanently grow government.

It remains to be seen if the pandemic-related packages that the EU has presented will have the same outcome. As recently as June of this year, the European Commission announced a €750 billion 'recovery' package with a six-year spend-out rate. This money comes on top of stimulus measures taken by member-state governments.

However, even if the stimulus packages do not lead to permanent spending growth, the room for more debt among member states is already limited. Practically every European country ran a budget deficit in 2020 in excess of the limit imposed under the Stability and Growth Pact. Only Denmark managed to *de facto* balance their budget, running a minuscule deficit of 0.2% of GDP, while Sweden, with a deficit of 2.8% of GDP, barely avoided violating the Pact's debt cap.

These deficits came on top of a long streak of pre-pandemic deficits, as well as the experiences from the Great Recession of 2009-2011. At the trough of that economic downturn, 22 of 27 current EU members ran a budget deficit in excess of the Pact's three-percent-of-GDP cap. It was not until 2013 that a majority of EU states were again in compliance with the deficit rule.

As a result of persistent deficits, by 2019, 11 EU countries had a public debt that exceeded the 60% limit imposed by the EU fiscal rules described in the Stability and Growth Pact. Greece topped all the others with a debt-to-GDP ratio of 181%. They were followed by Italy at 134%, Portugal at 117% and Belgium at 98%. The debt ratio was 77% for the EU as a whole and almost 84% for the euro zone.

From one viewpoint, President Macron's ambition to reform the Stability and Growth Pact is welcome. Currently, the EU has suspended the enforcement of the Pact, allowing its member states to build up more debt while responding to the pandemic. However, the fiscal rules are currently suspended only through 2022, which means that if no reform is done, the EU Commission could be back enforcing them again in 2023. Many countries would be on the receiving end of the EU's enforcement, with Portugal as a prime example.

The consequences of such enforcement are well known. During the Great Recession a decade ago, the EU, together with the European Central Bank and the International Monetary Fund, responded harshly to excessive budget deficits in several member states. In exchange for promises to help them bankroll their debt, the EU-led 'troika' enforced fiscal compliance by strong-arming targeted states into putting other economic goals, such as full employment, on the back burner.

Greece and other countries, including but not limited to Portugal, Spain, and Italy, were forced to implement serious austerity policies. Higher taxes and cuts in government spending are supposed to nudge government budgets toward an eventual balance, but in doing so they can also wreak havoc on an economy. The negative consequences tend to be more serious the more the austerity policies rely on tax hikes, but all other things being equal, even cuts in spending at constant tax rates can reduce economic growth, and thereby employment.

In other words, if Macron wants the European economy to grow, he will have to safeguard the member states against another austerity episode. It is evident that Europe still suffers from the last economic crisis: the countries that took the hardest austerity beatings during the Great Recession have barely recovered the jobs lost. It took Portugal six years, from the start of the recession in 2009 to 2015, until they had returned to the same employment rate. Spain and Italy needed another year, while in Greece an even smaller percentage of the population is working today than they were in 2009.

Macron is not alone in calling for reforms to the Stability and Growth Pact. Already in 2013, Oxfam released a study of the consequences of austerity in Greece, pointing to the unreasonable costs of enforcing the Pact. As recently as in May 2021, Bruegel Institute economist and Deputy Director Maria Demertzis penned an op-ed outlining a vision for how the Pact can indeed be reformed.

Recognizing the rigidity with which the Pact has been applied in the past, Demertzis wants to see it reformed to allow for more coordination between EU member states in terms of government spending. Fiscal rules, she explains, "can no longer solely be about constraining public spending."

Macron echoes this same idea, including Demertzis's desire to see government invest in "the green and digital transformation." The idea is that the EU and its member states should fund long-term investment programs with new public debt. In accordance with conventional Keynesianism, this would grow the economy and lead Europe toward full employment.

Before we explore why it is problematic to increase government debt in Europe, it is important to acknowledge that as the Stability and Growth Pact stands today, it is indeed practically unenforceable. The best evidence of this is in the Greek economy, which has never recovered from the austerity policies.

In 2004-2007, the years immediately preceding the Great Recession, the Greek economy grew by more than 3.5%per year, on average. From 2008 to 2014, as austerity policies went into effect, the Greek economy shrank by 26%, adjusted for inflation. More than one quarter of the nation's economy was wiped out.

By 2013, one in four Greek workers aged 20-64 had lost their jobs and close to 60% of all young Greeks were unemployed. Two years later, Greece had lost two-thirds of all its business investments. By 2017, the average Greek family had seen 38% of their earnings evaporate. While government spending cuts reduced social-benefit programs by as much as 50-90%, taxes increased from 39% to 50% of GDP.

With this inventory from Greece in mind, it is evident that the Stability and Growth Pact needs reform. However, for two reasons, a reform that simply allows for more government spending is not the right direction. First, in order to allow for more government debt, the EU would have to centralize government borrowing. Demertzis refers to this as a form of "risk-sharing:" the EU borrows money and then simply transfers the funds to the member states.

To do so credibly on the open sovereign-debt market, the EU would need collateral. That collateral is future tax revenue, which means that in order to implement any systematic plan for centralized government debt, the EU would also need to centralize taxation. Either it will have to take over taxation authority from its member states, or add new taxes on top of the ones already levied by the states.

The second reason why centralized EU borrowing is a problematic idea is that it would lead to a significant expansion of government spending. Statistically, there is a clearly negative relationship between, on the one hand, the ratio of government spending to GDP and, on the other hand, economic growth. When government spending exceeds 40% of GDP, economic growth generally slows below 3% per year. When government spending takes up more than 45% of GDP, it is difficult to even reach 2% growth.

Slow economic growth means slow growth in tax revenue. Slow growth in tax revenue means larger and more persistent budget deficits. Larger deficits lead to increased cost of borrowing for indebted governments. It does not matter if that government is Greece or the European Union itself: eventually, it runs out of its own credit line. The bigger it allows its government to grow, the faster it reaches the end of that line.

President Macron and others are correct in that the Stability and Growth Pact needs reform. However, simply allowing more government spending is the exactly wrong way to go. If they want policies to grow government, they should design reforms that put entrepreneurs, risk-taking investors and career-minded workers in the front seat.