SEISMIC FAULTS
IN THE EUROPEAN UNION

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On 2-3 December the Sapiena University of Rome organised a Conference on "Present and Future of the EU and EMU", in honour of Francesco Forte. Speakers at the conference illustrated Forte's scientific and professional merits. This contribution discusses Forte's statement that "I governanti europei sono cretini", arguing that this is only part of the problem: those who govern Europe have a different agenda, and European institutions and policies can be likened to seismic faults, with an earthquake probability gradually approaching near certainty over time. Forte also is on record stating that "nothing is irreversible in economics", facts prevail on rules written on paper.

Introduction*.* Brexit is widely viewed as a tendency towards EU disintegration, with the risk of contagion spreading to its weaker member states. In truth the crisis is much more serious: the EU has many fault lines, institutions and policies sliding over one another and colliding like tectonic plates. There are also external pressures similar to continental drift. With the passing of time the probability of a catastrophic institutional earthquake approximates near certainty.

Crisis management is not a way to, and does not promote greater integration. At best it is ineffective, causing delays and inertia in multiple crises; at worst it is used as a political tool to justify "mission creep" and to avoid democratic monitoring of EU élites political, non-transparent agendas and behaviour.

Fault Lines. There are a dozen fault lines in the EU:

1 *Brexit*. Cameron promised a Referendum to defuse UKIP challenge, hoping to replicate the success of the referendum on Scottish independence, in destroying the Scottish Labour Party while denying independence from the UK. He destroyed UK Labour, alright, but in the whole of the UK a 52% majority on a large turnout secured independence, i.e. to LEAVE the EU; he had to resign. His successor Theresa May confirms “Brexit means Brexit”. Brexit will be punitive: migrations control and EU migrants’ lower access to welfare provisions, no ECJ jurisdiction, and the rest, mean reduced UK access to the single market, in spite of significant mutual losses, in order to discourage other exits or *a’ la carte* membership.

2 Trade policy. There is a clear democratic deficit: *either* representatives of 3.5mn Wallonians can block a Treaty affecting 545mn; *or* after 7 years of secret negotiations with Canada, the Treaty on CETA (Comprehensive Economic and Trade Agreement, like Transatlantic TIP and TransPacificPA, now unlikely to be signed under Trump, who also intends to denounce NAFTA as “the worst trade deal ever”) was unduly favourable to international investors, enjoying an *ad hoc* ISDS (Investor-State Dispute Settlement) mechanism, protection of profits from regulatory legislation, excessive protection of patents.

There is a pro-multinational corporate bias also in EU “Gold Plated Revolving Doors” recruitment policy of high officials (Monti, Draghi, Issing, Barroso, Bangemann, etc.).

The role of the nation state is that of protecting its citizens from multinational corporations (Judt 2010): self-evidently this role cannot be entrusted to the European Union.

***3 Migrations*.** In 2014-16 there was an acceleration of migrant inflows into the EU from the Middle East, the Balkans, South-East Asia and Africa. Refugees escaping war and persecution are entitled to asylum (art. 13, Universal Declaration of Human Rights) but most migrants are economically motivated and, unlike refugees, their right to migrate is unmatched by a corresponding obligation under international law, to receive them.

Migrations yield a net welfare gain. In a world *without borders* this would range between 143.3% (Hamilton *et al.* 1984) and 7% of global GDP (Docquier *et al.* 2012).

Gross losses are also involved (of workers in host countries, especially if unskilled, and employers in countries of origin) which cannot be overcompensated by gross benefits (accruing to migrants, workers who remained at home, employers in the host country; consumers all round benefiting from greater competition) so as to make everybody better off, because transfers from gainers to losers would have to be international (impractical) and/or from the poor to the rich (undesirable). Trickle-down cannot be taken for granted, trickle-up is just as likely.

Migrations also involve the dilution of social capital (whether viewed as physical infrastructure, or as welfare state benefits, or trust and cohesion) freely appropriated by migrants while private capital is fully protected globally. An unsustainable contradiction.

Moreover, any benefits of cultural enrichment can be matched by losses from cultural impoverishment. Here the seismic fault is an East-West divide, that caused Schengen area collapse, the building of walls and the spreading of populism.

Populism must include cross-party and inter-class protest against the reintroduction of poverty, mass unemployment, poor services in stable societies, and above all against all losses from globalisation. Such protest is an integral part of democracy and no longer deserves contempt and demonization. A re-definition of populism is required also by the diffusion of Information Technology and the fast inter-connectivity of people in everyday life (e-mail, social media, blogging, mass access to leaked official documents and to expertise, etcetera.)

4 *Austerity*. Maastricht rules on budget deficit and public debt ceilings, and the tougher GSP and the Fiscal Compact, have condemned member states to pro-cyclical fiscal policies, protracted recession and mass unemployment, creating a North-South divide.

Early claims of a possible "expansionary fiscal consolidation" were disproved by the IMF Research Department and now have been abandoned.
The IMF and other international organisations had under-estimated fiscal multipliers in EU and OECD countries throughout 1970-2009, at an average 0.5 now recalculated upwards to be as much as 1.7 (Blanchard & Leigh, 2013).

This revision is due to the ineffectiveness of monetary expansion close to a zero interest rate, lack of opportunities for exchange rate devaluation, a large gap between potential and actual income and simultaneous consolidation across countries. Also, fiscal multiplier for expenditure cuts turns out to be up to ten times higher than for tax rises.

Fiscal consolidation is much more expensive in terms of output loss than previously believed. Worse, it can be proven that, starting from a hypothetical fiscal balance, a fiscal consolidation (tax increases plus government expenditure cuts) will always necessarily result in an *increase instead of a decrease of the Public Debt/GDP ratio*, with respect to what that ratio would have been otherwise, *as long as the fiscal multiplier is greater than the country's GDP/Public Debt ratio.*

Thus fiscal consolidation works only in countries with a low Public Debt/GDP ratio, that do not need a consolidation. Renzi promised to make Europe "change direction " but run perversely large primary surpluses and slowed down debt growth **

***5 Tax competition*.** Taxation across the EU is not sufficiently harmonised. In order to attract foreign investment a *beggar-my-neighbour* tax competition destroys national and EU collective tax revenue potential, making fiscal discipline more difficult.

As Luxembourg Premier, in 2002-2010 Jean-Claude Juncker made "sweetheart deals" with at least 340 multinational corporations, reducing their tax liabilities by billions of dollars. A poacher turned gamekeeper, he now enforces austerity in countries which he robbed of their tax revenue. Ireland, levying a 0.005% (sic!) tax on Apple European revenues, is the most spectacular instance. It was fined €13bn but tax recovery is doubtful and is not going to benefit the EU members damaged by its policy. See also Fiat's move to the Netherlands, *etcetera.*

6 The tiny EU budget (about 1% of EU GDP). The USA have a federal budget of over 20% of US GDP, which can support the issue and service of federal debt. Individual member states can issue their own bonds involving a default risk without threatening the dollar or the US financial system.

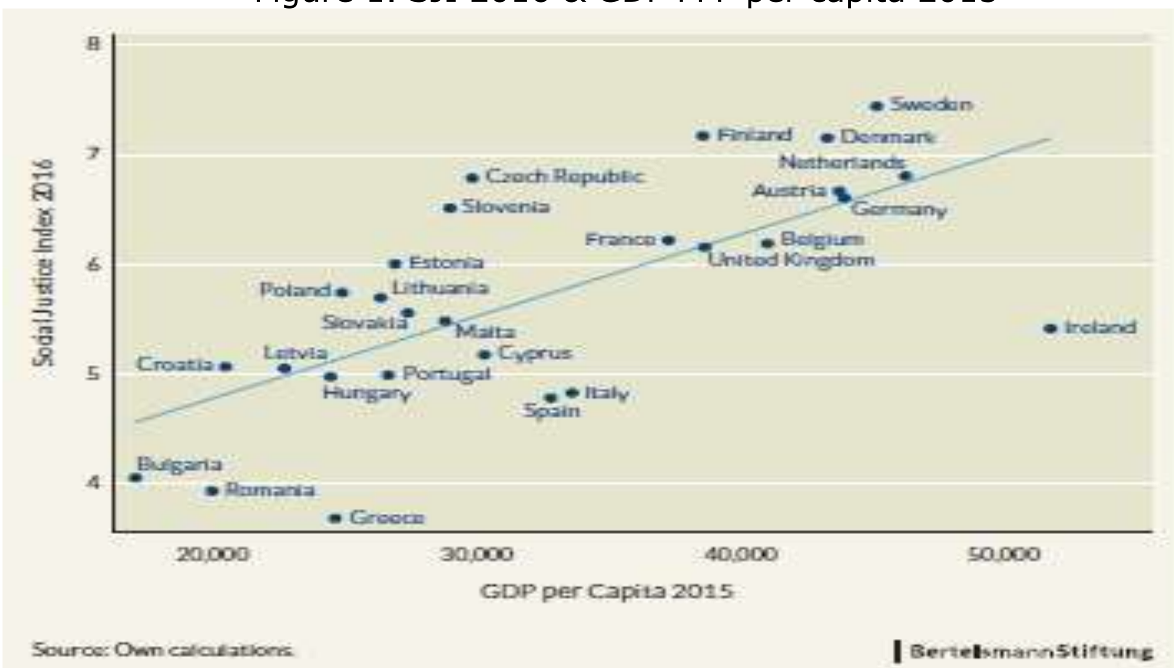
The tiny EU budget, combined with the rule that it should always be balanced *ex-post* (by a variable income tax on member states) rules out the possibility of issuing and servicing EU debt. It also rules out financing major Europe-wide investment in infrastructure, or counter-cyclical policies: the Juncker Investment Plan (€2bn EU funds expected to mobilise €315bn private investment through impossible multiplier effects) has remained a dead letter.

7 Divergence of welfare policies. Until the early 2000s the European Social Model, a desirable target though not part of membership obligations, relied on institutions as well as markets, providing employment protection and a generous welfare state. The Model was diluted and debased by EU enlargement to the East (2004-06), globalisation of labour and austerity. The Bertelsmann Stiftung computes a Social Justice Index for all 28 EU states, summarising: poverty prevention, equitable education, labour market access, social cohesion and non-discrimination, health, as well as intergenerational justice.

In the vast majority of EU countries the Index, after years of decline, reached the lowest point in 2012-14 but is still noticeably worse than before the crisis. There are significant country differences, impacting on the relative attraction of migrations.

Note the dispersion of both income per head and SJI throughout the EU. The rejection of a financial Transfer Union has involved a *de facto* Labour Transfer Union.

Figure 1. SJI 2016 & GDP PPP per capita 2015



8 Tolerance of Illiberal Democracy. The original European design was committed to shared values, listed by Angela Merkel in her message to President Trump as "democracy, freedom, …respect for the rule of law and the dignity of the individual, regardless of their origin, skin colour, creed, gender, sexual orientation or political views."

Such commitment has been neglected by EU acquiescence in member states' illiberal regimes.   Hungary and Poland have restricted freedom of speech, media pluralism and the protection of minorities.

In Hungary since 2010 the Fidesz government of Viktor Orbán changed the election system, redesigned electoral districts, eliminated checks and balances within governance built over the past two decades, reshaped the juridical system and gained nearly full control over the media and all state institutions.

Transparency International describes Hungary as a "state captured by

private interest groups”. Viktor Orbán in 2014 announced his desire to create an “illiberal state” modelled on China and Russia. Recently he declared the end of the era of “*liberal blah blah*”, predicting that Europe would come around to his “Christian and national” vision of politics.
On 2 October 2016 an overwhelming majority of Hungarian voters rejected the EU's migrant quotas, though turnout was marginally too low to make the poll valid.

In Poland, since October 2015 Kaczyński’s PiS party “attacked the country’s Constitutional Court, politicized the judiciary and the civil service, and launched an assault on media pluralism.” (Müller 2016). The EU treated it as a Rule of Law violation but took no further action for the moment.

Accession state Turkey’s Erdoğan, emphasizing traditional Islamic morality, claims to be a “conservative democrat.” Turkey’s authoritarian involution accelerated after the failed coup of 16 July, when over 100,000 people were purged. In November the European Parliament condemned "disproportionate repressive measures" and called for a freeze on EU accession, but MEPs have no formal role in accession talks. Turkey will still receive €6bn to take back migrants who failed to obtain asylum in Greece.

Robert Fico’s government in Slovakia has pursued a similar brand of what has been dubbed “raw majoritarianism” (Sierakowski 2016). Renzi’s constitutional reform (rejected by the 4 December Referendum) was also a move towards power concentration beyond democratic control. A fault line is dividing liberal and illiberal Europe.

***9 The Euro: premature, handicapped, divergent*. ** The common currency was supposed to “crown” European integration, after political, fiscal and banking integration, and a common foreign and defence policy, but was introduced prematurely, an exemplar of the “crises create opportunity for integration” myth. It was also handicapped by the ECB limited powers: unlike the Fed, the BoE and BoJ the ECB cannot finance the EU budget or that of member states purchasing government bonds in primary markets. The Euro also suffered from increasing divergence of member state fundamentals. Nevertheless, the Euro gave us ten years of low inflation, low and converging interest rates, trade and investment integration; its crisis was due to contagion from the US credit crisis, and worsening public debt due to bank rescues, feeding back onto banks’ balance sheets.

On 12 July 2012 ECB President Mario Draghi announced that the ECB was “ready to do whatever it takes” to preserve the Euro. He tried Long Term Refinancing Operations, Outright Monetary Transactions and Quantitative Easing, against German opposition, but on a scale much lower than in the

US. Monetary expansion on its own, without fiscal expansion and with debatable "structural reforms", soon loses effectiveness. QE comes to a natural end for lack of eligible bonds. Negative interest rates were introduced, to induce commercial banks to expand credit, but failed to re-launch economic growth. "Negative interest rates are stupid. They only shrink a bank's capital, hinder the sale of credit and weaken the economy" (Stiglitz 2016). Helicopter money might work, but then traditional fiscal expansion seems preferable.

10 The recapitalization of commercial banks. The fragility of European banks is due to the long deep recession worsened by austerity, uncontrolled expansion of derivatives transactions, local credit concentration and bank governance failures.

Large scale bail-out (Germany €278bn) is no longer available since the EU bail-in directive came into force on 1-1-2016. Deposit insurance is still the responsibility of national Treasuries. Bank resolution rules will come into force in 2018. Bank supervision (stress tests, etc.) is feeble.

German commercial banks are still in jeopardy because of the persistent derivatives crisis (Deutsche Bank); liabilities to US fines for selling toxic bonds (Deutsche and Commerz Bank) as well as the precarious state of German Landesbanks. Basel III rules should make banks safer, but their introduction in a recession slows down lending.

11 Foreign Policy. After 1992 the EU was complicit in NATO enlargement to the East, in violation of the 1990 confirmed deal between Gorbachev and George H.W. Bush whereby NATO would expand not "one inch to the east," (James Baker, see Zuesse 2015). A needlessly aggressive policy became a missed opportunity for *détente* with Russia (Romani 2014).

In 1991, after the dissolution of the SFRY, Germany's hasty recognition of Slovenia and Croatia put the EU in front of a *fait accompli* and was followed by civil war (Bosnia 19923-95) and NATO intervention (1999).

In Ukraine the EU helped initiate and supported the Euromaidan movement that in February 2014 ousted pro-Russian President Viktor Yanoukovich, elected in 2010. This was followed by Russian annexation of Crimea, a "present" by Khrushchev to Ukraine in Soviet times (1954) but ethnically Russian and militarily essential for access to warm-water ports. The EU joined sanctions against Russia which damaged member states asymmetrically (Germany continued to import oil and gas from Russia.)

After the US Presidential election Juncker declared that Trump "did not know the world and his first two years would be wasted while he travelled and learned"; his campaign had been "disgusting" – not exactly a sober, diplomatic reaction. Merkel's Social Democratic coalition partner, Deputy Chancellor Sigmar Gabriel, imitated Juncker and greeted Trump as "the trailblazer of a new authoritarian and chauvinist movement."

Member states are committed to CFSP – a Common Foreign and Security Policy, aimed at Conflict Prevention and Crisis Management. Acronyms (EUGS, HRVP, EDA, EEAS, EDP, CDA, INTCEN, EUMS INT …) and paperwork abound.

12 Defence. Every EU member state controls its own army but under the Common Security and Defence Policy more than 30 civilian and military operations have been launched since 2003, in Europe as well as Asia and Africa. France, Germany Belgium, Spain and Luxembourg also created Eurocorps, a military body for rapid deployment to hotspots.

The lack of a democratic, political route to decision-taking in military and paramilitary action at EU level is a further source of gross instability. The EU was divided over the Iraq War. Unilateral military initiatives were taken against Gaddafi's Libya by Cameron and Sarkozy, with Italian acquiescence. The fight against Daesh is handicapped by divisions over the Assad regime, Turkey's dominant anti-Kurd stance, Saudi Arabia's involvement and differences in policy towards Iran.

A Franco-German Plan for closer EU defence cooperation was discussed at the Bratislava summit last September; British Defence Minister Michael Fallon declared that the UK would veto the creation of EU military capabilities so long as it remained an EU member. President Trump's plan to require European states pay up for NATO's costs contributes to sources of dissension.

Other Potential Fault Lines. There are other potential fault lines: *energy policy* – energy saving, alternatives to fossil fuels and the nuclear option being still nation-based – or *environmental policy* - the Paris agreement was ratified by the EU but relies on national implementation policies; and the VW emission scandal uncovered by the US and compensation denied to European customers.

External pressures. Trump's election to the US presidency might worsen the EU crisis. The likely rise in interest rates, following his plans for $1,000bn infrastructure investment, is bad for the European South and bad for banks which should have sold government bonds much earlier but did not; the Euro will probably fall, generating a greater German export surplus which *ceteris paribus* will force the South to run larger budget deficits. Trump's plans are reminiscent of Reagan's policies which led to defaults in Latin America.

Interconnections. Many of the EU faults are inter-connected: immigration was encouraged by the divergence of welfare policies; its problems were aggravated by austerity; it was precipitated by EU foreign policy and war involvement; has contributed to Brexit.

Difficulties with CETA are bound to hinder any after-Brexit EU-UK Treaty. Tax competition clashes badly with austerity. ECB negative interest rates contribute to the crisis of commercial banks and raise their recapitalisation requirements, and so on.

Local earthquakes feed back onto the Union as a whole: e.g. the failure of Union attempts at stopping the authoritarian involution of Hungary and Poland, and of enforcing national quotas for refugees relocation, has damaged further EU credibility.

Remedies. In principle, the virtual tectonic plates that make up the EU could be controlled by European governance. The remedies to secure the EU entire system are available, in many cases even without amending the Treaties.

Thus Brexit might be softened by revamping UK membership of the EEA (Yarrow 2016) or the creation of a European Continental Partnership (Bruegel 2016). The migration crisis might be reduced by a common asylum acceptance regime; a stronger common external border; re-location of refugees across countries under penalty of losing structural funds; stopping the Dublin Treaty placing an unfair burden on EU frontier countries; deducting the financial burden of migrants from the permitted fiscal deficit. Migrants welfare entitlements might be restricted to what their states of origin would offer the recipient country's nationals, on plausible grounds of reciprocity. Entitlements might be restricted during an initial period (the current UK proposal), or made conditional on residence requirements. Re-patriation of economic migrants often is problematic, but ought to be considered with greater determination. During his campaign Trump has caused a sensation by announcing plans to repatriate 11 million undocumented immigrants, scaled down to 2 million after the election. But during his tenure in 2009-2016 President Obama re-patriated 2.5 million immigrants, often in debatable circumstances – more than the previous 19 Presidents combined. Pakistan re-patriated 800,000 Afghans; last year Sweden announced the re-patriation of 80,000 immigrants.

Austerity might be loosened by excluding from the permitted deficit public investment, which does not involve an inter-generational transfer, or the payment of government arrears towards suppliers, which involve a change of creditors and not an increase in debt. Potential output, relatively to which the permitted deficit is calculated, might be estimated according to a more permissive methodology like that of the OECD. The maximum trade surplus permitted, currently of 6% of GDP, should be reduced to 4% in line with the maximum trade deficit permitted; surplus countries exceeding that ceiling (like Germany at 8.5%, or Holland) could be forced to run a parallel budget deficit in order to facilitate other members' fiscal discipline. ECB seigniorage could be mobilised to fund the issue of bonds to reduce national public debts in proportion to ECB shares, as proposed by Wyplosz and Pâris 2014 in their PADRE scheme (Politically Acceptable Debt Restructuring in the Eurozone) and by Nuti 2014. This would avoid a Transfer Union .

The adverse distributive effects of globalisation are harder to handle: short of a global Exchequer taxing gainers and over-compensating losers, the transfers involved have to take place within nation states or Unions, compensating domestic losers from additional revenue raised by taxing domestic taxpayers regardless of whether they are gainers from globalisation, or out of savings in domestic expenditure.

Clashes. These effective remedies are in line with the original European design. However, they unfortunately clash with the hyper-liberal design that has gradually perverted European policies, as well as with conflicts of interest between states, ideologies, welfare regimes, classes, bureaucracies, memories and expectations.

In Germany the Ordo-liberal tradition of Walter Eucken in the 1930s, based on competition and monetary stability as the pillars of society, is still a heavy inheritance. In German and Dutch the same word *Schuld*, means both Debt and Guilt.

German memories are long about interwar hyper-inflation, wrongly believed to have caused Hitler's ascent to power, generated instead by the deflation and austerity of Chancellor Brüning in 1929-32. But Germans have a short memory about their own *Wirtschaftswunder,* the result of a redistributive currency reform, cancellation of public debt of over 300% of GDP and Marshall Aid – all measures which they denied to Greece. "Thomas Mann dreamed of a European Germany. His wish has turned into its opposite. Today we have a German Europe." (Lafontaine, 2015).

Lenin (1915) was prophetic: "… a United statesof Europe, under capitalism, is either impossible or reactionary". Conversely, Hayek (1939) strongly supported interstate federalism as essential to his liberal project: international mobility of goods and factors would constrain national state policy, and heterogeneity of interests would constrain federal policy. Hence Thatcher's support for UK membership (Parijs 2016).

The New European recently stated that "Brexit is not an earthquake. It is the aftershock of the death of European Social Democracy". This is only partially correct: Brexit and other forms of the EU crisis, and Trump's triumph, are not an aftershock but a foreshock, part of a seismic swarm which may or may not be followed by "the big one".

And it is the agony – not quite the death yet – of a particular, perverted form of Social Democracy: hyper-liberal, globalist, austerian, pro-multinationals, unequal, politically correct, pre-Keynesian after Keynes and pre-Minskyan after Minsky, relying on alleged but unreliable mechanisms of self-regulation and self-balancing of markets, through international mobility of labour (Schengen, Pope Francis, Hillary Clinton) and capital (Maastricht).

Exitaly. Citizens are reluctant both to move from locations of high seismic risk, and to face the cost of implementing anti-seismic measures to secure their homes and public buildings and infrastructure. EU countries are reluctant to abandon Europe and the Euro, despite the proven impossibility of securing sustainable European institutions.

Therefore the idea that "there is no salvation outside Europe", and that "we need *more* European integration rather than less" - instead of a *different* Europe – is just as senseless and fearful as the refusal of actual and potential earthquake victims to move elsewhere, and the purblind commitment of the Italian government to "rebuild everything as it was, where it was."

In any case, it is absolutely necessary to imagine, investigate and assess the likely consequences of an exit from the Euro and Europe, on the part of Italy and other countries that have suffered the consequences of European multiple crises. This would strengthen the negotiating position of those seeking to reduce the risks from catastrophic shifts and collapse.

We might be required to leave. Imagine a balance of payments crisis, a burst of capital flight, restrictions on capital movements and bank withdrawals, a panic run on the banks. European assistance might be provided, subject to draconian conditions. This is where Greece got to before it capitulated. But Italy is much larger, it might be offered assistance in insufficient quantity, or the government might be unwilling or simply unable to meet the required conditions before the imposed deadline.

Then the ECB would no longer be able to provide emergency liquidity assistance, and the only choice left would be between a barter economy or the introduction of a national currency. The trouble is that this would require long and secret preparations, which are difficult to imagine in Italy.

The cost of Exitaly would be enormous, but perhaps not as large as it is often suggested. It should not be taken for granted that the undoubted cost of leaving Europe would be necessarily greater over time, in terms of present value, than the cost of remaining in Europe without the necessary, possible but unlikely improvements.

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**Given D=Public Debt, Y=GDP, d=D/Y (initially d=0) consider a fiscal consolidation x=tax rises plus expenditure cuts of given composition, expressed as a share of GDP, $\Delta D=-xY$, $\Delta Y= -mxY$, where m is the appropriate fiscal multiplier; we then have

$$\Delta(D/Y) = \frac{(\Delta D)Y - (\Delta Y)D}{Y^2} = \frac{(-xY)Y - (-mxY)D}{Y^2} =$$

$$= \frac{-x\,Y^2}{Y^2} + \frac{mxY\,D}{Y^2} = -x + \frac{mxD}{Y} = mxd - x$$

and therefore $\Delta(D/Y) = x(md - 1) = xd(m - 1/d)$
from which we can see that the ratio D/Y must increase, i.e. $\Delta(D/Y) > 0$ if and only if $m > 1/d$. Q.E.D. See Nuti 2013