

# **The Cyclically Adjusted Budget: History and Exegesis of a Fateful Estimate**

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## **ABSTRACT**

This paper traces the evolution of the concept of the cyclically adjusted budget from the 1930s to the present. The idea of balancing the budget over the cycle was first conceived in Sweden in the 1930s by the economists of the Stockholm School and was soon reinterpreted and incorporated into the fiscal program of the American political coalition supporting the New Deal, especially by the Committee for Economic Development during and after World War II. In the 1960s, Keynesian economists associated with the Kennedy and Johnson administrations reformulated the notion. Despite their claims at the time, their version differed only in degree from the earlier CED approach, the transformation being largely conditioned by changing political circumstances. In the 1980s, however, the concept changed substantially. Methods for calculating it transformed dramatically, as the notion became a device to limit and direct

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## Introduction

“Dogmas and formulas, these mechanical tools designed for reasonable use—or rather abuse—of [individual] natural gifts, are the fetters of an everlasting nonage.”

Immanuel Kant, *What is Enlightenment?*<sup>1</sup>

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 is usually 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 actions.<sup>2</sup>

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.

In the process, we will show that 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.

This 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.

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 track 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 names of the "High" or "Full Employment Budget," developed into 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. Economists working with the U.S. Committee for Economic Development pioneered the "High Employment Budget" notion in the 1940s. This was explicitly designed as a budget targeting device that precluded discretionary fine tuning of the economy. In the sixties, President Kennedy's economic advisers transformed the concept into the "Full Employment Budget" and made it momentarily famous as an indicator for the diametrically opposed policy of macroeconomic fine tuning. Though the Kennedy economic team expressed disdain for the older "High Employment Budget," we will argue that the differences were not as large as the Keynesians of that time liked to claim either in terms of underlying logic or the derived policies; mostly the new concept represented an adaptation to changing political conditions.

From the late seventies, however, the CAB changed yet again, this time into a device for 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 discussed below, 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 around a natural and satisfactory level.



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.

The Swedish economists worried that the unorthodox character of such propositions could generate an “adverse reaction of business confidence, which has too often restricted or even possibly reversed [the] stimulating effects [of a countercyclical expansion of public spending]” (Myrdal, 1939a, p. 187). According to Myrdal, the solution was “[...]to come back to a reasonable degree of automatic reactions” (*Ibid.*, p. 188) in order to progressively change the “political psychology” of public finance. In other words, a set of fiscal formulas was needed in order to win the confidence and the support of the private business sector, while guaranteeing the government the resources required for an effective anti-cyclical policy. As Myrdal explained, “[...] to tie the hands of governments and legislators in good times and hinder them from expansion beyond the trend at that time, but to be able to release their hands and spur them to action in depressions” (*Ibid.*).

However, the insistence on following a fixed budget principle without “concession to expediency” did not reflect pure political opportunism. On the contrary, its deepest rationale relied on Myrdal's specific theoretical explanation of cyclical crises. In the Myrdalian world, 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 behavior 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.*, p. 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).<sup>3</sup>

The Stockholm economists thus focused on cyclical instability and on what eventually came to be termed disequilibrium economics (in ex ante terms) (Lundberg, 1985). According to them, prolonged stagnation could only occur in presence of specific dysfunctions in the structure of the economy that could only be resolved by basic changes in the institutional framework. By contrast, appropriate counter-cyclical fiscal policy could deal with temporary GDP shortfalls.

In the mid-1940s, when the international debate turned to consider the possibility of reaching and maintaining full employment, the basic Stockholm School approach did not change. Though the Scandinavian economists shifted their focus from stabilizing the economy to supporting growth rates and reaching full employment, they did not perceive the problem in terms of the instability or insufficiency of aggregate demand,<sup>4</sup> but as a result of inefficiencies of the private sector supply side that could be solved through intensive economic planning and active labor market policies (Myrdal, 2005).

By then, however, the theoretical approach introduced by Keynes in his *General Theory of Employment, Interest, and Money* (Keynes, 1936) was well on its way to conquering much of the Western world. The main arguments of this very influential book were the rejection of Say's Law and the statement of the principle of aggregate demand. Together they implied the rejection of the notion of ex ante equilibrium between investments and savings, so important to Myrdal and to his cyclical budget. In fact, since investment and public spending in general generate the ex post savings necessary to cover the previous outlays, there is no logical reason for a cyclical budget constraint. Moreover, Keynes believed that because the capitalistic system very likely stabilizes at low rates of employment

of available resources, public spending (especially investment) and policies to correct income inequality could play a crucial role in attaining high growth and employment rates beyond the cycle.

But while Keynes provided a general theoretical framework and a few practical suggestions, he did not propose a specific plan for contingent action. “Another Keynes Plan might be one too many,” (Skidelsky, 2001, p. 270) he said, referring to his unsuccessful but memorable involvement at the Conference of Versailles. Michał Kalecki, for a time Keynes’ colleague at Cambridge before moving on to Oxford, was famously skeptical: he did not believe that the theoretical possibility for capitalism to reach full employment implied its historical feasibility (Kalecki, 1943). Nonetheless, one could argue, as indeed many have, that Keynes himself was dubious about purely demand-side attempts (either fiscal or monetary) to steadily emancipate capitalism from stagnation and the cyclical swings. In fact, although theoretically speaking the Stockholm School misses some crucial Keynesian concepts, 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 investment planning and the focus on income distribution are concerned (Caffè, 1978, 1990).<sup>5</sup>

### **Keynes, the Americans, and the High Employment Budget**

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 for 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.

Parts of this history are well known, but existing accounts of the CED’s budgetary deliberations rely heavily on memoirs and first person testimony (Stein, 1969; Collins, 1981). They neglect important parts of the institutional context and do not draw on notes and protocols of the group’s meetings that have until recently been locked in archives. When those pieces are fitted together, a substantially different picture emerges, especially in regard to the CED’s views of discretionary fiscal policy and its influence on economic theory and political practice in the sixties.

Let us begin with a closer look at the historical and institutional context in which the CED was born



and acted. It developed organically out of policy debates of the Great Depression, as some of the *General Theory's* main ideas were being popularized and spread thanks to the independent action of Alvin Hansen, through his publications and seminars at Harvard (Galbraith, 1987). His translation of Keynes' message found a ready reception among younger economists who also embraced the New Deal or, in the case of many, social movements still further to the left (Galbraith, 1965).

In his first term, President Roosevelt had cobbled together a succession of policy packages that on balance were expansionary in response to immediate political pressures, but which did not reflect any clear commitment to a coherent set of economic ideas (Sweezy, 1972; Collins, 1981; Hall, 1989). The absence of convictions led to trouble almost immediately after the President's triumphant reelection. Early in 1937, the administration began a series of sharp budget cuts while the Federal Reserve raised interest rates. The result was a steep fall in national income.<sup>6</sup>

As the plunge continued, the President and his advisers looked around for policy ideas to reverse it. In April 1938, finally, the President unveiled an emergency stimulus program to combat the recession that drew on explicitly Keynesian reasoning. The conversion was less than whole hearted; the President and his advisers did not persist and, after the most acute phase of the recession passed, they slipped back to more traditional austerity policies (Collins, 1981).

Save for a moment at the start of Roosevelt's first term, most American businessmen perceived the New Deal as a political program bent on transforming the US into a socialist state, reminiscent of the Soviet Union. As a result, most renewed their traditional commitment to the opposing Republican Party while the major general purpose business organizations – the United States Chamber of Commerce and the National Association of Manufacturers (NAM) turned sharply against the New Deal. Especially after the late Spring of 1935, when Roosevelt turned decisively to the left with his so-called "Second New Deal" that included Social Security and the Wagner National Labor Relations Act giving legal protection to labor organizing, much of American business embarked on something resembling a crusade against him. NAM in particular saw its budget and total membership spiral rapidly upwards as major business groups opposed to the New Deal took control and proselytized for wider support (Burch, 1973; Collins, 1981; Ferguson, 1984).

However, the traditional picture of a business community almost monolithically opposed to Roosevelt

and the Democratic Party is now known to be seriously mistaken – and this point is critical to understanding the role and origins of the CED. Recent research has shown that the Second New Deal also included major measures very attractive to capital-intensive, internationally oriented businesses such as Standard Oil of New Jersey and General Electric; a dramatic turn toward free(r) trade and a measure bringing the domestic price of oil into alignment with agreements among the major international oil firms. These firms did not favor unionization, but because they were capital intensive, they were not threatened nearly as much by it as those in older, more labor intensive sectors. Depending on the ebb and flow of labor's surges and on the efforts the administration made to restrain these, they often supported Roosevelt against the much more highly protectionist Republican Party. The shift on trade also strongly attracted major American financiers, who had long favored cuts in American tariffs as a way to resume world trade.<sup>7</sup>

In this convergence of political interests we find the deep forces that shaped the transformation of the ideas and practice of fiscal policy, giving birth to the High Employment Budget and, later, to the Full Employment Budget. In 1933, Roosevelt's Commerce Department had organized a Business Advisory and Planning Council (renamed two year later as the Business Advisory Council) that was frankly intended as a link to the business community separate from traditional business organizations. It included some key figures of the above mentioned capital-intensive, internationally oriented bloc: Gerard Swope of General Electric, Walter Teagle of Standard Oil of New Jersey, Marion Folsom of Kodak. This group played a significant role in many administration decisions although it did not adhere entirely to the New Deal. In sharp contrast to the U.S. Chamber of Commerce, however, key members supported reforms to implement Social Security and mild forms of economic planning. However, toward the end of the first term, as the more radical course of the New Deal heightened tensions within business, disenchanted members left in substantial numbers and the Council's influence diminished.

Yet even after the Business Council declined, many executives and firms that had been connected remained friendly to many ideas of the New Deal. Among them, the idea of government efforts to stimulate the economy found some early supporters who were later to play prominent roles in the CED. For example, Standard Oil of New Jersey and a handful of smaller firms organized in the Taylor Society that championed technical innovation and modern management had been enthusiastic from very early on (Ferguson, 1984). The Taylor Society firms included a number of entrepreneurs, including Henry Kendall, Henry Dennison, and Ralph Flanders, who, like Teagle, served on the

Business Advisory Council. In 1938, Flanders, together with Henry Dennison, Morris Leeds and Lincoln Filene, a celebrated Boston retailer who championed free trade, authored a book advocating government spending as a measure against Depression: *Toward Full Employment*. The book reached mainly other businessmen, within the social circle of the authors (Collins, 1981). Their ghost writer was a Harvard Economics professor named John Kenneth Galbraith.

Even more important for the CED was Beardsley Ruml, a top Rockefeller family advisor who long controlled several of the family's foundations before eventually becoming Treasurer of Macy's, a retail house that strongly favored free trade and whose owners supported Roosevelt.<sup>8</sup> Ruml appears to have been a keen observer of the furor over Keynes' ideas even before publication of the *General Theory* and he personally conveyed a draft of what became the administration's stimulus plan in 1938 to President Roosevelt (Collins, 1981).

Those efforts were not sufficient to convince the rest of the business community or the administration: it was demand for war materials that finally pulled the American economy out of the Depression (Gordon and Wilcox, 1978; Gordon and Krenn, 2010).

By then, however, policy uncertainties associated with war time management and post-war planning were creating a host of new anxieties for American business. Unease over the course the Roosevelt administration might chart generated powerful new pressures to organize an authoritative guiding voice at a moment when the traditional organizations, NAM and the Chamber, appeared hopelessly out of touch with political realities and unable to constructively influence the administration.

The Committee for Economic Development was born in 1942 with the precise intent of filling the void. It brought together many business figures associated with the earlier Business Advisory Council, along with Ruml and other executives from firms that either had supported the New Deal or wished to avoid associating themselves with the deep conservatism of the older business groups.

A distinctive feature of the new group was the way it tried to integrate academic research into its policy formulation process. The group made extensive use of experts, that is academically credentialed professionals, while very carefully staying aloof from direct and stable ties to any one university or school of thought.<sup>9</sup> No less importantly, the CED made a deliberate effort not to appear as the

expression of specific social interests. It presented itself as speaking in the name of a broad public interest. This apparent independence was a key feature of its public image. Formally, it addressed the public and policymakers, but never as a “lobby.” (To this day, the CED is not registered to lobby in the technical legal meaning of that term.<sup>10</sup>) In a classic terminology, the CED plainly aspired to cultural hegemony. Its minutes reveal that it sometimes maintained divergences with other business groups for strategic reasons.<sup>11</sup>

Fiscal policy inevitably became a major focus of the CED’s 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.<sup>12</sup>

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 argued 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, p. 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, p. 10).

For this reason, the CED insisted that measures of budgetary balance required cyclical adjustment. As Ruml summarized at one Advisory Board meeting: “[...] the question of fiscal policy is a question of the greatest consequence. It is necessary to take financial transactions [...] and look behind them for economic consequences. No one can estimate with accuracy what they will be. The tax on tobacco will be different in effect than a tax on inheritance. To equate these financial transactions as if they were all equal as is done in the present budget is foolish.” “[T]he [actual] Federal budget if balanced is

deflationary.”<sup>13</sup>

Both CED fiscal statements settled on the high employment surplus as the proper tool for stabilizing budget policy, which they “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, p. 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 carefully considering their effect on output. 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 taxes.<sup>14</sup> It also endorsed some social programs such as unemployment compensation that, similar to progressive taxation, operated 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 investment.<sup>15</sup>

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.”<sup>16</sup>

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.

It is interesting to recall that Myrdal’s policy proposals for anchoring fiscal policy to a cyclical constraint, reflecting a democratic preference, derived from his theory in which expectations played a crucial role. His CAB did not require any exercise in estimation, but was based simply on accounting quantities and measures. The basic idea was to make sure that the governments maintain responsibility for their financial actions beyond conventional accounting and policy intervals to create an equilibrium between the social control of government action and protection of far-sighted and well pondered priorities from random political influences.

By accepting the possibility of under-employment equilibrium and the efficacy of fiscal policy for growth and at the same time incorporating these concepts into a stable budget structure and budget yield target, the CED exposed itself to criticism on both its left and right flanks. Traditional budget analysts on the right, of course, were highly opposed. Keynesians allied with the New Deal’s progressive wing were much more sympathetic (VV.AA., 1949), though they nonetheless criticized the Committee’s insistence on a stable budget structure and disavowal of discretionary policies outside of emergencies. Richard Musgrave (Musgrave, 1944) and Alvin Hansen (Hansen, 1949), for example, both doubted whether automatic stabilizers could be relied upon to secure recovery from slumps. A later generation of Keynesians echoed this skepticism, charging that the CED’s policy program was rooted in a “Puritan” (Heller, 1957, p. 650) understanding of budgetary issues that they identified with

fiscal conservatism and a less than courageous embrace of the potential of a discretionary fiscal policy.

But the minutes of the group's meetings show that a more subtle set of political considerations lay behind the CED's insistence on automatic stabilizers.

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 to oppose "less acceptable"<sup>17</sup> 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 two different but related sets of concerns.

First, its members realized that given conservative reluctance to accept the idea of compensatory fiscal policy at all, advocating discretionary fiscal policy might well boomerang, leading to a disastrous move back to budget orthodoxy at the wrong time and a repeat of 1937.<sup>18</sup> This was especially the concern of the most progressive members of the CED, such as Beardsley Ruml. In addition, amid waves of strikes and political stirrings on the left that eventually culminated in Henry Wallace's independent bid for the White House in 1948, proposals to levy new taxes on business were proliferating. These the CED unanimously abhorred.

The hope was therefore to minimize legislative interference, which in the late 1940s, did not promise to be uniformly benign from the point of view of business.

Thus the CED's discussion of fiscal policy was deeply affected by what its members perceived as the realities of the balance of power between labor and business at the time. This last concern was heightened because throughout World War II, the possibility of state action to guarantee post-war full employment had been extensively debated in both Great Britain and the United States (Beveridge, 1944; "White Paper on Employment Policy," 1944). In the U.S. this led to a proposal for a Full Employment Act, first conceived by Alvin Hansen and a group of economists from the Bureau of the Budget and the Federal Reserve, including Richard Musgrave, Marriner Eccles, Walter Salant and Gerhard Colm (Bailey, 1950).

Ralph Flanders' correspondence conveys what CED members perceived to be at stake: “Howard Myers' confidential communication of the 25th enclosing the new form of the Murray Bill, plus the nomination of Mr. Wallace and his plans as revealed, indicate that the CED will meet with what is practically a fait accompli [underlined in the original version] so far as the administration program is concerned. This program is in the same field in which we are working and goes at the problem by other means. This poses serious problems which, it seems to me, should be the main subject of our discussion at the research committee executive session at the time of the February meeting. Please give the matter your best thought.”<sup>19</sup>

Unlike most of American big business, the CED was not implacably opposed to the Full Employment Act proposal (informally called the Murray Bill). But the first version of that bill, backed by the New Deal's Progressive wing, that was introduced on January 22, 1945 by Montana Senator James Murray (Bailey, 1950), did not please the CED. That measure contained “[...] three main elements. First, it proclaimed the right of all Americans 'able to work and seeking work' to useful, regular, and full time employment and affirmed the responsibility of the government to guarantee that right. Second it provided a planning mechanism, the National Production and Employment Budget, by which such a guarantee would be executed [...]. Third, the bill directed that if a gap existed between the full employment requirement and the original estimated expenditures and investment, the deficiency should be made up first by encouragement of non federal and private spending, and, if that was insufficient, finally by government spending” (Collins, 1981, p. 100).

In accord with its mission, the CED was forced, although reluctantly, to address the issue. As Donald David wrote to Gordon Wasson, another CED member: “The problem of maintenance of a high level of employment is now before us and has been placed there by the Beveridge book, the Murray Bill, by Mr. Wallace and by our own utterances. I think it is time we recognize this and that our research activities be directed much more broadly than they have been thus far.”<sup>20</sup>

As mentioned above, the CED was opposed to job guarantees and did not view major public spending programs with favor nor support any tendency to substitute public for private control on markets and enterprises.<sup>21</sup> As Ruml explained: “It is because I want a free economy that I want to revise our ideas on taxes. If we can leave sufficient purchasing power in the hands of the people and let private business compete to get it we will have a very different situation than if we have purchasing power pumped out



by the central government under the direction of bureaucracy” (Collins, 1981, p. 139).<sup>22</sup>

The possibility that the first, more radical version of the bill would pass was considered very unlikely by the CED members. They mostly feared an ultra-conservative reaction leading to its complete rejection that would have risked reviving acute class struggle. As Ruml said: “The Murray Bill is reassuring in some ways. There are some fighting words but we should be able to discuss the substance of the Bill without too much confusion.”<sup>23</sup>

The Committee decided to address the maintenance of high levels of employment as part of a wider economic policy problem that government, labor and business all needed to contribute to solving. “The most important thing to get into the Bill are instruments of policy that [...] maintain high levels of employment. In 1937 there were enormous surpluses in Social Security and no construction or conservation policy geared to anything. In addition there were rising taxes. [We need to eliminate] administrative discretion in our taxes through automatic controls.”<sup>24</sup> “[Post-War time] is a new situation in which it is entirely possible to attain the purposes of the Murray bill by tax reduction” (*Ibid.*).

From this perspective, the 1947 CED tax statement with its automatic and fixed budget mechanisms can be understood more broadly as one product of the CED's composite reaction to the full employment act and, more generally, to the political atmosphere of those years.<sup>25</sup>

The final version of the legislation, approved as the 1946 Employment Act “[...] diluted the bill by extending its scope beyond employment to the problems of production and the maintenance of purchasing power [...] and it eliminated the National Production and Employment Budget, replacing it with a less powerful President's Economic Report, to be prepared with the assistance of a Council of Economic Advisers” (Collins, 1981, p. 107). The solution it preferred minimized governmental tinkering, leaving key decisions to a council of experts working directly with the President, not Congress.

We do not know exactly to what extent the CED or its members individually contributed to this outcome, though several prominent executives are known to have been favorably inclined and involved behind the scenes (Bailey, 1950). The CED did not intervene publicly and officially on the matter of

the bill, as it never commented on legislative proposals under discussion.<sup>26</sup> However the CED approved a “presidential” solution, probably again with a view of minimizing legislative interference, as their policy statement titled *Toward More Production, More Jobs and More Freedom* (CED, 1945) published in November 1945 shows, as well as a confidential letter to the president dated September 1945.<sup>27</sup>

While some CED members were more concerned than others with the problems of price stability and public debt, the notion of putting fiscal policy on automatic pilot was thus not really motivated by fiscal puritanism or dogmatism. The 1947 CED tax statement with its automatic and fixed budget mechanisms was a way to minimize the danger of political degeneration (from the point of view of business) with a concrete legislative proposal, at the moment when big business’ confidence that it could control national policy was near an historical low point. Instead the CED plumped for a stable budget process, based on a technical, professional, objective reasoning that privileged the Executive, rather than the Legislative branch of the government, as a way to reduce the risk of a political confrontation business might lose.

### **From High Employment Budget to Full Employment Surplus and Back**

The critical role background political considerations played in the evolution of the concept of the cyclically adjusted budget becomes even clearer when one retraces how the late forties notion of the High Employment Budget was reborn as the Full Employment Surplus of the Kennedy-Johnson years.

The way its champions have mostly told the story, the contrast with the older viewpoint could hardly be more jarring: instead of a rule constraining governments to a fixed fiscal course, the new notion became famous as a symbol of the possibilities of discretionary fine tuning of the economy long advocated by progressive Keynesians.

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.

The first of these is a vast topic, too big for this paper to treat in detail. But it is the most important link in the chain, comparatively easy to summarize, and not controversial save in details. In the late 1940s, American domestic politics was riven by deep conflicts. Strike rates, no matter how measured, were at an all-time high (Hibbs, 1976). So were rates of unionization (Mayer, 2004). Third party political efforts, on both the left and the right, were strong by historical standards, with former Vice President Henry Wallace running on President Harry Truman's left and then South Carolina Governor Strom Thurmond to the right of both major parties in 1948. Not surprisingly, efforts to tax business that drew the ire of the CED then were also very frequent (Carlson, 1987).

By the end of the nineteen fifties, the political climate was strikingly different. In 1952, the long search by big business leaders for a moderate Republican capable of breaking the Democrats' hold on the White House ended with the election of the former General who had commanded allied forces in Europe during World War II, Dwight David Eisenhower. Eisenhower's consciously supra-party (or "bipartisan") style of leadership reduced elite political conflicts. Both Republicans and Democrats turned on organized labor and cooperated in investigations of alleged Communist influence in labor unions, Hollywood, and the teaching professions, leading to a round of dismissals and purges. Strike rates plunged; by the late fifties they were at less than half of the levels of the decade before (Hibbs, 1976), while a system of "pattern bargaining" brought relative labor peace to much of American industry (Maher, 1961; Eckstein and Wilson, 1962; Goldin and Margo, 1991; Ferguson and Galbraith, 1999). In 1954, labor union membership peaked as a percent of the workforce (Mayer, 2004) and thereafter went into steady decline. In a defensive merger, the much more conservative American Federation of Labor joined with the Congress of Industrial Organizations to form the AFL-CIO on terms that greatly advantaged the former. In a development with particular relevance to this paper, proposals for new taxes on business dropped all the way to zero by 1954 (Carlson, 1987). From 1955 to 1962 there were no major variations of the tax rates (Carlson, 1967). By the late fifties, consensus politics had replaced confrontation as the watchword of American politics, as the center of gravity of the whole system shifted markedly to the right.

With not only Republicans, but the Democrats becoming increasingly business friendly, New Deal tensions faded. Earlier CED worries about what might happen if the Executive branch of the government attempted to program economic policy in the short run eased. With business political ascendancy solidifying, the need for automatic rules was vanishing. The CED began financing research that openly contemplated varying even tax rates within ranges set by Executive decree, bringing it much closer to the progressive Keynesian ideas of the late forties.

In the meantime, the CED's open embrace of a version of Keynesian economics helped mightily to reduce prejudices against the new doctrine. The change in the intellectual climate is hard to overestimate, though only rarely recognized.

This evolution, however, found only a pale reflection in the administration of Eisenhower who, rather like FDR, was willing to embrace Keynesian programs in recessions, but not prepared to sustain them beyond that. During his presidential campaign, he won support from many members of the Committee for Economic Development and several served in high posts within his administration. But within the Republican Party, the CED's Keynesian proclivities were still widely suspect, with some far right Republicans accusing the CED, the Ford Foundation, and the Council on Foreign Relations and similar establishment organizations of socialist inclinations. Treasury Secretary George M. Humphrey was strongly anti-Keynesian and highly orthodox on budgetary policy. His insistence on balancing the budget at every stage of the cycle accentuated the American economy's stop-go propensities, especially in the late fifties, when it was widely blamed for causing the 1958 recession (Canterbery, 1968).

By the end of the decade, the US economy's relatively weak growth rates, particularly in comparison to those of the Soviet Union (*Ibid.*), had become an object of widespread elite concern. Frustrated by the administration's irresolution, the Rockefeller Brothers Fund, the Ford Foundation, the CED, and other establishment groups all commissioned studies on how to get the US rate of growth up and improve economic performance (Rockefeller Brothers Fund, 1961; Canterbery, 1968; Ferguson and Rogers, 1986).

The older Keynesians concerns about the original CED proposals had centered on precisely the issues that now came to the fore: growth vs stability and discretion vs automatic mechanisms. At issue were

contrasting perspectives on fiscal policy: on one side was the notion that the economic system oscillates around a more or less stable full employment level of output, and therefore that fiscal policy should focus on maintaining stability. But on the other was the idea that potential output should also be advancing and that to reach this the system required appropriate fiscal stimulus. The two perspectives generated contrasting anxieties: on one hand, fear that excessively strong fiscal interventions could result in inflationary pressures. On the other, that of wasting the nation's potential growth capacity.

In his critique of the original CED proposal, Hansen had zeroed in on the linkage between full employment and capacity enlargement: "The CED program [of the forties] would be reasonably adequate if the modern economy tended always, with mild oscillations around the norm, toward full employment. But that is not the kind of society we live in. Rather it is one of intermittent surges of growth, with spurts of capital formation lasting precariously only so long as autonomous outlets for investment hold out. When these become exhausted the leverage effect operates swiftly in reverse, with induced investment and induced consumption rapidly dwindling along with the decline in autonomous investment. At times these upward surges [...] drive the economy up to full employment and occasionally even beyond; but often the expansion is halting and inadequate" (Hansen, 1949, p. 180).

As a consequence, Hansen explained, "the boom being temporary and often short-lived, there is neither time nor adequate incentive to bring capacity up to a level which would yield low total unit cost at full-employment" (Hansen, 1949, 105). If, instead, the state assumed responsibility for assuring continuing full employment "here would be both time as well as the incentive to enlarge capacity, thereby pushing the cost curves to the right [...]" (*Ibid.*).

Musgrave (Musgrave and Miller, 1948) and Brown (Brown, 1956) found important empirical results in favor of counter-cyclical discretionary measures. Keynesians increasingly asserted that fiscal policy choices were always choices and that policymakers should frankly acknowledge this. As Paul Samuelson eventually summed up, any automatic mechanism "is set up by discretion, is abandoned by discretion and is interfered with by discretion" (Blinder and Solow, 1974, p. 38).

In the late forties, as McCarthyism and Congressional investigations of suspected Communist spies gripped the American political imagination, prominent researchers at MIT and other schools also faced embarrassing and potentially career disabling questions about their "loyalty." As he drafted the first

edition of his landmark textbook, for example, Samuelson admitted being “carefully and lawyer like,” fearing he might suffer the fate of Lorie Tarshis, one of Keynes’ few North American students. Tarshis wrote a textbook (Tarshis, 1947) that, after initial rapid success, was soon removed from programs by many universities that had originally adopted it, after far right critics organized a slander campaign that depicted it as plainly socialist and a bearer of anti-market views (Colander and Landreth, 1998; Davidson, 2009).

But Samuelson's caution sufficed. His textbook did not draw similarly virulent attacks. In the new climate of *Trasformismo*, with both political parties moving to the right-center, Keynesian ideas appeared as a rich well of new ideas for big business to mine. Samuelson's Neoclassical Synthesis Keynesianism became the Bible of conventional economic wisdom.

Together with the extensive financial support lavished on Keynesian economics by leading American foundations, the new, more conservative MIT Neoclassical synthesis reinforced the bond between Keynesians and the CED: on a technological plateau, growth (the goal of business) and full employment (the original concern of Keynes and Hansen) went hand in hand, provided that conflict over income distribution did not get in the way.

Whatever his own intentions, Robert Solow’s growth model (Solow, 1957) admirably resolved this problem, rooted as it was in a basically harmonious representation of the distribution of income, reminiscent of what the CED envisioned when it tried to square the circle of the Employment Act: both labor and capital contribute to growth and earn accordingly. Rebuilding growth theory on the basis of the aggregate production function amounted to crossing the Rubicon in economic theory – it split the Keynesian front in a way that is still unresolved – but also provided deep intellectual reassurance that reviving the New Deal coalition of the 1930s, with its mix of organized labor and capital intensive, internationally oriented business could function smoothly in the less turbulent sixties.

Progressive Keynesians were thus encouraged to revive the New Deal era theme that both economic efficiency and equity could benefit from a fiscal expansion.

Commonly, the Keynesians staked out their position in the technical language of modern welfare economics. Richard Musgrave, Walter Heller, Francis Bator, and John Kenneth Galbraith all raised

pointed questions about the proper mix of public and private goods in the economy. As Nelson Rockefeller – himself a liberal Republican who had famously almost become a Democrat after serving in Franklin Roosevelt’s administration – led a charge in New York state for large scale social spending projects, Rockefeller Brothers Fund studies promoted detailed studies in this vein. Keynesians argued with increasing boldness that it was time for the US economy to address a broad range of social issues that they believed held back productivity, such as minority unemployment.

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.”<sup>28</sup> 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 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.

The members of the new economic team that John F. Kennedy brought into the White House were convinced that they were above ideology. Their conceit was widely accepted within the profession generally. James Tobin recalls that: “[t]he tide of reaction against the New Deal on which Eisenhower swept into office in 1952 contained a wave of resentment and distrust of government and academic economists, especially strong in the business community. During the 1950s economists were demoted from policy-making roles in government [...] and their views were rarely sought or heard in public discussion of economic issues” (Tobin, 1974, p. 4). With the advent of the New Economics, instead, at least “in the realm of macro-economics, [...] problems and issues were coming to be treated as technical rather than ideological. [...] From outside, the economics profession appeared quite unified, as befits a guild of technicians and pragmatists” (Tobin, 1974, 5).

This attitude toward the economic profession together with their consensus strategy, is relevant for understanding how Keynesians comprehended and used the concept of the full employment surplus.

Their intended use of the idea was primarily educational, almost for public relations: it was meant to make the public realize the potential of fiscal stimulus for growth, while reassuring about the consequences for price and budget stability. Their Full Employment Surplus was a convenient communication tool, rather than an engine of analysis: “The public seems to need a number, traditionally a budget deficit, to view with pride or alarm as the case may be. [Unfortunately,] whenever one attempts to reduce a multidimensional concept – like the influence of the Government on aggregate economic activity – to a single dimension, index number problems inevitably arise. [...] However, the political realities of the day seem to dictate settling on a single index to measure the overall expansionary or contractionary effect of any proposed tax and expenditure program” (Blinder and Solow, 1974, p. 8).<sup>29</sup>

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, p. 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. Firstly, 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, etc.).<sup>30</sup> The appropriate tax rates are then applied to those components. Secondly, 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% unemployment rate 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





measure perfectly the effect of a given budgetary change because it does not reflect changes in the composition of the budget. Moreover, a rise in the level of the budget may have a stimulating effect even with no change in the full-employment surplus. But the full-employment surplus is the best simple measure available and is a useful tool of analysis” (Council of Economic Advisers, 1965).

Moreover, the estimate does not account for how each budget component acts on output, which would require, at least, the estimation of multipliers. However, it lends itself to interpretation, having a certain theoretical framework in mind, which roughly returns such information.

Precision on this matter was not, however, very relevant, since the Kennedy economists did not intend the Full Employment Surplus as a target.<sup>31</sup> In fact, their ultimate goal was not that of reaching potential output, but rather that of accelerating the growth of the latter. That was consistent with the idea that potential output is not the “normal” level at which the economy tends, but a short term ceiling. Their refusal of exclusive reliance on the built-in mechanisms is explained accordingly: not only are they insufficient stimulus, but their effects are undesirable during the upward part of the cycle, if the economy stands below potential output (Musgrave, 1964).

This ultimate goal was to be attained through a careful mix of interventions. Since, for instance, private demand could move unexpectedly, sustainability depended on flexible use of all government policies, including money and credit: “[i]f private demand shows unexpected strength, public policy must and will act to avert the dangers of rising prices. If demand falls short of current expectations, more expansionary policies will be pursued. In 1962, vigilance and flexibility must be the guardians of economic optimism” (Council of Economic Advisers, 1962, p. 13). That is the well-known Keynesian idea of fine tuning.

The FES assisted such policy mix, returning the magnitude of the difference between planned private investments and planned private savings necessary to assure maintenance of full employment, given a certain budget program: “[i]f the FES is too large relative to the strength of private demand, economic activity falls short of potential. Correspondingly, the budget surplus actually realized falls short of the FES; indeed a deficit can occur. If the FES is too small total demand exceeds the capacity of economy and causes inflation. But whether a given full employment surplus is too large or too small depends on other government policies, as well as on the economic circumstances affecting the general strength of

private demand” (Council of Economic Advisers, 1962, p. 81).

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). Nevertheless, actual output came to be very close and even superior to potential between mid-1965 to the end of 1969. According to Okun, the chair of the CEA at the time, “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).

In fact, the FES supported the idea that the resources spent to achieve the employment and output targets would be generally compensated by the revenues yielded by a higher national income, with no destabilizing effect on prices. In other words, it also had a less heralded use as an indicator of the sustainability of a budget policy, consonant with the focus on aggregate demand as a factor of growth. For example, running a deficit in the actual budget with output levels below full employment, thanks to the FES, could be interpreted as a sign that the fiscal stimulus was not strong enough, and vice versa. 15 years after the 1947 CED report, such reassurance was still much needed to many American electors and elites but perhaps became difficult to maintain without further details as inflation rose.

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.

For a long time, however, the risk of inflationary pressures and, ultimately, the price-wage issue had remained just an abstract concern.<sup>32</sup> But the matter was bound to become increasingly compelling in the late sixties, along with a revival of public fears of 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 assumptions about agents’ behavior.

This late positivism carried them toward a progressively more defined relationship between the output gap and inflation, from which derives their ready acceptance of the unemployment-inflation trade-off. The possibility for entrepreneurs to determine the preferred macroeconomic level of employment, by fixing the mark-up, came thus to be expressed as a natural and automatic mechanism of adjustment and stabilization of the economy. It thereby undermined the theoretical economic foundation of the idea that governments carry responsibility for the achievement of full employment.

Like stars that we see shining most brightly long after they have gone dead, the Keynesians in the mid/late sixties were perhaps worthy subjects of a German Decadent novel. At the apex of their success, as new economic and political tensions arose to menace the world that made them famous, their weapons were becoming blunt, worn away by repeated adjustments and compromises. Their theory was left to be the mere projection of a powerful revolution in economic method, theory and practice whose flame had been suffocated.

President Lyndon Johnson was unwilling to risk political support for his Great Society programs by raising taxes to reduce the net financial weight of the American military involvement in Southeast Asia on government deficits. The swelling deficit, in a gold exchange standard system, fed into already ongoing inflationary trends in most countries (Triffin, 1968).

In addition, the American economy faced an intensifying competitiveness challenge. Many US firms faced rising costs of production from their own increasingly centralized and complex productive structures as well as rising imports from more competitive, export led countries, such as Japan and some Western European countries (Halevi, forthcoming).

At the same time, all over the world political uprisings questioned the very foundations of economic and political systems. In many developing countries, frankly anti-capitalist national liberation movements proliferated. In Latin America as well as in the Middle East and in Asia, they challenged American political and military hegemony.

In the waning days of Johnson's presidency, inflation, rising deficits, civil disorders, and the seemingly endless war in Vietnam put the Democrats in a weak position. A Republican president, Richard Nixon,

was narrowly elected. Intent on curbing inflation, the new administration immediately let the economy slide into recession.<sup>33</sup> But this was not enough to prevent the unilateral abandonment of the gold exchange standard by the U.S. in 1971. As various stop-gap exchange agreements collapsed, the international value of the dollar declined. The dollar's fall, the Fed's refusal to raise rates in advance of Nixon's reelection bid in 1972, an agricultural price shock, and the oil price crisis of 1973 caused inflation to surge. By then it was the first and most feared economic problem of most American elites and, eventually, of the public (Iyengar and Kinder, 1987).

For economists, the recurrent surges in inflation, especially when the economy operated well below capacity, were an embarrassment. As the term "stagflation" crept into public discourse, the employment-inflation trade off, expressed by means of the Phillips-Samuelson-Solow curve, began to crumble under its own analytic weaknesses. Other interpretations gained ground that flatly denied that policy could have long-term effects on the unemployment rate and asserted that attempts to lower it would result only in higher inflation. These newer views claimed that stagflation resulted precisely from attempts to "ride the Phillips curve."<sup>34</sup>

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 the 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.

Monetarism was less a complete theory than a set of policy prescriptions resting on a radical neoclassical interpretation of the Keynesian models (IS-LM, AS-AD models and the Phillips curve). Its strength and success rested perhaps in its reliance on a set of simple assumptions.<sup>35</sup> The long run is defined as that time when adaptive expectations are correct and no influence on the natural levels of

employment and output can be exercised. The economy tends automatically to the long run, natural level of output, thanks to the operation of natural forces of markets. In the short run, a positive relation between output and inflation normally obtains. Even then, however, expansionary fiscal policy is inappropriate, because it can trigger unpredictable and cumulative effects on prices and output, impose a fiscal drag on the economy and, when it takes the form of public investment, simply crowds out private investments. In a situation of rising inflation, restrictive fiscal policy and restrictive monetary policy help restore normal economic conditions quickly.

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 economists in both the 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.

The Keynesians still held solid leading positions in prestigious universities and public institutions. Most importantly, the idea of full employment still had a powerful grip on the public imagination. The appointment of the conservative but famously pragmatic Herbert Stein as President Nixon's Chair of the Council of Economic Advisers heralded the transition (Stein, 1969). Stein had worked for many years in senior positions at the Committee for Economic Development. His appointment was intended to represent the return of public policy to a wiser, more business oriented mode of policy making. In the hands of Stein and other conservative Keynesians, the Full Employment Surplus once again became a means of restraining government's fiscal actions, with a very seventies twist: a dominating concern for inflation. So began the process of turning the estimate into an inflation yardstick and a tool for advocating the achievement of an adjusted budget balance: "Constancy of the balance at full employment is the best single guide to budget policy that neither pushes the economy above its desired level nor holds the economy below it" (Council of Economic Advisers, 1973, p. 74).

This use of the estimate reflected the administration's need to balance conflicting priorities in a recession: it could pretend it could square the circle, maintaining a commitment to lower inflation even as it feared the likely consequences of cutting the budget.

There were, however, some technical problems: the FES, as the Keynesians had used and built it, was

not a target in its own right, unlike the early CED's proposal.<sup>36</sup> Debates about methods of calculation fired up. Those centered principally on the incorporation of price movements into the potential output estimate and various possibilities for weighing budget components, according to their different effects on output (Okun and Teeters, 1970).

Some Keynesians participated in the effort to turn the FES into an appropriate policy target, hoping to maintain some room for fiscal action. Okun himself presided over a set of discussions, mainly hosted by the Brookings Institution, in which economists of different theoretical backgrounds intervened. They reached no consensus. In the absence of agreement, the methods for calculating the FES did not change significantly, save for the introduction of the awkwardly named "High Employment Unemployment rate" from 1977 to 1980, which still corresponded to a 4 or 4.5% unemployment rate. But the reality of stagflation made striking even that adjusted balance difficult; the adjusted budget balance estimate began to be treated as long term guideline and opponents of counter-cyclical fiscal policy intensified efforts to discard it.

President Ford's inability to control inflation even during a major recession (along with Watergate) brought the Democrats briefly back to power in 1976. But steady pressures on the dollar and intransigent inflation led to swelling demand for big budget cuts, just as big business pushed for higher defense expenditures and substantial tax cuts. For the Democrats, who could not cut social expenditures entirely, these unrelenting pressures proved too much. Their attempts at compromise alienated most of their supporters in the business community while dismaying many voters (Ferguson and Rogers, 1986).

Enthusiasm for Monetarism grew among business elites and policy makers as inflation surged, budget deficits increased, and the slide in the dollar that the Carter administration accepted threatened to accelerate. Eventually, amidst a run on the dollar, the Democratic President Carter appointed Paul Volcker, previously at Chase National Bank, as Federal Reserve Chair. Volcker immediately tightened the money supply and raised interest rates, inverting the direction of capital flows to U.S. and throwing the economy deeper into recession, as oil prices soared. Jimmy Carter failed of reelection, as the old Democratic coalition and their Keynesian advisers were buried by the simple Draconian solutions offered by the Republicans and their economic advisers.

The new President, Ronald Reagan, brought in an economic package calling for sharp cuts in taxes,

sweeping cuts in domestic spending, and large increases in military spending.<sup>37</sup> The Congressional bargaining process over the economic package, however, turned the initial set of policies into a prolonged economic trench warfare: the Democrats blocked the domestic spending cuts. As a result, the public deficit swelled and fed into a strategy described by Federico Caffè as *economic alarmism* (Caffè, 1976), that is, the practice of misrepresenting the economic situation, exaggerating the negative aspects and creating the impression of unprecedented conditions of emergency, as a way to present a certain policy mix, often disruptive of the previous socio-economic equilibrium, as the only possible solution. In other words, the Republicans calculated that surging deficits would force the Democrats, subject to heavy business lobbying (Ferguson and Rogers, 1986) to give way completely (Greider, 1981).

### **Something New, Something Old: The Return to Cyclical Adjustment in the New Liberal Era**

As the new decade started, firms were left with an obfuscated and weakened perception of the advantages of state support for long term growth and employment, which had been the main cement of the New Deal Coalition. Several factors contributed to curbing it: public spending reductions and tight monetary policy forced American firms to increase international competitiveness. 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.<sup>38</sup> Inflation became widespread, with price shocks raising concerns far beyond financial circles.

The 1982 *Economic Report*, a veritable manifesto of Reaganomics, displayed a sharp change of tone from the past. It harshly denigrates the role of public institutions in the economy: “The most important cause of our economic problems has been the government itself” (Council of Economic Advisers, 1982, p. 294). Economic growth, it claimed, arises from increases in the quantity of productive resources and their productivity, implying that effective demand is not an issue worthy of discussion: the economy spontaneously gravitates around full employment, with welfare systems having only a residual function of helping poor people. The rhetoric of the Report is addressed almost exclusively to individuals, especially savers and investors on financial markets (the middle class, rentiers, and financial investors) interested in price stability and worried about strong state involvement in the economy. It emphasizes that flexibility in wages and prices reduces the transitional costs of ending inflation.



The document openly criticized Keynesian economics: “The Administration believes that fine tuning of the economy – attempting to offset every fluctuation – is not possible. The information to do so is often simply unavailable, and when it becomes available it is quite likely that underlying conditions will already have changed” (Council of Economic Advisers, 1982, p. 36). In fact, “[w]ere we to stay with existing policies the result would be readily predictable: a rising government presence in the economy, more inflation, stagnating productivity, and higher unemployment” (Reagan, 1981).

As to the cyclical effects on the budget, the 1982 Economic Report mentions that: “[...]it is not only the annual deficit that affects the economy but also the trend in deficits over the business cycle and beyond. Because of the structure of certain spending and tax programs, deficits tend to vary inversely with the economy. To some extent, deficits that are generated when the economy is weak can be made up when the economy is strong. It is the trend of deficits that serves as an indicator of fiscal discipline” (Council of Economic Advisers, 1982, p. 97). Accordingly, the Report announced “The Administration will continue to enforce a trend toward a balanced budget” (*Ibid.*, p. 101).

In practical terms, however, the administration was consciously far from a clear definition: “Analysts differ in their views about the relative effects of different conditions on inflation, investment, and economic growth. Unless these differences in opinion are recognized, debates that ostensibly focus on the deficit often mask broader underlying debates on how the economy works” (Council of Economic Advisers, 1982, p. 99).

In fact, the discussions of the seventies had not brought the economists to a common ground. They had only underscored the importance of how potential output was calculated.

In December 1983, the Commerce Department’s Bureau of Economic Analysis, which since 1980 had been vested with responsibility for producing estimates of the High Employment Surplus, published three series corresponding to three different calculation methods. The new series reflected “widespread dissatisfaction with the concept and measurement of potential output, an integral part of the methodology of the high-employment budget” (de Leeuw and Holloway, 1983, p. 25), but the real message was that results depended crucially on the method adopted.

One series was based on the CEA's official estimates of potential output, using the High Employment Unemployment rate (4.5%) and included a correction for inflation. A second was based on a 6% unemployment rate, while the third series, called the Cyclically Adjusted Budget, introduced a middle-expansion output trend estimate in place of potential output. This latter version, declared the authors, closely trailed the actual path of output and did not incorporate any preference about the level of income (or prices, for that matter) to be attained by the policies under consideration. It also bypassed all the controversies over NAIRU and variants of the potential/natural unemployment rate, since those did not enter into the equation.

According to the authors, this new mode of estimation returned accurate estimates of the automatic stabilizers, but was not suitable for policy guidance, since it did not specify the relation between the budget and an output target.<sup>39</sup> Their interpretation differed from that of other economists at the time who had started to identify these sorts of moving averages of output with the trend estimate of actual output and the latter with the economy's potential. These statistical methods for smoothing out peaks and troughs from actual output grew in popularity as, over the eighties, potential output came to be progressively understood as a supply determined, long term concept, attracting actual output through movements of prices and expectations. They reflected the partial incorporation through Monetarism of an emerging economic doctrine with more radical anti-state implications, signaling the definitive irrelevance of Keynesian attempts to compromise and leaving virtually no room for an activist policy "consensus."

These new tendencies gradually won the day. Criticism was infrequent (Eisner and Pieper, 1984). The new approach, called New Classical Macroeconomics (Barro, 1976; Lucas, 1975, 1977), developed in the late seventies and 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 microfoundations.<sup>40</sup> 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 run. 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 led to 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 more specific political recommendations were also derived, including 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 about best practices 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 to rise along with household indebtedness (Picketty and Saez, 2001). Other indicators of both market concentration and financialization show continuous rises.

Perhaps, thus, what has been perceived as a decline of the state – at least for the aspects that we are now considering – is rather a decline of the capacity of formal democracy to convey social interests and provide them with relevant and adequate political representation. In fact, governments have not ceased to enact economic policy strategies (Peck, 2010; Crouch, 2011; Mirowski, 2013). They, however, dodge responsibility for their macroeconomic and distributional effects, thanks to an ideology that does not recognize such responsibility. The capacity of the state to act as the political arm of the elite is thereby reinforced.

The evolution of economic theory seems to respond to the necessity to refine this mechanism and make it more flexible. New Keynesian NAIRU models eventually incorporated the new interpretation of potential output, differing from the monetarist natural rate models only in that their equilibrium rates included some involuntary unemployment. In neither model, however, could demand side policies affect levels of unemployment except by smoothing out cycles, since now output gaps were just (symmetric) fluctuations around potential output (Palumbo, 2013).

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 disappeared in the empirical literature as methods for calculating the CAB reduced to two options that differed 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; Palumbo, 2013; 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  $\varepsilon$  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 and Appendix A).

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: downward movements 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 a direct relation between output gaps and changes in inflation holds true. However, as a large literature testifies, no empirical support can be provided 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; Thirlwall, 2014; Garbellini, 2015).

Various versions of the purely statistical methods proliferated (Baxter and King, 1999; Beveridge and Nelson, 1981; Kàlmàn, 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 of the 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 average to 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 now easily available statistical software and because they do 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 as 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).

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 unit labor costs, in 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, including Cross, 1988; Galbraith, 1997; Gordon, 1997; and Storm and Naastepad, 2012. As Palumbo summarized: “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 closely follow actual rates (see also Gordon, 1997; Havik et al., 2014; Truger, 2014).

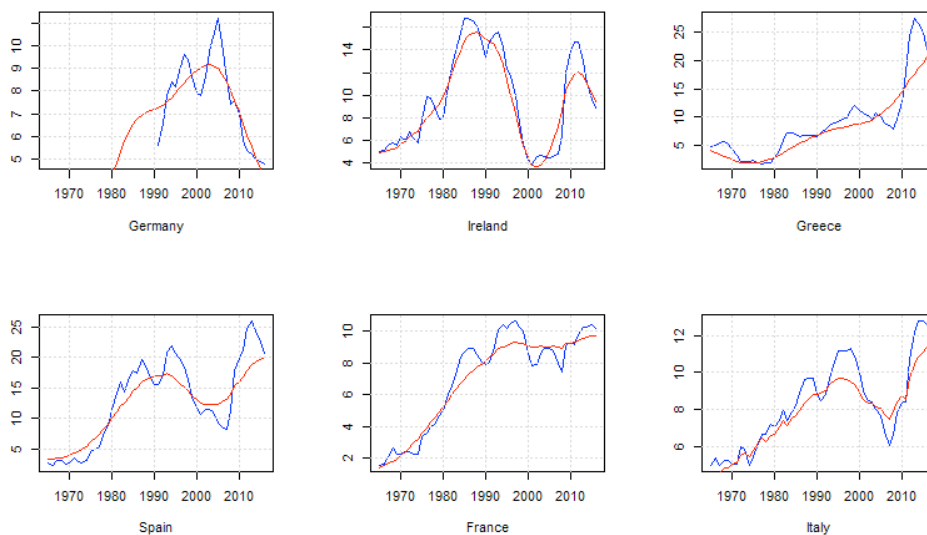
Theoretically speaking, both purely statistical and production function approaches share the logic that economic growth is supply-driven. The production function method, however, permits explicit consideration of those supply-side aspects in the estimate rather than implicitly, as the filters do.

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 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.

Fig. 1: NAWRU (Red Line) and Actual Unemployment Rate (Blue Line) in E.U.



Source: AMECO; Data Downloaded March, 2013.

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 modified by adding a limited range of exceptions. Those are often seen as factors that might partially snag the perfect machine and make room for limited public intervention. It is interesting to notice that no endogenous explanation for those hampering factors is provided. They are, in fact, just exogenously



determined exceptions (Tcherneva, 2008; Stirati, 2015).

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.

Woodford, for example explains that his models respond to the needs of central bankers, especially of the Federal Reserve, for theoretical justification for their occasional monetary easing (Tcherneva, 2008). Likewise, the acknowledgment of a positive effect of joint fiscal and monetary impulses that can be found in some recent papers should be seen as a response to the demands for theoretical justification by governments and central banks in the aftermath of the financial crisis, for actions such as the bail out of private financial institutions.

Thus, fiscal and monetary policies have remained the way for political institutions to cope with the growing size and complexity of societies and economies thanks to their capacity to produce a wide range of effects from redistribution to recovery or plain recession. What has changed are the economic goals those institutions serve as well as how the theory incorporates them and how the public rhetoric represents them.

The ad hoc character of these constructions became clearly visible in the aftermath of the 2007 financial crisis when Bernanke cautioned: “[...] the design and implementation of the fiscal program are critically important. A fiscal initiative at this juncture could prove quite counterproductive, if (for example) it provided economic stimulus at the wrong time or compromised fiscal discipline in the longer term” (Bernanke, 2008). The criteria for setting the limits of government intervention are explained by Bernanke: “any program should be explicitly temporary, both to avoid unwanted stimulus beyond the near-term horizon and, importantly, to preclude an increase in the federal government's structural budget deficit” (Bernanke, 2008). In practical terms, this meant rule rigidity coupled with theoretical ambiguity.

## **The Case of the European Union**

As the Cyclically Adjusted Budget completed its metamorphosis from a tool for ensuring high employment into an instrument for less than highly principled 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 Union's macroeconomic policy framework, which reflected political compromises at the heart of the 1992 Maastricht Treaty.

The Treaty incarnated a strongly Neoliberal vision of European governance that chiefly reflected accords between France and Germany: the Europe of the *cercles concentriques*.<sup>41</sup> 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 create strong representative institutions – such as the European Parliament, which still lacks the formal power of legislative initiative – the Treaty set down the convergence criteria and defined the path to the creation of the Economic and Monetary Union, informally called the Eurozone.

The most important step was the creation in 1998 of a powerful independent monetary institution, the European Central Bank and its European System of Central Banks,<sup>42</sup> that was charged by statute with guaranteeing price stability (as well as securing the other objectives of the E.U., without prejudice for price stability – a clause that would become crucial later for justifying unconventional emergency measures).<sup>43</sup> The Bank was prohibited from purchasing sovereign bonds at issue on the primary markets, which left the member countries exposed to possible insolvency and their public debts individually subject to the whims of financial markets. 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).

Similarly, the overriding commitment to Neoliberalism along with nationalistic fears and budget anxieties,<sup>44</sup> 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 came thus to depend crucially on harmonizing individual country budgets, because this was virtually the only form of common economic policy institutionally possible.

The architects of Maastricht respected the power of traditional national and bureaucratic forces that were unsympathetic to anything resembling true political union. Hence, the Union's governance mechanisms were (and remain) more a space for negotiations between political representatives of member countries and other well organized, powerful groups rather than unified expressions of popular political sentiments and policies.

The European project was inherently economic. French aspirations of making the Union an international financial center needed a guarantee of price stability, which only Germany could provide (Parguez, forthcoming). In exchange, Germany benefited from a relatively under-valued currency that weakened Italy's competitive position. 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 pressures for convergence and 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 (O'Connell, 2011; Storm and Naastepad, 2014, 2015). 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.

In spite of the initial inter-governmental inspirations, then, the absence of active convergence policies, coupled with a one size fits all monetary policy, encouraged divergent economic dynamics among countries. Those over time created a core-periphery structure within the system, as economic integration initiated a process of market entanglement, restructuring, and increasing concentration that

tended in the medium run to overthrow traditional national economic patterns. The combination of financial deregulation, fiscal austerity and ECB's policy restrictions further eroded national sovereignty, eventually threatening the whole edifice, as we are witnessing now.

But in the meantime, the CAB's ability to throw a cloak of spurious statistical precision over any mix of cross-pressures and interests made it a near perfect policy instrument for managing the conflicts that arose early in the new century, in the wake of the formal advent of the Euro and the stock market collapses in the US and Germany. As clashes between the European Commission's prescriptions and national political pressures multiplied, 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 took place in 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 exerted at different times over national decisions and policies.

Stage 1 began in the mid-nineties, as German finance minister Theo Waigel began a campaign to codify the rules and procedures of EU fiscal sovereignty. The agreement led to a fiscal rule formulated 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 appeared as one among several tools for surveillance, without explicit mention in legislation. The accord defined ceilings 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.<sup>45</sup>

The process required individual countries to submit their fiscal plans to the European Commission 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 monetary fines.

In 1996 the French finance minister, Dominique Strauss-Kahn 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 only came about five years later, 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. Requests for relaxation of budgetary constraints multiplied, preparing the ground for Stage 2 of the CAB’s ascent within the Brussels machinery.

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 France.<sup>46</sup>

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. As criticism of the 3% ceiling spread (Blanchard and Giavazzi, 2004) 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).<sup>47</sup> 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 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, remained dissatisfied. 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, 2005a) 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 innovation. 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, this more elastic version of the 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).

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.<sup>48</sup>

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 domestic objections to full throated de-regulation of the labor market, privatization and social spending cuts – always in the name of Europe.

But by the time the banking crisis and other economic pressures forced the question of further reform on the agenda in 2011, divergences between the economies of the core and periphery within the Eurozone had enormously intensified, changing the political equilibria: interest rates on the bonds of Eurozone peripheral countries rocketed upward when they were forced to bail out private banks and financial institutions. The result, inevitably, was a substantial increase in the relative power of the creditors.

On its face, the 2011 reform of the Pact, the so-called Six Pack Agreement, appeared to be a much tighter framework than the 2005 Pact (Frayne et al., 2013). This in fact is the case – for weaker countries. Those countries whose public debt exceeds the limit must continuously reduce it by an average of one twentieth of the difference between their actual debt to income ratio and the 60% of GDP. This is calculated either over the previous three years (a backward-looking benchmark) or, if such target is not met, against the Commission’s forecasts (forward-looking benchmark). Mitigating conditions can be invoked to take account of the effects of the cycle and of exceptional circumstances. The agreement fixes the structural budget constraint at 0.5% of GDP and 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.”

However, as we will see, what the recent reforms have made stricter is rather the explicit control of the supranational European institutions over 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.”<sup>49</sup> 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



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).

The result is that 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.

But one overriding trend emerges: 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, 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 2012 Fiscal Compact (Treaty on Stability, Coordination and Governance, TSCG) modifying the Stability and Growth Pact requires countries in the Eurozone to incorporate the GSP guidelines and procedures into their national constitutional law. But the new agreement 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 presaging the formal establishment of an independent European authority. It is ironic that the 2005 reform that so many countries believed would provide them more room of maneuver played a pivotal role precisely in accelerating this process.

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. In the meantime, each time a conflict arises, the estimate comes to the fore. It has been happening systematically since 2002, as the technical discussions between the Italian government representatives and the Commission testify (Cottarelli et al., 2014; Mc Morrow and Röger, 2014) and once again during the Greek negotiations between the IMF and the Commission.

In fact, while the crisis has most dramatically uncovered European capitalism’s need for a stronger central power able to react rapidly to economic and financial down-swings with temporary discretionary interventions, it is an open question as to whether a stable but fully flexible institutional and power equilibrium will emerge.

Though the crisis has left it as virtually the only national power standing, there are real questions about whether Germany can really assume a leading position within the Eurozone in the long run. Its commitment to Neo-Mercantilism and austerity may just be too strong. Thus it was Germany in 2011 that pressed for an enhancement of the Commission's role, only to regret it when the latter was forced by circumstances and by other countries to be slightly less strict than Germany would be regarding, for instance, the operations of the ECB and proposals for European investment programs. Indeed, German understanding of a process of centralization of power seems to be merely an emancipation of the political power of the core countries – and of itself uppermost – from the influence of the periphery: “[...] the current crisis must be viewed as an appeal to transform Europe in such a way that it will produce better elites and give these elites more latitude to take action. [...] Prior to the EU's expansion into Eastern Europe, a debate was held over the EU's future development, but it was based on the false alternative of ‘deepening or expansion.’ The real question should have been how strong the center must be to handle a larger periphery. Now the periphery dominates the center and dictates both its political agenda and the rhythm of its decision-making processes” (Münkler 2011). “[...] A situation in which a country like Greece, whose economic output comprises between 2 percent and 2.5 percent of that of the entire euro zone, can imperil the European economy and drag the European common currency to the brink of failure reveals serious design flaws in the political constitution” (*Ibid*). This is how the democratically elected government of Greece becomes – in the German rhetoric – an illegitimate counterparty for the common definition of the EMU policies.

The process of transformation of the EMU and of the EU is ongoing and its outcome uncertain. A further democratization of the European institutions is unlikely in the short run and there is little prospect of the various national electorates agreeing on the type of Europe they would like. Hence, democratic attempts to influence this process can at the moment work only through national governments. Those, however, with the recent exception of Greece, have generally tried to marginally alter the existing rules rather than openly recognizing their flaws and publicly calling for a forthright reconsideration of the economic principles guiding the EMU fiscal policies and their political implications.

## **Conclusion: The Political Uses of Technical Instruments**

The Cyclically Adjusted Budget estimate has animated an eighty year long discussion of fiscal theory and practice. Its function and method of estimation have changed radically over the course of time, responding to different impulses: the changing expressions themselves, for example – at first High Employment Surplus, later Full Employment Surplus, and then the Cyclically Adjusted Budget – have closely tracked the rise and fall of employment as a priority target of fiscal policy.

The CAB's history is also closely tied up with the concept of automatic stabilizers. For the CED, relying on automatic stabilizers, 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 of 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 significance. At that point, when the political climate was becoming more favorable 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 labor, government administration, 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 a quasi-official reference theory of the Democratic administrations in the sixties. It appeared as a rupture with the compensatory policy and automatic fiscal adjustments praised by the CED in the forties.

We might therefore generalize that a fixed and automatic budget rule eases the management of periods



on its neighbors (Semieniuk et al., 2011).

Today, the CAB is commonly formulated in such way that it reflects and supports fiscal policies that are the exact opposite of those it was used to support in the 1940s. But regardless of the political view that it has represented in the various circumstances, the CAB has always served the idea that contingent political matters can be prevented from intruding in fiscal policy decisions, for instance by lending itself to mechanical applications of budgetary targets and fiscal soundness criteria.

Its evolutionary path coincided with the spread and development of effective mass democracy, but it did not function as a tool for a progressive opening to generalized and transparent political debate of the implications of its construction – Myrdal's original ideal. Neither was the debate the prerogative of the technicians, who sometimes were honest about its limits. On the contrary, it has been an expression of political processes involving very fundamental social and economic forces, but preceding – and often occluding – public discussion and electoral confrontations.

The role of technicians is, however, a crucial validating factor. This is the CED's legacy: the use of experts, as a way to attach to economics the status of science that is not ideologically shaded, and the use of indexes and formulas that are tangible expression of that scientific status and serve as opaque rhetorical supports for their arguments.

The evolution of the CAB, thus, has represented the refinement of a technique that the elites can use to secure autocratic outcomes, in presence of formal mass democracy.

Following the rise of the CAB in the EU legislation, it is possible to trace a progressive – but not linear nor pre-set – redefinition of the locus of power and decision making in the E.U. National constitutions and parliaments, crucial to the post-war European democracies, are becoming increasingly useless. Those represented the attempt, after the totalitarian experiences of the previous decades, to build institutional guarantees for the maintenance of well-balanced democratic representation and resolution of political and economic interests.

In this context, the use of structural rather than nominal targets has represented an evolution away from strict Ordo-Liberalism<sup>53</sup> in favor of a degree of flexibility toward specific interests during crises while

retaining a disciplinary argument. The accomplishment of a stable central EU power may lead to much greater flexibility, given the instability of the current international economic context. But it is telling that the main critiques of the fiscal framework today concern the introduction of one or another variant of the CAB estimate rather than reconsideration of the underlying political system. 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. This leaves little hope for the possibility of establishing an open and democratic discussion of fiscal policy.



## **Appendix A**

### **The CAB of the European Commission**

The current formula of the CAB used by the European Commission is based on the traditional two stage procedure (eq. 1 and 2). The method was decided by the Economic and Financial Affairs group of the European Commission and its extension, the Output Gap Working Group (Havik et al., 2014).

A cyclical component of the budget balance CC is first estimated and subsequently subtracted from the nominal budget BB, so that  $CAB = BB - CC$  (eq. 1). The cyclical component is obtained by applying a budgetary sensitivity parameter  $\varepsilon$  to an estimate of the output gap OG, that is the difference between potential output and actual output:  $CC = OG \times \varepsilon$  (eq. 2).

#### 1) Sensitivity parameters

The reference methodology for the estimation of the sensitivity parameters was developed by the OECD (Girouard and André, 2005; Mourre et al., 2014). It takes account of the elasticity with respect to output of the revenues arising from four different sources (personal income taxes, corporate taxes, social security contributions, indirect taxes) and of unemployment-related expenditures. The measurement also requires estimates of the distribution of income and the tax rule. Furthermore, the elasticities are computed by approximating the tax basis by wage income in the manufacturing sector, which means that neither the self-employed nor the other sources of income of workers in manufacturing, such as interest income, are taken into account. This might be relevant if, for instance, we think that the interest rate on public bonds is cyclically-related.

Such individual elasticities are then weighted according to their share of the total tax burden and on total government outlays. The weighted sum is computed in terms of a reference year, in the case of outlays, or averaged over ten years, in the case of revenues. This latter aspect is consistent with the attempt to detect discretionary deviations within a fixed budget structure, although less justifiable is the fact that the European Commission used, until 2014, the weights computed for the decade 1995-2004.

Nevertheless, due to the difficulty of the calculation process, the individual elasticities are updated very rarely and treated as time-invariant in the meantime: the elasticities that the European Commission used until last year were computed in 2005 and based on tax codes of 2003 and data on income

distribution collected in 2001. They are now using the updated elasticities, with data up to 2013. Thus, the obvious delay in data availability causes that the deviations in the budget deriving from a change in the distribution of income connected to the cycle cannot be taken account of (European Commission, 2005b; Mourre et al., 2013).

Hence, this parameter prevents the CAB from being a credible indicator of the size of the automatic stabilizers relative to that of the discretionary fiscal measures, regardless of how the potential output is measured.

## 2) Potential Output in the short term

The reference method for EU potential output calculations is based on a Cobb-Douglas production function with constant returns to scale and factor price elasticity equal to one.

The function  $Y$  of GDP is therefore given by:

$$Y = L^{\alpha} K^{1-\alpha} \text{TFP}$$

where the input factors are  $L$ , labour,  $K$ , capital stock, TFP, Total Factor Productivity. The TFP includes indexes of the degree of utilization of the inputs and of their technological level. The output elasticity  $\alpha$  is equal to the wage share, according to the assumption of the functional form.

Potential output corresponds to the output resulting from:

- full utilization of the capital stock
- a normal degree of utilization of labor (obtained from the estimate of the trend labor force and of the NAWRU)
- a normal level of efficiency of factor inputs, with this trend efficiency level being measured using a bivariate Kalman filter model which exploits the link between the TFP cycle and the degree of capacity utilization in the economy.

The choice of a Cobb-Douglas function in itself is very problematic because of its theoretical and empirical deficiencies. The assumption of constant returns to scale, for example, is highly restrictive and unrealistic (Sylos Labini, 1995; Felipe and McCombie, 2007, 2013). Moreover, the method adopted by the EU still does not avoid the end of sample bias problem connected to the alternative Hodrick-Prescott filter method, since the latter is used in the estimation of some of the variables in the production function.

But these scarcely exhaust the problems with this formulation of CAB. The trend labor force is obtained by multiplying population of working age  $Pop_t$  with the trend participation rate estimate  $Par_t$ , which corresponds to the HP filtered participation rate. Potential employment  $PE_t$  is then given by:

$$PE_t = Pop_t Par_t (1 - NAWRU_t)$$

The NAWRU is obtained from a Kalman filter estimate, under the assumption of a Phillips curve relationship, that is that the unemployment gap is negatively related to the change in wage inflation. The unemployment gap takes the form of an auto-regressive process of the second order, assumed stationary and with sample mean of zero.

Thanks to the above conditions and to the assumption that normal output cyclically fluctuates around potential, the NAWRU values frequently appear to be close to those of the actual unemployment rate, especially at the end of the sample (see Figure 1).

This property of cyclical unemployment, together with those applying to the other filtered series that enter in the calculations, guarantees that the output gap also has a mean of zero over the sample.

Furthermore, the choice to use the actual value of capital, without detrending it like all the other variables, is indeed surprising, especially in times of intense speculation, because it implies the assumption that capital accumulation is not cyclically sensitive.

## **Appendix B**

### **Three Methods for Measuring the Output Gap**

The graphs in Figure 2 show the output gap measured with different methodologies for six countries, five of which are part of the European Union.

What is referred to as Keynesian methodology corresponds to the following formula for output gap:

$$\text{OGAP} = (u - u^*)\varepsilon^{-1}$$

Where  $u$  is the unemployment rate,  $u^*$  is the target unemployment rate, OGAP is the output gap and  $\varepsilon$  is a parameter obtained by applying the first differences method suggested in Okun's paper (Okun, 1962):

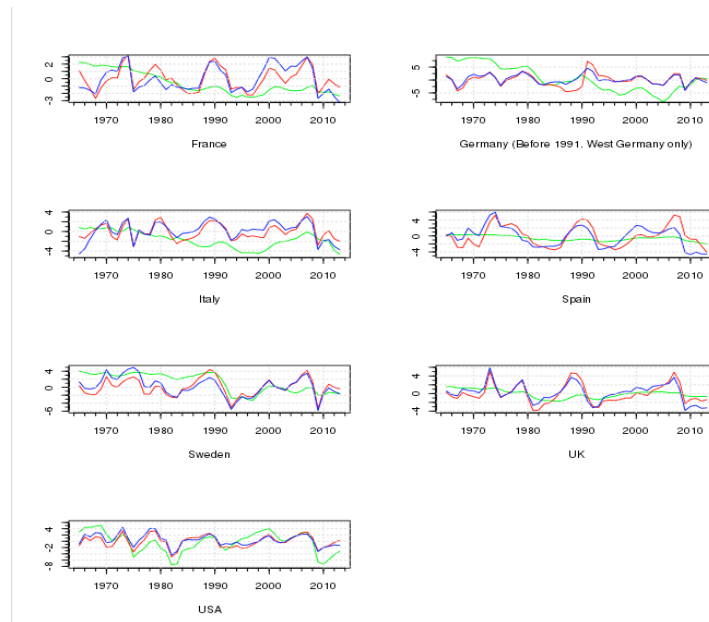
$$x = a + \varepsilon \times Y$$

where  $x$  and  $y$  are the annual change in the unemployment rate and in GDP respectively, both expressed in percentage points.

$\varepsilon$  is then obtained by running a linear regression.

The HP method simply consists in applying an HP filter to the real GDP series. Finally, the EU potential output was simply retrieved on the European Commission database.

Fig. 2  
 Output Gaps Obtained with Keynesian Potential Output,  
 EU Production Function and HP Filtering Methods



Source: EU Commission, ECOFIN, AMECO Database, Tables 1 and 6.  
 From Data Downloaded March, 2013.

Blue line: EU production function method.

Red line: HP filter;  $\lambda=100$ .

Green Line: Okun's Output Gap, Unemployment Rate Target = 6%.



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## Notes

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- 1 Kant, 1784. Translation by Mary C. Smith: <http://www.columbia.edu/acis/ets/CCREAD/etscc/kant.html>
  - 2 Similar or equivalent definitions can be found in Sawyer (2012) and in Les Economistes Atterrés (2012).
  - 3 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).
  - 4 Interestingly, the unemployment rate already achieved in Sweden at the time was between 2 and 4%. See Lundberg, 2005.
  - 5 Keynes himself in an article published in *The Times* in 1937 wrote: "The railway companies, the port and river authorities, the water, gas, and electricity undertakings, the building contractors, the local authorities, above all, perhaps, the London County Council and the other great Corporations with congested population, should be asked to investigate what projects could be usefully undertaken if capital were available at certain rates of interest – 3½ per cent, 3 per cent, 2½ per cent, 2 per cent" (Keynes 1937).
  - 6 The Chairman of the Fed at the time was Marriner Eccles, one often indicated as a proto Keynesian and influential progressive figure of those years. Another proto-Keynesian involved in the decision to raise rates was Gerhard Colm. This clearly indicates how strongly the fear of inflation could pressure policymakers.
  - 7 The trade shift was incarnated in the Reciprocal Trade Act of late 1934 and the subsequent drive by Secretary of State Cordell Hull to sign trade treaties. See Ferguson, 1984, also for the capital intensive industries.
  - 8 In the late thirties and early forties, Ruml was part of a group gathered around Nelson Rockefeller. They called themselves the “junta.” Rockefeller eventually shocked the political establishment by accepting a post of Assistant Secretary of State for Latin America (Ferguson, 1984).
  - 9 Although this was not unprecedented, it rarely happened to the same extent and so explicitly.
  - 10 An indication of how the members of the CED perceived the peculiarity of their methods of action emerges from their meeting minutes. For instance: “Mr. Cowles asked, to what extent would the organization lobby to get its recommendations enacted into law. It was agreed that CED would continue to avoid lobbying, using a low key approach and restricting itself to general issues.” CED Meeting Minutes, March 15, 1946, Donald David Papers, Box 23, Folder 2, conserved in the historical archive of the Harvard Business School.
  - 11 In the CED meeting July 7, 1945: “Mr. Benton reported that he and Mr. Scherman had met recently with representatives of the Twin Cities group, National Association of State Chambers of Commerce, and the Falk Foundation group on the question of getting together on a joint business tax program. It was agreed that the development of a joint business tax program was a mistake. [...]Mr. Ruml stated that he looked with great suspicion on meeting with these other groups. Mr. Davis felt it would be a mistake to compromise with them,” CED Meeting Minutes, July 7-8, 1945, Donald David Papers, Box 23, Folder 9. Also: “Several members felt that it would be unwise to develop anything that could be characterized as a 'business tax program.' Mr Taylor pointed out that any consolidated position would be become the basis for compromise,” Ibid, April 7-8, 1945, Box 23, Folder 7, David Papers.
  - 12 Two other plans for a High Employment Budget were published in the same year: Ruml and Sonne, 1944; Twin Cities

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- Group, 1944. The first reflected the personal ideas of the CED's member Beardsley Ruml and of the American Keynesian Christian Sonne, the latter was expression of the Twin Cities business group.
- 13 CED Meeting Minutes, September 7 1945, Donald David Papers, Box 23, Folder 2.
  - 14 Musgrave compares the Twin Cities (TC) group program with the CED's and the Ruml-Sonne's (R-S). He finds the "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).
  - 15 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).
  - 16 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.
  - 17 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.
  - 18 As opposed to what the later Keynesian literature on the subject would lead one to think, people inside the Committee who favored discretion were typically the ones who were most concerned by inflationary pressures deriving from fiscal expansion and vice versa.
  - 19 Ralph Flanders to members of the CED's Research Committee, January 30, 1945, Donald David Papers, Box 24, Folder 13.
  - 20 Donald David to Gordon Wasson, March 17, 1945, Donald David papers, Box 23, Folder 14.
  - 21 In a discussion on the opportunity of tax rate stability, Ruml says: "Stable tax rates are more desirable than the rising of tax rates in times of depression." However, "I would rather sacrifice the stability of tax rates than go into a program of public spending" CED meeting minutes, June 24, 1947, Donald David Papers, Box 23, Folder 10. Moreover, as

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- specified by Herbert Stein some time later: “[w]hile 'stronger' programs could be easily conceived, the Committee argued that these stronger programs are likely to be unstabilizing, because of errors of forecasting, lags, and biases in the decision-making process.” The definition of “stronger” is that it “[...] may turn to measures of control inimical to freedom without realizing their consequences” (CED 1954, p. 87 and Stein, 1969).
- 22 Ruml to Dudley Cates, September 17, 1945, series 2, Box 3, Ruml mss, quoted in Collins p. 139.
- 23 CED meeting minutes, May 20 and 21, 1945, Donald David Papers, Box 23, Folder 6.
- 24 CED meeting minutes, May 20 and 21, 1945, Donald David Papers, Box 23, Folder 6.
- 25 In the meeting of April 8, 1945, “Mr. Fennelly remarked that [...] [w]e will be asked to testify on it and might as well start taking positions now. Mr. Hoffman stated that Senator Murray had agreed that it would be improper for the Committee to testify except on matters on which it has already reached conclusions. C.E.D. should not take position on the Murray bill as such, but we can say a good deal in terms of principles on the basis of the work already done. The statement to be prepared should be a constructive document and one which does not attack the Murray bill. It would add to the nation's economic understanding and give the C.E.D. the time needed to reach a solution on issues which we have not yet had time to thrash out. Several persons agreed with Mr. Hoffman's formulation. Mr. Wasson pointed out that C.E.D. has been accused of believing that business should have sole responsibility for stabilization. The Murray bill and the statement under discussion give the C.E.D. an excellent opportunity to clear up this misconception, to emphasize that government has a responsibility and indicate in general terms what this consists of.” CED meeting minutes, DD Papers, Box 23, Folder 7.
- 26 Some of its members, namely Hoffman and Flanders, were called upon Congress for testimony.
- 27 September 11, 1945, Donald David Papers, Box 24, Folder 12.
- 28 Ferguson and Rogers, 1986.
- 29 The same idea was expressed by Arthur Okun (1962).
- 30 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).
- 31 Of course a more precise measurement of fiscal performance was pursued but in other contexts and with other means. See for instance (Musgrave 1964).
- 32 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



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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-wages [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).

- 33 “[...][T] he experimental demonstration of the Phillips curve has failed. Prices go on rising along with unemployment. Now suddenly and abruptly the second half of Keynes' theory [see note 32 above] has been accepted and President Nixon decides to alter the rules of the game in industrial relations by decree” (Robinson 1972, p. 6).
- 34 As Francis Bator explains, Monetarists were mainly 'just' confuting the Keynesians assertions by adding simple and had hoc assumptions: “Phelps and Friedman in 1968 – they laid it all on expectations, and this opened the door for a lot of mischief” (Bator 1987, p. 33). On the tension between theory and empirical facts in mainstream (neoclassical and Keynesian) economics, see Stirati, 2015.
- 35 Markets are well organized and prices are flexible; that if real exogenous shocks occur, automatic mechanisms of adjustments operate strongly and rapidly; that the demand for money is stable; that consumption depends on the discounted value of all future income rather than on current income; that real and financial assets are highly interchangeable; and that individuals base their decisions on adaptive expectations.
- 36 At least in the CED's intentions, the impact on fiscal measures was estimated or at least considered.
- 37 A first successful attempt to direct discretionary spending toward politically “acceptable” goals is what has been called the Truman solution. Although Keyserling supported Hansenian spending programs for growth and social welfare rather than compensatory fiscal policy, the political climate was such that a truly progressive solution was impractical. The famous Truman solution was the well rehearsed to this day growth-friendly military spending. By contrast, in 1947 Beardley Ruml was still arguing: “If we get the world organized for peace, we will get a larger change downward in [tax] rates, because of the cuts in armament” CED meeting minutes, 24 June 1947, Donald David papers, Box 23, Folder 10.
- 38 A large literature exists on the productive and financial transformation occurred in the developed world in the Seventies/Eighties. See for instance: Aglietta, 1976 or Vercelli, 2003.
- 39 For that purpose, the potential output estimate needs to be invariant to the cycle.
- 40 Bator (1987) summarizes the New-Classical 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 thus 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 critical literature on the new-classical model, to some of which

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this paper refers in the following sections.

- 41 A famous expression of François Mitterrand, who of course saw France and Germany at the core of the spiral.
- 42 The ECB and the ESCB were preceded by the European Monetary Institute, active from 1994 to 1998.
- 43 “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).
- 44 Some call it Neo-Mercantilist (Bellofiore et al. , 2011).
- 45 How the two now famous ceilings came to be set to 3% and 60% is a matter of mythology. Indeed, as Luigi Pasinetti wrote already in 1998: “[i]f a 3% public deficit/GDP ratio is to be rigidly adhered to and regarded as a symbol of European fiscal and financial stability (even at the cost of heavy sacrifice), it surely should be an absolutely necessary condition for fiscal and financial stability. Nobody has ever proved this. In fact it cannot be proved” (Pasinetti, 1998). The passion for budget balance is usually traced to the German-speaking Ordo-Liberal, Hayekian, and anti-Keynesian tradition. But in fact austerity has found crucial supporters also in France where, as Alain Parguez eloquently writes, “[n]o New Deal ever came to wreck its hold on [elites] spirits” (Parguez, 1993 p. 82, our translation). According to Parguez, a direct line links the budget policy of the 1926 conservative government of Raymond Poincaré to the policies of the V Republic of De Gaulle, where the 1958 *Rapport sur la stabilité financière*, written by Jacques Rueff for the Minister of the Treasury and insisting that expenditures and revenues of the state should be exactly equal, was intended to have quasi-constitutional strength. But the line continues unexpectedly to brace the Socialist Party in 1982 and at the time of the Maastricht Treaty. Lying behind it is nationalistic idea that a strong country must have a strong currency, the simple fear of growing social security expenditures, and the identification of this economic theoretical framework with that of the political theories of Social Order (*Ibid.*).
- 46 The Commission won the case and an Excessive Deficit procedure was opened for France and Germany, only to be rapidly closed by the Commission itself.
- 47 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 deeply 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 surmised 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).
- 48 [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/corrective\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm)
- 49 In January 2015, at the end of the Italian presidency of the Council, the Commission issued a new guidance to its application of the existing rules, specifying the implementation of the “investment,” “structural reform,” and “cyclical conditions” clauses.
- 50 Under the EFSM, operational since May 2010, 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.

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- 51 The European Financial Stability Facility (EFSF) was created as a temporary crisis resolution mechanism in June 2010. Since July 2013 it may no longer engage in financing programs but keeps dealing with the Greek crisis, that is since the permanent rescue mechanism, the European Stability Mechanism (ESM) started its operations (8 October 2012), after the necessary amendment to the Maastricht Treaty was approved. The latter 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 ESM and is also expected to address a 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.
- 52 Art. 14 of the Two Pack reform of the Stability and Growth Pact.
- 53 Ordoliberalism is a “theory developed by economists such as Walter Eucken, Franz Böhm, Leonhard Miksch and Hans Großmann-Doerth as a reaction both to the consequences of unregulated liberalism in the early years of the twentieth century and subsequent Nazi fiscal and monetary interventionism. The central tenet of ordoliberalism is that governments should regulate markets in such a way that market outcome approximates the theoretical outcome in a perfectly competitive market (in which none of the actors are able to influence the price of goods and services). Ordoliberalism differs from other schools of liberalism (including the neo-liberalism predominant in the Anglo-Saxon world) in that it places a greater emphasis on preventing cartels and monopolies. At the same time, like neo-liberalism, ordoliberalism opposes intervention into the normal course of the economy. For example, it rejects the use of expansionary fiscal and monetary policies to stabilise the business cycle in a recession and is, in that sense, anti-Keynesian” (Guérot and Dullien, 2012).