Eu Type Of Austerity: Brief Analysis And Criticism

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Abstract: - Although it has become a common place to blame austerity policies for lengthening the economic downturn of EU economies, the figures reveal that public spending increased in most of the EU countries between 2007 and 2013. Although budget deficits from EU countries were indeed reduced in the last 4 years, the cutbacks were more the result of increasing government revenues and hiking taxes than of decreasing public expenditures. The article will feature: (1) a brief analysis of the evolution of public spending compared to government revenues in EU countries and also, (2) a concise literature review on austerity, highlighting some of the most important theoretical controversies on this topic. The main thesis defended in the article is that – although EU type of austerity, narrowly focusing on fiscal consolidation, drove indeed to unfavorable economic consequences – the criticism formulated by pro stimulus economists is rather flimsy, given the fact that public expenditures actually increased in most of the EU countries.

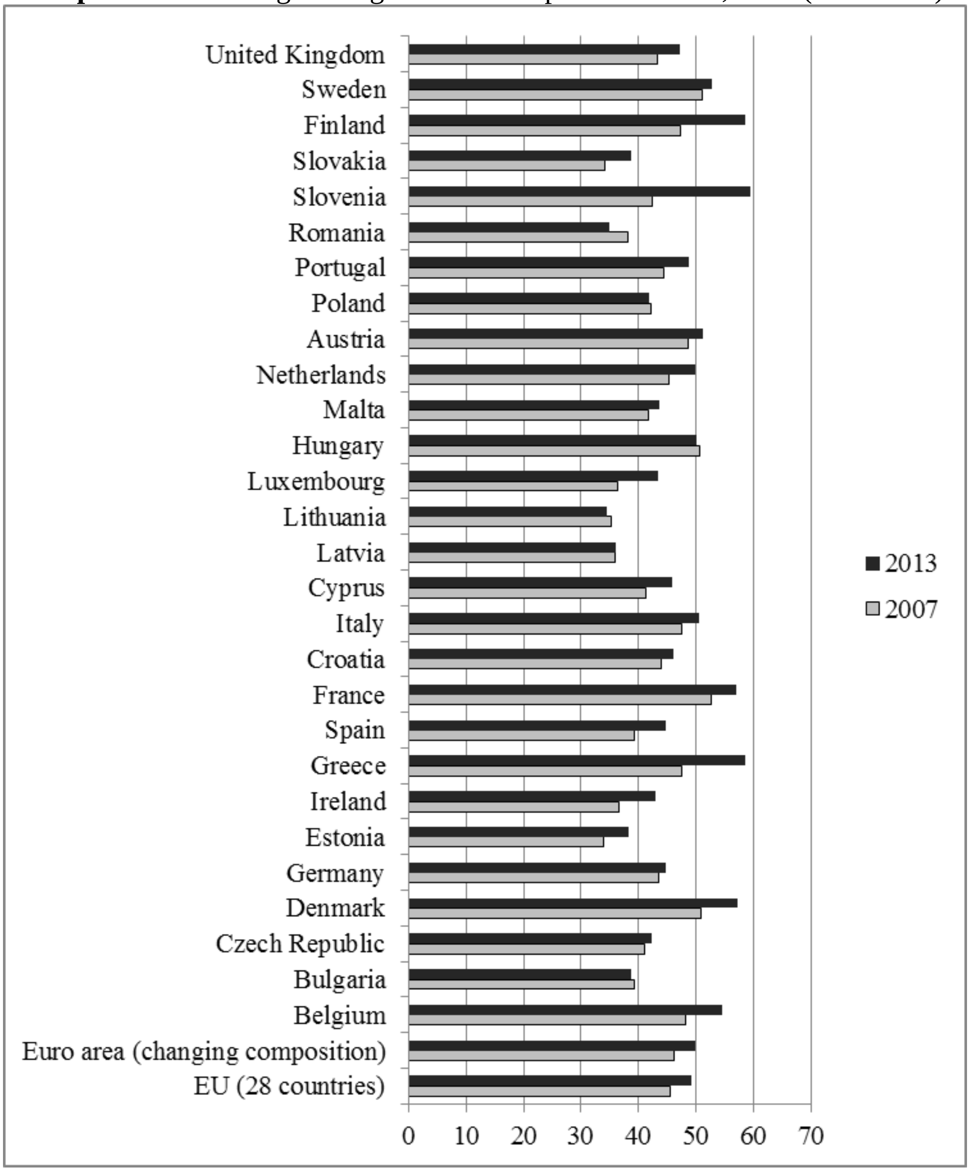
Key-Words: - austerity, EU economies, public spending, government revenues, taxes, budget deficit, economic crisis, fiscal stimulus

1. Austerity in EU Countries: Brief Analysis

Although austerity policies are blamed for lengthening the economic downturn of EU economies, a graph of public spending in the EU countries (**Graphic 1**), published this year (August 18) on the website of European Commission reveals that government spending is significantly higher in 2013 than before the 2008 financial crisis in most of the EU countries, especially in Eurozone and GIIPS countries.

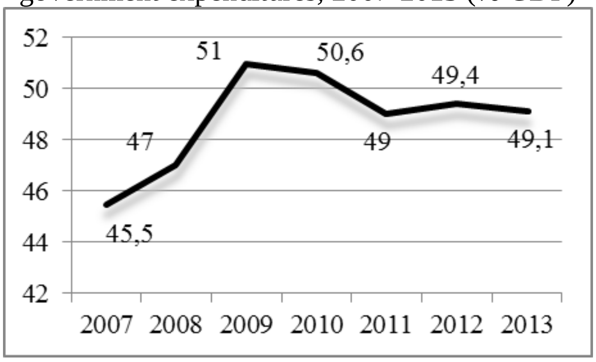
An analysis of EU public spending-to-GDP ratio discloses that total general government expenditure in the EU reached 49.0% of GDP, averaging 12,617 euro per person in 2013. Also, the public expenditure-to-GDP ratio increased by 3.5 percentage points between 2007 and 2013, amounting to 6.41 trillion of euro in 2013 (**Graphic 4**). The evolution of governments' spending over this period reveals that between 2007 and 2009, EU public expenditure-to-GDP ratio increased exceeding 50 percent, then decreased slightly to 49% between 2009 and 2013 (**Graphic 2**). Therefore, the increase of public spending in EU between 2007 and 2013 was not perfectly linear, but still the trend of public spending remained ascendant during this time.

Graphic 1- EU total general government expenditure 2007, 2013 (% of GDP)



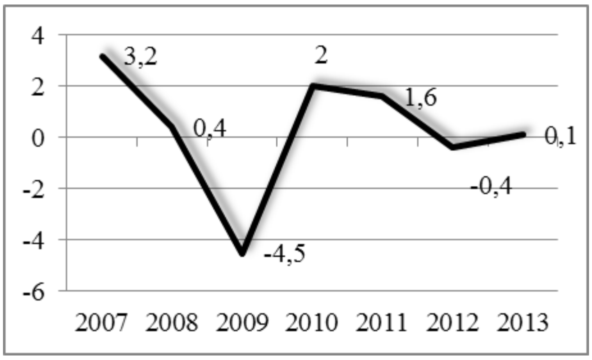
Source: Eurostat, 2014

Graphic 2 - EU 28 total general government expenditures, 2007-2013 (% GDP)



Source: Eurostat, 2014

Graphic 3 - EU 28 GDP growth (%)

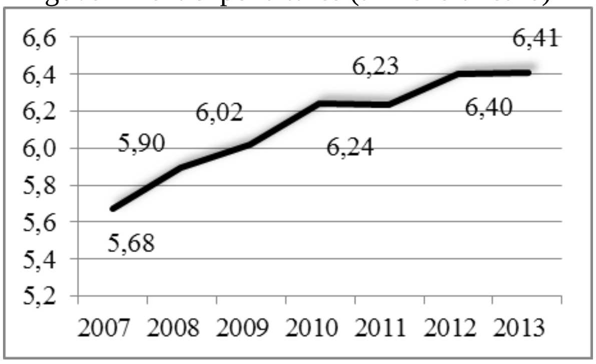


Source: Eurostat, 2014

Public expenditure-to-GDP ratio differs greatly across the EU countries: in some of the member states, governments' expenditures accounts for more than 54% of GDP, while in other states the proportion is between 34% and 39%. However, most of the EU states (23 of 28) spent more in 2013 than before the economic crisis of 2008. For example, in Italy, the government spent 47.6 percent of GDP in 2007 and 50.6 percent of GDP in 2013; in Spain, government expenditures reached 39.2 percent of GDP in 2007 and 44.8 percent of GDP in 2013; Greece's government spent 47.5 percent of GDP in 2007 and 58.5 percent of GDP in 2013; in Portugal, government spending increased from 44.4 percent of GDP in 2007 to 48.6 percent of GDP in 2013; in Ireland government spent 36.7 percent of GDP in 2007 and 42.9 percent of GDP in 2013 etc. Public expenditure-to-GDP-ratio decreased in 2013 compared to 2007 in 5 countries only: Bulgaria, Hungary, Lithuania, Poland and Romania (**Graphic 1**).

Recent Eurostat data reflects what some of the critics of EU model of austerity pointed out already, namely that real austerity measures (i.e. cutting of government spending) were not implemented in most of the EU countries. Martin Masse (2013) – associate researcher at Institut économique Molinari in Paris – noted that although it was almost universally taken for granted that austerity measures adopted in Europe have meant drastic spending cuts combined with some tax increases, actually government spending has risen in the EU as a whole most of the time, since the beginning of the financial crisis (**Graphic 4**).

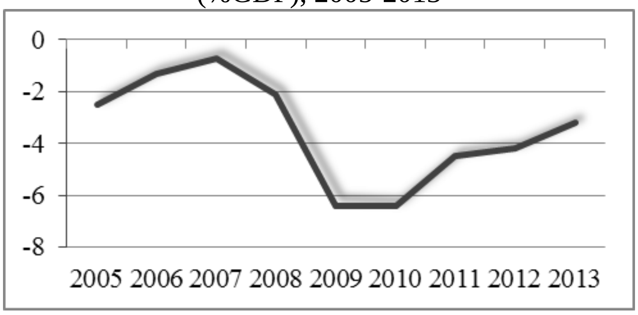
Graphic 4 - EU 28 total general government expenditures (trillions of euro)



Source: Eurostat, 2014

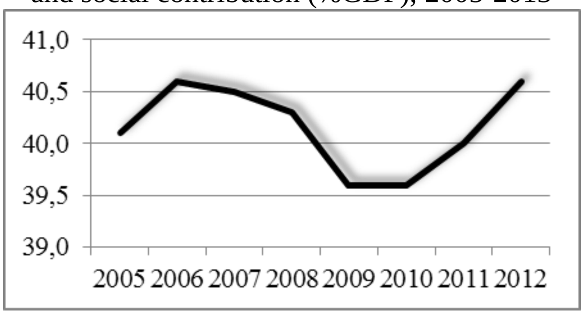
Statistics indicating that government deficit has gone down was commonly set forth as evidence of the austerity measures implemented in EU countries. General government deficits decreased indeed in EU between 2010 and 2013 (**Graphic 5**), but deficits can be reduced not only by spending cuts, but also by increasing revenue (e.g. increasing taxes) more than increasing spending.

Graphic 5 – EU government deficit (%GDP), 2005-2013



Eurostat, 2012-2014

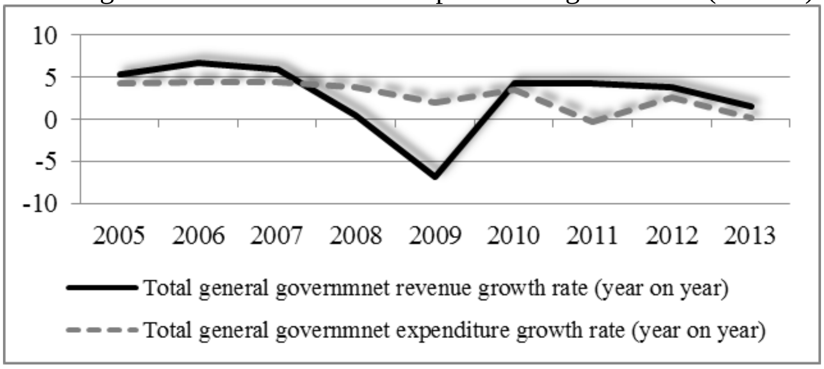
Graphic 6 – EU total receipts from taxes and social contribution (%GDP), 2005-2013



Eurostat, 2012-2014

This is exactly what happened in most of EU countries: when government revenues fell faster than expenditures, the deficits increased (2008-2009); also when government revenues have gone up faster than public spending the deficit decreased (**Graphic 7**).

Graphic 7 - EU General government revenues and expenditures growth rate (% YoY)

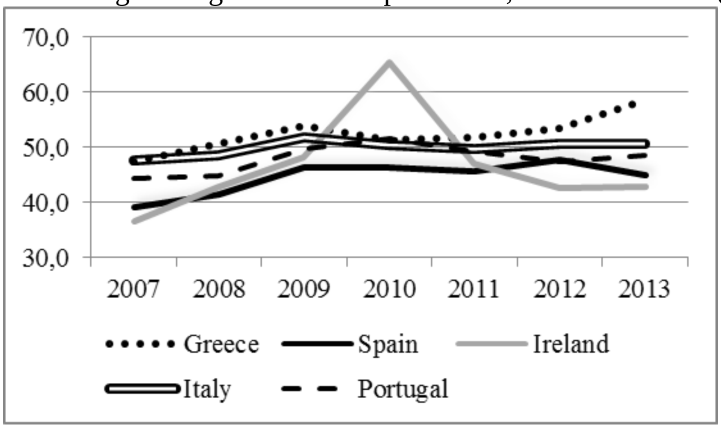


Source: Author's calculations based on Eurostat data, 2014

Therefore, Martin Masse rightly emphasized that almost whenever governments announced budget cuts, they were actually referring not to absolute reductions in total expenditures but simply to spending increases that were lower than previously planned or to cuts of expenditures for some budget lines that were offset by higher budgetary spending elsewhere (Masse, 2013).

Also, Georg Erber (2013) from German Institute for Economic Research (Berlin) pointed out that while official story is that GIIPS countries have been devastated by cutbacks in public spending during last years, the figures shows a different picture. GIIPS countries increased massively public spending between 2000 and 2008; then, between 2008 and 2014, although the upward trend of public expenditure was not perfectly linear, nevertheless it was maintained (**Graphic 7**).

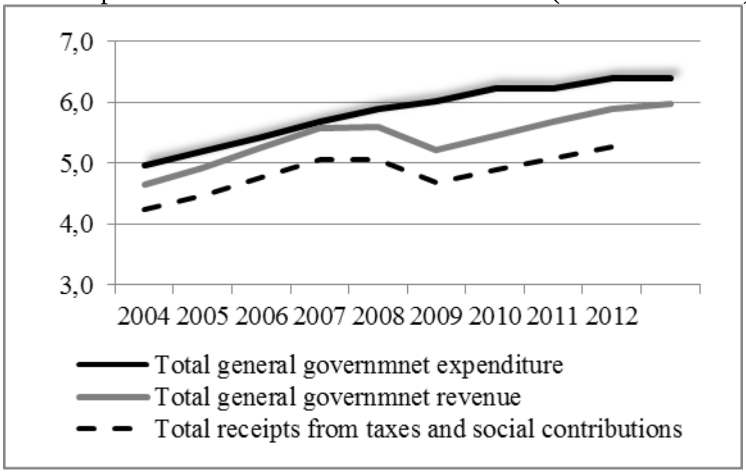
Graphic 7 - Total general government expenditures, GIIPS countries (% GDP)



Source: Eurostat, 2014

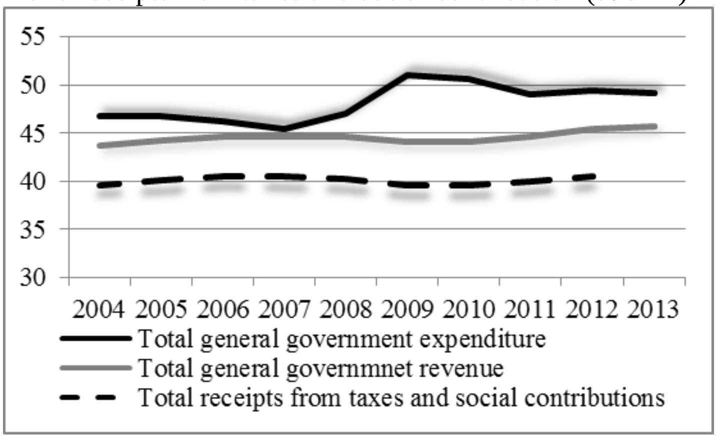
It should be noted that between 2004 and 2013 the evolution of public spending in the EU countries was strongly influenced by business cycle's boom and bust phases. During the phase of economic expansion, both governments' revenues and public spending went up considerably in most of EU member states. Then, after the financial crisis hit EU economies in 2008-2009, total receipts from taxes and social contributions and total governments' revenues decreased, but the upward trend of government revenue was soon resumed in 2009-2010. Between 2010 and 2011 governments' expenditures decreased slightly but not as much as governments' revenues collapsed in 2009, given the economic downturn that followed the 2008 crisis. However, the trend of public spending remained ascendant across EU as a whole between 2004 and 2013 and also between 2007 and 2013 (**Graphic 9 & 10**). Therefore, the decrease of public spending that some of the EU countries experienced between 2009 and 2011 is not so much the result of EU governments' effort to reduce spending (if any at all) as the consequence of economic downturn that followed 2008 crisis. Household incomes decreased in the context of crisis (given the increase of unemployment, bankruptcies etc.). Consequently, total receipts from taxes and social contribution and total government revenues decreased as well. Public expenditures did not decrease at all in most of the countries or they did not shrink as much as EU economies collapsed. Between 2010 and 2013 budgets deficits decreased across EU as a whole, but this was mainly the result of an increase of total receipts from taxes and not so much the outcome of public spending cuts (**Graphic 5&6**). Most of EU countries increased some taxes as part of their austerity programs (value-added taxes, real estate taxes etc.). This means that the entire burden of governments' deficits reduction in EU was carried out mostly by taxpayers and private sector.

Graphic 9 - Government expenditure, government revenue, and receipts from taxes and social contribution (trillions of euro)



Source: Eurostat, 2014

Graphic 10 - Government expenditure, government revenue, and receipts from taxes and social contribution (%GDP)



Source: Eurostat, 2014

In summary, the policies enforced by most of the EU member states, inspired by IMF-ECB neoliberal view focused narrowly on fiscal consolidation, entailing tax increases, heavy regulation of markets and preserving a quite important role of state in economy. Although EU officials announced in 2009-2010 important cuts in public expenditures, such policies were not really implemented. Even though budget deficits were reduced between 2010 and 2013 this outcome was achieved in most EU countries by increasing taxes more than reducing governments' expenditures. Also, even if some spending cuts were applied, in most cases, these did not lead to absolute reductions in total governments' expenditures.

2. Theoretical Perspectives on Austerity and Fiscal Stimulus

Austerity policies were fiercely criticized by Keynesian and neo-Keynesian economists, like Paul Krugman (2013) on the ground that big spending cuts drive to deeper slumps. Krugman and many other Keynesian and neo-Keynesian economists advocate pro-growth fiscal stimulus policies. Their main idea is that economic growth can be maintained only by keeping the aggregate demand high – fiscal multiplier being one of the main building blocks of Keynesian economics. The idea of Keynes' fiscal multiplier and its questionable assumptions (e.g. inflexible prices and wages etc.) has been subject to detailed critiques by economists like

William Hutt (1963, p. 247-289), Henry Hazlitt (1959, p. 135-155) and M. N. Rothbard (2009, p. 866-868) and others. Furthermore, recent studies realized by mainstream economists did not confirm a clear positive impact of stimulus policies on economy. There is no consensus regarding the size of multipliers used to estimate the amount of additional income created by additional government spending. A brief review of such studies is realized by Joseph Salerno (2012), mentioning the research of Robert Baro – who, in a 2009 paper analyzing US stimulus program (*Vodoo Multupliers*) argued that the peacetime multiplier was essentially zero – and also the IMF working paper of Ethan Ilzet, Enrique G. Mendoza and Carlos A. Vegh (2011) who announced similar findings.

Also, researches undertaken by supply side economists, showing the positive impact of tax reduction on economic growth are also relevant. Contrary to pro fiscal stimulus economists, who sustain that doesn't matter how budget deficits and public debts reduction are achieved (i.e. by cutting government spending or by hiking taxes), there is an increasingly literature documenting empirically the impact of taxes on economic growth. For example, Alesina, Favero & Giavazzi (2012) concluded on the basis of their study that adjustments based upon spending cuts are much less costly in terms of output losses than tax-based ones: spending-based adjustments have been associated with mild and short-lived recessions, while tax-based adjustments have been associated with prolonged and deep recessions. In response, Paul Krugman and Christina Romer contended that economies performed well after government spending cuts because of expansionary monetary policies or because business cycle picking up. Alesina *et al.* (2012) answer was that they took into account both factors (monetary policy and business cycle phases) and concluded that the difference between spending cuts and hiking taxes regarding the impact on economic output remains and it is significant. According to their research, when government spending fall, private investment is rising and that prevents economy from slumping. Alesina explains that in the case of spending-cut deficit reductions, private-sector capital accumulation rise, with firms investing more in productive activities (buying machinery and opening new plants) while after the tax-hike deficit reductions, capital accumulation drops. Finally, Alesina *et al.* (2012) concluded that carefully designed spending cuts can reduce debt without killing growth, especially if spending cuts are associated with measures like deregulation and liberalization of markets, especially of labor market. At the same time, they admitted that spending cuts do not always lead to economic growth, but pointed out that tax-based deficit reduction (hiking taxes) is always recessionary. A concise literature review of supply side economist's view on austerity is realized by Robert Murphy (2013) in his article *What Economic Research Says About Fiscal Austerity and Higher Tax Rates*. R. Murphy shows that contrary to the claims of some proponents of both deficit spending and increases in the highest income tax rates, there is a large literature on the historical success of supply-side economics and fiscal austerity based on cuts in government spending.

Austerity has different meanings and consequently different ways to be implemented depending on the conceptions about economic growth, about the role of governments in the economy etc. F. Hollenbeck (2013) distinguished between three concepts of austerity: (1) EU type of austerity inspired by neoliberal view of IMF-ECB, stressing less government spending and higher taxes; in practice, most of the EU governments have raised both public spending and taxes, which led to an increase in the relative size of public sector and government role in the economy; (2) Keynesian form of austerity, requiring governments to use fiscal stimulus in order to bust growth and balance their budget (mainly through tax increases) only when economies get stronger; (3) deficit control by shrinking the size of governments and their role in economy (emphasizing government austerity *versus* private sector austerity) sustained by Austrian economists, entailing both slashes of government spending and taxes.

The distinction between austerity conceptions remains important because each view presupposes different values and objectives and it is translated in practice with various results. However, some of these conceptions are more or less conflated or considered much of the same. For example, M. Blyth (2013) in his book, *Austerity, the History of the Dangerous Idea*, attempting to reconstruct "the intellectual history of austerity" presupposes rather unwarranted that there is such affinity or historical continuity in thinking about austerity between classical liberals, Austrian economists, German ordoliberals and the IMF-ECB neoliberals with their programs of fiscal and structural adjustments. All these conception are rather too different in values and scope to be considered akin. Furthermore, although M. Blyth point out fairly well that the negative effects of financial crisis cannot be wiped out merely by fiscal policies, he has no principled objection against fiscal stimulus policies, but only against deficit reduction policies. M. Blyth explains in his quite extensive analysis that Austrian economists' conception about austerity is related to their view on boom-bust business cycles, but neither the reasons of Austrian economists' rejection of fiscal stimulus policies nor their view on money, banking and credit are really tackled in his analysis. The principled rejection of fiscal stimulus by Austrian economists has much to do with Say's Law. It is known that Keynesian economists reject Say's Law based on a peculiar interpretation thereof, while most of their critics reject Keynes interpretation of Say's Law (Hazlitt 1959, Hutt 1974, Kates 1998). According to W. Hutt (1974), Say's law states that on a coordinated market, the supply of any good constitutes a demand for a noncompeting good. This implies that it is never an insufficiency of demand, but only a "withholding" of supply, with potential input suppliers asking more than "market-clearing input prices" (Hutt, 1974, p. 44). Therefore, what the critics of fiscal stimulus contend, based on Say's Law, is that the level of aggregate demand doesn't really matter and that fiscal stimulus cannot bring prosperity or end economic recessions, it only causes wealth redistribution and, in most of the cases, capital consumption. Most of Austrian economists accept Hutt's interpretation of Say's law, rejecting on principle fiscal stimulus. From this perspective, policies targeting deficits reduction must rely on government austerity, not on private sector austerity – exactly the opposite of austerity policies implemented in EU countries. For instance, M.N. Rothbard considers that the proper way to reduce budget deficits is to lower governments' role in economy slashing both expenditures and taxes, particularly taxes that interfere with saving and investment. The reduction of tax-spending level will shift the societal saving-investment–consumption ratio in favor of saving and investment, lowering significantly the time required for returning to prosperity (Rothbard 2000, p. 22). Such kind of policies aiming to lower the role of governments in economy is rather uncommon in current political and academic climate.

Neither neoliberals, nor even supply side economists sustain spending cuts accompanied by tax rate cuts intending to shrink the size and role of governments. IMF programs of structural adjustments (e.g. Washington Consensus) entail fiscal stimulus policies – fiscal consolidation being only a means to enable governments to apply more targeted pro-growth public spending. Also, most of the supply side economists sustain tax cuts as a tool to expand government revenues, according to Laffer curve. Therefore, taking into account such differences in scope, meaning and also consequences in terms of policies and their implications, it is rather unwarranted to claim any affinity between all these conceptions regarding austerity, as M. Blyth presupposes in his analysis. Each conception involves a different stance regarding prosperity, economic growth and best means to attain them and also each conception is guided by different ethical, social and political values. Likewise, M. Blyth conclusions that "austerity has been applied with exceptional vigor during the ongoing European financial crisis" and that "the costs of epistemic arrogance" of austerity advocates have been, and continue to be "horrendous" are an utter exaggeration. The natural tendency of governments is to increase public spending and so far no theory or ideology proved to be so "dangerous" to reverse this historical trend and the case of EU austerity is not an exception so far.

3. Conclusions

In 2009-2010, EU officials announced important cuts in public expenditures, emphasizing that the ideal fiscal consolidation must be focused on spending cuts and not on tax hikes. Such policies were not really implemented in EU countries, the figures revealing that public spending increased in most of the EU member states between 2007 and 2013. The criticism of pro stimulus economists, contending that economic downturn of Eurozone is the result of large cuts in public spending proved to be groundless. Between 2004 and 2013 both governments' revenues and public spending increased in most of EU member states and in EU as a whole. Between 2010 and 2011 governments' expenditures decreased slightly but not as much as governments' revenues collapsed in 2009, given the economic downturn that followed the 2008 crisis. However, the trend of public spending remained ascendant across EU as a whole between 2004 and 2013 and also between 2007 and 2013.

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