Austerity and Growth: A contradiction?

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The Greek public deficit is projected to approach 10 per cent of GDP in 2011, unexpectedly dire conditions in the Spanish regions probably pushed total public deficit for 2011 past the previous estimate of 6 per cent of GDP to more than 8 per cent, and Italy's new Prime Minister Mario Monti is trying to cut the Italian deficit by tens of billions of Euros. Most EU countries have violated the limit of 3 per cent of GDP stipulated – and then largely ignored – when the Euro was first introduced. With public deficits of these magnitudes the current mood of austerity seems fitting, and the German push for more, prudent. Several countries have added budget deficit clauses to their constitution and the EU is discussing how best to "punish" spendthrift countries.

This almost entirely one-sided focus, however, leaves too little focus on structural reforms that might have less of an immediate impact on the budget deficit, but which will encourage growth in the long run. This is unfortunate for at least four reasons.

First, in a situation such as the present where demand is already constrained the imposition of further austerity only adds to the pain. Public spending cuts and higher taxes constrain aggregate demand, reduce income and thereby government income, only further increasing the pressure on public finances. The problem is exacerbated within a tightly integrated economy like the European common market: when one country tightens its finances the contraction in demand affects aggregate demand in other countries, only further slowing down the European economy.

Second, though the debt to GDP level is the immediate focus of most governments, the fraction can be reduced both through a reduction of debt and through an increase in GDP. Though budget reductions can have immediate effect on the deficit and structural reforms often only slower and more indirect effects on GDP, the concern should be on the long-run sustainability of the ratio and not on its immediate value.

Third, rushed budget cuts are likely to be haphazard budget cuts. In early January Belgium had to rush to cut € 1bn from its budget for 2012 in order to fulfill the new European fiscal rules. This was done primarily through a freeze on railway maintenance and defense, targets that were most likely chosen for expediency more than prudence. Structural reforms on the other hand have the potential of expanding the pie by increasing overall GDP.

Fourth, but certainly not least, the present real challenge within the Eurozone is convincing investors that sovereign debt trajectories are credible. For many Southern European economies a crucial task is to convince investors of future growth in GDP. Mr. Monti will have to convince markets that the coming decade will not be a repetition of the preceding "lost decade" of no growth and he can do so only by convincing them that the structural problems of Italy are being addressed head on.

So what structural reforms are necessary? There are many elements in common on the wish lists for the most severely troubled economies, but it is worth emphasizing a few. With an unemployment rate of more than 20 per cent, and youth unemployment close to 50 per cent, Spain stands out as a ripe candidate for labor market reforms. Italy is mired in a culture of tax evasion, where official records indicate that less than 1 per cent of the population has annual earnings of more than € 100,000. Clearly, a tax reform would be a good place to start. In addition, the economy is too characterized by local monopolies either sanctioned or supported by the government, which stifles growth and innovation, certainly another area that Mr. Monti and his cabinet are discussing these days. Greece's public companies are so over-bloated and inefficient that even back in 1992, the then minister of finance famously announced that he could shut down the public railways, give all passengers cab fare, and still have money to spare.

This naturally begs the question of why these obvious reforms are not being carried out. To be fair, they are to some extent in some places. In Italy, Mr. Monti is accompanying his strict austerity measures by proposing reforms to labor unions and the tax system. The success of recent increased effort of tax inspectors has illustrated the potential, but also the difficulties of tax reforms. Though the efforts were met with marked success, both in catching tax fraud and in encouraging the honest reporting of income, angry responses from the centre-right "Forza Italia" of the previous Prime Minister Silvio Berlusconi foreshadows political difficulties for Mr. Monti in pushing through his reforms. So why are structural reforms difficult to enact? The difficulties of Mr. Monti demonstrate the first of three apparent reasons.

Any structural reforms will leave some special interest group feeling especially aggravated; the super-rich in Italy, the powerful labor unions in Spain, and the public employees in Greece, to name but a few. Such powerful interest groups can often sidetrack the political process and prevent reforms. Broadly spread austerity measures and cuts are usually easier to enact and balance such that all have to bear some of the costs and therefore easier to push through. Naturally, well-conceived reforms will bring sufficient economic benefits to compensate the loses of specific groups. One can compensate the losers from tax reforms by overall lower tax rates and additional training might help former public employees find new employment should they lose their jobs from privatization. It is important to consider such compensation schemes along with structural reforms. Both to ease the transition for those who are hurt and to ease the implementation of the reforms.

Second, it is often more difficult to communicate the necessity of structural reforms to the general electorate. It is easy to explain why government spending must be reined in when it has excessively surpassed government income, much less so why you would want to fire employees in public companies or increase ease of firing when unemployment is already high. Two articles in the previous issue of the International Economic Overview by Profs. Toribio and Cabral specifically address why labor market reforms are both necessary and overdue in Spain and much of Europe.

Third, the details of necessary structural reforms are often specific and the effects somewhat unpredictable, which makes it difficult for the European Union to set up specific requirements that must be met by all member countries, though the common market has had some success in this respect. This is contrary to deficit and debt which are relatively easy to measure and therefore to subject to central rules as is now being attempted within the European Union.

So what are the prospects for future structural reforms in Europe? Perhaps surprisingly, probably better than ever. The current situation with several large European countries on the verge of default, has provided the sense of urgency that propelled a change in government in Italy, Spain, and Greece; governments with a clear mandate for change. Italy provides the clearest example of a change of direction. The majority of Italians support the efforts of Mr. Monti and even an overall reform of the tax system might gain popular support. Whether he will be able to push it through both chambers of parliament has yet to be seen, but Ms. Merkel, the German Chancellor has already praised his reform efforts. In Spain so far only rhetoric support of reforms is to be found in the new cabinet. The recently elected Prime Minister Mariano Rajoy has promised aggressive reforms of the labor market, but although more than 2 months have passed since he won the election we have still to see what the concrete plans for labor market reforms entail.

Importantly, the political power houses of Europe, Germany and France, headed by Ms. Merkel and Mr. Sarkozy have increased their focus on measures to increase growth in the EU. Such measures could include increased encouragement for workers to move between European countries, say, from crisis stricken Spain, to Germany, where signs of labor shortages are showing, as well as a more specific growth-enhancing role of structural funds of the European Union. Though these discussions are encouraging it is clear that the real issues have to be addressed nationally.

It is said that every cloud has a silver lining. Perhaps the darkening cloud over Europe has finally convinced its leaders of the need for long overdue structural reforms.