Achim Truger and Christoph Paetz
Berlin School of Economics and Law

The Economic Effects of Austerity Policies in Europe: Some back-of-the-envelope calculations

Abstract:
Fiscal policy in the Euro area is currently dominated by austerity measures implemented under the institutional setting of the 'reformed' stability and growth pact, the 'fiscal compact' and the EFSM with devastating economic and social consequences. With respect to the recent past the paper tries to identify the size of the austerity packages and its economic impact for the Euro area economies. With respect to the future the paper tries to disentangle which of the numerous constraints on public deficits will most probably be binding (excessive deficit procedure, structural deficit criterion under the fiscal compact, excessive deficit procedure with respect to public debt ratio) and to the ensuing negative fiscal stance. The potential consequences of austerity for GDP growth both in the past and in the future are examined with the help of plausible values of the fiscal multiplier. Employment effects can be discussed by assuming plausible values for the income elasticity of employment. The potential output and employment losses of the current strategy are shown to be irresponsibly high so alternative strategies must be implemented.

Corresponding Author:
Achim Truger
Berlin School of Economics and Law
Faculty of Business and Economics
Badensche Straße 50-51
D-10825 Berlin
www.hwr-berlin.de
Tel.: +49 (0)30 30877-1465
Fax: +49 (0)30 30877-1199
E-Mail: Achim.Truger@hwr-berlin.de

1. Introduction

After a short and unexpected period with a macroeconomically sensible 'European Recovery Programme' in 2009 accompanied by many counter-cyclical policy responses in most individual EU-member states, panic caused by exploding spreads for government bonds in some Euro area economies has driven European fiscal policy back into an unprecedented regime of austerity. Fiscal policy in the Euro area is currently dominated by austerity measures implemented under the institutional setting of the 'reformed' stability and growth pact, the 'fiscal compact' and the EFSM with devastating economic and social consequences. Fiscal policy in the countries hit by the Euro crisis has been very restrictive up to date and must be expected to remain restrictive in the medium term according to the old Stability and Growth Pact (SGP) and its reinforced successor as well as to the new institutional arrangements to constrain public deficit and debts.

Against the background of these developments the purpose of the current paper is threefold: With respect to the recent past, the paper tries to identify the size of the austerity packages and its economic impact the Euro area countries. With respect to the future, the paper tries to disentangle which of the numerous constraints on public deficits and debt will most probably be binding (excessive deficit procedure, structural deficit criterion under the fiscal compact, excessive deficit procedure with respect to public debt ratio) and how large the ensuing negative fiscal stance can be expected to be. The consequences of austerity for GDP growth both in the past and in the future are examined with the help of plausible values of the fiscal multiplier. Employment effects can be discussed by assuming plausible values for the income elasticity of employment.

2. The damage done so far (until 2012)

It is difficult to assess the damage done by austerity measures in the Euro area so far as there is still considerable uncertainty about the exact nature and size of the restrictive discretionary measures taken. A revised and enlarged version of this paper will give an overview and analysis of the relevant literature. In order to get a first impression, in this paper we use the annual change in the cyclically adjusted budget balance as a proxy for the discretionary fiscal stance. We use OECD figures as their method of cyclical adjustment has proven to be the least sensitive to the endogeneity bias whereby a cyclical slowdown technically leads to a 'structural' slump. The method employed by the EU-commission has instead proven to be highly sensitive to that bias, which is the reason why we explicitly refrain from using EU

Commission estimates for cyclically adjusted or 'structural' budget balances in this study. In some cases the resulting fiscal stance may be biased by rescue measures for the national banking sector. A revised version of this paper will try to account for this.

Table 1 gives an overview of the development of the cyclically adjusted budget balance in the Euro area countries covered by the OECD from 2007 to 2012 (estimate) and the resulting discretionary fiscal stance.

Table 1: General government cyclically-adjusted balances and fiscal stance in the Euro area in % of GDP (2007-2012)

	Balances						fiscal stance			
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2007 to 2009**	**2009 to 2010**	**2009 to 2011**	**2009 to 2012**
Austria	-2.3	-2.4	-3.4	-3.4	-2.1	-2.1	-1.1	0.0	1.3	1.3
Belgium	-1.5	-2.3	-4.8	-3.4	-4.0	-2.3	-3.3	1.3	0.7	2.4
Finland	2.9	2.1	-1.0	-1.9	-0.7	-0.4	-3.9	-0.9	0.2	0.6
France	-4.2	-4.4	-6.5	-5.6	-3.9	-2.8	-2.3	0.9	2.6	3.7
Germany	-0.6	-0.9	-1.6	-3.3	-1.0	-0.9	-1.0	-1.7	0.6	0.7
Greece	-9.9	-12.5	-16.4	-9.6	-5.4	-1.8	-6.5	6.8	11.0	14.6
Ireland	-3.5	-8.8	-11.1	-25.6	-8.8	-4.5	-7.6	-14.6	2.3	6.6
Italy	-3.2	-3.6	-3.5	-2.5	-2.2	0.8	-0.3	1.0	1.3	4.3
Luxembourg	1.6	1.2	0.0	0.5	0.8	0.6	-1.6	0.5	0.8	0.6
Netherlands	-0.8	-1.1	-5.8	-4.2	-3.9	-2.9	-4.9	1.6	1.8	2.8
Portugal	-3.9	-4.0	-8.9	-8.9	-2.8	-1.6	-5.0	0.0	6.0	7.2
Slovenia	-2.9	-5.4	-5.5	-5.4	-5.4	-1.8	-2.6	0.1	0.1	3.7
Spain	0.3	-5.4	-9.5	-6.6	-5.5	-1.5	-9.8	2.9	4.0	8.1
Euro area	**-2.1**	**-3.2**	**-5.1**	**-4.7**	**-3.0**	**-1.4**	**-3.0**	**0.3**	**2.1**	**3.6**

Source: OECD Economic Outlook 91, statistical annex.

With the exception of Italy in all countries a substantial countercyclical expansionary stance can be observed in the year of the deep crisis 2009. In 2010 the expansionary stance continues in Austria, Finland, Germany and Portugal, whereas Belgium, France, Greece – in the most brutal manner –, Luxemburg, the Netherlands, Slovenia and Spain begin their 'fiscal exit'. By 2011 all Euro area countries had switched to negative fiscal stances. By 2012 the cumulative negative fiscal stance measured from the first year of fiscal restriction was quite substantial for most countries: The average negative fiscal stance for the Euro area from 2009 to 2012 was 3.6 % of GDP. For the most troubled countries Greece, Portugal, Ireland, Spain and Italy it amounted to 14.6 (!), 7.2, 6.6, 8.1 and 4.3 % of GDP, respectively.

Unless one believes in expansionary fiscal restriction or very low multipliers, a fiscal restriction in this dimension will certainly cause serious economic damage. In fact, a look at the development of GDP growth over time (see table 2) shows, that the countries with the largest negative fiscal stance are also those countries which are currently in recession.

Table 2. Real GDP in the Euro area countries, growth rate in %
(2003 - 2012)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Austria	0.8	2.3	2.7	3.7	3.7	1.1	-3.6	2.5	3.0	0.8
Belgium	0.8	3.2	1.9	2.7	2.8	0.9	-2.7	2.2	2.0	0.4
Finland	2.0	4.1	2.9	4.4	5.3	0.3	-8.4	3.7	2.9	0.9
France	0.9	2.3	1.9	2.7	2.2	-0.2	-3.0	1.6	1.7	0.6
Germany	-0.4	0.7	0.8	3.9	3.4	0.8	-5.1	3.6	3.1	1.2
Greece	5.9	4.4	2.3	5.5	3.0	-0.2	-3.2	-3.5	-6.9	-5.3
Ireland	4.2	4.5	5.3	5.3	5.2	-3.0	-7.0	-0.4	0.7	0.6
Italy	0.0	1.6	1.1	2.3	1.5	-1.2	-5.5	1.8	0.5	-1.7
Luxembourg	1.5	4.4	5.4	5.0	6.6	0.8	-5.3	2.7	1.6	0.6
Netherlands	0.3	2.0	2.2	3.5	3.9	1.8	-3.5	1.6	1.3	-0.6
Portugal	-0.9	1.6	0.8	1.4	2.4	0.0	-2.9	1.4	-1.6	-3.2
Slovenia	2.9	4.4	4.0	5.8	6.9	3.6	-8.0	1.4	-0.2	-2.0
Spain	3.1	3.3	3.6	4.1	3.5	0.9	-3.7	-0.1	0.7	-1.6
Euro area	0.7	2.0	1.8	3.4	3.0	0.2	-4.4	1.9	1.5	-0.1

Source: OECD Economic Outlook 91 statistical annex.

Although many other factors must be taken into account, it does not seem far fetched to assert that restrictive fiscal policy has prevented and/or ended the recovery in the most troubled economies and has driven them into recession which in turn was responsible for the forecast stagnation in the rest of the Euro area economies in 2012. The shaded cells in table 2 indicate for the individual member countries the years in which they fell back into recession or stagnation after 2009. As can be seen for the 'strong' economies Austria, Belgium, Finland, France, Germany and the Netherlands this happens only in 2012 and as there is no striking negative fiscal stance in this year for most of these economies the current slowdown must be attributed to the general economic slowdown in the Euro area and beyond. However, even before the recent slowdown France and the Netherlands that both started early with their 'fiscal exit' witnessed only a comparatively weak recovery. For Greece, Italy, Portugal and Spain the picture seems pretty clear: Their fall into recession coincides quite well with a year of strong fiscal contraction.

3. The damage still to come

3.1. Estimating fiscal stances under the new institutional EU constraints[1]

Governments' deficits and debts in the EU are currently constrained by numerous rules. In their panic to calm down financial markets and prevent risk premiums for the crisis countries' government bonds from rising indefinitely EU member states' governments kept on tightening the institutional constraints on public deficits and debt. Those constraints had certainly never been simple in the past, but after the numerous hasty amendments they have become increasingly complex so that it is quite difficult to disentangle which of the constraints will most probably be binding for the different member countries from 2013 onwards. Three sets of constraints seem to be most important in determining the fiscal stance in the Euro area over the next 5 to 10 years:

- The **Excessive Deficit Procedure (EDP)** within the Stability and Growth Pact (SGP) is currently being applied to all Euro area members with the exception of Estonia, Finland, Germany and Luxemburg. It requires the general government budget deficit to be reduced to below 3 % of GDP. Member states under the EDP must bring their budget deficit below 3 % of GDP within a time period specified by the EU council. For most countries the current deadline is 2013 although for Greece and Spain it is 2014 and for Ireland it is 2015. If the current deadlines are seen as binding and the 2011 budget deficit is taken as a starting point to evaluate the necessary fiscal adjustment to reach the target deficit of below 3 % then the deficit reductions presented in table 3 will be necessary for the relevant countries. The necessary deficit reductions can be interpreted as 'structural' reductions and therefore as fiscal stances if the output gap remains unchanged from 2013. We make this assumption, because we do not think that a substantial improvement in the output gap from 2013 to 2015 is very probable: Most forecasts expect the output gap to widen on 2013 and the growth outlook remains very modest.

[1] This section is based on the results in Paetz (2012, 30-62).

Table 3: Annual deficit reductions necessary from 2013 to 2015 for member countries under the EDP in % of GDP

	2013	2014	2015
Belgium			
Germany			
Ireland	2.5	2.5	2.5
Greece	2.0	2.0	
Spain	1.8	1.8	
France	1.1		
Italy			
Cyprus			
Malta			
Netherlands	0.9		
Austria	0.8		
Portugal	1.3		
Slovenia	1.7		
Slovakia	1.0		
Euro area	**0.64**	**0.29**	**0.04**

Source: EU Commission; Ameco Database May 2012; authors' calculations.

- The constraints for 'structural' (=cyclically adjusted) deficits under the **Fiscal Compact.** Member states that have not reached their medium term budgetary objective had already been obliged to decrease structural deficits annually by a minimum of 0.5 % of GDP under the old SGP. The Fiscal Compact has made these prescriptions more binding by calling for institutionalised debt brakes on the national level that are to ensure that cyclically adjusted deficits are kept under 0.5 % of GDP. The compact will probably become effective in 2014 and will call for a fast transition to the new structural deficit targets which will probably have to be met in 2016. Taking the EU-Commission's estimate for the structural deficits in 2011 as a starting point and distributing the necessary structural deficit reductions evenly from 2012 to 2016 one gets the following results for the fiscal stance implied by the Fiscal Compact (table 4).

Table 4: Annual structural deficit reductions necessary under the fiscal compact in % of GDP 2013-2015

	2013	2014	2015	2016
Belgium	-0,6	-0,6	-0,6	-0,6
Germany	-0,5	0,0	0,0	0,0
Ireland	-2,3	-2,3	-2,3	-2,3
Greece	-2,0	-2,0	0,0	0,0
Spain	-1,3	-1,3	-1,3	-1,3
France	-0,7	-0,7	-0,7	-0,7
Italy	-0,5	-0,5	-0,5	-0,5
Cyprus	-1,1	-1,1	-1,1	-1,1
Malta	-0,4	-0,4	-0,4	-0,4
Netherlands	-0,6	-0,6	-0,6	-0,6
Austria	-0,5	-0,4	-0,4	-0,4
Portugal	-0,5	-0,5	-0,5	-0,5
Slovenia	-0,9	-0,9	-0,9	-0,9
Slovakia	-0,9	-0,9	-0,9	-0,9
Euro area	**-0,7**	**-0,6**	**-0,5**	**-0,5**

Source: EU Commission; Ameco Database May 2012; authors' calculations.

- The new debt related branch of the EDP calling for a 1/20th annual reduction of the part of the debt-GDP ratio that is above the 60 % threshold of the SGP. This rule will become effective after member states have left the EDP, because they have reached the 3-%-target with respect to the budget deficit. The consequences of this rule are the most difficult to calculate, because many assumptions have to be made. If we assume that all the deficit reductions necessary under SGP and fiscal compact are reached in 2016, real GDP growth equals the medium term EU Commission (modest) estimate for potential growth rate until 2016 and then remains on its 2016 level, inflation is at 2 % for all member states and the average interest rate on public debt remains unchanged then the major part of consolidation will already have been achieved by the earlier deficit reductions. For most of the member states the additional negative fiscal stances required to meet the debt criterion are virtually non-existent (Germany, France, Malta, the Netherlands, Austria, Slovakia) or comparatively small (Belgium, Spain, Cyprus, Slovenia). For Ireland, Greece, Italy and Portugal, however, the necessary additional restraint could be considerable due to the high debt level they will have reached when the debt criterion becomes binding.

Table 5: Fiscal stance implied by the EU constraints on government deficits and debt in the Euro area member states in % of GDP, 2012-2020.

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Belgium	-0,7	-0,7	-0,7	-0,7	-0,6	-0,1	-0,1	-0,1	-0,1
Germany	-0,5	-0,5	-0,0	-0,0	-0,0	-0,3	-0,0	-0,0	-0,0

Ireland	-2,3	-2,5	-2,5	-2,5	-2,3	-1,3	-1,3	-0,5	-0,2
Greece	-2,0	-2,0	-2,0	-2,5	-2,5	-2,5	-0,0	-0,0	-0,0
Spain	-1,4	-1,8	-1,8	-1,5	-1,5	-1,5	-0,0	-0,1	0,1
France	-1,0	-1,1	-0,9	-0,9	-0,9	-0,1	-0,0	-0,0	-0,0
Italy	-0,6	-1,7	-1,7	-1,7	-0,5	-0,1	-0,1	-0,1	-0,1
Cyprus	-3,4	-1,6	-1,6	-1,6	-1,1	-0,0	-0,0	-0,0	-0,0
Malta	-0,4	0,5	-0,5	-0,4	-0,4	-0,0	-0,0	-0,0	-0,0
Netherlands	-1,0	-0,9	-0,6	-0,6	-0,6	--0,1	-0,0	-0,0	-0,0
Austria	-0,7	-0,8	-0,4	-0,4	-0,4	-0,0	-0,0	-0,0	-0,0
Portugal	-1,1	-1,3	-1,4	-1,4	-1,4	--0,4	-0,1	-0,1	-0,1
Slovenia	-1,5	-1,7	-1,2	-1,2	-1,2	--0,1	-0,0	-0,0	-0,0
Slovakia	-0,9	-1,0	-0,9	-0,9	-0,9	-0,0	-0,0	-0,0	-0,0
Euro area	**-0,84**	**-1,09**	**-0,87**	**-0,85**	**-0,64**	**-0,34**	**-0,06**	**-0,05**	**-0,04**

Cumulative

	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Belgium	-0,7	-1,4	-2,0	-2,7	-3,3	-3,4	-3,4	-3,5	-3,6
Germany	-0,5	-1,0	-1,0	-1,0	-1,0	-1,3	-1,3	-1,3	-1,4
Ireland	-2,3	-4,8	-7,3	-9,8	-12,1	-13,4	-14,7	-15,2	-15,4
Greece	-2,0	-4,0	-6,0	-8,5	-11,1	-13,6	-13,6	-13,6	-13,5
Spain	-1,4	-3,2	-5,0	-6,5	-7,9	-9,4	-9,4	-9,5	-9,5
France	-1,0	-2,1	-3,0	-3,8	-4,7	-4,8	-4,8	-4,9	-4,9
Italy	-0,6	-2,3	-3,9	-5,6	-6,1	-6,2	-6,3	-6,3	-6,4
Cyprus	-3,4	-5,0	-6,6	-8,1	-9,2	-9,3	-9,3	-9,4	-9,4
Malta	-0,4	-0,9	-1,3	-1,7	-2,1	-2,2	-2,2	-2,3	-2,3
Netherlands	-1,0	-1,9	-2,5	-3,1	-3,8	-3,7	-3,7	-3,7	-3,7
Austria	-0,7	-1,5	-1,9	-2,3	-2,7	-2,7	-2,7	-2,7	-2,7
Portugal	-1,1	-2,4	-3,8	-5,2	-6,6	-6,2	-6,3	-6,3	-6,4
Slovenia	-1,5	-3,2	-4,4	-5,6	-6,8	-6,7	-6,7	-6,8	-6,8
Slovakia	-0,9	-1,9	-2,8	-3,7	-4,6	-4,6	-4,6	-4,6	-4,6
Euro area	**-0,84**	**-1,94**	**-2,81**	**-3,65**	**-4,30**	**-4,64**	**-4,70**	**-4,75**	**-4,79**

Source: EU Commission; Ameco Database May 2012; authors' calculations.

Table 5 shows the fiscal stance that results from the one of the three institutional constraints just discussed that gets binding in the specific case. As can be seen the cumulative negative fiscal stance required is very substantial and reaches more than 4 % of GDP by 2016. For some of the individual member states the stance becomes alarmingly high: In Ireland and Greece – despite the efforts already undertaken – it goes above 10 % of GDP in the medium term.

3.2. Estimating the ensuing output and employment effects[2]

[2] This section modifies and simplifies some of the results in Paetz (2012, 63-77).

The potential consequences of austerity for GDP growth both in the past and in the future are examined with the help of plausible values of the fiscal multiplier. In order to get an idea of the possible output effects in line with recent reviews of the literature (e.g. Bouthevillain et al. 2009) we assume that the multiplier for government spending is equal to 1 and the revenue multiplier is equal to 0.5. We further assume that consolidation efforts are concentrated on the expenditure side of the budget i.e. 70 % of the measures are on the expenditure side and 30 % on the revenue side. The average multiplier applied in the calculations is therefore 0.85. Needless to say, that in the current situation in the Euro area with simultaneous consolidation efforts everywhere, monetary policy at the lower bound and expectations in the crisis countries extremely pessimistic, the assumed values of the multiplier are quite low. Simple multiplication of the cumulative fiscal stance with the multiplier results in the output effect which is shown in table 6. Obviously, if applied the fiscal constraints at work in the Euro area have the potential to weaken the (already weakened) Euro area economy by a further 3 %. For the most troubled economies in the Euro area the destructive potential is even much higher: Over the medium term Ireland, Greece, Spain, Italy and Portugal face the risk of loosing a further 4 to 11 % of their GDPs.

Table 6: Output (GDP) loss due to negative fiscal stance in the Euro area member states in %, 2013-2020

	2013	2014	2015	2016	2017	2018	2019	2020
Belgium	0,6	1,1	1,7	2,2	2,3	2,3	2,4	2,4
Germany	0,4	0,4	0,4	0,4	0,7	0,7	0,7	0,7
Ireland	2,1	4,3	6,4	8,3	9,4	10,6	11,0	11,1
Greece	1,7	3,4	5,6	7,7	9,9	9,8	9,8	9,8
Spain	1,5	3,1	4,3	5,5	6,8	6,8	6,9	6,9
France	0,9	1,7	2,4	3,1	3,2	3,3	3,3	3,3
Italy	1,4	2,8	4,3	4,7	4,8	4,8	4,9	4,9
Cyprus	1,3	2,7	4,0	5,0	5,0	5,0	5,1	5,1
Malta	0,4	0,8	1,1	1,5	1,5	1,5	1,6	1,6
Netherlands	0,8	1,3	1,8	2,3	2,3	2,3	2,3	2,3
Austria	0,7	1,0	1,4	1,7	1,7	1,7	1,7	1,7
Portugal	1,1	2,3	3,5	4,7	4,3	4,4	4,5	4,5
Slovenia	1,4	2,5	3,5	4,5	4,4	4,5	4,5	4,5
Slovakia	0,9	1,6	2,4	3,1	3,2	3,2	3,1	3,1
Euro area	**0,9**	**1,7**	**2,4**	**2,9**	**3,2**	**3,3**	**3,3**	**3,4**

Source: EU Commission; Ameco Database May 2012; authors' calculations.

Employment effects can be discussed by assuming plausible values for the income elasticity of employment. We assume an elasticity of 0.65. Table 7 shows the resulting potential employment losses to be expected from the EU austerity regime. Over the medium term, Euro area wide employment losses of 3 Mio. persons or 2 % of the Euro area workforce must be expected. Ireland and Greece might be losing employment in the dimension of more than 5 % of their workforce.

Table 7: Employment effects due to negative fiscal policy stance in the Euro area member states in 1000 persons and in % of the workforce, 2013 to 2020.

(in 1000)	2013	2014	2015	2016	2017	2018	2019	2020
Belgium	-22,7	-42,7	-62,6	-80,5	-82,5	-84,4	-86,4	-88,4
Germany	-115,2	-115,2	-115,2	-115,2	-177,7	-184,0	-190,2	-196,4
Ireland	-24,7	-49,4	-74,1	-96,9	-109,9	-122,8	-128,0	-129,5
Greece	-47,8	-95,6	-156,3	-217,1	-277,9	-276,8	-276,3	-275,8
Spain	-181,1	-362,2	-509,1	-656,0	-802,8	-805,7	-811,3	-816,8
France	-165,7	-295,4	-425,0	-554,7	-571,6	-578,8	-586,0	-593,2
Italy	-225,6	-451,1	-676,7	-744,1	-754,2	-764,0	-773,7	-783,2
Cyprus	-3,5	-6,9	-10,4	-12,8	-12,9	-13,0	-13,1	-13,2
Malta	-0,4	-0,9	-1,3	-1,6	-1,7	-1,7	-1,8	-1,8
Netherlands	-42,8	-72,1	-101,4	-130,7	-126,3	-127,1	-127,9	-128,7
Austria	-18,5	-27,7	-37,0	-46,2	-45,4	-46,0	-46,6	-47,3
Portugal	-34,6	-72,0	-109,3	-146,7	-134,8	-137,0	-139,3	-141,5
Slovenia	-8,8	-15,0	-21,3	-27,6	-26,9	-27,1	-27,3	-27,5
Slovakia	-13,3	-25,3	-37,4	-49,4	-49,8	-49,5	-49,2	-48,8
Euro area	**-904,6**	**-1631,4**	**-2337,0**	**-2879,3**	**-3174,3**	**-3218,1**	**-3257,1**	**-3292,0**

(% of the workforce)	2013	2014	2015	2016	2017	2018	2019	2020
Belgium	-0,5	-0,9	-1,3	-1,6	-1,7	-1,7	-1,7	-1,8
Germany	-0,3	-0,3	-0,3	-0,3	-0,4	-0,4	-0,4	-0,5
Ireland	-1,2	-2,3	-3,5	-4,6	-5,2	-5,8	-6,1	-6,1
Greece	-0,9	-1,8	-2,9	-4,1	-5,2	-5,2	-5,2	-5,2
Spain	-0,8	-1,5	-2,2	-2,8	-3,4	-3,4	-3,5	-3,5
France	-0,6	-1,0	-1,4	-1,9	-1,9	-1,9	-2,0	-2,0
Italy	-0,8	-1,7	-2,5	-2,8	-2,8	-2,9	-2,9	-2,9
Cyprus	-0,8	-1,6	-2,4	-3,0	-3,0	-3,0	-3,1	-3,1
Malta	-0,2	-0,5	-0,7	-0,9	-0,9	-0,9	-1,0	-1,0
Netherlands	-0,5	-0,8	-1,1	-1,5	-1,4	-1,4	-1,4	-1,4
Austria	-0,4	-0,6	-0,9	-1,1	-1,1	-1,1	-1,1	-1,1
Portugal	-0,6	-1,3	-2,0	-2,6	-2,4	-2,5	-2,5	-2,5
Slovenia	-0,9	-1,5	-2,1	-2,7	-2,6	-2,7	-2,7	-2,7

Slovakia	-0,5	-0,9	-1,4	-1,8	-1,8	-1,8	-1,8	-1,8
Euro area	**-0,6**	**-1,0**	**-1,5**	**-1,8**	**-2,0**	**-2,0**	**-2,0**	**-2,1**

Source: EU Commission; Ameco Database May 2012; authors' calculations.

3.3. The imminent triple fiscal strangulation of the Euro area economy

The negative output effects calculated so far would of course also result in higher government deficits (and debt levels) that would – under the current institutional and political circumstances – in turn increase the necessary fiscal restriction in order to reach the given target values. This applies for all three fiscal constraints: If the deadline to correct the excessive deficit under the currently active EDPs is not shifted, then further consolidation measures will become necessary with the result of a further economic deterioration. In the case of the fiscal compact, 'structural' deficits will also go up due to the endogeneity of potential output calculations, in turn increasing the negative stance necessary for the structural deficit to be reduced to 0.5 % of GDP by 2016. And finally, higher deficits and lower GDP levels would lead to a rise in the debt-to-GDP-level which would have to be reduced under the relevant branch of the EDP.

Therefore, the emergence of a vicious circle of consolidation efforts leading to higher deficits and debt levels and in turn to higher consolidation efforts a.s.o. is a real and dangerous possibility in the current setting. And in fact, in the case of Spain the potential vicious circle might already be under way: Despite the fact that Spain was given more time to correct its excessive deficit it still had to increase fiscal restriction to meet the new 'less ambitious' target as the economy was moving deeper into recession.

And the bad news is that this dangerous possibility can only be precluded by reforming all of the three relevant institutional constraints for fiscal policy at the same time. If the council decides to provide more leeway by shifting the EDP deadline, the necessary adjustment under the fiscal compact will automatically become larger. And if for some national or European reason the transition path to the almost balanced structural government balance is extended, then the adjustment required under the EDP-debt criterion will grow. What may look like a very tight three-layer system of ensuring fiscal 'sustainability' may turn out to be the way towards or three-step or even triple strangulation of the Euro area economy.

4. Some fiscal policy conclusions

The potential output and employment losses of the current strategy have been shown to be irresponsibly and unbearably high even under moderate assumptions regarding multipliers. Therefore, austerity must be stopped and be replaced by a suitable method of growth-friendly consolidation. Elements of such a strategy can be less restrictive fiscal constraints for the most troubled member states, a more expansionary fiscal stance in the economically ‘strong’ member states, the use of the balanced budget multiplier, a coordinated public investment strategy focussing on higher productivity in the economically ‘weaker’ member states, fiscal transfers or fiscal equalisation etc.

References

Bouthevillain. C. et al (2009): Pros and cons of various fiscal measures to stimulate the economy. Banco de Espana. Economic Bulletin. July 2009. CD.

Eur-Lex (1997): Resolution of the European Council on the Stability and Growth Pact Amsterdam. 17 June 1997. 31997Y0802(01). Official Journal C 236 . 02/08/1997 P. 0001 - 0002. CD.

Eur-Lex (2008): Protocol No. 12. 12008M/PRO/12. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008M/PRO/12:EN:NOT. CD.

Paetz. C. (2012): “Fiskalpakt“ – Impuls zum Aufschwung in Europa? Auswirkungen der forcierten europäischen Konsolidierungspolitik auf Wachstum und Beschäftigung im Euroraum. unpublished Bachelor Thesis. Berlin School of Economics and Law. 2012.