2 Austerity and the neglect of public investment in the Euro area

Fiscal policy in most developed economies has been dominated by consolidation measures after the strong increase in government debt as a result of the global financial and economic crisis in recent years. Fiscal restriction was particularly strong in the Euro area because of the strict fiscal framework of the Stability and Growth Pact (SGP) and the additional policy reactions after the onset of the Euro crisis. Above all the so called periphery countries (Greece, Ireland, Portugal and Spain) whose government bonds had come under speculative attacks from the financial markets were forced into austerity policies under the relevant rescue programmes and/or by the European Commission/Council strictly enforcing and even reinforcing the tight framework of the SGP (see Blyth 2013 and Truger 2013).

Figure 1 shows the general government structural primary budget balance (SPB) for the Euro area (12 countries due to lack of data), the European Periphery and selected individual countries from 1999 to 2013. The change in this variable over time is a standard measure of the fiscal stance, i.e. the discretionary changes in fiscal policy. With the exception of the non-Euro area countries Denmark and Sweden the fiscal stance was substantially negative almost everywhere after 2009/2010. The fiscal effort in the Euro area as a whole was in the dimension of 3 per cent of GDP within only three years from 2010 to 2013. In the periphery as an aggregate it was as large as almost 10 per cent of GDP within the four years from 2009 to 2013.

Figure 1: General government structural primary budget balance in the Euro area, the European Periphery and selected countries in per cent of GDP, 1999-2013

Source: European Commission (2014a); author’s calculations.
Furthermore, it is by now widely accepted that the change in the SPB is a problematic measure for the fiscal stance which tends to seriously underestimate the fiscal effort in times of economic contractions. The SPB is calculated by cyclically adjusting the headline primary balance and subtracting one-off measures. The usual methods of cyclical adjustment tend to underestimate the cyclical fluctuations of the economy and will therefore have pro-cyclical effects if applied to fiscal policy. The method employed by the EU Commission (see d’Auria et al. 2010) has proven to be highly sensitive to this endogeneity bias, i.e. the problem that potential output is highly sensitive to variations in actual output (see Horn and Logeay 2007, Klär 2013 and 2014; Truger and Will 2013). During economic contractions – especially during large and durable contractions as those that had to be observed in the Euro crisis – the estimates of potential output are substantially revised downwards: Such dramatic downward revisions of potential GDP have substantial consequences for the calculation of structural budget balances and the assessment of consolidation efforts (Andrade et al. 2014). These efforts will usually be underestimated because a substantial part of the fiscal effort is wiped out, as a larger part of the actual deficit is registered as structural although in fact it may well just be cyclical, i.e. caused by the (in principle) temporary contraction. A further underestimation or at least inaccuracy as to the estimate of structural balances may result from deviations of actual budget semi-elasticities from the estimated average values in the procedure of cyclical adjustment (see European Commission 2010: 124-128).

The European Commission has already admitted that the estimates of the fiscal effort based on the change in the structural (primary) budget balance tend to underestimate the true discretionary consolidation efforts and has developed complementary indicators to assess fiscal effort (European Commission 2013a: 101-132 as well as Carnot and de Castro 2015). Using the results by Carnot and de Castro (2015: 10) it must be concluded that the estimate of fiscal effort based on the SPB underestimates discretionary fiscal effort for Portugal by 20 per cent, for Ireland by 45 per cent, for Spain by almost 75 per cent and for Greece by almost 90 per cent. In this case, the true fiscal effort in the periphery as a whole from 2009 to 2013 would be 16 per cent of GDP instead of “only” 10 per cent as indicated by the SPB (see similarly Darvas et al. 2014: 10-15).

The potential consequences of austerity in that dimension can most easily be illustrated by using the concept of the fiscal multiplier. Multiplying the cumulative negative fiscal stance for a given year in relation to some base year with the multiplier gives a rough estimate of the output effects of austerity relative to a baseline scenario without any consolidation measures. Recent estimates suggest that the multiplier, particularly
under the current conditions in the Euro area with monetary policy at the lower bound, fixed exchange rates within the currency union and simultaneous consolidation, tends to be large and (sometimes well) above one (Gechert 2013 and Gechert and Ranneberg 2014). Applying such multipliers to fiscal stances of the order of magnitude shown before, unavoidably leads to the result of devastating economic effects of austerity policies in the Euro area. In fact, a strikingly clear correlation between the cumulative fiscal stance and the development of real GDP since the trough of the crisis can be established (Truger 2014). The countries that saw the strongest fiscal restriction tended to perform worst in terms of GDP growth. Although many other factors must be taken into account, it does seem pretty obvious that austerity has prevented and/or ended the recovery in the most troubled economies and has driven them into recession which in turn – together with the global economic slowdown – was responsible for the stagnation in the rest of the Euro area economies in 2012.

Figure 2: General government gross fixed capital formation (ESA 2010) in relation to total expenditure in the Euro area, the European Periphery and selected countries in per cent of GDP, 1999-2013

Source: European Commission (2014a); author’s calculations.

It is plausible to assume that the strong fiscal pressure in the Euro area led to particularly strong cuts in public investment. Unlike many other spending categories public investment is not mandatory and – in the absence of institutions like the Golden Rule – politically relatively easy to cut. In fact, this is exactly what happened in the countries under severe budgetary pressures (see figure 2): In the periphery government gross
fixed capital formation (=public investment) declined from slightly below 10 per cent of total government expenditure to only 4.5 per cent in 2013. Italy saw a decline from about 7 per cent to 5 per cent, whereas in most other countries it remained relatively stable.

Darvas et al. (2014: 15-27) present a more detailed account of the composition of expenditure side consolidation measures by main expenditure category and function from 2009 to 2013. Obviously, capital expenditure was the most widespread and largest component of consolidation measures, but compensation of employees and other current primary spending – as well as in some cases social spending – were also substantially affected.¹ According to Barbiero and Darvas (2014: 5) the cuts in public investment in the periphery until 2011 strongly affected all kinds of public investment, but they were relatively strongest in investment in defense, housing and community amenities, health, general public services as well as environment protection.

Figure 3: General government gross fixed capital formation (ESA 2010) in the Euro area, the European Periphery and selected countries in per cent of GDP, 1999-2013

The development of gross public investment in relation to GDP showed a similar pattern (see figure 3): It almost halved from more than 4 per cent before the crisis to only 2.2 per cent of GDP in 2013 in the European periphery. Net public investment, i.e.

¹ See Darvas et al. (2014) for an analysis of austerity's effect on poverty and social hardship.
gross investment minus depreciation, decreased from about 2 per cent of GDP to a negative -0.6 per cent of GDP – the net public capital stock in the periphery was shrinking. For the Euro area as a whole and for Germany net public investment was zero in 2013.

Figure 4: General government net fixed capital formation (ESA 2010) in the Euro area, the European Periphery and selected countries in per cent of GDP, 1999-2013

Source: European Commission (2014a); author’s calculations.

Figure 5: General government real gross fixed capital formation (SNA 2008) in the Euro area and selected countries (2007 = 100), 2007-2013

Source: OECD (2014); author’s calculations.
It is sometimes argued that the development of investment ratios in relation to GDP may exaggerate the decline in public investment over time or in international comparison. If the deflator of public investment grows more slowly than the GDP deflator then the real (relative) decline of public investment may be substantially smaller than suggested by the nominal investment ratio (see for example Ragnitz et al. 2013: 97-99). As much of public investment is construction investment and the prices in that sector came under severe pressure after the bursting of the real estate bubble and the sharp decline in government orders, particularly in the periphery, this argument seems plausible. However, the available OECD (2014) data for the development of real public gross fixed capital formation for Ireland and Greece show that there was, in fact, a sharp fall in the level of real public investment (see figure 5). In Greece the fall was almost in line with the fall in real GDP since 2008, in Ireland it was even much stronger. Therefore, there can be no doubt, that austerity policies in the Euro area have negatively affected public investment in a disproportionately strong manner.