The FRENCH CORRECTION

Showing why EUROPEAN GOVERNMENTS need a NEW APPROACH to AUSTERITY

For several years now, European governments have tried versions of austerity in an attempt to reduce the ratio of government debt to national income and in the hope of reviving the continent's failing economies.

But most of them, says VERONIQUE de RUGY, have failed. Indeed many believe these policies have actually made things far worse. Take France, for example…

For months, the French economy has been stalled or shrinking.

Its debt to GDP ratio is growing and has now reached 90 per cent. The country's unemployment rate is well above 10 per cent, and a large number of rich and younger
French people are leaving, seeking jobs or a more hospitable environment abroad.

More ominously, Reuters cited a recent OECD report which warned that France is "falling behind southern European countries that have cut labor costs and become leaner and meaner".

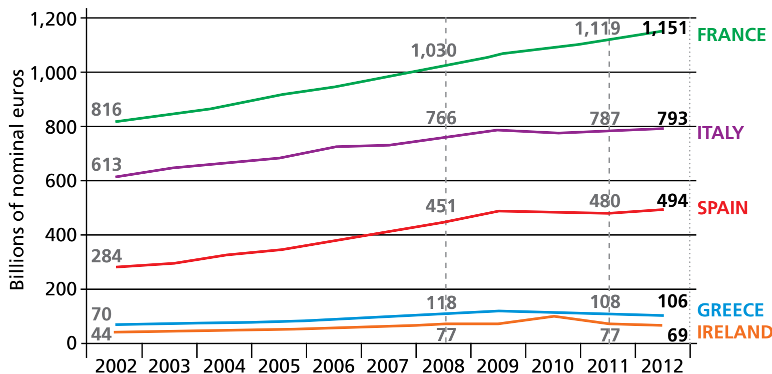
In fact, the whole mess led to Standard & Poor's decision to downgrade France to an AA+ bond rating, a move that outraged *New York Times* columnist Paul Krugman who seems to think that the downgrade has nothing to do with the country's economic health and is a plot against France for President Francois Hollande's refusal to pursue austerity measures and cut spending (a promise he made during his presidential campaign). Among other things, Krugman is well-known as an anti-austerity crusader who predicted a few years back that "Austrians" pushing for fiscal retrenchment would destroy Europe.

What type of austerity?

Unfortunately, the debate over the merits of austerity (the implementation of debt-reduction packages) has been a very frustrating one for two main reasons. Firstly, the word itself is confusing because it means different things to different people. That is because, in theory, a country can reduce its debt by increasing taxes, by cutting spending or by doing a mixture of both. What makes this more confusing is that not all policies meant to reduce the deficit and debt qualify as austerity measures. For example, policies that cut taxes can be growth inducing and lead to lower deficits because of their supply-side effects and therefore might have support from some supply-siders, as well as Keynesians.

The word austerity therefore causes a lot of misunderstanding on both sides of the political aisle. On the free-market side, people will say: "Where is the austerity in Europe?" when what they mean is "Spending wasn't cut very much in Europe, and often it wasn't cut at all". Their opponents will respond: "It is not true, austerity was implemented in Europe" while pointing to data about the size of fiscal-adjustment packages in Europe as a share of GDP.

Figure 1: Total government spending in selected euro zone countries



Source: Eurostat via European Commission. Accessed on May 1, 2013.
Note: Expenditure data accounts for all levels of government.

THE "BEST BUY" WHEN IT COMES TO DEBT REDUCTION IS STRUCTURAL REFORM COMBINED WITH SPENDING CUTS…INSTEAD IN EUROPE WE HAVE POLICIES THAT NEITHER SUPPLY SIDERS NOR KEYNESIANS WOULD RECOMMEND

In a sense, both sides are right, but are looking at the problem differently. Supply-siders want austerity in terms of government spending cuts and not tax increases (public-sector austerity rather than private-sector austerity) and Keynesians want neither.

Though austerity has taken place in Europe, with some rare exceptions the form of austerity has been to increase taxes and has not involved large spending cuts (*see figure1*).

In Greece, where there have been spending cuts and large tax increases, there was little chance that austerity, no matter what form it took, would work given that the country should have (or would have) defaulted if it were not for the numerous bailouts it has received over the last few years.

What does the research say?

This distinction between spending-cut austerity and tax-based austerity matters tremendously for the quality of this debate. That is because, as the large volume of work on fiscal adjustments by Harvard University economist Alberto Alesina suggests, when pursuing austerity, the important question has less to do with the size of the austerity package than the type of austerity measures implemented.

In fact, this is one of the rare areas of consensus in the academic literature: historically fiscal adjustments based more heavily on spending cuts are much more likely to achieve successful and lasting reductions in the debt-to-GDP ratio than tax rises. In their influential 2009 paper, Alesina and Silvia Ardagna looked at 107 examples in developed countries over 30 years and found that successful austerity packages – defined by a reduction in debt to GDP greater than 4.5 per cent after three years – resulted from making spending cuts without tax increases. This research is consistent with the work of economists at the IMF.

In 2010, Andrew Biggs, Kevin Hassett and Matthew Jensen of the American Enterprise Institute looked at how successful different kinds of spending cuts are at reducing the debt ratio. Consistent with other studies, they find that successful fiscal consolidations focus spending cuts in two areas: social transfers

(which largely means entitlements in the American context), and the government wage bill (which means the size and pay of the public-sector workforce).

This should make intuitive sense to policy makers since austerity based on spending cuts signals that a country is serious about getting its fiscal house in order in a way that increasing taxes and continuing spending does not. Sadly, in a time of crisis (indeed especially in a time of crisis), lawmakers tend to adopt policies for the sake of politics rather than good policy. Countries in fiscal trouble generally got there through years of catering to interest groups and pro-spending constituencies (on both sides of the political divide) and their fiscal adjustments tend to make too many of these same mistakes. As a result, failed fiscal consolidations are more the rule than the exception.

The second source of frustration in this debate is that we tend to lump together the impact of fiscal adjustments on a country's debt and its impact on short-term growth. Yet these effects are very different and should be looked at separately.

Research shows that, while spending cuts will effectively reduce a country's debt, they can also lead to greater economic growth in the short term – though they do not necessarily do so. Alesina's work has shown that, in the past, austerity pursued through spending cuts accompanied by measures such as an appropriate monetary policy, liberalisation of goods and labour markets and other structural reforms is more likely to be associated with economic expansions rather than with recessions. Even Keynesian academics such as economist David Romer have admitted that possibility.

One leading paper in the austerity debate usually cited to show that spending cuts do not lead to economic growth is by IMF economists Jaime Guajardo, Daniel Leigh and Andrea Pescatori. But even this paper also shows that, whilst spending cuts can hurt the economy in the short run, they do not hurt the economy as much as tax increases.

These findings are consistent with the work that looks at the most recent attempts at austerity. The new work of Heritage Foundation economist Salim Furth looks at the data from the most recent episodes of fiscal adjustment, mostly in the USA and in Europe. He too finds very compelling evidence that raising taxes is not the way to go.

Supply-side only?

So, if the strongest research for the Keynesian case were accepted, it might lead to short-term concerns about growth if austerity were pursued through spending cuts. Does this mean a country should not try to reduce its debt by spending cuts and shouldn't engage in structural reforms designed to rein in its future debt by raising national income? I don't think so.

In fact, there is a strong case to be made that cutting spending and reforming a country's fundamental structural problems should be done independently of the impact on short-term growth, mostly because the alternative of doing nothing and letting long-term problems continue is not acceptable and will bring much more harm.

Indeed, if we look beyond the short term, spending cuts will tend to lead to more growth. In a recent paper co-authored with Harvard University's economist Robert Barro we look at the five-year impact of cuts to defence spending and we find that for each dollar cut the economy will grow by $1.30. Unfortunately, austerity critics refuse to acknowledge this point or even discuss it.

Worst buy debt reduction policies

In light of these findings we should not be surprised about the sad state of the French economy.

In a recent paper for the Heritage Foundation, I looked at the policies implemented by the French government since the crisis started in 2007. The data show that under both Presidents Nicolas Sarkozy and Francois Hollande "austerity" mostly took the form of spending increases and severe tax hikes.

Specifically the tax increases detailed in the case study (*below left*) are notable, taking account also of plans up to the end of 2014.

The bottom line is that French austerity is a case study of how to increase a country's debt and trigger a recession. ising taxes, raising spending and not reducing regulation is the "worst buy" policy when it comes to dealing with high levels of government debt.

Best-buy debt reduction policies

Knowing what to do to get governments out of debt and economies towards higher growth does not mean that it will be easy. European countries have the added problem that they cannot set their own monetary policy to ease some of the pain of cutting spending (for better or worse). France and many other euro zone countries also have a serious banking system problem, which is made worse by the fear of contagion from country to country and this is quite paralysing.

Yet, doing nothing is not an option. As such, I would like to see a debate over austerity that unbundles the type of austerity that has taken place and that separates the impact of austerity on debt levels and its impact on growth. Hopefully that will encourage countries to implement austerity packages that actually help their economies rather than hurt them.

The "best buy" when it comes to debt reduction is structural reform combined with spending cuts and, if at all possible, tax cuts. Instead in Europe we have policies of tax increases and, often, government spending increases that neither supply siders nor Keynesians would recommend.

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FRENCH AUSTERITY: A case study

- **Between 2007 and the end of 2012, taxpayers were subjected to 205 separate increases in their tax burden.**
- **The marginal income tax rate rose from 40 to 41 per cent in 2010 and again to 45 per cent in 2012.**
- **Though Hollande's proposed 75 per cent tax rate on personal income above €1 million was struck down by the Constitutional Council, this will be revived in 2014.**
- **Value Added Tax (VAT), which has been stable at 19.6 per cent since 2007, is scheduled to increase in 2014.**