The Politics of Austerity

The debate over austerity – whether by cutting public spending, raising taxes, or both – has dominated European economic policy circles since the continent's sovereign debt crisis began at the end of 2009. For its proponents, fiscal consolidation is the only way to restore business confidence, thus creating incentives for further investment and therefore also growth. For its opponents, austerity is only going to make matters worse; governments should consolidate their finances, but now is not the time take even more demand out of the economy.

This debate is not completely foreign to what is going on in the United States. The implications are nevertheless very different because the European Union is not one country but (now) twenty-eight. Some European governments have embraced austerity with enthusiasm; others complain that austerity is being forced upon them either by European institutions or by other governments (like Germany).

This brief provides a survey of the austerity debate in Europe and suggests how events are likely to unfold. The first section of the brief sketches a background of Europe's present economic challenges and how austerity is meant to address them. The second section examines the case for austerity in the domestic context, highlighting those countries which have been relatively aggressive in making voluntary public sector cutbacks. The third section delves into the politics of imposing austerity abroad, discussing how the pro-austerity coalition came to dominate the policy response to economic crisis in the European periphery. The fourth section then turns to the recent weakening of the pro-austerity coalition while the fifth and concluding section offers an outlook for the future.

A Primer on European Austerity

"Austerity" describes a host of related policies aimed at improving the government's finances. Chiefly, it involves the shrinking of public sector employment, the reduction of pay and benefits offered to public sector employees, the privatization of state-owned entities, and the reduction of government services. The central intent of such policies is to reduce government spending, pay down public debt, and restore confidence in a country's financial stability. This lowers interest rates for both the sovereign and for domestic borrowers and so makes it more likely that firms will invest.

The case for fiscal retrenchment in Europe today stems from the upward spiral of sovereign debt which began during the global financial crisis of 2007-08. The steep cost

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of bailing out domestic financial institutions during the acute phase of the crisis and the subsequent slowing of growth, combined with the cost of automatic stabilizers such as unemployment insurance have conspired to damage European countries' debt dynamics. In other words, government spending rose faster than economic growth, causing debt as a percentage of national income to rise. Debt across the 27 (now 28) EU member states rose from 69 percent to over 95 percent between 2007 and 2011. Even Germany, the only AAA-rated economy in Europe with a stable outlook, saw its debt burden rise to nearly 25 percent of GDP during this period.[1]

For some countries, fiscal retrenchment was seen by domestic political parties as necessary for combating the increase in debt and restoring economic confidence. This idea carries weight not only in Germany, but also in the Netherlands, Austria, the United Kingdom, and Finland. British and Finnish conservative parties gained power by campaigning on the idea that the government needed to shrink in order to give the private sector room to grow. These ideas are not shared by everyone. Other countries, such as France, have been more ambivalent. Rather than embracing austerity, they have inched toward fiscal consolidation while at the same time seeking to persuade credit rating agencies not to lower their creditworthiness and institutional investors to keep buying French government bonds (and thus hold down sovereign borrowing costs).

Not every government has the same liberty to choose between austerity and its alternatives. The sharpest austerity programs in Europe today are in countries which have little choice in the matter: Greece, Ireland, Portugal, Spain, and Italy. Some of these countries have been compelled to make cutbacks because they already carried relatively large debt burdens when the financial crisis struck. Others suffered major private sector malfunctions which eventually cost national governments dearly.

On one end of the spectrum are Greece and arguably Italy, where government debt has long stood at over 100 percent of GDP. It is worth noting that the Greek and Italian tendency toward profligacy is overstated: Greek government debt grew modestly from 103 to 107 percent of GDP between 2000 and 2007 while the Italian sovereign debt burden declined from 108 to 103 percent over the same period.[2] Despite this relative stability, sovereign debt markets began paying attention to more indebted countries once growth began to slow in 2008-09. Greece was the first country to come under increased scrutiny in late 2009 when the newly-elected government revised the country's 2008 and 2009 deficits upwards.[3] Italy, by contrast, was among the last of the peripheral European economies to come under market pressure in 2011. There, borrowing costs rose only once it became evident that then-Prime Minister Silvio Berlusconi was incapable of pursuing economic reforms.[4]

On the other end of the spectrum are Ireland and Spain, where sovereign debt stood at only 25 and 36 percent of GDP as late as 2007. The problem in both countries was with hyperactive banking sectors: the Irish financial sector on the eve of the financial crisis was the most oversized in Europe, with non-derivative assets held by Irish banks amounting to nearly 1600 percent of GDP. In Spain, the smaller Caja banks collaborated

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with local government to fund dubious infrastructure and housing programs. Between 2001 and 2007, the Irish and Spanish banking sectors expanded by 740 and 146 percent of GDP respectively. When the global financial crisis struck, governments in both countries were forced to support these overextended banks – costing approximately €40 billion euros to each government.[5]

Despite their differences, each of these countries shares something in common: they were all major recipients of capital during the early 2000s. When the global financial system seized up in 2007-08, these inward infusions of capital disappeared. The core problem in each country, irrespective of whether the capital was being directed toward the government or private sector, was this "sudden stop" of previously abundant capital flows.[6]

To some observers, the sudden stop was only problematic because it cut off funds to overindulgent borrowers. To others, the sudden stop was dangerous because it caused growth to slacken. To still others, the sudden stop reflected a fundamental deficiency in European financial and monetary integration. Each of these alternate perspectives naturally leads to different policy prescriptions. Austerity, with its focus on government spending, is the policy choice of those who see Europe's present dilemma through the lens of excessive borrowing.

Home-Grown Austerity

Early on in the European sovereign debt crisis, austerity was seen by a variety of domestic political constituencies as the best means of dealing with the crisis. Germany has led the way in this regard, with the center-right coalition of Christian Democrats (CDU/CSU) and Liberals (FDP) presenting a 2011 budget package which aims to shave nearly $100 billion from government spending between 2011 and 2015. That package calls for a cull of 10,000 state jobs, a major reduction in the size of the German military, the scaling back of jobless benefits, and tax hikes on financial transactions, electricity, and airline tickets.[7] These cuts were pursued despite Germany's relative economic stability – and over the objections of countries like the United States, which argue that the German government should use its economic strength to boost European (and therefore also global) demand.[8]

Though austerity may be most closely associated with Germany, enthusiasm for austerity is not confined to the Germans. In Britain, for instance, the Conservative party argued that its 2010 victory represented a loss for "high-spending, all-controlling, heavy-handed … statism." By cutting back on the state, the Tories argued, they could avoid high interest rates, the loss of Britain's AAA rating, and ultimately pave the way for a private-sector-led recovery.[9] A similar argument carried the day in Finland's 2011 election, which saw the conservative National Coalition Party take the head of a new governing coalition, promising to pursue an agenda of fiscal retrenchment despite the country's relatively low level of debt. Until 2013, the Dutch and Austrian governments had also implemented fiscal cutbacks without much external pressure to do so.

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Financial markets have also stoked austerity programs in European countries where there would otherwise be little home-grown pressure to follow the German example. In countries like France or Italy, the fear of credit downgrades and higher interest rates on government borrowing has driven austerity-minded policies. France haltingly moved toward the implementation of austerity budgets in 2011-12 in an (unsuccessful) effort to protect its AAA credit rating.[10] In Italy, Berlusconi was deposed as part of an effort to bring down interest rates on Italian sovereign debt.

Compelling Austerity Abroad

The sharpest austerity programs in Europe, however, have not resulted from domestic support or even market pressure. In the most vulnerable of European economies, the impetus for austerity has come from other European member states.

The most important and consistent supporter of austerity throughout the euro zone has been Germany's government under Chancellor Angela Merkel. Germany, together with center-right governments in the Netherlands and Finland, constitute the hard core of the pro-austerity group in the euro zone. This coalition has pressed for debt problems in Greece, Ireland, Portugal, Spain, Italy, and Cyprus to be resolved through domestic cutbacks rather than through Keynesian stimulus or the use of communal debt instruments. The periphery's need for external funding has given Germany and its allies significant leverage over domestic policies.

Significant domestic constituencies in these hard-core countries view the sovereign debt crisis through the lens of irresponsibility. Germany, Finland, and the Netherlands – three of the four remaining AAA-rated euro zone economies (the fourth is Luxembourg) – tend to set themselves apart from the euro zone periphery in moralistic terms. Merkel has drawn fire for stating that the Greeks' problem is that they "get lots of vacation time," clearly suggesting that the problem in the European periphery is laziness.[11] The same sorts of rhetoric are on display in Finland and the Netherlands: Finns are prone to describing sovereign debt crises in terms of "moral decay," and Dutch newspapers lament the "wasteful Greeks," with opinion polls reflecting a desire to kick Greece out of the euro zone.[12]

Indeed, the center-right parties in power in these three countries have struck a moderate tone relative to certain domestic political voices. Finland and the Netherlands, in particular, are home to large nationalist parties which have resisted efforts to offer financial assistance to the European periphery. The True Finn party in Finland grew to become the third-largest party in Parliament on the back of opposition to European bailouts. Geert Wilders' Dutch Party for Freedom (PVV) remains the third-largest party in the Netherlands despite a decline in support during the 2012 parliamentary elections. This sort of nationalist opposition has tended to push the governments of Europe's most fiscally stable economies to attach strict conditions to any assistance offered.

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From a technical standpoint, the pro-austerity coalition argued that the problem in the European periphery was that “the handling of the excessive deficit procedure [was] not sufficiently regulated.”[13] The three key policy responses to the crisis have been rooted in this belief: the formation of the European Stability Mechanism (ESM) to offer strictly conditional bailouts to stricken countries, the crafting of an EU-level set of rules to reassert the excessive deficit procedure, and the so-called “fiscal compact” treaty.

The ESM, formed out of the temporary European Financial Stability Facility (EFSF) and European Financial Stability Mechanism (EFSM), was created in order to deal with emergent situations. It raises funds on the open market, secured by both the EU budget and by capital provided by euro zone members, to loan to economies that are no longer able to raise capital on their own. However, these funds are offered only in exchange for the promise of steep cuts in public spending. Greece, Ireland, Portugal, and Cyprus have all received funds in exchange for a commitment to making specific policy adjustments.

Whereas the ESM aimed to bail out countries experiencing acute financing difficulties, the EU’s longer-term strategy, encapsulated in the “six-pack” and “two-pack” of EU reforms, focuses on strengthening the Union’s macroeconomic surveillance and discipline regimes. The new rules reaffirm the EU commitment not only to preventing excessive deficits, but also to lowering overall debt burdens and limiting macroeconomic imbalances. They do so by codifying the penalties for countries carrying more than 60 percent of GDP in debt or exceeding set tolerance levels for a collection of economic variables. The revised rules also intensify multilateral economic surveillance, compelling member states to consult with the European Commission and Council on the formation of short- and medium-term budgets. For countries receiving ESM funds, surveillance is more intense: in those cases, the EU is given a major role in crafting domestic economic policies.

Finally, the Treaty on Stability, Coordination, and Governance (TSCG), often known as the “fiscal compact,” constitutes a further attempt to codify austerity policies as national law. The treaty committed signatories to fiscal rectitude by asking them to write a balanced budget rule into their constitutions. The treaty, though largely duplicating the content of the EU’s six-pack, adds a requirement that countries run no more than a 1 percent structural deficit at any time. This ceiling drops to 0.5 percent if the country in question has a relatively large debt burden.

As successful as the pro-austerity coalition has been in pursuing its positive agenda, it has been equally successful at opposing alternative strategies. Early on in the crisis, European leaders ruled out stimulus altogether: The December 2009 Council’s conclusions committed member states to “exiting … broad-based stimulus policies” and called for fiscal consolidation in 2011 “at the latest.”[14] The pro-austerity camp has also strenuously opposed any attempt to create a communal debt instrument, arguing that this would turn the EU into “a debt union and not a stability union.”[15]

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The Limits of Austerity

Austerity has dominated European economic policymaking since 2009 despite widespread opposition. In the countries subject to ESM agreements, austerity protests are widespread – as is resentment of Germany's role as the "austerity dictator."[16] Yet these protests have thus far not resulted in a clear revolt against Germany's favored policies. In Spring 2011, Greek protests failed to stop George Papandreou's government from signing up for more cuts in exchange for a second bailout. When Papandreou suggested that further cuts be put to a referendum, he was forced to resign in favor of a technocratic government with a mandate to continue pursuing economic reforms. Since 2009, there have been similarly futile demonstrations and/or breakdowns of ruling coalitions in Portugal, Spain, and Ireland.

Hostility to budget cutbacks was never confined to the European periphery; even countries with pro-austerity conservative governments are also home to parties and interest groups opposed to government policy. For instance, Germany's center-left Social Democratic Party (SPD) – while not advocating a clean break from austerity – has suggested that growth must be prioritized.[17] Anti-austerity protests have struck in virtually every European country, including Germany.[18]

However, the opposition to austerity has significantly strengthened since 2012. An effort to pass new austerity measures brought down the Dutch government led by the Liberal Party's Mark Rutte early that year. Rutte was returned to power in the subsequent election, but by early 2013, he indicated that he was willing to break with Germany by reevaluating further public cutbacks. Though Finnish Prime Minister Jyrki Katainan has threatened another round of austerity measures, junior ministers have threatened to push for greater stimulus and local business leaders have expressed skepticism toward continuing with fiscal consolidation. Austria, a traditional member of the pro-austerity bloc, has also opened a discussion of outright stimulus.[19]

Most notably, Germany has softened its line amid increasing international isolation. At July's meeting of the G-20, Merkel found virtually no support for her country's continued advocacy of public cuts.[20] She has grown openly frustrated with the perception of Germany as the bad guy, arguing that the term "austerity" made balancing the budget "sound like something truly evil."[21] While not backing down from the wider commitment to austerity, Merkel's finance minister, Wolfgang Schaeuble, indicated that Germany would concede the need to allow countries more flexibility to implement budget cutbacks.[22]

Outlook

Although support for austerity has softened, this trend should not be overstated. The president of the European Commission, Manuel Barroso, stated in April 2013 that though he thought austerity was "fundamentally right," he also believed it had "reached its limits."[23] French Finance Minister Pierre Moscovici declared, "We're witnessing the end

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of the dogma of austerity."[24] These statements undoubtedly go one step too far. Austerity remains well-entrenched as the status quo across Europe. Ultimately, whether or not austerity continues to dominate European economic policy rests on two fundamental questions: First, does austerity actually work as its proponents believe it does? And second, is there really any alternative?

Austerity measures have generated few results, fueling opposition to those policies. Those countries which have pursued austerity most aggressively have little to show for it: Finland has slipped into a triple-dip recession, and Britain only narrowly avoided the same fate. Aside from Germany, each of the euro zone's remaining AAA-rated sovereigns has been put on a negative watch despite their attempts to rein in state spending. Even Italy saw its debt-to-GDP ratio rise in 2012 due to the continued economic contraction.[25] Ultimately, debt in the European periphery continues to spiral upward despite years of painful spending cuts. To economists like Larry Summers and Paul Krugman, these facts prove that austerity measures hurt rather than help wounded economies by cutting nominal debt at the expense of growth.[26]

The only country where austerity seems to be working is Germany. However, this may be because Germany's domestic cuts have been softened by offsetting stimulus that other countries lack the leeway to duplicate: the 2012 budget included some funding for infrastructure spending, increased the state's stake in EADS, subsidized childcare, provided funds to those impacted by military base closures, and implemented modest tax cuts.[27]

While the evidence for the efficacy of austerity is limited to nonexistent, there is a subtler reason to believe austerity-minded policies will continue: There may be no viable alternative. When a former IMF official criticized Ireland's strict austerity measures in mid-2013, Irish Finance Minister Brian Hayes reacted by pointing to the country's utter lack of options: "People are pretending there is some alternative to this fiscal correction," he argued. "There isn't."[28] Belgium, Ireland, Greece, France, Italy, Cyprus, Portugal, and the United Kingdom have each carried national debt burdens greater than 100 percent of GDP since 2011. For these countries, stimulus is likely to prove impossible: For countries receiving ESM funds, any stimulus would require the approval of European creditor countries. For France, Belgium, and Britain, any stimulus spending would risk their credit ratings further, potentially stoking an increase in borrowing costs.

In the end, the lack of alternatives is the operating constraint on European economies. Even if all parties agree that a return to growth is more important than cutting deficits and debts, kick-starting growth in an already high-debt environment is likely to prove difficult. Germany, the only country with the leeway to spend more, remains adamantly committed to the idea of consolidation or – at best – restrained stimulus. The French idea of stoking growth through extra funding for infrastructure through the European Investment Bank is potentially valuable but relatively small-scale.

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The dynamic for the foreseeable future is therefore likely to be highly uncertain: The will to continue with the status quo has eroded yet no competing idea has emerged to replace it. In the medium term, this may tempt countries to attempt more radical – and potentially unilateral – alternatives in order to restart their domestic economies.

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