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Austerity and the alternatives

Briefing #1: The failure of austerity

OCTOBER 2013

Austerity and crisis in Europe

High time to change course

Latest figures suggest that the worst of the recession could be past for the European economy. However, it remains to be seen whether a full-blown recovery is under way. While the European Commission has shown some flexibility in its approach to deficit reduction for some countries, austerity remains firmly the order of the day. In a speech in Vilnius on 13 September, Economic and Financial Affairs Commissioner Olli Rehn argued for the need to "stay the course of reform", and so we can expect more austerity and more labour market "reforms".

It is all the more important, therefore, to remind ourselves that austerity hasn't worked. That not only has austerity not delivered an economic turnaround but that it has not even delivered on the central aim of reducing government deficits as a proportion of economic output (GDP).

EPSU has asked ETUC economic advisor Ronald Janssen to put together a series of briefings examining the main arguments around austerity, the role of the financial markets, the links between wages and productivity, the bail-out and proposed regulation of the banking sector and question of labour market reform. This first briefing focuses on how austerity has failed.

Since the beginning of the crisis EPSU has been consistent in calling for measures to boost the European economy. It argued for real wage growth to maintain demand and increased public investment to support obs and the long-term competitiveness of the European economy. For more on EPSU's policy see page 14.

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Introduction

The policy course of austerity which Europe embarked in the aftermath of the 2009 financial crisis is disastrous. It has pushed Europe's economies back into a new recession, a recession that started at the end of 2010 and which has continued for six quarters in a row. It has destroyed jobs, with employment in Europe falling by one million over the past six months.

The sad truth is that 26 million Europeans are now without a job, 10 million more than at the start of the crisis. Long- term unemployment is increasing and youngsters are hit very hard. Precarious jobs, poverty and inequalities are increasing sharply.

The news over the summer indicated that economic activity seemed to be stabilising, however, the crucial question remains whether this will be followed by a recovery that is intense enough to sustain itself or whether economies will instead continue to 'bump along the bottom'.

Confronted with outcomes such as these, the least one could expect is that those who are responsible for these policies would take a step back and reconsider their course of action.

This, unfortunately, is not happening. Under the leadership of the European Central Bank and with the full support of the corporate lobby of European business, the basic policy message coming from European policy makers is to "stay with the policy course" (for one example see here: http://blogs.ec.europa.eu/rehn/recovery-is-within-reach/).

The only thing that is taking place is that the original argument for fiscal austerity is getting tweaked a bit. Faced with the fact that several member states (despite massive cuts in expenditure) failed to reach the 3% deficit criterion in 2013 anyway, the Commission had little choice but to the extend deadlines by one two years. However, in return for this flexibility, the Commission is expecting member states to do two things.

First, they need to undertake new rounds of austerity measures, with the Commission defining a precise amount of structural fiscal consolidation that is still highly ambitious.

Secondly, member states have to intensify structural reforms to improve competitiveness, with 'structural reforms' mostly being a code for a radical deregulation of labour market institutions that protect workers' rights and promote fair wages. This is adding insult to injury. Fiscal austerity is already damaging enough. Complementing this with a downwards spiral of competitive dumping across Europe by devaluing wages and undermining wage formation institutions will only make matters worse.

However, the 'austerians' are unshakable in their beliefs. In their view, their policies are bearing fruit and are returning growth to the economy and confidence to financial markets. In their view, the social outcomes may be dismal but they are a necessary price to pay to restore competitiveness and access long-term economic benefits.

This series of briefings replies to several of the arguments used by the "austerians" to confuse the discussion and help them continue with their policies.

The second in the series will focus on the arguments that claim that all will be well because austerity, in some way or other, will restore 'confidence' and reassure financial markets.

The third and fourth briefings will delve deeper into the structural reform agenda and the twin fairy tales of workers being paid wages beyond productivity and the lack of sufficient labour supply.

The final briefing will document how banks and the corporate sector at large are being generously supported by policy while at the same time austerity is being imposed on the rest of us.

The conclusion from all of this is clear: Europe cannot continue on the road of austerity and social deregulation, Europe urgently needs to choose a different course.

The failure of austerity

Austerity without limits

The supporters of austerity claim that in practice its impact has been modest. People have hardly felt the measures, as the president of the European Council has repeatedly stated. Hence, since it is so modest, austerity can have no significant negative effects on the economy.

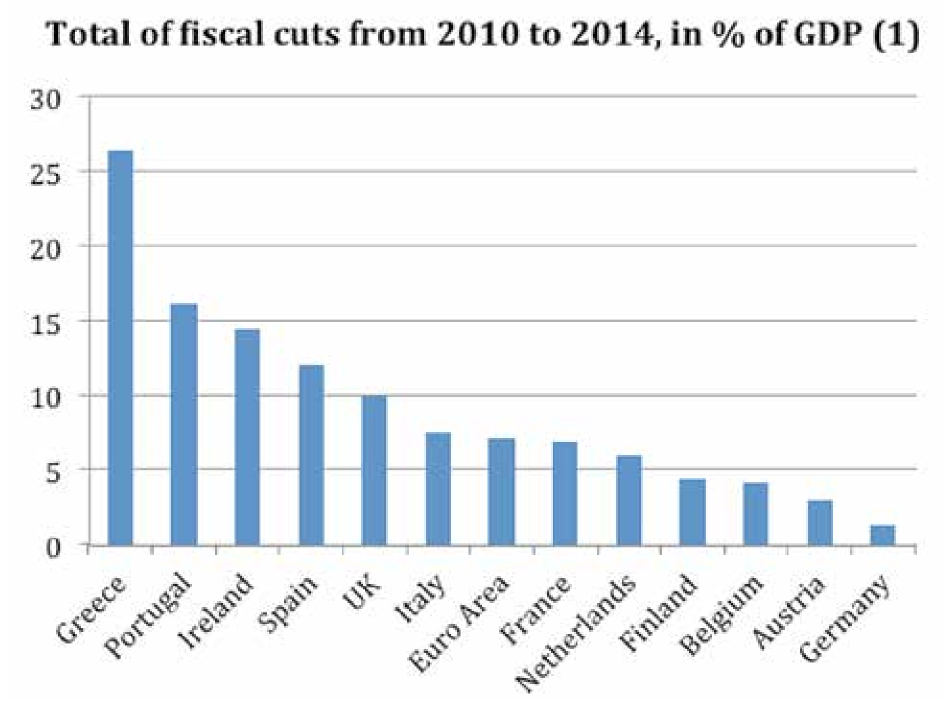
The reality is that austerity has had a massive negative impact on the European economy. In just the five years between 2009 and 2014, deficit cuts have amounted to 7% of GDP in the Euro Area alone. This represents €700 billion.

Moreover, at the level of individual member states, austerity has been pushed much further in a futile attempt to appease financial markets.

In Spain, Ireland and Portugal, austerity over this period has taken the equivalent of respectively 12%, 14% and 16% of GDP out of each economy. In the UK, a non-euro member state, the figure is 10%. The absolute austerity champion however is Greece, with the total value of consolidation programmes reaching a horrific 26% (one quarter!) of its GDP.

These numbers are historical records. They testify to the fact that what is going on in Europe is a doubtful experiment in which a policy of fiscal contraction is being applied on a massive scale and in a coordinated way across big parts of Europe.

Austerity has taken €700 billion out of the European economy



Source: IMK Report. Die Krise schwelt weiter. March 2013.
Note: 1 Change between 2009 and 2013 in government structural primary balance.

The economic and social price of austerity

The advocates of austerity claim it is working and that deficits in Europe have already fallen from 7% of GDP in 2010 to below 4% of GDP in 2012.

Considering the total amount of fiscal cuts that had to be made in order to reach this result, this can hardly be seen as a success. In effect, governments have had to cut expenditure and raise taxes to the tune of 7% of GDP to achieve this 3% deficit reduction for the Euro Area.

At the level of individual member states, the same phenomenon can be observed. While Portugal squeezed 16% of GDP out of its economy, the deficit there fell by only 5%. In Spain, a 12% fiscal contraction brought about a 3% fall in the deficit, while in Greece, the corresponding figures are 26% and 9%. In the UK, to reduce the deficit by 5%, cuts to the order of 10% of GDP had to be imposed.

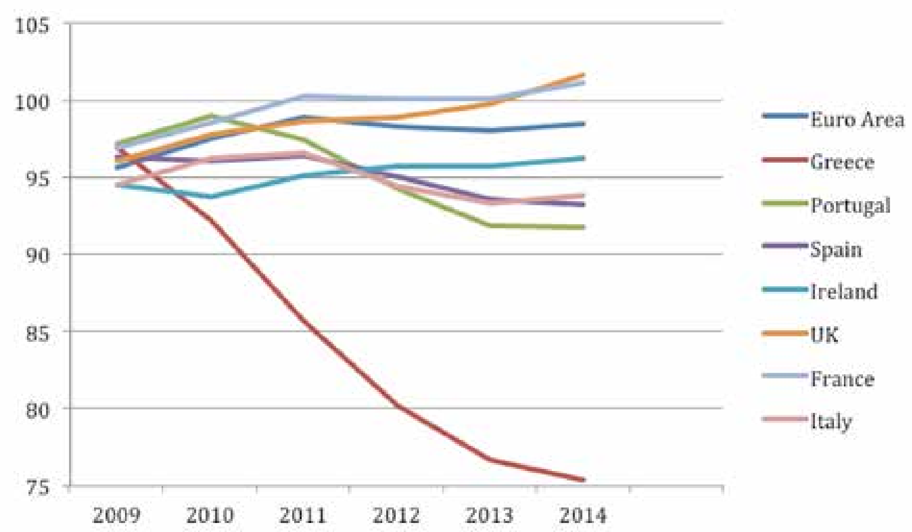
The reason for this is straightforward. If pushed too hard and particularly when economic activity is weak, deficit cuts bring about large falls in economic activity. However, a faltering economy means tax revenues fall while unemployment benefits go up. This pushes the deficit back up so that governments, if they want to stick to the initial deficit targets, have to go for a new round of austerity.

In the end, the price that Europe is paying for austerity is huge – a prolonged downturn of the economy with enormous job losses. Five years after the 2009 financial crisis, economic activity in the Euro Area will still be far below the pre-crisis level (see graph). In Spain, Portugal and Italy, activity in 2014 will be 8% to 10% below the pre-crisis level. Under the weight of austerity, the Greek economy has simply collapsed and economic activity has shrunk by a quarter since 2008 with unemployment exploding to 26% of the active population. In France and the UK, activity is due finally to catch up with its pre-crisis level in 2014 but this still represents half a decade of economic stagnation.

These are not results to boast about. Yes, the deficit has been reduced somewhat but the price paid is simply too high while the initial deficit targets have not been reached. Moreover, the same policies will produce the same results. If the strategy of austerity is continued and if additional cuts are made to reduce the deficit further from 4% to below 3% and then close to zero, there's actually still serious economic and social pain to come.

Five years on and economic activity in the Euro area is still below the pre-crisis level

Evolution of real GDP (2009 = 100)

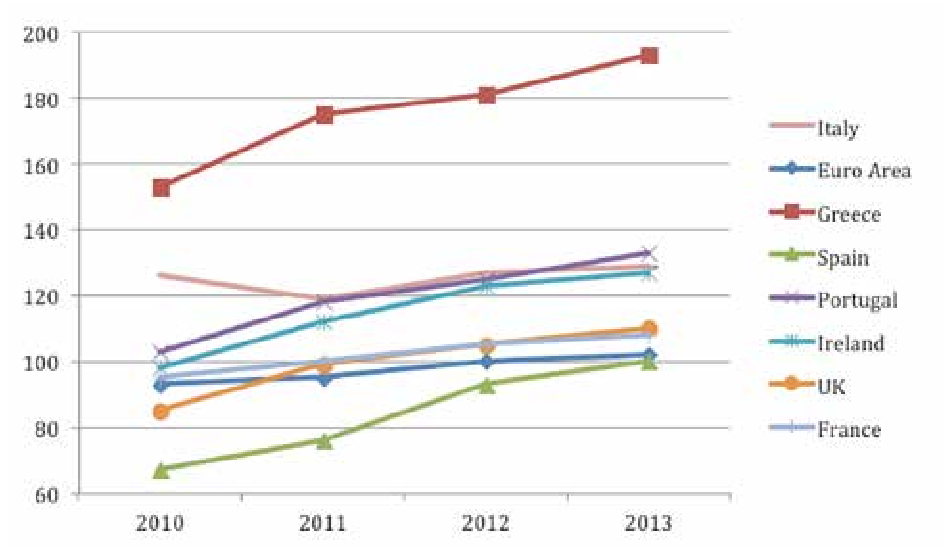


Self-defeating austerity

Their claim is that austerity is necessary to halt the trend increase in public debt and to lower public debt ratios.

When public debt ratios are concerned, the policy of austerity is completely self defeating. Despite (or rather exactly because of) massive austerity, public debts and public debt ratios have simply kept increasing. In the financially distressed economies where austerity has been massive (Greece, Spain, Ireland), public debts have exploded (see graph).

Public debt as a percentage of total output (GDP)



Source: Organisation for Economic Co-operation and Development

Massive doses of fiscal cuts lead to economic collapse

Austerity itself is to blame. The massive doses of fiscal cuts lead to economic collapse, not only in in real terms (activity and jobs) but also in nominal terms (lower inflation) with falling or stagnating nominal GDP in several economies as a result. However, since public debt is expressed as a ratio with nominal GDP in the denominator, this fall in nominal GDP immediately works to push public debt as a percentage of GDP back up. This 'denominator' effect of a falling nominal GDP has proven to be more powerful than the (limited) falls in deficit numbers in the nominator. The end result is a substantial increase in the public debt ratio.

The long term starts now

Their claim is that all of these setbacks are just temporary. Once structural deficits have been sufficiently brought down, cuts are no longer necessary so that growth can resume and can start pushing public debts back down.

The distinction economists tend to make between the long term and the short term is a theoretical construction. First, the 'short term' can take a very long time. In practice, the short term boils down to a half or even an entire decade. Second, an austerity induced collapse of the economy also impacts negatively on the potential for the economy to grow in future. The consequence is that, also in the long term, the expected positive effects of austerity do not materialise either or only in an insufficient way.

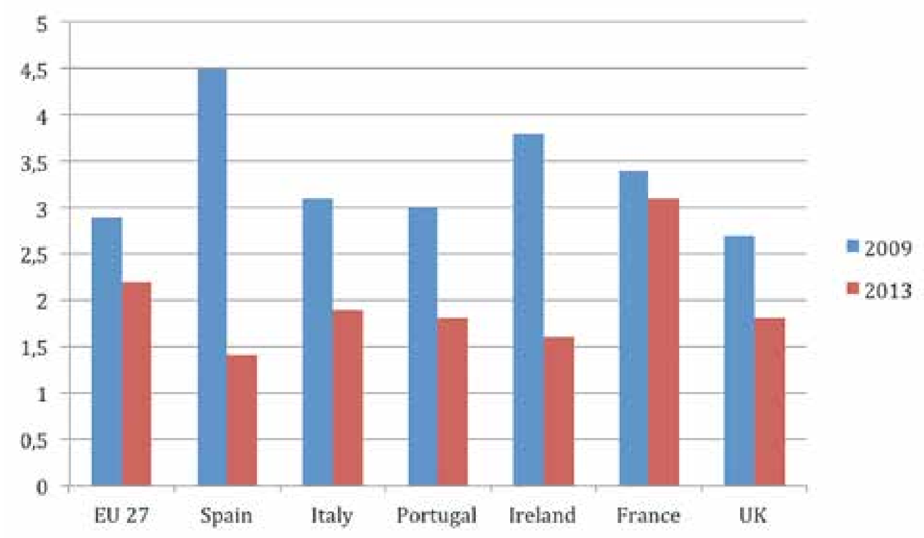
Different mechanisms are at work here: A prolonged recession increases the number of long term unemployed, resulting in a cohort of demotivated workers detached from the labour market ('human capital effect'). An enduring crisis also translates itself into an increase in the incidence of precarious contracts (agency work, fixed term work). This in turn tends to end up in employers discriminating against workers with a history of such contracts because these workers are being perceived as unable to hold to a steady job. Finally, recession means business and the public sector cut down on investment, thereby reducing the economy's stock of capital and holding back innovation.

One illustration is the damage austerity is inflicting through the channel of public investments. All across Europe, governments have slashed public investment in a desperate attempt to reach their deficit targets. Public spending on investment has collapsed, from 2,9% of GDP in Europe in 2009 to just 2,2% in 2013.And this is actually just the tip of the iceberg. These figures cover public material and infrastructure investment and don't reflect the fact that government expenditure on education and health has also been slashed.

How can the European austerians hope to build a future competitive economy with good growth performance on the basis of downgraded educational expenditure and the nation's investments in the future?

Even if public investment had been kept at just 2.9% of GDP it would be €90 billion higher today

Public investment as a percentage of total output (GDP)



EPSU POLICY

At the very beginning of the economic downturn EPSU highlighted the need for action in key areas to counteract the recession created by the financial crisis. In Executive Committee and Congress resolutions in 2009 it argued that:

- The root of crisis lay in financial sector and so could not be used to justify attacks on public sector and public sector workers;
- Need for increased investment in public services and infrastructure as part of recovery strategy;
- Financial system needs reform at global level with a financial transactions tax a key element;
- Sharing the burden fairly means fair and progressive taxation and action to deal with tax havens and tax evasion;
- European economic policy needs reform with changes to the Stability and Growth Pact and role of the European Central Bank with a voice for EPSU in the European economic debate;
- Maintaining the purchasing power of wages is an important factor in sustaining demand;
- Sustainable development needs to be part of long-term solutions to crisis;
- Need to challenge the idea that more privatization and liberalization and increase reliance on public-private partnerships are part of the solution.

Above all EPSU argued that major changes were need to the global economic and financial system and there shouldn't be a return to business as normal.

As austerity measures began to bite, in November 2009 the EPSU Executive Committee was underlining the fact that: "the public sector is central to the recovery with a continuing need for investment in public services and public infrastructure. Public services play a key role in protecting people from the worst effects of the recession and despite the first signs of growth, the predictions are that unemployment will rise over the coming months and that rather than cutbacks, increased support will be needed for some time to come. And rather than pay cuts and pay freezes, it is vital to maintain and improve real wages in order to boost demand as part of the strategy to get the European economy moving again."

Since then EPSU has continued to call for measures to boost the European economy and provide additional sources of income for public services particularly through a financial transactions tax (http://www.epsu.org/r/575) and through action to recoup the €1 trillion a year lost to tax fraud and tax havens (http://www.epsu.org/r/640).

European Federation of Public Service Unions (EPSU)
Rue Joseph II 40 bte 5
1000 Brussels
32 2 250 10 80 tel / 32 2 250 10 99 fax
epsu@epsu.org / www.epsu.org