Choosing the Best Policy Mix to Cure Europe's Stagnation

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A great number of European governments have decided on austerity policies to reduce their fiscal deficits and public debt. In order to evaluate such policies, it is necessary to analyze the present and past economic situation of European countries, and to recognize the important role that savings plays in understanding this economic situation and possible future developments. After examining the economic background of austerity policies and the role of savings, this article discusses the choice of different types of austerity policies and policy mixes.

The Economic Background of Austerity Policies

The current economic situation of most European countries is the outcome of long-run eurosclerosis and the recent financial crisis.

Eurosclerosis

Countries that suffer from eurosclerosis are those in which there has been a low rate of economic growth and a high rate of unemployment for the last several decades. For instance, in France the annual rate of growth has been slightly higher than 3 percent only five times since 1980. The rate of unemployment has been higher than 7 percent every year since 1982, and often close to 10 percent.

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Such a long-lasting situation may seem strange in a country with an open economy, a well-educated labor force, and entrepreneurial traditions. Only one possible explanation can be given to this state of affairs: misguided economic policies that prevent individuals from creating wealth. More precisely, high levels of taxation and a large welfare state, as well as innumerable regulations, especially in the labor market, have hampered efficient production and wealth creation.

The role of taxation is obvious: it destroys the incentives to work, innovate, save, and invest. Indeed, the higher the tax rate, the lower the propensity of taxpayers to create wealth. In a system where there is a high level of taxes, it is like telling entrepreneurs: "Invest, produce, and hire workers. If you fail, you are responsible and you lose the whole of what you have done. But if you are successful, the state will take the greatest part of the wealth you have created."

The present tax systems are introducing a bias in the choice between the future and the present. They are dissuading people from saving because of the multiplicity of taxes on capital and because the income tax and VAT are based not only on resources that are consumed but on resources that are saved—that is, reintroduced into the economic circuit. It is also well known that a pay-as-you-go pension system does not induce individuals to save as much as they would with a fully funded system. In sum, the tax and welfare systems should be considered as important brakes to growth, because there can be no growth without accumulation of capital.

Regulations also play a negative role by decreasing the flexibility of markets and introducing an additional degree of risk (since the state can add new and paralyzing regulations at any time and in a completely discretionary way). This is particularly noticeable in the labor markets. Thus, entrepreneurs become more reluctant to hire workers as it becomes more difficult to fire them whenever it is necessary or desired.

The Financial Crisis

It is in such a context that the 2008–09 financial crisis occurred, and it added a further cause of low—or even negative—growth and high unemployment. The mainstream explanation for that crisis stresses the fundamental instability of financial markets, the greed of traders and bankers, and the deregulation of the financial sector, but the true causes are quite the opposite (see Salin 2010). In fact, the main cause of the crisis has been the instability of monetary policy, especially in the United States (but also in Europe, Japan, and England). Interest rates have been very low and money creation very high in the beginning of the 21st century, inducing an artificial expansion of credit and malinvestment. The distortions introduced in the structure of prices and production called for a readjustment that came in the form of the financial crisis.

Of course, other causes contributed to the financial crisis. U.S. housing policy, which led to the subprime problem, played a major role, as did other misguided government decisions and practices. For instance, the role of the Federal Reserve in protecting banks deemed "too big to fail" encouraged risk-taking and leverage.

It is strange that for most commentators the only relevant debate was between Keynesians and monetarists. Within those limits, they considered that Keynesians gave the best explanation of the crisis and of the necessary policies to get out of it. But they mainly ignored the theory that best explained the crisis—namely, the Austrian theory of the business cycle. Contrary to the Keynesian approach—as well as the monetarist—the Austrian theory does not focus solely on aggregate demand; it stresses the importance of structural distortions. Monetary authorities lower interest rates by expanding money and credit in the absence of any voluntary increase in savings. As such, they induce changes in the allocation of factors of production and in the structure of production, as producers choose production processes of longer duration because of the low interest rates. This is important because it means that the real problems are structural problems, not problems related to the level of aggregate demand.

The Role of Savings

The common cause of both the eurosclerosis problem and the financial crisis is the lack of voluntary savings. Tax and welfare systems are discouraging savings in comparison to consumption, thus slowing down the accumulation of capital. Likewise, the lack of savings was the deep-rooted cause of the financial crisis. It is true that part of this lack of savings, which is particularly obvious in the United States, has been compensated for by borrowing from some emergent countries in which the rate of savings is very high (e.g., China). But this lack of savings may have also induced monetary authorities to engage in expansionary policies, thus creating conditions for malinvestment. In a world with abundant voluntary savings, there would be a more rapid accumulation of capital, therefore a higher rate of growth and no incentive to pursue expansionary monetary policies, therefore no business cycle. There is therefore a strong relation between the long-run situation and the business cycle, which also means that policy reforms aiming at restoring the propensity to save of individuals would both entail the end of the business cycle and bring about long-run prosperity.

It is paradoxical that people accept, without any rigorous analysis, the idea that whenever there is an economic crisis, governments must apply Keynesian solutions—namely, increase aggregate demand, especially consumption and public expenditures. In fact, we know from the Austrian theory of the business cycle that the problem to be solved is not a global problem (in terms of aggregate demand) but a structural problem, which, in fact, can be solved only by letting markets do the necessary adjustments in relative prices and production. Moreover, the roots of the financial and economic crisis are exactly the opposite of what Keynesians usually assume. According to Keynes, unemployment occurs for very specific reasons. He assumed that there was an excess of savings over investment. In such a case, according to traditional classical economics, the flexibility of interest rates would rebalance savings and investment: a decrease in interest rates would increase investment and decrease savings. But, according to Keynesians, such a market adjustment does not take place for very specific (and arbitrarily designed) reasons. They assume that investments become inelastic with respect to interest rates or that individuals keep "idle cash reserves" (i.e., they keep cash instead of investing it). However, there is no reason to believe that any rational human being might keep useless cash balances instead of spending them for present consumption or future consumption via the purchase of financial assets.

Unfortunately most governments did adopt Keynesian economic policies with the hope they might accelerate economic recovery after the financial and economic crisis. In France, President Sarkozy decided to borrow a huge amount of money and, later on, he asked the Council of Ministers and a special committee how to spend it. Imagine what would happen if a private entrepreneur borrowed a huge amount of money and then asked his staff how he should spend it! But these spending policies have had outcomes quite different from their intended consequences: huge deficits, debt crises, and no economic recovery. This is not surprising, since it is an illusion to believe that it is possible to increase aggregate demand at will, at least if one considers real demand and not nominal demand. Additional real public expenditures—financed by taxes or borrowing—are necessarily made at the expense of private expenditures. Moreover, there is a loss of efficiency when resources are shifted from those who had created them, and are responsible as owners of them, to politicians and bureaucrats who have a very limited responsibility and do not care much about a possible waste of resources. In fact, it may be considered that Keynesian recipes have only been a pretext to justify public deficits, which are always desired by governments because they make it possible to give voters present benefits, whereas the cost is shifted to the future.

The Debt Crisis and Austerity Policies

Unfortunately, this future is not far away and it is striking to see that, some months after having launched their huge spending policies, governments have difficulties in paying their debts, are afraid of the burden of the debt, and deem it necessary to adopt austerity policies.

When speaking of austerity, people have the feeling that one enters into a period in which the standard of living of individuals will decrease. In fact austerity just means a policy of reducing the government budget deficit. But the very name "austerity policy" implies a Keynesian-type policy. It is feared that the reduction of the budget deficit may decrease aggregate demand and, therefore, decrease production and incomes. Therefore, it would be preferable not to use the term "austerity policy" but to label it for what it is: "government budget deficit reducing policy."

Given the desirable nature of government budget deficits for Keynesians, why do they care about them and why should they adopt an "austerity policy"? In fact, they consider that there is a tradeoff between two consequences of budget deficits. The positive one, in their opinion, is the support of aggregate demand. The negative one is the fact that financial markets lose confidence in the capacity of the government to repay its debt and pay interest. In such a case, interest rates rise and the burden of the debt increases, which may push the government into a vicious circle of increases in debt and interest rates. Meanwhile, the national prestige may suffer if ratings agencies downgrade public debt. Governments also fear that they might lose independence in the design of their economic policies if they have to accept financing from the IMF or European institutions.

In the past, it was considered that the main tradeoff in designing economic policies was the one between unemployment and inflation made famous by the Phillips curve, until Milton Friedman demonstrated that such a tradeoff could exist only in the short run and that the long-run effects of an expansionary monetary policy were harmful. Now, the fashionable tradeoff is between recovery policy (via a government budget deficit) and a reduction in the budget deficit (to lower interest rates to finance the deficit and to preserve national independence). It is not surprising if there is a hot debate about austerity policies in many European countries because most policymakers are Keynesians, and this tradeoff is quite embarrassing for them. Many among them consider that it would be regrettable to "kill growth" by reducing the fiscal deficit in order to comply with the wants of the disliked financial sector.

There is also a contradiction in the present policies supported by Keynesians (and, therefore, most governments). They do not care about the fact that financing the budget deficit implies a shift of financing resources from private investment, because they implicitly and wrongly assume that there is an excess of savings over investment. But, if ever it was the case, why would it be necessary to implement an expansionary monetary policy? In fact, such a monetary policy is desired not because people believe that there are not enough cash balances, but because they feel that the corresponding credits, artificially created, make it possible to finance additional investments. But why should it be necessary to create these artificial savings if there is too much saving in the economy?

Which Austerity Policy and Policy Mix?

Following the financial and economic crisis, the policy mix adopted in many countries has been deficit spending and expansionary monetary policy. Unfortunately, as already stressed, the public deficit is unable to contribute to the economic recovery and it adds new distortions in the structure of production, because the goods and services demanded by the public sector are normally not the same as would have been demanded by the private sector. As for the expansionary monetary policy, it is only a destructive illusion that creates the risk of another business cycle in the future. Therefore, since the main problems are sectoral problems and not global problems, the best policy mix would have been to let markets make the necessary adjustments in the structures of production and the structures of prices, without money creation or budget deficits.

Unfortunately, after the instability introduced by expansionary monetary policies at the beginning of the 21st century, public authorities have now added a new source of instability created by the variability in the fiscal policies. After the increase in public expenditures, the sudden concern with the public deficit created unforeseen changes in expenditures, taxation, and public borrowing. As a consequence, instability in interest rates has increased and people are uncertain about future tax rates and the possible creation of new taxes.

The financial and economic crisis is the means by which the economy comes back to the normal long-run structures of production and relative prices. Similarly, the austerity policy is the means by which a government suppresses the distortions it had introduced in the structures of production and prices via public deficits that were not sustainable in the long run. Adjustments are always painful, but it is better to accept them rather than postpone the return to equilibrium. It would have been preferable not to have had instability in monetary policies and public deficits, but it is impossible to change the past. Instead of complaining about the financial and economic crisis or the austerity policy, one ought to complain about the disequilibrating policies that have made them absolutely necessary. Instead, we are now left with both an economic crisis and a debt crisis and, in order to alleviate the debt crisis, many governments have adopted austerity policies, which Keynesians consider harmful because they interpret them as decreases in aggregate demand. However, as is well known, there are two different austerity policies: (1) decreasing public expenditures, which means austerity for the government and some beneficiaries of public expenditures; and (2) increasing taxes, which means austerity for citizens or, at least, some of them, for instance the richest ones who have a comparatively lower voting weight.

For a Keynesian it does not matter much whether one chooses one austerity policy or the other, since he cares only about the total deficit and not about the consequences of taxes on incentives or the existence of structural distortions. Moreover, as governments usually consider that it is easier to raise taxes than to cut expenditures, they prefer tax increases.

Thus, the favorite policy mix for most governments is an increase in taxes (in particular on high-income taxpayers) combined with a small decrease in public expenditures and an expansionary monetary policy. Such a policy mix may lead an economy into a vicious circle, as the increase in taxes may slow growth, thus reducing public revenues and increasing the public deficit, so that governments may react by deciding to enact an additional increase in taxes.

A far more efficient policy mix would be to decrease public expenditures and welfare payments, cut tax rates, end the overtaxation of savings, and decrease regulation (particularly in the labor market). There should also be no monetary "stimulus" that leads to artificially low interest rates and malinvestment. This policy mix would help solve the long-run eurosclerosis problem and lead countries out of their economic and budget crises.

European governments of the eurozone are now introducing a "golden rule" for budget management that would limit budget deficits to no more than 3 percent of GDP, thus introducing anew the famous criteria of the Maastricht Treaty. This rule might put a constraint on the temptation of governments to run public deficits. However, it also implies a risk because a tax-cut policy, which is highly desirable, may become impossible, and governments may be tempted to increase tax rates in order to comply with the rule in the short run. Whenever there are large tax cuts, public revenues first decrease—so that the government budget deficit increases—because people need time to adjust to the new tax rates. Thus, the tax base does not increase much in the short run. But, later on, the expansionary effect on production makes possible an increase in tax revenues. This process—known as the "Laffer effect"—has occurred in most experiences of large tax-rate cuts, such as the ones made by President Ronald Reagan.

The pernicious effect of a golden rule has already been experienced with the Maastricht criteria. Several years before the introduction of the euro governments did not dare lower tax rates because they feared a decrease in tax revenues in the short run would lead to deficits, which the public believed would be financed by inflation. After the eurozone was created, there was an incentive for governments to free-ride because they assumed that if they encountered large budget deficits, a part of their debt would be financed by money creation at the expense of other members of the eurozone.

In order to avoid a situation in which too many governments behave in such a manner, there has been a push toward a system of centralized control of economic policies, thus paving the way to a European central governance, which is certainly not desirable. Such a process fits with the expectations of those who supported the creation of the euro and who believed that the single currency could be a powerful instrument toward the creation of a single European nation. The push toward centralization, therefore, is not the outcome of a spontaneous process of evolution. It is a designed process explained by the politicization of society, not by the logic of human action.

Conclusion

One should be very concerned about the future of most European countries. They may enter into a long-run period of stagnation, characterized by institutional rigidities, economic instability, and poor economic performance. In addition to the financial, economic, and debt crises, it is now common to speak of a "euro crisis." In principle, there ought not to be a euro crisis, since there is no reason to say that there is a monetary crisis just because some countries belonging to the eurozone have debt problems (see Salin 2012). Those problems ought to be solved mainly by reducing public expenditures. But governments wrongly believe that real problems can be solved by using monetary instruments (money creation or devaluations). Thus, they arbitrarily create a link between debt problems and monetary problems. In fact, in order to overcome the difficulties they meet to finance their deficits, European governments put pressure on the European Central Bank to monetize public debt. Thus, contrary to what had been claimed when the ECB was created, it is buying public bonds issued in countries such as Greece. This monetary policy means more inflation and even, possibly, the risk of a new business cycle. The resulting inflation can be seen as a means not to comply with the public deficit criterion. As a consequence of this obstacle to tax cuts, Europe may suffer from a situation of steady stagnation.

References

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