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Separating European Austerity Fact from Fiction

A Lesson for the U.S. on Why Budget Cutting Works

By Matthew Melchiorre*

Rarely a week goes by without mention in the media of European governments' failure to restore economic growth through "savage" budget cuts. There is only one problem with that narrative: It is not true. Government austerity is nowhere to be found in Western Europe—and neither is prosperity. But both are present in the oft-ignored east, as Estonia is outperforming its West European neighbors and likely will continue to do so in the future. Why? Because Estonia is the only Euro Zone country to implement real spending cuts and tax reform that does not involve squeezing more revenue out of an economy in recession. America should take note: Real austerity works. Fake austerity does not.

The United Kingdom is a frequent target of the anti-austerity crowd's criticism, for the failure of its supposed budget "cuts" to revive a stagnant economy. In reality, the British government has increased spending and raised taxes since it announced implementation of austerity in June 2010. The problem is that economists, pundits, and journalists fixate on what Chancellor of the Exchequer George Osborne says rather than what he actually does. Even *The Wall Street Journal* gets it wrong when it editorializes that Britain has taken a "bold gamble on a program of government-spending cuts."

Estonia has not gained much media attention, but it should. Beginning in 2009, it has implemented real austerity through actual spending cuts and tax reform that did not aim to increase revenue in nominal terms from its pre-austerity level. (There were tax increases as well as cuts, but these were not central to Estonia's austerity program.)

The United Kingdom has consistently increased outlays and revenues relative to its pre-austerity level in every successive 12-month period since June 2010, as Figures 1 and 2 show. Estonia has consistently decreased both. Although Estonian revenues do begin to increase in the third year after austerity's implementation (2011), this was not the result

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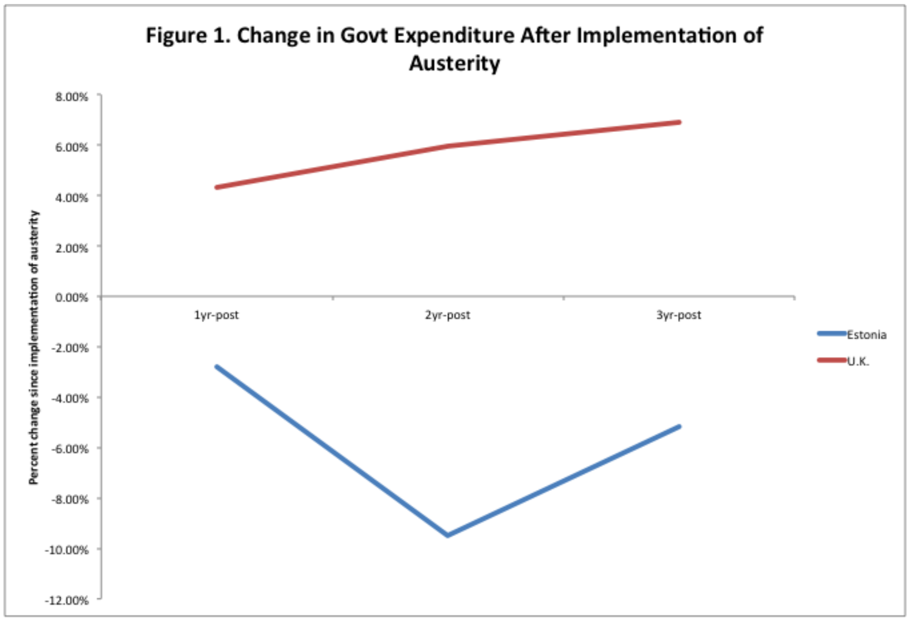
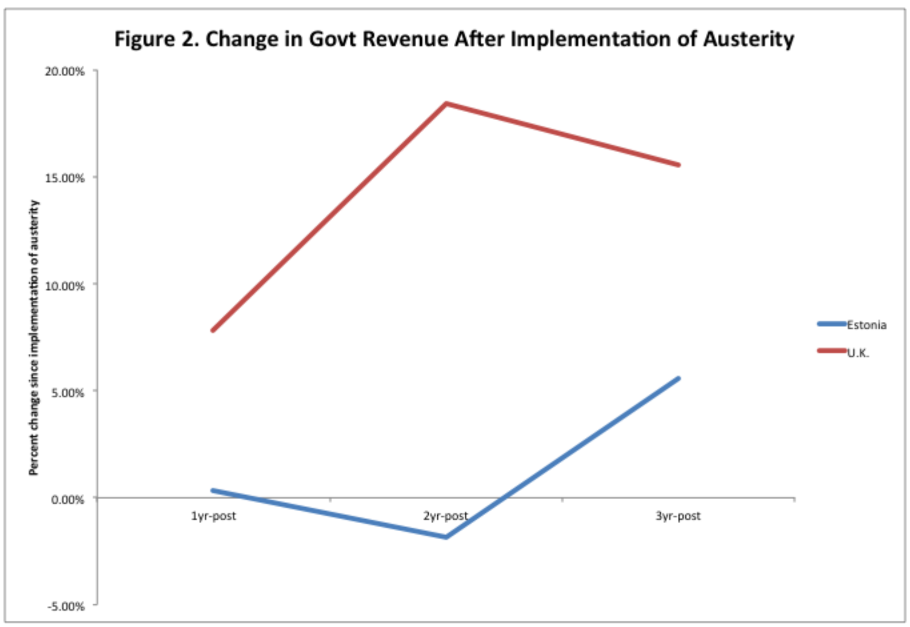
of an increased average tax burden, which had fallen by approximately 6 percent from the previous year (Author's calculations based on [European Commission] data), but it was the result of economic growth, which had already reached 2.3 percent in 2010 and 7.6 percent in 2011. The problem with the U.K.—and the rest of Western Europe—is that government is squeezing more and more tax revenue out of a shrinking economy.

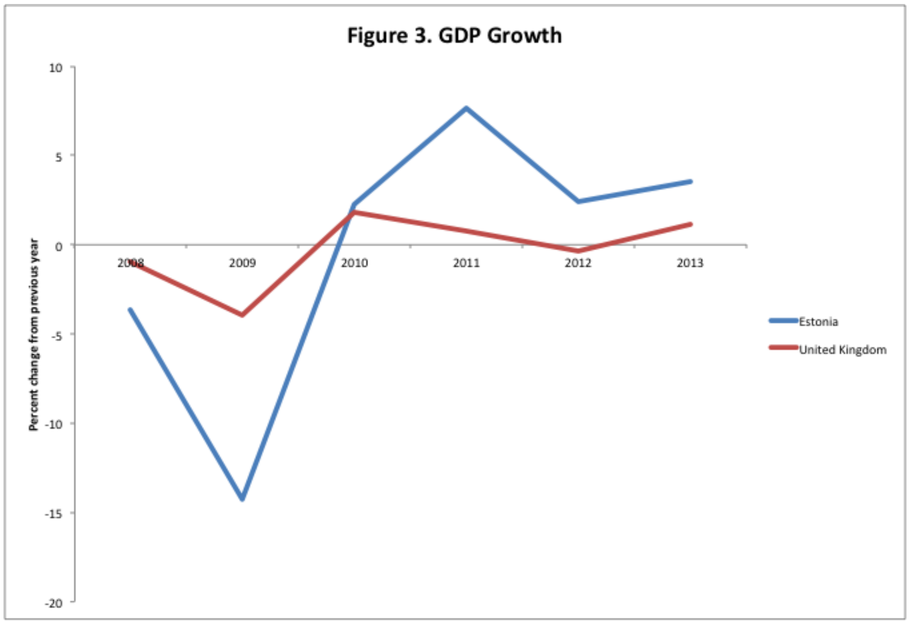


Source: Author's calculations based on [Eurostat] data



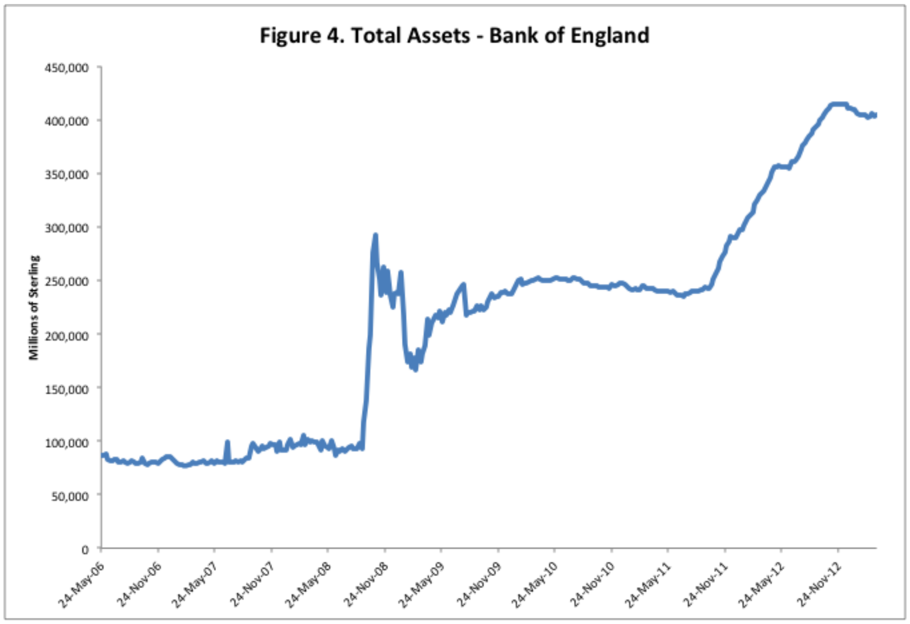
Source: Author's calculations based on [Eurostat] data

Austerity for Whom? The difference between the British and Estonian austerity programs lies in different answers to the question, "[Austerity for whom]?" Increased taxation aside, the private sector faces austerity by means of recession and the reduced economic activity that naturally ensues. In contrast to the U.K., Estonia let the public sector share in the austerity that the private economy had already been enduring.



Source: [IMF, World Economic Outlook, October 2012]

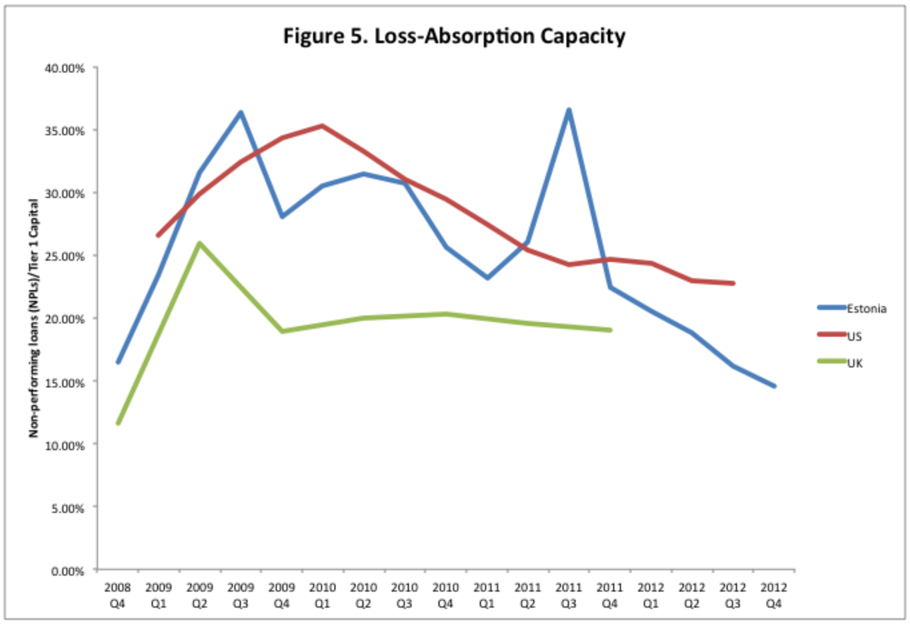
Monetary policy in Britain has prolonged its economic pain, making its financial sector flush with cash at the expense of the rest of the economy. The Bank of England's balance sheet has expanded by a whopping 334 percent since the beginning of the crisis, thereby propping up insolvent financial institutions and preventing the liquidation of bad assets.



Source: [Bank of England]

Meanwhile, Estonia has maintained both monetary and fiscal rectitude (the fact that it had maintained a currency band with the euro in order to join the European currency union in 2011 helped with the latter). After a real estate bubble hobbled Estonia's economy and rising wages relative to productivity threatened the country's competitiveness, the Baltic state let markets sort out the inefficiencies accumulated over the previous decade.

Estonia let banks repair their balance sheets, halving the ratio between non-performing loans (NPLs) and tier 1 capital—a bank's core capital, used as a measure of its financial health—from 2009 to today. By contrast, the U.K. has been propping up bad assets through monetary stimulus. When Britain can no longer forestall market forces from weeding those bad assets out of the banking system, it will face a stark increase in the ratio of NPLs to tier 1 capital as did Estonia at the start of its austerity program. U.K. banks will have no choice but to liquidate NPLs in order to repair their balance sheets.



Source: IMF, Financial Soundness Indicators

The Results to Date. In the U.K., a combination of tax-and-spend policies and monetary expansion has prevented necessary economic adjustments from taking place. The country's decade-long competitiveness gap has continued unaddressed. Meanwhile, Estonia's hands-off policy toward the global recession restored competitiveness. It began closing the gap between labor productivity and wages by its austerity program's second year. As a result, Estonian exports have rebounded while British exports have stagnated.

Unemployment in Estonia began rapidly decreasing at 6 percent annually by the sixth quarter of austerity, while Britain's jobless ranks did not start shrinking until the eighth quarter of its own "austerity" program. However, Estonia's success in this area may be a bit overstated, as it suffered a decline in its employment rate—the percentage of working age population in the labor force—at a magnitude roughly seven and three percentage points higher than in the U.K. in 2009 and 2010, respectively, before bouncing back in 2011 and 2012 (author's calculations on Eurostat data).

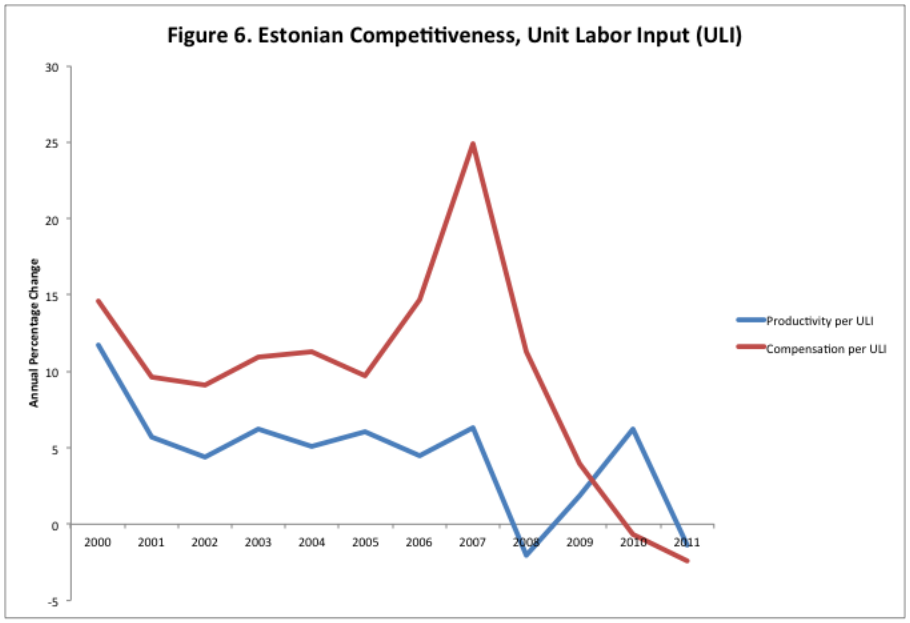


Figure 6. Estonian Competitiveness, Unit Labor Input (ULI)

Source: [*OECD iLibrary*]()

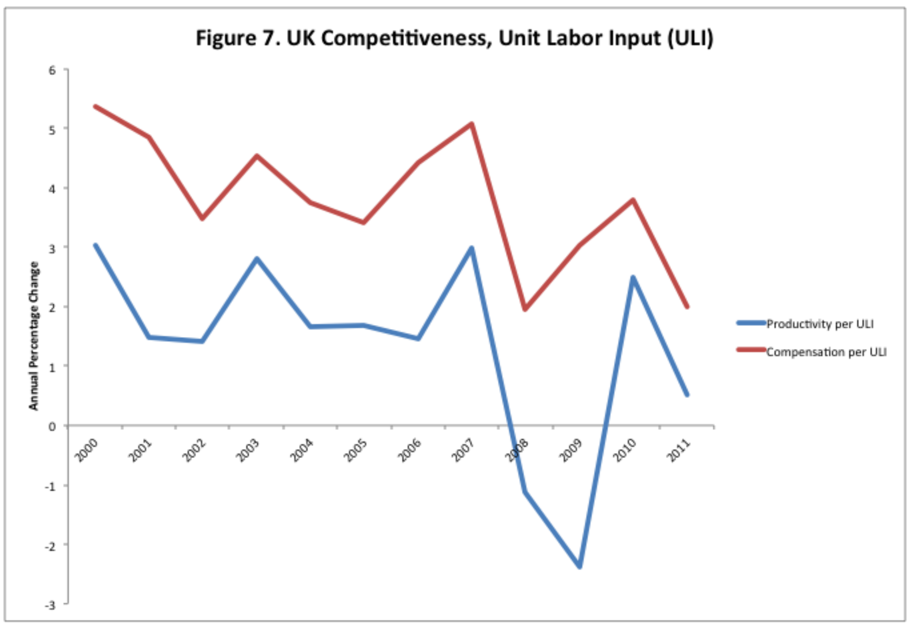
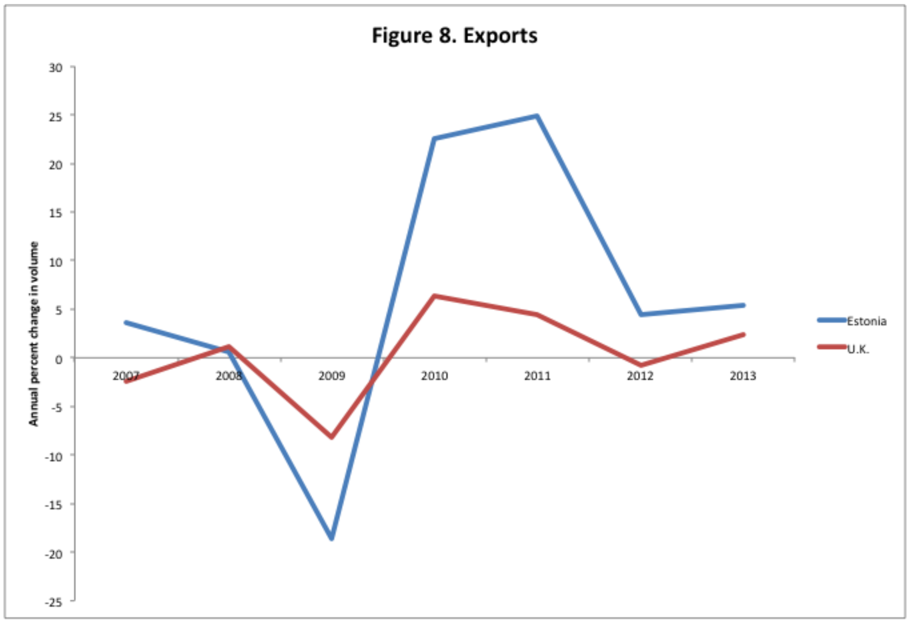
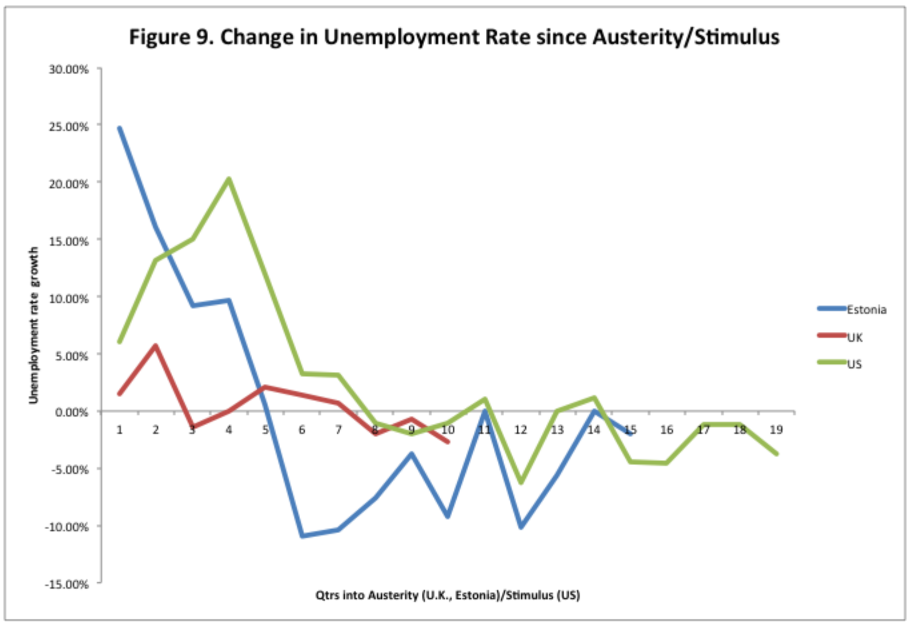


Figure 7. UK Competitiveness, Unit Labor Input (ULI)

Source: [*OECD iLibrary*]()



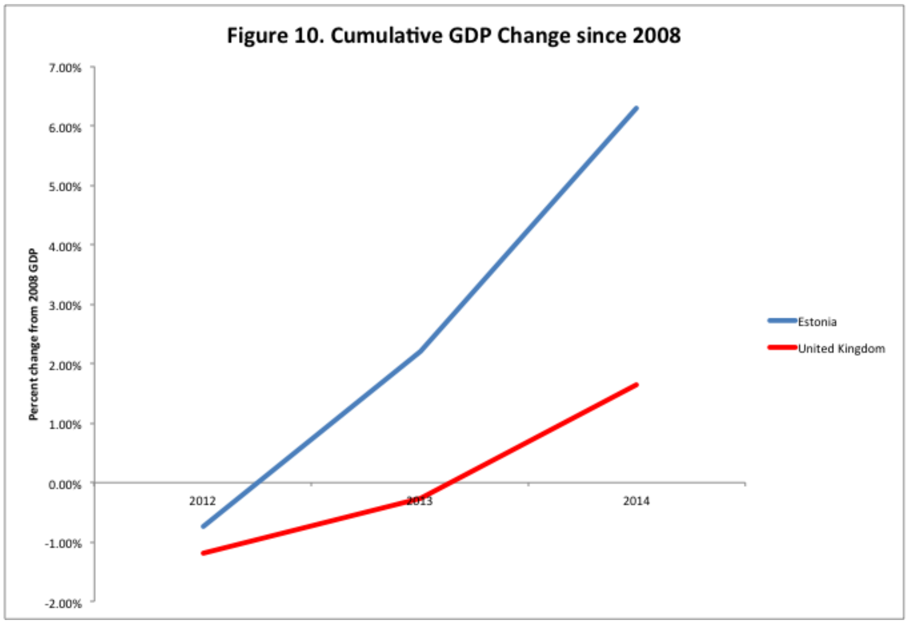
Source: [IMF, World Economic Outlook, October 2012]



Source: [Eurostat]

What did Estonia get in return for six quarters of austerity? It made up its cumulative economic losses by 2012. That is more than can be said for the U.K., which has endured a net economic loss at 1.2 percent of GDP since 2008.

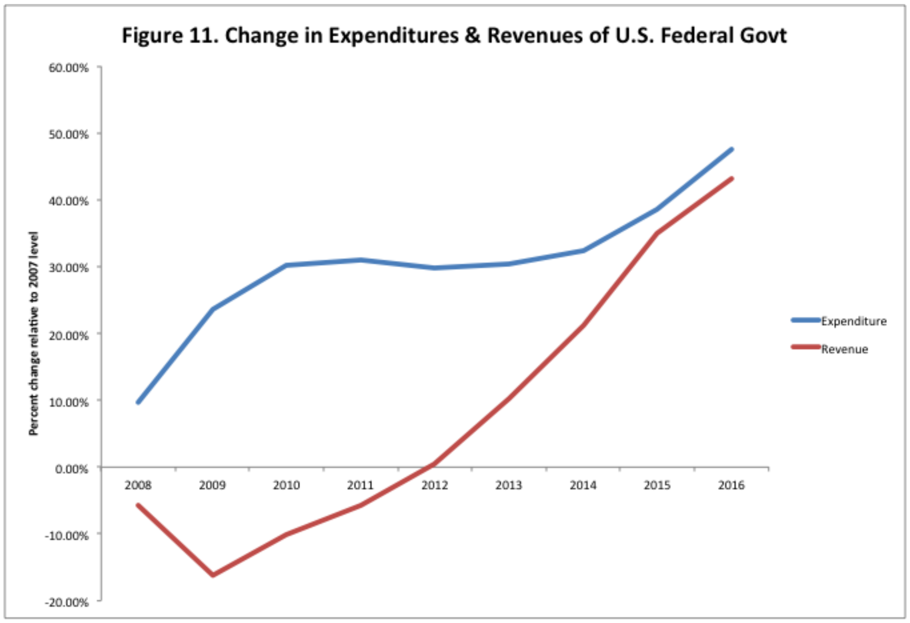
Economic projections from the International Monetary Fund indicate that Estonia will enjoy future net economic gains much higher than will Britain.



Source: Author's calculations based on [IMF, World Economic Outlook, October 2012] data

For the U.K., reality may be even darker than this dim picture. Estonia's economic gains, driven by increased competitiveness and export revenue, are more sustainable than Britain's, which have been driven by government spending. Interventionist policy in the U.K. has not allowed bad assets to liquidate, propped up inefficient businesses, and prevented workers from shifting to more productive endeavors. Estonia, on the other hand, allowed these market-correcting processes to take place during 2009-2010.

Lessons for America. The United States has been following a similar path as the United Kingdom, engaging in round after round of fiscal and monetary stimulus, for nearly five years now—with no sign of stopping. Federal spending relative to its 2007 pre-crisis level has increased, and under President Obama's proposed budget, will continue to do so in the future. Revenues, which had been decreasing prior to 2012, increased last year and will shoot up by over 10 percent by the end of this year as the taxman reaches further into Americans' pockets—even as the economy remains stuck in neutral. Instead, American policy makers should learn from Estonia's success.

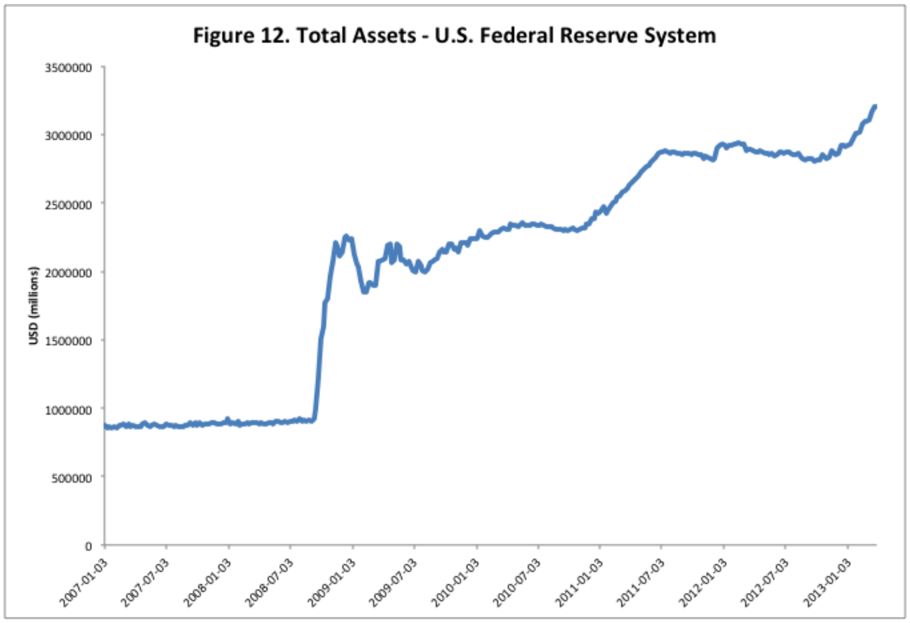


Source: Author's calculations on Bureau of Economic Analysis data

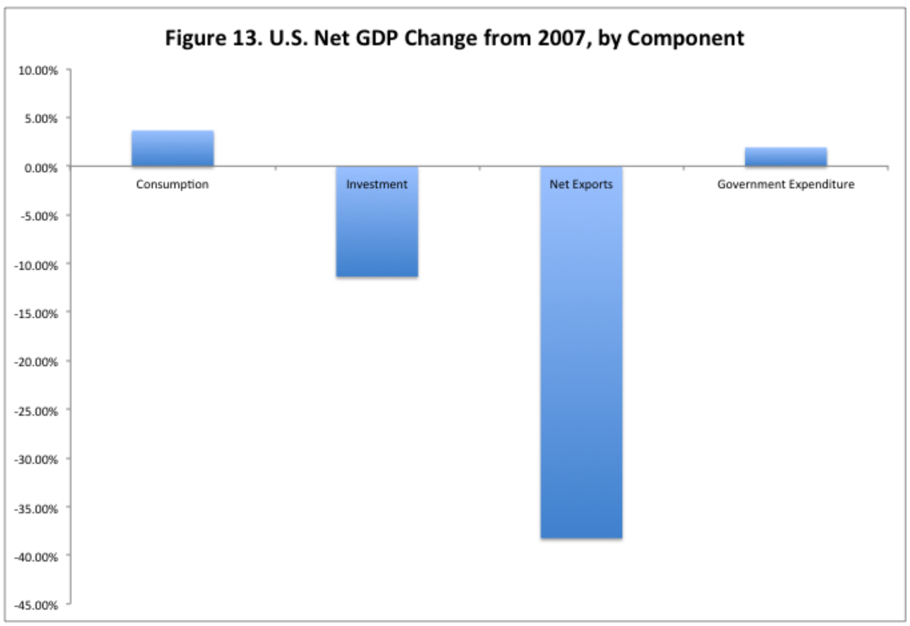
The Federal Reserve has increased its balance sheet by 253 percent since September 2008, thereby propping up inefficiencies within the U.S. banking system that keep the ratio of NPLs to tier 1 capital higher than in the U.K., and even higher than in Estonia during its austerity program (see figure 5).

The Fed is also acting as a seemingly bottomless piggy bank for a heavily indebted federal government, providing it more dollars by increasing the money supply. What has America's economy gotten for enlarging government's footprint? Anemic net economic growth since 2008 at 2.9 percent of the pre-crisis level—unsustainably driven by private and public debt-funded consumption (see figure 13)—and increasing unemployment for seven straight quarters since stimulus began in February 2008 (see figure 9). America's jobless situation is also worse than the unemployment rate suggests, as the workforce participation rate has been decreasing since 2008 (Bureau of Labor Statistics data).

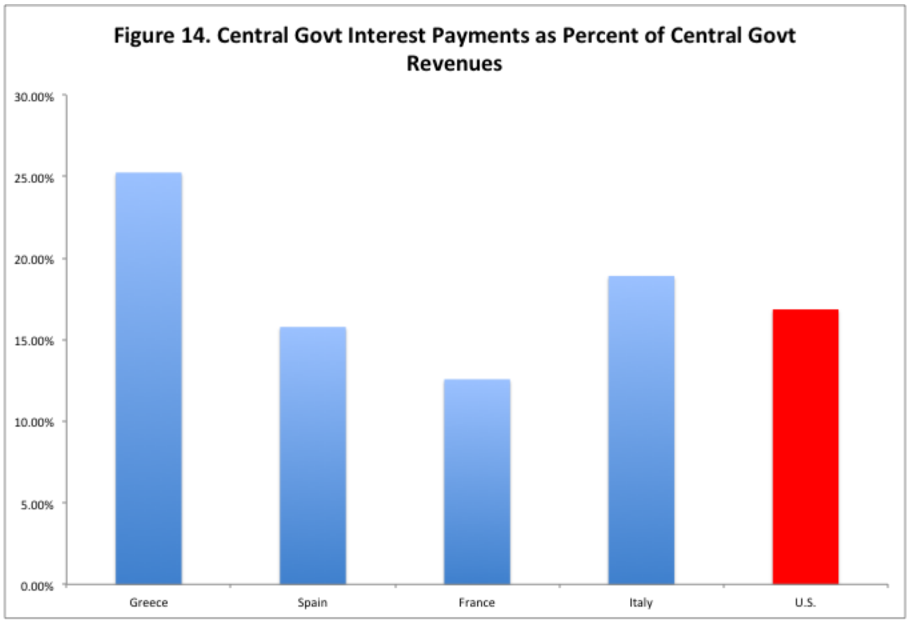
Washington needs to get its fiscal house in order before it runs out of road with the world's creditors, who continue to prop up a distorted U.S. economy. Interest payments comprise 17 percent of federal government revenues—a level rivaling that of Spain, Italy, and even inching toward Greece. Treasury cannot borrow at near-zero percent interest rates forever. Washington must begin shrinking the national debt before financial markets no longer have the distractions of the Euro Crisis and Japanese monetary expansion to draw attention away from America's weak economic performance.



Source: [Federal Reserve Economic Data, Federal Reserve Bank of St. Louis]



Source: Author's calculations based on [Bureau of Economic Analysis] data



Source: Eurostat, TreasuryDirect: Interest Expense on Debt Outstanding, BEA

Conclusion. Restoring growth and reducing public debt requires austerity that must be borne by businessman and bureaucrat alike. The politics, of course, are difficult. That is why politicians—and the constituencies they represent—must have the courage to embrace short-term pain for long-term prosperity. That is what happened in Estonia, and voters rewarded its pro-austerity party with gains in parliament during the 2011 election.

The United States has yet to take the necessary measures to rebalance its economy as Estonia has. Like the United Kingdom, America faces adjustment in the future that will come at considerable economic cost. As the U.K.'s recent experience shows, continued procrastination on reform will only make a bad situation worse.