

# The trade-off between austerity and growth during the post-crisis economic recovery

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## **Abstract**

*The rationale of this research goes into the origins of the nature of economic trade-off between economic policies developed by governments during economic crisis and aftermath. The paper is willing to underpin new ideas on the recovery policies and the understanding of the origins of crisis for future prevention of these. A familiar account about economic recoveries underlines the importance of economic indicators of growth, but growth is to be linked to international markets expanding theirs potential rather than when they embrace the policy of cutting costs. Financial innovations overheated the world economy and made market participants focus on macroeconomics indicators of growth whereas menaces of exponential growth realities were ignored because of an irrational exuberance. Considering the evidence analyzed in this paper, the present approach of the trade-off between austerity and growth puts forward new highlights of economic thought.*

*Keywords: economic crisis, public finances, austerity policies, economic growth, domestic confidence*

*JEL codes: B26, F43, G18, N14, N20*

## **1. Introduction**

In the wake of the last financial crisis, perhaps even the most reluctant economists to welfare state have found solutions other than Keynesian ones. It was mandatory to maintain functional the financial system, letting it fall behind being an alternative whose lethal consequences faced at that time a future hard to anticipate. In the mid of August 2007 when the biggest hedge funds of Bear Stearns defaulted, it was pretty easy to imagine what was about to happen, and what precisely has led to that. Insufficient tested financial innovations, subprime credits, greed, moral hazard, irrational exuberance and the like formed the mainstream derived apparently from the lowest regulated market economy era. Welfare state supporters presented therefore the proof that the “invisible hand” of the market can slap the world economy as well as the visible hand of the state. Templates and parallels with The Great Depression have been made, but this time America was not alone in the frontline of the financial crisis. Even though the financial globalization dragged close to default other economies, write-downs from Wall Street and money saved by BRIC, along with as much money as states could inject in their wounded economies, saved one more time the world from disaster. Unpleasant to accept

for the free market zealots, not only was the state at that time, as an economic agent, the usual suspect, but it even had an important contribution to help world financial system to avoid general collapse.

Whether by the investment bank's greed or the fast decay of leverage bets, the dream of Great Moderation was spooked by the ghost of a new Great Depression between 2007 and 2010. A fragile recovery seemed to put the world economy back on track, but the specter of a new economic crisis is about to bid a tearful goodbye to that. Had the state support failed in the 2007 financial crisis, the world economy would have been seriously tested, or even defaulted. But this time the institution which needs help is the very one from whom help was traditionally expected, namely the state. European countries budget imbalances gathered the clouds of a new economic crisis not only over Europe, but over the entire world as well. Huge budget deficits made people wind down hopes for a brighter future, as long as some governments faced depleted funds for future payrolls, especially in Portugal, Italy, Ireland, Greece and Spain, countries also known as PIIGS, no wonder why. This new financial crisis is a sovereign-debt crisis, in other words a crisis where the state defaulted. This hypothesis confounded critics and raised awkward questions such as, if the state defaulted, who will save the state? Other states could back a default state up, but what if the sovereign debt crisis is as scary as dangerous and other states face the same menace? This is why the world economy has to prove once more robust enough to withstand a new major challenge by finding the very causes of sovereign debt-crisis, huge budget deficits (Roubini and Stetser, 2008).

A budget deficit exposes a financial accounting problem of great social and political importance. Budget deficits are might be acceptable for certain periods of time, and sometimes can explain future output and improvements in the living standard. For John Maynard Keynes budget deficit is a key in post-crisis recovery (Keynes, 1936), and for John Kenneth Galbraith is a pillar for a perfect society, through fiscal and budget policies. Keynesian doctrine supports the recovery of aggregate demand through huge government spending, hence the deficit, whereas Galbraith doctrine admits budget deficit as a natural way to achieve public capital (Galbraith, 1998). Between budget deficit and huge budget deficit is not a very long path. The government's outstanding debt from past borrowing yet to be repaid is nothing else than national debt. These measures could pass as reasonably adequate when government spending was focused on infrastructure and defense for example, but even these are liable to further discussion. A budget deficit or surplus justifies different decisions to public contingencies or different levels for taxes or expenditures. The national debt might be justified just like the debt of any market participant, person or corporation, as current expenditures expected to yield positive returns in future years. The national debt could be also seen as imbalance between revenues, or tax collection and spending. Budget policies are always related to fiscal policies, because there is a reasonable connection between government spending and fiscal reality as the accounting numbers covered roughly the same periods of time of spending commitments (Bonilla, 2011).

Deficit imbalances are marked when governments apply for long-term commitments, such as providing income and medical insurance benefits to older citizens in a distant future. Long-term commitments are sometimes made without consulting economic realities of equilibrium. Therefore future income and health support have their roots in contemporaneous transfers, and not especially in real savings. The difference between future benefit payments and future tax collections is surpassed by budget and fiscal policies. Along with this mismatch of future decisions, present savings behavior of younger people today is affected by demographic transition to a society with a higher ratio of older to younger people. It means that in the future, fewer working young people will sustain more retired old people. A low score for work incentive could be an important side effect. Analyzing only budget imbalance could cast doubts over the conclusion, hence the importance to analyze it along with fiscal imbalance and generational imbalance. Fiscal imbalance is an economic concept of present value of the difference between all projected non-interest spending and all projected revenue. Generational imbalance indicates how much of the fiscal imbalance derives from older generations shifting tax burdens to younger generations. These three concepts of imbalance provide an overlook of the total future debt. Had the governments used this approach of budget deficit, the sovereign debt crisis would have been at least anticipated.

## 2. Between subprime crisis and sovereign-debt crisis

As prestigious economists mentioned in the previous chapter, deficits can be economically necessary, risky or irrelevant under different hypotheses, as follows:

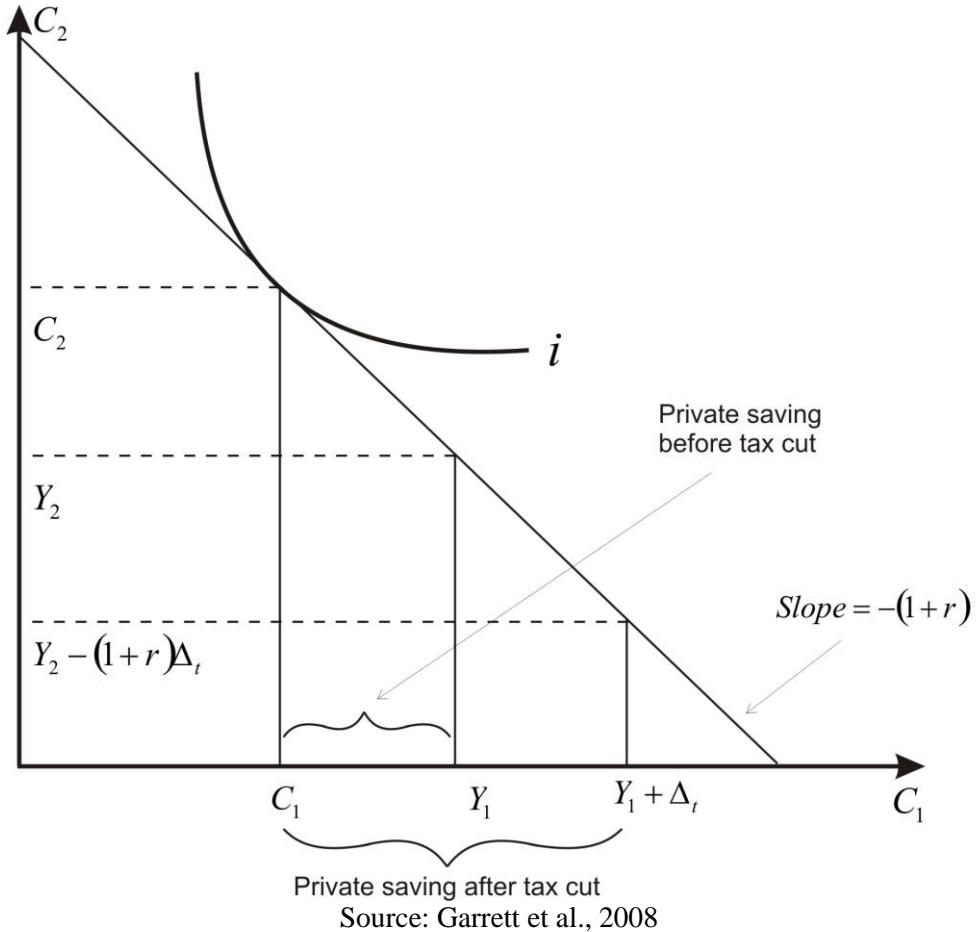
Table 1. Effects of deficits under different hypotheses :

<b>GOOD, DESIRABLE, ACCEPTABLE:</b>
<ul style="list-style-type: none"> <li>- For countercyclical device, automatic stabilizers in recession, early recovery; additional discretionary policy desirable in extreme cases after Federal Reserve moves aggressively;</li> <li>- For financing investment (that passes stringent cost–benefit analysis);</li> <li>- For tax smoothing of large, temporary spending swings (e.g., wars).</li> </ul>
<b>BAD, HARMFUL:</b>
<ul style="list-style-type: none"> <li>- Crowds out private investment (rather than increasing private saving or crowding in foreign capital);</li> <li>- Causes central bank to monetize the deficit and leads to inflation;</li> <li>- High debt–GDP ratio leads to expectations of inflation, depreciation of currency, capital flight, financial panic;</li> <li>- Especially in low-private-saving context.</li> </ul>
<b>IRRELEVANT:</b>
<ul style="list-style-type: none"> <li>- Ricardian equivalence idea of private saving offsetting public borrowing; for given level of spending and assuming the deficit does not affect future spending or the structure of taxes.</li> </ul>

Source: Garrett et. al., 2008

Whether a large deficit is good or harmful would always underpin a rationale for interesting debates between free market and welfare state economists. Based on circumstances, it can be each. The first issue over huge deficits is the delay of paying the current bills by shifting the cost of the current generation's consumption to future generations. When a deficit comes after old deficits, then huge deficits are assembling in the national debt. But long before huge deficits would come into debt, deficits will alter private investment. Had the deficits been accepted for solid economic expansion and productive public investment, deficit policy would have been reasonable, at least to some extent. Germany made it. When accumulation of all previous deficits is rising into an outstanding debt as a burden for next generation, constraining future spending and leading to inflationary monetary policy, deficit policy could be harmful. Post-crisis recoveries after economic recession require additional funds which can be provided through increasing deficits (Garrett et al., 2008). The national debt is the accumulation of all previous deficits. Austerity means that once the debt matures, the citizens have to accept increasing tax revenues to pay it off. Whether citizens pay to retire or to refinance the debt, they will have to accept trade-offs, paying for themselves or for others. Nevertheless, the effects of austerity, should market participants choose to accept it, may have several potential future effects. There are direct effects on the short-run aggregate demand and long-run effects on productivity, labor supply, human and capital formation and private spending. All these are not as much under the influence of deficit as they are under the influence of debt, but especially of future taxes. Whether citizens would agree over future taxes will be a matter of future debt, just as follows:

Figure 1: Effect of deficit on consumption



Where:  $T_i$  = taxes (net of transfers) in  $i$ ,  $G_i$  = government purchases in  $i$ ,  $d_i$  = deficit in  $i$ ,  $D$  = debt at the beginning of the second period = deficit from the first period =  $d_1$ . If there is no previous debt, then in Period 1 the level of deficit will be  $d_1 = G_1 - T_1$ , covered by the governments by selling treasury bonds. In the second period government must collect taxes to repay debt and interest:

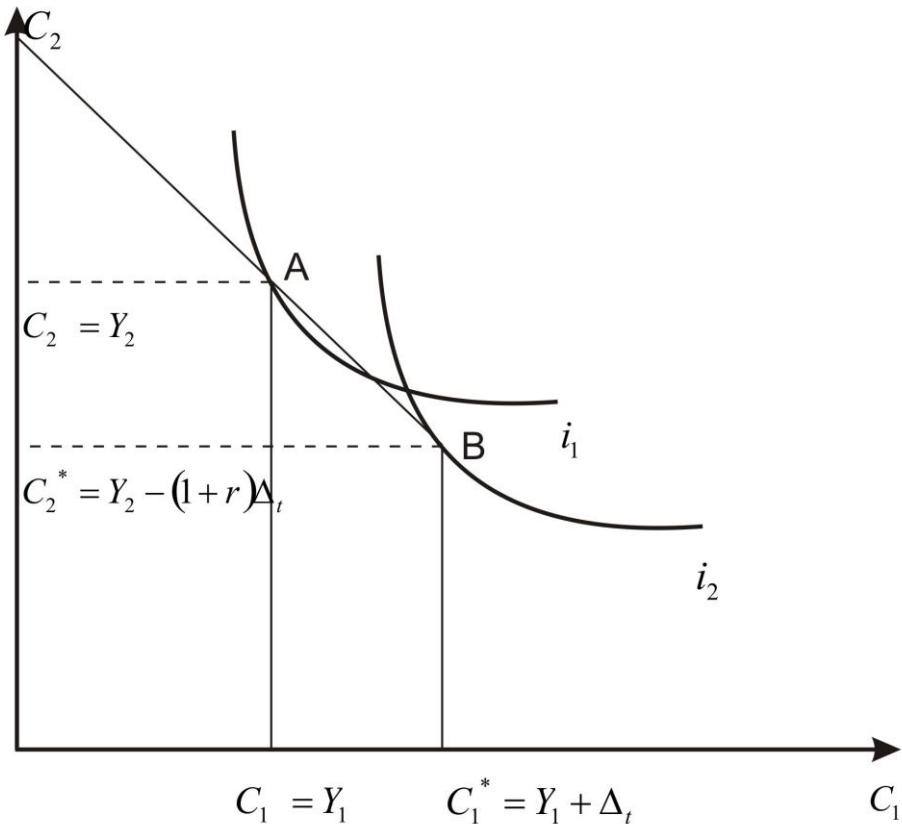
$$T_2 = (1+r)D + G_2 \quad (1)$$

$$T_2 = (1+r)(G_1 - T_1) + G_2 \quad (2)$$

$$T_1 + T_2 / (1+r) = G_1 + G_2 / (1+r), \text{ known as the government's budget constraint} \quad (3)$$

If the government cuts taxes in the second period with  $\Delta_t$  but maintain the level of its previous expenditure, in the next period it must raise taxes by  $(1+r)\Delta_t$ . Intertemporal budget constraint remains unchanged. Meantime, household trade the present income  $Y_1$  and future income  $Y_2$ , but also the amount of consumption in both two periods by borrowing or saving at the rate of interest  $r$ . Indifference curves  $C_1$  and  $C_2$  represents the indifference curves where highest points mark optimal intertemporal consumption (Garrett et al., 2008).  $C_1^*$  and  $C_2^*$  are new level of consumption in the second period, after  $\Delta_t$  tax cuts, with  $C_2^* = Y_2 - (1+r)\Delta_t$ .

Figure 2: Effect of deficit on liquidity-constrained consumers



Source: Garrett et al., 2008

The household consume less in the first period and save more, to fulfill raising expectations over taxes in the second period. In this case taxes do not affect consumption, because tax cut is equivalent with additional savings, known as “Ricardian equivalence” (Garrett et al., 2008).

But private spending could as well be affected by deficits. There is a mismatch between the present wealth resulted by taxes decrease and the present value of the future taxes. Tax cut lead to a rise of present income and therefore to a bigger consume in first period, moving from point A to point B in figure 2.

Increasing debt is able to drive-up interest rates and inflation rate because different limits to government's debts hold by private sector. There will be also time distortions about present and future trade-offs. Inflation will act as an indirect tax but it will affect the real value of national debt too. But the most important effect is the influence over future spending (Graeber, 2008).

### 3. Deficit approaches between American and European economic policies

The government provides services and different public goods, from infrastructure to national security, and retirement and health security for its citizens. As long as availability of resources can steam the government's expenditure, these programs will rally in distant future. Current net debt held by the public plus the future government's spending must be balanced by its future receipts. If those are equal, one might assume that the government's fiscal policy is balanced. In Europe, this golden formula was far from written. In order to meet their goals, governments make projections but only under the methodological umbrella of present fiscal policies. Narrower concern animates the government's lender, because the value of a monetary unit will depend on the long-term interest rate discounted by the governments trying to cover the fact that future money is worth less than present one. Finding an appropriate formula for a fiscal balance could help market participants to go through trade-off between austerity and growth more confident in their future, along with their incentive to work hard further on (Neck and Sturm, 2008).

Gokhale and Smetters (2003) proposed a fiscal imbalance formula at the end of year  $t$  and also a generational imbalance formula which enhances the present value of projected outlays that will be paid to current generation. Its simplified form is presented as follows:

$$GI_t = PVE_t^L - PVR_t^L - A_t \quad (4)$$

$PVE_t^L$  stands for the present value of projected outlays that will be paid to current generations;  $PVR_t^L$  represents the present value of projected tax revenues from the same generations and  $A_t$  designates the program's current assets.

European deficit does not cover fiscal and generational imbalances. In the event of outright liquidation, a state may face an awkward dilemma of not having enough money for its expenditure into the near future. The debt can be domestic and external. The first one is the most contentious issue in a sovereign debt crisis. The difference between the two kinds of debt is based on the principle of residency. External debt is any debt held by a foreign resident. Legally speaking, the difference focuses on the governing law. Domestic debt is defined as debt governed by domestic law, regardless of whether the debt is held by a foreign or a domestic resident (Roubini, Setser, 2004). Whether to domestic or external creditors, the debt must be paid, but there are arguments to subordinate external creditors' claims to domestic creditors'. Domestic residents are fighting on two fronts, they have to recover their money, and they also have to confront themselves with the crisis in their homeland. Even if they recover all their money, they are still under the menace to lose some of their purchasing power. Domestic outlook is already bleak, because of economic contraction, falling real incomes and fiscal tightening, whereas foreign creditors do not have to worry for all these problems. Another argument in favor of domestic creditors stays with the fact that local banking system often holds more domestic debts than foreign debts, hence the peril of a bank run in the case of domestic debt restructuring. More than this, domestic residents are the ones who would face the trade-off between growth and austerity, as fiscal adjustment requires filling the gap between state's revenues and expenditures. This is equivalent to an increase in taxes and cuts in public spending and services.

Along with lower income, domestic residents have to manage the shortfalls in output, employment and consumption necessary to improve the country's external balance. Austerity is imposed because the budget imbalance is a proof that the government can no longer act as lender of last resort and has to regulate the financial system by freezing the deposits, turning short-term deposits into long-term bonds, implementing capital controls and restricting access to domestic financial assets (Roubini, Setser, 2004). This policy of restructuring assets during an economic crisis gives the real overview of the future trade-off between growth and austerity, because the restructuring process will eventually make assets to confirm loses in their real value.

The budget deficit is the first step to insolvency for a country, and then for a sovereign-debt crisis, because the debt is the sum of all previous deficits. Once the insolvency is inevitable, the country's foreign debt becomes impossible to be paid, regardless of any domestic adjustments made by the government. If the debt grows to this extent, foreign investors must gap the missing funds to restore the country's solvency. It is particularly the case of Greece with its outstanding debt which was finally agreed to receive another bailout fund to avoid default, courtesy of Europe, and especially Germany, the steam engine country of the European Union.

Sovereign-debt crises are susceptible to be ignited by budget imbalances, but the current state of the world economy would have been less gloomy without the 2007 financial crisis. Huge amount of money were to be pumped into the financial system. The leading economy of the world, the United States', along with the moral guilt of the financial crisis, already faces the perspective of losing its pole position because of the outstanding fiscal imbalance of \$44.2 trillion, almost all of it a consequence of social Security and Medicare, and of two expensive fronts in Iraq and Afghanistan. Europe, the historic economic poll of the Modern era, faces an unbridgeable gap between its spending and revenues, especially for PIIGS countries. This problem is not anything new, but subprime crisis hit hard the entire world, and the budget imbalances of PIIGS were over passed in the financial storm. Along with globalization, European countries confront themselves with the statute of the members of the European Union. They can not simply default just as Bear Stearns or Lehman Brothers did. First of all they especially can not leave the monetary union at least without huge costs, in a domino effect

with incalculable consequences. The United States managed to find money from the Chinese over-saving economy whereas Europeans expect another German miracle, although Germans are reluctant to let their hard-working savings fill the gaps of irrational spending from other European countries. Without these other European countries Germans are fully aware as well that 40% of their exports will not meet any demand. The essential conclusion in the wake of this sovereign-debt crisis is that market participants are to accept the trade-off between massive tax increases or benefit reduction, in other words between growth and austerity.

Tabel 2: Government spending and revenues with reference to national accounts categories

Government revenue	Government expenditure
<ul style="list-style-type: none"> <li>- sales consisting of market output, output for own final use and payments for other non-market output</li> <li>- taxes on production and imports, receivable</li> <li>- other subsidies on production, receivable</li> <li>- property income, receivable</li> <li>- current taxes on income, wealth, etc., receivable</li> <li>- social contributions, receivable</li> <li>- other current transfers, receivable</li> <li>- capital transfers, receivable</li> </ul>	<ul style="list-style-type: none"> <li>- intermediate consumption</li> <li>- gross capital formation</li> <li>- compensation of employees, payable</li> <li>- other taxes on production, payable</li> <li>- subsidies payable</li> <li>- property income paid (including interest)</li> <li>- current taxes on income, wealth, etc., payable</li> <li>- social benefits other than social transfers in kind, payable</li> <li>- social transfers in kind related to expenditure on products supplied to households via market producers</li> <li>- other current transfers payable</li> <li>- adjustment for the change in net equity of households in pension funds reserves</li> <li>- capital transfers payable</li> <li>- acquisitions less disposals of non-financial nonproduced assets (public investment spending)</li> </ul>

Source: Eurostat

The budget deficit becomes dangerous for economy when true cost of fiscal policy remains in shadow and prompts the economic mechanism to shut down. Therefore, European governments should take into account American approach to budget imbalance, along with fiscal imbalance and generational imbalance. The first issue of this approach is already well known, the European Union has no fiscal integration at all, hence the lack of central fiscal policy for Europeans. European countries' deficit proves itself to be less dangerous than United States', but the European Union is not a single entity, politically or economically. The currency might be European, but treasuries are run by national institutions. Some of the newest members of the European Union are not fully integrated. Under the sovereign-debt crisis' menace, each country defends itself against the liability for debt of the others. The main economic agenda is whether a country should pay for other countries' default or save the money to save itself. Even so, national parliaments finally agreed to a second bail-out for Greece, recapitalization of banks and more flexibility for European Financial Stability Facility (EFSF).

#### 4. The sovereign-debt crisis menace

Greece's debt increased at a sharp rate during the 1980s, and at a lower rate during the 1990s and 2000s. Sooner or later its public debt was to affect the country's economy and then the Europe's. Productive investment has fallen and consumption increased. More than this, Greece became heavily indebted to foreigners. This dreadful situation became possible because Greek citizens were accustomed to live beyond their means using money that their government has borrowed from other countries, whether governments or private lenders. Greece's debt was an average of 4,1% per year during the 1990s. The debt increased to 10,2% during the 2000s. Between 2000 and 2009 external debt increased from 42,7% to 82,5%. Access to cheap European money was harder since poorer

eastern European countries joined the European Union, and additional funds were directed towards them, instead towards Greece. Interest payments increased along with the debt. Greek government issued bonds, but there were not enough private savings to purchase them. This was the ground zero of sovereign-debt crisis: external elements of the debt ballooned from about 10% in the early 1990s to around 80% in 2009:

Table 3. Greek Government deficit

Decade	1960-69	1970-79	1980-89	1990-99	2000-09
Government deficit (% of GDP)	0,6	1,2	8,1	8,4	5,9

Source: Manolopoulos, 2011

Table 4. Greek public debt at the end of each decade

Year	1980	1990	2000	2009
Government debt (% of GDP)	26	71	101,5	115,1

Source: Manolopoulos, 2011

Table 5. Greek deterioration of investment and the increase in consumption (% of GDP)

Decade	1970-79	1980-89	1990-99	2000-09
Consumption	77,2	85,1	90,1	88,8
Investment	30,7	23	20,6	22,6

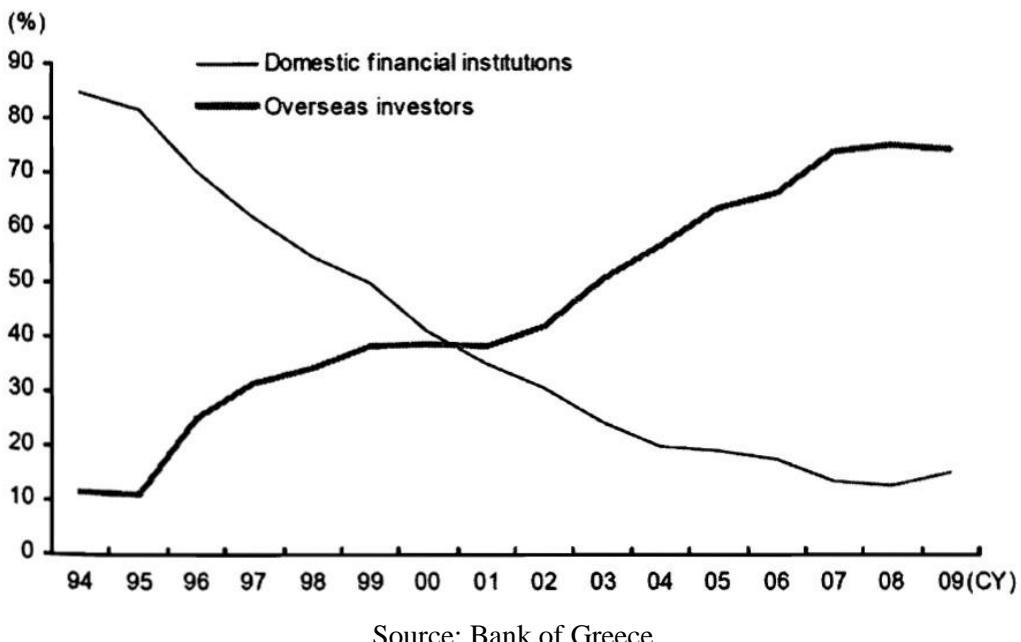
Source: Manolopoulos, 2011

There was actually no investment in the technological and industrial capacity of the economy, and too little into research and human capital development. The final destination for the borrowed money was “The bulk was spent instead to increase the wage bill in the public sector, i.e., more public servants and higher salaries, and to increase the pension bill, i.e., more pensioners and higher pensions” (Manolopoulos, 2011). Greece’s economy got oriented to small and low-tech evading taxes companies. Generalized corruption along public sector and the tax evading mentality of almost all Greek citizens deepened the national debt. In numbers, the general overlook can be presented as it follows:

- 321: number of dead individuals aged over 100 and receiving a pension;
- 768009: total number of civil servants, according to preliminary results of July 2010 census – the first attempt to assess the number of public sector employees;
- \$11 billion: final cost of the 2004 Athens Olympics, double the initial budget
- 324: number of householders in northern Athens declaring for tax purposes that they own swimming pools; 16974: number of residential swimming pools in northern Athens detected by satellite photography.
- 53: number of years that have passed since Lake Kopais was drained. There is still an office to manage the lake’s affairs, staffed by 30 fulltime civil servants.

People wanted higher incomes, but fewer private savings came from this to finance investments. The money that the government managed to raise from funds was not spent on public infrastructures hence the decrease in the aggregate productive investment by the public and the private sectors. Continuous current account deficit and accumulation of public debt helped for a while an unsustainable growth of consumer-based spending. Then, the Greek government allowed the switch from domestic to foreign creditor profile.

Figure 3. Holders of Greek Government Debt



Source: Bank of Greece

Unfortunately, the Sovereign-debt crisis is not an isolated case in a country like Greece. The blame for it can not be put only on the Greek government and foreign investment banks, but on the entire Europe whose economic imbalances and North-South gaps were aggravated under the monetary union. European Union's leaders kept the appearance of economic growth financed by borrowing the consumption as a proof of better living standard.

Greece must accept sharp reforms of the labor market, closed shops, and has to cut public waste sector. Digitalization, IT and technical investment are required. The main reform is a transformation from a low tax economy with low government service to higher tax and higher government service, as the safest way to avoid future debt.

\*This work was cofinanced from the European Social Fund through Sectoral Operational Programme Human Resources Development 2007-2013, project number POSDRU/1.5/S/59184 „Performance and excellence in postdoctoral research in Romanian economics science domain.

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