Two kinds of austerity

May 10, 2012
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Austerity is destroying Europe, we are told. In fact, this "anti-austerity" slogan is supposedly an important reason for defeat of former French president Nicolas Sarkozy and for the victory of newly elected socialist Francois Hollande.

First, France has yet to cut spending. In fact, to the extent that the French are frustrated with "budget cuts," it's only because the increase in future spending won't be as large as they had planned. The same can be said about the United Kingdom. Spain, Italy and Greece have had no choice to cut some spending. However, in the case of these particular countries, the cuts were implemented alongside large tax increases. In fact, The Washington Examiner's Conn Carroll calculated that "Europe raised taxes by almost ?9 for every ?1 in actual spending cuts."

This approach to austerity, also known in the United States as the "balanced approach," has unfortunately proven a recipe for disaster. In a 2009 paper, Harvard University's Alberto Alesina and Silvia Ardagna looked at 107 attempts to reduce the ratio of debt to gross domestic product over 30 years in countries in the Organisation for Economic Co-operation and Development. They found fiscal adjustments consisting of both tax increases and spending cuts generally failed to stabilize the debt and were also more likely to cause economic contractions. On the other hand, successful austerity packages resulted from making spending cuts without tax increases. They also found this form of austerity is more likely associated with economic expansion rather than with recession.

The Baltic nations of Latvia, Lithuania and Estonia provide good examples of successful fiscal adjustments. In the last few years, and contrary to the rest of Europe, the Baltic countries have focused on significantly cutting government spending without equivalent increases in taxes. As a result, the Cato Institute's Dan Mitchell reports, between 2008 and 2011, Estonia and Lithuania reduced nominal spending by 5 percent, and Latvia by 11 percent. France and the United Kingdom increased spending more than 8 percent over the same period, and Spain and Italy increased spending by 3 percent. In contrast to these others, the Baltic states have experienced some of the largest economic gains in the world: Between 2009 and 2010, Estonia's economy rose from an annual GDP growth of minus-13 percent to 3.1 percent.

Sweden is another good example. The data show that after the recession, Sweden's finance minister, Anders Borg, not only successfully implemented reduction in welfare spending but also pursued economic stimulus through a permanent reduction in the country's taxes, including a 20-point reduction to the top marginal income tax rate. As a result, the country's economy is now the fastest-growing in Europe, with real GDP growth of 5.6 percent. Unsurprisingly, the Financial Times recently declared Borg the most effective finance minister in Europe.

While the debate over austerity continues, the evidence seems to point to the conclusion that austerity can be successful, if it isn't modeled after the "balanced approach." It's a lesson for the French and other European countries, as well as for American lawmakers who often seem tempted by the lure of closing budget gaps with higher taxes.

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