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Austerity, cyclical adjustment and the remaining leeway for expansionary fiscal policies within the current EU fiscal framework

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Achim Truger

Abstract:
Fiscal policy in the Euro area is still dominated by austerity measures implemented under the institutional setting of the 'reformed' stability and growth pact, and the even stricter 'fiscal compact'. At the same time, calls for a more expansionary fiscal policy to overcome the economic crisis have recently become more frequent. In his Jackson Hole speech Mario Draghi, the president of the ECB, called for a more expansionary fiscal stance for the Euro area as a whole and a public investment programme on the European level insisting, however, that the existing rules of the Stability and Growth Pact be respected. The European Council at its meeting in June 2014 also saw the need to stimulate growth, but insisted as well that this be realised within the current institutional framework. Recently, the EU-Commission in this spirit has launched the Juncker-Plan to stimulate (public) investment and is using a less strict interpretation of the Stability and Growth Pact in order to provide more fiscal leeway for countries under unfavourable economic circumstances. The paper argues that these steps do not go far enough and that a truly expansionary fiscal policy in the dimension of two to three per cent of Euro area GDP for a few years is possible even within the existing institutional framework. Special emphasis is put on the method of cyclical adjustment employed by the European Commission in order to assess member states' fiscal position and effort as well as on ways to increase public investment. It will be shown that even in the existing framework the leeway for a macro economically and socially more sensible fiscal policy using the interpretational leeway inherent in the rules could be quite substantial.

Keywords: Fiscal policy, austerity, cyclical adjustment of public finances, Euro area

JEL Classification: E61, E62, E65, H62, H63

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Austerity, cyclical adjustment and the remaining leeway for expansionary fiscal policies within the current EU fiscal framework[1]

1. Introduction

Fiscal policy in most Euro area countries has been dominated for several years by austerity measures implemented under the institutional setting of the 'reformed' stability and growth pact and the 'fiscal compact'. From a Keynesian perspective the outcome in terms of devastating economic, social and political consequences was predictable (see e.g. Observatoire Français des Conjonctures Économiques et al. 2012, Truger 2013). The serious risk of a vicious circle of consolidation efforts leading to higher deficits and debt levels and in turn to higher consolidation efforts seems to have materialised and moved the Euro area economy to the verge of deflationary stagnation.

However, recently the calls for a more expansionary fiscal policy have become louder, as it is getting clearer that monetary policy alone will not be able to spark off the recovery. In his by now famous Jackson Hole speech, Mario Draghi called for a more expansionary fiscal stance for the Euro area as a whole and a public investment programme on the European level insisting, however, that the existing rules of the Stability and Growth Pact (SGP) be respected (Draghi 2014). The European Council at its meeting in June 2014 also saw the need to enhance growth, but insisted as well that this be realised within the current institutional framework: 'The possibilities offered by the EU's existing fiscal framework to balance fiscal discipline with the need to support growth should be used.' (European Council 2014, **7**). With regard to this, the new Commission has launched two initiatives, thereby substantially enlarging its predecessor's efforts: The 'Juncker-Plan' and a clarification on making optimal use of the flexibility within the SGP (European Commission 2014f and 2015).

[1] Support of the work on this paper by the Berlin School of Economics and Law by a research allowance reducing my teaching load is gratefully acknowledged. Earlier versions of section 2 and results of the calculations were presented at the 11th conference 'Developments in Economic Theory and Policy' at the University of the Basque Country, Bilbao, at the 7th workshop 'Jahrbuch für öffentliche Finanzen 2015" at the University of Leipzig, at the 20th workshop on Alternative Economic Policy in Europe, organized by the Euromemorandum group and Economia civile at the Sapienza University, Rome and in the research seminar of the Institute for International Political Economy at the Berlin School of Economics and Law. I would like to thank participants for the discussion and for helpful comments. The corresponding paper has been submitted as 'The fiscal compact, cyclical adjustment and the remaining leeway for expansionary fiscal policies in the Euro area' to the journal Panoeconomicus (Truger 2015a). Parts of sections 3 and 4 are based on chapter 5 of my study 'Implementing the Golden Rule for Public Investment in Europe. Safe-guarding Public Investment and Supporting the Recovery' for the Austrian Chamber of Labour (Truger 2015b) and the German language paper 'Eine expansive Finanzpolitik in Europa ist möglich – zur Not auch im bestehenden institutionellen Rahmen! ' submitted to the Jahrbuch für öffentliche Finanzen (Truger 2015c). The usual disclaimer applies.

Against this background the central question is whether given the lack of institutional changes, the current institutional framework – that had severely been tightened by the reforms of the SGP and the Fiscal Compact (European Commission 2013a, 13-42) – still allows for a fiscal expansion strong enough to spark off a real recovery in the stagnating Euro area economy. The current paper argues that, indeed, there is substantial leeway for expansionary fiscal policies provided the European Commission is willing to more aggressively use the technical and interpretational leeway that is inherent in the central ambiguous concepts used in the current framework.

In order to show this, section 2 will reconsider the crucial concept of cyclical adjustment. As a consequence of the stagnation, the estimate of potential output has been pro-cyclically decreased leading in turn to an underestimation of the output gap and an overestimation of the structural budget deficits. Correcting for those effects leads to substantially higher estimates for the volume of austerity programmes which are markedly in line with the development of output in most Euro area economies. Section 3 turns to the European Commission's way of dealing with the problem and shows that its initiatives do not go far enough. Section 4 then tries to identify the remaining leeway for a fiscal boost to the European economy within the existing institutional framework. Section 5 briefly concludes.

2. Cyclical adjustment of public finances and austerity in the Euro area

Cyclical adjustment in general and that of public finances in particular plays a major role in the EU Commission's concept of budgetary surveillance within the framework of the Stability and Growth Pact and the Fiscal Compact (Larch and Turrini 2010). With the exception of the excessive deficit threshold, all target values for the government budget balance are expressed in terms of structural, i.e. cyclically adjusted, values, and the cyclical condition of the economy plays a major role in assessing the necessary consolidation effort and potential exceptions. The most important concept in this respect is the structural budget balance, i.e. the cyclically adjusted government budget balance corrected for one-off measures in terms of which the consolidation requirements under the SGP (and the fiscal compact) are expressed. The method used by the Commission so far severely – and deliberately – overestimates the consolidation requirements and underestimates the fiscal effort already undertaken by the member states. All of this is well known and has in principle already been acknowledged by the Commission and used to justify exceptional circumstances for several countries in retrospect, but the Commission hesitates to modify its method in a more forward-looking manner and grant fiscal

policy the leeway that is essential to end the stagnation in the Euro area and the depression in the periphery (see section 3 below). As will be argued in the present paper, a reassessment of the structural balances in combination with the application of the recent findings regarding the size of the fiscal multiplier may be sufficient to bring about a substantially positive fiscal stimulus.

The European Commission in its calculations proceeds in two steps. First, potential GDP is estimated in order to determine the cyclical condition of the economy, i.e. the output gap as the percentage deviation from potential output. Second, with the help of budgetary semi-elasticities (Mourre et al. 2013) the cyclical impact on the budget balance is identified which then allows for the calculation of cyclically adjusted balances. The separation of trend or potential GDP and cyclical GDP and its effects on the budget balance constitutes a major progress compared to a situation in which fiscal policy targets are formulated in terms of the actual budget deficit which would result in completely pro-cyclical fiscal policies.

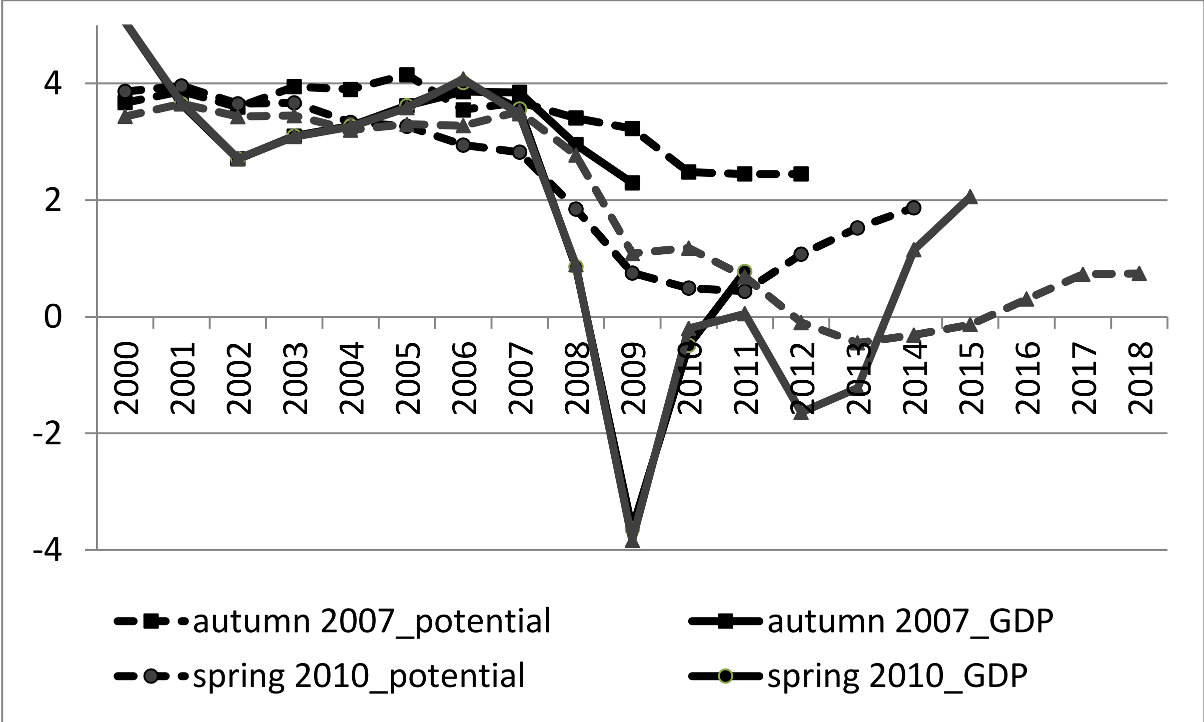
However, many fundamental objections can be raised. First, it must be doubted whether the setting of strict target values for the government budget balance is adequate, because, in fact, fiscal policy plays a major role in stabilising the economy and should therefore not be constrained (see e.g. Arestis 2011). Second, the theoretical idea behind the concept of identifying potential GDP that is determined by structural factors, above all on the labour market, can be criticised for a number of reasons (Hein and Stockhammer 2011). Third, and somewhat more pragmatically, the usual methods of cyclical adjustment tend to underestimate the cyclical fluctuations and will therefore have pro-cyclical effects if applied to fiscal policy. In the rest of this section we focus on the latter aspect and illustrate the pro-cyclical downward revision of the European Commission's potential GDP estimates during the Euro crisis, particularly in the crisis countries and the resulting underestimation of the tremendous consolidation efforts.

2.1. The pro-cyclical nature of the EU Commission's potential output estimates

The European Commission estimates potential output by means of a Cobb-Douglas-production function. This combines a potential labour input (the product of the working age population, the participation rate and per capita hours of work minus structural unemployment), a capital input (the product of the gross fixed investment in relation to potential output and potential output minus a constant depreciation) and total factor productivity (see D'Auria et al. 2010). The estimate of potential output is a medium-term projection based on short-term forecasts.

All the ingredients are forecast separately: demographic trends, the participation rate, structural unemployment, per capita hours of work, the investment ratio, the rate of depreciation (usually a constant), and the total factor productivity as Kalman-filtered capacity utilisation. The estimate is calculated for all EU member states using semi-standardised specifications. The specifications are usually adjusted regularly. The main problem in the current context is that the method employed by the EU Commission has proven to be highly sensitive to the endogeneity bias, i.e. the problem that potential output is highly sensitive to variations in actual output (see Logeay and Tober 2006, Klär 2013 and 2014; Truger and Will 2013). During economic contractions – especially during large and durable contractions such as those observed in the Euro crisis – the estimates of potential output are revised substantially downwards: Increases in actual unemployment will be reflected in increases in NAWRU estimates and stagnating investment will reduce the estimate of the capital stock in the production function (for the Euro area see Klär 2014 in detail as well as Andrade and Duarte 2014).

Figure 1: Real actual and potential GDP in Spain as of different European Commission's forecasts, annual growth rate in % 2000-2018



Source: European Commission (2014b), author's calculations.

The effects can be very well illustrated by the Spanish case (see figure 1). Before the crisis, potential output growth as estimated by the Commission was around 4 per cent annually with a clear slowdown due to the expected slowdown in actual economic growth from 2008

onwards. In spring 2010, after the bubble had burst and Spain was only slowly recovering from the global economic and financial crisis, the Commission very substantially decreased its potential output estimates for the Spanish economy. After consecutive waves of austerity had taken effect and had driven the Spanish economy back into serious recession, potential output was again revised downwards in a dramatic way in 2012 and 2013: Potential output was expected to shrink in four consecutive years from 2012 to 2015.

Table 1: Output gap in % of potential GDP, EMU-12 countries 2007-2015 with potential GDP growth of EU Commission's spring 2014 forecast compared to EU Commission's spring 2010 forecast

	Output gap with potential GDP from EU Commission spring 2014								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Euro area (12 countries)	2.8	1.7	-3.4	-2.1	-1.3	-2.4	-3.3	-2.7	-1.8
Belgium	2.6	2.0	-1.9	-0.8	-0.3	-1.3	-1.7	-1.1	-0.5
Germany	1.9	1.8	-4.2	-1.4	0.6	-0.1	-1.1	-0.7	-0.3
Ireland	4.5	1.3	-4.1	-4.1	-1.2	-0.6	-1.4	-1.0	0.0
Greece	3.2	1.5	-1.5	-4.7	-8.7	-12.2	-12.6	-9.3	-4.0
Spain	2.8	0.9	-4.0	-5.3	-5.9	-7.3	-8.1	-6.7	-4.7
France	3.4	1.8	-2.4	-1.8	-0.9	-2.0	-2.7	-2.8	-2.4
Italy	3.4	1.8	-3.5	-1.7	-1.4	-3.0	-4.3	-3.6	-2.5
Luxembourg	4.6	1.3	-5.0	-2.4	-1.8	-3.6	-2.8	-1.6	-0.3
Netherlands	2.1	2.2	-2.5	-1.4	-1.0	-2.4	-3.3	-2.6	-1.8
Austria	2.1	1.9	-2.9	-2.0	-0.1	-0.4	-1.1	-0.8	-0.4
Portugal	1.1	0.3	-3.0	-1.6	-2.6	-5.0	-5.6	-4.0	-2.3
Finland	5.0	3.8	-5.4	-2.5	-0.1	-1.4	-2.7	-2.6	-1.9
	Output gap with potential GDP from EU Commission spring 2010								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Euro area (12 countries)	2.9	1.9	-3.3	-2.2	-1.7	-3.6	-5.4	-5.7	-5.6
Belgium	2.3	1.5	-2.4	-1.1	-0.5	-1.7	-2.6	-2.3	-2.0
Germany	3.2	3.3	-2.8	0.2	2.2	1.2	0.0	0.2	0.6
Ireland	4.0	0.0	-6.0	-6.2	-4.4	-6.0	-8.9	-10.5	-10.9
Greece	3.3	1.1	-3.4	-8.9	-16.1	-22.3	-25.7	-25.8	-24.3
Spain	1.8	0.8	-3.8	-4.4	-4.8	-7.3	-9.9	-10.5	-10.3
France	1.7	0.0	-4.3	-3.9	-3.0	-4.2	-5.3	-5.7	-5.6
Italy	3.8	2.3	-3.4	-2.0	-2.2	-5.3	-8.0	-8.7	-8.8
Luxembourg	4.6	0.4	-7.3	-6.4	-6.9	-9.9	-11.1	-12.0	-12.7
Netherlands	2.5	2.4	-2.6	-2.0	-2.3	-4.8	-7.3	-8.2	-8.9
Austria	3.6	3.2	-2.0	-1.7	-0.3	-1.2	-2.5	-2.8	-2.9
Portugal	4.9	4.2	1.1	2.7	0.9	-3.5	-6.2	-6.6	-6.8
Finland	5.5	3.7	-6.2	-4.0	-2.6	-4.9	-7.6	-8.8	-9.3
	Difference								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Euro area (12 countries)	0.1	0.2	0.0	-0.1	-0.3	-1.1	-2.1	-3.0	-3.8
Belgium	-0.3	-0.5	-0.5	-0.3	-0.2	-0.4	-0.9	-1.3	-1.5
Germany	1.3	1.5	1.4	1.5	1.6	1.3	1.0	0.9	0.8
Ireland	-0.5	-1.3	-1.9	-2.2	-3.2	-5.5	-7.5	-9.5	-10.9
Greece	0.1	-0.5	-1.9	-4.3	-7.4	-10.1	-13.2	-16.6	-20.3
Spain	-1.0	-0.1	0.2	0.9	1.1	0.0	-1.8	-3.8	-5.7
France	-1.8	-1.8	-2.0	-2.2	-2.1	-2.2	-2.5	-2.9	-3.2
Italy	0.5	0.4	0.1	-0.3	-0.8	-2.3	-3.7	-5.1	-6.3
Luxembourg	0.1	-0.9	-2.3	-4.0	-5.1	-6.3	-8.2	-10.3	-12.4
Netherlands	0.4	0.2	-0.1	-0.5	-1.3	-2.4	-4.0	-5.6	-7.1
Austria	1.5	1.2	0.9	0.3	-0.1	-0.8	-1.4	-2.1	-2.5
Portugal	3.8	3.9	4.1	4.2	3.5	1.6	-0.5	-2.6	-4.5
Finland	0.5	-0.1	-0.8	-1.5	-2.5	-3.5	-4.8	-6.2	-7.3

Source: EU Commission (2010a, 2014a, 2014b), author's calculations.

It is of course difficult – if not theoretically meaningless – to decide by how much the crisis has really affected potential output (OFCE, Economic Council of the Labour Movement. Institut für Makroökonomie und Konjunkturforschung in der Hans-Böckler-Stiftung 2013). However, it seems clear, that the medium term growth prospects were negatively affected by the bursting of the Spanish real estate bubble. But that does not mean that it is plausible to assume that the downward revision continues more than four years after the crisis. Indeed, given the pro-cyclical nature of the production function approach used by the Commission, it is much more likely that the ongoing downward revisions simply reflect the worsening cyclical condition of the Spanish economy that in turn was brought about by massive austerity policies. A similarly pro-cyclical downward revision of potential GDP with a corresponding downward revision of the output gap can be identified from the spring 2010 to the spring 2014 Commission forecast (see table 1).

In this paper the spring 2010 forecast is used as a baseline, because at the time potential GDP estimates had already been revised downwards very substantially. At the same time, most Euro area economies were recovering, before in the summer of 2010, a switch to a fast exit and the beginning of austerity in the Euro area was decided (see Blyth 2013, chapter 3). Table 1 shows the Commission's spring 2014 estimates of member states' output gaps and contrasts them with the output gaps that would have been estimated had the spring 2010 potential GDP forecasts remained unchanged. The European Commission (2014b) published potential output estimates until 2014. For the calculation the 2014 potential growth rate was simply reproduced for 2015. From 2013 to 2015, for all countries with the exception of Germany, the output gap would have been substantially higher had it not been for the crisis induced downward revision of potential GDP since spring 2010.

One might argue that the downward revision of potential GDP could be plausible also from a more Keynesian point of view if hysteresis was involved. However, firstly, the downward revision implicit in the EU Commission's calculations is occurring in a very fast manner. And secondly, the Keynesian solution would be to prevent or fight those effects by counter-cyclical fiscal policy. Therefore, it is consistent to take the year 2010 as a starting point for the alternative calculations, because it is exactly the year in which counter-cyclical policy was abandoned and replaced by austerity policies. In the numerical analysis we focus on the 12 countries of the 'old' Euro area for several reasons: Firstly, with the exception of Slovenia this is the Euro area that existed at the pre-crisis starting point of our calculations. Secondly, because of permanent new accessions to the Euro zone, a consistent Euro area average would not have otherwise existed. Thirdly, the crisis countries in the periphery, that were the focus of

the debate from the beginning, all belonged to the group of 'old' member states. Of course, this is not, at all, to say that the problems addressed here were not relevant for the 'new' member countries, or, even, that those countries were less important. In fact, as in their case, potential output calculations have to be based on relatively few observations and their output development was quite erratic over time, the resulting endogeneity problems are probably even stronger. However, this deserves to be tackled in greater depth than is possible in this paper.

2.2. The resulting underestimation of fiscal restraint in the Euro area

Such dramatic downward revisions of potential GDP have substantial consequences for the calculation of structural budget balances and the assessment of consolidation efforts (see Eschenbach and Schuknecht 2004, Romer and Romer 2010 as well as Guajardo, Leigh and Pescatori 2011. These efforts will usually be underestimated because, first, a substantial part of the fiscal effort is wiped out, as a larger part of the actual deficit is registered as structural although in fact it may well just be cyclical, i.e. caused by the (in principle) temporary contraction. Second, a further underestimation or at least inaccuracy concerning the estimate of structural balances may result from deviations of actual budget semi-elasticities from the estimated average values in the procedure of cyclical adjustment (see European Commission. 2010b. 124-128, Zack et al. 2014, for the case of Spain as well as Hein and Truger 2014, 24-25 for the case of Germany).

Focusing on the first problem, this can be demonstrated by comparing the fiscal stance derived from the Commission's original estimates with the one derived from the Commission's estimates correcting for revisions in potential output since spring 2010 (tables 2 and 3). The structural primary budget balance is the cyclically adjusted budget balance corrected for one-off measures, minus interest payments on outstanding government debt. Table 2 gives an overview of the development of the structural primary budget balance in the Euro area countries from 2008 to 2014 (estimate) and the resulting cumulative discretionary fiscal stance from the trough of the crisis in 2009 as calculated by the EU Commission. Positive (negative) values for the fiscal stance indicate contractionary (expansionary) fiscal policy. As can be seen the so called 'fiscal effort', i.e. the discretionary measures taken in order to consolidate the budget is quite substantial. On average for the EMU-12 as a whole, the cumulated volume of consolidation measures is more than 3 % of GDP from 2009 to 2015 with the bulk of measures realised within only three years from 2011 to 2013. As was to be expected, Greece and to a lesser extent Ireland, Spain and Portugal stand out with a total volume of 7.3 (Portugal) to 14.9

% (Greece) of GDP. France and Italy show substantial efforts slightly above the EMU-12 average whereas the Netherlands and above all Belgium, Germany and Austria consolidated to a much lesser extent. According to the EU Commission's calculations Luxembourg and Finland even showed some small fiscal expansion.

Table 2: General government structural primary budget balance (SPB) and (cumulative) fiscal stance (annual change in the SPB), Euro area countries 2007-2015 in % of GDP

					Balances				
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Euro area (12 countries)	0.8	0.1	-1.6	-1.5	-0.4	1.1	1.7	1.8	1.7
Belgium	2.4	1.6	-0.3	0.0	-0.1	0.4	0.9	0.8	0.5
Germany	2.0	2.0	1.9	0.4	1.6	2.7	2.8	2.4	1.9
Ireland	-1.1	-6.7	-7.6	-6.1	-5.1	-4.2	-1.5	0.2	0.7
Greece	-3.3	-4.7	-9.5	-3.3	1.1	4.0	5.9	5.4	4.7
Spain	2.2	-3.1	-6.8	-5.1	-4.0	-1.0	0.6	1.1	0.1
France	-2.0	-1.5	-3.7	-3.5	-2.2	-1.3	-0.7	0.0	0.5
Italy	1.3	1.2	0.4	0.8	1.3	4.0	4.4	4.4	4.4
Luxembourg	1.8	2.9	2.1	0.8	1.5	2.2	1.9	1.1	-0.7
Netherlands	1.2	1.5	-2.0	-2.1	-1.7	-0.8	0.5	0.4	0.9
Austria	0.8	0.7	0.1	-0.5	0.4	1.0	1.4	1.3	1.4
Portugal	-0.8	-1.5	-5.7	-5.6	-2.1	0.8	1.6		
Finland	4.2	3.8	1.6	0.0	0.5	0.0	0.3	0.1	0.6
					Fiscal Stance (2008-2015)				
		2008	2009	2010	2011	2012	2013	2014	2015
Euro area (12 countries)		-0.7	-1.7	0.1	1.1	1.5	0.6	0.1	-0.1
Belgium		-0.8	-1.9	0.2	-0.1	0.6	0.5	-0.1	-0.2
Germany		0.0	0.0	-1.6	1.2	1.1	0.1	-0.4	-0.6
Ireland		-5.6	-0.9	1.5	1.0	0.9	2.6	1.7	0.5
Greece		-1.3	-4.9	6.2	4.5	2.9	1.9	-0.5	-0.8
Spain		-5.3	-3.7	1.7	1.1	3.0	1.6	0.5	-1.0
France		0.5	-2.2	0.3	1.3	0.9	0.5	0.7	0.4
Italy		-0.1	-0.8	0.4	0.5	2.7	0.3	0.0	0.1
Luxembourg		1.1	-0.8	-1.3	0.7	0.7	-0.3	-0.8	-1.8
Netherlands		0.3	-3.5	-0.1	0.4	0.9	1.3	-0.1	0.4
Austria		-0.1	-0.6	-0.6	1.0	0.6	0.4	-0.1	0.1
Portugal		-0.7	-4.1	0.0	3.6	2.9	0.8		
Finland		-0.4	-2.2	-1.6	0.5	-0.5	0.3	-0.3	0.6
					Cumulative Fiscal Stance (2010 – 2015)				
				2010	2011	2012	2013	2014	2015
Euro area (12 countries)				0.1	1.2	2.7	3.3	3.4	3.3
Belgium				0.2	0.1	0.7	1.2	1.0	0.8
Germany				-1.6	-0.4	0.7	0.9	0.5	-0.1
Ireland				1.5	2.5	3.4	6.1	7.8	8.3
Greece				6.2	10.7	13.5	15.5	14.9	14.2
Spain				1.7	2.8	5.8	7.4	7.9	6.9
France				0.3	1.6	2.5	3.0	3.8	4.2
Italy				0.4	0.9	3.6	3.9	3.9	4.0
Luxembourg				-1.3	-0.6	0.1	-0.2	-1.0	-2.8
Netherlands				-0.1	0.3	1.2	2.5	2.4	2.8
Austria				-0.6	0.4	1.0	1.4	1.2	1.4
Portugal				0.0	3.6	6.5	7.3	7.3	7.3
Finland				-1.6	-1.1	-1.6	-1.3	-1.5	-1.0

Source: EU Commission (2014a), author's calculations.

Table 3: General government structural primary budget balance (SPB) and (cumulative) fiscal stance (annual change in the SPB), Euro area countries 2007-2015 in % of GDP (potential GDP growth as of EC's spring 2010 forecast)

	Balances								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Euro area (12 countries)	0.7	-0.1	-1.6	-1.5	-0.3	1.7	2.8	3.3	3.6
Belgium	2.6	1.9	0.0	0.2	0.0	0.7	1.4	1.5	1.4
Germany	1.3	1.1	1.1	-0.5	0.7	1.9	2.2	1.9	1.4
Ireland	-0.9	-6.2	-6.8	-5.2	-3.8	-2.0	1.5	4.0	5.0
Greece	-3.4	-4.4	-8.6	-1.2	4.8	8.9	12.4	13.5	14.6
Spain	2.7	-3.0	-6.9	-5.5	-4.5	-1.0	1.4	2.7	2.5
France	-1.1	-0.5	-2.7	-2.3	-1.0	-0.1	0.6	1.6	2.2
Italy	1.1	1.0	0.4	1.0	1.7	5.2	6.3	7.1	7.8
Luxembourg	1.7	3.4	3.2	2.7	4.0	5.3	5.9	6.1	5.4
Netherlands	1.0	1.4	-1.9	-1.8	-1.0	0.6	2.9	3.7	5.0
Austria	0.1	0.1	-0.3	-0.7	0.5	1.4	2.1	2.3	2.6
Portugal	-2.7	-3.4	-7.6	-7.7	-3.8	0.1	1.9		
Finland	3.9	3.9	2.0	0.7	1.7	1.7	2.7	3.0	4.2

	Fiscal Stance (2008-2015)							
	2008	2009	2010	2011	2012	2013	2014	2015
Euro area (12 countries)	-0.8	-1.6	0.1	1.2	1.9	1.1	0.6	0.3
Belgium	-0.7	-1.9	0.2	-0.2	0.7	0.7	0.1	-0.1
Germany	-0.1	0.0	-1.6	1.2	1.3	0.3	-0.3	-0.5
Ireland	-5.3	-0.6	1.6	1.4	1.8	3.5	2.5	1.1
Greece	-1.0	-4.2	7.4	6.0	4.2	3.5	1.1	1.1
Spain	-5.7	-3.9	1.4	1.0	3.4	2.4	1.4	-0.2
France	0.5	-2.2	0.4	1.3	1.0	0.7	0.9	0.6
Italy	-0.1	-0.6	0.6	0.7	3.5	1.1	0.8	0.7
Luxembourg	1.6	-0.2	-0.5	1.3	1.3	0.6	0.2	-0.8
Netherlands	0.4	-3.3	0.2	0.8	1.6	2.3	0.8	1.3
Austria	0.0	-0.5	-0.3	1.2	0.9	0.7	0.2	0.3
Portugal	-0.8	-4.2	0.0	3.9	3.9	1.8		
Finland	-0.1	-1.9	-1.3	1.0	0.0	1.0	0.4	1.1

	Cumulative Fiscal Stance (2010 – 2015)					
	2010	2011	2012	2013	2014	2015
Euro area (12 countries)	0.1	1.4	3.3	4.4	5.0	5.2
Belgium	0.2	-0.1	0.6	1.4	1.5	1.4
Germany	-1.6	-0.5	0.8	1.1	0.8	0.3
Ireland	1.6	3.0	4.9	8.3	10.8	11.9
Greece	7.4	13.4	17.5	21.0	22.2	23.2
Spain	1.4	2.4	5.9	8.3	9.6	9.4
France	0.4	1.7	2.6	3.3	4.3	4.9
Italy	0.6	1.3	4.8	5.9	6.7	7.4
Luxembourg	-0.5	0.8	2.1	2.7	2.9	2.2
Netherlands	0.2	1.0	2.5	4.8	5.6	6.9
Austria	-0.3	0.8	1.8	2.5	2.6	3.0
Portugal	0.0	3.9	7.7	9.5	9.5	9.5
Finland	-1.3	-0.3	-0.3	0.7	1.1	2.2

Source: EU Commission (2010a, 2014a, 2014b), author's calculations.

Table 3 shows the corresponding numbers after controlling for the downward revision of potential output by assuming that the development of potential GDP that was forecast in spring 2010 remained unchanged. In most cases and years, this led to an upward revision of potential GDP and therefore also an upward revision of the structural budget balance, which automatically leads to more sizable estimates of the fiscal effort. For the calculations, the EU Commission's budgetary semi-elasticities for the individual countries (Mourre et al. 2013)

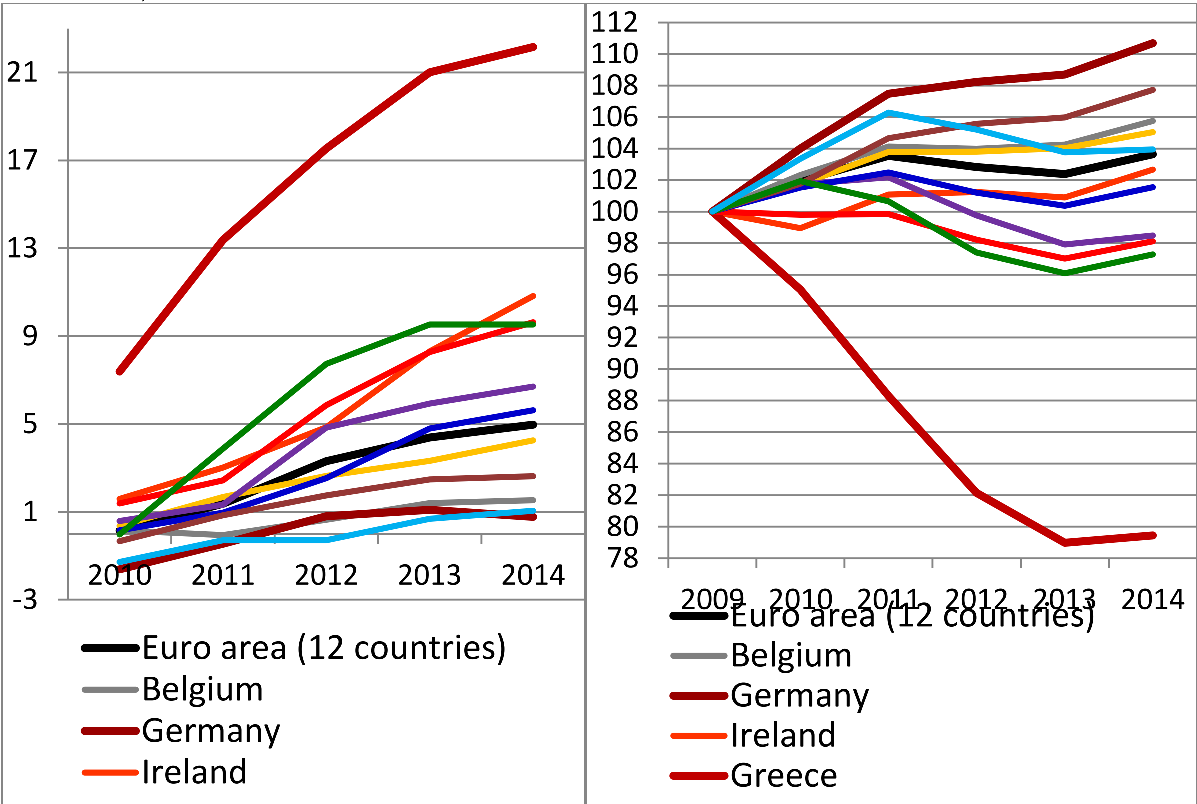
were used and applied to the corrected output gap. As can be seen, in virtually all cases the resulting numbers for the fiscal effort are substantially higher.

2.3. The economic effects of austerity policies

The potential economic consequences of austerity in the huge dimension stated in the previous section can most easily be illustrated by using the concept of the fiscal multiplier. Multiplying the cumulative negative fiscal stance for a given year in relation to some base year with the multiplier gives a rough estimate of the output effects of austerity relative to a baseline scenario without any consolidation measures. The size of the multiplier then becomes the pivotal issue. Maybe one of the very few and small positive side effects of the Great Recession and the austerity crises in many countries is that it has strongly encouraged empirical research on fiscal policy effectiveness and the size of the multiplier. And, in fact, many of the recent studies support the more Keynesian views of a sizeable multiplier. Firstly, the case for expansionary consolidation has been severely damaged by Guajardo, Leigh and Pescatori (2011) as well as Perotti (2012). Secondly, especially under the current conditions in the Euro area with monetary policy at the lower bound, fixed exchange rates within the currency union and simultaneous consolidation, the multiplier tends to be large and (sometimes well) above one (Auerbach and Gorodnichenko 2012, Batini, Callegari and Melina 2012, Blanchard and Leigh 2013; Baum, Poplowski-Ribeiro and Weber 2012, Coenen et al. 2012, De Long and Summers 2012; Holland and Portes 2012). Thirdly, as suggested by the standard Keynesian textbook models and the Haavelmo-Theorem, the expenditure multiplier tends to be larger than the revenue side multiplier (Auerbach and Gorodnichenko 2012, Batini et al. 2012, Gechert 2015). Fourthly, multipliers tend to be higher during strong recessions (Auerbach and Gorodnichenko 2012, Batini et al. 2012, Baum and Koester 2011, Baum et al. 2012; Creel, Heyer and Plane 2011 and Fazzari, Morley and Panovska 2012). According to Batini et al. (2012, 23) the expenditure multiplier during recessions may be in the range of 1.6 to 2.6 whereas the tax multiplier only in the range of 0.16 to 0.35.

Of course, most of the conclusions reached by the recent studies – most notably that there tend to be sizeable multipliers and that expenditure multipliers are larger than revenue side ones – could easily also have been drawn on the basis of the earlier literature well before the crisis (see e.g. the overviews by Hemming, Kell and Mahfouz 2002, Arestis and Sawyer 2003, Bouthevillain et al. 2009 and Creel et al 2011).

Figure 2: Cumulative fiscal effort 2010-2014 in % of GDP and real GDP index (2009=100) 2009-2014, Euro area-12.



Source: EU Commission (2010a, 2014a, 2014b), author's calculations.

Applying multipliers of the sizes conveyed in the older and more recent reviews of the literature to fiscal stances of the magnitude shown before unavoidably leads to the result of devastating economic effects of austerity policies in the Euro area. In fact, a strikingly clear correlation between the cumulative fiscal stance and the development of real GDP since the trough of the crisis can be established. With the exception of Ireland and Finland, the countries that saw the strongest fiscal restriction (as calculated in table 3) obviously performed worst in terms of GDP growth (figure 2). This result – to a somewhat smaller degree – also holds when the EU Commission's original data for the fiscal stance as displayed in table 1 is used. It gets stronger if instead of GDP, domestic demand is used. Although many other factors must be taken into account, it does seem pretty obvious that restrictive fiscal policy has prevented and/or ended the recovery in the most troubled economies and has driven them into recession which in turn – together with the global economic slowdown – was responsible for the stagnation in the rest of the Euro area economies in 2012.

3. The EU Commission's insufficient strategy for public investment and fiscal stimulus

It is by now widely accepted on the EU level that a more expansionary fiscal policy against the imminent deflationary stagnation is necessary, because monetary policy alone will not be able to ignite the recovery. The new Commission has launched two initiatives substantially enlarging its predecessor's efforts (European Commission 2014f and 2015). For expositional purposes they can be divided into three main sets of measures. The first two are particularly concerned with promoting (public) investment in Europe. First, the so-called 'investment clause' under the preventive arm of the treaty is specified and will potentially be made applicable more frequently. Second, an Investment Plan for Europe, the 'Juncker-Plan' has been launched, i.e. a European Fund for Strategic Investments (EFSI) to finance investment on a large scale. Third, the interpretation of the SGP has been clarified with the aim of providing more fiscal leeway for member states under adverse economic conditions and/or implementing structural reforms.

With regard to the first measure, the underlying idea of the 'investment clause' dates back to the Commission 'blueprint for a deep and genuine economic and monetary union', which envisaged allowing a temporary deviation from the MTO or the adjustment path towards it under the preventive arm if it was the result of 'non-recurrent, public investment programmes with a proven impact on sustainability of public finances' (European Commission 2012: 25), e.g. projects co-financed by the EU.[2] However, the Commission made clear from the very beginning that this would have nothing to do with a golden investment rule which it called 'an indiscriminate approach [that] could easily put in danger the prime objective of the SGP by undermining the sustainability of government debt' (European Commission 2012: 25). In this spirit the implementation of the idea was very restrictive, and it continues to be, even under the clarifications made by the new Commission:

> "Member States in the preventive arm of the Pact can deviate temporarily from their MTO or adjustment path towards it to accommodate investment, provided that: their GDP growth is negative or GDP remains well below its potential; the deviation does not lead to an excess over the 3 per cent deficit reference value and an appropriate safety margin is preserved; investment levels are effectively increased as a result; the deviation is compensated within the timeframe of the Member State's Stability or Convergence Programme. Eligible investments are national expenditures on projects co-funded by the

[2] See Prota and Viesti (2013) for a summary of the developments around and the debate about the 'investment clause'.

> EU under the Structural and Cohesion policy, Trans-European Networks and the Connecting Europe Facility, as well as national co-financing of projects also co-financed by the European Fund for Strategic Investments." (European Commission 2015b: 9).

The only improvement compared to the earlier interpretation is that the adverse economic conditions that have to apply now refer only to the member state in question and not to the overall situation of the EU or the Euro area (European Commission 2015: 9). In the past the 'investment clause' provided support for Bulgaria, Romania and Slovenia (European Commission 2015: 9) while it was denied to Italy (Barbiero and Darvas 2014: 6). The EU Parliament had passed a resolution that the 'investment clause' was too narrow and might therefore be extended to completely exclude expenditures for co-funded public investment (European Parliament 2013), but obviously its initiative as to a 'small-scale golden investment rule' has not been taken up by the Commission to date. Even if it had, the overall impact on public investment in the EU would have been extremely limited, as the volume of eligible projects is relatively small. However, particularly the CEE member states might have profited substantially (Barbiero and Darvas 2014: 7).

The second and most prominent measure is the Investment Plan for Europe with – according to the Commission's hopes – a European-wide total investment impact of 315 bn. Euros from 2015 to 2017 (European Commission 2014f). This is supposed to be reached without accumulating any additional public debt on the national or European level and without any additional EU expenditures by the creation of a European Fund for Strategic Investments (EFSI) which is guaranteed by 21 bn. Euros from the EU budget (16 bn. through reallocation from existing resources) and EIB reserves (5 bn.). The aim of the fund is to mobilise finance for investments in key areas such as infrastructure, education, research and innovation. For this purpose, an investment pipeline of strategic projects supported by a specialist investment hub of technical assistance will be provided. Finally, barriers to investment are to be removed and improvements in the regulatory regime achieved. As a leverage effect of 15 is expected, through the use of financial instruments by the EIB, the 21 bn. Euros are supposed to deliver an overall investment volume of 315 bn. Euros. Funding shall be provided to both public and private investors mostly for long-term large scale investment (240 bn. Euros) and to a smaller extent (75 bn. Euros) to support investment by small and medium sized firms. An even larger investment volume is suggested to the extent that contributions from the private sector or from the member states increase the guaranteed capital. Indeed, in order to enable member states to contribute, the Commission has made it clear that such contributions will be excluded from both the preventive and the corrective arm of the SGP (European Commission 2015: 6-7).

It is difficult to evaluate the prospects of the Investment Plan for Europe as it is still in its very early stages. However, there are many open questions and whether the Plan will really deliver is quite doubtful. First of all, one may question whether the volume of the plan is large enough. Even if it really led to 315 bn. Euros of additional investment that would be about 2.25 per cent of EU GDP or 3 per cent of Euro area GDP spread over three years, i.e. 0.75 or 1 per cent of GDP per year, respectively. Given the depth of the economic crisis, particularly in the euro area, this may well be too little. Furthermore, given the long term character of many of the large scale investment projects it will probably take quite a long time before a significant number of projects will be realised.

The most important doubts, however, relate to the question of whether the Plan will really be able to mobilise sufficient additional investment: If it is to stimulate private investment, animal spirits, particularly in the crisis countries, will be typically low, which means that it will be difficult to find investors irrespective of the terms of the programme. If investors are found, then the danger of windfall gains, i.e. that the investors would have chosen the project, anyway, could be large. And if they really invest because of the favourable conditions of the programme, the question pertaining to the efficiency of the programme arises, especially if it is a PPP project: If the fund offers private investors attractive returns, then these returns will have to be paid for, either directly by the public contributor involved or indirectly through charges to the private sector that might otherwise have been avoided. If the fund is to stimulate public investment, one may wonder why this could not be realised by national governments' regular investment. If it is because of fiscal constraints due to the stability and growth pact, an obvious alternative would be removing or loosening those constraints. All in all, therefore, the risk is high that the Investment Plan for Europe will deliver disappointingly little too late.

The third set of measures consists of different clarifications and formalisations of the interpretation of the SGP (European Commission 2015: 9-17). First, structural reforms may justify temporary deviations from the MTO or the adjustment path towards it under the preventive arm.

> "The Commission will take into account the positive fiscal impact of structural reforms under the preventive arm of the Pact, provided that such reforms (i) are major, (ii) have verifiable direct long-term positive budgetary effects, including by raising potential sustainable growth, and (iii) are fully implemented." (European Commission 2015: 12).

Even under the corrective arm structural reforms may be considered as a 'relevant' factor, which may lead to the decision that no excessive deficit exists or that the deadline for correcting

an existing excessive deficit may be postponed under certain conditions. Second, a clarification of cyclical conditions has been provided. Under the preventive arm, adverse cyclical conditions may lead to a diminishing of the adjustment requirement towards the MTO. In exceptionally bad times no structural adjustment is required, in very bad times it is only 0.25 per cent of GDP instead of the previous standard value of 0.5 per cent. For member states under the corrective arm, an unexpected fall in economic activity may now be better accommodated, as fiscal effort will be assessed in a more differentiated way using measures of discretionary fiscal effort that do not suffer from the endogeneity bias of the structural budget balance. Third and finally, the Commission has stated that a severe downturn in the Euro area or the EU as a whole may justify slowing down the pace of consolidation for all member countries both under the preventive and the corrective arm.

All in all, the measures introduced or proposed by the new Commission constitute some progress with regard to counter-cyclical fiscal policies and (public) investment. However, it must be doubted that they will lead to a substantial increase in (public) investment. And the clarifications concerning the SGP may contribute to relieve the pressure from fiscal consolidation and slow down the pace of consolidation somewhat, but obviously they are designed to permit only a slightly less restrictive fiscal stance but not to provide a truly positive fiscal stimulus.

4. Towards a more ambitious re-interpretation of the SGP: using the existing institutional leeway to boost the European economy

What can be done instead to help the Euro area economy recover strongly? Of course, the current institutional framework with the SGP and the Fiscal Compact does not generally offer a favourable climate for expansionary fiscal policy. Governments' deficits and debts in the EU are currently constrained by numerous rules (see European Commission 2013 for an overview). The **Excessive Deficit Procedure (EDP)** within the corrective arm of the Stability and Growth Pact (SGP) is currently being applied to eight Euro area members: Cyprus, France, Greece, Ireland, Malta, Portugal, Slovenia and Spain. Cyprus and Greece face even stronger restrictions as they are subject to financial assistance programmes It requires the general government budget deficit to be reduced to below 3 % of GDP. Member states under the EDP must bring their budget deficit below 3 % of GDP within a time period specified by the EU Council after recommendations from the Commission. The constraints for structural deficits under the preventive arm of the Stability and Growth Pact and the Fiscal Compact apply to all member

states not under the excessive deficit procedure**.** Member states that have not reached their medium term budgetary objective (MTO) had already been obliged to decrease structural deficits annually by a minimum of 0.5 % of GDP under the old SGP. The Fiscal Compact has made these prescriptions more binding by calling for institutionalised debt brakes on the national level in order to ensure that cyclically adjusted deficits are kept under 0.5 % of GDP with automatic corrections in the case of deviations. The **new debt related branch of the EDP** calls for a 1/20th annual reduction of the part of the debt-GDP ratio that is above the 60 % threshold of the SGP. This rule will become effective after member states have left the EDP, because they have reached the 3-%-target with respect to the budget deficit. As the target for debt-GDP ratio is taken into account in the formulation of national medium term objectives this new prescription will most probably not be binding in most cases.

As stated before, without a substantial fiscal expansion the Euro area will hardly escape from stagnation (or even deflationary stagnation or depression) for at least a few years. As in the short run major institutional reforms do not look very likely, alternative means will have to be found within the existing framework unless some governments decide to openly disobey the rules and risk possible (though maybe not probable) sanctions and political quarrels within the European Union. Therefore, the European Commission would have to change its current interpretation of the existing framework which – as argued before – still shies away from re-empowering fiscal policy as a macroeconomic policy instrument. If the Commission instead used the interpretational leeway that the current institutions afford, it could provide substantial room for manoeuvre for national governments to switch to a truly expansionary fiscal policy. Indeed, the clarification by the Commission in relation to making optimal use of the flexibility (European Commission 2015) can be seen as hinting at the direction that would need to be followed. It would at some points simply need a few further interpretational steps to enable a substantial fiscal policy boost. Unlike the Juncker-Plan to boost public or (publically supported) investment through investment funds, the strategy would provide a direct boost to public (investment) spending on the national level and does not have to rely on highly insecure shifting and leveraging of public funds on the European level in the hope of finding private investors at times when business confidence is extremely low.

Least controversially, the one country that is currently in a rather favourable budgetary position, Germany, should use up its safety-margin to its Medium Term Objective and to the limits of its national debt brake and increase public (investment) spending in order to stimulate domestic demand, increase imports and help its neighbours to recover. Currently, the safety margin as calculated by the EU Commission is s1 % of GDP in 2014 (see table 6). If that was

in fact used to increase public (investment) spending, the overall effect for the Euro area economy would not be very large, but certainly not completely negligible. Actually, using this leeway was even recommended by the European Commission (2014e, 6) and approved by the Council.

Additionally, the EU-Commission should use aggressively any interpretational leeway within the preventive as well as the corrective arm of the SGP in order to allow for a more expansionary fiscal stance in additional countries.[3] In this sense, at least the following eight measures that are generally complementary to each other should be considered (see table 5).[4]

Table 4: Eight ways to strengthen investment and facilitate an expansionary overall fiscal policy stance in Europe

(1) more active use of the 'investment clause'
(2) allow for temporary investment programmes (analogous to EFSI)
(3) interpret temporary investment programmes as structural reforms
(4) incorporate realistic investment multiplier in budgetary analysis ex ante
(5) use leeway in economically bad times
(6) use exception for severe downturn in EU or Euro area
(7) temporarily higher spending with a view to Europe 2020 goals
(8) implement better methods of cyclical adjustment

Source: author's compilation.

There are at least four possibilities to explicitly strengthen public investment within the current fiscal framework (measures 1 to 4 in table 5). Indeed, strengthening public investment within the Euro area should be of the highest priority: Public investment is particularly conducive to growth both in the short and the long run (see Truger 2015b: chapter 3) and it has suffered from austerity policies in a disproportionally strong way (Barbiero and Darvas; Truger 2015b: chapter 2).

[3] See Micossi and Peirce (2014) as well as Truger (2015) for an earlier overview of the potential flexibility that is provided within the European fiscal rules that partly anticipated the new interpretation by the European Commission (2015). Micossi's and Peirce's conclusion that the rules provide sufficient flexibility and that, therefore, there is no need for reform is, however, not shared.

[4] This paper only includes measures that could plausibly be implemented without any changes in the current institutional framework. See Truger (2015) for a proposal of a Golden Rule for Public Investment that would generally allow debt financing of net public investment. Although the case for such a rule is very strong, it is not included here, as it would most probably require a change of the European treaty or at least of the relevant Council regulations (see Blanchard and Giavazzi 2004: 15).

Turning to the 'investment clause', this should at least be opened to unconditionally include all investment that is supported by European funds as was called for by the European Parliament (2013) (measure 1 in table 4). Furthermore, additional net investment could be justified if it came in the form of a temporary investment programme, analogous to the way the Commission interprets contributions to the EFSI (measure 2 in table 4). Additionally or alternatively, it may also be possible to treat a sufficiently comprehensive investment programme as a structural reform that temporarily allows for deviations from MTO or the adjustment path towards it (measure 3 in table 4). All of this could further be supported if realistically high multiplier values were used in assessing the budgetary impact of additional investment, which may not be significantly negative or even positive. This would mean that such additional investment could be irrelevant at least under the excessive deficit procedure as it would not (or hardly not) increase the deficit: The additional spending should not be counted as a one-to-one increase in the (structural) government deficit. If the EU Commission adopted a realistic attitude to fiscal multipliers that was in line with the recent results from the literature referred to in section 2.3, any increase in public (investment) spending would lead to a much smaller increase in the deficit due to its positive macroeconomic effects. As seen, spending multipliers – especially for public investment – are well above one which means that such spending increases will be self-financing to a substantial extent (e.g. 50-75%). If this were taken into account when evaluating national stability programmes and the existing leeway within the preventive and corrective arm (see below) were used for the remaining temporarily higher deficit, the potential positive fiscal stance could be substantial (at least twice or three times as large as the resulting increase in the budget deficit). For example, an increase in public investment by 1 per cent of GDP would only lead to an increase in the budget deficit of 0.25 to 0.5 per cent of GDP – a deviation that may be easy to justify with the structural reform argument or with exceptional circumstances. Furthermore, if the European Commission stuck to its pro-cyclical method of cyclical adjustment, the resulting increase in GDP and decrease in unemployment should lead to an upward revision of potential GDP. Also, an increase in public investment should automatically lead to an increase in the investment to GDP level which should in turn increase potential GDP.

In addition to the four measures to specifically increase public investment at least four more exist to justify a more expansionary fiscal policy stance, be it to (further) promote public investment or other desired stimulus measures (measures 5-8 in table 4). For example, reference to adverse cyclical conditions may help to increase fiscal leeway even further (measure 5 in table 4), although this could create the danger of a stop-and-go policy, if cyclical

conditions improve as can be expected under a stimulus programme. Probably the most convincing way to do this would be to use the provision concerning a severe downturn in the Euro area or the EU to justify a temporary deviation from the consolidation path, thus allowing for a substantial European stimulus programme (measure 6 in table 4). The Commission has explicitly made a comparison with the 2008 European Economic Recovery Plan (European Commission 2008) to give an example of the potential use of this provision (European Commission 2015: 17). As a condition for the use of this provision it "should remain limited to exceptional, carefully circumscribed situations to minimise the risk of moral hazard." (European Commission 2015: 17). Actually, one may well argue that the Euro area is right now in such an exceptional situation after years of recession and stagnation and the threat of deflation while monetary policy is at the lower bound. Such a European stimulus programme should provide an annual stimulus of at least one per cent of GDP for two or three years. One option for the direction of the programme would be to use it in order to start phasing in traditional net public investment. Alternatively or additionally, such a programme could also be used to allow for spending needs beyond the narrow national accounts definition of public investment (measure 7 in table 4).[5] Such a direction would address concerns that raditional tangible investment would be promoted whereas other important forms of investment in the economic sense of the word would be neglected. This could be investment in education, including child care, but it could more generally focus on spending with a view to achieving the currently neglected Europe 2020 goals such as social inclusion or other areas that have strongly suffered from austerity over the last years.

Last, but certainly not least, a reconsideration of the EU Commission's method of cyclical adjustment (measure 8 in table 4) – e.g. to be more in line with the OECD method and results – would help tremendously in creating further leeway as it might increase the cyclical part of the budget deficit thus reducing the structural deficit (Truger 2015). The European Commission's reaction to the problems of the cyclical adjustment of public finances are – at best – ambivalent. On the one hand, on an intellectual level the Commission seems to be conscious of the problems and is regularly addressing them in papers or through some essentially minor (in terms of the policy implications) changes in the technical procedures. On the other hand, the Commission shies away from drawing obvious conclusions in terms of practical fiscal policy and consolidation requirements for the future. The Commission has

[5] Aiginger (2014) has made a similar proposal which he called the 'silver rule' proposal. Whereas the golden rule allows permanent debt financing of all net investment, the silver rule allows temporary debt financing of additional investment.

continuously been changing its method of cyclical adjustment over time (see Truger and Will 2013). For the autumn 2010 economic forecast, the estimation procedure for total factor productivity was changed, explicitly with the aim of providing more stability for the short term potential output and output gap estimates (European Commission 2010b, 120-124). Also the Commission has often dealt with the problem of time-varying tax elasticities and their role in the determination of the structural budget balance (European Commission 2010b, 124-130). It has even admitted that the estimates of the fiscal effort based on the change in the structural (primary) budget balance tend to underestimate the true discretionary consolidation efforts and is since then using complementary measures to assess fiscal effort (European Commission 2013a, 101-132) that have even been used in the assessment of effective action taken under the excessive deficit procedure (European Commission 2013b). Time varying tax elasticities and a deterioration of potential output have even been accepted as a retrospective justification that the structural budget balance did not improve as required under the excessive deficit procedure, e.g. in the case of Spain, by the European Council (European Council 2013, 8). Finally, in the spring 2014 forecast, the Commission changed its NAIRU estimation procedure, an important part of the determination of potential output, in order to avoid ‘excessively pro-cyclical NAWRUs under certain circumstances’ (European Commission 2014d, 27). Most probably this reaction was initiated by the Spanish finance ministry claiming that estimates for the Spanish NAWRU of 28 % were most implausible (Klär 2014, 24-28). However, the reaction was delayed due to protests from European governments, namely the German one (Klär 2014, 25), and in the end the Commission decided that the ensuing positive revisions of structural budget balances – which in the Spanish case amounted to almost 2 % of GDP for 2015 – did not lead to a revision of the required fiscal effort (European Commission 2014d, 29).

As already illustrated in the calculations before, this could lead to a much more adequate picture of the fiscal effort that has already been undertaken by the member states which in turn would make it easier to justify exceptional circumstances under the preventive and the corrective arm. The upward revision of (negative) output gaps (table 1) would underline the extremely bad cyclical condition in which many member states are trapped. It is simply ridiculous to assume (as the Commission does) that the Greek output gap in 2015 will only be -4 % when the Greek economy will have lost about a quarter of its pre-crisis output. Last but not least, the estimates of the structural budget balance would then be revised upwards lifting a number of member states above their MTOs so that they would enjoy additional leeway. For example, table 5 shows that in addition to Germany; Italy, Luxembourg, the Netherlands, Austria and Finland would already have reached their MTOs in 2014 if the structural balance

had been calculated with the potential growth estimates of the pre-austerity-era in spring 2010. And for practically all other countries the distance to their MTOs would have been reduced substantially.

Table 5: Output gap, structural budget balance (EU Commission spring 2014 estimate and modification) 2014 and medium term objective for 12 Euro area countries in % of GDP

	Output gap 2014 (Commission)	Output gap 2014 (modification)	Structural balance 2014 (Commission)	Structural balance 2014 (modification)	Medium term objective (MTO)
Euro area (12 countr.)	-2,7	-5,7	-1,1	0,4	-0,2[1)]
Belgium	-1,1	-2,3	-2,3	-1,5	0,75
Germany	-0,7	0,2	0,5	0,0	-0,5
Ireland	-1,0	-10,5	-4,5	-0,7	0
Greece	-9,3	-25,8	1,0	9,1	--
Spain	-6,7	-10,5	-2,4	-0,8	0
France	-2,8	-5,7	-2,3	-0,8	0
Italy	-3,6	-8,7	-0,8	1,9	0
Luxembourg	-1,6	-12,0	0,6	5,7	0,5
Netherlands	-2,6	-8,2	-1,3	2,0	-0,5
Austria	-0,8	-2,8	-1,2	-0,3	-0,45
Portugal	-4,0	-6,6	--	--	-0,5
Finland	-2,6	-8,8	-0,9	2,1	-0,5

[1)] weighted average of available values.

Source: European Commission (2010a, 2014a, 2014g); author’s calculations.

Taking all of the proposals for a more expansionary interpretation of the existing institutional framework together, a Euro area-wide expansionary fiscal stance of two to three per cent of GDP would be quite realistic. One might want to argue that the interpretational changes proposed here are so far-reaching that they might, in fact, be seen as a an abandonment of the existing SGP, involving questions of time-inconsistency and credibility. However, this would hardly seem convincing. Firstly, the interpretation proposed here still uses the terminology and the framework of the existing pact. Therefore, if there is a problem of credibility, then it is one that is inherent in the current framework, with its vague and imprecise terminology that leaves much room for interpretation. Not the particular interpretation, but the current fiscal framework as such would then suffer from problems of credibility. Second, the EU Commission has, for several years in a row, insisted upon a strict application of the rules ex ante, only to relax the

requirements when countries ran into problems ex post. One can well argue that a clear ex ante-relaxation of requirements is more credible than a ritual game of strict announcements that have to be regularly scrapped ex post.

5. Conclusion

Most parts of the Euro area have seen seven years of deep economic crisis. Austerity problems have played a major role in this economic, social and political tragedy. The EU needs to address these problems. The previous strategy of tightening the fiscal constraints of the SGP has driven many member states into austerity and has disempowered national fiscal policy as a macroeconomic policy instrument. Unfortunately, in the current situation, with depressed aggregate demand, deflationary tendencies and monetary policy at the lower bound, national fiscal policy is the only instrument left that could bring about a sustained recovery. The EU Commission is shying away from this conclusion and tries to evade anything that might change the present institutional framework of fiscal policy.

In the medium to long run the Euro area (and the EU) will probably need a far-reaching reform of its institutional framework to foster growth and employment and to protect and strengthen the welfare state (see e.g. Hein, Truger and van Treeck 2012). However, even in the short run, the current institutional framework (SGP, fiscal compact) offers sufficient interpretational leeway to allow for a substantial fiscal expansion that could boost the European economy at least for the next two or three years. If the new European Commission acted responsibly and used the opportunity in a way similar to the one sketched, the prospects for a strong recovery in the Euro area would not be too bad. All it would need is the will to be a bit more consequential in using the leeway provided by the current framework. It is to be hoped that it will not again take years of stagnation and more millions of unemployed before European policy makers draw the right conclusions and start reviving fiscal policy.

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