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A review of the economic crisis: solutions and failures in the European Union

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Abstract. *Welfare-state European model has been profoundly affected by the economic crisis. In this context, most of the EU member states decided to respond by undertaking short run policy measures. Government spending has been extended in order to create new jobs and to stimulate economic recovery. The fact that the EU member states are still facing the crisis suggests that the policies implemented were inefficient. Moreover, EU officials seem trapped in a vicious circle dominated by the crisis growing effects and their own commitments to bring back economic recovery. This study emphasizes the policy measures' inconsistencies and, as a consequence, the failure of economic recovery initiatives.*

Keywords: economic crisis; welfare state; budget cuts; financial stimulus; economic recovery.

JEL Codes: E24 E32 E65.
REL Codes: 8D, 8H, 13C, 20C.

Welfare-state European model has been profoundly affected by the economic crisis. Government deficits and huge public debt have facilitated the spreading of its negative effects. In this context most of the EU member states decided to respond by undertaking short run policies. European officials had to embrace budget cuts policies and to implement stimulus packages in order to countervail the effects of the crisis. As can be seen, their goal was to diminish budget deficits rather than implementing real reforms. Stimulus packages consisted mostly in extending government spending in order to preserve and create new jobs. The fact that the EU member states are still facing the crisis suggests that the policies implemented were inefficient.

The main problem with the adopted policies is that they are contradictory. While budget cuts should mean diminishing government spending, stimulus packages generates exactly the opposite effect. The huge dimension of state's interventionism in the EU doubled by the dissimulated will of reforming determined budget cuts only for compensation of employees and social benefits. In order to stimulate economic recovery most of the EU member states adopted the Keynesian solution of enhancing government spending in some strategic domains. The real reforms necessary to stimulate economic recovery and private initiative lacked or, in the best case, were considered of secondary importance.

This is why the crisis's effects persist for the most of the EU member states and, moreover, tend to become critical for some of them despite the budget cuts measures. The explanation for this is simple: governments must respond properly to budget constraints but, at the same time, the huge dimension of the welfare state is an impediment mainly for implementing the social benefits' cuts. The dimension of state intervention is too big for the budget cuts to be easily implemented and without resistance. This is also the cause of the fact that EU citizens are mainly adapted to the benefits of social assistance and, hence, they are not willing to give them up.

Creating new jobs is the main reason for increasing public spending on various projects in the most of the EU member states. The main error of such measures consists in ignoring public spending's long term implications for the economy. Although it may seem like putting money to the other pocket of the public budget, the reality is that such spending generates only deficits. The need for fiscal consolidation calls for constraints which negatively affect private sector, either by raising taxes, either by inflation or both. Therefore, EU member states seem trapped in a vicious circle dominated by the crisis growing effects and their own commitments to stimulate economic recovery.

This study emphasizes those stated above. In order to attend this purpose it succinctly exposing the policy measures that the EU member states have implemented during the economic crisis.

1. The end of the welfare state illusion and the austerity solution

At the end of the 2008, EU member states adopted budget cuts policy measures. The potential crash of the Eurozone and of the entire EU political and economic construction revitalized discussions about the commitments concerning budget deficits. Under these circumstances, EU member states decided to bring their own budget deficits down to 3 percent of GDP by 2013.

One must emphasize that budget cuts are not anti-crisis policy measures, but consequences of it. This assertion is logically and chronologically consistent. An advantage of this disambiguation consists in identifying a positive relation between welfare state dimensions in various EU member states and the intensity of budget cuts policy measures they adopted. Policy makers avoided to emphasize the real reason for the budget cuts. Otherwise, they had to criticize the illusive welfare state benefits which, actually, they continued to finance at the expense of the same deficient public budgets.

Table 1

Budget cuts and government spending, 2009

	Budget cuts (%GDP)	Government spending (%GDP)		
	2010-2015	2009	2010	2011
Austria	0.9	52.6	52.6	50.5
Belgium	5.3	53.7	52.8	53.4
France	4.5	56.8	56.6	56.0
Germany	3.0	48.2	47.7	45.3
Hungary	1.6	51.4	49.8	49.6
Greece	10.7	53.8	50.2	50.1
Italy	1.6	51.9	50.4	49.9
Portugal	6.6	49.8	51.3	48.9
Spain	8.2	46.3	45.6	43.6
United Kingdom	6.0	51.5	50.4	49.0

Note: Budget cuts are intended during 2010-2015.
Source: Paolo Manasse – *Budget cuts across Europe: Coordination or diktat?*, 24 July 2010, www.voxeu.org; Eurostat.

Budget cuts initiatives ought to be analyzed in correlation with the budget deficits in the member states. Associating them with the public spending one can understand the real dimension of government intervention, on the one hand, and the resistance against austerity measures in some countries, on the other. Budget cuts were mainly oriented toward diminishing public workers' compensations or freezing them. Therefore, citizens protested violently against austerity measures taken by the government officials in countries like France and Spain. The main explanation for this situation resides in the welfare state incentives. Thus, during the boom period, the government spending has been increased because of the growing number of public employees. An analysis of

the public spending with the compensation of employees reveals the earlier conclusion. As can be seen in the figure below, compensations have increased in 2009 compared to the previous year in most of the EU member states and the trend persisted for the next year in some countries, although the EU economy was already confronting the crisis.

Table 2

Government compensation spending and social benefits

	Compensation spending (%GDP)				Social benefits (%GDP)			
	1996	2008	2009	2010	1996	2008	2009	2010
Belgium	11.9	12.0	12.7	12.6	22.6	23.3	25.4	25.1
France	13.6	12.8	13.5	13.4	22.7	23.5	25.4	25.7
Germany	8.8	7.4	8.0	7.9	26.0	23.9	26.2	25.5
Hungary	10.8	11.6	11.5	10.9	16.0	18.6	19.4	18.5
Greece	9.6	12.0	13.4	12.1	13.7	19.6	21.1	20.8
Ireland	9.5	11.2	12.2	11.8	12.5	14.2	17.3	18.0
Italy	11.3	10.8	11.2	11.1	18.5	20.3	22.0	22.1
Portugal	12.7	12.0	12.6	12.2	12.7	19.3	21.9	21.9
Spain	11.2	10.9	12.0	11.9	15.6	15.2	17.7	18.3
United Kingdom	10.5	11.0	11.6	11.4	14.5	13.3	15.1	15.1
Poland	10.5	10.0	10.2	10.1	18.6	16.1	16.9	17.0
Czech Republic	7.2	7.3	7.8	7.6	16.4	17.5	19.5	19.7
Bulgaria	7.2	9.2	9.9	9.3	9.2	11.6	13.7	14.3
Romania	6.4	10.5	10.9	9.8	10.1	11.0	13.3	13.8

Source: Eurostat Statistical Books – *Government finance statistics*, Summary tables -2/2011, http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-EK-11-002/EN/KS-EK-11-002-EN.PDF.

Budget cuts solution becomes extremely sensitive matter when social benefits must be reduced or, in some cases, eliminated. As can be seen in the previous table, states that form welfare state European model's core, namely France and Germany, register the highest social benefits-to-GDP ratios. Surprisingly, these ratios rose in 2009 compared to the previous year. In some cases ratios rose insignificantly (Hungary and Poland supplemented their social spending only with 0.3 and 0.8 percentage points (pp) of GDP, respectively). Other countries (Germany, Ireland, Portugal, Spain, United Kingdom, Bulgaria and Romania) extended social benefits with at least 2 pp of GDP in 2009 and even for the next year. A possible explanation for this is the decline in real GDP in 2009. Therefore, the social benefits-to-GDP ratio increased for the most of the EU member states.

Another severe criticism to budget cut solution relies on the economic deficiencies induced by the consumption decrease. The economic crisis will persist because consumption financed through social spending will fall inevitably and private firms will be affected. Moreover, the fall in consumption spending is directly correlated with the social benefits-to-GDP ratio. Accepting this argument means also admitting the fact that increasing compensation of employees and social spending was beneficial for private sector. This reasoning

is profoundly fallacious because it ignores the government spending-to-GDP ratio which has been increased altogether with the GDP during the year 2010. In this particular case the only way to extend public spending is by extracting funds using fiscal policy.

Stating that private spending or its governmental substitute is the “engine” of economic growth emphasizes a severe misunderstanding of the free market economy and creates a false image of an economic recovery coordinated by public policies. The alleged beneficial function of increasing governmental spending on aggregate demand goes beyond the borders of an economy when it comes to argue that diminishing the public spending will negatively affect the recovery of the global economy(1).

Such policy measures negatively affect and delay economic recovery, forcing entrepreneurs to make inadequate decisions. Moreover, the entire economic environment is oriented toward inefficient decision making. One cannot explain the private firms’ constant fear of decreasing aggregate demand but by accepting the mere fact that public policies concerning compensation of employees and social benefits created a structure of distorted incentives. The consequence of demand contraction would be the business plans’ readjustment.

Table 3

Multipliers used to evaluate fiscal packages

	Government consumption		Transfers to household		Tax cuts	
	An 1	An 2	An 1	An 2	An 1	An 2
Belgium	0.3	0.4	0.2	0.4	0.1	0.2
France	0.6	0.7	0.4	0.7	0.2	0.4
Germany	0.4	0.5	0.3	0.5	0.2	0.3
Hungary	0.3	0.4	0.2	0.4	0.1	0.2
Greece	0.5	0.6	0.4	0.6	0.2	0.4
Ireland	0.3	0.4	0.2	0.4	0.1	0.2
Italy	0.6	0.7	0.4	0.7	0.2	0.4
Poland	0.4	0.5	0.3	0.5	0.2	0.3
Portugal	0.4	0.5	0.3	0.5	0.2	0.3
Czech Republic	0.3	0.4	0.2	0.4	0.1	0.2
Spain	0.5	0.6	0.4	0.6	0.2	0.4
United Kingdom	0.5	0.6	0.4	0.6	0.2	0.4

Source: OECD Economic Outlook Interim Report March 2009, Chapter 3 - *The Effectiveness and Scope of Fiscal Stimulus*, 2009, www.oecdbookshop.org.

Another argument that shows the over evaluated importance of public spending resides in the main pillar of the entire Keynesian theory edifice. This theory of government interventionism introduced the concept of multiplier equally associated with the private and the public spending. Accepting, even as a mere example, the importance of aggregate demand stimulation, one can easily observe that the impact of diminishing public spending on economic

performances is insignificant. This is the cause of public spending's multipliers small values (lower than 1) for different European countries which means a low effect on the aggregate output.

Resuming those stated above one can argue that budget cuts policy measures were a mere reaction of the EU member states to the fact that welfare state European model could not be financed anymore. These policies didn't reach their goal because they concentrated mainly on preserving oversized government interventionism. Real reform policies were replaced by stimulus packages that distorted firms' readjusting efforts. Therefore, the fact that EU member states still face economic crisis is a consequence of institutional rigidity implemented by the welfare state European model.

2. Stimulus packages and the failure of economic recovery

More than budget cuts policy measures were needed in order to fight against crisis. Therefore, EU member states implemented stimulus packages as economic recovery policies. Mainly, these packages consisted in increasing governmental spending. The purpose was to create new jobs and preserve the existing ones. According to EU Commission (2009, p. 36) the official short term policy was "keeping people in employment" and it was to be implemented using massive financial stimulus packages. Member states had to maintain the existing jobs in order to avoid the negative effects and "human costs of the crisis" (Commission, 2009, p. 38).

One can easily identify that the policy measures implemented were contradictory. While budget cuts try to diminish public spending, financing stimulus packages generates exactly the opposite effect. Moreover, budget cuts should have meant also reducing taxation. But as this study emphasizes, the economic logic is replaced by the "budgetary" one due to stimulus packages.

The most popular use of public money is financing infrastructure projects in order to increase the aggregate outcome. The main argument of using stimulus packages is based on the Keynesian theory according to which "investing" in infrastructure generates multiplying effects. Job losses and fall in aggregate demand fueled interventionism. Therefore, increasing number of IMF and OECD studies aimed to validate empirically the multiplying effects of governmental spending on infrastructure. Using various and controversial estimation techniques of public spending, these studies reach the same conclusion: the multiplier effect of infrastructure spending is stronger than the others(2).

Because of the controversies, some of these studies advocate for an even-minded use of multiplying effects as arguments for government intervention policies (Cogan et al., 2009, pp. 8). Cwik and Wieland (2009, p. 17) and Marinas (2010, p. 64) emphasize the threat of increasing government spending

on private consumption and investment. The excessive optimism concerning the multiplying effects originates from ignoring the ability of economic agents to anticipate the future evolution of the economy. So, they expect rising taxes in order to finance growing public spending and, therefore, consumption and investment will decrease because of the crowding out effect. Ono (2009, pp. 4-5) offers similar conclusion. Other studies emphasize the inefficiency of public spending multiplier comparing to the fiscal one. Despite the Keynesian theory's prescriptions, private spending falls in response to growing government spending which means a value below unity for the governmental spending multiplier (Ramey, 2012, pp. 20-21).

Therefore, EU member states launched massive infrastructure spending programs. 21.53 billion euros were spent in 2009 (0.17% of GDP) and 10.34 billion were intended to be spent in 2010 (0.08% of GDP). Most of these expenses (13.7 billion euros) are dedicated to transportation infrastructure (Commission, 2009, p. 53).

The policy measures implemented by the member states, although largely accepted, have many deficiencies concerning exactly their expected benefits. Therefore, it is fallaciously argued that an increase in aggregate demand will allow firms to exist on the market while the public money used to finance the economy will be restored through the tax system. It seems like economy's public financing means putting money in the other pocket. This conclusion is wrong because budget deficits will occur and financing them will lead to an increasingly public debt.

Table 4

Government spending on infrastructure (%GDP)

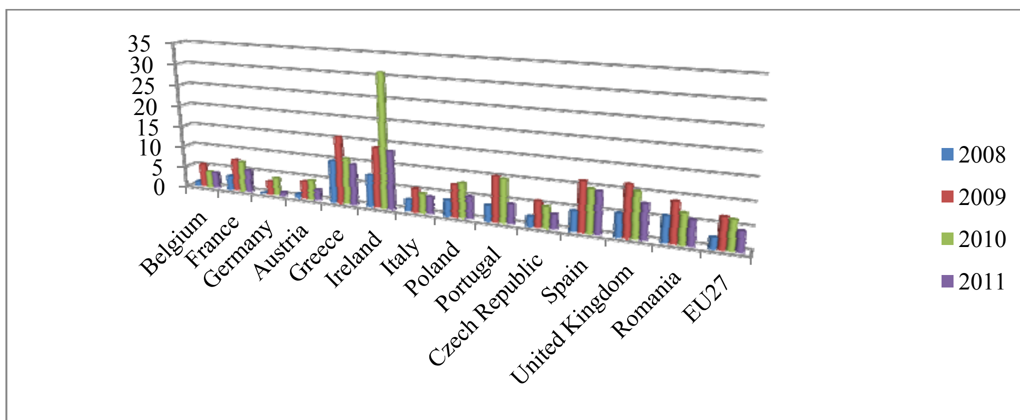
	Spending on infrastructure
Belgium	0.11
France	0.22
Germany	0.17
Austria	0.35
Poland	1.10
Portugal	0.18
Czech Republic	0.33
Spain	0.84
United Kingdom	0.12

Source: European Commission - The *EU's response to support the real economy during the economic crisis: an overview of Member States' recovery measures*, Occasional Papers 51, July 2009.

This is exactly what happened in the EU during the crisis. Budget deficit reached its highest level (6.8% of GDP) in 2009 and 2010 and public debt grew from 62.3% of GDP in 2008 to 80.3% of GDP in 2010[(3)] (Commission, 2011, p. 17). As can be seen in the chart below (Figure 1), EU member states accumulated growing budget deficits during 2009. Some of them (Belgium,

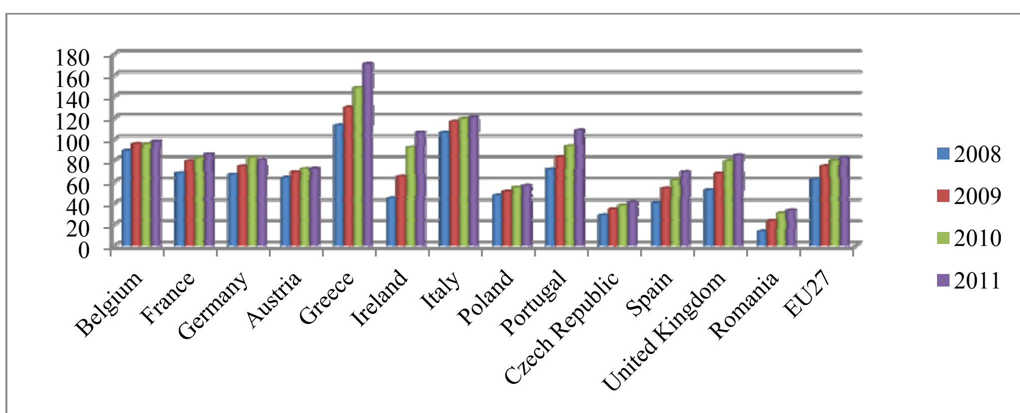
Germany and Austria) had small deficits in the previous year. Others (Greece, Ireland, Spain, and United Kingdom) continued to accumulate deficits although they had already one of the biggest figures across the EU. In other cases, like Portugal, the deficit almost tripled during 2009 comparing to the previous year.

Budget cuts policy measures implemented in the next two years determined smaller budget deficits for most of the EU member states. But the damage has already been done: increasingly public debt has been accumulated because of the stimulus packages, banks' bailouts and external credit. Therefore, member states had to accept a two-track crisis, including the sovereign debt one. Public debt accumulated constantly during 2008-2011 and in some countries (Romania and Ireland) has doubled its value.



Source: Eurostat newsrelease, *Euroindicators*, 149/2012, october 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22102012-AP/EN/2-22102012-AP-EN.PDF.

Figure 1. *Budget deficit, 2008-2011*



Source: Eurostat newsrelease, *Euroindicators*, 149/2012, october 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22102012-AP/EN/2-22102012-AP-EN.PDF.

Figure 2. *Public debt, 2008-2011*

Extending budget deficits forced EU member states to implement fiscal consolidation measures. The adopted solution was budget cuts policy measures. Even, as stated above, the budget deficits decreased the accumulation of increasing public debt tends to anticipate the failure of fiscal consolidation measures. An argument for this is the attitude adopted by the member states. Most of the EU member states didn't resist the temptation of increasing taxes, despite the fact that many studies emphasize the negative impact of such policy measures (Alesina et al., 2012, p. 26). These studies argue that adjusting public spending doesn't generate recession, despite the severe critics against reducing government spending. On the contrary, private spending tends to grow due to lower tax expectations.

Table 5

Public debt during the crisis

	2008-2011 evolution (%)
Belgium	9.6
France	26.1
Germany	20.5
Austria	13.5
Greece	51.1
Ireland	139.1
Italy	13.8
Poland	19.7
Portugal	50.8
Czech Republic	42.2
Spain	72.4
United Kingdom	62.5
Romania	149.3
EU 27	32.6

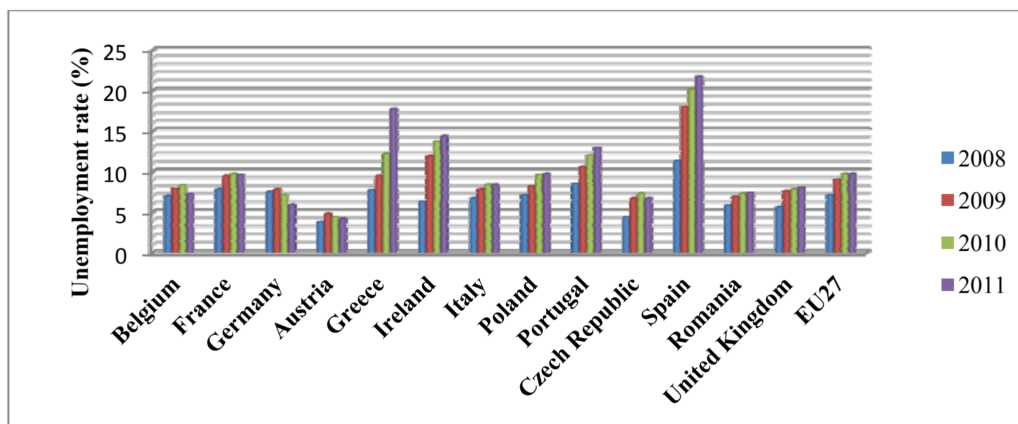
Note: Refference year 2008.
Sursa: Own calculation based on data available in Eurostat newsrelease, *Euroindicators*, 149/2012, october 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22102012-AP/EN/2-22102012-AP-EN.PDF.

But the fiscal arrangements in the EU reveal exactly the opposite of those stated above. Tax reductions, level of taxation or regulations are far from being in place. Most of the EU member states choose to increase taxation in order to attain fiscal consolidation. Therefore, income taxes and social contributions increased (Commission, 2012a, p. 31). Despite the fact that corporate tax has been maintained constant in most of the EU member states, tax burden reached 38.4% of GDP in 2010 (Commission, 2012b, p. 26).

Therefore, one can emphasize the failure of stimulus packages concerning their main objective: preserving and creating new jobs. The number of job

losses in the EU during the crisis amounts about 5 million and unemployment rate kept rising and reached 10% in April 2012 (Commission, 2012c, p. 6).

EU member states that have the biggest financial difficulties are also confronted with the most severe unemployment rates (Spain, Greece, Ireland, and Portugal). An interesting exception is the case of Germany. The unemployment rate fell in this country for the last three years consecutively. An analysis concerning various economic sectors' contribution to this situation may be useful. Germany's economy performances in this matter are based mainly on the contribution to employment of the construction sector and non-market services (notably public administration). Not surprisingly, the latter generated net employment gains in most of the EU member states. The construction sector's contribution to employment has been negative except for a few countries, despite the fact that it was the main beneficiary of the stimulus packages. In Germany's case, construction industry and non-market services stimulated employment with 3.5% and 3.2%, respectively. Similar situation is registered in Belgium (3.3% and 5.0%, respectively) and Austria (0.4% and 3.8%, respectively) (Commission, 2012c, p. 23). Unemployment rate decreased for both of the EU member states during the year 2011, but in the case of Austrian economy, employment growth occurred mainly in the public elastic administration).



Source: European Commission - *Labour Market Developments in Europe, 2012*, European Economy, no. 5, September 2012.

Figure 3. *Unemployment rate, 2008-2011*

Analyzing labor market data, one can argue that unemployment rates decreased mainly as a consequence of public administration's net employment gains, despite the stimulus packages implemented. In other economic sectors like industry and agriculture job creation was negative as a result of institutional

rigidity and lack of reforms. On this background, expectations concerning job creation are modest: unemployment rate will maintain relatively constant despite insignificant employment growth (Commission, 2012c, p. 44).

Those stated above suggest the need for labor market institutional reform. The measures implemented didn't reach their goal because they are contradictory with the proper institutional frame needed to encourage private initiative and stimulate the existing business. Many EU member states adopted job creation policy measures based mainly on wage subsidies. These measures failed because of the high tax burden on labor generated, among other causes, by the member states' goal of fiscal consolidation(4).

Conclusion

The EU member states seem to be trapped between interventionist policies and the financial pressure they generate. In absence of institutional reform needed to encourage investment, economic crisis will persist. Simplified business regulations and adjusted bureaucracy frame can reduce tax burden in the economy and stimulate recovery. In other words, more economic freedom means getting out of the crisis, while government interventionism means exactly the opposite.

Notes

(1) Because of these precarious concerns government officials argue for "stronger domestic demand growth" in countries like Germany and Japan (Moore, 2010). The argument is the spillover effects induced by the growing aggregate demand in the two countries. The Keynesian multiplier theory was proved to be empirically fallacious through various simulations. According to these simulations, the impact of increasing public spending in Germany on the real GDP of France and Italy would have been insignificant and decreasing during 2009-2011. Thus, the real GDP of France could have grown with 0.012% in the fourth quarter of 2010; the real GDP of Italy would have decrease with 0.049% in the same period of time (Cwik, Wieland, 2009, p.16).

(2) 1.8 is the value of this multiplier and only 0.6 for the fiscal multiplier according to one of the most optimistic estimation based on such studies (IMF, 2009, p. 31).

(3) This negative public finance evolution cannot be entirely explained by the stimulus packages implemented. EU member states adopted also policy measures in order to sustain the financial system.

(4) Employer social security contribution rate is over 20% of average wage and the total tax wedge is over 30% for most of the EU member states according to the available data for 2011 (Commission, 2012c, p. 39).

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