Turkish Economic Review
www.kspjournals.org
Volume 3 June 2016 Issue 2

Austerity, Cyclical Adjustment and How to use the Remaining Leeway for Expansionary Fiscal Policies within the Current EU Fiscal Framework

By Achim TRUGER [a†] & Michael NAGEL [b]

Abstract. Fiscal policy in the Euro area has been dominated by austerity measures implemented under the institutional setting of the 'reformed' stability and growth pact, and the even stricter 'fiscal compact' for some years. Since mid-2014 calls for a more expansionary fiscal policy to overcome the economic crisis have become more frequent. 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. This paper argues that these steps do not go far enough and that indeed 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 is demonstrated that even in the existing framework the leeway for a macroeconomically 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. E61, E62, E65, H62, H63.

1. Introduction

Fiscal policy in most Euro area countries has been dominated by austerity measures implemented under the institutional setting of the 'reformed' stability and growth pact and the 'fiscal compact' for several years. 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 had moved the Euro area economy at the verge of deflationary stagnation by 2012-2014.

Therefore, since about spring 2014 the calls for a more expansionary fiscal policy have become louder, as it was getting clearer that monetary policy alone will

[a†] Berlin School of Economics and Law, Faculty of Business and Economics, Badensche Straße 50-51, D-10825 Berlin, Germany, and Senior Research Fellow at Macroeconomic Policy Institute (IMK) at Hans-Böckler-Foundation, Düsseldorf, Germany.
☎. +49 (0)30 30877-1465
✉. Achim.Truger@hwr-berlin.de
[b] Berlin School of Economics and Law, Faculty of Business and Economics, Badensche Straße 50-51, D-10825 Berlin, Germany.
☎.
✉. l.m.nagel@web.de

not be able to spark off the recovery. In his 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 support 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 finally the new European Commission led by Jean-Claude Juncker has launched mainly two initiatives 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; 2015). However, quite obviously, those initiatives have so far not been effective. Despite all efforts growth forecasts for the euro area have been stagnating since summer 2014.

Against this background the central question is whether for lack of will to change the existing institutional framework – that had even 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 that 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 and its pro-cyclicality. As a consequence of the prolonged economic crisis 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. Section 2 shows that correcting for those effects – by simply not revising potential output growth projections since the spring 2010 Commission forecast – leads to substantially higher estimates for the size of austerity programmes which is very well 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 argues 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 draws some policy conclusions.

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

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

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 & 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 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. However, the Commission hesitates to modify its method in a more foreward-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 4 below). A reassessment of the structural balances in combination with the application of the recent findings as to the size of the fiscal multiplier may be sufficient to bring about a substantially positive fiscal stimulus.

The European Commission proceeds in two steps in its calculations. First potential GDP is estimated in order to determine the cyclical condition of the economy, i.e. the output gap as the percentage deviation of actual from potential output. Second, with the help of budgetary semi-elasticities (Mourre et al. 2014) the cyclical impact on the budget balance is identified which then allows 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 those of the labour market, can be criticised for a number of reasons (Hein & 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 and its potential contribution to the economic crisis.

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 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 & Tober 2006; Klär 2013 and 2014; Truger & Will 2013). During economic contractions – especially during large and durable contractions as those

that had to be observed in the Euro crisis – the estimates of potential output are substantially revised 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 & Duarte 2014).

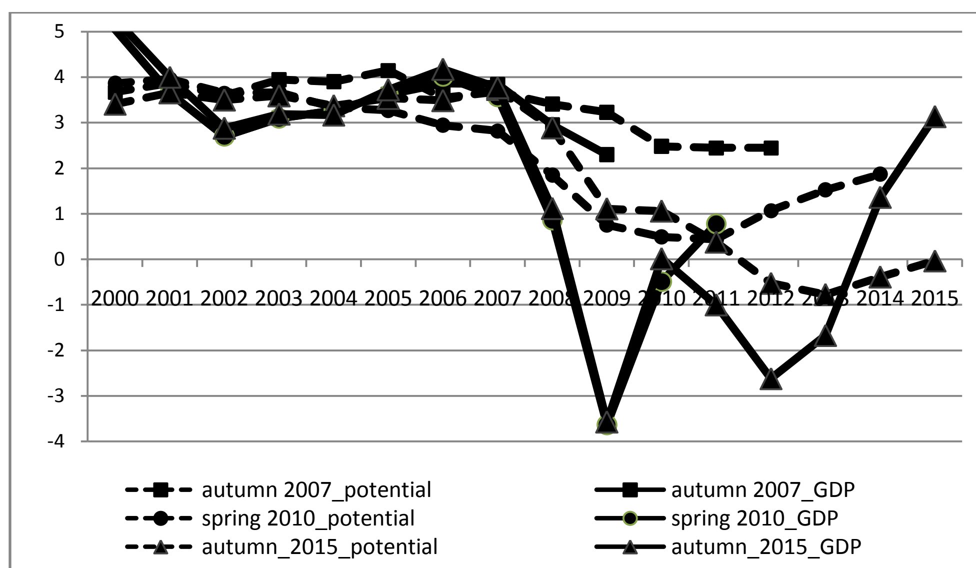

Figure 1. *Real actual and potential GDP for Spain as of different European Commission's forecasts, annual growth rate in %, 2000-2015*
Source: European Commission (2015b), authors' calculations.

The effects can very well be illustrated for the Spanish case (see figure 1). Before the crisis potential output growth as estimated by the Commission in its autumn 2007 forecast was around 4 per cent annually with a clear slowdown to around 2.5 per cent due to the expected slowdown in actual economic growth from 2008 onwards. After the bubble had burst and Spain was only slowly recovering from the global economic and financial crisis in spring 2010 the commission very substantially decreased its potential output estimates for the Spanish economy to only 0.5 per cent. After consecutive waves of austerity had taken effect and had driven the Spanish economy back into serious recession in 2012 and 2013 potential output was again revised downwards in a dramatic way: In its autumn 2015 forecast the Commission expected potential output to be even shrinking for four consecutive years from 2012 to 2015.

It is of course difficult – if not impossible – 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 is plausible to assume 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 hit. 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.

2.2. Methodology

The aim of our numerical analysis is to show what would have happened to the cyclical adjustment calculations by the Commission if it had not been for the

repeated downward revisions of the potential output estimates. Therefore, in the first step we need an alternative assumption for the development of potential growth: Here we simply use the Commission spring 2010 forecast of potential output, because at that time potential GDP estimates had already been revised downwards very substantially. We just rule out any further revision of potential output after spring 2010. The reason is that after the deep recession in 2010 most Euro area economies were recovering before in the summer of that year a sudden switch to a fast exit and the beginning of austerity in the Euro area was decided (see Blyth 2013, chapter 3). One might argue that a further downward revision of potential GDP after 2010 might be plausible also from a more Keynesian point of view if hysteresis was involved. However, first, the downward revision implicit in the EU Commission's calculations is occurring in a very fast manner. Second, the Keynesian solution would be to prevent or fight those effects by counter-cyclical fiscal policy. Therefore, we think it plausible and 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 given up and replaced by austerity policies. We then determine the alternative output gap by comparing actual GDP as of the Commission autumn 2015 forecast with our alternative potential output.[i]

In the second step we calculate our alternative cyclical component by multiplying the EU Commission's budgetary semi-elasticities for the individual countries (Mourre et al. 2014) with our corrected output gap. This in turn allows us to calculate the structural budget balances. The annual fiscal stance can then be determined as the year on year change in the primary structural budget balance, which can also be cumulated for several years to show the overall fiscal stance for a given period of time.

This is exactly the method that was used in Truger (2015b and 2015c) based on the spring 2014 forecast data. Updating the calculations for the autumn 2015 forecast data poses two major challenges due to the general revision of the system of national accounts from ESA 95 to ESA 2010 since the autumn 2014 forecast (see Dunn, Akritidis, & Biedma, 2014). Due to the revision, a direct comparison with data from earlier vintages (based on ESA 95) was no longer possible. As this comparison is necessary to show the revisions of potential output and the resulting fiscal impulses, some adjustments had to be made.

The new ESA 2010 framework in general led to an upward revision of GDP for all countries, mainly because R&D activities and military spending on weapons systems are now counted as investment expenditures. Together with other relatively smaller changes, this led to an increased level of output. All in all, methodological changes and statistical improvements led to upward GDP revisions of 3.7 percent for the EU28 countries under the new methodology, while growth rates remained virtually unchanged. (Dunn, Akritidis, & Biedma, 2014). To incorporate the changes in the GDP level, nominal GDP as estimated in the last vintage under ESA 95 (spring 2014) was compared with the first vintage under ESA 2010 (autumn 2014) and the old Commission 2010 data was adjusted by the difference with some corrections for forecast revisions in the more recent years from 2011 to 2015.

Additionally, for ESA 2010 the Commission no longer provides data for the structural budget balance for years preceding 2010, because one-off measures have not been revised backwards far enough. In order to include an estimate of the fiscal stance for 2010 – which was a crucial year for austerity policies – we used the one-offs and temporary measures provided by the last ESA 95 data from the EU Commission spring 2014 forecast (EU Commission 2014a) for the years 2007-2009 to calculate the structural balances. One has to be aware that there is a structural break in the time series in 2010, but as for most countries the differences

between the ESA 2010 and the ESA 95 one-offs are not large in more recent years so that we think our approach is justified.

In our 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 the permanent new accessions to the Euro zone, otherwise a consistent Euro area average would not have existed. Thirdly, the crisis countries in the periphery, that were in 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 that these 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 may well be even stronger. However, this deserves to be tackled in greater depth than is possible in this paper.

2.3. The resulting underestimation of the fall in the output gap

Table 1 shows the Commission’s autum 2015 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. From 2013 to 2015 for all countries with the exception of Germany the output gap would have been substantially more negative had it not been for the crisis induced downward revision of potential GDP since spring 2010. For the EMU-12 average the output gap more than tripes from -2 % to -6.9 % of GDP in 2015. Particularly for the crisis countries this effect is even stronger: For Greece an output gap of -26.9 % as compared to the official estimate of only 5.6 % is calculated.

Table 1. *Output gap in % of potential GDP, EMU-12 countries 2007-2015 with potential GDP growth of EU Commission’s fall 2015 forecast compared to EU Commission’s spring 2010 forecast*

	Output gap with potential GDP from EU Commission fall 2015								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Austria	2,0	2,0	-2,7	-1,7	0,4	0,4	-0,3	-0,8	-0,9
Belgium	3,3	2,6	-1,3	0,0	0,2	-0,6	-1,1	-1,0	-1,2
Euro area (12 countries)	2,5	1,6	-3,4	-2,0	-1,1	-2,2	-3,0	-2,7	-2,0
Finland	4,6	3,7	-5,1	-2,5	-0,2	-1,6	-2,8	-2,8	-2,4
France	3,1	1,8	-2,1	-1,2	-0,2	-0,8	-1,4	-2,0	-1,8
Germany	1,6	1,6	-4,7	-1,6	0,8	0,0	-1,1	-0,9	-0,7
Greece	5,2	4,2	0,5	-3,0	-8,8	-11,6	-11,9	-8,6	-5,6
Ireland	6,0	1,7	-4,6	-4,8	-2,7	-4,0	-5,5	-3,7	-3,7
Italy	2,2	1,0	-4,2	-2,2	-1,6	-3,3	-4,2	-3,9	-3,1
Luxembourg	3,9	1,2	-6,0	-2,7	-2,4	-4,9	-5,0	-4,8	-4,0
Netherlands	1,5	1,8	-2,5	-2,0	-1,1	-3,0	-3,9	-3,6	-2,9
Portugal	1,0	0,5	-2,5	-0,7	-2,1	-4,9	-5,6	-4,4	-2,9
Spain	3,1	1,3	-3,3	-4,3	-5,3	-6,8	-7,2	-5,5	-2,9
	Output gap with potential GDP from EU Commission spring 2010								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Austria	3,9	3,3	-2,2	-1,3	0,3	-0,5	-2,1	-3,7	-4,7
Belgium	3,1	2,5	-1,4	-0,1	0,4	-0,6	-1,5	-1,6	-1,7
Euro area (12 countries)	2,4	1,4	-3,9	-2,7	-2,2	-4,2	-6,1	-6,8	-6,9
Finland	7,2	5,2	-5,2	-3,0	-1,8	-4,5	-7,1	-8,6	-9,7
France	1,0	-0,5	-4,2	-3,9	-3,0	-3,8	-4,8	-5,8	-6,1
Germany	2,8	2,9	-3,7	-0,6	1,7	0,4	-1,1	-1,1	-0,9
Greece	3,0	1,1	-3,7	-8,9	-17,5	-23,3	-26,7	-26,7	-26,8
Ireland	2,2	-2,1	-7,9	-8,0	-5,7	-7,7	-10,2	-9,1	-9,0
Italy	2,1	0,5	-4,9	-3,5	-3,5	-6,9	-9,5	-11,0	-11,7
Luxembourg	7,5	-0,3	-8,7	-4,8	-4,6	-7,6	-9,0	-9,5	-9,6
Netherlands	3,3	3,0	-2,3	-2,0	-1,6	-4,5	-6,9	-8,0	-8,4
Portugal	3,9	3,0	-0,2	1,4	-0,9	-6,0	-8,8	-9,6	-9,6
Spain	1,3	0,6	-4,2	-4,9	-5,9	-8,8	-11,3	-11,7	-10,9
	Difference								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Austria	1,9	1,4	0,5	0,4	-0,1	-0,9	-1,8	-2,8	-3,9
Belgium	-0,3	-0,1	-0,1	-0,1	0,2	0,1	-0,3	-0,6	-0,6

Euro area (12 countries)	-0,1	-0,2	-0,5	-0,7	-1,1	-2,0	-3,1	-4,1	-4,9
Finland	2,6	1,5	0,0	-0,5	-1,6	-2,9	-4,4	-5,8	-7,3
France	-2,1	-2,2	-2,1	-2,7	-2,8	-3,0	-3,4	-3,9	-4,3
Germany	1,2	1,3	1,0	1,0	0,9	0,4	-0,1	-0,3	-0,2
Greece	-2,2	-3,1	-4,1	-5,8	-8,7	-11,7	-14,8	-18,1	-21,3
Ireland	-3,8	-3,7	-3,3	-3,2	-3,0	-3,7	-4,7	-5,4	-5,3
Italy	-0,2	-0,4	-0,7	-1,3	-1,9	-3,6	-5,3	-7,1	-8,6
Luxembourg	3,6	-1,5	-2,7	-2,0	-2,2	-2,8	-4,1	-4,7	-5,6
Netherlands	1,9	1,2	0,2	0,0	-0,5	-1,4	-3,0	-4,4	-5,6
Portugal	2,9	2,6	2,4	2,1	1,2	-1,1	-3,3	-5,2	-6,8
Spain	-1,8	-0,7	-0,8	-0,5	-0,6	-2,0	-4,1	-6,1	-8,0

Source: EU Commission (2010a; 2014a; 2014b; 2015b), authors' calculations.

2.4. The resulting underestimation of fiscal restraint in the Euro areaand effects on economic performance

The dramatic downward revisions of potential GDP shown in the previous section have substantial consequences for the calculation of structural budget balances and the assessment of consolidation efforts (see Eschenbach & Schuknecht 2004, Romer & Romer 2010 as well as Guajardo, Leigh & Pescatori 2011). These efforts will usually be underestimated because 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.[ii]

This can be demonstrated by comparing the fiscal stance derived from the Commission's 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 less 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 2015 (estimate) and the resulting cumulative discretionary fiscal stance from the trough of the crisis in 2009 as calculated by the EU Commission in its autumn 2015 economic forecast. 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 cumulative volume of consolidation measures is almost 3 % of GDP from 2009 to 2015 with the bulk of measures realised within only three years from 2011 to 2013 and a more or less neutral fiscal policy since then. As was to be expected Greece and to a lesser extent Ireland, Spain and Portugal stand out with a total volume of 7.4 (Portugal) to 13.3 % (Greece) of GDP. France and Italy show substantial efforts slightly below 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 Luxemburg and Finland even showed some substantial 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
Austria	0,6	0,3	-0,6	-0,3	0,3	0,9	1,4	1,8	1,8
Belgium	2,4	1,7	0,0	-0,3	-0,4	0,1	0,6	0,3	0,4
Euro area (12 countries)	0,8	-0,1	-1,5	-1,5	-0,6	1,0	1,5	1,7	1,4
Finland	3,9	3,4	1,8	0,2	0,5	0,3	0,3	-0,5	-0,6
France	-1,9	-1,5	-3,5	-3,5	-2,5	-1,7	-1,3	-0,6	-0,7
Germany	1,9	1,8	1,9	0,3	1,2	2,2	2,3	2,6	2,4
Greece	-4,4	-6,4	-10,1	-4,3	0,9	4,7	6,0	4,5	3,2
Ireland	-1,2	-6,2	-7,5	-5,9	-4,1	-2,4	0,0	0,8	0,3
Italy	1,9	1,5	0,7	1,0	1,4	3,9	4,0	3,6	3,3
Luxembourg	2,1	3,1	2,6	0,9	1,9	3,0	2,5	2,5	1,1
Netherlands	0,9	1,0	-1,6	-1,8	-1,8	-0,6	0,6	0,9	0,3
Portugal	-0,7	-1,7	-5,3	-5,2	-1,9	1,8	2,3	3,5	3,1
Spain	1,9	-3,3	-6,8	-5,2	-3,7	-0,4	1,5	1,6	0,6

	Fiscal Stance (2008-2015)							
	2008	2009	2010	2011	2012	2013	2014	2015
Austria	-0,3	-0,9	0,3	0,6	0,6	0,5	0,4	0,0
Belgium	-0,7	-1,7	-0,3	-0,2	0,6	0,4	-0,3	0,1
Euro area (12 countries)	-0,8	-1,4	0,0	0,9	1,6	0,5	0,2	-0,3
Finland	-0,5	-1,6	-1,6	0,3	-0,3	0,0	-0,8	-0,1
France	0,3	-2,0	0,0	1,0	0,8	0,4	0,6	-0,1
Germany	-0,1	0,1	-1,6	0,9	1,0	0,1	0,3	-0,1
Greece	-2,0	-3,6	5,8	5,2	3,8	1,3	-1,5	-1,3
Ireland	-5,0	-1,2	1,6	1,7	1,8	2,3	0,8	-0,4
Italy	-0,3	-0,8	0,3	0,4	2,5	0,0	-0,4	-0,3
Luxembourg	1,0	-0,5	-1,7	1,0	1,1	-0,5	0,0	-1,4
Netherlands	0,1	-2,6	-0,2	-0,1	1,2	1,2	0,3	-0,7
Portugal	-1,0	-3,6	0,1	3,3	3,7	0,6	1,2	-0,4
Spain	-5,2	-3,5	1,6	1,5	3,3	1,8	0,1	-1,0

	Cumulative Fiscal Stance (2010 – 2015)					
	2010	2011	2012	2013	2014	2015
Austria	0,3	0,9	1,5	2,0	2,4	2,4
Belgium	-0,3	-0,5	0,1	0,6	0,3	0,4
Euro area (12 countries)	0,0	0,9	2,5	3,0	3,2	2,9
Finland	-1,6	-1,3	-1,6	-1,6	-2,4	-2,4
France	0,0	1,0	1,8	2,2	2,8	2,8
Germany	-1,6	-0,8	0,3	0,3	0,7	0,5
Greece	5,8	10,9	14,7	16,1	14,6	13,3
Ireland	1,6	3,3	5,1	7,4	8,2	7,8
Italy	0,3	0,6	3,2	3,2	2,8	2,6
Luxembourg	-1,7	-0,7	0,4	-0,1	0,0	-1,5
Netherlands	-0,2	-0,2	1,0	2,2	2,5	1,9
Portugal	0,1	3,4	7,1	7,6	8,8	8,4
Spain	1,6	3,1	6,4	8,3	8,4	7,4

Note: * Due to the revision of the national accounts to ESA 2010 the EU Commission no longer publishes structural balances for years before 2010 since the autumn 2010 economic forecast as the one-off measures have not yet been revised. In the calculations we use the unrevised ESA 95 values for the one-off measures to calculate the structural balances (see methodology in section 2.2).

Source: EU Commission (2010a; 2014a; 2014b, 2015a; 2015b), authors' 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
Austria	-0,5	-0,5	-1,0	-0,5	0,3	1,4	2,4	3,4	4,0
Belgium	2,6	1,7	0,1	-0,2	-0,5	0,1	0,8	0,6	0,8
Euro area (12 countries)	0,8	0,0	-1,3	-1,2	0,0	2,0	3,0	3,8	3,9
Finland	2,4	2,6	1,9	0,5	1,5	1,9	2,8	2,8	3,6
France	-0,6	-0,2	-2,2	-1,9	-0,8	0,1	0,8	1,7	1,9
Germany	1,2	1,1	1,4	-0,3	0,7	2,0	2,3	2,7	2,5
Greece	-3,3	-4,9	-8,1	-1,4	5,1	10,4	13,3	13,4	13,6
Ireland	0,8	-4,2	-5,7	-4,2	-2,6	-0,4	2,4	3,6	3,1
Italy	2,0	1,7	1,1	1,7	2,4	5,9	6,8	7,4	8,0
Luxembourg	0,5	3,8	3,8	1,8	2,8	4,2	4,3	4,6	3,6
Netherlands	-0,3	0,2	-1,7	-1,8	-1,5	0,3	2,5	3,8	3,9
Portugal	-2,2	-3,0	-6,5	-6,2	-2,5	2,3	4,0	6,2	6,6
Spain	3,0	-2,9	-6,3	-4,8	-3,4	0,9	3,9	5,3	5,5
		Fiscal Stance (2008-2015)							
		2008	2009	2010	2011	2012	2013	2014	2015
Austria		0,0	-0,5	0,4	0,8	1,1	1,0	1,0	0,6
Belgium		-0,8	-1,6	-0,3	-0,3	0,6	0,7	-0,2	0,1
Euro area (12 countries)		-0,8	-1,3	0,1	1,1	2,0	1,0	0,7	0,1
Finland		0,2	-0,7	-1,3	1,0	0,5	0,8	0,0	0,8
France		0,5	-2,0	0,3	1,1	1,0	0,6	0,9	0,2
Germany		-0,1	0,3	-1,6	0,9	1,3	0,3	0,5	-0,2
Greece		-1,6	-3,2	6,6	6,6	5,3	2,9	0,1	0,3
Ireland		-5,0	-1,5	1,5	1,6	2,2	2,8	1,2	-0,5
Italy		-0,2	-0,6	0,6	0,7	3,5	0,9	0,6	0,5
Luxembourg		3,3	0,0	-1,9	1,0	1,3	0,1	0,3	-1,0
Netherlands		0,5	-1,9	-0,1	0,3	1,8	2,2	1,3	0,1
Portugal		-0,9	-3,5	0,3	3,8	4,8	1,7	2,2	0,4
Spain		-5,9	-3,4	1,5	1,5	4,2	3,1	1,4	0,2
				Cumulative Fiscal Stance (2010 – 2015)					
				2010	2011	2012	2013	2014	2015
Austria				0,4	1,3	2,4	3,4	4,4	5,0
Belgium				-0,3	-0,6	0,0	0,7	0,5	0,6
Euro area (12 countries)				0,1	1,2	3,3	4,3	5,0	5,1
Finland				-1,3	-0,4	0,1	0,9	0,9	1,7
France				0,3	1,4	2,4	3,0	3,9	4,1
Germany				-1,6	-0,7	0,6	0,9	1,4	1,2
Greece				6,6	13,2	18,5	21,3	21,4	21,7
Ireland				1,5	3,2	5,3	8,2	9,3	8,8
Italy				0,6	1,3	4,8	5,7	6,3	6,8
Luxembourg				-1,9	-0,9	0,4	0,5	0,9	-0,2
Netherlands				-0,1	0,2	2,0	4,2	5,5	5,6
Portugal				0,3	4,0	8,8	10,5	12,7	13,1
Spain				1,5	2,9	7,2	10,3	11,6	11,8

Note: * Due to the revision of the national accounts to ESA 2010 the EU Commission no longer publishes structural balances for years before 2010 since the autumn 2010 economic forecast as the one-off measures have not yet been revised. In the calculations we use the unrevised ESA 95 values for the one-off measures to calculate the structural balances (see methodology in section 2.2).
Source: EU Commission (2010a; 2014a; 2014b, 2015a; 2015b), authors' 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 a more sizable estimate of the fiscal effort. As can be seen, in virtually all cases the resulting numbers for the fiscal effort are substantially higher. The cumulative fiscal effort for the EMU-12 average increases to 5.1 % of GDP. The size of the austerity packages in the periphery is revised to between 8.8 % for Ireland and 21.7% (!) for Greece. Finally, three countries that did not seem to show any remarkable consolidation efforts in the official estimates, Finland and above all Austria and the

Netherlands, are now seen to have gone through substantial fiscal restriction (cumulative 1.7, 5.0 and 5.6 % of GDP, respectively).

The potential economic consequences of fiscal restraint in such dimensions 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. Obviously, the size of the multiplier then becomes the key 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 as well as a recent meta-regression covering more than 100 different empirical multiplier studies by Gechert (2015) support the more Keynesian views of a sizeable multiplier, even substantially above one for the expenditure side.

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 (about 1 as compared to 0.5) – could also easily have been drawn on the basis of the earlier literature well before the crisis (see e.g. the overviews by Hemming, Kell & Mahfouz 2002, Arestis & Sawyer 2003, Bouthevillain et al. 2009 and Creel et al 2011).

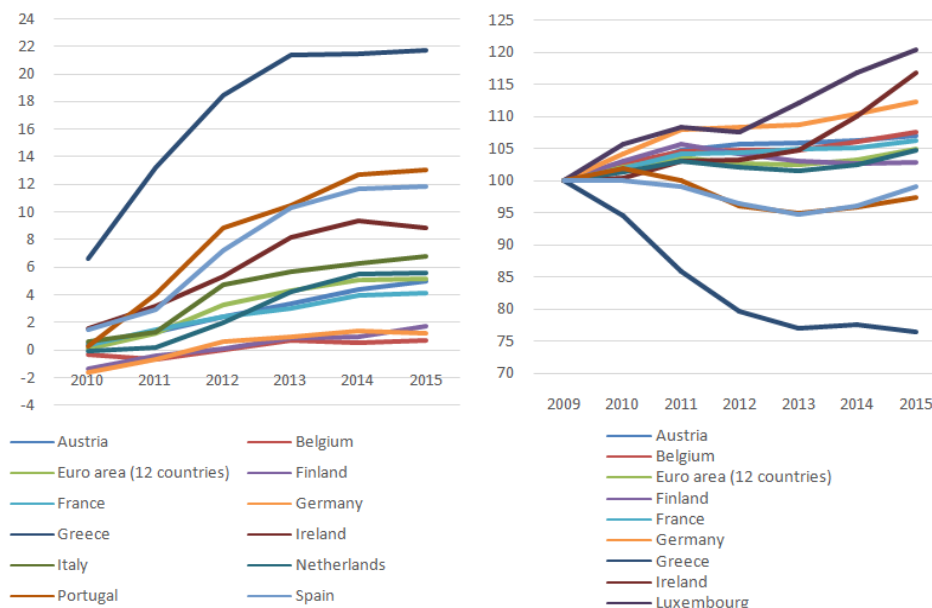

Figure 2. *Cumulative fiscal effort 2010-2015 in % of GDP and real GDP index (2009=100) 2009-2015, Euro area-12.*
Source: EU Commission (2010a; 2014a; 2014b, 2015a; 2015b), authors' calculations.

Applying such sizeable multipliers to the fiscal stances just calculated 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 2 is used. Although many other factors must be taken into account, it does

seem quite 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. It can also be seen that the economic recovery that set in in some countries in the periphery in 2014 and 2015 may well be related to a slowdown in the pace of fiscal consolidation or even a slight expansion.

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. Therefore the new Commission has launched mainly two initiatives substantially enlarging its predecessor's efforts (European Commission 2014f and 2015c). They can be divided into three main sets of measures. The first two of them 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 on more occasions. 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.

As 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.[iii] 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.

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 2015c: 9) while it was denied to Italy (Barbiero & 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 & 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 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 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 through the use of financial instruments by the EIB is expected, the 21 bn. Euros are supposed to deliver the 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 SGB (European Commission 2015c: 6-7).

It is difficult to evaluate the prospects of the Investment Plan for Europe as it is still in its early stages. However, there are many open questions and whether the Plan will really deliver is quite doubtful. First of all, one may call into 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 is insufficient. 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 realized. The most important doubts, however, relate to the question whether the Plan will really be able to mobilise sufficient additional investment: If it is to stimulate private investment, particularly in the crisis countries typically ‘animal spirits’ will be 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 as 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 realized 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 2015c: 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 2015c: 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 are obviously only designed to permit 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 offer a generally favourable climate for expansionary fiscal policy. Governments' deficits and debts in the EU are 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 seven Euro area members: Cyprus, France, Greece, Ireland, Portugal, Slovenia and Spain.[iv] 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 that are 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* calling 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 for at least a few years the Euro area will hardly escape from stagnation or even deflationary stagnation.. As in the short run major institutional reforms do not look very likely, alternative ways must be found within the existing framework unless some governments decide to openly refuse obeying the rules and taking into account 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 leave, it could provide substantial room for manoeuvre for national governments to switch to a truly expansionary fiscal policy. Indeed, the clarification by the Commission as to making optimal use of the flexibility (European Commission 2015c) can be seen as hinting at the direction that would need to be followed. It would at some points simply need a few interpretational steps further 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 controversial, the one country that is currently in a rather favourable position as to its budgetary situation, 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 in the order of magnitude of 1.4 % of GDP in 2015 (see table 5). If it was in fact used to increase public (investment) spending, the overall effect for the Euro area economy would not be very strong, but certainly not completely negligible. Actually, using this leeway was even recommended by the European Commission (2014e) 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.[v] In this sense, at least the following eight measures that are generally complementary to each other should be considered (see table 5).[vi]

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: Authors' compilation.

There are at least four possibilities to explicitly strengthen public investment within the current fiscal framework (measures 1 to 4 in table 4). 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 & Darvas, 2014; Truger 2015b: chapter 2).

Turning to the 'investment clause', this should at least be opened to unconditionally include all investment that is supported by European funds, exactly as it was called for by the European Parliament (2013) (measure 1 in table 4). Furthermore, at least 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 as to fiscal multipliers that was in line with the recent results from the literature, 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 for the remaining temporarily higher deficit the existing leeway within the preventive and corrective arm (see below) were used, the potential positive fiscal stance could be substantial (at least twice or triple 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 (see Truger 2016). In addition to this, 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 2015c: 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 2015c: 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).[vii] Such a direction would meet concerns that traditional 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 calculated 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 some more or less 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 continuously been changing its method of cyclical adjustment over time (see Truger & 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 as important part of the determination of potential output, in order to avoid 'excessively pro-cyclical NAWRUs under certain circumstances' (European Commission, 2014d, 27), however making clear that this would not lead to a revision of the required fiscal effort (European Commission, 2014d, 29).

Table 5. *Output gap, structural budget balance (EU Commission fall 2015 estimate and modification) 2015 and medium term objective for 12 Euro area countries in % of GDP*

	Output gap 2015 (Commission)	Output gap 2015 (modification)	Structural balance 2015 (Commission)	Structural balance 2015 (modification)	Medium term objective (MTO)
Austria	-0,9	-4,7	-0,6	1,7	0.45[1)]
Belgium	-1,2	-1,7	-2,5	-2,1	0,75
Euro area (12 countr.)	-2,0	-6,9	-1,1	1,4	-0,3[1]
Finland	-2,4	-9,7	-1,7	2,4	0
France	-1,8	-6,1	-2,7	-0,2	-0.4
Germany	-0,7	-0,9	0,9	1,0	-0.5
Greece	-5,6	-26,8	-1,1	9,3	0
Ireland	-3,7	-9,0	-3,0	-0,2	0
Italy	-3,1	-11,7	-1,0	3,7	0
Luxembourg	-4,0	-9,6	0,7	3,2	0.5
Netherlands	-2,9	-8,4	-1,1	2,6	-0.5
Portugal	-2,9	-9,6	-1,8	1,6	-0,5
Spain	-2,9	-10,9	-2,5	2,4	0

[1)] weighted average of available values.

Source: European Commission (2010a; 2014a; 2014b, 2015a; 2015b); Author's calculations.

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 most implausible to assume (as the Commission does) that the Greek output gap in 2015 was as small as -5.6 % when the Greek economy had 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 and Luxembourg – Austria, Finland, France, Italy, the Netherlands, Portugal and Spain would already have reached their MTOs in 2015 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.

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 be seen as an abandonment of the existing SGP, involving questions of time-inconsistency and credibility. However, this would hardly seem convincing. First, 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, announced strictness in the application of the rules ex ante, only to relax the requirements when countries ran into problems ex post. One may 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 withdrawn ex post.

4. Conclusion

Most parts of the Euro area have seen eight years of deep economic crisis. Austerity policies 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 a situation, with depressed aggregate demand, deflationary tendencies and monetary policy at the lower bound, 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 although in practice it regularly concedes leeway for member states.

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 interpretational leeway sufficient 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 be quite good (see Truger 2016). All it would need is the will to be a bit more consequent 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.

Notes

[i] The European Commission (2010a) published potential output forecast only until 2014. For the calculation the forecast 2014 potential growth rate was simply reproduced for 2015.

[ii] A further underestimation or at least inaccuracy in the estimation of structural budget balances may result from deviations of actual budgetary 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 & Truger 2014, 24-25 in the case of Germany).

[iii] See Prota & Viesti (2013) for a summary of the developments around and the debate about the ‘investment clause’.

[iv] Cyprus and Greece face even stronger restrictions as they are subject to financial assistance programmes.

[v] See Micossi & 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.

[vi] 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 & Giavazzi 2004: 15).

[vii] 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.

References

Andrade, J.S., & Duarte, A.P. (2014). Output-gaps in the PIIGS Economies: An Ingredient of a Greek Tragedy." Estudos do GEMF No. 06/2014, Coimbra: Faculdade de Economia da Universidade de Coimbra Grupo de Estudos Monetários e Financeiros (GEMF). [Retrieved from].

Arestis, P. (2011). Fiscal policy is still an effective instrument of macroeconomic policy. *Panoeconomicus*, 6(2), 143-156. doi. 10.2298/PAN1102143A

Arestis, P., & Sawyer, M. (2003). Reinventing fiscal policy, *Journal of Post Keynesian Economics*, 26(1), 3-25. doi. 10.1080/01603477.2003.11051388

Barbiero, F., & Darvas, Z. (2014). *In Sickness and in Health: Protecting and Supporting Public Investment in Europe*, Bruegel Policy Contribution 02/2014. [Retrieved from].

Blanchard, O., & Giavazzi, F. (2004). Improving the SGP through a proper accounting of public investment. CEPR *Discussion Papers*, No. 4220. [Retrieved from].

Blanchard, O., & Leigh, D. (2013). Growth Forecast Errors and Fiscal Multipliers. IMF *Working Paper*, No. 13/1, Washington D.C.

Blyth, M. (2013). *Austerity. The history of a dangerous idea.* New York: Oxford University Press.

Bouthevillain, C., et al., (2009). Pros and cons of various fiscal measures to stimulate the economy. *Banco de Espana Economic Bulletin*, July 2009, 123-144. [Retrieved from].

Creel, J.H.E., & Plane, M. (2011). Petit précis de politique budgétaire par tous les temps. Les multiplicateurs budgétaires au cours du cycle. *Revue de l'OFCE*, 116(1), 61-88. doi. 10.3917/reof.116.0061

D'Auria, F., Cécile, D., Havik, K., McMorrow, K., Planas, C., Raciborski, R., Röger, W., & Rossi, A. (2010). The Production Function Methodology for Calculating Potential Growth Rates and Output Gaps. *European Commission, Economic Papers* No. 420. [Retrieved from].

Draghi, M. (2014). Unemployment in the euro area, Speech by Mario Draghi, President of the ECB." Annual central bank symposium in Jackson Hole, 22 August 2014. [Retrieved from].

Dunn, M., Akritidis, L., & Biedman, L. (2014). The impact of ESA 2010 on key indicators of the national accounts in Europe, Eurostat Review on National Accounts and Macroeconomic Indicators, 2/2014, 7-27.

Eschenbach, F., & Schuknecht, L. (2004). Budgetary risks from real estate and stock markets. *Economic Policy*, 19(39), 313-346. doi. 10.1111/j.1468-0327.2004.00125.x

European Central Bank, (2014). Economic and Monetary Developments: Part 5, Fiscal Developments. *ECB Montly Bulletin*, September: 84-94. [Retrieved from].

European Commission, (2008). Communication from the Commission to the European Council: A European Economic Recovery Plan, Brussels, 26.11.2008 COM(2008) 800 final. [Retrieved from].

European Commission, (2010a). Annual macro-economic database (Ameco), May 2010.

European Commission, (2010b). Report on Public Finances in the EMU. *in*, European Economy No. 4, Brussels: European Commission, Directorate-General for Economic and Financial Affairs.

European Commission, (2012) Blueprint for deep and genuine Economic and Monetary Union – the launching a European debate, COM(2012) 777 final/2.

European Commission, (2013a). Report on Public Finances in the EMU" *In European Economy* No. 4, Brussels: European Commission, Directorate-General for Economic and Financial Affairs.

European Commission, (2013b). Annex to the communication from the commission: assessment of action taken by Spain, France, Malta, the Netherlands and Slovenia in response to the Council Recommendations of 21 June 2013 with a view to bringing an end to the situation of excessive government deficit, 19 November, COM(2013) 901 final/2, annex 1, Brussels.

European Commission, (2013c). The 2013 Stability and Convergence Programmes: An Overview, European Economy, Occasional Papers No. 152, June, Brussels: European Commission, Directorate-General for Economic and Financial Affairs.

European Commission, (2014a). Annual macro-economic database (Ameco), Spring 2014.

European Commission, (2014b). Annual macro-economic database (Ameco), Autumn 2014.

European Commission, (2014c). The 2014 Stability and Convergence Programmes: An Overview, European Economy, Occasional Papers No. 199, July, Brussels: European Commission, Directorate-General for Economic and Financial Affairs.

European Commission, (2014d). European Economic Forecast Spring 2014, *European Economy*, 3, Brussels: European Commission, Directorate-General for Economic and Financial Affairs.

European Commission, (2014e). Recommendation for a Council recommendation on Germany's 2014 national reform programme and delivering a Council opinion on Germany's 2014 stability programme {SWD(2014)406 final}, 2.6. COM(2014) 406 final, Brussels.

European Commission, (2014f). Communication from the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank;, An Investment Plan for Europe, Brussels, 26.11.2014, COM(2014) 903 final.

European Commission, (2015a). Annual macro-economic database (Ameco), autumn 2015.
European Commission, (2015b). Circa database on output gaps, autumn 2015.
European Commission, (2015c). Communication from the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank; Making the best use of the flexibility within the existing rules of the Stability and Growth Pact, Strasbourg, 13.1.2015 COM(2015) 12 final.
European Commission, (2015d). The 2015 Stability and Convergence Programmes: An Overview, European Economy, Institutional Paper No. 002, July, Brussels: European Commission, Directorate-General for Economic and Financial Affairs.
European Council, (2013). Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Spain, 20 June, 0560/1/13 REV 1 (en), Ecofin 478, Brussels.
European Council, (2014). European Council 26/27 June 2014 Conclusions, EUCO 79/14, CO EUR 4 CONCL 2, Brussels.
European Parliament, (2013). Resolution of 8 October 2013 on effects of budgetary constraints for regional and local authorities regarding the EU's Structural Funds expenditure in the Member States', (2013/2042 (INI)), [Retrieved from].
Gechert, S. (2015). What fiscal policy is most effective? A meta-regression analysis. *Oxford Economic Papers*, 67(3), 553-580. doi. 10.1093/oep/gpv027
Hein, E., & Stockhammer, E. (2011). A post-Keynesian macroeconomic model of inflation, distribution and employment. *in*, Hein, E., & Stockhammer, E. (eds.): *A Modern Guide to Keynesian Macroeconomics and Economic Policies,* Cheltenham, Edward Elgar.
Hein, E., & Truger, A. (2014). Fiscal policy and rebalancing in the Euro area: A critique of the German debt brake from a Post-Keynesian perspective. *Panoeconomicus* 61(1), 21-38. doi. 10.2298/PAN1401021H
Hein, E., Truger, A., & van Treeck, T. (2012). The European financial and economic crisis: Alternative solutions from a (Post-)Keynesian perspective. *in*, Arestis, P., & Sawyer, M. *The Euro Crisis*, International Papers in Political Economy, Basingstoke: Palgrave Macmillan: 35-78.
Hemming, R., Kell, M., & Mahfouz, S. (2002). The Effectiveness of Fiscal Policy in Stimulating Economic Activity: A Review of the Literature. IMF *Working Paper*, No. 02/208, Washington D.C.
International Monetary Fund, (2012). World Economic Outlook October 2012.
Klär, E. (2013). Potential economic variables and actual economic policies in Europe. *Intereconomics*, 48(1-2), 33 - 40. doi. 10.1007/s10272-013-0442-2
Klär, E. (2014). Die Eurokrise im Spiegel der Potenzialschätzungen: Lehren für eine alternative Wirtschaftspolitik?. WiSo-Diskurs, April, Bonn: Friedrich-Ebert-Stiftung.
Larch, M., & Turrini, A. (2010). The cyclically adjusted budget balance in EU fiscal policymaking. *Intereconomics* 45(1), 48-60. doi. 10.1007/s10272-010-0324-9
Lavoie, M. (2009). Taming the new consensus: hysteresis and some other Post-Keynesian amendments. *in*, Fontana, G., & Setterfield, M. (eds.) *Macroeconomics and Macroeconomic Pedagogy*. Basingstoke, Palgrave Macmillan: 191-213.
Logeay, C.,e & Tober, S. (2006). Hysteresis and the NAIRU in the Euro Area. *Scottish Journal of Political Economy*, 53(4), 408-429. doi. 10.1111/j.1467-9485.2006.00387.x
Micossi, S., & Peirce, F. (2014). Flexibility clauses in the Stability and Growth Pact" No need for revision *CEPS Policy Brief* No. 319, 24 July.
Mourre, G., Astarita, C., & Princen, S. (2014). The cyclically-adjusted budget balance used in the EU fiscal framework. European Economy, Economic Papers 536: Brussels: European Commission.
Organisation for Economic Co-operation and Development, (2012). Restoring Public Finances. Update, Paris.
Observatoire Français des Conjonctures Économiques, Economic Council of the Labour Movement, Institut für Makroökonomie and Konjunkturforschung in der Hans-Böckler-Stiftung, (2013). Independent annual growth survey: first report, Brussels: Progressive Economy.
Prota, F., & Viesti, G. (2013). Which European investment clause?. *Social Europe Journal*, [Retrieved from].
Truger, A. (2013). Austerity in the euro area: the sad state of economic policy in Germany and the EU. *European Journal of Economics and Economic Policies, Intervention,* 10(2), 158-174. doi. 10.4337/ejeep.2013.02.02
Truger, A. (2015a). Austerity, cyclical adjustment and the remaining leeway for expansionary fiscal policies in the Euro area. *Panoeconomicus,* 62(2), 157-175. doi. 10.2298/PAN1502157T
Truger, A. (2015b). Implementing the Golden Rule for Public Investment in Europe. Safe-guarding Public Investment and Supporting the Recovery. Materialien zu Wirtschaft und Gesellschaft, Working Paper Reihe der AK Wien No. 138, Abteilung Wirtschaftswissenschaft und Statistik der Kammer für Arbeiter und Angestellte für Wien.

Truger, A. (2015c). Austerity, cyclical adjustment and the remaining leeway for expansionary fiscal policies within the current EU fiscal framework, *IPE Working Paper*, No. 50, Institute for International Political Economy Berlin.

Truger, A. (2016). The Golden Rule of Public Investment – a Necessary and Sufficient Reform of the EU Fiscal Framework? *IMK Working Paper*, No. 168, May, Düsseldorf: Institut für Makroökonomie und Konjunkturforschung in der Hans-Böckler-Stiftung.

Truger, A., & Will, H. (2013). The German 'debt brake': A shining example for European fiscal policy?. *Revue de l'OFCE / Debates and Policies*, The Euro Area in Crisis, 127, 155-188. doi. 10.3917/reof.127.0153

Zack, G., Poncela, P., Senra, E., & Sotelsek, D. (2014). Some New Results on the Estimation of Structural Budget Balance for Spain. *Hacienda Publica Espanola / Review of Public Economics*, 210(3), 11-31. doi. 10.7866/HPE-RPE.14.3.1

Copyrights

Copyright for this article is retained by the author(s), with first publication rights granted to the journal. This is an open-access article distributed under the terms and conditions of the Creative Commons Attribution license (http://creativecommons.org/licenses/by-nc/4.0).