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EXTENT OF THE CRISIS AND POST-CRISIS CONSOLIDATION OF PUBLIC FINANCES IN GERMANY, FRANCE, SPAIN AND IRELAND IN 2009 – 2018

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ABSTRACT

The goal of the paper is to evaluate the effects of budget policy aimed at improving the condition of public finances in selected countries of the euro area. Author focuses on countries that prior to the crisis had budget surpluses and low public debt (Ireland and Spain) but also on France and Germany that fulfilled treaty criterion on budget deficit and were close to fulfilling the public debt criterion. Aftermath of the 2008-2009 crisis in the case of public finances of the analyzed countries were varied in terms of the size of budget deficit and growth of public debt. Dramatic destabilization of public finances occurred in Ireland and Spain. In France public finance crisis deepened with the second wave of recession and tackling continuous low economic growth. The paper includes results of balancing budgets and reducing public debt in analyzed countries. Author also points to the facts that the major impact on progress in budgetary consolidation stemmed from: economic growth, stability programmes, sources of primary imbalances and realisation of public investment.

Keywords: euro area, varied consequences of crisis, budgetary costs of crisis, public finances consolidation, determinants of consolidation

INTRODUCTION

Budget situation in the euro area before the beginning of the financial crisis in 2008 was shaped mainly by economic growth rate and budget discipline. In 1997-2000 both factors contributed to the decline of budget deficits, while during the subsequent three years (2001-2003) - economic slowdown and growing budget expenditure negatively affected budget balance-to-GDP ratio in most of the euro area countries, in particular Greece, France, Germany, Italy and the Netherlands. In Portugal budget deficit had either been over the reference value or dropping to the 3% threshold since 1997. Economic boom in euro area started two years after the US - only in 2004, but it was relatively weak and budget situation improved moderately. Marked improvement in terms of economic growth and budget balance occurred in 2006-2007, albeit varied significantly between countries. The following countries had budget surpluses: Finland, Luxembourg, Ireland, Spain, the Netherlands and Germany (only in 2007). The largest deficit - of twice the reference value - occurred in Greece while Portugal and France's deficits were only slightly over the reference value [3]. Average deficit in the euro area (12) declined to 0,7% [3].

Public debt average for the euro area (12) in 2007 was 65,7% of GDP which is higher than the reference value, but it was mostly due to the situation in the most indebted countries such as Greece (103,1% of GDP), Italy (99,8% of GDP) and Belgium (87,0%

of GDP). The lowest public debt ratios occurred in Luxembourg (7,7%), Ireland (23,9%), Finland (34,0%), Spain (35,6%) and the Netherlands (45,3%) [3].

Financial crisis began within the United Kingdom's banking sector as the financial condition of mortgage bank Northern Rock worsened. Initially it received a loan from the Bank of England, but eventually it had to be nationalized [10]. The crisis deepened following the collapse of Lehman Brothers bank in the United States in the second half of 2008 which led to destabilization of financial markets and deep recession in 2008-2009. Many governments had taken action to stop the disintegration of the financial sector and further decline in demand. They included bailout packages for banks and other financial institutions as well as anti-cyclical fiscal packages. These resulted in large increases of public spending in particular in countries where banking sectors constituted a large share of the economy as well as in countries that stimulated demand in 2009-2010 using various instruments affecting the growth of: consumption and investment demand, economic activity and employment. Rescue packages for banks as well as fiscal packages to stimulate economic activity were a huge burden for public budgets which led to the debt crisis not only in the euro area and the EU, but also United States and many other countries. The largest aid for the financial sector (in relation to GDP) occurred in the United Kingdom, and in the case of the euro area: the Netherlands, Ireland, Luxembourg, Belgium, Slovenia and Germany [14]. As a result average public debt in the euro area (16) increased by 2,5% of GDP at the end of 2009 and in the above-mentioned countries the increase ranged from 11,3% of GDP in the Netherlands to 3,5% of GDP in Germany [14]. The main forms of aid were: acquisition of shares, loans, capital injections and asset purchases. Budget burdens also increased as a result of guarantees offered to banks and taking over the liabilities. The largest guarantees were awarded in Ireland, Belgium, the Netherlands, Spain and the United Kingdom [14].

Anti-cyclical instruments of budget policy were used in 2009-2010 within *European Recovery Plan* agreed on the 15th of November 2008 during the G20 summit in Washington. The goal was to strengthen the anti-recession effects of the automatic economic stabilizers which are the basis of the budget policy in the EU and euro area. According to the European Commission fiscal stimulus package (discretionary measures) in the euro area amounted to nearly 2% of GDP (1,1% in 2009 and 0,8% in 2010) and the pro-growth effects (a total fiscal impulse) in 2009-2010 was 4,9 p.p. of GDP - 2,4 p.p. of which were due to automatic stabilizers and 2,5 p.p. - a result of active budget policy (the fiscal package) [14]. Not all euro area members introduced large budget packages. In 2009 the biggest stimulus packages in relation to GDP were adopted in: Luxembourg (3,4%), Cyprus (2,7%), Spain (2,4%), Germany (1,7%), France (1,6%) and Finland (1,6%) and in countries outside the euro area: the Czech Republic (2,3%), the UK (1,9%) and Sweden (1,7%). In 2010 the biggest active budget policy packages within the euro area (16) were introduced in: Finland (2,7%), Cyprus (2,4%), Germany (2,4%), Luxembourg (2,2%), Austria (1,8%) and Slovenia (1,8%) [7]. In the case of the remaining EU countries the largest budget packages impacting the economic conditions were adopted in Poland (3,2%), Sweden (2,7%) and Hungary (2,1% of GDP) [7].

From the point of view of economic recovery the most meaningful were the active budget policy instruments introduced in countries with largest economic potential (Germany, France and Spain) as they significantly impacted the demand all over the European Union. In 2009, 50% of fiscal incentives in the euro area originated in Germany and 25% - in Spain which had the greatest fiscal package out of the large economies - 2,4% of GDP which was spent as follows: public investment (0,9% of GDP), economic activity (0,8% of GDP), consumption demand (0,5% of GDP) and support to employment (0,1%) [12].

The aftermath of high costs of aid for the financial sector and budget policy including automatic stabilizers and anti-cyclical stimulus package was an increase in budget deficits of the euro area and the other EU countries and as a result - public debt crisis. Countries with deepest recession and largest increases of budget spending experienced a dramatic worsening of the condition of their public finances. Author's analysis focuses not on the countries joining the euro area with already high public indebtedness (such as Greece, Italy or Belgium), but on those that in 2007 had budget surpluses and low public debt in relation to GDP plus on Germany and France which were within the deficit criterion and on their way to fulfil the debt criterion.

The goal of the paper is to evaluate public finances consolidation in Germany, France, Spain and Ireland - countries which experienced a shocking increase in budget deficits that resulted in a prompt growth of public debt (Ireland and Spain) as well as France and Germany - the largest economies of the euro area, that suffered from a significant worsening of the public finances condition. The basis of the assessment will be the budget deficit and debt in 2009-2018 and comparison of consolidation paths of selected countries with scenarios of diminishing public debt constructed by Ad van Riet (2010).

THE EXTENT OF THE CRISIS AND THE RESULTS OF PUBLIC FINANCE CONSOLIDATION

Improvement of the public finances situation can be obtained by: 1) decreasing of budget expenditure, 2) increasing of budget income as a result of higher tax burdens, 3) joint activities leading to the limiting of the spending and increasing of budget revenues. Policy of recovering budget balance and decreasing public debt is important for a number of reasons: 1) to ensure the conditions for economic growth, 2) to lessen the cost of debt servicing, 3) to recover the trust of financial markets which analyze macroeconomic data, and in particular the condition of public finances and budget policy, to assess the risk of insolvency in debt distressed countries.

Research on budget strategies in EU countries in 1992-2006 revealed that more stable strengthening of the budgetary position occurs as a result of decreased spending rather than activities aimed at increased revenue [2] [9] [13]. What is more, in recession, EU countries have rather lowered taxes (including CIT) in order to stimulate private investment. However, studies show that the impact of tax cuts on GDP growth may be low. In 2012, the correlation coefficient between the rate of changes in GDP and CIT in the EU-27 was -0,17 [15]. In recessionary conditions the enterprises’ propensity to invest is weak due to low profit rate and high risk. Moreover, cutting public spending leads to the limiting of public investment that contribute to GDP and income growth. This pertains to infrastructural investment in particular. There is vast economic literature available on this issue. Significant input into creating theoretical basis for analysis and assessment of infrastructure's impact on economic and income growth was made by D. Aschauer (1989), who claimed that level of infrastructure development is essential for the improvement in

Total Factor Productivity [4]. Intensification of research on infrastructure's impact on socio-economic development occurred in the 1990s as a result of systemic changes within the highly developed economies - in particular in Western Europe. These meant privatization of the public sector and encompassed mostly public services. Research confirmed Aschauer's thesis that development of infrastructure contributes to economic and income growth, reduces inequality in terms of income and helps to enhance economic activity in less-developed regions [5].

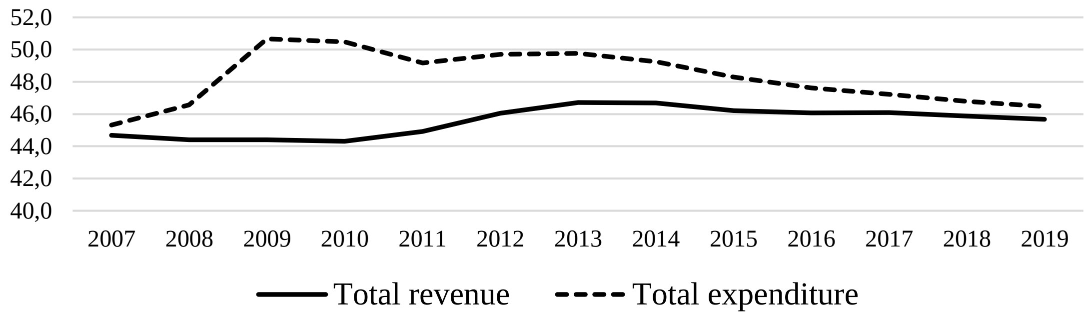
Debt crisis in the euro area and the EU - its scale as well as cost of debt servicing in various member countries affected the extent and methods of public finance stabilization. Limiting of expenditure pertained to public investment as well. Both public and private investment remain subdued compared to the pre-crisis years (2008-2009) and investment-to-GDP ratio up to 2018 was below the long-term average [6]. Low investment ratio and a threat of secular stagnation in the EU became the source for the lively debate on investment's drivers and barriers as well as macroeconomic effects of public investment. A. Abiad, D. Furceri and P. Topalova [1] carried out an analysis and evaluation of macroeconomic effects of public investment realized in 17 OECD countries in 1985 - 2013 concluding that: 1) increase in public investment was a cause for increase in product (both short and long-term), increase in private investment and decline of unemployment, 2) its impact on budget situation was dependant on the method of financing - either increased taxes, limiting other expenditure or increasing public debt, 3) effectiveness of public investment was higher in highly developed countries. In order to promote the most effective public investment in the EU in 2015 *The Investment Plan for Europe* (Juncker Plan) was introduced.

Table 1. Total revenue and total expenditure (general government) in 2009 – 2019 (% GDP)

	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Euro area											
Revenue	44,4	44,3	44,9	46,1	46,7	46,7	46,2	46,1	46,1	45,9	45,7
Expenditure	50,7	50,5	49,2	49,7	49,8	49,2	48,3	47,6	47,2	46,8	46,5
Germany											
Revenue	44,3	43,0	43,8	44,3	44,5	44,6	44,5	45,0	45,1	45,0	45,0
Expenditure	47,6	47,3	44,7	44,3	44,7	44,3	43,9	44,2	44,2	44,0	43,9
Ireland											
Revenue	33,2	33,0	33,6	33,9	34,1	33,9	26,9	26,4	26,0	25,9	25,7
Expenditure	47,0	65,1	46,3	41,9	40,2	37,5	28,8	27,1	26,4	26,0	25,9
Spain											
Revenue	34,8	36,2	36,2	37,6	38,6	38,9	38,5	37,7	37,9	38,0	38,2
Expenditure	45,8	45,6	45,8	48,1	45,6	44,8	43,8	42,2	41,1	40,4	39,9
France											
Revenue	49,6	49,6	50,8	52,0	52,9	53,1	53,1	53,0	53,1	53,0	52,7
Expenditure	56,8	56,4	56,0	56,8	57,0	57,1	56,7	56,4	56,0	55,9	55,7

Source: [3]

Figure 1. Total revenue and total expenditure (general government) in euro area in 2007 – 2019 (% GDP)



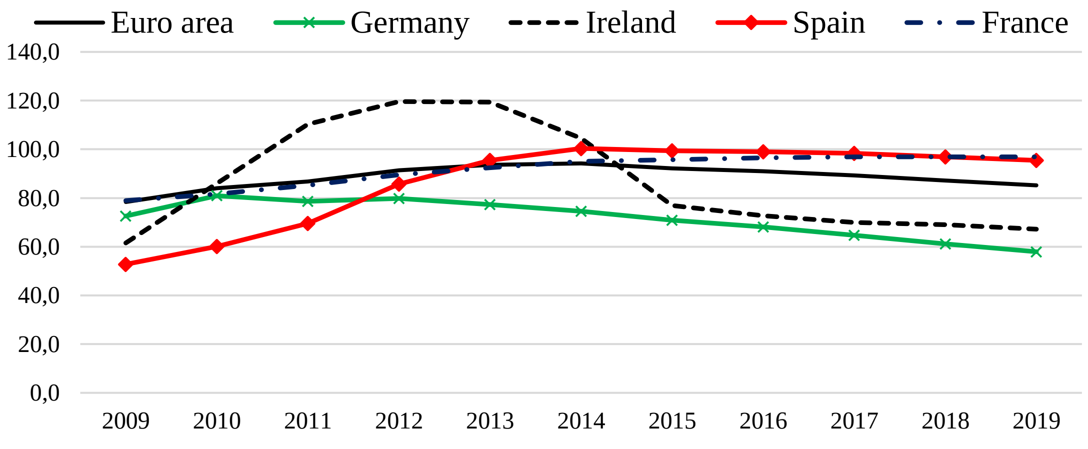
Source: [3]

Table 2. General government consolidated gross debt in 2009 – 2019 (% GDP)

	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Euro area	78,4	84,1	86,8	91,4	93,7	94,2	92,1	91,1	89,3	87,2	85,2
Germany	72,6	80,9	78,6	79,8	77,4	74,6	70,9	68,1	64,8	61,2	57,9
Ireland	61,5	86,1	110,3	119,6	119,4	104,5	76,9	72,8	69,9	69,1	67,2
Spain	52,8	60,1	69,5	85,7	95,5	100,4	99,4	99,0	98,4	96,9	95,5
France	78,9	81,6	85,2	89,6	92,4	95,0	95,8	96,5	96,9	96,9	96,9

Source: [3]

Figure 2. General government consolidated gross debt in 2009 – 2019 (% GDP)



Source: [3]

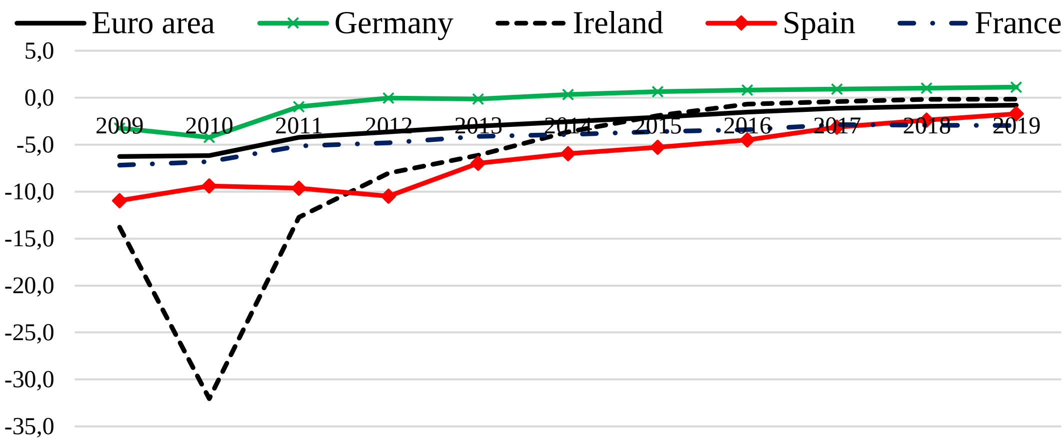
Table 3. Net lending (+) or net borrowing (-) in 2009 – 2019 (% GDP)

	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Euro area	-6,3	-6,2	-4,2	-3,6	-3,0	-2,6	-2,1	-1,5	-1,1	-0,9	-0,8
Germany	-3,2	-4,2	-1,0	0,0	-0,1	0,3	0,6	0,8	0,9	1,0	1,1
Ireland	-13,8	-32,1	-12,7	-8,0	-6,1	-3,6	-1,9	-0,7	-0,4	-0,2	-0,2
Spain	-11,0	-9,4	-9,6	-10,5	-7,0	-6,0	-5,3	-4,5	-3,1	-2,4	-1,7

France	-7,2	-6,8	-5,1	-4,8	-4,1	-3,9	-3,6	-3,4	-2,9	-2,9	-3,0

Source: [3]

Figure 3. Net lending (+) or net borrowing (-) in 2009 – 2019 (% GDP)



Source: [3]

Landscape of public finances in the euro area (19) was presented through data in tables 1-3 and figures 1-3. The highest budget deficit in the euro area occurred in 2009-2010 and it ranged from 6,3% - 6,2% of GDP. In 2011 it was significantly lower (by 2 p.p.)

Budget situation of euro area members, including the ones under analysis in this paper, was strongly varied. Extremely high deficit - the highest in the EU - occurred in Ireland 13,8-32,1% of GDP (2009-2010), but high deficits, higher than the euro area average, affected budgets of Spain and France (especially Spain). On the other hand, an increase of deficit in Germany was slight compared to other analyzed countries and the average for the euro area. Due to the well-balanced pre-crisis budget Germany was able to introduce intensive stimulation of GDP growth funded from the public budget and as a result in 2010 they had relatively high economic growth (4%) that increased their capacity to improve budget situation.

Vast deepening of budget deficits in 2009-2010 resulted in a compelling worsening of the condition of public finances in euro area countries and increasing divergence within the common currency area in terms of size of budget deficit and public debt. In 2010 Irish public debt surpassed 86% of GDP and further increased in 2012-2013 reaching the level of over 119% of GDP, but since 2014 it has begun to visibly decline. Since 2015 Ireland fulfils treaty criterion of budget deficit and public debt declined in 2016 to 72,8% of GDP and continues to remain on a downward trend. Forecasts claim that by the end of the decade it should approximate the reference value.

Second country that, despite several years of budget surpluses and low debt, suffered from a significant worsening of its public finances was Spain. Prolonged recession that had lasted until 2014 resulted in a dramatic decline of budget revenues. At the same time, expenditure on rescuing the banking sector and supporting GDP growth in 2009 plus an increase of unemployment rate up to approximately 25% and growing social expenditure as a result of automatic stabilizers caused a wide spread between revenue and expenditure up to 2015. Budget deficit started to decline with a lag compared with other analyzed countries and the rate of decline was also slower. In 2016 deficit was still relatively high - 4,5% of GDP. Due to long-term budget disequilibrium, debt accumulation continued. It increased from 51,8% of GDP in 2009 to 100,4% of GDP in 2014, and the decrease in 2015 was only slight.

Another country that suffered serious breakdown of its public finances due to the financial-economic crisis was France. Increase of the budget deficit in 2009-2010 was higher than the euro area average, albeit in 2010 the difference was only 0,6 p.p. Nevertheless, in 2011-2016 deficit-to-GDP ratio in France declined by only 1,7 p.p. and remained above the reference value. What is more, forecasts for 2017-2019 are not overly promising. The aftermath of the state of public budget was continuous growth of public debt until 2017. It is supposed to stabilize in 2017-2019 at the level of 96,9% of GDP.

Germany was first to achieve budget balance (in 2012) and since 2014 the positive balance has been increasing. The highest public debt ratio in Germany occurred in 2010 and it was 80,9% of GDP. Lasting downward trend in terms of public debt continues since 2013 and forecasts for 2018 place it only slightly over the reference value.

The analysis carried out shows that the crisis of 2008-2009 affected public finances of euro area countries in different ways, and the results of consolidation have also been highly diversified. Taking into account the extent of deficit and debt, the best results in consolidating public finances were achieved in Ireland where deficit has been reduced by 31,4 p.p. and debt by 46,8 p.p. (2016).

Comparing achievements in reducing public debt of analyzed countries with scenarios developed in 2010 by Ad van Riet the following information comes to light. Ad van Riet presented three paths of public debt level evolution: green (optimistic), blue (moderate) and red (no plan of fiscal consolidation). Ireland reduced its public debt much sooner than the green (optimistic) scenario predicted. According to it Irish debt in 2020 was supposed to amount to 128% of GDP. In reality it reached 72,8% in 2016. Germany admittedly did not bear high budget cost due to crisis, but public debt increased anyway to 80,9% of GDP. Nevertheless, the rate of debt reduction was faster than the green scenario. In the case of France, real public finances condition was worse than the green scenario because it failed to overcome upward trend regarding public debt growth. As a consequence, current level of debt is closer to the blue scenario. Situation in Spain in terms of debt was better than in France as since 2015 the debt continues to decline, however slowly. In general the state of public finances in Spain and France is comparable.

CONCLUSION

Factors affecting the process of public finances consolidation include both economic growth and rescue plans as well as sources of primary imbalances. In the euro area private consumption is the main source of economic growth on the demand side. Whereas input of investment into GDP growth remains low since both private and public investment linger below pre-crisis levels. What is more, a decline in public investment was a consequence of reducing budget expenditure within the stability programmes. Prior to the crisis (2000-2006) the highest public investment-to-GDP ratio pertained to Spain (4%). They were concentrated in transport, especially in railway [11]. Second highest investment occurred in France (3,9%) and the third - Ireland (3,7%). Public investment in Germany was over 2,1% of GDP [8]. Neither Germany nor France changed their policy and maintained public investment on the same level after 2010. France started to decline in 2014. On the other hand, Ireland and Spain considerably reduced their public investment.

Assessing the effects of public finances consolidation in four analyzed countries, it is necessary to point out that they combined the approach to reduce expenditure with the one to increase budget revenue. More opportunities in terms of increasing revenue were available to those countries that regained their ability to economic growth sooner - Ireland and Germany. Spain started to improve GDP growth rate only in 2014 thus the long recession inhibited improvement of budget situation. Since 2015 the range between expenditure and revenue in Spain clearly started to decline. France is a particular case. After a short recovery in 2010-2011 economic activity diminished again, economic growth remains subdued and fulfilment of social commitments inhibits the ability to decrease budget expenditure, deficit and public debt.

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