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Europe's public finances

Weighed down

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The recession has left a fiscal burden that many countries will struggle to shed

Illustration by Peter Schrank



THE BAD thing for politicians about good news on the economy is that they can no longer avert their eyes from the state of public finances. Figures released on November 13th showed that the euro-area economy crawled out of recession in the three months to the end of September. GDP rose by 0.4%, the first quarterly increase for more than a year. Given the scale of the downturn, the recovery is modest: GDP was still 4.1% lower than a year earlier.

Such a deep slump has wrecked public finances. The average budget deficit in the 16-country euro area will be 6.4% of GDP this year, rising to 6.9% in 2010, according to the European Commission's forecast. If no action is taken to tame deficits, public debt will rise to 88% of GDP by 2011, a third higher than it was before the crisis (see chart).

This mix of fragile economies and weak public finances creates a policy dilemma. There is a risk that public debt will eventually spiral out of control unless taxes are raised or spending cut. But if fiscal support is withdrawn too quickly, the economy could tip back into recession. To address this, European Union countries have agreed in principle to an "ambitious" tightening of fiscal policy, but only from 2011. By then, it is hoped, the economy will be strong enough to withstand it.

The commission will play the role of co-ordinator and monitor, though it remains to be seen how binding its prescriptions will be. On November 11th it proposed that 13 EU countries with big deficits should get them below 3% of GDP by 2014 at the latest. EU ministers will consider those

plans on December 2nd. Countries in the worst fiscal shape have most to do. Ireland, for instance, will need to raise taxes or cut spending worth 2% of GDP each year for five years to meet the targets, says the commission. Germany, by contrast, will need to tighten by an average of only 0.5% of GDP for three years.

A repair job on public finances stands a better chance of being durable if it relies on spending cuts rather than tax increases. But this remedy will be hard to apply too strictly, especially in the worst-hit countries such as Ireland and Spain. Ireland's tax receipts have declined by a third since 2007, far more than the 13% fall in nominal GDP. As in Spain, revenues stemming from the housing boom—value-added taxes (VAT) on new homes, capital-gains tax, and transaction levies—have dried up and will not return.

A shift in both economies away from domestic spending has also hurt. Export-led growth has its appeal but offers less help for public finances where expenditure taxes are a big share of total revenues (see [article](#)). Burst housing bubbles have revealed how thin the tax base is.



Ireland has already tightened fiscal policy by some 5% of GDP since July 2008, in the midst of a savage recession. The government will set out its budget plans for 2010 on December 9th, and is expected to find €4 billion of savings or extra taxes to stabilise the deficit. Its pre-budget report drew attention to the big increases in public-sector wages and jobs over the past decade. That is a strong hint that pay cuts are among options being considered. Spain plans to trim its deficit by raising the main VAT rate from 16% to 18% next July, phasing out tax rebates and cutting back on the small investment schemes that were part of the fiscal stimulus.

What's French for retrenchment?

Such actions to address budgetary problems owe more to fears of retribution from bond markets than lectures from Brussels. The euro-zone's largest members will need to stick with the commission's programme if it is to carry any weight. Joaquín Almunia, the EU's economics commissioner, seems relaxed about the new German government's plans for tax cuts, though they were not part of his reckoning. Germany has enough capacity and credibility to tighten its policy a bit later than others. Italy has been remarkably disciplined. With investors so skittish during the crisis, Italy could ill afford to add much to its huge public debt. It eschewed any meaningful fiscal stimulus in recession so now has less to do to control the deficit.

The commission's strictures may chafe far more with France. Brussels wants a cumulative fiscal tightening of 5% of GDP by 2013. France may want the deadline extended. Even if granted that, it will still struggle. The share of public spending in the economy is the highest in the euro area. Cuts in entitlements, not tax increases, would be the best remedy for the budget gap. But it is hard to imagine an assault on social spending with a general election due in 2012. France has so little practice at fiscal retrenchment that a 3% deficit seems a distant prospect.

A more immediate problem is what to do about Greece (see [article](#)). Its new government now says that the budget deficit would be 12.7% of GDP this year, far higher than its previous forecasts. What is worse, last year's shortfall was revised up to almost 8% of GDP—partly, it seems, because of unpaid bills to medical suppliers. Fitch, a ratings agency, immediately cut Greece's bond rating from A to A- and gave warning of a further downgrade if the government does not spell out how it will right its public finances.

The commission has judged that "no effective action" has been taken by Greece to tackle its deficit, a rebuke which it expects to be endorsed by EU ministers next month. It will set a new action plan for Greece by February. Without remedial action, public debt is expected to reach an alarming 135% of GDP in 2011. Yet investors seem sanguine: Greece's ten-year bond yield is comfortably below 5%. That may reflect an assumption that its euro-zone partners will save Greece should it run into trouble. The anger about its persistent laxity means that cannot be relied upon.

The countries with the deeper pockets have enough troubles of their own. The money sprayed around to make recession less painful—in wage supplements, make-work schemes and subsidies for car purchases—has to be financed. Cutting back fiscal support will weigh on a recovery that has started quite slowly. Given the scale of the adjustment needed in some countries, it is hard to be too optimistic about the euro-zone's growth prospects.

