Public Sector Austerity: Path to Crisis or Path to Recovery?

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Austerity measures are shaping current EU economic policy and lie at the centre of the economic policy debate in many countries, including Slovenia. All such debates are based on the argument that we can deal with the current economic crisis by focusing on balancing public revenues and expenditure by implementing deficit-cutting policies and thereby preventing the growth of public debt. In Slovenia general government expenditure amounted to 50.9 percent of GDP in 2011, while in the same year general government revenues represented just 44.5 percent of GDP. The resulting general government deficit thus amounted to 6.4 percent of GDP in 2011.[1] Although it will probably take until the second half of 2012 for Slovenia's general government debt to exceed 50 percent of GDP, the entire economic policy package that was recently introduced only seeks to eliminate the deficit generated, while neglecting almost all other policy issues. The measures suggested by Slovenia's current government follow the EU's austerity guidelines by attempting to cut general government expenditure while preserving the general government revenues as a share of GDP. To justify these measures the government employs typical European political rhetoric by arguing that future economic growth and increases in employment will be impossible without cutting general government expenditure! Such rhetoric makes the general government sector's cuts an unavoidable necessity and regards what is referred to here as the public sector as a major burden on European business.

This paper discusses why the policy measures in response to the current crisis that are called for by governments in Brussels, Greece, Spain, Portugal, Italy and other countries including Slovenia are setting them on the wrong course.

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[1] See UMAR (2012), Development Report 2012, Ljubljana.

Public and private sector growth

Let us first turn our attention to the structure of GDP. It is amassed by many different products and services ranging from car window opening mechanisms to customs and border protection services. Services represent up to 75 percent of GDP in some countries and the share of material goods in the structure of GDP in such countries is declining. The services accounted for in GDP are offered either by public providers, organised by the state, or offered by private providers where the former make up what we usually refer to as the general government or the public sector. In Europe, the public sector 'produces' about two-thirds of all services.

The size of the share of GDP created by the public sector depends on economic efficiency. According to (micro)economic theory, the free market and private ownership cannot result in a Pareto-efficient society where no one can be made better off without making at least one individual worse off in cases of imperfect competition and market failures associated with externalities, public goods and information asymmetries. It is precisely these market imperfections that call for the regulatory role of the state and the state or public provision of some products and services, thereby justifying the existence of the public sector. If we keep this basic economic knowledge in mind, we have to regard everything that shapes the GDP of a specific country as its wealth, regardless of whether it is created by the public or the private sector. Furthermore, brushing up on economic fundamentals would remind policymakers that the role of the public sector is not one of acting as a burden on European business, but one of a Pareto-superior way of providing certain products and services.

The structure of GDP in both the sense of the combination of material products and services and products and services by type of provision, i.e. public vs.

private, is determined by the preferences of consumers and the resulting demand. Output in the form of refrigerators and output in the form of nursing services both add to GDP, but their produced amounts have to correspond to the structure of demand. If demand for health care services increases, one cannot regard nurses as an increased burden on the workers producing refrigerators. The only relevant issue to be resolved in such a case is how a society can change the structure of its GDP to adapt to changes in the structure of its population's demand. If Slovenians, for example, demand more health care services because their overall health status declines, then it makes a lot more sense to think about the increased burden of workers involved in the production of refrigerators on health care personnel than *vice versa,* particularly because the given allocation of production factors between different types of production prevents sufficient increases in the supply of health care.

Economic growth is realised through growth in GDP that materialises either through the increased output of nurses providing health care services; or when the output of car exhaust system manufacturers rises. The reverse also applies. GDP declines either when a construction company is forced into bankruptcy or when the Ministry of Health decides to shut a public hospital down. When thinking about the sources of growth it is very important to note that, in developed economies, the share of home appliances in total demand is declining, while the opposite holds true for demand for services like education and health care as today's societies transition towards knowledge societies. It is already becoming evident that for such societies, a lot of effort has to be put into achieving growth by increasing the value of, for example, steel, oil, car or home appliance production. If the obstacles to exploiting such sources of growth are too large either because of the increasing competitiveness of other countries, or due to rising burdens on the environment, developed economies do have an attractive alternative to exploit the growth possibilities offered by the services often linked to the public sector. There are plenty of signs that in the near future modern societies will be able to attain economic growth precisely through the growth of the public sector.

Therefore, those economies currently focussing on implementing austerity measures aimed at shrinking the public sector to cut their general government budget deficits will unfortunately also very likely restrain growth precisely in those economic sectors that are capable of generating GDP growth due to changes in consumers' preferences and their demands. If the growth in health care expenditure is reduced in circumstances where the needs and demand for health services continue to rise, economic growth will not be stimulated by, for example, the increased production of material goods that are becoming less relevant to society's welfare. In these circumstances, public sector austerity cannot translate into anything other than the decline of economic growth.

Public and private spending

Economic growth and employment can only be generated through the increased output of the public sector if the latter is dictated by demand, since consumers determine the structure of GDP through their preferences and incomes. Leon Walras stated that we cannot spend more than we earn; and that we can only earn as much as we spend, which reflects the fact that demand does indeed dictate the structure and value of GDP. This is most evident if we ignore international trade and savings for the sake of simplicity and imagine that we live in a Robinson Crusoe like economy where we purchase our GDP using incomes generated by selling our GDP to ourselves. Therefore, the production of all products and services or the production of a country's private and public sectors reflects a corresponding flow of aggregate (real) income to households, which the latter directly or indirectly spend on consumption and investment goods, and pay taxes on.

The resulting expenditure of the income generated by sale of the created GDP can be either private or collective. In the first case, consumers (households) make individual consumption and spending decisions using their disposable income. In the second case, consumers (households) make spending decisions collectively through governmental organisations or funds, and transfer part of their disposable income to the state. This generates general government revenues. These are the primary, but not the only source of the general government sector's spending or public spending given that the general government can also incur debt for this purpose.

Public spending emerged because, as societies developed, some the family's functions were shifted to the state. The Industrial Revolution brought about this change, most notably as workers were needed en masse for capitalism to prevail. Individuals could only become part of the workforce if they were relieved of caring for the sick and the elderly, caring for and educating their children, and other traditional roles assumed by healthy and able-bodied family members. Public spending also evolved because, as previously mentioned, the production of some products and services proved more efficient under state or public provision; and such public provision required financial means to ensure production. If we use public spending to finance the output of the public sector, and if the public provision of this output indeed assures more efficient production compared to private sector production, then collective spending is more efficient than private spending. This is what justifies public spending and gives it a legitimate role in any contemporary society.

Unfortunately neither history nor theory proves very helpful in determining the line between private and collective or public spending. In some countries, public spending amounts to nearly 60 percent of GDP, while public spending as a share of GDP in other countries is below 40 percent. Yet it is important to note that differences in the share of public spending between countries are smaller today than in the period following the Second World War.

As the above discussion illustrates, public and private spending are rivals from the GDP perspective, since the value of GDP equals the combined value of public and private spending. However, public and private spending cannot be considered rivals from a customer perspective. Increasing public spending does decrease private spending for a particular consumer. However, public spending does not represent a burden on anyone, as public spending merely acts as a substitute for the loss of private spending. If the public sector indeed provides those services that are produced more efficiently through public provision, then the average individual is made even better off, as his/her final consumption is maximised in this way. Of course, individuals can receive dental care in either a public health centre or private dental clinic. They can pay for the services that they obtained either out of funds generated collectively through, for example, compulsory health insurance; or directly out of their disposable income, i.e. from their own pocket. However, these two types of spending are the only alternatives available to any individual requiring dental care.

The way that produce goods and services are produced and the way that they are funded depend on our choices, which are determined historically and by taking into consideration how our society is organised to maximise its social utility function. Increases in health care spending that, due to budget constraints, require reduced spending on goods such as, for example, cars are a consequence of our deteriorating health and ageing population, and are not caused by a growing and overly extensive public sector. And if a decision is made to pay for health care using collectively accumulated funds (and not through private spending); and to provide for the additional output of health care services through public providers (and not private providers), this decision be taken because collective spending enables the larger consumption of heath care services than private spending and because it maximises social welfare. This implies that, at least theoretically, the upper boundary for public spending is set at 100 percent of GDP and, contrary to concern expressed by politicians in Slovenia, the country's public spending, which totals 50.9 percent of GDP, has not reached its upper boundary.

Public sector output and public spending

The real problem of the Slovenian public sector thus stems from the fact that in 2011 general government expenditure was 50.9 percent of GDP, but general government revenue only amounted to 44.5 percent of GDP. General government revenue represents funds that were collectively accumulated for publically provided services. It is thus a source of funding for public spending. General government expenditure, on the other hand, generates the public sector's income, which is equivalent to the value of the public sector's output. In 2011 in Slovenia, the funds collectively accumulated for publically provided services represented 44.5 percent of GDP, while the public sector's output was 50.9 percent of GDP. To eliminate this gap in the funds accumulated for public spending that enabled the purchase of the public sector's output, the state needed to incur debt totalling 6.4 percent of GDP.

All issues raised by the austerity measures that have been introduced derive from two simple facts. The first is that we transferred an insufficient amount of income to the state so that the state could collectively spend it on the public sector's output. The second is that we also failed to privately spend this insufficient amount of money on services provided by the public sector. These two simple facts led to the need for the state to compensate for insufficient funds for the public sector's output by increasing its indebtedness. These facts demonstrate that the problems characterising the public sector today were not created because Slovenia generated a huge public sector due to a lack of austerity. If a lack of austerity was the true problem, then implementing austerity measures can be considered as the only appropriate response. Yet the real problem lies in the imbalance between the public sector's output and the amount of funds that were collectively accumulated for publically provided services.

Besides the imbalance between the public sector's output and the amount of funds that were collectively accumulated for publically provided services, three other types of imbalances can emerge in any economy. The first such imbalance can be created between savings and investment. The second possible imbalance can emerge in the relationship between household incomes and expenditure. The third type is the imbalance between exports and imports or an imbalance in the current account of the balance of payments. Given that, at the end of the day, a society can always spend only as much as it has earned, an imbalance in one area has to be offset by an imbalance in another area.

This discussion illustrates that anyone who argues in favour of the fiscal rule as the one necessary thing we have to reach a consensus on in order to resolve the current economic crisis is disregarding basic macroeconomics. Even although the fiscal rule does prevent excessive imbalances between the public sector's output and the funds that were collectively accumulated for publically provided services, it does not set any boundaries for other types of imbalances. While the fiscal rule implies that the general government sector no longer incurs debt to assure sufficient funding for publically provided services, this does not rule out the possibility of other sectors creating imbalances, leading to an economic crisis or prolonging the country's crisis-exit process. The imbalance created when investments exceed the savings of the private sector can result in a negative imbalance between exports and imports; and the end result is the same as if the public sector's output were to persistently exceed the amount of funds collectively accumulated for publically provided services – namely increased foreign indebtedness. Whoever fails to understand this also fails to comprehend that in Slovenia the large increases in the private sector's indebtedness in the 2004–2008 period contributed far more to the onset of the crisis than the increased general government indebtedness in the 2009–2011 period.

A general government deficit can be resolved in two ways. One alternative is to reduce the public sector's output from the existing amount of 50.9 percent of GDP to 44.5 percent. The other alternative is to do the opposite, i.e. to increase the collectively accumulated funds from 44.5 to 50.9 percent of GDP. The first alternative implies society's decision to shrink the public sector by lowering the salaries of public employees, reducing the budgets of universities and social security funds, either by closing down or lowering the standards of public hospitals, schools and kindergartens and by eliminating other public programmes. All of these actions represent the measures that constitute today's public sector austerity programmes. The second alternative can be realised by, for example, increasing taxes such as VAT, implementing reasonable reforms of the pension system, introducing real-estate taxes and taxes on various financial transactions and transactions involving the sale of land, privatisation, or improving the efficiency of the tax system and its tax recovery capacity. By introducing some measures such as caps on social contributions, lowering legal entity income taxes and various subsidies that are advocated in Slovenia together with the proposed austerity measures, the general government deficit could further deteriorate or austerity programmes be made more stringent because they are aimed at reducing the 44.5 percent share of collectively accumulated funds for public spending in GDP.

Disregarding political aspects and social welfare concerns, a society can opt for either of the two approaches described above to reducing its general government deficit. Both alternatives can also be combined. However, the paths outlined differ considerably when it comes to economic growth, employment, the incomes of the population and society's living standards and welfare.

Economic growth and public spending

The austerity programme being implemented in Slovenia aims to reduce the public sector's output from 50.9 percent of GDP to 44.5 percent of GDP. Such programmes alter the supply side and the way that GDP is generated. Cuts in the public sector's output enable the reduction or elimination of public debt. However, by reducing public spending as a share of the amount funded by debt, the public sector's output can only amount to 44.5 percent of GDP. Given that there are no reasons for changes (increases) to any other elements of private spending under such circumstances (to consumption and investment goods, and taxes) including export demand, and given that public and private spending including export demand together equal the value of GDP, this then implies that GDP has to decrease to the value of the reduced effective demand. Reductions in the size of the public sector thus also lower the GDP created and the austerity measures implemented contribute to negative GDP growth rates. The smaller quantities of services that comprise a country's GDP are sold to consumers and, as a consequence, the incomes generated are also lower. These lower incomes thus also lead to less funds being collectively accumulated for publically provided services if tax rates remain unaltered. This implies that, despite the austerity measures implemented, the imbalance between the public sector's output and the amount of funds collectively accumulated for publically provided services would continue to persist while the size of GDP would decline. This discussion illustrates that austerity programmes negatively impact economic growth, decrease employment and do not eliminate the general government budget deficit. The latter would persist even if production were transferred from the public sector to the private sector if the privately-owned providers continued to rely on public spending as their source of income.

It has already been mentioned that, instead of implementing austerity measures to cut the general government budget deficit, Slovenia could opt to increase the value of the funds that are collectively accumulated for publically provided services from the existing 44.5 percent of GDP to 50.9 percent of GDP, which is the value of the output produced by the public sector. Unlike implementing austerity programmes, this alternative alters the demand side by changing the structure of demand and replacing private spending with collective spending. In this case, there is only a reallocation between private and collective spending. Such a reallocation could reduce imports (without impacting exports) and, in this way, the elimination of the general government deficit also implies the elimination of the external imbalance if such an imbalance exists. It is, however, also possible that, along with the elimination of the general government deficit, an imbalance emerges either between investments and savings or in the consumption of goods and services by the household sector if the external imbalance persists. The relevant conclusion in either case is that under such circumstances no element of GDP is affected (domestic output in the form of consumption goods and services for domestic demand, domestic output in the form of investment goods for domestic demand, the public sector's output for domestic demand and domestic output intended for exports). This implies that GDP could remain unaltered.

This also implies that by attempting to increase the 44.5 percent of GDP aggregate spending on the produced products and services that comprise GDP is maintained. Economic growth and employment thus remain unaffected. The same holds true for incomes generated and any resulting spending. On the other hand, the share of funds collected from individuals for the purpose of collective spending increases, thereby reducing the general government deficit. This impact can be achieved by any measure aimed at increasing the 44.5 percent share of incomes reallocated to collective spending in GDP, including a VAT increase.

This paper has shown that replacing private spending with collective spending impacts the structure of demand. The same also applies to the transformation of collective spending to private spending. Given that such a transformation only impacts the structure of demand, it does not decrease the burden on the business sector. The burden on society created by collective spending is simply replaced by the burden created by the need to spend privately, while aggregate spending remains unchanged.

Furthermore, the reallocation between private and collective spending has no influence on the costs of producing GDP. If we accept the statement that increased collective spending poses a heavier burden on any business, then we must also agree with the statement that increased private spending does the same. Both statements reveal an unclear understanding of economics, particularly because costs are not determined by the way in which the incomes of consumers are spent, but by the quantities and prices of inputs used.

Economic growth can thus also be attained through public sector growth, and an expansion of the public sector should not be considered an inferior source of economic growth and employment. Yet this statement warrants caution. Its implications for growth are not the same for an economy with underutilised production capacities and an economy characterised by near-full capacity utilisation.

In the first case, any increase in demand, regardless of whether it is generated by private or collective spending, leads to economic growth because production can increase due to better utilisation of capacities. The latter reduces average fixed production costs and improves the economy's competitiveness, thereby further stimulating economic growth either through increased exports or the increased incomes of domestic household and business consumers. The increased consumption of households, larger investments, higher state expenditure and strengthened exports all drive economic growth, stimulate employment and improve a society's welfare because better capacity utilisation implies increased productivity and improved efficiency. Public or collective spending can contribute to economic growth quite significantly and consumers usually regard the public sector's output as valuable and necessary. Smaller marketing efforts are thus needed to convince consumers to demand such services compared to goods such as a new and improved model of some kitchen appliance or car.

The story differs somewhat if an economy is faced with full capacity utilisation. Under such circumstances, additional capacities are required and investments take on a central role as they create new capacities. Investments can be either private, i.e. made by households or the business sector, or collective, i.e. executed by the state. The only important thing is that these investments are actually realised, because otherwise increased demand results in inflation, not a larger GDP. Even if an economy does not have the possibility to grow by increasing its capacity utilisation rates, it can still grow through increased collective spending, but the latter has to comprise of investments.

The public sector and efficiency

Economic growth is not a sufficient precondition for improving a society's welfare. Stronger demand, higher GDP and increased employment do not automatically translate into improved welfare or strengthen a country's competitiveness. This highlights another important question, namely what is the relationship between a euro spent on production factors and the resulting output. This question is equally important if GDP is generated through the provision of nursing services or the supply of car window opening mechanisms. When a supplier sells its products or services it generates revenues that can subsequently be used to purchase inputs that are in turn used to produce additional goods that make up a country's GDP. This input-output relationship depends on productivity and efficiency. Productivity and efficiency help create the added value that makes an economy more or less competitive and a society richer or poorer. It is important to note that the added value of providing services is usually high. This is why it is no exaggeration to state that those economies that will lead in developing their public sector will also be the most prosperous.

If the austerity programmes aimed at reducing the public sector are viewed in this light, it becomes fairly obvious that they not only hinder future economic growth, but also lower a country's productivity, efficiency and international competitiveness. After taking this discussion into account, it becomes needless to say that the debated austerity measures and the negative attitudes to the public sector are setting European countries on the wrong course for exiting the crisis.