Published on *Business Spectator* (http://www.businessspectator.com.au)

Economy

Big government makes Europe a no-grow zone

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24 October 2013

On Monday Europe's statistical agency, Eurostat, published its official annual data for the European Union's public finances. Superficially, there is at least some good news in the figures: the eurozone deficit for 2012 was 3.7 per cent of GDP. That is certainly high. Too high, in fact, for the European treaties, which only allow 3 per cent of new debt per year. But at least it is better than the 4.2 per cent deficit recorded in 2011, let alone the 6.2 per cent deficit in 2010 or the 6.4 per cent in 2009.

On the other hand, the Eurostat data still make for depressing reading. Though the deficit may be shrinking, even a diminishing deficit means that the total debt burden is rising. From 2009 until 2012, the debt to GDP ratio for the eurozone has risen by 10 percentage points, from 80 to 90 per cent. In absolute figures, this sounds even more horrendous. Public debt was €7.1 trillion in 2009 but €8.6 trillion in 2012.

The deficit is, obviously, the difference between government revenue and government expenditure. With all the talk about 'austerity', one might naively assume that the deficit reduction was purely the result of government shrinking its activities.

Well, not quite.

Government spending did in fact go down since 2009. Back then, eurozone governments accounted for 51.2 per cent of the economy. In 2012 this figures was down to 'just' 49.9 per cent. In other words, the eurozone was now just 0.1 per cent short of being half-socialist.

Reducing government expenditure by 1.3 percentage points was accompanied by similar increases in government revenue: from 44.9 per cent of GDP to 46.3 per cent of GDP, a gain of 1.4 percentage points. So in actual fact, about half the eurozone's deficit reduction was due to revenue increases; the other half due to actually cutting back government spending.

A reduction of government spending by just over 1 per cent of GDP over four years can hardly pass as radical austerity, especially if it leaves total government spending in the vicinity of 50 per cent of the economy.

The real problem with these data is the trends they show. Though the eurozone may manage to bring government spending and revenue closer together, this will happen at very high levels. At the end of this deficit reduction process, both figures will be around 48 per cent or 49 per cent of GDP. This may be good for government budgets, and it will stabilise government debt – but it is not what the eurozone's economy really needs.

Economic history suggests that larger governments tend to slow down economic growth, though it is notoriously difficult to estimate by how much. The outcomes depend not only on the proportion of government activity in the economy, but also on other social and cultural factors.

In a 2011 study, Swedish economists Andreas Bergh and Magnus Henrekson surveyed the economic literature for empirical studies estimating the link between government size and growth. Their conclusion: “The most recent studies find a significant negative correlation: An increase in government size by 10 percentage points is associated with a 0.5 to 1 per cent lower annual growth rate.”

Determining an optimal, growth-maximising size of government is even more difficult than estimating the growth differential between different government sizes. Having said that, it is clear that it is certainly not as high as it is in the eurozone today. Some liberal economists such as James Gwartney, co-author of the annual *Economic Freedom of the Worl*d report, believe it could be as low as 15 per cent of GDP. Others, such as former IMF director Vito Tanzi, believe the optimum lies around 30 per cent of GDP.

If Tanzi was right and we assume that 10 percentage points of government spending makes an annual growth differential of, say, 0.75 per cent, then the eurozone could lift its game by an extra 1.5 per cent of growth per year by shrinking its government sectors. Obviously, this could not (and should not) be done overnight. But if Europe wanted its economies to grow stronger, it is clear that government cannot remain as big as it is at the moment.

An extra 1.5 per cent of growth per year may not sound like much. Over longer periods of time, such differences make a substantial difference, thanks to the power of compound growth. Growing at 1 per cent a year only leads to 22 per cent growth over two decades. Growing at 2.5 per cent, however, increases the economy by 64 per cent over the same period.

Creating an environment that promotes growth and prosperity is a challenging task. It certainly requires more than just getting the size of government right. Secure property rights, stable political institutions and freedom of contract are important as well.

Nevertheless, there can be little doubt that unlocking Europe’s growth potential would require a significant cutback of the state and its activities. The public’s unease with so-called austerity measures so far suggests that there is no appetite for such policies in Europe. Conversely, if such reforms are politically unfeasible, we may well expect Europe’s growth rates to remain sluggish in the future – irrespective of whether governments manage to balance their books.

Meanwhile, growing the eurozone’s economy remains the best way of dealing with its debt crisis. Stopping the absolute growth of government debt, let alone repaying it, is illusory. Therefore the alternative must be to grow the denominator in the debt to GDP ratio. This would at least allow the eurozone to leave its acute debt problems behind by growing out of them.

Unfortunately, on its current trajectory, this will not happen anytime soon.

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