

EUROPE AND THE UNITED STATES: ON THE FISCAL BRINK?

Jagadeesh Gokhale and Erin Partin

What are the implications of Europe's economic troubles for America? Several EU economies now face deep private and sovereign debt overhangs—a situation not unlike that in the United States, which also faces its own challenges with fiscal policy. How do the economic conditions in America and the EU compare in the short and longer terms? This article provides an overview of key indicators that summarize and help to project the two regions' economic prospects. It should be noted at the outset, however, that economic conditions and policies in the two regions differ in substantive ways. As in the United States, most European economies—members of the European Monetary Union (EMU)—now participate in a single currency (euro) system operated by the European Central Bank—the counterpart of the U.S. Federal Reserve System. However, the EU lacks a single central fiscal authority that operates a significant cross-nation transfer system. Having surrendered authority over monetary policy and, by the definition of a single currency, exchange rate policy, EMU member nations must depend on national fiscal policies to exert stewardship over their economies.

Many analysts predicted that such a system would display increasing fiscal deficits in response to cyclical downturns—deficits that would be difficult to reverse because of the incentives that such a system creates: Short-term economic (and political) benefits of

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expansionary fiscal policies occur domestically, but long-term costs are spread throughout the single-currency area through higher interest rates on sovereign debt (Feldstein 2005: 1–2).

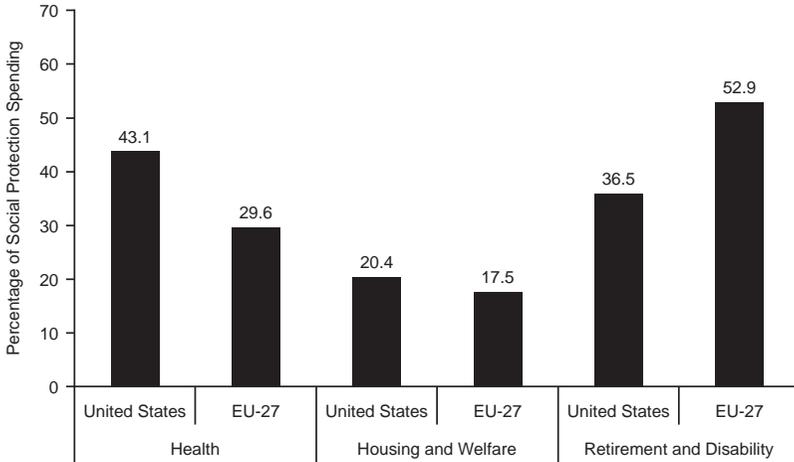
Since the advent of the euro, all EMU countries have had to navigate through two key transitions: (1) an aging population and (2) intensifying competition in global labor markets, especially for low-skilled workers. Those trends imply increasing demands for social protection—particularly retirement and health care benefits—for a bulging retiree cohort and welfare support for low-skilled workers facing stagnant wages, greater job-market volatility from business outsourcing, and a progressively shortening skill-obsolescence cycle.

But both the U.S. and EMU regions already face large debt overhangs. For EMU countries, different domestic economic pressures imply different capacities to adhere to the Stability and Growth Pacts statutory fiscal limits on national debt and annual deficits. In the United States, massive global defense commitments compete with other spending priorities in discretionary spending. And the discretionary component of the U.S. federal budget competes with growing spending projected for mandatory (entitlement and welfare) programs—a clash that is likely to intensify during the next few years.

Social Protection Spending in Europe and the United States

Figure 1 shows expenditure components within general government “social protection” programs in the United States and EMU nations that include central government public retirement and disability, health, and housing and welfare programs. Figure 1 shows that while both economic blocs spend similar shares of their social protection expenditures on housing and welfare programs, the United States spends a much larger fraction of its “social protection dollar” on health care expenditures (43 percent) than EMU nations collectively spend out of their “social protection euro” (30 percent). It turns out that the ratio of the higher health-spending share in the United States compared to EMU nations (1.45) is identical to the ratio of the higher share of Social Security (old age and disability insurance) expenditures of EMU nations (53 percent) compared to the United States (37 percent).

FIGURE 1
COMPONENTS OF SOCIAL PROTECTION EXPENDITURES IN
THE UNITED STATES AND EMU NATIONS

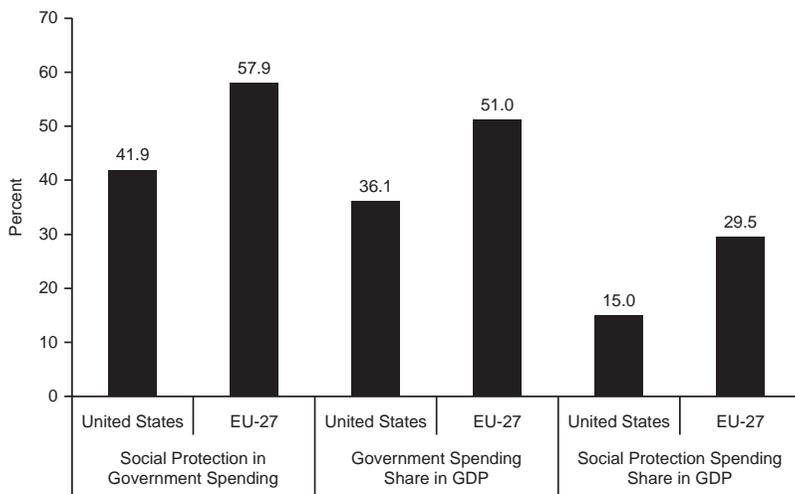


SOURCES: Eurostat and U.S. Congressional Budget Office.

Figure 2 shows that U.S. social protection expenditures are much smaller as a share of total government spending (42 percent), compared to EMU countries (58 percent). In addition, U.S. general government expenditures are also smaller as a share of GDP (36 percent) compared to EMU nations (51 percent). These two relative expenditure shares imply that U.S. social protection expenditures are a much smaller fraction of U.S. GDP (15 percent) compared to EMU nations' social protection expenditures as a share of EMU GDP (30 percent).

It is noteworthy that across all government function classifications, the United States expends larger shares of its GDP on defense expenditures (international and domestic) than EU-27 nations as a whole. But EU-27 nations spend more out of GDP on each and every other government function category, with the largest spending-share difference occurring in social protection services. It may be that U.S. expenditures on defending Europe is inducing greater spending by EU nations on social welfare and other expenditures. But prospects for EU nations' future economic and budget outlook will depend on how well they can consolidate budget expenditures to live within their means. Ultimately, however, Europe's economic and fiscal sus-

FIGURE 2
SOCIAL PROTECTION EXPENDITURE SHARES IN GDP



SOURCES: Eurostat and U.S. Congressional Budget Office.

tainability prospects depend on the evolution of fundamental economic factors, namely, the growth of its population and productivity.

Population and Employment

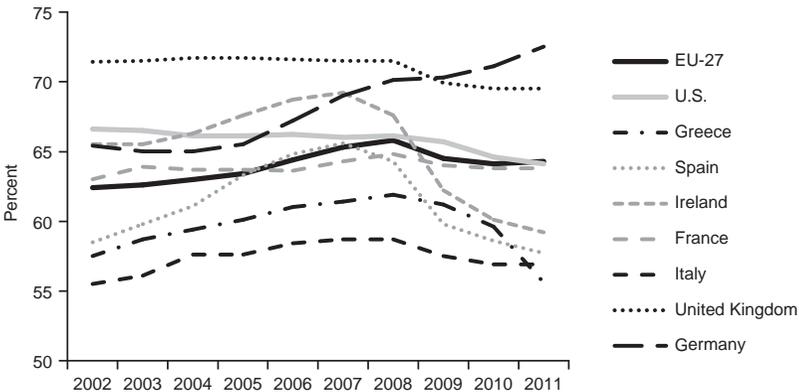
As for population growth, three factors—immigration, mortality, and fertility—will determine the age structure of the population, which is crucial for the sustainability of age-related expenditure programs such as Social Security and health care. For short and medium terms, however, demographic factors are predetermined and the population’s age structure cannot be altered except through very substantial changes in European net international immigration policies, which appear unlikely. What economic policies could target, however, is the share of the population that is employed. This could be achievable through the adoption of pro-work economic policies. Such policies will determine whether the direction of causality will be from demographics to social protection spending to consumption and ultimately to (low) growth in economic output or, alternatively, from policy-induced increases in labor supply and output to additional

resources in support of the growing pool of retirees and workers who suffer economic setbacks.

High consumption stimulated by an aging population is likely to require higher tax rates on the young. In addition, high consumption means low saving and, therefore, financial constraints on investment. If investment is not sustained, and higher taxes erode work incentives, economic growth, which is already quite low, is likely to suffer during the medium and long terms. The policy challenge that EU nations face is to promote faster growth through enhanced work incentives. If such policies are introduced and could successfully achieve higher employment rates and faster output growth, they would help to accommodate future social protection expenditure needs.

Figure 3 shows employment-to-population ratios in EU-27 nations, selected individual EU nations, and the United States. EU-27 employment rates were significantly below U.S. rates during the early 2000s. Indeed, the explanation offered for the difference was higher taxes in the EU for funding a generous social insurance state (Prescott 2004). However, as Figure 3 shows, with booming housing and asset prices and associated increases in employment and income during the mid-2000s, EU employment had caught up with that of the United States by just before the

FIGURE 3
EMPLOYMENT RATES IN THE UNITED STATES,
EU-27, AND SELECTED EU COUNTRIES

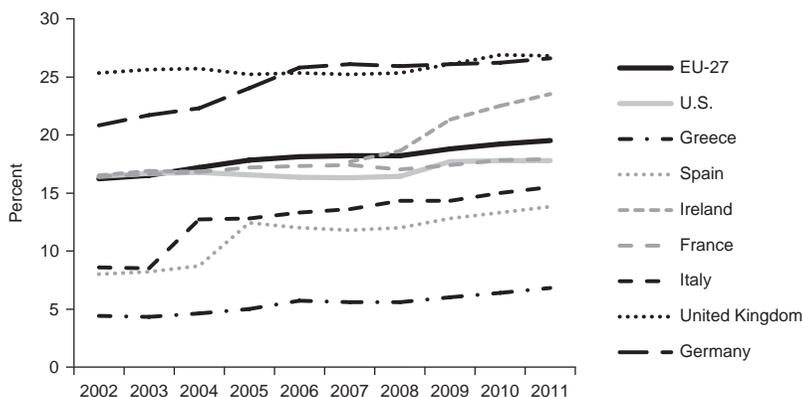


SOURCES: Eurostat and U.S. Bureau of Labor Statistics.

Great Recession of 2008–09. With the onset of that recession, employment fell precipitously in Greece, Spain, and Ireland—countries that were hardest hit by sovereign debt induced downturns or the bursting of the house-price bubble. Employment rates declined more sedately in France and the United Kingdom, whereas they increased in Germany, which had adopted a “short-term-work” program of employment subsidies.

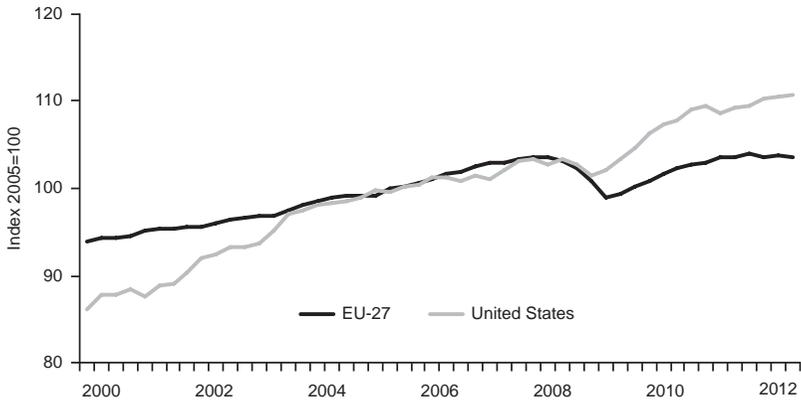
Figure 4, which shows part-time employment rates in the same countries as Figure 3, shows increases in employment rates. Presumably, many former full-time employees were compelled to downshift to part-time work after the recession began. As a result, total employment has not declined as much as it would have otherwise. Figure 3 also reveals differences among labor markets in EU nations—probably stemming from differences in labor supply incentives, institutions, unionization, and participation rates among women. For instance, pre-recession employment rates in Italy, Greece, and Spain were much lower than in other EU nations. Employment policies—such as statutory full retirement ages, generosity of retirement benefits, unemployment support, and labor market regulations on hiring and layoffs—across EU countries could be better harmonized to increase employment rates in low-employment countries. For the European monetary union to work better,

FIGURE 4
PART-TIME EMPLOYMENT RATES IN THE UNITED STATES,
EU-27, AND SELECTED EU COUNTRIES



SOURCES: Eurostat and U.S. Bureau of Labor Statistics.

FIGURE 5
OUTPUT PER PERSON IN THE UNITED STATES AND EU-27



SOURCES: Eurostat and U.S. Bureau of Labor Statistics.

EU policymakers may need to broaden economic convergence criteria to include such labor market metrics along with the EU Stability and Growth Pact's convergence criteria in terms of overall deficit and debt ratios. The harmonization must also emphasize the adoption of policies consistent with stronger work incentives designed to raise employment rates in nations with low rates rather than vice-versa. Doing so is likely to be very challenging as it will require harmonizing many politically sensitive tax, welfare, and retirement rules, many of which provide benefits unrelated to engagement in the labor market and make working less attractive.¹

Productivity

Figure 5 shows output per person during the 2000s in EU-27 and the United States. Productivity increased more rapidly after

¹Of course, this is easier said than done because of entrenched political interest groups among current workers, their unions, retirees, and those wishing to protect against erosion of public pension promises. However, the reforms mentioned in the text could be introduced gradually, targeting the longer-term labor-market environment that today's younger workers will face, allowing them to adjust their market-supply choices, including migration across EU nations, to achieve greater labor-market flexibility and a quicker structural response to cross-country disparities in compensation and work environments—a condition that is currently lacking among EU countries.

the recession onset in 2008 in hard-hit countries—Spain, Ireland, and Greece (initially). One interpretation of this is that companies in these countries responded to the downturn by increasing their production efficiency. But a more straightforward explanation is that the more rapid productivity growth observed in hard-hit countries is the artifact of higher layoffs in those countries of marginally productive workers. Productivity growth in France and Germany (the largest EU nations) hews closely to the EU-27 average, as expected (country details not shown).

Output per person also grew faster in the United States compared to EU-27—probably an artifact of the greater absorption of workers into part-time employment in the EU compared to the United States. Thus, the situation in both the EU and the United States is one of a large pool of underemployed and laid-off workers, some of the latter being at risk of becoming permanently unemployed, and improving productivity growth (measured as output per person) among those who remain employed in the economy. The challenge, therefore, is to find ways to retrain and assimilate the unemployed and underemployed workers back into full-time employment—and to hasten the so-far rather tepid economic recovery. The strategy for triggering an economic recovery depends upon the nature of the unemployment in the United States and Europe. In the United States, recent research shows that among two types of unemployment—cyclical and structural—the former dominates in the aftermath of the Great Recession (Lazaer and Spletzer 2012).² The implication of this finding for the United States is that there is no severe skills mismatch among workers and jobs in the United States and that the key solution is through increasing aggregate demand (i.e., consumption plus investment). Europe, however, continues to be plagued by labor market inflexibility in adjusting to a new postrecession world with increasingly intense international competition in product markets. This challenge requires shifting the work force into higher value-added occupations and requires revising labor market regulations to encourage greater worker mobility across occupations, sectors, and regions within the EU.

²This finding is unlikely to be true for Europe, where labor laws generate several types of rigidities and retirement and welfare programs create poor work incentives.

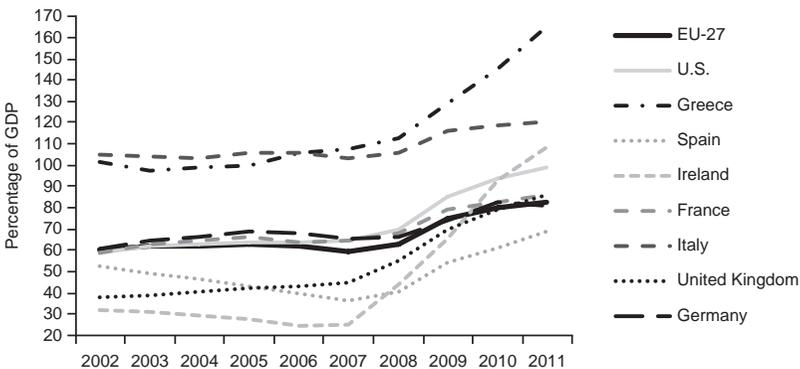
Economic Growth Strategy: Transition from Stimulus to Debt Reduction

What might be the best approach to rapidly return employment close to its pre-recession high—and push the unemployment rate back toward its pre-recession low?

The United States federal government implemented large fiscal and monetary stimulus measures to support the economy during the recession. In European countries with large government debt overhangs, however, the response has been the opposite—to reduce government spending and lay workers off in order to sustain financial market confidence and maintain low borrowing rates. EU nations with critical limits on government revenue-generating abilities have been awarded many billions of euros in bailout funds from the EU, the European Central Bank, and international lending institutions. Clearly, such initiatives have negative consequences—moral hazard among private investors, government officials, and policymakers charged with implementing budget consolidations—which means that they must eventually be curtailed or reversed. As shown below, one key reason that bailouts cannot be continued for long is that most EU nations, including the strongest ones such as Germany and France, are facing large internal fiscal imbalances.

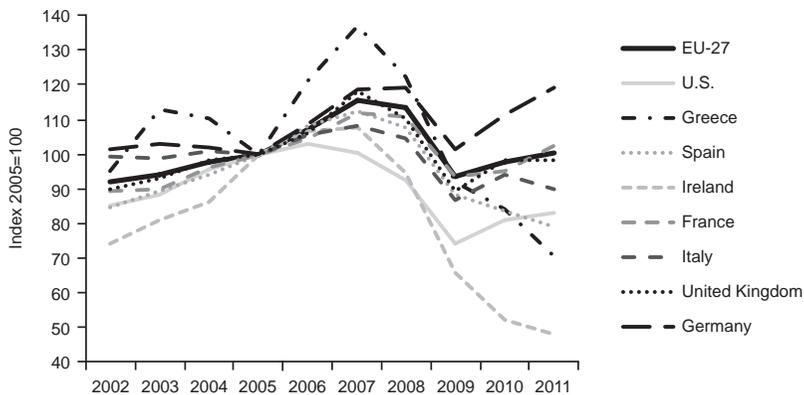
The short-term results of these deficit-financed stimulus measures can be seen in Figure 6. Gross (explicit) debt as a percentage of GDP

FIGURE 6
GROSS (EXPLICIT) DEBT AS A PERCENTAGE OF GDP



SOURCES: Eurostat and U.S. Bureau of Economic Analysis

FIGURE 7
GROSS DOMESTIC INVESTMENT IN THE UNITED STATES,
EU-27, AND SELECTED EU COUNTRIES

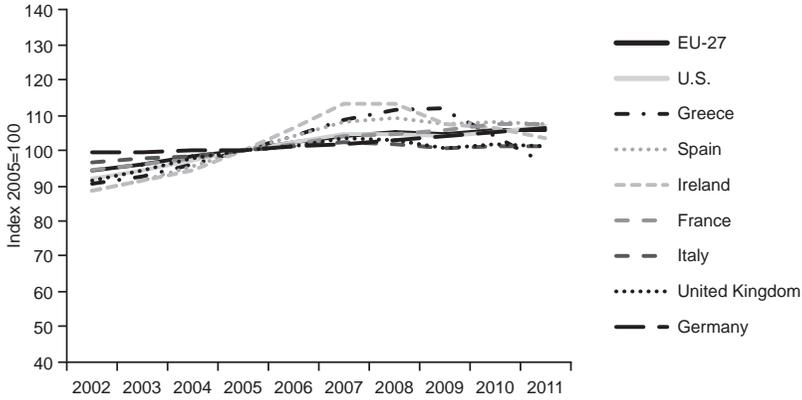


SOURCES: Eurostat and U.S. Bureau of Economic Analysis

in both EU nations and in the United States increased significantly during the recession as governments injected considerable amounts of stimulus funds into stagnating economies.

The increase in debt-financed government spending compensated for reduced aggregate demand from a decline in private gross domestic investment as shown in Figure 7. In the longer term, however, such heavy reliance on government deficit-financed expenditures would be unsustainable. The normal and natural process of economic recovery must occur through a restoration of private-sector investment and consumption demand to support job creation and sustainable economic growth. As Figure 7 shows, the key shortfall is in private investment demand, which declined precipitously during the Great Recession and has yet to return to pre-recession levels. Unfortunately, the near-term outlook for a resurgence of private investment demand appears to be poor. Pervasive uncertainty caused by political dysfunction in the United States in reducing large projected deficits and uncertainty over near-term public spending and taxes continues to discourage investors and lenders from risk taking. And recent electoral results in Italy cast doubt on the ability of EU nations to sustain budget consolidation plans. Failure to resolve policy uncertainty in both Europe and the United States means that private investment demand is unlikely to surge anytime soon.

FIGURE 8
PRIVATE CONSUMPTION EXPENDITURE IN THE UNITED STATES, EU-27, AND SELECTED EU COUNTRIES



SOURCES: Eurostat and U.S. Bureau of Economic Analysis.

A quick look at recent history on private final consumption demand in Figure 8 (shown on the same vertical-axis scale as Figure 7) reveals that in the EU as a whole, private final consumption expenditures were growing through 2008 and have since remained flat. The overall consumption time series for the EU is an average across significantly different consumption-change patterns—from strong pre-recession surges giving way to significant declines in hard-hit countries such as Greece, Spain, and Ireland, to countries where demand has simply stalled such as the UK and Italy, and to countries with continued consumption growth such as France and Germany. Note that despite the large size of France and Germany, overall consumption growth in the EU as a whole has remained flat after the recession because the declines in hard-hit countries have been substantial. Notwithstanding cross-country differences, however, consumption demand remains stable or positive in the EU and is not the key reason for economic stagnation in Europe. In the United States consumption growth has resumed after a short setback during 2009.

The balance of trade in goods and services, suggests that the trade balance is not large for the EU as a whole. The key reason for this is that the vast majority of the goods and services trade of EU nations occurs with other EU countries. The data (not shown) indicate that

only Ireland and Germany have been net exporters—benefitting from foreign demand for their products. Most other EU nations (with the exception of Spain, which appears headed for an export surplus in 2012) and the United States are accruing annual trade deficits—implying a structural imbalance in exchange rates, international uncompetitiveness in export markets, and a siphoning, on net, of domestic demand to foreign shores. This effect is especially large for the United States. However, that has been the case since well before the recession. In particular, the recession does not appear to have widened the gap between U.S. exports and imports and, by implication, should not bear as high a responsibility (as a target of policy measures) for boosting the economic recovery.

The key shortfall in aggregate demand is, therefore, contributed by private investment demand. For both the EU as a whole and the United States, investment flows declined significantly during the recession and have yet to recover. For EU-27, investment flows are still 15 percent smaller than their pre-recession levels. For the United States, they are running 17 percent slower. Since private investment is crucial for sustaining employment growth in the short term and boosting productivity in the long term, this shortfall, if sustained, is likely to visit lasting damage on long-term labor market and output growth potentials in both regions.

One symptom of low investment demand in the United States is massive cash accumulation with businesses. The share of cash-equivalents increased as the Great Recession commenced and has not returned to its pre-recession share. The most likely reason for this is high continued uncertainty about the future course of U.S. fiscal policy, especially with regard to additional taxes that may be imposed on capital and capital returns.

There are frequent references in the financial market literature about the potential for capital flight in response to higher taxes on capital returns. Many cite strong business incentives to transfer capital and profits to low-tax countries, with such tax competition penalizing countries with high corporate income taxes and investment inflexibility created by high capital gains taxes. The first step in preparing for capital flight from the United States would, naturally, be to preserve capital in the form of liquid assets. Because of its flexible labor and asset markets and the abundance of complementarities with high-skilled workers, the United States is still considered to be a highly desirable place to invest. But facing considerable

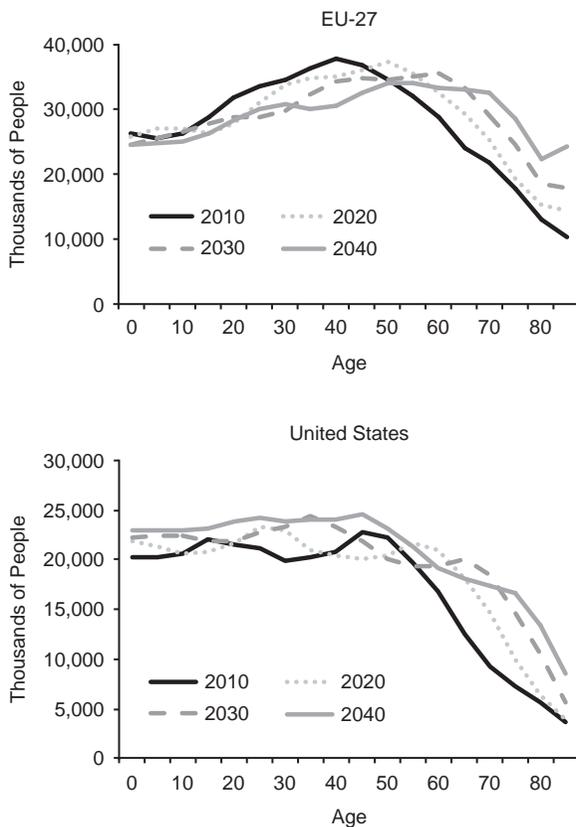
uncertainty about future tax policies that could affect business incomes negatively, the observed corporate holdings of higher portions of financial assets in cash and cash equivalents may be intended to make it easier to transfer assets to other shores with better opportunities and returns—in case policy uncertainty persists for too long or is resolved in an adverse manner.

Fiscal Imbalances in Europe and the United States

Prospects of future fiscal policy changes must be evaluated relative to payment obligations that governments have assumed and the resources available to pay them. Unfortunately, most European countries and the United States are facing large debt overhangs that extend well beyond their officially recognized financial liabilities. Government obligations to pay include not just official explicit (or contractual) debt, but also noncontractual promises to pay retirement, health, and other benefits to citizens under today's laws governing public social security and health insurance programs. Significant unfunded obligations on account of these programs arise, in part, from their demographic profiles, with large cohorts of baby-boomer scheduled to enter retirement within a few years. Figure 9 shows the demographic profiles in the EU and the United States. The solid black line refers to the population's age distribution during 2010 ("today") and the light solid line shows the projected age distribution in 2040. Figure 9 shows large increases in the population share of older individuals, implying higher costs of funding old-age retirement and health care benefits. It is noteworthy that among EU nations, the population share of younger individuals is depressed in Spain, Greece, Germany, and Italy whereas it remains high in the UK, United States, France, and Ireland (data not shown).

The extent of population aging depends on mortality improvements and the rates of fertility declines in various countries. The fertility rates shown in Figure 10 indicate that many developed economies are now experiencing fertility rates well below the replacement fertility rate of 2.1 children per woman. Among the countries shown in Figure 10, Germany, Spain, Italy, and Greece have among the lowest fertility rates and the EU average is also not close to the replacement fertility rate. The one heartening feature for European countries, however, is that fertility rates have been

FIGURE 9
POPULATION AGE DISTRIBUTIONS IN THE
UNITED STATES AND EU-27

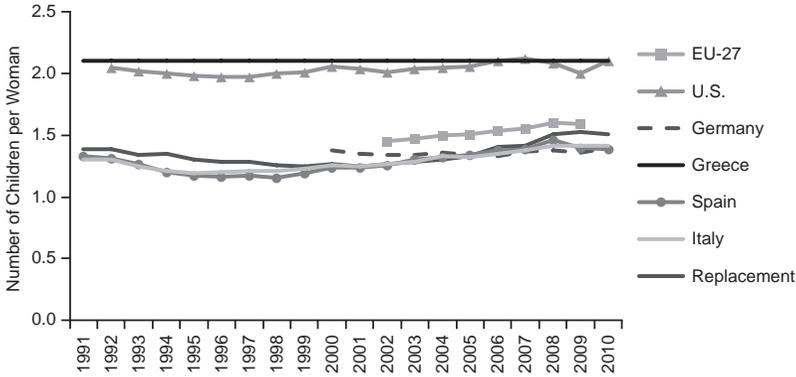


SOURCES: Eurostat and U.S. Census Bureau.

trending upward during the decade of the 2000s. Figure 10 shows that fertility in the United States is very close to replacement, implying that even a small rate of immigration would ensure positive population growth in the future.

Rapid population aging from lifespan extension and low (below-replacement) fertility rates contribute toward increased fiscal burdens on future generations who must remain productive to fund old-age consumption of retired boomers. However, other factors also contribute to high prospective fiscal burdens on younger cohorts.

FIGURE 10
TOTAL FERTILITY RATES: U.S. AND MAJOR EURO-AREA
COUNTRIES

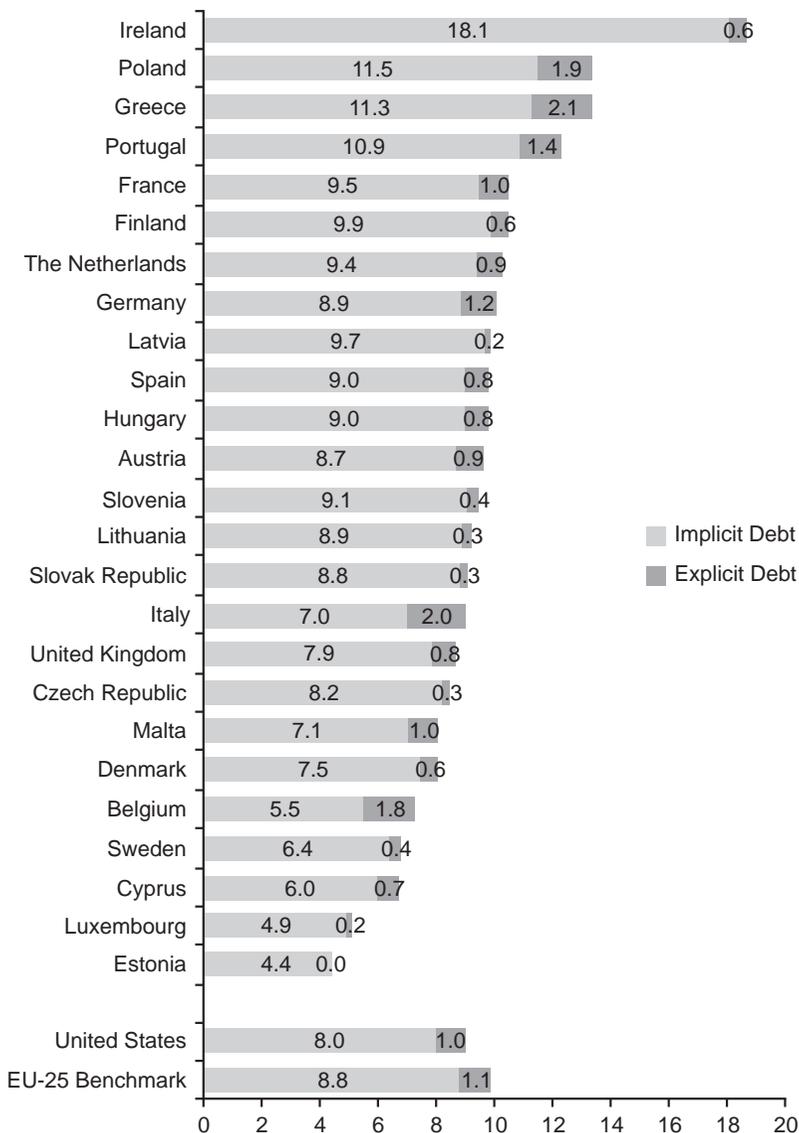


SOURCES: Eurostat and U.S. Census Bureau.

One is the share of the budget allocated to generational transfer programs. Another is the intensity of generational transfers within each such program (how highly skewed benefit awards are toward retirees and how steep are taxes on younger workers relative to older ones). Yet another factor is the rate of growth of the economy and whether generational transfer benefits are linked to economic growth and inflation. If they are linked, faster economic growth may translate into larger fiscal burdens on the young, especially when population aging is rapid (see Gokhale 2007). All of these factors are estimated by combining budget data and micro-survey data (separately for each nation) to measure their collective effect in determining each nation's fiscal imbalance.

Estimated fiscal imbalances are reported in Figure 11 as ratios to the present value of future GDP separately for EU-25, the United States, and for 25 European Union countries. The figure reports the implicit and explicit debt ratio components separately, with the sum of the two equaling the fiscal imbalance ratio. As Figure 11 shows, the fiscal imbalance ratio for the United States (calculated as of 2012) equals 9 percent of the present value of U.S. GDP and 9.9 percent for the EU-25 as a ratio of the present value of EU-25 GDP. These ratio values are deceptively small because most tax bases are much smaller than GDP. For example, the U.S.

FIGURE 11
 FISCAL IMBALANCE RATIOS IN THE UNITED STATES (2012)
 AND EUROPE (2010)



NOTE: The fiscal imbalance equals the government’s explicit debt plus the present value difference between all projected government receipts and government expenditures under current fiscal policies.

SOURCE: Author’s calculations.

payroll tax base equals slightly less than one-half of U.S. GDP, implying that the 15.3 percent U.S. payroll tax rate would have to be more than doubled to resolve the U.S. fiscal imbalance.

The EU-25 benchmark fiscal imbalance ratio of 9.9 percent of the present value of future EU-25 GDP is the consequence of a stronger population aging process and more generous social insurance programs favoring older generations in Europe compared to the United States. With such large imbalances looming for even the strongest EU nations (with both German and French fiscal imbalance ratios exceeding 10 percent), it is difficult to argue in favor of significant additional deficit financed economic stimulus policies with the hope of speeding up economic growth. A better way to improve the economic and policy environment is to restructure social protection programs by reducing benefit growth and to stimulate private investment by maintaining low and stable tax rates.

Conclusion

Demographics appear to be destiny in many European nations and in the United States. Unless growth of social protection programs (so-called entitlements) is curbed, higher fiscal burdens on today's young workers and future generations and a spending squeeze on nonentitlement government operations appear inevitable.³ In the United States, which has extensive defense commitments around the globe, the battle between "guns and butter" could not be more explicit. At the time of this writing, Congress and the Obama administration have postponed all spending-related policy actions and have voted to make G.W. Bush era tax cuts permanent for the vast majority of taxpayers. European nations do not have similar commitments abroad, but many of them are clearly overextended in their domestic social protection commitments. However, the larger fiscal burdens on younger and future working generations, which such a fiscal policy stance implies, threaten to sap their productive abilities (education and skill acquisition) and reduce their incentives to remain attached to the labor force. The overall resource allocation calculus, for both Europe and the United States could be shifted, at the margin and in a budget neutral manner, from entitlements and social protection expenditures for the elderly to education and job-training initiatives for employers and younger workers.

³See Gokhale (2013) for more details for the United States.

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