Austerity: Measuring the Pain

By Cormac O'Sullivan

As Budget 2013 approaches, much uncertainty remains concerning what measures the government will introduce. One thing we do know is that the government will seek to make savings of €3.5 billion, €2.25 billion of which will be achieved through cuts in government expenditure and €1.25 billion of which will be achieved through additional taxation. We have become accustomed to thinking of austerity measures in terms of monetary targets such as these: last year the target for Budget 2012 was €3.8 billion, and the year before that the target for Budget 2011 was €5.4 billion. Since July of 2008, austerity measures valued at €23.9 billion have been brought in.

Table 1: Austerity Measures, 2008-2014 (€ millions)

	tax increases	spending cuts	total	cumulative
Jul-08		1,000	1,000	1,000
Budget 2009	2,000	2,100	4,100	5,100
Supplementary budget 2009	3,500	1,800	5,300	10,400
Budget 2010	1,000	3,300	4,300	14,700
Budget 2011	1,400	4,000	5,400	20,100
Budget 2012	1,600	2,200	3,800	23,900
Budget 2013*	1,250	2,250	3,500	27,400
Budget 2014*	1,100	2,000	3,100	30,500
Budget 2015*	700	1,300	2,000	32,500
Total Planned Adjustments	**12,550**	**19,950**	**32,500**	

*Future planned adjustments

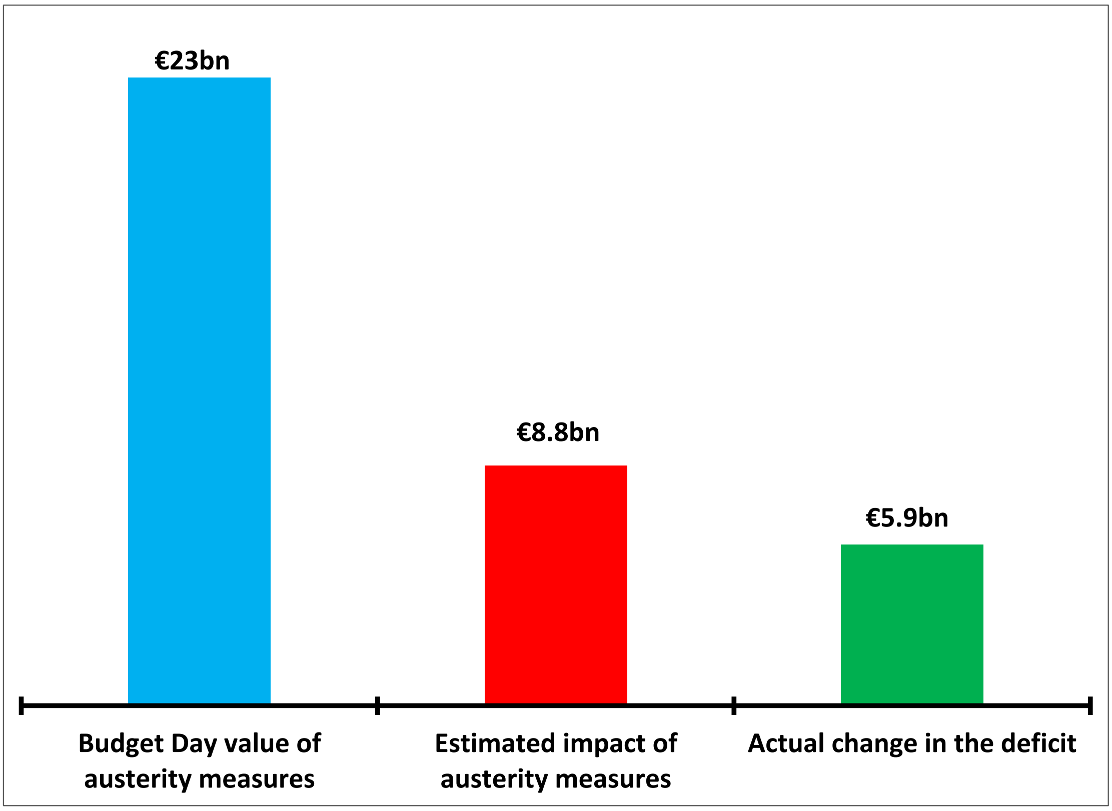
But it does not follow that this €23.9 billion worth of austerity measures have reduced the gap between government revenue and expenditure by the same amount. This gap was widest in 2009 when it reached €18.5 billion, and is projected to come down to €13 billion this year, an improvement of €5.5 billion. However, the total value of measures introduced over this period in Budgets 2010-2012 was €13.5 billion.

The reason for this discrepancy is that the value placed on austerity measures before a Budget is based on how much they were worth in the preceding year. In reality, the government deficit also depends on a myriad of economic factors that change over time – and were changing rapidly during the bust – such as output, earnings, employment and prices. To illustrate how economic factors influence the fiscal arithmetic, imagine if the government was to increase public sector salaries by 1% at a time when the general price level was increasing by 2%. Public sector salaries will have nominally increased, but they will buy less goods and services than they did in the previous year. In real terms spending on public sector salaries will have fallen and the government will have effectively taken money out of the economy by not increasing spending in line with inflation.

The picture is skewed even further by the fact that the underlying economic factors are also influenced by the austerity measures themselves; when the government takes money out of the economy through austerity measures, it also depresses economic output, leading to lower incomes and employment and reduced inflationary pressure. A smaller economy with lower employment reduces the tax base and increases spending on welfare to the unemployed. In this respect, implementing austerity is akin to hitting a moving target.

A new article by Ide Kearney[1], an economist with the Economic and Social Research Institute (ESRI), helps disentangle the real impact of austerity measures for each year between 2009 and 2012, and throws up some surprising results. The article finds that the cumulative effect of austerity measures has been to take €8.8 billion out of the economy, compared to Budget Day valuations of austerity measures of €23 billion.

Figure 1: Total Impact of Austerity 2009-2012, €billion



[1] [Kearney, I., *Measuring Fiscal Stance 2009*-2012, Special Article in the Quarterly Economic Commentary Autumn 2012, ESRI, 2012]

The table below shows the year-by-year comparisons of the original valuations and the estimated effect, both expressed as a percentage of GDP.

Table 2: Measures of Austerity, 2009-2012 (% of GDP)

	2009	2010	2011	2012*
Budget Day valuation	-5.8%	-2.7%	-3.4%	-2.3%
Estimated effect	-0.4%	-1.9%	-1.5%	-1.8%

*Based on estimates

The results for 2009 are surprising – despite the steep austerity measures introduced in Budget 2009 and the Supplementary Budget in that year, the fiscal impact was only -0.4% of GDP. The reason for this is that the price level was falling rapidly in 2009, with Consumer price inflation down 4.5%. This meant that a single euro of government expenditure would go further in 2009 than it would in 2008. In a reverse of the example given earlier, by not cutting spending on salaries and transfers in line with the falling price level, government current expenditure was essentially acting as a stimulus that counterbalanced some of the negative effects of the tax increases and cuts in capital expenditure in 2009.

For the years 2010-2012, the price level was more stable than in 2009 and so the real impact of austerity is estimated to have been greater. Nonetheless, the estimated effect is less than the Budget Day valuation in each of these years due to the contractionary effect austerity has on the economy.

An often heard sentiment has been that we need to take the pain of adjustment up front – that if we get it over and done with it will be less painful, less torturous, and will allow people to get on with their lives. In nominal terms, the government has done this: the larger adjustments happened earlier in the crisis, with the exception of Budget 2011 which brought in more austerity measures than Budget 2010. Pain, however, is felt in real terms, and falling prices cushioned the blow of higher taxes and lower government spending between 2008 and 2010. With prices now back on the rise, this cushion is gone, and Budget 2012 is estimated to be nearly as painful as Budget 2010.

Concluding Remarks

Stating that austerity measures do not succeed in achieving their Budget Day valuations in savings is not the same as saying that austerity to date has been unsuccessful. Looking at international evidence, the ESRI's John FitzGerald[2] finds that the improvement of the government's finances during adjustment periods tends to be muted, because the negative effects of the austerity measures weigh on the economy. But once the austerity programme has been completed and the government stops taking money out of the economy, the deficit improves much more rapidly. Essentially, then, we will not know how successful fiscal policy has been until after the programme for adjustment set out in Table 1 has been completed.

[2] FitzGerald, J., *Fiscal Policy for 2013 and Beyond*, in T. Callan (ed.), "Budget Perspectives 2013", ESRI, 2012