CEI OnPoint

Competitive Enterprise Institute
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Advancing Liberty – From the Economy to Ecology

June 26, 2013 No. 184

The True Story of European Austerity

Cutting Taxes and Spending Leads to Renewed Growth

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European governments that have cut both spending and taxes as part of their austerity programs have higher rates of economic growth than their neighbors. Then why do we hear lamentations from the news media and politicians about "savage" budget cuts leading Europe to economic ruin? Because they are looking at the data in the wrong way.

Many analyses cited in the U.S. news media select a base year for all countries from which to measure changes in spending, taxation, and growth—usually 2007 or 2008.[1] This methodology is imprecise because not all European countries have implemented austerity programs at the same time. Therefore, for many countries, measurements of austerity capture the time before they began making budget cuts.

This report measures austerity and its effects from the time austerity officially began in each country. The results are quite different from those that have been cited widely in the media. Proclamations of austerity notwithstanding, most European countries have cut neither spending nor taxes. Yet, the ones that have are now growing the fastest.

Austerity—or not. Austerity in Europe takes many different forms. While countries label their policies with the common term "austerity," their actions are far from similar. Only four countries in Europe have engaged in what can truly be considered austerity—cutting both spending and taxes—Bulgaria, Ireland, Latvia, and Lithuania. Instead, more countries have followed the opposite path—increasing both spending and taxes—than any other option. This does not qualify as austerity in any reasonable sense of the term. Businesses bear all the burden of fiscal consolidation while governments bear none. Contrary to popular belief, austerity is largely absent from Western Europe.

Other countries have pursued different combinations of increasing or decreasing either spending or taxation, and in varying degrees. While classifying some of these programs

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as “austerity” may be reasonable, they should be differentiated from the stricter form of austerity that entails significant cuts in both taxes and spending. There are nine potential categorizations of austerity, listed in Table 1. For a country to qualify for an increase or decrease in spending or taxation, there must have been at least one year after the implementation of austerity[2] in which either of these measurements changed by a rate greater than a full percentage point relative to its pre-austerity level. Otherwise, the measurement is qualified as “steady.”[3]

Table 1. Austerity Categories and Country Groups

Group	Expenditures	Taxation	Country
1	Decreased	Decreased	Bulgaria, Ireland, Latvia, Lithuania
2	Decreased	Increased	Estonia, Greece, Hungary, Portugal
3	Increased	Decreased	Sweden
4	Increased	Increased	Belgium, Czech Republic, France, Germany, Malta, Romania, Slovakia, Spain, United Kingdom
5	Decreased	Steady	Slovenia
6	Increased	Steady	Austria, Denmark, Finland, Luxembourg
7	Steady	Increased	Italy, Poland
8	Steady	Decreased	Netherlands
9	Steady	Steady	Cyprus

Source: Categorizations based on calculations of Eurostat data in Tables 3 and 4

Cutting Government Means Greater Economic Growth. Different forms of austerity have resulted in different rates of economic growth. This report assessed economic growth for the six years following austerity’s implementation in each European country, using a combination of GDP growth rates through the fourth quarter of 2012, as reported by Eurostat, and projected growth rates through 2017 from the International Monetary Fund.[4] Median post-austerity growth rates for each country were calculated,[5] and those figures were averaged by austerity group.

Table 2 shows the results of this analysis for all austerity groupings containing at least four countries (and therefore large enough for their averages to be meaningful).[6]

Table 2. Average Median Post-Austerity Growth Rates by Austerity Group

Group	Expenditures	Taxation	Average Median 6-Year Growth Rate
1	Decreased	Decreased	2.65%
2	Decreased	Increased	-0.32%
4	Increased	Increased	1.46%
6	Increased	Steady	1.40%

Source: Author’s calculations on Eurostat and IMF World Economic Outlook (April 2013) data, Table 3

The only austerity group that experienced an average median GDP growth rate above 2 percent—generally considered the standard threshold for healthy economic growth—was Group 1, which cut both spending and taxes. The countries in Group 4, which implemented "austerity" programs of spending and tax increases, grew at an average median growth rate of less than 1.5 percent.

Table 3 shows the percentage change in government nominal expenditure by country relative to the respective pre-austerity level during each year of each country's austerity program. Expenditure decreases are marked in red; "steady" values are marked in blue.

Table 3. Changes in Government Expenditure Post-Austerity as % of Pre-Austerity Level

Country	Austerity Enacted	Years Post-Austerity			
		1	2	3	4
Group 1					
Bulgaria	**Q3-09**	-5.21%	-9.28%	-5.96%	
Ireland	**Q1-11**	-25.97%	-33.43%		
Latvia	**Q1-09**	-9.48%	-12.42%	-13.04%	-9.16%
Lithuania	**Q1-09**	-0.92%	-3.03%	-0.83%	-1.62%
Group 2					
Estonia	**Q1-09**	-5.14%	-9.51%	-5.14%	6.91%
Greece	**Q1-10**	-8.33%	-13.09%	-14.91%	
Hungary	**Q2-09**	-5.42%	-5.58%	-4.87%	
Portugal	**Q2-11**	-5.39%			
Group 3					
Sweden	**Q1-09**	-6.67%	6.47%	15.12%	23.39%
Group 4					
Belgium	**Q1-12**	4.61%			
Czech Republic	**Q1-11**	2.15%	3.36%		
France	**Q3-10**	1.64%	3.76%		
Germany	**Q1-09**	5.55%	9.22%	7.71%	9.12%
Malta	**Q1-11**	4.01%	11.71%		
Romania	**Q3-10**	-0.55%	3.32%		
Slovakia	**Q1-11**	0.62%	1.63%		
Spain	**Q1-10**	0.15%	-0.96%	1.84%	
United Kingdom	**Q3-10**	4.43%	6.14%		
Group 5					
Slovenia	**Q3-11**	-4.34%			
Group 6					
Austria	**Q1-11**	0.82%	5.30%		
Denmark	**Q1-10**	4.99%	6.70%	12.09%	
Finland	**Q1-12**	4.42%			
Luxembourg	**Q1-11**	4.09%	11.55%		
Group 7					
Italy	**Q3-11**	0.26%			
Poland	**Q1-11**	-0.32%	0.19%		
Group 8					
Netherlands	**Q1-11**	-0.43%	0.41%		
Group 9					
Cyprus	**Q3-11**	-0.58%			

Source: Author's calculations based on Eurostat data

Table 4 measures the percentage change in the total tax burden during each year of each country's austerity program, relative to every country's respective pre-austerity level.[7] However, this does not measure the deadweight economic loss created by higher taxes—and thereby probably underestimates the economic impact of tax increases—but it does measure how much wealth the public sector is taking out of the economy, and does so in a consistent way that is comparable across countries.

Table 4. Changes in Government Revenue/GDP Post-Austerity as % of Pre-Austerity Level

Country	Austerity Enacted	Years Post-Austerity 1	2	3	4
Group 1					
Bulgaria	**Q3-09**	-9.29%	-15.32%	-9.10%	
Ireland	**Q1-11**	-1.05%	-1.79%		
Latvia	**Q1-09**	-2.49%	1.26%	0.03%	1.06%
Lithuania	**Q1-09**	4.41%	3.58%	-1.80%	-3.37%
Group 2					
Estonia	**Q1-09**	7.49%	11.34%	7.49%	9.57%
Greece	**Q1-10**	5.93%	10.54%	16.66%	
Hungary[9]	**Q2-09**	1.79%	24.57%	13.55%	
Portugal	**Q2-11**	6.80%			
Group 3					
Sweden	**Q1-09**	0.02%	-3.05%	-5.03%	-5.02%
Group 4					
Belgium	**Q1-12**	2.79%			
Czech Republic	**Q1-11**	2.33%	3.05%		
France	**Q3-10**	0.45%	2.99%		
Germany	**Q1-09**	2.55%	-1.01%	1.23%	2.62%
Malta	**Q1-11**	1.95%	4.85%		
Romania	**Q3-10**	8.74%	8.01%		
Slovakia	**Q1-11**	2.98%	2.43%		
Spain	**Q1-10**	4.36%	1.78%	3.77%	
United Kingdom	**Q3-10**	1.34%	6.89%		
Group 5					
Slovenia	**Q3-11**	-0.60%			
Group 6					
Austria	**Q1-11**	-0.11%	0.91%		
Denmark	**Q1-10**	-0.64%	0.65%	0.13%	
Finland	**Q1-12**	-0.41%			
Luxembourg	**Q1-11**	-0.98%	0.45%		
Group 7					
Italy	**Q3-11**	1.55%			
Poland	**Q1-11**	2.46%	2.12%		
Group 8					
Netherlands	**Q1-11**	-1.60%	0.46%		
Group 9					
Cyprus	**Q3-11**	-0.82%			

Source: Author's calculations based on Eurostat data

Conclusion. European countries have reacted in different ways to the economic crisis that began in 2008. Those that have reduced the economic footprint of their public sectors have more prosperous economies. Curbing inefficiencies and getting government out of the way of businesses and entrepreneurs have allowed for greater productive economic activity to flourish. That is the real story of "austerity" in Europe.

Much of the news media, unfortunately, tells a different narrative—that shrinking the size of government has led to economic stagnation. Also fallacious are claims that significant cuts have occurred all across Europe. Rather than cutting out the heart of Europe's economies, downsizing their public sectors is cutting out the rot. And there are only a handful of European countries that have had the courage to do this.

The United States, beset by high levels of unemployment, discouraged workers, and economic uncertainty, is on pace to increase its spending and taxes through the end of this decade. Washington ought to take a lesson from Europe. When recession hits, the public sector cannot be shielded from the austerity necessary for the economy to return to sustainable growth.

Notes

[1] For a sampling of the conventional wisdom on austerity and of analyses that use blanket base-year measurements, see: Dylan Matthews, "Yes, Europe really is in the throes of austerity," *The Washington Post*, June 5, 2013, http://www.washingtonpost.com/blogs/wonkblog/wp/2013/06/05/yes-europe-really-is-in-the-throes-of-austerity/; Paul Krugman, "Austerity Europe," *The New York Times*, February 23, 2013, http://krugman.blogs.nytimes.com/2013/02/23/austerity-europe-2/; Brad Plumer, "Yes , there's been austerity in Europe," *The Washington Post*, May 8, 2012, http://www.washingtonpost.com/blogs/wonkblog/post/yes-theres-been-austerity-in-europe/2012/05/08/gIQAQ1NsAU_blog.html; and Krugman, "Austerity and Growth," *The New York Times*, February 18, 2012, http://krugman.blogs.nytimes.com/2012/02/18/austerity-and-growth/?_r=1. Such sloppy analysis is not only found on the left. For example, in his June 4, 2013 testimony before the Senate Budget Committee, Salim Furth of the Heritage Foundation uses a single blanket base-year, 2007, to measure various countries' austerity programs. The countries he classifies as having enacted "real austerity"—Italy, Hungary, and Greece—have either increased both spending and taxes or decreased spending but increased taxes; they have not enacted real austerity. The blanket base year yields imprecise measurements of whether austerity has taken place. Salim Furth, "The Fiscal and Economic Effects of Austerity," Testimony Before the Committee on the Budget of the United States Senate, June 4, 2013, http://www.heritage.org/research/testimony/2013/06/the-fiscal-and-economic-effects-of-austerity.

[2] Defined as implementation of "austerity," "budget consolidation," or "fiscal retrenchment" that includes at least two proposed significant fiscal changes to social services, government administration, or the discretionary budget. In cases where a country's austerity program did not begin within the first annual quarter, this report measures each post-austerity year in four-quarter increments from austerity's implementation. For example, post-austerity year one for a country implementing austerity in the third quarter of 2009 would encompass Q3 2009 through Q2 2010.

Austerity program implementation schedule, by country

Country	Austerity Begins	Nearest Quarter
Austria	January 2011	Q1-11
Belgium	January 2012	Q1-12
Bulgaria	July 2009	Q3-09
Cyprus	July 2011	Q3-11
Czech Republic	January 2011	Q1-11

Denmark	January 2010	Q1-10
Estonia	January 2009	Q1-09
Finland	January 2012	Q1-12
France	June 2010	Q3-10
Germany	December 2008	Q1-09
Greece	February 2010	Q1-10
Hungary	May 2009	Q2-09
Ireland	January 2011	Q1-11
Italy	July 2011	Q3-11
Latvia	January 2009	Q1-09
Lithuania	January 2009	Q1-09
Luxembourg	January 2011	Q1-11
Malta	January 2011	Q1-11
Netherlands	January 2011	Q1-11
Norway	N/A	N/A
Poland	January 2011	Q1-11
Portugal	May 2011	Q2-11
Romania	July 2010	Q3-10
Slovakia	January 2011	Q1-11
Slovenia	June 2011	Q3-11
Spain	February 2010	Q1-10
Sweden	January 2009	Q1-09
Switzerland	January 2013	Q1-13
United Kingdom	June 2010	Q3-10

Source: Individual media articles and reports for each country

[3] Some countries began implementing austerity much later than others, so spending and revenue data for these countries are not available for later years. Switzerland and Norway are excluded from this analysis because the former began implementing fiscal consolidation in January 2013, yielding a mere two quarters of measurements, while the latter has yet to announce an austerity program at all. For categorization purposes, decreases are weighed more heavily than increases because austerity programs in which real cuts to spending, taxation, or both took place were also often accompanied by deregulation (the effect of which is not captured by spending and revenue statistics, so the weighting compensates for this underestimation in austerity's magnitude). To qualify for an "increased" categorization, the country must meet two conditions: 1) the number of post-austerity years of increased values must be greater than the number of post-austerity years of decreased values; and 2) the total net change for all post-austerity years must be positive and greater than a full percentage point above the pre-austerity level.

[4] The IMF reported GDP figures in annual denominations. Therefore, each 2012-quarter GDP value from Eurostat is adjusted by the annual change in GDP as projected by the IMF. These calculations resulted in quarterly GDP value projections for the period 2013-2017.

[5] Using median growth rates prevents the growth data from being skewed in misleading ways by extreme transitory values. For example, several countries experienced severe economic contraction during the first year of their austerity programs, because austerity, carried out properly, entails retrenchment for both the public and private sectors, and therefore acts as a sudden but temporary shock to the economy as markets clear out inefficiencies to make way for more productive activities. Thus, if the growth rate for the first year after the implementation of austerity was highly negative and subsequent years were positive, using a six-year growth rate average would bias the average down. This report seeks to measure the results of austerity, and as such, must allow time for markets to complete their clearing process.

[6] Austerity groupings with fewer than four countries are unlikely to be representative in any meaningful sense. For example, the average median growth rate for Group 7, a two-country group of countries that

implemented "austerity" consisting of steady expenditures and increased taxes, was 1.32 percent, but its component countries' median growth rates were 0.15 percent for Italy and 2.46 percent for Poland. Therefore, the 1.32 percent value is not an accurate representation of growth within the austerity group. There was too great a divergence between country growth rates and too small a sample size to identify and adjust the results for the outlier. Nonetheless, no austerity grouping of any size, besides Group 1, which decreased both expenditures and taxes, managed to achieve an average median six-year growth rate above 2 percent.

[7] The European Commission's most recent tax report, *Taxation Trends in the European Union*, the most comprehensive set of tax reports for EU countries, only provides implicit tax burden data through 2011. Comparable data for each country's tax burden is only available through 2011, so this analysis uses revenues/GDP as a proxy for the total tax burden. European Commission, *Taxation Trends in the European Union: Data for the EU Member States, Iceland and Norway*, 2013 edition (Luxembourg: Eurostat Statistical Books), http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2013/report.pdf.

[9] In an effort to reduce its deficit, the Hungarian government effectively nationalized the country's private pensions on February 1, 2011. Media outlets, such as *The Economist*, estimated the revenue gained through obtaining private pension assets at roughly €10 billion ($13.1 billion) (off-balance sheet). Because the nationalization amounts to a 100 percent tax on private pension disbursements from Q1 2011, the €10 billion figure was divided equally during the five remaining quarters of austerity measurement and added to the figures for general government revenue. "When solidarity is obligatory," *The Economist*, November 25, 2010, http://www.economist.com/blogs/easternapproaches/2010/11/hungarian_pensions.