cyclical expenditures.[31] However, in the recent international debate on austerity, it has been argued that austerity measures could lower the economy's long-term supply capacity (e.g. through lower capital spending or the damaging effects on employment prospects of long periods of unemployment). These impacts could damage long-term fiscal performance (see, for example, Krugman, 2011). To the extent that this undermines confidence, it could have further negative effects on output (and thus the deficit) in the present. If these impacts were strong enough it is possible that austerity could be self defeating but the conditions for this seem unlikely.[32]

While there is not too much doubt that the adverse growth effects of austerity are real (Box 4.1), recent Irish developments do not appear to support the more extreme self defeating hypothesis. Even though domestic demand has fallen significantly (at least in part due to the austerity measures undertaken) and domestic demand has remained weak, the General Government deficit is improving. The underlying deficit[33] has declined from 11.8 per cent of GDP in 2009, to a projected 10 per cent this year. Austerity measures are working to reduce the deficit.

Box 4.1: The Real Effects of Austerity

The size of fiscal multipliers is one of the most contentious questions in macroeconomics. An issue is the impact on GDP and other macroeconomic variables of discretionary changes in government spending or taxation. Unfortunately, efforts to identify the size of these effects are bedevilled by the two-way causality running from the macroeconomic to the fiscal variable. A cut in government spending, for example, can lead to a fall in domestic demand and GDP; but a fall in GDP can also lead to an increase in government spending through automatic stabilisers (notably an increase in social welfare spending) and also through discretionary changes in spending implemented to counteract a recession. To further complicate the identification effort, both fiscal variables and GDP can be affected by a common third factor. A relevant

[31] From a modelling perspective, the static model outlined in Box 3.2 reflects this idea: the reduced-form deficit multiplier is positive for any size of the (positive) deficit multiplier and (negative) automatic stabiliser coefficient.

[32] Another way in which austerity might be self defeating is that austerity measures adversely affect the debt to GDP ratio. This could happen even if the primary deficit falls as a result of these measures. If the adverse growth effects are strong enough, the standard equation for the change in the debt to GDP ratio shows that the debt to GDP could rise despite a fall in the primary deficit. Thus austerity is still self defeating in terms of the goal of stabilising (and then reducing) the debt to GDP ratio. However, simulations do not indicate that this is the case given the parameter assumptions of the fiscal-feedback model used here.

[33] This is the General Government deficit excluding assistance to the banking sector. For further details, see Department of Finance Maastricht Returns data.