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New study: fiscal consolidation dampens growth and increases inequality

- *The dampening effects are significantly stronger during recessions than during upturns*
- *Fiscal consolidation in Austria is taking place during a recovery phase, so the negative effects on growth have been manageable so far*
- *Further fiscal consolidation should be socially balanced in order to mitigate any negative effects on employment and income distribution*

Reducing high budget deficits and consolidating public finances is a delicate undertaking. But what are the economic implications of fiscal consolidation, and how can it best be designed to minimise negative effects on a country's economy?

These questions are addressed in a new study by Philipp Heimberger and Anna Matzner of the Vienna Institute for International Economic Studies (wiiw). The authors used the latest scientific methods to examine the macroeconomic effects of fiscal consolidation in 12 EU countries (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, Spain and Sweden) for the 1980-2020 period.

The study results show the average effects of fiscal consolidation amounting to 1 percentage point (pp) of GDP. To put this into context, the Austrian government is planning consolidation amounting to an average of around 0.5 pp of GDP per year over the course of the current legislative period (2024-2029).

Real economic output in the EU countries examined in the study falls by around 0.6% in the first year as a result of fiscal consolidation amounting to 1 pp of GDP. Three years later, GDP losses will total 1.6%. The unemployment rate will rise as a result of consolidation: by 0.6 pp when the measures are implemented and by a total of around 0.9 pp after two years. Income inequality will increase in the short to medium term. In addition, the dampening effects on growth will also reduce the inflation rate, specifically by around 0.35 pp after about one year and by roughly 0.15 pp in the medium term.

Although austerity measures can help to stabilise a government's financing costs, the negative effects of government decisions on economic growth, income distribution and employment must be taken into account.

Less negative impact during upturns

'Our study shows that fiscal consolidation slows economic performance much more significantly during recessions than during upturns,' says Anna Matzner, economist at wiiw and

co-author of the study. In recessions, economic output falls by significantly more than one euro for every additional euro of fiscal consolidation; in upturns, however, it falls by only around half a euro for every euro of consolidation.

For Austria, this suggests that the current austerity measures are having a dampening effect on the economy. However, this effect is less severe than it would have been in a prolonged recession. The implementation of fiscal consolidation as part of the 2025/2026 double budget falls within a recovery phase that, although not representing a self-sustaining upturn, has nevertheless improved the framework conditions for fiscal policy.

Based on the findings of the wiiw study and taking into account the Austrian government's multi-year budget plan until 2029, fiscal consolidation in the country could reduce GDP by a total of around 1.5% by that same year. *‘However, if the economy weakens again due to external factors, or if the next consolidation measures disproportionately affect growth- and employment-sensitive areas, the overall dampening effects on the economy could be more pronounced,’* says Philipp Heimberger, lead author of the study and head of the Macroeconomics Research Group at wiiw.

Ensure socially balanced consolidation

A balanced mix of spending cuts and tax increases can help to mitigate the negative effects of fiscal consolidation on employment and income distribution. The wiiw study refers to research by the International Monetary Fund (IMF) showing that cuts in public investment, in particular, have a strong dampening effect and should therefore be avoided.

Consolidation measures that primarily affect financially well-off households lead to lower macroeconomic losses than those that burden lower-income groups. Since wealthy households consume a smaller proportion of their income and are better able to cushion income losses through savings, the decline in demand is correspondingly weaker.

‘In Austria and other EU countries, future fiscal consolidation measures should therefore be designed to be as socially balanced as possible in order to minimise negative effects on employment and income distribution and to boost acceptance among the population,’ Heimberger concludes.

The full study is available for download here.

About the Vienna Institute for International Economic Studies (wiiw)

Founded in 1972, the Vienna Institute for International Economic Studies (wiiw) is an economic think tank that produces economic analyses and forecasts on 23 countries in Central, East and Southeast Europe. In addition, wiiw conducts research in the areas of European integration, macroeconomics, international economics, industrial studies, labour markets and regional development. www.wiiw.ac.at

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