The insanity of Austerity

By Isabel Ortiz and Matthew Cummins

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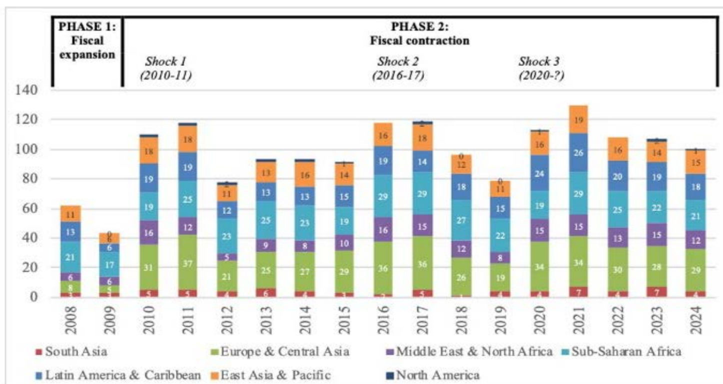
Although austerity measures do not command the same attention that they did in the aftermath of the 2008 financial crisis, they are still central to the prevailing policy playbook. Worse, the longer that governments cling to this failed policy approach, the harder it will be to achieve sustainable, inclusive economic growth.

As finance ministers gather in Washington, DC, for the International Monetary Fund and World Bank Annual Meetings, most of the world's population is bearing the burden of government budget cuts. For many of these individuals and households, living standards have deteriorated markedly over the past decade, and will continue to do so until economic policies are changed.

If world leaders want inclusive, jobs-rich economic growth and sustainable development, they must reverse a policy trend that began in 2010. Following the 2008 global financial crisis, governments in both high-income and developing countries suddenly abandoned fiscal stimulus and began slashing public expenditures in the name of balanced budgets and debt reduction. And as we show in a new report, further austerity-minded adjustments will continue at least until 2024. With belt tightening having become the "new normal," investment in the sources of future growth will remain at a level far below what it otherwise could have been, and inequalities and social discontent will likely increase.

Based on IMF projections, we predict that another fiscal-adjustment shock will take hold next year. By 2021, total government expenditures as a share of GDP will be declining across 130 countries, nearly three-quarters of which are in the developing world. Moreover, 69 countries will be undergoing excessive contraction, entailing cuts in expenditure (as a share of GDP) to far below pre-crisis levels. Among those with the direst development and humanitarian needs are Angola, Burundi, Congo, Djibouti, Egypt, Eritrea, Ethiopia, Iraq, Jamaica, Jordan, Nigeria, and Yemen.

Number of countries cutting public expenditure (as a % of GDP) by region, 2008-2024



Source: Ortiz and Cummins (2019), based on the IMF's *World Economic Outlook* (April 2019)

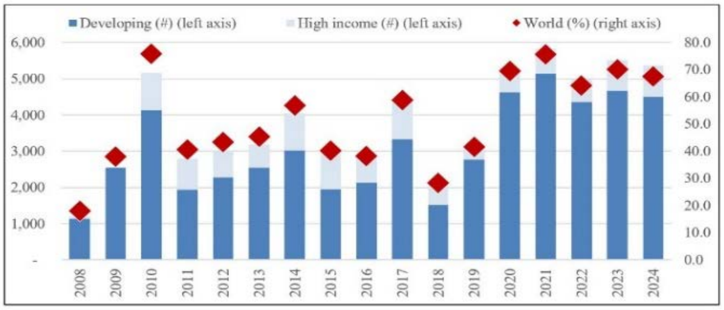
Normalizing austerity

The global reach of austerity policies after the 2008 crisis is staggering. By 2021, such policies will affect nearly six billion people – around 75% of the world's population. Of these, 5.1 billion (90% of those affected) reside in developing countries, where persistent employment crises and spending cuts have translated into a substantial deterioration of living conditions.

To be sure, how governments shape their austerity policies is as important as the scale of the retrenchment. There are many ways to reduce deficits or – even better – boost budget revenues through new funding sources. Yet governments that have been advised by the IMF and other international financial institutions

(IFIs) have usually adopted highly regressive policies, much to the detriment of ordinary people.

Population affected by public-expenditure contraction (in millions and as a % of global population), 2008-2024



Source: Ortiz and Cummins (2019), based on the IMF's *World Economic Outlook* (April 2019)

Slashing incomes and services

For example, proposals to reform pension and social-security systems feature prominently in the IMF's 2018-19 country reports. Governments in 49 developing countries and 37 high-income countries have been considering various changes to their pension schemes, including stricter contribution requirements, higher worker-contribution rates, lower employer contributions, smaller pension-tax exemptions, a higher retirement age, and other structural reforms. As usual with policies recommended by the IFIs, these measures all have a fiscal objective that crowds out equity considerations. Thus, they threaten to weaken public social-security systems, reduce the benefits accruing to future pensioners, and widen existing inequalities between pension beneficiaries.

Governments are also seeking to reduce their public-sector wage bill**.** Because salaries for teachers, health workers, and other civil servants are a large component of most national budgets, around 80 countries – 61 developing, 19 high-income – are considering reforms that would cut these costs. Among the most popular methods are measures to allow salaries' real (inflation-adjusted) value to erode, payment arrears, and public-sector hiring freezes. Needless to say, such cuts could severely undermine the consistency or quality of public services.

The IFIs' austerity agenda goes beyond fiscal issues; it also aims to dismantle labor regulations through caps on the minimum wage and regular salary adjustments, more decentralized collective bargaining, and a loosening of rules concerning the firing of employees or the hiring of temporary workers. Some 44 developing and 35 high-income countries are considering such policies, which would be billed as measures to boost competitiveness at a time of weakening global growth. Yet there is ample evidence to show that, far from creating more good jobs, boosting labor-market "flexibility" during an economic slowdown will make working conditions more precarious, depress wages, and reduce aggregate demand, thereby hampering economic recovery.

A related area is the social safety net. Around 60 developing and 17 high-income countries are looking for ways to reduce welfare benefits. In addition to tightening eligibility criteria, policymakers are considering cuts to child grants, disability pensions, maternity benefits, and many other smaller measures that support families. Yet in most developing countries, middle- class households actually have very low incomes, and will become increasingly vulnerable if they are excluded from social programs.

Making matters worse, 14 developing and 19 high-income countries are also exploring regressive health-care reforms, such as higher fees and co-payments for patients and new cost-saving measures in public health-care centers. Yet insofar as these countries exclude a greater share of the population from accessing high-quality health care, they could be undermining their own future growth potential.

In each of these cases, the logic of austerity has impelled governments to scale down social policies to realize short-term cost savings. But if policymakers really want to achieve sustainable growth and development, they should be scaling up these programs and making investments in their countries' people.

Starving public policies

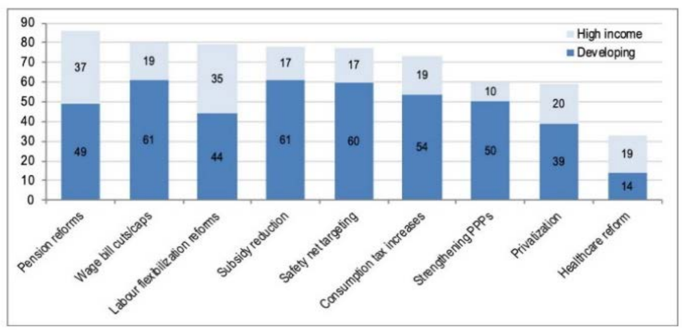
Meanwhile, 61 developing and 17 high-income countries have also begun to limit public subsidies for fuel, electricity, food, and agricultural inputs. This tightening is coming at a time when food and energy prices are near record highs, suggesting that basic goods could soon become unaffordable for many households. In fact, there have already been major protests against rising food and fuel prices in Algeria, Argentina, Burkina Faso, Cameroon, Ecuador, Egypt, India, Iran, Iraq, Nigeria, Peru, Senegal, and Sudan in recent years.

Obviously, fossil-fuel subsidies need to be phased out globally in the medium and long term. But given the current economic environment, it is worth remembering that higher energy prices will put downward pressure on economic activity and demand for labor, requiring additional outlays to support the working population.

Thus, 54 developing and 19 high-income countries are also looking for ways to increase taxes, either through higher rates of value-added tax (VAT) and sales taxes, or by eliminating exemptions. The problem is that such measures will further raise the costs of basic goods and services, placing additional strain on households and stifling overall economic activity. Consumption taxes are regressive, because they do not differentiate between wealthy and poorer households (which must spend a greater share of their incomes to meet basic needs). At a minimum, then, these governments should be considering more progressive approaches, such as taxes on personal and corporate income, financial transactions, property, and inheritance.

Finally, austerity is also ushering in a wave of privatization, with 39 developing and 20 high-income countries exploring how the sale of public assets and services could generate short-term revenues. Whatever the immediate gains, privatization will translate into long-term losses of future revenues. Moreover, asset sales also raise the risk of degraded basic goods and services, layoffs, regulatory capture, and monopolization (leading to higher prices and diminished investment). Owing to these effects, many governments that privatized public services in recent years have already re-nationalized or re-municipalized them. Perhaps the best-known case is the re-municipalization of water services by Paris in 2010; delivery improved and prices fell.

Incidence (in number of countries) of austerity measures, 2018-2019



Source: Ortiz and Cummins (2019) analysis of 161 IMF country reports published from January 2018 to August 2019

Who gains?

One of the most disturbing conclusions to be drawn from the past decade of austerity is that these "reforms" were never actually necessary. On the contrary, governments could have – and still could – pursue many alternative policy options that would have far more positive social outcomes.

The problem is that macroeconomic policy decisions are too often made behind closed doors by technocrats who have not fully considered the social consequences of their actions. Even when it is predictable, the impact of austerity policies on children and other vulnerable groups comes merely as an afterthought.

And yet, the macroeconomic and fiscal-policy choices made by governments over the last decade have been nothing short of alarming. The G20 committed $10 trillion to support the financial sector after the 2008 crisis, and then passed the costs on to the general public. Once the financial sector had been bailed out, policymakers – following the advice of prominent economists and of the IFIs – decided that it was time to pursue fiscal consolidation. As public spending was slashed, tens of millions of people were pushed into poverty or experienced a decline in their living standards, and the middle class was squeezed like never before.

Nonetheless, the worldwide drive toward austerity continues, even though it obviously will further undermine growth, threaten employment, and sow the seeds of social and political discontent. It is thus reasonable to ask whom this development model is meant to serve.

Clearly, "fiscal prudence" has been used as a Trojan horse to enrich the wealthy and reinforce the "Washington Consensus": a development approach that calls for a reduced public sector and an expansion of private services. Under this model, austerity sets into motion a vicious circle, whereby a contraction of public budgets reduces economic growth and revenues, prompting governments to seek still more policies to minimize the size of the public sector. Thus, they have to resort to private delivery.

Beyond austerity

Budget cuts do not need to be the "new normal." Even the poorest countries have alternatives. Specifically, governments can create fiscal space for public services and development policies through progressive taxation, a crackdown on illicit financial flows, improved debt management, fiscal and foreign-exchange reserves, more accommodative macroeconomic frameworks, well-prioritized public investment, and – in the case of lower-income countries – lobbying for greater aid.

All of these alternatives have been endorsed by the United Nations and the leading IFIs. And many governments have been relying on them for decades, showing that self-defeating austerity is not the only option.

For example, Costa Rica and Thailand have reallocated military expenditures in order to fund universal health care. And in recent years, many countries have increased social investment by taxing not consumption but income, corporate profits, and property. Bolivia, Mongolia, and Zambia are financing universal old-age pensions, child benefits, and other schemes from taxes on mining and natural-gas extraction. Brazil's previous governments used a financial-transaction tax to pay for expanded social protections. Ghana, Liberia, and the Maldives have introduced taxes on tourism; Algeria, Mauritius, and Panama have complemented social-security revenues with high taxes on tobacco.

Moreover, a report from the International Labor Organization shows that plenty of countries have expanded social-security coverage to achieve universal social protection, rather than allowing welfare systems to erode. More than 60 countries have successfully re-negotiated sovereign debt, and more than 20 countries – including Ecuador, Iceland, and Iraq – have defaulted or repudiated debt (often nationalized private-sector debt), using the savings to fund social programs. Chile and Norway, among others, are using fiscal reserves to support social development. And many other countries are using deficit spending and more accommodative macroeconomic frameworks to meet pressing fiscal demands at a time of slow growth.

As these examples show, governments do not need to paint themselves into a corner by slashing public expenditures. Instead, they can create the fiscal space needed to invest in the sources of future growth and pursue the

UN Sustainable Development Goals, to which they have all committed.

The need for the new

When confronting large-scale crises, policymakers have an obligation to rethink the *status quo*. After the financial crash of 1929, US President Franklin D. Roosevelt's administration responded to the Great Depression with the New Deal, which amounted to a fundamental overhaul of America's prevailing economic and development model.

In the face of slowing growth, rising inequality, and a looming climate crisis, an equally ambitious policy push is required today. The continued weakness of the post-2008 global recovery presents an opportunity not for short-term cuts, but for new long-term policies to generate more inclusive and sustainable growth. When it comes to revitalizing economies and keeping our development commitments, austerity should be the last thing on the agenda.

It is time for world leaders to abandon an approach that benefits the few at the expense of the many. Not only has the past decade of austerity been a failure; it never should have happened in the first place.

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