Thinking about fiscal consolidation: theory, ideology and consequences

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Where do the economic ideas and justification for fiscal consolidation and austerity come from?

- They are not – as often presented – the result of pragmatic, common-sense policies and practical responses to growing budget deficits and debts
- They are political decisions informed by ideology and supported by mainstream economics views
- They are justified by neoclassical economics, particularly
  - Monetarism (associated with Milton Friedman), and
  - New Classical Economics (associated with Robert Lucas)
  - The macroeconomic theory and models used are unrealistic and open to harsh criticism
  - Mainstream macroeconomic models also fail empirically
- They stem from a neoliberal ideology based on reduction in the role, capacity, size and influence of the state and ostensibly 'free market' policies
- For developing countries this ideology is associated with
  - The Washington Consensus and
  - Structural Adjustment Programmes of the IMF and WB

Famous mainstream economists critiques of mainstream macroeconomics

- William Buiter, a former member of the Monetary Policy Committee of the Bank of England, wrote in 2009 that

  'the typical graduate macroeconomics and monetary economics training received at Anglo-American universities during the past 30 years or so may have set back by decades serious investigations of aggregate economic behaviour and economic policy-relevant understanding'.

- Buiter (2009) referred to models based on New Classical and New Keynesian economics, as the **kind of modelling that offers no clues as to *'how the economy works – let alone how the economy works during times of stress and financial instability'***
- Robert Solow famous for his 1956 neoclassical growth model, has also repudiated DSGE models, saying that its foundations were ***'dumb and dumber macroeconomics'*** (Solow, 2003)
- Solow (2008) argues that recent efforts by DSGE advocates to add complex alterations to their models will not make them any better or more realistic
- Joseph Stiglitz (2015) asserts that macroeconomics has done poorly over the years:

  "the models/theories that guided policy were not just innocent bystanders in the crisis that unfolded beginning in 2008'" but "they were critical in the creation of the crisis and in the inadequate responses to it"

Ideology, politics and monetary rewards

- Paul Samuelson (2007) has suggested that politics and monetary rewards cause some theories to overtake others
- Paul Krugman (2013), wrote:

  'the austerity agenda looks a lot like a simple expression of upper-class preferences, wrapped in a facade of academic rigor. What the top 1 percent wants becomes what economic science says we must do.'

- Paul Romer (2016, p. 1), the former chief economist at the World Bank wrote that he *had 'observed more than three decades of intellectual regress' in macroeconomics, adding that it had turned into 'pseudoscience'*
- Romer explicitly targeted the work of Robert Lucas and that of the New Classical economists

South African monetary and fiscal policy is based on Monetarist and New Classical macroeconomic theories and models

- The point is that when NT and other mainstream neoliberal economists justify their proposals to Parliament and the public by saying that is what Economics or Economic Theory tells us. Or, that is what all the textbooks say" or refer to "the markets" – they are referring to unrealistic and patently incorrect Monetarist and New classical economic theories and models.
- These mainstream macroeconomic models are not suitable for evidence based policy making

What is wrong with fiscal consolidation?

- The mainstream theoretical justification for fiscal consolidation is flawed
- Fiscal consolidation does not support growth but constrains and reduces growth
- Fiscal consolidation reduces government's ability to ensure protection of human rights and to address gender and other injustices in society
- Fiscal consolidation deepens existing schisms and crises and intensifies risks
- The NT pushed South Africa onto the fiscal consolidation bandwagon in 2011 after policymakers in developed countries pivoted sharply away from the fiscal stimulus policies they had supported in response to the global financial crisis (GFC) of 2008
- Why did they change their policy stance?:
  - The sharp rise in public debt in much of Europe due to bailouts to private finance
  - The rise of US "Tea Party" conservatives after the November 2010 congressional elections
  - The lack of a convincing political narrative about raising government expenditure after years of promoting neoliberal ideology and balanced budgets
  - Reducing the deficit and debt advances long-term goals of reducing the size of the state

Fiscal consolidation and austerity after the GFC

- Two prominent arguments based on mainstream macroeconomic theory and empirical analyses became the main selling points for fiscal consolidation and an austerity stance:
  - **Alberto Alesina**'s case for "expansionary austerity", and
  - **Reinhart and Rogoff**'s empirical work to show that large deficits negatively affect GDP

Consolidation causes contraction

- Alesina and Ardagna (2009) said fiscal consolidation would be expansionary
- They argued it was more effective if spending cuts rather than tax increases
- Alesina received much acclaim for his argument that "large, credible and decisive spending cuts" would change expectations of market participants
- He asserted that businesses' change of expectations would bring forward investments that were held back by policy uncertainty in the recession.
- Their empirical work for a large sample of countries showed that governments that successfully cut deficits enjoyed reduced debts & higher growth
- But there were serious problems with Alesina's empirical work:
  - None of the cases of expansionary austerity occurred during recessions
  - Misclassified some periods of fiscal expansion as periods of contraction
  - IMF (2010) noted that classifications of fiscal policy as expansionary and contractionary had very little connection with actual fiscal policy changes
  - Washington Post (2013): "No advanced economy has proved Alesina correct in the wake of the Great Recession"
- Austerity did not deliver higher growth
- Instead, output contracted more or less exactly in line with the degree of austerity they managed to impose

Reinhart and Rogoff

- Reinhart and Rogoff (2010) had a massive impact beyond academia at the time of the sovereign debt crisis and still referred to by the NT
- They did economic modelling that showed that debt to GDP levels over 90% would have a negative impact on GDP
- The idea that public debt was bad for GDP was already widespread amongst mainstream economists so R&R's results accepted without question
- Ash, Herndon and Pollin showed that R&R's results were the consequence of coding errors and omissions and nonstandard weighting of data.
- The 90% drop-off in growth disappeared when errors were corrected.
- Dube (amongst others) showed that if at all there was a correlation between debt and growth, it was more likely that episodes of low growth led to higher levels of debt rather than the other way around.
- This counter argument had been made by opponents of austerity and could have easily been verified by supporters of austerity but simply had not been taken seriously
- Since consolidation constrains growth it is likely that consolidation worsens levels of debt

Some famous mainstream economists on impact of fiscal consolidation

- Blanchard and Leigh (2013) in an IMF WP report that:

  … in advanced economies, ***stronger planned fiscal consolidation has been associated with lower growth than expected****, with the relation being particularly strong, both statistically and economically, early in the crisis.*

- Carrière-Swallow, David, and Leigh (2018) in an IMF WP report that:

  The effects of fiscal consolidation on economic activity in advanced and emerging market economies may thus be more similar than typically assumed*…. Fiscal consolidations undertaken in periods of economic booms and slumps do not have significantly different estimated effects on economic activity in LAC economies.* ***Their effects are contractionary in both cases****.*

- Fatas and Summers (2018)

  The large size of the effects points in the direction of self-defeating fiscal consolidations …. ***Attempts to reduce debt via fiscal consolidations have very likely resulted in a higher debt to GDP ratio*** *through their long-term negative impact on output…. If the negative effects of fiscal consolidation are long lasting, countries can enter a negative loop where attempts to reduce government debt are not effective because of the reductions in GDP.* ***As GDP falls permanently, attempts to reduce debt via reductions in spending or increases in taxes lead to a higher debt to GDP ratio***

Fiscal consolidation, human rights and gender discrimination and violence

- International Human rights law stipulates that fiscal constraints do not justify countries' failure to guarantee certain minimum social security standards as enshrined in the international human rights framework and other conventions, particularly wrt low-income and other vulnerable groups
- (UNHCHR 2013) indicates that policy makers should demonstrate
  - the existence of a compelling State interest;
  - the necessity, reasonableness, temporariness and proportionality of the austerity measures;
  - the exhaustion of alternative and less restrictive measures;
  - the non-discriminatory nature of the proposed measures;
  - the maintenance of at least basic minimum levels of living standards and other rights; and
  - the genuine participation of affected groups and individuals in decision-making processes
- The general global experience, including SA, is that even though there are international agreements and constitutional stipulations, in practice business interests are prioritized over human rights considerations and social and ecological development objectives

Fiscal consolidation, human rights and gender discrimination and violence

- Un Women (2015), amongst other feminist literature on rights and economics show that macroeconomic policies, and in particular fiscal consolidation policies, are enormously consequential for the ability of states to fulfil their obligations to women's human rights and carry immense gendered impacts
- UN agencies and international human rights groups have shown that the human rights cost of fiscal consolidation are devastating
- Costs are cumulative, intensify inequality and erode the social fabric
- These costs are disproportionately shouldered by women and marginalized
- Fiscal consolidation worsens structural gender inequalities (discriminatory social norms and prejudices) that reduce women's participation and voice in political and economic decision making
- Women bear the brunt of the degradation of the social fabric, often in the form of gender based violence within households and communities
- Reduction in social grants and subsidies to the poor disproportionately harm women who traditionally bear most responsibility for reproductive work
- The burden of care and household work increases when fiscal consolidation reduces the level and quality of basic services

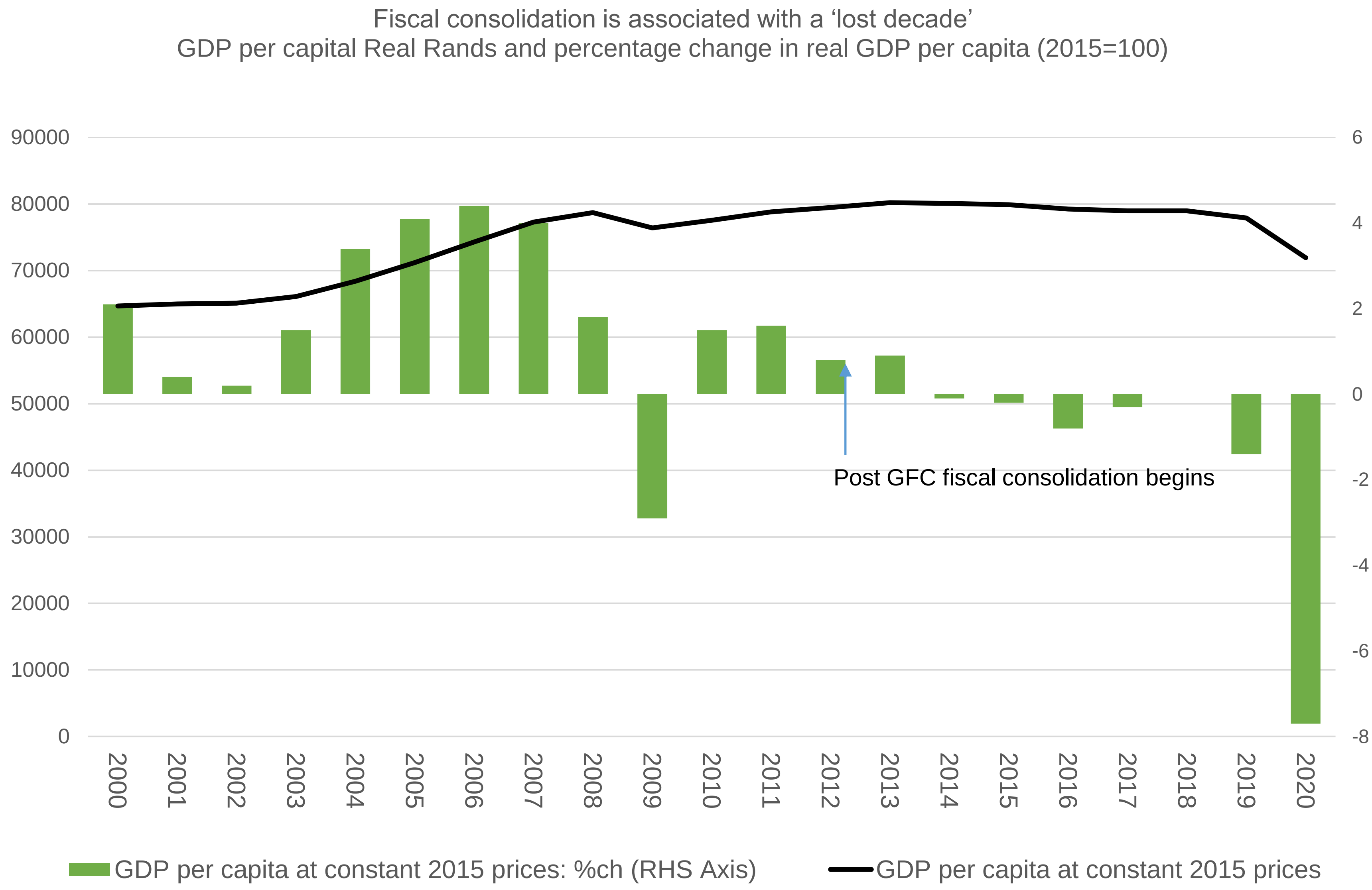
The impact of fiscal consolidation and an austerity mindset on the SA economy

- The government's macroeconomic policy approach adopted soon after the1994 elections was based on mainstream economics and inspired by neoliberal, Washington Consensus-type thinking.
- I.e., they were implementing macroeconomic aspects of a 'self-imposed structural adjusted programme' with a built-in austerity bias
- They have focused on supply-side solutions where 'prudent' macroeconomic policy is viewed as supporting business confidence but generally incapable of promoting demand-led growth and employment
- They talk about structural reforms rather than structural transformation, which means that they have been unable to examine and address the deeper social and economic structural factors that impede accumulation
- SA's extraordinarily high level of structural unemployment is not simply a 'skills mismatch problem.
- It is related to long-term evolution of the sectoral structure of the economy in an economy defined by dispossession and racist ownership, educational and labour market practices
- The deeper structural factors related to the extraordinary and longstanding levels of inequality and market concentration and control are not adequately factored into analyses of the economic growth path, path dependency & economic performance

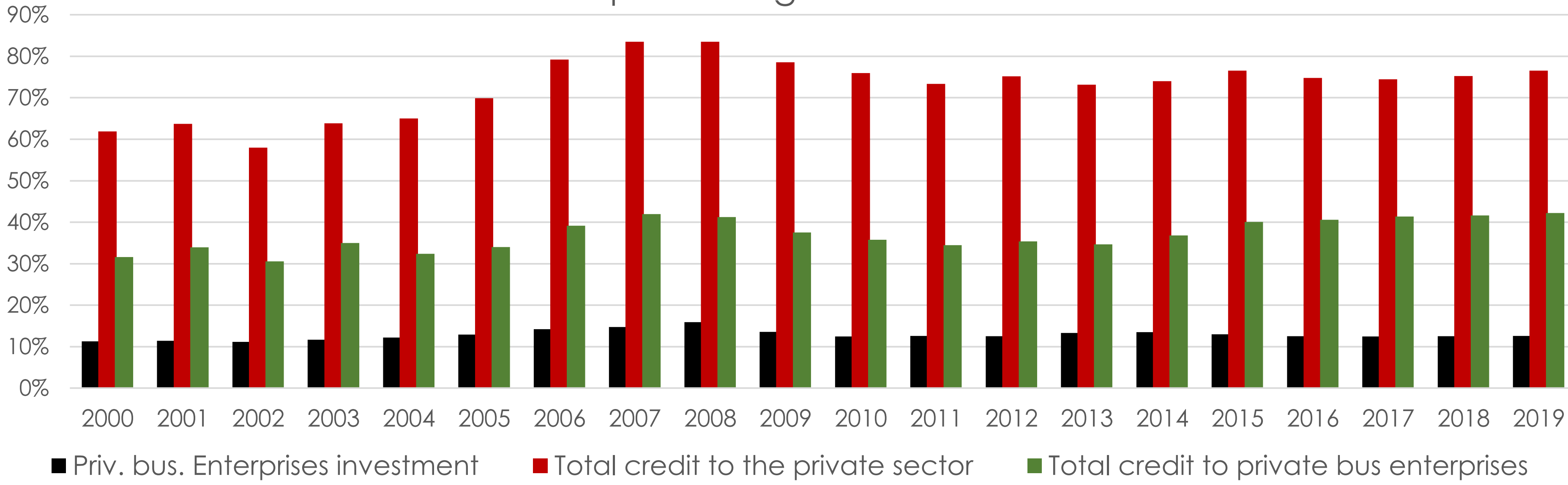
The impact of fiscal consolidation and an austerity mindset on the SA economy

- It is underappreciated, the extent to which the government's attitude of treating spending on basic services and social transfers as consumption rather then investments in productivity and economic development undermines prospects for growth and development
- Inadequate spending to reduce the impact of poverty in an economy with structural unemployment (deeper than skills mismatch) has worsened poverty and inequality
- Serious global and domestic risks (the "Polycrisis) require governments to build resilience within households, firstly, and in the overall economy
- The fresh experiences in SA with the pandemic, the July 2021 social unrests, floods and droughts show us that many of these risks may have sudden and very large costs to society and directly on public finances
- Fiscal consolidation has worsened service delivery, e.g., teacher to student ratios, health workers per capita, and constrained increases in social transfers to the elderly and children
- It has eroded resilience which worsens the potential long-term costs and impact of these risks
- High inequality and the intersection of racial and gender disparities means that the burden of potential disasters and the costs may most likely be borne by the poorest, black households, particularly female headed households

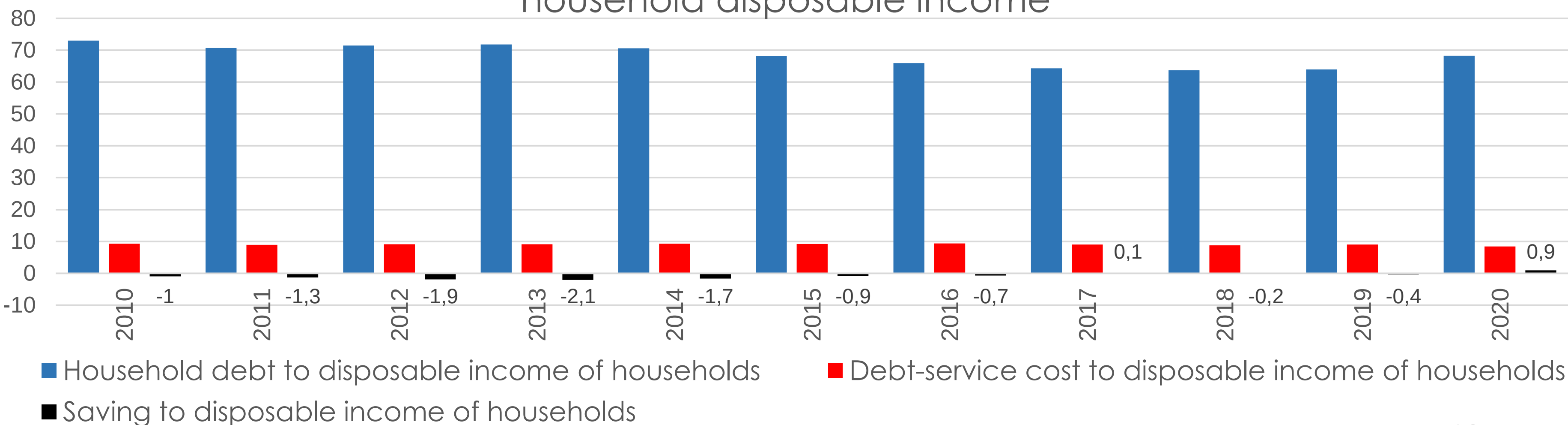
The impact of fiscal consolidation and an austerity mindset on the SA economy



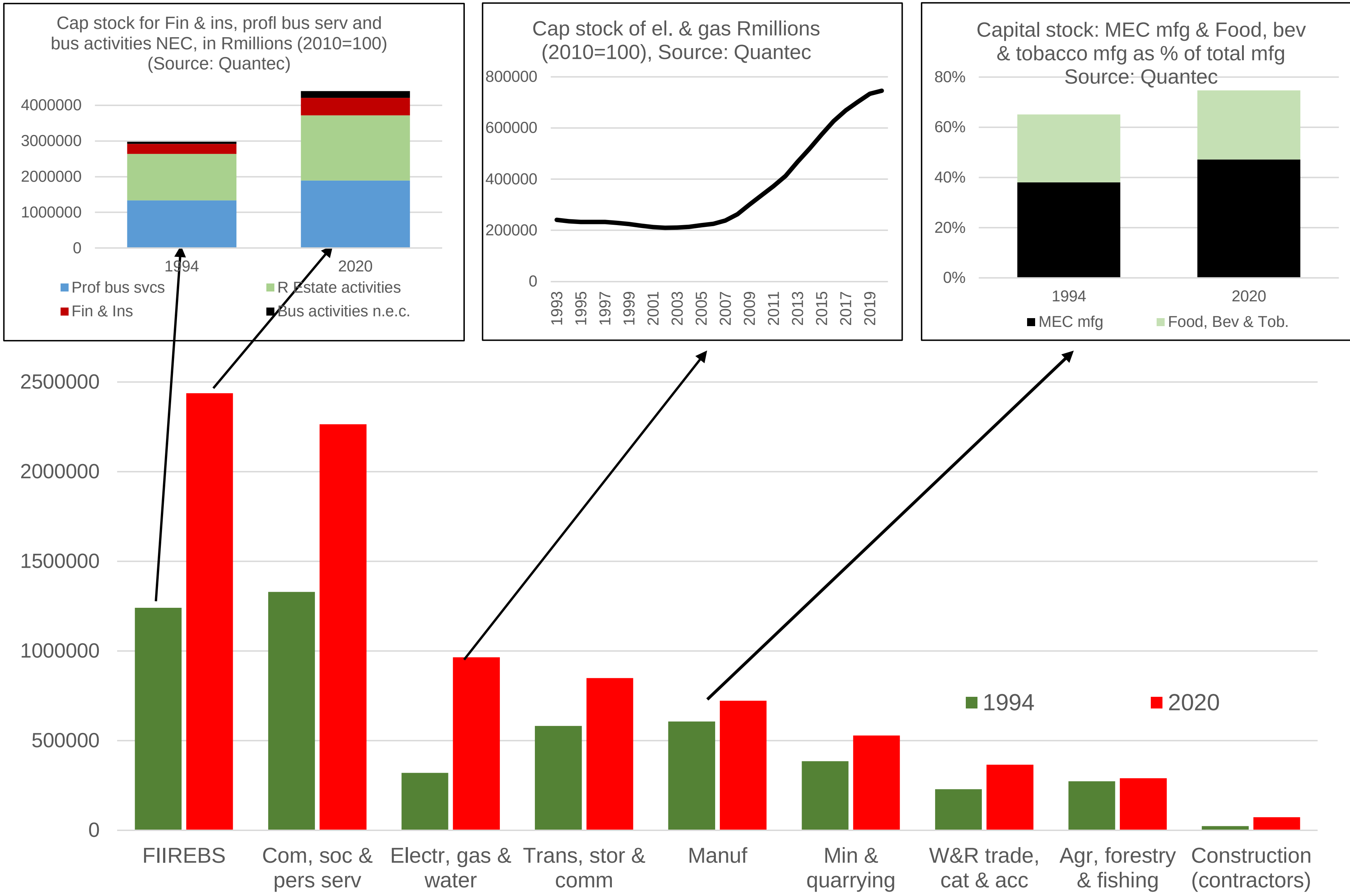
Credit extension to the private sector and private business investment as percentages of GDP



Household debt, debt service costs and savings as percentages of household disposable income

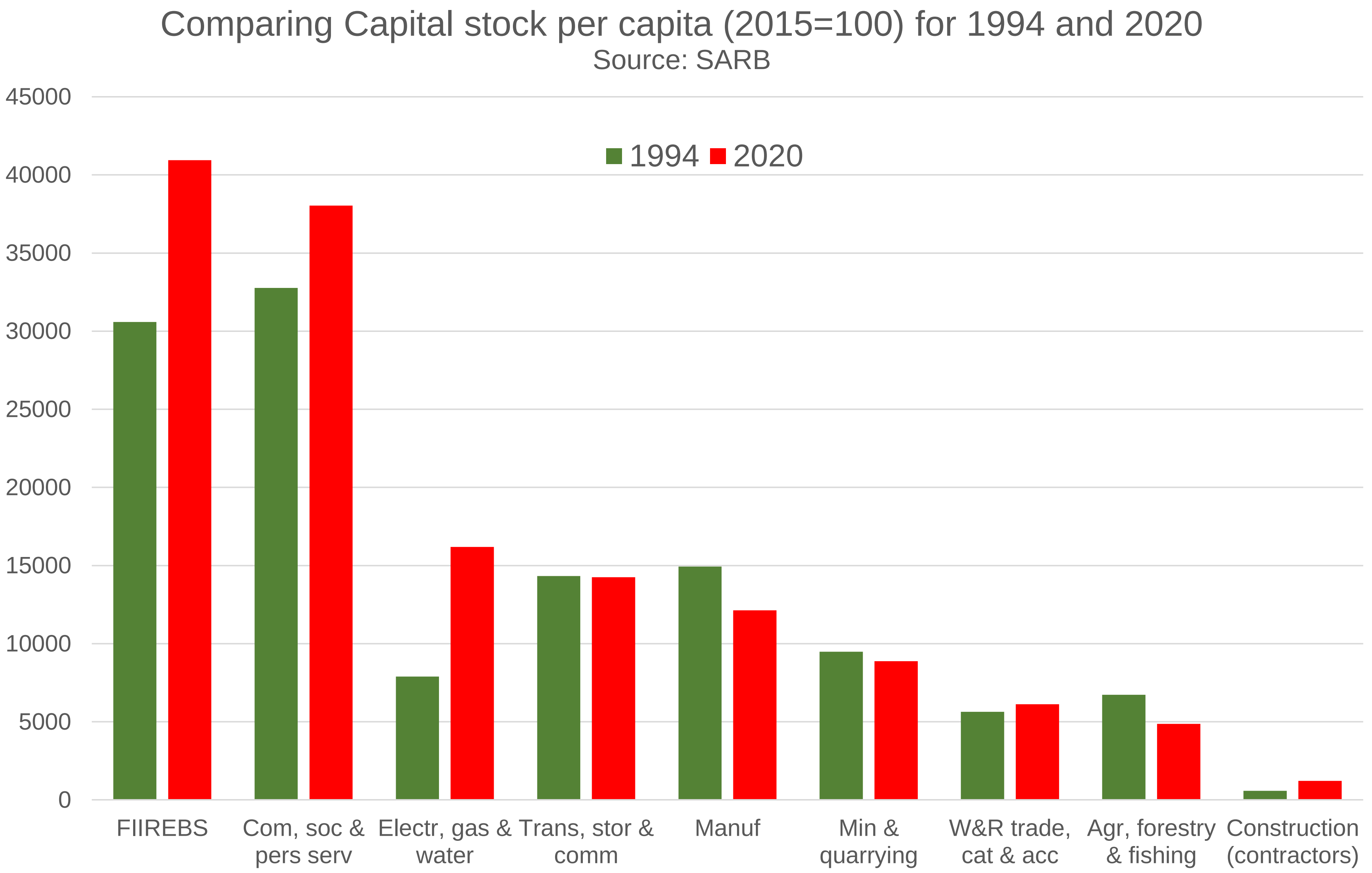


Capital stock of different sectors, 1994 & 2020



Capital stock of different economic sectors, Rmillions, 2015=100, Source: SARB

Comparing Capital stock per capita



Employment for different sectors