The Forthcoming Adjustment Shock

Policy Brief based on *The Decade of Adjustment: A Review of Austerity Trends 2010-2020 in 187 Countries*

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Expenditure projections: A new contraction in 2016-2020

Analysis of the latest IMF expenditure projections for 187 countries between 2005 and 2020 reveals that there have been two distinct phases of government spending patterns since the onset of the global economic crisis.

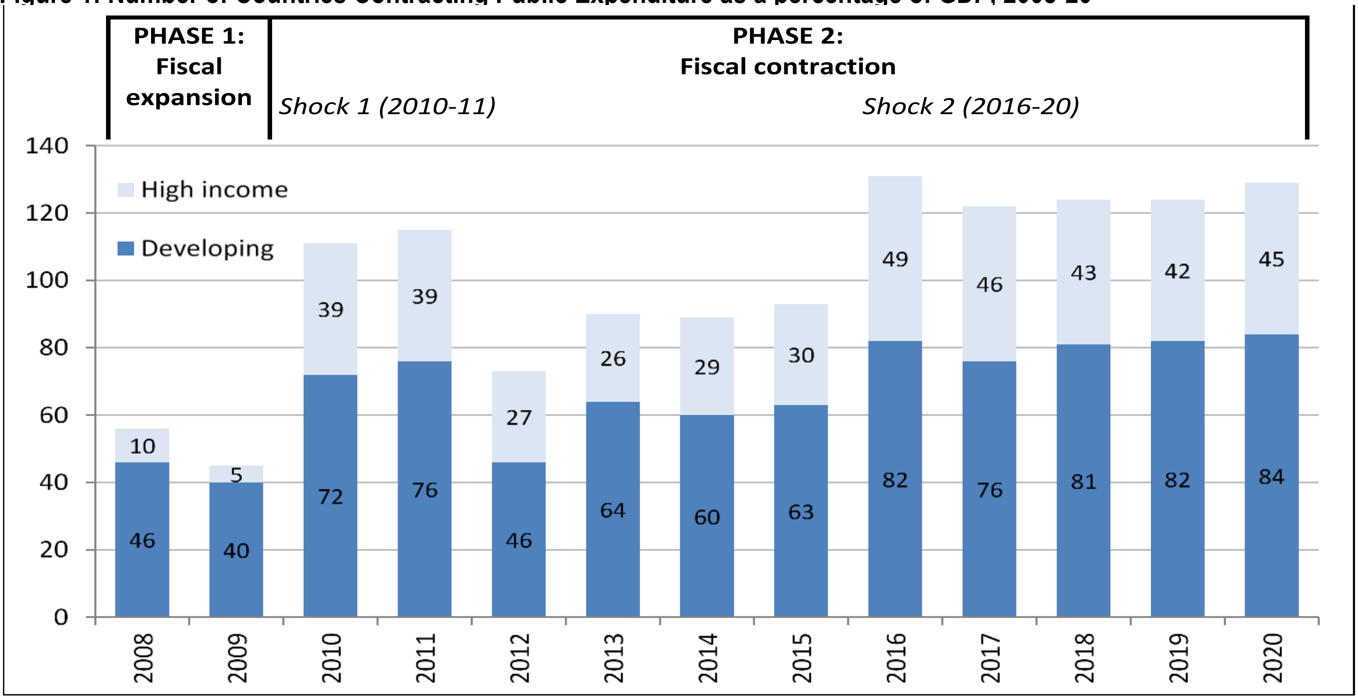
- **First phase (2008-09) – Fiscal expansion**: Nearly all countries introduced fiscal stimulus and expanded public spending as a countercyclical measure to cushion the impacts of the global crisis on their populations. Overall, 137 countries (or 73 per cent of the world) ramped up expenditure, with the average annual expansion amounting to 3.3 per cent of GDP. About 50 high- and middle-income countries announced fiscal stimulus packages totalling US$2.4 trillion, of which approximately a quarter was invested in counter-cyclical social protection measures.
- **Second phase of the crisis (2010 onwards) – Fiscal adjustment:** In 2010, however, premature budget cuts became widespread, despite the ongoing and urgent need of vulnerable populations for public support.

This phase is characterized by two major contractionary shocks, the first occurring in 2010-11 and the second expected to hit in 2016 and continue at least until 2020.

A new adjustment shock in 2016: According to IMF projections, 2016 marks the beginning of a second, major period of expenditure contraction globally. Overall, budget reductions are expected to impact 132 countries in 2016 in terms of GDP and hover around this level until 2020. One of the key findings is that the developing world will be the most severely affected. Overall, 81 developing countries, on average, are projected to cut public spending during the forthcoming shock versus 45 high-income countries. Expenditure contraction is expected to impact more than two-thirds of all countries annually, affecting more than six billion persons or nearly 80 per cent of the global population by 2020.

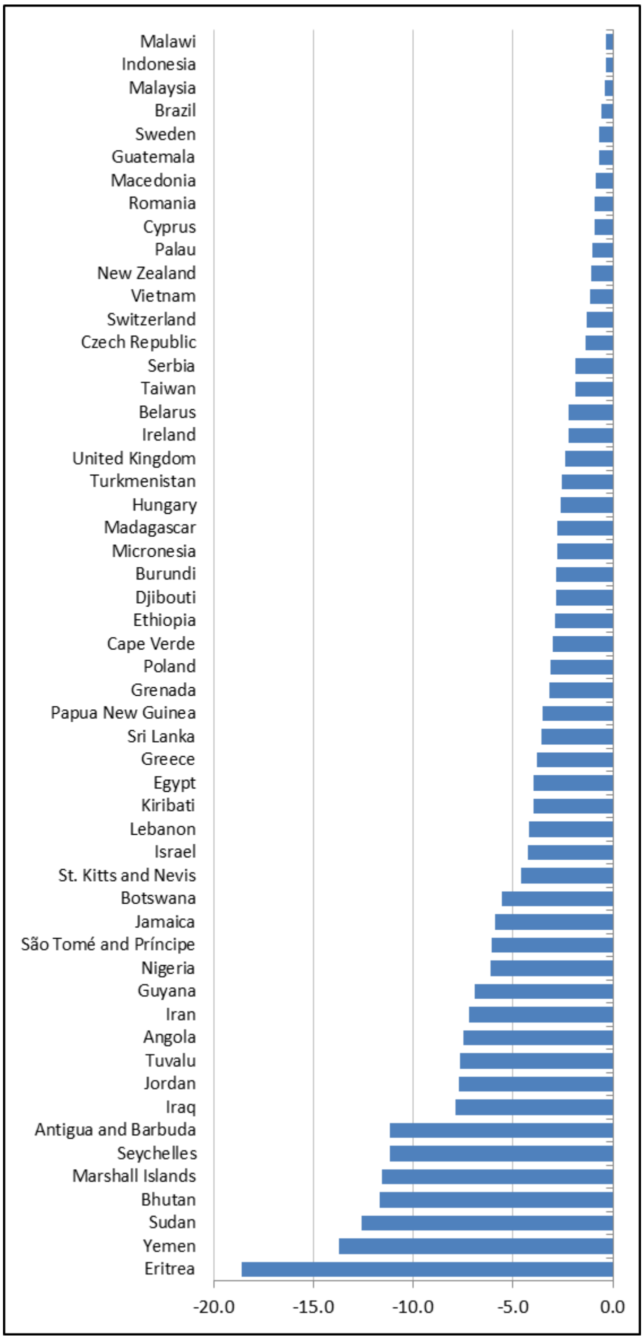
Excessive contraction: Comparing the 2016-20 forthcoming shock and 2005-07 (pre-crisis) periods further suggests that 30 per cent of all countries are undergoing excessive contraction, defined as cutting expenditure below pre-crisis levels in GDP terms.

Figure 1: Number of Countries Contracting Public Expenditure as a percentage of GDP, 2008-20



Source: Authors' calculations based on the IMF's *World Economic Outlook* (April 2015)

Figure 2: Excessive contraction: Change in Total Government Spending, 2016-20 avg. over 2005-07 avg., in percentage of GDP



Source: Authors' calculations based on the IMF's *World Economic Outlook* (April 2015)

Adjustment measures in 2010-2015

A desk review of 616 recent IMF reports indicates that governments are weighing various cost-cutting options, as summarized below.

1. Eliminating or reducing subsidies: Overall, 132 governments in 97 developing and 35 high-income countries are reducing or removing subsidies, predominately on fuel, but also on electricity, food and agriculture. The Middle East and North Africa along with Sub-Saharan Africa are the regions being hardest hit. When basic subsidies are withdrawn, food and transport prices increase and can become unaffordable for many households. Higher energy prices also tend to slow down economic activity and thus generate unemployment. The elimination of subsidies is often accompanied by the development of a safety net as a way to compensate the poor; however, while subsidies can be removed overnight, a social protection system takes time to be fully functional; further, targeting to the poorest does not compensate vulnerable groups near the poverty line and the middle classes.

2. Wage bill cuts/caps: As recurrent expenditures like salaries of teachers, health workers and local civil servants tend to be the largest component of national budgets, an estimated 130 governments in 96 developing and 34 high-income countries are considering to reduce the wage bill, often as a part of civil service reforms. This policy stance may translate into salaries being reduced or eroded in real value, payments in arrears, hiring freezes and/or employment retrenchment, all of which can adversely impact the delivery of public services to the population.

3. Rationalizing and further targeting social safety nets: Overall, 107 governments in 68 developing and 39 high-income countries are considering rationalizing their spending on safety nets and welfare benefits, often by revising eligibility criteria and targeting to the poorest, which amounts to reducing social protection coverage. IMF country reports generally associate targeting with poverty reduction, as a way to reconcile poverty reduction with austerity; however, targeting risks excluding large segments of the vulnerable and low income households. In most developing countries, targeting to the poor only increases the vulnerability of middle classes—the majority of which earn very low incomes—along with those who sit just above official poverty lines. Rather than targeting and scaling down safety nets to achieve cost savings over the short term, there is a strong case for scaling up in times of crisis and building social protection floors for all.

4. Reforming old-age pensions: Approximately 105 governments in 60 developing and 45 high-income countries are discussing different changes to their pension systems, such as through raising contribution rates, increasing eligibility periods, prolonging the retirement age, lowering benefits, sometimes structural reforms of contributory social security pensions. As a result, future pensioners are expected to receive lower benefits. These reforms have contested by a number of national courts as anti-constitutional, and reforms reversed.

5. Labour reforms: Labour market flexibilization is being discussed by 89 governments in 49 developing and 40 high-income countries. Related reforms generally include revising the minimum wage, limiting salary adjustments to cost of living benchmarks, decentralizing collective bargaining, and easing firing and compensation arrangements at the enterprise level. Labour market reforms are supposedly aimed at increasing competitiveness and supporting businesses during recessions, partially intending to compensate for the underperformance of the financial sector. However, available evidence suggests that labour market flexibilization will not generate decent jobs. On the contrary, in a context of economic contraction, this approach is likely to generate labour market "precarization," depress domestic incomes and ultimately hinder recovery efforts.

6. Reforming health systems: 56 governments in 34 developing and 22 high-income countries are discussing reforms to their healthcare systems, generally through increasing fees and co-payments as well as by introducing cost-saving measures in public health centres. The main risk of these budget cuts is that vulnerable persons are excluded from receiving benefits and critical assistance at a time when their needs are greatest.

7. Increasing consumption taxes on goods and services: Some 138 governments in 93 developing and 45 high-income countries are considering options to boost revenue by raising value added tax (VAT) or sales tax rates or removing exemptions. However, increasing the cost of basic goods and services can erode the already limited incomes of vulnerable households and stifle economic activity. Since this policy does not differentiate between consumers, it can be regressive, shifting the tax burden to vulnerable families and exacerbating inequalities. Alternatively, progressive tax approaches should be considered, such as taxes on income, inheritance, property and corporations, including the financial sector.

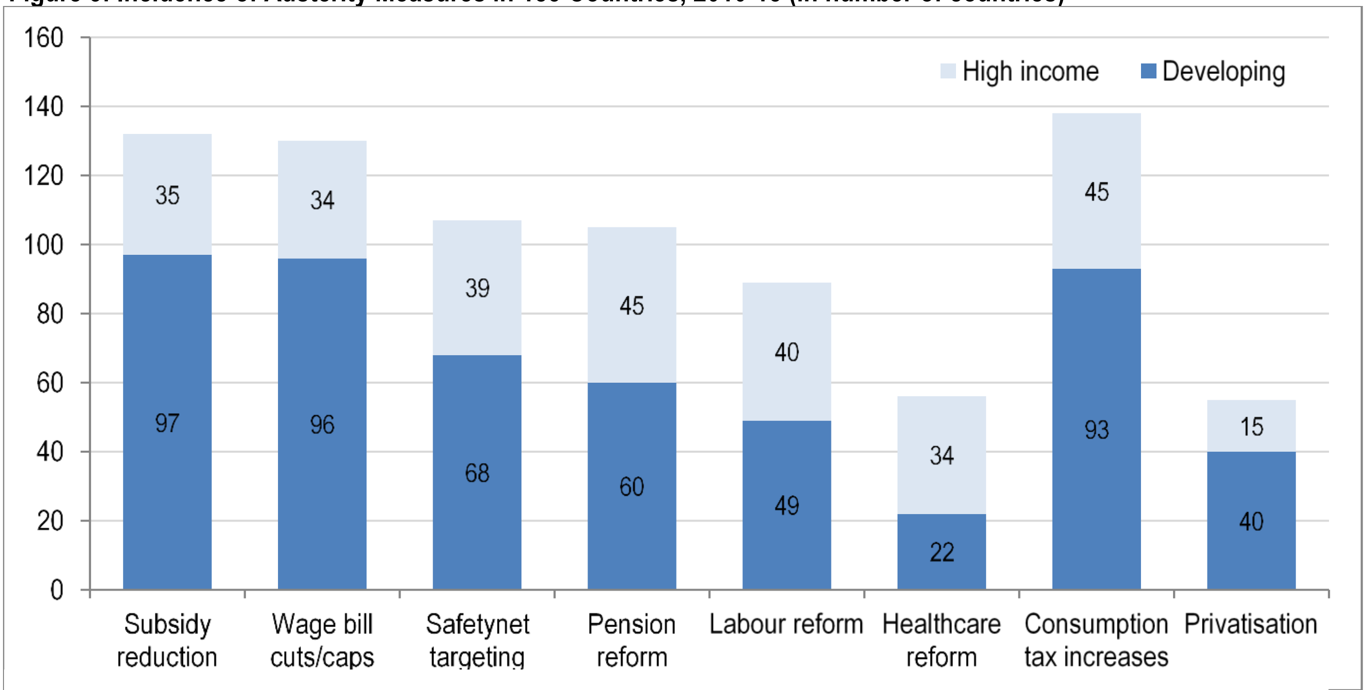
8. Privatization of public assets and services: According to IMF reports, this revenue generation approach is being pondered by 55 governments in 40 developing and 15 high-income countries. Sales proceeds produce short-term gains, but also long-term losses given the lack of future revenues; additionally, privatization risks include layoffs, tariff increases, unaffordable and low quality goods and public services.

Contrary to public perception, austerity measures are not limited to Europe; in fact, many of the principal adjustment measures feature most prominently in developing countries. Overall, at least two policy options are being discussed in 169 countries, three or more in 145 countries, four or more in 122 countries, five or more in 91 countries, six or more in 56 countries and seven or more in 15 countries.

Impacts on Jobs and Growth

Projections with the United Nations Global Policy Model indicate that the expected spending cuts will negatively affect GDP and employment in all regions. Compared to the baseline scenario without spending

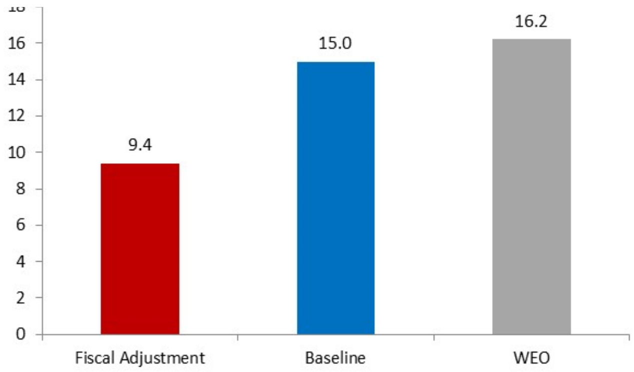
Figure 3: Incidence of Austerity Measures in 183 Countries, 2010-15 (in number of countries)



Source: Authors' analysis of 616 IMF country reports published from February 2010 to February 2015 contraction, global GDP will be 5.5 per cent lower by 2020 resulting in a net loss of 12 million jobs. Compared to IMF projections, the loss of GDP will be even larger, approximately 7 percent by 2020.

Upper-middle income and low income countries will be the hardest hit, with fiscal adjustment reducing GDP by roughly 7.5 and 6 per cent, respectively, over the 2016-20 period. East Asia and Sub-Saharan Africa will be the most affected regions.

Figure 4: Global GDP Growth Rates, 2015-2020



Source : Authors' analysis based on the Global Policy Model

Impact of Fiscal Adjustment on GDP and Employment compared to baseline, 2015-2020

	GDP (%)	Jobs (millions)
All Countries:		
High Income	-4.98	-4.75
Upper-Middle Income	-7.62	-4.39
Lower-Middle Income	-2.60	-0.14
Low Income	-6.17	-2.45
Developing countries:		
Eastern Europe and Central Asia	-3.73	-0.39
Middle East and Northern Africa	-3.67	-0.71
Sub-Sahara Africa	-4.92	-2.46
East Asia and Pacific	-11.58	-2.60
South Asia	-2.66	-1.06
Latin America and the Caribbean	-2.43	-0.54
World	-5.57	-11.73

Source: Authors' analysis based on Global Policy Mode

This paper questions if the projected fiscal contraction trajectory—in terms of timing, scope and magnitude—as well as the specific austerity measures being considered are conducive to socio-economic recovery and the achievement of the Sustainable Development Goals (SDGs). This paper encourages policymakers to recognize the high human and developmental costs of poorly-designed adjustment strategies and to consider alternative policies that support a recovery for all.

It does not need to be a decade of adjustment. Most developing countries did not pursue this policy stance in 2012-14 in order to attend to the pressing demands of their populations at a time of slow growth. Moreover, policymakers have a variety of options to expand fiscal space at their disposal, which should be examined in open, national dialogue. And some governments are actually increasing subsidies and the wage bill, and expanding coverage/benefits of social protection and health, despite their contractionary fiscal environments

Fiscal space exists even in the poorest countries

In difficult times, it is imperative that countries aggressively explore all possible alternatives to promote national socio-economic development with jobs and social protection. There are many options, supported by policy statements of the UN and international financial institutions:

1. Re-allocating public expenditures
2. Increasing tax revenues
3. Expanding social security coverage and contributory revenues
4. Lobbying for aid and transfers
5. Eliminating illicit financial flows
6. Using fiscal and foreign exchange reserves
7. Borrowing or restructuring existing debt
8. Adopting a more accommodative macroeconomic framework

Source: "*Fiscal Space for Social Protection: Options to Expand Social Investments in 187 Countries*," Geneva: ILO.

This policy brief is based on the working paper "The Decade of Adjustment: A Review of Austerity Trends 2010-2020 in 187 Countries" by Isabel Ortiz, Matthew Cummins, Jeronim Capaldo and Kalaivani Karunanethy, published by the International Labour Organization, the Initiative for Policy Dialogue at Columbia University and the South Centre; Geneva: 2015

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