



The IMF and The End of Austerity

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The IMF and The End of Austerity

By Ann Pettifor and Douglas Coe

This PRIME briefing sets out the issues, including the implications of the new IMF analysis of multipliers, as well as the UK Treasury assumptions, which are now heavily questioned.

At their annual meeting in Tokyo this year, IMF economists destroyed the case for austerity. While their analysis constituted a small part of a routine report – the *World Economic Outlook*¹ – and was technical in form, the devastating impact of their conclusions could not be ignored by the media. These IMF conclusions are of the greatest possible importance and must not be allowed to be lost with the passage of time. We are concerned that they should be fully understood by the public at large.

IMF economists have finally acknowledged what politicians have long denied. They have shown that austerity policies implemented by politicians and demanded by financial markets are severely damaging to what economists define as ‘growth’. Ultimately, argues the IMF, these policies are self-defeating. As most thinking people now recognise, rather than repairing the broken and bankrupt economies of the world, austerity is making matters worse.

The IMF’s analysis goes further: it shows that Plan B is not only feasible, it is essential.

Assuming (wrongly) that the government’s budget is like a household budget, many conclude that the right policy for a debtor government might be to cut expenditure and increase taxation.

Governments have always understood that in a slump, cuts would have damaging effects on the wider economy. Nevertheless they consider these effects to be small relative to the greater good of restoring the public finances to order. So they called on us to accept austerity and “tough choices”, and argued “we are all in this together”. Indeed previously the IMF themselves supported this course of action as necessary and effective.

However IMF economists have now shown that the damaging effect of austerity is far more severe than they previously advised. As the opponents of cuts argued all along, austerity has gravely damaged economies, tipped some countries into recession and intensified recession in others. (The IMF analysis also shows that some countries – most notably Germany – entirely avoided austerity and increased spending, i.e. they adopted expansionary policies.)

The IMF restrict their analysis to technical matters, but certain conclusions necessarily follow. Austerity, i.e. lower economic activity and higher unemployment, leads inevitably to lower tax revenues and higher expenditure on benefits. These changed flows of money offset any saving the government makes by the original reduction in its expenditure. Under certain conditions, any saving implied by cuts is *entirely* offset, so

¹ <http://www.imf.org/external/pubs/ft/weo/2012/02/index.htm>

that actions taken to supposedly improve the public sector finances actually end up making them worse. These conditions depend on three factors:

1. The extent to which public expenditure revives economic activity: this is captured by the idea of the multiplier;
2. The relation between tax revenues and growth; and
3. The relation between benefit expenditures and growth.

The IMF analysis focused on the first point, the extent to which public spending affects economic activity. Peering behind the technicalities and seemingly slightly skewed range estimate, a (still) conservative estimate for the multiplier effect on the economy is 1½.

What this means is that a *reduction* of 1% in public expenditure will lead to a reduction in national income of 1.5%.

The UK Treasury sees things differently. (See Treasury Economics Working Paper No. 5: ‘Public finances and the cycle’)². It estimates that, government revenues will increase by roughly half of any *increase* in national income, and government expenditures on various benefits will be reduced by a quarter of any increase in national income. Any such figures are highly approximate but are indicative. We may infer that roughly the same ratios would apply in reverse for any *decrease* in national income and government expenditure.

Using this analysis, in the table below we compare three scenarios. First, the outcome of a cut of say, £1000 million in expenditure, and the British government’s assessment of the impact. Second, a cut of £1000 million in expenditure and the IMF’s assessment of the impact. And third, an increase in government expenditure (an expansionary policy) and its impact as analysed by the IMF. (NB M = Multiplier, which, for simplicity, we assume is the same for both an increase and decrease in expenditure.)

Initial policy	Initial outlay	Total impact on economy = (1) * M	Change in tax revenues = (2) * 0.5	Change in benefit etc expenditure = (2) * 0.25	Change in public borrowing =(1)-(3)-(4)
	(1)	(2)	(3)	(4)	
DECREASE IN GOVT SPENDING:					

² http://www.hm-treasury.gov.uk/d/pbr08_publicfinances_444.pdf

Austerity under government view, M=0.5	- 1000	-500	-250	-125	-625
Austerity under IMF view, M=1.5	- 1000	-1500	-750	-375	+125
INCREASE IN GOVT SPENDING:					
Expansionary policy under IMF view, M=1.5	+ 1000	+1500	+750	+375	-125

The first row shows how, under government and previous IMF assumptions, a cut in expenditure of £1000 million leads to a reduction in public borrowing of £625 million.

The second row shows that under the IMF's *revised* estimate of the impact, the same cut leads to an increase in government borrowing of £125 million, i.e. a deterioration in the public finances.

The third row shows the logic that has defied British and Eurozone policymakers: increased public expenditure leads to a cut in borrowing, i.e. an improvement in the public finances. In other words, government expenditure pays for itself.

Of course some types of expenditure will be more effective than others. Expenditure on infrastructure will have the greatest positive impact – that is, the highest multiplier.

This is the point we have argued all along. In a recession the only means to improve the public finances is for the government to invest and create work for both firms (think of the construction sector) and the unemployed. Public investment in sound projects will generate income – wages, salaries and profits. Newly employed workers will spend their income and this will further boost activity and revive the private sector. Confidence will return across the economy; taxes paid on incomes will increase the government's revenues and lower unemployment will mean lower government spending on benefits.

The logic has for some time been perfectly obvious, for example to various BBC Question Time audiences. And official statistics are already beginning to show a deterioration in public sector finances across the Eurozone and (despite the slightly less bad September figures) the UK.

The present policy of austerity degrades both industrial capacity and social well being, with the consequences being played out on the streets of Athens and Madrid.

The tragic fact is that the positive impact of the multiplier is not new to economists. It has been known and applied since the 1930s. The Roosevelt administration's investment in the New Deal is a shining example of how the multiplier works. It was also applied with deliberate action in the UK. But in spite of the protestations of a select but significant minority (e.g. Skidelsky, Krugman, Stiglitz, Portes, van Reenan) many economists (including some on the Financial Times, reflecting no doubt the perspectives of the City of London) have supported a course of action destructive of economic activity, and damaging to the public finances.

The failures and inaction of the economics profession should no longer surprise us. Many simply stand aloof from the fray. But be of no doubt, the policies that many others have supported through government lobbying, newspaper columns and letters to the press, and by half-baked analyses - have severely undermined the stability of the world.

IMF staff appeared to go along with this consensus. But influential IMF economists have now taken decisive action to warn against the dangers of austerity. Their stand is courageous and we owe them our profound gratitude.

The next steps lie with governments and their advisers, and with politicians of all parties. Will they also have the courage finally to admit their error? So far the signs are not good. The people of the world must demand better.

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