

# GEGI Working Paper

RESEARCH FROM THE GLOBAL ECONOMIC GOVERNANCE INITIATIVE

## Is There More Room to Negotiate with the IMF on Fiscal Policy?

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### Executive Summary

During the 1980s the IMF emerged as a global “bad cop,” demanding harsh austerity measures in countries faced with debt problems. Has the Great Recession changed all that? Is there more room to negotiate with the Fund on fiscal policy?

The answer is yes. If we take a close look at what the IMF researchers say and what its most influential official reports proclaim, then we can see that there has been a more “Keynesian” turn at the Fund. This means that today one can find arguments for less austerity, more growth measures and a fairer social distribution of the burden of fiscal sustainability. The IMF has experienced a major thaw of its fiscal policy doctrine and well-informed member states can use this to their advantage.

These changes do not amount to a paradigm shift, à la Paul Krugman’s ideas. Yet crisis-ridden countries that are keen to avoid punishing austerity packages can exploit this doctrinal shift by exploring the policy implications of the IMF’s own official fiscal doctrine and staff research. They can cut less spending, shelter the most disadvantaged, tax more at the top of income distribution and think twice before rushing into a fast austerity package.

This much is clear in all of the Fund’s *World Economic Outlooks* and Global Fiscal Monitors published between 2009 and 2013 with regard to four themes: the main goals of fiscal policy, the basic options for countries with fiscal/without fiscal space, the pace of fiscal consolidation, and the composition of fiscal stimulus and consolidation.



## Mapping out Stability and Change

One should not expect large international organizations to change overnight and radically. The IMF is the case in point. Table 1 shows the extent of changes in the IMF's fiscal doctrine. The text in *italics* indicates post-crisis changes that capture the revisionist (rather than paradigmatic) transformation of fiscal policy doctrine. The table tells us that there to be no dichotomy between a pre-crisis "neoliberal" line and a post-crisis "Keynesian" one, the former emphasizing balanced budgets at all times and the latter centered on counter-cyclical fiscal stimulus packages in the case of recession.

Instead, before 2008 the Fund was already open to selective Keynesian insights such as the counter-cyclical use of automatic stabilizers and even discretionary spending in countries like Japan, the US or China. It is clear, however, that the applicability of these insights became significantly broader after 2008.

Such broadening falls parallel with changes in advice about the timing and composition of fiscal consolidation that generally reduce a recession's pro-cyclical effects and spread the social costs more broadly than before. Although these findings do not necessarily point towards a paradigm shift, the apparent "edits" are quite extensive when compared with the pre-crisis doctrinal script.

**TABLE 1: Pre- and Post-Crisis Themes in IMF Analyses**

<b>Pre-crisis</b>	<b>Post-crisis</b>
The main goals of fiscal policy are growth and the reassurance of sovereign bond markets through credible fiscal sustainability policies.	The main goals of fiscal policy are growth and the reassurance of sovereign bond markets through credible fiscal sustainability policies.
Only high-income economies with fiscal space (stronger fiscal positions, lower public debt) should let automatic stabilizers operate in full, even at the cost of deficits.	<i>All economies with fiscal space (stronger fiscal positions, public debt) should let automatic stabilizers operate in full, even at the cost of deficits. Given the smaller increase in their debts, most developing countries are less likely than wealthy countries to experience substantial increases in debt service over the medium term as a result of their fiscal expansions.</i>
Only high-income countries with fiscal space but weak welfare states (US, Japan) should also use discretionary spending to stimulate the economy even at the cost of deficits. This spending should be directed at tax cuts.	<i>All economies with fiscal space should also use discretionary spending to stimulate the economy even at the cost of deficits. This spending should be directed at public investment in infrastructure and should avoid tax cuts.</i>
Countries for whom fiscal consolidation is the only option should prefer spending cuts over revenue increases.	<i>Countries for whom fiscal consolidation is the only option should balance spending cuts and revenue increases. Fiscal consolidations based solely on spending cuts are less likely to be sustainable.</i>
The cuts should be targeted at public job programs, social transfers, public sector wages, employment, housing and agricultural subsidies. Public investments should not be adopted because they crowd out private investments.	<i>The spending cuts should be targeted at public job programs, social transfers, public sector wages, employment, housing and agricultural subsidies. Public investments should be prioritized, as they do not crowd out private investments in the conditions of the Great Recession.</i>

### Pre-crisis

If fiscal consolidation is in order, it should always be introduced immediately (frontloading). Fiscal consolidation is likely to have expansionary effects on output.

The best tax policy package reduces marginal income taxes, expands the tax base, increases reliance on flat consumption taxes, enforces the neutrality of the tax system.

Low-income countries for whom fiscal consolidation is the only option should prefer revenue increases over spending cuts, particularly cuts of health and education outlays.

### Post-crisis

If fiscal consolidation is in order, it should be introduced *gradually (backloading)*, *unless the country faces collapse in confidence on sovereign bond markets*. Fiscal consolidation is *unlikely* to have expansionary effects on output.

The best tax policy package reduces marginal income taxes, expands the tax base, enforces the neutrality of the tax system, *increases taxes on dividends and the estates of the wealthy, adopts financial transaction and environmental taxes, aggressively pursue off-shore wealth,*

Low-income countries for whom fiscal consolidation is the only option should prefer revenue increases over spending cuts, particularly cuts of health and education outlays.



### Not all Changes are Equal

These are important revisions but their depth and span varies over time. There was a great deal of fiscal policy optimism in 2008 and 2009, but by 2010 the tone changed in favor of an earlier exit from stimulus. The 2010 GFM report applauds the unwinding of the discretionary stimulus in all countries with fiscal space and turn to consolidation. Yet the 2010 report also reflects support for continued stimulus in fast-growing emerging markets with excessive external surpluses and low debt. The bumper sticker is: “a down payment on consolidation now with continued gradual tightening over the medium term” (GFM 2010).

This advice is based on optimistic projections that consolidation has a low fiscal multiplier that is less than 1 and on the assumption that medium and long-term fiscal measures are not sufficient to reassure markets. Nevertheless, the departmental reports leave the door open to expansion in wealthy countries with fiscal space, should economic activity fall short of WEO projections. The reports also caution against an “abrupt fiscal withdrawal” (a cut in the deficit greater than 1

percent a year) and state that the output cost of a 1 percent of GDP fiscal consolidation can double to 2 percent for a small open economy where the interest rate is at the zero lower bound and consolidation is done by almost all countries at the same time.

In 2011 the reports swing to a more orthodox line. The IMF documents praise Europe's strong frontloading of austerity and make optimistic projections of its effects on credibility. Moreover, based on a FAD study showing that bond yields in emerging markets are very sensitive to global risk aversion, they counseled for low and middle-income economies to rebuild fiscal buffers and cut spending despite the fact that they were facing less market pressure than developed countries. The report contains an unambiguous denunciation of the expansionary austerity thesis.

Subsequent reports qualify this doctrinal retrenchment. The 2012 GFM and WEOs acknowledge that fiscal multipliers of consolidation were much larger than the Fund realized and therefore advised slower adjustment in countries with low credibility. The reports also stress the importance of expansion in countries with credibility and criticize the harsh spending cuts in the U.S. and the Eurozone. Critically, both reports warn that austerity could be self-defeating as its negative effects on output have already increased public debt in countries that implemented the most aggressive spending cuts. Also in 2012 and 2013 in the GFMs and WEOs emerge call for tax reforms that shift some of the burden of consolidation onto the wealthy.

What do we make of this? If you look closely, these changes can be traced to IMF staff research. So **know your IMF staff research to increase your leverage in negotiations with the Fund**

Staff research is not just an exercise in intellectual futility. The defining moment of the Fund's intellectual evolution was the publication on December 29, 2008 of a joint RED-FAD staff position paper (Spilimbergo, Symansky, Blanchard, and Cottarelli 2008). The paper was co-authored by Blanchard and Cotarelli among others and laid down the groundwork for macroeconomic policy during recessions: "[a] timely, large, lasting, diversified, and sustainable fiscal stimulus that is coordinated across countries with a commitment to do more if the crisis deepens" (Spilimbergo et al. 2008, 2).

Its reasoning went as follows: given the collapse in private demand, states should not only let automatic stabilizers run, but also ramp up public investments and expand the reach of income transfers to those who were more likely to spend (the unemployed and poor households). Against the Fund's pre-2008 policy line, the authors stressed the role of public investments and downplayed the expansionary virtues of tax cuts. To this end they deployed the Keynesian argument that tax cuts are more likely to be saved. The authors also dismissed once-fashionable IMF policy advice such as exclusive reliance on activist monetary policy and export-led recovery. They also spurned as irrelevant the well-worn orthodox objection that spending increases have long lags. Given the Fund's mission to ensure relative

stability in the sovereign bond market, there were also big caveats. The paper stressed that only countries with fiscal space could afford a stimulus and that expansionary measures should be reversible. Expansionary measures should also be announced in parallel with measures that ensure fiscal sustainability such as permanent cuts in healthcare and pension budgets in the medium and long term.

Such changes have had far-reaching consequences for the Fund's official doctrine. When the official fiscal policy pronouncements of RED and FAD came up in 2009 and 2010 evidence of the origins of doctrinal change and continuity in staff research was there for all to see. We now turn to five lessons that emerge from the IMF staff studies cited in the reports.



## **Austerity, Growth and Social Fairness in Five IMF Lessons**

### ***1. Whenever possible, stimulate and tax***

In 2009, WEO uses staff research to call for a fiscal stimulus (Spilimbergo et al 2008; Decressin and Laxton 2009; Clinton, Johnson, Kamenik, and Laxton 2009; Cihak, Fonteyne, Harjes, Stavrev, and Nier 2009). The GFM does too and adds that in the context of the lower tax collection rates in a crisis-ridden environment, governments should strengthen tax institutions rather than cut taxes (Brondolo 2009). The report also renounces the claim that policies that make income taxes more progressive lead to a decline in revenues (Baunsgaard and Simansky 2009).



### ***2. When you have to be austere, don't rush. Try to tax financial transactions, and if you cut spending don't expect expansion as a result.***

In 2010, the year of the turn to austerity in Europe, a more qualified endorsement of fiscal stimulus is apparent. WEO cites studies warning of high

debt and deficits' negative effects on output and market credibility (Baldacci and Kumar 2010; Kumar and Woo 2010), while the GFM reiterates arguments against extensive debt restructuring. Yet most of the cited studies contain anti-austerity implications. WEO asks countries to refrain from frontloading consolidation based on IMF research that finds high risks of deflation (Decressin and Laxton 2009). The studies cited in GFM find that beyond a certain threshold of adjustment spending cuts are no longer effective (Baldacci and Gupta 2010; Blanchard and Cotarelli 2010). Critically, WEO debunks an iconic study of the austerity camp (Alesina and Perotti 1997) and uses Blanchard's 2002 methodological innovations to show that fiscal stimulus packages have higher multipliers than consolidation and that the latter is contractionary and increases unemployment during recessions (Freedman et al 2009; Clinton et al 2010). The 2010 GFM's citations echo the December 28, 2008 paper (Spilimbergo et al 2008) and suggest that financial transaction taxes are an appropriate contribution to the fiscal sustainability effort (Keen et al 2010).



### **3. If the markets force you to be austere, make sure you turn this into an opportunity to reduce inequality.**

The 2011 WEOs and GFMs cite IMF studies that try to balance austerity and stimulus while starting a discussion about how the costs of consolidation should be distributed. The WEO critiques existing medium-term adjustment plans for vagueness and renders them consequently incredible (Bornhorst, Budina, Callegari, ElGanainy, Gomez Sirera, Lemgruber, Schaechter, and Shin 2010). The 2011 report at the same time endorses front-loaded fiscal consolidation on the spending side in Southern Europe and Ireland (Bornhorst et al 2010). But other cites are less hawkish. The report cites research that stresses the importance of current account deficit reduction in debtor countries and expansion in surplus countries (Blanchard and Milesi-Feretti 2009; 2011; Lane and Milesi-Feretti). It also warns that countercyclical budget rules are better for fiscal sustainability than balanced budgets (Kumhof and Laxton 2009). The report is also ambivalent about the effects of fiscal consolidation on reducing the external deficit (Clinton et al 2010). The studies cited by GFM emphasize the importance of pairing fiscal consolidation and structural reforms (Allard and Everaert 2010) and warn about the fiscal risks of declining credit ratings (Jaramillo 2011; Jaramillo and Tejada 2011). WEO inveighs- yet again- against the expansionary austerity thesis of Alberto Alesina and

colleagues at the time his followers were shaping fiscal policy in Europe (Blyth 2013). The 2011 WEO finally endorses IMF research that calls for a more progressive distribution of income and reproduces research that indicates that financialization boosts inequality and inequality contributes to unsustainable growth trends such as those that predated the Great Recession (Berg and Ostry 2011).

While still alert to sustainability issues, the 2012 report indicates an interest in IMF studies that warn about the risk of self-defeating austerity. One of the studies cited in WEO deplores growing inequality and unemployment and layers demands for more income redistribution on top of old IMF recipes (retraining, better education, increase productivity in the service sector) as the price that may be needed to avert a protectionist backlash (Dao and Loungani 2010). The emphasis on the inequality-unsustainable growth nexus is reaffirmed (Berg and Ostry 2011) and the cited studies go beyond conventional recipes to endorse more redistribution and to boost aggregate demand in the short term to help labor markets recover (Ball, Leigh, and Loungani 2011).



#### **4. Harsh austerity can increase your debt levels, making it self-defeating so avoid it if you can.**

Most importantly, although more research warns about the importance of medium-term fiscal frameworks for keeping debt in check (Berg and Ostry 2011; Kumar and Woo 2012), there is a resolute turn against frontloaded austerity in the 2012 WEO. There are warnings about the risk of deflation (Decressin and Laxton 2009) but what is particularly striking is that two new lines of attack appear. The most important is the finding that since 2008 the economic slack was so large, the interest rates so low, and fiscal adjustment so synchronized that fiscal multipliers were constantly well over 1. This finding implies that the IMF underestimated the negative effects austerity had on output because it assumed values of the fiscal multiplier that were too low (Batini et al 2012). This concern is echoed in IMF studies cited in the year's GFM (Baum, Poplawski-Ribeiro, and Webel 2012). Second, even as another cited study encouraged spending cuts in health, pensions and public employment in wealthy countries like Italy, its findings also stressed that fiscal consolidation had been ultimately self-defeating in the past because it increased public debt levels (Ball et al 2011). The same finding is echoed in studies cited in GFM that argue that consolidation when the multiplier is high erodes some of the gains in market credibility as a result of a higher debt ratio and lower short-term growth, which causes an increase borrowing costs (Cotarelli et al 2011; 2012).



## **5. Rather than focus on spending cuts, get serious about taxing real estate wealth, offshore wealth and financial transactions.**

IMF research cited in the 2013 reports makes similar points but unprecedentedly emphasizes raising more revenue via more taxation of the wealthy. In WEO, deflation warnings from a 2002 paper are sounded yet again (Decressin and Laxton 2009) and the need for stimulus in countries that enjoy fiscal space is reaffirmed (Blanchard and Leigh 2013; Spilimbergo et al 2008; Kang et al 2013; Ostry and Ghosh 2013). Such ideas co-habit in the report with warnings about the growth-depleting effects of high debt (Kumar and Woo 2010). The GFM struggles to achieve a similar balance. It cites studies that establish the ineffectiveness of default (Das, Papaioannou, Gregorian and Maziad 2012; Borensztein and Panizza 2009) and inflation (Akitoby, Komatsuzaki, and Blinder 2013) as debt reduction strategies while stressing the importance of reducing debt. At the same time, the GFM cites studies that seem to represent a new taxation philosophy at the Fund. They continue to endorse a few old recipes (the reduction of income taxes while increasing consumption, the scrapping of loopholes in personal and corporate income tax, the elimination of differential VAT rates, resistance to high marginal income tax, reduced employers' social contributions) yet also advocate greater reliance on taxes targeted at the wealthy: property taxes targeted at the top 1 percent (a measure estimated to raise between 2-3 percent of the global GDP in new tax revenue), financial transactions tax, and a coordinated taxation of offshore incomes (Torres 2013; Acosta and Yoo 2012; Norregaard 2013).

## **Conclusion**

In sum, at least with regard fiscal policy, the IMF is no longer your grandfather's "bad cop" but it has not become a full-fledged Keynesian superhero either. You can use its research to negotiate more fiscal space and more progressive redistribution outcomes, but only as long you convince them that bond markets give you "fiscal space." You can squeeze the top one percent a bit more and even follow them in off-shore havens. But, overall, it all depends on whether your decisions are thought by the Fund to be in the range of behaviors that sovereign bond traders approve of and that call is, of course, still in the exclusive province of the IMF.

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