WHAT WORKS
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International Labour Organization

HOW TO BALANCE FISCAL RESPONSIBILITY WITH EMPLOYMENT OBJECTIVES?

The combination of weak global commodity prices and recessions in several major emerging economies has resulted in renewed calls for fiscal consolidation. However, the austerity policies that dominated in many developed countries after the global financial and economic crisis of 2008 have, by and large, been proven to have been counterproductive: not only in terms of debt sustainability, but also as means of boosting employment growth. As a number of emerging countries grapple with revenue constraints and weak growth, it is important to learn lessons from recent experience in this area, and to bear in mind that fiscal and employment goals can be achieved together. In this regard, both the pace and nature of fiscal consolidation are of the utmost importance.[1]

Key findings

- Efforts to improve fiscal sustainability during periods of low economic growth need not necessarily come at the expense of employment creation.
- A fiscally-neutral change in the expenditure and revenue composition of fiscal consolidation can boost job creation.
- Finding the right policy mix – one that is mindful of both the composition of fiscal consolidation and its time horizon – is central to attaining the twin objectives of fiscal responsibility and employment growth.

Research question

During the height of the 2008 financial and economic crisis, governments around the world, notably those of the G20, provided substantial fiscal stimulus to boost economic activity. These efforts prevented the global recession from deepening and helped stop unemployment from rising further. However, the boost to aggregate demand was short lived: private investment and consumption failed to pick up and weak economic growth persisted (and continues to persist relative to historical trends). Against this backdrop of weak demand and falling government receipts, public debt rose substantially.

Faced with the prospect of high public debt and weakening aggregate demand, many countries around the world, principally advanced economies, shifted their policy approach away from supporting jobs and instead embarked on a phase of fiscal consolidation. This approach was viewed, in many instances, as a way to calm financial markets in the short term and, more fundamentally, to pave the way for private investment and growth (and, in turn, job creation). However, given that it was implemented during a period of low confidence, it instead weakened demand further, failed to spark private investment and led only to deterioration in public finances. More specifically, the policy approach led to a worsening of the employment outlook and, as unemployment and long-term unemployment rose, household income fell, thus suppressing demand further. The result was a vicious cycle of weak demand, falling consumption and delayed investment.

1 This What Works Research Brief is based on "The employment effect of changes in the composition of fiscal consolidations", *International Review of Applied Economics*, Vol. 31, No. 1, pp 45–68 (Escudero and López Mourelo, 2017).

The implications of this downward spiral reverberated across the rest of the world, in part triggering the slowdown in major emerging economies that began in 2015. In fact, global GDP growth hit a 6-year low in 2016 due to deeper than anticipated contractions in several major emerging economies, such as Argentina, Brazil and the Russian Federation. The slowdown continues to be particularly marked among commodity exporters and, as a result, their fiscal balances have come under pressure. Therefore, many of these countries are considering or have already embarked on dramatic cuts to expenditures. This could have important implications on unemployment in these countries (which in some instances is already on the rise), but it might also have negative spillover effects. Indeed, while a number of developed economies, particularly in the EU, have benefited from lower commodity prices, they could nevertheless be negatively affected by austerity policies in the emerging world (box 1).

Box 1. A return to austerity? The potential impact of fiscal consolidation on global unemployment

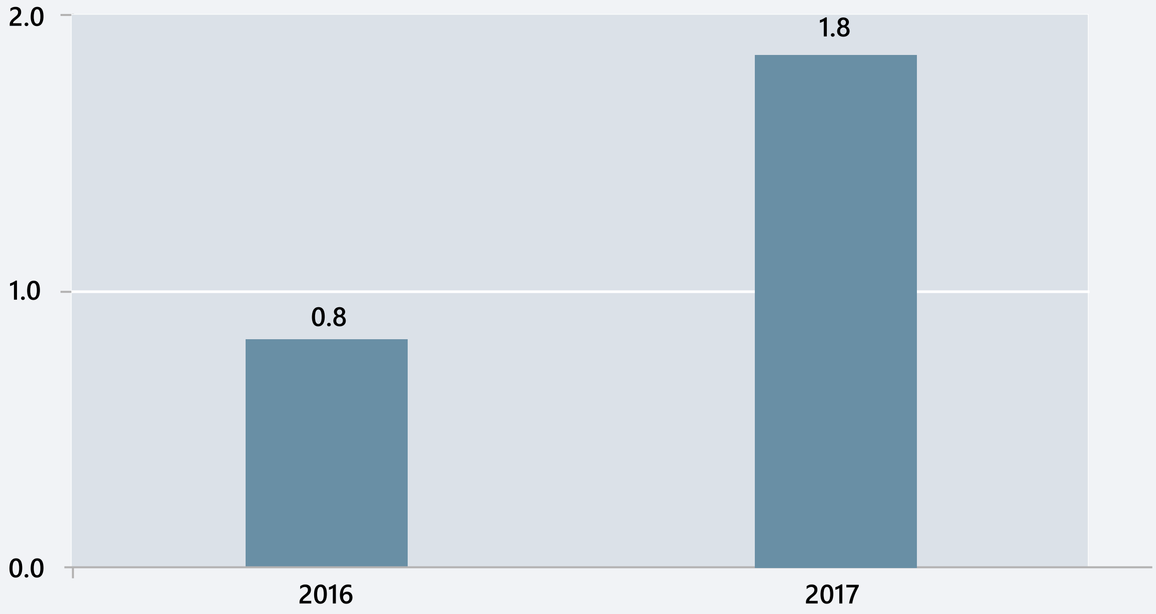
Between 2004 and 2015, commodity exporters had come to rely heavily on high oil prices to achieve a fiscal balance. Now that oil prices are hovering at levels well below those seen during that period, some commodity exporters have begun (or are considering) to embark on efforts to consolidate fiscal expenditures. The question that remains to be answered is, what effect will fiscal consolidation have on unemployment?

To assess the potential impact of fiscal consolidation on unemployment, the ILO Research Department has carried out a number of estimations, with interesting results.

For example, if we assume that commodity exporters reduce their expenditures by half of the additional deficit they incurred due to the fall in commodity prices by 2017, we would expect 37 countries to reduce their expenditures, and that the average reduction in expenditure would be equivalent to 2.4 per cent of GDP.

Under such a scenario, unemployment would increase by 1.8 per cent globally, with the larger share occurring emerging markets (where the majority of commodity exporters are located). The reduction in demand from these economies would mean that developed countries are also negatively affected, but to a much lesser extent.

Figure 1. *Potential unemployment increases in a scenario involving expenditure cuts by commodity exporters (percentages)*



Source: ILO, *World Employment and Social Outlook Trends 2016.*

What works?

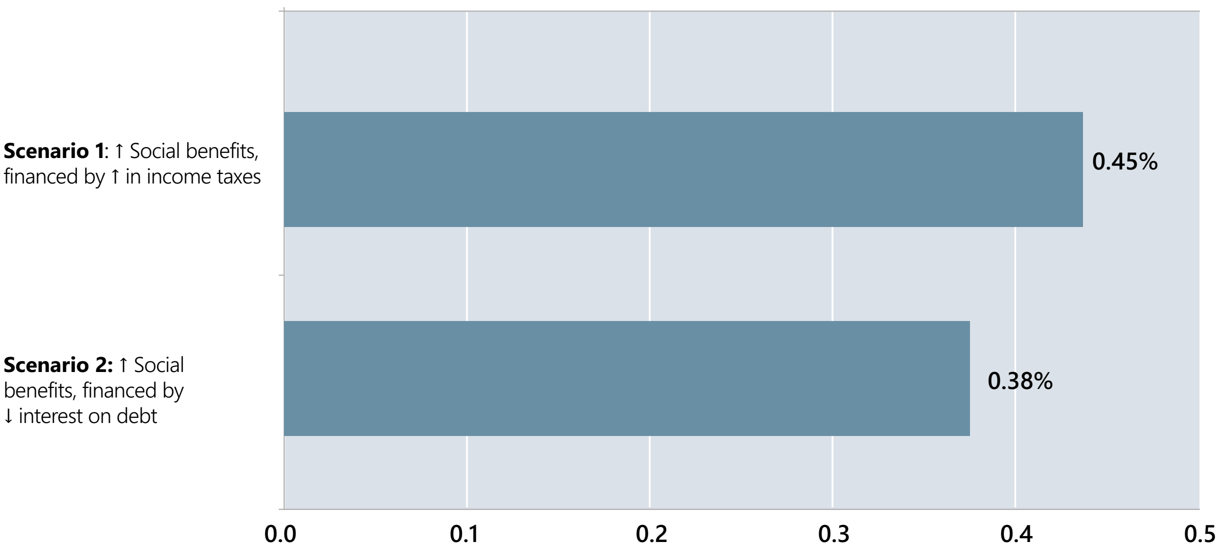
The question is, therefore, how will large emerging economies react to falling revenues caused by the growth slowdown and lower commodity prices? Are there ways to kick-start growth and create quality employment opportunities without damaging public finances? To help answer this, there are lessons from the experiences of advanced economies that can be shared. In particular, in an effort to study the employment implications of different consolidation strategies and shed light on how fiscal and employment goals can be achieved together, an empirical analysis was carried out, based on recent austerity measures adopted by advanced country governments during the 2008 economic crisis. The results of the analysis are illustrated through a number of scenarios, which show that poorly designed fiscal cuts will have a dampening effect on job prospects. In particular, two fiscally-neutral (i.e. no deterioration in public finances) scenarios[2] are outlined here to shed light on how a change in the expenditure and revenue composition would affect job creation (figure 2).

The first scenario assumes a 1 percentage point increase in social benefits (e.g. contributory and non-contributory social insurance benefits) that is financed by an equivalent increase in income taxation (scenario 1). Under this scenario, employment would rise by 0.45 per cent in 1 year (compared with the baseline scenario of continued fiscal consolidation,[3] where employment would increase by a meagre 0.2 per cent).

The second scenario assumes a similar boost in expenditures on social benefits, but rather than raising income taxes, the spending is financed by reducing interest payments on debt (scenario 2). Such a scenario gives an employment boost in the order of 0.38 per cent. And while the policies assessed in scenario 2 are unlikely to be operational for many countries (countries do not often have the ability to refinance their debt at lower interest rates or reduce the cost of existing debt), they nevertheless illustrate that a strategy that balances long-term debt reduction and employment policies can be more effective that one narrowly focused on debt reduction.

It should be noted that the aim of this analysis was to show the relative magnitudes of different spending compositions on job creation. Therefore, the scenarios are not intended to suggest there is one correct policy mix, but rather that fiscal goals can be consistent with employment objectives.

Figure 2. *Employment gains under different policy mix scenarios (percentages)*



Source: ILO calculations based on Escudero and López Mourelo, 2017.

2 Additional scenarios to those presented in this brief are available in Escudero and López Mourelo (2017).

3 The continued fiscal consolidation corresponds to austerity in the 2011 form. This is a combination of a cut in public wages (1.98 per cent), a decrease in public investment (7.82 per cent) and an increase in income taxes (3.8 per cent).

Policy considerations

Optimal policy decisions vary substantially in time and across countries due to a range of economic, social and political factors. It is clear there is no panacea to the problem of poor employment performance during periods of weak growth. However, as suggested by this brief, and the detailed analysis on which it is based, a number of policy lessons can be drawn from the varied policy approaches that governments of advanced countries adopted in response to the 2008 crisis. The main lesson is that, if properly designed, fiscal responsibility does not need to come at the expense of job creation.

Fiscal consolidation can be counterproductive during periods of weak demand

When economic growth weakens, government revenues fall. This can result from several often inter-related factors. For instance, in commodity exporting economies, when the price of oil or other natural resources falls, government revenues are often directly affected. In other instances, economic growth might weaken because of declining confidence and weak investment, which in turn negatively affects consumption and income tax revenue – leading to an erosion of public finances. As revenues fall, governments have the choice of either reducing expenditures, in an effort to boost market confidence and stabilize fiscal balances, or prioritizing public investment and employment, to support the economy until private sector demand recovers. Unfortunately, the former alternative was adopted by most advanced countries during the 2008 crisis.

When a reduction in expenditures takes place during a period of slow growth, rather than stabilizing the economy it can instead create a vicious cycle of dampened confidence, lower consumption, weak investment, job losses and, ironically, a worsening of government revenues, which in turn opens the door to more fiscal consolidation.

Therefore, as major emerging economies grapple with balancing budgets, they should bear in mind these results and factor in the evidence that the timing of fiscal consolidation is central to any strategy aimed at boosting confidence, economic activity and jobs – otherwise the approach risks being counterproductive and self-reinforcing. Moreover, in the face of weak global demand, cutting fiscal deficits could also have negative spillover effects, affecting other countries and exacerbating the global situation.

Composition of fiscal consolidation matters

Importantly, in the face of diminished revenues and increased pressure to reduce fiscal imbalances, and given the limitations of monetary policy, the key question is how can fiscal policy be used to stimulate economic activity and boost job creation without damaging public budgets? As the empirical evidence summarized in this brief shows, fiscally-neutral changes in the revenue and expenditure composition could boost job creation. For this to occur, emphasis will need to be placed on both employment and socially-oriented expenditure and revenue items.

In other words, as countries seek ways to trim expenditures, in order to reach both employment and debt objectives, it is central to consider a shift in the composition in spending and revenues towards job- and social-friendly measures (e.g. social benefits and income taxes). Such an approach, as the Brief has highlighted, would lead to job creation, higher revenues and, eventually, improved public finances.

Further reading

Escudero, V.; López Mourelo, E. 2017. "The employment effect of changes in the composition of fiscal consolidations", in *International Review of Applied Economics*, Vol. 31, No. 1, pp. 45–68.

International Labour Organization (ILO). 2012. *World of Work Report: Better Jobs for a Better Economy* (Geneva, International Institute for Labour Studies).

—. 2016. *World Employment and Social Outlook Trends 2016*, January (Geneva).

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