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Is Austerity the Most Effective Policy to Solve the Present Financial Crisis?

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The current policy of salary reductions might have been the only available emergency measure for the KRG to counter its empty treasury. However, continuing the current policy, focusing on a single sector of the economy is an unsuitable response to the on-going financial crisis and is likely to significantly dampen and delay recovery.

Background

In response to the financial crisis in the Kurdistan Region of Iraq (KRI) many policy makers and political observers have advocated the need to reduce government spending and increase revenue. This in economic terms translates to austerity. Plummeting oil prices, federal budget cuts, hosting enormous numbers of refugees and IDP's, involvement in the war against the Islamic State (IS) and endemic corruption have strained the Kurdistan Regional Government's (KRG) – and the Iraqi government's – budget, leading to large budget deficits. The private sector is crippled because of a lack of liquidity. The KRG, as a countermeasure, has started paying partial salaries in arrears and halted most, if not all, development and infrastructures projects. The question remains: is this policy, which has been in place since 2015, working?

Foundational economist John Maynard Keynes wrote in 1937, "The boom, not the slump, is the right time for austerity at treasury." Austerity is appropriate during an economic boom to attain a fiscal surplus and keep inflation in check. Interestingly, nearly every country that suffered a budget deficit after the 2007-2009 market crash turned to austerity in 2010, with the aim of resuming economic growth. They were influenced by a study "Growth in a Time of Debt" conducted by Harvard professors Carmen Reinhart and Kenneth Rogoff. However, time and again it has been shown that austerity fails to boost growth, and spending cuts inflict greater damage on weak economies than policymakers expected.

The KRI's Gross Domestic Product (GDP) consists of consumption, investments, government spending, and negative net export. Consumption heavily depends on disposable income. However, the vast majority of the workforce in the KRI is employed by the public sector thus any cuts in government-paid salaries will adversely impact the disposable income – therefore consumption – of a large portion of consumers.

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Private investment in the KRI has been reduced drastically; investors are increasingly hesitant to invest due to the risks associated with insecurity, political instability, and corruption. Additionally, investors have traditionally relied on government loans and procurement; therefore, any cuts in the government budget will have a significant impact on the overall investment as well as the overall GDP.

The KRI is currently running a negative net export and due to current policies, the GDP is shrinking while poverty and unemployment rates are rising. Consequently, continuing the current policy of reducing (by "withholding") salaries, focusing on a single sector of the economy, and putting extra pressure on low and middle income families is an unsuitable response to the on-going financial crisis and likely to significantly dampen and delay recovery. The current policy of salary reductions might have been the only available emergency measure for the KRG to counter its empty treasury, but sustaining this policy in the long run is arguably counterproductive in an imploding economy.

Consequences of Austerity

In late 2012, the IMF admitted that austerity is much worse for economies than was generally thought, and in its biannual World Economic Outlook it stressed that efforts among wealthy countries to shrink deficits through tax hikes and spending cuts has done far more damage than experts had assumed. In the KRI, the consequences of the current austerity policies are clearly palpable. Many young, talented and highly educated employees are leaving the country or resigning permanently from government employment to seek better job opportunities. Evidently, those leaving government jobs are among the most competent and work in vital sectors, which may face further deterioration in efficiency and quality. Moreover, there is also the issue of efficiency lost to phantom-employment, cronyism, and corruption, which remain problems that contribute to the decay of the government budget.

Furthermore, the middle class in the KRI has been experiencing a squeeze with many falling below the poverty line. Others, who constitute the majority among the consumers are losing confidence in the economy and are spending less. If the current austerity and downward trends continue, a deflationary spiral may occur. As a consequence, the entire economy could collapse, or demand could continue to decrease, leading to incremental aggregation of the recession with a chronic depression of the economy.

Solutions

The perfect remedy for the deep financial crisis would have been a fiscal stimulus, had Erbil and Baghdad's coffers not been empty. However, there are several alternatives, both at a macro and micro-economic level. It is time to reverse the fiscal squeeze and revise the negative policy of pay cuts of public sector workers. Of course reversing this policy will put extra pressure on the KRG's budget. But in order for the KRG to support the economy, it must support consumption growth, which must be supported by income growth. To counterbalance this extra pressure, the KRG can implement a degree of selective spending cuts, impose a moderate tax system, and reduce subsides, in addition to other options.

In this sense, the following approaches represent some more suitable options for the KRG in response to the economic crisis. However, it is important to note that politics and economics are always intertwined. Hence all the KRI's political parties must pursue political concessions and resume parliamentary sessions to produce legislation and act as a monitoring body.

Short-term measures

- **Increase Revenue:** by increasing taxes on luxurious and demerit goods. Although this will not collect enough revenue to fix the budget shortfall, a sin tax will reduce consumption of goods with long-term, negative, external effects that are a drag on the productivity of the economy. Remove tax amnesties and exemptions. Currently, investment law in the KRI exempts many internal and external investors from paying taxes. Lifting this immunity or limiting the exemption period will create another source of revenue for the government. Introduce incremental fines and penalties for minor offenses such as traffic violations, littering, polluting and so on, these will create a culture of compliance with the law and respect for regulation. These of course, have to be accompanied by investment in improved services.

- **Save:** by gradually removing utility subsidies, especially energy subsides. Annually, the KRG spends billions of dinars on subsidizing both energy consumption and production. This subsidy has created a large burden on the government's budget, distorted prices, and caused inefficiency. Removing this subsidy and letting the market dictate the price per unit produced and consumed will encourage households to use it more efficiently, and investors to invest in this sector. In the short-run, removing subsidies will negatively impact low and middle-income households. But in the long run, it will be compensated by increased efficiency, improved services, and more reliability in the availability of electricity.

Long-term measures

- Persuade the Central Bank of Iraq (CBI) to activate its branches in Erbil and Sulaymaniyah and restore its link with, and authority over the region's central bank branches. In return, the CBI should allow the Iraqi Dinar to devaluate in order to revive the economy. Subsequently, it would restore national and international confidence in the KRI's banking system.
- Privatize several public utilities and services that the private sector can manage efficiently and at a lower cost than the government, such as water supply, electricity, and building bridges and roads, etc. Lack of funds has prevented the government from finishing development and infrastructure projects or starting new ones. The KRG can hand over these abandoned projects, and future projects, to the private sector through proper rules and regulations that protect the interests of consumers, taxpayers, and investors. Ceding these categories of projects to the private sector will create more job opportunities outside the public sector.
- Crackdown on corruption, following any financial crisis, corruption significantly reduces the success of any attempts to consolidate budgets. Corruption affects all sectors of the KRG, from top to bottom, and has not only weakened the KRI's economy, but also contributed to the political instability and paralysis. Thus, to get the economy on the right track, policymakers must make the eradication of corruption a top priority. Good governance, rule of law, and transparency are essential preconditions to ensure success in any economy.

Conclusion

Designing, formulating and implementing any strategic economic plan to mitigate current, and avert future, economic and financial crises in the KRI is achievable. The KRG must demonstrate political will and determination, which are paramount for a country in crisis, in order to consider policy options and implement them according to comprehensive plan.

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