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SUPPORTIVE MACROECONOMIC AND INDUSTRIAL POLICIES FOR A BROAD-BASED, JOB-RICH RECOVERY

SUPPORTIVE MACROECONOMIC AND INDUSTRIAL POLICIES FOR A BROAD-BASED, JOB-RICH RECOVERY

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Garments workers gathered on a ferry as they travel back to Dhaka for resume and return to their work areas during lockdown Shimulia ferry ghat in Munshiganj, on July 31, 2021. — Photo by mamun11021981@yahoo.com

INTRODUCTION

This paper responds to the resolution of the 109th General Conference of the International Labour Organization (ILO): "A global call to action for a human-centred recovery from the COVID-19 crisis that is inclusive, sustainable and resilient", adopted in June 2021.[1] The resolution suggests, among other actions, the pursuance of "supportive macroeconomic, fiscal and industrial policies that also foster equity and stability". Thus, this paper aims to outline basic features of supportive macroeconomic and industrial policies for a broad-based, job-rich recovery from the COVID-19 crisis.

The paper begins by highlighting the key features of the ILO resolution and its significance, followed by a brief overview of the context necessitating the adoption of the resolution in favour of supporting macroeconomic and industrial policies. In particular, the paper highlights falling labour income share and rising inequality, and reflects on the causes of such trends that have been exacerbated by the COVID-19 pandemic. The paper then debunks the myths that drive the current neoliberal economic policy paradigm, followed by a presentation of the evidence base for supportive macroeconomic policies. It then outlines the necessary features of supportive macroeconomic and industrial policies for inclusive, sustainable, resilient and job-rich recovery. The paper also contains several case studies highlighting features of such policies.

Notes on break-out boxes
The boxes whose sources are not mentioned are written by the author. Those with sources mentioned are reproduced from the sources with minimum changes.

1 https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---relconf/documents/meetingdocument/wcms_806092.pdf (3/10/2021)

BOX 1: FISCAL, MONETARY AND INDUSTRIAL POLICIES

Policymakers have two main economy-wide tools of macroeconomic policy at their disposal – fiscal policy and monetary policy – to mitigate economic fluctuations (that is, stabilisation), and to induce sustained high enough economic growth with "reasonable" price and exchange-rate stability in order to absorb a growing labour force into productive employment. These have to be supplemented with sectoral or micro-level policies to achieve desirable outcomes or steer the economy in particular directions, such as low-carbon and more employment-intensive activities. Industrial policy is critical in this regard.

Fiscal policy is the use of government spending and taxation. Governments influence the economy by changing the level and types of taxes and the extent and composition of spending. Ministries of finance or treasury are responsible for designing and conducting fiscal policy and reflecting governmental economic programs or priorities, as set out in annual budgets.

Monetary policy entails adjusting the supply of money in the economy to achieve some combination of price and output stabilisation. It is conducted by central banks through adjustments to interest rates, bank reserve requirements and the purchase/sale of government bonds and foreign exchange. The interest rate that central banks focus on is called "policy rate" – a short-term, often overnight, rate that banks charge one another to borrow funds. By raising the policy rate, for example, central banks raise the borrowing cost for banks to reduce their borrowing and lending. Commercial banks are required to keep a certain percentage of customer deposits with central banks as security. Since central banks determine this requirement, they may, for example, reduce it during economic downturns to enable banks to lend more. Finally, central banks can influence money supply by buying and selling government securities, and foreign exchange, known as "open market operations". When central banks buy, they inject money into the system, and when they sell, they withdraw (or soak up) money from the system.

Industrial policy strategically encourages the development and growth of the economy, often focused on all or part of the manufacturing sector. It aims at improving the competitiveness and capabilities of domestic firms and promotes structural transformation. Traditional examples of industrial policy include subsidising export industries and import substitution industrialisation (ISI), where trade barriers are temporarily imposed on some key sectors, such as manufacturing. By selectively protecting certain industries, these industries are given time to learn (learning by doing) and upgrade. Once competitive enough, these restrictions are gradually lifted to expose the selected industries to the international market. Contemporary industrial policies are more complex, involving both "vertical" and "horizontal" measures. Vertical measures, such as subsidies, tax holidays, or support for specific firms or industries, are often referred to as "picking winners", and may also involve "supporting losers". Horizontal measures, such as infrastructure spending and support for research development, are non-discriminatory, targeting broad sectors by improving their overall business environment. Contemporary industry policy can be labelled as having a "matrix approach" (Aiginger and Sieber 2006) which increasingly supports linkages between firms and upstream technologies.


Photo: Public Services International

THE ILO RESOLUTION AND ITS SIGNIFICANCE

The ILO resolution commits governments, employer organisations and worker organisations to "placing the aim of full, productive and freely chosen employment and decent work, the needs of the most vulnerable … [and] to build forward better from the crisis" (p. 4).

Recognising the need to tailor strategies to "specific situations and taking into full account of national circumstances and priorities" (p. 4), the resolution identified four broad deliverables towards implementing it. They are:

1. Inclusive economic growth and employment
2. Protection of all workers
3. Universal social protection
4. Social dialogue (pp. 4-9)

The resolution also identified 11 action areas under Deliverable 1: Inclusive economic growth and employment. The first on the list is:

> *Provide for a broad-based, job-rich recovery with decent work opportunities for all through integrated national employment policy responses, recognising the important role of the private and the public sector and the social and solidarity economy, including:*
>
> 1. *supportive macroeconomic, fiscal and industrial policies that also foster equity and stability; and*
> 2. *appropriate public and private investment in sectors hit hardest by the crisis, such as hospitality, tourism, transport, arts and recreation and some parts of retail, and those with strong potential to expand decent work opportunities, such as the care economy, education and infrastructure development (p. 4)*

This paper focuses on the "supportive macroeconomic, fiscal and industrial policies that also foster equity and stability; and … appropriate public investment" (p. 4), emphasising the following key phrases of the ILO resolution:

- human-centred recovery that is:
  - inclusive,
  - sustainable, and
  - resilient.
- full employment that is:
  - productive,
  - decent work, and
  - freely chosen.
  - the needs of the most vulnerable, and
  - build forward better from the crisis

SIGNIFICANCE

It is critical to note the resolution's reference to "build forward better" as opposed to the commonly cited phrase, "build back better". This signifies a fundamentally different approach to recovery. The phrase "build back better" is backward looking; hidden in it is a desire to maintain the status quo, albeit with less-sharp edges. On the other hand, "build forward better" emphatically declares that the status quo is not acceptable, no matter how "soothing" or "smoother" it is made to look; it would be "old wine in a new fancy bottle". As Nobel Laureate Joseph Stiglitz said, "We need a comprehensive rewriting of the rules of the economy" (2020, p. 18).

Thus, the ILO resolution is about a new economic governance architecture that respects universal human and labour rights (full employment, inclusive, needs of the most vulnerable, freely chosen, productive decent work) as well as the earth's planetary boundaries (sustainable and resilient).

In short, the resolution is revolutionary. It demands a major shift from neoliberal economic governance approaches which have dominated since the 1980s, with their focus on debt, deficits and inflation that assume sustained, sustainable, and inclusive growth; full, productive, decent employment; and gender equity in income, wealth and opportunity would follow or "trickle down". The neoliberals, putting their faith in the efficiency of markets, argue against active industrial policies, including regulations protecting the environment and labour rights. Instead, they promote privatisation, liberalisation, and deregulation in favour of unfettered markets, believing in self-regulating markets.

However, despite pursuing such economic policies and governance approaches for over four decades, the world has become dangerously warmer, making climate change an existential threat. While the share of wages (or labour) in national income declined persistently in most countries – developed and developing – inequality of all sorts (income, wealth, opportunity, and gender) increased around the world. Deindustrialisation in developed countries and premature deindustrialisation in many developing countries increased economic vulnerability and job insecurity, whereas increased financialisation has led to declining productive investment and hence productivity. The world has also witnessed more frequent and deeper financial and economic crises; for example, the Latin American debt crisis in the 1980s, the 1997 Asian financial crisis (AFC), and the 2008–2009 global financial crisis (GFC) were much wider and deeper than the previous crises.

In essence, the landmark ILO resolution requires revisiting the post-World War II economic governance paradigm that produced the “golden age” of job-rich growth and sustained declines in inequality until the late 1960s while reasonable price stability (inflation) was maintained, and fiscal positions (deficits and surplus) adjusted over the business cycles. Such a return is, in fact, consistent with the United Nations Charter (Article 55), International Monetary Fund (IMF)’s Article of Agreement (Article IV) and the ILO Philadelphia Declaration (III. a) – all of which recognise full or maximum employment and higher standards of living.

The full or maximum employment pledge embodied in the charters of the United Nations System “marks a historic phase in the evolution of the modern conception of the functions and responsibilities of the democratic state” (United Nations, 1949, p. 5). Its explicit recognition as a practical objective of national economic policies is an expression of each member state’s commitment to the Universal Declaration of Human Rights.


Thai People cleaning the road PhanuwatNandee

THE CONTEXT: THE FALLING LABOUR INCOME SHARE AND RISING INEQUALITY

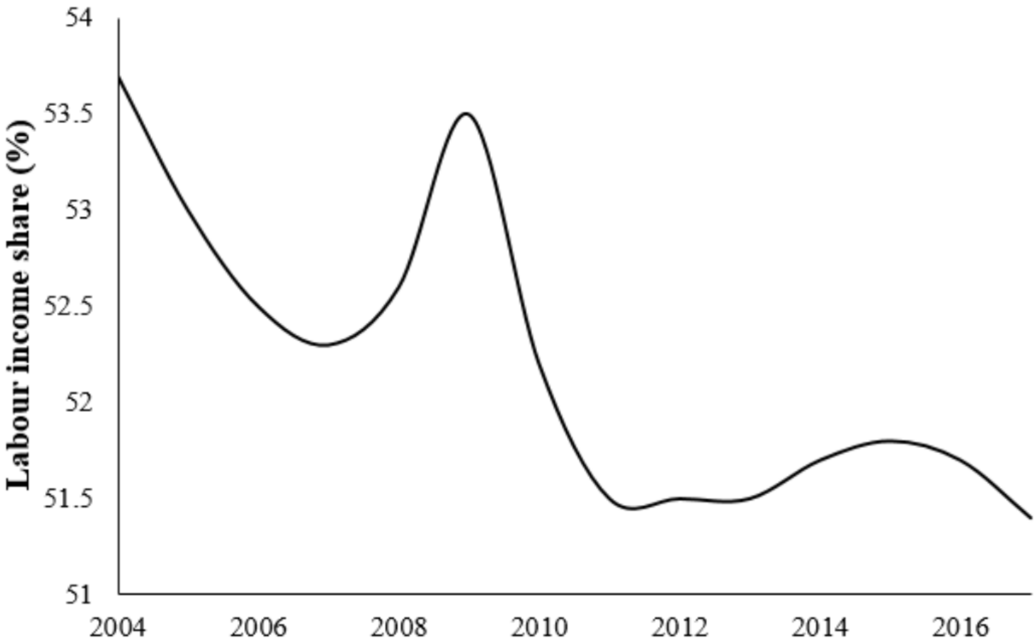
The urgency of supportive fiscal, monetary and industrial policies has arisen from more than four decades of falling share of wages (labour income) in national incomes; rising inequalities of income, wealth and opportunities; deindustrialisation in developed countries; and failure to adequately diversify in developing countries causing increased economic vulnerability and job insecurity. To a large extent, this has been a result of the neoliberal economic governance paradigm, characterised by restrictive and procyclical fiscal and monetary policies, increasingly regressive taxation systems, and abandonment of active industrial policy in favour of market and trade liberalisation since the early 1980s. Understanding of the context and militating factors are essential for designing supportive fiscal, monetary and industrial policies.

FALLING LABOUR INCOME SHARE

National income is the sum of all income available to the residents of a given country in a given year. The division of national income between labour and capital is called the functional distribution of income. The labour income share (or labour share) is the part of national income allocated to labour compensation, while the capital share is the part of national income going to capital.

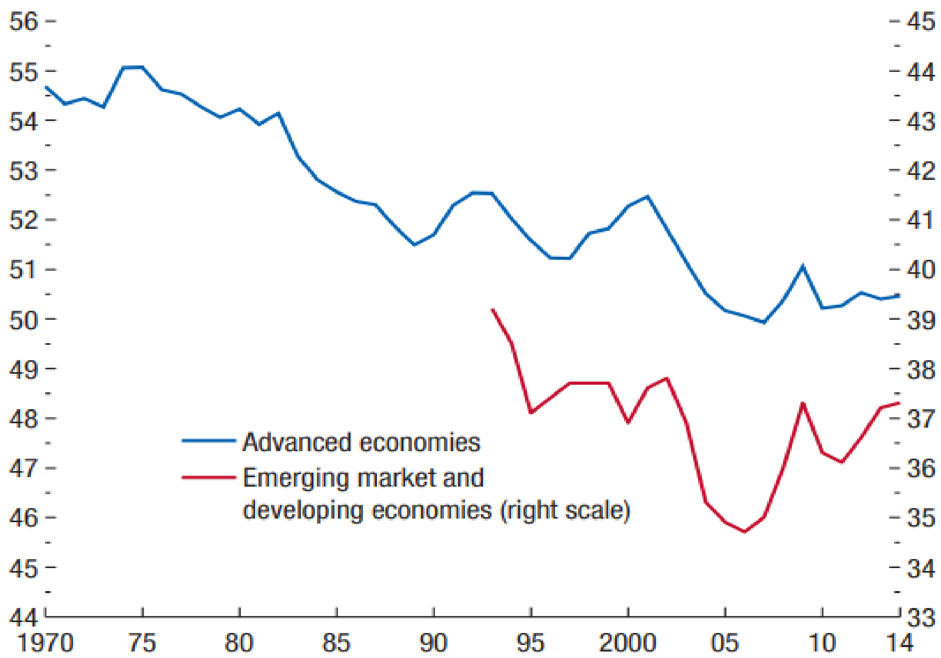
A stable labour income share was accepted as a "stylised fact" of economic growth at least until the early 1980s (ILO-OECD 2015). However, this conventional wisdom has been challenged over the past four decades by evidence revealing a downward trend for the labour share in many countries (OECD 2012a; ILO 2012, 2019; IMF 2017a). Figure 1a shows that the global labour income share declined substantially between 2004 and 2017. Figure 1b shows that labour has been losing out in both developed and developing country groups. The jump in labour income share during the 2008 GFC does not imply that wages and labour income increased. Instead, profits – a form of capital income – dropped faster than labour income. The labour income share declined far below the pre-crisis levels after this temporary blip.

FIGURE 1A: DECLINING GLOBAL LABOUR INCOME SHARE



Source: Gomis (2019)

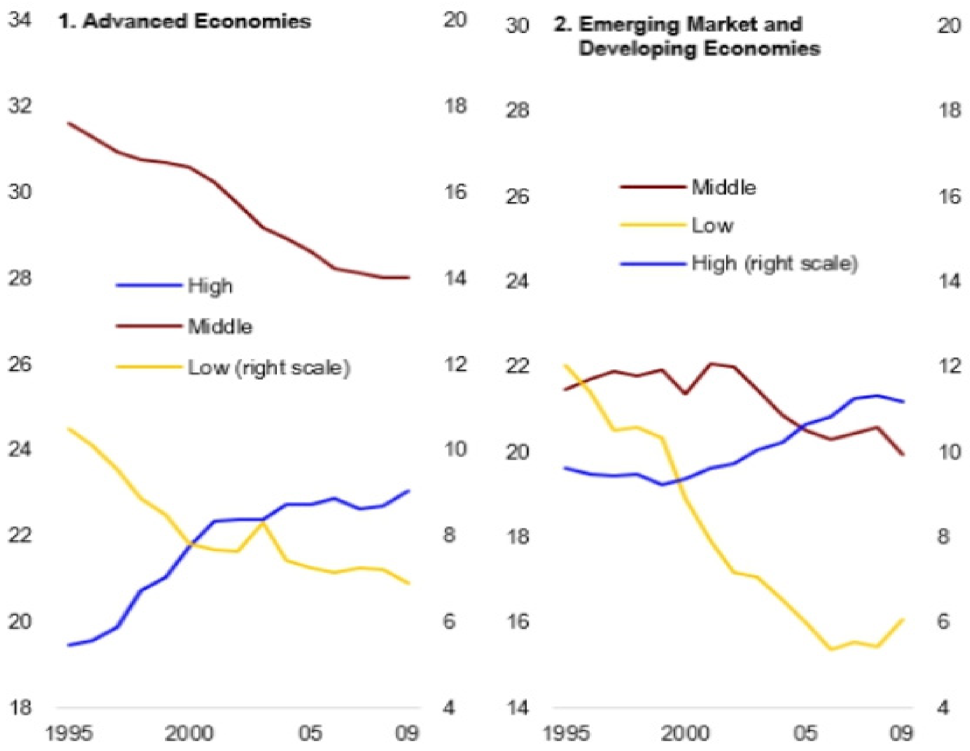
FIGURE 1B: LABOUR LOSING OUT EVERYWHERE



Source: IMF (2017a, p. 122)

Figure 1c shows that low-skilled and middle-skilled workers have been feeling the squeeze. According to the IMF *World Economic Outlook* (April 2017), between 1995 and 2009, the global income shares of low-skilled and middle-skilled labour dropped by more than seven percentage points. In contrast, the income shares of high-skilled labour rose in both advanced and emerging market economies.

FIGURE 1C: LABOUR INCOME SHARES: LOW-SKILLED AND MIDDLE-SKILLED FEELING THE SQUEEZE



Source: IMF (2017a, p. 128)

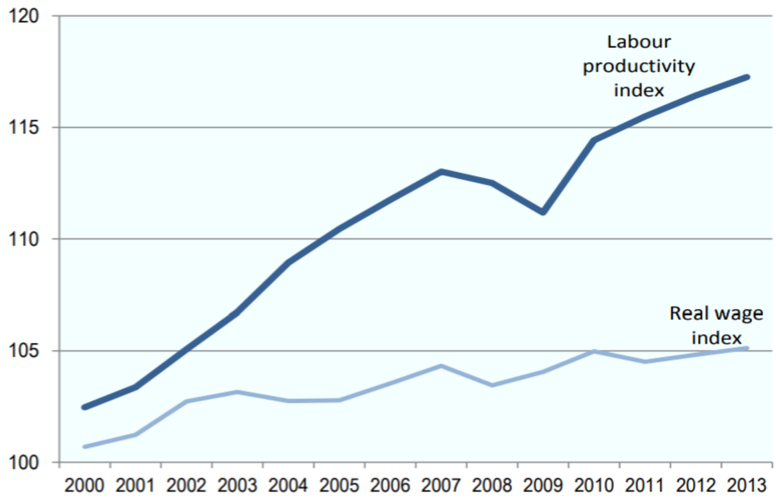
GROWING GAP BETWEEN WAGE GROWTH AND PRODUCTIVITY GROWTH

Commensurate with declining labour income share, there has been a growing disjoint between productivity growth and real wage growth (Figure 2). What is of concern is not wage growth remaining below productivity growth, but the growing gap between them. Some wage moderation or slower wage growth may be desirable as part of industrial transformation strategies to gain international competitiveness and to encourage more dynamic industries to reinvest. However, a growing gap between productivity growth and wage growth has adverse consequences not only for labour income share and inequality, but also for overall growth potential and structural transformation.

The ILO (2014) has shown that in countries where labour income shares declined, wage growth significantly lagged behind productivity growth. In most of the G20 advanced countries for which data were available, the aggregate growth of real wages was significantly slower than that of aggregate productivity. The ILO's Global Wage Report 2018/19 found that in real terms (adjusted for price inflation) global wage growth declined from 2.4% in 2016 to 1.8% in 2017,[2] the lowest rate since 2008, and far below levels before the GFC.

2 The findings are based on data from 136 countries.

FIGURE 2: REAL WAGE LAGGING BEHIND PRODUCTIVITY GROWTH



Source: ILO-OECD (2015, p. 8)

A low-wage trap can be a barrier for a long-term catching-up process as labour income remains the main source of income for households and private consumption makes up the largest part of aggregate demand. Real wages persistently falling behind productivity growth means that wage incomes do not grow and consequently consumption does not grow. This depresses demand prospects, a crucial determinant of investment and growth. Moreover, low wages are an easy way to increase profits, and thus do not provide incentives for investment in technology or upgrading. Such a situation not only hampers future productivity growth but also creates the vicious circle of a "low-wage, low-productivity" economy.

HIGH AND RISING INEQUALITY

Rising income inequality within countries has become a common phenomenon since the early 1980s in most countries worldwide. The richest 1% of humanity captured 27% of world income between 1980 and 2016, while the bottom half got only 12% (Alvaredo et al. 2018). Globally, the richest 10% has captured around 60% of income growth, while the poorest 50% has only captured around 10% (Oxfam, 2018).

Both relative and absolute inequality increased substantially and steadily throughout 1975–2010 in almost all regions of the world (UNU-WIDER 2016).[3] One survey found that "today's global income inequality levels are much higher than they were in 1820, irrespective if measured in absolute or in relative terms" (Goda 2016, p. 49). Oxfam (2014) found that seven out of 10 people lived in countries in which the gap between rich and poor was greater than it was 30 years ago.

Inequality of wealth and income has gathered pace since the 2008 GFC. In 2016, 82% of the wealth went to the richest 1% of the world's population, while

3 Say in country A, 10 years ago one individual, X, received $1 and another individual, Y, received $10. The absolute inequality is $9 (=$10-$1), and relative inequality is 10 (Y receiving 10 times that of X). In 10 years, incomes of both X and Y increased 10 times. That is, X now receives $10 and Y receives $100. The absolute inequality between X and Y increased from $9 to $90 (=$100-$10), while relative inequality remains at 10.

the 3.7 billion people in the poorer half of humanity got next to nothing, resulting in the biggest increase in billionaires in history – a new one every two days. Billionaire wealth increased by US$762 billion between March 2016 and March 2017. This 12% increase in the wealth of the very richest contrasted with a fall of 11% in the wealth of the poorest half of the world's population (Oxfam 2018).

Rising inequality is not just a phenomenon in developing nations. Income inequality in OECD countries is currently at its highest level for the past half century. The average income of the richest 10% of the population is about nine times that of the poorest 10% across the OECD, up from seven times 25 years ago.[4]

Thus, the primary concern is not with inequality per se, but unacceptably high and rising inequality. The outrage manifested in various public protests across the globe, such as the "Yellow Vest" movement in France, "Abolish Billionaires" campaign in the US (Manjoo 2019), and street protests in Latin America and Lebanon, were all responses to horrifying and yet growing inequality.

What ordinary citizens resent are fundamentally unfair levels of inequality. When workers understand that inequality is not the result of a lack of effort, but instead arises from a combination of circumstances (inherited wealth, class, gender, race, and location) and the concentration of power and influence in the hands of the wealthiest, they are rightfully angered. The Brexit vote, and the rise of populism (especially on the right) in the United States and Europe, are clear manifestations of a growing discontent among the working and middle classes which is undermining democracy and multilateralism.

Thus, President Barack Obama described "dangerous and growing inequality" as "the defining challenge of our time".[5] As the former Secretary-General of the OECD, Angel Gurría emphasised, "Inequality can no longer be treated as an afterthought. We need to focus the debate on how the benefits of growth are distributed".[6]

4 https://www.oecd.org/social/inequality.htm, 08/08/2021.
5 Remarks by the President on Economic Mobility, https://obamawhitehouse.archives.gov/the-press-office/2013/12/04/remarks-president-economic-mobility (24/08/2020)
6 https://www.oecd.org/social/inequality.htm (08/08/2021)

CAUSES OF FALLING LABOUR INCOME SHARE AND RISING INEQUALITY

There are many causes of falling labour income shares and growing inequality, such as rapid technological change and reforms encompassing privatisation, deregulation, liberalisation and globalisation. Fire-sale privatisation of public assets and public enterprises saw the transfer of a massive amount of public wealth to private hands globally (Alvaredo et al. 2018). At the same time, privatisation or outsourcing of public services, such as healthcare, education and water, disproportionately impacted socioeconomically disadvantaged groups through a decline in both the quality of services and access to them. Privatisation also saw reductions in contracted workers' wages and benefits (In The Public Interest (ITPI) 2016). Capital account liberalisation allows short-term capital to come into and go out of a country, thus causing exchange-rate volatility and fragility of the financial sector, leading to frequent and ever-deeper financial crises which disproportionately harm poor and vulnerable populations (Furceri and Loungani 2013). However, most causes of growing inequality relate to three significant factors – decline in labour's bargaining power, macroeconomic policies becoming "unsupportive", and a decline in tax progressivity.

LABOUR'S DECLINING BARGAINING POWER

Chapter 2 in the IMF's ***World economic outlook, April 2017*** explains how rapid technological change, globalisation and other liberalising/deregulating reforms led to declines in the bargaining power of labour globally, especially of low-skilled labour in relation to capital. Rapid technological change favours highly skilled workers and displaces low-skilled workers. The relative scarcity of highly skilled workers bestows them with stronger bargaining power and weakens the bargaining power of unorganised low-skilled workers. This translates to a faster rise of skilled workers' wages while the wages of low-skilled workers either decline or stagnate, thus widening income inequality.

Privatisation in the absence of strong anti-monopoly regulations saw the rise of large corporations with monopoly power not only in the product market but also in hiring (called "monopsony" power). At the same time, workers' bargaining power declined with the deregulation of labour markets designed to reduce rates of unionised labour. As the IMF (2017a, p. 124) noted, "changes in institutional arrangements (such as unionisation rates) may have contributed to the decline in labour's share of income by lowering labour's bargaining power". The IMF (2017a, p. 132) also noted, "changes in market regulations over the past two decades – for example, those that regulate worker hiring and dismissal or competition in product markets" as factors contributing to the decline in labour income shares.

Globalisation further exacerbated the erosion of workers' bargaining power that was caused by outsourcing: "offshoring – or the threat thereof – lowers labor's bargaining power ..., further reducing the labor share within remaining tasks" (Dao, Das and Koczan 2019, p. 11). Capital account liberalisation enhanced capital's bargaining power in relation to workers. In fact, multinational corporations have successfully used the threat of leaving to engage countries in the race to the bottom by diluting labour rights and cutting corporate tax rates: "By increasing competitive pressure on domestic firms and credibly raising their ability to relocate abroad, trade and financial integration may have also lowered labor's bargaining power" (IMF 2017a, p. 124).

"UNSUPPORTIVE" MACROECONOMIC POLICIES

In much of the 20th century, fiscal policy, and to some extent monetary policy, played a mitigating role against inequality. This has changed since the 1980s when both fiscal and monetary policies became more restrictive as focus shifted from growth and employment to reductions of budget deficits, debt and inflation. It was assumed that growth and employment would follow from lower or no budget deficits and lower inflation.

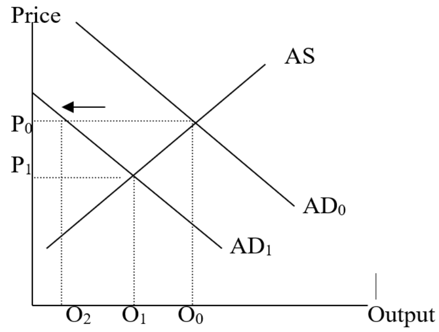
The excessive worries with debt, deficit and inflation have led to procyclical macroeconomic policies (Carneiro and Garrido 2015; Combesa, Mineaa and Sow 2017). This meant macroeconomic policies became "unsupportive" of jobs and growth in the face of shocks and cyclical fluctuations of business activities. Rochon and Rossi (2006) found a decline in the wage share in countries that had adopted an inflation-targeting monetary policy framework. Inflation-targeting regimes have been shown to have two major shortcomings: (1) they have difficulty coping with large supply and demand shocks, and (2) they do not promote financial stability (Beckworth 2014)

As explained in Box 2, when price stability or inflation becomes the sole aim of macroeconomic policies, the entire burden of adjustment falls on output and employment, adversely affecting labour income, poverty and inequality.

BOX 2: PROCYCLICAL MACROECONOMIC POLICIES ARE UNSUPPORTIVE OF GROWTH AND EMPLOYMENT

Adjustment to demand shocks

Figure A: Adjustment to demand shocks



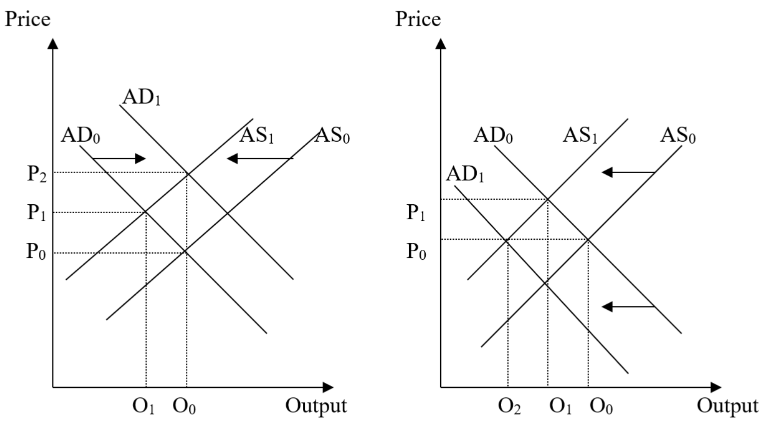
Notes: AS = Aggregate Supply; AD = Aggregate Demand
0 = before shock; 1 = after shock

Figure A shows that the decline in output is larger in the case when price is not allowed to fall than when price falls in response to an adverse demand shock. This can have an adverse effect on employment and hence on the income of low-skilled poor workers. If the adjustment happens through cuts in output and employment, the first to lose their jobs are the unskilled and unorganised workers.

On the other hand, if the adjustment happens through declines in wages, again the unorganised and unskilled workers would be forced to accept lower wages. Thus, the poor, unorganised workers are forced to choose between jobs and lower real wages. Multi-country evidence shows that the average income of the poor is negatively related to aggregate demand variability (Romer and Romer 1999). Therefore, from the point of view of protecting the poor, macroeconomic policies need to stabilise output in the face of adverse demand shocks.

Adjustment to supply shocks

Figure B: Adjustment to supply shocks



Panel 1: Expansionary or supportive response   Panel 2: contractionary response

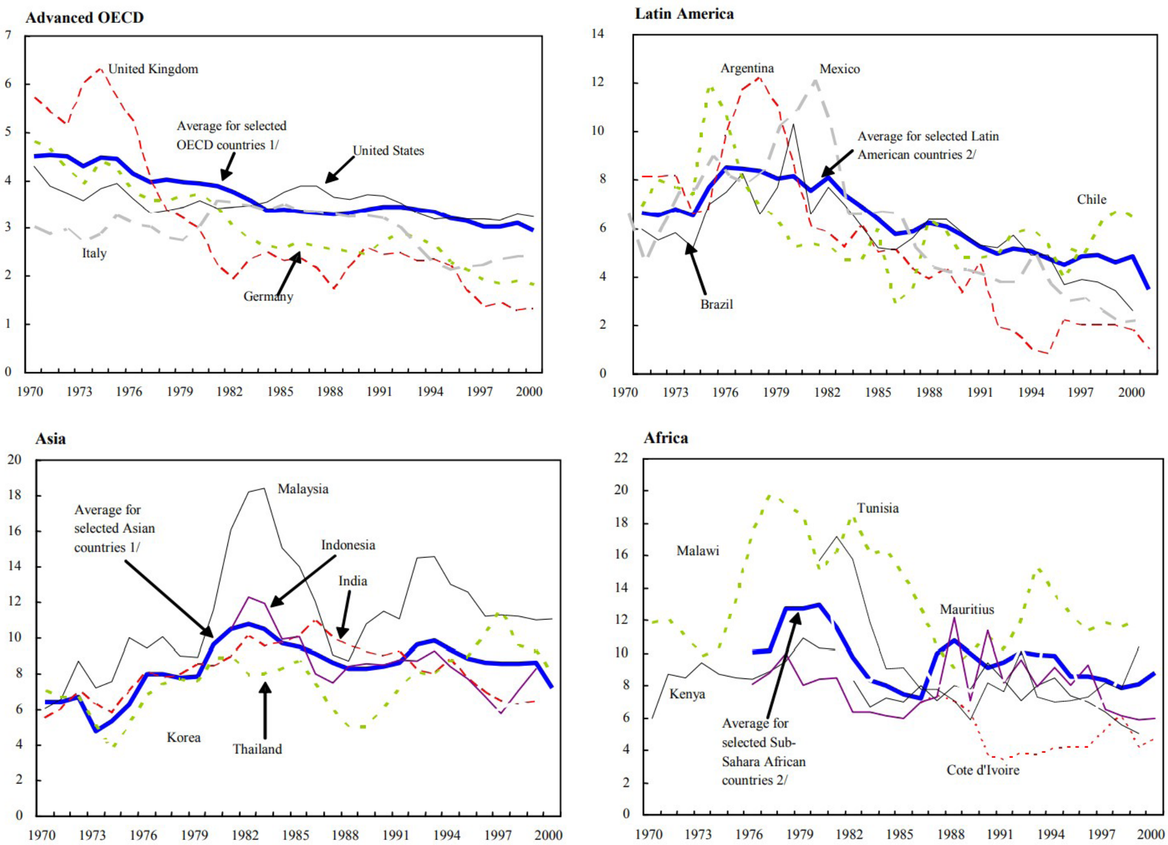
Notes: AS = Aggregate Supply; AD = Aggregate Demand; 0 = before shock; 1 = after shock

The choice between output and price stabilisation becomes starker in the case of a supply shock (Figure B). In Panel 1, the responses to an adverse supply shock are expansionary macroeconomic policies to stabilise output at O_0, whereas in Panel 2, the responses are contractionary macroeconomic policies to stabilise the price level at P_0. When the responses are expansionary policies, the price level rises further to P_2, causing higher inflation. On the other hand, when the objective is price stabilisation with contractionary macroeconomic policies, output declines further to O_2. Beddies (1999) has demonstrated that inflation-targeting macroeconomic policies do not lead to an optimal output stabilisation of aggregate supply shocks. That is, a price-stabilisation target leads to greater output and employment variability. Gramlich (1979) has shown that accommodation policies in response to supply shocks are likely to be less costly.

Therefore, macroeconomic policies need to be countercyclical to protect output and employment, regardless of whether shocks originate from the demand or supply side. The logic for such a policy stance is evident. It is the low-income unskilled wage workers who are first to lose jobs during an economic downturn and their jobs and incomes are protected when the economy is stabilised.

Chowdhury (1999) has shown that excessive focus on deficits and debt in all regions worldwide led to declines in public infrastructure investment (Figure 3) as countries attempting to "repair budgets'' found it politically easier to justify cuts in public expenditure. Public investment remained flat during the first part of the 2000s and rose slightly after the 2008 GFC, but had been downward sloping since 2010 (Gurara et al. 2018). Contrary to the expectations of proponents of the conventional approach, declines in public investment were not matched by commensurate rises in private investment. Thus, the overall lower trend growth of the capital stock has adversely affected potential growth in the major advanced economies since the 1980s (Arsov and Watsdon 2019). Such policy approaches also saw cuts to essential public services, social protection, public education and healthcare, thus reducing opportunities and access for vulnerable populations.

FIGURE 3: PUBLIC INVESTMENT DECLINED IN ALL REGIONS



Source: IMF (2004, p. 7)

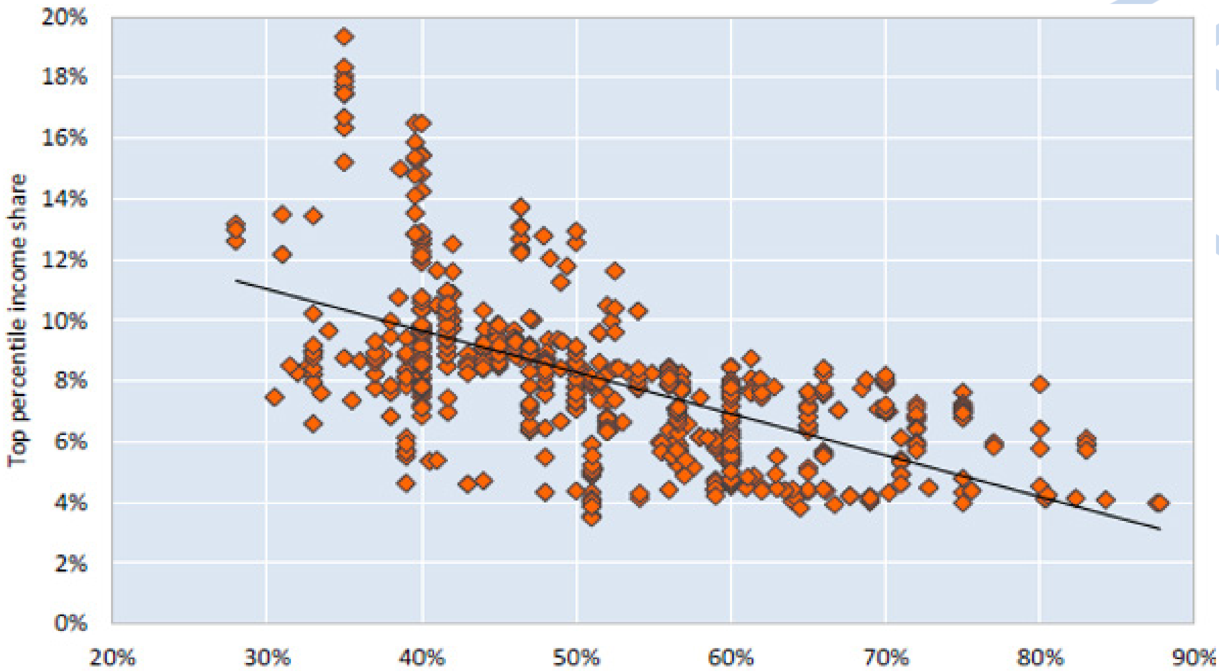
In developing countries, the excessive focus on debt, deficits and inflation has been largely due to the legacy of the structural adjustment programs of the IMF-World Bank, but this has had disastrous consequences for inclusive growth (Easterly 2001; World Bank 2005). Reviewing the lessons of such a policy focus in the 1990s, the World Bank (2005, p. 93) observed, "the expected growth benefits failed to materialise, at least to the extent that many observers had forecast". The IMF acknowledged, "Against this background, questions have been raised about the widely used approach to fiscal analysis and policy, which focuses on the overall fiscal balance and gross public debt" (2004, p. 3).

DECLINING TAX PROGRESSIVITY

More progressive taxes mean higher income tax rates for high-income individuals and lower-income tax rates for low-income individuals. Since the early 1980s, there have also been cuts in personal and corporate income tax rates (Figure 4) while the emphasis shifted to indirect taxes, such as value-added tax (VAT) or goods and services tax (GST) (IMF 2017b; OECD 2012; Abbas et al. 2012; Ernst and Young 2016). The average top income tax rate for OECD member countries fell from 62% in 1981 to 35% in 2015 (IMF, 2017b). In addition, tax systems are less progressive than indicated by the statutory rates, because wealthy individuals have more access to tax relief. Thus, fiscal policy lost its redistributive powers to combat worsening inequality.

Research reported by the OECD finds that taxes and transfers have a significant redistributive impact. Inequality in income after taxes and transfers, as measured by the Gini index,[7] was about 25% lower than for income before taxes and transfers on average in the OECD area in the late 2000s. For the same period, poverty measured after taxes and transfers was 55% lower than before taxes and transfers for the OECD average (Joumard, Pisu and Bloch 2012).

Figure 4: Top marginal tax rates and top percentile income share (17 OECD countries 1975–2012)



Source: OECD (2014, p. 7)

Corporate tax cuts are often justified by claims they will boost investment. However, tax is low on the list of factors that influence the investment location decisions of companies. For example, the OECD noted:

> [I]t is not always clear that a tax reduction is required (or is able) to attract foreign direct investment (FDI). Where a higher corporate tax burden is matched by well-developed infrastructure, public services and other host country attributes attractive to business … tax competition from relatively low-tax countries not

7 The Gini coefficient is a measure of inequality. A Gini coefficient of 0 expresses perfect equality, where all values are the same (that is, where everyone has the same income). A Gini coefficient of 1 (or 100%) expresses maximal inequality among values (that is, for a large number of people where only one person has all the income and all others have none). A Gini coefficient above 0.4 is often associated with political instability and growing social tensions.

> offering similar advantages may not seriously affect location choice. Indeed, a number of large OECD countries with relatively high effective tax rates are very successful in attracting FDI (2008, p. 3).

This is corroborated by the World Bank's 2017–2018 survey of enterprises (World Bank 2018), which found that tax incentives are not high on the list of critical factors affecting inflows of FDI. The IMF's research also reports that the net impact of corporate tax cuts to incentivise private investment is quite often negative on revenues and hence governments' ability to spend on education, health, social protection and other public services (IMF 2017b).

Cross-country research has found no relationship between changes in top marginal tax rates and growth (Piketty, Saez and Stantcheva 2013). On the other hand, low tax rates for the rich make it more attractive for CEOs to take big pay cheques (Anderson et al. 2012).

BOX 3: NEOLIBERALISM AND RISING INEQUALITY

For the rich, the last few decades have been "heads I win, tails you lose". Top managers sign on pay packages that give them hundreds of millions of dollars for failing – and many times more for doing a decent job. Corporations are subsidised on a massive scale with few conditions – sometimes directly but often indirectly through government procurement programs (especially in defence) with inflated price tags and free technologies produced by government-funded research programs. After every financial crisis, ranging from the 1982 Chilean banking crisis through to the AFC of 1997 and the 2008 GFC, banks have been bailed out with hundreds of trillions of dollars of taxpayers' money and few top bankers have gone to prison. In the last decade, the asset-owning classes in rich countries have also been kept afloat by historically low rates of interests. In contrast, poor people have been increasingly subject to market forces.

In the name of increasing "labour market flexibility", the poor have been increasingly deprived of their rights as workers. This trend has reached a new level with the emergence of the so-called "gig economy", in which workers are bogusly hired as "self-employed" (without the control over their work that the truly self-employed exercise) and deprived of even the most basic rights (such as sick leave or paid holidays). With their rights weakened, these workers have to engage in a race to the bottom in which they compete by accepting increasingly lower wages and increasingly poor working conditions.

In the area of consumption, increasing privatisation and deregulation of industries supplying basic services on which the poor are relatively more reliant upon – like water, electricity, public transport, postal services, basic health care and basic education – have meant that the poor have seen a disproportionate increase in the exposure of their consumption to the logic of the market. In the last several years since the 2008 GFC, welfare entitlements have been reduced in many countries and the terms of their access (such as increasingly mean spirited "fitness for work tests" for the disabled, the mandatory training for CV-making for those receiving unemployment benefits) have become less generous, driving more and more poor people into labour markets they are not fit to compete in.

Source: Polychroniou (2017) (interview with Ha-Joon Chang)

COVID-19 exacerbates inequalities and vulnerabilities

Inequality continues to grow unabated during the COVID-19 pandemic (Avent 2020). More than five million people became millionaires across the world in 2020 despite pandemic-induced economic damages. While many poor people became poorer, the number of millionaires increased by 5.2 million to 56.1 million globally (Credit Suisse 2021). Billionaires' fortunes rose by 27% during the pandemic and the combined wealth of the world's 10 richest men rose by US$540 billion, enough to buy vaccines for all of humanity (Oxfam 2021).

Even as the pandemic forced pay cuts, furloughs and layoffs, a new survey of the highest-earning chief executives at public companies in the US found that CEO pay in 2020 continued to soar compared to employee pay (Hansen 2021). Of the 200 companies with the largest CEO pay packages included in the survey, 68% had larger gaps between CEO pay and worker pay in 2020 than they did before the pandemic.

This happened through some ingenious rewriting of the rules of the game. It was decided that:

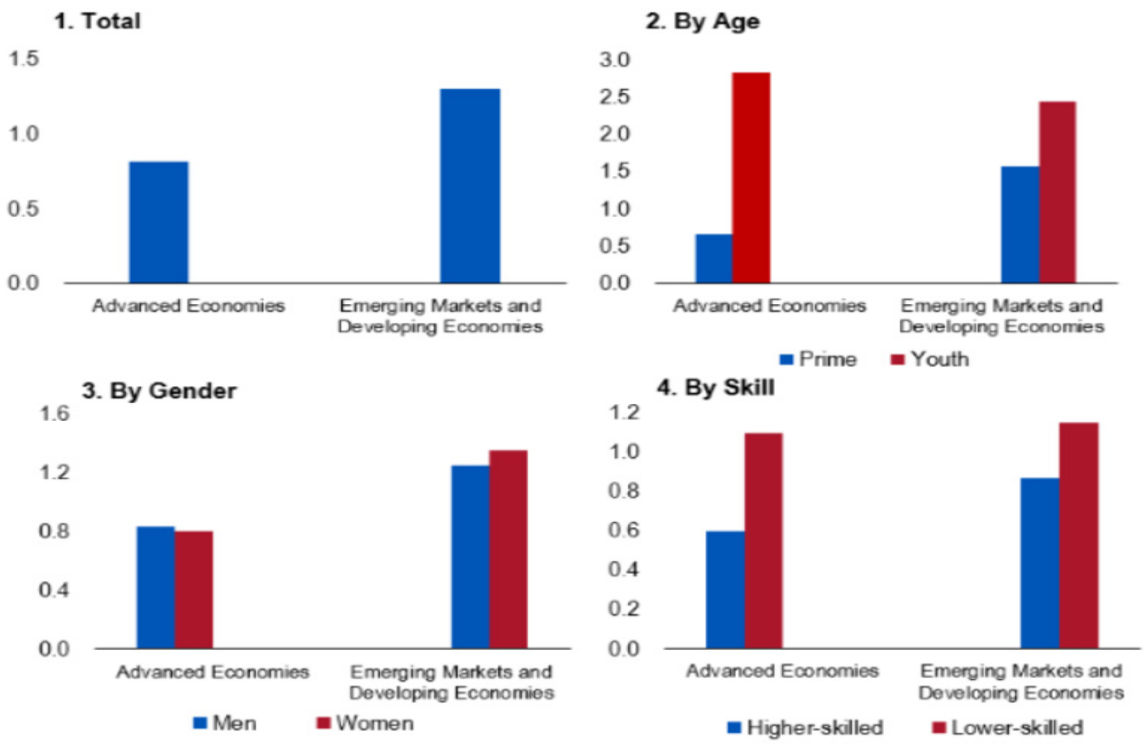
> [T]he crisis wasn't the bosses' fault, so they shouldn't suffer the consequences. Boards handed out "special awards" for persistence. They eased up on performance goals, so executives could still collect bonuses. Directors granted retention awards, so leaders wouldn't get discouraged and quit (Melin 2021).

Such machinations also occurred when bank executives got options at the depth of the 2008 GFC and reaped a windfall. In the aftermath of the 2008 crash, corporate boards protected the pay cheques of those executives who sat at the corporate summit.

The COVID-19 pandemic has exacerbated the plight of vulnerable workers, including women and the young. As can be seen in Figure 5, youth and lower-skilled workers have borne the brunt of job losses during the pandemic. Women, especially in emerging markets and developing economies, have also suffered, experiencing higher job losses. Many of these workers face earnings losses and difficult searches for job opportunities.

According to the IMF (2021), sectors that have shrunk the most during the pandemic include hotels, restaurants, and wholesale and retail stores. Physical distancing and behavioural changes induced by the pandemic intensified reductions in employment in these industries. By contrast, the information technology and communication sector as well as the finance and insurance sectors have seen employment growth. Many of the more impacted sectors – often with fewer jobs amenable to remote work – tend to employ higher shares of youth, women, and lower-skilled workers, contributing to unequal effects across worker groups.

FIGURE 5: UNEQUAL IMPACT OF THE PANDEMIC ON YOUTH AND LOW-SKILLED WORKERS (AVERAGE UNEMPLOYMENT RATE CHANGE IN PERCENTAGE POINTS, CALCULATED AS THE AVERAGE QUARTERLY UNEMPLOYMENT RATE IN 2020 RELATIVE TO ITS AVERAGE VALUE OVER 2018–2019)



Source: Bluedorn (2021)

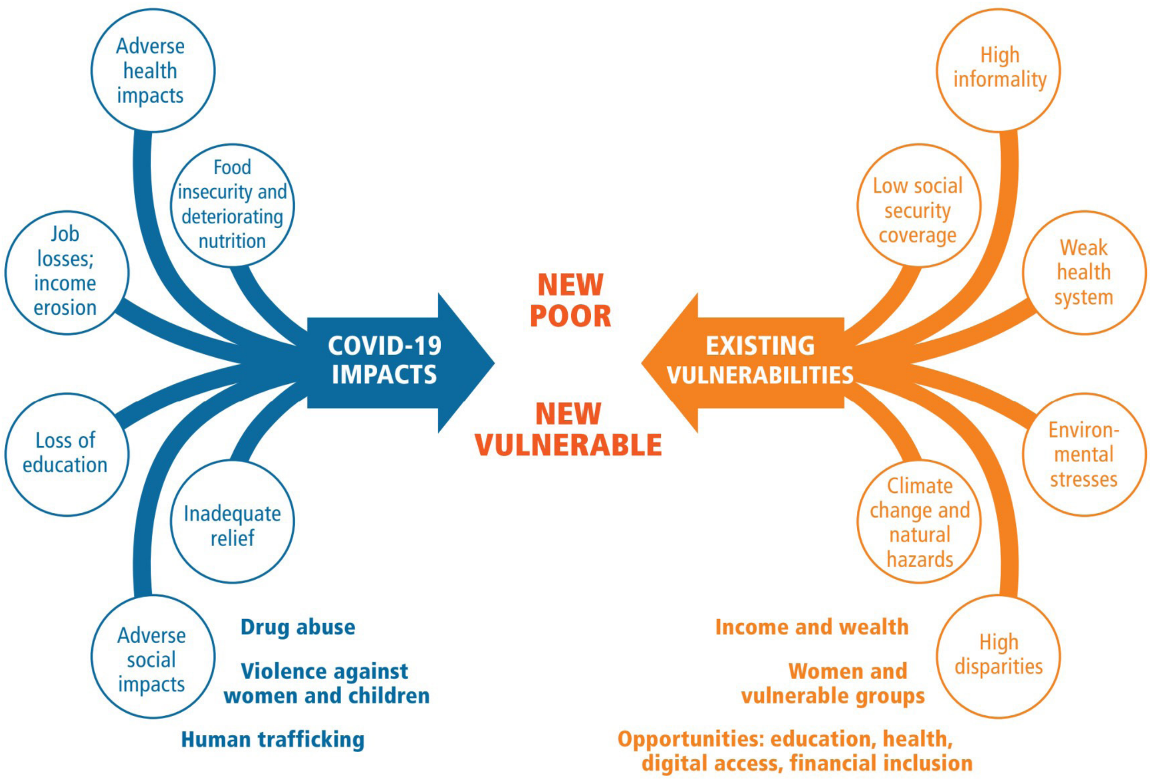
Even after the pandemic recedes, structural changes to the economy in the wake of the shock may mean that job options in some sectors and occupations permanently shrink and others grow. Long before the pandemic, deregulation, liberalisation, privatisation, globalisation and technological upheaval have been upending labour markets, exacerbating inequality, making jobs increasingly precarious, and deepening economic insecurity. With millions of jobs lost, robots on the rise, and white-collar workers working largely from home, COVID-19 appears to have ushered in a “new normal” in the global workplace, and accelerated a shift towards more informal and precarious work (Dewan and Ernst 2020).

Figure 6 shows how the pandemic has exacerbated pre-existing societal inequalities and vulnerabilities. In the absence of supportive relief, recovery and reform policies, there will be “K-shaped” recovery, with increased polarisation within and between countries, defeating the overarching principle of the United Nations Agenda 2030 for Sustainable Development Goals (SDGs), *“leaving no one or no country behind”*.

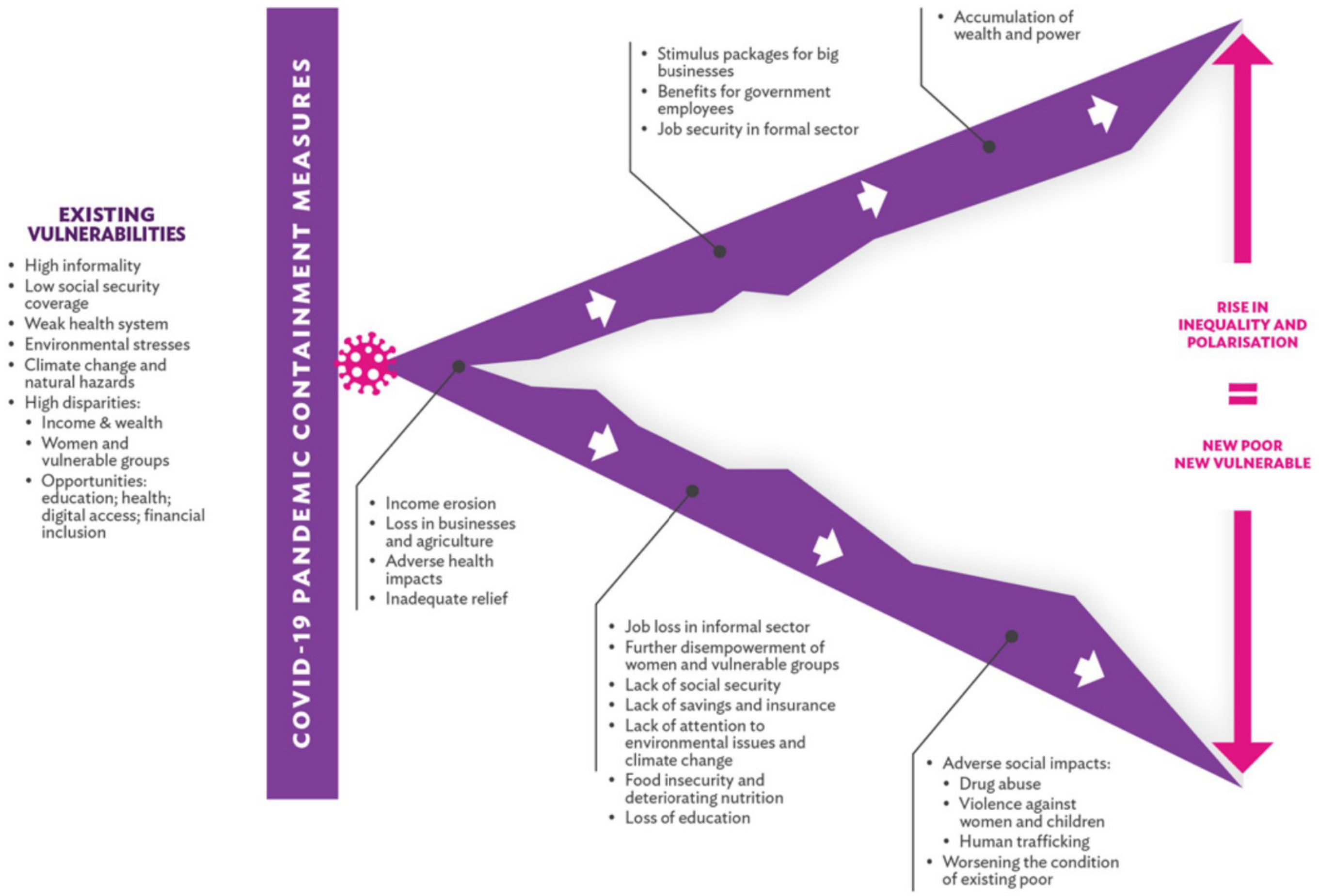
POLICY DESIGN AND POLICY ACTION MATTER

The IMF (2021) found that a package of measures to help workers keep their jobs during the pandemic, combined with measures to encourage job creation and ease the adjustment to new jobs and occupations as the pandemic ebbs, can markedly dampen the negative impact and improve the labour market’s recovery from COVID-19. On the other hand, in the absence of measures to protect jobs and livelihood, the pandemic-induced economic shock hits occupations asymmetrically and leads to an enormous and rapid rise in unemployment and a grinding adjustment. For example, job retention and worker reallocation support have cushioned employment impacts in many countries while also helping workers and firms adjust faster. Properly designed relief packages, especially involving the wider community, are found to benefit lower-skilled workers and more vulnerable population groups. Such relief measures targeting more impacted populations (such as youth and women) also hasten the recovery.

FIGURE 6: PANDEMIC WORSENS EXISTING VULNERABILITIES



Source: Titumir (2021, pp. 17-18)



EXISTING VULNERABILITIES
• High informality
• Low social security coverage
• Weak health system
• Environmental stresses
• Climate change and natural hazards
• High disparities:
• Income & wealth
• Women and vulnerable groups
• Opportunities: education; health; digital access; financial inclusion
COVID-19 PANDEMIC CONTAINMENT MEASURES
• Stimulus packages for big businesses
• Benefits for government employees
• Job security in formal sector
• Accumulation of wealth and power
• Income erosion
• Loss in businesses and agriculture
• Adverse health impacts
• Inadequate relief
• Job loss in informal sector
• Further disempowerment of women and vulnerable groups
• Lack of social security
• Lack of savings and insurance
• Lack of attention to environmental issues and climate change
• Food insecurity and deteriorating nutrition
• Loss of education
• Adverse social impacts:
• Drug abuse
• Violence against women and children
• Human trafficking
• Worsening the condition of existing poor
RISE IN INEQUALITY AND POLARISATION
=
NEW POOR NEW VULNERABLE

BOX 4: APPROPRIATE RELIEF MEASURES

All governments must try their best to prevent protracted recessions becoming extended depressions. Relatedly, policymakers need to ensure that temporary short-term liquidity problems do not become full-blown solvency crises.

Measures are needed to change contracts and other obligations to enable firms to better cope with involuntary suspension of business operations. Much more is needed to address specific challenges facing small family businesses.

Income maintenance policies can help those losing some of their income. Often unable to earn their livelihoods from home, low-paid and casual workers are more likely to be displaced by lockdowns. Typically, they have much less in savings to ride out temporary earnings losses.

Social protection has been poorly, if at all, institutionalised in most developing countries. Instead, temporary "social safety nets" have been recommended in response to crises, and deemed adequate by influential international financial institutions and donors. Such one-off relief measures typically involve targeting, usually missing many of the deserving as they strive, often at great cost, to prevent opportunistic "undeserving free-riders" abusing such chances to secure benefits.

Many high-income and upper-middle-income governments have served as "payers-of-last-resort", helping "suspended" businesses to continue paying their involuntarily idle employees instead of firing them. Large firms have also been able to get governments to help settle some of their unavoidable bills, to cover their overheads and maintenance costs – such as rent, utility and other payments – during "stay in shelter" lockdowns.

Such payer-of-last-resort programs have successfully complemented effective contagion containment measures, enabling early resumption of economic activity. While high, such costs can remain manageable if governments can secure sufficient fiscal resources and space.

BOX 5: JOB RETENTION SCHEMES AND THE ROLE OF SOCIAL PARTNERS

Job retention schemes (JRS) have been one of the main policy tools in many OECD countries to contain the employment and social fallout of the COVID-19 crisis. By May 2020, JRS supported about 50 million jobs across the OECD, about 10 times as many as during the GFC. JRS seek to preserve jobs at firms experiencing a temporary reduction in business activity by alleviating firms' labour costs while supporting the incomes of workers whose hours are reduced. These schemes provided the necessary liquidity to firms to hold on to their workers, including their talent and experience, and allowed them to ramp up operations quickly once economic activity resumed, without having to go through the process of hiring and training new workers.

The design and implementation of JRS differed according to whether countries already have short-time work schemes as part of collective bargaining or industrial relations system (for example, the German Kurzarbeit programme or the French Activité partielle) to promote job retention during economic downturns. Countries that already had such measures in place typically took steps to facilitate access, expand coverage and increase the generosity of these schemes during the crisis.

Countries without pre-existing schemes introduced new ones that tended to take the form of furlough schemes, which restrict support to jobs that are temporarily suspended (such as the UK Coronavirus Job Retention Scheme), or wage subsidy schemes, which subsidise hours worked, but can also be used to top up the earnings of workers on reduced hours (for example, the Australian JobKeeper Payment or Dutch Emergency Bridging Measure (Noodmatregel Overbrugging Werkgelegenheid)). Social partners have been involved in the design and implementation of JRS in several countries.

In a number of countries, including Austria, Denmark, Korea, Norway and Sweden, JRS used during the COVID-19 crisis derive their main features from national-level collective agreements and declarations (such as The Global Deal for Decent Work and Inclusive Growth, 2020). For example, in the Republic of Korea (South Korea), the decision to increase the Employment Retention Subsidy from 63% to 75% was taken following a tripartite declaration on the COVID-19 crisis. In Spain and Ireland, social partners have been instrumental in the simplification of procedural requirements and the adjustment of eligibility requirements.

In certain other countries, social partners have been active in shaping JRS through the use of sectoral collective bargaining agreements. In Germany, sectoral agreements have raised replacement rates up to 90% and have enabled the use of short-time work in the public sector. In Italy, a collective agreement was signed in the temporary agency work sector to allocate €75 million from a bipartite fund to protect the continuity of employment and pay for temporary agency workers for the month of March 2020.

Sources: OECD (2020, 2021a)

While protecting jobs and livelihoods is critical, recovery cannot be the status quo. Policymakers cannot be complacent about achieving the goal of pre-pandemic growth rate or employment levels. Instead of "building back" the unsustainable and unfair status quo ante before the pandemic, governments should now selectively target public expenditure to "build forward better", emphasising measures for structural transformation consistent with the SDGs. Sadly, most SDGs were off track even before the pandemic.

Therefore, fiscal, monetary and exchange-rate policies (or macroeconomic policies) have to be urgently linked to structural transformation strategies, in particular pro-active industrial policies, to support a job-rich, inclusive, resilient and sustainable recovery. That is, relief, recovery and reform measures should incorporate desirable changes, such as working in new ways, creating new activities, accelerating digitalisation, revitalising neglected sectors and enhancing sustainability. Such changes cannot be left to the market or to the decisions of multinational corporations regarding the location of their global value chains.

However, designing such supportive policies requires dispelling some myths that lie at the centre of the current neoliberal policy approach that has failed to achieve desirable outcomes and has instead contributed to falling labour income share, and increased inequality, unsustainability, economic insecurity and vulnerability.

BOX 6: RECOVERY MEASURES SUPPORT STRUCTURAL TRANSFORMATION

The European Central Bank (ECB) has aligned "quantitative easing" with the European Commission (EC)'s pandemic response. By indicating it would buy newly issued government bonds in the secondary market, the ECB has effectively financed government borrowing despite the ban on directly lending to the government.

Thus, considerable ECB purchase of government bonds has lowered borrowing costs for member states' pandemic responses. These include the EC's Next Generation package, including the European Green Deal and its "digitalisation transition".

The Bank of Japan is also supporting government efforts for relief, recovery, economic growth, structural change, disaster management and global warming mitigation and encouraging companies to invest in digitalisation and green technologies.

The South Korean central bank has also purchased more government bonds. Several measures have provided monetary support for the Korean New Deal, including pandemic relief, recovery, digital and green investments, and employment safety nets.

China's central bank's targeted monetary policy tools are also increasingly aligned with the government's long-term strategic goals. These include supporting key sectors while preventing asset price bubbles and "overheating".

Debunking the myths of neoliberalism

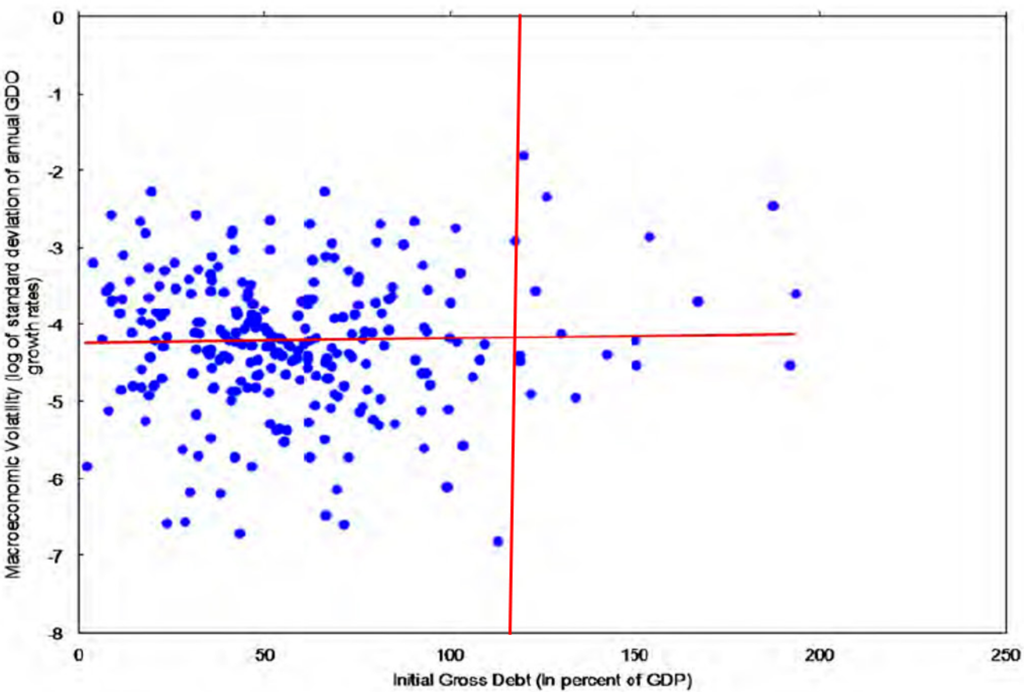
This section debunks the myths that neoliberals have propagated for over four decades and thus have become almost articles of faith for most policymakers. Such myths, having little or no empirical foundations, are sustained often by referring to historically exceptional circumstances or outliers. Thus, it should not surprise that the outcomes of policies driven by myths rather than a solid evidence base have been utterly disappointing as reviewed in the preceding sections.

MYTH 1: DEFICITS AND DEBTS CAUSE MACROECONOMIC INSTABILITY, BALANCE OF PAYMENTS CRISES AND HENCE RETARD GROWTH

Figure 7a reveals that the relationship between debt–GDP ratio and macroeconomic instability is very weak. There is virtually no relationship between initial gross debt and macroeconomic stability. The apparent slight positive relationship is due to outlying values – debt in excess of around 120% of GDP.

FIGURE 7A: GOVERNMENT DEBT AND MACROECONOMIC INSTABILITY

Source: IMF (2010, p. 67); Note: GDO (gross domestic output)



This also means that the current fixation with a particular debt–GDP ratio lacks any sound basis. For example, the 60% debt–GDP ratio used by the EC and the IMF as the upper threshold for fiscal sustainability was decided arbitrarily – the “European authorities never provided sound economic justifications” (Priewe 2020, p. 111). It was actually only the average debt ratio for some powerful members (Buiter et al. 1993). Similarly, the 3% budget deficit rule of the EU was determined arbitrarily. None of these ostensible benchmarks imply optimality in any meaningful, economic sense.

The IMF’s 40% debt–GDP ratio limit for developing and emerging market economies is only for external, not domestic, debt and certainly not for total government debt, as is often implied. The IMF has acknowledged, “it bears emphasising that a debt ratio above 40 percent of GDP by no means necessarily implies a crisis – indeed … there is an 80 percent probability of not having a crisis (even when the debt ratio exceeds 40 percent of GDP)” (IMF 2002, p. 25).

The IMF has also noted, “There is no simple relationship between debt and growth. In fact, there are many factors that matter for a country’s growth and debt performance. Moreover, there is no single threshold for debt ratios that can delineate the “bad” from the “good” (IMF 2012a, p. 109). This simply vindicates the World Bank’s observation made two decades ago: “There is no unique set of thresholds for each macroeconomic variable between stability and instability” (2001, p. 6).

The IMF favours an infrastructure investment push in the face of low borrowing costs and weak aggregate demand. It also observed that “debt-financed projects could have large output effects without increasing the debt–GDP ratio, if clearly identified infrastructure needs are met through efficient investment” (IMF 2014, p. 75). Recent IMF staff research shows that when governments spend on infrastructure, they create many new jobs (Moszoro 2021).

Therefore, what really matters is how and where the money is used. If government debt or borrowing is for investment in education, infrastructure, healthcare and social protection, there should be positive impacts on productivity, and hence attracting more private investment. The combined impact of productivity growth and higher private investment as a result of productive government spending would be higher GDP growth.

However, a distinction needs to be made between domestic and foreign debt. In fact, domestic currency debt is deemed sustainable as long as national economic growth is greater than the interest rate (IMF 2020). Moreover, governments can “roll over” domestic currency debt, although interest costs may be higher. While external borrowing can increase a country’s access to resources, domestic borrowing only transfers resources within the country. Hence, only external debt generates a “transfer” problem (Keynes 1929). Second, since central banks in developing countries cannot print the hard currency necessary to repay external debt, external borrowing is usually associated with vulnerabilities that may lead to debt crises.

On the other hand, as one World Bank research paper (Bua, Pradelli and Presbitero 2014) notes, domestic financing has some prominent advantages: the lower exposure of the public debt portfolio to currency, a lower vulnerability to capital flow reversals, the possibility to undertake countercyclical monetary policy to mitigate the effect of external shocks, and the improved institutional infrastructure underlying the organisation and functioning of local financial markets. In general, long-term domestic currency-denominated debt reduces maturity and currency mismatches and hence tends to be safer.

Since the early 2000s, several developing countries adopted aggressive policies aimed at retiring public external debt and substituting it with domestically issued debt. As a result, the share of domestic public debt (in total public debt) in developing countries rose from around 30% in 1994 to around 40% in 2005 (Panizza 2008).[8] Data compiled by Carmen Reinhart and Kenneth Rogoff (Reinhart and Rogoff 2008) show that the domestic debt of central governments is much larger than their external debt, accounting for almost two-thirds of the total public debt for the 64 countries in the sample. For advanced economies, it represented the lion's share of total debt.

Central bank governors have long agreed that "the scope for relying more on domestic markets, and less on international markets, is considerable" (Turner 2002, p. 3). Nevertheless, borrowing in domestic currency should not enable fiscal irresponsibility. The key challenge is to ensure the most effective and productive use of such borrowed funds. Pragmatism requires considering capacities, capabilities and checks against abuse and wastage.

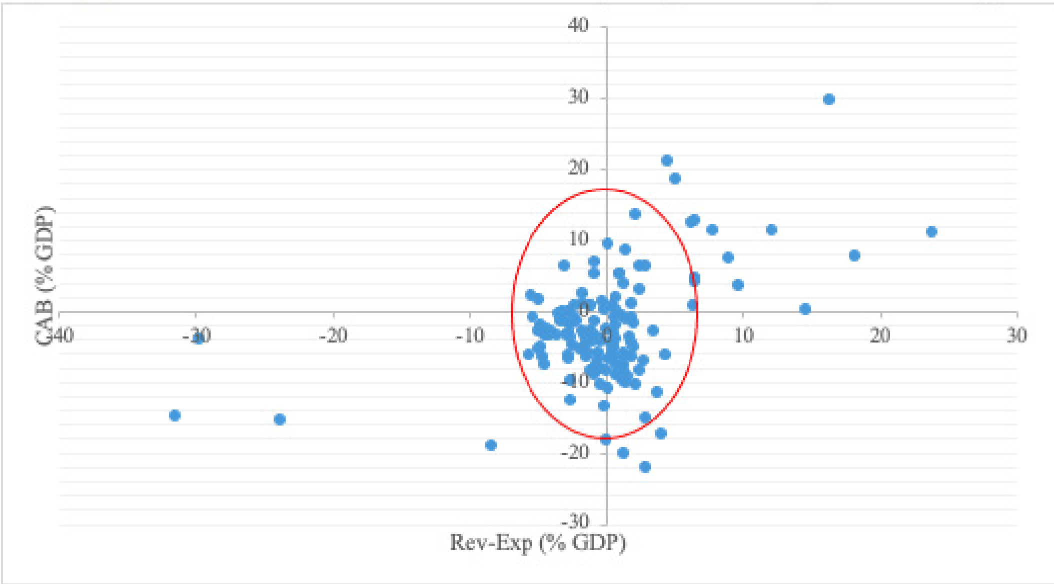
Concerns with foreign debt are legitimate, as any shocks to export incomes or policy changes in the global market can trigger a debt crisis as was seen during the 1970s and 1980s. FDI should be preferred to borrowing and must lead to increased productivity.

The neoliberals argue that expansionary fiscal measures, financed by domestic borrowing, worsen balance of payments problems in several ways. First, higher interest rates attract more capital inflows, causing the exchange rate to appreciate, and making the country less export competitive. Second, higher domestic demand implies more imports for both consumption and production. Third, rising inflationary pressures make domestic products more expensive and imports more attractive.

In Figure 7b fiscal balance is shown horizontally and current account balance (exports–imports) as percentage of GDP is shown vertically. Figure 7b dispels the fears that fiscal deficits inevitably cause balance of payments problems (larger current account deficits). For the majority of the cases, there is no obvious relation between the two. Nonetheless, it seems that fiscal positions with +10% and -10% (shown in the red circles) can serve as a useful marker; that is, fiscal positions within this range may not have any significant impact on the balance of payments of a country. Governments can also use countervailing measures, such as restricting luxury imports and managing capital flows, to maintain a competitive exchange rate and promote exports.

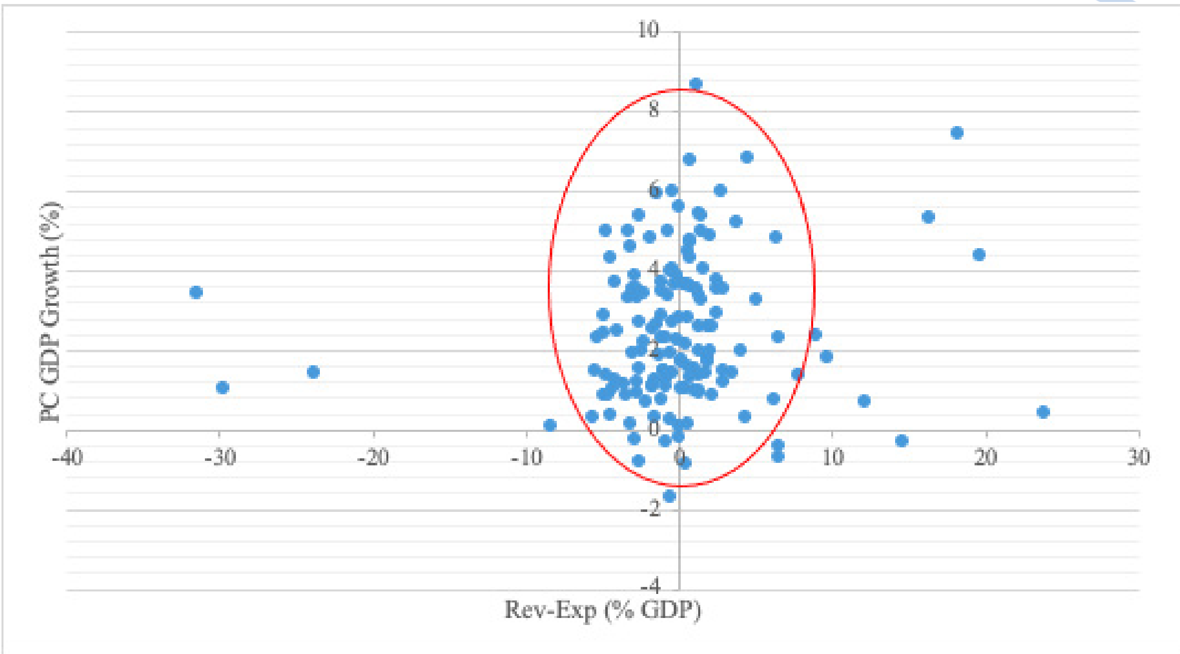
8 When weighted by GDP, the average share of domestic debt rose from 49% in 1994 to around 70% in 2005.

FIGURE 7B: FISCAL BALANCE & CURRENT ACCOUNT BALANCE (AVERAGE, 2000-2019; 141 COUNTRIES)



Source: World Bank on-line data

FIGURE 7C: FISCAL BALANCE & PER CAPITA GDP GROWTH (AVERAGE, 2000-2019; 147 COUNTRIES)



Source: World Bank on-line data

Thus, it is not surprising that fiscal deficits do not necessarily retard growth as revealed in Figure 7c, which shows fiscal position (revenue *minus* expenses as percentage of GDP) horizontally and per capita GDP growth vertically. As is evident, the per capita GDP growth of countries can be high even when a budget deficit exceeds 5% of GDP. On the other hand, per capita growth can be low if a budget surplus exceeds 10% of GDP. Thus, it seems that countries can have fiscal positions (deficit/surplus) within +10% and -10% (shown in red circle) without inevitably harming growth.

These findings provide considerable countercyclical policy space for fiscal policy. At times of economic downturns or shocks, governments can increase fiscal deficits up to 10%, while tightening the fiscal belt during economic booms to raise fiscal surplus beyond 10% may harm growth.

MYTH 2: DEBT-FINANCED GOVERNMENT EXPENDITURE CROWDS OUT PRIVATE INVESTMENT AND PRIVATE SPENDING

A related myth to Myth 1, linking macroeconomic instability and debt–GDP ratio, is "crowding out". That is, the myth that government borrowing and spending push up interest rates which discourages private investment. This view ignores the fact that government spending is needed to keep economies ticking, especially as contemporary recessions are partly due to government policies to contain the pandemic. State inaction would only worsen problems such as mass unemployment and bankruptcies.

More importantly, the argument of interest rising is too simplistic, based on a very simple model that regards money supply as fixed and does not include the role of retail banks in creating credit money. When a government spends, the central bank credits the commercial bank accounts of recipients. Thus, expansionary fiscal policy augments retail banks' cash reserves, and their ability to lend more or create credit money unless the central bank raises the mandatory reserve requirements for the banks against their deposits. The overall money supply, thus, increases if central banks do not offset or "sterilise" such effects, for example, by selling government or central bank or short-term securities, or associated derivatives such as "repurchase" agreements.

Therefore, instead of pushing up interest rates, the central bank discount rate declines, exerting downward pressure on retail interest rates. Hence, the neoliberal claim that government spending "crowds out" private investments, tends to be exaggerated.

And if a government borrows for infrastructure investment or skill development, overall productivity increases, and business costs decline. Hence, debt-financed infrastructure and public social investment would "crowd-in", rather than "crowd-out" private investment as emphasised in debunking Myth 1.

Furthermore, the arguments of "crowding out" and balance of payments crisis are not internally coherent, especially when considered in conjunction with another neoliberal myth – "Ricardian equivalence" – that government borrowings (deficits) cause equivalent increases in private sector savings (decrease in private spending) in anticipation of higher future tax liabilities to pay for the debt. Thus, according to this neoliberal myth any possible impact of debt-financed government expenditure on aggregate demand and output or employment is neutralised.

However, if the "Ricardian equivalence" myth holds then neither the "crowding out" myth nor the balance of payment crisis myth can hold. Therefore, it is not surprising that extensive surveys by IMF researchers of related literature could not find any robust support for either of these myths (Hemming, Kell and Mahfouz 2002). As argued by Hemming, Mahfouz and Schimmelpfennig (2002 p. 5), "There is little evidence of direct crowding out or crowding out through interest rates and the exchange rate. Nor does full Ricardian equivalence or a significant partial Ricardian offset get much support from the evidence".

Furthermore, massive fiscal and monetary measures during the current pandemic-induced crisis and the 2008 GFC helped prevent economic depressions without causing the kind of problems that the neoliberal myths have propagated. In fact, the neoliberals' scare-mongering of impending debt crises has been responsible for premature withdrawal of fiscal stimulus and the introduction of austerity measures that prevented robust recovery from the GFC.

True, debt levels rose in almost every country – developed, developing and emerging economies, especially since the 2008 GFC (World Bank, 2019). While high levels of debt always raises concerns, any discussion of debt must distinguish between domestic and external debts, and between private and public debts. While external and private debts can destabilise an economy, the relationships between fiscal positions (deficits and debts) and macroeconomic variables (such as growth and balance of payments) are influenced by extreme values (outliers). The relationship also depends on whether debt finances infrastructure and other productive ventures, such as skill formation.

MYTH 3: GOVERNMENT BORROWING FROM CENTRAL BANKS CAUSE INFLATION

Neoliberals claim that government borrowing to finance deficit spending causes inflation and currency depreciations. This myth has led to such institutional fetters as central bank independence with a single mandate to keep inflation at a targeted low level. Concerned about the possibility of government borrowing and consequent increase in money supply causing inflation and currency depreciation, Milton Friedman argued that macroeconomic stability is best achieved using an "unconditional" policy rule: his famous "k-percent" money growth rule.

However, the overwhelming experience of central banks' purchase of government bonds (known as monetary financing of the government) since the 2008 GFC, including during the current pandemic, is that government borrowing from central banks does not necessarily lead to rising inflation and currency depreciations. During the current pandemic central banks in Croatia, Hungary, Poland, Romania and Serbia rolled out asset purchase programs (APPs), buying up local currency bonds issued by governments. The ECB is also purchasing government bonds through an innovative mechanism to circumvent the law prohibiting such purchase.

In Asia, the Bank of Japan announced that it will "purchase a necessary amount of Japanese government bonds without setting an upper limit".[9] The central banks of Australia, New Zealand, and Turkey also introduced APPs, while Indonesia and the Philippines suspended legislation barring government borrowing from central banks to enable them to finance relief and recovery measures. In Latin America, the central banks of Chile, Mexico, Peru and Colombia are purchasing government bonds and the Brazilian Congress passed a constitutional amendment authorising the central bank to purchase public and private debt

9 https://asia.nikkei.com/Economy/Bank-of-Japan-vows-to-buy-government-bonds-without-upper-limit (6/10/2021)

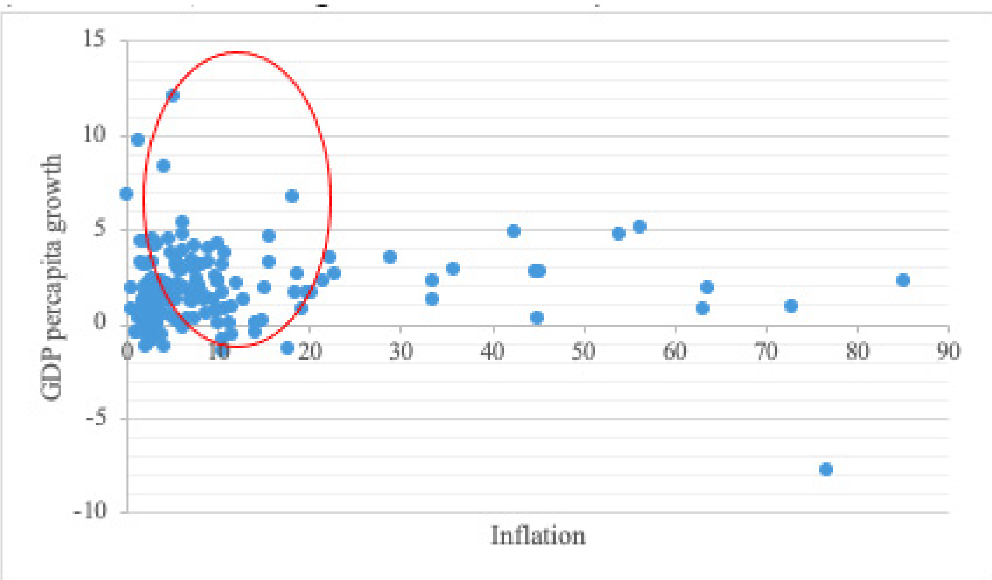
securities.[10] The South African central bank also began purchasing government bonds to help the government finance COVID-19 relief and recovery measures. Ghana's central bank too has resorted to financing the public deficit.

In none of these cases has there been a major surge in inflation. Neither has there been any inflationary pressure when many leading central banks adopted unconventional monetary policies and injected huge amounts of liquidity in the aftermath of the 2008 GFC. A majority of economists agree that the recent spike in inflation is transitory,[11] caused by supply shortages due to COVID-induced disruptions such as breakdowns in global supply chains, and precautionary/ preventative restrictions such as lockdowns. The current inflation is also caused by rising commodity, such as oil, prices.[12]

MYTH 4: INFLATION HARMS GROWTH AND THE POOR

Neoliberals claim that inflation is harmful for growth and poverty reduction. Figure 8a plots average inflation and average per capita GDP growth in 176 countries (including West Bank and Gaza) for the period 2000–2019. Three facts stand out: (a) inflation and growth are positively related for inflation up to 50%, (b) the inflation–growth relation becomes negative when inflation exceeds 50%, and (c) growth rates can be high or low for inflation up to 20%. Similarly, Figures 8b & 8c show that inflation–poverty relationships are influenced by extreme values or outliers above 30%. Poverty can be high or low for inflation up to 20%. This holds for both extreme poverty (below US$1.90/day) and near poverty (US$3.20/day).

FIGURE 8A: INFLATION & PER CAPITA GDP GROWTH (AVERAGE, 1990–2020) (176 COUNTRIES, INCLUDING WEST BANK & GAZA)



Source: World Bank on-line data

10 https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/ArticulosAnaliticos/20/T4/descargar/Files/Rep_LatinAmericanEconomy_Box1.pdf (6/10/2021)
11 See article: "Seventeen winners of the Nobel Prize in economics sign letter in support of the President's Build Back Better package" https://www.epi.org/press/nobel-laureate-economist-joseph-stiglitz-issues-statement-in-support-of-build-back-better-agenda/ (23/09/2021). Also, Dudash (2021); Gopinath (2021); Ha, Kose and Ohnsorge (2021); Krugman (2021); Stiglitz (2021)
12 https://www.wsj.com/articles/commodity-price-surges-add-to-inflation-fears-11623079860 (6/10/2021)

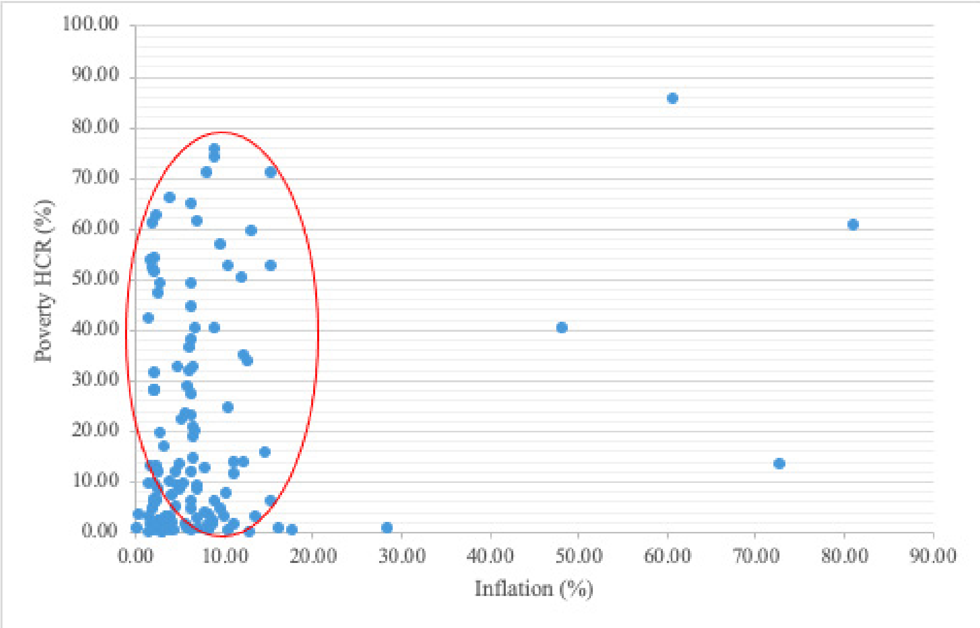


FIGURE 8B: INFLATION & POVERTY (US$1.9/DAY) (AVERAGE, 2000–2019, 130 DEVELOPING COUNTRIES)

Source: World Bank on-line data

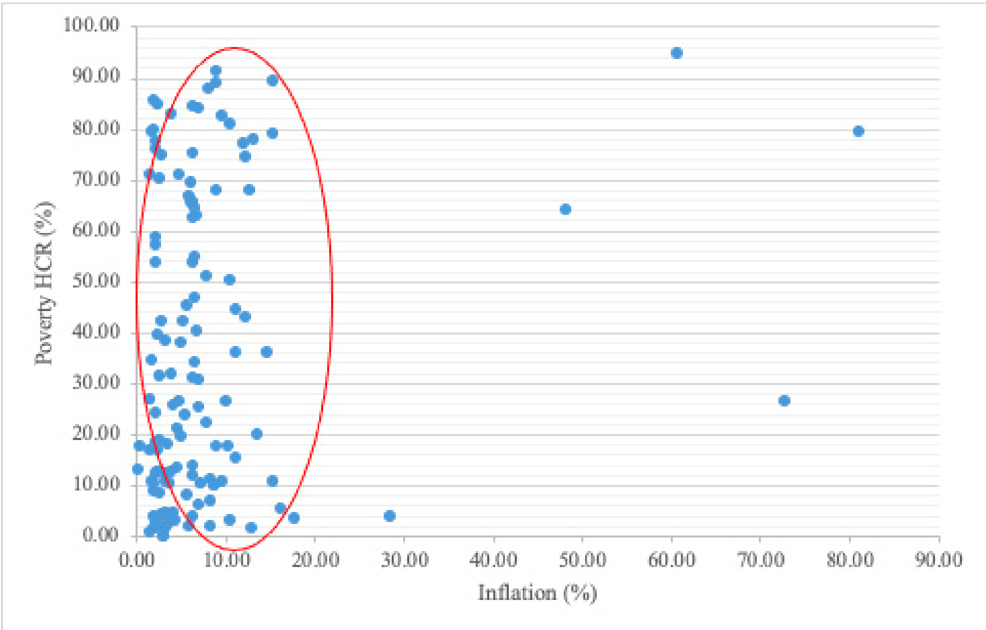


FIGURE 8C: INFLATION & POVERTY (US$3.2/DAY) (AVERAGE, 2000–2019, 130 DEVELOPING COUNTRIES)

Source: World Bank on-line data

Therefore, there is no solid empirical basis for the commonly used inflation targets of around 2–3% for developed countries and 5% for developing countries. Asking “Is inflation harmful to growth?”, and based on their cross-country econometric analysis, two senior World Bank economists, Michael Bruno and William Easterly, concluded, “The ratio of fervent beliefs to tangible evidence seems unusually high on this topic” (Bruno and Easterly 1998, p. 3).

As the experience of fast-growing Asian economies shows, inflation and growth go hand-in-hand, except when there is a financial crisis (such as the 1997 AFC) or external shocks (for example, the 1994 Java Tsunami). Just as a running machine causes friction and hence heat, a growing economy causes inflation. Too restrictive money and credit policies stifle an economy as businesses need access to finance to invest. A certain amount of inflation is also needed to induce structural change towards desirable and dynamic sectors. Higher prices signal where resources should move.

Higher inflation also means a lower value of debt and hence benefits the indebted poor. Higher inflation may not necessarily mean lower real wages or loss of employment if inflation is due to rapid growth (as revealed in Figure 8a) and structural transformation. Thus, the relationship between inflation and poverty is complex and inflation does not necessarily harm the poor as is commonly believed.

Empirical studies on the inflation–growth relation found various threshold levels beyond which inflation may harm growth. More importantly, these thresholds do not necessarily mean a sharp cliff-edge implying that growth would plummet when the threshold is hit. It is more likely that the threshold is a plateau and hence policy makers do not have to overreact every time the inflation rate edges up.

These empirical findings give monetary authorities considerable policy space, and they need not respond aggressively whenever any sign of inflation emerges. Anti-inflationary or stabilisation policies need to consider growth and distributional consequences. In the wake of the 2008 GFC, both the managing director and chief economist of the IMF at the time criticised the "one policy one instrument" approach of bluntly using the interest rate to tackle all kinds of inflation. They also raised doubts about the conventional view of a low inflation strategy (Blanchard 2012; Strauss-Kahn 2011).

While both inflation–growth and inflation–poverty relationships are influenced by extreme values or outliers, moderate inflation does not harm growth or poverty rates. There is no doubt that hyperinflation is harmful for both growth and the poor. However, episodes of hyperinflation (in excess of 20%) are rare and are often caused by breakdowns of either a political system (such as the collapse of the Soviet Union in 1991), wars, or external shocks. Thus, the fear of accelerating inflation is not fully justified.

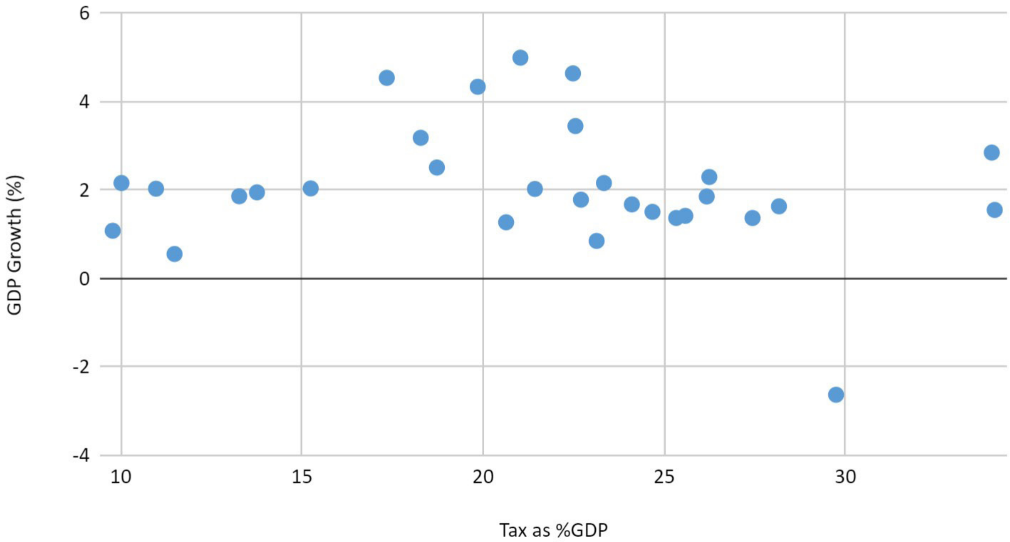
Nonetheless, as Chowdhury (2022) emphasised, policymakers should be watchful, especially against wage–price spirals, that is, giving in to demands for higher wages because of higher inflation. In most such circumstances, higher wages are passed on to higher prices, and thus can create a viciously repeating cycle of inflation, wage demand, inflation, and so on.

Chowdhury (2002) also noted that policymakers should not always resort to interest rates without examining the sources of inflation. There are alternative measures to deal with inflation and wage demand, for example, subsidised provisioning of services, such as childcare, healthcare, education and public transport. Collectively, they can be termed as "social wage", made possible by supportive fiscal policy.

MYTH 5: HIGHER TAXES HARM GROWTH

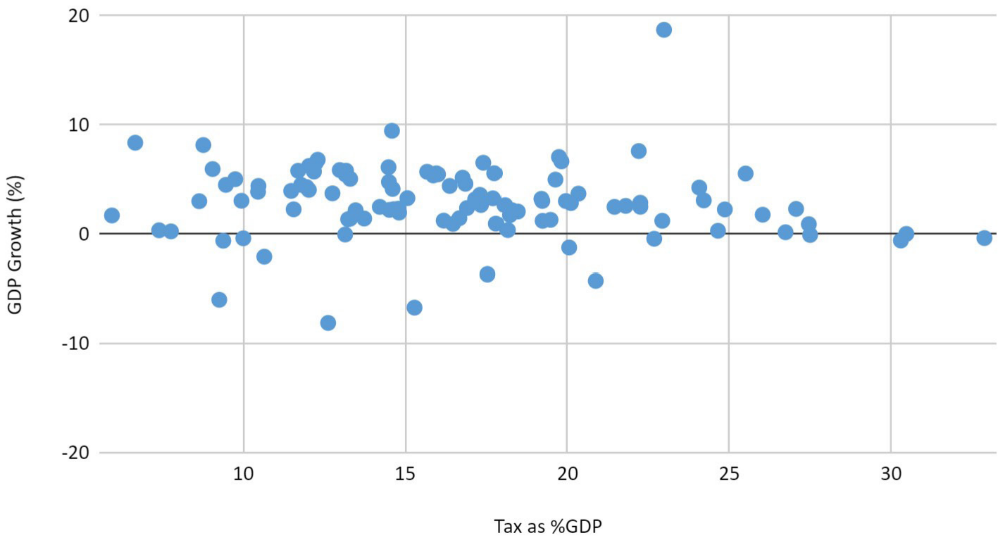
As shown in Figures 9a and 9b, the relationship between tax rates and economic growth is mixed; while the relationship is positive in the case of developed countries (Figure 9a), economic growth in developing countries is not adversely affected even when the tax–GDP ratio is as high as 25% (Figure 9b).

FIGURE 9A: TAX & GDP GROWTH (30 DEVELOPED COUNTRIES) 2019 OR LATEST AVAILABLE DATA



Source: World Bank on-line data

FIGURE 9B: TAX & GDP GROWTH (107 DEVELOPING COUNTRIES) 2019 OR LATEST AVAILABLE DATA



Source: World Bank on-line data

These findings are contrary to the so-called "optimal taxation" theory and the "supply-side" economics of neoliberals who hold the view that higher income taxes cause disincentives and harm economic growth. Instead, the finding implies that developed countries should endeavour to enhance progressivity of their tax structure, and developing countries should not unnecessarily fear of endangering their economic growth when they endeavour to enhance domestic resource mobilisation.

Interestingly, myth-mongering neoliberals ignore contrary messages coming even from conservative sources. For example, surveying the available empirical evidence, John O'Sullivan noted in *The Economist* (2017) that the relationship between tax rates and growth or investment was not very strong. He concluded, "the decision to invest in a country depends on a lot more than tax" (O'Sullivan 2017). Research within the OECD has shown that these may include good infrastructure, high quality education, and social cohesion (OECD 2008). As mentioned earlier, the World Bank's 2017–2018 enterprise survey found that tax incentives were not high on the list of critical factors affecting inflows of FDI (World Bank 2018).

Evidence base for supportive macroeconomic policies

Having debunked several neoliberal myths, this section highlights key stylised facts that provide the empirical foundation or evidence base for supportive macroeconomic policies.

COUNTERCYCLICAL MACROECONOMIC POLICIES ARE GOOD FOR THE POOR

Countercyclical fiscal and monetary policies cushion the income of the poor from business cycles and shocks. They also dampen income inequality. Figure 10a shows that, excluding extreme values (outliers), when the economy is stabilised (lower variations of nominal GDP), average income of the poor rises. Therefore, as expected inequality (Gini coefficient, the most common measure of inequality) declines (Figure 10b).

The logic for such outcomes is obvious. It is the low-income, unskilled wage workers who are first to lose jobs during an economic downturn. Therefore, their jobs and incomes are protected when the economy is stabilised. This conclusion is supported by studies of European Union (Dossche et al. 2021) countries and of Latin American (Lustig 2021) countries.[13] Box 7 summarises impacts of restrictive fiscal and monetary policies on inequality.

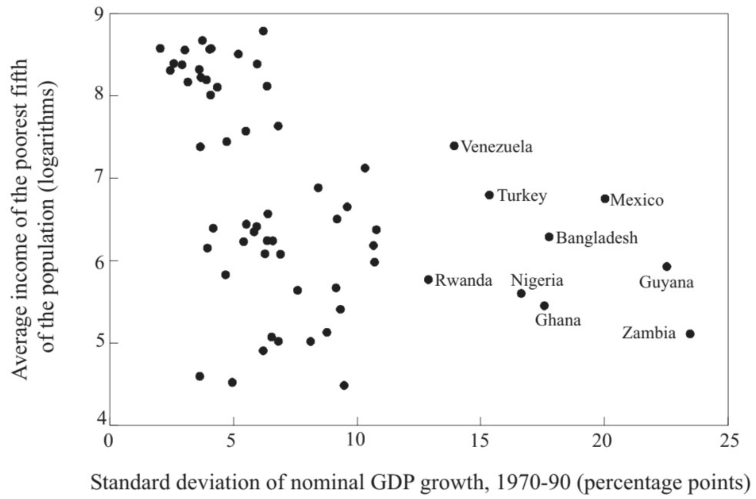
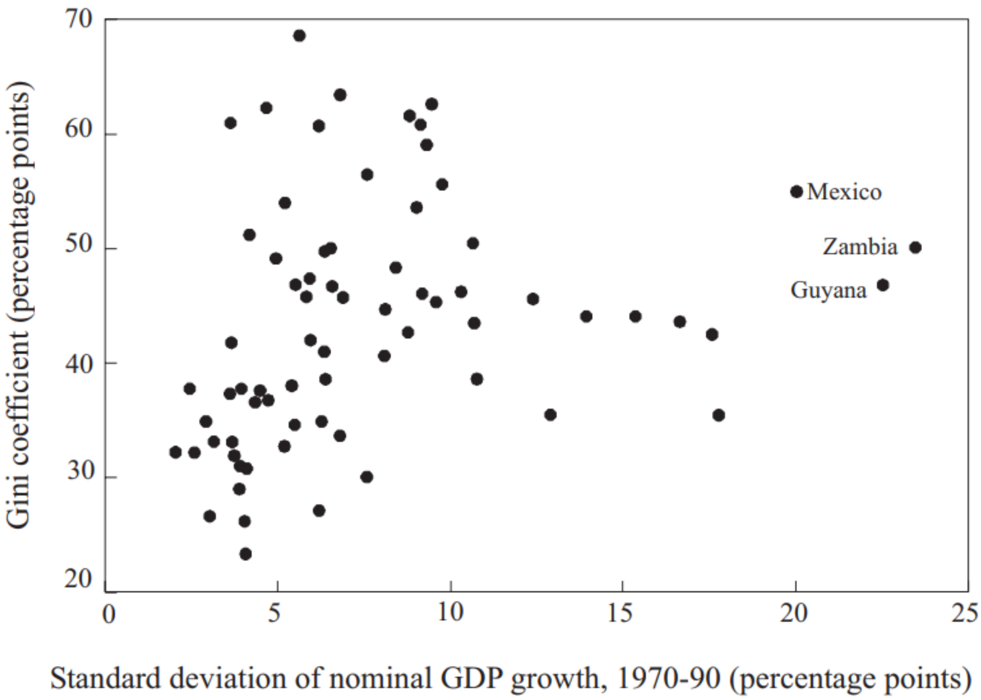


FIGURE 10A: STABILISATION & INCOME OF THE POOR

Source: Romer and Romer (1999, p. 35)

13 See, for example, Dossche, Slačálek and Wolswijk (2021) for EU countries and Lusting (2000) for Latin America.

FIGURE 10B: STABILISATION & INEQUALITY



Source: Romer and Romer (1999, p. 45)

BOX 7: FISCAL AUSTERITY AND CONTRACTIONARY MONETARY POLICIES WORSEN INEQUALITY

Coordinated global fiscal response prevented the 2008–2009 Great Recession from becoming another Great Depression. However, in 2010, buoyed by what turned out to be mistaken signs of a strong recovery, many advanced economies signalled a U-turn in their fiscal stance, a policy choice that many regard as partly responsible for the tepid recovery that followed and the consequent failure to bring about reductions in debt–GDP ratios. The turn to austerity also led to cutbacks in governments' health expenditures in the run-up to the COVID-19 pandemic.

Research within the IMF found that in the aftermath of past pandemics, severe fiscal austerity measures were associated with inequality increases (see, for example, Furceri, et al. 2021). Earlier research by the IMF found that capital account liberalisation and fiscal austerity has contributed to rising inequality since the mid-1980s (Furceri and Loungani 2013).

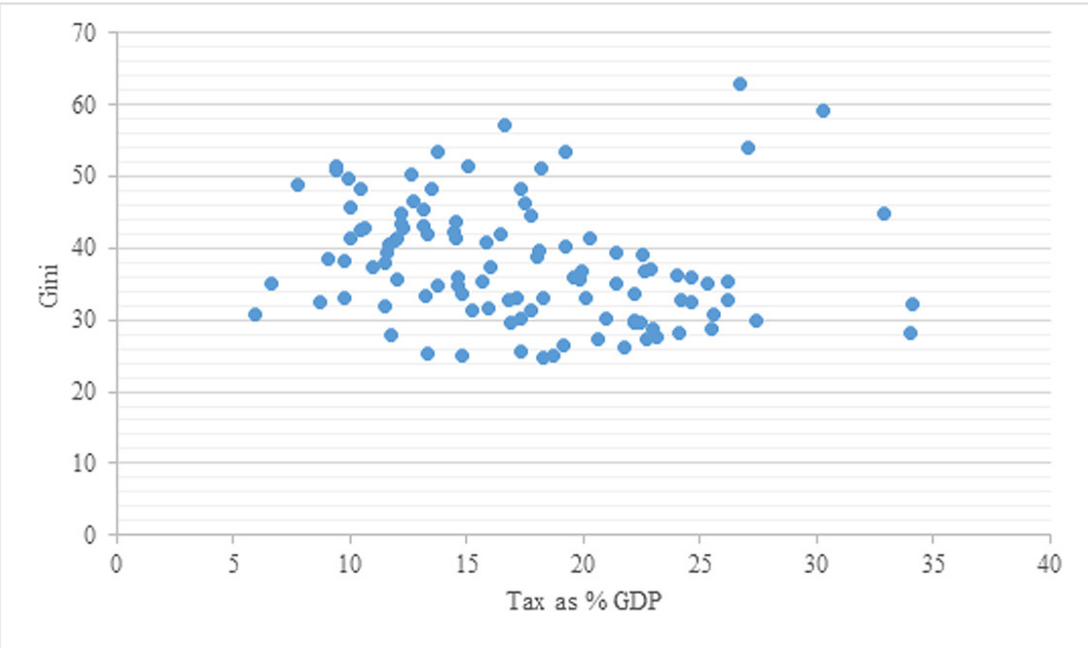
IMF research also found that contractionary monetary policy with an unexpected increase in policy rates increases inequality (Furceri, Loungani and Zdzienicka 2016). Studies of recent unconventional expansionary policies in advanced countries reveal a mixed picture of impacts on inequality. While such expansionary monetary policy in general reduces income inequality, it may also raise wealth inequality. Nonetheless, in most cases, the easing of monetary policy would seem, overall, to have dampened economic inequality in recent years (Dossche, Slačálek and Wolswijk 2021).

TAX PROGRESSIVITY SIGNIFICANTLY REDUCING INEQUALITY

Figures 11a and 11b are scatter plots for 26 developed and 80 developing countries. As can be seen, if four extreme values or outliers (South Africa, Mozambique, Namibia and Chile) with high Gini coefficients above 0.44 are excluded, there is a clear negative relationship between tax progressivity and inequality. That is, the higher the tax–GDP ratio, the lower the inequality. These findings corroborate an earlier observation about the OECD countries: that there is a negative relationship between top (marginal) tax rates and top (marginal) income shares (Figure 4). Thus, fiscal policy plays a critical role in affecting income distribution.

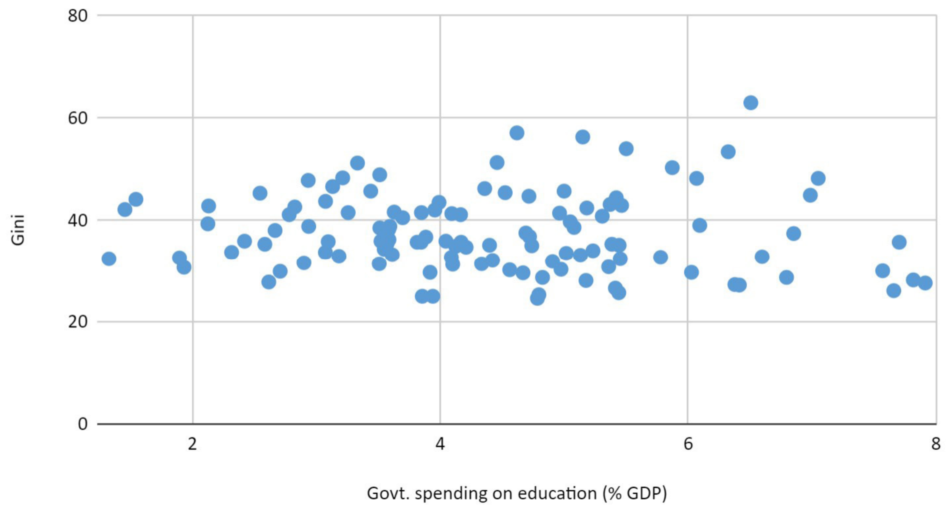
There is a simple rationale for why governments' ability to mitigate inequality depends on their revenue capacity. Lower revenue efforts constrain governments' ability to spend on public provisioning of services such as primary healthcare, social protection and education that normally benefit low-income people. As shown in Figure 11b, there is a negative correlation between government education expenditure and Gini, when outliers with Gini coefficients above 0.4 are excluded. This implies that higher government social spending is associated with lower inequality.

FIGURE 11A: TAX & GINI
(106 COUNTRIES – 26 DEVELOPED, 80 DEVELOPING)
2019 OR LATEST available data



Source: World Bank on-line data

FIGURE 11B: GOVERNMENT SPENDING ON EDUCATION & INEQUALITY



Source: World Bank on-line data

FISCAL POLICY IS AN EFFECTIVE TOOL FOR DEVELOPMENT AND STABILISATION

From the mid-1930s until about the mid-1960s, fiscal policy played a major role, both in developed and developing countries, in the stabilisation of national economies. Fiscal deficit was the main policy instrument to address the Great Depression of the 1930s and later, to maintain full employment in developed countries. Deficits and surpluses were adjusted counter-cyclically over business cycles. In his 1936 budget speech, US President Roosevelt noted, “the deficit of today ... is making possible the surplus of tomorrow”.[14]

Governments in developing countries have played a major role in building infrastructure and providing basic public services such as healthcare and education. They did not have the resources, domestic or foreign, to rebuild their economies as war-torn Europe had with the Marshall Plan.

Thus, the main way to develop their newly decolonised countries was by running deficits, financed by borrowing from central banks, often referred to as “printing money”. This was also the case even for the US when it emerged as a newly independent nation. Alexander Hamilton, the first US treasury secretary under President Washington, incurred debt to establish “sound credit”, laying the foundation for a robust future market in US debt.

Fiscal policy can promote macroeconomic stability by sustaining aggregate demand and private sector incomes during an economic downturn and by moderating economic activity during periods of strong growth. In recent times, the GFC was successfully tackled by massive fiscal expansions in many developed and developing countries. Economies have been kept afloat with massive fiscal support worth over US$16 trillion globally during the current pandemic.

14 https://www.presidency.ucsb.edu/documents/annual-budget-message-7, 24/08/2020

IMF's 2015 (April) *Fiscal Monitor* looked at the experience of fiscal stabilisation during the past three decades in a broad sample of 85 advanced, emerging market, and developing economies. It concluded that governments can use fiscal policy to smooth fluctuations in economic activity, and this can lead to higher medium-term growth.

An important stabilising function of fiscal policy operates through the so-called "automatic fiscal stabilisers". These work through the impact of economic fluctuations on the government budget and do not require any short-term decisions by policy makers. The size of tax collections and transfer payments, for example, are directly linked to the cyclical position of the economy and adjust in a way that helps stabilise aggregate demand and private sector incomes.

Stabilisation can also result from discretionary fiscal policy-making, whereby governments actively decide to adjust spending or taxes in response to changes in economic activity. However, discretionary fiscal measures must be linked to governments' long-term development and structural transformation goals. Thus, countries come out better and more resilient through recessions, rather than returning to the pre-recession status quo.

CENTRAL BANKS HISTORICALLY PLAYED A DEVELOPMENTAL ROLE

Historically, central banks have played a developmental role, for example, by financing public investment (Florence and Volz 2015). Even though many statutes are not explicit about the developmental roles of central banks, the two oldest central banks – the Bank of England and Sweden's Riksbank – are not prohibited from vigorously promoting priorities. For example, the Riksbank's active promotion of housing for all.

The Bank of England even pioneered creating specialised development institutions, such as the Industrial and Commercial Finance Corporation, the Finance Corporation for Industry, and the Bankers' Industrial Development Company.

The US Federal Reserve Act is committed to realising "the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates...in furtherance of the purposes of the Full Employment and Balanced Growth Act of 1948."

Central banks of Italy, Germany, Japan and the Netherlands have used various means to finance areas underserved by credit markets. These include lowering bank reserve requirements and lending for priorities such as housing, agriculture, exports, small business and underdeveloped regions.

Even before independence, the Reserve Bank of India observed, "it may be desirable for Central Bank credit to be made available in a larger number of ways and with less restrictions" (Quoted in Chandavarkar 1987, p. 35). However, it was not until the 1950s that the Reserve Bank of India embarked on its developmental activities (Chandavarkar 1987).

Developmental objectives are explicit in many developing countries' central bank statutes. The statutes of some central banks established in the 1970s and 1980s with IMF technical assistance have specific provisions for developmental roles, including in Bhutan, Botswana, Fiji, Maldives, Solomon Islands, Swaziland and Vanuatu (Chandavarkar 1987).

The Bangladesh central bank adopted a sustainable finance policy in 2011 to promote green investment and sustainable agriculture.[15] Ninety developing country central banks have signed the Maya Declaration to promote financial inclusion (FI) since 2011.[16]

BOX 8: BANGLADESH BANK PROMOTES FINANCIAL INCLUSION (FI) AND SUPPORTS GOVERNMENT'S DEVELOPMENT STRATEGY

As a developmental central bank, the Bangladesh Bank (BB) has a dual mandate of price stability and inclusive growth (Muqtada 2015). The BB's contribution to inclusive growth is largely predicated on its array of programmes on FI. Among the many FI initiatives during the recent past, the following are noteworthy:

- Agriculture sector credit policy
- A credit programme for sharecroppers
- 10 Taka account for farmers
- Access to finance for small and medium-sized enterprises
- Mobile banking

There are multiple programmes and activities within each of the FI initiatives mentioned above.

The BB is also a keen promoter of environmentally-friendly projects, and has introduced special refinanced lines to encourage commercial banks and financial institutions to extend loans to such areas as renewable energy and energy-efficient technologies, in line with SDG 7. It has also introduced incentives towards "planned" promotion of lending for crop diversification and cultivation of crops that could potentially reduce dependence on their imports.

15 https://www.bb.org.bd/mediaroom/circulars/gbcrd/dec312020sfd05.pdf, 12/08/2021
16 https://www.afi-global.org/global-voice/maya-declaration/ (12/08/2021)

Chile 26th March 2020 People waiting in Providencia streets to enter inside the banks and shops during the last hours before the curfew because of coronavirus disease COVID-19 — Photo by abriendomundo / Depositphotos

Designing supportive macroeconomic policies[17]

Historically, macroeconomic policies have had both stabilisation and development roles. The United Nations has consistently highlighted the need for striking a balance between stabilisation and development since the 1950s: "There is always some risk, however, that if pressed sufficiently far, the application of general monetary restraints may unduly check demand even for necessary long-term industrial investment and thus hamper economic growth" (United Nations 1956, p. 6).

SUPPORTIVE FISCAL POLICY

> The fiscal deficit is a useful indicator for purposes of stabilisation and for controlling the growth of government liabilities, but it offers little indication of longer-term effects on government assets or on economic growth (World Bank-IMF Development Committee 2006, p. i).

Above is an important reminder from the joint Development Committee of the World Bank and IMF for policymakers designing fiscal policy. The Bank-Fund Joint Development Committee lays out some instructive guidelines for supportive fiscal policy that balances stabilisation and developmental objectives. It notes that "attention be focused on the likely growth effects of the level, composition and efficiency of public spending and taxation" (World Bank-IMF Development Committee 2006, p. i). It also warns: "Fiscal policy that neglects these effects runs the risk of achieving stability while potentially undermining long-term growth and poverty reduction" (World Bank-IMF Development Committee 2006, p. i).

Therefore, there is a need to identify and incorporate the transmission channels through which public spending and taxation influence long-term growth and equity (that is, income and wealth distribution, access and opportunities). The historical development and countercyclical stabilisation roles of fiscal policy are summarised earlier.

17 This section draws on Chowdhury and Islam (2018), and Chowdhury and Popov (2019).

COUNTERCYCLICAL STABILISATION: AUTOMATIC STABILISERS

Social protection and progressive taxation act as automatic stabilisers. During economic downturns, governments' social protection spending increases and tax collections decline, thus giving more money to the hands of individuals in order to spend. This cushions the impact of economic shocks. On the other hand, during economic upturns, social protection spending declines and tax collection improves. This restrains spending by individuals and prevents the economy from overheating.

In many developing countries, a large number of middle-income people remain vulnerable to poverty as they live at the edge of the poverty line and a small shock can push them into poverty. This can be prevented through well-designed universal social protection systems that act as automatic stabilisers. By reducing the variability of income and employment, broad-based stabilisation policies also prevent inequality from rising, and thus enhance the poverty-reducing effect of growth as elaborated earlier.

BOX 9: AUTOMATIC STABILISERS

Supportive fiscal and monetary policies must provide some "automatic stabilisers" such as:

- progressive taxation, which reduces the negative fiscal impact on the poor
- welfare programmes and social protection policies, including worker protection, special access to non-collateral-based credit, public distribution systems for food and other necessities, and income support for poor households
- automatic adjustments of tariffs to external prices, such as a variable tariff system
- a counter-cyclical tax, such as an export tax, that allows governments to generate more revenue during export booms, to be set aside for a price stabilisation fund for future exports
- a tax on capital inflows, limited to, say, equity and portfolio capital, as opposed to "green field" investment, when such inflows are excessive
- restricting activities associated with speculative bubbles, through measures such as imposition of higher capital gains taxes and bank regulations that reduce lending for such activities.

A bundle of macroeconomic policies of this kind, by restoring the central role of government in driving growth, can ensure that the cycles and recession characteristics of predominantly market-driven systems are moderated and managed, with attendant positive effects on SDGs.

Source: Parisotto and Ray (2017)

BOX 10: GOVERNMENTS AS EMPLOYER AND PAYER OF LAST RESORT

Governments' roles as employers of last resort (ELR) and payers of last resort (PLR), as part of broader social protection measures have been found to be extremely useful automatic stabiliser tools during the ongoing pandemic. ELR could include various job guarantee schemes, such as India's National Rural Employment Guarantee Act (NREGA) that provides 100 days of guaranteed employment to every rural household,[18] and the US programme that provides federal funding for employment in state and local governments. If governments are forced to bail out big businesses and banks, they can at least make their support contingent on maintaining employment levels. Workers are less likely to become demoralised and deskilled due to layoffs, and employers do not have to look for skilled workers or retrain them when the economy rebounds. During the COVID-19 pandemic the UK and Australia essentially introduced such schemes to guarantee employment helping "suspended" businesses to continue paying their involuntarily idle employees, instead of firing them.

During the ongoing pandemic many high-income and upper-middle-income governments have also served as PLR. Businesses have been able to access government relief packages to help settle some of their unavoidable bills, to cover their overheads and maintenance costs – such as rent, utility and other payments – during stay in shelter lockdowns. Such PLR programs have successfully complemented effective contagion containment measures, enabling early resumption of economic activity. While high, such costs can remain manageable as they prevent widespread business failures and help early recovery.

18 For an analysis of its applicability of ELR in developing countries, see Wray (2007).

CREATING FISCAL SPACE

Fiscal space generally refers to the capacity of a government to identify, allocate and manage budgetary resources for discretionary purposes, without undermining the sustainability of its financial position (Heller 2005, p. 3). However, the term is used in a narrow sense to describe the scope for "sustainable" increases in public debt (Ostry et al. 2010, p. 6). This leads to a focus on the primary fiscal surplus as the critical requirement to align the level of public debt to the debt limit implied by the country's past record of fiscal adjustment. Fiscal sustainability should also consider the growth potential of a government's development and social expenditure.

From the point of view of meeting wider development objectives, a broader view should be maintained where all potential resources are taken into account. In this regard, the notion of the "fiscal diamond" originally introduced by the Bank-Fund Joint Development Committee (World Bank-IMF Development Committee, 2006), provides a useful diagnostic tool.

The first corner of the "diamond" suggests domestic resource mobilisation efforts, starting with broadening the tax base, improving tax collection, reducing the scope for multinational corporations to shift their profits to tax havens, and fighting illicit financial flows and capital flight. As mentioned earlier, contrary to the neoliberal myth, the tax–growth relationship shown in Figures 9a and 9b imply that both developed and developing countries have considerable scope to strengthen their tax efforts without jeopardising their growth. Innovative taxes, such as a tax on capital leaving the country, raised about US$1 billion annually in Ecuador's government revenue from 2012 to 2015 (Weisbrot, Johnston and Merling 2017).

However, countries lose a considerable amount of tax revenue due to multinational corporations' (MNCs) "base erosion and profit shifting" (BEPS), which entails posting profits in low-tax jurisdictions or tax havens. BEPS practices cost countries US$100–240 billion in lost revenue annually, which is the equivalent to 4–10% of the global corporate income tax revenue.[19] MNCs use trade misinvoicing in transactions involving their subsidiaries or "shell companies" for BEPS. Tax havens collectively cost governments around US$500–$600 billion a year in lost corporate tax revenue, depending on the estimate, through legal and not-so-legal means (Shaxson 2019). Of that lost revenue, low-income economies account for some US$200 billion – a larger hit as a percentage of GDP than advanced economies and more than the US$150 billion or so they receive each year in foreign development assistance. American Fortune 500 companies alone held an estimated US$2.6 trillion offshore in 2017.

Countries also lose revenues due to illicit financial flows. Corporations are not the only ones engaged in illicit financial flows. Individuals have stashed US$8.7 trillion in tax havens, according to one study published in 2017 (reported in Shaxson 2019). Another more comprehensive study published in 2016 found an astonishing total of up to US$36 trillion. Both studies put global individual income tax losses at around US$200 billion a year, which must be added to the corporate total.

Stemming such loop holes requires international cooperation. The OECD is tasked by the G20 to work on this issue. The recent decision by G20 countries in favour of a global minimum corporate tax at 15%, while low, was still a move in the right direction to prevent profit shifting. However, the current proposal to share additional recovered revenue favours developed countries where MNCs are headquartered. Developing countries, therefore, should work jointly to ensure they receive their fair share of recovered revenue.

An additional challenge in tax collection is digital cross-border transactions. While the OECD is working on the issue, some developing Asian countries have leveraged a more traditional VAT for a digitalised economy. The IMF estimates that requiring non-resident suppliers of digital services and e-commerce marketplaces to register with local tax authorities and remit VATs on their sales could raise revenue between 0.04% and 0.11% of GDP in some countries in Asia, translating to an additional US$166 million in Bangladesh, US$4.8 billion in India, US$1.1 billion in Indonesia, US$365 million in the Philippines, and US$264 million in Vietnam (Dabla-Norris et al. 2021).

However, digital services taxes (DSTs) are regressive, will raise relatively little tax and move further away from needed international solutions to effectively tax the excess profits of global tech giants. Moreover, poorly designed DSTs could create a false impression that they have ended tax dodging or, alternatively, be used by lobbyists to argue that tax changes are ineffective. This would undermine the public support and political will needed for genuine reforms to ensure that all global corporations pay their fair share.

19 https://www.oecd.org/tax/beps/#:~:text=BEPS%20practices%20cost%20countries%20100,global%20corporate%20income%20tax%20revenue. (17/12/2021)

BOX 11: OECD AGREEMENT ON GLOBAL MINIMUM AND DIGITAL SERVICES TAX

The recent OECD agreement to set a minimum tax rate of 15% for large multinational enterprises (MNEs) from 2023 has significant conceptual and practical flaws and will deliver very little revenue – especially to the countries which need it most. To secure the OECD agreement, the negotiating countries suspended collection of DSTs. However, its implementation remains doubtful, especially in light of the difficulties it may face in the US Congress. It may also face political resistance in some low-tax countries, such as the Netherlands and Estonia.

Some observers believe that the OECD agreement has missed the opportunity of making the tax system more transparent and less complicated, which is likely to give rise to novel ways of circumventing the rules.[20] EconPol Europe, the European Network for Economic and Fiscal Policy Research, estimates that Pillar One will only cover 78 of the world's largest 500 companies and the allocation would amount to US$78billion, much below the OECD estimates. Less than half of this amount would come from tech companies. EconPol also estimates that had the financial services sector been included, the possible amount would double.[21]

Some developing countries and advocacy groups argue that the deal does not take their interest sufficiently into account and that it benefits mostly the wealthy nations, thus increasing inequality. Oxfam regards the deal as a watered-down solution and "a mockery of fairness",[22] with loopholes that may be exploited by the MNEs. It estimated that 52 developing countries would receive only around 0.025% of their collective GDP in additional annual tax revenue from Pillar One.

Oxfam also underlined that the 15% minimum global corporate tax rate is well below the 20% to 30% rate recommended by the UN Financial Accountability, Transparency and Integrity Panel. Similarly, it is significantly below the 25% recommended by the Independent Commission for the Reform of International Corporate Taxation. The BEPS Monitoring Group argued that a 15 % minimum rate would not remove the incentive for MNEs to shift profits out of source countries, because they mostly have rates of at least 25%.[23]

The Tax Justice Network criticised the deal stating that it will not keep profit shifting in check.[24] At the same time, it will provide significant revenues to a limited number of OECD members while leaving out everybody else, particularly the lower-income countries. The Financial Accountability and Corporate Transparency Coalition called the deal "historic", but expressed concerns that the voices of developing countries calling for a more equitable share in the revenues had not been taken into account, risking the long-term political viability of the reform.[25]

20 https://www.ft.com/content/17de8ec7-f4c8-4ed0-9570-bb1b732add85 (17/12/2021)
21 https://www.econpol.eu/sites/default/files/2021-07/EconPol_Policy_Brief_36_Who_Will_Pay_Amount_A_0.pdf (17/12/2021)
22 https://www.oxfam.org/en/press-releases/oecd-tax-deal-mockery-fairness-oxfam (17/12/2021)
23 https://www.bepsmonitoringgroup.org/news/2021/7/31/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy (17/12/2021)
24 https://taxjustice.net/press/oecd-tax-deal-fails-to-deliver/ (17/12/2021)
25 https://thefactcoalition.org/global-tax-deal-advances-but-questions-persist/ (17/12/2021)

BOX 12: REFORMING THE TAXATION SYSTEM

Ideally, the tax regime in any country should provide increased collection without disproportionately harming the poor or having other regressive effects. This entails:

- improving tax administration and enforcement by reducing exemptions and loopholes and spending more on tax collection
- diversifying sources of tax revenue instead of relying predominantly on a single indirect tax such as VAT
- relying on rule-based and non-discretionary tax instruments which reduce corruption and transaction costs
- increasing personal income tax collection from the rich and targeting luxury consumption
- taxing capital, especially speculative capital movements, including through small transactions taxes in foreign exchange and capital markets
- using trade taxes creatively and flexibly to the extent permitted within the framework of existing trade agreements, in order to manage trade and the balance of payments as well as generate more revenue

The Australia Institute suggested five simple principles to assess any tax reform:[26]

- Principle 1 – The tax should minimise the change in behaviour unless it is something that we want less of, in which case it should be effective at changing that behaviour
- Principle 2 – The tax should reduce inequality
- Principle 3 – The tax should be levelled on those who are best able to pay
- Principle 4 – The tax should be simple to comply with, simple to administer and easy to understand
- Principle 5 – The tax should be difficult to avoid

Country examples during pandemic

A number of countries increased tax to expand their fiscal space to tackle the pandemic-induced crisis. While a few of these tax increases are one-off or temporary measures, most are intended to be permanent. Some countries introduced tax increases on high-income earners, including increases in top personal income tax (PIT) rates, and some countries (such as the Czech Republic and Russia) moved from flat to progressive PIT systems. The US and the UK announced increases in CIT rates, from 21% to 28% and from 19% to 25% respectively. The Netherlands reversed the intended decrease of the CIT rate to 21.7%, maintaining the rate at 25%. Luxembourg introduced a 20% withholding tax on income derived from real estate located in Luxembourg by certain Luxembourg investment funds from 2021. Sweden announced a new tax on the financial sector that will be in force in 2023 (OECD 2021b).

Indonesia's parliament approved a law on 7 October 2021 for one of the country's most ambitious tax overhauls, including raising VAT next year, a new carbon levy and cancelling a planned CIT rate cut. The law, aimed at optimising revenue collection and improving tax compliance, is expected to raise the tax–GDP ratio in 2022 to 9.22% of GDP, up from 8.44%.[27] The Philippines government is carrying out a property valuation reform programme, expected to boost real property tax collections by local governments by 25% from 2023.[28] Argentina's senate passed "millionaire's tax" – a one-off tax of at least 2% – on 4 December 2020, raising around US$2 billion by the first week of April 2021.[29]

26 https://australiainstitute.org.au/wp-content/uploads/2021/07/Principles-of-a-good-tax-WEB.pdf (17/12/2021)
27 https://www.reuters.com/world/asia-pacific/indonesian-parliament-vote-major-tax-overhaul-2021-10-06/ (8/10/2021)
28 https://www.adb.org/news/features/covid-19-pandemic-spurs-asia-focus-tax-resource-mobilization-reform (8/10/2021)
29 https://batimes.com.ar/news/economy/argentinas-wealth-tax-fought-by-the-rich-raises-us24-billion.phtml (8/10/2021)

The second corner of the diamond concerns the need to improve the effectiveness and efficiency of public expenditure. The first task in this regard is the elimination of wasteful subsidies, such as fuel subsidies, that generally benefit the urban middle class. Any reallocation of the budget between sectors should try to preserve jobs by creating new productive jobs and active labour market programs (ALMP) in light of SDG 8.

The third corner refers to additional borrowing, which could be from domestic or external sources. The opportunity for external borrowing is limited for most developing countries, especially when their external debt is already quite high. Debt relief can considerably help developing countries' fiscal space. As mentioned earlier, governments should not be restrained from borrowing from domestic sources due to the unfounded neoliberal myth of crowding out or inflationary consequences, as long as their borrowing is for productive investment such as infrastructure, education and health.

BOX 13: DEBT RESTRUCTURING/DEBT RELIEF AND FISCAL SPACE

Ecuador offers an excellent recent example of how restructuring sovereign debt can be used to create fiscal space for social development expenditures. In 2008, Ecuador defaulted on its "illegitimate" debt and freed up public resources for expanding health care, education and social protection programs. Social spending more than doubled from 4.8% in 2006 to 10.3% of GDP in 2011.

The newly released public resources were also successfully used to help the economy recover from the 2008 financial crisis. GDP growth increased from 0.4% in 2009 to 7.8% in 2011, surpassing the pre-crisis growth rate of 7.2% in 2008.

Debt restructuring enabled the government, through social and human development investments, to reduce poverty rates from 37.6% in 2006 to 22.5% in 2014, while the Gini coefficient (measuring inequality) declined from 0.54 to 0.47 during 2006–11.

Contrary to critics' expectations, Ecuador's credit reputation did not suffer as its social investments are regarded as a developmental success. Ecuador was able to sell US$2 billion worth of bonds in 2014 when it returned to the international capital markets.

The idea of swapping debt for development has been around since the 1980s as a way out from the Latin American debt crisis. During the decade 1998–2008, 18 debt swaps in 14 countries converted about US$608.8 million in debt into support for local development.

The Highly Indebted Poor Countries (HIPC) Initiative, launched in 1996 by the IMF and the World Bank, helped eligible countries reduce their debt service payments by about 1.8% of GDP between 2001 and 2014. Linking debt relief to poverty reduction and social policies allowed these countries to increase their expenditures on health, education and other social services. On average, such spending is now about five times the amount of debt service payments.

The fourth corner of the diamond is official development assistance (ODA). Unfortunately, most OECD development partners have failed to fulfil the promised aid target of 0.7% of their gross national income. Some have also cut their aid budget during the current pandemic. In such situations, strengthening South-South cooperation among developing countries would be critical.

HIGHLIGHTS OF SUPPORTIVE FISCAL POLICIES

- Supportive fiscal policy balances stabilisation, growth and distribution objectives:
- Consistently countercyclical at all times. That is, accumulates fiscal resources during boom periods and uses such resources to finance expansionary policies or targeted interventions during downturns.
- Comprises a balanced mix of automatic stabilisers such as job and social protection together with discretionary countercyclical measures.
- Prioritises public healthcare, basic education, social protection, ALMP and infrastructure, especially those that improve access for rural and remote regions as well as disadvantaged population groups.
- Eliminates wasteful subsidies, especially those that encourage unsustainable production and consumption, and restrains non-development spending.
- Follows the Golden Rule: avoid borrowing for recurrent expenditure, especially when the economy is not in a downturn; borrow for development expenditure only.
- Mobilises resources to expand the fiscal space for consistent countercyclical measures and long-term development and public expenditure programs.
- Maintains and enhances tax progressivity balancing equity (distributive) and efficiency (incentive) impacts.

SUPPORTIVE MONETARY POLICY

> Each member shall ... endeavour to direct its economic and financial policies towards the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances (IMF, Article of Agreement IV).

The IMF sets out the above guidelines for economic, in particular, monetary policy. The key here is “reasonable” price stability and due regard for country-specific circumstances. However, inflation targets constitute an important aspect of the IMF’s “surveillance” of member countries. The IMF believes that “when (annual) inflation passes the 5%-mark, investment and economic activity ... suffer”.[30]

As discussed earlier, there is no sound basis or empirical ground for an excessive focus on a very low single-digit inflation target. Therefore, monetary authorities should not excessively focus on a predetermined inflation target without any

30 IMF-supported programs – frequently asked questions, https://www.imf.org/external/np/exr/faq/progfaqs.htm, 24/08/2020.

regard for growth or causes of inflation. This can create a "stabilisation trap" (Chowdhury 2006).

Monetary policy has implications for issues beyond inflation and payments, including climate change and inequality. It would be disingenuous, even dangerous, for central bankers to deny those connections, or to insist that they are someone else's problem. Even when central banks use monetary policy to tame inflation, they must direct their regulatory powers at other pressing concerns.

Historically, central banks have played an important role in development by easing the constraint of access to credit for firms through credit allocation policies as elaborated earlier. For example, subsidised bank loans (known as "policy loans") were a vital instrument for the implementation of the strategy of the Republic of Korea for promoting heavy and chemical industries. In India, a decisive shift in credit deployment in favour of the agricultural sector took place in the 1970s and 1980s. From an extremely low level at the time of bank nationalisation, the credit share of the sector had moved to nearly 11% in the mid-1970s and to a peak of about 18% at the end of the 1980s, which was the official target. This change played an important role in the increase of agricultural output in India.

Therefore, monetary and credit policies should ensure financial inclusion and adequate supply of credit to productive sectors, especially agriculture and small and medium enterprises (SMEs). For example, in the United States, the Community Reinvestment Act of 1977 tasks regulators, including the Federal Reserve Bank, with ensuring that low-income and moderate-income families have adequate access to credit. Ecuador mandated in the wake of the 2008 GFC that all banks hold 45% of their liquid assets domestically. This was increased to 60% in August 2012, and the actual amount of these reserves held domestically increased to more than 80% by 2015 (Weisbrot, Johnston and Merling 2017). The monetary authority should also ensure that credit does not create a property bubble or fuel speculative activities, especially in the capital market.

HIGHLIGHTS OF SUPPORTIVE MONETARY POLICIES

Supportive monetary policy promotes job-rich pro-poor growth with reasonable price and exchange-rate stability. Such policies:

- work in tandem with countercyclical fiscal policy and governments' development priorities
- tolerate moderate inflation to facilitate growth and structural transformation
- consider supply-side sources of inflation and eases credits to affected sectors
- facilitate allocation of credit to priority sectors and industries to bolster productive and decent job creation as well as structural and "green" transformation
- enhance financial inclusion of poor "unbanked" households, household enterprises and small and medium enterprises (SMEs)

- strengthen central banks' supervisory and regulatory functions to strengthen financial sector stability and to promote effective and efficient financial intermediation
- ensure an adequate supply of credit for productive investment and to prevent speculative activities

THE CHOICE BETWEEN FISCAL AND MONETARY POLICIES

The choice between fiscal and monetary policies must be based not only on economic but also on social and political considerations. While both sets of policies impinge on effective demand, they are likely to produce significantly different effects on virtually every element of the community. This would, thus, require rigorous empirical studies on distributional consequences of fiscal and monetary policy instruments.

Viewed in this light, the excessive favour that the use of monetary policy is currently enjoying, one may ask whether the pendulum has swung too far. The UN has consistently warned against such excessive use of monetary policy or a single policy tool such as interest rates. What the UN said more than half a century ago, "A single economic policy seems no more likely to overcome all sources of imbalance … than is a single medicine likely to cure all diseases which produce a fever" (UN 1957, p. 7), still resonates in the context of current COVID-19 pandemic relief, recovery and transformation.

There is also a need for discretion in applying monetary policy to combat inflation since inflation may arise due to factors other than excess demand or "too much money chasing too few goods". Attempts to deal with cost inflation by measures appropriate for demand–inflation may generate socially unacceptable levels of unemployment before they produce any significant effect on the balance of payments.

Most importantly, a variety of scenarios should be considered, in particular, the possibility of the coexistence of both demand and supply factors of inflation. That is, it is possible for some sectors to experience a surge in demand, while some other sectors suffer from production difficulties. Additionally, in developing countries, inflation may be caused due to structural rigidities that prevent the structure of production from adapting itself sufficiently rapidly to the pattern of demand (Rao 1952). In such circumstances, anti-inflationary policies need to balance the need to restrain demand in certain sectors with the need to encourage investment in some other sectors.

Another challenge is the possibility of a wage–price spiral that may arise from the conflict between the owners of capital and workers on their claims over the proceeds of production. Wage–price spirals can be the main driving force of inflation in developing countries, especially when food price rises. In developing countries, levels of living are generally so low that they cannot be cut much further without generating powerful social forces for redressing the balance (Dasgupta 1954). Any increase in the price of food or other essential consumer goods thus gives rise to counter-pressures for compensatory increases in wages. Higher wage costs are then offset by higher prices, and a wage–price spiral, once started, may build up at a rapid rate, entirely out of proportion to the initial inflationary impulse.

An additional key element in inflationary pressures, especially in developing countries, is the high import content of GDP. A significant amount of inflation could be due to high import cost, not related to domestic excess demand per se.

Thus, deflationary fiscal and monetary policies are inadequate in reconciling the problems of growth and stability. They need supporting policies such as "incomes policy", aimed at keeping money incomes in line with available output or, more specifically, to hold year-to-year increments in incomes within the limits set by gains in productivity. Public provisioning of services such as basic healthcare, housing, transport and education, can be regarded as "social wage" and can be an integral element of income policies to break the wage–price spiral.

IMPLICATIONS FOR EXCHANGE RATE AND CAPITAL FLOWS MANAGEMENT

Supportive monetary policies have implications for exchange rate and capital flows management policies (Ocampo 2017). IMF research found that capital account liberalisation contributed to financial instability (crisis) and the rise in inequality (see, for example, Furceri and Loungani 2013). Capital account liberalisation eases restrictions on capital flows across a country's borders.

The capital account in a country's balance of payments covers a variety of financial flows – mainly FDI, portfolio flows (including investment in equities), and bank borrowing – which have in common the acquisition of assets in one country by residents of another. It is possible, in principle, to control these flows by placing restrictions on flows going through official channels. Controls on capital account transactions represent a country's attempt to shield itself from risks associated with fluctuations in international capital flows.

Thus, both the IMF and the World Bank have recognised capital flow management as an essential macroeconomic policy tool (IMF 2012b; World Bank 2010). IMF research has suggested a range of tools for managing capital flow (see, for example, Ostry et al. 2011). Capital flow management is a sovereign right of a country under the IMF's Article of Agreement (Article VI), and enhances monetary authorities' policy space to cope with global economic volatility.

Some developing countries also use capital controls to steer the composition of inflows towards more stable forms, such as FDI. Countries favour FDI, among other reasons, because it usually involves flows that are relatively long term and not subject to rapid reversals associated with changes in investor sentiment – as are, say, stocks and bonds. Some countries have also used selective capital controls to try to induce a shift from shorter-term to longer-term inflows – in Chile's case, by imposing an implicit tax on capital inflows reversed within less than a year. As mentioned earlier, in the case of Ecuador, a tax on capital leaving the country raised a significant amount of revenue.

Several Asia-Pacific countries (including China, Malaysia, Philippines, Thailand, and Vietnam) introduced measures to manage excessive short-term capital flows while still encouraging FDI after the 1997 AFC. Therefore, capital account openness should not be viewed as an all-or-nothing proposition. Capital accounts can be open to equity flows – both portfolio and FDI – when money and bond flows are managed, or volatile short-term flows and excessive private sector external borrowings are restricted.

EXCHANGE RATE STABILITY

For developing economies with a significant degree of trade and financial integration, the real exchange rate plays a key role in driving export growth, structural transformation and employment creation. Given the role of exports and FDI and the need to stabilise the economy, a developing country should follow an exchange rate stability approach as argued by a number of macroeconomists and by UNCTAD (see, for example, Epstein and Yeldan 2008); Frankel 2010; UNCTAD 2010).

However, maintenance of real exchange rate stability is challenging when central banks also have a fixed inflation target. It leads to painful trade-offs because of the use of a single instrument (the policy interest rate) to simultaneously meet the twin targets of inflation and exchange rate stability (see, for example, Epstein and Yeldan 2008; Frankel 2010; Ocampo 2016).

More rigid exchange rate regimes help countries anchor inflation expectations, and hence ease pressure on monetary policy. However, they increase vulnerability to crises, and impede external adjustment. IMF research found that “growth performance is best under intermediate exchange rate regimes” (Ghosh and Ostry 2009, p. 39).

Most countries prefer some management of their exchange rates – presumably because of concerns about competitiveness or the balance sheet effects of sharp depreciations under floating exchange rates. Successful management of exchange rate regimes depends on a complex set of factors, including how the central bank manages the exchange rate (defending or preventing overvaluation), and whether it has other instruments (such as macroprudential measures) that can be deployed to mitigate financial stability risks.

An important lesson of the AFC is that nominal stability must not end up in real appreciation. The experience in fast-growing East Asia, including China, also shows that an undervalued exchange rate can be an effective non-discriminatory industry policy that can overcome the problem of rent-seeking.

Many developing countries have accumulated foreign exchange reserves as a precautionary measure against volatile capital flows. However, it also has opportunity cost – foreign exchange reserves could have been used for social investment. On the other hand, reserve accumulation allows countries to keep the exchange rate undervalued to boost exports.

Challenges in implementing supportive macroeconomic policies

Supportive macroeconomic policies are needed to address poverty and growing inequality, especially to mitigate the adverse impacts on SDGs during the pandemic, and to ensure robust inclusive and job-rich post-pandemic recovery. However, implementing supportive fiscal and monetary policies can be challenging in view of constraints on policy space in dealing with multiple targets. This is particularly so in open economies due to "spill-over effects" of external developments on exchange rates and capital flows. Challenges also arise from developments such as digitisation of the economy, including the "gig" economy and digital currencies, which have created additional complexities for authorities.

Mitigating these challenges would require institutional arrangements for a high degree of coordination between fiscal, monetary and sectoral authorities. Such coordination will enhance not only the policy space, but also the effectiveness of fiscal and monetary policies, and hence will maximise desired and shared developmental outcomes, such as SDGs.

Many countries – developed and developing – have in fact shrugged off restrictive fiscal and monetary policy frameworks and responded with unprecedented fiscal and monetary measures for relief and recovery during the current pandemic. Such actions have helped a V-shaped recovery. Similar actions were also seen in response to the 2008 GFC – at least at the beginning, before most governments prematurely reversed course and introduced austerity programs. Some countries have linked recovery and stimulus packages to industrial and structural transformation, such as digitisation, emissions reductions, and revitalisation of regional and rural economies. These experiences provide valuable lessons for policymakers in implementing supportive fiscal, monetary, and industrial policies.

INSTITUTIONAL ARRANGEMENTS FOR SUPPORTIVE MACROECONOMIC POLICIES

SDGs remain the shared aspiration of the global community and hence should guide the design of supportive macroeconomic and industrial policies for recovery. That is, fiscal and monetary policy goals must align with SDGs and structural transformation. However, the effective implementation of supportive fiscal and monetary policies depends critically on (1) high-level coordination between fiscal, monetary and key sectoral authorities, and (2) the evidence base.

For example, Ecuador's central bank, which had previously been independent of the government, was made part of the executive branch's economic team. This also included the new Economic Planning Ministry (Ministerio Coordinador de la Política Económica), created by President Correa during the second month of his administration. These changes, especially with regard to the accountability of the central bank, have proven very important to the implementation and coordination of new economic policies in Ecuador (Weisbrot, Johnston and Lefebvre 2013).

However, there is no "one-size-fits-all" recipe. Institutional arrangements that may be necessary will have implications for countries which have adopted fiscal rules specifying deficit/debt targets and central bank independence with an "inflation-targeting" mandate, as well as having legislation prohibiting government borrowing from central banks. Such rules and legislative prohibitions are found to be too rigid even in countries where some flexibility is allowed for exceptional circumstances because of difficulties in precisely defining exceptional circumstances and the lengthy legislative process for desired amendments. Moreover, such rules are not conducive for countercyclical responses to mitigate impacts of shocks or business cycles.

Nevertheless, these rules and legislative restrictions have some usefulness. They are intended to prevent abuse by fiscal authorities and political interference with the operation of the monetary authorities. Therefore, some balance has to be found. Instead of rigidly fettering the hands of the fiscal and monetary authorities, the following can be considered for supportive fiscal and monetary policies:

1. Constitutional dual mandates for fiscal and monetary authorities. For the fiscal authority – countercyclical and pro-poor, inclusive growth goals. For the monetary authority – decent employment and price stability goals.
2. Strengthen transparency and accountability of fiscal policy by instituting democratic oversight; for example, a parliamentary budget office or an independent fiscal institution, and social dialogue mechanisms to regularly evaluate and monitor the fiscal strategy in terms of the fiscal authority's countercyclical and pro-poor, inclusive growth goals, as well as to prevent fiscal abuse.
3. Distinguish between the "goal independence" and "operational independence" of the monetary authority. While the short-term and medium-term targets for mandated goals – "maximum" decent employment and "reasonable" price stability – should be decided

in consultation with the government, central banks should have operational independence to choose and apply appropriate tools to achieve these targets.

4. Have an independent central bank board comprising of different stakeholders, representing business, labour, and vulnerable communities to prevent over-bureaucratisation and bias towards its inflation goal to the neglect of SDG priority areas.[31] This is critical as central banks are now, especially since the 2008 GFC, tackling diverse issues almost by default, be it pandemic, climate change, or inequality.
5. Subject the monetary policy-setting process to democratic oversight, such as the regular congressional hearings in the US, and parliamentary hearings in the UK, to ensure that monetary policy setting is consistent with the fiscal policy setting and other objectives, while the central bank's operational independence is maintained.[32] Central banks must justify their actions and explain how their policy decisions advance the mandated objectives.

Box 14: Diversity of Central Bank boards

Central banks are increasingly called upon to deal with diverse issues. However, they are likely to be affected by such factors as groupthink, insufficient challenge, poorly assessed risk, and problems with culture, such as, bias against women, indigenous people and migrant communities. Thus, there is a growing chorus calling to diversify central banks at all levels to reflect better the heterogeneity of societies. Historically, with a few exceptions, most central bank governing boards have been drawn from business communities. There has been little participation from minorities, women, or from areas of the economy, including labour and civil-society organisations, who could make important contributions.

Examples of labour representations in central bank boards include: Bob Hawke (1973–1978) and Bill Kelty (1987–1992) on the Reserve Bank of Australia Board when they were President and Secretary of the Australian Council of Trade Unions (ACTU); Shay Cody, former General Secretary of Fórsa, Ireland's second largest trade union, on the Ireland's Central Bank's Commission since 1 December 2020. Dave Prentis, President of Public Services International (PSI) was a non-executive director of the Bank of England in 2012–2015 and the Trade Union Congress (TUC) General Secretary Frances O'Grady became a non-executive director of the Bank of England in October 2020.

31 Milton Friedman noted that "… money is too important to be left to the central bankers" (1962, p. 219). He elaborated his concerns as follows: "The political objections are perhaps more obvious than the economic ones. Is it really tolerable in a democracy to have so much power concentrated in a body free from any direct political control? … One economic defect of an independent central bank … is that it almost invariably involves dispersal of responsibility… Another defect … is the extent to which policy is … made highly dependent on personalities… A third technical defect is that an independent central bank will almost invariably give undue emphasis to the point of view of bankers… The defects I have outlined constitute a strong technical argument against an independent central bank" (Friedman 1985, p. 8).

32 In the case of the Bank of England, democratic oversight is exercised via a number of formal and informal mechanisms, including parliamentary scrutiny, with the governor and other bank officials being called to testify in the front of the Treasury Committee, and reporting requirements, such as the obligation to publish the minutes of the meetings of the Monetary Policy Committee and the publication of the Bank's Inflation Reports on a quarterly basis. The European Central Bank (ECB), which is seen as very strongly independent, also has various mechanisms of democratic accountability. For example, the ECB is accountable to the European Parliament according to Article 284 (3) of the Treaty on the Functioning of the European Union (TFEU) and Article 15 of the European System of Central Banks (ESCB) Statute. The ECB is also subject to judicial review by the Court of Justice of the European Union (CJEU), which can judge

In addition, the following should also be institutionalised for the effective implementation of supportive macroeconomic policies:

1. Regular consultation and coordination mechanisms between the ministries of finance or treasury and central banks at the highest level, while working level interactions among key senior officials (such as section chiefs) of the fiscal and monetary authorities for reviewing the economy and impacts of fiscal and monetary policy settings on their respective mandates.
2. Periodic review of government expenditure within the medium-term fiscal frameworks (MTFFs), a tool for linking the budgetary processes to broad fiscal policy goals beyond the annual budgetary cycle. This will allow authorities to have multi-year budget estimates, which could typically have a span of three to five years. Such exercises also help improve the efficiency of budgetary allocation and prevent the build-up of wasteful expenditures.
3. Align MTFFs with the integrated national financing frameworks (INFFs), a tool to spell out how national sustainable development priorities can be financed. This will ensure that budgetary allocations and resource mobilisation are consistent with financing needs of SDG priorities

Finally, for better design of evidence-based supportive fiscal and monetary policies, both fiscal and monetary authorities should establish and strengthen research capacity. They should also undertake joint research on macroeconomic trends and relationships between key indicators, and develop research links with independent think-tanks and academic institutions.

Implementation of supportive fiscal and monetary policies will also have implications for countries which have undertaken extensive privatisation and deregulation reforms. They may need to undertake objective comparative social and environmental cost-benefit analyses of such reforms and adopt supportive industrial policy to effectively translate supportive macroeconomic policies at the sectoral levels for job-rich, inclusive, sustainable, and resilient recovery.

SUPPORTIVE INDUSTRIAL POLICY

Neoliberals are averse to industrial policy; but what they advance, that is, deregulation, liberalisation, privatisation, labour market "flexibility", and lower taxes, are in fact industry policies. According to neoliberals, such measures improve the business environment. However, such measures leave the outcome, that is, what kind of industries would emerge, to the location decisions of MNCs. Liberalising and market-friendly neoliberal measures cannot ensure the desired structural transformation, nor can they drive productivity or innovation-driven industrialisation or a job-rich, inclusive, resilient recovery. As discussed earlier, over four decades of these neoliberal measures have resulted in declining labour income shares, rising inequality, and increasing economic insecurity and vulnerability.

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the legality of the acts and decisions of the ECB according to Article 263 TFEU and Article 35 of the Statute of the ESCB. However, critics have argued that these are not sufficient. For example, Fabian Amtenbrink argued that the existing democratic deficit of the ECB is an expression of the democratic deficit of the EU at large, rather than a particular deficiency of the institution (Amtenbrink 1999).

Contrary to neoliberal claims that the best and most efficient way to achieve growth and development is to follow markets or so-called comparative advantages bestowed by nature, no country has made the arduous journey from widespread rural poverty to post-industrial wealth without employing targeted and selective government policies to modify its economic structure and boost its economic dynamism. For example, England used ISI policies during the 1400s, which saw value added to English wool by spinning it into woollen cloth and garments. This was mainly achieved by raising export duties on raw wool, making English wool cheaper for domestic manufacturers than for foreign ones.

The first US treasury secretary and one of the founding fathers, Alexander Hamilton's famous *Report on the Subject of Manufactures*, issued in December 1791, not only provided theoretical justifications for the promotion of domestic manufacturing, but as a policy document, it made specific proposals for government action. These proposals included higher import duties on certain final goods, lower import duties on certain raw materials, pecuniary bounties (production subsidies) for selected industries, government assistance for the immigration of skilled workers, and so forth: "To this day, the report is often heralded as the quintessential American statement against the laissez faire doctrine of free trade and for activist government policies in favour of manufacturing, including protectionist tariffs" (Irwin 2004, p. 1).

Back then, the US was trying to free itself from a colonial economic relationship with the British monarchy, in which British industries wanted to exploit America's raw materials, untaxed. The founding fathers wanted to encourage their own emerging manufacturing industry. Thus, raising import tariffs provided not only protection to America's nascent manufacturing but also revenue to finance the new government. So, the new congress approved Hamilton's recommendation to raise taxes on all manufactured steel, iron, and textile imports, thus helping the US to become an industrial power.

Another latecomer, Germany, also introduced in 1879 tariffs on a wide variety of manufacturing and agricultural goods to protect them from competition from the early industrialisers, notably Britain. Interestingly, the theory of infant industry was formally developed by Friedrich List, a German-American political economist. In his 1841 book, *National System of Political Economy*, List refined, formulated, and provided a comprehensive overview of the infant industry argument.

An infant industry is characterised by a lack of efficiency, competitiveness, and a high vulnerability to sudden market changes. Infant industries lack the experience and size to compete effectively against established competitors abroad. So, they require protection until they can acquire similar economies of scale.

The infant industry argument is one of the oldest arguments used to justify the protection of industries from international trade: "The case for infant industry protection has been generally accepted ... over the last two centuries – although some of the arguments supporting protection have come under successful attacks over the years" (Melitz 2005, p. 178).

IS THE INFANT INDUSTRY ARGUMENT STILL VALID?

The neoliberals would answer "no" to this question. They generally cite examples of failures of ISI in Latin America with regard to successes of "export-oriented industrialisation" (EOI) strategies in East Asia. However, they grossly misrepresent the truth.

First, the Latin American debt and balance of payments crises in the 1980s had nothing to do with their ISI. The crisis was largely triggered by the sudden increase in US interest rates when President Reagan adopted "fight inflation first" policies. Earlier, the US banks, which received billions of petrodollars from oil-producing and oil-exporting countries, encouraged Latin American governments to borrow at cheaper interest rates. Thus, the sudden manyfold rises in interest rates caused difficulties for many Latin American countries in servicing their foreign currency debts, resulting in balance of payments crises.

Second, East Asia's EOI strategy was a continuation of ISI that built their manufacturing base. The role of Japan's Ministry of Trade and Industry in the industrialisation of Japan is well known. South Korea, Singapore, and Taiwan also had sophisticated ISI before their manufacturing became export competitive. Even Hong Kong used various forms of industrial restructuring strategies to move upstream (see, Chowdhury and Islam 1993).

However, when neoliberals acknowledge the existence of strategic intervention measures in East Asia, they attribute their success to "exceptionally capable bureaucracy" and "political ability to withdraw benefits from nonperforming firms" (Pack 2000, p. 64). They claim that most developing countries do not possess these exceptional capabilities, and hence inefficient industries will continue to survive, draining governments' fiscal revenues through wasteful subsidies and tax concessions. They further argue that directly unproductive rent-seeking activities will breed corruption, causing further strains on growth. So, they recommend universal free trade. Some also argue that the World Trade Organisation (WTO) rules do not allow pursuance of trade policies in line with the infant industry argument.

Neoliberals also conveniently ignore the fact that targeted, industrial policy still prevails in various forms in most developed countries, including the US, the most advanced industrial economy. For example, as recorded by Reinert (2000, pp. 18–19) the Small Business Administration financed 26,000 companies in 1992; in 1997 the number of companies receiving subsidised finance from this federal office alone had grown to 58,000. Reinert (2000) listed many US federal government programs to support industries – big and small. Some subsidy programs also covered such multinational companies as General Electric, Microsoft, Ford, Exxon/Mobil, Motorola, Boeing, Procter and Gamble, and Monsanto, and such mature products as petroleum products, cars, and basic consumer goods.

Provision of assistance to producers and exporters is not confined to the US. Enormous amounts of subsidies are provided to producers in European Union countries, for example, under common agricultural policies. The emergence of Airbus as the world's leading manufacturer of large commercial aircraft competing with the US's Boeing is an example of successful European industry policy.

If the neoliberal arguments are accepted on face value, then it is difficult to see how countries at all levels of development can respond constructively to contemporary challenges – from job creation and poverty reduction to participating in the technological revolution and global value chains, from promoting efficient and clean energy to mitigating climate change and greening the economy. Countries certainly would need some kind of targeted industrial policy to address these challenges and structurally transform economies.

While arguing that the infant industry argument is still valid, it is critical to mention certain caveats. Hamilton, the originator of the infant industry argument, cautioned against raising tariffs so high that they would eliminate healthy foreign competition. His idea was to encourage domestic industry, not protect it (Irwin 2004).

Although List (1841) recommended selective rather than across-the-board protection of infant industries, he was against both international trade and export expansion (Shafaeddin 2000). As Shafaeddin (2000, p. 1) highlighted, List emphasised "the importance of trade and envisaged free trade as an ultimate aim of all nations; but he regards protection as an instrument for achieving development". According to List, infant industry protection is necessary for countries in the early stages of industrialisation if some countries 'outdistanced others in manufactures'. Nevertheless, protection should be temporary, targeted and not excessive" (Shafaeddin 2000, p. 1). Guarding against premature liberalisation, List argued that " domestic competition should in due course be introduced, preceded by planned, gradual and targeted trade liberalisation" (Shafaeddin 2000, p. 1).

In supporting the case for infant industry protection, John Stuart Mill (1848) alluded to one of the main prerequisites for such industries: the presence of dynamic learning effects that are external to firms.[33] Like Hamilton and List, Mill emphasised that protection must be temporary and that the infant industry must then mature and become viable without protection. Charles Francis Bastable added another condition requiring that the cumulative net benefits provided by the protected industry exceed the cumulative costs of protection (Bastable, 1891). Together, these conditions are known as the "Mill–Bastable" test.

Ragnar Prebisch, who is generally credited for ISI, did not favour complete autarky (see Chowdhury 2021). According to Prebisch, the solution instead lies in knowing how to extract, from continually growing foreign trade, the elements that will promote economic development. He also emphasised the importance of FDI for industrialisation and linkage between FDI and exports. He was quick to point out the critical importance of macroeconomic (in particular monetary) policies in maintaining currency stability for the expansion of trade and "well-directed" FDI leading to "more active capital formation". It is interesting to note that well-directed and more active capital formation were the two important cornerstones of industrial policy of the newly industrialised economies of East Asia (South Korea, Singapore, and Taiwan Province of China).

33 The full statement is reprinted in Kemp (1960, pp. 65–67).

INDUSTRIAL POLICY INSTRUMENTS

Partly following Warwick (2013), Weiss (2015a) has identified five categories of industrial policy instruments for low-income and middle-income countries, relating to the product market, labour market, capital market, land market, and technology. They are further categorised into market-based (defined as instruments operating through pricing) and public goods (referring to the provision of goods and services that private firms would not supply on their own). Table 1 presents industrial policies for low-income economies and Table 2 for middle-income economies to upgrade their industrial strategies and sustain industrialisation and development.

TABLE 1: SELECT INDUSTRIAL POLICIES IN LOW-INCOME ECONOMIES

Policy domain	**Instruments**	
	Market-based	Public goods/direct provision
Product market	Import tariffs, export subsidies, duty drawbacks, tax credits, investment/FDI incentives	Procurement policy, export market information/trade fairs, linkage programs, FDI country marketing, one-stop shops, investment promotion agencies
Labour market	Wage tax credits/subsidies, training grants	Training institutes, skills, councils
Capital market	Directed credit, interest rate subsidies	Loan guarantees, development bank lending
Land market	Subsidised rental	EPZs/SEZs, factory shells, infrastructure, legislative change, incubator programs
Technology		Technology transfer support, technology extension programs

Source: Weiss (2015a, p. 9); Notes: EPZs (export processing zones), FDI (foreign direct investment), SEZs (special economic zones)

TABLE 2: SELECT INDUSTRIAL POLICIES IN MIDDLE-INCOME ECONOMIES

Policy domain	**Instruments**	
	Market-based	Public goods/direct provision
Product market	Import tariffs, duty drawbacks, tax credits, investment/FDI incentives	Procurement policy, export market information/trade fairs, linkage programs, FDI country marketing, one-stop shops, investment promotion agencies
Labour market	Wage tax credits/subsidies, training grants	Training institutes, skills, councils
Capital market	Interest rate subsidies, loan guarantees	Financial regulation, development bank (first/second tier) lending, venture capital
Land market	Subsidised rental	EPZs/SEZs, factory shells, infrastructure, legislative change, incubator programs
Technology	R&D subsidies, grants	Public-private research consortia, public research institutes, technology transfer support, technology extension programs

Source: Weiss (2015a, p. 23); Notes: EPZs (export processing zones), FDI (foreign direct investment), SEZs (special economic zones)

It is important to note that some industrial policy instruments are expensive, and hence may not be suitable for countries with severe fiscal constraints. Mobilising resources thus becomes crucial along with choosing those instruments which are within a country's fiscal means in the immediate run and then gradually moving upstream as its fiscal space grows. This once again highlights the importance of a pragmatic and evolutionary approach to policy making.

Policy instruments in capital markets and technology domains are relatively costly and complex. Capital markets are rudimentary or may not even exist in some low-income countries. They evolve along with the level of development of a country, allowing governments to provide venture capital to projects with a high-risk profile but high growth potential (such as innovative projects in new technological fields). Similarly, as firms accumulate knowledge and capabilities and the state technical and administrative capabilities grow, governments can offer a number of incentives to stimulate innovation. The experience of East Asian economies is once more illuminating in this regard.

Weiss (2015b) identified three categories – not mutually exclusive – of industry policies for developed countries: defensive IP, catch-up IP and innovation-based IP. Defensive IP addresses the problems of declining sectors, or more generally of lagging regions or areas where the declining activities are based. Accepting that structural transformation is inevitable, the objective of IP should be to ease the transition. That is, an orderly adjustment of a declining activity, restructuring, and re-equipping where it is deemed there is long-run potential, and retraining workers where long-term jobs cannot be assured.

Catch-up IP is designed to raise productivity to the levels of global market leaders with the expectation that newly competitive activities will sell to the world market; so, this broadly corresponds to the "EOI".

Innovation-based IP is premised on the idea that growth for high-income economies must be innovation driven as this provides the basis for long-term competitiveness. The basic innovation-based IP combines horizontal and vertical measures relating to the business environment, infrastructure provision, support for cluster development, training, and improvements to financial intermediation combined with specific measures to support innovation, including state funding for research as well as credit for higher risk-innovative investment. Table 3 summarises Weiss's taxonomy of IP for developed countries.

TABLE 3: INDUSTRY POLICY FOR DEVELOPED COUNTRIES

Category	Examples	Policy instruments	Implications for WTO rules
Defensive IP	Adjustments to oil shock in the early 1970s and to the 2008–09 financial crisis (UK, France, US, Japan)	Provision of credit, training grants, demand stimulus, temporary import restrictions	Potential challenge where specific subsidies, or export subsidies exist
Catch-up IP	National Champion policies in the 1960s and 1970s (UK, France, Japan,Korea). Foreign investment promotion (Ireland, Czech Republic, Spain)	Provision of credit, seed funding, and tax incentives for R&D, merger policy. Tax incentives, investment grants, package of support measures	Potential challenge under specific subsidies in relation to differential incentives
Innovation-based IP	Innovation and competitiveness policies (EU, UK, France, US, Japan)	Finance for basic research and its commercial application, R&D tax credits, procurement policy, highereducation policy	Potential challenge under specific subsidies to innovation

Source: Weiss (2015b)

CHALLENGES IN DESIGNING AND IMPLEMENTING SUPPORTIVE INDUSTRY POLICY

Policymakers face three interrelated challenges in designing and implementing supportive industry policy. First, they have to decide about broad strategies; second, they have to select industries to protect or support, and decide how long they will support them for; and third, they have to select instruments, such as tax concessions, subsidies, tariff protection, and so forth.

Choosing strategies

With regard to broad strategies, Justin Lin, the former chief economist of the World Bank, initiated a debate on how industries ought to be supported, especially concerning the technology ladder. He developed the idea of comparative advantages following (CAF) and comparative advantages defying (CAD) industrial strategies. The best result, according to Lin, could be achieved if countries develop industries consistent with their comparative advantages, as determined by their endowment structure, and do not try to overleap necessary stages aiming at exporting the goods which are exported by very advanced countries (Lin 2011). Thus, for instance, oil-rich countries like Kazakhstan and Azerbaijan should aim at developing heavy chemicals, not, for example, high-tech computer industries. Similarly, labour surplus countries, such as Bangladesh or Nepal, should concentrate on labour-intensive activities, and try to catch the lower end of the global value chain. Following the same logic, the Pacific Small Island Developing States should focus on eco-tourism and marine-based activities.

The CAF strategy is fundamentally neoliberal and consistent with the “flying geese” paradigm: as more competitive countries move to more advanced types of exported products; the vacated niches are occupied by less-developed countries. The policy conclusion that follows from such a view is market based, and governments should ensure business-friendly macroeconomic and regulatory environments, and must avoid selective interventions.

Justin Lin and Ha-Joon Chang, on the other hand, favour CAD industrial strategies which defy the country’s comparative advantages. Such industries take time to develop, yet they could be worthwhile. For example:

> Japan had to protect its car industry with high tariffs for nearly four decades, provide a lot of direct and indirect subsidies, and virtually ban foreign direct investment in the industry before it could become competitive in the world market. It is for the same reason that the electronics subsidiary of the Nokia group had to be cross subsidised by its sister companies for 17 years before it made any profit. History is full of examples of this kind, from eighteenth-century Britain to late twentieth-century Korea (Lin and Chang 2009, p. 491).

The suggestion by Hausman, Hwang and Rodrik (2007; Rodrik 2006) to promote high-tech industries and research and development (R&D) in relatively poor countries is not that dissimilar to Lin and Chang's CAD strategy. The CAD strategy does not necessarily imply a transition to more technologically sophisticated industries, but rather, to industries that are not linked to the comparative advantages of a particular country. Theoretically, it could be a transition from chemicals to machine building with the same, or even lower, levels of R&D intensity and technological sophistication.

Hausman, Hwang and Rodrik's idea is that externality benefits from the production and export of new products are proportional to the degree of their technological sophistication, which is measured by the comparison of export structures of rich versus poor countries. High-income countries export on average more high-tech products. Developing high-tech production in poor countries may be costly, yet the returns from such a policy could be greater. It may well pay off for a relatively poor country to make "a big leap forward" by investing heavily in the education of the labour force and high-tech industries, bypassing the intermediate stages of producing goods with medium-research intensity.

Choosing "winners" and time frame

There is no denying that in terms of industrial sectors, selecting "winners" is not easy. Unfortunately, economic theory does not suggest any definite clues for picking the winners, except for the idea that these industries should have the highest externalities, that is, their social returns should be higher than their private returns. Yet it is not easy to measure these externalities. Similarly, it is not easy to apply the Mill–Bastable test, that is, to estimate dynamic learning effects, or to calculate all future costs and benefits, without making some simplifying assumptions which may not conform with reality. Nevertheless, upon examination of the literature and the experience of countries with industry policies, it is possible to isolate methods which can aid in the identification of industries that should be supported (Popov and Chowdhury 2016a).

Some authors have specified the characteristics that such winning sectors must have, for example, export, job, and knowledge-creation potential (Reich 1982); activities new to the economy (Rodrik 2004); higher technological content and the promotion of innovative activities with strong backward and forward linkages to the rest of the economy (Ocampo et al. 2009). Melitz (2005) has proposed that the decision to protect an industry should depend on the industry's learning potential, the shape of the learning curve, and the degree of substitutability between domestic and foreign goods. In order to overcome risky rent-seeking and complacency, it is suggested that support measures be in place for a fixed period on the condition that the supported/protected firms/industries must achieve certain goals (such as exports) within the pre-specified period. For example, a government can support several promising industries with the condition that assistance ends if the increase in export is not achieved within, for example, five years. This is called EPconEP – effective protection conditional on export promotion (Jomo 2013).

Choosing instruments

Some authors argue that the distinction between functional (horizontal) and selective (vertical) industrial policy instruments may be less relevant as “even the most ‘general’ policy measures favour some sectors over others” (Salazar-Xirinachs et al. 2014, p. 20; see also, Rodrik 2008). For instance, infrastructure investments, generally considered a functional (horizontal) industrial policy instrument, favours a certain region and the industries that populate it. Similarly, training programs aim to create knowledge and skills in specific technical areas. Therefore, policymakers cannot avoid some kind of selection and prioritisation.

Formal models show that the protection provided by production subsidies is preferable to that provided by tariffs or quotas, as the latter additionally distort consumption (Melitz 2005). However, production subsidies may not be feasible due to government fiscal constraints and difficulties associated with raising the needed revenue.

Melitz (2005) argues that flexibility should be an important criterion in choosing instruments. Ideally, policymakers should be able to decrease the level of protection as learning progresses and eliminate protection once learning has ceased. That is, subsidies or tariffs need to be constantly lowered over time to produce this effect; however, these adjustments may not be feasible in practice.

A fixed import quota, on the other hand, automatically reduces its level of protection as domestic costs fall and production expands. The import fixed quota (or licensing) can also be chosen so as to become nonbinding once learning ceases. Thus, import quotas have advantages over tariffs and subsidies. Any uncertainty concerning the learning curve reinforces these advantages.

However, no choice is without trade-offs. For example, in the case of import quotas, policymakers need to be aware that such quotas typically generate less revenue (for example, through licensing fees) than tariffs. The quota system also has higher risk of being abused, such as through rent-seeking and corruption. Binding quotas eliminate some of the market discipline of tariffs when firms have market power.

Following Lall and Teubal (1998), UNCTAD and UNIDO describe industrial policy as involving:

> A combination of strategic or selective interventions aimed at propelling specific activities or sectors, functional interventions intended at improving the workings of markets, and horizontal interventions directed at promoting specific activities across sectors (2011, p. 34).

They aim to promote cross-sector activities for which markets are missing or are difficult to create. A typical example is innovation and R&D policy.

Governments can also choose to support some general principles, such as productivity, competitiveness, environmental soundness and inclusiveness, without necessarily identifying particular sectors/activities (“winners” or “losers”). Firms which fall under the industry average or a specified benchmark will have to either improve or disappear, whereas above-average firms will become more dynamic.

For example, governments can raise minimum wages to nudge low-productivity firms to improve their performance and move towards higher productivity activities. Higher minimum wage applies to all, but low-productivity activities can find them in a disadvantageous position in relation to high-productivity activities (see Box 15). Exchange rates and reserve accumulation policies also apply uniformly across the economy and can be similarly used to promote export-oriented activities (see Box 16).

BOX 15: WAGE AND LABOUR MARKET POLICIES FOR STRUCTURAL TRANSFORMATION

Singapore used labour-markets, in particular wage policies during the later phase of its industrialisation, to restructure its industries by phasing out labour-intensive activities. However, it is obvious that at a later stage of development wages must rise commensurate with the higher levels of per-capita GDP. The symbiotic relationship between the union and the government helped Singapore's economy without union resistance.

Being part of the policy-making process, trade union leaders understood the need for economic restructuring to remain internationally competitive. Trade union leaders also helped the government devise compensation packages and retraining programmes for workers who lost jobs due to restructuring. The government of Singapore introduced a Skills Development Fund to collect levies from the "sunset" industries (low-skill, low-wage), thereby encouraging firms to retrain workers and making sure they remain employable. Employers were also required by law to contribute to workers' retirement funds.

The government, by legislating compulsory employer contributions to the government-managed Central Provident Fund, has been able to create a sense of fairness in industrial relations. As the sunset firms exited under the pressure of rising costs, their workers did not fear losing their entitlements.

Finally, the tripartite wage-fixing mechanism at the national level accelerated the industrial restructuring process. By de-linking productivity-based wage increases at the enterprise level and adhering to the industry-wide average productivity-based wage increases, the system raised the unit labour cost of firms with below-industry-average productivity, thereby forcing them to exit. This also meant that firms with above-industry-average productivity enjoyed lower unit labour costs, hence higher profit rates for reinvestment.

A similar industrial relations approach was used in Australia during 1983–1996. The "Accord" between the Labor Government and the unions was signed in 1983. Under the agreement, workers would stop seeking wage increases, and in return the government would deliver a "social wage" – entitlements and benefits such as subsidised childcare, health and education. The government would also support industries and have active labour market programmes to ease transition during the process of structural transformation of the economy. The peak union body also had representation in the Reserve Bank of Australia.

Thus, unions were drawn into the decision-making process and their trade-offs secured benefits for all Australians.

Minimum wages have many benefits apart from boosting workers' income. Increased incomes for workers boosts consumption demand, while increased labour costs trigger new economic activities with higher value-added content. Minimum wages thus improve the competitiveness of an economy by raising the knowledge-based skill content of workers in preparation for increased international labour competition.

Such wage policies also contribute to the reduction of income inequality by redistributing income towards low-wage workers as well as lower labour market inequality. This, in turn, improves workers' morale and reduces the risk of industrial unrest, which ultimately increases productivity and reduces worker turnover, resulting in a lower cost of production and allowing firms to absorb the rise in unit labour cost.

A common criticism of minimum wage adjustments is that they interfere with market forces in wage setting and that they raise labour costs, resulting in layoffs of workers – especially in small and medium-sized enterprises (SMEs). This may be a valid consideration if minimum wages were increased abruptly without appropriate measures for adjustment in labour-intensive sectors. However, fears that minimum wages per se lead to employment losses appears to lack empirical verification. Instead, a growing number of studies indicate that the relationship between the minimum wage and employment is not necessarily negative.

Source: Popov and Chowdhury (2016a), Basu and Tateno (2013)

BOX 16: EXCHANGE RATE AS AN INSTRUMENT OF INDUSTRIAL POLICY

As the experience of successful countries shows, the use of the exchange rate as an industrial policy instrument can avoid the pitfalls of rent-seeking. Exchange rate affects the entire economy as it applies uniformly, providing stimuli to all producers of tradables at the expense of real wages (consumption) and non-tradables. To be able to use an undervalued exchange rate as an effective industrial policy tool, however, countries need to be able to accumulate foreign exchange reserves and manage them judiciously.

Undervaluation of the exchange rate via accumulation of foreign exchange reserves is an industrial policy gaining support in the literature. It aims at promoting export-oriented growth by benefiting the producers of tradables and exporters at the expense of the producers of non-tradables and importers. If there are externalities from exports and the production of tradables (industrialisation, development of high-tech sectors), undervaluation of the exchange rate resulting from the accumulation of reserves provides a subsidy to these activities and this subsidy is automatic; that is, it does not require a bureaucrat to select possible beneficiaries.

In short, this is a non-selective industrial policy promoting export and production of tradables that seems to be quite efficient especially in resource rich countries. However, it needs to be said that the policy of reserve accumulation is often considered to be self-defeating because in order to avoid inflation (that would eat up the impact of devaluation on the real exchange rate), it is necessary for the monetary authorities to carry out sterilisation policy – that is, to sell government bonds in order to neutralise the impact of purchases of foreign currency on money supply. But sales of government bonds leads to higher interest rates that in turn attract capital from abroad and contribute to an increase in foreign exchange that again should be sterilised, which creates a vicious circle.

That is why economists talk about the “impossible trinity” – a country cannot maintain an open capital account, managed exchange rate and independent monetary policy at the same time. But many developing countries exercise control over capital flows (for example, China, Fiji, Chile, and Vietnam) and even without such a control, capital mobility – especially for large economies – cannot be considered perfect.

In practice, as the statistics show, the accumulation of foreign exchange is financed through government budget surplus and debt accumulation, but not through money printing. That is to say, most countries that accumulated reserves rapidly exhibited low inflation, and low budget deficit (or budget surplus), but increasing holdings of government bonds by the public.

Source: Popov and Chowdhury (2016b)

BOX 17: GOVERNMENT PROCUREMENTS AS AN INSTRUMENT OF INDUSTRY POLICY

Public procurement offers an enormous potential market for innovative products and services. Used strategically, it can help governments boost innovation at both the national and local levels and ultimately improve productivity and inclusiveness. Each year, an average of 15% of global GDP is spent through public procurement systems, amounting to over US$10 trillion. These systems yield tremendous benefits in terms of delivering public goods and services, but they can also reap secondary benefits, such as increased standards of living and social equality, and more resilient economies.

Thus, according to former UN-Secretary-General, Ban Ki-moon:

> Innovative procurement offers tremendous opportunities to use government buying power to shape the world around us for a better tomorrow. Through investment in new technology and research, the promotion of domestic manufacturing, increased transparency and accountability in public fund management, and support for small and medium-sized enterprises, procurement systems can help develop national capacity and attain SDGs (Year, p.).[34]

A recent OECD report, *Public procurement for innovation – good practices and strategies*, shows that 81% of OECD countries have developed strategies or policies to support innovative goods and services through public procurement, and 39.4% of OECD countries are measuring the results of their support to innovative goods and services through public procurement.

The report, *Post-pandemic economic growth: industrial policy in the UK*, on UK post-pandemic economic growth by the Business, Energy and Industrial Strategy Committee of the House of Commons noted that the government had an "opportunity to reshape how public procurement can be used to drive innovation by British businesses". Citing the fact that the public sector as a whole spent around £268bn each year on procurement, equivalent to around 14% of GDP, it concluded:

> Industrial policy could better harness the power of public procurement to encourage innovation ... There now exists an opportunity for the government to reconfigure its relationship with business on the principle of public/private co-production … Rather than acting as an occasional and remote investor the government could become a driver of innovation by utilising its purchasing power, reforming public procurement rules and establishing a credible post-Brexit state aid policy.

US Democratic lawmakers proposed in September 2021 an expansion of tax credits for electric vehicles (EVs) that includes significantly higher subsidies for union-made zero-emissions models assembled in the United States. The proposal, a key part of President Joe Biden's goal to ensure EVs comprise at least 50% of US vehicle sales by 2030 and boost US union jobs, will give Detroit's Big Three automakers a big competitive edge.

Similarly, long-term strategic financing must be directed towards building end-to-end innovation systems governed by the goal of providing common goods, especially in the case of the health sector. Most health innovation is backed by extensive public investment – either directly or by de-risking private investment – from which the public should benefit. Therefore, public funding must come with conditionalities to guarantee wide availability, fair prices, transparency, and technology sharing. And because private finance also plays a critical role in health innovation, conditionalities, regulations, and incentives should be used to forge symbiotic public-private partnerships, and to align private investments with the goal of Health for All (Mazzucato and Gosh 2021).

34 Procurement and innovation: Supplement to the 2013 Annual Statistical Report on United Nations Procurement, https://content.unops.org/publications/ASR/ASR-supplement-2013_EN.pdf (18/12/2021)

INSTITUTIONAL ARRANGEMENTS FOR SUPPORTIVE INDUSTRY POLICIES

Addressing these challenges requires redesigning institutional arrangements. While there are no "one-size-fits-all" institutions, this section offers some generic suggestions. In designing institutions, one key objective is to prevent rent-seeking and bias towards certain views or sectors. This requires a participatory approach involving all stakeholders, especially labour unions. Thus, social dialogue must be an embedded feature in policy design and implementation. The ILO defines social dialogue as an institutional arrangement that includes all types of negotiation, consultation or simply exchange of information between, or among, representatives of governments, employers and workers, on issues of common interest relating to economic and social policy.

Fundamental to any consideration of citizen engagement or social dialogue in policymaking and the design of policies is the recognition that the citizens in a democracy have both rights and duties. Thus, citizens must have opportunities to participate actively in shaping their world. Such participation can be realised in multiple ways and at various levels, from informal local and community settings, through incorporated entities, such as labour unions and similar peak bodies of business, to such key institutions as legislatures, the courts and the public service.

The design of institutional arrangements should be driven by three fundamental principles. The first is to minimise the creation of new bureaucracy. However, it may not be possible to avoid creating new departments or agencies given the complexities and demand for transparency and accountability. It should be understood that the participatory principle of this strategy requires the development of open dialogue methods and proceedings between all stakeholders; at the same time, it makes a special effort to improve inter-institutional coordination mechanisms and spaces for dialogue. The second is to strengthen the technical capacity of public sector institutions. The third is to open and strengthen public and private spaces for dialogue and civil society organisations.

Figure 12 shows how different actors can interact in a participatory approach to supportive industry policy. Such arrangements are necessary for transparency and accountability so that policies are not hijacked by particular interest groups or professionals.

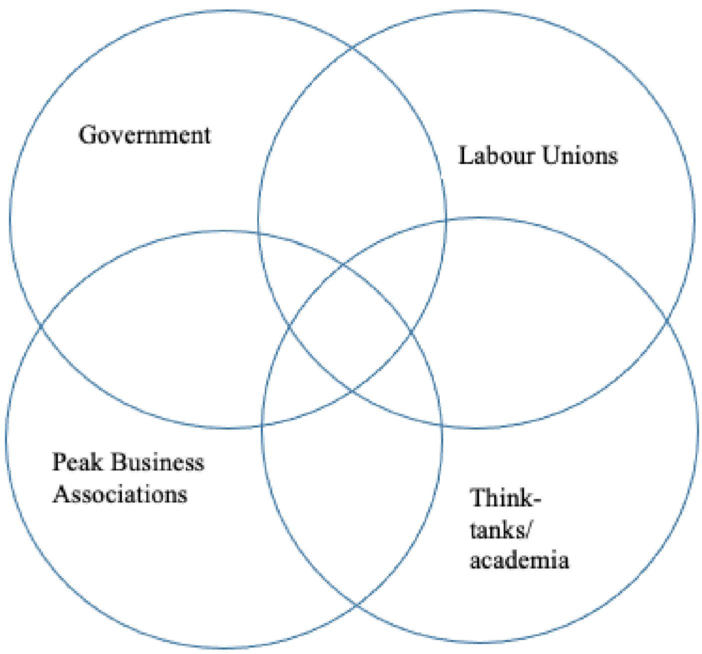

Figure 12: Relationships among four sectors of social actors

Given the technical complexities and political asymmetries that confront supportive industry policy, the institutional arrangements need to yield information about the wider benefits to the community of such policies. This is not just to inform government decision-makers about what policies may be more beneficial and build a technical case for policy interventions but also to alert the potential winners about what is at stake for them, and to suggest measures needed to minimise the pain of adjustment. To serve this purpose, institutions would need:

- the capacity to generate such information
- to be "plugged in" to policy-making processes to at least be in a position to influence decision-making in those areas. For example, when South Korea seriously began its structural transformation, the head of the newly created Economic Planning Board (EPB) was made deputy prime minister, signifying the importance of EPB in policy formulation and implementation

Four further features that would also seem to constitute *de minimis* requirements are:

- a mandate to focus on the economy-wide impacts of relevant policies and to identify changes that would generate gains for the community as a whole
- sufficient independence to ensure that research, findings and recommendations are not susceptible to undue influence by special interests
- no domination by particular professional groups; there should be balanced representations of economists, sociologists, political scientists, environmentalists and other key professionals
- operating procedures and outputs that are open to public consultation and scrutiny

Many countries have instituted SDG implementation cells within the prime minister's office (for example, Bangladesh) or president's office. Design and implementation of supportive industry policy should be integrated within such high-level cells. For example, in Indonesia, the Presidential Decree mandates the establishment of a National Coordinating Team led by the President as the Chairman of the Advisory Board, Vice President as the Vice Chairman of the Advisory Board, Minister of National Development Planning/Head of Bappenas as the implementing coordinator which involves all stakeholders taking part in the implementation of the SDGs.

Medical staff clap their hands at the entrance of Fundacion Jimenez Diaz hospital, in Madrid, to thank people back for supporting them as they fight coronavirus. Everyday madrilenos take to their balconies to pay tribute to doctors and nurses — Photo by EnriqueCB/ Depositphotos

Key recommendations

SUPPORTIVE FISCAL POLICY

- Adopt a countercyclical fiscal policy stance that works hand-in-hand with monetary policy to smooth the business cycle and sustain jobs and long-run growth
- Build up capacities and institutional arrangements to maintain "fiscal portfolios" that comprise a balanced mix of automatic stabilisers together with discretionary countercyclical measures aligned with the country's SDG priorities
- Develop a fiscally sustainable, comprehensive social protection system, taking into account the country's demographic shifts. Consider ELR and PLR as part of a comprehensive social protection system
- Increase public investment for green transformation and infrastructure as well as to strengthen public health and education systems aligned with SDG priorities
- Design sustainable fiscal incentives (tax and subsidies) for supportive industrial policy for green transformation that is job-rich, inclusive and resilient
- Improve the tax system by enhancing its progressivity and introduce innovative sources of tax, such as financial transactions tax, "sin" tax (such as taxes on harmful consumption like cigarettes), wealth tax, and digital services tax

SUPPORTIVE MONETARY POLICY

- Adopt a dual mandate for the central bank that encompasses reasonable price stability and maximum employment
- Strengthen supervisory and regulatory functions to promote

effective and efficient systems of financial intermediation, ensuring an adequate supply of credit for small and young firms and start-ups as well as small farmers

- Enhance financial inclusion of poor "unbanked" households and household enterprises
- Facilitate allocation of credit to SDG priority sectors and industries to support green structural transformation that is job-rich, inclusive and resilient
- Supportive exchange rate and capital account policies
- Manage exchange rate for a stable real exchange rate; avoid overvaluation
- Build up foreign currency reserves as a prudential buffer for self-insurance against market volatility. However, avoid excessive accumulation so that SDG priorities are not restricted due to inability to access needed foreign currencies
- Engage in active capital account management to prevent disruptive short-term capital flows and thus reduce exposure to international financial volatility and speculation
- Monitor external borrowing and currency mismatches by resident firms and banks
- Ensure conditions for productive investments – both domestic and foreign – to stimulate structural transformation and decent employment creation

SUPPORTIVE INDUSTRIAL POLICY

- Undertake objective social/environmental cost–benefit review of privatisation, deregulation and liberalisation measures
- Undertake objective financial/social/environmental cost–benefit review of existing industry support measures, such as subsidies, tax concessions and tariffs
- Align government procurement policies with SDGs
- Initiate coherent job-rich green industrial development strategies
- Introduce ALMP and income support measures to ease structural transformation

INSTITUTIONAL ARRANGEMENTS

- Set up coordination mechanisms between fiscal, monetary and sectoral authorities/ ministries
- Legislate mandates for fiscal and monetary authorities aligned with SDG priorities
- Set up democratic oversight over fiscal, monetary and sectoral authorities
- Embed social dialogue in design and implementation of supportive fiscal, monetary and industrial policies
- Adopt MTEFs aligned with integrated national financing frameworks (INFFs)
- Set up research departments and enhance research capabilities within both fiscal and monetary authorities, as well as within the ministry or cell in charge of SDGs

Concluding remarks

For the sake of job-rich, inclusive, sustainable and resilient recovery from COVID-19, countries must avoid dogmatic fiscal consolidation and strict low-inflation targeting in favour of consistent countercyclical fiscal and monetary policies. While public spending should be directed to productive infrastructure and social sectors, governments have to ensure efficiency of public spending. Governments should eliminate wasteful subsidies which generally benefit the non-poor and encourage unsustainable consumption and production. Instead, they must protect social sector spending such as basic education and public health. Maintenance of input subsidies such as on renewable energy is essential for keeping production costs down and encouraging a "green" transition.

Governments must build and expand fiscal space to enhance their capabilities. They must abandon supply-side prescriptions – that is, corporate and PIT cuts, and expansion of indirect taxes such as VAT or GST – to improve tax progressivity. Such actions, together with transfers like pensions or social security, reduce inequality and support inclusive growth. Governments must also eliminate tax loopholes and take actions against tax evasion and illicit transfer of funds.

Central banks must adopt a more flexible and pragmatic attitude towards inflation, and avoid monetary tightening in every situation without considering the sources of inflation. Central banks must also perform their developmental role by (1) fulfilling government's development finance needs, (2) pursuing financial sector and credit policies to ease access to finance for small and micro enterprises, including for small and peasant farmers, and (3) adopting a more strategic approach in managing exchange rates to support export-oriented sectors.

Prudential regulations must also be put in place to ensure financial sector stability, and for managing capital flows to avoid the risk of financial sector fragility and sudden capital outflows.

Governments should abandon uncritical faith in market solutions, give pause to the privatisation, deregulation and liberalisation agenda, and undertake cost–benefit analyses of all such reform programs that take into account financial, social and environmental factors. Governments should also strengthen regulations concerning labour rights, environment protection and carbon emissions.

Finally, serious efforts should be given to align fiscal, monetary and industrial policies with SDGs.

This paper has used the following consultancy reports by of the author besides his published work cited in the paper:

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