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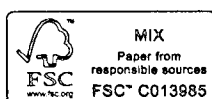
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Fiscal crisis, financial crisis and the fragile welfare state

Kevin Farnsworth and Zoë Irving

There is an ongoing tension – some would argue a contradiction – that goes to the heart of capitalist welfare states. On the one hand, states face ever-growing demands to provide more and better services. Some of these demands are made by citizens who desire better schools, hospitals, roads and rail services. Some of these demands come from the corporate sector: for better educated workers; better funded public research facilities; more generous subsidies; public bailouts; and increased injections of public spending to increase macro-economic demand. Few, however, appear to want to pay higher taxes to fund all these services. Citizens of ordinary means are resistant to paying more, especially when the super-rich appear to be so reluctant to pay their fair share. Politicians also appear to have little appetite to tax the wealthy for fear of dampening their entrepreneurial spirit and causing them to flee to less punitive tax regimes, while increases in corporation tax are largely unthinkable. In any case, the wealthy and large corporations can employ various means to avoid paying even the tax levels laid down by law.

Governments, meanwhile, are caught in an uncompromising bind. Better services are vote winners, higher taxes are vote losers. They also face sophisticated and well-funded lobbyists employed by the wealthy to represent their particular interests. And they are confronted by an overwhelming reality that, if they fail to create the right economic conditions to encourage new corporate investment and boost corporate profits, the revenues on which they depend will be rapidly depleted while demands on benefits systems and welfare services will rapidly increase as unemployment goes up.

This, in a nutshell, describes the roots of the fiscal crisis of welfare states. This chapter begins with a more detailed review of the nature and scope of fiscal crisis followed by a discussion of how economic globalisation, and more particularly its neoliberal transformation, has contributed to shaping the conditions for the most recent financial crisis. The final section analyses the impact of the variety of crises evolving from the financial collapse in 2008 and the implications for welfare states.

Understanding fiscal crisis

The spectre of the ‘fiscal crisis’ that lies at the heart of the welfare state was popularised in the 1970s by both Left and Right. The basic problem of the welfare state for neo-Marxists and

neoliberals alike was the fact that the public sector stifles private investment to the detriment of economic growth. The core of the arguments is different but the net result is fiscal crisis of the state.

To understand the basis of fiscal crisis, we have to first understand the relationship between state revenue (income) and expenditure. Government expenditure is usually based on three forms: taxation, borrowing and any surpluses generated by government activities. The latter may include contributions from nationalised industries, money generated from the sale of state assets or charges levied on state-provided services, but such contributions tend to be small. The most profitable nationalised industries have long since been privatised by many governments, and those that continue to be run by the public sector tend to bring low returns or incur losses. In some instances, state returns are deliberately reduced so that they may be used to effectively reduce prices to consumers or subsidise the costs of the private sector (O'Connor, 1973: 7–8; Gough, 2000, p. 68).

Funding state expenditure through borrowing brings its own problems. To begin with, borrowing represents deferred expenditure with the addition of interest charges. This is not a problem if borrowing is used to fund exceptional expenditure; for instance, if it covers the short-term costs associated with a dramatic economic slowdown. Indeed, borrowing to boost consumption during a recession will help reduce its depth and could stave off an economic depression. It can thus reduce its medium- and long-term costs. However, borrowing will squeeze budgets later on and is therefore unsustainable over the long term. Another alternative, officially referred to as 'quantitative easing' but which amounts to 'printing money', does offer an attractive option when the conditions are right – where it is used for investment, where government borrowing rates are low and where governments control their own currency – but it is not a long-term solution to funding current (everyday) expenditure.

In the long run, taxation is the only sustainable way of funding government expenditure. Taxes are levied on individual and corporate incomes or expenditure. The key taxes paid by individuals include income taxes, national insurance contributions, property taxes and taxes on consumption. Business taxes include taxation levied on profits, capital gains and employment (in the form of payroll taxes and national insurance contributions). The way in which taxation is levied is as important as state provision in determining final incomes. Taxes may be progressive (taking more as a proportion of income from the better off), flat rate (taking an equal percentage of all incomes) or regressive (taking more from the poorest). Thus, how governments raise and spend tax revenues is a major determinant of final income distribution, consumption and access to essential services.

Fiscal crises occur whenever there is a structural gap between the revenues raised through these various measures and state expenditure (O'Connor, 1973: 221). O'Connor views this gap as inevitably arising from the endemic contradictions that confront capitalism, the key one being that governments have to fulfil functions: on the one hand, they need to facilitate capitalist accumulation; on the other, they need to put in place programmes that legitimate capitalism. The struggle between these two is ongoing; spending on one limits the resources available for the other.

For Marxists, capitalist states are compelled by their existence within capitalist economies to ensure that public policies address (or at least do not harm) private economic activities, or more specifically, private businesses. In the *Communist Manifesto*, Marx and Engels famously argued that the state manages the general affairs of the capitalist class or, to put it another way, it operates to satisfy capital's systemic needs (Wetherly, 2005). State activities are accordingly limited to those that promote, or at least do not undermine, the economic base; thus it is not the pressure brought to bear on policy-makers by various actors that has the most impact upon government, but the fact

that the state's own interests are 'tied by a thousand threads' to the fortunes of capitalists (see Wetherly, 2005: 122). The capitalist state is, therefore, far from neutral; rather it acts as a factor of cohesion within capitalism, as Poulantzas (1973: 291–305) put it, to satisfy the 'needs' of capital and stabilise otherwise unstable economic systems (Wetherly, 2005: 122). This argument does appear to be rather tautological at one level: the capitalist state is argued to preserve and protect capitalism because it is a capitalist state. But there are solid reasons why the capitalist state operates in this way. Elite Pluralists, led by Dahl and Lindblom (1976; Lindblom, 1977) and neo-Marxists, including Fred Block (1977: 6–28) and Offe and Ronge (1984: 119–129), emphasise the importance of future production, consumption and investment by the business sector to ensure the strength and authority of governments as well as the continued sustainability of state revenues. Whether for sustainable economic growth, long-term financial stability, employment and political stability, or in order to acquire the resources to establish civil order or national defence, capitalist states also ultimately depend on capitalists (see Farnsworth and Gough, 2000). But servicing the systemic needs of capitalism, including the specific needs of individual corporations and the needs of citizens, brings us back to the fiscal crisis problem. Higher taxes will undermine accumulation and require compensating measures (which will further undermine the fiscal balance), and the imposition of higher taxes risks a corporate and citizen-led tax revolt (O'Connor, 1973: 228).

For neoliberals, the argument is different. Although governments may feel compelled to intervene in economies, this compulsion is primarily motivated by the personal gains and/or objectives of politicians (political agency rather than structure) (Downs, 1957). The public sector is, according to this perspective, unproductive and inefficient compared with the private sector, and as a result of its inefficiencies, but also as a result of the motivations of politicians, the public sector will tend to grow and divert (or crowd out) increasing resources away from the private sector (Bacon and Eltis, 1976). Private investment and consumption will suffer and the knock-on effects will be that state resources will tend to decline over time. Revenues raised through the private sector will be squeezed as the pressures to increase public sector spending increase.

In reality, of course, policy solutions are not determined entirely by economics any more than politics can be divorced from economic context. Existing and past policy decisions shape and/or mediate crises; hence capitalism can exist and thrive with different balances between public and private. And in relation to the post-2008 crises there are two factors that seriously challenge the thesis that high public spending leads to crisis. First, the size of the public sector did not determine the extent to which the Great Recession had an impact upon economies and, if it did, it was precisely the states with larger public sectors that escaped the worst effects, even allowing for their lesser exposure to the effects of bank collapse. Second, the 'extent' of fiscal crisis within states does not appear to determine the extent to which governments are cutting back on state spending. Large cuts in some economies are risking undermining recovery and weakening fiscal positions still further. Clearly, national politics and the local economics matter. But so does the global.

Globalisation and the seeds of crisis

Globalisation refers to the dramatic increase in the flow of goods, services, economic stocks and information between people, firms and states, over increasingly large distances, since the 1970s. Political globalisation – the extension of political power and political activity across the boundaries of the nation state (Held *et al.*, 1999) – is of growing importance as international and supranational governmental organisations such as the EU, the World Bank, the IMF and the WTO play increasingly important roles in national policy-making. Economic globalisation – characterised by

internationally mobile corporations and the international industrial and financial trading environment – has transformed the ways in which governments and corporations engage with each other. Both elements are important here. Post-1970s globalisation has been as much about spreading neoliberal political ideas as it has been about economic integration. Neoliberal globalisation has promoted the ideas of smaller government – in particular fewer regulations on business, less public sector ownership, more private sector involvement in the running of public services, fewer trade restrictions and more open economies. At the same time, economies have become more integrated, and more formally locked together if we include the rise of trading blocs in the equation. As a result of these changes, national economies have been transformed. High-volume, low-value production has moved in search of cheaper labour inputs, and more specialised and technologically advanced production has flourished in developed economies. Capital mobility has increased exponentially and employment markets have been transformed. These developments have had several implications for welfare states and their fiscal positions therein. To begin with, governments have altered their tax bases in order to both encourage entrepreneurialism and free-floating transnational corporations to invest in their economies. Thus, corporate taxes and top-rate income taxes have been cut dramatically. Second, globalisation has placed downward pressure on workplace regulations. When coupled with broader economic structural transformations, the effect has been to increase unemployment levels and the significance of low-wage jobs. Third, the effect of the first two forces combined has been growing economic inequality in most countries. Fourth, as regulations on financial capital have been reduced, so private borrowing and debt has increased.

In this context, the fiscal positions of states have been further undermined. The transformation in the tax base has dislocated the stability of government revenues and has made them more sensitive to relatively minor hiccups in the economy. Higher unemployment and greater instability for those in work have pushed up benefit claims. Governments have also sought to expand services that more clearly contribute to accumulation, including boosting tertiary education and training provision. Further, in political environments that appear to be increasingly hostile towards tax increases, many governments have come to depend more heavily on debt to finance spending (see Figure 29.1).

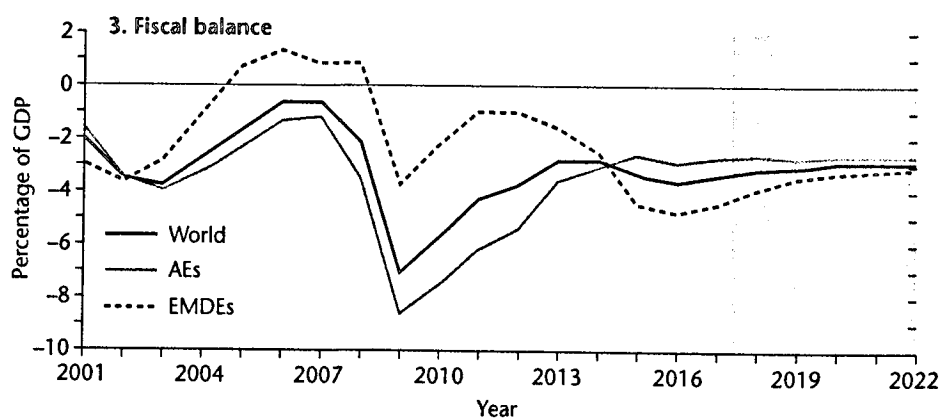


Figure 29.1 Fiscal balance (percentage of GDP).

Source: IMF (2017, p. 14, fig. 1.15, www.imf.org/en/Publications/WEO/Issues/2017/04/04/world-economic-outlook-april-2017#Chapter%201).

Notes

AEs = advanced economies.

EMDEs = emerging market and developing economies.

The 2008 economic crisis and the 'Great Recession'

The impact of the post-2008 'global' crisis was felt in almost every country, although not at the same time and not to the same extent. The response to it involved multilateral engagement to a degree that had not been seen since the Second World War. In terms of depth, as Figure 29.2 illustrates, events in 2008 were also more serious for the major economies than previous recent 'crises'. In terms of its actual impact upon nation states and its implications for social policy, the global crisis may best be understood as a series of consecutive international crises that were played out in various ways within different regions and different nation states. The international political response has also been variable: early on, the crisis did promise a multilateral response, but entrenched national and economic interests came to dominate at the expense of full international cooperation, and new differences and divisions were created between and within states.

The 2008 financial crisis and subsequent events should actually be seen as a series of crises that evolved over at least three separate waves. The first wave began with the initial banking crisis and the global credit crunch which originated in the US. In the wake of the US crisis, several economies faced the near-total collapse of their national banking systems, and one economy – Iceland – effectively unilaterally defaulted on its foreign debts. The trigger was the contagion that spread from the collapse of the US sub-prime mortgage market. These 'high-risk' mortgages were repackaged into financial products that were bought and sold in international markets – but the risks associated with them were undervalued or undisclosed. As the US economy slowed in 2007, it became apparent that banks and other financial institutions held a vast quantity of effectively worthless or heavily devalued securities which meant that they would, at some point, suffer huge losses. In simple terms, the stock they owned was worth a lot less than was

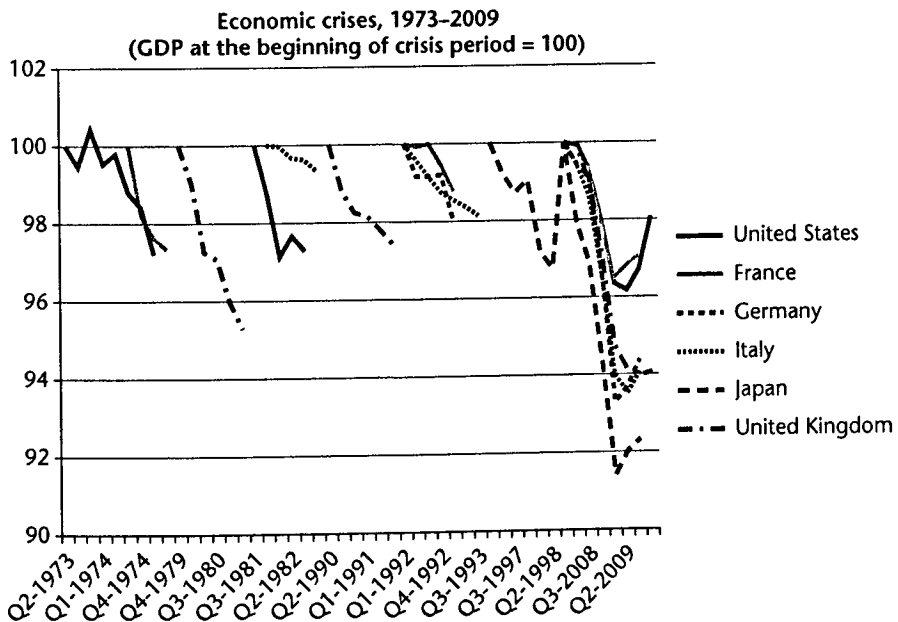


Figure 29.2 The depth of the 2008 crisis compared with others in the recent past.

Source: compiled from OECD data (<http://stats.org.oecd.index.html>).

previously thought. At the same time, it became clear that the companies which provided insurance against loan defaults would never be able to cover the level of risk to which they were exposed. The relaxation of key regulations governing the amount of capital that banks were required to hold, bank lending arrangements and the internationalisation of national banks meant that the crisis was virtually invisible until it was too late for states to reverse the damage. Not all nations had gone down this route, but those that had – the US, UK, Iceland, Ireland – were hardest hit in this first wave of the crisis. Other economies mostly escaped the dire effects of this first wave. More surprisingly, the liberal economies – considered to have the most lax regulation of all – showed considerable variation. Canada and Australia, in contrast to the US, UK and Ireland, fared remarkably well in the first wave of the crisis (Farnsworth and Irving, 2011).

The response of the banks was to act speedily to make up the shortfall in their losses and to attempt to recapitalise in order to protect themselves against bankruptcy. They closed down lending facilities to their customers, stopped issuing mortgages and stopped lending to each other. This had an immediate negative impact upon economic growth and precipitated the second wave of the crisis – the onset of the ‘Great Recession’. How nations experienced the recession depended, in turn, on the depth of their exposure to the banking crisis and the timing and relative size of the macro-economic interventions they instigated in order to protect their economies from falling demand. The spiral of falling demand for housing, plummeting consumer confidence and rising unemployment began to affect most, if not all, economies, although the order of magnitude varied. This second wave of the crisis added to the financial woes of those hurt by the first wave, but it also levied a heavy toll on the strong exporting nations. While Finland, Germany, Sweden and China escaped the first-wave ‘crisis’, they suffered the effects of the global economic slump. Germany and China in particular suffered major downturns in export markets, but in both countries, pre-emptive measures to boost demand, including social policies, appeared to stave off deep recessions. Similarly, the Nordic countries appeared to survive the worst of the crisis and focused on dealing with recession rather than crisis management. These countries’ crises in the early 2000s assisted in responding to the post-2008 period, since they had already learned some of the lessons of rapid bank deregulations. They were also better positioned to forestall economic slowdown given their already large public policy infrastructure, not to mention their interventionist histories. For these reasons Germany, Finland and Sweden adjusted far more painlessly to the changed circumstance than countries that bore heavy costs during the first wave of the crisis. The role of experience and the use of ‘crisis’ measures in informing and shaping the measures materialising in the post-2008 context are thus important. Indeed, for countries such as Iceland, Ireland and the UK, there was much about the 2008 crisis that lacked precedent.

The third wave of the crisis began in 2009 and was caused by a combination of: (1) the huge costs borne by governments in their attempts to protect their financial sectors; (2) the costs associated with attempts to boost domestic demand and/or provide the growing number of unemployed with benefits; and (3) falling tax revenues. The extent to which economies suffered in this third wave again depended on a number of factors, but the effects were especially marked in the worst affected economies in the eurozone. Here, a combination of growing debt and an inability to control macro-economic policy, including monetary policy, increased the likelihood of national bankruptcies. The cost of servicing government borrowing thus became prohibitively expensive for Ireland, Greece, Portugal and Spain, and required intervention by the European Central Bank and the IMF to prevent economic collapse.

From the global crisis to a new fiscal crisis of the welfare state?

The 2008 crisis resulted in national interventions that were exceptional, not only in their scale but also in their scope. The costs of the various measures borne by governments in their efforts to rescue *just* the financial sector were enormous. The total value of the support packages put in place to rescue the financial sector between 2008 and 2010 ranged from zero in several countries to 267 per cent of GDP in Ireland. The value of the packages in the US and UK was over 80 per cent of GDP. Upfront financing representing actual amounts pumped into the economy by government was negligible in some countries, but in the UK it amounted to 18.9 per cent of GDP (IMF, 2010). This does not include the costs of liquidity measures, including making short-term loans to the banking sector or buying up treasury bonds by printing money. State subsidies in the form of below retail-rate loans to banks, which can then lend to their customers at much higher rates, are not accurately costed in official figures and may never actually be known. Governments are able to recoup some costs over time, although the amount recovered from the sale of assets, such as shares, does not fully reimburse the initial layout, let alone the costs of servicing that layout, including interest charges. IMF estimates suggest that recovery rates from such 'crisis' interventions typically amount to around 51 per cent in developed economies and 13 per cent in emerging economies (IMF, 2009).

The impact of the bailouts and the recession upon the public finances has been huge. As Figure 29.1 indicates, fiscal balances declined sharply in 2008 and may take more than a decade to recover. In 2010, Germany was spending the equivalent of over 5 per cent more in GDP terms than it was raising in revenues; France in excess of 9 per cent more; Japan and the US in excess of 10 per cent, and the UK more than 13 per cent (IMF, 2010). Accumulated national debt (gross debt) has accordingly risen sharply (see Figure 29.3). Average gross debt in the G7 is projected to remain as it has since 2010, at 120 per cent of GDP, until 2022 (IMF, 2017a).

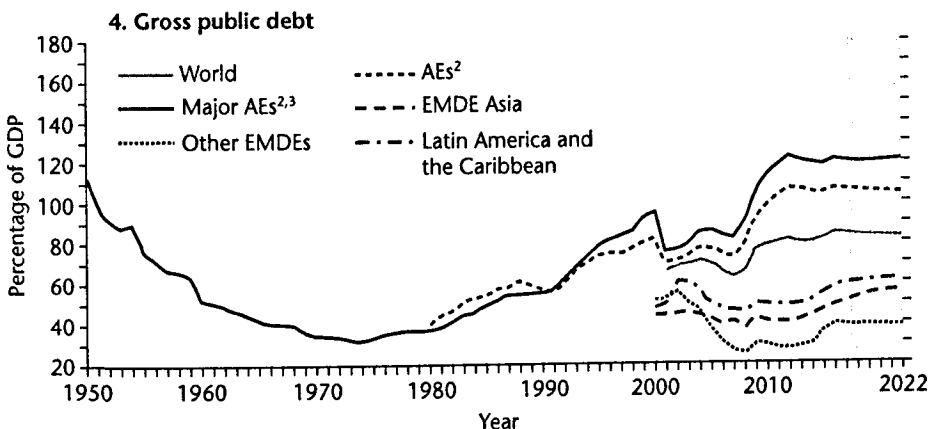


Figure 29.3 Gross public debt (percentage of GDP).

Source: IMF (2017, p. 14, fig. 1.15, www.imf.org/en/Publications/WEO/Issues/2017/04/04/world-economic-outlook-april-2017#Chapter%201).

Notes

AEs = advanced economies;

EMDEs = emerging market and developing economies.

² Data through 2000 exclude the United States.

³ Canada, France, Germany, Italy, Japan, United Kingdom, United States.

To summarise, the post-2008 crisis and Great Recession had at least three effects on welfare states. First, governments poured huge amounts into trying to rescue their banking sectors. Second, the 'Great Recession' stalled or reversed growth in many economies, leading to a massive reduction in government revenues. Consumption and income taxes (including taxes on profits) both took a huge hit. At the same time, increasing unemployment levels increased government outlays. These 'automatic stabilisers' helped stave off even deeper levels of economic collapse, but they also further undermined the fiscal positions of governments. Third, in order to try to stave off an even deeper recession, governments implemented various stimulus measures, including tax cuts, new corporate subsidies and increases in social welfare provision.

These various initiatives have all further undermined the fiscal positions of states. Of course without them, the macro-economic environment would undoubtedly be worse. However, the pursuit of these various programmes has had a negative, and in some countries a devastating, impact on welfare provision. Two factors conspired to make the post-2008 situation worse than O'Connor could have predicted. First, the global crisis had a dramatic impact upon the availability of credit, even to governments with relatively sound financial management. Second, the weaker eurozone economies faced an even graver economic situation than other economies because their capacity to act in their national interest is limited by rules imposed by the European Central Bank. Thus, for a number of economies, the fiscal position is constrained by their inability to borrow. This inability to borrow further reduces their economic stability, which further undermines their ability to borrow. In this context they continue to face particularly intense fiscal crises.

Nor was it just the eurozone economies that experienced difficulties in servicing their debts, however. During the third wave of the global crisis, governments found it more difficult to obtain credit and its costs increased – economically but also politically. Governments and political parties formed new dependencies in order to try to resolve economic challenges and maximise support. The best example of this is the increased dependence of the US and Europe on China which agreed to buy up government bonds and large amounts of US dollars and euro in order to stave off impending crises in the US and the eurozone. Moreover, the paradoxical position of state dependence on finance capital also increased as governments continued to try to pare back the debts that many had accumulated in their attempts to bail out financial institutions. Concentration in the banking sector in a number of OECD countries contributed to the too-big-to-fail problem and concentration continued to increase following the crisis (OECD, 2011). In the early aftermath of 2008, the fiscal crisis was therefore as much about trying to fund borrowing at a time when credit was more scarce, even for governments, since it is in the interest of finance capital to restrict credit and increase interest rates. The US, UK and even Germany, for example, struggled to sell government bonds during 2011.

What of the implications for welfare systems? Ballooning deficits in the post-2008 period were accompanied by consequent pressures to reduce public spending. Figure 29.4 plots average public expenditure levels between 2000 and 2008 in a number of countries alongside the prescribed 'IMF adjustment' to spending levels that countries should, according to the IMF, make between 2010 and 2020. The arrows illustrate the IMF's revised prescriptions between 2009 and 2010. Apart from clearly illustrating the different 'hit' that economies took between the first and third waves of the crisis, Figure 29.4 shows that if followed, the gap between the countries that pursue the most progressive social welfare models and those that pursue the most regressive would increase. Based on the IMF's prescriptions, the higher spending welfare systems were expected to make the least cuts, the lower spending ones the highest cuts, which leads to consideration of the variety of responses available to states in times of economic uncertainty.

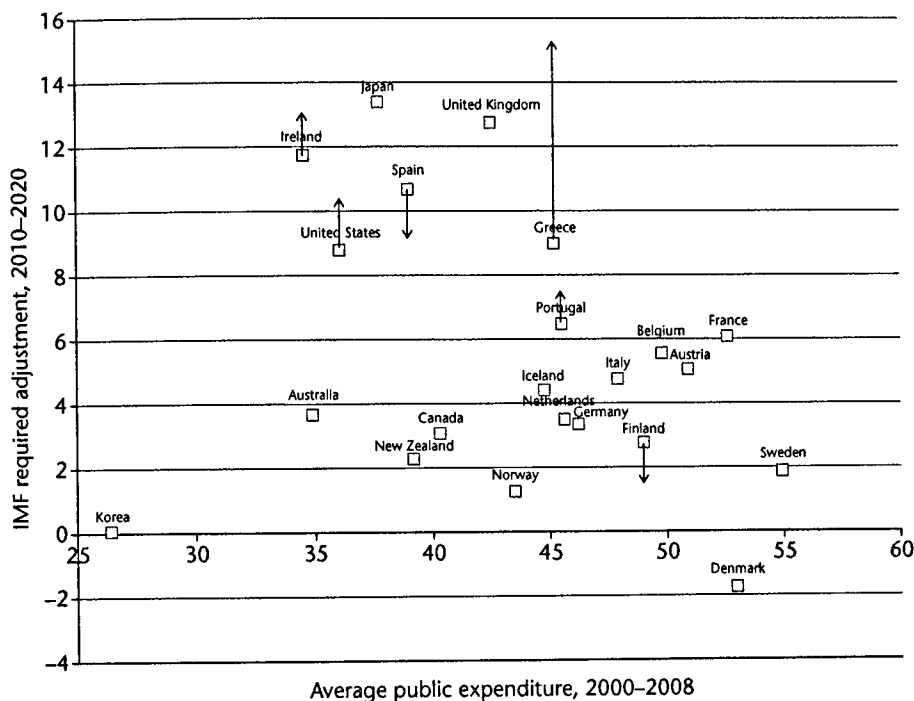


Figure 29.4 IMF prescribed adjustment, 2010 to 2020 and average public expenditure, 2000 to 2008.

While there are a limited range of options open to states that choose to cut expenditure in order to restore fiscal balance, reducing spending is only one of several strategies over the long term. Crises such as those emerging after 2008 can provide opportunities for social investment as much as justifications for retrenchment (van Kersbergen *et al.*, 2014), and this was the case in China (Cook and Lam, 2011). However, the pursuit of ‘social investment’, as evidenced in advanced economies at least, tends to privilege public spending which is expected to produce economic results rather than that with a broader concern for welfare (Midgley *et al.*, 2017). Discretionary spending remains at risk and this also risks damaging the legitimating elements of welfare states. States may also therefore focus their revenue-raising measures on increasing taxation, although in the post-2008 context this approach was extremely limited (Theodoropoulou and Watt, 2011). The dominant post-crisis solution has been ‘austerity’. In political terms, austerity lowers welfare expectations and depoliticises welfare demands through the elimination of alternative economic and consequently democratic choices (Schäfer and Streeck, 2013). In economic practice, ‘fiscal consolidation’, the driving down of spending to match revenues, has been pursued across the globe. Fiscal consolidation measures are found to be widespread in the 2016 to 2020 budget plans of 187 national governments in high- and low-income countries (Ortiz *et al.*, 2015).

Economic growth is of course an obvious objective so far as accumulating surplus is concerned. Austerity in fact slowed growth from 2010 in particular, an effect predicted by many commentators (e.g. Blyth, 2013) and now accepted by the IMF (IMF, 2017a). For the first time since 2011, advanced economies began to show an ‘easing’ of the ‘fiscal stance’ (a measure combining fiscal balance and output potential) in 2016 – by 0.2 per cent according to the IMF

(2017b). This may indicate that fiscal consolidation is on the wane, but does not necessarily herald the demise of austerity as a political objective. GDP growth since the 2008 crisis has been slow but the IMF (2017a) indicates that this trend began to reverse in 2016 with global growth expected to rise 0.5 per cent to 3.6 per cent in 2018. However, the increase in the rate of growth necessary to return to pre-crisis levels of welfare expansion, in addition to generating extra income with which debts and interest payments can be settled, requires more radical approaches to economic progress than those with which governments have hitherto engaged, for reasons outlined above. Not least of alternative approaches is a reappraisal of 'debt' and the place of borrowing in national economies which from a far from radical Keynesian perspective is both necessary and legitimate. In Europe, there remains a wide dispersion between the perceived policy possibilities for countries considered 'creditors' (e.g. Germany and the Netherlands) and those considered 'debtors' (e.g. Greece and Ireland) but there is an indication that many countries have recognised that growth requires commitment to public spending (IMF, 2017b).

In conclusion, it is clear that fiscal crisis as the enduring mismatch between a capitalist ideal and the real world inhabited by people with needs and capacity to make demands is as significant in the 2010s as it was in the 1970s. Globalisation has altered many of the processes through which social policies, and the means to support them, are played out, and has heightened and expanded the effects of crisis. Nevertheless, as actors, states make choices regarding the compromises and balances they seek in the economic and political spheres and it is these choices that determine social progress.

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