The Impact of the Global Economic Crisis on the Budgets of Low-Income Countries

A research report for Oxfam

Katerina Kyrili and Matthew Martin
Development Finance International

July 2010

This report examines the impact of the global financial crisis on the budgets of low-income countries, especially their spending to reach the Millennium Development Goals. The crisis created a huge budget revenue hole of $65bn, of which aid has filled only one-third. As a result, after some fiscal stimulus to combat the crisis in 2009, most LICs (including those with IMF programmes) are cutting MDG spending, especially on education and social protection. They have also had to borrow expensive domestic loans, and increase anti-poor sales taxes. Almost all LICs could absorb much more aid without negative economic consequences (whereas they have much less space to borrow or to raise taxes). The report therefore urges the international community to make strong new aid commitments at the Millennium Summit in September 2010, funded by financial transaction taxes or other innovative financing; the IMF to encourage LICs to spend more on MDG goals and on combating climate change and to report regularly on such spending; and LIC governments to increase spending on social protection and education; taxation of income; property and foreign investors; and efforts to fight tax avoidance.

Development Finance International

Oxfam

www.development-finance.org www.oxfam.org

Acknowledgements

The authors are very grateful to Duncan Green, Elizabeth Stuart, Richard King, Max Lawson, Pamela Gomez, and Caroline Pearce, and to participants at an IMF–Oxfam seminar in April 2010, for comments on earlier versions of this paper. They would also like to thank Myriam Sallah and Maria Holloway and numerous LIC government officials for their assistance in collecting the country budget information; and David Wilson for assistance with the copy-editing.

The authors

Matthew Martin is Director of Development Finance International, a non-profit economic policy capacity-building, research and advocacy organisation which specialises in enhancing developing country capacity to design and implement policies for financing their development (see www.development-finance.org). Matthew has worked on development financing issues at the Overseas Development Institute, Oxford University and the World Bank, among others.

Katerina Kyrili is Researcher at Development Finance International, focusing on the impact of the financial crisis on Low-Income Countries, South–South cooperation and aid trends. She was previously a Research Officer at the Centre for Development Policy and Research of the School of Oriental and African Studies (SOAS) in London; and at the Institute of Social Studies (ISS) in the Hague. She has also worked as a consultant for Save the Children UK creating the Global Child Development Index, and for the European Commission on 'Micro Level Analysis of Violent Conflict'.

This research report was commissioned by Oxfam from Development Finance International. Its purpose is to share research results, to contribute to public debate and to invite feedback on development policy and practice. This report does not necessarily reflect Oxfam policy positions. The views expressed are those of the authors and not necessarily those of Oxfam. For more information, or to comment on this report, email research@oxfam.org.uk

Published by Oxfam GB for Oxfam International under online ISBN 978-1-84814-112-4 in July 2010.

Summary

Clearly, we want fiscal policies to counteract the crisis, not make it worse. And this is happening. More than three-quarters of low-income countries let budget deficits get bigger as revenue fell. One-third also introduced a discretionary fiscal stimulus. The fiscal cushion can protect the poor and vulnerable from the ravages of the crisis.
– Dominique Strauss-Kahn, Managing Director, International Monetary Fund[1]

We are, of course, also thinking ahead with member governments on how they can most efficiently get back to a solid, sustainable budget position once the storm has passed'
– John Lipsky, Deputy Managing Director, International Monetary Fund[2]

The financial crisis has hit developing countries hard, driving millions more people into poverty and reversing several years of rapid progress towards the Millennium Development Goals (MDGs). For most of the poorest people, the impact will depend on what governments do with their budgets – how much they spend to fight against the crisis, protect the poorest, and revive progress towards the MDGs. This report examines what 56 low-income countries[3] have done in 2009 and are planning to do in 2010. It is unique in drawing on budget documents issued in June–December 2009, and therefore in being able to describe what is happening in detail, in order to look ahead to 2010 and beyond. This study is particularly timely as the deadline for countries to reach the MDGs is now only five years away.

The crisis has created a huge 'fiscal hole' in the 56 low-income countries (LICs), by reducing their budget revenues (and their ability to spend to confront the crisis and reach the MDGs) by $53bn in 2009 – nearly 10 per cent of their pre-crisis revenues – and by $12bn in 2010. This creates a total additional fiscal hole of $65bn over the two-year period.

Revenues fell in 60 per cent of LICs in 2009. For almost half of them (46 per cent), revenues will still be below 2008 levels by the end of 2010. Even if the rich world recovers, the crisis will still be wreaking havoc in the poorer countries, due to the time lag in transmission.

Low-income country response to the fiscal hole

In marked contrast to the response to the Asian financial crisis in the late 1990s, two-thirds of the countries surveyed have increased their budget deficits, providing a laudable initial 'fiscal stimulus' to combat the crisis. But only one-quarter have continued this stimulus in 2010. Countries with IMF programmes implemented more stimulus than others in 2009 but, conversely, are forecast to cut it back more sharply in 2010. This implies that, while the IMF protected social sector spending at the start of the crisis, it is now advising countries to reduce it.

In Latin America, Africa, and countries with IMF programmes, the deficit increase was mainly caused by rises in expenditure. Three-quarters of African countries with an IMF programme increased spending in 2009, and most of this spending went to anti-poverty programmes. In other regions, and without IMF programmes, many countries cut expenditure sharply to adjust to revenue falls.

But in 2010 deficits are set to halve, and not because of recovery or increased revenue. In virtually every region except Africa, and regardless of whether countries have IMF programmes or not, there will be spending cuts. And countries with IMF programmes are cutting faster than others: half of African countries (and 75 per cent of other LICs) with an IMF programme are cutting spending, even though most need to massively increase it if they are to reach the MDGs by the 2015 deadline.

Impact on MDG spending

Some effort has been made to increase expenditures on essential MDG-related sectors, but the picture is mixed. Health has been the darling, and social protection the orphan. Infrastructure and agriculture have benefited from higher spending, but in many countries in 2010 this spending will be cut. Education has done particularly badly.

Worse still, the initial commitment to MDG-related spending appears to be waning. Two-thirds of countries are cutting budget allocations in 2010 to one or more of the priority pro-poor sectors of education, health, agriculture, and social protection, just at a time when they need to massively increase such spending.

Africa has performed better than other regions and is expected to end 2010 with higher spending in all sectors except social protection, and with spending on agriculture, education, and infrastructure matching for the first time that of other regions as a percentage of national income. However, Africa continues to lag behind other regions on health and social protection. Countries with IMF programmes have done better on overall MDG spending, agriculture, education, and social protection, but worse on infrastructure and health (African countries with IMF programmes fared better than non-programme countries on education, health, and agriculture).

In terms of types of revenue, direct taxes on income and property, including royalties from commodity production, were mainly responsible for the fall in 2009, but by the end of 2010 the crisis will have moved tax burdens towards indirect taxes on consumption, and therefore will hit poor people harder, as they are forced to consume higher percentages of their earnings.

Response of the international community

G20 leaders pledged huge external financing rises to help poor countries combat the crisis and reach the MDGs, but they have not met those promises. While there has been an average increase in grants of $4.1bn a year, this has filled only 13 per cent of the ‘fiscal hole’ created by the crisis. Accordingly, three-quarters of poor countries were forced to borrow more in 2009, and half will do so in 2010. Most of these external loans are cheap, so there is little risk of a new external debt crisis. Indeed, most LICs could afford to borrow considerably more to accelerate MDG progress. An analysis of how much countries can afford to borrow shows that one in three can afford to borrow more, both internally and externally.

But external loans and grants have together filled only one-third of LICs’ fiscal hole in 2009–10. In addition, the response has been very slow, taking between six and 18 months for G20 financing commitments to reach the international financial institutions (IFIs) and for them then to commit money to LICs. Disbursements have been further delayed by continuing high levels of conditionality.

Because the international community’s response to the crisis has been so slow, LICs have had to fill two-thirds of the fiscal hole by borrowing domestically or by running down reserves. In 2009, three-quarters of LICs were forced to borrow from expensive domestic markets. Partly as a result of this, and due to lack of sufficient aid, many LICs are already cutting spending for fear of unsustainable external or domestic debt levels: this must be halted, except in a very few countries with extremely high levels of debt.

There is little sign that financing or flexibility on the scale needed will be forthcoming. Recent trends in many donor countries have been to reduce aid pledges, concentrate aid on fewer countries, and focus on only a few of the MDGs. The IMF appears to be retreating to its traditional fiscal tightening position, meaning that the poorest countries with IMF programmes are progressively undoing the fiscal stimulus introduced during the crisis, without paying sufficient attention to the longer-term need to stimulate demand and reduce poverty in order to reach the MDGs.

These trends need urgently to be reversed, by ensuring that world leaders sign up to tough new aid targets (not just on quantity, but also for balanced allocation across countries and sectors) at the Millennium Summit in September 2010 and that they deliver them for the next five years; and by ensuring that the IMF builds on its recent flexibility and encourages LICs to spend much more in order to reach the MDGs and begin the huge task of adapting to climate change.

Finally, five years away from the deadline for reaching the MDGs, it is scandalous that no international organization is tracking MDG spending in the way that this report has done at the level of individual LICs. This vital function must be taken on by an international organization with the capacity to make budget information public, such as the IMF.

If these changes are not made, the fiscal hole caused by the crisis risks becoming a 'black hole' into which the MDGs, and the lives and education of many of the world's poorest citizens, will disappear.

These findings lead to a number of urgent recommendations:

The international community should

- Sign up to tough new aid targets (not just on quantity, but also for balanced allocation across countries and sectors) at the Millennium Summit in September 2010, and deliver on them for the following five years. Rich countries should increase grants and highly concessional loans for LICs;
- Ensure additional sources of 'innovative financing' to fund progress to the MDGs. A Financial Transaction Tax could raise $400bn a year (Schulmeister, 2010), providing more than enough funds to reach the MDGs and combat climate change.

The IMF should

- Together with LIC governments, make even greater efforts – especially outside Africa – to ensure that countries with IMF programmes (and others where the IMF is providing policy advice) do not cut back spending in 2010 and 2011, and spend more to meet the MDGs and tackle climate change;
- Provide even greater space in the design of its macro-economic frameworks for countries to absorb grants and concessional loans, and actively encourage the international community to provide such funding;
- Provide grants in exceptional circumstances, e.g. a major exogenous shock such as the global economic crisis;
- Pay much closer attention to domestic debt;
- Ensure that MDG spending is tracked and published in a transparent way.

Low-income country governments should

- Increase MDG-related expenditure, especially on education and to establish major social protection programmes. This is vital to ensure that countries accelerate progress to the MDGs beyond the crisis;
- Fill the revenue hole caused by the crisis by raising taxes on income and property – so hitting poor people least – as well as on foreign investors, particularly in extractive industries, and by combating tax avoidance via tax havens.

1 Introduction

The financial crisis has hit developing countries hard. The most severe phase of the crisis, which involved the total freezing of global credit and trade finance markets – and, for developing countries, sharp falls in growth rates, exports, private capital inflows, and exchange rates – is now mostly in the past. Trade is recovering, especially due to the rapid economic improvement in emerging markets such as Brazil, China, and India; in major OECD economies the recovery has been slower and more fragile. However, even if recovery continues, there is likely to be a lasting reduction in OECD growth and demand, due to high unemployment rates and public expenditure cuts made to reduce borrowing levels.

For low-income countries (LICs), the crisis – coming on the heels of the food and oil price crises – has also seen sharp falls in growth. In the absence of extensive social protection systems, it has driven millions more of their citizens into poverty. As the world enters the final years of the effort to achieve the Millennium Development Goals (MDGs) before their 2015 deadline, 2008–09 will have seen a reversal of progress on MDG1 (which targets halving extreme poverty).

For the other MDGs, one key potential impact has been fiscal. Lower levels of GDP, exports, imports, and remittances have sharply reduced tax revenues from income, enterprises, trade, and consumption. As a result, a large fiscal hole has opened up in many LICs. The World Bank estimates that LICs saw revenues decline by 4.3 per cent of GDP in 2009 (World Bank, 2010), creating a hole of $35–50bn of financing needed to maintain 2008 programmed expenditure levels.[4] At the same time, countries have faced demands for higher expenditure, both as a fiscal stimulus to protect growth, and on social protection against the crisis for the most vulnerable people. Depending on the spending chosen, this could contribute to MDG progress or divert spending away from it. If it is financed by debt, it could undermine debt sustainability.

On the other hand, in 2010, some have already turned attention to how to reduce the higher LIC budget deficits produced by the crisis, and get them back to 'sustainable' levels. This could lead to expenditure cuts or tax rises, ignoring the fact that many LICs need to sharply increase both expenditure and external assistance if they are to have any chance of reaching the MDGs. For most of the world's poorest people, the long-term impact of the crisis will depend on what governments do with their budgets – how much they spend to fight the crisis, protect poor people, and revive progress towards the MDGs.

Oxfam International therefore commissioned this study to quantify the fiscal hole created for LICs by the crisis, and to examine their governments' policy responses. The key value-added of this study, compared with others, is that it is based on direct and detailed analysis of 43 LIC budget documents produced in June–December 2009, rather than just using global IMF datasets.[5]

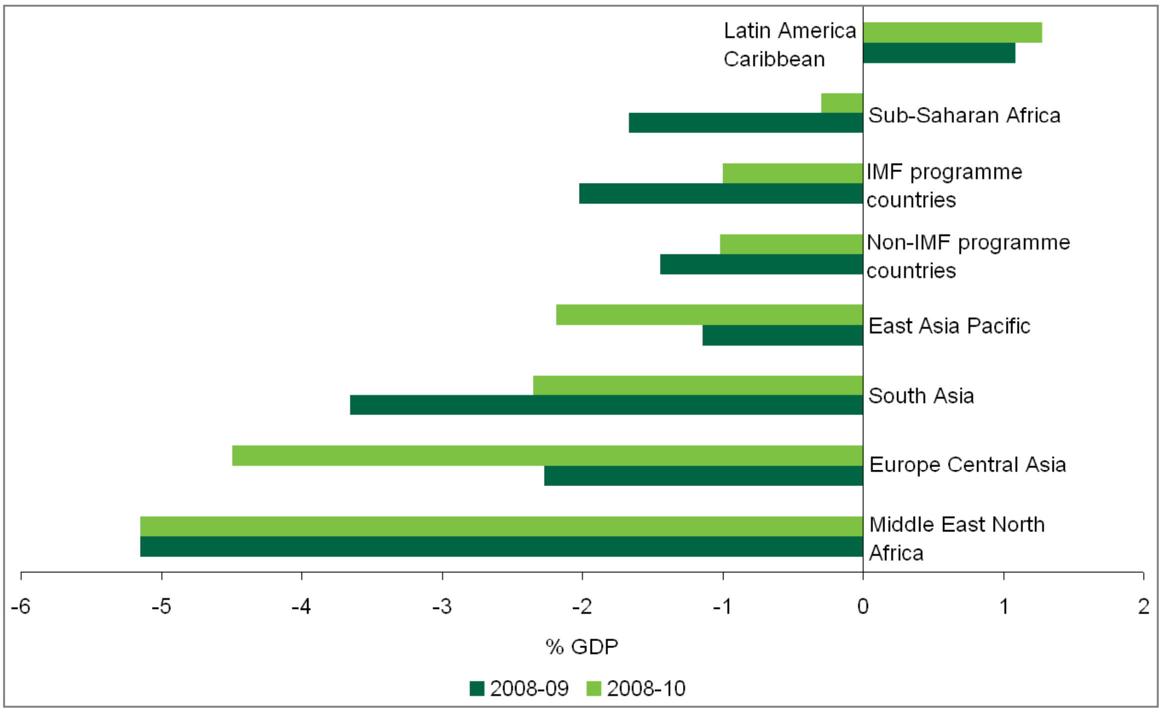
Section 2 of this paper presents the fiscal hole in budget revenue created by the crisis; section 3 analyses fiscal policy responses in terms of budget deficits and expenditures, looking in detail at expenditures needed to reach the MDGs; while section 4 looks at how the expenditures were paid for. Section 5 shows that countries have the fiscal space to spend more on making progress towards the MDGs.

2 How big is the fiscal hole?

A fiscal hole is a fall in availability of budget revenue to fund spending,[6] caused by unexpected events such as the global crisis. In developing countries such a hole is very worrying, because it reduces their ability to spend money on reaching the MDGs – at a time when many LICs are already off-track, in large part due to the failure of OECD governments to supply aid promised for 2005–10. This section therefore looks at the impact of the crisis on LIC budget revenue.[7]

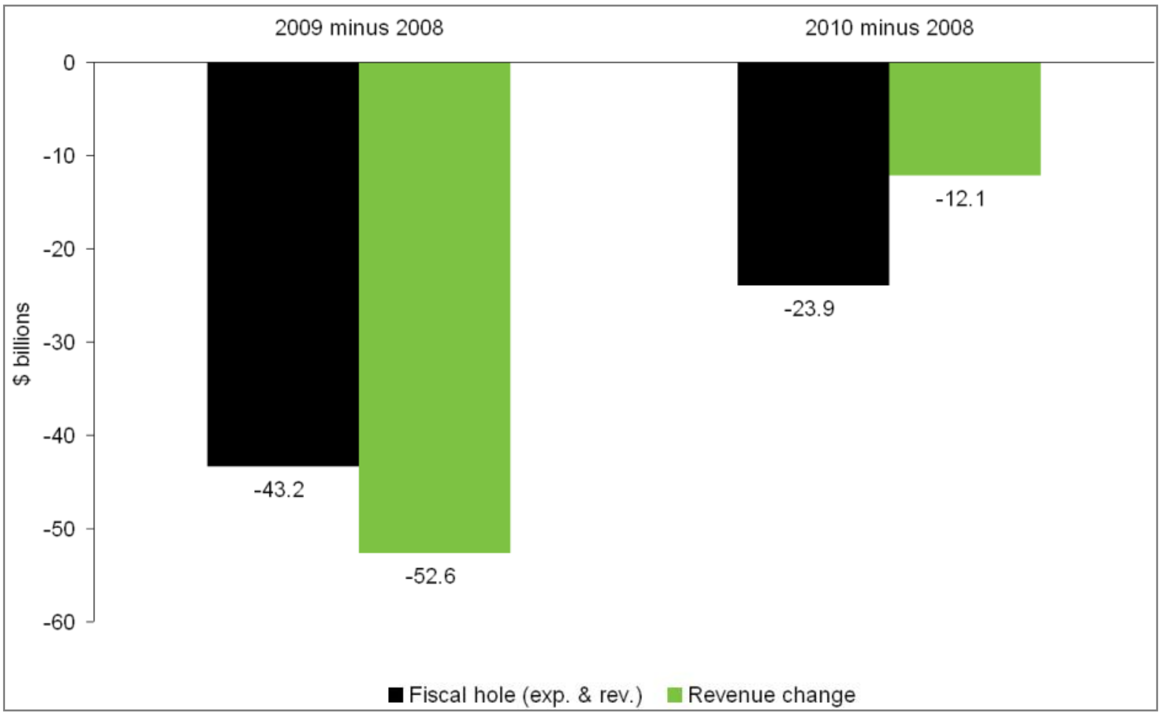
Figure 1 shows the changes in revenues for LICs between 2008 and 2009–10, overall and broken down by regions, and according to whether countries had IMF programmes in place. On average, revenues fell by 1.8 per cent of GDP, or 8 per cent of 2008 revenue, in 2009, in all regions except Latin America and the Caribbean. The sharpest falls were in South Asia, Europe and Central Asia, and the Middle East and North Africa. In 2010, although recovering somewhat, revenues will still be 1.1 per cent of GDP, or 5 per cent of 2008 revenue, lower than in 2008. The revenue impact of the crisis will not wear off by the end of 2010.

Figure 1: The fiscal hole (% of GDP)



What does this mean in dollar terms? Figure 2 shows the revenue hole: in 2009, revenues fell by $52.6bn from 2008 levels, and in 2010 they were still $12.1bn lower.

Figure 2: Total fiscal and revenue holes in LICs



Figures 3 and 4 show changes for individual countries. In 2009, revenues as a percentage of GDP were below 2008 levels for 29 LICs, but rose in 20. In 2010, they were still below 2008 levels for 24 countries, but for 25 were higher. So for half of LICs, 2010 revenues will still be below 2008 levels; the negative effects of the crisis on revenues have still to unwind.

Figure 3: Revenue changes for Africa

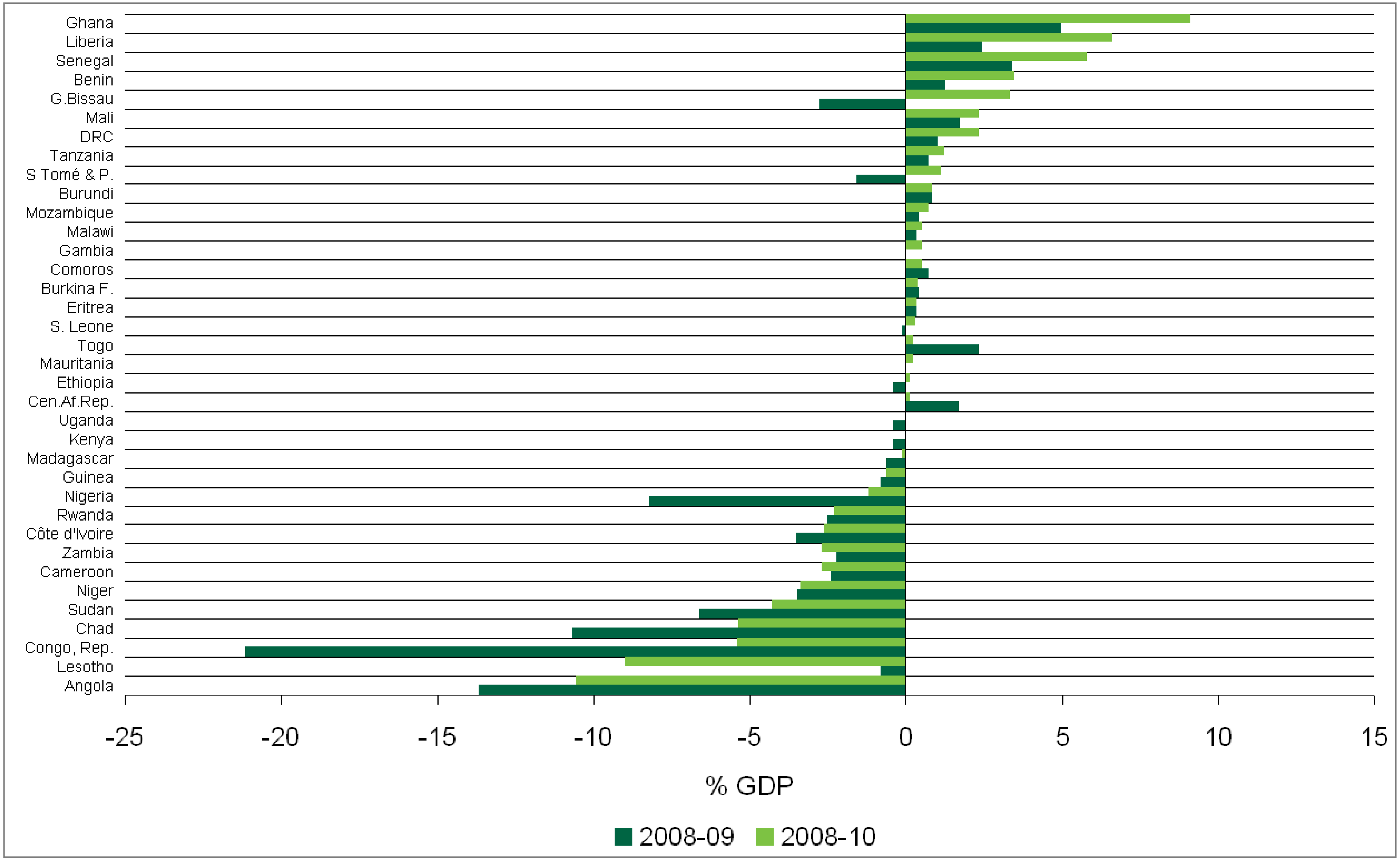
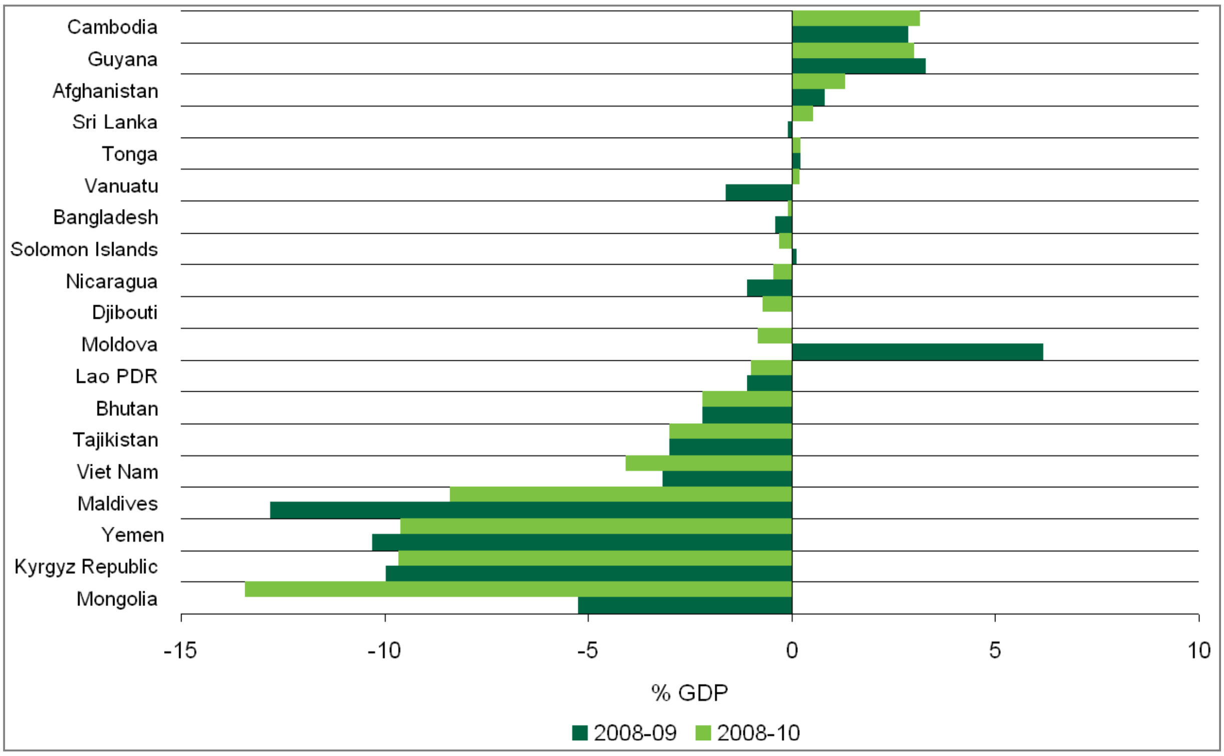


Figure 4: Revenue changes – other LICs



Is there any other pattern to these decreases and recoveries? In 2009, 14 countries earning most of their revenues from exports of oil and/or gas (ten) and minerals (four) suffered most of the sharpest falls, but 15 others also suffered falls. In 2010, some of the sharpest revenue increases came in six oil-producing countries, as world oil prices rose, but revenues from minerals stagnated, and there were also revenue rises in 13 other countries. So at the end of 2010, two-thirds of countries that will have lower revenues/GDP than in 2008 will be oil or minerals exporters, but the other third will not. Rises in revenues/GDP in either year (and 11 countries saw rises in both years) tended to reflect new minerals discoveries or contracts, specific tax rises to reduce high budget deficits, or ongoing intensive tax reform programmes (although in two-thirds of these countries revenue levels fell short of forecast increases due to the crisis).

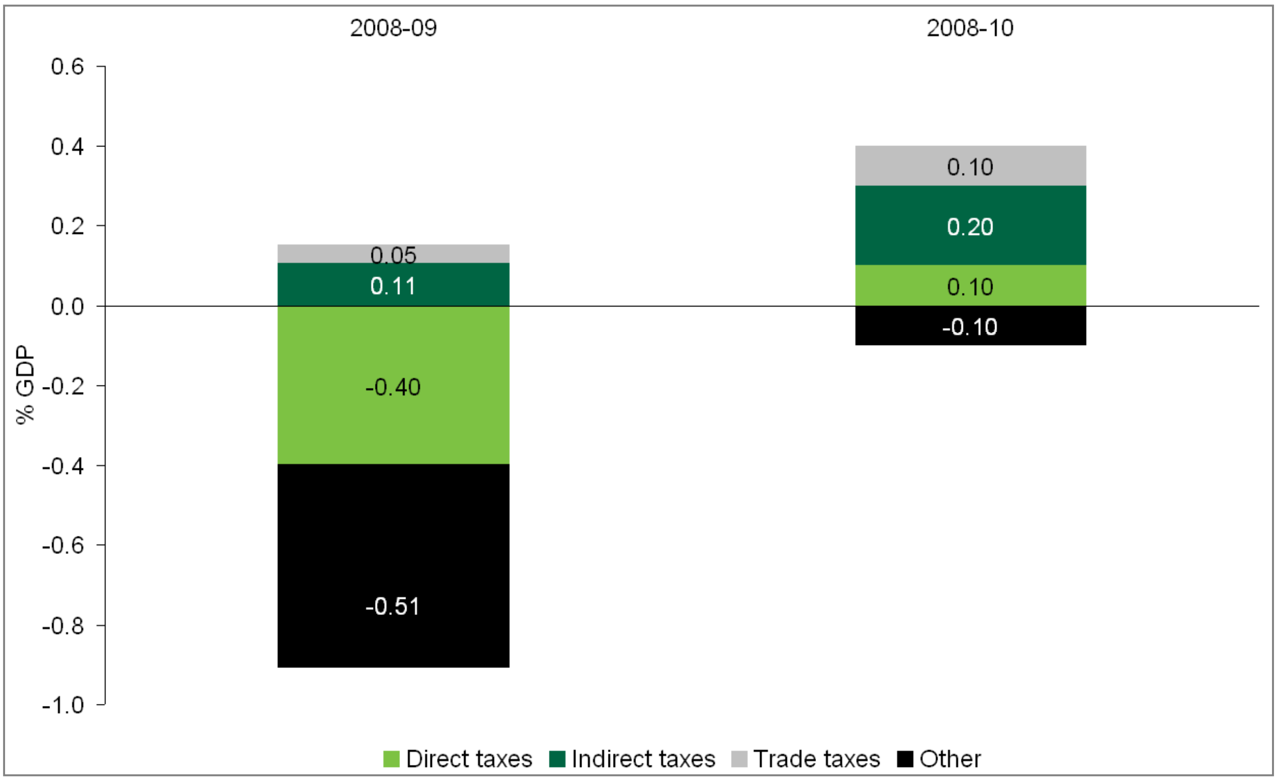
What kinds of revenue have accounted for these falls?

- ***Direct taxes*** (on income or property of individuals or enterprises) fell in 38 per cent of countries in 2009, but rose in 50 per cent. In 2010 direct taxes will recover in most countries and will fall in only 20 per cent.
- ***Indirect taxes*** (on consumption or expenditures) fell in 50 per cent of countries in 2009 and will fall in 30 per cent in 2010. In most cases, this reflected lower revenues from VAT, but excise taxes were important in Zambia, for instance, and tourism levies fell in Gambia, Kenya, and the Maldives.
- ***Trade taxes*** fell in 42 per cent of countries in 2009, but rose in 38 per cent. They will continue to fall for 31 per cent of LICs in 2010.
- ***Other revenues*** (royalties and other payments for oil or minerals concessions) fell sharply in oil-exporting countries in 2009, but are mostly recovering in 2010. They also fell in mineral-exporting countries such as Niger (uranium) and Zambia (copper, cobalt), but have shown little sign of recovery in 2010. However, minerals revenues rose in Liberia and Mongolia in 2009 and will rise further in 2010, due to new contracts and mines.

Even though a smaller number of countries was affected by falls in direct taxes, such taxes represent a large share of overall taxation in many countries and therefore their impact on revenues is more significant. Figure 5 shows this for 20 countries with December 2009 budgets.

It is also worth noting that, while most of the 2009 fall was in direct taxes, the 2010 recovery will be split between direct, indirect, and trade taxes. At the end of 2010, there will have been a minor shift towards indirect taxation, which tends to fall on poor people, as they consume a higher proportion of their income. Therefore the tax trends produced by the crisis may have slightly increased the regressiveness of the tax system.[8]

Figure 5: Revenue trends by type (December 2009 budgets, % GDP)



3 How are low-income countries responding?

Faced with this fiscal hole and the wider negative impact of the global crisis, countries have to decide how to respond through fiscal policy. They have essentially two options:

- To ***'adjust'*** to the crisis – assume that no more financing is available from the international community, and therefore cut expenditures in line with the fall in revenue, or increase tax burdens, in order to avoid increasing their budget deficits;
- To ***'grow out of'*** the crisis – this involves spending more money, a 'fiscal stimulus' to accelerate economic recovery and recovery in budget revenue levels. This could be done only if countries can find money to finance greater budget deficits, either from borrowing (externally or domestically) or by mobilizing more aid grants from donors.

The first response option is typified by LIC 'adjustment' programmes with the IMF, of the sort adopted by countries responding to the Asian financial crisis in the 1990s. The second is the response to the current crisis advocated (and adopted in their own economies) by the G20.

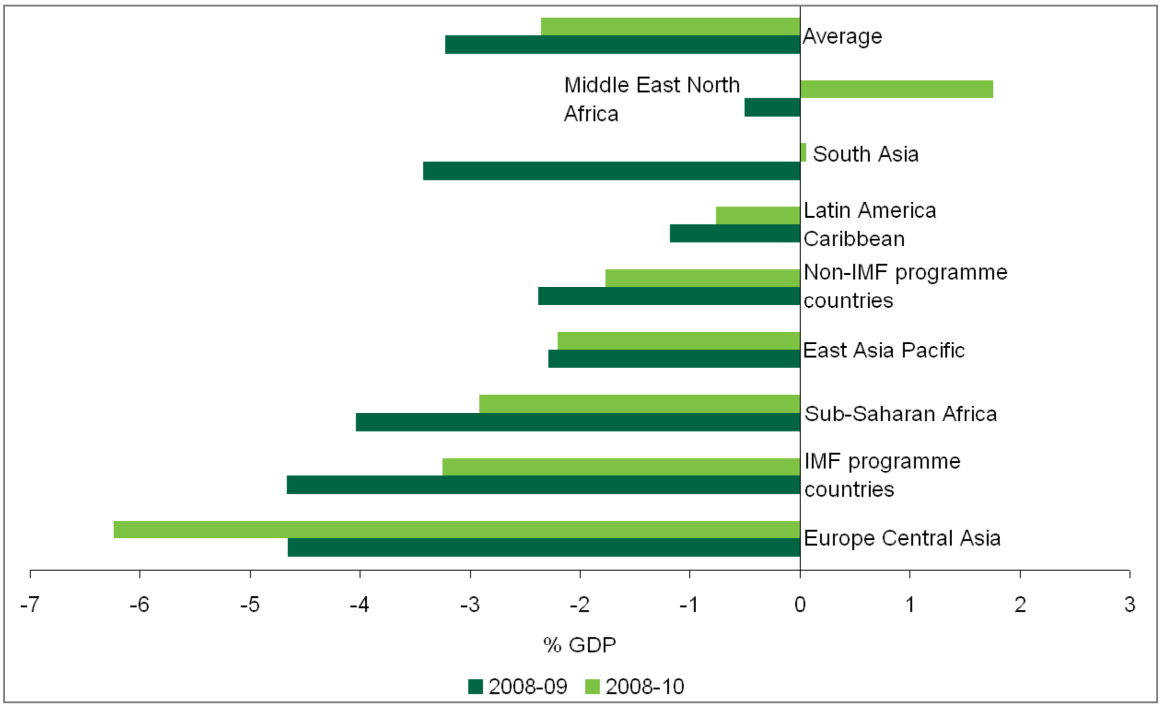
3.1. Budget deficits

Overall, as shown in Figure 2, the deficit in the 56 countries surveyed increased by $43.2bn in 2009, and is forecast to be $23.9bn higher in 2010 than in 2008.

Two-thirds of the countries surveyed increased their budget deficit in 2009, and 24 per cent will continue to do so in 2010. Figure 6 shows trends by region and for countries with and without IMF programmes. This presents a dramatic contrast with the response to the Asian crisis in the 1990s, when most countries (especially those with IMF programmes) reduced their deficits sharply and thus aggravated the recession, as well as cutting social spending.

However, in 2010 there is forecast to be a 0.9 per cent fall in the average deficit, with falls in all regions except Europe and Central Asia. Even after this fall, deficits will still be larger than in 2008 as a percentage of GDP, in all regions except South Asia and the Middle East/North Africa. Nevertheless, the 2010 forecast represents a significant unwinding of fiscal stimulus, and more rapidly than in OECD economies.

Figure 6: Change in fiscal balance



Deficits grew more sharply for countries with an IMF programme in 2009 – indicating that the IMF played a positive role in allowing countries to increase deficits. However, countries with IMF programmes are also the ones that are cutting their deficits more sharply in 2010, suggesting that the IMF is not doing all that it could to prevent this fiscal tightening. According to the IMF, 'Where growth is expected to rebound to pre-crisis levels, spending plans need to be cast consistent with medium-term fiscal objectives, unwinding any short-term stimulus that might have been provided' (IMF, 2010e).

Box 1: Two different worlds: oil exporters and fragile states

Analysis of two key groups of LICs, oil exporters and 'fragile states' (those countries defined by the World Bank as having less good policy performance or institutions, shows that:

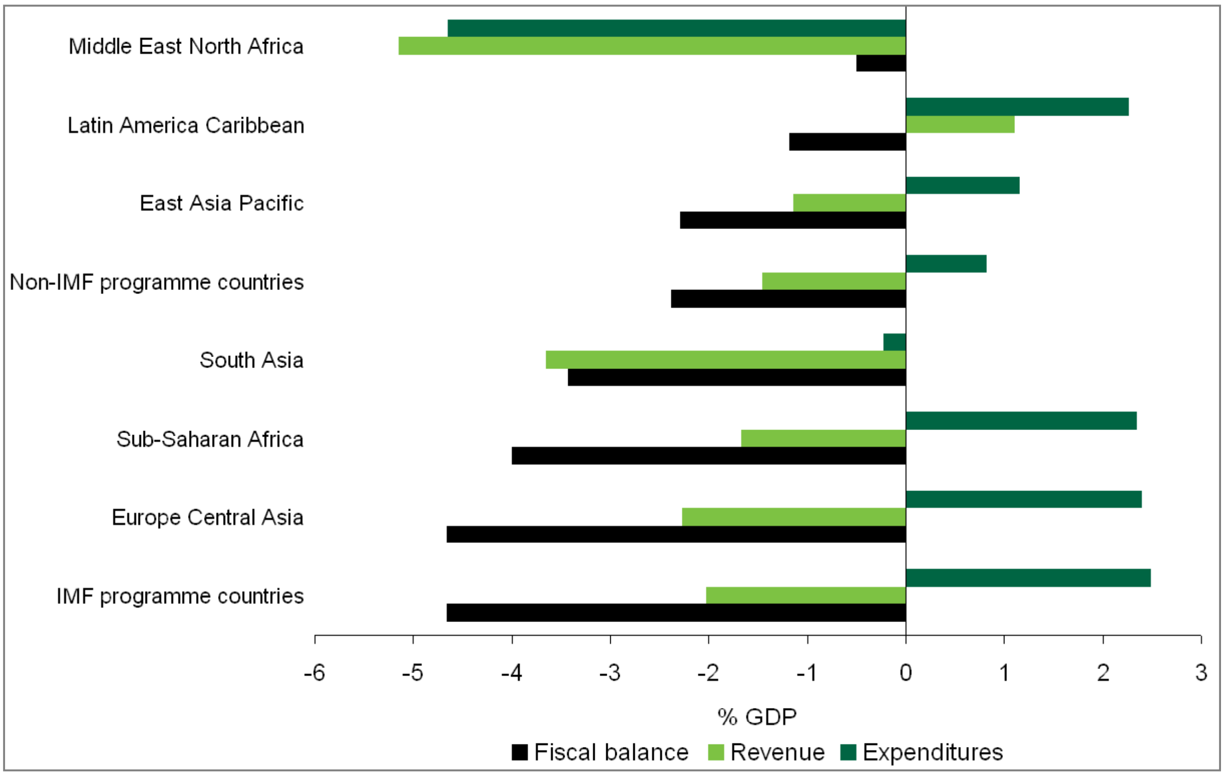
In **fragile states**, the crisis has created a revenue hole for only around half of the countries (including Côte d'Ivoire, Guinea-Bissau, São Tomé and Principe, and Sierra Leone), partly because others already have very low revenue levels. In the other 50 per cent of cases, fiscal deterioration was due to spending increases. External financing (90 per cent grants, although loans rose sharply) funded half the extra deficits and domestic borrowing the rest. In 2010, although revenues have risen due largely to ongoing tax reforms, deficits in fragile states continue to deteriorate because of further large increases in spending. External loans and grants in roughly equal amounts finance the additional spending, marking a major increase in the use of external loans.

Oil-exporting countries have suffered a massive fiscal hole due to the fall in global oil prices, due largely to the revenue shortfall but also due to small spending increases. Virtually all of the deficit increase was financed by drawing down on deposits and reserves, although most of the additional project spending was funded by external or domestic loans (in many cases expensive ones). In 2010, oil exporters' revenues have risen, helped by rising oil prices, and deficits have declined accordingly. There is virtually no change in the financing composition in oil-exporting countries.

3.2. Government spending

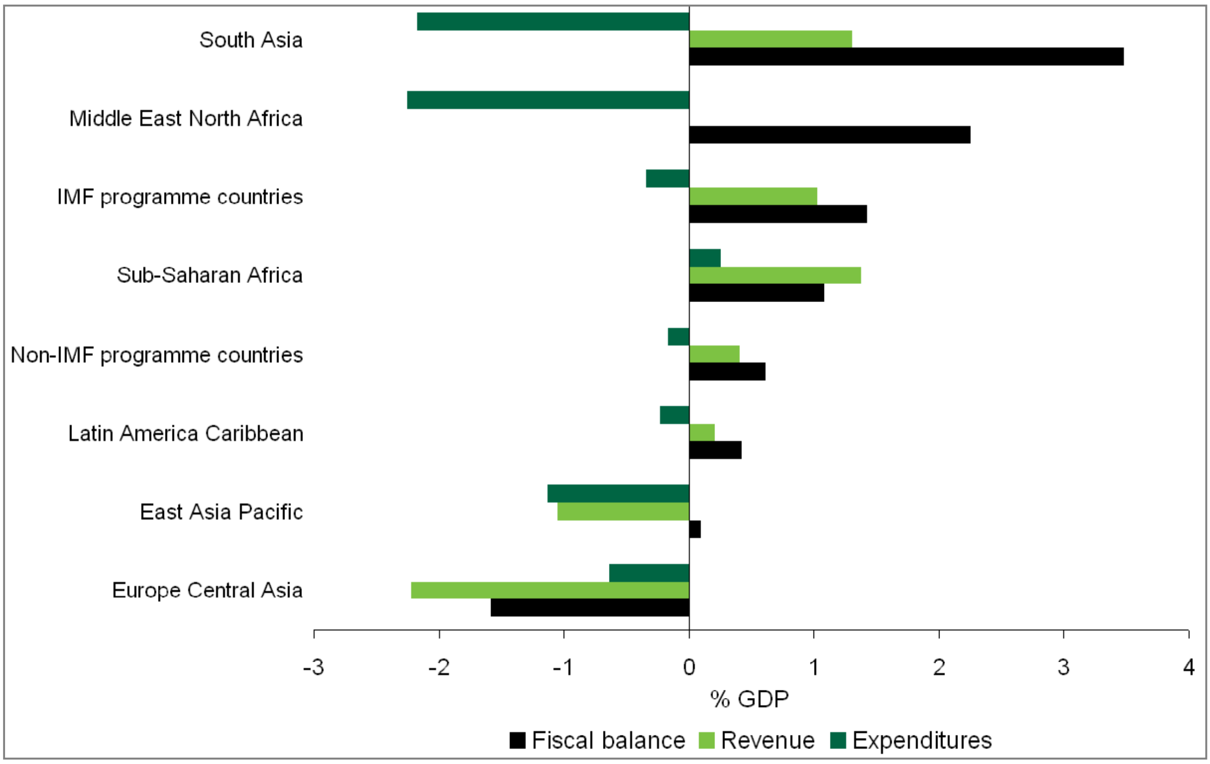
So why did the deficits grow sharply in 2009? Figure 7 shows some striking contrasts. In East and Central Asia, revenue falls and expenditure rises were equally responsible for growing deficits. Expenditure also grew sharply in Latin America, sub-Saharan Africa, and countries with IMF programmes, bearing more responsibility for increasing deficits than falls in revenue. However, expenditure grew much less strongly in countries without IMF programmes, and it fell slightly in South Asia and sharply in the Middle East. All of these countries were trying to adjust to revenue falls, and with few prospects of mobilizing additional finance in the absence of IMF programmes, since the IMF's 'gatekeeper' role means that a Fund programme is required by many lenders and donors as a condition for other grants or loans.

Figure 7: Reasons for deficit changes (2008–09)



However, as shown in Figure 8, this picture will change dramatically in 2010, when deficits are set to halve. Expenditure cuts are planned in five of six regions (although there is projected to be a small increase for sub-Saharan Africa), including slightly larger cuts for IMF programme countries. This is more evidence that a reversal of fiscal stimulus is already under way.

Figure 8: Reasons for deficit changes (2009–10)



How has the picture varied for individual countries? Figure 9 groups countries in sub-Saharan Africa (SSA) and other LICs by trends in expenditure in 2009 and 2010. It shows that in both years a higher percentage of SSA countries increased expenditure, and a lower percentage cut expenditure, than was the case in other LICs. This discrepancy between Africa and other regions is even wider in countries with IMF programmes, as shown in Figure 10, so that in 2010, 75 per cent of SSA countries with IMF programmes will have higher expenditure/GDP than in 2008, compared with only 25 per cent of LICs in other regions.

Figure 9: Expenditure trends (% GDP)

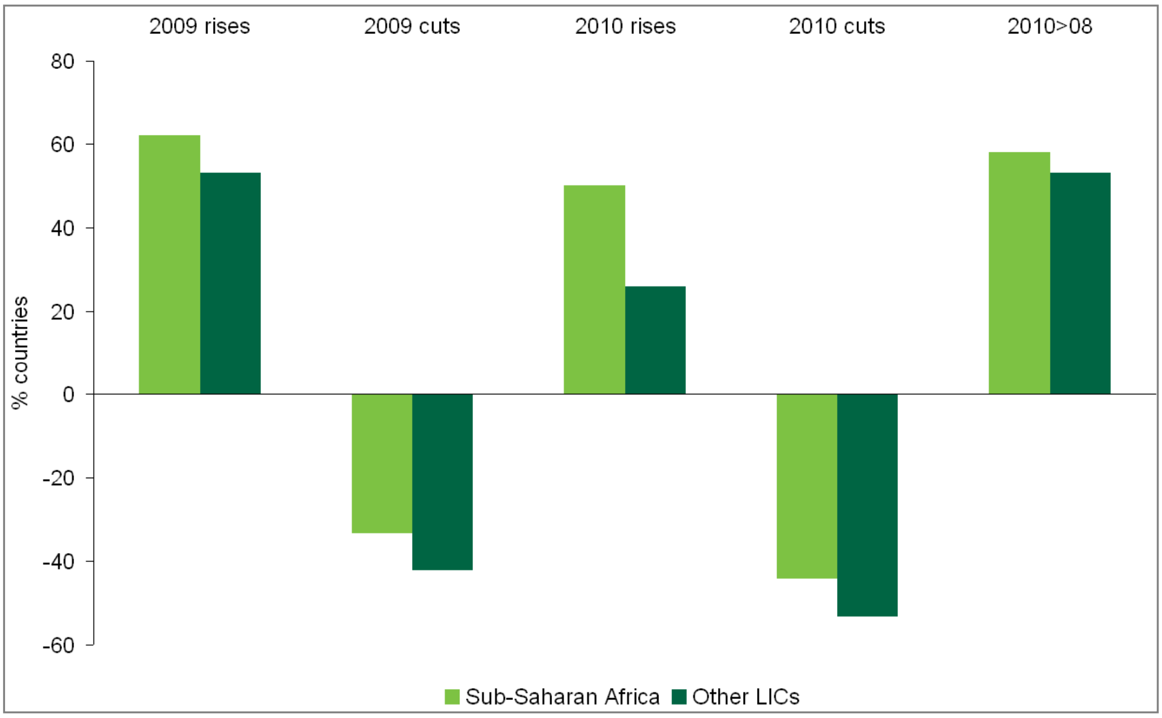
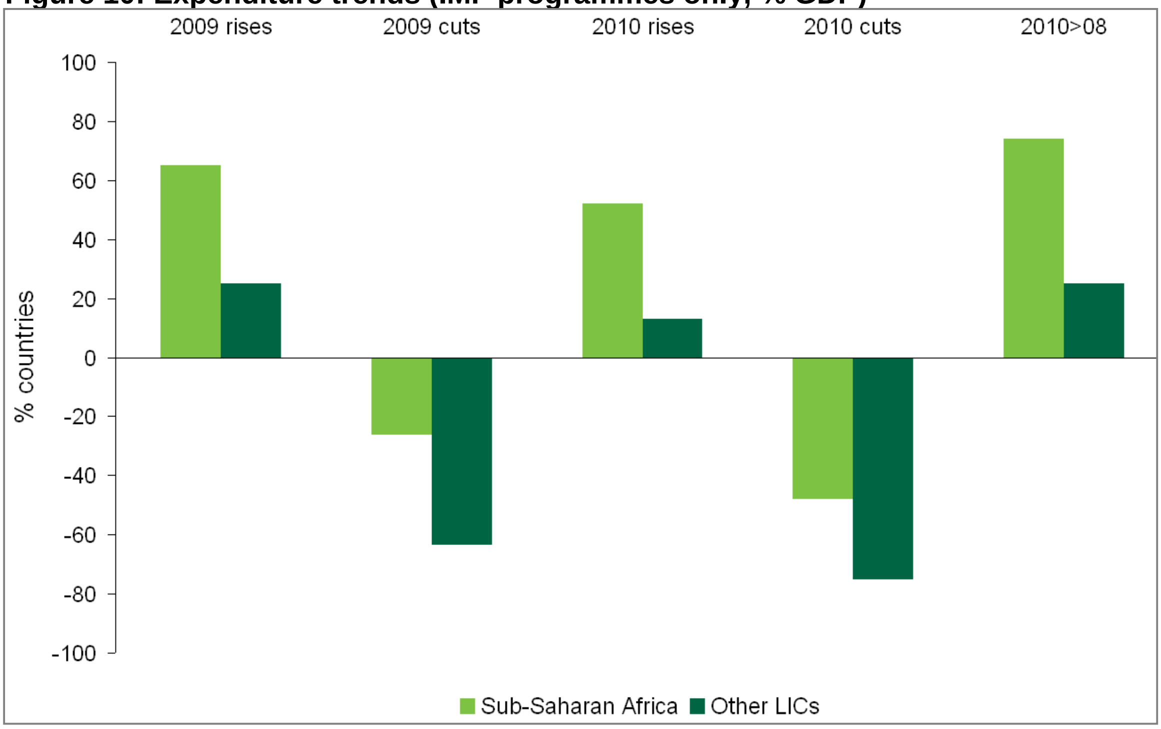


Figure 10: Expenditure trends (IMF programmes only, % GDP)



3.2.1. Types of expenditure

This section analyzes how these trends have affected spending, looking at whether cuts have hit capital/investment expenditures or recurrent expenditures (such as wages and salaries, goods and services, and subsidies). This is important because it is often said that countries should particularly not cut capital/investment expenditures in a time of crisis: they should instead continue to invest to improve their infrastructure and future productivity, and build schools and clinics, in order to reach the MDGs and improve their ability to recover from the crisis. On the other hand, much recurrent expenditure in LICs is on medicines, schoolbooks, teachers' and doctors' salaries, and social protection programmes, so cuts in recurrent expenditure might also be bad for progress towards the MDGs. Overall, capital expenditure will have gone up as a percentage of GDP and by much more than recurrent expenditure overall.[9] If countries are to sustain progress towards the MDGs, they need to increase both capital and recurrent expenditure. Therefore the key issue, covered in the next section, is the impact of the crisis on MDG expenditures.

3.2.2. Sectoral expenditure trends

Even during a crisis, particular efforts can be made to increase expenditures on essential MDG-related sectors that could act as cushions against the impact on the poorest people (i.e. education, health, social protection), as well as to invest more in key infrastructure sectors (electricity, transportation, water and sanitation) and agriculture, which could increase pro-poor growth and thereby reduce poverty. On the other hand, expenditure cuts in these sectors could exacerbate the damage the crisis is inflicting on the poorest people and on pro-poor growth.

Therefore, to assess potential effects on the MDGs, this study examines in detail sectoral expenditures related to education, health, and infrastructure.[10] Annex 1 presents sectoral expenditures as percentages of GDP for 28 countries for which comparable breakdowns were available.[11] Figures 11–18 show various types of analysis of these expenditure trends.

Figure 11 shows average changes in sectoral expenditure as a percentage of GDP. Education spending fell in 2009, and although it is the only sector forecast to rise in 2010, it will end 2010 at lower levels than in 2008. Expenditures on infrastructure, health, and agriculture rose in 2009 and fell in 2010, but not to below 2008 levels. Spending on social protection fell in both years and ended 2010 more than 0.2 per cent of GDP lower than in 2008.[12]

Figure 12 looks at trends for individual countries. Health spending performs best, with three-quarters of the 28 countries increasing spending as a percentage of GDP in 2009, and 87 per cent ending 2010 with higher health expenditure than in 2008. Around 50–60 per cent of countries raised spending in all other sectors in 2009, and 40 per cent will do so in 2010, but the scale of increases vary, so that whereas 60 per cent of countries will have increased education, infrastructure, and agriculture spending over the two years in 2008–10, only 27 per cent will have increased spending on social protection.

Figure 11: Sectoral expenditure changes

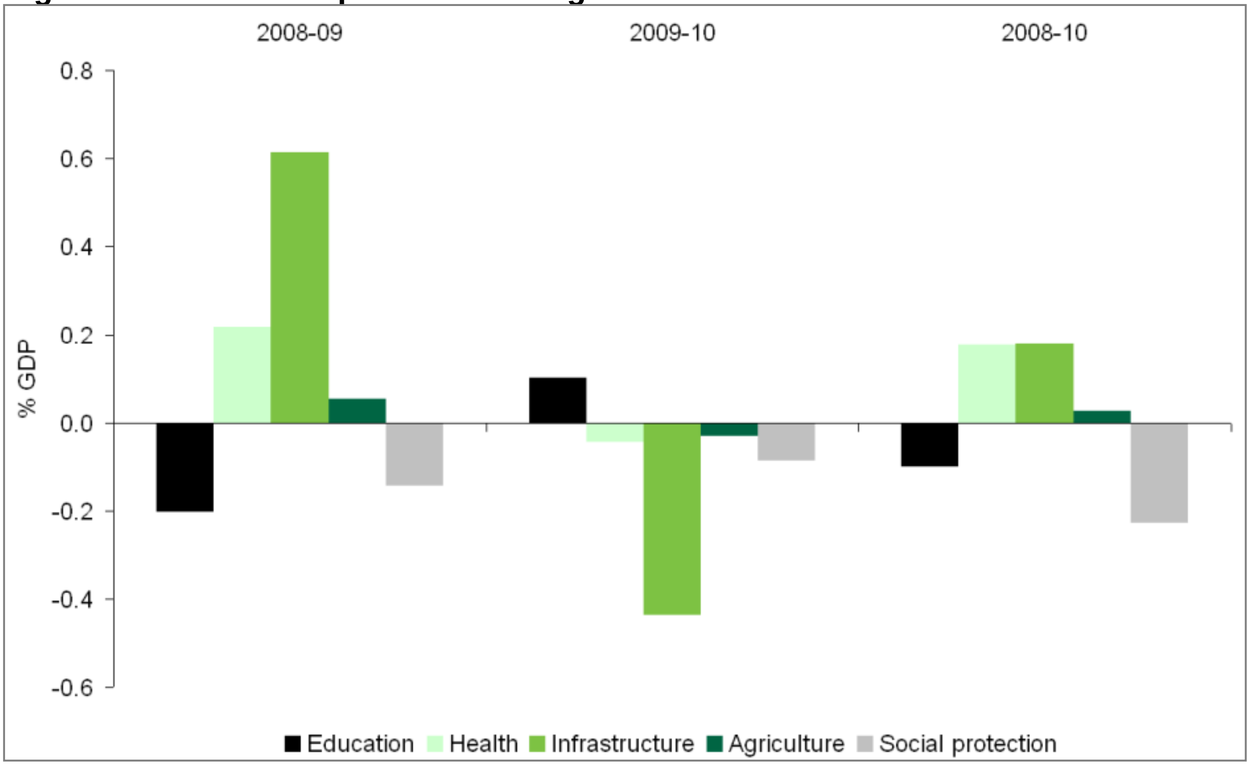
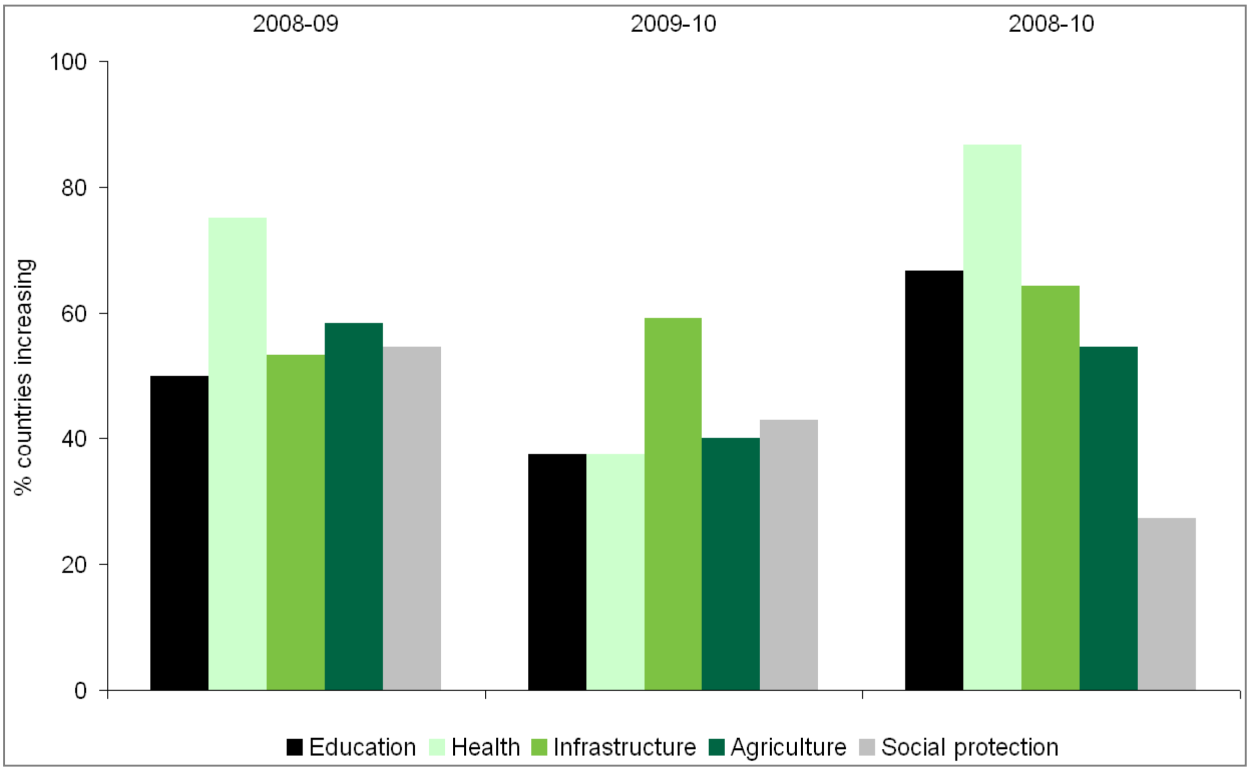


Figure 12: Sectoral country trends



Figures 13–18 show trends in sectoral expenditures disaggregated by various analytical groups – sub-Saharan Africa/other and IMF programme/non-programme. They show some fascinating variations:

- **Education spending** fell for all groups in 2009. It is forecast to rise in 2010 (sharply in sub-Saharan Africa), but there will be sharp cuts in non sub-Saharan Africa IMF programmes. Only sub-Saharan Africa countries with IMF programmes will have higher spending in 2010 than in 2008.
- **Health spending** rose in 2009 and will end 2010 higher than in 2008 for all groups. However, it is forecast to fall for non-SSA countries, and to rise less sharply for IMF programme countries than others.
- **Infrastructure spending** rose sharply in all groups in 2009, but is forecast to fall in all of them in 2010. However, it rose most sharply in 2009 for SSA countries with IMF programmes, and is likely to remain well above pre-crisis levels in SSA countries by the end of 2010.
- **Agriculture spending** rose for all groups in 2009 but, whereas it will fall outside Africa in 2010, it will continue rising in Africa. For all four groups it will end 2010 higher than in 2008.
- **Social protection spending** fell for all four groups in 2009, will continue to fall in 2010, and will be lower in all groups in 2010 than in 2008, but the fall has been less steep in countries with IMF programmes. The IMF (2010a) explains this as being due to the lack of existing social protection programmes on which to build, which is a severe indictment of the neglect of this issue by all concerned.
- **Overall MDG spending** rose for all groups in 2009 and fell back in 2010. However, SSA countries with IMF programmes are forecast to end 2010 with spending higher by 0.23 per cent of GDP than in 2008, whereas LICs as a whole will have an increase of only 0.02 per cent of GDP.[13]

From this analysis, the following can be concluded:

- **Sectorally,** health has been the darling, and social protection the orphan, of expenditure during the crisis. Infrastructure and agriculture have come out of it with higher spending, but this will be cut in many countries in 2010. Education has done particularly badly.[14]
- **Regionally,** Africa has done much better than other regions, ending 2010 with higher spending levels in all sectors except social protection. However, its spending levels as a percentage of GDP, while matching those of other regions on education and infrastructure for the first time, and exceeding them on agriculture, are still much lower on health and especially on social protection.
- **Countries with IMF programmes** have done better than others on overall MDG spending and in agriculture and education, equally badly on social protection, and worse on infrastructure and health.[15] Among those with IMF programmes, African countries have fared better on education, health, and agriculture, and similarly to LICs in other regions on infrastructure and social protection.

However, the scale of the additional spending remains tiny. The IMF (2010a) indicates that for the 25 per cent of LICs that needed to bail out their banking systems as a result of the crisis, the average spend was 1.2 per cent of GDP. This compares with an increase of only 0.1 per cent of GDP on MDG-related spending across LICs as a whole, or a 0.3 per cent increase for the most favoured group – sub-Saharan African LICs with IMF programmes. However, due to the fall in LIC GDP in 2009, this means that MDG spending in dollar terms is likely to have fallen, at a time when there are already huge financing gaps for the major MDGs.

Figure 13: Education spending

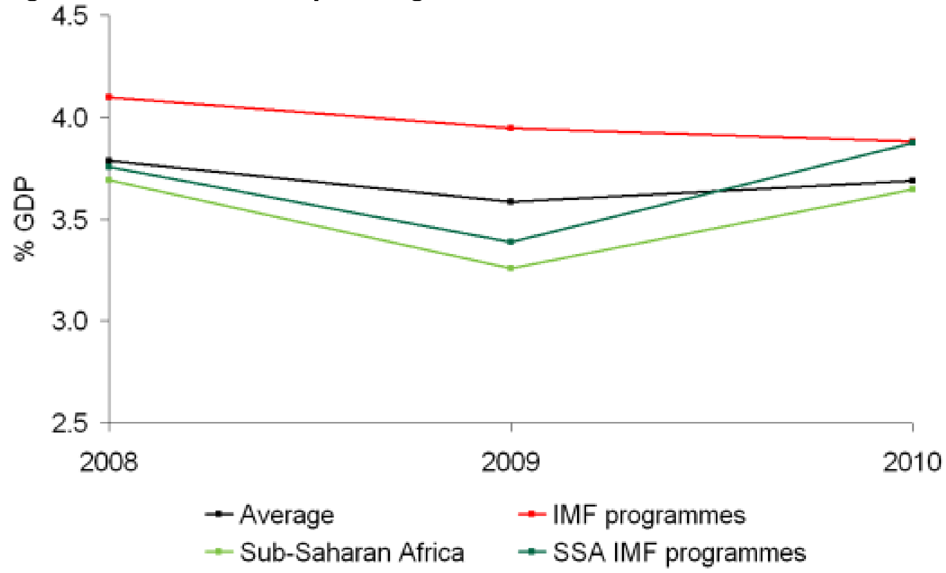


Figure 14: Health spending

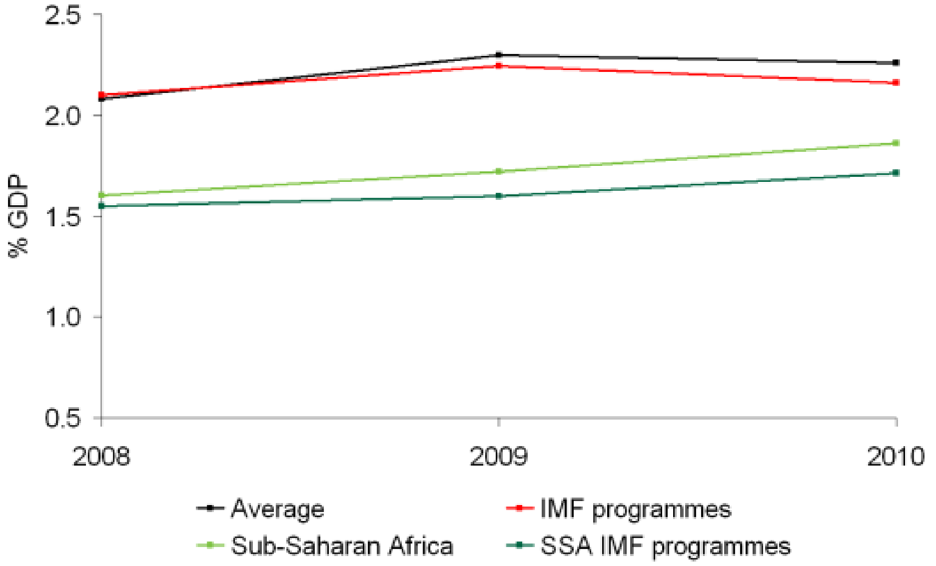


Figure 15: Infrastructure spending

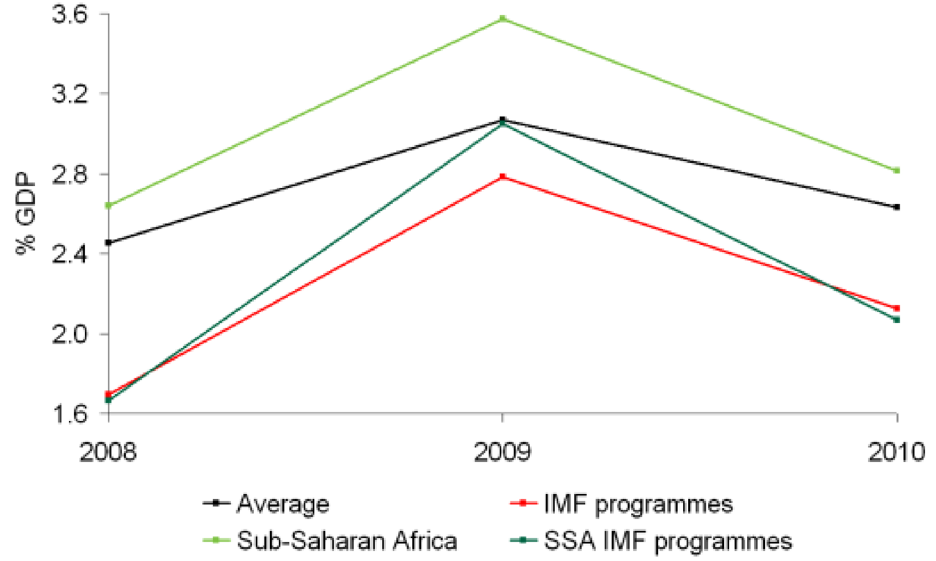


Figure 16: Agriculture spending

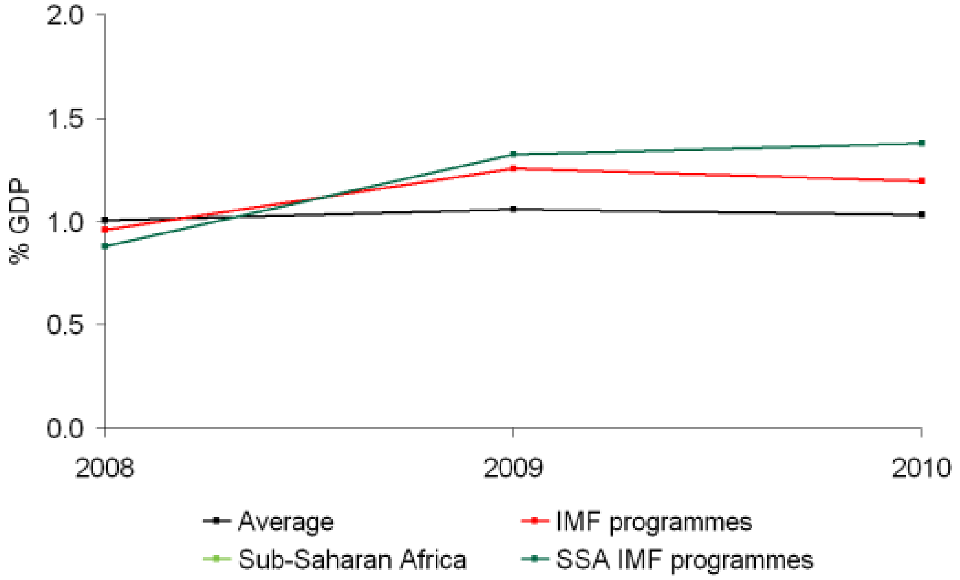


Figure 17: Social protection spending

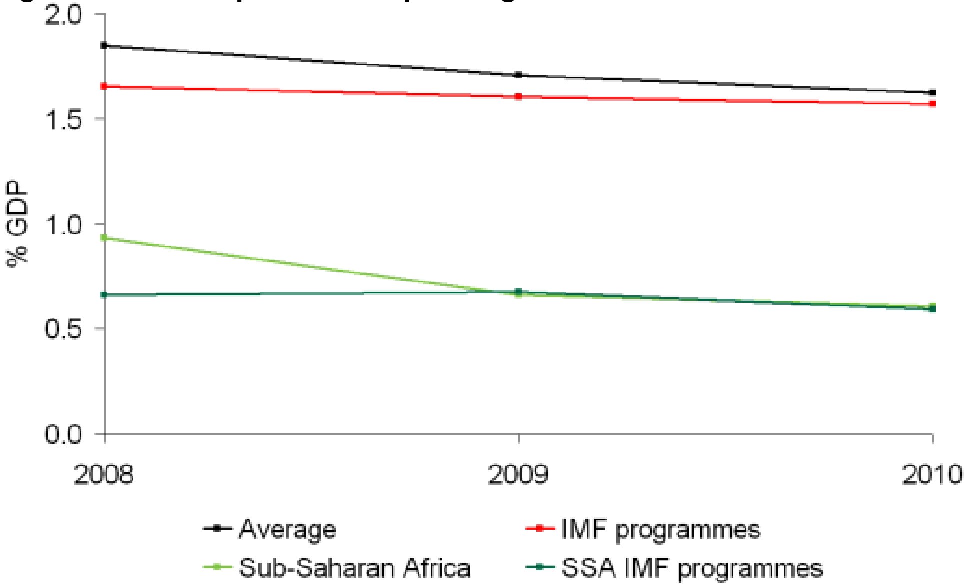
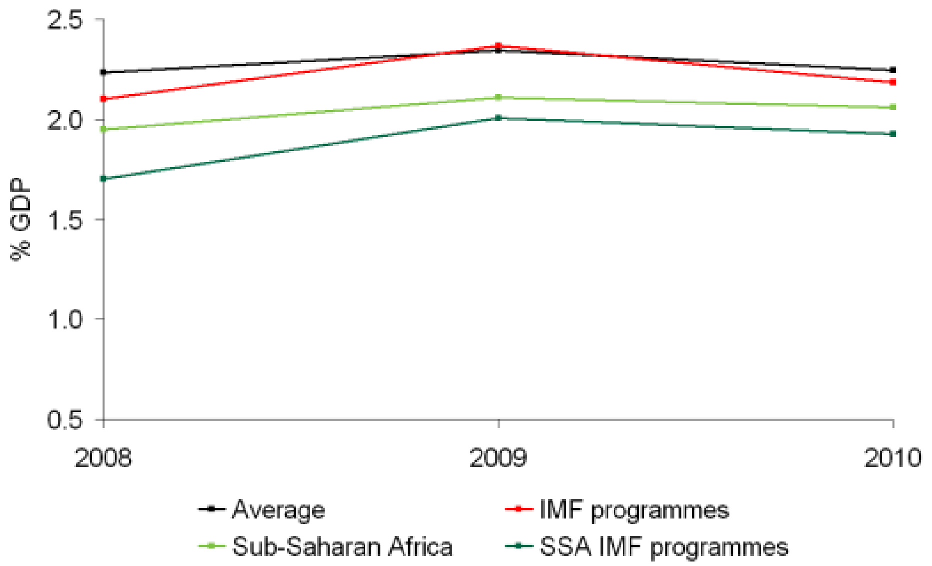


Figure 18: Overall MDG spending



4 How have governments funded the fiscal stimulus?

This section looks at how governments have paid for spending increases. They had three choices: grants from aid donors; external borrowing from international lenders; or domestic borrowing from their own banks and citizens. Grants have the advantage over the other sources that they do not increase a country's debt burden, while domestic financing has the advantage of not increasing dependence on external sources of funds for national development.

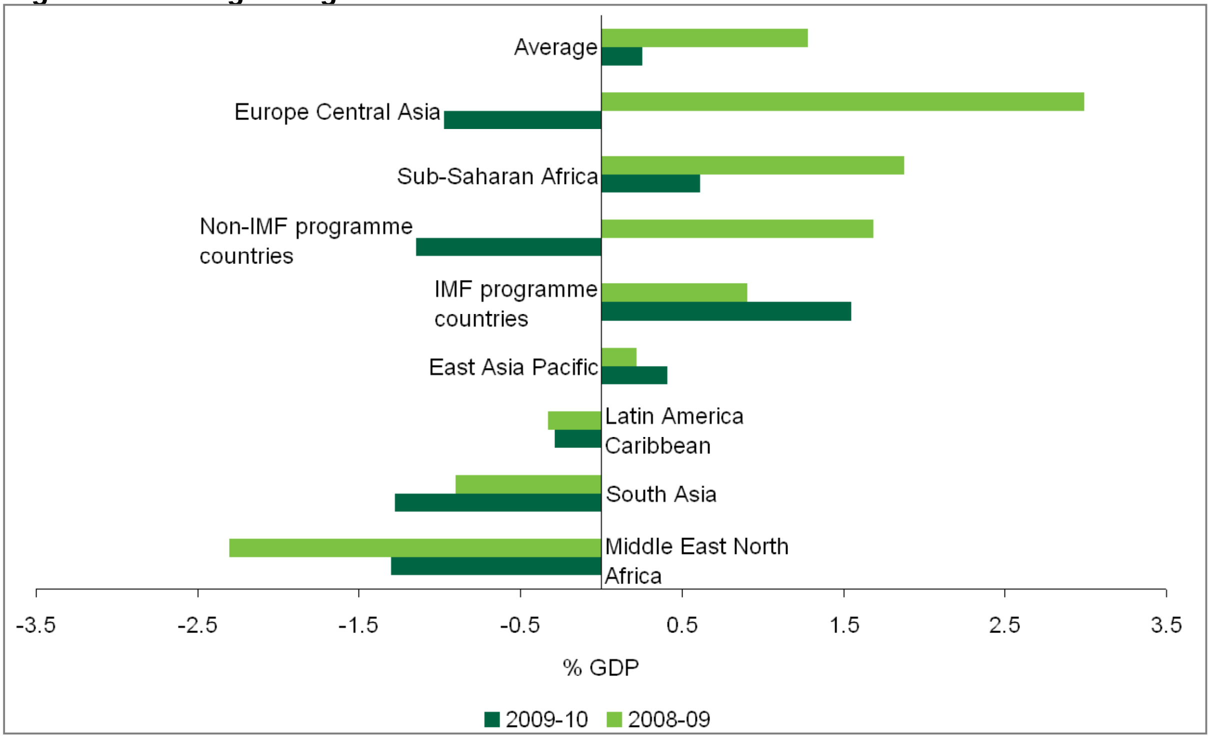
In March 2009, G20 leaders promised that low-income countries would receive $50bn more in external financing to combat the crisis, through multilateral institutions, in grants or loans. They have fulfilled most of these pledges, by providing multilaterals with resources which they can supply as loans or grants to LICs. However, other pledges have not been kept. In addition, in 2005 G8 and OECD donors promised to increase global aid by approximately $50bn between 2005 and 2010, and aid to Africa by $25bn (constant 2004 prices). Current analysis indicates that there will be major shortfalls: donors are likely to deliver only $29bn globally and $11bn for Africa by the end of 2010 (OECD, 2010). At the same time, global estimates of financing needs to reach the MDGs show that the 'missing $20bn' could easily have been very productively spent on education, maternal and child health, nutrition, and water and sanitation, bringing countries much closer to meeting the MDGs.

The analysis in this section is therefore important because it shows whether or not additional external financing was delivered to LICs' budgets, especially at a time of crisis when the financing provided should have been higher according to G20 pledges. It also shows whether this has been in the form of loans (which could increase the risk of debt problems) or grants.

4.1. Grants

On average, grants rose sharply in 2009. However, they will rise only marginally in 2010 – indeed they are forecast to fall in all groups except in countries with IMF programmes (where they will rise more sharply than in 2009), sub-Saharan Africa (where they will rise but by much less than in 2009), and East Asia (where they will rise by small amounts in both years). Once again, IMF programme countries and countries in sub-Saharan Africa appear to be performing best in terms of mobilizing grants (Figure 19).

Figure 19: Changes in grants 2008–10

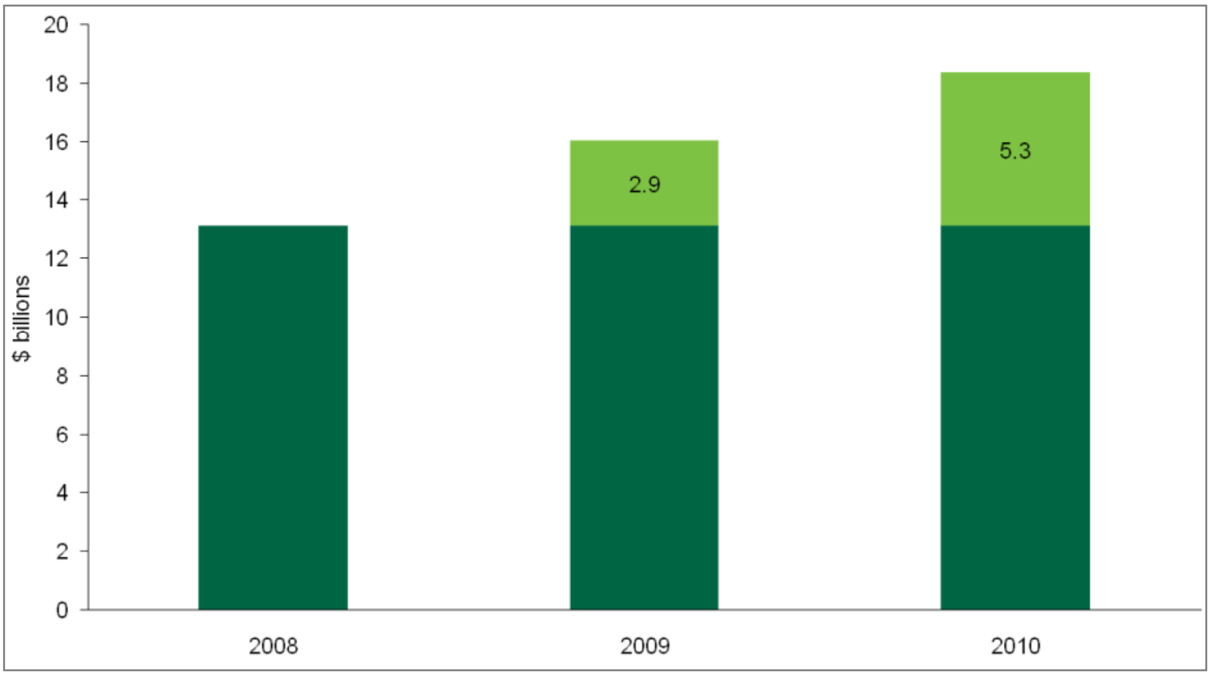


Analyzing 54 LICs individually, 27 increased grants in 2009 and 17 will increase them in 2010. However, 19 are forecasting declines in grants as a percentage of GDP in 2009 and 26 in 2010.

What does this mean in terms of amounts reaching LIC budgets? Figure 20 shows that, compared with 2008, the international community increased grants through LIC budgets by $2.9bn in 2009, and is forecast to increase them by $5.3bn in 2010, bringing the total to $8.2bn. At first sight this looks like a fairly major response to the crisis; it is certainly positive news that grants rose by 22 per cent in nominal terms in 2009 and may rise by a further 15 per cent in 2010. However:

- It is not possible to distinguish how much of this was a response to the crisis, and how much was a result of wider plans for scaling up aid;
- The average annual increase of $4.1bn compares poorly with global promises to scale up aid by about $8bn a year (not all of which would have gone to LICs);
- The 'revenue hole' due to the crisis averaged $32bn per year over 2009 and 2010, so only 13 per cent was filled by grants.

Figure 20: Additional grants in 2009–10



Taken together, these figures indicate that the availability of grants to offset the impact of the crisis has been patchy for different regions and country groups, and tiny compared with the fiscal hole created by the crisis. Grants will also rise much more slowly in 2010, increasing pressure to balance fiscal deficits by reducing spending or increasing borrowing. However, countries with IMF programmes do seem to be planning to accelerate grants in 2010, and those in sub-Saharan Africa and East Asia will also see an increase.

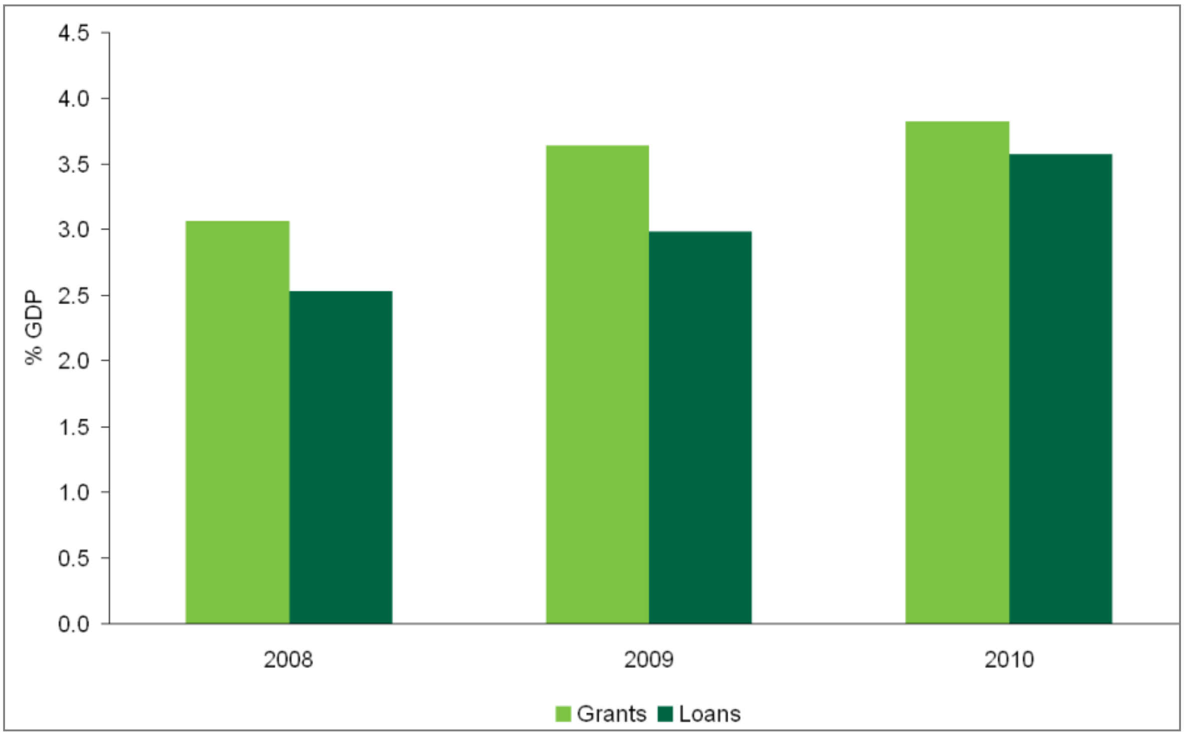
4.2. Loans

Grants alone have not risen by enough to provide LICs with all the funding needed to fight the crisis and cover expenditures. As a result, three-quarters have been forced to resort to additional borrowing. Recent IMF analysis (2010a) indicates that 50 countries were planning to resort to additional domestic borrowing to fund their deficits, and around 40 were planning to resort to external borrowing, while ten were planning to draw down oil reserve funds or other deposits.

Due to differing budget presentations, it has been possible to obtain data for only 21 LICs on external loan disbursements. Of these, 71 per cent increased loans as a percentage of GDP in 2009, and 48 per cent intended to do so in 2010.[16] This means that the proportion of countries increasing loans was 20 per cent higher in 2009 than for grants, and will be 17 per cent higher in 2010.[17]

As shown in Figure 21, loans overall will have risen considerably faster than grants as a percentage of GDP for this group of countries, especially according to the forecasts for 2010. In addition, the percentage of countries relying more on loans than grants will have risen from 33 per cent in 2008 to 64 per cent by 2010. This is a somewhat worrying trend, reflecting the fact that those external funders which have been in the best position to respond to the crisis (multilateral development banks and non-OECD lenders such as China and India) provide much of their financing as loans rather than grants.

Figure 21: Grants and loans

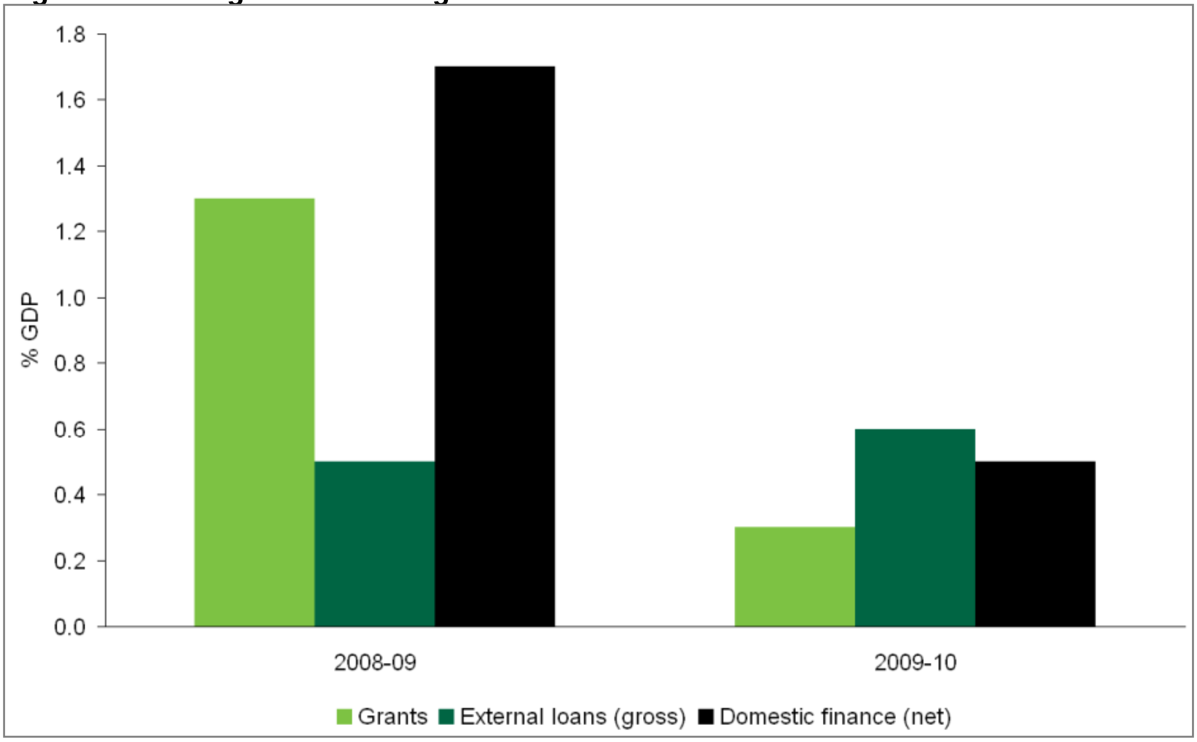


What of domestic borrowing? Our data confirm that external financing filled only around one-third of the fiscal hole, leaving two-thirds to be filled by other sources. As a result, 53 per cent of countries increased their use of domestic borrowing in 2009, and 46 per cent in 2010. Average use of domestic borrowing rose by 1.7 per cent of GDP in 2009 and 0.5 per cent in 2010. As shown in Figure 22, this far exceeded external loans and even exceeded grants in 2008, and in 2009 far exceeded grants and almost matched external loans.[18]

These loans are almost always far more expensive (with much higher interest rates and shorter maturity periods) than external loans, and so pose more of a problem for LIC debt burdens. Nevertheless, to judge by a survey of country authorities conducted by DFI, countries felt forced to turn to domestic borrowing first in 2009, so that they did not have to cut spending levels while they waited for the international community to respond.

Do these findings indicate that LICs face a dramatically increased risk of returning to the debt crises of the 1990s, in spite of the $100bn poured into debt relief for Heavily Indebted Poor Countries. To judge by the most recent IMF (2010a) analysis, the answer is clearly no. The IMF indicates that external debt levels for LICs rose by only about 5 per cent of GDP in 2009 and, although ten countries have higher levels of debt distress as a result of the crisis, for six of them this is a temporary situation. In addition, these increased debt burdens have been largely due to lower growth rather than to any 'irresponsible' new borrowing by LICs. Many LICs remain well below risky levels of debt and can certainly afford to borrow more, especially for high-return, growth-promoting infrastructure projects.

Figure 22: Changes in financing



However, the IMF analysis does not sufficiently take into account the potential burden of domestic debt, and recent analysis for UNESCO (Martin and Kyrili, 2009) has indicated that more LICs face domestic debt problems than external debt problems. Therefore a much closer eye should be kept on this issue.

The IMF analysis also indicates that, even in 2009, countries with higher risks of debt distress were more prone to 'tighten fiscal policy' (especially through spending cuts). In other words, the absence of grants was already forcing countries to cut spending for fear of making debt levels unsustainable once again. If this continues in 2010, it will be deplorable, especially because the negative effects of the crisis on revenues have yet to recede in half of the poorest countries.

The lessons to be learned from this analysis are that the international response to the crisis (and the future financing of the MDGs) needs to be much more rapid in future, to avoid countries turning to expensive domestic financing as a first resort. It should also preferably be even more in grant form than it is currently – through such measures as further increasing aid and providing some IMF finance as grants – and these grants should especially be concentrated on countries with high risks of debt distress, to avoid them pre-emptively cutting expenditure due to worries about their debt burdens. However, there is still some scope for many LICs to borrow more to fund their development without restarting a debt crisis, and most LICs still have some limited scope to contract more expensive loans for high-return projects, especially those with low risk of debt distress.

5 Fiscal space for further response

5.1. Assessing fiscal space for more MDG spending

A number of arguments are often used against accelerating MDG spending:

- It would cause unsustainable debt levels;
- It would make countries too aid-dependent if funded by aid;
- Countries cannot mobilize more revenue from domestic sources to fund the expenditure;
- Higher expenditures would provoke excessive levels of inflation or budget deficits, destabilizing the macro-economy.

This section therefore examines whether LICs have more 'fiscal space'[19] to combat the crisis and accelerate progress towards the MDGs, without compromising macro-economic stability or debt sustainability, risking excessive aid dependence, or overtaxing their economies. A 'fiscal space index' is used to assess the space that governments have to mobilize resources to fund additional MDG expenditures. The first three of the five indicators comprising the index are:

1. ***Sustainable borrowing levels:*** One way a country could finance its expenditure is by borrowing domestically or externally. Excessive borrowing could risk creating 'unsustainable debt' which would undermine growth, or increasing inflation through domestic borrowing. Therefore we look at levels of both external and domestic debt, to create a composite 'debt distress' indicator, whereby a country with either external or domestic debt distress has no further scope for government borrowing.

2. ***Sustainable domestic revenue levels:*** A further way for a government to generate resources to fund expenditures is to increase domestic revenue mobilization. Many countries in our sample have made remarkable progress in increasing revenue in recent years (see African Economic Outlook, 2010; UNECA, 2009) by increasing taxes, widening the tax base, or improving the efficiency of tax collection. However, it is also generally accepted that excessive tax rises, especially for the limited number of individuals and enterprises with sufficient income to pay tax in LICs, can be inimical to long-term growth by undermining incentives for earnings and profitability.

3. ***Sustainable aid levels:*** A third way to finance additional expenditures is to mobilize more grants. Although aid to many IDA countries has increased substantially in recent years, it is still falling considerably short of earlier promises (ONE, 2010; UNECA, 2009). As also demonstrated above, grants have declined for some countries in 2009 or are forecast to do so in 2010. If donors live up to their earlier promises, there should be considerable space to increase grant flows to combat the crisis. Nevertheless, studies indicate that excessive aid dependence can be inimical to development.

These three indicators are aggregated into an index: countries which could use all three types of resource are described as having 'high' fiscal space; those constrained on one type of finance have 'moderate' space; those constrained on two have 'low' fiscal space; and those constrained on all three have 'no' fiscal space.

Even if a country has scope to mobilize more finance, the IMF and others might argue that it should not do so if this would provoke macro-economic instability, via an excessive fiscal deficit or inflation. To judge whether either of these factors constrain fiscal space, the index results are reassessed taking into account two additional indicators:

4. ***Sustainable fiscal deficit:*** On the basis that it would be unwise for a country to borrow more if its fiscal deficit is high (though it could still use additional grants or revenue, which would leave the deficit unchanged).

5. ***Sustainable inflation levels,*** as a country should not use additional loans or grants, i.e. absorb more aid, if these might push up inflation (though it could increase revenue as this would make spending inflation-neutral).

5.2. Country results of the assessment

As shown in Annex 3, of 54 LICs, only nine have high fiscal space, 24 moderate, 19 low, and two none (Burundi and Liberia). However, within these categories, the scope for financing the MDGs from different sources varies dramatically, as shown in Figure 23:

- 59 per cent of the countries have no space to increase domestic revenue;
- 57 per cent of the countries have critical levels of debt (19 for domestic debt and 17 for external debt) and therefore could not borrow further;
- On the other hand, only 9 per cent (five countries) have excessive levels of aid dependence. For 16 of these countries, aid grants are the only feasible way to finance MDG expenditures.

Including the additional two check indicators – inflation and fiscal deficit – the picture changes, as presented in Figure 24. The number of countries with no fiscal space increases to four (Angola, Burundi, DRC, and Liberia). Of the remaining countries, 27 have low space, 16 moderate, and eight high. The proportion of countries with no revenue space increases to 61 per cent, those with no debt space to 74 per cent, and those with no aid space to only 13 per cent. The number of countries that need to rely on aid grants to increase their MDG spending rises to 23.

Virtually all the countries that have no aid space – i.e. those that already have very high levels of aid – are post-conflict or conflict-affected countries (Afghanistan, Burundi, Guinea-Bissau, Liberia). Many studies (notably Collier and Hoeffler, 2004) have shown that aid tends to rise during and after conflicts, and that it can be most effective in the post-conflict period, therefore justifying higher levels than normal. According to OECD data, much of the aid being spent in these countries is going towards demobilization, resettlement of refugees, de-mining, and other essential conflict prevention programmes.

The amounts of aid are also somewhat inflated by the fact that donors tend to implement aid in conflict-affected countries via intermediaries (consultants and project implementation units), which also increase aid needs. Furthermore, donors are planning to reduce their aid to most of these countries as they emerge from conflict (OECD-DAC, 2010). It is therefore likely that within two to three years most of the countries will have reduced aid sharply and will have more space to absorb aid for spending to accelerate progress towards the MDGs.

For two other countries with no fiscal space (Angola and the DRC) this is temporary, due to high inflation. Their inflation rates are forecast to fall rapidly to levels that would allow them to absorb more aid (in Angola's case by 2011 and in the DRC's by 2012).

Overall, the results of the fiscal space index reinforce the case that the primary means of financing LIC progress to the MDGs must be through aid grants. Almost every LIC already has or soon will have space to absorb additional grants, while far less than half could increase borrowing or budget revenue to fund the MDGs. It is imperative that the international community provides more grants to allow MDG progress without negative economic results.

Figure 23: Financing sources with fiscal space

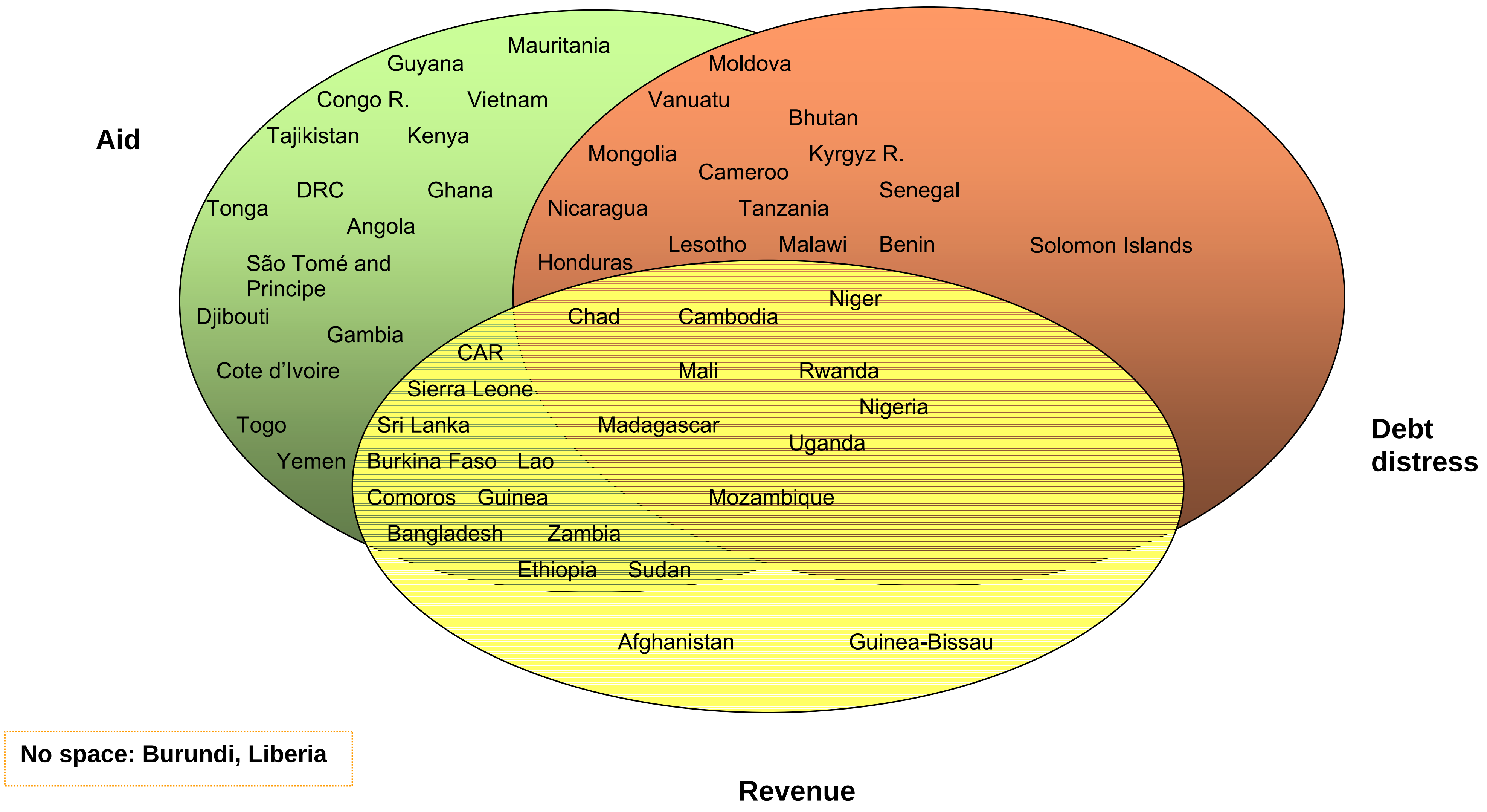
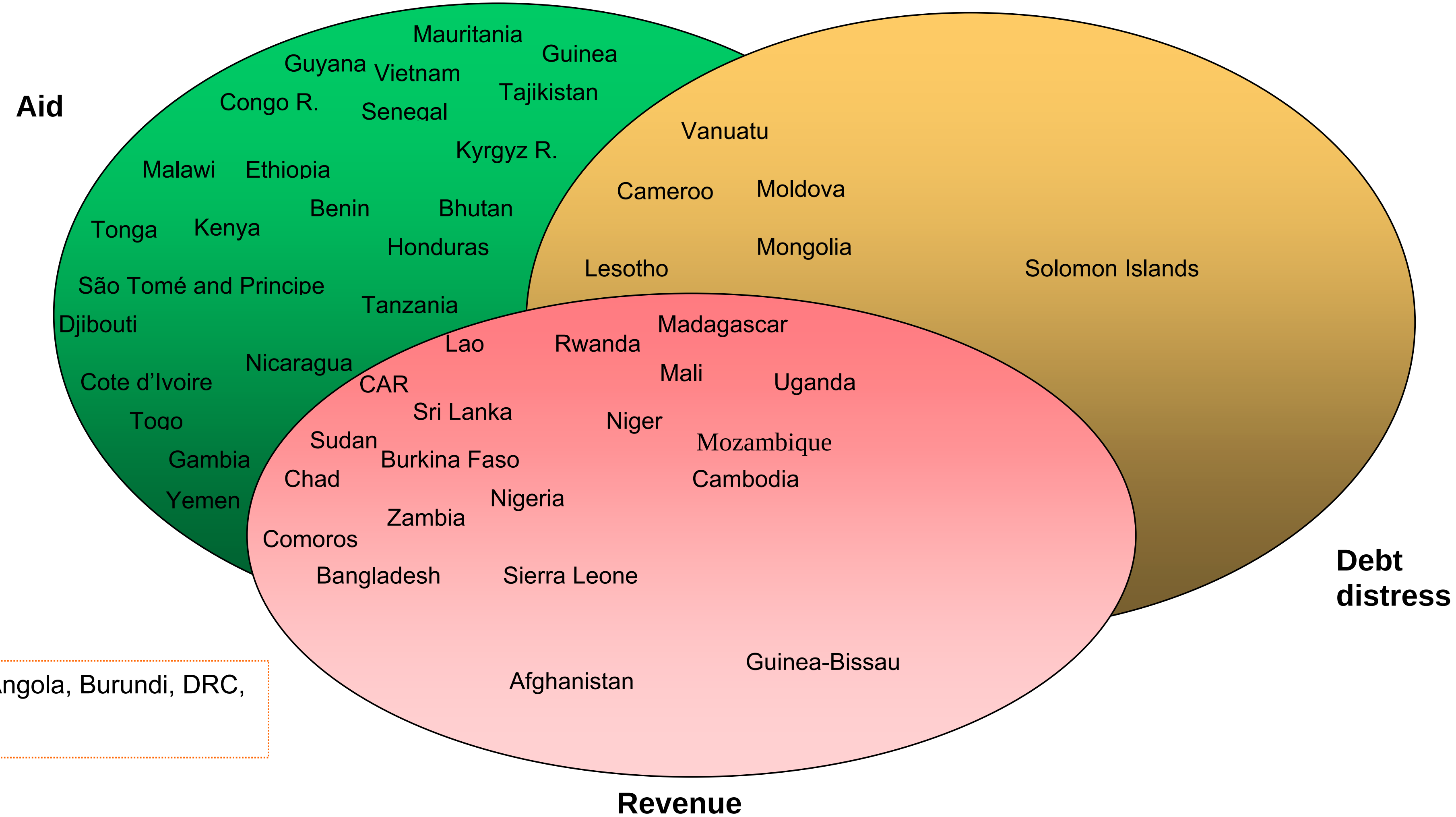


Figure 24: Financing sources with 'fiscal space' (corrected for high fiscal deficits or inflation)



No space: Angola, Burundi, DRC, Liberia

Conclusion

Because the international community's response to the crisis has been so slow, LICs have had to fill two-thirds of the fiscal hole by borrowing domestically or by running down reserves. In 2009, three-quarters of LICs were forced to borrow from expensive domestic markets. Partly as a result of this, and due to lack of sufficient aid, many LICs are already cutting spending for fear of unsustainable external or domestic debt levels. This must be halted, except in a very few countries with extremely high debt.

There is little sign that financing or flexibility on the scale needed will be forthcoming. Recent trends in many donor countries have been to reduce aid pledges, concentrate aid on fewer countries, and focus on only a few of the MDGs. The IMF appears to be retreating back to its traditional position, arguing that the poorest countries must progressively undo the fiscal stimulus introduced during the crisis, without paying sufficient attention to the longer-term need to stimulate demand and reduce poverty in order to reach the MDGs.

These trends need urgently to be reversed, by ensuring that world leaders sign up to tough new aid targets (not just on quantity, but for balanced allocation across countries and sectors) at the Millennium Summit in September 2010 and that they deliver on them for the next five years; and by ensuring that the IMF builds on its recent flexibility and encourages LICs to spend much more in order to reach the MDGs and begin the huge task of adapting to climate change.

Finally, five years away from the deadline for reaching the MDGs, it is scandalous that no international organization is tracking MDG spending in the way that this report has done at the level of individual LICs. This vital function must be taken on by an international organization with the capacity to make public budget information, such as the IMF.

If these changes are not made, the fiscal hole caused by the crisis risks becoming a 'black hole' into which the MDGs, and the lives and education of many of the world's poorest citizens, will disappear.

These findings lead to a number of urgent recommendations:

The international community should:

- Sign up to tough new aid targets (not just on quantity, but for balanced allocation across countries and sectors) at the Millennium Summit in September 2010, and deliver on them for the next five years. It should increase grants and highly concessional loans for LICs;
- Ensure additional sources of 'innovative financing' to fund progress to the MDGs. A Financial Transactions Tax could raise $400bn a year (Schulmeister, 2010), providing more than enough funds to reach the MDGs and combat climate change.

The IMF should:

- Together with LIC governments, make even greater efforts – especially outside Africa – to ensure that countries with IMF programmes (and others where it is providing policy advice) do not cut back spending in 2010 and 2011, and spend more to meet the MDGs and tackle climate change;

- Provide even greater space in the design of its macro-economic frameworks for countries to absorb grants and concessional loans, and actively encourage the international community to provide such funding;
- Provide grants in exceptional circumstances, e.g. a major exogenous shock such as the global economic crisis;
- Pay much closer attention to domestic debt;
- Ensure that MDG spending is tracked and published in a transparent way.

Low-income country governments should:

- Increase MDG-related expenditure, especially on education and to establish major social protection programmes. This is vital to ensure that countries accelerate progress to the MDGs beyond the crisis.
- Fill the revenue hole caused by the crisis by raising taxes on income and property – so hitting poor people least – as well as on foreign investors, and by combating tax avoidance via tax havens.

References

ActionAid (2007) 'The IMF's Policy Support Instrument: Expanding Fiscal Space or Continuing Belt-Tightening?', Policy Brief, Johannesburg, October 2007. www.actionaid.org/assets/pdf%5CPSI%20FINAL.pdf

African Economic Outlook (2010) 'The State of Public Resource Mobilisation in Africa', available at www.africaneconomicoutlook.org/en/in-depth/public-resource-mobilisation-and-aid/the-state-of-public-resource-mobilisation-in-africa/

African Economic Research Consortium (AERC) (2004) ' Financing Pro-Poor Growth in Africa' AERC Senior Policy Seminar IV, Kampala 2-4 March 2004.

Barro, R. (1991) 'Economic growth in a cross-section of countries', *Quarterly Journal of Economics,* 106(2), 407-443.

Benhabib, J. and M.M. Spiegel (1994) 'The role of human capital in economic development: evidence from aggregate cross-country data', *Journal of Monetary Economics,* October, 34(2), 143-174.

Collier, P. and A. Hoeffler (2004) 'Aid, policy and growth in post-conflict countries', *The European Economic Review*, Vol. 48, pp.1125-1145.

Commonwealth Secretariat (2009) 'Fiscal Sustainability of Debt', paper prepared by Development Finance International (DFI), CEMLA, and Commonwealth Secretariat, April 2009. www.thecommonwealth.org/files/190143/FileName/FISCALSUSTAINABILITY.pdf

Commission for Africa (2005) 'Our Common Interest', Report of the Commission for Africa, March 2005.

Development Committee (2006) 'Fiscal Policy for Growth and Development: An Interim Report', 6 April 2006. http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20890698/DC2006-0003(E)-FiscalPolicy.pdf

Foster,M. and A. Keith, (2003), ' The Case of Increased Aid', Final Report to the Department for International Development, 1, December 2003.

Friedman, J. and N. Schady (2009) 'How Many More Infants Are Likely to Die in Africa as a Result of the Global Financial Crisis?', Policy Research Working Paper 5023, World Bank, Washington, D.C.

International Monetary Fund (2010a) 'Coping with the Global Financial Crisis: Challenges Facing Low-Income Countries' a staff team led by Stefania Fabrizio—Washington, D.C.: International Monetary Fund, 2009.

IMF (2010b) 'Central African Republic: Staff Report for the 2009 Article IV Consultation and Fifth Review Under the Arrangement Under the Poverty Reduction and Growth Facility, Requests for Waiver of Nonobservance and Modification of Performance Criteria, and Financing Assurances Review – Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Central African Republic', Country Report No. 10/21, January, IMF: Washington D.C. www.imf.org/external/pubs/ft/scr/2010/cr1021.pdf

IMF (2010c) 'Zambia: 2009 Article IV Consultation, Third Review Under the Three-Year Arrangement Under the Poverty and Reduction and Growth Facility, and Request for Modification of Performance Criteria – Staff Report; Staff Supplement: Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Zambia', Country Report No. 10/17, January 2010, IMF: Washington D.C.
www.imf.org/external/pubs/cat/longres.cfm?sk=23539.0

IMF (2010d) 'Burkina Faso: Staff Report for 2009 Article IV Consultation, Fifth Review Under the Poverty Reduction and Growth Facility, and Requests for Augmentation of Access and Modification of Performance Criteria', IMF Country Report No. 10/7, January 2010, IMF: Washington D.C.
www.imf.org/external/pubs/ft/scr/2010/cr1007.pdf

IMF (2010e) ‘Regional Economic Outlook October 2010: Sub-Saharan Africa’, IMF: Washington, D.C. www.imf.org/external/pubs/ft/reo/2010/AFR/eng/sreo0410.pdf

IMF (2009a) ‘Regional Economic Outlook October 2009: Asia and Pacific’, IMF: Washington, D.C. www.imf.org/external/pubs/ft/reo/2009/apd/eng/areo1009.pdf

IMF (2009b) ‘Regional Economic Outlook October 2009: Europe’, IMF: Washington, D.C. www.imf.org/external/pubs/ft/reo/2009/EUR/eng/ereo1009.pdf

IMF (2009c) ‘Regional Economic Outlook October 2009: Middle East and Central Asia’, IMF: Washington, D.C. www.imf.org/external/pubs/ft/reo/2009/MCD/eng/mreo1009.pdf

IMF (2009d) ‘Regional Economic Outlook October 2009: Sub-Saharan Africa’, IMF: Washington, D.C. www.imf.org/external/pubs/ft/reo/2009/AFR/eng/sreo1009.htm

IMF (2009e) ‘Regional Economic Outlook October 2009: Western Hemisphere’, IMF: Washington, D.C. www.imf.org/external/pubs/ft/reo/2009/WHD/eng/wreo1009.pdf

IMF (2009f) ‘Angola: Request for Stand-By-Arrangement’, Country Report No. 09/320, November 2009, IMF: Washington D.C. www.imf.org/external/pubs/ft/scr/2009/cr09320.pdf

IMF (2009g) ‘Democratic Republic of the Congo: Request for the Rapid-Access Component of the Exogenous Shocks Facility and Report on the 2008 Staff Monitored Program’, Country Report No. 09/317, November 2009, IMF: Washington D.C. www.imf.org/external/pubs/ft/scr/2009/cr09317.pdf

IMF (2009h) ‘Republic of Congo: First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Request for Waivers of Nonobservance of Performance Criteria, and Modification of Performance Criteria – Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Congo’, Country Report No. 09/217, July 2009, IMF: Washington D.C. http://www.imf.org/external/pubs/ft/scr/2009/cr09217.pdf

IMF (2009i) ‘Democratic Republic of Timor-Leste: 2009 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Democratic Republic of Timor-Leste’, Country Report No. 09/219, July 2009, IMF: Washington D.C. www.imf.org/external/pubs/ft/scr/2009/cr09219.pdf

IMF (2008) ‘Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries’, October 2008, Washington D.C. www.imf.org/external/pp/longres.aspx?id=4297

IMF (2005) ‘Back to Basics – Fiscal Space: What It Is and How to Get It,’ IMF quarterly magazine, 42 (2), June 2005, IMF: Washington D.C. www.imf.org/external/pubs/ft/fandd/2005/06/basics.htm

Martin, M. and K. Kyrili (2009) ‘The Impact of the Financial Crisis on Fiscal Space for Education Expenditure in Africa’, background paper for the ‘Education for All Global Monitoring Report 2010: Reaching the Marginalized’ (2009), UNESCO.
http://unesdoc.unesco.org/images/0018/001868/186832e.pdf

OECD-DAC (2010) ‘Development aid rose 2009 and most donors will meet 2010 aid targets’, Paris, April 2010, accessed at www.oecd.org/document/11/0,3343,en_2649_34487_44981579_1_1_1_1,00.html

ONE, (2009) ‘The DATA Report 2010: Monitoring the G8 Promise to Africa’, at http://www.one.org/report/2010/en/

Psacharapoulos, G. and H.A. Partinos (2004) ‘Returns to education: a further update’, *Education Economics*, Vol. 12, No. 2, August 2004.

Rathin, R., H. Antoine, and E. Letouze (2007) ‘Fiscal Space for What? Analytical Issues from a Human Development Perspective’, UNDP. Paper prepared for the G20 Workshop on Fiscal Policy, Istanbul, 30 June–2 July 2007.

Schulmeister, S. (2010) 'Boom-bust Cycles and Trading Practices in Asset Markets, the Real Economy and the Effects of a Financial Transactions Tax', Working Paper 364/2010, Öesterreichisches Institut für Wirtschaftsforschung, Vienna.

Union Economique et Monetaire Ouest Africaine (UEMOA) (2008) 'Rapport Semestriel d'Execution de la Surveillance Multilaterale', December 2009. www.uemoa.int/Publication/2003/RappSMJuil2003.pdf

United Nations Economic Commission for Africa (UNECA) and Organisation for Economic Co-operation and Development (OECD) (2009) 'The Mutual Review of Development Effectiveness in Africa: Promise and Performance', joint UNECA and OECD report. www.africapartnershipforum.org/dataoecd/62/43/42179846.pdf

UNECA and OECD (2007) 'Development Finance in Africa: From Monterey to Doha', document prepared for the 11th Meeting of the Africa Partnership Forum in Addis Ababa, 17–18 November 2008.

World Bank and International Monetary Fund Debt Sustainability Framework for Low-Income Countries (2010) 'List of LIC DSAs for PRGF-Eligible Countries', latest update January 2010, IMF: Washington D.C.

World Bank (2010) 'Global Economic Prospects, Crisis, Finance, and Growth', February 2010. http://go.worldbank.org/OE8NEB3JP0

Annex 1: Sectoral expenditure trends in LICs (% GDP)

Country/sector	Education			Health			Infrastructure			Agriculture			Social protection		
	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
Angola	.	3.9	3.6	.	2.9	2.1	.	8.0	6.5	.	0.9	0.8	.	4.8	4.1
Benin	3.2	3.2	.	2.6	3.5	.	4.8	5.4	.	2.1	1.8	.	.	.	.
Burkina Faso	2.3	2.6	2.7	1.6	1.8	2.1	0.1	0.1	0.1	.	.	.	1.5	2.3	1.9
Cambodia	0.4	0.4	0.4	0.9	1.1	1.2	0.1	0.1	0.5	0.1	0.2	0.2	0.3	0.4	0.4
Cameroon	1.1	1.5	1.5	0.8	1.1	1.1	0.4	0.6	0.5	0.4	0.5	0.6	.	.	.
Central African Republic	1.6	1.5	2.1	1.4	1.2	1.9	1.6	2.3	1.4	0.4	0.5	0.5	0.4	0.2	0.1
Chad	5.6	4.4	4.2	2.0	2.7	3.0	10.4	7.8	8.8	.	.	.	2.6	0.6	0.7
Congo, Dem. Republic	.	3.7	3.6	.	2.1	2.9	.	8.5	10.3	.	0.6	0.9	.	0.5	0.7
Congo, Republic	.	.	3.0	.	.	2.2	.	.	0.2	.	.	1.0	.	.	0.5
Côte d'Ivoire	4.7	4.9	5.3	0.9	1.1	1.1	0.4	0.6	0.7	.	.	.	0.1	0.1	0.1
Ghana	9.0	6.8	7.4	.	3.5	3.8	.	1.6	1.6	.	0.3	0.4	.	.	.
Guinea-Bissau	4.2	3.3	5.1	2.7	2.8	3.4	3.4	12.7	3.7	1.3	3.5	3.7	0.7	0.7	0.6
Guyana	6.4	6.9	6.9	3.8	4.3	4.3	5.2	4.4	4.2	2.3	0.2	0.4	.	.	.
Mali	.	1.3	1.0	.	1.2	1.2	.	3.8	4.4		1.3	1.4	.	0.5	0.6
Mauritania	4.8	4.4	4.1	0.4	0.5	0.5	0.4	2.0	2.9	0.4	0.5	0.5	0.3	0.2	0.2
Moldova	2.5	3.2	3.0	3.3	4.5	3.9	1.1	1.7	2.0	1.2	1.5	1.2	3.1	3.8	5.5
Mongolia	7.4	7.0	4.9	3.7	3.4	2.4	2.5	2.5	2.8	1.2	1.2	0.6	6.2	5.0	3.5
Mozambique	6.3	7.1	.	.	.	.	.	.	.	.	.	.	.	.	.
Nicaragua	3.7	4.1	3.9	3.7	4.0	3.8	1.7	2.1	2.1	0.9	0.7	0.6	.	.	.
Niger	.	3.8	3.4	.	2.8	2.1	.	2.2	1.3	.	0.8	1.6	.	.	.
Nigeria	1.1	0.8	0.8	.	0.6	0.5	.	1.1	1.5	.	0.6	0.5	.	.	.
São Tomé and Principe	.	4.9	4.5	.	5.3	4.8	.	7.3	13.1	.	8.2	4.2	.	.	.
Senegal	4.8	3.4	4.5	1.6	1.5	1.8	3.9	3.4	4.4	1.4	1.3	1.5	.	.	.
Sierra Leone	1.2	1.4	1.8	.	1.8	1.3	.	.	5.9	.	.	.	.	.	.
Timor-Leste	.	10.6	14.2	.	5.6	9.0	.	25.3	28.6	.	5.7	2.3	.	.	.
Vanuatu	.	.	5.4	.	.	2.6	.	.	2.2	.	.	0.7	.	.	.
Viet Nam	3.5	3.9	3.6	1.3	1.7	1.6	.	.	.	.	.	.	3.4	3.8	3.1
Zambia	3.8	4.0	4.4	2.9	2.8	1.8	3.2	2.8	2.9	1.5	1.7	1.5	1.0	0.6	0.6
Average	3.79	3.59	3.69	2.08	2.30	2.26	2.45	3.07	2.63	1.00	1.06	1.03	1.85	1.71	1.63
IMF programmes	4.10	3.95	3.88	2.10	2.25	2.16	1.69	2.79	2.12	0.96	1.26	1.19	1.65	1.60	1.57
Sub-Saharan Africa	3.69	3.26	3.65	1.60	1.72	1.86	2.64	3.57	2.81	0.88	1.32	1.38	0.94	0.66	0.61
SSA IMF programmes	3.76	3.39	3.87	1.55	1.60	1.72	1.67	3.05	2.07	0.88	1.32	1.38	0.66	0.67	0.59

Sources: national budget documents; IMF documents

Note: Expenditures for Timor-Leste are expressed as a percentage of non-oil GDP

Indicates decline	Indicates increase	Indicates no change

Annex 2: On the fiscal space index

On the index

This study aims to identify the fiscal space of IDA-only countries and the different ways in which they have space to react towards decreased revenues. To analyze these issues, we have used the fiscal space index developed for the UNESCO 2010 GMR (Martin and Kyrili, 2009). The index is partially based on the fiscal space diamond developed by the Bretton Woods Institutions (BWIs) and UNDP (Development Committee, 2006; Rathin et al., 2007) which aims to assess how much potential fiscal space is available, by defining maximum desirable levels for comparable indicators (borrowing, revenue mobilization, and budget deficits).

On the indicators

1. Sustainable borrowing levels

One way that a country could finance its expenditure is by borrowing, either domestically or externally. As explained in this report, many IDA countries rely extensively on debt financing for their development. Excessive borrowing could risk creating 'unsustainable debt' which could undermine growth, as well as increasing inflation in the case of domestic borrowing. To assess the maximum level of 'sustainable' borrowing a country can cope with, the index uses internationally accepted indicators for 'debt distress', which comprise:

(i) For ***external debt***, the country's classification according to the BWIs' Low-Income Countries' Debt Sustainability Framework (LIC-DSF) – which is in turn based on a series of indicators comparing the present value of debt, and debt service, with the country's GDP, exports, and budget revenue. Any country with high risk of debt distress, or which is already in debt distress, is assumed not to have scope for external borrowing, and therefore this is not an option to increase resources. Source data for these indicators are taken from the January 2010 updated list of LIC DSAs (WB and IMF DSF, 2010).

(ii) For ***domestic debt***, the IMF definition of nominal domestic debt stock as unsustainable is if it exceeds 15 per cent of GDP (Commonwealth Secretariat, 2009; IMF, 2008). Any country whose domestic debt exceeds 15 per cent of GDP is assumed not to have scope for domestic borrowing. Data for this indicator have been retrieved from different IMF country reports to obtain up-to-date actual information and to reflect 2008 or 2009 values.

The space for overall government borrowing is then assessed by creating a composite 'debt distress' indicator, whereby a country with either external or domestic debt distress is not assumed to have further scope for government borrowing (value of 1) and those without distress have fiscal space to borrow additionally (value of 0). This has been done because it is assumed that, in a situation of either external or domestic debt distress, additional borrowing is not desirable as the focus should be on reducing the debt burden. However, an alternative method could be to evaluate the indicators separately and assess a country's space to borrow either externally or domestically.

2. Sustainable domestic revenue levels

A further way for a government to generate resources in order to fund its expenditures is to increase domestic revenue mobilization. Some of the countries in our sample have made remarkable progress in increasing their revenue levels in recent years (see UNECA, 2007; Commission for Africa, 2005), by increasing taxes (especially indirect taxes), widening the tax base, and/or improving the efficiency of tax collection (see also AERC, 2004). However, it is also generally accepted that excessive rises in tax levels, especially for the limited number of individuals and enterprises with sufficient income to be able to pay tax in low-income countries, can be inimical to long-term growth prospects by undermining incentives for earnings and profitability.

There is a considerable debate as to what constitutes a sustainable level of tax revenue for low-income or IDA countries. For the majority of IDA countries it is not straightforward to increase taxation. Accounting for this, and in order to have a commonly accepted benchmark for our sample, we use the indicator of acceptable levels of 'revenue effort' accepted as the 'economic convergence criterion' for the CFA Franc Zone. According to this, revenues excluding grants as a percentage of GDP should reach 17 per cent (UEMOA, 2008). We recognize that this benchmark is rather low and that it indicates a general level that revenues should reach, as opposed to strict inability of the country to increase revenues. Therefore interpretation could be more flexible, for example setting a threshold of 20 per cent, which is closer to the country average. Data on domestic revenue have been retrieved from the recent budgets of countries for 2009 outturns, as well as April 2009 REOs (IMF, 2009[0]a-e).

3. Sustainable aid levels

The third way to finance additional expenditures in IDA countries is to mobilize more grants. Although aid flows to many IDA countries have increased substantially in recent years, they are still falling considerably short of earlier promises such as those made in 2005 (see ONE, 2009; UNECA 2009). As also demonstrated above, grants declined for some of the countries in 2009 or are forecast to do so in 2010. If donors live up to their earlier promises, there should be considerable space to increase grant flows to combat the crisis. Still, studies indicate that excessive aid dependence can be inimical to development, and therefore it is important to set a threshold for aid beyond which countries might be seen as excessively aid-dependent. The most recent studies have suggested that only aid which actually reaches a recipient country should be included (such as the OECD definition of Country Programmable Aid or CPA),[20] and that this level should be set at around 25 per cent of GNI (Foster and Keith, 2003). We therefore assume that countries whose CPA exceeds 25 per cent of GNI have no space to increase their aid dependence. Data on aid dependency are based on total 2008 CPA data received from the OECD, with 2008 GNI taken from the World Bank WDI data (WDI, 2009).

Additional check indicators

Aside from the three indicators presented above, two more indicators are considered for additional check purposes: a) fiscal balance and b) inflation. Even if a country has scope to mobilize more financing, the IMF and others might argue that it should not do so if this would provoke macro-economic instability, through an excessive fiscal deficit or a high level of inflation. To judge whether either of these factors might constrain the overall fiscal space available to governments, the fiscal space index assesses these two indicators.

According to a recent study by the IMF, which examined how to define ‘mature stabilizers’, a country’s fiscal deficit, including grants, should be below 5.5 per cent of GDP to demonstrate that it has a fiscal deficit which is sustainable, and the level of inflation (CPI) that is optimal for growth is under 12.5 per cent of GDP. Therefore, countries with a larger deficit cannot increase it further to mobilize loan resources, without running the risk of provoking an inflationary spiral. Deficit data have come from budget documents and reflect 2009 outturns, complemented by October 2009 REOs (IMF 2009a-2009e). Data on inflation for all countries are from 2010 so as to avoid capturing the impact of food and fuel prices that might still be reflected in 2009 inflation values. Data were taken from the latest REOs and in limited cases from country reports.

The index

As our purpose is to see how much fiscal space countries have to spend more on the MDGs, the three indicators are aggregated into an index reflecting debt, domestic revenues, and aid. Countries that are not constrained in relation to any source of resources are described as having ‘high’ fiscal space; those constrained on one indicator have ‘moderate’ space; those constrained on two indicators have ‘low’ fiscal space; and those constrained on all three indicators have ‘no’ fiscal space. To facilitate the aggregation, the indicator is given the value 1 if its level is beyond the threshold and 0 if it is below. Therefore countries with high fiscal space have a score of 0, and those with no space 3.

A second assessment is conducted using the ‘check’ indicators of fiscal balance and inflation. Here we assume a country could not borrow additionally if its fiscal deficit exceeded 5.5 per cent, including grants – but it could still use additional grants or revenue (which would leave the deficit unchanged). It also could not use additional grants, i.e. absorb more aid, as these might push up inflation; however, it could increase revenue as this would make spending inflation-neutral. So we add 1 to a country’s score if its debt space is eliminated by the deficit, and 1 to its score if its grant space is eliminated by inflation risk. In this assessment, the scores are analyzed the same way as in the first.

Annex 3: Fiscal space in IDA-only countries

	Not adjusted for check indicators		Adjusted for check indicators	
No space	Burundi Liberia		Angola	Congo, Dem. Republic
			Burundi	Liberia
Low space	Afghanistan	Solomon Islands	Afghanistan	Kyrgyz Republic
	Angola	Tajikistan	Benin	Malawi
	Congo, Dem. Republic	Togo	Bhutan	Mauritania
	Congo, Republic	Tonga	Congo, Republic	Nicaragua
	Côte d'Ivoire	Vietnam	Côte d'Ivoire	São Tomé and Principe
	Djibouti	Yemen	Djibouti	Senegal
	Gambia		Ethiopia	Solomon Islands
	Ghana		Gambia	Tajikistan
	Guinea-Bissau		Ghana	Tanzania
	Guyana		Guinea	Togo
	Kenya		Guinea-Bissau	Tonga
	Mauritania		Guyana	Viet Nam
	São Tomé and Principe		Honduras	Yemen
			Kenya	
Moderate space	Bangladesh	Malawi	Bangladesh	Sudan
	Benin	Moldova	Burkina Faso	Vanuatu
	Bhutan	Mongolia	Cameroon	Zambia
	Burkina Faso	Nicaragua	Central African Rep.	
	Cameroon	Senegal	Chad	
	Central African Rep.	Sierra Leone	Comoros	
	Comoros	Sri Lanka	Lao PDR	
	Ethiopia	Sudan	Lesotho	
	Guinea	Tanzania	Moldova	
	Honduras	Vanuatu	Mongolia	
	Kyrgyz Republic	Zambia	Nigeria	
	Lao PDR		Sierra Leone	
	Lesotho		Sri Lanka	
High space	Cambodia	Niger	Cambodia	Niger
	Chad	Nigeria	Madagascar	Rwanda
	Madagascar	Rwanda	Maldives	Uganda
	Mali	Uganda	Mali	
	Mozambique		Mozambique	

Notes

[1] Speech, Washington D.C., 17 September 2009. www.imf.org/external/np/speeches/2009/091709.htm
[2] Speech to the parliament of Ghana. www.imf.org/external/np/speeches/2010/021710.htm
[3] 'Low-income countries' in this case refers to the group of 'IDA-only' countries within the World Bank classification system. For a list of such countries, see http://data.worldbank.org/about/country-classifications/country-and-lending-groups#IDA
[4] The IMF (2010a) estimates external (not fiscal) financing needs at an average $25bn more in 2009–10.
[5] This study examines budgets of 56 low-income, IDA-only countries. Of those, 43 budgets were issued in June–December 2009 and 13 in June-July. December 2009 budgets fully capture the impact of the crisis in 2009 and policy response for 2009 and 2010. Earlier analysis for UNESCO (Martin and Kyrili, 2009) showed that December 2008 budgets had ignored the crisis, March 2009 budgets had begun to include its impact, and June 2009 budgets included it more fully. Due to data limitations, the fiscal space index covers 54 countries and disaggregated data on sectoral spending only 28.
[6] An alternative definition might be the change in the budget deficit, but this does not show as clearly the direct impact of the crisis, as it also includes any changes in expenditure (cuts or increases) made in response to the crisis.
[7] The change in revenue due to the crisis is certainly underestimated, because some LICs have taken additional revenue-raising measures.
[8] In LICs, the very poorest people are generally not taxed as they do not have formal income or buy products from sellers who apply taxes. So it is poorer citizens who are beginning to use formal markets who are the most heavily penalized by indirect taxes.
[9] The IMF (2010) suggests that IMF programme countries place more emphasis on increasing capital spending, but it has not been possible to test this due to data limitations.
[10] Initially it was also intended to examine spending on social protection and safety nets, but very few countries disaggregate data on this expenditure.
[11] Data availability varied by sector, making it possible to analyze 28 countries for education, 27 for health, 26 for infrastructure, and 22 for agriculture, but only 15 for social protection. Availability also varied in different years, as countries changed budget classifications. As a result, all averages and figures (except Figure 14) refer only to countries with three years of relevant data – for which samples are 18 countries on education, 15 on health, 14 on infrastructure, and 11 on agriculture and social protection. The findings of the averages and charts should therefore be treated with considerable caution.
[12] Social protection includes initiatives such as conditional cash transfers, pensions, and school feeding programmes.
[13] The IMF (2010a) suggests that, in 2009, 24 of 31 countries were 'preserving or increasing real social spending, including 15 countries that had initiated a Fund-supported program in 2008–09'.
[14] However, earlier work for UNESCO based on June 2009 budgets indicated a more positive picture for education in 2009, and a less positive one for health. It also seems, comparing 2008 and 2009 budgets, that some countries planned to increase education spending but actual spending fell short.
[15] The IMF (2010) suggests that 70 per cent of countries have emphasised 'social spending' (usually meaning education and health).
[16] The latter number is broadly consistent with IMF estimates (2010a).
[17] These figures for loans do not include IMF loans, which are not included in fiscal accounts for LICs because they are treated as a supplement to reserves. Their inclusion would increase the amount of loan disbursements substantially.
[18] The IMF (2010a) suggests that for a wider sample of countries the picture may be even more dramatic, with domestic financing increasing by six times as much as external borrowing.
[19] Fiscal space is a relatively longstanding concept, which has been defined in various ways (see ActionAid, 2007; IMF, 2005; and Rathin et al, 2007). The common aspect of all definitions is that fiscal space represents the ability of the government to generate resources by mobilizing external and domestic borrowing and grants, and domestic revenues and finance, thereby financing its expenditures. The government should use any additional space to finance projects essential for development (Barro, 1991; Benhabib and Spiegel, 1994; Psacharapoulos and Patrinos, 2004). This study uses the index developed for UNESCO by Martin and Kyrili (2009). Annex 2 provides details on the fiscal space index, indicators used, and choice of threshold for each indicator.
[20] CPA is a relatively new concept to measure assistance. From the total ODA amount, it subtracts unpredictable elements of assistance (debt relief, humanitarian aid, administration costs), ODA that is spent within the donor country, food aid and core funding to national or international NGOs. In short, CPA measures the portion of ODA that includes budget support, sector-wide programme support and many forms of project and programme mechanisms that promote development, representing what partner countries themselves can programme.