Chapter V

Crises, fiscal space and national response[33]

As noted in Chapter I, transmission of the effects of the recent financial and economic crisis to developing countries occurred through a number of different channels depending on each country's openness to trade and financial accounts. Given the global nature of the current crisis, developing countries, in general, have found it more difficult this time around to increase their exports in order to stimulate economic recovery in the same way that some countries did following previous crises. Therefore, the space for counter-cyclical domestic demand policies and their effectiveness have been crucial in determining the ability of countries to mitigate the effects of recent strong external shocks (Ocampo and others, 2010).

Some developing countries were able to launch expansionary domestic demand policies during the current crisis because they had strengthened their external balance sheets prior to its onset (see box V.1).

Despite improvements in the external balance sheets of some developing countries during the years preceding the crisis, a considerable number of these countries remained vulnerable to external shocks. For example, of a sample of 100 developing countries, 39 were highly vulnerable (or exposed) when the crisis occurred because of their high levels of poverty and decelerating economic growth rates (World Bank, 2009). Of the highly vulnerable countries, about 75 per cent had either low institutional capacity or low fiscal capacity. In a sample of 70 low-income countries, 26 were particularly vulnerable to the unfolding crisis, including low-income countries heavily dependent on commodity exports, such as oil exporters, as well as fragile States with little room to manoeuvre (International Monetary Fund, 2009).

Therefore, many poorer developing countries were not in a position to initiate counter-cyclical fiscal policies. To make the situation worse, the crisis itself created huge fiscal burdens for low-income countries. An Oxfam study found that, in 56 low-income countries, budget revenues fell by $53 billion in 2009—nearly 10 per cent of the level of their pre-crisis revenues—and by $12 billion in 2010 (Kyrili and Martin, 2010). Revenues fell in 60 per cent of low-income countries in 2009. By the end of 2010, revenues will probably be found to have remained below their 2008 levels in 46 per cent of these countries. This situation has severely affected

33 This chapter draws heavily on a paper commissioned for this Report: see Chandrasekhar and Ghosh, (2010).

the ability of these countries to use spending to overcome the effects of the crisis and to achieve the Millennium Development Goals. The same study observed that "even if the rich world recovers, the crisis will still be wreaking havoc in the poorer countries, due to the time lag in transmission" (Kyrili and Martin, 2010, p. 3).

Nonetheless, two thirds of the surveyed countries initially responded to the crisis by initiating fiscal stimulus packages. This was in marked contrast to the more limited response during the 1997-1998 Asian financial crisis. However, the increased expenditure in the face of falling revenues has significantly increased the budget deficits of the countries surveyed, and may have led to a reduction of such stimulus spending programmes, with only one quarter of these countries still implementing them in 2010. The study also found that countries with IMF programmes had implemented more stimulus spending than others in 2009, but were expected to cut back more sharply on such spending in 2010.

This chapter focuses on the impacts of the crisis on fiscal space and government social spending. It also examines the design and implementation of national rescue packages, concentrating in particular on the composition of stimulus packages in terms of social protection and employment measures.

Impact on fiscal space

The crisis had a marked contractionary impact on government revenues. For many developing countries, this decline in government revenues simply reflected

Box V.1

Pre-crisis macroeconomic conditions in developing countries

During the economic boom period of 2003-2007, many developing countries made major improvements in their fiscal and external balances and overall financial health. The external balance sheets of many developing countries had indeed improved on a fairly broad basis. Although an increasing number of countries still had large current account deficits during this period, they were making major improvements in their debt ratios, while accumulating significant foreign exchange reserves.

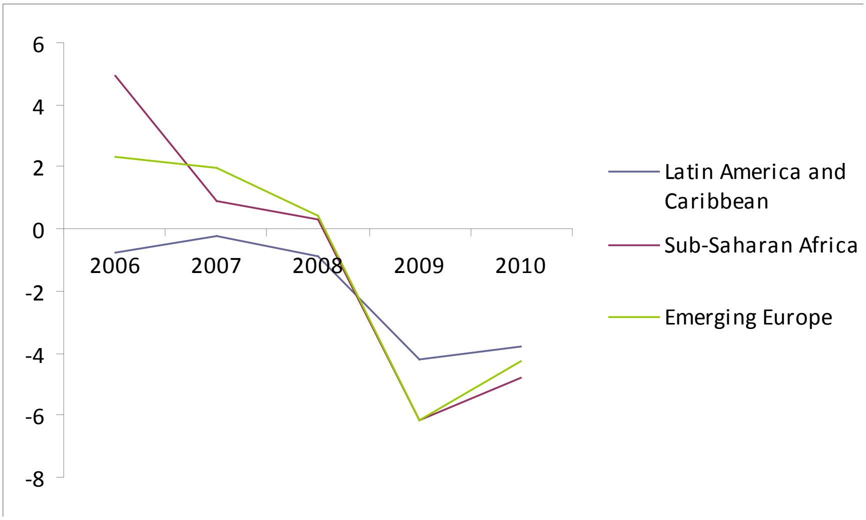
In regional terms, the Middle East and Asia recorded the best performance in three dimensions: current account deficits, external debt and foreign reserves. The Commonwealth of Independent States performed well in terms of current account deficits and foreign reserves, but not debt. Africa had large current account deficits, but made significant improvements in the other two dimensions. As a region, Latin America and the Caribbean stood out for its historically unprecedented avoidance of current account deficits, as well as the significant improvements it made in debt ratios. The performance of Central and Eastern Europe was the weakest by far, being characterized by large current account deficits, with limited or no improvements in debt and foreign exchange reserve positions.

Source: Ocampo and others, 2010

Figure V.1

Public sector balance, 2006-2010 *(percentage of GDP)*

Source: International Monetary Fund (2010a).



Note: Data are in simple unweighted averages for countries across the region concerned.

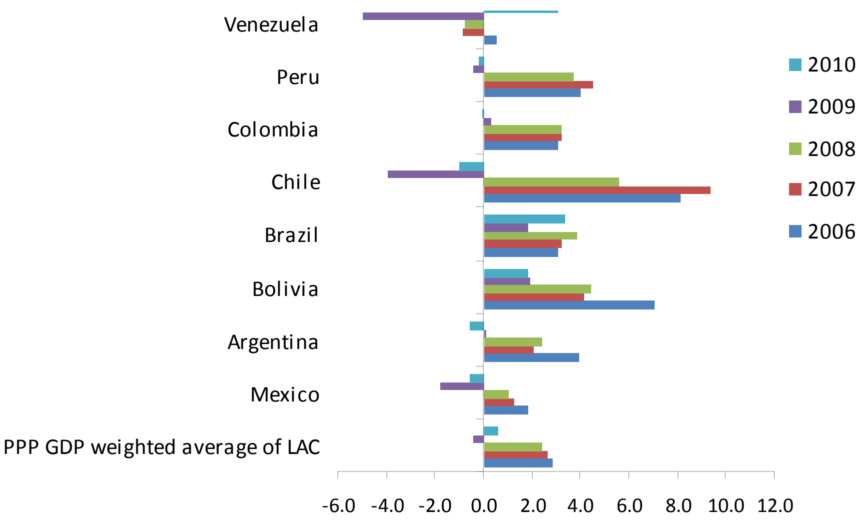
the decline in economic activity that affected both indirect and direct taxes. In 2009, government revenues fell in all regions except Latin America and the Caribbean. The sharpest falls occurred in the Middle East and North Africa, where government revenues fell by over 5 per cent of GDP, in South Asia, where they fell by almost 4 per cent of GDP, and in Europe and Central Asia, where they fell by over 2 per cent of GDP (Kyrili and Martin, 2010).

For most of the developing world, fiscal deficits emerged as a result of the global crisis (because of falling revenues or as a result of the stimulus spending in response to the crisis) following periods of fairly disciplined fiscal behaviour. Except for a few countries, most developing countries had low deficits or even fiscal surpluses in the years preceding the crisis (see figure V.1).

The increased fiscal deficits following the start of the crisis did not necessarily reflect a more expansionary fiscal stance in the affected countries, since interest payments tend to account for significant chunks of the overall deficits in most countries. Figure V.2 indicates how the primary public sector balance, that is, the deficit without public sector debt service payments, changed during this period in Latin America and the Caribbean. In the region as a whole, the primary balance either stayed in surplus or moved only marginally into deficit during the crisis and immediate post-crisis periods. Even in countries that showed a primary

Figure V.2

Primary government balances[a] in Latin America and the Caribbean, 2006-2010 (*percentage of GDP*)



Source: International Monetary Fund (2010a).

Note: PPP: purchasing power parity; LAC: Latin America and the Caribbean; Bolivarian Republic of Venezuela.

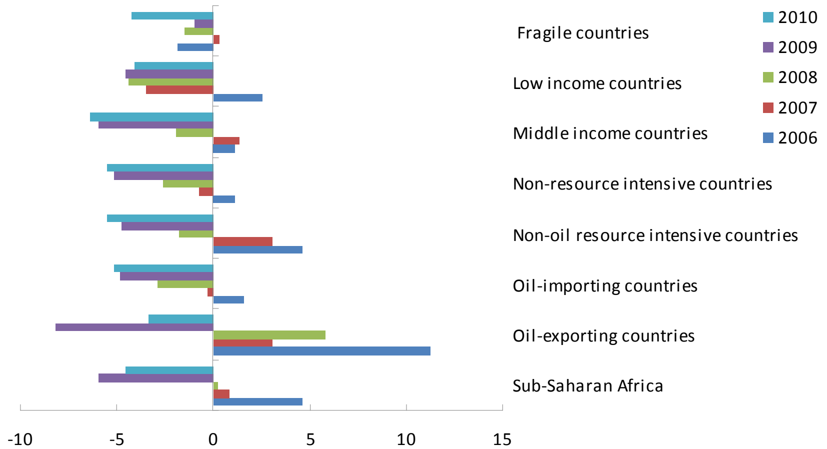
[a] The primary government balance is usually defined as government net borrowing or net lending excluding interest payment on consolidated government liabilities.

deficit in 2009, such deficits were typically associated with revenue losses, because of falling GDP and oil price declines rather than increased public expenditure (as case in Mexico and Venezuela). Several countries were projected to "over-correct" for fiscal improvement in 2010, largely through control of public expenditure. This suggests that, in the Latin American and Caribbean region, fiscal responses to the crisis were quite muted.

The sub-Saharan African experience shows a somewhat different pattern, as indicated in figure V.3. On average, there has been a significant change in the fiscal balances of governments in the region as percentages of GDP. When countries are grouped by type of economy a more nuanced picture emerges. Oil-exporting countries have experienced the largest fall in fiscal balances. In contrast, countries requiring the most proactive fiscal policies—the low-income and fragile economies—show smaller changes in fiscal balances. This is probably

Figure V.3

Fiscal balances in sub-Saharan Africa, 2006-2010 (*percentage of GDP*)



Source: International Monetary Fund (2010b).

Note: Low-income countries: Benin, Burkina Faso, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mali, Mozambique, Niger, Rwanda, Senegal, United Republic of Tanzania, Uganda and Zambia; fragile countries: Burundi, Central African Republic, Comoros, Côte d'Ivoire, Democratic Republic of the Congo, Gambia, Guinea-Bissau, Liberia, Sao Tome and Principe, Sierra Leone, Togo and Zimbabwe.

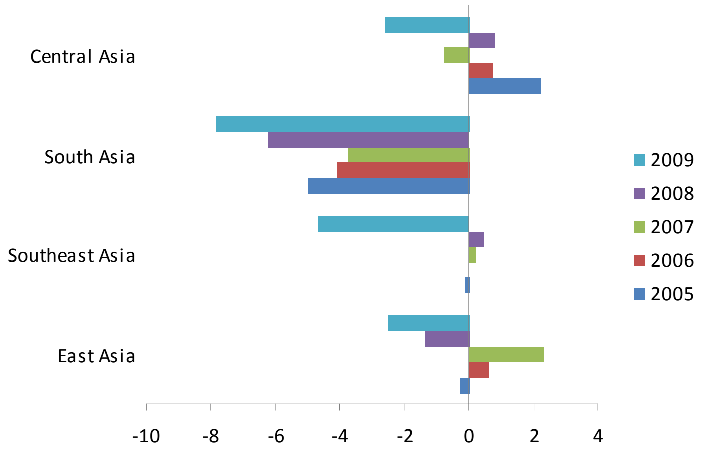
due to fiscal capacity, since these countries generally had large pre-existing levels of public debt.

Overall, most Governments in sub-Saharan Africa increased their expenditure-to-GDP ratios during the crisis (Ortiz and others, 2010). However, the increase was most significant for middle-income countries and minimal for low-income countries, reflecting the fiscal space constraints that poorer countries face. The increased government expenditure in "fragile" economies was probably made possible by the flows of official development assistance to these countries, observed in 2009 and 2010. The importance of ensuring greater flows of counter-cyclical aid and other assistance to such countries also emerges from analysis of the types of government expenditure affected by the changing economic circumstances.

In developing Asia, there is a significant difference between South Asia (which had high fiscal deficits in the pre-crisis period) and other parts of Asia (which had fiscal surpluses or very low deficits on average). Once again, the aggregate figures hide substantial intraregional differences (Asian Development Bank, 2010a).

Figure V.4

Fiscal balances in developing Asia, 2005-2009 (percentage of GDP)



Source: Asian Development Bank (2010b).

Note: Data are in simple averages.

Nevertheless, countries in East and South-East Asia seem to have most dramatically changed their fiscal stances in response to the crisis, as they moved quickly from surplus to deficit, or experienced increased deficits (see figure V.4). In China, for example, the deficit was associated with a significant increase in expenditure by the central Government amounting to 3.3 percentage points of GDP. However, in many other countries, government spending as a share of GDP did not increase very much. It is interesting to observe that the ratio actually fell in countries such as Pakistan, which had to meet loan conditions imposed by the International Monetary Fund.

Effects on social spending

In the face of reduced fiscal space, rising public debt and a policy shift by Governments towards fiscal austerity, the crisis is expected to continue to adversely affect social spending. The initial evidence—albeit somewhat limited—suggests that social spending has suffered significantly in Eastern Europe and Central Asia, areas most severely affected by the downturn. In Latin America, where the impact has been less severe, social spending has been maintained and even increased in some countries. For instance, Mexico has been severely affected, but still expected to increase spending on health and education by 10 per cent

(World Bank and International Monetary Fund, 2010). On the other hand, in sub-Saharan Africa, declines in economic growth may result in a cumulative loss of about $30 billion in public spending on education from 2009 to 2013, if the share of public expenditure devoted to education remains constant (United Nations Educational, Scientific and Cultural Organization, 2010).

The education systems of developed countries are also feeling the crunch. A recent survey found that public and private universities in the United States lost an average of 23 per cent of the value of their endowment funds in late 2008 (Zezima, 2009). Children's educational prospects and opportunities have been diminished as many States have cut their budgets for education. In particular, in the face of such cuts in spending on public education, children living in poverty are disproportionately hurt as they cannot afford the cost of alternative private education.

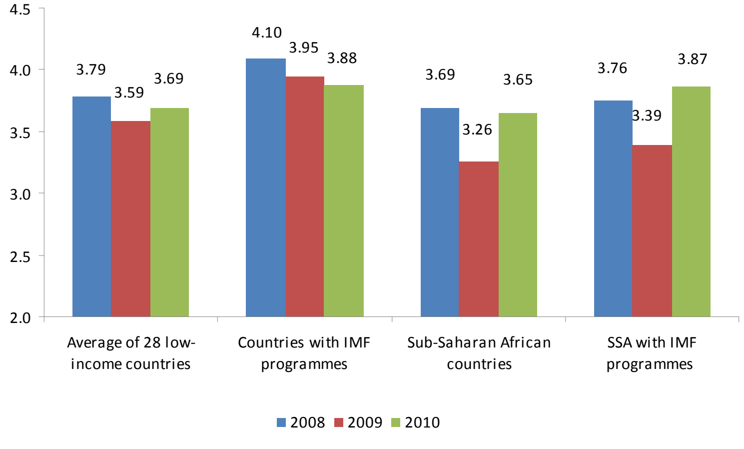
The fiscal accounts of 28 low-income countries during and after the crisis, as presented in figures V.5 to V.9, indicate a very mixed picture. They reveal estimated budget shortfalls of $52.6 billion in 2009 and $12.1 billion in 2010, relative to 2008.

Education spending

Government spending on education has clearly suffered in low-income countries. Such spending fell, in both relative and absolute terms, as GDP declined in a

Figure V.5

Government spending on education, 2008-2010 (*percentage of GDP*)



Source: Kyrili and Martin (2010), annex 1.

number of countries in 2009 (see figure V.5). Even when spending on education was projected to improve in 2010, in most cases spending on this sector was not expected to recover to 2008 levels. As a case in point, Kenya recently delayed financing free education for 8.3 million primary school children and 1.4 million secondary school children (United Nations Educational Scientific and Cultural Organization, 2010). At the same time, some Governments have called for restoring user fees to close the funding gap.

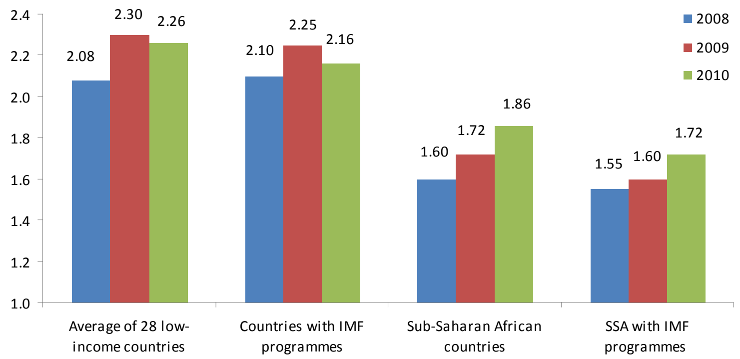
Spending on health and social protection

In the wake of the crisis, government expenditure as a percentage of GDP has increased for health but declined for social protection. However, although health expenditure has increased as a percentage of GDP, it may not have increased in absolute terms, since GDP has declined as a result of the recession. In addition, the rise in health expenditure may be a direct result of the decline in spending on social protection. The decline in social protection at a time when it is needed leaves most people more vulnerable and can lead to more health problems. Government spending on health and social protection in 28 low-income countries is shown in figures V.6 and V.7.

Out-of-pocket expenditure on health care tends to fall during recessions because people have less disposable income and tend to reduce or avoid spending money on health; alternatively, they may eschew private sector heath care and turn to public services instead. This is what happened in the Republic of Korea

Figure V.6

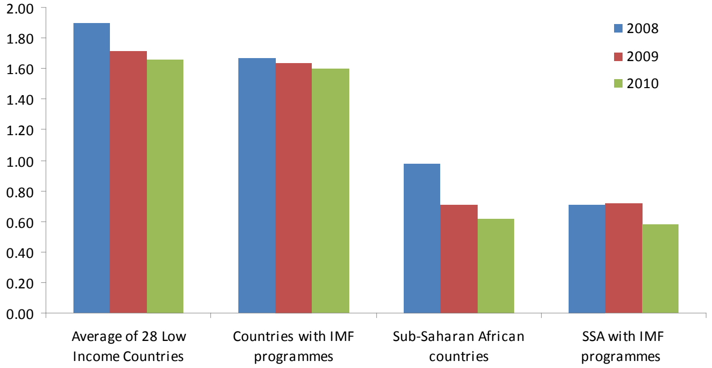
Government spending on health, 2008-2010 *(percentage of GDP)*



Source: Kyrili and Martin (2010), annex 1.

Figure V.7

Government spending on social protection, 2008-2010
(percentage of GDP)



Source: Kyrili and Martin (2010), annex 1..

during the 1997-1998 Asian financial crisis; there was a clear shift of patients from private hospitals and clinics to public health centres (Yang, Prescott and Bae, 2001). The same may have happened more recently; employees with private insurance who lost their jobs may have turned to public health services. The upshot is that Governments are forced to spend more on health, or at least maintain their health budget. In countries where public sector health programmes are already overstretched or under financial strain, an increase in demand for these services could cause additional financial problems.

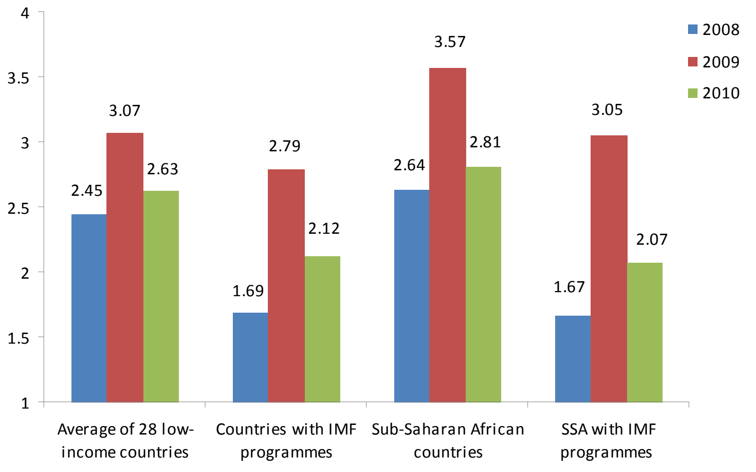
In developed countries, social protection measures serve as "automatic stabilizers", rising in periods of crisis when employment and livelihoods are adversely affected. In low-income countries, however, social protection systems do not automatically grow during periods of greater social need because they are weakly developed (with miniscule public funding) and not adequately institutionalized. Indeed, it is more likely that budgetary stringency, associated with falling State revenues, will result in cuts in spending on social protection at a time when social protection is most needed.

Spending on infrastructure and agriculture

The available evidence for low-income countries indicates that during the current crisis, spending on infrastructure and agriculture, as shares of GDP, was

Figure V.8

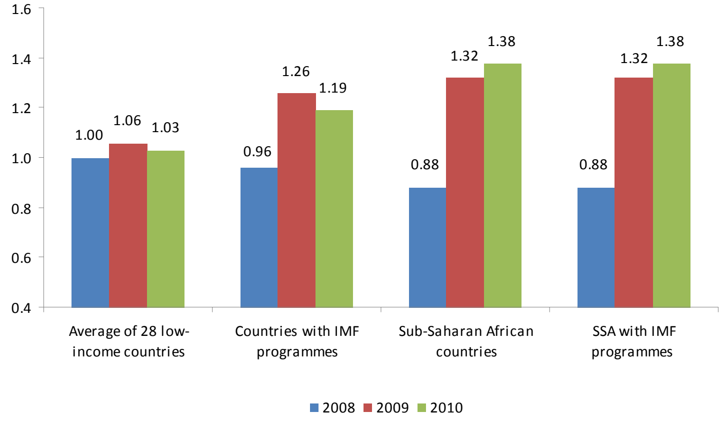
Government spending on infrastructure, 2008-2010 (*percentage of GDP*)



Source: Kyrili and Martin (2010), annex 3.

Figure V.9

Government spending on agriculture, 2008-2010 (*percentage of GDP*)



Source: Kyrili and Martin (2010) annex 1.

maintained initially and even increased later (see figures V.8 and V.9). This is reassuring because these low-income countries have very weak infrastructure and tend to be economies where agriculture is the main source of livelihood. However, spending on infrastructure and agriculture is likely to decline as fiscal pressure mounts and developed countries cut their aid budgets in their efforts to consolidate their fiscal situations.

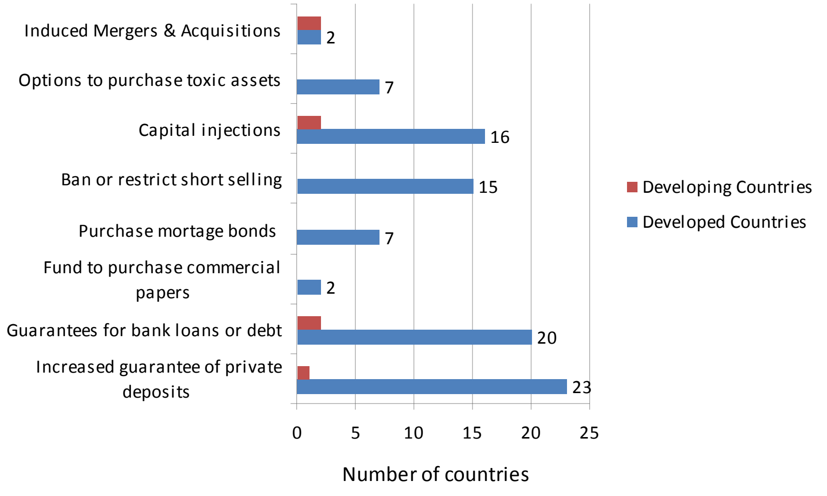
Policy responses to the crisis: an overview

By mid-2009, many developed countries as well as some developing countries had announced a range of stimulus measures, involving monetary, financial, fiscal and labour market policies, about $2.6 trillion in total (United Nations, 2009b). Most of the countries initially adopted expansionary monetary policies, as reflected in their interest rate adjustments until the end of 2008. These steps were supplemented by efforts to repair the financial system in developed countries (figure V.10).

By the end of 2008, it was clear that the global financial and economic crisis could not be tackled through expansionary monetary policy alone, and many countries rolled out fiscal stimulus packages. On average, in 2008, 48 countries

Figure V.10

Financial policy responses to the crisis, 2008-2009



Source: International Labour Organization (2009b).

spent about 4.3 per cent of their GDP on fiscal stimulus measures (see table V.1). There were several countries that announced fiscal stimulus measures in excess of 10 per cent of their GDP: China (13.2 per cent), Georgia (19.9 per cent) and Thailand (17.2 per cent), with the package of Viet Nam being almost at that level (9.7 per cent). All these packages entailed a combination of spending on infrastructure, income transfers and tax cuts.

Social protection and labour market measures

An analysis of fiscal stimulus packages announced in 35 countries found that, on average, about 25 per cent of the stimulus spending was disbursed on social protection measures in these countries (Zhang, Thelen and Rao, 2010).[34] Allocations for this purpose amounted to about $653 billion, or almost 1 per cent of global GDP in 2008. Of these 35 countries, 29 had allocated more than 10 per cent of their fiscal stimulus measures to social protection. The economies that devoted the largest proportion of their fiscal stimulus package to social protection were South Africa (56 per cent), Singapore (52 per cent), Taiwan Province of China (47 per cent) and Finland (43 per cent). In the United States, 39 per cent of the stimulus package was devoted to social protection; France devoted 16 per cent and Germany 25 per cent (Zhang, Thelen and Rao, 2010). The top three expenditure items, accounting for 62 per cent of the total, were infrastructure, social protection and other specific support measures. In absolute terms the two top spenders on social protection were the United States ($310 billion) and China ($135 billion).

Spending on the construction and maintenance of public and social housing was included in the packages of 10 countries. For example, China announced it would spend 400 billion yuan, 10 per cent of its total stimulus package, on public housing. The stimulus package of Viet Nam included 24 trillion dong (17 per cent of the total for stimulus measures) to build houses for workers and low-income families. A number of countries also announced direct or indirect health funding, such as increased spending on public health (China, Honduras, Indonesia, Japan, Kenya, Peru, South Africa, Thailand,

34 The study is based on fiscal stimulus packages for which the authors found reliable information. They constitute a subset of all stimulus packages announced at the onset of the crisis. The amounts presented may understate the actual size of the social protection components of the fiscal stimulus measures in some countries because information on their stimulus plans is incomplete. Additional social protection measures not included in the stimulus plans may have been put into place. Thus, the size of the social protection stimulus presented includes only stimulus spending announced in official sources. As there is no unanimous definition or clear categorization of social protection measures, social protection measures are defined here as policy interventions aimed at reducing poverty and vulnerability (including transitory poverty and vulnerability due to economic or other shocks) and improving human welfare. Examples of such interventions include public education, health and housing, labour market and social protection measures, as well as contributory social insurance programmes and non-contributory safety net (social assistance) programmes.

United States), compensation for contributions to statutory health insurance schemes (Germany), health insurance assistance (Switzerland, United States), or lowering the value added tax rate for medication (Austria); 13 countries included new measures for education. Developing countries tended to focus on primary education: China devoted 150 billion yuan to pro-poor and pro-rural health care and education; Malaysia committed 0.2 billion ringgit to preschool education.

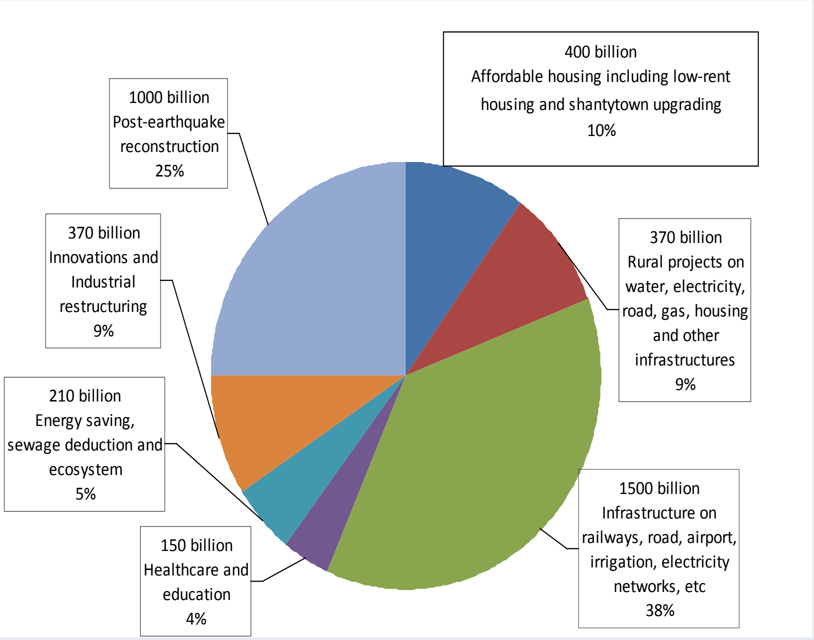
The crisis also accelerated plans to expand social protection coverage. China launched a major reform in December 2009 to introduce a basic pension scheme for 700 million rural residents (International Labour Organization, 2010f). Pakistan introduced the Benazir Income Support Programme for 6-7 million poor households. Yemen extended its cash-for-work and cash transfer programmes. The Philippines recently launched a conditional cash transfer programme that is being rapidly scaled up in response to the crisis. Brazil has expanded its successful *Bolsa Familia* (family allowance) programme to cover an additional 1.8 million families and has increased the programme's benefit by 10 per cent to compensate for increased food prices (Berg and Tobin, 2011).

In Latin America, conditional cash transfer programmes as well as higher spending on social protection programmes ensured that the region was better prepared to respond to and mitigate some adverse effects of the crisis. Today, conditional cash transfer programmes reach more than 22 million families in 17 countries (Economic Commission for Latin America and the Caribbean, 2009). Governments also took additional steps to protect the poor and indigent from the effects of the global recession. Argentina expanded welfare payments to 3.5 million children through its Universal Child Allowance (*Asignación Universal por Hijo*) while Brazil and Mexico have continued to expand coverage of their cash transfer programmes to low-income households. Chile and El Salvador have also undertaken initiatives to promote the employment of women by providing micro and small enterprise subsidies for female heads of households, and temporary income support for young men and women from the poorest urban municipalities (Economic Commission for Latin America and the Caribbean, 2009).

In sub-Saharan Africa, many countries tried to ease the burden of the crisis on the most disadvantaged and vulnerable members of society by increasing spending on existing as well as new social safety net programmes. Ethiopia introduced wheat subsidies to ease the impact of inflation on the urban poor and vulnerable rural populations. Senegal created a cash transfer programme for mothers and young children, and Namibia and South Africa enhanced support grants for the elderly and children, while increasing spending on health and low-income housing. Interventions in Ghana, Kenya and Nigeria included food distribution to vulnerable groups, school feeding programmes and cash transfers (te Velde and others, 2010). However, restrictions on incurring further external debt have constrained the ability of countries that benefited from international debt relief efforts to implement broad fiscal stimulus measures (Arieff, Weiss and Jones, 2010).

Box V.2

Fiscal stimulus package of China



The largest fiscal stimulus package in absolute terms after that of the United States is China's. A recent study (Jia and Liu, 2010) of that fiscal stimulus package found that the overwhelming share of the public expenditure package, worth 4 trillion yuan, was for infrastructure, with less than 4 per cent allocated for health care and education.

These measures should increase output and productivity in the economy in the medium to long term (with some effects already visible). It is generally agreed that improved transport infrastructure and greater connectivity have positive implications for human development, including living conditions and access to education and health services. However, specific measures are also required.[a] Therefore, some other incentives have been provided to increase consumption, including tax cuts on consumer durables and easing credit, which have boosted consumer confidence and housing finance. Nevertheless, it is clear that fiscal stimulus in China was effective in maintaining aggregate demand and growth, and in enabling employment to recover quickly.

a Health reform has been proposed as a measure to ensure access to basic health services and drugs for the entire population, which would require an additional 850 billion yuan in government spending over the next five years. This measure is designed to decrease the need for household out-of-pocket health expenditures, as well as the associated need for precautionary savings; however, its impact has yet to be felt.

Source: Jia and Liu (2010), pg. 4.

In the Middle East and North Africa, the most popular responses were to subsidize basic food prices, protect wages in some sectors and improve access to education and health services. Egypt, Morocco, Saudi Arabia and Turkey also adopted fiscal stimulus measures designed to create jobs through infrastructure investments (Jones and others, 2009).

In addition to extending social protection measures, developed economies pursued large-scale rapid-response measures aimed at stimulating labour demand and accelerating employment recovery. These included support for small and medium-sized enterprises, various active labour market programmes, hiring incentives for employers and increased public sector employment to compensate for the decline in private sector jobs. For example, in France and the Netherlands, short-term work schemes have been promoted through government subsidies. Germany also reduced working hours to prevent layoffs through its work-sharing programme called *Kurzarbeit*, which by mid-2009 involved 1.5 million workers. In Australia and the United Kingdom employers were provided with hiring subsidies, while in the United States and other OECD countries unemployment benefits were extended (International Labour Organization and Organization for Economic Cooperation and Development, 2010). These policies contributed to reducing job losses besides maintaining and enhancing workers' skills.

In the Asia-Pacific region, several countries provided the unemployed and laidoff employees with job-training programmes. For example, Thailand targeted new graduates, while Bangladesh focused on laidoff returning migrant workers. Viet Nam offered loans at preferential rates to the poorest to encourage production and trade in rural areas. Public works programmes, sometimes referred to as cash-for-work programmes or employment guarantee schemes, were adopted in many countries in response to rising unemployment.

Policy responses to the food crisis

Many developing countries were faced with a number of policy dilemmas and challenges. At least 80 countries tried to curb rising food prices and minimize the impact of the food price crisis on the poor by putting in place short-term measures, including food subsidies, price controls, export restrictions and outright bans on foreign exports (Lustig, 2009). Some countries modified their biofuel policies to reduce the pressure on food supplies, while others released government-held grain stocks onto domestic markets (Swinnen and Herck, 2010). Such measures helped stabilize food prices and ease the food burden faced by the poor and other vulnerable groups.

Food-importing countries in sub-Saharan Africa took aggressive actions to lower tariffs or value added taxes on food grains in order to reduce prices for consumers (Revenga, Wodon and Zaman, 2008). These measures were complemented by strengthening food safety nets, such as cash transfer programmes, food-for-work schemes, school feeding programmes and food rationing. In practice, the impact of these programmes was limited because of the tight fiscal space that these Governments faced. In the Middle East and North Africa, Eastern Europe and Central Asia, price controls and subsidies were some of the most common responses. Unfortunately, the safety nets targeting the poor did not protect the "new poor" or poor households not poor enough to be covered by such programmes. Also, many middle-income households were forced to adjust their food consumption patterns.

Yet, these policies did not address the root causes of the global food price spike. In order to better protect their populations from the vagaries of the markets, however, several developing countries have taken steps to boost domestic food production, including provision of free or subsidized agricultural inputs, such as fertilizers, and improving access of farmers to credit.

Concluding remarks: policy space is crucial

Developing countries have largely overcome past economic crises through export-led recoveries. The global nature of the recent crisis limits that option. Countries with the flexibility to implement counter-cyclical policies have been better able to mitigate the impacts of the crisis on their economies and people. Likewise, countries that have social protection systems as well as active labour market programmes in place, have been in a better position to mitigate adverse social impacts. It seems many countries learned lessons from previous crises and devoted substantial shares of their stimulus spending to the social sector to either expand existing programmes or to implement new ones.

Unfortunately, many poorer developing countries lack the institutional and/or fiscal capacity to finance effective stimulus and welfare measures on their own. Instead, they must depend on aid to fill budgetary shortfalls in education, health and other programmes aimed at addressing poverty. The United Nations Educational, Scientific and Cultural Organization estimates that the average annual shortfall in funding needed to meet the internationally agreed development goals in education is $16 billion, $5 billion more than previously estimated (United Nations Educational Scientific and Cultural Organization, 2010). The crisis dampens the prospects for closing this gap. Thus, policy adjustments to support social spending and improve economic growth are essential to limit the impact of the crisis on poverty. The adequacy of international responses to the crisis is examined in the next chapter.