

IS THERE FISCAL SPACE FOR FINANCING AN ARAB DEVELOPMENT TRANSFORMATION?

Working Paper number 88 February, 2012

Khalid Abu-Ismaïl

UNDP

Rathin Roy *and* Raquel Almeida Ramos

International Policy Centre for Inclusive Growth (IPC-IG)

Copyright© 2012
International Policy Centre for Inclusive Growth
United Nations Development Programme

International Policy Centre for Inclusive Growth (IPC - IG)
Poverty Practice, Bureau for Development Policy, UNDP

Esplanada dos Ministérios, Bloco O, 7º andar

70052-900 Brasília, DF - Brazil

Telephone: +55 61 2105 5000

E-mail: ipc@ipc-undp.org ▪ URL: www.ipc-undp.org

The International Policy Centre for Inclusive Growth is jointly supported by the Poverty Practice, Bureau for Development Policy, UNDP and the Government of Brazil.

Rights and Permissions

All rights reserved.

The text and data in this publication may be reproduced as long as the source is cited. Reproductions for commercial purposes are forbidden.

The International Policy Centre for Inclusive Growth disseminates the findings of its work in progress to encourage the exchange of ideas about development issues. The papers are signed by the authors and should be cited accordingly. The findings, interpretations, and conclusions that they express are those of the authors and not necessarily those of the United Nations Development Programme or the Government of Brazil.

Working Papers are available online at www.ipc-undp.org and subscriptions can be requested by email to ipc@ipc-undp.org

Print ISSN: 1812-108X

IS THERE FISCAL SPACE FOR FINANCING AN ARAB DEVELOPMENT TRANSFORMATION?*

Rathin Roy, Khalid Abu-Ismaïl and Raquel Almeida Ramos

1 INTRODUCTION

The fundamental development challenge in the Arab region is one of economic transformation or, more pertinent, a lack thereof. Heavy sectoral weights of extractive industries lead to dependence on global oil prices, even in oil-producing countries. The structure of production limits employment generation for skilled and semi-skilled labour. Low-skill services and informal activities then absorb the labour force, with corresponding harm to aggregate productivity and living standards. The slow emergence of manufacturing capacities distinguishes the economies of the Arab region from other developing countries. Compared to suitable aggregates or, more poignant, the successful Asian emerging economies, manufacturing exports from the Arab region do not contribute sufficiently to growth. Concurrently, growth is volatile and saving and investment rates are significantly below what is required to undertake this economic transition (see Arnim et al., 2011; Abu-Ismaïl, Moustafa, and Arabaci, 2011; Abu-Ismaïl et al., 2011).

Certainly, counter-cyclical measures can support macroeconomic stability even in the face of commodity export dependence. However, several Arab countries have implemented such measures only recently through the creation of oil-stabilization funds. Structural retardation rather than structural transformation can thus characterize the analysis of macroeconomics of the Arab region. ‘Dutch disease’—the negative relationship between the relative size of extractive resource industries and overall GDP growth—appears to affect the oil-producing regions. Further, exploitation of natural resources crowds out investment and policy interest in developing manufacturing and high-value-added services, harming productivity and employment. Oil resources have thus largely retarded structural transformation for most of the Arab region (Arnim et al., 2011). The task is to reverse this retardation.

This paper therefore approaches fiscal space by asking: What barriers to the creation and use of such fiscal space must be removed in order to undertake such a transformation? In posing this question, the paper seeks to clearly demarcate its treatment of the fiscal space issue from that of the fiscal fundamentalist: its concern is to ensure that fiscal space is created not in the abstract for an unspecified purpose. The purpose matters and, hence, judging the feasibility of creating and using fiscal space depends on the purpose for which the space is to

* An earlier draft of this paper was presented at the International Conference on Financing Development, Beirut, in 2011. Our thanks are extended to various participants who gave us valuable comments, in particular, Lamia Moubayed from *Basil Fuleihan* Institute of Finance and Ali Abdel Gadir from the Arab Planning Institute. Last but not least, we wish to thank Gihan Ahmed, Asmaa Abdel Nabi and Adham Ali for their research support. Rathin Roy is the Director of the UNDP International Poverty Center for Inclusive Growth (IPC-IG), Khalid Abu-Ismaïl is UNDP's Regional Adviser on Poverty and Macroeconomics at UNDP Egypt and Raquel Almeida Ramos is UNDP's Macroeconomist at IPC-IG. Arab Development Challenges Background Paper 2011, UNDP, Second Arab Development Challenges Report, *Background paper 2011*, October 2011. UNDP Regional Centre in Cairo (RCC). All rights reserved.

be used. The rest of the paper details concrete policy options for undertaking the required structural transformation across the region. This transformation will doubtlessly require public resources. However, the resources will bring returns beyond the traditional growth dividend—first, in expanding the fiscal base; second, in fostering changes in the sources of revenue that will occur as the transformation takes effect; and third, in improving the equity and progressivity of the incidence of the fiscal burden and of public spending compared to the present situation. The discussion of fiscal space in this paper needs to be centred in this context.

2 APPROACH

A sustainable fiscal policy (a) does not undermine fiscal sustainability in the long term and (b) is not charity-based or rely on exogenous and, as has been frequently pointed out, highly volatile sources of external finance such as bilateral aid, concessional and non-concessional foreign borrowing. Such a policy requires:

- An analytical framework that specifies the main features of such a framework for the long-term mobilization of resources.
- Specific indicators to assess fiscal sustainability and, if possible, to suggest fiscal rules that could secure the long-term sustainability of such a framework.

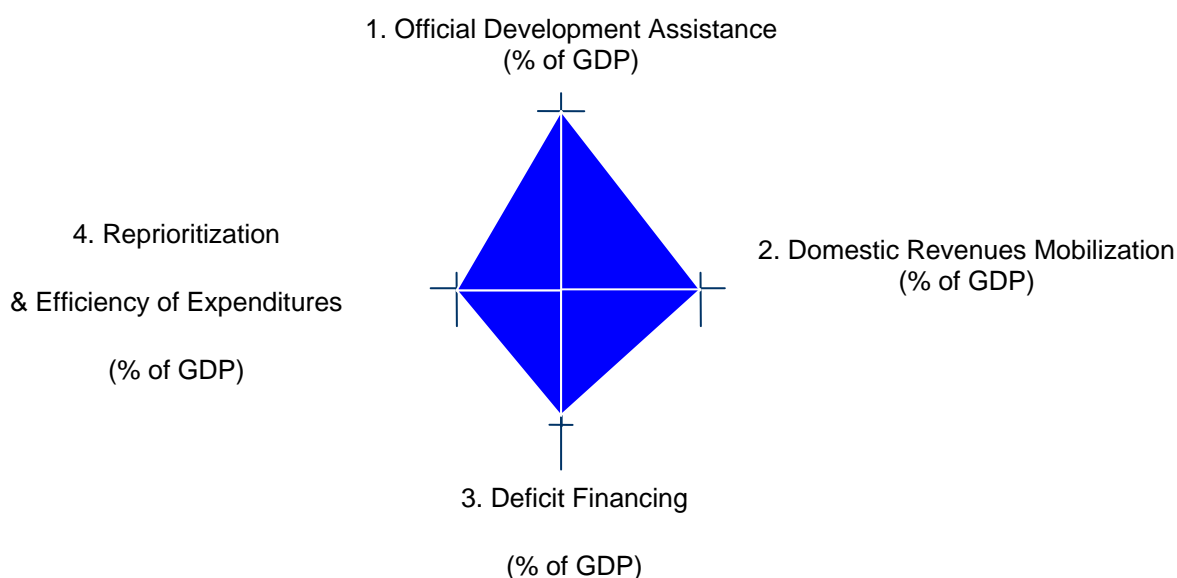
There are two major differences between designing an analytical framework for long-term fiscal policy and designing one for short-term fiscal policy. The first is that of long-term endogeneity. In the short run, the different instruments used to create fiscal space do not depend on the object of their spending to assess whether they are sustainable. The second difference arises when one asks, “Will countries such as Tunisia and Yemen be spending on the same things to meet their development challenges? Will the same fiscal instruments be used?” Different development situations will require different kinds of spending—in fact, different weights placed on the stabilization, allocation and distribution functions of public finance.

The fiscal space diamond is a useful device to explain what such an analytical framework would look like (Roy, Heuty and Letouzé, 2006). The diamond seeks to address the questions that arise when policy makers wish to know what the macro fiscal possibilities are for raising fiscal space in order to achieve intended policy goals. Such a diagnostic of fiscal space must be highly country-specific to have operational relevance.

As shown in Figure 1, the fiscal space diamond has four pillars that secure fiscal space. The diamond is created by putting the four pillars together in Cartesian space, with the area of the diamond representing the aggregate fiscal space available to the country. The diamond does not include seignorage, which is not commonly considered to be a desirable option.

The diamond is constructed by (a) mapping the four pillars, one on each axis, with the total resources available under each header presenting a point on the axis and (b) joining the points. Variations of this generic diamond are also possible, of course. For example, if one were to calculate the grant element of a concessional loan, then that part of the loan could be put under the aid pillar with the balance under the loan pillar. The diamond can be constructed in incremental or absolute terms.

FIGURE 1

Fiscal Space Diamond

Source: Roy et al. 2009.

The diamond can be used as an operational tool in many different situations, depending on the policy assumptions. In the short run, for example, expenditure-switching policies and tax policy measures to increase revenue would be of limited value compared to measures that make public expenditures more Pareto-efficient (for example, productivity gains) and to tax administration reform measures. Conversely, in the long term, the magnitudinal significance of the latter measures is likely to be smaller than that of the former. It is therefore essential to define precisely the policy assumptions underlying the diamond, the timeframe within which the different measures take effect, and whether the possible policy actions to tap into a source of fiscal space are endogenous or exogenous to *domestic* policy-making.

There are five steps in constructing the diamond: identify macroeconomic context and human development issues; identify short- and long-term fiscal challenges; identify whether challenges are exogenous or endogenous in the short term; build the diamond; and present the overall analytical framework.

Given the relatively low importance of ODA in this region, the focus is on the other three elements of the diamond. Roy and Heuty (2009) argue that inequality and social exclusion are the main structural challenges to achieving long-term economic growth and sustainable development in middle-income countries. The reason for this is that poverty and vulnerability in such countries reflect unequal distribution of income and assets. This is true for many of the countries of the region, as argued elsewhere in this paper. For this reason, domestic resource mobilization—through deficit financing and through tax policy alike—needs to be neutral if not progressive. Thus, an important question for the region asks, “Is the pattern of revenue mobilization progressive?”

With respect to expenditure, such contexts afford considerable scope to increase fiscal space through expenditure-switching policies. This does not simply mean earmarking a

specific proportion of the budget for subsidies and social protection schemes. Indeed, a basic perusal of the recent economic history of countries in the region shows that such transfers are often regressive. If the use of such resources impedes the required economic transformation, then they can ossify, rather than modernize, existing iniquitous production structures.

The second important feature of the fiscal space situation in the region is that it is extremely vulnerable to exogenous shocks, such as oil price shocks and political economy shocks that affect income from sources like tourism. This is particularly worrisome in the region, since significant segments of the population are constantly vulnerable to downward mobility precisely because they are not living in extreme poverty. Among developing countries, lower- and upper-middle-income countries are most vulnerable to this, compared to high- and low-income countries (Roy and Heuty, 2009).

In summary, this paper's main concerns for securing fiscal space are:

- (1) To ensure that there is sufficient cushion in current spending relative to current revenue to be able to undertake counter-cyclical expenditures and expenditures on well-designed and appropriate social programmes.
- (2) To ensure that the revenue and expenditure structures are aligned with the overall structural transformation as it takes place.
- (3) To ensure that there is sufficient fiscal space for public investment and that such investment is in areas most directly conducive to the desired structural transformation.

What are the constraints to increasing fiscal spending here? The region is ill-served by existing fiscal rules that focus unproductively on setting debt and deficit ceilings. Recent work on the subject shows that the major fiscal rule requiring attention in the long term is the zero current deficit rule or some modified version of such taking account of the specific circumstances of the region (see Roy and Heuty, 2009; Abu-Ismaïl and Roy, 2011).

What are the limits to borrowing for public investment? The common concern—crowding out or the impact on private investment behaviour—is not of primary importance (though it remains a policy concern), as the production structure of the region's economies requires transformation. This requires the creation of new and diverse productive assets and a shift away from current areas of private investment. While encouraging this shift requires more than fiscal incentives, there must be key public goods for such a shift in private investment to occur—investments in human capital, infrastructure, knowledge and quality—and investments in an environment that reduces the risks of exogenous shocks would require public spending on the current and capital accounts. The portfolio of such spending would, of course, need to be radically different from what obtains at present. However, the case for such spending is automatic if the premises of this paper are accepted.

Under the zero current deficit rule, what would the limit on capital spending be? Clearly, such spending in the short run would be limited by the cost of capital for the domestic private sector and by the interest burden on government's current expenditure. The latter is easily captured by looking at government primary expenditure, whereas the former, if such spending is domestically financed, would ultimately be connected with the long-term savings behaviour of the economy and the economy's capacity to attract foreign savings in the form of foreign direct investment.

3 PARAMETERS OF FISCAL SPACE

In consonance with this paper's analytical approach to fiscal space, the empirical analysis of fiscal data for the Arab states does not measure fiscal adequacy by referring to a simplistic aggregate such as the fiscal deficit or the debt-to-GDP ratio. Since the concern is with (a) medium-term fiscal sustainability consistent with the fiscal requirements of transformation and (b) the adequacy of fiscal effort relative to capacity, this paper assesses both dimensions of fiscal space using context-specific indicators.

3.1 ADEQUACY OF CURRENT REVENUE

At a very minimum, this paper assesses performance with respect to the zero current deficit rule. Applied most broadly, this would require government consumption expenditure (measured as the sum of wage and establishment expenditures of general government) to be fully financed from current revenues. For the sample of countries for which data is available, there is a comfortable positive balance across the region. In other words, there is sufficient fiscal space for expenditure other than on the instruments of government from the existing revenue effort to invest in current expenditures and transfers.

TABLE 1

Current Revenues Net of Privatization Minus Current Expenditure (% of GDP), 2000-2010

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
Algeria	-	11.41	11.09	15.58	15.81	24.43	25.90	21.40	26.93	13.47	12.80	17.9
Djibouti	-	-	-	(6.5)	(7.2)	(3.1)	(6.7)	(3.6)	(3.9)	(3.8)	(2.3)	(4.6)
Egypt	-	-	-	-	-	(6.2)	(2.6)	(3.1)	(3.2)	(5.8)	(5.5)	(4.4)
Jordan		(2.2)	(2.8)	(5.4)	(3.1)	(4.7)	(0.6)	(1.3)	(3.2)	(2.4)	(2.6)	(2.8)
Kuwait	42.34	21.88	25.34	23.17	29.71	55.51	37.63	46.93	18.84	24.11	22.66	31.6
Lebanon	-	-	-	6.3	6.5	4.4	4.2	1.2	1.6	2.4	5.7	4.0
Libya	24.60	8.78	24.31	19.64	30.13	49.02	49.05	46.63	48.52	38.29	39.60	34.4
Morocco	1.6	1.5	2	0.9	1.2	(0.6)	3.7	5.7	3.5	3.9	4.8	2.6
Qatar	-	-	-	15	10.6	21.3	19.7	16.5	23.5	21.4	-	18.3
Sudan	-	-	-	-	-	-	-	(0.6)	1.6	-	-	0.5
Syria	8.90	13.20	9.90	11.10	8.30	5.65	9.22	5.58	(0.5)	4.75	5.07	7.4
Tunisia		4.3	4.3	4.1	3.9	3.2	3.5	3.7	4.8	4.7	3.7	4.0
UAE	7.81	0.67	(2.31)	7.89	13.55	24.22	32.63	26.77	29.52	11.34	17.60	15.4
Yemen	-	-	-	6.3	6.9	7.7	10.1	1.4	2.5	0.5	1.9	4.7
Average	17.0	7.4	9.0	8.2	9.7	13.9	14.3	11.9	10.8	8.7	8.6	

Source: IMF, Countries' Article IVs.

For the Arab region, it makes sense to break down government revenue into revenue from oil and gas and revenue from other sources. The conventional wisdom suggests a fiscal rule whereby government consumption expenditure is entirely covered by non-oil revenues. Indeed, this was the basis of the analysis of fiscal space for Syria and Yemen that UNDP made in

the middle of the last decade (Karshenas, Abu-Ismaïl and McKinley, 2006; Fadil et al., 2007). However, an alternative view is also admissible: that non-oil revenues, being essentially derived from the growth of the *non*-natural-resource-based economy, are more permanent. Hence, policy should limit government consumption to an amount equal to or less than that of oil revenue so that development spending remains unaffected by fluctuations in the quantity and price of natural resources. Government expenditure, being fully endogenous to policy action of government (though not discretionary as understood in the usual fiscal sense), can then maintain fiscal stability irrespective of fluctuations in natural resource revenues.

This paper does not favour either argument. Instead, it first examines both scenarios. A look at the balance of non-oil revenues to government consumption reveals that three of the five major oil-exporting economies—Qatar, Libya and Algeria—managed to keep government consumption expenditure below total non-oil revenue even during the economic crisis. The United Arab Emirates show a sharp increase in government consumption expenditure during the crisis, while non-oil revenues stagnated. This led to a deficit, albeit one that declined steadily from fiscal year 2003 and achieved balance in 2006 and 2007 (i.e., before the crisis). Kuwait is significantly in deficit throughout the period. Among the non-oil exporters, only Yemen has a negative balance, though even this has been declining throughout the decade.

TABLE 2

**Government Non-oil Revenue Minus Government Consumption Expenditure
(% of GDP), 2000-2010**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
Algeria	-	0.9	2.3	1.4	0.9	1.1	1.4	0.7	0.6	1.4	(1.2)	0.9
Egypt	-	-	-	-	-	12.6	13.4	12.9	15.4	7.8	11.3	12.2
Kuwait	1.1	(5.5)	(9.9)	(10.4)	(5.1)	10.6	5.1	3.7	(2.5)	(9.9)	(9.4)	(2.9)
Libya	2.9	1.3	0.6	(2.3)	(1.3)	(2.7)	(1.7)	(2.1)	(0.2)	1.9	1.8	(0.2)
Qatar	-	-	(5.2)	(5.8)	(4.6)	(6.0)	(6.4)	2.0	0.6	6.9	-	(2.3)
Syria	9.2	6.2	7.3	7.1	9.1	10.1	11.3	11.6	6.7	10.1	9.3	8.9
UAE	(9.6)	(11.4)	(11.2)	(11.6)	(8.3)	(2.7)	0.1	0.9	(3.7)	(9.1)	(8.3)	(6.8)
Yemen	-	-	-	(4.9)	(3.7)	(3.7)	(4.4)	(5.4)	(4.3)	(3.3)	(2.2)	(4.0)
Average	0.9	(1.7)	(2.7)	(3.8)	(1.9)	2.4	2.3	3.0	1.6	0.7	0.2	0.3

Source: Ibid.

A look at the balance of oil revenues to government consumption reveals that all major oil exporters maintain a positive balance. It is interesting that Yemen, although not a major oil exporter, also maintains a positive balance.

TABLE 3
Oil Revenue Minus Government Consumption Expenditure
(% of GDP), 2000-2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
Algeria	-	13.6	11.4	15.8	16.0	22.6	24.4	21.0	27.6	12.6	11.8	17.7
Egypt	-	-	-	-	-	(7.9)	(7.8)	(6.3)	(7.6)	(8.0)	(9.5)	(7.8)
Kuwait	30.8	17.1	22.4	20.9	28.0	40.3	35.3	40.2	36.2	30.9	32.6	30.4
Libya	20.1	16.5	30.2	38.0	37.9	51.3	51.0	46.2	50.5	41.9	42.8	38.8
Qatar	-	-	-	-	9.5	10.1	4.9	10.4	6.1	(0.1)	-	6.8
Syria	6.7	11.9	6.2	7.7	4.2	0.4	0.5	(1.2)	(2.2)	(2.6)	(1.4)	2.7
UAE	2.0	(1.7)	(5.5)	4.1	8.0	18.0	26.6	19.3	24.8	7.8	13.8	10.7
Yemen	-	-	-	8.8	10.2	14.1	15.1	7.0	13.6	1.4	1.9	9.0
Average	14.9	11.5	12.9	15.9	16.3	18.6	18.7	17.1	18.6	10.5	13.1	15.6

Source: Ibid.

These trends lead to the conclusions that there is domestic fiscal space for financing the required development transformation that this paper advocates and that the focus should therefore be not on prudence or adequacy, but on the purposes to which the fiscal space is put. The fiscal position of the major oil exporters (excluding the UAE and Kuwait) is comfortable even without taking oil revenue into account. Yemen, too, could use its non-oil fiscal space to bring about a development transformation while financing—and, indeed, limiting—government consumption to the oil revenue. Among the non-oil exporters, adequate resources exist to undertake current expenditures from non-oil revenues. Only Kuwait appears to need to expand non-oil revenues in the short term, although, given the comfortable surplus of oil revenues over government consumption, there is no immediate call for a fiscal squeeze.

Since such an exercise is only feasible for a limited number of countries that have sufficient data, this paper uses a different (though more fiducially focused) measure to assess the adequacy of current revenues to meet existing expenditure commitments. Thus, it takes current revenues net of privatization and current expenditures net of interest payments to assess fiscal adequacy. The logic underlying this measure is related to policy: if total revenues cover current expenditures (less interest) without relying on privatization receipts, then the policy focus should be (if needed) on reducing the interest burden. This can be done endogenously through monetary policy and/or the amortization of public debt using privatization receipts. As an alternative, multilateral action could alleviate the interest burden on public debt through agreed debt relief or rescheduling measures, depending on a country's circumstances.

TABLE 4
**Current Revenues Net of Privatization Minus Current Expenditures
 Net of Interest Payments, 2000-2010**

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
Algeria	-	14.9	14.1	17.7	17.2	25.4	26.7	22.3	27.5	13.8	13.1	19.3
Djibouti	-	-	-	(2.1)	(3.0)	0.9	(1.9)	0.9	0.4	0.8	2.2	(0.2)
Egypt	-	-	-	-	-	11.0	11.6	12.8	14.1	6.4	8.7	10.8
Jordan		2.2	1.0	(1.7)	(0.3)	(1.7)	2.4	1.7	(0.9)	(0.2)	(0.3)	0.2
Kuwait	44.6	23.8	26.4	23.8	30.3	55.9	38.0	47.2	19.1	24.1	22.7	32.3
Lebanon	-		21.8	22.8	18.5	14.7	14.3	15.2	13.5	15.6	18.8	17.2
Libya	26.0	10.9	26.3	22.0	32.3	51.5	51.2	49.0	54.7	50.7	50.8	38.7
Morocco	9.5	7.7	7.4	5.5	6.3	4.8	9.2	11.4	11.5	10.7	10.9	8.6
Qatar	-	-	-	18	12.7	22.8	20.8	17.4	24.1	21.9	-	19.7
Sudan	-	-	-	-	-	-	-	11	14	-	-	12.6
Syria	16.0	19.4	15.6	16.5	14.4	11.9	14.5	10.4	5.1	11.2	11.4	13.3
Tunisia		10	10.1	9.4	9.8	9.6	9.9	10.5	11.9	10.4	9.2	10.1
UAE	13.3	8.5	3.6	11.4	16.7	28.2	38.1	31.6	33.8	16.4	22.4	20.4
Yemen	-	-	-	17	18.9	22.3	24	16.2	23.2	11.5	11.9	18.1
Average	13.7	6.1	7.9	10.0	11.6	18.4	19.9	21.5	22.9	19.3	20.2	

Source: Ibid.

The results are more mixed than when other indicators were used, but still fairly encouraging. First, the region as a whole has a reasonable current surplus by this measure. In some cases, notably that of Morocco, there have been significant improvements in fiscal health. Second, relatively few countries need attention: Lebanon and Egypt, only—Jordan has a relatively small deficit, pre-crisis. In Egypt's case, non-oil revenues cover current government consumption, so the deficit is generated by necessary large transfer expenditures. Lebanon's debt problems derive from a series of shocks that can fairly be described as 'crisis-related'; the problem is well known and the consequent need for collective action has been argued for some time.

3.2 POTENTIAL FOR EXPANSION OF CURRENT REVENUES

There is a fairly strong relationship between tax revenues and GDP levels (Hinrichs, 1966). In general, one can expect tax-to-GDP ratios to exceed 20 per cent of GDP in middle-income countries and to hover between 10 and 15 per cent of GDP in low-income and lower-middle income countries. Furthermore, tax revenues less than 10 per cent of GDP reflect a minimalist state or other specific economic features (such as reliance on a single source of non-tax revenue) that are not structurally desirable.

TABLE 5

Tax Revenue (% of GDP), 2000-2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
Algeria	-	9.4	10.6	10.0	9.5	8.5	8.5	8.1	8.7	11.2	11.4	9.6
Djibouti	21.4	20.5	21.0	20.5	19.9	20.0	20.3	20.4	18.4	18.6	19.1	20.0
Egypt	-	13.4	13.4	13.9	14.0	15.8	15.4	15.4	15.7	12.4	14.9	14.4
Lebanon	-	-	14.4	15.1	15.7	14.5	14.6	14.8	16.5	17.4	18.4	15.7
Libya	11.6	11.4	4.6	2.4	3.7	2.6	2.5	2.9	3.1	5.6	5.0	5.0
Morocco	24.1	22.8	22.9	19.7	19.9	21.4	22.2	24.8	25.5	25.9	26.1	23.2
Sudan	-	5.6	5.3	5.8	7.4	7.0	6.3	6.9	6.2	-	-	6.3
Syria	9.8	9.1	10.2	10.6	11.6	10.8	11.6	10.9	8.4	12.2	11.6	10.6
Tunisia	-	21.6	21.5	20.6	20.7	21.0	20.5	20.8	-	-	-	21.0
Yemen	-	-	-	7.1	7.3	7.4	7.2	7.3	7.1	7.4	7.8	7.3
Average	16.7	14.2	13.8	12.6	13.0	12.9	12.9	13.2	12.2	13.8	14.3	13.3

Source: IMF, WEO.

An examination of tax revenue trends in the Arab states suggests that there is considerable scope for tax revenue expansion. While some of this would not increase current revenues, but would substitute tax for non-tax revenue, the reform would be essential for the structural transformation that this paper considers critical for the region. The reason is that financing the delivery of public goods and services, as well as redistributive measures, need to be linked to changes in the income and consumption bases of economic agents (households and firms); this grounds the public finances in the domestic economy, reduces distortions, and allows for calibrated increases in spending on the allocative and distributive mandates of the state. In a sense, this argument is very similar to that used to advocate for a higher share of taxes on domestic income and consumption, as opposed to taxes on international trade, and that was the subject of much worldwide public policy action in the first decade of globalization. In the middle-income countries of the region, therefore, one would look for scope to increase the importance of direct taxation in tax effort, as well as look to ensuring that, in the process of economic transformation, overall levels of tax effort are roughly comparable to those in countries with similar income GDP levels.

TABLE 6

Tax Revenue (% of GDP), Non-Arab Countries, 2000-2008

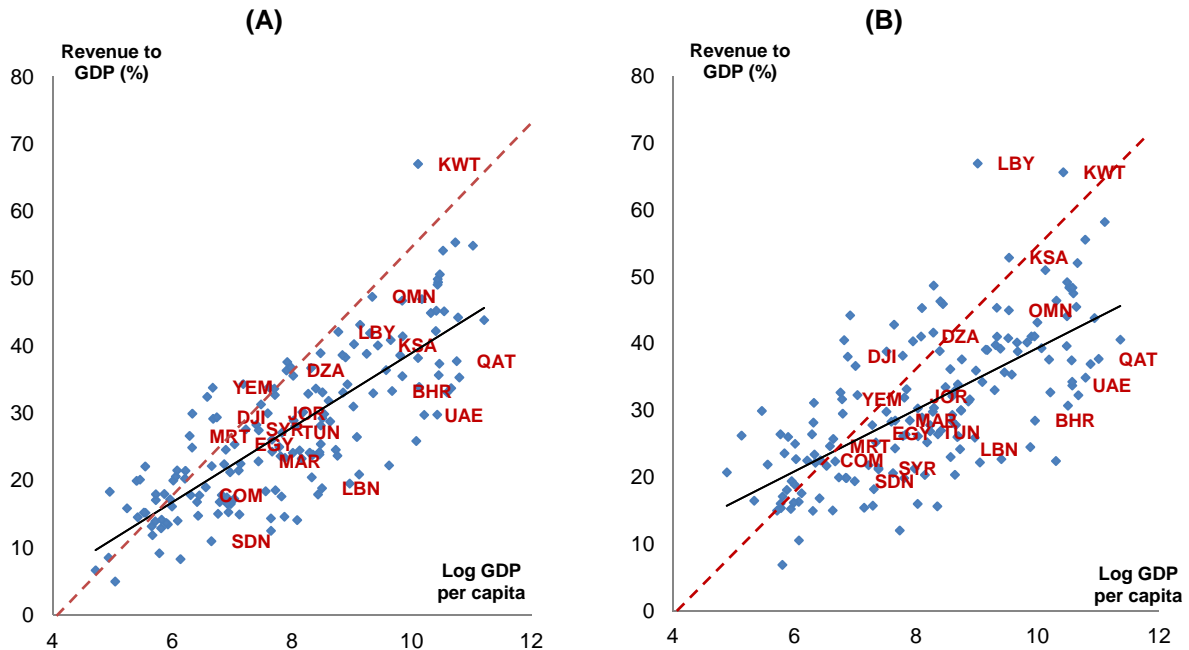
Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	Average
Argentina	-	-	9.8	12.5	14.2	-	-	-	-	12.2
Bangladesh	-	7.6	7.7	8.1	8.1	8.2	8.2	8.0	8.8	8.1
Brazil	-	-	-	-	-	-	15.5	16.0	15.8	15.7
Chile	16.7	16.6	16.8	16.3	17.0	18.7	20.6	21.4	19.7	18.2
El Salvador	-	-	10.7	11.2	11.0	12.5	13.4	14.0	13.9	12.4
Ghana	-	17.2	17.5	18.5	21.8	21.3	20.5	22.9	23.8	20.4
Guatemala	10.1	10.9	11.9	11.7	11.6	11.2	11.9	12.1	11.3	11.4
Honduras	-	-	-	13.7	14.5	14.5	15.2	16.3	15.9	15.0
India	9.0	8.2	8.8	9.2	9.4	9.9	11.1	11.8	12.3	10.0
Kenya	16.8	17.8	17.3	15.8	17.0	18.7	17.4	17.9	18.9	17.5
Paraguay	-	-	-	-	-	11.9	12.1	11.5	11.8	11.8
South Africa	24.0	24.8	24.2	24.0	25.3	26.9	28.4	28.8	27.7	26.0
Zambia		18.6	17.4	16.7	17.6	17.2	16.3	16.9	-	17.2
Average	15.3	15.2	14.2	14.3	15.2	15.5	15.9	16.5	16.4	15.4

Source: IMF, Countries' Article IVs.

When it comes to total revenue, it is clear that the non-Gulf Cooperation Council (GCC) Arab countries have revenue-to-GDP ratios that are roughly comparable to those in Latin America and the Caribbean as well as in Southeast Asia. However, tax effort is much lower in the Arab region, even compared to relatively poor tax effort performers. Yemen and Syria, for example, have lower tax revenues than India. Egypt and Lebanon, middle-income countries, have lower tax revenues than Brazil—itsself a poor performer when compared to countries like South Africa and even Kenya.

This indicates that considerable scope exists across the Arab region to undertake fiscal reform. This is also clear from the location of most Arab oil-importing countries below the revenue-to-GDP and GDP per capita regression line in Figure 2. However, this fiscal reform would be directed not at increasing fiscal space, but at bringing about a transformation in the fiscal structure of Arab countries in which revenue performance depends on tax effort and is thus virtuously linked to overall economic performance. This reform would enable the governments of the region to benefit from the recommended structural transformations, while simultaneously reducing distortions inherent in excessive dependence on non-tax revenues.

FIGURE 2

Revenue to GDP (Per Cent) and GDP Per Capita 2000-2003 (A) and 2006-2010 (B)

Source: IMF Article IV for Arab countries and WEO.

3.3 POTENTIAL FOR EXPENDITURE-SWITCHING POLICIES

The other source of fiscal space, expenditure-switching policies, requires an examination of the functional disposition of government expenditures. Unfortunately, this paper does not have access to this data for all countries in the region and so it reports trends only for a few countries. The trends differ markedly for each country. In the case of Egypt, the bulk of spending is on general services and social protection. Economic services and the provision of key public goods like health and education come out extremely short and the latter have, in fact, even been steadily declining. In Jordan, the lion's share of expenditure is on general services, defence and social protection. Again, there is extremely low spending on economic services, health, and education. In Tunisia, on the other hand, expenditure on education and general and economic services is significantly higher than average for Arab middle-income countries (MICs). This, however, has come at the expense of traditional social protection expenditure, which averaged less than 1 per cent of GDP during the past decade.

In the two GCC countries for which data is available, there is significant spending on public good provisioning along with a maintenance of high levels of expenditure on defence and general services. In both cases, this is possible because of the relatively high share of government spending in GDP.

TABLE 7
Outlays by Functions (% of GDP), Egypt, 2002-2008

	2002	2003	2004	2005	2006	2007	2008
Total outlays	25.4	25.3	24.9	25.0	29.7	26.9	31.5
General public services	6.7	6.7	7.1	7.5	7.2	6.7	8.0
Defence	3.4	3.2	3.0	2.7	2.6	2.4	2.2
Public order and safety	1.6	1.7	1.6	1.7	1.7	1.5	1.5
Economic affairs	2.4	2.3	2.3	2.2	1.8	1.9	2.1
Environmental protection	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Housing and community amenities	1.4	1.4	1.2	1.1	0.9	1.2	1.5
Health	1.8	1.8	1.7	1.3	1.6	1.4	1.5
Recreation, culture, and religion	1.4	1.4	1.4	1.4	1.2	1.2	1.2
Education	5.0	4.9	4.7	4.8	4.2	3.7	3.8
Social protection	1.9	1.9	2.3	2.8	9.0	7.3	9.6

Source: IMF, GFS.

TABLE 8
Outlays by Functions (% of GDP), Jordan, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total outlays	31.2	32.1	32.4	33.0	35.5	39.3	36.7	37.7	31.5
General public services	5.7	6.1	9.9	10.1	15.0	5.4	6.4	6.1	5.1
Defence	5.9	5.6	6.6	7.2	5.3	4.8	4.7	6.3	5.9
Public order and safety	2.9	2.9	2.8	2.9	3.2	3.2	3.1	3.3	3.4
Economic affairs	2.4	2.6	1.2	1.1	1.6	3.2	3.1	2.8	2.7
Environmental protection	-	-	1.1	1.2	0.4	0.1	0.1	0.0	0.0
Housing and community amenities	0.5	0.6	0.8	0.8	0.8	0.3	0.3	0.3	1.0
Health	3.2	3.4	3.5	3.4	3.5	3.2	4.1	2.7	3.3
Recreation, culture, and religion	0.5	0.5	0.6	0.6	0.6	0.8	0.5	0.3	0.6
Education	5.0	5.2	5.0	4.9	4.7	5.1	4.9	5.2	3.7
Social protection	5.2	5.4	1.0	0.8	0.6	12.9	9.5	10.5	5.7

Source: Ibid.

TABLE 9

Outlays by Functions (% of GDP), Kuwait, 2002-2009

	2002	2003	2004	2005	2006	2007	2008	2009
Total outlays	40.0	34.7	31.2	26.7	22.7	34.3	27.1	66.9
General public services	2.8	2.9	2.7	2.6	1.9	3.2	3.2	5.7
Defence	6.8	6.4	5.4	4.4	3.5	3.3	3.1	4.3
Public order and safety	3.7	3.2	2.7	2.2	2.1	1.9	1.8	3.3
Economic affairs	4.2	4.0	4.2	4.1	3.7	4.3	4.9	14.3
Environmental protection	-	-	-	-	-	-	-	-
Housing and community amenities	2.3	1.9	1.9	1.9	1.8	2.8	1.9	4.1
Health	2.8	2.4	2.1	1.6	1.5	1.7	1.5	3.8
Recreation, culture, and religion	1.1	1.0	0.9	0.7	0.6	0.6	0.6	1.1
Education	4.2	3.7	3.0	2.5	2.1	2.4	2.1	3.9
Social protection	8.6	5.9	4.9	3.8	3.6	9.1	2.8	25.7

Source: Ibid.

TABLE 10

Outlays by Functions (% of GDP), Qatar, 2004-2008

	2004	2005	2006	2007	2008
Total outlays	31.3	32.8	32.4	33.1	27.0
General public services	13.5	15.2	13.0	13.5	9.6
Defence	2.4	2.1	1.9	2.0	2.2
Public order and safety	1.7	1.5	1.5	1.8	1.3
Economic affairs	4.7	4.5	6.6	7.8	6.5
Environmental protection	0.1	0.1	0.1	0.1	0.1
Housing and community amenities	0.0	0.0	0.0	0.0	0.0
Health	2.6	2.3	1.8	1.5	1.6
Recreation, culture, and religion	3.7	4.2	5.4	4.1	2.3
Education	2.6	3.0	2.1	2.1	3.4
Social protection	0.1	0.0	0.0	0.1	0.2

Source: Ibid.

TABLE 11
Outlays by Functions (% of GDP), Tunisia , 2000-2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total outlays	26.5	26.5	26.6	25.7	25.8	25.7	25.1	24.8	26.0	26.1
General public services	6.1	5.8	5.3	5.1	5.1	5.0	4.8	4.5	4.3	5.2
Defence	1.7	1.7	1.6	1.6	1.6	1.6	1.6	1.4	1.4	1.3
Public order and safety	2.5	2.5	2.6	2.5	2.5	2.4	2.3	2.2	2.2	2.2
Economic affairs	5.4	5.7	5.7	5.3	5.4	5.7	5.5	6.1	7.4	6.2
Environmental protection	-	-	-	-	0.3	0.4	0.5	0.4	0.4	0.5
Housing and community amenities	1.6	1.6	1.7	1.5	1.4	1.1	0.9	1.0	1.2	1.1
Health	2.0	1.9	1.9	1.8	1.7	1.7	1.7	1.5	1.5	1.6
Recreation, culture, and religion	1.0	0.9	0.8	0.9	1.0	0.9	0.8	0.8	0.8	0.9
Education	5.8	6.0	6.5	6.5	6.4	6.4	6.5	6.4	6.3	6.6
Social protection	0.4	0.4	0.5	0.5	0.5	0.6	0.5	0.5	0.6	0.6

Source: Ibid.

What can be concluded from this snapshot? First, some expenditure switching—particularly into the provision of public health and education—could produce sufficient fiscal space in the non-GCC countries. Second, the high expenditure on social protection does not appear to yield much development. This is not so much because such expenditures are inherently undesirable—indeed, recent global experience suggests that social protection is a key element of counter-cyclical expenditure—but rather that what passes for social protection expenditure in these countries is not fit for its purpose, as it suffers from poor programme design and thus is greatly lacking in efficiency and effectiveness. This is particularly the case with fuel subsidies in Egypt, which, as recent studies show, suffers from poor targeting (IMF, 2011).

3.4 FISCAL SPACE FOR PUBLIC INVESTMENT

Table 12 presents the economic classification of government expenditure for key countries in the region. It is clear from the table that most countries in the region have extraordinarily low public investment relative to total government spending. Most governments invest less than 7 per cent, on average. Only Algeria, Libya, Yemen and Syria, all of which have relatively small private sectors and very little non-oil private investment, have spending exceeding 10 per cent of GDP. Thus, there is no doubt that current levels of public investment, even with heroic efforts at capital portfolio restructuring, will be insufficient to undertake the required structural transformation.

TABLE 12

Economic Classification of Expenditures (% of GDP), 2007-2010

	Qatar				Kuwait				Egypt			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Total Expenditure	29.5	28.4	34.2	0.0	9.6	18.1	11.8	15.5	31.5	33.8	27.4	28.8
Current Expenditure	17.7	18.9	22.5	0.0	8.2	16.5	10.3	13.4	27.7	29.6	24.3	26.1
Wages and salaries	5.2	5.4	6.7	0.0	2.8	3.4	3.6	3.8	7.0	7.3	7.4	7.1
Interest payment	0.6	0.5	0.8	0.0	0.1	0.1	0.0	0.0	5.6	5.1	6.0	5.9
Goods and services	9.2	11.4	12.9	0.0	1.8	1.9	2.0	2.8	2.1	2.4	2.3	2.4
Subsidies and transfers	0.0	0.0	0.0	0.0	3.2	10.6	4.4	6.5	10.3	12.2	6.2	8.3
Others	2.7	1.6	2.1	0.0	0.4	0.5	0.3	0.3	2.7	2.6	2.4	2.4
Capital Expenditure	11.8	9.5	11.7	0.0	1.4	1.6	1.5	2.1	3.8	4.2	3.1	2.7
	Libya				Jordan				Lebanon			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Total Expenditure	35.3	39.3	55.9	49.1	37.2	33.2	33.2	29.2	35.2	34.7	37.5	34.1
Current Expenditure	14.1	15.4	28.2	25.3	31.0	27.8	25.7	24.3	32.8	33.0	34.6	31.4
Wages and salaries	8.4	6.8	11.3	10.2	4.8	4.5	4.3	4.3	9.5	9.2	11.3	11.3
Interest payment	0.0	0.0	0.0	0.0	3.0	2.3	2.2	2.3	12.5	11.4	12.7	13.1
Goods and services	0.0	0.0	0.0	0.0	2.9	3.7	3.7	1.8	0.5	0.6	0.6	0.5
Subsidies and transfers	2.4	6.1	12.4	11.2	10.7	7.9	6.2	7.0	2.2	1.5	1.8	1.6
Others	3.4	2.5	4.4	4.0	9.5	9.4	9.2	8.8	8.0	10.2	8.2	4.9
Capital Expenditure	21.1	23.9	27.7	23.8	6.2	5.4	7.5	4.9	2.4	1.7	2.9	2.7
	UAE				Algeria				Sudan			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Total Expenditure	21.9	26.4	34.2	29.8	33.1	38.0	41.4	42.6	26.0	23.3	20.4	21.4
Current Expenditure	19.6	23.1	29.7	26.1	17.8	20.1	22.5	25.9	21.2	20.1	17.6	17.7
Wages and salaries	2.8	3.0	4.0	3.9	6.7	7.5	8.6	11.4	6.8	4.9	5.4	5.4
Interest payment	0.0	0.0	0.0	0.0	0.9	0.6	0.4	0.3	1.0	0.9	1.0	1.3
Goods and services	4.7	5.1	7.3	6.9	1.0	1.0	1.1	1.4	2.1	2.4	1.9	1.4
Subsidies and transfers	4.8	4.3	5.1	4.8	8.1	10.1	11.1	11.5	10.6	11.7	8.4	8.9
Others	7.3	10.7	13.3	10.5	1.1	0.9	1.3	1.3	0.7	0.2	0.9	0.7
Capital Expenditure	2.3	3.3	4.5	3.7	15.3	17.9	18.9	16.7	4.8	3.2	2.8	3.7
	Djibouti				Syria				Morocco			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Total Expenditure	37.7	34.8	36.8	34.7	26.6	23.8	27.4	26.0	28.4	31.3	31.1	30.7
Current Expenditure	26.5	24.4	24.5	22.7	17.0	16.6	17.1	16.4	23.9	26.4	26.1	25.4
Wages and salaries	13.8	12.8	12.2	11.7	4.9	4.6	6.1	5.7	10.6	10.6	10.6	10.5
Interest payment	0.4	0.4	0.5	0.6	0.8	0.7	0.6	0.4	3.1	3.0	2.6	2.9
Goods and services	7.0	6.4	6.0	5.3	1.2	1.2	1.1	1.1	0.0	0.0	0.0	0.0
Subsidies and transfers	3.1	3.0	3.4	3.4	4.0	4.9	5.8	5.9	2.6	5.0	4.2	3.2
Others	2.2	1.8	2.4	1.7	6.1	5.2	3.5	3.3	7.6	7.8	8.7	8.8
Capital Expenditure	11.2	10.4	12.3	12.0	9.6	7.2	10.3	9.6	4.5	4.9	5.0	5.3
	Tunisia				Yemen							
	2007	2008	2009	2010	2007	2008	2009	2010				
Total Expenditure	26.0	24.7	24.7	24.6	38.6	41.7	29.6	28.4				
Current Expenditure	20.1	19.0	18.1	18.0	31.4	34.6	23.6	22.4				
Wages and salaries	11.6	10.4	10.7	10.5	10.9	10.4	9.7	8.9				
Interest payment	2.6	2.1	2.0	1.9	2.2	2.2	2.6	2.6				
Goods and services	1.7	1.6	1.7	1.7	3.9	3.0	2.8	2.9				
Subsidies and transfers	4.2	5.0	3.7	3.6	12.3	18.1	7.6	7.0				
Others	0.0	0.0	0.0	0.3	2.0	1.0	1.0	1.0				
Capital Expenditure	5.9	5.8	6.6	6.6	7.2	7.1	6.0	6.0				

Source: IMF, Countries' Article IVs.

It is also clear that, in most Arab countries, there is a stark choice between subsidies and public investment. While subsidies currently do not fundamentally destabilize fiscal sustainability, as argued in a previous section, the figures in the Table 12 leave no doubt that many countries have levels of subsidies and transfers that merit re-examination, given their

low public investment. This is particularly true for countries facing a stark infrastructure deficit, such as Sudan, Yemen and Egypt (particularly in rural areas). Last, it is also clear that some significant countries in the region now have levels of public expenditure that reflect a government-spending-to-GDP ratio close to the feasible limit; thus, in Egypt, Algeria, Yemen, Lebanon and Djibouti, the scope for enhanced fiscal spending will have to come at least as much from demonstrated improvements in the allocation of public expenditure priorities as from further drafts of private consumption (through taxation) and private investment (through domestic-borrowing-financed deficit financing). While this means that a lot of sober reflection is needed on expenditure priorities, it does not preclude modest incidence-neutral increases in the revenue-to-GDP ratio.

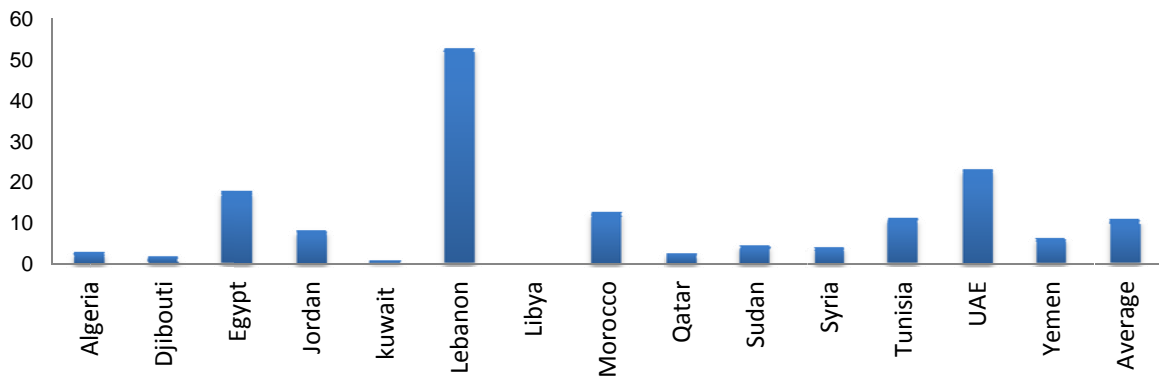
The standard measure of the ability of a country to finance public investment (through domestic borrowing) is determined by assessing the extent of which such expenditure raises claims on government that consume future revenues. Several measures are used for this purpose. This paper will not go into issues of debt sustainability; recent events have shown that measures of debt sustainability tend to be remarkably flexible in the case of advanced countries and that the very metric used to measure the *current* fiscal stance of government is now wide open. While this does not mean that debt stocks are irrelevant or unimportant, the link between debt stock and fiscal deficit levels cannot be used credibly where long-term fiscal sustainability is linked to the success of a structural transformation that this paper argues is imperative.

This does not, however, mean that there are no curbs on deficit spending. As argued in Section 2.1, the ultimate long-term indicator of affordability of increased deficit financed public investment would be the behaviour of private savings as the structural transformation takes place. It is worth looking more immediately at whether the stress of increased deficits would impact current expenditures negatively. If so, then there would be a policy trade-off between two expenditure financing requirements, namely, current expenditures and public investment. This paper argues that both are necessary if the structural transformation required of the region is to be effective.

The most apparent indicator of such affordability is the magnitude of interest payments in current expenditure. Figure 3 shows that this magnitude is, on average and for most countries of the region, currently fairly low. The three countries where such expenditure is in double digits are Morocco, Egypt and especially Lebanon. In Morocco, the share of interest in current expenditure has been declining, including through the crisis. Other than in Egypt and Lebanon, therefore, there is no bar on this score to increasing public investment levels through domestically financed public deficits.

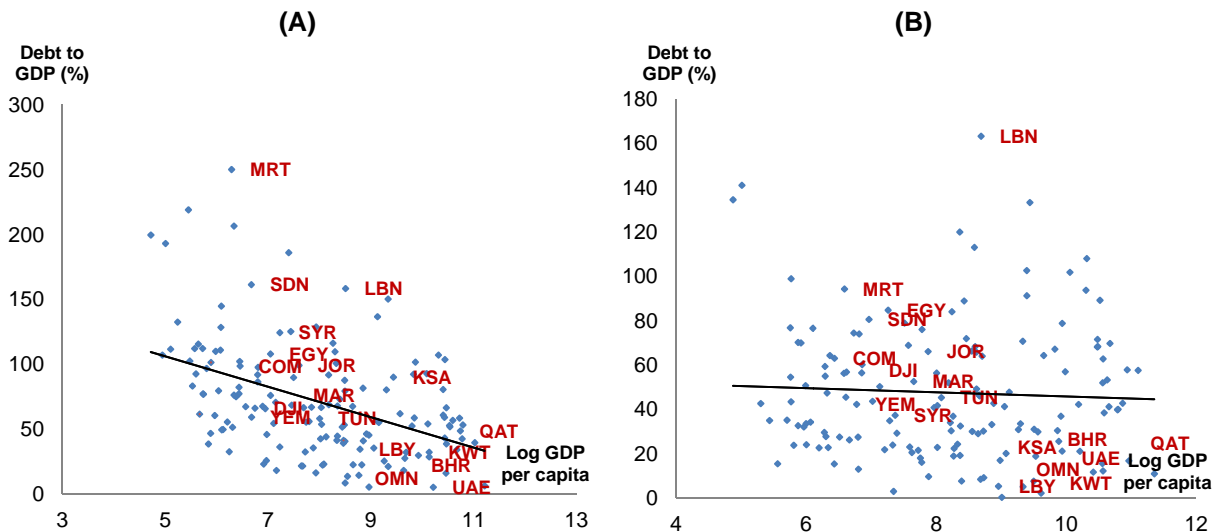
Furthermore, Figure 4, which plots the average total debt-to-GDP ratio against average per capita GDP from 2000 to 2003 and from 2006 to 2010, yields two interesting observations. First, there has been a general decline in the debt-to-GDP ratio for most highly indebted Arab countries, namely, Lebanon (after debt rescheduling), Mauritania and Sudan. Syria's debt reduction (most of which was owed to the former Soviet Union) was also quite significant. Second, with the exception of Sudan, all oil exporters lie below the regression line. Saudi Arabia has also used the recent oil boom to restore its debt-to-GDP ratio to a level commensurate with other high-income Arab oil exporters. It is also interesting to observe that, along with Syria and Tunisia, Yemen lies well below the regression line, indicating that there is scope for debt financing.

FIGURE 3
Interest Payments as Percentage of Current Expenditures, 2008



Source: Ibid.

FIGURE 4
Total Debt to GDP (Per Cent) and GDP Per Capita 2000-2003 (A) and 2006-2010 (B)

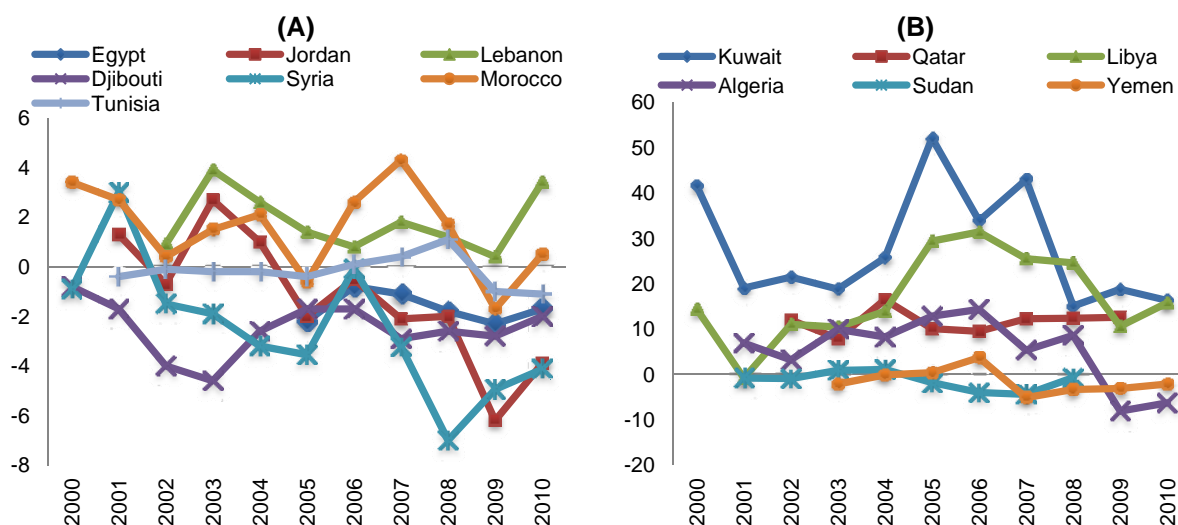


Source: IMF Article IV for Arab countries and WEO.

Turning finally to the primary balance, Figure 5 shows that most countries in the region have small primary deficits. Allowing for a modest primary deficit of, say, 4 per cent (and perhaps less for countries with a currently high interest burden), there appears to be no need for undue conservatism on this score. Certainly, it would be possible to conceive of a scenario where public investment could rise in most countries by up to 2 percentage points of GDP, with the revenue gains from incremental tax effort and expenditure switching being devoted to the required increases in current public expenditure. In addition, the region as a whole has a primary surplus. If the regional surplus were invested within the region through a regional agreement, then the scope for increasing public investment would be even greater. Furthermore, fiscal deficit (marked by the red line in Figure 6) does not appear to be a major threat to inflation (marked by the blue line) among oil importers, since the continuous rise in the latter was accompanied by a decline in the former. The situation is different for oil exporters.

FIGURE 5

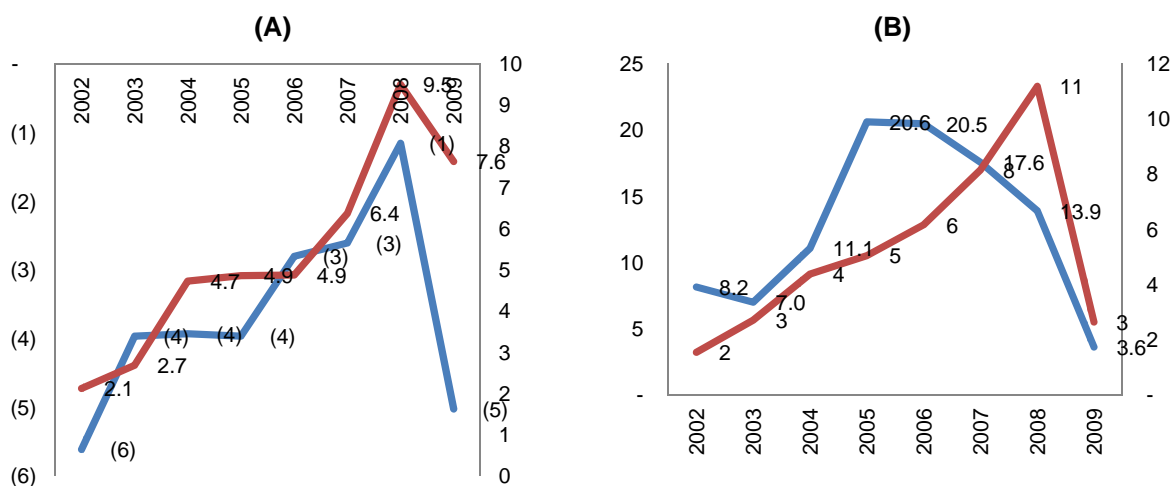
Primary Balance for Arab Oil Importers (A) and Oil Exporters (B), 2000-2010



Source: IMF, Countries' Article IVs.

FIGURE 6

Fiscal Balance and Consumer Price Index (annual change, %) for Arab Oil Importers (A) and Oil Exporters (B), 2002-2009



Source: IMF, Countries' Article IVs and WEO.

3.5 FISCAL RULES

Having identified the broad dimensions of a long-term fiscal framework within which to underpin a development transformation, this paper now outlines possible rules and indicators that would help to implement such a long-term fiscal framework.

Economic theory establishes that, ex post, investment equals savings. In the context of economic development, the investment-savings identity has traditionally been interpreted as an important constraint for securing development finance. This has often resulted in an

emphasis on short-term macroeconomic stability at the expense of investment and long-term economic growth (Development Committee, 2006; Roy, Heuty and Letouzé, 2006)

However, there are only two ways to finance a long-term development strategy: through GDP growth or through reduced consumption to sustain investment levels (Roy, Heuty and Letouzé, 2006). This is intuitively the case for saying that an important determinant of the fiscal sustainability of an aid-financed strategy is the savings rate when there is exit from aid. And if reduced consumption is not desirable, then there needs to be growth in GDP that, *inter alia*, generates an increase in savings that is sufficient to substitute for the aid financing. The net result—higher levels of production *and* consumption as well as higher rates of saving *and* investment relative to GDP—collectively constitutes a higher-order *process* of capital accumulation.

From the fiscal perspective, this is direct interestingly especially when the 'I' is public investment. Assuming a fiscal rule that requires the current deficit to be zero, and, as a simplifying assumption, zero government saving, the aid-financed scale-up in public investment would need to be replaced over time through recourse to either domestic or foreign borrowing.¹

The decision on which path to take would be country-specific, but domestic borrowing at reasonable interest rates has the great merit of not detracting from a country's GDP, although there are important implications for the *distribution* of GDP (Lerner, 1948). The point here is that, if for this or some other reason, the policy choice is to finance the exit from aid domestically, then savings must increase to allow this. For this to occur without negative effects on consumption, a higher order capital accumulation process would be required.

For all these reasons, the projected savings/GDP ratio is therefore an important *indicator* of the sustainability of an aid-financed development strategy. It is important to emphasize here that this ratio would serve as an *indicator* and *not* an *objective* of fiscal policy. There is a vast body of theoretical and empirical research on the savings-growth relationship, and the position that policy makers wish to adopt on that debate would determine whether an increased savings rate is a desirable policy objective. The point here is simply that the future projected rate of savings would provide an indicator of the extent to which aid-financed capital expenditures could, in the future, be financed, to scale, using domestic resources. Such an indicator would allow an assessment of the feasibility of using a 'golden rule' for a long-term fiscal framework, i.e., that domestic borrowing be used exclusively to finance capital investments.

Table 13 clearly shows that the savings rate for the Arab region is significantly below the level required to support a development transformation in most oil-importing economies and in least-developed countries (LDCs). Moreover, savings rates are not only low, but have even declined in many countries: Egypt, Jordan, Lebanon, Syria, Tunisia and Yemen. With the oil exporters, on the other hand, savings are not needed for public investment. Their high savings numbers simply show a low propensity to invest in non-oil sectors and that, more recently, these countries have been channelling less oil wealth to consumption and more to sovereign wealth funds and/or public investment (as in the case of Saudi Arabia in 2011).

Table 13
Gross National Savings (% of GDP), 1990-2000, 2001-2011 and Projections for 2011

Country	2011 (projections)	1990-2000	2001-2011
Algeria	56.6	29.2	50.0
Bahrain	40.3	14.9	32.0
Djibouti	17.2	8.5	19.3
Egypt	15.3	22.0	19.5
Jordan	15.8	22.7	19.9
Kuwait	48.4	5.2	47.0
Lebanon	14.6	15.0	13.2
Libya	n/a	23.4	59.6
Mauritania	20.8	15.2	18.2
Morocco	29.6	26.1	31.0
Oman	45.6	15.4	34.6
Qatar	60.5	13.7	56.9
Saudi Arabia	43.5	14.3	38.4
Sudan	16.3	2.1	11.9
Syria	20.0	24.3	18.7
Tunisia	19.0	21.4	21.2
UAE	29.4	31.4	28.3
Yemen	8.3	20.2	15.7
Arab countries	38.3	23.2	35.2
Oil exporters	42.3	19.9	38.7
Oil importers	18.3	21.7	20.3
Newly industrialized Asian economies	33.0	34.2	32.2
Emerging and developing economies	34.2	22.8	30.6
Developing Asia	45.7	31.6	40.5
Latin America and Caribbean	20.8	18.2	20.9
Sub-Saharan Africa	22.3	15.6	19.8

Source: IMF, WEO.

Second, *what* these investments are, matters critically for fiscal sustainability. It is also important to specify further norms or rules regarding *which* investments should be financed. As this paper argued earlier, existing indicators ignore—or lead to fiscal strategies that underestimate (Goldsbrough, 2007)—the positive endogenous outcomes of public spending. But for this to be so, we must first be convinced that the objects of government spending are likely to lead to such positive endogenous outcomes when the development transformation unfolds. The case for being so convinced is clearest if there is a credible plan for achieving specific quantifiable development outcomes—such as economic transformation and the MDGs –, and if that plan is implemented through the identification

of critical interventions that would secure such outcomes; this makes it necessary and fiscally prudent to adequately calculate the development, rather than fiduciary, benefit of enhanced fiscal space in the long term.

A study by Rodriguez and Moreno (2006) of the sustainability of fiscal expansions in 109 economies finds in this context that the sustainability of fiscal expansions depends on the *type* of expenditures. If the development payback is sufficiently high, then deficit-financed public investments are compatible with fiscal sustainability and an expanded G/GDP ratio. The authors find that expenditures on democracy and education tend to have more sustainable fiscal expansions, whereas defence spending has a negative effect on sustainability. Clearly, therefore, the sustainability of a fiscal expansion is critically dependent on the purposes of the expansion.

A corollary to this argument is that norms and/or rules within the long-term fiscal framework that specified the type of financing should not encourage the privileging of infrastructure investments over other investments by excluding them from any fiscal sustainability calculus. Instead, fiscal expansion should depend on the total package of investments in interventions that can produce precisely and predictably demonstrable benefits for development; furthermore, such benefits should be measurable by quantitatively assessing the progress of such interventions toward development outcomes such as the MDGs.

While these rules and indicators provide guidelines for fiscal space for securing capital spending required for a development transformation, though, what about current (recurrent) spending?²

Most budgets classify current and capital expenditures separately. However, the fiscal deficit does not make this distinction, as it is defined as the difference between current revenues, on the one hand, and current and capital expenditures, on the other.³ A fiscal rule that recognizes the distinction between current and capital expenditure line items in the budget would ensure that fiscal restraint does not discourage growth in the aggregate public capital stock (the corresponding on-budget flow variable being gross public sector capital formation). On this count, the current budget deficit/surplus would be a logical indicator to choose.

A zero current deficit rule is thus an important long-term policy target for fiscal responsibility in a long-term fiscal framework. While some allowances may be made for negative current deficits during a development transformation, with external grant financing making up the shortfall, the long-term fiscal framework must plan for all such expenditures to be financed entirely from current revenues. This is a non-negotiable requirement for a prudent long-term fiscal policy. It is salutary to note the importance that has been attached to securing this fiscal target by, for example, the Finance Minister of India, even in a situation where high growth and booming current account surpluses afford that country room to manoeuvre and where historic and present current deficits do not immediately threaten fiscal solvency.

In this context, it is important to strictly follow the present definition of items that are treated as current (or recurrent) expenditures in the economic classification of public expenditures. Again, it is necessary to emphasize this point because there is confusion between the definition of current expenditure as used in the economic classification and the argument that public expenditures that output “constructed by the public sector that provide

longer-term benefits to society over time” should be treated as capital expenditures (Mintz and Smart, 2006). For example, health services use labour (doctors and nurses) and buildings (hospitals and dispensaries) to produce health services. The joint output—health services—yields future returns through higher income paid to a healthier workforce. Why, then, shouldn’t public expenditures on teachers’ or nurses’ salaries be treated as capital expenditures, given that they yield future returns?

Such a rule has the added merit of acting as an automatic stabilizer on domestic borrowing, when supplemented by rigorous procedures that require the recurrent consequences of capital expenditure (RCCE) to be calculated and accounted for in budget estimates as a prior condition for clearing capital expenditure proposals.⁴

Thus, these rules and indicators would provide the long-term complement to short-term assessments of fiscal solvency and sustainability. Replacing the fiscal deficit as the summary indicator of fiscal prudence with a—more stringent—zero current deficit rule liberates space for exit from aid to a degree consistent with the availability of future domestic resources, as signalled by the forecasted savings-to-GDP ratio. The macroeconomic analysis that informed the design of such a fiscal framework would therefore need to specify the future impact of the development transformation on the revenue base and the savings rate to enable fiscal policy makers to assess the extent to which plans to scale up such transformation would be sustainable in the long-term. In the long term, the sustainability would be contingent on the availability of *domestic* fiscal space to finance government’s current and capital expenditures and would be implemented using fiscal rules very different from those used to assess short-term sustainability and solvency. They would not contradict the short-term rules—in the short run, it would remain important whether short-term government fiscal solvency, ‘Dutch Disease’ effects, absorption-spending issues, etc. were being managed. However, it would remove a major policy impediment to assessing the sustainability of scaling up from a long-term perspective: the use of short-term rules and analytical frameworks to assess the long-term availability of fiscal space with the consequent underestimation of the real economy payback of a well-designed and well-implemented strategy to secure development transformations such as those implied by the MDGs.

4 CONCLUDING REMARKS

This paper has argued that securing a development transformation while assuring fiscal sustainability makes the answer to the question “Fiscal space for *what?*” necessary to address the question “Is fiscal space sustainable?” For this reason, this paper has moved away from an accounting and incremental definition of fiscal space toward a policy-oriented definition in which structural transformation is the principal anchor for fiscal policy.

Stylized facts reviewed here also suggest that the boundaries of fiscal space vary significantly among Arab countries, depending on their level of income and on whether they are oil exporters or oil importers. Clearly, oil exporters that do not belong to the low-income group (i.e., the GCC plus Algeria and Libya) do not have a problem with fiscal space. They are also far more advanced on the MDG front. Hence, the main issue confronting these countries are not resource constraints, but rather the need to choose and adopt appropriate policies for economic diversification. Their main development challenges of unemployment and economic diversification can thus be addressed if there is sufficient political will and an appropriate set of macroeconomic and labour market interventions.

Lower-income oil exporters (Yemen and Sudan) are in a more precarious position. Yemen is in a particularly unenviable position, as it faces a water shortage and a decline in oil reserves that, given the recent rise in food prices, may take a heavy toll on human development and worsen poverty. Yemen has some room for debt financing; however, it is quite marginal compared to the order of magnitude of financial resources required. The inevitable policy conclusion is that ODA will be needed to support the Yemeni economy in the short or medium term. This conclusion is also equally applicable to oil-importing LDCs. For Sudan, the prospect of better use of oil revenues and the potential of the agriculture sector (which, though, has been significantly reduced since the cessation of South Sudan) place the country in a relatively more comfortable situation *vis-à-vis* the need for ODA. Still, given the large size of the North and the huge disparities among its states, a significant scale-up of public investment will be necessary.

This leaves the middle-income oil importers where fiscal space will have to be managed with care: Egypt, Syria, Morocco, Jordan, Lebanon and Tunisia. The latter three are, of course, in a more comfortable zone by virtue of its smaller populations and higher level of development. Furthermore, tourism, transfers and remittances play an important role in cushioning their economies. In that respect, the constraint on fiscal space is considerably less binding for them—although Lebanon's high debt-to-GDP ratio places it as a distinct outlier.

For Syria, Morocco and Egypt, however, the fiscal challenge is a priority, since their income levels are too high for an aid-dependent development strategy (which, in any case, is not advisable), yet they are still too poor to rely on tradition measures such as expenditure switching. Egypt and Syria are in a particularly difficult situation, given the latter's reliance on declining oil revenues and the former's relatively constrained space for increasing internal debt financing. The solution to these countries' fiscal problem will be contingent on 1) their ability to find the right set of policies that would maximize fiscal space from the three components of the fiscal diamond other than ODA and 2) their ability to further diversify their economic bases. For example, the high cost of fuel subsidies in Egypt, coupled with the findings from many recent studies regarding their poor targeting, makes a strong case for a radical change in policy. The difficulty, of course, would consist in implementing this policy adjustment in a manner that would minimize its negative impact on the poor (for example, by shifting to natural gas to support public transportation systems).

In view of these stylized facts, this paper's position on fiscal policy is clear. In the case of some middle-income oil-importing economies (Jordan, Lebanon and Tunisia) and to some upper-middle- and high-income oil-exporting economies (Algeria, Libya and GCC), fiscal policies' stabilization and allocation roles are of major importance. There is a second scenario in which the objective of fiscal policy is to finance a permanent increase in public investment to secure the same internationally agreed development goals. In this context the growth and allocation functions of fiscal policy are at the cutting edge of pro-development policy formulation. This scenario applies to all Arab LDCs. As argued, the case for some lower-middle-income oil importers, Egypt, Syria and Morocco, is more difficult to assess, as they as they possess features that will have to invoke a combination of both scenarios.

In the short run, countries embarking on development transformations of the type implied in the second scenario face numerous challenges, such as aid volatility, 'Dutch disease' effects, and the coordination of fiscal monetary and exchange rate policy to manage 'absorption-spending' issues. In this case, the negative consequences of these effects on

short-term stability need to be managed to mitigate their impact on public financing of interventions to secure the development transformation, rather than be considered as binding constraints on securing the financing available for such transformations. In other words, the desirability of the fiscal expansion must be assessed by weighing the costs of short-run instability against the expected long-term benefits. Furthermore, in countries where the scale-up is initially financed by ODA, a strategy to exit from aid becomes operationally necessary in order to secure long-term fiscal sustainability.

A long-term fiscal framework is meant to complement—not replace—existing fiduciary assessments focused on short-term fiscal solvency and sustainability. Indeed, the latter are essential prerequisite inputs for the former. However, the absence of such instruments does not mean that an exercise where such short-term instruments are used for want of anything better is either appropriate or desirable. Institutionally, the mandate and expertise of the chief dispenser of technical advice on fiscal affairs—the International Monetary Fund—is focused on short-term fiscal analysis and on sound public financial management. In order to implement the long-term perspective required to meet the development financing challenge of the MDGs and to respond to the Monterrey Consensus, there must be an institutional arrangement in which assessments of long-term development payback conducted by United Nations development agencies mandatorily inform the IMF's technical and surveillance work, particularly Article IV activities. A collaborative effort using the IMF's expertise in fiduciary instruments and the UN system's expertise in demonstrating the long-term human development benefits of well-designed public investment programmes, in equal partnership with other development partners and developing country groupings, is therefore very urgent.

ANNEX TABLES

TABLE 1

Revenue to GDP (Per Cent) and GDP Per Capita 2000-2003 and 2006-2010

Country	2000-2003		2006-2010	
	Average GDP per capita-B	Average Revenue-B	Average GDP per capita-L	Average Revenue-L
Algeria	7.91	36.32	8.08	41.02
Bahrain	9.67	33.28	9.96	28.42
Comoros	6.45	17.77	6.43	22.48
Djibouti	6.74	29.36	6.88	38
Egypt	7.04	25.36	7.28	27.76
Jordan	7.59	29.96	7.9	28.45
KSA	9.43	40.05	9.53	52.82
Lebanon	8.5	18.83	8.72	24.15
Libya	8.77	42.06	9.01	66.92
Mauritania	6.29	26.6	6.58	24.62
Morocco	7.44	22.83	7.66	28.43
Oman	9.34	47.26	9.53	44.94
Qatar	10.75	37.71	11	37.67
Sudan	6.65	10.97	6.99	19.36
Syria	7.23	27.58	7.38	21.31
Tunisia	7.83	27.09	8.1	28.89
UAE	10.21	29.72	10.57	33.68
Yemen	6.67	33.76	6.78	31.63

Source: WEO.

TABLE 2

Total Debt to GDP (Per Cent) and GDP Per Capita 2000-2003 and 2006-2010

Country	2000-2003		2006-2010	
	Average LN GDP pc	Average Debt/GDP-B	Average LN GDP pc6	Average D-GDP-L
Bahrain	9.69	32.07	9.94	21.05
Comoros	6.46	98.51	6.44	62.93
Djibouti	6.75	66.08	6.86	60.08
Egypt	7.05	107.86	7.26	84.67
Jordan	7.6	99.08	7.88	66.01
KSA	9.44	89.95	9.53	18.73
Kuwait	10.14	32.14	10.42	11.59
Lebanon	8.51	158.26	8.69	163.18
Libya	8.79	34.44	9.01	0.21
Mauritania	6.29	250	6.59	94.23
Morocco	7.46	68.4	7.65	52.48
Oman	9.34	21.14	9.5	7.48
Qatar	10.74	48.57	10.96	16.68
Sudan	6.68	161.27	6.97	80.49
Syria	7.23	124.27	7.37	37.24
Tunisia	7.85	66.82	8.08	45.21
UAE	10.22	5.15	10.56	15.45
Yemen	6.68	59.14	6.78	42.16

Source: WEO.

REFERENCES

- Abu-Ismaïl, K., Ahmed, G., Olmsted, J. and Moheiddin, M. (2011) Employment, vulnerability, social protection and the crisis of Arab economic reforms. Background paper for *Arab Development Challenges Report 2011*.
- Abu-Ismaïl, K. and Roy, R. (2011) Fiscal space in Arab Countries: a human development perspective. International Conference on Recent Trends in Financing Development, Beirut, Lebanon, 11-13 April 2011.
- Abu-Ismaïl, K., Moustafa, A. and Arabaci, M. (2011) Is there space for *development* friendly trade and industrial policies in Arab countries? Background paper for *Arab Development Challenges Report 2011*.
- Arnim, R., Rada, C., Gadir, A. A. and Abu-Ismaïl, K. (2011) Structural retardation of Arab economies: symptoms and sources. Background paper for *Arab Development Challenges Report 2011*.
- Development Committee (2006) *Development Committee Communiqué*, Washington DC, April 23.
- Fadil, M. A. Abu-Ismaïl, K., Roy, R., Ghonemy, R., Moustafa, A., Vernengo, M., El-Laithy, H, Islam, I., Mckinley, T. (2007) Macroeconomic policies for poverty reduction: the case of Syria. Damascus: UNDP.
- Goldsborough, D. (2007) The IMF and constraints on spending aid. UNDP International Poverty Center One Pager No. 34. New York: UNDP.
- Hinrichs, H. H. (1966) A general theory of tax structure change during economic development. Cambridge: Harvard Law School.
- IMF (2011) Regional Economic Outlook: Middle East and Central Asia, International Monetary Fund. Washington, D.C. May 2011.
- Karshenas, M., Abu-Ismaïl, K. and McKinley, T. (2006) Macroeconomic policies for growth, employment and poverty reduction in Yemen. Beirut: UNDP.
- Lerner, A. (1948) The burden of the national debt. In *Income, Employment, and Public Policy: Essays in Honor of Alvin H. Hansen. Annals of the American Academy of Political and Social Science*, Vol. 260, *Postwar Reconstruction in Western Germany (Nov., 1948)*, 230-231.
- Mintz, J. M. and Smart, M. (2006) Incentives for public investment under fiscal rules. World Bank Policy Research Working Paper 3860, March 2006. Washington, D.C.: The World Bank.
- Rodriguez, F. and Moreno, M. (2006) Plenty of room? Fiscal space in a resource abundant economy. Wesleyan Economics Working Paper 2006-022.
- Roy, R. and A. Heuty (2009) Fiscal Space: Policy Options for Financing Human Development. Sterling: Earthscan.
- Roy, R., Heuty, A. and Letouzé, E. (2006) Fiscal space for public investment: towards a human development approach. Paper prepared for the G24-Meeting in Singapore, September 2006. New York: UNDP. Retrieved from <<http://www.g24.org/rroy0906.pdf>>.

ACRONYMS AND ABBREVIATIONS

EU	European Union
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFS	Global Finance Statistics
IMF	International Monetary Fund
LDC	Least Developed Countries
MDG	Millennium Development Goals
MIC	Middle-income Countries
ODA	Official Development Assistance
RCCE	Recurrent Consequences of Capital Expenditure
UAE	United Arab Emirates
UN	United Nations
UNDP	United Nations Development Programme
WEO	World Economic Outlook

NOTES

1. There are, of course important balance of payments implications of foreign (including concessional borrowing). That impact on debt sustainability. We acknowledge this constraint but treat it as exogenous within the scope of this paper.
2. Current spending is defined per the economic classification as all government consumption expenditure.
3. There is, of course, the issue of which expenditures fall under each category, a point that this section takes up later.
4. It is important to make annual revisions of the RCCE, which is subject to significant changes over time.



International Policy Centre for Inclusive Growth (IPC - IG)

Poverty Practice, Bureau for Development Policy, UNDP

Esplanada dos Ministérios, Bloco O, 7º andar

70052-900 Brasília, DF - Brazil

Telephone: +55 61 2105 5000

E-mail: ipc@ipc-undp.org ▪ URL: www.ipc-undp.org