

Making effective use of fiscal space for sustainable development

Fiscal policy is integral to the implementation of the 2030 Agenda for Sustainable Development, through its role in allocating resources to such critical areas as education, health and infrastructure, enhancing income distribution and addressing externalities, both positive and negative (e.g. Research and Development versus pollution). For fiscal policy to support development priorities in a sustainable manner, attention is needed to debt sustainability and other measures of fiscal space. This policy brief assesses how much fiscal space countries in the Asia-Pacific region have, and whether that space is being used effectively.

Quantifying fiscal space?

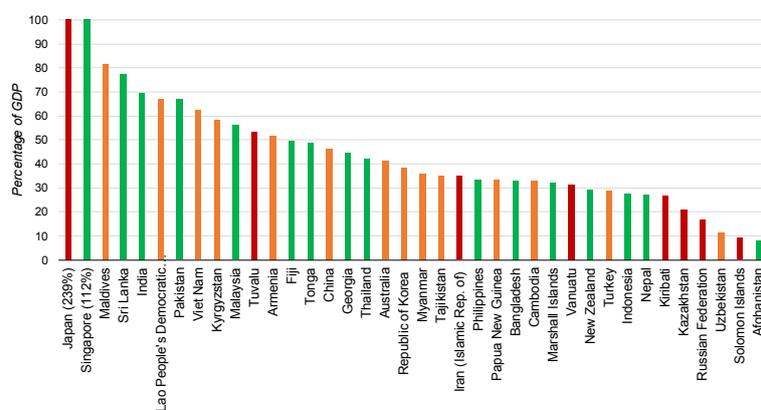
Fiscal space is a complex concept. Its definitions include: “the availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government’s financial position”¹, or “the financing that is available to government as a result of concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective, for a specified set of development objectives.”². Moreover, there are different measures of fiscal space. For instance, a Government’s long-term debt service capacity could be proxied by GDP or alternatively, tax revenue, over which it has more control. Fiscal space also depends on the buffer that would be desirable against possible shocks, such as in global interest rates or exchange rates – in the case of external debt or debt denominated in foreign currencies.

A popular approach to measuring fiscal space is to calculate the “fiscal gap”, defined as the difference between the current fiscal balance and the constant balance that stabilizes debt over a medium-term horizon at a sustainable level. The sustainability of government debt depends not only on the primary balance but also on the differential between economic growth and borrowing costs. Thus, even Governments with persistent deficits can reduce their debt-to-GDP ratio if the economy grows at a sufficiently high rate. Conversely, even countries with surpluses can see their debt-GDP ratio increase with an economic slowdown – which is why fiscal austerity can be self-defeating. Slower economic growth was also behind the recent marginal increase in debt-to-GDP ratios in the

Asia-Pacific region, as interest rates were stable or even trending downwards. In this situation, there is a need for fiscal sustainability analysis to incorporate the fiscal impact on economic growth.

Basic calculation of the fiscal gap suggests that, despite fiscal deficits, if current economic growth rates are sustained, for most Governments of countries in the region debt-to-GDP ratios would stabilize in coming years (figure 1). In other words, there is room for pursuing an expansionary fiscal stance without adversely affecting fiscal sustainability. However, what if economic growth slows or interest rates suddenly spike? Governments should be prepared for such alternative scenarios in light of recent experiences, such as large terms of trade loss among commodity exporters or potential interest rate hikes prompted by capital flow reversals. In the figure, a one standard deviation shock to the differential between economic growth and interest rate is applied based on country-specific historical data for the period 1990-2016. Under this alternative scenario of a negative shock, to keep the debt ratio stable, fiscal policy would have to make up for less favourable growth performance, higher interest rates, or both. As a result, more than half the countries would then experience upward pressure on their debt ratios.

Figure 1. Government debt, percent of GDP – a measure of fiscal space



Source: ESCAP, based on World Bank, Fiscal Space Database, and its own calculations. [au/business/data/assets/pdf_file/0005/262166/Harnessing-Potential-Report.pdf](http://business/data/assets/pdf_file/0005/262166/Harnessing-Potential-Report.pdf).
Note: If the primary balance, borrowing cost and GDP growth remain as in 2016, countries in RED will see their debt ratio increase, while for others it will fall. Under a less favourable scenario in which a 1 standard deviation shock is applied to the differential between borrowing costs and GDP growth, only the countries in GREEN would see their debt ratio decrease, while for others (RED plus ORANGE) it would increase.

Spending better

Although budget deficits or government debt can serve as useful indicators of short-term macroeconomic stability, they offer little indication of the long-term effects of fiscal policy on economic growth and development.³ For sustainable development, what matters is where and how the deficit is being spent. Is it, for instance, being spent for enhancing human, physical or social capital that would improve productivity and hence economic growth? If that is the case, then government debt, even though it rises in the short term, would be sustainable. Several studies have found sizeable (indirect) positive impacts on economic growth. For instance, for East Asian economies, it was estimated that a 1 percent increase in mean years of schooling could lead to an increase in GDP growth by 0.25-0.5 per cent, and a similar increase for health outcome as proxied by life expectancy.⁴ The importance of public investment in developing countries is also well known, as economic diversification and upgrading critically depend on having good-quality infrastructure.

In the Asia-Pacific region, there have been positive examples of enhancing the composition and quality of public expenditures. For instance, many countries have identified new sources of fiscal space to extend social protection coverage and benefits. Thailand reallocated part of its military expenditures for universal health; Mongolia financed a universal child benefit from a tax on mineral exports; and Indonesia extended its social protection programme through a reform of energy subsidies. Latest available data indicate that 39 percent of the population in the region are now covered by at least one social protection benefit (figure 2a). Available data for 10 countries indicate that, between 2013 and 2015, fossil fuel subsidies were reduced by as much as 89 percent for Viet Nam and 12 percent for oil-exporting Islamic Republic of Iran (figure 2b).

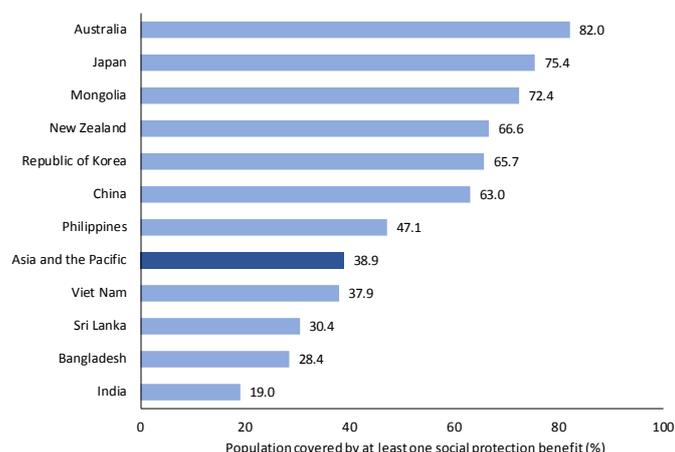
Despite such progress, there seems to remain significant room for strengthening and reorienting the national budget towards these priority areas. For instance, combined education and health expenditures at below 5 per cent of GDP in such countries as Cambodia, Bangladesh and Pakistan.

In addition to budget reallocation, Governments could increase expenditure efficiency and ensure equal access to basic public services. Without such efforts, additional spending may not translate into better development outcomes. Estimation of public expenditure efficiency suggests that many countries in the region have ample room for improvement. For instance, compared with regional peers at the frontier of expenditure efficiency, Pakistan could decrease its public expenditure by about 33 per cent in education and 17 per cent in health to produce the same level of education and health outcomes (figure 3a).⁵ Similarly, it was estimated that in developing countries, about 30 percent of the potential benefits of public investment are lost due to inefficiencies in the investment process.⁶

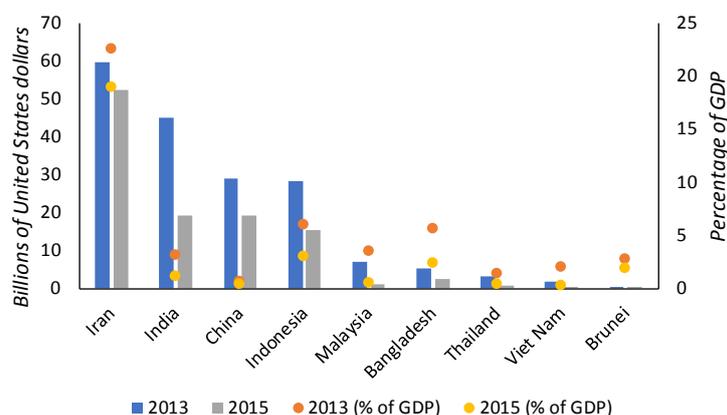
While there are sector-specific ways to improve expenditure efficiency, a cross-cutting factor is good governance. Between 2005 and 2014, the impact of better governance on public sector efficiency was as high as 57 percent in Georgia in the health sector and as high as 32 percent in Indonesia in the education sector.⁷ Moreover, as highlighted in recent ESCAP analysis, good governance could help better leverage private capital for infrastructure development. One of the ways in which Governments could improve fiscal governance is by leveraging technology; for instance, countries which proactively use e-government tools also tend to perform better in terms of corruption perception (figure 3b).⁸

Figure 2. Social protection coverage and fossil fuel subsidies – examples of budget reallocation

2a. Social protection coverage



2b. Social protection coverage

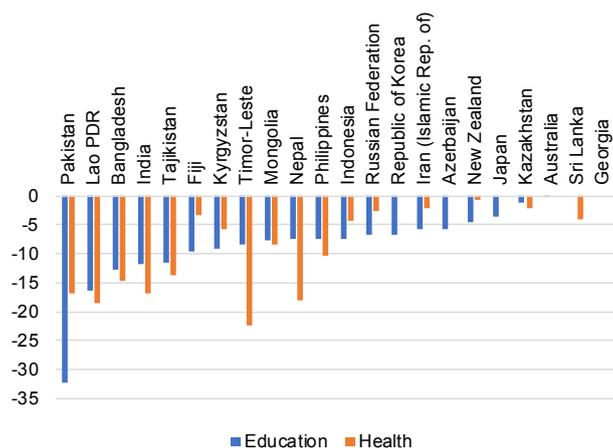


Source: International Labour Office, World Social Protection Report 2017-19: Universal Social Protection to Achieve the Sustainable Development Goals (Geneva, 2017). Available from www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/publication/wcms_604882.pdf; and ESCAP Statistical Database.

Source: ESCAP, Sources: ESCAP, based on Standard and Poors, "Global aging 2013: rising to the challenge", RatingsDirect, 20 March 2013.

Figure 3. Government expenditure efficiency

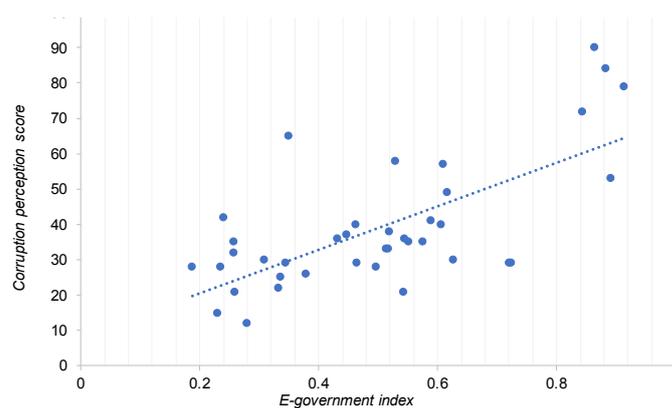
3a. Expenditure efficiency in education and health



Source: ESCAP, *Economic and Social Survey of Asia and the Pacific: Governance and Fiscal Management*. Sales No. E.17.II.F.8. Available from www.unescap.org/publications/economic-and-social-survey-asia-and-pacific-2017.

To summarize, this policy brief shows that in many countries in the Asia-Pacific region, there is room for pursuing an expansionary fiscal stance without adversely affecting fiscal sustainability. Given the need for fiscal buffers on the one hand, and the need for increased spending in support of the 2030 Agenda on the other, countries should nevertheless strengthen fiscal space through both expenditure and revenue reforms. While progress has been made in reprioritizing expenditures, there also seems to be room for enhancing expenditure efficiency, including in such critical areas as education and health. This will require good governance and effective fiscal management.

3b. E-government and corruption perception



⁵ ESCAP, *Economic and Social Survey of Asia and the Pacific: Governance and Fiscal Management*. Sales No. E.17.II.F.8 (Bangkok, 2017). Available from www.unescap.org/publications/economic-and-social-survey-asia-and-pacific-2017.

⁶ IMF, *Making Public Investment More Efficient* (Washington D.C., 2015). Available from <http://www.imf.org/external/np/pp/eng/2015/061115.pdf>

⁷ ESCAP, *Economic and Social Survey of Asia and the Pacific: Governance and Fiscal Management*. Sales No. E.17.II.F.8 (Bangkok, 2017). Available from www.unescap.org/publications/economic-and-social-survey-asia-and-pacific-2017.

⁸ ESCAP, *Economic and Social Survey of Asia and the Pacific 2017: Year-end Update*. ST/ESCAP/2808 (Bangkok, 2017). Available from www.unescap.org/sites/default/files/publications/Economic_and_Social_Survey_of_Asia_and_the_Pacific_2017_Year-end-Update.pdf.

¹ Peter S. Heller, *Understanding Fiscal Space*. IMF Policy Discussion Paper (Washington, D.C.: International Monetary Fund, 2005).

² Rathin Roy and Antoine Heuty, *Fiscal Space: Policy Options for Financing Human Development* (New York: United Nations Development Programme, 2009).

³ United Nations, Economic and Social Commission for Asia and the Pacific (ESCAP), *Economic and Social Survey of Asia and the Pacific 2013: Forward-looking Macroeconomic Policies for Inclusive and Sustainable Development*. Sales No. E.13.II.F.2 (Bangkok, 2013).

⁴ Hongyi Li and Liang Huang, Health, education, and economic growth in East Asia. *Journal of Chinese Economic and Foreign Trade Studies*, vol. 3, Issue 2 (2010), pp.110-131.

The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This issue was prepared by Daniel Jeongdae Lee, Nixie Abarquez, Kiattkanid Pongpanich and Farzana Sharmin, under the guidance of Hamza Ali Malik. For further information on this issue, please contact Hamza Ali Malik, Director, Macroeconomic Policy and Financing for Development Division, ESCAP (escap-mpdd@un.org).