Enhancing social expenditure and fiscal sustainability

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How much does public social expenditure translate into economic growth? That remains a central question for policymakers and researchers. The results depend on factors such as the quality of governance, and macro-level savings and investment.[141] But in broad terms, targeted public social expenditure can enhance human development, speed the accumulation of human capital and enhance growth at a macro level, especially in low- and middle-income countries.[142] In the wake of the pandemic, such considerations are more urgent than ever, with the Arab region requiring an additional $491 billion to achieve a resilient, fast recovery on par with other regions.[143] These challenges come on top of those that already exist in realizing the SDGs.

Following a decade of stops and starts in the region after the 2008-2009 global financial crisis, the pandemic has exacerbated existing concerns around low growth and mounting deficits and debt that constrain already tight fiscal space. Strategies to enhance fiscal space are critical to sustain public social expenditure and the continued pandemic response. This chapter examines different options for generating greater fiscal space, including through tax reforms and debt relief. Macroeconometric models help map well-strategized debt finance scenarios that consider debt-to-GDP stabilization in the medium term while factoring in fiscal sustainability and macroeconomic stability.

Targeted public social expenditure can enhance human development, speed the accumulation of human capital and enhance growth at a macro level, especially in low- and middle-income countries.

A. A decade of pressure on fiscal space

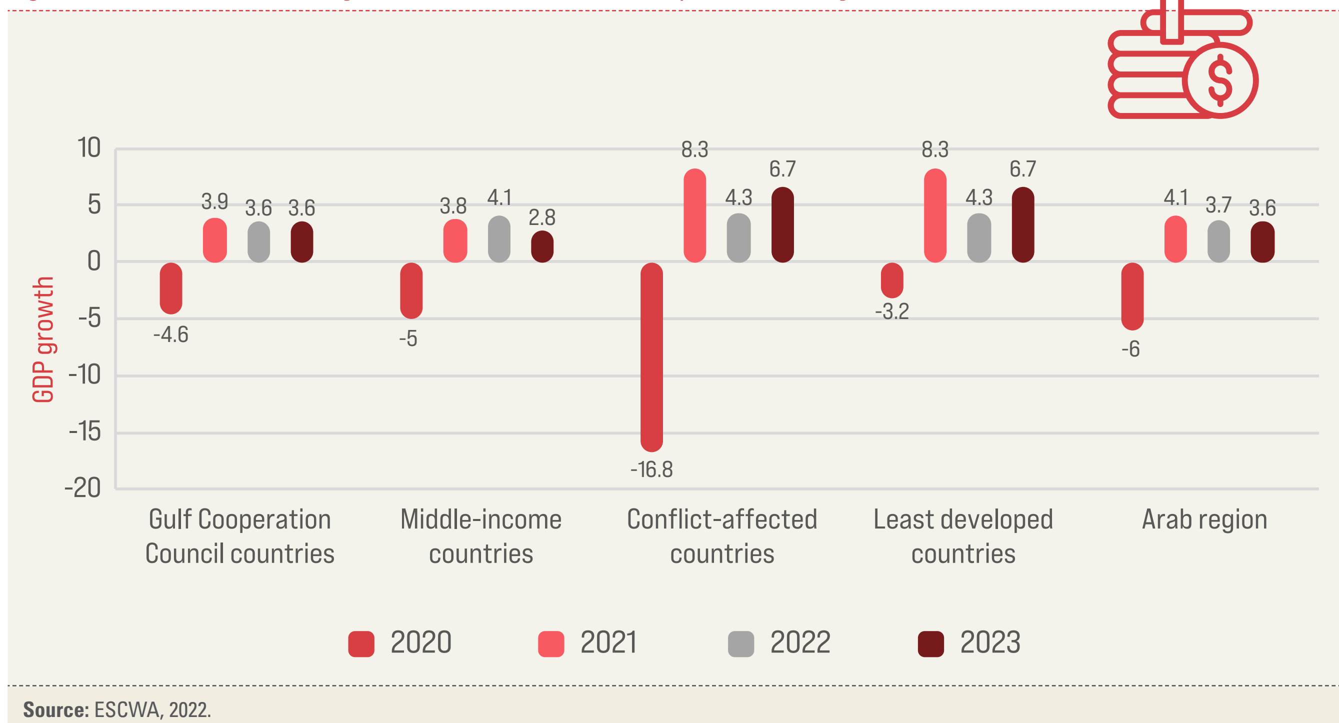
The COVID-19 crisis, coming after a decade of economic and political shocks and downward pressure on growth and Government finances, has widened fiscal deficits and spurred debt growth that in some cases teeters on unsustainability. Strains on public budgets make resources for essential social expenditures difficult to find. Since an inclusive recovery from the pandemic and continued progress on the SDGs require bolstering Government finances in general and social expenditure in particular, Governments need to consider fiscal strategies geared towards efficiency, equity and sustainability, and built around smart investments.

1. COVID-19 made economies even more vulnerable

Since the global economic slowdown in 2008-2009, economic and political shocks in the Arab region have generated continuous pressure on growth, with further weakening from the oil price plunge in 2014 and the slow recovery since then. While growth forecasts were slowly moving up in 2018 and 2019, the pandemic and the collapse of oil prices derailed prospects for 2020. Data for 2020 indicate a contraction of economies of around negative 6 per cent compared to the pre-pandemic projection[144] of 2.5 per cent growth.[145] Equivalent to a loss of about $159 billion in real GDP, the drop-off comes from combined negative fallout on oil markets, tourism receipts, trade, and investment flows.

Impacts vary, however, by different subregions and country groups (figure 84).[146] Economies vulnerable before the pandemic became even more so. A rebound in growth in 2021 depended on a global rebound and increased demand for oil and on the reasonable success of vaccination campaigns.[147]

Figure 84. Forecast annual GDP growth rates show slow recovery in the Arab region, 2020-2023

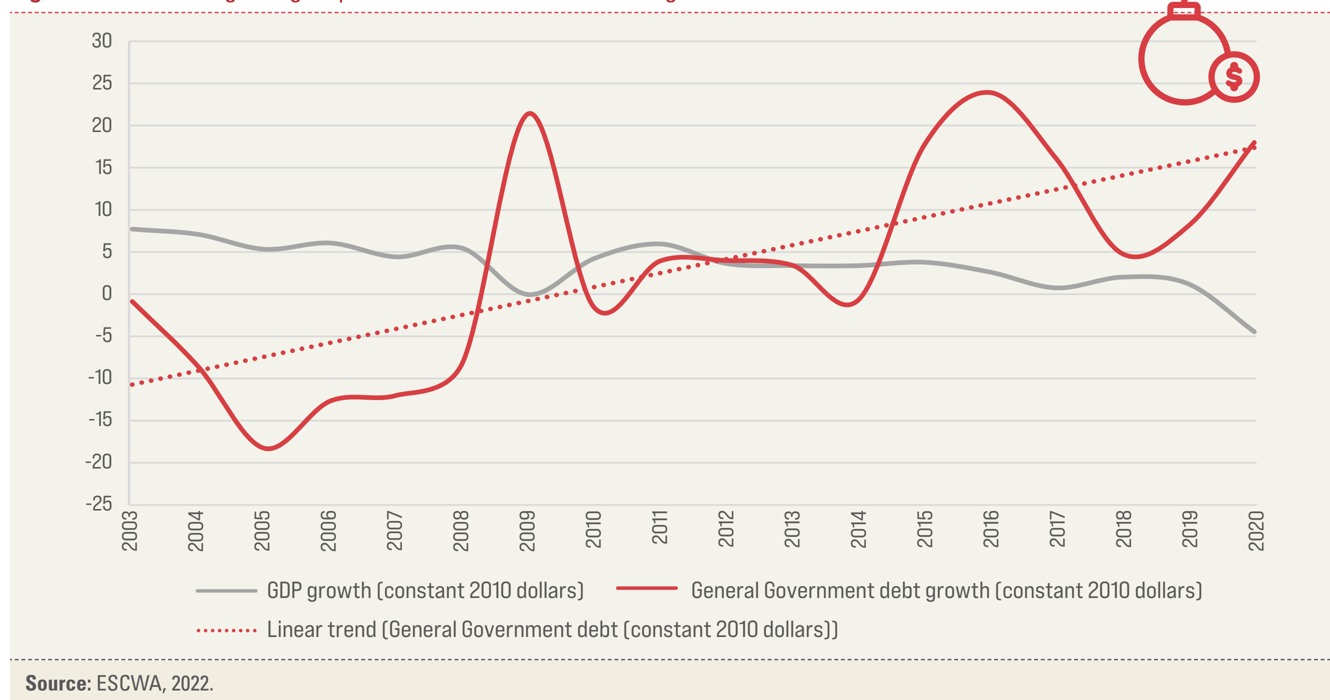


Source: ESCWA, 2022.

2. More debt, less liquidity

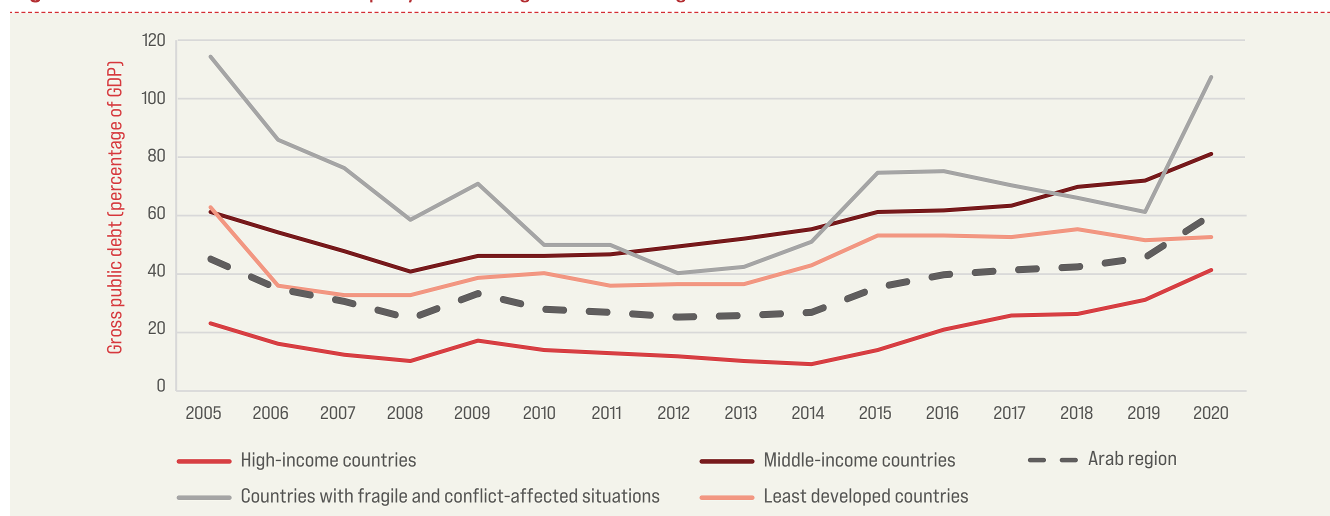
The region has faced rising public debt since the beginning of the 2010s, putting it in the territory of debt unsustainability (figure 85). COVID-19 amplified already heavy debt burdens, complicating recovery and social expenditure for several low- and middle-income countries. Debt in the region reached an estimated 60 per cent of GDP in 2020 (equivalent to $1.4 trillion), up from 25 per cent in 2008 (figure 86). Rapidly escalating debt has resulted from a combination of factors, including a general lack of adequate fiscal and monetary policy responses, recurrent trade and fiscal deficits and low economic growth.

Figure 85. GDP is stagnating as public debt soars in the Arab region



Source: ESCWA, 2022.

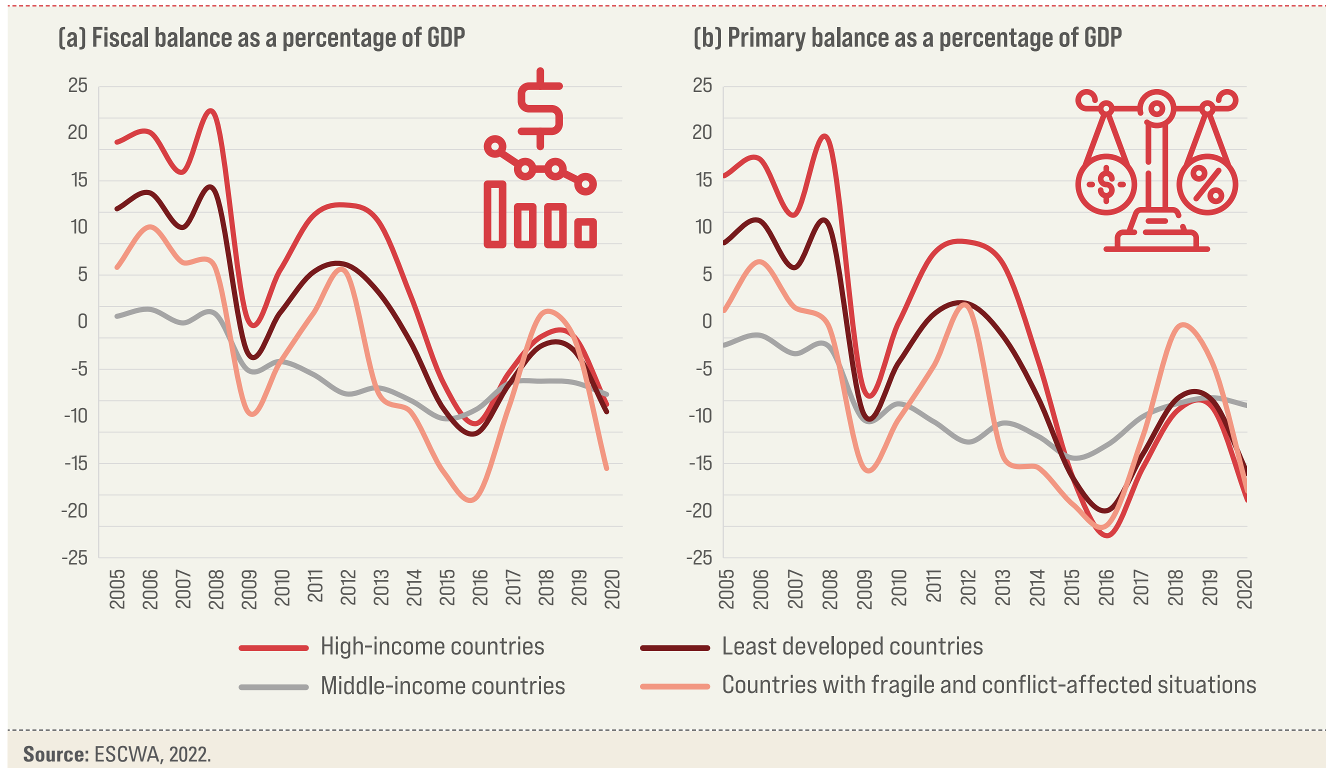
Figure 86. Public debt-to-GDP is rapidly escalating across the region



Source: ESCWA, 2022.

Note: The aggregate for the conflict-affected countries excludes the State of Palestine and the Syrian Arab Republic. The aggregate for the least developed countries excludes Somalia and the Sudan.

Figure 87. The region has seen continuous declines in fiscal balances



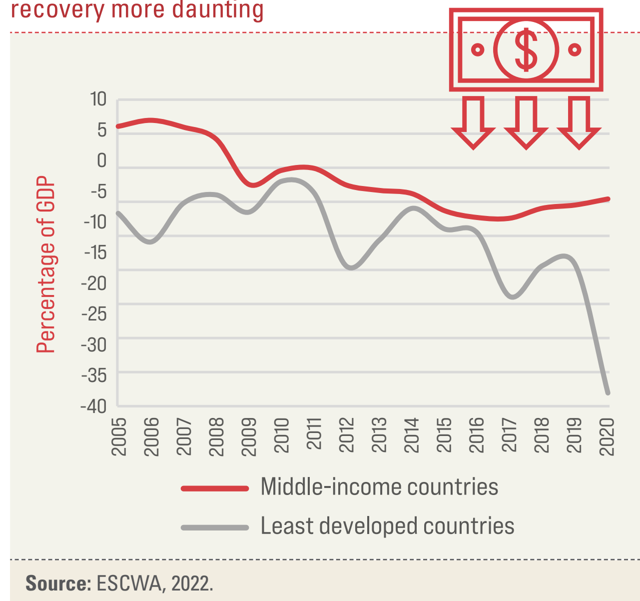
Source: ESCWA, 2022.

High-income countries are relatively better off, although they are increasingly using debt financing for expenditure as oil revenues remain volatile. Fiscal pressure is high for most middle-income countries, least developed countries and those with fragile and conflict-affected situations with heavy debt burdens. The least developed countries experienced a threefold increase in debt between 2008 and 2020, from $2.4 billion (33 per cent of GDP) to nearly $7 billion (52 per cent of GDP). For them, grant finance and debt relief measures, including those under the Group of 20 (G20) Debt Service Suspension Initiative and the Heavily Indebted Poor Countries Debt Relief Initiative, are essential to counter the adverse impacts of the pandemic and finance social expenditure. Current initiatives are not enough, however. Somalia, the Sudan and Yemen are in debt distress, and Djibouti and Mauritania are at risk of debt distress[148] having experienced severe output contractions even as pandemic relief and recovery demanded a massive infusion of funds.

Middle-income countries carry nearly half of the region's debt burden. In 2020, large fiscal shortfalls due to COVID-19 pushed their public debt to $575 billion (81 per cent of GDP), up from $205 billion (41 per cent of GDP) in 2008. Egypt, Jordan and Tunisia together borrowed more than $10 billion in April-May 2020 under the IMF's short- and medium-term lending mechanisms.[149] While the economic downturn has increased debt risks for the middle-income countries, they are not eligible for current forms of debt relief.

Beyond the sheer amount of debt, its composition has been changing. For middle-income countries, a larger share comes from private creditors at higher costs, given reduced concessional borrowing from official creditors.[150] Tunisia spent more than 20 per cent of its revenues; Egypt, Jordan and Morocco spent more than 10 per cent of their revenues on external debt service. While expanding fiscal space to mitigate the medium to long-term impacts of COVID-19 is imperative, debt servicing presents a major impediment to releasing resources for essential social support.

Figure 88. Current account deficits make the path to recovery more daunting



Source: ESCWA, 2022.

High and persistent fiscal deficits drive debt accumulation and liquidity challenges that constrain social and economic investments.

High and persistent fiscal deficits drive debt accumulation and liquidity challenges that constrain social and economic investments. Middle-income countries have witnessed a continuous decline in fiscal balances as a percentage of GDP since 2008. COVID-19 further widened fiscal and primary balances to minus 8 per cent of GDP and minus 2 per cent of GDP in 2020, respectively (figure 87). Average fiscal and primary balances in the least developed countries remained mostly negative after 2013. In 2020, their average fiscal and primary balances reached minus 9.5 per cent and minus 7.9 per cent, respectively, due to the pandemic.

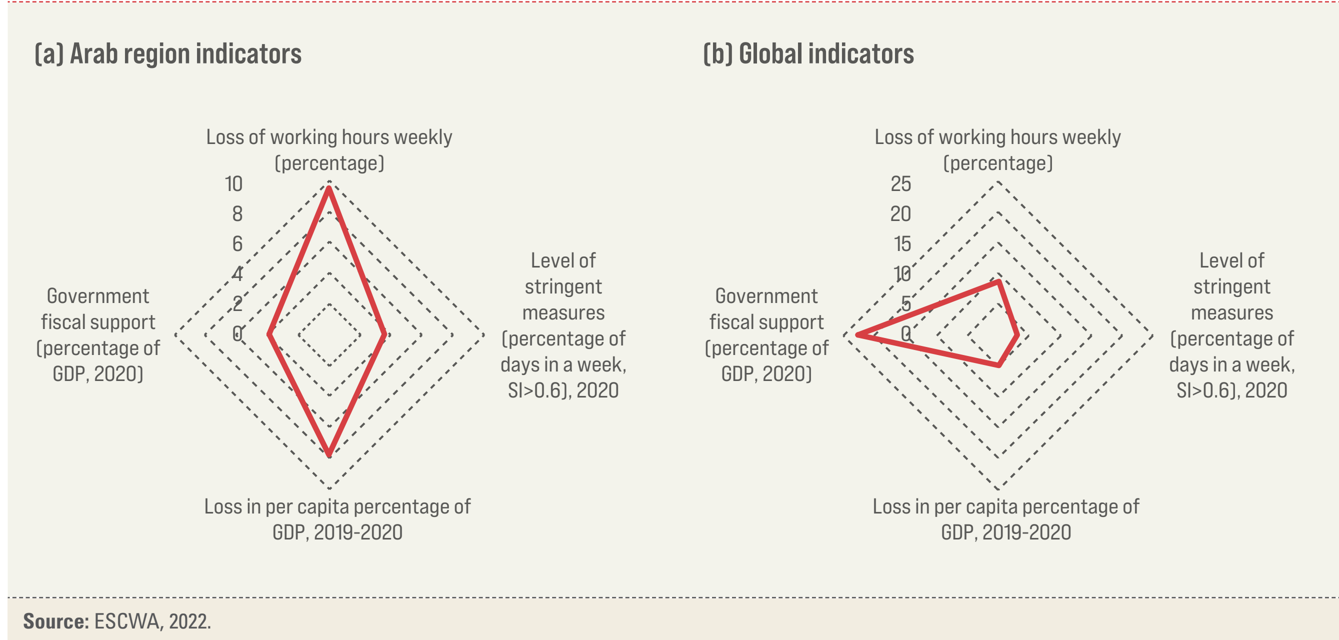
For high-income countries, average fiscal and primary balances as a percentage of GDP turned negative from 2015 onwards given the 2014 oil price plunge. This led them to issue sovereign bonds in international capital markets to meet expenditure needs. They also introduced new value added taxes and cut subsidies. In 2020, as COVID-19 caused significant oil revenue losses, these countries pushed their fiscal and primary deficits to minus 8.8 per cent of GDP and minus 10.2 per cent of GDP, respectively. Recurring negative primary balances in several countries have led to increased debt finance and the rollover of outstanding debt.

Persistent current account deficits in the middle-income and least developed countries constrain liquidity in foreign currency and drive external borrowing. Current account deficits are a major concern because these countries heavily rely on imports for local consumption while their exports are largely limited to primary products. In 2020, the current account deficit reached 6 per cent of GDP for the middle-income countries and around 37 per cent of GDP for the least developed countries (figure 88). The associated liquidity constraints will make the path to recovery from COVID-19 more challenging and likely obstruct financing for the SDGs and social investments.

3. Fiscal constraints undercut recovery and the SDGs

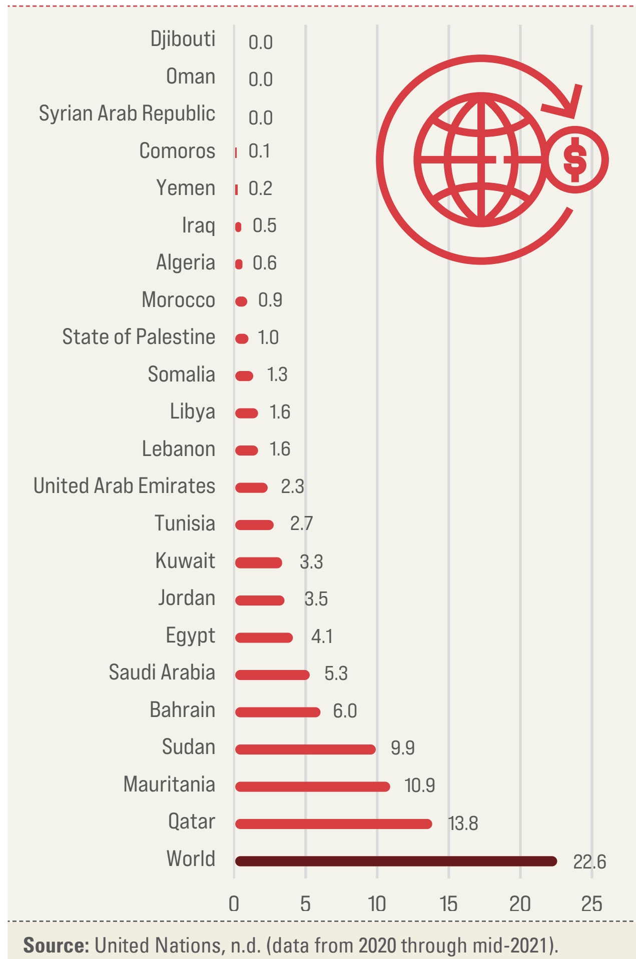
Constrained fiscal space and liquidity challenges are apparent in the Arab region's inability to respond to pandemic fallout much less jumpstart a resilient recovery. Fiscal stimulus in the region was low both compared with the global average and given needs arising from dramatic losses in income and jobs, and strict pandemic containment measures (figure 89).

Figure 89. Fiscal stimulus remained limited even as needs escalated



Source: ESCWA, 2022.

Figure 90. Stimulus packages fell far below the global average in 2020 as a percentage of GDP

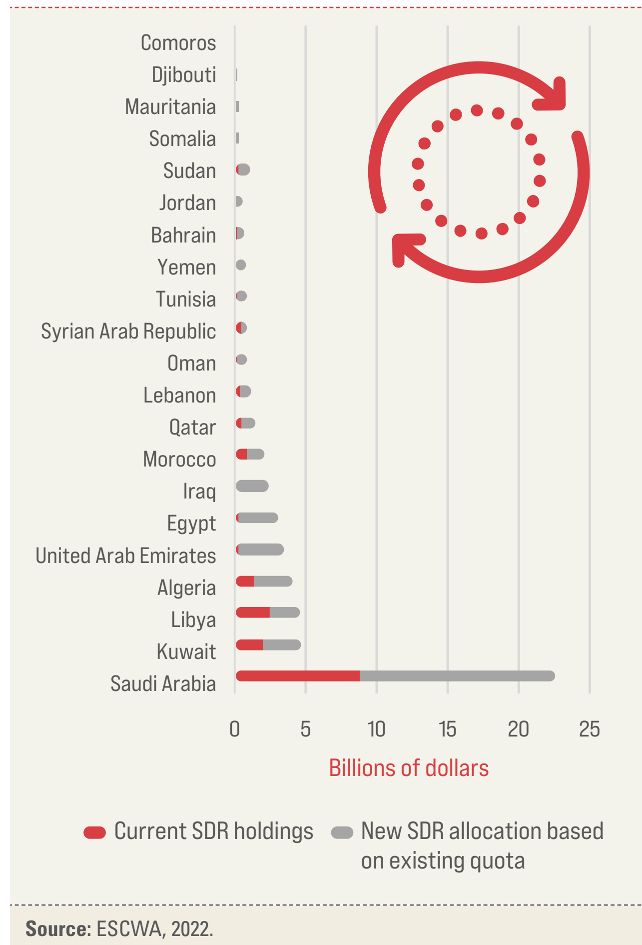


Source: United Nations, n.d. (data from 2020 through mid-2021).

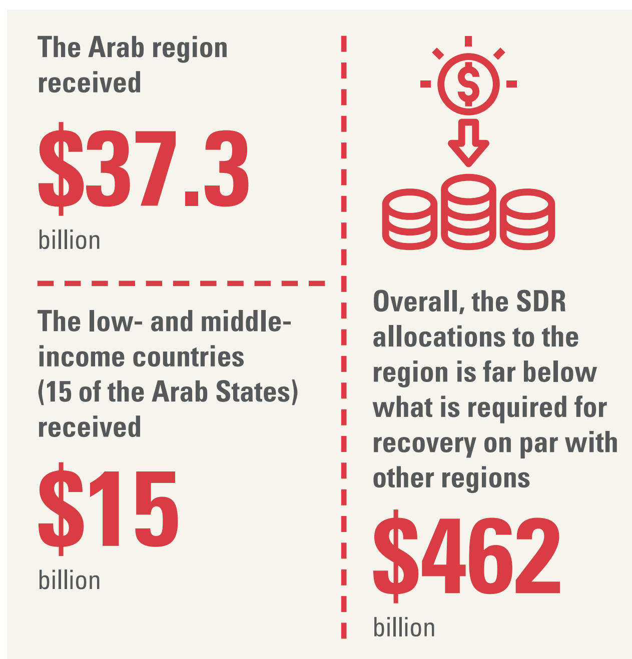
Of total global fiscal support of $18.7 trillion, Arab countries allocated only $94.8 billion, around 4 per cent of GDP in 2020, compared with a global average of 22 per cent (figure 90).[151] Governments provided support quite differently, largely in line with available fiscal space. Mauritania and the Sudan stand out among the least developed countries, where the fiscal response was otherwise marginal. Mauritania created a special $800 million fund for social solidarity, a large proportion of a stimulus that reached 11 per cent of GDP. The Sudan allocated significant fiscal and monetary resources to social safety net measures but mainly to shore up the health-care system.

The IMF's new issue of Special Drawing Rights is potentially a useful liquidity support measure, but it remains skewed towards high-income countries based on existing quotas for distribution. Out of $650 billion in total, the share of the Arab region was $37.3 billion, with the low- and middle-income countries (15 of the Arab States) receiving only about $15 billion (figure 91). Overall, the allocation to the region is far below what is required for recovery on par with other regions, an estimated $462 billion.

Figure 91. Current and new Special Drawing Rights do not meet recovery needs



Source: ESCWA, 2022.



These challenges are on top of those the region already faces in progressing towards the SDGs. The Arab Sustainable Development Report 2020[152] and the Arab Human Development Report 2022[153] showed uneven and worrying trends, with the region likely to fall short on many key indicators by 2030. It lags in addressing income poverty, gender equality, health-care coverage, social protection, peace and security, the sustainable management of natural resources, consumption and production, and climate change. The estimated $3.6 trillion that Arab countries need for achieving the 17 SDGs between 2018 and 2030 goes beyond their own means.[154] At the same time, the slowdown in economic activity has made financing more difficult on multiple fronts. External private financing fell by $700 billion in 2020 globally.[155] Declining official development assistance (ODA) is particularly concerning for the least developed countries, which rely on it for essential social services.

B. Fiscal strategies for enhancing social expenditure

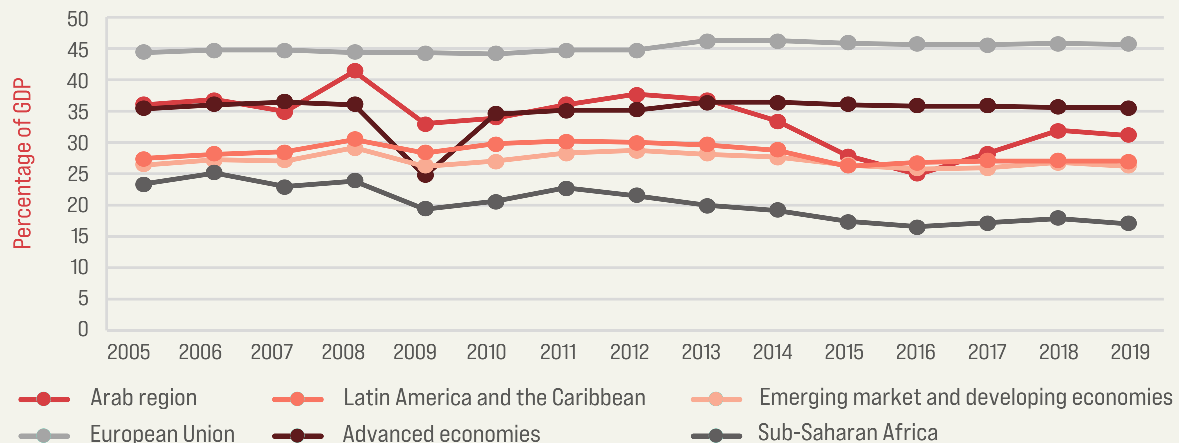
To secure adequate public finance and meet current needs, many Arab countries will need to turn to domestic revenue mobilization. This may entail improving tax collection, widening the tax base and/or enhancing tax progressivity. But it will not be sufficient given the scale of funds required. Debt relief and innovative financing solutions, including debt swaps, are other options to enlarge fiscal space in the immediate term. Fiscal space may also grow by stabilizing debt to GDP at a higher rate in the medium term, in line with a requirement for social investments that enhance human capital and GDP. Such a strategy can ensure both debt sustainability and higher output.

1. Total revenues vary widely across the region

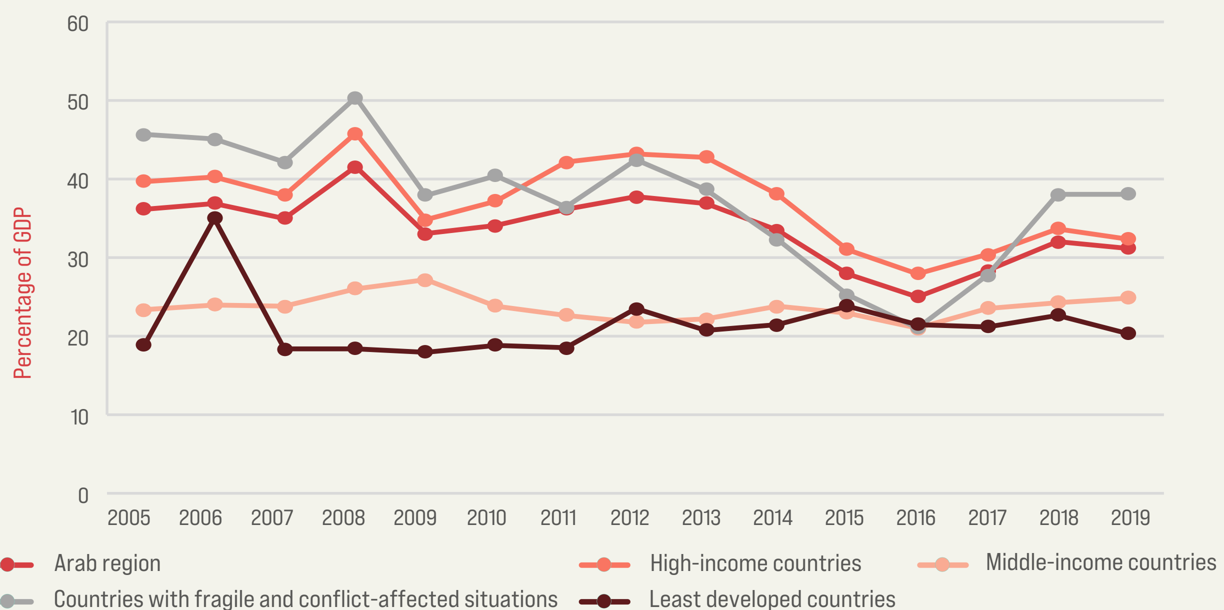
Public revenue as a share of GDP has dropped over time, from a peak of 42 per cent in 2008 to 31 per cent in 2019 (figure 92). Widely varying shares across countries track differences in natural resources and income. The share in middle-income countries was about 25 per cent, compared to 32 per cent in the high-income countries and 20 per cent in the least developed countries. The high-income country share fell from 46 per cent in 2008, a sharp decline that drove the regional trend and was strongly associated with changes in international oil prices.[156] Countries with fragile and conflict-affected situations, such as Iraq, Libya and Yemen, have experienced significant losses of revenues over the same period.

Figure 92. The region experienced downward trends in public revenues

(a) Total revenue across world regions



(b) Total revenue in the Arab region and subregions



Source: ESCWA, 2022.

Note: Regional and subregional aggregates are weighted averages. The averages exclude Somalia, the State of Palestine and the Syrian Arab Republic due to unavailable data. The classification of emerging market and developing economies follows that of the IMF World Economic Outlook.

Figure 93. Revenues as a percentage of GDP plunged during the pandemic: percentage point difference between 2019 and 2020

Source: ESCWA, 2022, based on World Economic Forecasting Model estimates, which may vary from actuals in some cases.

Public revenue in the middle-income countries, which rely mainly on taxation, has remained largely unchanged and below the 30 per cent average of emerging market and developing economies globally.

COVID-19 cost the Arab region nearly $150 billion in lost revenues. By 2020, the share of revenues to GDP had dropped to 27 per cent (figure 93). Downward pressure came in part from tax relief measures to relieve financial distress for individual taxpayers and businesses. These have included tax exemptions, deferment of tax collection and waivers or reductions of customs duties. Egypt increased personal deductions and reduced the tax burden on transactions executed on the Egyptian Stock Exchange, for example, towards promoting investment and stimulating economic activity. Morocco introduced tax exemptions for individuals who lost their jobs because of the crisis.

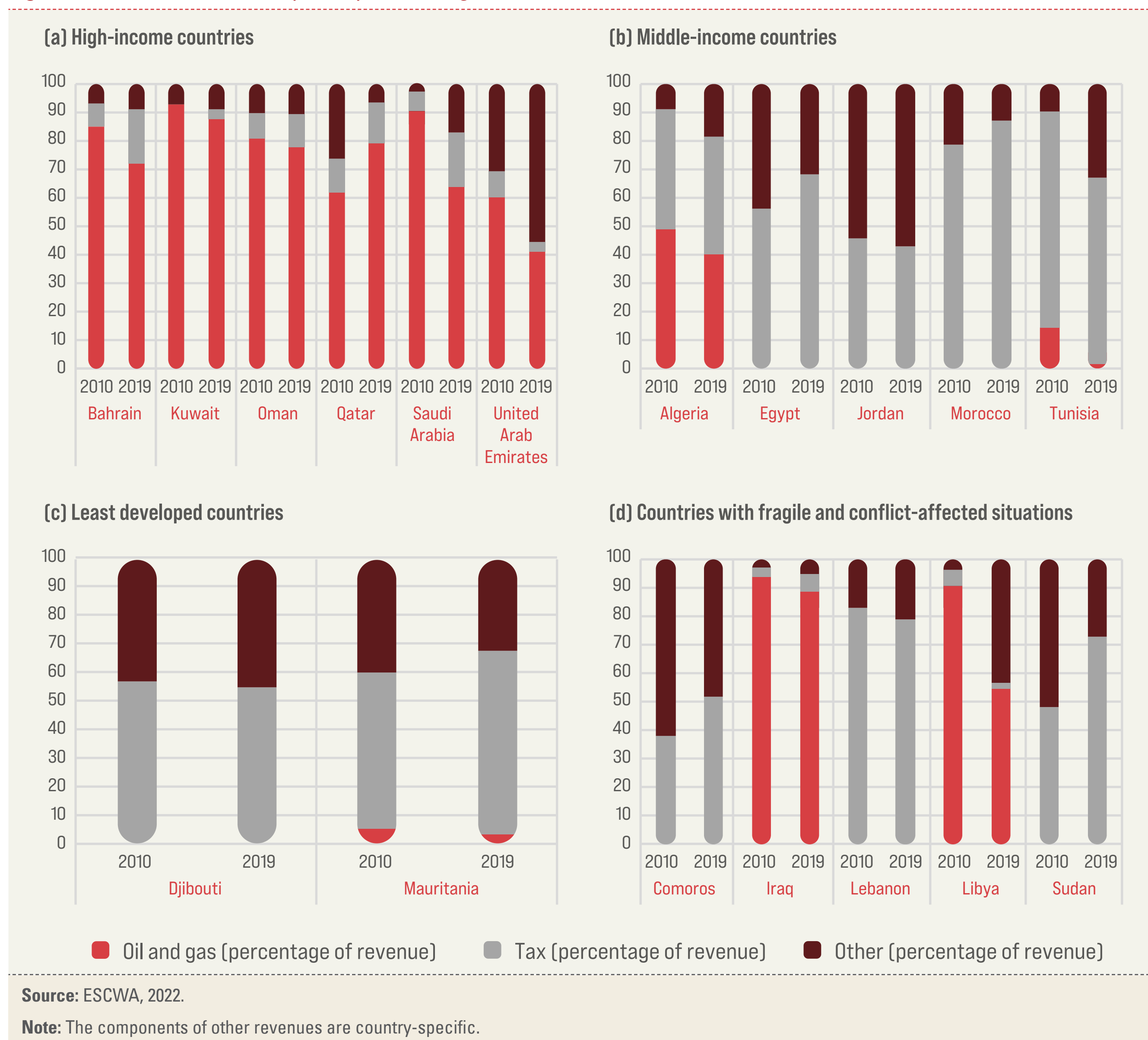
Revenue sources differ widely (figure 94). Oil and gas comprise the main share in GCC countries.

In recent years, tax revenues increased in several countries, including Bahrain, Kuwait, Oman, Qatar, and Saudi Arabia, which introduced value added or customs and excise taxes as oil revenues plummeted.

The middle-income countries depend mainly on taxes and excise duties for public revenues, except Algeria, which relies on oil. Morocco and Tunisia are relatively good performers in mobilizing more than three quarters of their revenues from taxes. In recent years, Egypt and Morocco have increased customs duties or used mechanisms such as privatizing public investments to boost revenues.

Taxes and foreign grants constitute major revenue sources for the least developed countries, although the share of taxes in total revenue increased from 2010-2019 in the Comoros, Mauritania and the Sudan. Among the conflict-affected countries, Iraq and Libya remain heavily dependent on oil revenues.

Figure 94. Revenue sources vary widely (Percentage of total)



Source: ESCWA, 2022.

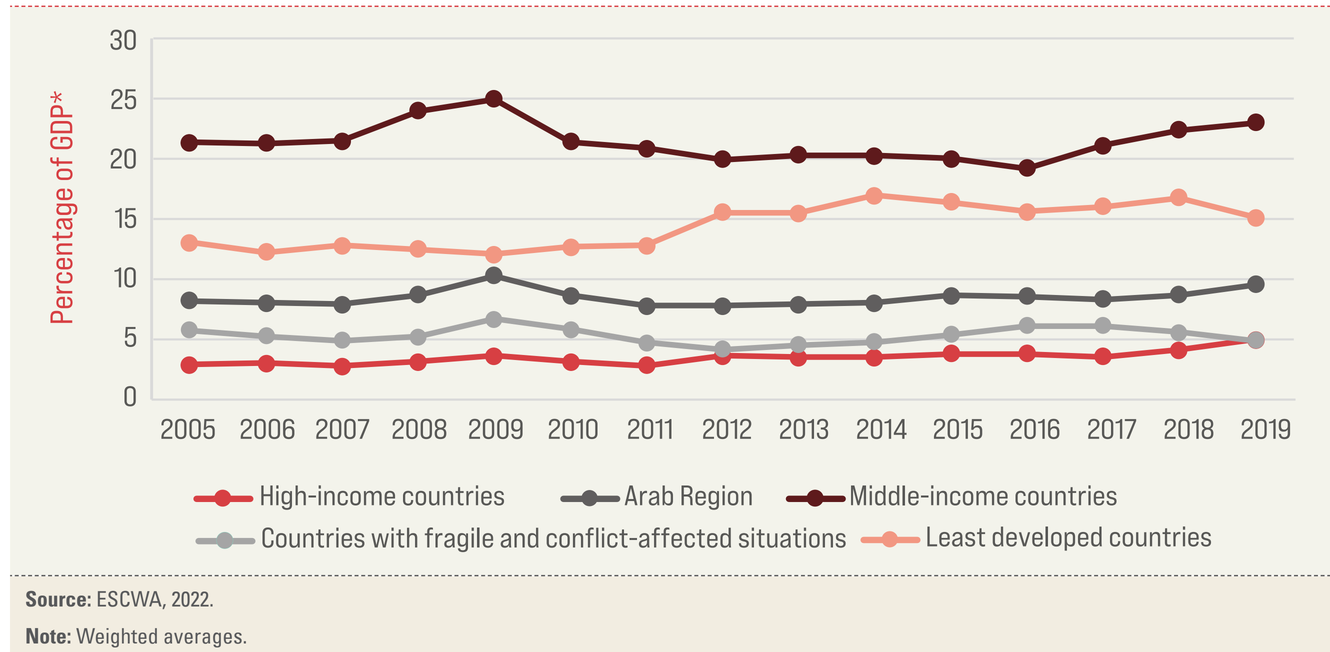
Note: The components of other revenues are country-specific.

2. Tax equity and efficiency need to improve

Improving tax revenues remains a challenge for most countries in the region. Total tax revenues in the region as a share of GDP have remained at around 8 per cent since 2010 (figure 95). The share in 2019 ranged from a low of 1 per cent in one oil-exporting country, the United Arab Emirates, to 25 per cent in one oil-importing middle-income country, Tunisia. Although middle-income countries depend mainly on taxes for public revenues, a steady decline in the taxes-to-GDP ratio between 2009 and 2016 has come from the global economic slowdown combined with conflicts in the region. Middle-income countries have introduced several reforms to increase tax revenues in the last five years, which explains a slightly increasing trend in taxes to GDP between 2016 and 2020. But the median ratio remains low, at around 16 per cent in 2019 compared to 25 per cent in the world's developed countries and around 18 per cent in the

world's middle-income countries.[157]

Figure 95. Improving tax revenues remains a challenge given a relatively stagnant share of GDP



Source: ESCWA, 2022.

Note: Weighted averages.

Figure 96. Personal and corporate income taxes are low in most middle-income countries (Percentage)

Source: ESCWA, 2022.

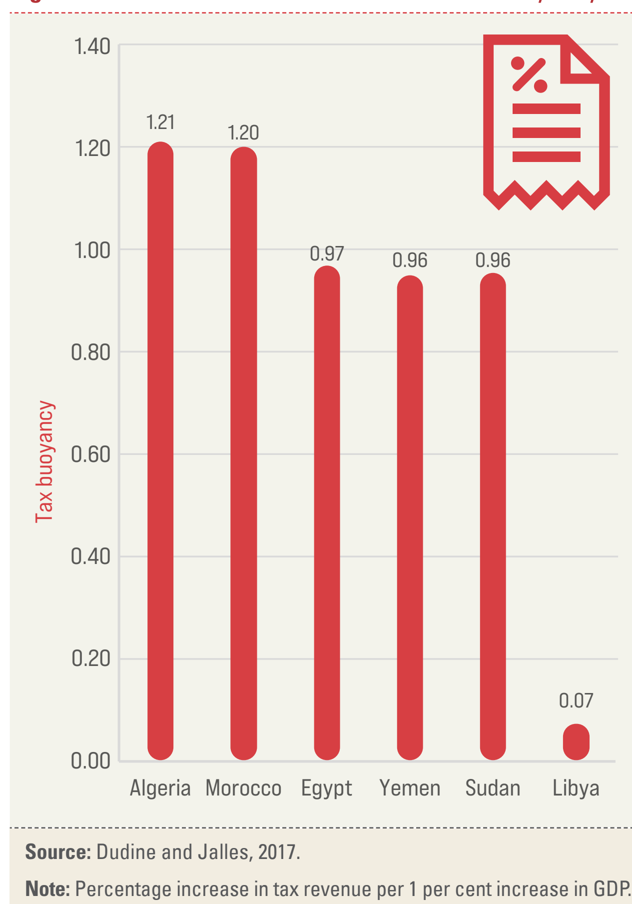
Note: For Tunisia, revenues from goods and services tax include revenues from value added taxes, consumption duties and other indirect taxes. The dark, green-dotted pattern includes goods and services, property and other taxes.

The high-income countries have not historically imposed taxes on individuals and goods and services, which explains their low tax-to-GDP ratio. Their tax systems mainly rely on corporate income taxes. Since the 2014 plunge in oil prices, they have increased their focus on fiscal policy reforms, mainly concentrating on introducing taxes on goods and services, such as value added and excise taxes, as part of efforts to diversify the revenue base and improve revenue collection. The low tax-to-GDP ratios of the least developed and conflict-affected countries reflect their development challenges.

Several tax reforms in the last decade have aimed to improve revenue mobilization but have not spurred the desired increase in public revenues. This is due, not least, to significant leakages that undermine the integrity of tax systems. Furthermore, reforms mostly fell short in improving tax equity and progressivity. The contribution of personal and corporate income taxes is low for most middle-income (figure 96) and least developed countries. Despite recent efforts to mobilize higher income tax revenues in several countries, the share of income tax in total taxes is generally 20 per cent at most. Tunisia is an exception with a share of around 30 per cent in 2019. Wealth taxes constitute a negligible part of total tax revenue despite the region’s high concentration of wealth among the top 1 per cent of people.[158]

The high share of taxes drawn from goods and services indicates the regressive nature of tax systems, since the burden of indirect taxes falls more on the poor and the middle class than the rich.[159] The recent introduction of value added taxes is also problematic as multiple tax exemptions and rates typically reduce equity and again are felt more by the poor and middle class.[160] The rationale for exemptions is often unclear and unfair, such as when tax exemptions are granted for luxury items only consumed by the wealthy.

Figure 97. Most Arab countries suffer low tax buoyancy



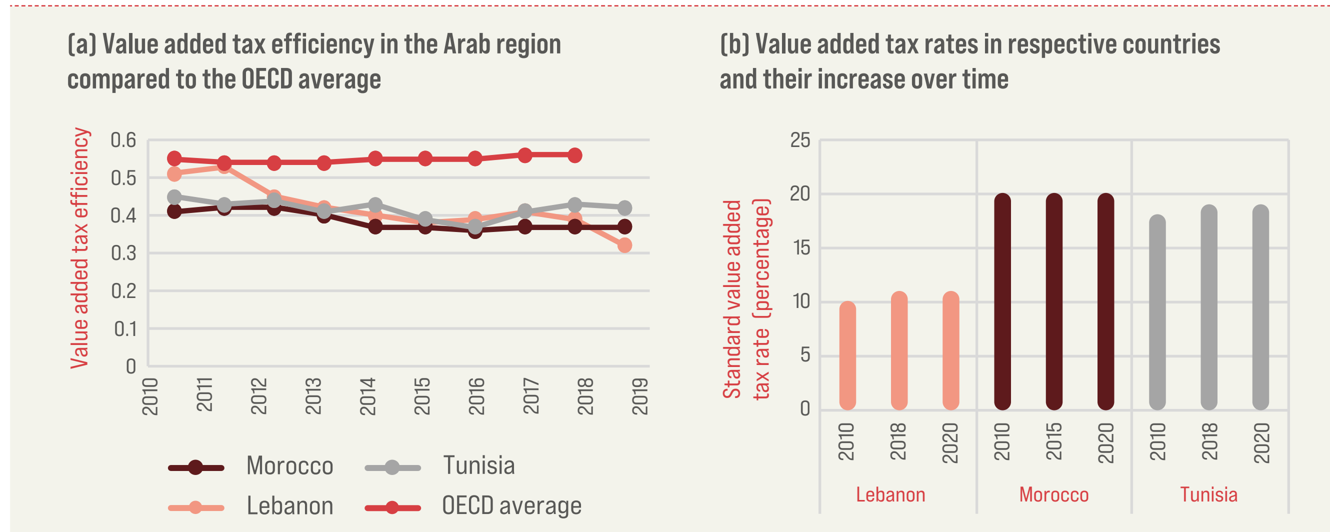
Source: Dudine and Jalles, 2017.

Note: Percentage increase in tax revenue per 1 per cent increase in GDP.

Outside Algeria and Morocco, most Arab countries still suffer from low tax buoyancy as GDP growth does not trigger a proportional rise in tax revenues. Weak tax administration and leakages explain this performance. While it is typical in settings where large parts of the economy are informal, much of the tax loss comes from high-net-worth individuals and hard-to-tax professional services (figure 97).

Despite reforms, value added tax efficiency remains low in the region, varying between 0.32 and 0.42, compared to global benchmarks such as the Organisation for Economic Co-operation and Development (OECD) average of 0.55. And efficiency is declining for most Arab countries, even those that increased value added tax rates, such as Lebanon and Tunisia (figure 98). In this context, revenue reforms should target tax leakages and tax system efficiency to improve revenue mobilization and open fiscal space.

Figure 98. Higher value added tax rates are not enough to improve tax efficiency



Source: ESCWA, 2022, based on data from ministries of finance of respective countries, IMF and OECD.

Note: The value added tax efficiency represents the ratio between collection measured as a percentage of GDP and the tax rate.

3. Official development assistance commitments must be met

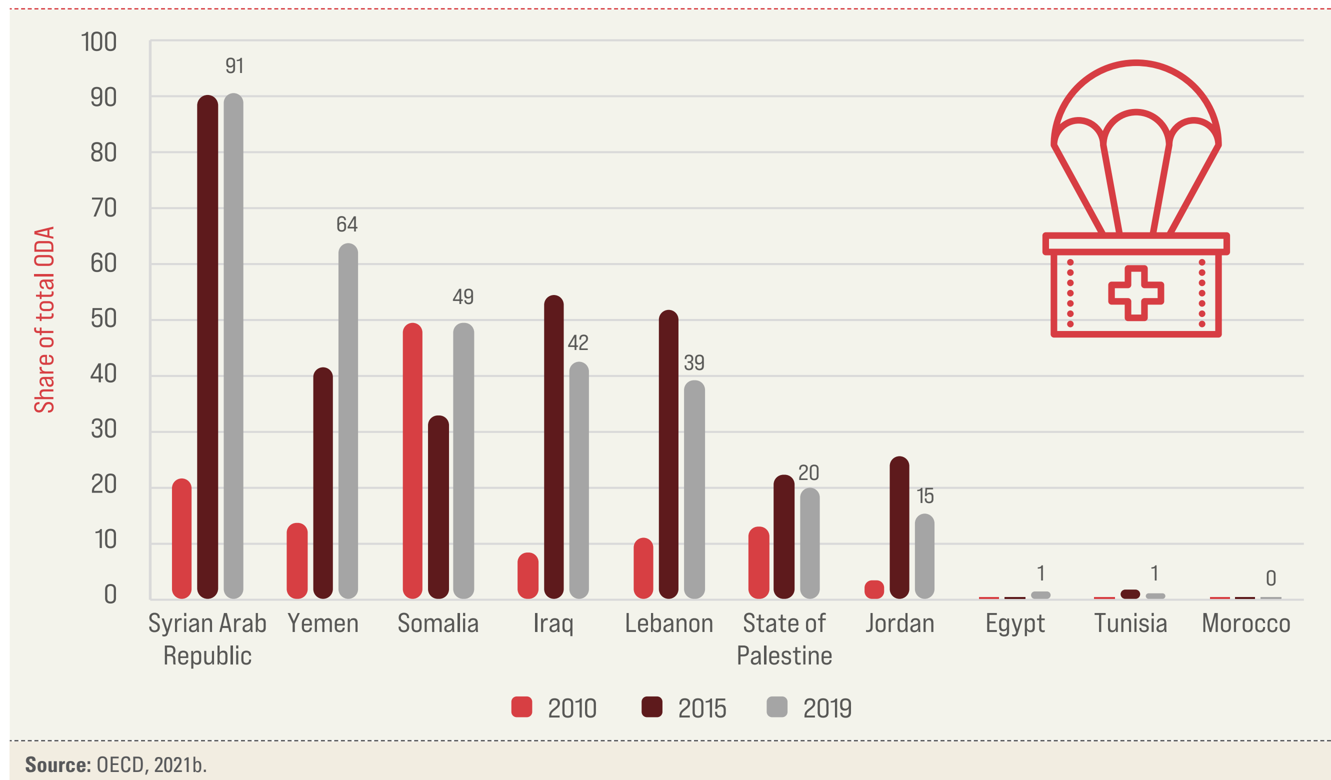
ODA is critical in realizing several SDG targets. The ODA to Arab countries has steadily increased since 2011, following sharp declines during 2008-2010. In 2019, total ODA to the region was $33.9 billion, approximately 10 per cent below 2018, the peak within the past decade. Of the ODA provided by all sources to developing countries in 2019, 17.6 per cent went to Arab States.

Increasing ODA to the region is largely influenced by in-country "refugee" costs and humanitarian aid (figure 99). About 90 per cent of ODA to the Syrian Arab Republic in 2019 was humanitarian aid. Among the least developed countries, Somalia and Yemen received a higher ODA inflow in the past five years, largely from humanitarian aid. In contrast, ODA to the Sudan declined significantly. Flows to middle-income countries, including Egypt, Jordan, Morocco, and Tunisia, appear to have increased during the past decade but remained volatile, fluctuating year to year.

This inconsistency remains problematic, coming alongside the failure of developed countries to keep their commitment to disburse 0.7 per cent of gross national income as ODA to developing countries. Other concerns centre on the low shares provided to essential services integral to realizing human rights. The share of ODA for education has declined, to about 7 per cent in 2019. The shares for health and water and sanitation remained neglible at 3 per cent and 4 per cent, respectively, in 2019. Together, water and sanitation, education, health, and commodity aid accounted for only 21 per cent of total ODA in 2019. The share for the production sector has contracted (figure 100). Significant resources are needed in all of these sectors to improve the quality and accessibility of public services, towards making societies more inclusive and sustainable.[161]

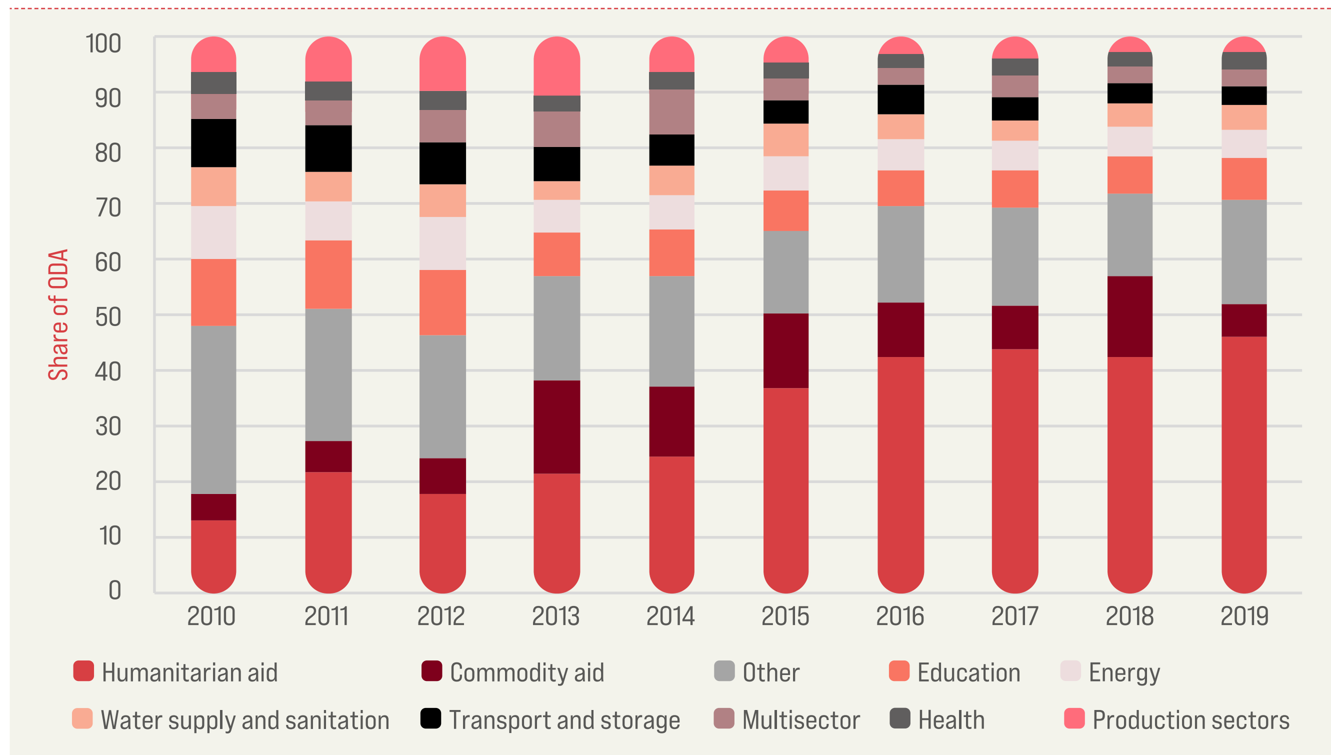
Together, water and sanitation, education, health, and commodity aid accounted for only 21 per cent of total ODA in 2019.

Figure 99. Increasing ODA to the region largely goes to humanitarian aid: ODA going to humanitarian aid (Percentage)



Source: OECD, 2021b.

Figure 100. Low shares of ODA fund services integral to human rights: share of total ODA (Percentage)

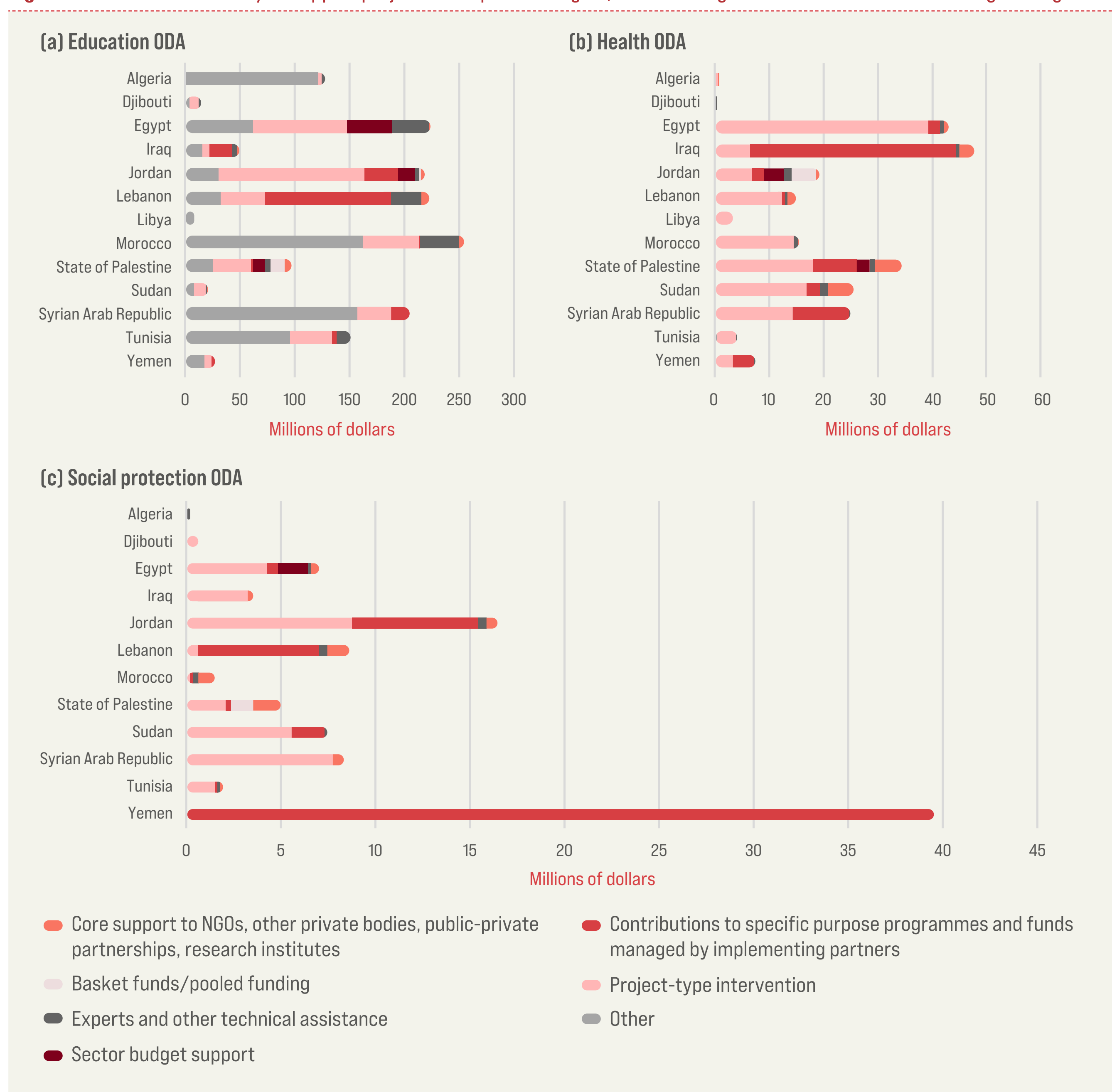


Source: OECD, 2021b.

Note: The other category includes unallocated or unspecified aid, government and civil society, banking and finance, and other social infrastructure and services, among other categories.

The share of ODA allocated "on-budget" or directly to recipient Government social sector budgets remains very low, despite the fact that a single revenue pool is vital for a coordinated national funding strategy (figure 101). Governments also need relative autonomy in deciding how and where finance is used. In 2019, only Egypt, Jordan and the State of Palestine received on-budget ODA for education, health and/or social protection. On-budget flows for education reached just over 4 per cent of the education total for the region, with Egypt at 18 per cent, the State of Palestine at 10 per cent and Jordan at 7 per cent. On-budget health ODA amounted to a mere 2.6 per cent of the total, with Jordan and the State of Palestine at approximately 20 and 6.5 per cent, respectively. Only Egypt received on-budget funding for social protection at approximately 20 per cent of ODA in this area.

Figure 101. ODA is more likely to support projects than public budgets, undercutting coordinated national financing strategies



Source: OECD, 2019a.

4. Swapping debt for more fiscal space

High debt burdens and insufficient finance in many Arab countries not only limit inclusive recovery from the pandemic but also could lead to deep and long-term social and economic scarring. Weak fiscal positions also severely constrain abilities to manage growing climate challenges and a green transition. Debt relief through innovative financial instruments, such as debt swaps, is one promising avenue to create fiscal space for investment in a sustainable, inclusive and green recovery.

The G20's Debt Service Suspension Initiative (DSSI) and subsequent establishment of the Common Framework on Debt Treatments Beyond the DSSI are important initial steps towards debt relief and increased fiscal space in many vulnerable countries. But middle-income countries with high debt burdens are not eligible for these. Further, no clear incentive or mechanism exists to encourage or compel private creditors to participate in debt relief. More comprehensive relief is needed, encompassing a wider group of countries and circle of creditors, particularly given the urgent need to finance recovery, the SDGs and climate action (box 6).

Climate and SDG debt swaps can provide debt relief and fiscal space for social and climate aims, especially for countries where debt burdens are high but have not yet become unsustainable. In 2020, the United Nations High-level Meeting on Financing for Development highlighted debt swaps,[162] which have historically been used for social or environmental objectives. Official creditors may cancel debt under such arrangements. If private creditors are involved, grant funding is used to purchase commercial debt in the market, where it is generally traded at a discount. Both cases involve using resources freed by debt relief to invest in agreed priorities.

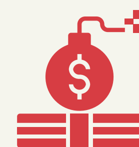
At the 2021 global climate talks, developed countries reiterated a commitment to improve climate finance for developing countries and reach a $100 billion annual target. The Arab region, however, receives climate finance mostly through external debt instruments, which exceed grant finance by a factor of 8.5.[163] Any new borrowing will add to the already heavy debt service burden, with risks amplified by the sharply increasing share of external debt held by the private sector.[164] New financing instruments need to be innovative because new debt is now a less viable option. Solutions to debt sustainability also require working out improved debt management strategies.

In 2020, ESCWA launched the Climate/SDGs Debt Swap–Donor Nexus Initiative to assist countries in improving fiscal space for financing the SDGs and climate action while reducing their debt burdens.[165] This initiative and the UNDP work in related field to improve SDG finance[166] create a next-generation debt swap instrument that considers the scalability of the swap amount, donor support and key performance indictors to maximize impact. They address the limitations of traditional swaps that were mainly implemented ad hoc with a marginal impact on development objectives.[167]

Swaps offer significant opportunity for middle-income Arab States, where external debt servicing consumes about $20 billion of their expenditures, equivalent to 11 per cent of their export earnings or nearly double the global middle-income country average.[168] Furthermore, climate finance in Arab countries lags the volume of other regions, particularly in water and agriculture where adaptation needs are greatest. Moving forward, success of the debt swap initiative will depend on developed country action on climate finance pledges to developing countries.

ESCWA launched the Climate/SDGs Debt Swap–Donor Nexus Initiative to assist countries in improving fiscal space

for financing the SDGs and climate action



while reducing their debt burdens

Box 6. Improving the management of debt and debt relief

Medium-term debt-stabilizing scenarios are important in countries still within the bounds of sustainable debt. They are not permanent solutions for countries staggering under high debt burdens. Adopting austerity measures and fiscal consolidation are not solutions either, given recovery needs. In these cases, debt restructuring is an alternative.[a] Following standard principles,[b] this requires agreement by the debtor and its creditors and carries potential sovereign credit rating risks. It also takes time to work out debt restructuring arrangements, which often makes this option difficult for debtor countries. The process has only become more complicated with the increasing share of private creditors in sovereign debt.

The United Nations Secretary-General has called on the international community to consider debt relief initiatives that build on and complement the G20 Common Framework for Debt Treatment.[c] The focus would be twofold: debt management combined with debt relief mechanisms for freeing resources for investment in more inclusive and sustainable societies. Developed countries can draw on existing initiatives, such as the United Nations Basic Principles on Sovereign Debt Restructurings and the G20 Common Framework. Establishing a multilateral sovereign debt forum would foster greater coordination among creditors and debtors, back sustainable sovereign debt resolution and link debt relief to SDG financing.[d]

[a] Stiglitz and Rashid, 2020. [b] United Nations, 2015. [c] United Nations, 2020b. [d] ESCWA, 2021a.

5. Mobilizing debt finance through debt-to-GDP stabilization

Reducing the ratio of debt to GDP is an important challenge for several Arab middle-income countries facing urgent needs to recover and invest in the SDGs. Even where debt burdens are high, however, additional debt finance may be necessary. Monetary policy has a key role in influencing debt sustainability gaps based on an assessment of the difference between the actual primary balance and the required debt-stabilizing primary balance. For many countries in the region, the interest rate and growth differential are not favourable, implying adverse consequences of a debt rollover.[169] Governments can borrow more, and debt is more sustainable, if interest rates are low and economic growth is high.[170] While there is no suggested threshold for debt, Governments need to be mindful of additional interest burdens.

One option is a debt finance strategy to stabilize debt to GDP in the near to medium term to open fiscal space for public expenditure on recovery and the SDGs.[171] An accounting exercise can guide the adoption of a debt-to-GDP stabilizing threshold, either maintaining the current ratio or any change in that ratio. Such an exercise can thus estimate how much fiscal space can be released or generated through debt finance without affecting solvency.[172]

A debt-stabilizing threshold above the baseline target in nominal terms over the medium term would imply increased fiscal space through more debt finance. A critical issue is that the share of interest payments to revenue flows should remain at an acceptable level while additional finance should be channelled to investments that generate the greatest productivity and growth and improve revenues. Ideally, these principles should be reflected in any medium-term framework for expenditures and revenues.

One option is a debt finance strategy to stabilize debt to GDP in the near to medium term to open fiscal space for public expenditure on recovery and the SDGs.

C. One way forward: modelling debt stabilization in Tunisia

The following case study of Tunisia demonstrates how debt stabilization works. It applied a structural macroeconomic modelling and forecasting framework, based on the World Economic Forecasting Model, to assess the impact on macroeconomic performance.[173] While Tunisia is a leader among Arab middle-income countries in increasing taxes as a share of GDP and has potential to improve tax collection, it still suffers from underlying inefficiencies and leakages.[174] Debt financing through stabilizing the debt-to-GDP ratio is also a viable option.

Baseline forecasts until 2030 used actual data through 2020, including the deep contractionary effect on Tunisia's economy from COVID-19. However, the estimates were undertaken prior to the war in Ukraine and do not consider the effects of inflationary pressures and monetary tightening around the world. Growth declined to minus 7.2 per cent in 2020. Forecasts show the economy bouncing back by 5.3 per cent in 2021 and improving by 3.2 per cent in 2022[175] with subdued growth thereafter ranging between 1.5-2 per cent annually. The pandemic increased the fiscal deficit to minus 7.4 per cent of GDP in 2020, worsening the negative 3.9 per cent deficit in 2019. The fiscal deficit is expected to narrow slightly to negative 6.8 per cent in 2021 and gradually shrink to minus 2.4 per cent at the forecast horizon in 2030. The share of debt to GDP, having climbed to 83 per cent in 2020, is forecast to fall to 78 per cent by 2030.

Stabilizing debt at about 85 per cent until 2030 (Scenario 1), instead of reducing it to 78 per cent as implied in the baseline scenario, can generate additional fiscal space for government expenditure of 21.2 billion TD from 2022 to 2030. This scenario would push government expenditure above the baseline from 2025 onwards. GDP growth would be above the baseline by 0.2-0.4 per cent from 2025 onwards, with output higher than the baseline starting from 2025. Additional nominal GDP generated between 2022 and 2030 would amount to 14.1 billion TD.

Private consumption,[176] as a proxy for improving socioeconomic outcomes at the household level, would rise from 67.5 billion TD in 2022 to 75.8 billion TD in 2030 and remain above the baseline level from 2025-2030. The share of interest payments in total revenues would go up initially to over 15 per cent, as expected with higher debt levels, before declining to just above 14 per cent by 2030. This share is on the high side but within reasonable limits as it remains below 15 per cent of revenues.[177]

An alternative scenario entails improving fiscal space through debt financing and domestic resource mobilization, namely, by raising taxes by 1 per cent of GDP (Scenario 2). This would generate an additional 40.7 billion TD in fiscal space between 2022 and 2030, which is more than Scenario 1. Higher GDP growth in the first half of the projection interval would yield slightly better results in terms of output (nominal GDP) and private consumption. The current account would see a slight deterioration while the primary balance would be close to that of the debt financing solution in Scenario 1. Increased fiscal space would be directed towards government expenditure in general, which by default is mostly current expenditure, and not towards productive and social investments. This might explain why increased fiscal space would not translate into much improved growth or socioeconomic outcomes, as reflected by private consumption trends.

Two additional modifications to Scenario 2 produce a third scenario. The two modifications comprise additional fiscal space of 38.8 billion TD allocated specifically to social sectors such as education, health and housing according to their relative shares within total social spending, and a phased-in increase in total factor productivity of 4 per cent[178]

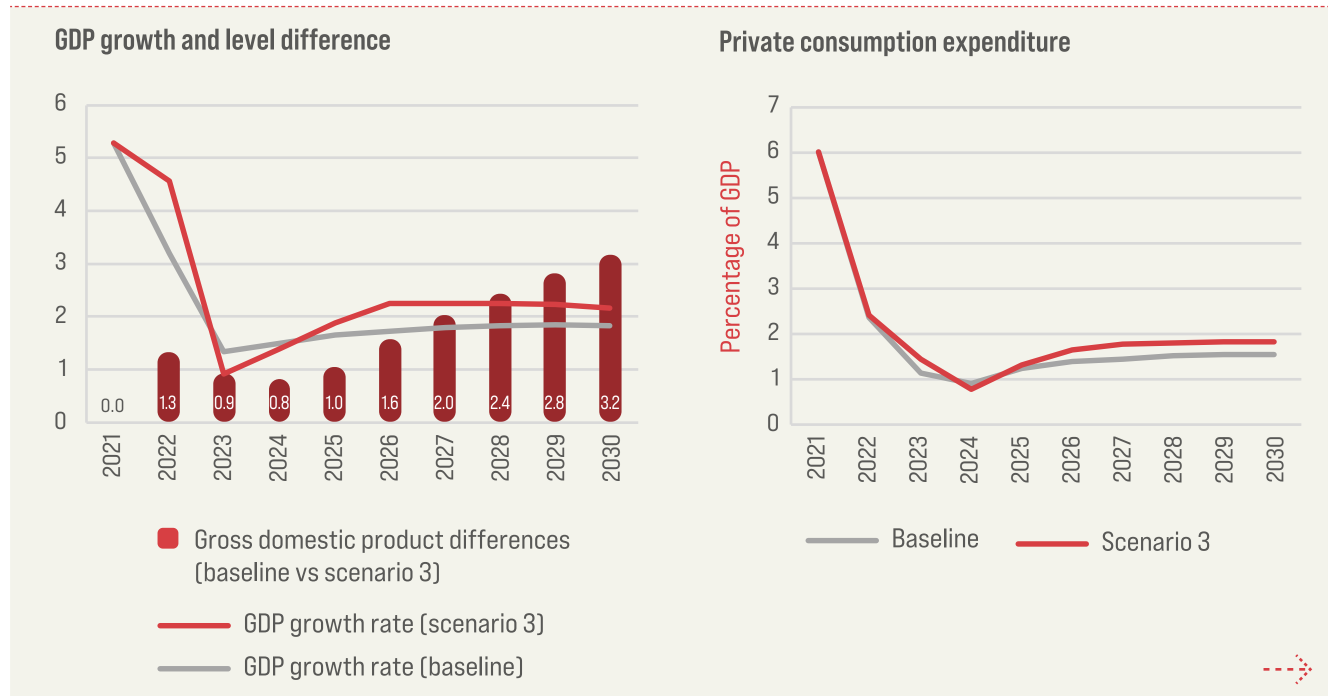
by 2030. Monetary policy intervention would be delayed, minimizing the adverse impact on the demand side. Additional fiscal space for government expenditure under Scenario 3 would amount to 42.2 billion TD from 2022 to 2030, an 8.3 per cent increase above the baseline, which compares to 8.0 per cent in Scenario 2 and 4.1 per cent in Scenario 1.

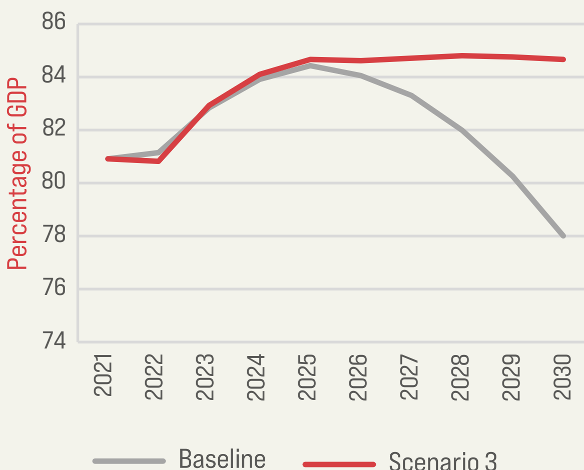
GDP growth under this scenario would remain similar to but slightly above the previous scenarios and more so above the baseline, stabilizing above 2 per cent. Output would remain above the baseline throughout the projection interval. A cumulative increase in nominal GDP of 29.2 billion TD would exceed previous scenarios. Private consumption would increase by 4.7 billion TD over the baseline between 2022 and 2030. This compares to approximately 2.3 billion TD under Scenarios 1 and 2, suggesting that Scenario 3 would be most effective in improving people's welfare. In short, Scenario 3 is the most efficient in increasing output and private consumption as well as maintaining macroeconomic stability with the share of interest payments in total revenues remaining at acceptable levels (figure 102).

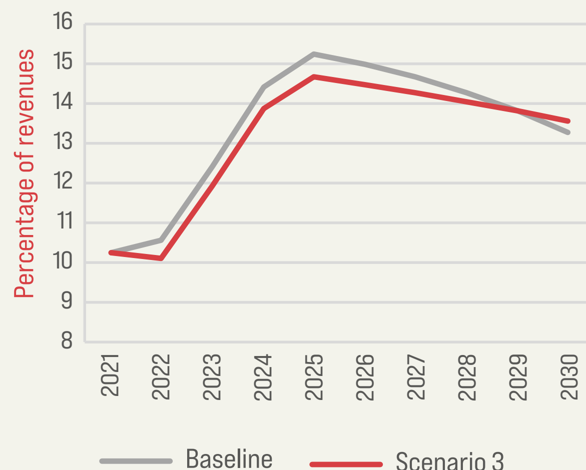
Increasing public expenditure is critical to building both human and physical capital stock and easing supply side constraints. This then drives growth, especially when the private sector is weak.

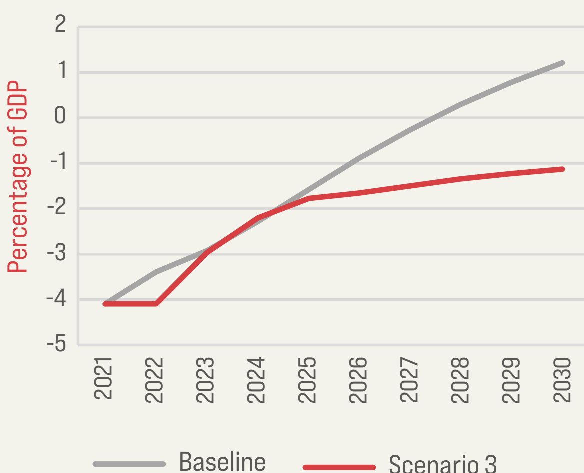
As the Tunisia case shows, increasing public expenditure is critical to building both human and physical capital stock and easing supply side constraints. This then drives growth, especially when the private sector is weak. While debt finance is important, it should be accompanied by a strategic fiscal policy for allocating funds efficiently and effectively to improve growth and achieve the SDGs.

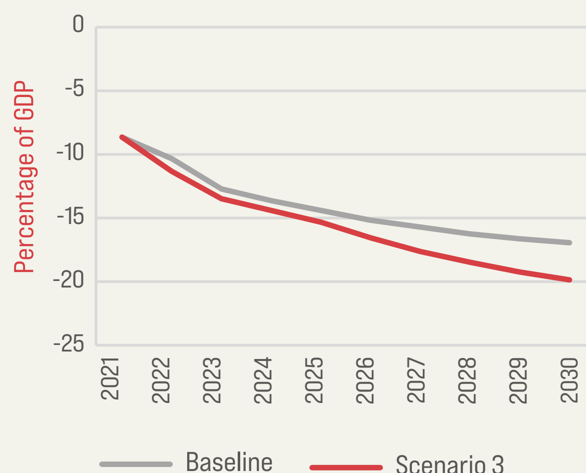
Figure 102. GDP growth and level differences











Source: Altshuler and Sarangi, 2021, simulations based on the World Economic Forecasting Model.

D. Managing for the future

On the heels of a turbulent decade in the Arab region, COVID-19 compounded challenges and hindered progress towards the SDGs. The pandemic erased $159 billion in GDP as regional debt rose to $1.4 trillion. With large fiscal shortfalls, the response to the crisis has been largely inadequate, leaving the region in a position of considering all options to enhance fiscal space.

Countries face increasing the efficiency, reach and equity of tax systems, considering that improving tax efficiency to the average OECD level would lead to a spike in revenues of as much as 45 per

cent in some cases. A wealth tax on the top ten percentile of the wealthiest people in the region could contribute to bridge the gap in finance for mitigating poverty caused by COVID-19 in low- and middle-income countries.[179] Much depends not just on tax reforms alone, however, but also on investing in quality public services that build trust and social cohesion and leave taxpayers at all levels of income willing to pay higher taxes.

One key to plugging gaps in fiscal stimulus packages for recovery and the SDGs is for developed countries to fulfil ODA commitments and climate pledges. Another is for IMF member States to channel unused Special Drawing Rights from advanced to developing countries based on indicators of vulnerabilities and needs, including in terms of trade and balance of payments imbalances, crises and financial shortfalls stalling recovery.

Innovative financing instruments such as debt swaps should be used to alleviate mounting pressures on public finance and release funds for the SDGs. Improved debt management practices could come from developing medium-term debt-stabilizing scenarios[180] that consider needs to finance the SDGs and boost economic growth. For countries on the brink of unsustainable debt, establishing a multilateral sovereign debt forum can help move creditors and debtors towards relief that promotes SDG financing.

All fiscal strategies discussed here lead in a common direction – towards more careful and comprehensive management of public resources that can be sustained for the long term. Only then can countries reach their most vulnerable citizens, uphold their social contracts and invest in a future that is more developed and just, realizing the vision of the SDGs.

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Endnotes

141 Sala-i-Martin, 1992; Atkinson, 1995; Filmer and Pritchett, 1999; Gupta, Verhoeven and Tiongson, 2003; Rajkumar and Swaroop, 2008; Khan and Bashar, 2015; among others.
142 Bellettini and Berti Ceroni, 2000; Baldacci and others, 2004; Sarangi and von Bonin, 2017; Haile and Niño-Zarazúa, 2018; Cammeraat, 2020.
143 United Nations, n.d.
144 The rate of growth and fiscal forecasts may vary by different estimates. For instance, according to IMF estimates, the rate of growth for the Arab region was -4.4 between 2019 and 2020 (IMF, 2022).
145 United Nations, 2020a.
146 Classification of country groups: High-income countries are the GCC countries, which include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates; middle-income countries include Algeria, Egypt, Jordan, Lebanon, Morocco, and Tunisia; conflict-affected countries are Iraq, Libya, the State of Palestine, the Syrian Arab Republic, and Yemen; the least developed countries are the Comoros, Djibouti, Mauritania, Somalia, and the Sudan. See ESCWA, 2022.
147 ESCWA, 2022.
148 World Bank, 2021d.
149 IMF financial assistance for emerging and advanced market economies comprises stand-by arrangements to address short-term or potential balance-of-payments problems; the Extended Fund Facility as medium-term support to countries facing protracted balance-of-payments problems because of structural weaknesses that require time to address; and the Rapid Financing Instrument to provide rapid assistance to countries with urgent balance-of-payments need to cope with shocks (see IMF, 2021b).
150 Sarangi, 2020; UNDP, 2020a.
151 United Nations, 2021a.
152 ESCWA, 2020a.
153 UNDP, 2022.
154 ESCWA, 2017c.
155 OECD, 2021b.
156 Sarangi, 2020.
157 United Nations, 2021b.
158 Alvaredo, Assouad and Piketty, 2018b.
159 Sarangi, Bhanumurthy and Abu-Ismail, 2015.
160 ESCWA, 2019a.
161 Sarangi and von Bonin, 2017.
162 United Nations, 2020a.
163 Sarangi and Griswold, 2020.
164 Sarangi, 2020; UNDP, 2020a.
165 Ibid.
166 UNDP Sustainable Finance Hub, n.d.
167 Sarangi and Griswold, 2020.
168 ESCWA, 2021a.
169 Sarangi, 2020.
170 Blanchard, 2019.
171 Sarangi, 2020; ESCWA, 2020a.
172 The stabilizing debt-to-GDP solution would not work in a case where debt is unsustainable and the default risk is high or a default has already occurred. In such cases, the approach is to restructure debt. See Stiglitz and Rashid, 2020.
173 See the detailed methodology in Altshuler and Sarangi, 2021.
174 ESCWA, 2017a.
175 In October 2021, the IMF published its latest version of the World Economic Outlook together with an updated database and figures for Tunisia. The current exercise does not consider the revised data; however, the intuition behind the results remains applicable.
176 The scenarios do not take into consideration any change of consumption pattern in imports of goods due to switching expenditures more to the social sectors (import elasticities are assumed to be same as before).
177 The interest payment to revenues ratio for developing countries of Latin America, on average, is around 15 per cent; this ratio is between 15-20 per cent for South Asia. The global average of interest payments to revenues was around 8 per cent in 2018. Therefore, the ratio of interest payment to revenues at around 15 per cent is high but reasonable for developing countries.
178 The increase in total factor productivity is based on the 10-year global average increase in productivity as a bare minimum achievement.
179 ESCWA, 2020b; 2020e.
180 Sarangi, 2020.

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