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Fiscal Policy in Emerging Markets – Successes and Challenges

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After the outbreak of the global financial crisis, not only the recession-hit advanced economies but also many emerging markets launched fiscal policy stimulus programmes. They could afford this because they had considerably consolidated their public budgets in the previous boom years. But whether the emerging markets' economic stimulus programmes are worthy of the high praise they received appears doubtful. Moreover, the debt indicators, most of which are comparatively positive, obscure the emerging markets' profound need to reform their fiscal policies, which should be addressed urgently to achieve economic, social and ecological objectives.

The emerging markets have had higher economic growth than the advanced economies for quite some time now. In particular, they have been significantly bolstering the global economy since the outbreak of the 2008 global financial crisis. But the crisis impacted the emerging markets as well, and their growth weakened. In accordance with the strategy agreed within the G20, the emerging markets then also launched their own fiscal economic stimulus programmes. They received much praise for this and were told that they lived up to their global economic responsibility by taking these measures. In addition, it is being noted with relief that the emerging markets have by no means used up all their ammunition but can fire another round if necessary. Nevertheless, not all that glitters is gold in the emerging markets' fiscal policy; a closer analysis paints a very nuanced picture.

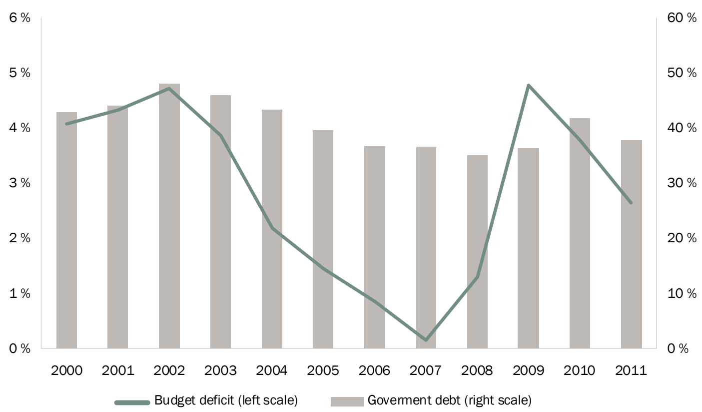
This survey reviews the emerging markets represented in the G20: Argentina, Brazil, Mexico, China, India, Indonesia, Russia, South Africa and Turkey. On the one hand, these countries have clearly consolidated their public budgets in the last decade, which is a welcome achievement. On the other hand, their economic stimulus programmes raise many questions, and fundamental fiscal policy distortions continue to exist there. These include not only various inefficiencies on the revenues and expenditure sides of the budget, but a continuing need for consolidation.

Consolidation successes before the outbreak of the global financial crisis

In the years after 2000, the budget deficits of these emerging markets had initially increased. The average overall fiscal deficit, weighted against GDP, increased to 4.7 % by 2002. Thereafter, budget deficits continually declined to nearly zero in 2007 (see Chart 1). The increase in the first phase was mainly due to Argentina and Turkey, which were in a severe recession. The budget deficit subsequently decreased in these countries as well. China, Indonesia, Russia and South Africa at times even achieved budget surpluses up to 2007. Cumulative government debt developed in a similar way. By 2002 it increased to 48 % of GDP and then gradually fell to 37 % in 2007 (see Chart 1).

Compared with the debt problems many advanced economies are grappling with today, these figures seem impressive. However, they should not be prejudged as expressing a consistent consolidation policy. From 2000/2002, consolidation was indeed an economic policy objective. The governments of India, Brazil and Mexico committed themselves to this objective with a fiscal responsibility law, Turkey under the IMF rescue package and the other countries through general declarations. Nevertheless, consolidation did not occupy a prominent place in the political agenda. The economic boom significantly facilitated the reduction of the budget deficit – with cumulative real GDP of the nine emerging markets growing by 93 % between 2000 and 2007. Consequently, the consolidation was not achieved by strict spending controls or an austerity policy (on the contrary, state expenditure actually rose sharply) but by a disproportionate increase in state revenue. The weighted average revenue-to-GDP ratio increased steadily from less than 20 % in

Chart 1: Budget deficit and general government debt of the nine emerging markets a)



a) In per cent of GDP, weighted average (weighted against GDP of 2011). Figures apply to the state as a whole (central government, territorial authorities and social protection system) where data are available.

Source: IMF

2000 to almost 25 % in 2007. But with this the emerging markets remain far behind the industrialised states (37 %); the question being debated in certain advanced economies of whether the government is suffocating the economy with excessively high levies is of less relevance.

The architecture of the 2008/09 stimulus programmes

In autumn of 2008 the G20 had agreed on an anti-cyclical fiscal policy as a response to the global financial crisis, and this economic policy stance was also endorsed by the IMF, for example. As a result, all emerging markets reviewed with the exception of Argentina designed similar packages of measures: higher government spending (investment, social sector, subsidies); lower revenues (turnover and corporate tax rates); advice to state-owned banks and industrial enterprises to increase their lending and investment; and prime lending rate cuts and other expansive monetary policy measures by the central banks. No precise data are available on the volumes of these stimulus programmes. As well, it is hardly possible to quantify them because in times of economic decline budget deficits occur not only through active economic policy but also through the effects of automatic stabilisers. The Chinese government claimed to have launched the biggest programme; at the end of 2008 it presented a package of measures worth USD 586 billion, or 12.8% of GDP.

Chart 1 shows that against this background a trend reversal began in the fiscal indicators of the emerging markets in 2008/09, and budget deficits and government debt increased again significantly. Both indicators subsequently improved again, but high economic growth was the decisive factor here yet again. The IMF evaluates the fiscal outlook of each country in its periodic Debt Sustainability Analysis. It has determined that current government debt can be rated sustainably viable in virtually all emerging markets. In India, however, the debt situation is indeed critical, with a budget deficit of 8.7 % and government debt of 68 % in 2011, both in relation to GDP.

Fiscal economic stimulation is questionable

The emerging markets received much recognition for their economic stimulus programmes. The rest of the world was relieved that the emerging markets were prepared to help stabilise the world economy. One of the reasons for this praise was that the emerging markets had become important sales markets for the advanced economies. These countries also hoped that the emerging markets' economic stimulus programmes would secure their exports. Impacts of this kind are likely to have occurred but probably to a modest degree only. The fact is that many of the programme measures mentioned hardly have an impact on demand for imports.

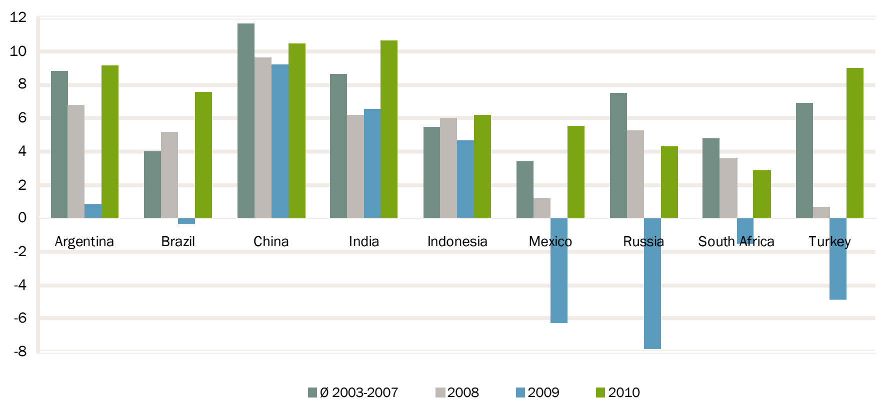
It is surprising that the stimulus programmes received such strong approval because the question arises whether the emerging markets had any need for fiscal economic stimulus at all in 2008. The economic policy recipe agreed at the G20 level constitutes a renaissance of Keynesian global control. It claims that the state must control economic activity by providing growth impetus through deficit spending during a downturn, while dampening overall economic demand by generating a budget surplus during a boom phase. Up until the outbreak of the global crisis, all of the emerging markets reviewed had experienced an economic boom. Their average annual GDP growth between 2003 and 2007 was between 3.4 % (Mexico) and 11.7 % (China) (see Chart 2). As described, they were right to use this boom phase to consolidate their national budgets. However, in 2008 growth slowed but remained positive in all countries, even remaining at a high level in seven of the nine countries. It is also noteworthy that in late 2008 the IMF and other institutions still forecast positive growth rates across the board for the subsequent years 2009 and 2010 with the exception of Mexico, for which the forecast for 2009 was -0.2 %. Departing from the consolidation course thus appears questionable.

However, it could be argued that the way the economy actually developed from the end of 2008 justified deficit spending after all. In fact, in 2009 the GDP of Brazil and South Africa contracted slightly and that of Turkey, Mexico and Russia fell significantly. There may have been a reasonable case for the government to stimulate demand here. What is also true, however, is that these countries were already back on a path of impressively high growth in 2010. This indicates that these countries possess high internal growth potential which would have enabled them to overcome the crisis even without an economic stimulus programme. This applies to China, India and Indonesia in particular. Even during the global crisis year of 2009, these countries maintained their growth dynamism and, although the pace of growth there slowed somewhat, it already accelerated again noticeably in 2010.

Doubts about the programme volume

Evidently, many governments succumbed to the temptation to try to increase the approval of their policies by reporting as comprehensive a programme as possible. However, a considerable portion of the programme measures had probably been planned anyway. For example, the Chinese government quantified its programme at 12.8 % of GDP (USD 586 billion), but this figure does not align with the claim that the budget balance changed merely from -0.4 % of GDP in 2008 to -3.1 % in 2009. If

Chart 2: Real GDP growth



Source: IMF

we look at how public spending at central and lower government levels changed and assume that the Chinese stimulus programme was implemented in 2009 and 2010, these doubts become more compelling. Combined government expenditure in these two years increased by only USD 433 billion. Besides, at best, this growth can be attributed only in part to the economic stimulus programme. Specifically, if we assume that without the stimulus programme expenditure would have increased at the average rate of the pre-crisis years of 2000-07, a difference of only around USD 130 billion remains, that is, only around one fifth of the USD 586 billion reported. The renowned Economist Intelligence Unit goes even one step further and quantifies the actual economic stimulus at only around 15 % of the volume reported.

Further points of criticism

The scepticism in regard to the allegedly beneficial impacts of the stimulus programmes on the emerging markets is also based on three aspects. First, the implementation of the programmes has often been criticised as very sluggish. Particularly for infrastructure investment, this can be of no surprise because planning and implementation in this area is very time-consuming. But as a result, the stimulus for the economy sets in late. Since the emerging markets only experienced a brief economic downturn, as shown above, this aspect is of particular relevance. This time lag problem is known to be one of the central weaknesses of Keynesian anti-cyclical global management.

Second, it can be assumed that in the 2008 economic environment outlined, in the emerging markets public demand crowded out private demand. It is true that the countries were able to use budget surpluses formed earlier to finance part of their stimulus programmes; that is, they were not forced to tap the capital market for all their borrowing needs. Likewise, it can be assumed that production capacities were not fully utilised. Nevertheless, it is likely that in infrastructure investment in particular the state ended up competing with private investors for the scarce capacities of the booming construction industry. Thus, the governments were probably only partly successful in stimulating the economy with their programmes.

Third, we see confirmation that it is very difficult to take back benefits once granted even though the basis for them no longer exists. For example, the economy in India is stubbornly holding onto the tax concessions adopted in 2008/09 and the government is unable to assert itself against this even though the IMF, for instance, criticises it severely.

Positive rating only from the aspect of economic psychology

It must be conceded, however, that the economic stimulus programmes of the emerging markets remained within the mainstream of the G20 strategy. It explicitly included a (psychologically) positive economic policy signal, namely to not repeat the errors of the global economic crisis of the 1930s by imposing a strict austerity policy. For the emerging markets this aspect is likely to be far less relevant than for the advanced economies in which the global financial crisis began. From the viewpoint of the emerging markets, the phase of expansive fiscal policy after autumn 2008 is to be rated as time largely lost on the way towards budget consolidation.

Need for fiscal policy reform

Several problem areas exist on both the state revenue side and the expenditure side of the emerging markets' national budgets that require a fiscal policy realignment. The following exposition is not meant to be exhaustive but focuses on the most important aspects.

Revenues side: untapped potential and weak tax system

With respect to state revenues, the continuing wide gap between the revenues/GDP ratio of advanced economies (37 % in 2011) and that of emerging markets (25 %) has already been mentioned. It is impossible to define what is a macroeconomically "appropriate" government expenditure rate, so the advanced economies do not have to be the absolute benchmark. But the comparison is at least an initial indication that untapped potential for government revenues still exists in emerging markets. An analysis of the various types of revenues in the two country groups reveals extreme differences, although less in regard to tax revenues but mainly social protection (which is also part of the public budget). In advanced economies the revenues of the social protection systems represent roughly one third of state revenue. In the emerging markets, only Brazil and Russia come close to this level, at 26 % and 20 %, respectively. South Africa and India have the lowest rates, at 2 % and 0.3 %, respectively, with no data available for some countries such as China. Establishing state social protection systems covering the main risks of life (ageing, disease, unemployment) is one of the current challenges of the emerging markets.

All emerging markets are still more or less far away from having a tax system that follows the principle of performance-based taxation and is efficiently managed. What is most deplorable is a weak tax administration throughout (corruption, arbitrariness, widespread tax evasion). Moreover, indirect taxes, which must be rated more critically under distribution policy than direct taxes, continue to account for a very high proportion in some countries (more than 60 % in China, Mexico and Turkey).

Expenditure side: old debts, questionable subsidies, infrastructure deficits

On the expenditures side, in some countries the most conspicuous item is the continuing high burden from interest payments. In Brazil, India and Turkey this consumes around 20 % of expenditure, greatly limiting fiscal scope in other areas. At the same time China, India and Russia maintain a military apparatus that commands some 15 % of expenditure. This does not lend itself to an economic assessment but in any case competes just as much with alternative productive uses. This also holds true for subsidies, which particularly in India and Indonesia amount to a high 15 % to 20 % of state expenditure in order to maintain energy prices on a low level. The governments in principle do not deny the harmful allocation and environmental impacts of this energy policy. But they justify the subsidies with allegedly positive impacts on alleviating poverty or consider a reduction to be politically unenforceable. This view is comprehensible but does nothing to change the negative assessment of this policy (including from the poverty alleviation and wealth distribution aspect).

Almost all emerging markets have an urgent need for state infrastructure investment. Economic infrastructure (transport, energy) has not kept pace with high economic growth, existing infrastructures are often obsolete or unsafe, and rural areas are particularly underdeveloped. Deficits in social infrastructure manifest themselves in poor educational and health indicators of the population that do not exactly deserve high praise. In many places the financial equalisation between the central and local governments is also deficient. If better use were made of the revenue potential, and shifts were made in state expenditure, substantial fiscal scope could be created to put such measures in place.

Conclusion: Consolidation and fiscal reforms are pressing challenges

Considerable doubts exist as to whether the stimulus programmes initiated by the emerging markets in 2008/09 deserve the great praise that other countries have given them. The emerging markets were able to afford these programmes (with the exception of India!), but this does nothing to mitigate the criticism. Moreover, it is lamentable that as the focus was placed on short-term cyclical aspects the necessary fundamental structural reforms of fiscal policy fell even further down the agenda. With this, emerging markets today are facing two challenges. In a positive economic environment they should again focus more strongly on budget consolidation and should have the political courage to deal with the fiscal hot potato. Such a strategy may be unpopular in the short term. In the longer term, however, these would be crucial steps, or even important preconditions to provide the emerging markets with prospects for an economically, socially and ecologically sustainable future.■