

Economics

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Middle East Macro View

How Will Social Spending Affect Long-Term Growth?

- As many regional governments raise social spending sharply in the face of unprecedented social unrest, we ask what likely impact this will have on long-term economic growth according to the economic literature.
- We begin the analysis from the neoclassical perspective that, all else equal, a rise in government expenditure will reduce national saving and investment, and therefore have a negative effect on long-term growth.
- We then introduce a number of factors that are relevant to Middle East countries that we believe could either exacerbate or mitigate the negative impact on growth predicted in the neoclassical approach.
- We draw the following conclusions from our analysis: (i) Long-term growth will be positively impacted by higher spending in oil exporters, but negatively impacted in oil importers, (ii) The quality of expenditure matters, even in oil exporters, (iii) Consumer demand across the region is set to grow in the near term, regardless of long-term growth prospects, (iv) A narrowing output gap in oil importers will increase inflationary pressures in the medium term, (v) Better targeting of social safety nets would increase the potential benefits of social spending on growth, and (vi) Tax policy responses to mitigate the fiscal impact of rising social expenditure could be harmful to growth prospects.

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How Will Social Spending Affect Long-Term Growth?

The wave of social unrest that has gripped many Middle Eastern countries since the beginning of the year reflects not only frustrated political aspirations, but also deep-rooted economic grievances. High levels of unemployment (particularly among the youth population), and slipping standards of living for the masses have made for a combustible social dynamic in certain countries, particularly at a time when strong but uneven economic growth has been driving an ever-wider gap between rich and poor. Anger has grown against those governments that are seen as plutocratic and corrupt, promoting the economic interests of the privileged few at the expense of the rest of society. Countries such as Egypt, Tunisia and Jordan had over the past decade gravitated increasingly towards market-oriented economic models, reducing subsidies and driving forward private sector growth while diminishing the public sector through rationalization and privatization. While this had made them the darlings of the international investor community, the net effect has been a growing sense of social injustice on their streets over the years.

It is therefore unsurprising that regional governments have reacted to the unrest with a raft of economic policies aimed at promoting social justice, reducing unemployment and raising the standard of living of their people. Even those unaffected by the unrest thus far have chosen to take action on a pre-emptive or precautionary basis. Common features of such policies include the creation of greater numbers of public sector jobs, raising public sector wages, paying out bonuses to public sector workers, increasing subsidies on basic consumer products, and allocating greater amounts of resources to social programmes, such as health, education and housing.

Such policies are putting pressure on government expenditures across the region and in this note, we assess the likely long-term economic impact that this will have according to the theoretical and empirical literature on the relationship between fiscal policy and economic growth. We take an approach similar to that of Gale and Orszag (2003), where we outline the simple neoclassical framework for assessing the impact of changes in fiscal policy on economic growth, and then discuss a number of other factors that may impact this simple neoclassical relationship.¹

The neoclassical relationship between expenditure and growth

The standard neoclassical economic relationship between fiscal policy and economic growth is captured by the following identity:

$$S + (R-G) = I + NFI$$

Where,

S = Private Savings
R = Government Revenues
G = Government Expenditures
I = Domestic investment
NFI = Net foreign investment

¹ Gale, William G and Peter R. Orszag, (2003), "Fiscal Policy and Economic Growth: A Simple Framework", *Tax Notes*, February 3, 2003.

The left hand side of the equation represents national savings, while the right hand side represents national investment. The two are equal.

Greater government expenditure will result in reduced national savings, all else equal. The above identity means that this will automatically result in a fall in national investment, either through lower domestic investment or a drop in net foreign investment. In theory, private savings could rise to entirely offset a fall in government savings. However, this is very rarely the case in practice, and the ensuing fall in national investment reduces long-term growth.

The neoclassical view of the economy provides a basic framework for analyzing the interplay between different aspects of economic behaviour, such as savings, investment and consumption. However, these relationships are much more complicated in reality, and will depend on a number of other factors that are not taken into account in neoclassical economics. For example, greater government expenditure may boost long-term growth if it enhances the quality of human capital (say, through education) or infrastructure (through investment), regardless of its impact on national savings in the near term. In the next section, we consider a number of such factors.

Factors affecting the simple neoclassical relationship

There are a number of reasons why the linear relationship between government expenditure and long-term growth described by the neoclassical model may not hold in reality. Certain factors may exacerbate the negative impact on growth, while others may mitigate or reverse it altogether. Here we consider those factors most relevant to the current situation in the Middle East.

Growth-enhancing qualities of the social safety net

A common driver of expenditure growth among many Arab countries in response to recent social unrest is the extension of the social safety net. This includes increased subsidies, unemployment benefits, raising salaries and the minimum wage, spending on health and education, and the extension of government job opportunities. Liberal economists tend to balk at such expenditure as being inefficient and politically motivated, but there is considerable evidence in the economic literature to suggest that government spending in these areas can promote long-term economic growth. Alderman and Hoddinott (2007) list a number of channels through which this may occur.² The underlying logic is that by providing basic services for the poor of society, government can encourage greater economic participation of the population, be it through consumption, saving or investment. Subsidies, for example, raise household disposable income, encouraging greater consumption or savings. Similarly, a healthier or better educated population makes for a more productive workforce.

This does not mean, however, that all social spending is productive. The most apparent flaw in social safety nets, particularly in the Middle East, is that they are often poorly targeted, and thus the benefits do not accrue only to those in need. Food subsidies, for example, are available to all consumers of basic foodstuffs, not just the poor. Fuel and electricity subsidies are also rarely means-tested. Raising government salaries benefits those already with jobs, not the unemployed. The less targeted social spending is, the more inefficient it is, and the lower the marginal benefit of such spending is in promoting long-term economic growth. Therefore, in parallel to widening the social safety net, we believe it is necessary that Middle

² Alderman, Harold and John Hoddinott, (2007), "Growth-Promoting Social Safety Nets", 2020 Focus Brief on the World's Poor and Hungry People, Washington DC: IFPRI.

Eastern countries work towards improving the efficiency of these safety nets in targeting the needy if they are to harness the potential gains to long-term growth that such spending may create.

Job creation and growth

Government spending tends to favour job creation, either through direct hiring in the public sector or through spending on labour-intensive projects carried out by the private sector. In the near term, this will boost private consumption (assuming a positive propensity for households to consume – see below), generating higher near-term growth. However, the long-term impact is less obvious. On the one hand, higher consumption and lower savings will reduce long-term potential growth due to lower investment, as described in the neoclassical approach. On the other hand, job creation may boost long-term productivity of the work force if it also results in on-the-job training and experience that expands society's stock of human capital. This would improve long-term growth potential. In the Middle East, bloated public sectors generally tend to provide limited opportunities for the development of individual skills and knowledge, and thus we would argue that public sector hires are unlikely to have a long-term economic benefit, although they will have a near-term positive impact on consumption.

Government investment

Increased government expenditure may take the form of capital expenditure, raising capital formation in the economy and long-term productive capacity. This raises the long-term potential growth rate and will offset the reduction in investment described in the neoclassical approach. That said, not all investment is productive. The key is for Middle East countries to invest in areas where long-term productivity is maximized – unproductive investments will not yield long-term benefits and will thus act as a drag on future growth potential. We believe there are questions regarding the long-term productivity of Middle East government investment strategies. A significant proportion of capital formation in the GCC over the past decade has been attributable to the real estate sector, for example, the long-term productivity of which is questionable, particularly given oversupply issues that have emerged in recent years. There are also concerns regarding replication of growth strategies (competing financial centres, airline industries, etc.) that call into question the long-term viability of some of the investments being made.

Tax policy

Tax policy will affect the incentives of individuals and companies to save, consume and invest, and may affect the international competitiveness of an economy. Higher sales or income tax, for example, may be a way of offsetting some of the negative impact of a rise in government spending on investment as it raises government (and thus national) saving. However, such taxes may reduce consumer demand and prove counterproductive. Similarly, higher corporate taxes, such as those suggested in Egypt, may reduce foreign investor demand and erode the cost competitiveness of local products in international markets. The design of tax policy is thus an important element of fiscal policy and its impact on growth.

Debt

A rise in government expenditures is often financed by debt, and the impact of rising debt on long-term economic growth is a controversial topic in the economic literature.³ In general, theory suggests that debt is initially good for economic growth as it provides the opportunity for investment to exceed savings through borrowing. However, when borrowing becomes excessive, a number of negative factors may take hold, among which:

- The “debt overhang” may reduce the incentive for further lending by creditors, and thus reduce investment and growth;
- Increased government spending on interest payments may crowd out more productive expenditure (eg investment, health and education);
- Rising government debt consumes greater amounts of private capital (eg bank assets), raising the cost of funding (interest rates) and crowding out allocation to more productive sectors of the economy;
- Rising debt levels may increase the sovereign risk premium and raise the cost of capital for the economy as a whole, reducing investment; and
- Rising debt levels increase uncertainty regarding future government policy and thus reduce private sector incentive to invest.

The empirical evidence is broadly supportive of a non-linear relationship between debt and long-term economic growth, where this is positive until a certain point, and then turns negative as debt becomes excessive.

The marginal propensity to save

For a given nominal rise in disposable income, lower-income households are likely to consume more and save less than high-income households. The variability of the marginal propensity to save according to household income will have a significant impact on the long-term growth impact of government fiscal policy. In poorer countries, fiscal policy that results in greater household disposable income (higher subsidies, jobs, etc.) is more likely to result in an immediate boost to consumption, but in lower savings and a long-term decline in investment, all else equal. The impact on economic growth is thus positive in the near term and negative in the long term. For higher-income countries, the near-term benefit may be less apparent as households spend relatively less of their windfall, but higher private savings will partially offset the negative impact on investment of falling government savings.

Implications for Middle East countries

When one moves away from a neoclassical analysis, the factors that could mitigate or exacerbate the impact of fiscal policy on long-term growth become very country-specific. Effectively, the relationship will depend on such things as the nature of expenditure (eg social spending vs. investment), the tax regime, debt levels and average household income. While no two countries are identical, we can divide the Middle East into two distinct groupings, the constituents of which share a number of commonalities in terms of how policies adopted in the face of social unrest are likely to affect their future growth prospects: Oil exporters and oil importers.⁴

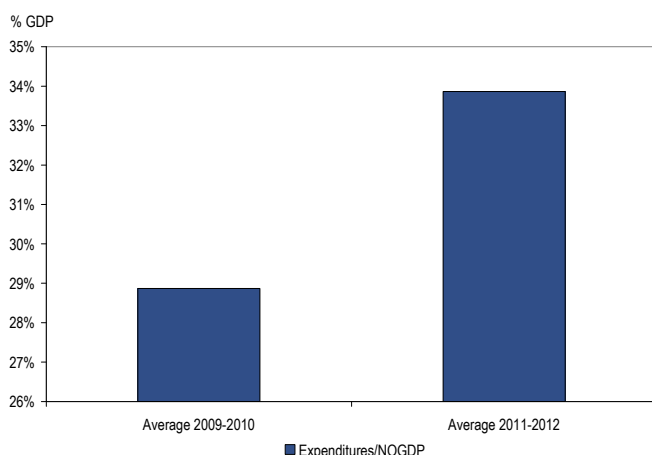
³ See Checherita, Christina and Philipp Rother, (2010), “The Impact of High and Growing Government Debt on Economic Growth: An Empirical Investigation in the Euro Area”, European Central Bank Working Paper No. 1237, August 2010.

⁴ We group Egypt with oil importers, although technically it is close to neutral in its oil BoP.

Oil exporters

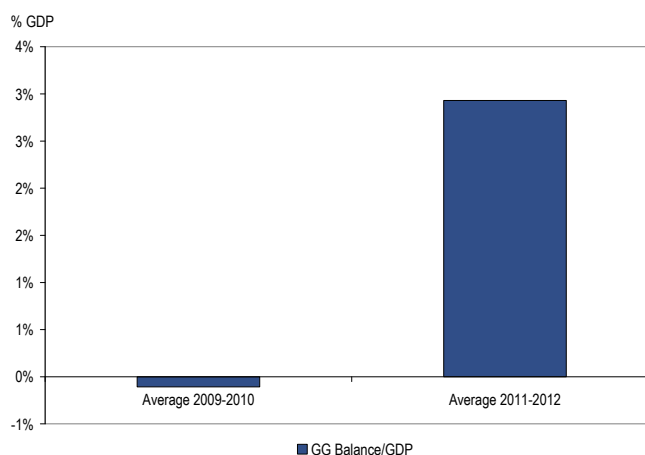
Unrest in Oman and Bahrain earlier in the year led to these countries' governments announcing a number of spending initiatives to address the economic grievances of their people. In Bahrain, these included the creation of 20,000 new jobs, a pledge to spend \$5 billion on housing for the poor, and a cash payout of \$1000 to each Bahraini family, pushing our forecast for 2011 spending up by some 37% over last year. Similarly, the Omani government announced it would create 50,000 new government jobs and introduced a monthly unemployment allowance of \$375. We expect spending will rise by 26% this year as a result. In Saudi Arabia, despite the country not experiencing any social unrest directly, the King announced a sharp rise in social spending in March that is expected to cost the Kingdom in the area of \$100 billion over the coming few years, and we are expecting a rise in 2011 spending of 40% relative to 2010. As Figure 1 shows, the weighted average ratio of expenditures to non-oil GDP in these three countries is expect to rise by 5% in the coming two years, relative to the past two years.

Figure 1. Expenditures among oil exporters are on the rise...



Note: NOGDP = non-oil GDP, weighted average of Saudi, Oman and Bahrain.
Source: Haver Analytics, CIRA estimates (2011-12)

Figure 2. ...But fiscal impact will be more than offset by higher oil revenues



Note: Weighted average of Saudi, Oman and Bahrain.
Source: Haver Analytics, CIRA estimates (2011-12)

So what is the likely impact of this surge in expenditure on economic growth? There are a number of factors that we believe mitigate the negative longer-term impact predicted by the neoclassical model:

- **Revenue growth** – the Middle East unrest has pushed oil prices up, meaning that the net impact on government (and national) savings is largely offset by the rise in government revenues. Indeed, as Figure 2 shows, we expect that government saving should increase in the coming two years if oil prices remain elevated, implying a boost to growth under the neoclassical model.⁵
- **Social safety net and job creation** – we expect that the extension of the social safety net and the impact on job creation will provide a further boost to near-term consumption, and will also result in greater private savings given the relative wealth of households in these economies.

⁵ This analysis ignores the \$20 billion GCC development programme announced in March, where \$10 billion will be made available to Bahrain and Oman over the next decade by GCC neighbours.

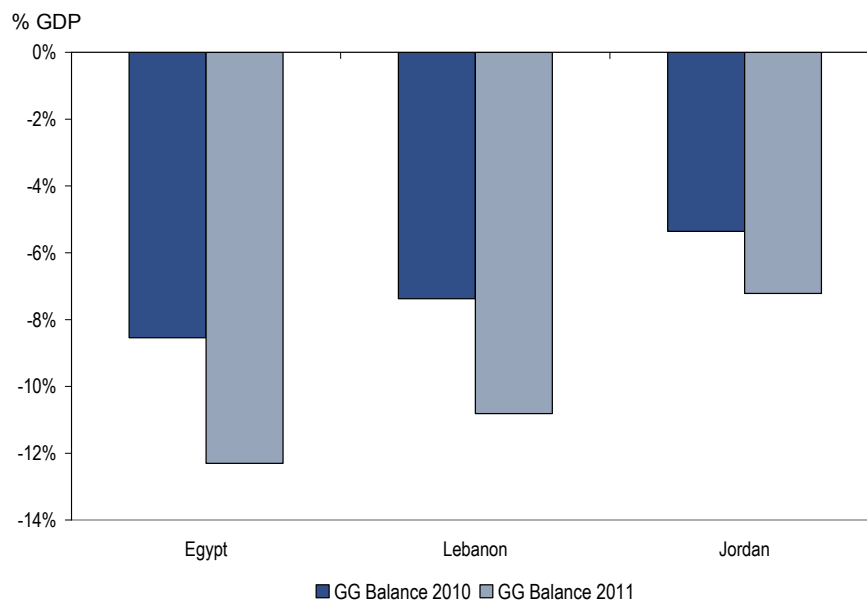
- **'Arabization' programmes** – in the GCC, particularly in Saudi Arabia, we have seen a redoubling of efforts to boost local employment and reduce the dependence on cheap foreign labour through 'Arabization' programmes. The impact on the economy of such programmes is ambiguous, in our view. On the one hand, they expand local employment and lift domestic consumption and savings. On the other hand, they may result in near-term productivity losses and a rise in costs/decrease in competitiveness (see *Saudi Arabia Macro Flash: Nitaqat: Saudization With Teeth*, May 31).
- **Government capital expenditure** – Oil-exporting countries have significant investment programmes in place as part of diversification efforts, which are generally set to expand productive capacity and long-term economic growth. Infrastructure investment, in particular, is very high in the GCC. That said, the debatable long-term productivity of some of the investments, given replication and competition in investment strategies, may mitigate somewhat the positive effect of this expenditure on long-term economic growth.
- **Tax policy and debt** – The GCC oil-exporting countries all have minimal to no tax on domestic corporates and individuals, and thus the potential distorting effects of tax policy on economic growth are largely irrelevant. Similarly, the extra spending is not being financed by debt, and public debt levels are very low among the oil-exporting Arab countries (all, with the exception of Iraq, are in a net asset position). We thus do not expect any drag on economic growth arising from tax and debt considerations.

In summary, while we are anticipating a surge in expenditure growth in the GCC, a number of factors will act to offset the negative impact on national saving, investment and growth that the neoclassical model describes. Taken together, we expect that long-term economic growth will be boosted by the looser fiscal stance and related economic policies of the GCC governments going forward.

Oil importers

For oil importers, we believe the efforts to quell social unrest through greater social spending will have a more negative impact on long-term growth, despite near-term benefits from greater consumption. In Egypt, we estimate a 25% increase in government expenditures in FY 2011/2012, mainly on higher wages and subsidies, will see the fiscal deficit widening to over 12% of GDP, from an expected 8.5% this fiscal year. In Jordan, due partly to the increase in subsidies and social expenditures announced in February, we expect the deficit to widen to over 7% of GDP. We also expect the 2011 fiscal deficit in Lebanon to rise to almost 11% of GDP, from 7.5% in 2010, although this is less related to social spending and unrest than in Egypt and Jordan. Figure 3 shows the widening fiscal deficits expected in these countries in the coming fiscal year.

Figure 3. Higher expenditures will hurt fiscal balances of oil importers



Source: Haver Analytics, CIRA estimates (2011)

Unlike the oil exporters, there appear fewer factors in these countries to mitigate the neoclassical prediction that rising expenditures will reduce long-term growth:

- **High commodity prices** – the impact of commodity prices, rather than providing a revenue windfall as is the case with oil exporters, will exacerbate spending pressures as these countries all subsidize to varying degrees local consumption of these products. Food and fuel subsidies are on the rise, as are state transfers to the electricity sector, particularly in Lebanon and Jordan (where a rise in the import price of Egyptian gas is likely to cost the government an additional 0.5% of GDP per year – see *Jordan Macro Flash: Rising electricity generation costs deepen fiscal woes*, June 21). This should reinforce the negative impact on long-term growth due to higher spending and lower national saving/investment.
- **Revenues** – Domestic political instability and a fall in regional tourism is likely to negatively impact the near-term economic prospects of Egypt, Jordan and Lebanon, and reduce tax revenues in these countries. Unlike oil exporters, government revenues in these countries are dependent on taxation. Lower revenues will accelerate the drop in national savings, and hurt long-term economic growth.
- **Tax policy** – it is possible that oil importers will endeavour to moderate the deterioration in their public finances through revenue-enhancing measures, particularly on the tax side. Egypt, for example, announced a rise in certain taxes in its FY 2011/2012 budget, including a 5% rise in corporate taxes. While this may reduce the negative impact on national savings, such taxes risk diminishing incentives to consume and invest, and may erode international competitiveness. Shifts in tax policy therefore have the potential to reduce long-term growth in oil-importing countries.

- **Debt** – Debt levels in the oil importers are relatively high compared with oil exporters. Widening deficits will add to these debt burdens, and have a negative feedback on economic growth as described earlier. In Egypt, we have estimated that, if local banks are forced to absorb the rising government financing needs, in a stress scenario government debt could rise from 40% of domestic banking assets to 70% within five years, crowding out private finance and reducing long-term growth (see *Egypt Macro View: At a Crossroads: Egypt's Post-Revolution Fiscal Trajectory*, June 13).
- **Social safety net and job creation** – Expenditure by Egypt and Jordan on extending the social safety net and raising employment are likely to have a positive impact on growth in the near term, in our view. We believe that poor Egyptian and Jordanian households are likely to have a high marginal propensity to consume, and domestic demand is likely to be boosted by raising the disposable income of such households. That said, given the relative poverty of households, private savings are unlikely to rise to offset the fall in government savings. Consumer-driven growth is therefore likely to level off longer term as productive capacity suffers from lack of investment. Moreover, the inefficiency of social spending are likely to result in wastage of government resources unless social safety nets become more targeted to those in need.

To summarise, we expect that there may be near-term benefits to economic growth from greater social spending in oil-importing countries by virtue of a surge in domestic demand as better income distribution boosts the disposable income of poor households. However, this is likely to be offset in the long run by a fall in national saving and investment, exacerbated by slow revenue growth, high commodity prices, rising debt levels and possibly counter-productive taxation policies.

Conclusions

We would highlight six key points to take-away from the above analysis:

1. The blow-out in government expenditures in response to social unrest in the Middle East is likely to have a positive impact on long-term economic growth for oil exporters, but presents challenges to oil importers given the likely ensuing drop in national saving and investment.
2. The questionable long-term productivity of some of the capital expenditure being carried out by GCC countries, given replication and competition in investment strategies, is likely to mitigate somewhat the positive effect of this expenditure on long-term economic growth.
3. Even if long-term growth prospects are diminished by a fall in national saving and investment in oil importers, consumer demand is likely to grow in the medium term as social spending boosts household income.
4. As growth becomes increasingly consumption-led and investment diminishes, the output gap in oil importers is likely to narrow in the medium term, resulting in inflationary pressures rising.
5. Better targeting of the needy would boost the efficiency and growth-enhancing qualities of social safety nets across the Middle East.
6. Oil importers may be tempted to claw back some of the fiscal loss from greater expenditure by raising taxes, but this carries significant risks to long-term growth if tax policies negatively impact incentives to invest, or erode international competitiveness.

Appendix A-1

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