The public finance responses to the 2008–09 global financial crisis are still evolving as many countries move from a concern to stimulate economic activity to one of reestablishing fiscal solvency. This transition in focus has implications for public finance in terms of aggregate fiscal management (Level 1), the prioritization of expenditures (Level 2), and the technical efficiency of government delivery (Level 3). During the period ahead, the management of public finances will need to take account of the links among these three levels for a successful transition.

The first-stage response to the crisis in developing countries was focused on letting automatic stabilizers work to the extent the available fiscal space allowed. This was supplemented in some cases (mainly in emerging markets and energy exporters) with directed stimulus measures. While there were high-profile cases of concern for the quality of spending, in many cases it appeared that countries were mainly concerned with getting money out the door as fast as possible and communicating a commitment to “protect” the population against some aspect of the distress that would otherwise have occurred. Initial hopes that stimulus measures could be designed to meet longer-term growth objectives, through the rapid implementation of “shovel-ready” investment
projects, as well as demand management objectives, turned out to be too ambitious in both developing and advanced countries.

But as the fiscal effects of the crisis continue to crystallize, especially through reduced revenues, larger calls for spending on benefits and other crisis-related items, and servicing of higher debt levels, the unease with unsustainable fiscal aggregates is becoming palpable. As countries begin to make the transition back to sustainability, they will need to reexamine the soundness of their expenditure allocations and decide if the operations of government can be harnessed in efficient ways, with a resulting dividend in terms of fiscal discipline and enhanced efficiency.

As the effects of the crisis mature, it is more likely that higher-income countries will curtail spending as well, perhaps to very significant degrees. The required adjustment in structural primary balance in G-20 emerging economies during 2010–20 to protect fiscal sustainability is 2.6 percent of gross domestic product (GDP) compared to a much more substantive 9.3 percent in high-income G-20 countries (IMF 2010). To achieve this adjustment, these emerging economies appear likely to rely mostly on revenue, while high-income countries plan a larger contribution from expenditure. Whether countries will be able to implement these plans remains to be seen; experience suggests that expenditure reform is an essential ingredient of successful large fiscal adjustment.

Done well, expenditure curtailments provide opportunities for countries to spring-clean their policies, improve targeting of core spending, introduce more effective budgetary institutions, and sponsor the sorts of public sector reforms that should see a lowering in the unit costs of service delivery. Done poorly, opportunities to improve aggregate fiscal management through improvements in Levels 2 and 3 are lost, with resulting costs for the population, especially the most vulnerable. Part of this process requires putting everything on the table—including transfers and subsidies—with revenue and expenditure restraint contributing to some form of social contract in which all sides have an incentive to negotiate a comprehensive package of reforms (OECD 2010:9)

The Prioritization of Expenditures

The global crisis has challenged countries to sustain spending that promotes future economic growth and poverty reduction. In particular,
countries have made efforts to safeguard expenditure for health, education, and investment. As the crisis was unfolding, the need to support aggregate demand mitigated pressures on public expenditures. But in the aftermath of the crisis, the need for fiscal consolidation will put renewed pressure on public expenditure in many countries.

Across-the-board cuts and freezes that indiscriminately affect programs and services can have perverse effects and may not actually help fiscal sustainability through time. Poor-quality cuts tend not to stand the test of time, often being reversed once rational analysis prevails. While top-down approaches are generally considered an appropriate tool in times of fiscal austerity, it is important that decision makers are aware of the links between the sinking lids provided to line ministries and the activities that are being identified for cuts. While efficiency measures and internal reallocations away from lower-priority policies may not generally make a large contribution to deficit reductions, they are nevertheless unambiguously beneficial for value for money and for the credibility of the fiscal path.

The good news is that countries have become more sophisticated at crisis management over time. This time around, countries are (temporarily) expanding safety nets, protecting social sector spending through loans, redirecting funding to retain social spending, and harnessing the crisis to achieve major reforms that improve efficiency and quality. A harbinger of this evolution is the case of Argentina in 2001. The government increased transfers to the provinces by 70 percent in real terms for nutrition, maternal and child health services, and the acquisition of essential drugs, in sharp contrast to earlier across-the-board cuts with little concern for the incidence of government actions. Countries appear to be relying more heavily on data and policy research in making spending allocations as budgets contract, replacing the ax with a scalpel to drive policy and future directions for their country.

**Core Spending**

The growth path of public expenditure on health and education (social spending) was interrupted by the global economic crisis. In the earlier part of the 2000s, social spending in developing countries (in 2005 constant prices at purchasing power parity [PPP] exchange rates) grew by an average of 4 to 10 percent. These rates are estimated to have fallen in
2009 to below 2 percent (see figures 11.1 and 11.2). As economic growth recovers from the crisis, social spending growth is also likely to recover, but it will take some years before spending growth returns to precrisis levels. The growth interruption due to the crisis was not severe enough to force declines in spending levels—education and health spending continued to rise as a share of GDP and in per capita terms (in PPP dollars; see figure 11.1).

The decline in spending growth rates due to the crisis risks setting back achievement of human development goals, because these depend on the rapid spending increases achieved in the 1990s and the earlier part of the 2000s. In fact, the present estimates of the impact of the crisis on spending are consistent with an earlier World Bank analysis that found that financing shortfalls to cover at-risk core spending on health, education, safety nets, and infrastructure amount to about US$11.6 billion for the poorest countries during 2009–10 (World Bank 2009).

Recovery of public health and education spending after the crisis is likely to be unevenly distributed between regions and developing countries at different levels of income. Countries in the Europe and Central

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**Figure 11.1 Public Social Spending (Averages for Developing Countries)**

![Graph showing public social spending](image)

- **Legend:**
  - Solid line: share of GDP
  - Dashed line: PPP$ per capita, percent change
  - Dotted line: PPP$ per capita (right axis)

**Source:** Lewis and Verhoeven 2010.
Figure 11.2 Public Spending

a. Public health spending (change in PPP$ per capita)

b. Public education spending (change in PPP$ per capita)

c. Public health spending (change in PPP$ per capita)

d. Public education spending (change in PPP$ per capita)

Source: Lewis and Verhoeven 2010.

Note: EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, LICs = low-income countries, LMICs = low- and middle-income countries, MENA = Middle East and North Africa, SAS = South Asia, SSA = Sub-Saharan Africa, UMICs = upper-middle-income countries.
Asia region faced the biggest fiscal challenges during the crisis, which has been reflected in comparatively large drops in the growth rates of education and health spending during 2009–10. These countries will also find it hardest to regain precrisis spending growth rates. This protracted bending of the growth path of spending could have a substantial impact on the accumulation of human capital and future growth prospects.

Expenditure reforms, such as initiated by several countries in Europe and Central Asia, are critical to mitigate the impact on human and economic development. Latvia, for example, is using the stringencies imposed by the crisis to rightsize its teaching force, and Romania substantially reduced education personnel in 2009, largely by curtailing supplements to base salaries. Countries in other regions, particularly the Middle East and North Africa, were not as affected by the crisis and have not seen an interruption in the growth of their social spending. In other regions, growth in social spending during 2011–13 is projected to rapidly return to close to precrisis rates.

**Public Investment Management**

Government investment, as measured by the net acquisition of physical assets, was less affected than social spending during the financial crisis. Stimulus spending kept up investments in a large number of developing countries, to an average growth rate of government net investment in per capita PPP terms of about 13 percent in 2009 and 2010 (see figure 11.3). In low-income countries (LICs), the increase in government investment substantially accelerated during 2009–10, and reached an average of over US$10 PPP per capita. Upper-middle-income countries (UMICs) and low- and middle-income countries (LMICs) saw larger increases in per capita investment, but this was still down from average increases earlier in the 2000s.

The prospects for government investment during the postcrisis period are less favorable. Fiscal consolidation is projected to further reduce investment spending growth rates during 2009–13. The drop is likely to be particularly severe in LICs. Under these circumstances, reforms in investment budgeting and implementation will be critical for increasing the efficiency of government investment and its impact on growth and development.
While improving the performance of investment is always important, it is particularly so in the current period of severe economic and fiscal challenge. Given the reduction in resources and the increase in urgency, it is imperative that public investment projects are delivered at the least
possible cost and on time and that maximum output is received from the resources invested. Careful and comprehensive project selection procedures will therefore be needed to help identify those projects that not only will give the highest return but also could be implemented more quickly.

Based on its global experience, the World Bank has identified key desirable features of a well-functioning public investment system, along with a diagnostic framework for assessing the quality of public investment management efficiency. The resultant “gap” analysis can be used to identify structural aspects of public investment decisions and management processes that may be weak and in need of attention and reforms to focus scarce managerial and technical resources where they will yield the greatest impact (see box 11.1).

**Box 11.1 Desirable Features for Efficient Public Investment Management**

The World Bank has developed guidance to help formulate a pragmatic and objective assessment of the quality of public investment efficiency in a context where governments are seeking to mobilize additional fiscal resources for investment. An indicator-based approach has been developed around a set of core “must-have” dimensions. These are as follows:

- Investment guidance and preliminary project screening
- A formal project appraisal process (with cost-benefit analysis being best practice)
- Independent review of appraisals (for example, including consideration of alternatives)
- Project selection and budgeting that establish envelopes for public investment so that a sustainable investment program can be undertaken
- Realistic implementation plans
- Adjustment for changes in project circumstances
- Facility operation (asset registers need to be maintained and asset values recorded)
- Evaluation (to ensure that there is some learning and feedback).

This approach is designed to provide a basis both for an objective assessment and for highlighting of weaknesses that should be addressed if the use of fiscal resources is to enhance public sector assets and economic growth. An assessment might therefore help to identify “quick win” reforms to accelerate investment spending during a crisis. While the approach does not seek to identify best practice, Organisation for Economic Co-operation and Development countries commonly provide guidelines and seek to strengthen their management capacity around similar dimensions.

*Source: Rajaram and others 2009.*
Emerging Lessons So Far

The worldwide crisis has required a country-led response. The role that core social spending and investment can play in the crisis response has also varied considerably. Future crises need to be approached on the same basis.

Governments are making a variety of interventions to try to achieve the best possible outcomes for their countries. An effective international response does not mean that all countries should have to take identical actions—for example, middle- and low-income countries may be more constrained, in terms of both fiscal space and capacity to design and deliver effective policies, and need to carefully sequence their response. Countries that entered the crisis in vulnerable states had less freedom and will need to focus more rapidly on the path back to sustainability. Fiscal actions should also take account of country needs, including the disparate impact of the crisis among countries.

1. **Investment and core social spending may be at risk if the global recession double dips and public finances weaken further.** Many governments are likely to come under increasing pressure to lower financing requirements. In such a situation, there is a real temptation to cut spending on investment as a first resort, since this is seen as being easier than raising taxes or cutting social expenditure or public service wages and salaries. If pressure on public finances were to become particularly acute, there is a risk that governments might be induced not only to postpone investment in new infrastructure, but also to reduce spending on maintaining existing infrastructure and facilities (Ferris 2009) and to cut down on core social spending.

2. **In spite of the urgency of responding to macrofiscal challenges as they arise, governments should focus on delivering good projects and improving the delivery of public services.** The scarcity of fiscal resources suggests that it is critical to focus on delivering public investment projects and social services at the least possible cost and that maximum output is received from the resources invested. Public investment must be focused on building capacity in key areas, such as infrastructure, education, and energy efficiency, and spent strategically in order to generate jobs for those hardest hit by the
recession. If investment in such areas can be delivered in a timely way and bottlenecks can be avoided, it can be an effective tool for stimulating economic activity and raising employment in the short run (OECD 2009).

3. Medium-term budgetary frameworks should be strengthened and should be consistent with a credible path for deficit reductions. A crisis can make it easier to adopt a deficit reduction plan, but also requires policy and administrative acuity. Having a central government ministry act as an active gatekeeper of the medium-term fiscal position provides useful discipline and reinforces the selection of efficient policy and delivery mechanisms. Usually this requires the finance ministry or its offshoots to be at the center of the process, acting within the context of a national plan for economywide development priorities and the protection of the fiscal position. Medium-term budget frameworks should provide forward visibility regarding resource availability and predictability of investments. Put another way, public investment projects and emerging social spending needs should fit with credible medium-term forecasts and comprehensive economic policy—that shows how the budget can be financed in a sustainable way—in order to ensure that there is capacity to accommodate such items (Flyvbjerg 2007; OECD 2010).

4. Spending decisions will be better if investment choices are assessed in terms of costs and benefits, and if the ministry of finance has the expertise to challenge the policies of line ministers and ministries. Ministries of finance can use the relative shortage of fiscal resources as a means to get tougher on poor-quality policies or expensive delivery mechanisms. As the Organisation for Economic Co-operation and Development has commented, development of savings proposals cannot be left solely to officials in line ministries; savings proposals may need to come from the center, but be supported with information flows from the line ministries. In this realm, countries are experimenting with service delivery units and reestablishing fundamental review mechanisms. Everything should be on the table. Governments need to identify not only which projects will give the highest return, but also which projects can be implemented more rapidly. To do this, they need to establish good guidance systems to deal with the technical aspects of project appraisal that are appropriate to the technical
capacity of their ministries. It is also important that there is rigorous, independent review of all public investment projects before they get the “go-ahead,” in order to ensure that they have the potential to yield the maximum economic and social benefits. Under the current circumstances, where speed is important, it may be necessary to develop standardized, if simpler, methods for project appraisal (that is, cost-effectiveness, multicriteria, and so forth) and standardized reference projects.

5. **There may be increased scope for public-private partnerships, but beware the folly of rushing into long-term contracts without proper considerations of fiscal risk.** Many governments now recognize that the involvement of the private sector is critically important in bringing their infrastructure up to world-class standards and in assisting in the delivery of public services. However, the crisis in financial markets meant that bank lending to the private sector declined. In a recent report (PPIAF 2009), the Public-Private Infrastructure Advisory Facility pointed out that, although it is still too soon to assess the full impact of the current crisis on new public-private infrastructure projects, there is strong evidence of lower rates of financial closure and of projects being postponed and cancelled, mainly in energy and transport. In an environment where private investment continues to be depressed, government expenditure will remain the only contributor to GDP growth in many countries.

6. **A good response would focus on improving organizational capacity and bolstering institutions.** Improvements in technical, financial, and managerial capacity can certainly help to increase a country’s capability and flexibility to deliver public investments and core social spending. The ongoing risks to the economic and fiscal outlook suggest (a) a strong benefit from well-functioning forecasting and oversight institutions and (b) an arrangement of institutions to support the professionalization rather than the politicization of that task. A number of countries have moved in this direction, such as Hungary, which has created a new independent institution to monitor fiscal developments. Significant capacity building in terms of deepening project management and implementation skills is not an easy task. But it is necessary, particularly in line ministries and public agencies that undertake public investment.
7. *Initiatives associated with transparency and accountability can provide benefits to private actors; fiscal rules have been tested and found wanting in many countries.* More and more, electorates look to be informed of what policies governments are implementing. Also, confidence in the way the economy is being managed can help encourage consumers, businesses, and financial markets to spend, subsequently supporting the recovery. And governments are responding. An example is the American Recovery and Reinvestment Plan. Another is Brazil’s Growth Acceleration Program, which shows progress in implementing the accelerated program of public works. At the start of June 2010, the U.K. Treasury announced the opening of the Combined Online Information System database. By comparison, fiscal rules have proved quite ineffective in guiding policy in the presence of major external shocks, because policy makers and circumstances have conspired to allow for a substantial deviation in the track of fiscal progress and the path allowed via rules. While a sluggish economy may make it difficult to implement a deficit reduction plan, it does not preclude the announcement of such a plan. Indeed, transparency concerning such plans can assist in moving market expectations in line with the regaining of sustainability. Rules may assist in the restoration process.

8. *Countries have made core social spending a priority, but uncertainties remain concerning donors.* Donor funding, which is an important component of social spending in many developing countries, tends to decline significantly when Organisation for Economic Co-operation and Development countries face a downturn. In the aggregate, rich countries do not respond to the needs of countries affected by global or regional crisis. However, there are specific instances where they have provided relief and support to individual countries, and in this crisis, consistency in HIV/AIDS funding is a departure from past practices of reneging on promises when banking crises hit donor economies (Lewis and Verhoeven 2010). While enhancing development effectiveness should include providing a source of support in times of crisis, domestic politics can make this problematic. Protection of progress toward the Millennium Development Goals could usefully be considered an overriding objective for the efforts in high- and low-income countries.
While the current crisis is not over, encouraging evidence suggests that social spending is increasingly a priority for countries (Green, King, and Miller-Dawkins 2010; IMF 2010). The big challenge is how well countries spend available funds and implement public programs. The rate of spending is only part of it.

Notes

1. Members of the G-20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, the Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union.
2. Estimates are based on panel analysis for 108 developing countries for 1980–2007. Estimates of health and education expenditure for the forecast period (2008–13) are based on income per capita in PPP terms and aggregate government spending from the International Monetary Fund’s World Economic Outlook database.
3. Data are based on the International Monetary Fund’s World Economic Outlook database estimates and forecasts.
4. This section draws from Thomas and Ferris (2009).

Bibliography