Are the Critics Right?

A new study finds that public education and health spending get a boost when low-income countries receive IMF financial support

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ONE of the most often repeated criticisms of the International Monetary Fund (IMF) is that the economic reform programs it supports restrict social spending by governments. The main argument goes something like this: countries must cut public spending to meet budget targets that are too tight, which squeezes high-priority expenditures on education and health and in turn hurts the poor.

But the numbers paint a different picture.

Our recent study suggests that IMF support helps countries' efforts to boost critical social spending (Clements, Gupta, and Nozaki, 2011). The positive effects on health and education expenditures are most pronounced in low-income countries.

It would be foolish to assert that, in the IMF's long history, there have never been exceptions. However, our results suggest that IMF-supported programs are consistent with countries' aspirations to increase social spending in support of economic and human development.

Social spending: A snapshot

Improving education and health is a priority for emerging and low-income economies. Public expenditures on education and health average about 4½ percent and 3 percent of GDP, respectively (see Chart 1). These expenditures represent a significant share—together about one-quarter (on average)—of government budgets.

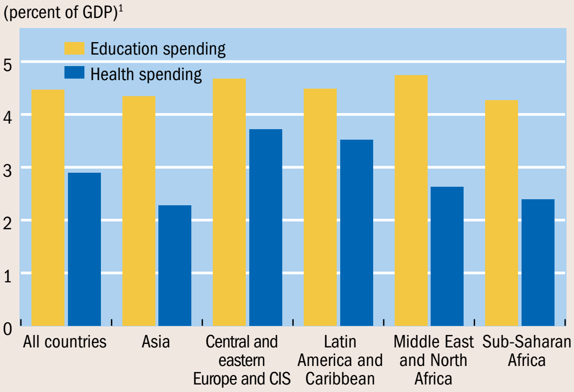
Empirical studies show that higher government spending in these areas can improve education and health outcomes (Baldacci and others, 2008). At the same time, excessive government spending can contribute to high budget deficits, macroeconomic instability, and lower economic growth. These, in turn, can adversely affect education and health indicators. To improve education and health, countries must find the right balance between spending on these services and maintaining a sustainable fiscal position. Policymakers also must address inefficiencies that hinder the effectiveness of spending on education and health outcomes.

Chart 1

Big deal

Education and health represent a significant share of government spending across all regions.

(percent of GDP)[1]



Source: IMF staff calculations based on the social spending database compiled in Clements, Gupta, and Nozaki (2011). The data set is available at *www.imf.org/external/pubs/ft/sdn/2011/data/sdn1115.xls*

Note: CIS = Commonwealth of Independent States.

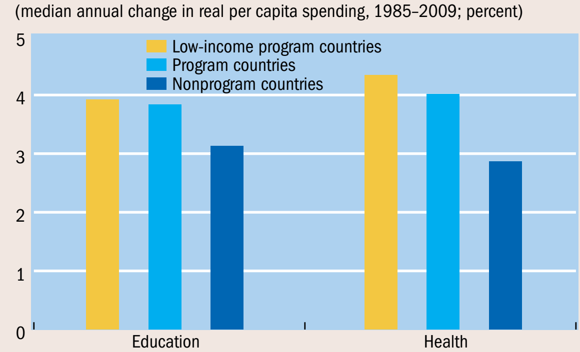
[1]Unweighted averages, based on the latest year for which data are available.

Chart 2

Rising spending

Spending on education and health rose more in program countries, especially low-income program countries, compared with nonprogram countries.

(median annual change in real per capita spending, 1985–2009; percent)



Source: IMF staff calculations based on the social spending database compiled in Clements, Gupta, and Nozaki (2011). The data set is available at *www.imf.org/external/pubs/ft/sdn/2011/data/sdn1115.xls*

Note: Countries are included in the program sample only for the years during which they have an IMF-supported program. For other years, they are part of the nonprogram sample.

Schoolchildren in Siem Reap, Cambodia.

When countries facing economic instability seek IMF financial assistance and policy advice, debate over the impact of reform programs on social spending naturally follows (see Box 1).

New findings

Given the small number of empirical studies to date—the last comprehensive statistical study on the subject was in 2003—and the availability of new data from the past decade, our work takes an additional step to address the critics' claims.

The data set we use is the most comprehensive ever assembled for this purpose. It draws on public spending data for education and health for 1985–2009 from 140 developing countries, including 70 low-income countries eligible for concessional IMF financing. Thus, our study adds weight to earlier empirical analysis by assessing the relationship between IMF program support and changes in social spending since 2000.

While education and health spending accelerated for all countries—program and nonprogram—in our sample, this spending increased faster in program countries, including low-income countries (see Chart 2).

- Both education and health spending increased each year by about 4 percent on a real per capita basis, compared with 3 percent increases for nonprogram countries.
- The benefits were most pronounced for the Middle East and North Africa, as well as for sub-Saharan Africa.
- Changes in the composition of spending, with a larger share for health and education, have been stronger in countries with programs.

Many other factors—the population age profile, income levels, and macroeconomic conditions—affect a country's social spending. So a true assessment of the impact of IMF-supported programs must take these factors into account. Using statistical techniques (see Box 2) that isolate the impact of an IMF-supported program, we again find that IMF support has a positive and statistically significant effect on social spending, including as a share of total government spending.

A sustained period of IMF support can have a substantial impact, raising social spending as a share of government spending and as a share of GDP. We estimated the effect of five consecutive years with IMF program support (see Chart 3). The results show a rise in education and health spending on a per capita basis by about 19 percent and 41 percent, respectively, after five

Box 1

Responding to the critics

Critics have long debated the effects of IMF-supported programs on social spending (for example, Stuckler and Basu, 2009). Here are some frequently raised points and the IMF staff's response (see IMF, 2009a).

- ***The IMF is preoccupied with keeping inflation under control and/or government debt low, leading to unnecessarily tight budgets.*** Programs have become more flexible in recent years about accommodating high budget deficits and inflation—this was evident during the global food and fuel price hikes in 2008 and the global crisis in 2009, when many low-income countries implemented countercyclical fiscal policy for the first time.
- ***Unnecessarily tight budgets restrict government spending on education and health.*** IMF-supported programs increasingly emphasize protection of social spending and of the poor. Studies of programs between the mid-1980s and mid-1990s found that social spending increased more in program than in nonprogram countries (for example, Gupta, Clements, and Tiongson, 1998; IMF Independent Evaluation Office, 2003; Center for Global Development, 2007). More recently, programs for low-income countries have, where appropriate, incorporated minimum social spending targets (IMF, 2009b).
- ***The IMF requires limits on overall government spending, including wage-bill ceilings, which may stymie employment growth in social sectors, such as health.*** The IMF introduced a new policy to curtail the use of such ceilings in 2007. As a result, none of the 26 IMF-supported programs in low-income countries has a wage-bill ceiling as a performance criterion, and only 2 have one as an indicative target—that is, a nonbinding condition.
- ***Financial assistance from other development partners, intended to support higher social spending, is diverted to repay domestic debt or increase international reserves.*** IMF support plays an important role in mobilizing aid and seeks to ensure full and effective use of donor funding. When aid flows are volatile, governments may not spend all aid immediately. This is motivated not by a desire to increase reserves, but to ensure stable provision of services over time.

years. However, our analysis suggests that the additional boost to spending diminishes over time, after the strongest increases in the earlier years. The effects are also smaller for countries that do not have programs continuously over the period.

IMF program support can help increase social spending by facilitating reforms that boost the necessary government revenues for such spending and by helping countries mobilize donor financing. IMF-supported programs that lead to higher growth can help generate additional funds and make higher social spending more affordable. And the emphasis in low-income countries' programs on using additional resources—including those generated by debt relief—for poverty-reduction spending helps direct more resources to education and health.

The effect of IMF support on social spending for countries outside the low-income country sample is more limited probably because the channels that typically increase social spending—catalyzing foreign financing and grants, raising revenues, and changing the composition of spending—are less powerful than in low-income countries.

To reach the objective of adequate education and health spending, a top priority will be to further spur economic growth, raise revenues, and make public spending more efficient. This will allow governments to finance higher social spending in a way that is affordable over the longer term. And making sure this spending goes to those who really need it will strengthen social spending as a powerful instrument to better the lives of the poor. ■

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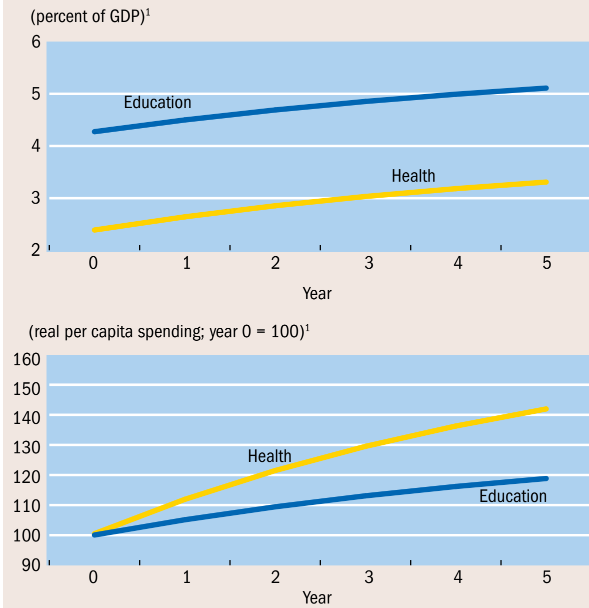
Chart 3

Positive effect

Social spending in low-income countries with IMF-supported programs rises both as a percent of GDP and in terms of real per capita spending.



Source: IMF staff calculations based on Clements, Gupta, and Nozaki (2011).
[1]Indicates an increase in social spending for a representative country (with spending equal to the average of low-income countries for 2001–09) with a consecutive five-year period of IMF-supported programs.

Box 2

Methodology at work

Our analysis (Clements, Gupta, and Nozaki, 2011) uses annual data for 1985–2009 for low-income countries (those eligible for concessional IMF lending) to estimate the effect of IMF-supported programs on social spending. We test quantitatively to identify the relationship between education and health spending and IMF-supported programs, as well as other factors that directly affect social spending, including the budget balance (to control for how much money governments have to spend); the age structure of the population (to control for demographic effects); and income levels (which generally correlate positively with social spending).

We also address the so-called selection bias problem. In the case of social spending, countries with IMF-supported programs are not directly comparable to countries that do not have them. The macroeconomic imbalances that countries with programs must address will influence fiscal policy and the government's ability to increase spending. To take this into account, we used what economists call the "instrumental variable" technique: we conduct the same test, but effectively replace the IMF-supported program variable with other variables that are typically well correlated with IMF-supported programs but do not usually affect social spending directly (for example, international reserves and the foreign exchange rate regime).

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