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Fiscal Policy, Private Sector Development, and Social Outcomes in an Indebted Arab Country:

Balancing Austerity with Pro-Growth Policies in Jordan

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In a nutshell

- *Jordan's economic trajectory has been characterized by long stop-go cycles. Real GDP per capita peaked in the early 1980s followed by a precipitous decline in 1992, then peaked again in the early 2010s. It has since declined to levels reached 20 and 40 years ago.*
- *These long swings have been associated with an increasing reliance on borrowing and more so on external financing, resulting in an unprecedented level of the debt-to-GDP ratio and a threefold increase in servicing the debt in the last decade.*
- *The level of debt doubled during the 2000s, but this went largely unnoticed as the debt-to-GDP ratio was reduced by half due to the high economic growth rates of that decade.*
- *The reasons why "the roof was not fixed when the sun was out" reflect political economy considerations and weak macroeconomic management that, as a consequence or intent, have reduced completion and constrained private sector development.*
- *Moving forward, in addition to volatile external factors – from geopolitics to interest rates – economic growth and the debt-to-GDP ratio will depend on: long-known and currently acknowledged policies by the government aiming to improve governance; the rationalizing, not necessarily reduction, of public expenditures; the reduction of growing pension liabilities and expansion of the social safety net; the raising of revenues in a non-regressive way; the attraction of investments; the increase of economic and political contestability; and the gaining of social acceptance.*

Lack of Sustainable Growth and Decades of Declining Incomes

Jordan has experienced short spells of high economic growth followed by precipitous declines (Figure 1). Much of the growth can be attributed to external factors such as (i) the high oil prices during the 1970s that benefited the region's oil-producing countries (Iraq and the GCC) with spillover effects on Jordan; (ii) the Iraq war that resulted in an increase in FDI in Jordan and, according to some sources, money laundering; and (iii) in between these two periods, the influx of Jordanian returnees, mainly from Kuwait following the Gulf War in the early 1990s.

Throughout its recent history, Jordan has economically relied on international and regional support. The IMF alone has provided support to Jordan in 1994, 1996, 1999, 2002, 2012, 2016, and 2020. Other international and regional organizations as well as bilateral donors have always been around to provide development help and assist when the economic situation deteriorated. Geopolitics have been part of their motivation to preserve Jordan's security and stability and its approach to refugees, the most recent example being after the conflict in Syria.

Today, per capita income is no higher than what it was 20 or even 40 years ago. Compared to the average upper-middle-income countries, Jordan's per capita income (in constant 2017 international USD) was higher by 30 percent in 1990 but lower by 50 percent in 2020. Per capita wealth has stagnated at under USD 40,000 in the last 30 years compared to the above-mentioned comparator group, where it grew by one-third and now stands at USD 140,000.

Jordan's Development Paradigm Seen from 10 Perspectives

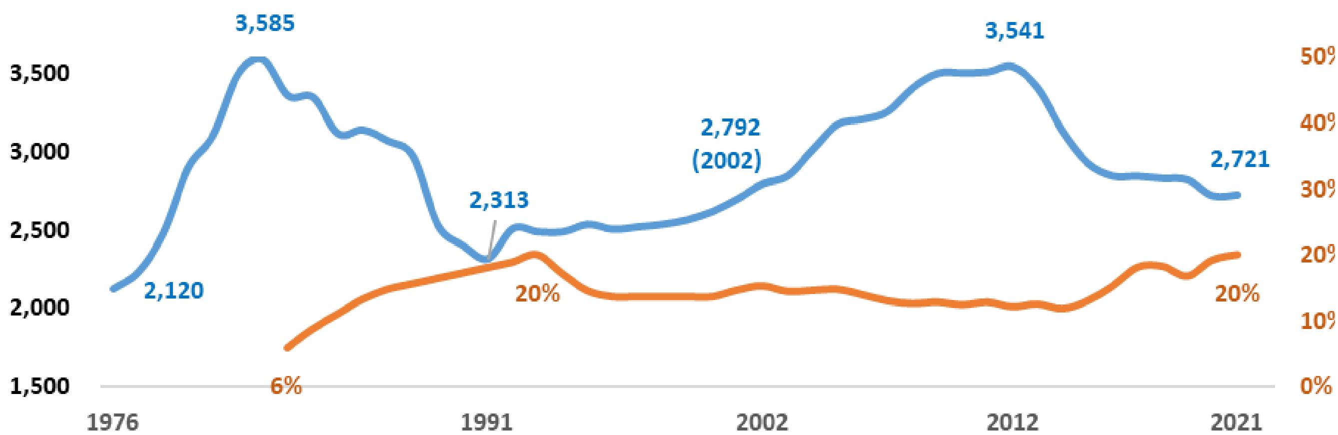
Structural transformation in Jordan has fallen behind what would have been required to meet the aspirations of its citizens, while macroeconomic management has been driven by outdated paternalistic practices that also constrain private sector development with rentier policies.

The macroeconomic paradigm that Jordan has pursued in the past survived to a significant extent during the 2010s. Focusing on the period since the end of the boom years by 2009, two interrelated symptoms of the paradigm relate to the lack of contestability in the private sector and the declining fate of the social sectors. These can be summarized as follows with reference to Figure 2, read from the bottom line.

First, investment has been on a downward trend and nearly halved by 2021. Not shown in the figure is the collapse of FDI during this period by nearly 90 percent, from 10 percent to less than 1.5 percent of GDP. This has been due to public investment taking the back seat given the priority that successive governments assigned to current expenditures that kept rising fast.

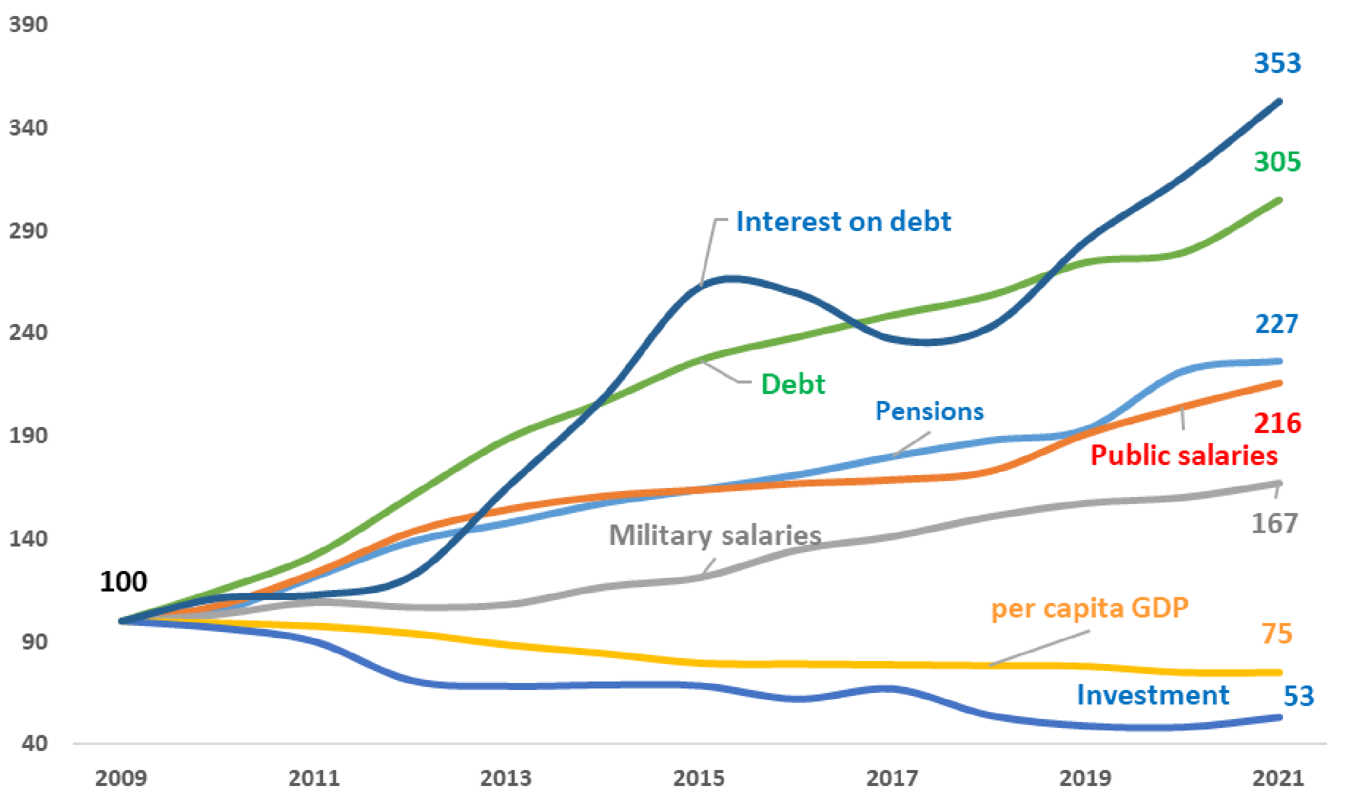
Second, having lost one of the main drivers for growth (the other being improvements in governance), real GDP growth has been low; in fact, it is less than half the rate of population growth (respectively two percent compared to 4.5 percent, or around 3.5 percent if one accounts for the presence of the Syrian refugees after 2011). Had it not been for the increase in the population due to Syrian refugees, the decline would have been 15 percent, though this would shave off some of the GDP, too.

Figure 1. Per capita GDP (constant $) and Unemployment Rate (right axis), 1976-2021



Sources: Department of Statistics (DOS) and World Bank Development Indicators.

Figure 2. Macroeconomic Indicators 2009-21 ($); Investment (% of GDP); Index 2009=100



Source: Authors' compilation from Central Bank of Jordan, DOS, IMF, Jordan Strategy Forum, Social Security Corporation, and World Bank.

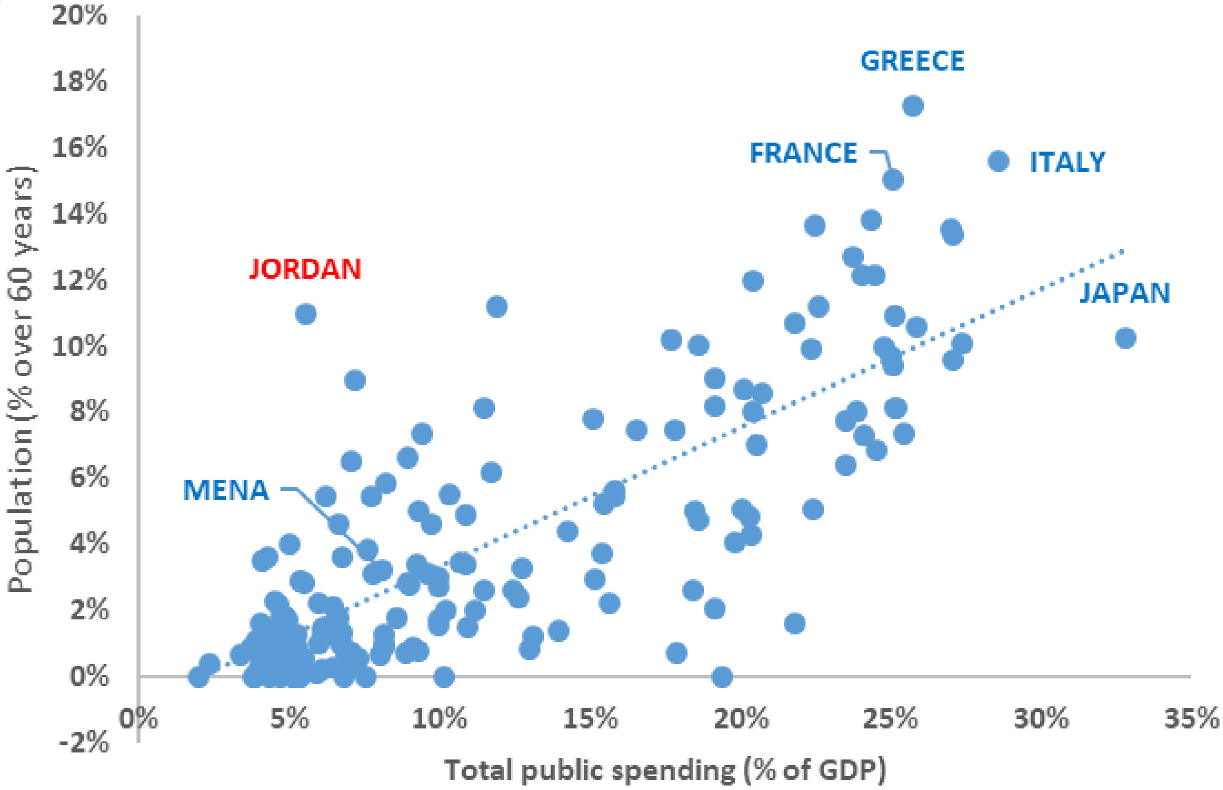
Third, current public expenditures increased quickly. This has been more so for government employees than military personnel, though the bill for the latter group is 50 percent and larger than that for the former. The combined public and private pension bill increased at a similar rate and was slightly higher than the public wage bill.

Fourth, spending on targeted assistance is minimal and most social protection is provided indirectly through the labor market and directly through pensions (see next point). On the one hand, public sector pay favors the less educated low-wage workers whose salaries and benefits are higher than those of comparable workers in the private sector. On the other hand, the Ministry of Labor sets the minimum wage unilaterally, admittedly after consultations with employers and workers. By design, the minimum wage caters to the less skilled low-wage workers, and its change in recent years has acted as a social protection measure for such workers. Since the end of the boom years, the minimum wage has increased by 240 percent compared to only 55 percent of the average per capita income across Jordan.

Fifth, the other big part of social protection is through pensions to public or public sector workers. The pension bill has increased quickly (Figure 2) to the point that it now accounts for a share of GDP as high as that in Japan, which has six times more elderly citizens in the population than Jordan (Figure 3). Pensions are not an effective way of reducing poverty; less than five percent of the pension bill is paid to those in the poorest quantile (20 percent) but 48 percent accrues to the richest quantile.

Sixth, the increasing spending on public salaries and pensions requires more funding. Given the lackluster performance of the economy and the low domestic revenue base, borrowing was the remaining option. The level of public debt and its service have increased at a much higher pace than all other indicators shown in Figure 2. Not shown in the figure is the increasing share of external borrowing in recent years compared to domestic borrowing. The ratio of the former to the latter increased to nearly 90 percent by 2021 compared to half of that in the early 2010s. Accordingly, servicing the external debt has increased by more than 350

Figure 3. Pension Spending (% of GD) against the Share of Elderly in the Population



Source: World Bank and Social Security Corporation (2021). Toward Coverage Expansion and a More Adequate Equitable and Sustainable Pension System in Jordan.

percent compared to servicing the domestic debt, which increased by 250 percent. Since 2009, servicing the debt has increased by 350 percent, or from 1.5 percent to more than four percent of GDP.

Seventh, public revenues have been short of expenditures, with public deficits averaging around seven percent of GDP. Even after the recent rationalization attempts, the share of expenditures is around 32 percent of GDP compared to 23 percent for domestic revenues (excluding grants). The share of taxes in GDP is only 18 percent. Further, most taxes are indirect; sales taxes are 3.5 times more than taxes on incomes and profits.

Eighth, the selective list of issues mentioned above has deprived the private sector of dynamism, with severe implications for the labor market. Jordan has moved into low value-added production combined with an increasing use of low-skill, low-wage non-Jordanians. Total factor productivity and labor productivity turned negative throughout the 2010s. Jordan's rank in the Global Innovation Index has slipped by 16 positions between 2011 and 2022. The country's score in the Economic Freedom Index declined by 13 percent and the Rule of Law by seven percent in the short period since the late 2010s and today.

Ninth, the increasing reliance on external borrowing can expose Jordan to currency risk, something that has been avoided by keeping the national currency pegged at 0.71 to the dollar for three decades. Though the real effective exchange rate (REER) is showing signs of decline, the peg has led to persistent trade imbalances. High interest rates discourage the private sector from borrowing while the still substantial share of domestic in total debt (55 percent) carries risks for the domestic banks. The risks remain elevated in an adverse case scenario.

Tenth, and finally, poverty has been increasing only partly, but significantly, due to the decline in the level of real per capita income. In purchasing power terms (PPP) the local currency has declined from 3.7 to 3.1 (JD to international USD). Unemployment has been high and persistent over time even though the number of Jordanians working abroad are around half of those working in the domestic private sector. In addition to the direct effects of low and declining incomes and high unemployment on social conditions, the once relatively high quality of public social services, especially those in the education and health sectors, has declined together with being increasingly privatized. Inequality is high, with the incomes of those in the top decile of the income distribution being nine times higher – this difference is more than double that found in OECD member countries and more commonly found in Latin America. Housing is becoming scarcer and more expensive. Transport services are largely inadequate. The renewable water supply barely meets two-thirds of the population's demands, while groundwater is being depleted twice as fast as it can be replenished. Climate change adaptation measures are also slow to appear.

Renewed Commitment to Reforms Facing Strong Winds Ahead

History has resulted in unpleasant economic dynamics for Jordan, some of which were due to external factors such as the Global Financial Crisis in 2008, the fallout of the Arab Spring in 2011 and the subsequent influx of Syrian refugees and Iraqis in 2013 after the emergence of ISIS, the disruption of trade with Iraq, the interruption of Egyptian gas supplies to the country in 2012/13, the COVID-19 pandemic in 2020, and, more recently, the food and fuel crisis from the Ukraine/Russia war. However, past domestic approaches have not "fixed the roof when the sun was out."

In Jordan, as in many other countries and not only developing ones, debt sustainability is of prime concern. When a sovereign default happens, it comes quickly and has systemic and devastating effects both on the economy and the social sectors. Then, in an attempt to balance the books, governments engage in ex-post fiscal consolidation by reducing expenditures and increasing taxes to service the debt. This is a narrow definition of debt sustainability that aims to avoid an imminent default, service the debt, and enable the country to access markets.

A more promising approach is to treat debt sustainability not purely as a short-term fiscal issue but as an economic one. This calls for redefining debt sustainability into the ability of governments to implement expenditure and revenue policies that ensure a steadily declining debt in line with the country's justified economic and social objectives. This approach calls for balancing austerity with growth, putting the emphasis on private sector development. Jordan is a case in point in two ways. The debt-to-GDP ratio nearly halved during the 2000s even though the amount of debt doubled. The reason is that the economy grew at a breakneck speed, albeit in Jordanian terms.

Leaving aside the specific reasons why Jordan "did not fix the roof when the sun was out," the country should try to quickly and preemptively adopt the required consolidation and implement the necessary structural reforms that have been known and due for long. For decades, Jordan has announced several country and sector strategies, plans, programs, and projects. Few of them were implemented in full and others were justifiably replaced with new ones when conditions changed but without evaluation of whether the previous ones were successful or not.

Looking forward, the IMF's debt sustainability assessment (DSA) forecasts that the debt-to-GDP ratio will be reduced to 80 percent by 2027 compared to 90 percent today – excluding the reserves of the Social Security Corporation. If the latter are included, the debt-to-GDP ratio increases to 110 percent. Moreover, the DSA is based on critical assumptions regarding short-term economic growth and interest rates, the absence of shocks, and that donor support and the commitment of authorities to the agreed upon reforms will be as expected. The future is uncertain, but what is more certain today is that Jordan is borrowing at a much higher rate than the economy's growth. In April 2023, Jordan raised a USD 1.25 billion five-year Eurobond at a rate of 7.5 percent. This alone undermines sustainability.

Economic forecasts being what they are, the road ahead requires a massive effort to enhance governance, revitalize the private sector, and improve social conditions. The fact that in 2019 Jordan identified 254 needed initiatives to be done across the whole intuitional and economic spectrum is indicative of the problems the country was facing then. By 2021, another 84 initiatives were added, bringing the total to 338. In April 2023, the government approved the Economic Modernization Vision 2023-25, bringing the number of initiatives to almost 400. For now, the prospect of eliminating the primary budget deficit (public expenditures excluding debt service payments) is slim. This is despite the fact that in 2022, revenues increased by 15 percent since the onset of COVID-19 due to strengthening the tax administration through digitalization, boosting anti-smuggling measures, improving compliance, fighting evasion, closing tax loopholes, and tightening tax exemptions. However, further increases may not be as forthcoming following Goodhart's law that "when a measure becomes an indicator, then it ceases to be a reliable measure" (in other words, people start to game it).

Barring external shocks, some of the institutional reforms, especially those aiming to improve governance and revitalize the private sector, are hard to design and approve and their effects may take long to show up, especially in the social sectors. Good governance requires authorities to use their powers to achieve shared objectives with the citizens. This calls for clear visions, complex design, reviews and assessments of organizational and functional structures, policy coherence, consistent implementation, and the development of systems, rules, and processes involving all stakeholders, particularly from the private sector, where attempts to enhance competition through increasing economic contestability can encounter issues related to political contestability.

From a sectoral perspective, two examples stand out. First, as an oil-importing economy, Jordan is vulnerable to energy price fluctuations in addition to the underperformance of the domestic National Electricity Company (NEPCO), which is burdened with deficits. Second, Jordan is one of the most water-poor countries in the world and the sector requires massive investment. As it is difficult to raise the required financing from domestic sources, Jordan would have to raise additional external borrowing and forcefully seek Public-Private Partnerships (PPPs). However, PPPs have not been very convincing for the private sector in the past. One can add the need for climate change adaptation policies that, when adopted (as they should), will increase the debt by two percentage points.

In conclusion, Jordan should consistently pursue its reform agenda as agreed with the donors since 2019 and on several occasions before that. Important areas with cascading economic and social effects are (i) improvements in governance, including through independent regulators; (ii) fiscal consolidation, first, by avoiding increases in public expenditures but switching toward development spending and the pro-poor provision of quality public social services and, second, by continuing the effort to increase public revenues giving less emphasis on regressive indirect taxes and more on property taxes that account for less than 0.5 percent of GDP. Other areas include, (iii) pension reforms to make the system actuarially sustainable while adopting poverty-targeted assistance and increasing the very low spending on the social safety net; (iv) the energy and water sectors that have for long hemorrhaged the public coffers and still have adverse impacts on the economy and households today; and (v) climate change adaptation measures that can have adverse effects for generations to come.

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