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Funding Education as an Investment in the Future

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Thank you to the organizers for inviting me to the 2024 Global Education Meeting and for the opportunity to discuss how low- and lower-middle-income countries can create room in their budgets for education spending to accelerate progress on SDG4. Given current trends, achieving SDG4 by 2030 appears increasingly unlikely.

There is a strong case for investing in education. It is a key driver of economic growth and fosters productivity gains, as seen by recent experiences in several Asian countries. We also know that that education not only reduces poverty but also mitigates inequality by promoting social mobility. A well-educated workforce helps countries remain competitive in the global economy. Importantly, education generates significant spillover effects, improving health outcomes and fostering civic engagement.

While the benefits of education are well recognized, realizing these outcomes depends on the availability of fiscal space to fund social and developmental goals. Fiscal space gives governments the flexibility to increase spending on priority areas or reduce taxes without risking access to financial markets or compromising their ability to meet current and future payment obligations.

Several factors influence fiscal space, including a country's revenue potential, the efficiency of resource utilization, future spending commitments (such as pensions and healthcare), and debt management practices. Additionally, the state of the global economy plays a crucial role in determining a country's fiscal space, particularly for commodity-exporting nations. For example, COVID reduced the fiscal space of many countries by curtailing profitable exports of commodities.

One common question in fiscal discussions is whether social sectors like education and health have their own fiscal space. The reality is that fiscal space is economy-wide, and the budget available for education or health depends on the overall fiscal capacity of the government and its other spending priorities.

What constrains higher spending on social sectors in low- and lower-middle-income countries? It's important to highlight five key factors that stand out in this regard, as we need to address these moving forward.

First, debt accumulation: In the 2000s, many low- and lower-middle-income countries benefited from debt relief initiatives, which reduced their debt service obligations and allowed for increased spending on social sectors. However, over time, increased domestic and external borrowing has led to a resurgence of debt burdens. Unfortunately, the investments financed by this borrowing did not generate the anticipated returns in the form of higher tax revenues.

Second, COVID-19 and subsequent developments: In response to the COVID-19 pandemic, these countries, like their advanced-economy counterparts, increased healthcare spending and implemented programs to protect lives and livelihoods. However, the decline in economic activity resulted in falling tax revenues, leading to rising budget deficits and a further increase in debt-to-GDP ratios. Although the debt ratios of low- and lower-middle-income countries increased less sharply than in advanced economies, their fiscal capacity became more constrained.

The subsequent rise in interest rates in advanced economies—with US interest rates at 22-year high in 2023—and depreciation of low- and lower-middle-income country currencies following Russia's invasion of Ukraine further increased interest payments on both domestic and external debt. By 2022, countries in debt distress were paying three times the share of revenues in interest compared to advanced economies, with Ghana's interest payments constituting 46 percent of revenues and Malawi and Zambia exceeding 30 percent. High oil prices in 2022–2023 further strained their ability to service debt.

These countries have yet to regain their pre-pandemic long-term growth potential. The IMF estimates that, due to the impact of COVID-19, they will now require more resources than before the pandemic to meet their Sustainable Development Goals.

Third, restricted access to international financial markets and a reduction in donor flows: In 2023, many low- and lower-middle-income countries, particularly in Sub-Saharan Africa, were effectively shut out of international financial markets, further constraining their liquidity. With tighter global capital markets, these countries were viewed as less attractive investment destinations. In fact, in 2022, these countries paid more to their creditors than they received in new financing. Securing debt relief has been a prolonged process, as evidenced by the experiences of Ghana and Zambia. Furthermore, since 2022, donor support has increasingly been diverted to Ukraine, further diminishing aid to these countries. The outlook for future aid appears bleak given fiscal pressure on donor countries and shifting geopolitical priorities. As donor countries prioritize reducing their own high debt and spending more on defense and care for aging populations, a significant increase in aid to low- and middle-income countries seems unlikely.

Fourth, stagnation of tax revenues: From 2012 to 2020, tax revenue as a percentage of GDP stagnated in these countries after significant gains between 1990 and 2012. In some low-income countries, tax revenue is less than 10 percent of GDP—far below the IMF's recommended threshold of 15 percent for sustainable growth. Below this level, governments face constraints in financing productive investments and implementing progressive taxation systems.

Finally, inefficiencies in public spending: Low- and lower-middle-income countries allocate about 6–7 percent of GDP to education and health, and up to 8 percent to public investments. On average, education receives around 4 percent of GDP, nearly double the allocation to the health sector, though donor assistance contributes an additional 1 percent of GDP in health spending, roughly twice the amount received by education. Despite these commitments, many countries have not achieved their public policy objectives efficiently.

Research I conducted at the International Monetary Fund, along with other studies, reveals wide disparities in the efficiency of education spending across countries. This suggests that education outcomes could improve significantly without increasing current spending levels. Some countries spend 20-35 percent more on education than their more efficient peers yet fail to achieve better results.

In sub-Saharan Africa, only 15 percent of students in primary and secondary schools meet minimum learning standards, and teacher training has declined over the last two decades. In Peru, the distribution of over 1 million laptops in recent years had no measurable impact on learning

outcomes. Furthermore, over one-third of public investments are wasted due to inefficiency in sub-Saharan Africa, a serious issue given the region's urgent infrastructure needs. Additionally, energy subsidies, which disproportionately benefit wealthier households in these countries, require reassessment. In 2022, global fossil fuel subsidies reached USD 7 trillion, with almost 80 percent attributed to the underpricing of environmental impacts, while explicit subsidies doubled since 2020, constituting 18 percent of the total subsidy amount. The recent increase in the budget share allocated to military spending in several countries is not helpful, with shares ranging between 8 percent and 10 percent, the highest being in fragile and conflict-affected states.

So, what should these countries and the international community do to expand fiscal space in low- and lower-middle countries?

First, enhancing tax collections: The IMF estimates that these countries could raise their tax-to-GDP ratios by a third to a half through tax system and institutional reforms. Key areas for revenue generation include broadening the Value Added Tax base, which has been weakened by exemptions and reduced rates, and reforming personal income and capital taxes, including on interest, dividends, and capital gains.

Second, rationalizing public expenditure: Improving the quality of public services is essential for increasing tax compliance. Without visible enhancements in service delivery, public support for higher taxes is unlikely to grow. Estimates indicate that rationalizing public spending could generate savings of up to 3 percent of GDP annually. Governments should prioritize reallocating resources to areas that can most improve education outcomes, addressing regional imbalances in teacher-student ratios, and improving the mix of spending between teacher salaries and non-wage inputs like teaching materials and teacher training. This approach would also help ensure parity across regions, directing education funding to low-income areas and reducing dropout rates.

Third, effective debt management: Maintaining a balanced approach to debt management is essential. These countries must manage short- and long-term debt maturities carefully, smooth out debt service schedules, and monitor interest rates to avoid excessive reliance on volatile international rates.

Fourth, international support for financing: Several low- and lower-middle-income countries face large principal repayments on external debt in the coming months—as noted before last year, they repaid more than they received in new financing. While many face temporary financing challenges, their debt remains sustainable. For them, the international community must facilitate increased financing on reasonable terms. For countries requiring debt restructuring, the process should be expedited.

Finally, designing temporary fiscal adjustment programs:
Given the extent of fiscal imbalances in these countries, it is crucial to design temporary fiscal adjustment programs that protect essential spending on education and health required for achieving the SDGs and transitioning to climate-resilient economies.

In conclusion, while we know how to expand fiscal space for education, achieving it requires discipline and political will. Simply hoping for more fiscal space for the sector is not enough, especially when donor funding has become increasingly constrained. Falling interest rates in major economies should ease pressures on these countries' fiscal space going forward. That said, governments must act by effectively utilizing the policy levers available to them.

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