Fiscal Management in Adjustment Lending

A recent OED study* confirms that fiscal deficit reduction leads to improved external balances and economic growth. But the process takes sustained, long-term effort, and continual vigilance against reversals. Contrary to the view prevailing in the early years of adjustment operations, the study suggests that fiscal mismanagement, not exogenous shocks, was the principal cause of persistent budget deficits. Almost all of the 26 countries studied reduced their deficits, mostly by increasing revenue and, to a lesser extent, by lowering capital spending. Targeted cuts in current expenditures proved more elusive. In recent years, however, budget deficits have grown again in several countries, accompanied by rising external debt and a growing ratio of debt to GDP.

The study concludes that fiscal measures were not strong enough to sustain solvency in many client countries for several reasons: (1) failure to address the role of the state, a role critical in determining the level of public finances; (2) treatment of fiscal issues separately from other macroeconomic reforms; (3) scant attention to issues of fiscal deficit coverage, measurement, and sustainability; and (4) conditionality that was too soft, ambiguous, or inconsistent across loans to the same country.

Why fiscal adjustment?

Management of the government budget influences private economic decisions both directly, through taxation and the pricing of public goods and services, and indirectly, by affecting other macroeconomic variables. Depending on how they are financed, fiscal deficits can lead to inflation, distorted interest and exchange rates, current account deficits, and poor external credit-worthiness. The combination of these factors can crowd out private investment and hurt growth. Fiscal balance is thus central to the success of adjustment. For this reason, fiscal adjustment has formed a major part of the IMF's and the Bank's policy-based assistance. As many as 250 of the Bank's structural and sectoral adjustment loans approved in 1979-94 for 86 countries had fiscal reform components.

Patterns of deficit reductions

Though poor data made country comparisons difficult, the study found quite a strong correlation between central government fiscal balances, GDP growth, and external balances. Fiscal adjustment proved to be a long-term process, more likely to succeed in regions and groups with a seven- to eight-year history in reducing fiscal deficits. Although the average deficit of the sample countries actually increased in the medium term, all countries studied (except for the unsuccessful adjusters) reduced their deficits in the long run.

While most countries sustained their lower deficits in the most recent period, significant reversals have occurred, particularly in Africa among low-income adjusters, the severely indebted, and primary exporters. (See figure.) What is more, deficits continue well above 3 percent of GDP in the sample as a whole and in almost all country groups. And the average ratio of external debt to GDP (a traditional indicator of credit-worthiness) increased from 37 percent in the preloan period to about 64 percent in the most recent pe-

How were deficits reduced?

How countries address their fiscal deficit problems—with tax increases, expenditure cuts, or a combination—matters because the choice affects incentives to save, invest, and produce. Fiscal adjustments were not sustained in countries that reduced their deficits through short run shifts in revenue or expenditure. Over the long term and during the most recent period, fiscal improvements were achieved primarily through revenue increases. All regions and country groups except the Middle East and North Africa and middle-income countries increased current expenditures, and all groups except East Asia and the Pacific pruned capital expenditures relative to the preloan period. Targeted reductions in current expenditures, while considered necessary in many cases, proved elusive. Countries with worsening fiscal deficits generally increased current expenditures without increasing revenue.

How was revenue increased?

Although Bank conditions calling specifically for increases in tax rates were rare, the ratio of tax revenue to GDP rose in 17 (65 percent) of the 26 countries that adopted revenue reform. Tax reforms supported by the Bank followed best practices specified in the Bank’s 1991 policy paper Lessons of Tax Reform: Loan conditions aimed to broaden tax bases and make tax systems simpler, more efficient, and easier to administer. The shifts in tax structure that followed were generally consistent with reform objectives. In 26 countries that adopted tax reforms, overall reliance on trade taxes diminished, from 27 to 25 percent, while reliance on domestic indirect taxes increased, from 41 to 43 percent.

Weaknesses in tax administration partly explain why revenues fell in some countries (Bulgaria, Côte d’Ivoire, Hungary, Senegal, Venezuela) and why revenue increases, where they occurred, failed to have
the desired fiscal impact (Bangladesh, Pakistan, Uganda). Reforms of tax administration, neglected in early structural adjustment loans, have increasingly become a part of Bank adjustment programs since 1987. But the approaches have been piecemeal instead of comprehensive. Bank conditions have lacked precision, and thus have been difficult to monitor.

Nontrade tax reform. In general, nontrade tax conditions formed only a small component of adjustment programs and (as with tax administration) were selective rather than comprehensive. Political constraints have generally stood in the way of comprehensive tax reform. Moreover, since the late 1980s the Bank has deferred to the IMF on tax reform, focusing instead on public expenditures. Consequently, the Bank has tended to piggyback on conditions already imposed by the IMF or other donors supporting government reforms.

How explicit were nontrade tax conditions? About 40 percent of the conditions were quantitative and thus easily monitorable. The other 60 percent either specified the direction of change in the tax code without stating how much change was expected or lacked both quantitative and qualitative criteria, leaving open the possibility of poor outcomes. Finally, none of the operations specified pre-reform benchmarks, such as marginal effective tax rates, making it difficult to evaluate the implementation and outcome of the reform.

Trade tax reform. In contrast to conditions on nontrade taxes, trade tax conditionality was specific, and reform objectives were clearly outlined, with quantified policy targets and deadlines specified. Compliance was thus easy to monitor. The record shows high compliance, but the pace of reform varied, often depending on how well trade reform was synchronized with other reforms. Revenue pressures often held up trade reform, as did insufficient progress on stabilization.

Expenditure reform

To encourage expenditure reform, loan conditions focused on the size and composition of spending. Conditions focused on reducing and restructuring capital expenditures, removing subsidies, reducing public employment and cutting the wage bill, emphasizing operations and maintenance of existing facilities, and increasing social sector spending (although attention to poverty reduction was weak). The record shows only modest performance.

Out of 27 countries studied, 22 required total spending cuts or restraint. Of those, spending declined in only 14, and in 3 the cuts were smaller than targeted. In several of the countries—Côte d’Ivoire, Kenya, and Tunisia—the decreases were achieved largely through reductions in capital spending rather than through the current expenditure cuts called for in structural adjustment programs. Although all 27 countries attempted to lower their current expenditures, only 10 countries actually did so. The reasons for poor performance were several: (1) weak budgetary systems and processes; (2) inability of governments to reduce or sustain cuts in employment (and thus in public sector wages and salaries); and (3) weaknesses in Bank conditions.

Comparisons between countries with expenditure conditions and those without indicate that conditions were only marginally effective in improving spending patterns. Countries with loan conditions on spending were more successful in increasing social spending and cutting subsidies and defense spending, and they ended the period with lower wage bills than countries without conditions. But these countries also had less success in cutting total expenditure (both groups started out with roughly equal ratios of total expenditures to GDP). Attempts to restructure current expenditures away from wages and subsidies to nonwage operations and maintenance and to cut public employment were generally short-lived or modest. Moreover, countries with capital expenditure conditions ended the period with relatively large unsustainable cuts in infrastructure spending.

In countries whose operations contained conditions on health and education spending, both sectors increased their shares in total spending, though these shares were only marginally better than in countries without conditions. Illiteracy rates declined in almost all countries studied—particularly for girls and women—as did infant mortality rates.

Recommendations

- Estimate the level of sustainable deficit for the country and provide guidelines for achieving it in Bank economic and sector work and adjustment lending. Integrating fiscal accounts into the macroeconomic framework of inquiry is essential for identifying tradeoffs among fiscal variables and acceptable levels of borrowing and other macroeconomic variables, setting quantitative targets for achieving public sector solvency and fiscal sustainability, and for monitoring macroeconomic outcomes. At the same time, the coverage of the fiscal accounts needs to be expanded and the transparency of accounts improved. This implies a need to incorporate state, local, and municipal accounts into the fiscal accounts, track quasi-fiscal deficits, and work out the implications of implicit taxes, subsidies, and government guarantees. Finally, the appropriate measure of the deficit for tackling the problem at hand needs to be identified—whether it is the overall deficit or the primary, the operational, or the structural deficit. All these tasks require improvement in the quality and coverage of fiscal data.

OED Précis
- Improve the sequencing of tax reform. If trade taxes contribute significantly to revenue, nontrade tax reforms to enhance revenue may need to precede trade tax reform. Reforms in tax administration should be closely sequenced with tax structure reform.

- Consider the role of the state and the appropriate mix of public/private provision of services in recommending public expenditure reform. What is the specific mix of government-provided goods and services that suits a country’s situation? Should the government assist the private sector with financing? In which areas should it withdraw to a regulatory role?

- Include poverty alleviation and equity objectives in public expenditure reform. Since expenditure solutions have greater potential than revenue reform in reducing poverty, expenditure programs that improve the targeting of subsidies and the poor’s access to basic services need to be in place. Basic education and health services might be provided free to ensure universal coverage, and innovative cost-recovery solutions explored to help finance tertiary education and health services.

- Build better monitoring and performance indicators for both tax and expenditure reforms. Building better performance indicators into tax and tax administration reform programs benefits design, implementation, and evaluation and focuses attention on the goals of reform.

Performance indicators should include marginal effective tax rates and, for tax administration, cost and output measures. With regard to expenditure reforms, performance monitoring indicators need to show intermediate (short run) outputs and final (long run) outcomes as well as measures of the level and composition of spending.

- The Bank should strengthen its internal capability for tax analysis to enhance Bank-Fund coordination. Both the Bank and the IMF recognize the critical importance of fiscal reform to macroeconomic stability and growth. While respecting the Fund’s lead role in giving fiscal advice, the Bank needs to take a more hands-on-approach to the design of fiscal reform in adjustment lending, particularly where the Fund may not be directly involved.

Bank management, in its response to the study, noted that the OED study highlighted some important facts: that fiscal adjustment had generally been attained by raising revenue than cutting expenditure, that fiscal problems were due more to economic mismanagement and not necessarily to terms of trade shocks or external indebtedness, and that deficit reduction is associated with improved external balances and faster growth. Management agreed with many of the study’s recommendations, such as making conditions more specific and time bound, sequencing reforms properly, ensuring transparency and extending coverage of fiscal accounts, and basing public expenditure reform on considerations of the role of government in the economy. But management also noted that OED’s emphasis on estimating the sustainable deficit deals with a still unresolved theoretical issue—the determination of the sustainable deficit. Management is planning to undertake a study on the sustainable deficit, possibly in collaboration with the IMF. With regard to the study’s recommendation for the Bank to strengthen tax policy analysis, management noted that there is always room to improve Bank-Fund collaboration, but the benefits of investing resources in tax policy analysis would have to be weighed against alternative uses of those resources, including investing in sector-level public expenditures, where the Fund is not doing any work.

The Committee on Development Effectiveness, in its discussion of the OED study, emphasized the need for fiscal conditionality in adjustment operations to be more precise, supported by specific and monitorable performance indicators; the need to define what is a sustainable deficit; the nature and causes of reversals in fiscal reforms; and the appropriate role of the public sector. The committee believes that Bank-Fund collaboration on expenditure policy and budget and tax reform proposals should be strengthened. But it shares management’s view that the principle of selectivity and partnership among international finance institutions argue for the Bank to assess carefully the work it assumes and what its comparative advantages are. As for the appropriate role of the public sector, the committee said that it is the prerogative of individual borrowers to decide what is appropriate in the context of their local conditions.