IMF SURVEY

International Monetary Fund
VOLUME 32
NUMBER 5
March 17, 2003

www.imf.org/imfsurvey

In this issue

65
Odling-Smee on Russia's recovery

65
Köhler on prospects for Latin America

70
Central American tax regimes

72
IMF, World Council of Churches meet

74
Global income inequality declines

76
Ravallion on poverty measures

78
Population aging in Austria

80
Aninat to leave IMF

and . . .

73
Recent publications

77
Selected IMF rates

79
New on the web

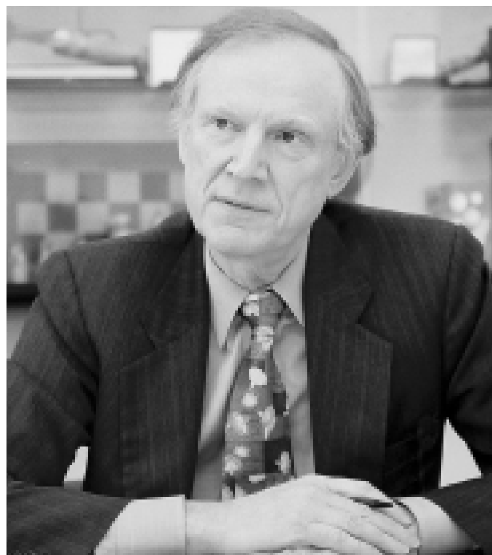
Interview with John Odling-Smee

Russia's rebound: will it last?

Russia's unexpectedly strong recovery since its 1998 crisis has left people wondering whether it is just a temporary result of higher oil prices and the postcrisis depreciation of the ruble or a sign of durable improvements in the much-battered economy. This question is addressed in the book Russia Rebounds, *written by members of the IMF's Russian team and due out later this year. John Odling-Smee, Director of the IMF's European II Department, spoke with Laura Wallace about Russia's prospects and its relationship with the IMF during the troubled 1990s. Odling-Smee, a U.K. national, joined the IMF in 1990 and took over responsibility for the IMF's relations with former Soviet Union countries in 1992. Before that, he served in the U.K. Cabinet Office and Treasury for about 15 years.*

IMF SURVEY: With hindsight, was Russia's 1998 debt default avoidable, given the Asian financial crisis and the oil price collapse?

ODLING-SMEE: Russia could have avoided default by adopting a more flexible exchange rate *(Please turn to the following page)*



Odling-Smee: "The big test for Russia will come when oil prices fall and the benefits from the depreciation have been totally eroded."

Köhler sees enormous potential for global growth

Speaking at the Bank of Spain in Madrid on March 11, IMF Managing Director Horst Köhler declared himself to be fundamentally optimistic about the global economy and about Latin America. There is, he said, enormous potential for growth, and the IMF is committed to working with Latin America. Excerpts from Köhler's speech, "Sustaining Global Growth and the Way Forward for Latin America," follow.

The world is facing great uncertainty, and the recovery in the world economy is weaker than earlier anticipated. But barring a protracted war in the Middle East, which is unlikely, I expect the tentative recovery to continue. The economic policies of the larger advanced economies remain broadly supportive, and there is further scope for monetary easing should that prove necessary. For 2003, I expect global economic growth to slightly exceed last year's level of 3 percent.

Although full confidence is unlikely to return until the geopolitical tensions have subsided, we must avoid undue pessimism. Despite the series of large shocks in recent years, the global economy and the international financial system have proved remarkably resilient. And we are in the midst of a technological revolution that has the potential to sustain global growth for many years to come. I expect markets to bounce back.

Latin American crisis

Latin America is facing particularly difficult economic circumstances. In 2002, real GDP fell by about ½ of 1 percent for the region, led by a sharp recession in Argentina. The adverse global economic environment brutally exposed weaknesses in the domestic policy framework in several countries. But there have been bright spots, notably in Mexico and Chile. And better policies in several other countries, including Brazil, Colombia, and Peru, *(Please turn to page 69)*

Russian needs to save oil windfalls

To cause serious fiscal problems, the oil price would have to fall a long way—to below $15 a barrel—and stay there for quite some time.
—John Odling-Smee

(Continued from front page) regime much earlier. But it was deeply committed to the fixed exchange rate policy as a means of disinflation. That left only fiscal policy. Russia could have avoided the crisis by running a much tighter fiscal policy, which the IMF urged it to do, not only in 1998 but as far back as the early 1990s. Fiscal policy was Russia's Achilles' heel.

IMF Survey: If there were rational steps that could have been taken, why weren't they?
Odling-Smee: You have to remember that during the 1990s, in Russia and all the other countries in the CIS [Commonwealth of Independent States], governments were very weak. As a result, strong vested interests were able to avoid paying taxes, wages, and even bills in general when it suited them. Had the government been stronger, it could have collected taxes, insisted that people pay up, and punished those who did not. But, in reality, very few people were punished for not paying their taxes. The government also contributed to this fiscal indiscipline by not paying its own bills, wages, and pensions when it was short of funds. This led to an elaborate system of offsetting unpaid government payments against unpaid taxes that further undermined the fiscal system.

IMF Survey: Would it have made a difference if the international community had called Russia's bluff and simply cut off all lending?
Odling-Smee: The availability of those loans clearly made it somewhat easier for the government to not impose strict fiscal discipline. But I don't think the unavailability of the loans would have resulted in significantly more discipline or a much higher collection of taxes. A more likely outcome would have been even more bills left unpaid by the government, with consequent social hardship and economic disruption. Or the crisis could have come earlier.

IMF Survey: Is the government strong enough now to follow through with strict fiscal discipline?
Odling-Smee: The situation has changed considerably since 1998, although it's important not to make too sharp a distinction between the precrisis and postcrisis years. There was a growing realization before the crisis that things had to change, and the government did move to end the offsets and clear its tax and pension arrears in 1996–97.

Also, it's always easier to follow a good fiscal policy when the economy is growing. So when growth resumed in 1999—initially because of the high oil price and the 1998 depreciation—it was easier to take the necessary fiscal steps. Moreover, when the depreciation brought a big jump in prices and thus revenues, the government resisted the temptation to boost spending to a similar extent. As a result, real expenditures—and especially real wages—fell, creating a lot of room in the budget and passing the burden on to the recipients of government wages. That was a very tough move. And for a time in early 1999, the IMF opposed this policy on the grounds that it was too tough!

IMF Survey: For quite a long time in the 1990s, Russia seemed to struggle with high inflation, no growth, severe fiscal problems, corruption, and so on. But, in the past three to four years, it seems to have made a breakthrough. Is that because of the temporary benefit of higher oil prices and greater competitiveness from the 1998 depreciation, or is there more to it than that?
Odling-Smee: The big test for Russia will come when oil prices fall and the benefits from the depreciation have been totally eroded. My view is that Russia won't go back to where it was before. The recent years of growth and strong oil prices have created confidence in the prospects for future growth, and the liquidity cushion makes it unlikely that the old nonpayment crisis will reemerge. Moreover, both economic agents and the government fully understand that the precrisis behavior was an aberration and a successful economy cannot be built without financial discipline. There's also much more agreement throughout the leadership about what needs to be done now, whereas before 1998, the Duma was always fighting the government.

IMF Survey: How important a role did the IMF play in turning Russia around?
Odling-Smee: It's always very difficult to say what role the IMF plays. One thing I don't take terribly seriously is the idea that our impact occurs wholly through the imposition of conditionality in IMF programs. To begin with, the policies included in IMF-

Russia and the IMF

Following the dissolution of the Soviet Union, the Russian Federation began its move toward a market economy and joined the IMF on June 1, 1992. Over the next seven years, it borrowed $21 billion from the IMF, receiving its final disbursement in 1999. Russia's sound economic policies have paid off, enabling it to repay over two-thirds of its obligations to the IMF, often ahead of schedule.

supported programs don't work very well unless the government really wants to implement them. And, in Russia, the problems were often a lack of implementation and not a lack of an intellectual commitment to a good idea. So, in the short term, I don't think we had much influence.

However, over the longer term, I do think that we had a lot of influence through our educational, pedagogical role. From 1992 on, we worked with key policymakers and technicians in the central bank, ministry of finance, and elsewhere on the importance of macroeconomic stability and how to bring it about. So when the political climate changed and the political leadership became convinced of the need for macroeconomic stability, the Russians were able to act.

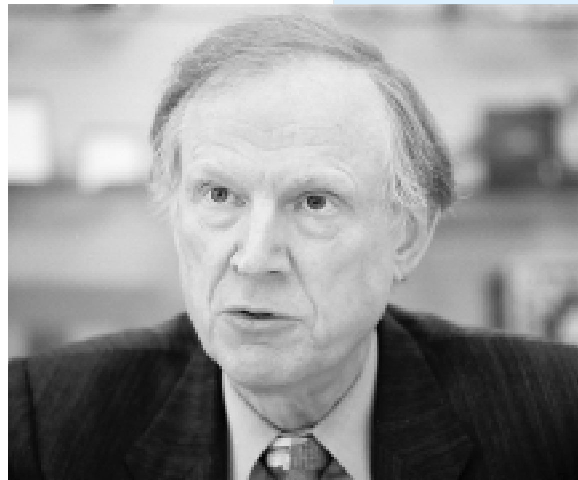
IMF Survey: How would a military conflict in Iraq affect economies in the region?

Odling-Smee: The biggest impact would come through a change in the oil price. The oil producers—especially Russia, Kazakhstan, and Azerbaijan—could be expected to gain considerably if the oil price rose sharply in the early stages of a conflict. Government revenues and oil-sector profits would increase. Further benefits would depend on whether the windfalls were saved. Azerbaijan and Kazakhstan have oil funds for this very purpose, and Russia is beginning to talk about an oil fund, which would be highly desirable. The other countries in the region, which are mostly oil and gas importers, would both lose and gain. They would lose on the higher oil price, but they could gain a bit from stronger exports to the three oil producers. Russia is still the biggest market for most countries in the region. On balance, the oil importers would not be hurt very much.

How about over the longer term? If a conflict in Iraq came to an end and the oil price fell, then some of those things would go into reverse, meaning that the oil-producing countries would have lower revenues and external current account surpluses. We advocate saving the windfalls to shield fiscal policy as much as possible from the fluctuations in oil prices. To cause serious fiscal problems, the oil price would have to fall a long way—to below $15 a barrel—and stay there for quite some time.

IMF Survey: Russia's real exchange rate depreciated dramatically after the 1998 default but has since returned to only about 20 percent below its precrisis level. Should the government continue to try to slow the appreciation to help non-oil exporters?

Odling-Smee: As long as oil prices are strong, the government recognizes that it will be very difficult to prevent some real exchange rate appreciation. Non-oil exports are still fairly competitive at the current exchange rate. It will, however, be important to prevent a rapid real appreciation, which could be disruptive. It is important to use fiscal policy rather than monetary policy to slow appreciation, which means saving as much of the windfall revenue from high oil prices as possible. The problem with using monetary policy to slow nominal appreciation is that you risk ending up with a higher inflation rate.



Odling-Smee: "The government is trying, quite rightly, to gradually diversify the economy away from an overdependence on natural resources."

IMF Survey: What is the desirable pace of slowing inflation as Russia confronts this trade-off between inflation and the real exchange rate?

Odling-Smee: There is no absolutely optimal pace, but the Russian authorities aren't being ambitious enough in reducing inflation. There's a risk, and we've seen this in other countries, that if inflation stays in the 10–20 percent range for a number of years, it will be difficult to get it below that range. We think the authorities should commit themselves to reducing core inflation—that is, inflation before adding the impact of special administrative price increases, such as for housing and communal services and energy—from 10 percent now to less than 5 percent by the end of 2004. Last year, Russia's headline inflation was 15 percent, and the authorities are targeting a headline rate of 10–12 percent in 2003 and about 9 percent—consistent with core inflation of 7 percent—in 2004.

IMF Survey: To what extent should capital inflows be regulated or controlled?

Odling-Smee: We wouldn't favor any controls on long-term capital [portfolio or foreign direct investment] inflows. But it's sometimes difficult to distinguish between long-term and short-term portfolio inflows. Right before the 1998 crisis, investors heavily bought longer-term GKOs [government securities] as a speculative move. Our concern now is that a situation could arise again where foreign investors want to speculate on a short-term basis in Russia, potentially complicating macroeconomic management. Under these circumstances, we would support some kind of market-friendly capital controls, such as the Chilean-type controls, to try to discourage speculative inflows.

With only the older generations now questioning the desirability of completing market reforms and integrating with the world economy, I believe that this strong drive will keep Russia moving in the right direction.
–John Odling-Smee

An improved business climate will encourage growth in Russia's non-oil sector. A soft drink bottling company, above, started production in Moscow in 1998.

IMF SURVEY: The IMF has generated much controversy by suggesting that the tax burden should be shifted from the nonenergy sector to the energy sector. And can the non-oil sector be stimulated without a major push for structural reforms to improve the investment climate?

ODLING-SMEE: The government is trying, quite rightly, to gradually diversify the economy away from an overdependence on natural resources. One way to do that is to lower the tax burden on the non-oil sector and shift it to the oil sector, which carries a lighter burden than oil sectors in comparable countries. However, if the government does this soon, it won't necessarily help because the problems that the non-oil sector faces are much more deep-rooted than taxation. The authorities' highest priority should be to improve the business climate throughout the economy to encourage growth in the non-oil sector. This will have a bigger impact on growth than tax cuts.

IMF SURVEY: What reforms are needed to improve the business climate?

ODLING-SMEE: Four reforms top the list. First, the government needs to reform the banking sector, which is small, weak, and unable to properly intermediate savings between savers and investors. Second, it needs to reform the natural monopolies, especially Gazprom and the electricity sector. This will mean raising prices to cover costs and create proper market pricing. This step will have to go hand in hand with a social safety net that enables the lower-income groups to afford the higher oil prices. Third, Russia needs to reform the social sector, reducing the subsidization of communal services and housing while strengthening income transfers to low-income households. Fourth, it needs to reform the civil service and public administration, which are still too large, intrusive, arbitrary, and underpaid––of course, encouraging corruption.

But tackling these four reforms will be very difficult politically. In fact, not much will happen before the elections scheduled for late this year and early next year. That's why it is vital to prepare the ground now and undertake a major push on reforms after the presidential elections in March 2004, when there will be a window of opportunity before the next round of elections.

IMF SURVEY: Are you hopeful that Russia can achieve these reforms?

ODLING-SMEE: I am always hopeful about Russia. I am a long-term optimist, although sometimes a short-term pessimist. I am hopeful now for a number of reasons. One is that, despite the difficulties of the past decade, we have, by and large, year after year, seen progress, reflecting the underlying wish of the people and the leaders to move in a reformist direction even during the tough times. Second, the whole of the leadership now wants reforms. It is true that there are various vested interest groups whose positions would be threatened by reforms, and they are resisting. That said, I don't think that they'll be strong enough in the long run to prevail. We are already seeing cases of some of the vested interests switching sides. Some of the big oligarchs have backed reforms even when they themselves didn't gain. True, they haven't yet backed reforms where they would lose a lot, but they are no longer a reactionary force; they've made their money and are willing to look at the big picture and take a philanthropic view of the country's future. Third, there is a tremendous will, especially among younger generations, to make up for the time that Russia has lost and the missteps taken in the past decade, not to mention during communist times. With only the older generations now questioning the desirability of completing market reforms and integrating with the world economy, I believe that this strong drive will keep Russia moving in the right direction. ■

Photo credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, pages 65–67, 74–76; Alexander Natruskin and Viktor Korotayev for Reuters, page 68; Bernardo Rodriguez for AFP, page 69; Pedro Ugarte for AFP, page 70; Peter Williams for WCC, page 72; and Arne Dedert for AFP, pages 79 and 80.

IMF is committed to Latin America

(Continued from front page) have allowed them to weather the storm reasonably well. I also welcome the stabilization of the economy in Argentina, although the situation remains fragile, and there is still a need for a more comprehensive medium-term economic program. Thus, the picture in Latin America is very differentiated. But, overall, there are signs of recovery. And this recovery will need to be nurtured with the right policies and decisive leadership.

Horst Köhler and Bank of Spain President Jaime Caruana in Madrid on March 11.

The debate about the causes of the current crisis is ongoing. But let me say clearly what, in my view, is not the cause: market-oriented policies. I agree with Ernesto Zedillo, former president of Mexico, that the main problem in much of Latin America has not been too much reform but too little. And I would also add inconsistent policies. Privatization was not adequately supported by a regulatory framework that ensured competition. Fiscal policies were often not consistent with exchange rate policies. And excessive income inequality and the neglect of social safety nets meant that popular support for economic reforms eroded, an issue particularly important for several of the new democracies in Latin America.

Allow me to present four reflections on what we have learned and the direction I see for the countries in Latin America. First, they need to be more crisis proof. Reducing their vulnerability requires sound macroeconomic policies, fiscal policy foremost. This means living within their means and incurring debt (under reasonable terms) only for productive purposes. Second, sound macroeconomic policies, while necessary, are not a sufficient condition for growth. Structural reforms are needed to unleash countries' long-term growth potential. There is considerable scope for trade liberalization, and, maybe most important, there needs to be better access to quality education. Third, there is an urgent need to strengthen the institutions that support democracy and a functioning market economy. Protecting property rights; upholding the rule of law; and providing sound regulation of product, factor, and financial markets are crucial. Fourth, it will be necessary to tackle social inequity and poor governance. Macroeconomic stability and stronger, better-functioning institutions will help the poor. But there is also a need to explicitly target policies to alleviate poverty and improve social equity. And combatting corruption will yield significant benefits for economic growth but will also address social equity issues directly, as it is the small businesses and the poor who often bear the brunt of the burden of corruption.

Brazil

I am particularly encouraged by the new government in Brazil, which is charting a courageous course to restore growth and achieve sustained poverty reduction. While the demands on economic policy are clear, there is little room for slippage. And we should recognize Brazil's enormous potential. Abundant natural resources and a potentially huge market continue to attract significant foreign direct investment. And advances in primary education achieved in recent years offer enormous promise for future economic growth.

President [Luiz Inácio] Lula da Silva knows that breaking the chains restraining the Brazilian economy is the responsibility of Brazil itself. But he rightly asks the international community for help for self-help. The main focus needs to be on trade. Brazil's agricultural exports face considerable, in some cases almost ridiculous, barriers. Take sugar exports to the EU market. Brazilian sugar must pay a tariff of well over 100 percent on sales in the European Union. In addition, European sugar beet producers were subsidized to the tune of about 1½ billion euros in 2002, enough to allow even Finnish farmers to compete with tropical sugar! World Bank estimates suggest that the liberalization of market access under free trade agreements with the European Union and the Americas could raise Brazil's exports by $18 billion, or 32 percent, the vast majority of which would be agricultural products. But we should not forget that Brazil's own trade barriers remain significant in some sectors, severely shackling domestic competition and innovation. These, too, need to be tackled. ■

I am particularly encouraged by the new government in Brazil, which is charting a courageous course to restore growth and achieve sustained poverty reduction.
—Horst Köhler

IMF Working Paper

How can Central American countries improve their tax systems?

Economic performance in Central America—Costa Rica, El Salvador, Honduras, Guatemala, Nicaragua, and Panama—and the Dominican Republic improved markedly in the 1990s, but important challenges remain, particularly in reforming the tax system. In a recent IMF Working Paper, "Central American Tax Reform: Trends and Possibilities," Janet Stotsky and Asegedech WoldeMariam identify steps to strengthen public finances and increase revenue yields.

Central American countries have modern tax systems—notably including value-added taxes (VAT)—but there is scope to improve them and help governments meet their revenue needs. These small open economies could benefit, for example, from harmonizing their tax systems and enabling their producers to compete with those in their larger neighbors, such as Mexico and Colombia, and from avoiding harmful tax competition for such scarce resources as capital and skilled labor.

According to Stotsky and WoldeMariam, the main challenges for these countries are threefold:

- Strengthen revenue collections and tax efficiency. Tax policies that have eroded tax bases and continuing weaknesses in tax and customs administration have caused many problems.
- Harmonize taxes on domestic goods and services, primarily VATs and excise taxes, to improve both revenue collections and tax productivity.
- Raise property taxes and other, more locally based charges or taxes, which could help strengthen the budget and spur fiscal decentralization.

Recent unpublished estimates suggest that evasion of the VAT may be as high as 40 percent in some Central American countries.

Recent trends

Central American tax systems, Stotsky and WoldeMariam point out, are diverse in certain respects, most notably in terms of the overall ratios of revenue to GDP. Between 1990–94 and 1995–99, all the countries experienced an increase in their ratios of tax revenue to GDP. Nicaragua and Panama had a high ratio of tax revenue to GDP (above 20 percent in 1995–99), while Guatemala had the weakest revenue ratio, at 8.9 percent during the same period, largely because of its prolonged civil conflict.

The average ratio of tax revenue to GDP for Central American countries differs little from that for Latin America more broadly, despite the lower average level of income in Central America. The average ratio for Central America rose from 14.5 percent of GDP in 1990–94 to 16.5 percent of GDP in 1995–99, paralleled by a similar change in total revenues to GDP and by an increase in tax revenues in Latin America between these two periods.

Popularity of the VAT

Domestic taxes on goods and services—consisting of the VAT, excises and selective sales taxes (sometimes applied to an extensive array of goods), and other consumption taxes—are the broadest and most robust source of tax revenue. Their yield, the authors report, rose from 39.5 percent of the total to 48 percent between 1990–94 and 1995–99, mirroring a similar rise in Latin America overall.

The VAT, having risen from 22.7 percent of tax revenue to 32.8 percent between these two periods, is these countries' main source of revenue from domestic goods and services. The standard VAT rate varies from country to country but has tended to rise over time, increasing the dominance of this source of revenue. As of 2001, all Central American countries except Nicaragua and Panama had a standard VAT rate of 12 or 13 percent (Nicaragua's was 15 percent and Panama's 5 percent). VATs are relatively easy to administer, but some questions remain about how efficient they are at generating revenues. While it is difficult to measure the productivity of a VAT, according to one commonly used measure (the "c-efficiency" ratio), average VAT productivity in Central America has declined over the past few years.

How can these countries strengthen their VAT collections? First, Stotsky and WoldeMariam argue, it is best to limit the VAT to a single rate because administrative complexity increases more than proportionately to the number of rates. Second, VATs should have few exceptions. Only exports should be zero rated (that is, sales should be exempt from the VAT), and exempt items should be limited to educational, medical, and social services, as well as financial intermediation, housing rentals, and a few other goods and services.

Excise taxes—typically levied on tobacco, alcohol, and petroleum, but also on other goods, such as motor vehicles and consumer durables—are a useful supplement to VATs and other broad-based sales taxes. In 1995–99, excise taxes generated 19 percent of tax revenues. Excise tax rates tend to vary considerably from one country to another, as does the manner in which they are levied. That said, the rates in Central America are, in general, not high compared with those in other

countries. There is thus scope, according to the authors, to increase excises on key goods, in several countries.

Broadening the tax base

Taxes on personal income and enterprise income or profits are another main source of tax revenue. In contrast to domestic consumption taxes, this component of taxation is relatively weak in most Central American countries, averaging only 19.2 percent of tax revenues in 1990–94 and 20.3 percent in 1995–99. These shares are slightly lower than in Latin America as a whole, although the trends diverged between the two periods, with the income tax share rising in Central America and dropping in the larger group of countries.

Enterprise income taxes form the larger of the two revenue sources in Central America. The top rate averaged 43.3 percent in 1986, declining to 28.4 percent in 1997, and then roughly stabilizing at this level through the most recent year (either 2001 or 2002, depending on data availability). Free trade zones and special incentives are quite common in developing countries. But the authors argue that a better way to attract additional investment would be through generous depreciation allowances and provisions for carrying losses forward and, possibly, some limited investment tax credits.

All countries in Central America levy personal income taxes with graduated rates, but the number of rate brackets, the income level at which the brackets apply, and the coverage of income—labor and capital income—vary from country to country. In Central America, the top and bottom bracket rates fell, on average, between 1990–94 and 1995–99. The current average range (2001 or 2002) is 10.3–27.3 percent.

Although all Central American countries define the tax base as including income from wages and salaries, most do not fully tax income from bonuses and fringe benefits. This creates inequities between taxpayers who earn these kinds of income and those who do not and disproportionately benefits higher-income employees. Personal income taxes, Stotsky and WoldeMariam argue, must be levied on higher-income taxpayers and those earning capital and other nonwage income.

Some countries have used the property tax as a key source of local revenues because the tax base is immobile. It has the potential to become even more important in Central America and should be strengthened. But, first, countries must have an accurate register of property and an up-to-date assessment of property values.

Improving administrative performance

The implementation of tax policies, the authors say, should be supported by the establishment and maintenance of modern and professional tax administrations based on the rule of law. Central American countries are taking a number of steps to enforce tax laws adequately. For example, they are expanding and improving withholding taxes, implementing self-assessments, improving audits, and computerizing.

However, recent unpublished estimates suggest that evasion of the VAT may be as high as 40 percent in some Central American countries. Although not unusual for developing countries—and even some developed countries—such high rates suggest that there is considerable scope for strengthening collections through general administrative practices, such as improved audits and tax structures.

More generally, Stotsky and WoldeMariam stress that there is a need to adopt rules (and supporting regulations) for corporate and personal income taxes—in particular, to deal with cross-border issues, such as transfer pricing, thin capitalization (excessive use of debt to remove earnings from a country through high interest deductions), and other devices used by multinational corporations. Because wealthy individuals may keep a large proportion of their wealth abroad, it is important both to extend the jurisdiction of the tax system to global income and to develop the tools and relationships with other countries that will make it possible to capture income from assets held abroad.

Equal is better

International issues have become increasingly important in tax policy reform in recent years. Central American countries, the authors argue, could gain through greater regional integration of their tax systems. Movement toward a common market would imply freer movement of tax bases.

In Central America, an increasing emphasis on regional tax harmonization has first entailed movement toward more uniform tariffs and the elimination of internal tariffs. Harmonization of domestic tax systems would also benefit Central American countries, given their natural links and small size. One goal might be to aim for a single VAT rate of 15 percent, as in the Caribbean region. Similarly, it might be useful to set certain minimum rates for excise taxes, as in the European Union, rather than a single set of rates, given the importance of flexible excise rates in meeting immediate budgetary needs. Over the medium term, the authors also indicate that a greater harmonization of income taxes—especially tax incentives—would be highly desirable. ■

Copies of IMF Working Paper 02/227, "Central American Tax Reform: Trends and Possibilities," by Janet Stotsky and Asegedech WoldeMariam, are available for $15.00 each from IMF Publication Services. See page 73 for ordering information. The full text is also available on the IMF's website (www.imf.org).

A better way to attract additional investment would be through generous depreciation allowances and provisions for carrying losses forward and, possibly, some limited investment tax credits.

Churches and Bretton Woods institutions exchange views on development

The IMF and the World Council of Churches (WCC), the main international organization of Protestant churches, along with the World Bank, met to discuss the evolution of their mandates and their views on development, poverty, and social justice. Academics from various countries and disciplines, invited by the WCC, also attended the February 13–14 meeting in Geneva.

Setting the tone for the sessions, Chairman Bob Goudzwaard (former professor of economic theory, Free University of Amsterdam, and a former member of the Dutch parliament) asked whether the institutions were ships passing in the night, greeting each other but then proceeding, each on its own unchanged course. Historically, the WCC and the Bretton Woods institutions had had little communication with each other, and Goudzwaard asked if a closer engagement was either possible or desirable. The discussions were successful in allowing participants both to address fundamental misunderstandings and to help establish a basis of trust for continuing a constructive dialogue.

Moderator Bob Goudzwaard (left), and Rob van Drimmelen at the WCC meeting with the Bretton Woods institutions.

Ecumenical view evolves

Rob van Drimmelen (General Secretary, Association of WCC-Related Development Organizations in Europe) traced the ecumenical debate on development issues during the twentieth century from the creation of the Commission on Churches' Participation in Development—the churches' think tank for these issues—to the development of a global response to the challenges of economic integration.

Initially, the ecumenical debate on development was not much different from the secular debate. Development was seen as a process by which the developing countries followed the example of the more advanced economies to catch up economically. But, as developing country churches became more active in the WCC, the idea of one dominant development model applicable to all countries began to be questioned. In the mid-1970s, the ecumenical movement began to pay greater attention to noneconomic factors in social transformations and to the crucial role of participation. The WCC is credited with the early emphasis on including both the poor and the whole of civil society in social and political decisions that affect them.

In the 1980s, the ecumenical movement broadened its view of development to cover justice and peace and focused on education, training, community development, and the environment. In the first part of the 1990s, as globalization advanced and the jurisdiction of international institutions expanded, globalization and global governance became important elements of the debate. This explains why the WCC agenda now focuses on three items: equity and values, trade, and the reform of the international financial architecture.

IMF paradigm shift

Graham Hacche (IMF External Relations Department) discussed the evolution of the IMF's governance structure and mandate, highlighting the important paradigm shift that the Poverty Reduction Strategy Paper (PRSP) process represents in the current setting. The constancy of the IMF's purposes, he said, as set out in the Articles of Agreement, has required the institution to respond to changes, especially in the structure of the world economy and in its membership, and to economic policy lessons the IMF and national policymakers have learned. These changes have radically affected the IMF's work and help explain how it has adapted its methods and activities over the past half century.

Elaborating on Hacche's presentation, Peter Heller of the Fiscal Affairs Department discussed the IMF's perspective on the promotion of poverty reduction and improved distribution of incomes. He explained the importance of seeking a balance between policies designed to enhance growth and those that are specifically geared to reducing poverty and increasing equity. He also described how the IMF takes account of social justice and environmental sustainability.

Brian Ames of the Policy Development and Review Department also pointed to the PRSP process as representing a major shift in the IMF's emphasis and noted its potential for broadening the debate to include key poverty issues. He reviewed progress made in the design of the PRSP, the significant challenges that still lie ahead, and the efforts that will be required from the international community if poverty is to be further reduced.

Shared goal

The meeting showed that, despite a history of misunderstandings and differences of opinion about their roles and priorities, the Bretton Woods institutions and the World Council of Churches share the goal of reducing poverty in the world. The main recurring themes were accountability of institutions, global governance, strategies for encouraging participation, responsibilities of the public and private sectors, and alternative measures of human development.

At the end of the two days, the participants expressed appreciation for the dialogue and unanimously agreed that it should continue. The next meeting, scheduled to be held in Washington in the fall, will focus on the participatory process in the context of the PRSP and the roles of the public and private sectors in the economy. It will also continue the discussion of broader issues, including governance (of the international financial institutions and of national governments) and responses to the challenges of economic globalization. ■

Bassirou Sarr
IMF External Relations Department

The Bretton Woods institutions and the World Council of Churches share the goal of reducing poverty in the world.

Recent publications

Working Papers ($15.00)

03/10: "FDI to Africa: The Role of Price Stability and Currency Instability," Kenneth Rogoff and Carmen Reinhart
03/11: "Dollarization of Liabilities: Beyond the Usual Suspects," Adolfo Barajas Estrada and Armando Morales
03/12: "Inflation Targeting Lite," Mark R. Stone
03/13: "Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World," Patrick Bolton
03/14: "Income Inequality and Redistributive Government Spending," Luiz R. De Mello Jr. and Erwin H. Tiongson
03/15: "Information Technology and Productivity Growth in Asia," Houng Il Lee and Yougesh Khatri
03/16: "Political Economy of Oil-Revenue Sharing in a Developing Country: Illustrations from Nigeria," Ehtisham Ahmad and Raju J. Singh
03/17: "What Happens After Supervisory Intervention? Considering Bank Closure Options," Michael Andrews and Mats A. Josefsson
03/18: "Anticipating Arrears to the IMF: Early Warning Systems," Chikako Oka
03/19: "Fiscal Sustainability and Resource Mobilization in the Dominican Republic," Oscar E. Melhado Orellana
03/20: "Portfolio Flows into India: Do Domestic Fundamentals Matter?" James P. Gordon and Poonam Gupta
03/21: "Medium-Term Exchange Rate Forecasting: What Can We Expect?" Guy M. Meredith
03/22: "Productivity Trends in India's Manufacturing Sectors in the Last Two Decades," Bulent Unel
03/24: "Financial Infrastructure, Group Interests, and Capital Accumulation: Theory, Evidence, and Policy," Biagio Bossone, Sandeep Mahajan, and Farah Zahir
03/25: "Some Implications for Monetary Policy of Uncertain Exchange Rate Pass-Through," Benjamin L. Hunt and Peter Isard
03/26: "Exchange Rate Regime Considerations in an Oil Economy: the Case of the Islamic Republic of Iran," Oya Celasun
03/27: "How Does Globalization Affect the Synchronization of Business Cycles?" Ayhan Kose, Eswar S. Prasad, and Marco E. Terrones Silva
03/28: "The Equilibrium Real Exchange Rate of the Malagasy Franc: Estimation and Assessment," John Cady

IMF Staff Country Reports ($15.00)

03/27: Republic of Croatia
03/28: St. Vincent and the Grenadines
03/29: St. Vincent and the Grenadines: Statistical Appendix
03/30: Cyprus
03/31: Cyprus: Selected Issues and Statistical Appendix
03/32: Bulgaria
03/33: Canada
03/34: Canada: Selected Issues
03/35: Barbados
03/36: Tonga
03/37: Tonga

Publications are available from IMF Publication Services, Box X2003, IMF, Washington, DC 20431 U.S.A.
Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey's* annual *Supplement on the IMF*, *Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's website (www.imf.org). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF's website.

What is behind the declines in global income inequality and poverty?

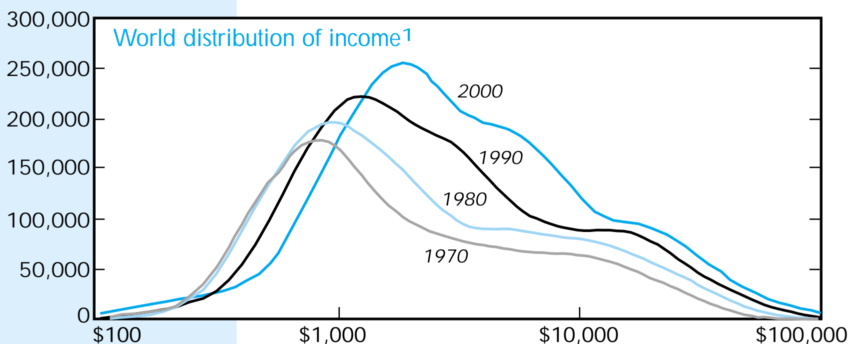
Xavier Sala-i-Martin

There has been a steady decline in global income inequality and a dramatic drop in poverty rates over the past two decades, according to Columbia University's Xavier Sala-i-Martin. Presenting revised estimates of the world distribution of income at a February 21 seminar at the American Enterprise Institute (AEI), he cautioned, however, that further gains in reducing inequality and poverty may well rest on Africa's ability to grow.

At the AEI seminar, Xavier Sala-i-Martin presented estimates of the world distribution of income that now include data for the countries of the former Soviet Union. He had been reluctant to include these in his initial estimates, he said, because communist-era data are "complex—half real, half imaginary." But he changed his mind because of "criticism from World Bank experts" about the biases from ignoring this large chunk of the world's population, particularly one that underwent a large decline in its fortunes in the 1990s.

A global middle class is emerging

Thousands of people



Data: Xavier Sala-i-Martin
[1]Annual income.

The inclusion of the new data does not, however, change Sala-i-Martin's central finding: Global inequality in incomes has declined because of the robust growth in populous countries like China and India since 1980. This growth has "filled the hole in the middle of the world income distribution" that existed prior to that time. Global poverty rates have declined to somewhere between 5 percent and 15 percent, depending on the precise details of how poverty is measured.

Catherine Mann

Imagine there's no country

Like the study by Surjit Bhalla (see *IMF Survey*, October 21, 2002, page 335), Sala-i-Martin's work focuses on inequality of incomes between people rather than between countries. Explaining the rationale for this choice, Sala-i-Martin said that "treating each country as one observation gives Lesotho and China the same weight" in the calculation of global inequality and global poverty rates. This does not make sense, he said, because "10 percent growth in China improves the welfare of 1.2 billion people, whereas 10 percent growth in Lesotho, while it would be welcome, would better the lives of, at most, a few million."

This concept of inequality (from a line in John Lennon's song "Imagine," in which he says to imagine there's no country) is easy to define but difficult to compute. "We do not know the income level of every person on the planet," Sala-i-Martin said. Filling in the gaps in our knowledge requires a tremendous amount of guesswork (see box, next page). But the end product is a rendition of how the world distribution of income has evolved over time (see chart, this page). The mean of the distribution has steadily shifted to the right since 1970; in other words, the global citizen has, on average, become richer. The distribution has also become more equal with the emergence of a global middle class, particularly in China and India.

Thanks to these income gains, poverty rates—measured using various common definitions of poverty—have fallen dramatically over time. Unfortunately, Africa has not shared in these gains. Per capita incomes in most countries there have stagnated or declined, with the result that the poverty rate for the continent as a whole has increased from about 35 percent in 1970 to almost 50 percent today (see chart, next page). Most of the decline in global poverty has occurred in Asia. Unless the trends in Africa are reversed, Sala-i-Martin noted, it is likely that world income inequality will widen in future decades and that global poverty rates will start rising again.

Countries matter

Commenting on Sala-i-Martin's work, Catherine Mann of the Institute for International Economics (IIE) noted that there are three concepts of inequality, each having a place in the policy discussion on the subject. The most familiar is within-country inequality—the difference between the incomes of the rich and the poor within a country. The second is cross-country inequality, measured as the inequality between the incomes of the average person in each country. (This may be termed the United Nations (UN) definition in that it uses a one-country, one-vote approach—analogous to the voting rule in the UN General Assembly—to measure inequal-

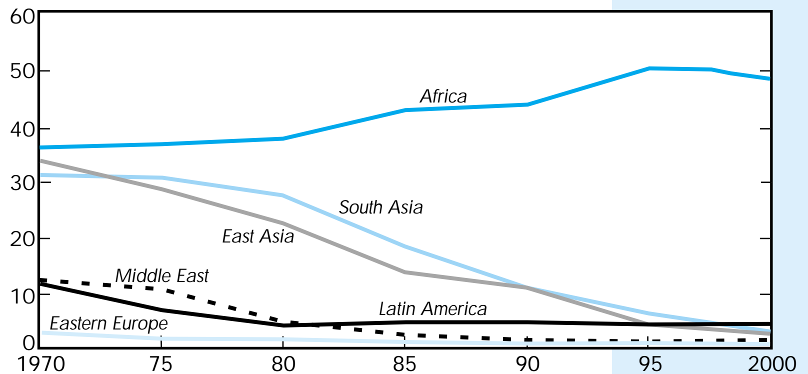
ity.) Measured in this way, inequality has clearly increased in recent decades; Mann noted that the Harvard economist Lant Pritchett has famously described this finding as "divergence, big time." The third concept is the one-person, one-vote approach to measuring inequality of incomes that is used in the work of Bhalla and Sala-i-Martin. Mann noted that the main finding of their work has been succinctly described by Sala-i-Martin as "convergence, period."

But Mann questioned whether the focus on people rather than countries is appropriate. The vast majority of people do not leave the country of their birth. What matters to them, therefore, is the living standard and inequality of income in that particular country. It is cold comfort to someone who cannot escape poverty in an African country to learn of the robust growth in China and the consequent reduction in global income inequalities. Moreover, economic policies are typically formulated at the country level. The cross-country inequality measure may thus be a better indicator of whether governments in poorer countries are adopting policies that would allow incomes in these countries to catch up with those in richer nations. That this measure has shown divergence over time suggests that many governments, particularly in Africa, have failed to adopt such policies.

Both rich and poor live longer

The second commentator, AEI's Nick Eberstadt, said that income data could be so fragile that it was essential to corroborate Sala-i-Martin's evidence using other socioeconomic indicators. One such indicator

Poverty has declined, except in Africa



Data: Xavier Sala-i-Martin.

is the measure of life expectancy. As an example, Eberstadt presented evidence showing how average life expectancy and the inequality between life expectancies of the rich and the poor have evolved in France since 1800: Life expectancy has increased from 30 years to over 75 years today, with a much faster rate of increase in the twentieth century than in the nineteenth century. Moreover, both rich and poor shared in the gains in life expectancy in France: Inequality between rich and poor has declined steadily, and at a particularly fast pace during the twentieth century. In other words, Eberstadt said, "it is much easier for the poor to buy extra years of life today" than it was 20 or 100 years ago. Evidence of this kind for other countries would be valuable, Eberstadt concluded. ■

Prakash Loungani
IMF External Relations Department

Nick Eberstadt

Conjuring up income distribution

Focusing on people rather than countries in analyzing the distribution of income immediately runs up against an immense practical problem: We do not know the income level of each person on the planet. But there are sources of information to help us piece together this information.

One source is countries' national accounts data, which give per capita incomes. Another source—thanks to surveys that most countries conduct periodically—is snapshots of the income shares of various segments of the population. But they are deficient in two respects. First, they are not available for every year. Second, even in the years for which they are available, they provide the income level not of every person in the country but of those at particular income levels (for example, of quintiles—that is, five equal segments of the population, each representing 20 percent). Guesswork and number crunching are needed to transform the snapshots into a movie of how the distribution of income has evolved over time.

The first deficiency is not major in countries for which there are quite a few snapshots of income shares; it is easy to fill in the gaps and conjecture what the income shares were in the missing (or nonsurvey) years. In countries where only a few snapshots are available, it is more difficult to picture the evolution of income shares over time. Sala-i-Martin paints in this missing data by assuming that countries in the same region have common patterns. For example, he fills in the missing income share data for, say, Paraguay by using the corresponding averages for the Latin American region as a whole. While this approach now provides income shares for each country over time, we are still a step away from computing the world distribution of income.

The income share data that Sala-i-Martin uses are for quintiles of the population. One could assume that every person within the quintile has the same income, but this is not a satisfactory assumption, particularly for populous countries in which each quintile represents several million people. Instead, Sala-i-Martin uses a variety of mathematical techniques to arrive at the income shares of people within each quintile.

IMF Institute seminar

Measuring poverty: pitfalls, prescriptions, and policy implications

Measures of poverty figure prominently in debates on the social impact of economic policies and are now routinely used to design targeted interventions to fight poverty. This, coupled with the prominence given to the UN Millennium Development Goal of halving the poverty rate in the world by 2015 (relative to 1990), highlights the need for close scrutiny of poverty data and measures. At a February 4 IMF Institute seminar, Martin Ravallion, Research Manager in the Development Research Group of the World Bank, reviewed current methods of measuring poverty and discussed their role in the debate over globalization's impact on poverty and inequality.

Ravallion: "Measurement issues play an important role in the debate over globalization's impact on poverty and inequality."

Measuring poverty typically involves three steps: choosing an indicator of individual economic welfare (which tends to be household expenditure or income over some period, adjusted for differences in household size and the cost of living); setting a poverty line (that defines the level of welfare deemed necessary for an individual to escape poverty); and identifying an aggregate poverty measure (one that summarizes the information from the first two steps).

A number of contentious issues surround this process, however. At the conceptual level, for example, there have been disputes over the household welfare indicator (should it be consumption or income, what should it include, and how should it take cost of living differences into consideration?); the poverty line (at what overall level should it be set, and should it vary in real terms by subgroup or date?); and the aggregate poverty measure (how should it treat inequality among the poor?). Increasingly, answers to these questions are being sought outside economics, for example, by studying individuals' perceptions of their well-being.

Deciphering definitions

A common source of confusion is the difference between absolute and relative poverty. Absolute poverty lines are fixed in real terms over time and in geographic space. Relative poverty, in contrast, rises as average incomes rise. In some cases, relative poverty lines are even set in proportion to average income, though this practice is hard to accept, Ravallion noted, because it implies that when all incomes grow at the same rate, poverty does not fall. He argued that the concepts of absolute and relative poverty can be unified by thinking of poverty as absolute in terms of individuals' well-being (low welfare makes one poor), though relative in terms of commodities, depending on how individuals' well-being is affected by their relative positions in society. Very little is known about the weight that individuals attach to their relative income. Further research is needed, he said, and one promising area is how self-rated welfare varies with individuals' own income and with that of a reference group consisting of, for example, coworkers or individuals living in the same area.

A related issue arises with inequality. Relative inequality depends on the ratios of individual incomes to the overall average, while absolute inequality depends on the absolute differences in levels of living. Consider an economy with just two household incomes: $1,000 and $10,000. If both incomes double in size, relative inequality will remain the same; the richer household is still 10 times richer. But the absolute difference in their incomes doubles, from $9,000 to $18,000. Relative inequality is unchanged but absolute inequality rises sharply.

Data issues

At a practical level, too, Ravallion said, many shortcomings are associated with the data used to measure these concepts. Household surveys are the main source of data. Statistics offices often put considerable effort into ensuring that the surveys provide reliable data, but some times people underreport their income or consumption or do not respond. Sometimes efforts are made to anchor poverty measures, instead, to national accounts data on consumption, assuming that the household surveys measure relative inequality correctly. However, this practice is fraught with further problems. Consumption data from the national accounts may well be even further off the mark because they are not designed to measure poverty, and survey noncompliance and underreporting are thought to be more of a problem for estimating incomes of the rich than of the poor.

Ravallion also cautioned that certain practices in setting poverty lines can be misleading if they do not account well for differences in people's actual cost of living. This is particularly worrisome because choices made in setting poverty lines influence decisions about, for example, which regions and types of households should be targeted. Ravallion described a computationally simple "cost of basic needs" method

for setting poverty lines that can often provide a reasonable approximation of the true cost of living differences facing poor people.

But aside from these problems, the inadequacy of income or consumption as a metric of welfare points to the need for supplementary indicators, notably measures that gauge access to public education and health services, income distribution within households, and maternal mortality and children's nutritional status. Not all of these are relevant in every context, he indicated, but, generally, multiple indicators are needed to provide a fuller or more accurate picture.

Measurement issues and policy debates

Measurement issues play an important role in the debate over globalization's impact on poverty and inequality. Some argue that the proportion of people living in extreme poverty in the developing world fell sharply in the 1990s; others argue that globalization has brought greater poverty. Some say that income inequality has been rising in the world; others claim that it is falling.

These discrepancies, Ravallion stated, stem in part from differences in the data and methods used but also from important conceptual distinctions. For example, proglobalizers appear to be more relativist about inequality, taking the view that if all incomes grow at the same rate, inequality is unchanged. Antiglobalizers, in contrast, tend to be absolutist about inequality, emphasizing the increase in absolute differences in levels of living that accompany economic growth even when relative inequality does not change. Neither is right or wrong; it is simply a question of interpretation.

Ravallion also pointed out that some recent claims of rising inequality in the world are based on the fact that poorer countries have tended to grow relatively slowly over the past 40 years. But taking into account the enormous variations in population size between countries, the picture of rising inequality among people in the world changes dramatically: There is no clear trend in relative inequality around the world over the past 20 years. Inequality has risen within many growing countries, including China and India, but these two countries' high economic growth rates have been a major factor in keeping down overall inequality.

Can the seemingly opposing positions taken in the globalization debate be reconciled? Ravallion sees hope. He said that poor people typically do share in the benefits of rising aggregate affluence, and they do typically suffer from economic contraction. But there are large differences between countries in how much poor people share in growth, and, often, there are losers among the poor during spells of growth, even when poverty falls on average.

Examining data for about 120 periods of growth or contraction across 50 developing countries, mostly during the 1990s, Ravallion found that the extent to which growth benefited the poor varied enormously between countries and over time. A 1 percent growth rate resulted in anything from a modest 0.6 percent drop in the poverty rate to a more dramatic 3.5 percent decline. Also, in about half the cases, relative inequality rose during periods of growth, and the rate of poverty reduction was lower than in other countries with similar growth rates. And, even when inequality was unchanged, how rapidly poverty fell in response to economic growth also depended on the initial level of inequality, in both income and nonincome dimensions (such as level of education and health status). For example, in a typical low-inequality country with a 2 percent rate of growth in per capita income and 40 percent of the population deemed poor, the poverty rate could be halved in 12 years. In a typical high-inequality country, halving the poverty rate would take 21 years.

And while economic growth tends to reduce poverty, not all growth-promoting policies do so, Ravallion said. Policies often have distributional implications that cannot be ignored. Combining growth-promoting economic reforms with the right social sector programs and policies to help the poor participate fully in the opportunities unleashed by growth will achieve more rapid poverty reduction. Ravallion emphasized the need to develop the human and physical assets of poor people; remove biases against them in public spending, taxation, trade, and regulation; and promote agriculture and rural development. Redressing inequalities of opportunity within developing countries as they open their economies is crucial for realizing the poverty-reducing potential of globalization, he said. This is the real challenge facing policymakers. ■

Some say that income inequality has been rising in the world; others claim that it is falling.
—Martin Ravallion

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
March 3	1.76	1.76	2.25
March 10	1.73	1.73	2.21

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the euro, the Japanese yen, the pound sterling, and the U.S. dollar, which constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171.

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

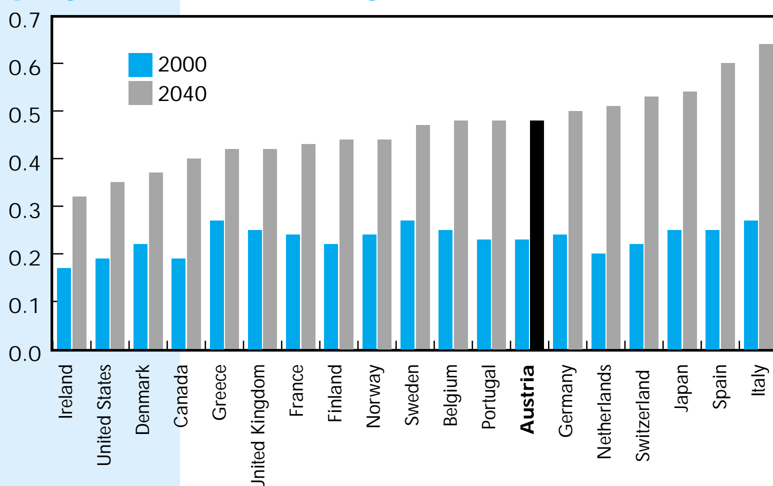
Working Paper

Aging population threatens Austria's welfare state

In Austria, the ratio of the elderly to people of working age will double over the next 50 years. This dramatic demographic shift—brought on by a major decline in fertility and mortality rates since the 1960s—will be more severe than in many other industrial countries (see chart). It will increase public spending on pensions, health care, and long-term care and decrease tax and social security revenues. In a new IMF Working Paper, Leif Lybecker Eskesen concludes that ensuring long-term fiscal sustainability in Austria will require bold reforms.

Austria has an expensive public pension system, while spending on health and long-term care is comparable to that in other European Union (EU) countries. The costs of these systems will increase markedly as the pronounced aging of the population translates into more people claiming pensions and needing care. Also, increased longevity will in itself increase the demand for care as health deteriorates with age. In public pension and health care systems, aging poses a major fiscal burden, one that Austria is ill prepared to meet, and the sustainability of Austria's public finances will be at serious risk absent bold public expenditure reforms, Eskesen says. He recommends timely implementation of further pension reforms and measures to reduce expenditures in other areas. Otherwise, the traditional Austrian welfare state will be threatened.

Ratio of elderly to working-age Austrians projected to double by 2040



Data: United Nations; and Statistik Austria

Generous pension schemes

In Austria, the principal source of income for retirees is a public pay-as-you-go pension system that provides old-age, early retirement, disability, and survivor benefits. Eligibility for old-age pensions depends on the length of the contribution period, with a minimum age requirement of 65 for men and 60 for women under the Allgemeines Sozialversicherungsgesetz (ASVG)—the major pension scheme for the private sector. For civil servants, the minimum pension age is 65 for both men and women.

Under the ASVG scheme, early retirement is permitted at a minimum age (and with a reduced pension) of 60 for men and 55 for women. This will rise to 61.5 and 56.5 years in 2003. For civil servants, the minimum age for early retirement is being raised to 61.5 from 60 for both men and women. Early retirement and disability pensions have become increasingly popular as a result of relatively easy access and generous benefits. In 1999, only about 15 percent of new pensions were regular old-age pensions, and the average retirement age was 57.6 years under private sector schemes and 59 years for federal civil servants. Compared with other European countries, the labor market participation rate of the elderly in Austria is low.

Austria's pension benefits are also generous by international standards. Total spending on pensions in 2000 was about 14.5 percent of GDP, significantly higher than the EU average of about 10 percent. Under private sector pension schemes, the maximum replacement rate—ratio of pensioners' initial benefit to their last wage—is 80 percent, while benefits for civil servants are not subjected to a maximum level. Contributions, which range between 10 and 15 percent of gross wages depending on the pension scheme, are insufficient to cover total spending on pensions; the current deficit in the pension system is about 5.5 percent of GDP. Consistent with the concept of solidarity among generations underlying the Austrian pension system, government budget transfers help cover the deficit.

Wide-reaching health and long-term care

In Austria, the responsibility for almost all health care lies with the federal government. Public health insurance is compulsory and practically all Austrians are covered. Public health care spending is comparable to that in other industrial countries. In 2000, it was about 5 percent of GDP (excluding long-term care spending), close to the EU average of 5.3 percent.

Health insurance contributions and general tax revenues finance the bulk of spending, but private households also provide some copayments and user fees. Contribution rates to the different health insurance funds vary by profession and range from about 6–7 percent of gross earnings for white-collar workers and farmers to about 9 percent for the self-employed.

Long-term care in Austria is less institutionalized than in many comparable industrial countries. Families play a larger role in caring for their elderly relatives, and a significant share of the elderly receive long-term care at home. Nevertheless, the central and local governments are responsible for providing financial resources or services to ensure that the elderly and others in need can receive the necessary care. All citizens have a right to long-term care if they need basic care or domestic help, regardless of their age and without being subject to a qualifying period. Long-term care consists of both cash benefits and benefits in kind provided by public and private suppliers. Spending on long-term care in Austria, which is financed by taxation, is lower than in other industrial countries. In 2002, it amounted to about 0.7 percent of GDP, compared with a weighted average of 1.3 percent for a selected group of EU countries.

Fiscal effects of aging

Current projections indicate that the share of Austria's elderly (older than 64) relative to working-age people (15–64 years) will rise to about 50 percent in 2050 from 23 percent today, and the share of very old people (over 79 years) will rise by even more. As a result, age-related expenditures will be higher.

Eskesen notes that the increase in pension spending will depend on the relative number of the elderly, the share of working-age people who are employed, the share of the elderly receiving pensions, and the pension level of recipients. Spending on health and long-term care services will also increase with the age of recipients. In 2000, average spending on acute health care for people 55 and over amounted to about € 2,900 a person, while average spending on

Available on the web (www.imf.org)

Press Releases

03/25: IMF Completes in Principle Fifth Review Under Mali's PRGF Arrangement and Approves $9 Million Disbursement, February 28

03/26: IMF Completes Fourth Review of Pakistan's PRGF-Supported Program, Approves $118 Million Disbursement, February 28

03/27: IMF Suspends Liberia's Voting Rights in the IMF, March 6

03/28: Deputy Managing Director Eduardo Aninat to Leave IMF in June, March 7

03/29: IMF and World Bank Support $675 Million in Debt-Service Relief for Mali: West African Country Reaches Completion Point Under Enhanced HIPC Initiative, March 7

03/30: Statement from MDB[multilateral development banks]/IMF Heads on International Women's Day, March 7

03/31: IMF Launches Enhanced Dissemination Standards Bulletin Board, March 10

03/32: IMF Mission Ends Visit to Turkey, March 10

03/33: Statement by IMF Mission to the Republic of Kazakhstan, March 11

Public Information Notices

03/17: IMF Concludes 2002 Article IV Consultation with Tonga, February 24

03/18: IMF Concludes 2003 Article IV Consultation with Canada, February 25

03/19: IMF Concludes 2002 Article IV Consultation with Spain, February 26

03/20: IMF Concludes 2002 Article IV Consultation with Cambodia, February 28

03/21: IMF Concludes 2002 Article IV Consultation with the Kingdom of the Netherlands-Aruba, March 3

03/22: IMF Concludes 2002 Article IV Consultation with the United Kingdom, March 3

03/23: IMF Concludes 2002 Article IV Consultation with Haiti, March 3

03/24: IMF Concludes 2002 Article IV Consultation with Belgium, March 4

03/25: IMF Concludes 2002 Article IV Consultation with Algeria, March 5

03/26: IMF Concludes 2002 Article IV Consultation with Korea, March 6

03/27: IMF Concludes 2002 Article IV Consultation with Albania, March 7

03/28: IMF Concludes 2002 Article IV Consultation with the Kyrgyz Republic, March 7

Speeches

"The Role of the IMF in a Globalizing World Economy," by Horst Köhler, Managing Director of the IMF, at the Fourth Annual Conference of the Parliamentary Network on the World Bank, Athens, March 9

Transcripts

Press Briefing by Thomas C. Dawson, Director, External Relations Department, March 4

Laura Wallace
Editor-in-Chief
Sheila Meehan
Senior Editor
Elisa Diehl
Assistant Editor
Jeremy Clift
Assistant Editor
Christine Ebrahim-zadeh
Assistant Editor
Natalie Hairfield
Assistant Editor
Kelley McCollum
Editorial Assistant
Lijun Li
Editorial Assistant
Philip Torsani
Art Editor/Graphic Artist
Julio R. Prego
Graphic Artist

Prakash Loungani
Contributing Editor

The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 22 times a year, plus an annual *IMF Survey Supplement* and an annual index. Opinions and materials in the *IMF Survey* do not necessarily reflect official views of the IMF. Any maps used are for the convenience of readers, based on National Geographic's *Atlas of the World*, Sixth Edition; the denominations used and the boundaries shown do not imply any judgment by the IMF on the legal status of any territory or any endorsement or acceptance of such boundaries. Text from the *IMF Survey* may be reprinted, with due credit given, but photographs and illustrations cannot be reproduced in any form. Address editorial correspondence to Current Publications Division, Room IS7-1100, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-8585; or e-mail any comments to imfsurvey@imf.org. The *IMF Survey* is mailed first class in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged $79.00 annually. Apply for subscriptions to Publication Services, Box X2003, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

people younger than 54 averaged only about € 800. For long-term care, the average spending per person for these two age groups was about € 500 and € 20. Thus, spending on these categories will rise because the shares of the elderly and the very old (over 80 years of age) are projected to increase. At the same time that age-related expenditures start to increase, the relative decline in the labor force will erode the tax and social security contribution base.

Options for ensuring fiscal sustainability

Given the dramatic changes expected in Austria's demographics and the prospect of a sharp deterioration in its fiscal position, what options are available to ensure the country's long-term fiscal sustainability? Eskesen explores the outlook for age-related spending and public finance sustainability under three scenarios: a "high case" (assuming solid growth and very successful outcomes of current structural reforms); a "low case" (lower growth and more moderate success of structural reforms); and a case in which additional pension reform measures are implemented.

Even if the pension and labor market reforms already under way are successful in containing early retirements and increasing labor force participation rates (especially of the elderly), Eskesen says, the fiscal pressures associated with the aging of the population will rise significantly. A better growth performance could have some positive effects on public finances but would still not alleviate the problem. Under less optimistic assumptions, the fiscal outlook would deteriorate quickly. The deterioration would be even more pronounced if the cost of health and long-term care increased faster than currently foreseen. Significant and timely improvements in the primary fiscal balance of more than 2–3 percent of GDP would be required to ensure long-term sustainability of public finances.

What is the best way for Austria to accommodate the projected bulge in age-related spending? An increase in taxes is not likely to be an available or desirable option—indeed, the government plans to reduce the tax burden over the medium term. Eskesen stresses that policy measures should focus on reducing spending—first and foremost through pension reforms. If such measures are not taken, or are insufficient, additional savings will need to be generated in other areas, for instance through reforms of the civil service or other welfare entitlements.

Additional reforms include bringing forward the harmonization of male and female retirement ages, further raising the minimum early retirement ages, strengthening the financial incentives for working longer, moving from wage to price indexation of benefits, and lengthening the wage assessment period for

measuring benefit entitlement. The sooner such reforms are implemented, Eskesen argues, the greater the long-term savings and, therefore, the smaller the needed fiscal adjustment. Introducing more user fees, tightening eligibility to certain services and benefits, and increasing the specialization of hospitals could also help contain the escalation of health and long-term care spending. He concludes by stressing the importance of adhering to fiscal discipline over the long term, since even small fiscal slippages will have large dynamic effects on public finances. In this context, the needed fiscal discipline and time consistency of fiscal policy could be supported by introducing a formalized fiscal framework. ■

Copies of IMF Working Paper No. 02/216, "Population Aging and Long-Term Fiscal Sustainability in Austria," by Leif Lybecker Eskesen, are available for $15.00 each from IMF Publication Services. See page 73 for ordering information. The full text is also available on the IMF's website (www.imf.org).

Aninat to leave IMF leadership post

IMF Deputy Managing Director Eduardo Aninat announced on March 7 that he plans to leave his post in June 2003. In December 1999, he joined the IMF's four-member management team with broad responsibilities in running the IMF, including chairing its Executive Board meetings.

Announcing his decision, Aninat said he held deep admiration for the IMF's dedicated staff and respect for the institution. "I have had the privilege of working in the IMF during challenging years for the international community. I am very grateful to my colleagues in management, in particular to Horst Köhler." Köhler described Aninat as a man of exceptional capabilities and said, "I have greatly benefited from his advice, support, and good counsel. During his stay here, he has contributed immensely to furthering the agenda of the IMF, drawing upon his vast experience of policy work, political acumen, and diplomatic skills. I am indeed sorry that Eduardo will be leaving us, but I understand his desire to move on to other challenges."