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Fiscal Adjustment for Stability and Growth

James Daniel, Jeffrey Davis,
Manal Fouad, and Caroline Van Rijckeghem

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Preface

This pamphlet is the product of a collaborative effort of the staff of the Fiscal Affairs Department (FAD). In particular, Peter Barrand, Matt Davies, Robert Gillingham, Michael Keen, Wojciech Maliszewski, Paulo Medas, and Theo Thomas provided valuable input. Advice and support from Teresa Ter-Minassian (Director of FAD) is gratefully acknowledged. The pamphlet also benefited from comments by staff of other departments within the IMF. Marina Primorac of the External Relations Department coordinated production of the publication.

Introduction

The IMF's approach to fiscal adjustment focuses on the role that sound and sustainable government finances play in promoting macroeconomic stability and growth. Achieving and maintaining such a fiscal position often requires adjusting fiscal policy, as well as strengthening fiscal institutions. Fiscal adjustment may involve either tightening or loosening the fiscal stance, depending on each country's circumstances.[1]

This paper updates and replaces the original 1995 pamphlet, *Guidelines for Fiscal Adjustment*. It reflects the significant changes in the world economy and in the way the IMF has approached fiscal adjustment since then. The key changes include globalization, which raises new challenges and opportunities for fiscal policy; the increasing importance of balance sheet variables, as highlighted by debt and capital account crises; the growing perception of institutions as key determinants of development success and macroeconomic stability; and the greater emphasis on helping low-income countries scale up productive expenditure and make good use of increased aid.

Fiscal policy and adjustment involve many fundamental and complex issues, about which much has been written and on which debate still flourishes. To be focused and more widely understood, this paper necessarily simplifies some of these issues. The paper also concentrates on broad topics and practical policy options, rather than on more technical or theoretical aspects, and is selective in the topics it addresses.[2] And, while much of the analysis is relevant for advanced economies, its focus is on emerging market and low-income economies.

In keeping with this practical emphasis, the paper is organized around five questions:

- When is fiscal adjustment needed?
- How should the fiscal position be assessed?
- What makes fiscal adjustment successful?
- How should fiscal adjustment be carried out?
- What institutions can help fiscal adjustment?

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[1]This broader definition of fiscal adjustment (compared with common usage equating fiscal adjustment with consolidation) reflects the increased emphasis on situations that warrant fiscal expansion.

[2]Only a few references are included in the main text. The bibliography section provides a fuller listing.

I.
When Is Fiscal Adjustment Needed?

Governments are necessarily continuing concerns. They have to keep going in good times and in bad. They therefore need a wide margin of safety. If taxes and debt are made all the people can bear when times are good, there will be certain disaster when times are bad.

—Calvin Coolidge (1872–1933)

Fiscal adjustment may be necessary to achieve longer-term goals, such as economic growth and poverty reduction, while heading off such fiscal vulnerabilities as the buildup of public debt. Shorter-term fiscal objectives should be pursued within this longer-term framework.

Fiscal Adjustment for Growth and Poverty Reduction

Governments typically aim to promote strong and sustainable economic growth, and lasting poverty reduction. Research indicates that a sound fiscal position is key to achieving macroeconomic stability, which is increasingly recognized as critical for sustained growth and poverty reduction. High-quality fiscal adjustment can also mobilize domestic savings, increase the efficiency of resource allocation, and help meet development goals.

Achieving Durable Macroeconomic Stability

Loose fiscal policy, on the other hand, can lead to inflation, crowding out, uncertainty, and volatility, all of which hamper growth (Gupta, Clements, and Inchauste, 2004).

- *Inflation.* Loose fiscal policy, especially when financed by printing money (see Section I, Fiscal Adjustment for Short-Term Macroeconomic Stability), can lead to high and volatile inflation. In addition to other costs, this undermines the efficiency of the price system as it leads firms and households to make incorrect decisions, confusing movements in the price level with changes in relative prices. This in turn reduces overall productivity (Fischer, 1993).

- *Crowding out.* When the government borrows to finance a looser fiscal position, the greater demand for loanable funds can reduce private investment (and other interest-sensitive components of private spending) by raising interest rates.[3] Under a floating exchange rate, higher interest rates will also tend to attract foreign capital, leading to an appreciation of the exchange rate, which will also crowd out exports.
- *Uncertainty and volatility.* Loose fiscal policy may not be sustainable. It implies, for example, continuously rising debt levels, which creates uncertainty as to how and when the loose policy will be corrected (e.g., through a burst of inflation, a disorderly depreciation, price and foreign trade restrictions, or large tax increases). These circumstances reduce private investment as they cause investors to wait and see how the uncertainty will be resolved and they prompt capital flight. Loose fiscal policy may also make the economic environment more volatile (e.g., by recurrent, and ill-timed, bursts of fiscal contraction and expansion), which can weaken investment by increasing risk and focusing investment on the short run (Bernanke, 1983).[4]

Indeed, in situations of high debt and deficits, fiscal consolidation can immediately expand output (see Section I, Fiscal Adjustment for Short-Term Macroeconomic Stability). In such situations, fiscal consolidation can reduce the risk premium on interest rates, catalyzing higher private investment and raising asset values. This boosts private consumption and eases supply constraints. The expectation of lower government spending can also lead the private sector to reduce its estimates of current and future tax liabilities, further boosting consumption and investment. It is not only the size of the fiscal deficit and the initial debt reduction that matter, however, but also the composition and the perception of the sustain-

[3]If, however, the government "represses" financial markets by controlling domestic interest rates, more government borrowing will result in either higher inflation and low (even negative) real interest rates or reduced financial intermediation—a reduction in the share of savings channeled through formal financial institutions to private investors. The quality of private investment suffers too: with credit rationed, governments typically end up choosing who gets credit and choosing less well than the market would.

[4]Excess economic volatility can also cause irreversible losses in human capital—including through the effect of more frequent spells of unemployment on learning-by-doing opportunities—compounding the negative effect on growth (Martin and Rogers, 1997).

ability of the adjustment effort (see Section III, Quality and Durability of Adjustment).

Mobilizing and Allocating Resources

Economic growth and human development critically depend on accumulating physical and human capital, which in turn requires an adequate level of national savings. As private sector savings are often low in developing (especially low-income) countries, fiscal policy can play a central role in mobilizing resources by raising revenue and reducing less productive spending. But the mobilized resources must be invested productively, and history is littered with examples of poor government investments. Indeed, a key channel through which expenditure consolidation in developing countries can spur growth is higher factor productivity, as public sector resources are freed up for the more efficient private sector. The impact of government spending on improving human development and growth depends on the efficiency of these outlays and how well they are targeted at the poor, not just on the level of spending.

Efficiency arguments suggest that public spending should be directed to areas with the highest social return and should complement, rather than compete with, the private sector. This involves either financing or supplying directly needed public goods that the private sector will not supply adequately because of market failure. Several categories of public expenditure can influence long-term growth—especially spending on education, health, and infrastructure—although what will work best depends on specific country circumstances. Higher growth, in turn, generates increased fiscal resources to finance productive spending, further bolstering the dynamism of the economy. Governments have, however, often tried to spur growth through producer subsidies and the tax system by, for example, imposing high tariffs or offering generous tax holidays (rather than the better method of reducing distortionary taxes; see Section IV, Improving the Tax System and Mobilizing Revenue). These have generally created inefficiencies and administrative complications, as well as larger fiscal deficits, and have not resulted in the anticipated growth benefits.

Meeting Development Goals

In recent years, fiscal policy in low-income countries has been increasingly geared to meeting the Millennium Development Goals (MDGs). These goals grew out of the agreements and resolutions of world conferences organized by the United Nations since the early 1990s. They have been commonly accepted as a framework for measuring development progress, and indicators of achievement of these goals are being monitored by the international community. The goals are directed at reducing poverty in all its forms. They include halving global poverty, achieving universal primary education, reversing the spread of HIV/AIDS, reducing child and maternal mortality, and ensuring environmental sustainability.

Fiscal policy can play a pivotal role in achieving the MDGs by fostering robust economic growth, which is critical for sustainable development and for improving social outcomes. For example, research suggests that growth usually benefits the poor and that there is a strong link between economic growth and improvements in nonincome dimensions of poverty, such as infant mortality and female literacy (IMF, 2002). Meeting the MDGs will also generally require changes in the structure of the budget to include higher outlays on productive social spending, a scaling up of aid, and more efficient government spending (see Section III, Size of Fiscal Adjustment).

Fiscal Adjustment to Reduce Vulnerability

A country's public finances may appear sound now, but may be vulnerable if underlying weaknesses threaten its future fiscal position and limit the government's ability to respond to fiscal policy challenges. Reducing fiscal vulnerability allows fiscal policy to respond countercyclically to downturns or shocks.

All countries, but especially developing ones, face shocks (e.g., terms-of-trade shifts, "sudden stops" in capital inflows, natural disasters, and aid shortfalls) that undermine, directly or indirectly, their public finances. Such shocks can reduce revenue, generate pressing expenditure needs, and make financing more difficult and expensive. Countries that have built up reserves in good times can draw on these resources during bad times. And those with low levels of debt may be able to increase their fiscal deficits, including through borrowing, during a downturn or even a crisis, without losing market confidence. But countries without such buffers are often forced to take emergency fiscal measures and have limited scope for countercyclical fiscal policy. Emergency fiscal tightening measures are more likely to damage investment, growth, and social indicators, as they can be less well planned and are often based on measures that produce short-term financial gains at the expense of longer-term efficiency.

The most common fiscal vulnerabilities stem from public debt—its sustainability, its structure, and the degree to which vulnerabilities are hidden (as through contingent liabilities). Rigidities in the structure of the fiscal sector can also undermine fiscal policy, as do longer term fiscal pressures. Globalization too heightens the importance of sound fiscal policy.

Debt Sustainability

Public debt is sustainable when the government can continue servicing it without requiring an unrealistically (from a social and political point of view) large correction to its future revenue or primary (noninterest) expenditure path. This broad definition implies that, at credible levels of primary balances, the government is both solvent (discounted future primary balances exceed the current net debt stock) and liquid (able to meet obligations as they come due; see Section III, Size of Fiscal Adustment).

In addition to fundamentals, market expectations play an important role. Even when debt is stable or declining under current policies, markets may be concerned about the government's continued ability to generate the requisite primary balances. This, in turn, raises risk premiums on public debt and can cause it to become unsustainable. Managing expectations thus becomes important: when countries are able to assure markets about future fiscal policies, they may be able to maintain larger debt levels than otherwise. Governments should be able to demonstrate that their overall debt burden is manageable and is likely to remain so under a range of plausible scenarios. Medium-term fiscal frameworks, which set out government targets and projections for fiscal policy, and strong fiscal institutions, such as effective tax administrations and expenditure management systems, may help improve both policies and expectations (see Section V).

Contingent Liabilities and Debt Structure

Contingent liabilities are financial obligations that are triggered by certain events, and are not readily captured by standard fiscal statistics and analysis. Contingent liabilities fall under two main categories: those that become due if certain events materialize, such as defaults on government-guaranteed debt that the government must then assume; and those that result from the government's implicit or "moral" commitment, for example, to protect depositors after a bank failure or to pay pensions if the pension scheme goes bust. Because their fiscal cost is typically invisible until they are triggered, contingent liabilities are a hidden subsidy, blur fiscal analysis, and can drain future government finances.

Debt contracted by public enterprises, local governments, and extrabudgetary funds often carries an explicit or implicit guarantee by the government. When such debt is not repaid, it has to be assumed by the government. Similarly, in public-private partnerships—such as build-operate-transfer contracts—the government frequently offers assorted guarantees (e.g., of minimum revenues). When market conditions prove to be unfavorable, liabilities for the government are triggered.

The structure of debt can also be an important source of vulnerability and risk. For example, when government debt is short term, indexed to short-term interest rates, or foreign-exchange-denominated/linked, pressures in the money and foreign exchange markets can rapidly translate into debt-servicing problems. The "balance sheet approach," which looks at links between the balance sheets of the various sectors of the economy, can help identify vulnerabilities and potential pressures stemming from balance sheets (Allen and others, 2002).

Active management of government liabilities can help address these problems. By reducing the risk that the government's debt will become a source of instability for the private sector, prudent policies in this area—as well as with respect to contingent liabilities—can make countries less susceptible to contagion and financial risk.

Fiscal Rigidities

Experience suggests that rigidities in the structure of the fiscal sector may undermine the government's capacity to adapt to changing circumstances. By ossifying current fiscal structures, rigidities can undermine future macroeconomic stability, debt sustainability, and fiscal policy. For example:

- Earmarking revenues for certain expenditures hampers the government's ability to adjust the revenues, or to spend them on changing priorities (e.g., schools rather than roads). If fiscal consolidation is needed, raising earmarked revenues is of little use as they automatically lead to higher spending.
- Constitutionally, or otherwise, mandated spending, employment levels, or taxation rates, impinge on governments' ability to adjust fiscal policy. Numerical fiscal rules, such as debt or deficit limits, especially if set in

the constitution, may also have the (in some cases, desired) effect of reducing a government's room for fiscal maneuver.

- Large shares of nondiscretionary spending (e.g., interest payments or spending on entitlement programs) in total expenditure complicate expenditure adjustment and can force cuts on higher-quality discretionary spending.
- Some fiscal federalism arrangements can undermine fiscal control. For example, arrangements that require certain revenues to be shared are likely to make fiscal consolidation more difficult (see Section V, Effective Intergovernmental Relationships).

Globalization

The importance of sound fiscal policy is further heightened by globalization. The credibility that derives from successfully maintaining, or restoring, sound fiscal policy can help emerging market economies (and developing countries more generally) exploit open labor and capital markets and free trade—including in services facilitated by modern communication systems. But if poor fiscal discipline compromises stability and growth objectives, access to international capital will likely be reduced. Tax competition has also become a fact of life, and tariff reductions have resulted in some loss of revenues, at least until the positive effects on growth materialized.[5]

Emerging Fiscal Pressures[6]

Developing countries in particular face many fiscal challenges that may lead to acute resource needs and require government intervention.

- In some parts of the world, the spread of HIV/AIDS and other pandemics inflict a high cost in terms of human suffering, loss of human capital, and need for more public sector support. More generally, ongoing technological innovations in health care, while effective in raising life expectancy, are likely to be financially costly.

[5]The initial stages of trade liberalization—which typically involve replacing nontariff barriers, such as quotas, with tariffs—tend not to be associated with revenue loss (IMF, 2005a). But many low-income countries seem to have had difficulty in replacing any revenue loss resulting from trade reform. Those that succeeded (1) sustained efforts, over several years, to broaden tax bases, including by improving revenue administration; (2) strengthened the domestic consumption tax system, through excise taxes and especially by a simple, broad-based, VAT; and (3) increased income taxes.

[6]See Heller (2003) for a fuller discussion of long-term fiscal challenges.

- Demographic changes, mainly aging populations, are likely to pose increasing burdens on public finances of some developing—as well as industrial—countries. Pension reforms may necessitate transitory financing requirements and higher explicit public debt when countries shift from public to private plans.
- Financial liberalization that frees banks from providing directed credit to favored sectors and enterprises may shift this burden onto the government by way of budgeted or unbudgeted credit subsidies channeled through public banks.
- Environmental degradation and global climate change may have wide-ranging implications that require government intervention.

Fiscal Adjustment for Short-Term Macroeconomic Stability

Short-term fiscal policy should be consistent with longer-term goals. Within this longer-term context, fiscal policy can contribute to short-term macroeconomic management. Most traditionally, fiscal adjustment can help mitigate cyclicality (recurrent recessions and booms), reduce large external current account imbalances, and contain inflation. In capital account crises, fiscal adjustment can restore confidence, ease financing constraints, and support growth.

Conducting Countercyclical Policy

Countercyclical fiscal policy—that is, adding to aggregate demand during downturns and withdrawing demand during upturns—can potentially play a role in responding to both normal variations in aggregate demand and larger aggregate demand shocks (supply shocks would typically require a neutral or procyclical fiscal response as the economy has to adjust to a lower level of potential output). For countercyclical fiscal policy to succeed, however, certain requirements must be met (Hemming, Kell, and Mahfouz, 2000).

Fiscal policy should be well coordinated with monetary policy. Monetary policy is generally a more effective countercyclical policy instrument because interest rate changes can be made in days and can be quickly reversed. But monetary policy adjustments may take longer than fiscal policy adjustments to affect aggregate demand. Moreover, fiscal policy contributes to broader-based stabilization through the impact of taxes and government spending on income-sensitive (in addition to interest-sensitive) components of aggregate demand.

When monetary policy is constrained in responding to output variations, fiscal policy should take a more central role. This may be the case if the mandate of the central bank focuses on securing low inflation, rather than stabilizing output. Also, if nominal interest rates are close to zero, monetary policy options are limited as interest rates cannot be lowered further. The relative effectiveness of fiscal and monetary policies will also depend on the exchange rate regime. Fiscal policy is relatively less effective under a flexible exchange rate regime and more effective under a fixed rate regime.

In some circumstances, the usefulness of countercyclical fiscal policy during downturns and recessions is limited. Most notably:

- If domestic and external imbalances are large, countercyclical fiscal policy may be inappropriate. Even though the economy may be turning down or in recession, avoiding or responding to rising inflation and a weakening balance of payments may be paramount.
- Financing constraints may place an upper bound on the fiscal deficit. Many emerging market and low-income countries face constraints on their borrowing, owing to undeveloped financial systems and a limited ability to tap external financial markets.

Even if countercyclical fiscal policy is appropriate, it may not have the desired impact on aggregate demand. Some factors could contribute to the impact being quite small. Moreover, in certain circumstances, fiscal contractions can be expansionary (Box 1).

- Fiscal expansions may be crowded out, at least partially. This happens when increased borrowing causes interest rates to rise and the exchange rate to appreciate. Fiscal expansions will therefore tend to be relatively ineffective in open economies with flexible exchange rates.
- In response to a debt-financed fiscal expansion, individuals who are not liquidity constrained may increase their saving so that they (or their children, via bequests) can pay the higher taxes that will be needed in the future to service the debt (the "Ricardian equivalence effect"). The offset is, however, likely to be partial and will depend on the extent to which consumers can borrow and lend to smooth consumption, as well as their degree of time preference (desire to consume now rather than later) relative to that of the government.
- The composition of measures may be inappropriate. For example, increases in transfers that benefit high-income individuals with relatively strong tendencies to save additional income would be less effective in influencing demand.

Box 1. Expansionary Fiscal Contractions

Fiscal tightening may expand the economy in the short term. The consolidation episodes of Denmark and Ireland have been particularly well documented, and there is evidence of expansionary fiscal contractions elsewhere—in particular, in such high-debt emerging market economies as Turkey. These episodes have a number of features:

- *They are associated with fiscal adjustment in high-debt countries.* As the government gains credibility in being able to service its debt and the threat of higher taxes and default subsides, risk premiums on interest rates fall, confidence rises, and aggregate demand is stimulated.
- *They are a function of the size and composition of fiscal adjustment and deficit financing.* In particular, consolidations based on cutting transfers and government wages tend to be associated with better growth outcomes, as are those that lead to lower domestic financing (see Section III, Quality and Durability of Adjustment).
- *They can manifest themselves either through changes in private consumption and investment or through factor productivity.* Changes in consumption and investment occur primarily through the credibility and wealth effect channels. The factor productivity channel is more important in developing countries (owing to the lower productivity of public spending).

- There may be long implementation lags, for example, because tax and expenditure measures are held up by the political process and budget procedures.

Where countercyclical fiscal policy is appropriate, research suggests that it may best be implemented through automatic stabilizers (IMF, forthcoming). Automatic stabilizers derive from the responsiveness of tax revenue and certain categories of spending (e.g., unemployment benefits) to output, which means that they take effect quickly and are self-reversing. However, automatic stabilizers are somewhat arbitrary, reflecting past decisions about the structure of taxation and spending, and are typically weak in emerging market and low-income countries.

Discretionary tax and spending measures may also have a role to play. They can be used to routinely bolster weak automatic stabilizers or offset strong ones, or they can be held in reserve to respond to larger aggregate demand shocks. The advantage of discretionary measures is that they can be tailored to stabilization needs, in particular by directing them to where they will have the largest impact on spending. Their main shortcomings are that they can be subject to long implementation lags and are not quickly reversible, and that they have been a particular source of procyclicality, especially in upturns.

Reducing External Current Account Imbalances

Fiscal adjustment may be needed to facilitate external adjustment, especially to reduce excessive current account deficits or surpluses (Easterly, Rodriguez, and Schmidt-Hebbel, 1994). As an ex post identity, a fiscal deficit must be matched by either net domestic private sector savings (the excess of private savings over private investment), an external current account deficit, or a combination of both.[7] But cutting the fiscal deficit (surplus) will not generally result in a one-for-one cut in the current account deficit (surplus), as the private sector's saving-investment balance will be affected too. For example, the lower fiscal deficit could spur private investment, as credit becomes cheaper and more plentiful, and reduce private sector savings.

Fiscal adjustment can also support current account adjustment through its effect on the real exchange rate.[8] Fiscal consolidation, for example, will tend to depreciate the real exchange rate by reducing the demand for, and thus the price of, nontradables, thereby increasing the relative profitability of the tradable sector and boosting (net) exports. And devaluing the nominal exchange rate without correcting fiscal disequilibria may primarily affect inflation rather than the real exchange rate, thus failing to bring about significant external adjustment.

Tackling Inflation (or Deflation)

Fiscal policy can affect inflation through many channels. In the short run, it can affect the price level through its impact on aggregate demand. Specifically, government purchases of nontradable goods and services add to aggregate demand, while transfers and tax changes affect private

[7] More formally: $CA = (S_{priv} - I_{priv}) + (S_{pub} - I_{pub})$, where CA is the external current account balance; S_{priv}, private sector savings; I_{priv}, private sector investment; S_{pub}, public sector savings; and I_{pub}, public sector investment. $S_{pub} - I_{pub}$ is a measure of the overall fiscal balance. The precise definition of each sector is critical (see Section III, What Makes Fiscal Adjustment Successful?).

[8] The real exchange rate is the relative price of tradables (such as televisions) to nontradables (e.g., haircuts). A real exchange rate depreciation (appreciation) improves (worsens) the external current account by diverting resources from the nontradable (tradable) to the tradable (nontradable) sector.

demand. Administered price rises also affect the price level, and public sector wage increases can induce cost pressures.[9] Sustained inflation, however, generally requires an ongoing increase in the money supply that outstrips money demand. Fiscal policy can play a central role to the extent that money creation is due to deficit financing. Monetary financing of the deficit is a cheap source of financing in the short run, but once it goes beyond accommodating the increase in money demand, it contributes to excess money supply and inflation.

Fiscal adjustment can also affect inflation via the demand for money, including through inflation expectations, interest rates, and confidence. For example, if monetary policy is seen to be accommodating, fiscal expansion—even if initially not financed by the central bank—can quickly lead to expectations of future money supply increases, and thus to inflation (Sargent and Wallace, 1981).

Financing deficits by relying on high inflation is particularly pernicious but increasingly rare. It means obtaining resources at the expense of those with fixed nominal assets or incomes, usually among the poorer groups in society. Over time, the scope for collecting the inflation tax narrows: when inflation rises, households and businesses reduce their holdings of domestic currency (after adjusting for inflation) as they seek alternatives to preserve the value of their assets (such as foreign currency). High inflation can also undermine revenue from explicit taxes if there are collection lags (the "Tanzi effect") or heavy reliance on specific taxes.

Similarly, expansionary fiscal policy can help tackle deflation. A well-timed tax cut will increase disposable incomes, encouraging consumption, and higher government spending can help boost production and reduce unemployment. But fiscal policy must be tailored to credibly boost aggregate demand. Spending programs and tax relief should ideally target low-income consumers and good-quality projects that boost the return to private investment.

Managing Capital Account Crises

Capital account crises—that is, a loss of investor confidence manifested in rapid capital outflows—can severely constrain fiscal policy. Once such

[9]Public sector wage increases could increase private sector wages by, for example, forming a benchmark for private sector wage increases or by raising the wage the private sector would need to offer to be competitive.

a crisis hits, fiscal consolidation becomes unavoidable as the deficit is constrained by a lack of financing. More generally, fiscal consolidation is important in those emerging market countries where crises originate mainly in market perceptions of fiscal profligacy and in unsustainable debt dynamics. In these countries, the direct contractionary impact of fiscal tightening on demand is likely to be offset by the beneficial effect of fiscal consolidation on market access and the cost of borrowing.

But where fiscal problems are not the root cause of the loss of confidence, fiscal retrenchment may be counterproductive, as the dampening effect on growth exacerbates the loss of confidence. A more relaxed fiscal stance, in this context, could offset the weakening economic activity (Ghosh and others, 2002). Moreover, to the extent that such weakening is in itself a concern to investors, too tight a fiscal stance risks eroding, rather than enhancing, confidence. This underlines the more general point that prudent fiscal policies during "good" times greatly increase the room for maneuver during "bad" times.

II.
How Should the Fiscal Position Be Assessed?

Without data, all you are is just another person with an opinion.
—Anonymous

Just as fiscal adjustment has many objectives, it can be measured in many ways. Even the best designed adjustment will fail if the fiscal indicators on which it is based are flawed. Different problems, objectives, and economic structures imply that no single measure will fit all circumstances. Individual country practices reflect this diversity, and international statistical standards themselves are changing as countries gradually adopt the IMF's *Government Finance Statistics Manual 2001*[10] (Box 2). The main issues relate to what should be included in the public sector, when fiscal transactions should be recorded, and what indicators should be used.

Coverage of the Public Sector

The components of the fiscal sector are the central government, subnational government, social security funds, and public corporations.

- *Central government* refers to the activities of a country's central authority. Transactions at this level should reflect the legal budget of the central government as well as fiscal actions of any extrabudgetary funds or autonomous agencies relevant to central government policies or under the central authorities' effective control.
- *Subnational governments* consist of the budgetary and extrabudgetary activities of decentralized governments operating only in parts of the country, such as regional, state, and local governments. The central and subnational governments together constitute the *general government*.

[10]The *Government Finance Statistics Manual 2001* is a reference volume for government finance statistics. It covers concepts, definitions, classifications, and accounting rules, and provides a comprehensive analytic framework within which to summarize and present fiscal data in a form appropriate for analysis, planning, and policy design.

Box 2. Key Differences between the 2001 and 1986 *GFSMs*

The 2001 edition of the *Government Finance Statistics Manual* (*GFSM*) differs from the 1986 edition in three main ways:

- **Accrual basis.** Unlike *GFSM 1986*, the 2001 manual emphasizes recording fiscal statistics on an accrual basis—at the time the economic event occurs, not necessarily when cash is paid or received.
- **Integration of stocks and flows.** The *GFSM 2001* is underpinned by a set of well-defined relationships between flows and stocks. Specifically, the government's opening and closing balance sheets are reconciled with the flows derived from government operations and other economic flows (e.g., valuation changes or the extinction of assets from natural disasters).
- **The analytic framework.** This consists of three main tables and four main balances.
    - The *Statement of Government Operations* distinguishes among transactions (1) affecting net worth, i.e., revenue and expense; (2) in nonfinancial assets; and (3) in financial assets and liabilities. The difference between revenue and expense is the *net operating balance* (similar to the current balance in *GFSM 1986*). Subtracting net acquisition of nonfinancial assets gives the *net lending/borrowing balance* (similar to the overall balance in *GFSM 1986*, except for net lending now excluded). This, in turn, is equal to the net acquisition of financial assets minus the net incurrence of liabilities.
    - The *Balance Sheet* shows the government's *net worth* at the end of the period. It is equal to the stock of nonfinancial assets plus net financial worth (the stock of financial assets minus liabilities). The change in net worth during a year is the sum of changes attributable to revenue and expense transactions and to other economic flows.
    - The *Statement on Sources and Uses of Cash* shows purely cash flows associated with revenue and expense transactions and transactions in nonfinancial assets, which yields the *cash surplus/deficit*. Adding cash flows in financial assets (other than cash) and liabilities to the cash surplus/deficit yields the net change in the stock of cash.

While full implementation of the *GFSM 2001* will be challenging for many countries, many of its benefits can be reaped in the interim just by presenting existing fiscal data in this new framework.

- *Social security funds* either form their own subsector or are part of the level of government at which they operate and are consolidated with either the central or general government.[11]

[11]In IMF publications, social security funds are normally classified with the level of government at which they operate. If the social security system is autonomous, with its liabilities perfectly matched with its assets (a defined contribution, or fully funded, scheme), it would be treated as part of the nonfinancial public sector.

- *Public corporations* consist of financial public corporations (FPCs, including the central bank) and nonfinancial public corporations (NFPCs). Consolidating NFPCs with the general government yields the nonfinancial public sector, and adding FPCs constitutes the consolidated public sector.

Fiscal policy can be carried out by different levels of government and through a range of institutions. Normally, it is implemented by entities wholly devoted to the economic functions of government, such as central and local governments. But public corporations (both financial and nonfinancial) can also carry out fiscal policy, typically without being explicitly recorded in the budget. For example, central banks may extend subsidized loans and nonfinancial corporations may not operate at market prices, or may provide social services. Such activities—known as "quasi-fiscal operations" (Mackenzie and Stella, 1996)—can have a fiscal impact comparable with that of more traditional government activities, although they are often difficult to measure.

Determining the specific coverage of the public sector for a given country entails striking a compromise between what is administratively feasible and what is important for fiscal policy. As a rule, fiscal policy should be assessed for policy purposes based on general government plus public corporations—whether financial or nonfinancial—that pose a significant risk to public finances. If some levels of government (e.g., local governments) are constrained by the need to run balanced budgets, it may be possible to abstract from them for some analytic purposes.

Whatever the exact coverage of fiscal indicators for policy purposes, fiscal statistics should be compiled both for general government and the public sector. Given that any public corporation, financial and nonfinancial, is a potential source of fiscal risk, the operations of all public corporations should be reported and monitored. This will improve transparency and accountability and also help identify any emerging problems.

When to Record Government Transactions

Governments generally record transactions on four bases: commitment, accrual, due-for-payment, and cash. Under the commitments basis, transactions are recorded when commitments to them have been entered into (usually when purchase orders are issued); under the accrual basis, transactions are recorded at the time of the economic event (e.g., when ownership of goods changes or services are provided); under a due-for-payments basis, at the latest time they can be paid for without incurring additional charges or penalties (or, if sooner, when the cash payment is made); and under the cash basis, when cash is received or disbursed.

Many countries, especially those with weaker public expenditure management systems, use a cash (or modified cash) basis. While operationally easier, it can distort the analysis of fiscal policy (e.g., its impact on aggregate demand and fiscal sustainability). This is because it records transactions after they have occurred economically and ignores noncash transactions, such as arrears and grants-in-kind.

Information on cash flows will still be important, even with accrual accounting—for example, to manage government liquidity and to assess the impact on monetary variables. This does not require a cash basis of recording, but a separate statement on cash flows. Cash-based systems can also be modified to allow some items to be recorded on a noncash basis (e.g., recording interest on a due rather than paid basis).

Main Fiscal Indicators

The fiscal position should be assessed in terms of both flow indicators, such as the overall balance, and stock indicators, such as the amount of government debt.

Flow Indicators

The *overall fiscal balance* is the most common fiscal indicator. It is the difference between total revenue (including grants) and total expenditures plus lending minus repayments. The widespread use of the overall balance reflects its links to the government's net financing requirements and to the external current account.[12]

An adjusted overall fiscal balance is an overall balance excluding such items as grants or revenue from certain enclave activities (e.g., the oil sector), or certain lumpy expenditure items.

- External grants are included under total revenue and grants because they do not add to debt and may finance expenditures that would otherwise

[12]The exact linkages are complex and depend on the specific accounting definitions. For example, including lending minus repayments "above the line" (unlike in *GFSM 2001;* see Box 2) would imply that the overall balance would not equal the change in the government's net financial position.

Box 3. Fiscal Policy and Nonrenewable Resources

Having nonrenewable resources, such as oil, should be a blessing, but experience suggests it is often a curse. It is a blessing in that exploiting such resources relaxes the traditional obstacles to growth (foreign exchange, domestic savings, and fiscal revenues), but it is a curse in that many such countries seem to suffer from excessive dependence on these resources.

Heavy dependence on nonrenewable resource revenue complicates fiscal policy. Nonrenewable resource revenues are typically volatile and uncertain—linking spending to such revenue induces macroeconomic volatility and reduces its quality. As the resource is by definition nonrenewable, it will, sooner or later, run out—consuming all the revenue now may mean difficult fiscal consolidation later. The influx of foreign exchange can appreciate the real exchange rate, shrinking traditional tradable sectors ("Dutch disease"). And the large windfalls can foster corruption and undermine governance. That said, many, especially low-income, nonrenewable-resource-producing countries face large and pressing social and development needs.

There is no "silver bullet" to fix these problems, and no substitute for prudent macroeconomic management. But research suggests some approaches can help (Davis, Ossowski, and Fedelino, 2003).

- *Adjust expenditure gradually.* Setting expenditure (or, more precisely, the primary balance excluding nonrenewable resource revenue as a ratio to GDP excluding the nonrenewable resource sector) in a medium-term framework will help avoid procyclicality. Countries with stronger financial positions have more leeway to increase spending in response to more permanent price rises, whereas those with weaker positions have less scope to finance downturns.

not take place. But grants are often volatile, unpredictable, and outside government control. Moreover, they may not last and do not reduce domestic demand. Thus, when grants are significant, the overall balance is often reported both with and without grants. The balance excluding grants also indicates the extent of grant dependency.

- Like grants, oil revenue is highly volatile and unpredictable. It is also, however, nonrenewable and consuming it reduces government wealth. Countries that are heavily dependent on oil (or on other nonrenewable resources) should focus on the non-oil balance, ideally as a ratio to non-oil GDP (Box 3). Privatization receipts are also often excluded from the overall balance for similar reasons.
- Externally financed project spending may be excluded as it is outside the government's control, typically has a large import component with

- *Save part of nonrenewable resource revenues.* Fiscal policy should be set so that no abrupt consolidation is needed when production wanes. This typically requires saving a significant share of the nonrenewable resource revenues, especially when production is not expected to last long. Financial savings should be held offshore to avoid imparting volatility to the domestic economy and excessive real appreciation (some real appreciation may be an intrinsic part of the process of absorbing resource revenues).
- *Be transparent.* Governments should establish a clear legal and regulatory framework for the nonrenewable resource sector and comprehensively disclose related revenue data. International and national nonrenewable resource companies should comply with international accounting standards.
- *Nonrenewable resource funds should be transparent and well integrated with the budget.* A well-designed fund, such as Norway's State Petroleum Fund, can help manage nonrenewable resource revenues, mainly for political economy reasons. A poorly designed fund, however, can complicate fiscal policy management, for example, by creating a dual budget and making cash management inefficient.
- *Consider hedging.* Hedging can help governments make their nonrenewable resource revenue stream more stable and predictable, but this requires institutional capacity and stringent control.
- *Set domestic nonrenewable resource product prices at international levels.* Subsidization is generally inefficient, poorly targeted, and often nontransparent.

consequent limited impact on domestic supply, and is automatically financed (though if financed by lending, it does increase debt). Excluding external grants, externally financed project spending and external interest payments yields the *domestic balance* (with specific definitions varying across countries).

- The *primary balance*—revenue minus noninterest (primary) expenditure—is an indicator of fiscal "effort," in that interest payments are predetermined by the size of previous deficits; the primary balance is a critical variable for debt sustainability analysis. The *debt-stabilizing primary balance* is the primary balance necessary to keep the debt-to-GDP ratio stable.
- The *operational balance* (the overall balance minus the part of debt service that compensates debt holders for inflation) is often reported when there is high inflation.

The *current balance,* the difference between current revenue and current expenditures, indicates the extent of government savings. Targeting the current balance could help safeguard investment in times of fiscal consolidation, while leaving the net worth of the government unaffected and promoting intergenerational equity. But focusing exclusively on the current balance is risky (IMF, 2004a) for the following reasons:

- Investment spending adds to aggregate demand.
- In countries where financing is constrained, there is little alternative to focusing on the overall balance. Indeed, if amortizations are large, fiscal targets may have to be set in the light of total, rather than net, financing availability.
- Borrowing may need to be constrained because of longer-term debt sustainability concerns.
- Debt can become unsustainable if public investment projects are not of high quality. Even when they are, governments may not be able to realize the fiscal dividends of growth (i.e., public investment does not typically pay for itself).
- Other uses of public funds—notably reducing tax rates or investment in human capital and operations and maintenance—may have a higher rate of return than public investment. Excluding public investment from fiscal targets would create a bias against these choices and may also discriminate against private sector involvement in infrastructure.
- Focusing on the current balance may invite creative accounting, with a view to classifying current expenditure as capital.

The *cyclically adjusted balance*[13] measures the fiscal position net of the impact of output effects on the budget (IMF, forthcoming). It is obtained by removing the cyclical component of the budget from the nominal fiscal balance. The cyclical component in turn depends on the size of the output gap and on the output elasticity of the budget (determined by the extent that individual budgetary items react to fluctuations in output, as well as by the size of the budget).

Budgetary targets are seldom framed in cyclically adjusted terms. This partly reflects the relative complexity of the techniques used to estimate output gaps and budgetary elasticities. But while the computation of cycli-

[13]While the terms *cyclically adjusted* and *structural* balances are often used interchangeably, structural balances refer to fiscal balances adjusted for deviations from benchmark levels of all economic variables with a significant fiscal impact (not just output).

cally adjusted balances is fraught with difficulties, a variety of measures can be undertaken to address them.[14] Cyclically adjusted balances can play a useful role as a reference for policy design and implementation.

The *augmented balance* is the overall balance, including such exceptional outlays as the fiscal costs of bank recapitalization or enterprise restructuring not otherwise captured in expenditure. Such outlays need to be financed and may have a significant impact on aggregate demand.

Gross financing needs and sources helps focus on liquidity issues. Needs comprise the overall deficit, any other transactions that require financing, plus amortization. This is equal to the necessary financing, from which the implications of meeting this need can be drawn. For example, if the necessary financing entails a level of external market access much greater than the government had previously enjoyed, this could portend liquidity problems.

Stock Indicators

Fiscal policy analysis has traditionally focused on such flow variables as the overall balance. But flows are changes in stocks, and stocks are increasingly seen as important yardsticks for gauging fiscal policy in their own right. Reconciling flows and stocks also serves as a consistency check on the quality of fiscal data. The starting point is the public (or government) balance sheet at a given moment. It comprises, on one side, public assets, both financial (e.g., government deposits) and nonfinancial (e.g., roads), and on the other, public liabilities (e.g., government debt) and net worth (the difference between assets and liabilities).

Liabilities, the bulk of which typically consists of debt, are a commonly used stock variable. Large or growing liabilities (typically measured against a scalar, such as GDP or revenue) may signal future debt-servicing problems.

Net financial worth recognizes that liabilities may be matched by financial assets, and thus looking just at liabilities may misrepresent the government's financial position.[15] But only liquid financial assets can be

[14]These include taking into account changes in the composition of output when estimating the output gap, as well as relying on estimates of built-in elasticities, excluding the impact of discretionary measures.

[15]The composition of liabilities can also be an important source of vulnerability (see Section I, Fiscal Adjustment to Reduce Vulnerability).

used to meet liabilities coming due. For example, government equity in public corporations may not be easily sold, and withdrawing government deposits from public banks may precipitate their collapse. In addition, netting offsetting claims/liabilities within the public sector against each other may mask mismatches, such as the central government's inability to service its debt to the social security fund.

Net worth goes further by recognizing that liabilities may also be matched, not just by financial assets, but also by nonfinancial assets. This is the most demanding stock variable to measure as it involves, for example, valuing nonfinancial assets.

The balance sheet can miss potentially critical aspects of the government's financial position and should be supplemented with additional information. For example:

- *Contingent liabilities*, such as loan guarantees (see the discussion in Section I on Fiscal Adjustment to Reduce Vulnerability), are frequently entered into for fiscal policy purposes, have important economic effects, and can threaten fiscal sustainability. The nominal amount, and the nature, of such liabilities should be published, as should, if possible, an estimate of their expected cost. Where guarantees are significant, budgets should limit their amount and include provisions for their expected cost.
- *Public-private partnerships* are essentially leasing arrangements in which the private sector provides initial finance and the state retains ownership and bears certain future costs. While public-private partnerships can elicit additional financing for investment and may increase efficiency, they may also (possibly deliberately) conceal fiscal activity and expose governments to greater (often hidden) costs than direct procurement of public works. To improve their transparency and assessment, governments should include information on public-private partnerships in budget documents and in end-year financial reports.

III.
What Makes Fiscal Adjustment Successful?

If it were done when 'tis done, then 'twere well it were done quickly.
—William Shakespeare (1564–1616)

Successful fiscal adjustments durably and efficiently improve the fiscal position while minimizing any welfare costs. Success depends on a range of variables, especially the timing and speed, size, and quality of adjustment.

Timing and Speed of Adjustment

The timing of adjustment is critical, although governments sometimes have little room for maneuver. For example, severe financing constraints may leave governments little choice but to consolidate, and political considerations may prevent consolidation until the problems posed by current policies result in a crisis. But when governments do have room to maneuver, as a rule, fiscal consolidation should occur during good times. More specifically, key considerations could usefully include the following.

- *The point in the domestic business cycle*. Fiscal consolidation (on a cyclically adjusted basis) should ideally begin to kick in as the economy starts the expansionary phase of the business cycle, which would mitigate any contractionary first-round effects. Similarly, fiscal loosening is most appropriate as the economy enters the contractionary part of the cycle.
- *The point in the global business cycle.* A worldwide recovery phase offers a window of opportunity to substitute rising external demand for any fiscally induced slowdown in domestic demand.
- *The stance of monetary policy*. Adjustment will be more successful when it is well coordinated with monetary policy. For example, to minimize any output loss, monetary conditions should ideally relax when fiscal policy contracts, the macroeconomic and public debt situation permitting.

Spreading any social costs over time may help reduce political resistance to fiscal consolidation. And it takes time to design and implement good-quality measures. Together, these factors may also make consolidation more credible. That said, frontloading is at times needed, for example, when a government must show a decisive break with the past or to seize the opportunity of political support, which may wane over time. Resistance to a gradual approach may also flare up at some intermediate stage, leaving the process incomplete, and a prolonged period of austerity can build up discontent.

Size of Fiscal Adjustment

The exact amount of fiscal adjustment needed depends on individual country circumstances, objectives, and constraints, and should be assessed relative to a baseline (unchanged policies) scenario. A decision-tree approach can help pin down the needed magnitude of adjustment. (1) Is debt sustainability (or financing) binding? (2) If not, does the macro-economy need stabilizing? (3) If the answers to (1) and (2) are "no," then fiscal policy has more space to maneuver to directly meet development goals.

Ensuring Public Debt Sustainability

For countries with public debt sustainability problems, the need to achieve fiscal sustainability should anchor the medium-term fiscal path. In these cases, the overriding objective is to improve the primary balance so that it is consistent with debt sustainability. The slower the improvement, the greater it will need to be, as the debt-to-GDP ratio will continue to increase in the meantime.

In theory, solvency requires that the present discounted value (PDV) of a government's current and future primary expenditure be no greater than the PDV of its current and future path of income, net of any initial indebtedness (Chalk and Hemming, 2000). In practice, solvency is typically assessed by checking whether the public debt–to-GDP ratio is stable or declining. Broadly speaking, the debt-to-GDP ratio increases owing to the sum of its own dynamics (the product of its initial value and the excess of the real interest rate over the real growth rate) and the primary deficit.[16] Thus, when the real interest rate exceeds the real growth rate, a primary surplus is needed to stabilize the debt-to-GDP ratio.[17]

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[16]In algebraic terms: $\Delta b = d + (r - g)\, b$, where b is the ratio of government debt to GDP (with Δ indicating the change in the ratio from one year to the next); d, the primary deficit ratio to GDP; r, the real interest rate; and g, the growth rate of real GDP.

[17]More sophisticated versions of the formula differentiate between domestic currency debt and foreign currency debt, while also taking into account non-debt-creating deficit financing (e.g., privatization receipts) and debt-creating items (such as the recognition of contingent liabilities), which are not captured in the deficit.

The main drawback of this approach is that it is silent on whether the initial, or targeted, debt-to-GDP ratio is appropriate. For example, even though the debt-to-GDP ratio might be falling, the debt may still be excessive as it may be causing high interest rates and crowding out private investment. Critically, solvency assessments ignore short-term liquidity issues. For example, a government may be solvent but unable to raise the financing necessary to meet a lumpy repayment. Solvency and liquidity are often interlinked: concerns about a country's solvency may lead to financing problems, and financing problems may induce insolvency, as larger primary surpluses are required to meet the higher interest bill.

Estimates of "safe" levels of government debt vary greatly and depend on individual country circumstances. Liquidity crises and sovereign debt defaults have occurred at very different public debt levels. Safe levels of public debt for low-income countries depend especially on the quality of a country's institutions. Countries operating in a weaker institutional and policy environment are likely to experience debt distress at significantly lower debt ratios. This is because such countries tend to have more difficulty raising revenue or cutting expenditure and are more prone to misuse and mismanage funds. Governments with more volatile revenue bases and primary balances will also tend to be able to sustain only lower levels of debt, especially if their economies are also volatile. As much of low-income-country public external debt is concessional, the PDV should be used, rather than nominal amounts, in calculating public debt ratios (although this requires a judgment on the appropriate discount rate).

Projected primary balances are another useful tool for assessing sustainable debt levels. If the PDV of the projected primary surpluses is below the current debt level, the government will not be able to repay its debt. A key decision is what levels of primary surpluses to project and the following are two useful approaches:

- What average, or peak, primary surpluses were generated in the past. While readily ascertainable, and a valuable reality check, the past may not reflect the current or future policymaking environment.
- What primary balances could the country generate given its institutions and other fundamental factors, derived from a cross-country model. This approach has the advantage of relying less on the country's historical performance. But it requires consideration of factors specific to other countries and may also not reflect a changed policymaking environment.

Recognizing that countries will always face shocks, that projections are necessarily uncertain, and that there is no single measure of debt sustainability, debt sustainability projections should be subjected to stress tests and assessed from different angles. Stress tests should be tailored to risks facing individual countries, but typical risks include lower growth, higher interest rates, sharp depreciation, lower primary surpluses, debt recognition, and market financing constraints. Comparisons to historical levels and past volatility can help gauge the degree of risk. Other useful indicators of sustainability include the ratios of external debt service to exports of goods and services, debt (or debt service) to revenue, gross new borrowing to amortization coming due (the "rollover" ratio), and domestic debt to broad money.

Stabilizing the Macroeconomy

Determining the exact amount of fiscal adjustment depends critically on the quality and type of fiscal adjustment measures. It ideally calls for a full-fledged macroeconomic model, where fiscal policy is linked to macroeconomic objectives through a set of well-defined equations. Such models are rarely available in practice, however, especially in developing countries.

For IMF-supported adjustment programs, the standard methodological framework within which fiscal policies are designed is generally referred to as "financial programming" (Ghosh and others, 2005). The objectives of a financial program are usually specified in terms of the targets for growth, inflation, and the balance of payments. The program is individually formulated within a set of economic and financial accounts (mainly the national income and product accounts, the balance of payments, and the fiscal and monetary accounts), which provides a consistent framework for policy analysis.

A central constraint driving financial programs is that the financing of the fiscal deficit should be consistent with macroeconomic objectives and constraints. Most critically:

- External borrowing should be based on an assessment of the balance of payments, the market's appetite for sovereign bonds, prospects for other official borrowing, and expected inflows through the banking system.
- Domestic borrowing should be based on assumptions about changes in broad liquidity, which in turn depend on money demand developments

(given macroeconomic parameters such as growth and inflation), net foreign asset projections consistent with balance of payments projections, and assumptions regarding credit to the private sector that are consistent with the growth projections.

Meeting Development Goals and Creating Fiscal Space

Countries without binding debt sustainability, financing, or macrostability constraints have more scope to increase government spending to meet development goals. In particular, in many low-income countries, the government plays a central role in providing infrastructure, education, and health services and public spending needs are large. The quantity and quality of these services are critical not only for achieving higher growth but also for human development. The twin goals of higher growth and human development are interrelated, as human capital can be a powerful engine of economic growth.

Fiscal scope for higher government spending on such priority needs can be created by reprioritizing nonproductive spending, increasing revenue, stepping up borrowing, and attracting larger external grants (Heller, 2005a). Public-expenditure-tracking surveys in some low-income countries reveal substantial waste and leakage that could be reduced by better public financial management and improved project selection. Tax revenue can be raised from a low base, but an excessive tax burden will hurt private sector activity. Excessive domestic borrowing will also crowd out the private sector and could lead to debt sustainability problems. Concessional external borrowing is an option, but it may not be available or sustainable. External grants, however, can be a convenient and effective way around these constraints.

That said, grants can complicate fiscal policy, especially when they are large and volatile. In particular, rapid increases in aid could (1) result in inflation and exchange rate appreciation ("Dutch disease") when spent on nontradables; (2) crowd out the private sector, for example, as central banks sell domestic debt to offset ("sterilize") the impact of aid inflows on the domestic money supply; (3) strain the limited absorptive capacity[18]

[18]Absorptive capacity typically refers to limits on a country's ability to use aid effectively owing to the quality of a country's policies and institutions and lack of administrative capacity in the form of specific skills or, more generally, of insufficient human resources and physical conditions (infrastructure and equipment) for policy and program implementation.

(especially if spending is increased rapidly) and impair governance; (4) undermine efforts to enhance the domestic revenue base; and (5) give rise to ongoing current spending requirements that cannot be met when aid flows decline (Heller, 2005b).

These potential adverse effects can be mitigated through such domestic policy responses as smoothing out aid fluctuations through international reserve cushions, strengthening public expenditure management, improving governance, easing supply bottlenecks, and addressing constraints faced by entrepreneurs. Donors can help by making their grants less volatile, more predictable, and less tied to specific projects. They can also usefully channel them through the budget and coordinate better with recipient country development frameworks and other donor countries.

Central to managing a scaling up in aid inflows is the coordination of fiscal policy with exchange rate and monetary policy (IMF, 2005b). From a fiscal perspective, the issue is whether to spend or save the additional aid. From a central bank perspective, the issue is whether to absorb the incremental aid by allowing the current account deficit (excluding aid) to widen, including via exchange and monetary policies.[19]

Absorbing and spending are the most appropriate responses to aid over the long run—the government increases expenditure and aid finances the resulting rise in net imports. Some real exchange rate appreciation may be necessary to enable this reallocation of resources. In the short run, other responses may also be useful:

- Saving incremental aid (i.e., neither absorbing nor spending it) may be a good way to smooth volatile aid flows and their effect on spending, build up international reserves from too low a level, and avoid real exchange rate appreciation.
- Absorbing but not spending substitutes aid for domestic financing of the government deficit. Where the initial level of domestically financed deficit spending is too high, this can help stabilize the economy, reduce government debt, and lower interest rates, thus "crowding in" the private sector.

To spend and not absorb is problematic, often reflecting inadequate coordination of monetary and fiscal policies. This response is similar to

[19]Absorption in this context measures the extent to which aid engenders a real resource transfer through higher imports or through a reduction in domestic resources devoted to producing exports. If the incremental aid directly finances imports, or is in-kind aid, spending and absorption are equivalent.

a fiscal stimulus in the absence of aid. The aid goes to reserves, so the increase in government spending must be financed by printing money or through government borrowing from the domestic private sector. There is no real resource transfer given the absence of an increase in net imports. In other words, a given aid dollar can be used to build reserves or to increase the fiscal deficit—but not both.

Quality and Durability of Adjustment

Research indicates that the success of fiscal adjustment, especially the growth response, depends on the quality and durability of the specific measures underpinning it. Government expenditures that are productive and a tax system that is efficient and broad based contribute to growth and development. And measures perceived as durable allay concerns about debt sustainability and alter people's behavior. Fiscal responsibility laws, transparency, and good governance can also play an important role in achieving high-quality and durable adjustment.

Quick Fixes

In reality, policymakers face constraints that can preclude smooth and timely implementation of high-quality reforms. This may be especially true when immediate fiscal tightening is needed to avert an impending crisis. In such cases, policymakers may opt for short-term reduction of deficits through measures that cannot be sustained or that hamper growth ("quick fixes")—which are typically spending cuts. If they cannot be avoided, they should at least be quickly replaced with better-quality measures.

- Across-the-board cuts often seem attractive; this approach allows each individual operating ministry to decide how to cut its budget and it appears to imply equal hardship for all. But cuts in dissimilar programs will not have the same economic consequences. Such cuts can also quickly lead to arrears, add to long-term costs (e.g., by postponing maintenance), avoid having to revisit priorities, and lead to inefficiencies by disturbing work patterns (e.g., no gasoline for tax inspection vehicles or ambulances). In the absence of a more fundamental review, any savings are likely to be reversed sooner or later.
- Across-the-board cuts in nonwage current spending can result in less funds for highly productive nonwage social sector inputs, such as medicines or textbooks.

- Spending financed from privatization proceeds may need to be reversed once this one-off source of financing dries up.
- Financial transactions taxes can drive financial transactions underground, especially if set at relatively high levels. Fewer financial transactions result in falling revenue yields, the economy loses productivity, and the banking system suffers.
- Export surcharges undermine the competitiveness of the critical export sector, reduce the country's access to foreign exchange, and weaken growth.
- Repeated tax amnesties—apart from raising fairness issues—erode taxpayers' incentives to comply with tax laws and damage the credibility of tax authorities. This results in lower revenues over the longer term, with the benefits typically accruing to the better-off in society.

Durable Adjustments

Durable expenditure reductions in industrial countries typically involve tackling the wage bill, subsidies, and transfers (Alesina and Perotti, 1997). Evidence also suggests that emerging market economies with lower subsidies and transfers or higher revenues are more likely to sustain consolidations. Similarly, developing countries that cut selected current spending while protecting capital expenditures tend to experience longer-lasting adjustment. For countries with low revenue-to-GDP ratios (most developing countries), revenue increases can also lengthen the duration of fiscal consolidation (Gupta and others, 2004).

Higher-quality and more durable reforms typically take time to implement and to yield budgetary benefits. This is true, for example, for broadening the tax base or shifting from trade taxes to broad-based sales taxes, especially when administrative capacity is weak. Civil service reform requires prior groundwork preparation, such as civil service censuses, and may also require severance outlays (Box 4). Such measures should therefore be implemented as part of an overall policy package that provides for an appropriate degree of short-run deficit reduction.

Fiscal Responsibility Laws

Fiscal responsibility laws aim to impose durable fiscal discipline and overcome the problem of "deficit bias" (IMF, forthcoming). Such laws attempt to impose an underlying constraint, of varying degrees of formality, on fiscal policy and often on those that make it. Fiscal responsibil-

Box 4. Civil Service Reform

Civil service reform often plays a central role in fiscal adjustment programs. Such reforms typically aim to reduce high wage bills (which they have often failed to do), improve productivity, and lessen incentives for corruption. A centralized reform strategy is based on a functional review that identifies unnecessary programs and positions. A decentralized strategy focuses on changing the incentive structure (freedom in hiring/firing/pay decisions and performance-based budgeting and assessment of top personnel). The prerequisites for a successful decentralized reform are a high degree of transparency and accountability.

Civil service reform is particularly difficult but careful sequencing helps.

- Civil service censuses and functional reviews should precede the design of retrenchment programs. In Cambodia, for example, a civil service census and the fingerprinting and registration of civil servants in all provinces reportedly eliminated thousands of ghost workers.
- Civil service wages should be set within the budget process (rather than independently by parliament), and monetization and consolidation of benefits should precede reforms of pay structures. In Honduras, for example, before reforming the salary structure, a new wage policy law had to be passed. The law eliminated special wage regimes and gave the ministry of finance (rather than congress) the power to determine government wage increases.

ity laws can entail numeric rules, such as a balanced budget, or impose procedures focusing on enhancing transparency and accountability. They typically require that the government commit to a monitorable fiscal policy strategy or to specific fiscal targets.[20] Some contain well-defined sanctions for noncompliance. Fiscal responsibility laws generally include explicit escape clauses that suspend their application during exceptional circumstances, such as natural disasters or severe recessions. They can also define fiscal targets in terms of multiyear horizons or structurally adjusted indicators.

[20]Independent fiscal authorities are an alternative to numerical rules to depoliticize fiscal policy decisions, but devolving such authority can be politically difficult. Fiscal councils that provide independent analysis are a less politically difficult option, but they are less binding on policy.

Because in most countries fiscal responsibility laws have not been around for more than a few years, evidence on their effectiveness remains preliminary. But some tentative lessons seem to be emerging:

- *Institutions should be sufficiently developed to support the requirements included in the legal framework*. Public finance management systems, in particular, should be sufficiently advanced to credibly implement, and enforce, the procedural and fiscal rules.
- *Fiscal responsibility laws require broad political consensus to be successful and are not a substitute for political commitment.* While the adoption of such laws can potentially catalyze meaningful reforms promoting fiscal prudence, experience suggests that broad support for fiscal prudence is a precondition for their success. Designing the framework takes time and should be aimed at addressing country-specific weaknesses in fiscal management that underlie poor fiscal outcomes. These requirements may not be met in countries facing large macroeconomic imbalances or political instability.
- *Fiscal responsibility laws should cover a broad definition of government.* Those with broader coverage of the public sector tend to be more successful than those more narrowly focused (e.g., only on the central government).
- *In countries with a weak track record of policy implementation, procedural rules may work better than numeric rules.* Under these circumstances, procedural rules[21] can often be beneficial by promoting fiscal discipline through increased transparency and accountability.
- *Numeric fiscal rules, if included, should be carefully designed.* Numerical rules can be helpful, for instance, in containing a deficit bias, but they are not in themselves the solution to structural fiscal problems. Numeric fiscal rules can even foster creative accounting and low-quality measures.
- *While fiscal rules have worked in particular cases, the evidence on their effectiveness in improving fiscal outcomes remains tentative.* If adopted, fiscal rules should be (1) well-defined regarding the specific fiscal indicator to be targeted, the institutional coverage, and, if any, escape

[21]Procedural rules aim to enhance transparency, accountability, and fiscal management. They typically require the government to commit up-front to a monitorable fiscal policy strategy, usually for a multiyear period, and to routinely report and publish fiscal outcomes and strategy changes.

clauses; (2) simple and transparent, to serve as an effective instrument of communication of government policy objectives; and (3) monitorable, so that noncompliance can be easily detected and addressed. Their credibility ultimately depends on the government's track record and on political and social consensus.

- *Enforcement mechanisms should be credible and effective.* Escape clauses should be reduced to a minimum to ensure the credibility of the process. These frameworks should also define enforcement mechanisms that could include financial or administrative sanctions for responsible government officials.
- *Fiscal responsibility laws should enhance transparency*. Countries with poor transparency and budget procedures are also unlikely to effectively monitor a meaningful quantitative fiscal target or enforce accountability.

Transparency and Governance

Fiscal transparency can support fiscal adjustment by contributing to better and more sustainable policies, and by strengthening accountability. Fiscal transparency seeks to enhance the public's understanding of the structure and functions of government, fiscal policy intentions, the soundness of public sector accounts, and fiscal projections (Box 5). It should contribute to a more balanced adjustment, especially in the short term, since targets can only be set on activities that are reported fairly reliably.

Fiscal transparency should make adjustment measures more durable by generating broader public support and understanding; by facilitating donor support through credible assurances about the use of donor funds; and by increasing predictability for, and confidence in, financial markets. Transparency also makes officials more accountable and reduces the scope for circumventing the declared adjustment effort by, for example, thwarting attempts to shift activities off budget. Parliaments can play a particularly important role in enforcing transparency.

Globalization has increased the pressure on, and rewards for, countries to be more transparent and accountable in managing their economies. It creates incentives for policymakers to reform policies and institutions to enable their countries to benefit from the rising international flows of capital, technology, and information. Increasingly, attracting foreign direct investment and accessing financial markets at reasonable rates requires

Box 5. Fiscal Transparency

The IMF's Code of Good Practices on Fiscal Transparency (IMF, 2001b) is a set of good practices that can be implemented by most countries over the medium to longer term. It presents a standard of fiscal transparency that provides assurances to the public, to donors, and to markets that a sufficiently complete picture of the government's structure and finances is available to facilitate a reliable assessment of the soundness of a country's fiscal position. The code is based on four general principles.

- The principle of *clarity of roles and responsibilities* requires specifying the structure and functions of government, responsibilities within government, and relations between government and the rest of the economy.
- *Public availability of information* emphasizes the importance of publishing comprehensive fiscal information at clearly specified times.
- *Open budget preparation, execution, and reporting* covers the type of information made available about the budget process. Budget documentation should specify fiscal policy goals, and the macroeconomic framework, and should clearly describe new policies and identify major fiscal risks.
- *Assurances of integrity* stress the quality of fiscal data and the need for independent scrutiny of fiscal information. This includes an external audit by a national audit body and assessment by independent experts of fiscal forecasts, the macroeconomic forecasts on which they are built, and all underlying assumptions.

not only sound macroeconomic policies but also more transparent and accountable public institutions.

Governance plays a critical role in determining the quality of fiscal adjustment, especially in scaling up expenditure in low-income countries. Good governance is generally recognized as a core ingredient of successful development. It is pivotal for translating resources into outcomes, given the strong link between the quality of a country's governance system and its development performance. And in an aid environment that increasingly rests on mutual accountability between donors and recipient governments, governance plays a vital role in stimulating and maintaining donor flows.

IV.
How Should Fiscal Adjustment Be Carried Out?

> *The most welcome way of increasing revenue would be for the prince to abolish superfluous expenditure, to disband redundant offices, to avoid wars and foreign tours, . . . to check the acquisitiveness of officialdom, and to pay more attention to the just administration of his territory than to its expansion.*
>
> *— Desiderius Erasmus (1469–1536)*

Fiscal adjustment should ideally be carried out through high-quality structural measures early in the process. These include sound revenue and expenditure policies for the medium term, as well as short-run options that are best for growth. Social safety nets can mitigate any short-term costs imposed by fiscal consolidation on the poor.

Improving the Tax System and Mobilizing Revenue

Structural problems in the tax system may well be a major contributor to fiscal deficits, and also to poor growth and unemployment. The ability to generate revenue by raising tax rates may be limited, particularly when an economy is undergoing substantial structural change, tax bases are narrow, hard-to-tax sectors (e.g., agriculture and the self-employed) are large, existing rates are high, or tax administration is weak—conditions that often reinforce one another. Thus, fiscal consolidation is often accompanied by measures to improve the tax system, while taking into consideration the equity and efficiency impact of reforms.

Tax systems need to balance macroeconomic and microeconomic objectives (Tanzi and Zee, 2000). In particular, a tax system should ideally be:

- *Productive*. A central goal of the tax system is to raise revenue to finance government spending. This requires a system that can generate revenue increases at least in line with the growth in income without frequent changes in tax rates or introducing new taxes. Charging low rates on a broad base typically best meets this objective. Exemptions and incentives—such as (and arguably worst of all) tax holidays—can severely undermine revenue-raising capacity, often with little if any offsetting benefits (Box 6).

- *Efficient.* Taxes distort relative prices and thus affect the pattern of production, consumption, investment, and income. Unless there is strong reason to suppose that market prices are themselves sending the wrong signals—which may be the case, for example, when some activity causes environmental damage—an efficient tax system imposes low and reasonably uniform tax rates on as broad a tax base as possible. It also avoids exemptions or special tax rates that artificially encourage investment in projects with below-market returns. However, when environmental or other externalities are present—where parties to some transaction do not bear all the social costs or enjoy all the social benefits—then particular taxes (e.g., on pollution) or, subsidies (e.g., to basic education) although less likely (given their revenue cost and potential for abuse) are in principle appropriate.
- *Fair*. Each country must decide for itself exactly what constitutes fairness. Distinguishing between vertical and horizontal equity can be useful. Vertical equity refers to differentiation of the tax burden according to ability to pay, and horizontal equity, to equal treatment of those in similar economic circumstances. Certain types of taxation may affect income distribution—for example, a progressive income tax or a reduced rate of value-added tax (VAT) on basic foods. But experience has shown that taxation is relatively ineffective in influencing income distribution in general, and in helping the poor in particular. And this is becoming increasingly true as tax bases (especially, but not only, capital income) become more mobile internationally. Expenditure policy is generally better suited to influencing income distribution, and equity effects should be designed and assessed comprehensively, embracing not only all taxes but also the spending they finance.
- *Simple and transparent*. Taxes with a single rate or a low number of rates and minimal exemptions are easier to administer and easier for the taxpayer to understand, comply with, and—ultimately—express views about. Tax rates should be stable and predictable. Once tax laws that generate buoyant revenue growth are in place, frequent amendments should be avoided. If changes are planned, taxpayers should ideally know the implications in advance (unless this creates unacceptable scope for tax avoidance).

Box 6. Dangers of Tax Holidays

Tax holidays—exemptions from tax, sometimes for many years—are a particularly ill-designed form of investment incentive for the following reasons:

- They attract the most footloose forms of business, since they can easily move elsewhere at the end of the holiday. These are the firms least likely to offer spillovers to the wider economy in terms of training or deep linkages with the domestic economy.
- They are open to abuse, undermining tax revenue not only directly but indirectly, by providing entrepreneurs with an incentive to use transfer pricing and financial arrangements that shift taxable income to holiday companies from companies that would otherwise be taxed. For example, taxpaying companies (able to deduct the interest payments) can arrange to borrow from holiday companies (not taxable on interest received).
- In many cases, the appeal of tax holidays has been that they protect companies from exploitation by corrupt tax administrations. By the same token, offering a holiday can be seen as signaling a low-quality civil service.
- They are relatively inefficient at encouraging employment (often the claimed objective) since, like other investment-based incentives, they encourage the use of capital, not labor.
- Developing countries have felt compelled to offer such incentives because of tax competition with each other, and this appears to be one of the reasons for the reduction in corporate tax revenues in many countries. But tax holidays do nothing to address the underlying problems that may deter foreign investment (e.g., instability of the tax system, an ineffective judicial system, arbitrariness in administration and red tape, and foreign exchange restrictions). The evidence suggests, indeed, that tax factors, while they do matter, are far from the main concern of foreign investors in deciding where to place their funds.

There are better options for stimulating investment, such as accelerated depreciation and capital allowances. Maintaining a reasonably broad base for the corporate income tax makes it easier to set a reasonably low corporate tax rate. This in itself is likely to protect the revenue base and provide a supportive environment for investment. Realizing this, a number of countries have scaled back tax holidays and other tax incentives for investment. Sometimes, however, countries feel pressure to retain or expand such incentives to compete with those available elsewhere. This leads to a mutually damaging form of tax competition. In such cases, regional agreements can be helpful—for example, on a code of conduct on business taxation, as adopted by the European Union.

The design of the major taxes should draw on the following criteria:

- *Sales tax or VAT.* This should be a broad-based tax on final domestic consumption that does not tax intermediate consumption or exports, and does not differentiate by source of production (foreign or domestic; see Ebrill and others, 2001). Because of its efficiency (in not affecting business use of inputs) and revenue security (in collecting revenue at all stages in the production chain, not just at final sale), the ideal instrument to achieve this goal is usually a VAT levied at a single positive rate—key elements being crediting provisions to remove businesses' input purchases from tax and zero rating[22] of exports. Exemptions should be avoided as far as possible, since they reduce the efficiency of the VAT by causing it to "cascade" through the chain of production (Harrison and Krelove, 2005). Zero-rating other than for exports should also be avoided, since it creates a need to pay refunds that can cause great administrative difficulty. Nevertheless, exemptions are often given either on technical grounds (for financial services) or—albeit misguidedly, since most of the benefit often goes to the better off, who buy more of these items than the poor—for equity reasons, as for selected basic foodstuffs and basic education and health services.
- *Excises.* Imposing excises (which, unlike the VAT, are not creditable) on a limited number of commodities can be a good tax handle when demand for the commodities is inelastic and the commodities can be easily monitored. They are appropriate for dealing with negative externalities (e.g., a gasoline tax to address problems of local air pollution and global warming) and have, for some, a particular appeal in limiting consumption of "harmful" items (e.g., alcohol and tobacco). Excises should be levied equally on domestic production and imports and, with a few exceptions—notably for petroleum products (to avoid worsening volatility)—on an ad valorem basis.[23]
- *Customs duties*. A low, across-the-board tariff is useful for revenue reasons in countries where other, preferable, taxes may be hard to administer. Schemes are needed to relieve exporters of the anti-export bias caused by customs duties on inputs, either by a system of drawback

[22]Under both "zero-rating" and "exemption," no tax is charged on sales; they differ, however, in that taxes paid on inputs are refunded under zero-rating but not under exemption.

[23]A tax, duty, or fee that varies based on the value of the products, services, or property on which it is levied.

(refunding duties paid on imports used to produce exports) or by one of suspension (excluding such imports from duty altogether). Exemptions from customs duties should be limited and clearly defined to avoid abuse. As trade liberalization proceeds, revenue from this source is likely to fall. For many developing countries, a key challenge is to strengthen their domestic revenue systems to replace lost trade tax revenues.

- *Export taxes*. Export taxes should generally be avoided as they tend to draw resources from the export sector toward less efficient uses, compromising growth. But they can be useful on a limited basis for hard-to-tax activities (common in the agriculture sector), as a temporary substitute for income taxation, and to absorb one-time windfall gains (e.g., from devaluation or from exceptional movements in world commodity prices).
- *Business income taxes*. A tax on profits should ideally be levied at a single rate, broadly comparable with the top marginal rate of the personal income tax. This minimizes the likelihood of tax-induced shifts between personal income and enterprises. Deductions, allowances, and credits are best applied neutrally across sectors and assets to foster efficiency. If tax incentives are considered, they should consist of accelerated depreciation—that is, allowing assets to be written off for tax purposes more rapidly than they actually depreciate. A minimum profits tax based on turnover or gross assets may be used in some circumstances to promote compliance and equity, and to secure revenue. For small businesses and the informal sector, a simple presumptive tax based on gross assets or other indicators can be used, given the difficulty of assessing their actual incomes.
- *Natural resource taxation.* This generally requires specialized tax instruments to ensure that risk and revenues are shared appropriately between the government and investors, and that the resource itself is responsibly exploited.
- *Personal income taxes*. A basic personal income exemption should be set high enough to exclude the poor. Sufficient progressivity can be achieved with only a few income tax brackets. Tax bands should be adjusted periodically for inflation to avoid "bracket creep," while incentive and compliance considerations argue for keeping rates as low as possible. It is not prudent, however, to expect a cut in high marginal rates—as seen recently in a number of countries that introduced a "flat tax"—to produce an actual increase in revenue. One textbook view is that income

taxes should be levied on a "global" base—charging tax on the sum of income of all kinds. However, it is often administratively convenient to establish schedular taxes[24] on different sources of income (e.g., through final withholding taxes on interest income). A number of countries have recently experimented successfully with a "dual" income tax of this kind, combining a low, flat rate of tax on capital income and a progressive tax on labor income.

Major reforms in tax design and administration take time to implement and to achieve their expected revenue impact. New legislation is often required and basic systems and procedures frequently need modification. Short-term measures may thus be needed. They should be assessed in terms of their effect on resource allocation, fairness, administrative feasibility, and their consistency with the desired direction of longer-term tax reform. The most promising measures for producing short- (and indeed long-) term revenue increases typically involve expanding the tax base by eliminating tax exemptions (especially tax privileges). Not only can this raise revenue, it can also simplify administration, freeing up resources for more productive activities, and it fosters taxpayer compliance as well.

Rationalizing Public Expenditure and Protecting the Poor

Public expenditure reform is typically undertaken to reduce government spending. But even when public spending need not shrink, expenditure reform can still improve the productivity of existing spending, free resources to help meet new needs, and improve governance and transparency (Gupta and others, 2005a). Reducing expenditures while improving their composition need not undermine growth or social indicators.

Spending cuts should be pragmatic—adequate to achieve the intended goals yet economically sound and socially feasible. Many measures can be taken quickly, but durable, good-quality expenditure reform typically demands a review of underlying government policies, the composition of spending, the coverage of activities by the public sector, and the modes of delivery of public services. Quite often, a thorough structural reform of government spending policies can be done only over a number of years (Box 7).

[24]A schedular tax system disaggregates income into components such as labor income, dividends, and royalties and then separately applies tax rates and exemptions.

Box 7. Fundamental Public Expenditure Reform

Fundamental structural reform requires asking basic questions about whether government activities are needed, should be provided by the public sector, or could be made more market based. For activities to remain in the public sector, specific objectives need to be set, desired outputs quantified (where possible), inputs determined, and managerial freedom given to pursue the most efficient delivery of services.

A comprehensive review might generate the following types of reforms:

- Eliminate unproductive or low-priority services.
- Privatize activities that can, and should, be carried out in the private sector.
- Introduce a more commercial approach to public activities, including competitive tendering and contracting out of some services to the private sector.
- Simulate market discipline, including in government purchasing and provision of services, for example, in health care.
- Enhance management of those services that are to remain in the public sector. This would entail, for example, more devolved managerial authority and linking of managers' salaries to performance.
- In countries where public expenditure management is advanced, introduce "performance-based" budgets that strengthen links between the results delivered by agencies and the funding they receive.

Longer-Term Expenditure Reform

Public spending should be judged on its impact on growth and investment, as well as on poverty and equity. Apart from core government functions, market failures (e.g., positive externalities, public goods, and imperfect credit markets) are a main justification for public sector activity. Public expenditures also play a redistributive role, especially when targeted at the poor.

The private sector may refrain from certain activities that have a large social return because the private return is too low. This will be the case when there are positive spillover effects ("externalities") and for public goods. In the case of positive externalities, the market will produce too little of a good relative to the socially optimal amount—for example, too little education relative to the benefits accruing to the community at large. In the extreme case of public goods, where it is impossible to charge people for the benefits they receive, these goods will likely not be produced by the private sector at all. Alternatively, the private return of an investment may be sufficiently high, but financing, owing to market failure, may be unavailable.

Productive expenditures are those that have a high social rate of return. Such rates of return are difficult to measure, but at the functional level, they are often highest in infrastructure, primary education, preventive and primary health care, and basic public services. In terms of their impact on poverty, programs in primary education, basic health care, water and sanitation, roads, rural development, agriculture, judicial systems, and anti-corruption appear to have the largest impact. Expenditure composition in many countries suggests that there is great scope for improvement:

- About one-fifth of education spending is allocated to tertiary education, which has a lower rate of social return than education spending at the primary and secondary levels.
- Similarly, in the health care sector, spending on basic preventive health care—such as immunizations—have a high social return and also a relatively larger impact on the poor. Still, almost two-thirds of public health care outlays tend to be absorbed by curative care rather than basic and preventive health care.
- Some governments provide generalized subsidies. These are usually distortionary. For example, subsidies that encourage wasteful power, water, and fertilizer use generally damage the environment and typically benefit the better-off in society as they consume more than the poor. In some instances, subsidies can be targeted at the poor, while in others, they can be eliminated and the proceeds used to benefit the poor (for example, by developing rural transportation networks).

Spending on goods and services other than wages can be highly productive, but it often bears the brunt of adjustment. Highly productive nonwage inputs, such as medicines and textbooks, are often crowded out by wages and salaries. As a result, health care workers and teachers are left without the necessary complementary inputs. Similarly, public investment programs often ignore the recurrent costs of a project, resulting in rapid deterioration of infrastructure.

Other than by targeting specific sectors, the productivity of government spending can be increased by addressing governance and management issues. In education, the quality of teachers, and whether they turn up and teach, is more important than class size. This underscores the relative importance of reasonable wages over the number of teachers. Investment expenditure is notorious for containing "white elephants," such as underused airports and bridges. The productivity of investment can be increased by following some basic principles. These include subjecting large projects to tighter scrutiny and rigorous cost-benefit analysis and monitoring all central and local governments proposed and ongoing projects.

Reducing corruption will tend to improve the quality of spending and the amount of revenue to finance it (Tanzi, 1998). In particular, corruption tends to be linked with less spending on health and nonwage operations and maintenance and with more allocations for less productive investment projects and military spending.

Countries with aging populations will require two very difficult adjustments, entailing not only changes in spending patterns but also in the promises that governments make.

- *Pension reform.* Pension systems face two challenges. First, most public pension systems promise benefits that cannot be financed with existing contributions. Countries have several options for addressing this medium- to long-term problem (Box 8). At one extreme, they can restructure existing pay-as-you-go systems to bring benefits into actuarial balance with contributions. At the other extreme, they can shift to private, funded systems, gradually reducing current implicit pension liabilities. Even in this latter case, adjustments in the legacy pay-as-you-go systems will be necessary to make the transition affordable. Second, the coverage of many pension systems is often narrow and provides preferential treatment for certain groups, such as public sector employees. It is important to widen coverage; in developing countries, this will require labor markets to become more formal. However, coverage should not be widened until existing systems have been reformed to ensure their long-run sustainability.
- *Health care.* Adjustments in how health care is rationed and financed may be even more daunting than pension reform. The elderly are the most intensive consumers of health care, and the aggregate demand for health care will grow rapidly as populations age. Rapid technological change in health care has been, and will likely continue, expanding available treatments, often at substantial cost. Other demands on the health care system, such as HIV/AIDS, may compound the growth in the demand for health care. Allocating health care spending in a manner that is both fiscally responsible and socially equitable is one of the biggest challenges currently facing economic policymakers.

Box 8. Key Issues in Pension Reform

The fiscal unsustainability of many public pay-as-you-go pension schemes has become increasingly apparent in recent decades. Many countries—especially developed countries with large unfunded liabilities—are attempting to remedy this problem. In so doing, several choices must be made:

- *Public versus private*. A threshold question is what role the government should play in the pension system. It may want to take an active role in the system if workers are myopic about their future income needs or might refrain from saving on their own in the belief that the government will provide assistance in any event. The government may also want the system to have a redistributive component.
- *Defined-benefit versus defined-contribution.* Pension systems are typically either *defined-benefit*, in which benefits are determined by formula based on prior income, or *defined-contribution*, where benefits are determined by the amount of accumulated contributions. These two choices differ in the manner in which risk is allocated between the plan sponsor—for instance, the government—and the participant.
- *Funded versus pay-as-you-go*. A system can be either *funded*, in which contributions are invested and accrue market returns, or *pay-as-you-go*, in which the contributions of current workers are used to pay the benefits of current retirees.

Choices along these dimensions must be carefully considered and will—at least for some developing countries—be dictated by the capacity of the private sector to administer the system and provide investment opportunities. Moreover, shifting from a pay-as-you-go to a funded system entails significant transition costs, and a country's ability to finance these costs will determine the feasibility and speed of such a shift. A transition to a funded pension system may be desirable, but there is no substitute for reforming existing pay-as-you-go systems to reduce unfunded liabilities.

Short-Term Expenditure Reform

There are no hard and fast rules about how public expenditure should be cut in the short run, when needed. This will depend partly on the factors driving the growth in spending (e.g., wages and salaries or the capital program), as well as on the social and political constraints facing policymakers. However, experience suggests some guidelines.

- *Protect core programs*. While fiscal consolidation in the short run may require lower overall spending, it is still possible to safeguard most, if not all, core productive expenditures and to protect the poor with well-targeted social safety nets.

- *Identify specific program reductions*. Many programs can and should be dropped, pruned, or consolidated as economies develop and priorities change. For instance, free milk distribution may become unnecessary when income levels rise above a certain level. Program elimination usually leads to effective savings—because it requires governments to redefine their priorities and is a first step toward a more fundamental expenditure review—and it preserves the efficiency of operations elsewhere in the public sector.
- *Cut the public sector wage bill*. Wage restraint and hiring freezes can be a major source of savings in the short run, but they are politically difficult to sustain and not necessarily desirable from an efficiency point of view. Thus, they should be seen as interim substitutes for structural reform that entails a deeper review of employment and pay policies and program staffing needs.
- *Target social programs narrowly*. General subsidies could be eliminated and transfers made more efficient by targeting eligibility and by reducing income replacement rates (Gupta and others, 2000a). Where possible, multiple programs for social protection should be consolidated into more global schemes of income transfers. This avoids significant overlap in entitlements provided by uncoordinated agencies.
- *Review the capital program*. The capital program is often the prime target for short-term retrenchment. Postponement of projects not yet begun can save resources with relatively little disruption of day-to-day government operations. The cost, however, may be lower growth and development. Capital programs are best cut in the context of an overall public investment review—often possible only as part of a medium-term strategy.
- *Raise fees and charges*. Governments are often reluctant to reduce volumes or standards of delivery in high-priority areas like education and health. Savings in these areas may best be achieved by cost recovery through an increase in the fees and charges for services, while protecting the poor.
- *Change public enterprise tariffs and subsidies*. If public enterprises are in deficit, their pricing structures may need to be adjusted and subsidies eliminated. The scope of their activities may also need redefining; their employment policy, adjustment; and their capital program, rationalization.

Social Safety Nets and Poverty and Social Impact Analysis

Social safety nets consist of a combination of measures aimed at protecting the poor from the adverse consequences of economic shocks and structural reforms, and helping them escape poverty. Because social safety nets need to work quickly and reliably, they must be tailored to the specific circumstances of each country, including its administrative capabilities, the strength of its informal and formal social support systems, and the characteristics of the poor. Typically, the major components of social safety nets include:

- *Targeted cash compensation, commodity subsidies, and fee waivers*. With effective targeting, these are the preferred schemes to protect consumption by the poor in the face of falling incomes or rising prices. When fees were introduced for budgetary reasons, fee waivers have been used to help maintain access for the poor to education and health services. Providing basic minimum services (such as electricity and water lifelines) at low cost is another option.
- *Enhanced unemployment benefits, severance pay, and public works schemes*. Because reforms may lead to a temporary rise in unemployment, assistance can be channeled through schemes designed to mitigate the fall in employment. Governments should maintain the distinction between social insurance, typically financed through contributions, and social assistance, which should be financed through the budget. A well-defined reemployment strategy (e.g., retraining schemes) can also play a role.

Targeting and incentives are the key issues in the design of social safety nets. Sophisticated means testing is generally not possible, owing to the lack of administrative capacity. Many countries rely instead on categorical targeting, such as limiting benefits to children or pensioners, or to households in certain especially poor regions. Another form of targeting that requires little administrative capacity is to limit subsidies to goods consumed disproportionately by the poor, or to limit the quantity that each household can consume, for example, via coupons. The fiscal cost of the social safety net is reduced the more sharply benefits are phased out with rising household income. This, however, increases the implicit marginal tax rate facing beneficiaries, and thus the potential adverse impact on work incentives.

PSIA can be used to determine the impact of expenditure (and other policies) on the poor. It is the analysis of the positive and negative consequences of changes in policy (e.g., taxation, trade reforms, public enterprise retrenchment, and social expenditures) on the welfare of different groups in society—with an explicit focus on the poor and vulnerable. Depending on country circumstances, PSIA may employ a variety of tools to gauge the impact of policies. These include incidence analysis, social impact surveys, micro-simulation models using household surveys, and computable general equilibrium models. These tools rely on inputs from governments, which, in turn, derive from an open consultative process, including with civil society. A PSIA may suggest modifying proposed policies or strengthening social safety nets to accompany new policies.

V.
What Institutions Can Help Fiscal Adjustment?

The more a people feel taxation, and the more jealously they watch over public expenditure, the better it is for them and for their rulers.

—Francis Wayland (1796–1865)

Fiscal adjustment does not happen in a vacuum. It is not enough for a finance minister simply to decide to adjust; the decision must be put into effect and supported by public institutions. Without well-functioning fiscal institutions, even the best-designed policy measures risk failure. Key fiscal institutions for achieving and sustaining fiscal adjustment include those that implement revenue administration (tax and customs), budget (public financial) management, and intergovernmental relations.

Modernizing Revenue Administration

Raising revenue and implementing revenue policies depends critically on the quality of revenue administration (Silvani and Baer, 1997). Customs departments face additional challenges, for example, from trade liberalization, the requirements of World Trade Organization membership, and the heightened need to protect national borders (Keen, 2003). Strong and modern revenue administrations will be better able to implement new revenue measures effectively, generating a rapid revenue response. Weak and outdated administrations typically need reforming if they are to deliver durable revenue improvements.

Modernizing revenue administrations means moving to a principle of voluntary compliance, where taxpayers and traders are expected to comply with their obligations with little intervention from revenue officials. This recognizes that no revenue administration can determine the correct liability and control the compliance of every taxpayer. Voluntary compliance is achieved through self-assessment, where taxpayers and traders—with access to information and assistance from the tax and customs departments—calculate their own liabilities, file returns and declarations, and pay the tax and duties that they themselves assess. If they fail to make accurate assessments and pay the correct amounts, they risk being audited and paying penalties. The roles for tax and customs departments are, first, to help taxpayers and traders understand and meet their obligations, and, second, to take action against noncompliers, particularly those with greatest impact on the revenue performance.

Beyond these general principles, modern revenue administrations require the following:

- *Clear and simple laws*. Laws and regulations that are easy to understand and apply facilitate efficient revenue administration and minimize taxpayer/trader effort and compliance costs.
- *Efficient collection systems and procedures*. Simple forms and straightforward assessment, filing, and payment arrangements facilitate administration and compliance. Administrations need to strike a balance between the controls necessary to protect revenue and the costs and inconvenience imposed on businesses in meeting their obligations.
- *Service orientation*. Tax and customs departments face increasing demands to improve their service to the business sector. This is particularly so for customs administrations, where improvements in service directly reduce the costs and enhance the competitiveness of exporters and importers.
- *Verification programs based on risk analysis*. Modern administrations optimize tax collection by focusing on taxpayers and traders posing the greatest risk to revenue. Tax and customs administrations should embrace risk-management approaches and develop analytical capabilities to better understand the make-up and compliance behaviors of the taxpayer and trader base.
- *Function-based organizational structures*. Experience strongly suggests that tax departments organized according to key functions (such as audit and enforcement) operate more efficiently than those structured by type of tax. Function-based administrations facilitate specialization. They also eliminate duplication and inefficiencies characteristic of tax-type-based structures.
- *High level of automation.* Because a large part of revenue collection involves high-volume transaction processing, modern revenue administrations rely heavily on information technology. Computerized systems are also essential for supporting the information needs and analysis associated with risk-management approaches.

Box 9. Features of a Dedicated Large Taxpayer Office

Taxpayers covered. Depending on the selection criteria used, the taxes to be covered, and the resources to be committed, large taxpayer offices typically cover 60–80 percent of the domestic tax revenue base but usually only 500–1,000 taxpayers (typically 1–2 percent of the total).

Taxes covered. Most large taxpayer offices and large taxpayer audit units in developing countries focus on collection, enforcement, and audit of (1) corporate and other income taxes; (2) VAT or sales tax; (3) excises; and (4) taxes withheld from the salaries and wages of their employees.

Criteria used to identify large taxpayer offices. Annual turnover is the most effective and objective way to identify large taxpayers. Other criteria sometimes used—but not preferred—include (1) amount of tax arrears; (2) level of imports; and (3) specific economic sectors (e.g., banks and insurance companies).

Large taxpayer office *organization and functions.* Function-based organizational structures work best. Key functions include registration, all information processing tasks, taxpayer assistance, collection monitoring and enforcement, and taxpayer audit.

Service strategy. Large taxpayer offices provide a single point of access for large taxpayer inquiries, requests for rulings on important technical issues, and so on.

Audit strategy. Because of the large amounts of revenue involved, and the complexity of many transactions and their taxation treatment, large taxpayers often require close audit attention. It is not uncommon, therefore, for 50 percent or more of large taxpayer office resources to be devoted to audit-related activities.

- *Differentiated treatment of taxpayers by their revenue potential*. A growing trend among tax administrations has been to give special attention to the largest taxpayers. As a first step, this often involves establishing a large taxpayer office for the most significant taxpayers (Box 9). A number of tax administrations have further segmented their taxpayer population and developed enforcement and service programs tailored to the needs and risk profiles of medium-sized enterprises and small businesses.
- *Effective management*. Modern revenue administrations increasingly recognize the importance of a strong and professional management team to formulate the revenue administration's strategy; communicate

the organization's direction and objectives to its staff and external stakeholders; ensure that the organization focuses on sustained and fundamental improvements in performance, not just short-term revenue targets; and ensure that resources match the required outputs.

All of this takes considerable time: a full-blown modernization program can take three to five years to carry out. Benefits are likely to flow during that time as new systems and processes come on stream. But the lag effect, as taxpayers begin to change their underlying behavior in response to a more effective tax administration, can take longer. In the short term, generating revenue quickly from administration reform alone is difficult and efforts should focus on specific areas of noncompliance:

- Better controlling large taxpayers. A large taxpayer office can usually be set up for administration of the biggest taxpayers within 12 months and it should be staffed with the best personnel from the tax administration.
- Ensuring that state-owned enterprises are compliant. This sends a strong signal to the private sector that the government is serious about compliance.
- Implementing compliance-enforcement programs to target the largest and newest arrears using task forces of specially trained staff.
- Establishing audit teams trained to deal with problematic sectors, and conducting a program of short and sharp routine VAT audits to generate a credible presence in the taxpayer community.
- Setting up registration task forces to bring in significant taxpayers that have opted out of the tax system can be productive, provided that they target medium-sized taxpayers and not a large number of nonproductive small taxpayers.
- If the VAT threshold is set too low, raising it can free up resources from administering a large number of nonproductive taxpayers and refocus these resources on the more significant medium-taxpayer group. Reducing filing frequency from monthly to quarterly for medium taxpayers can also substantially reduce administration and allow resources to be refocused.

Effective Public Financial Management

Implementing fiscal adjustment requires an effective public financial management (PFM) system (Potter and Diamond, 1999). Such a system provides a framework for policymakers to determine the appropriate amount of adjustment and the tools to deliver it. A PFM system is a multifaceted technical process that starts with budget preparation and extends to budget execution, accounting, and reporting. But even strong preparation and execution systems can be undermined by weak governance and a poor institutional setup. Ultimately, budgets and PFM systems must be supported by senior officials and politicians. Ministries of finance need to be able to enforce fiscal discipline over spending units that are unprotected by political patronage. In addition, different units in the PFM process need to be well coordinated and the legal framework needs to be supportive of, and supported by, a strong-willed executive.

The primary objective for the PFM system in fiscal adjustment is to enforce aggregate control: it must deliver expenditure outcomes consistent with macro-fiscal policy. This fundamental tenet of sound budget management requires *getting the basics right*. The budget needs to fully reflect expected liabilities. Timely and robust information on spending should be available so that meaningful expenditure control, which responds to changing macroeconomic conditions, can be exerted. Without these basic functions fulfilled, even the best policymaking can fail, with deficit targets missed, persistent payment arrears accrued, and expenditure priorities undermined.

Moving beyond these basic stabilization goals requires the public financial management system to focus on *enhancing expenditure efficiency.* It should provide policymakers information and mechanisms that enable them to pursue productive efficiency (ensuring outputs are delivered for the least cost) and allocative efficiency (ensuring that the optimum mix of outputs is provided). The costs of managing public funds should also be minimized.

Budget Preparation

Budget preparation will differ from one country to another, depending on budgetary systems and capacity. But there are common principles.

Getting the basics right entails ensuring that the budget covers all relevant expenditures in a way that enables policymakers to make the difficult decisions needed to secure an appropriate fiscal position. For many countries, this means swiftly extending budget coverage, improving the realism of annual budget projections, and consolidating recurrent and development budgets. The two key principles are:

- *Consistency with macroeconomic constraints*. This is best achieved by having the finance ministry set an overall spending ceiling (a "top-down" approach). Under a "bottom-up" approach, where the budget spending envelope is determined more by spending ministry requests than by macroeconomic considerations, the credibility of the budget could be undermined and macroeconomic stability threatened.

- *Unifying the budget.* Revenue and expenditure should be considered together to determine annual budget targets. The budget should cover all entities operated on a nonmarket basis, owned or controlled by the government, and predominantly funded by the budget. Budget fragmentation—involving, for example, separate development and recurrent budgets and extrabudgetary funds—complicates the development of a consolidated picture of government finances, hampers assessment of the recurrent costs of investment plans, and fosters duplication.

Enhancing expenditure efficiency requires a preparation system that can identify and prioritize growth-enhancing and poverty-reducing activities. For many countries, this means improving budget classifications, moving to multiyear frameworks, and gradually inserting measures of output and performance into the budget preparation system. The key principles are:

- *Universality.* All resources should be directed to a common pool to be allocated to government priorities. Rigidities in spending priorities—such as earmarked funds—are often introduced for political economy reasons and can make resource allocations inefficient and difficult to change. Rigid spending priorities can also complicate fiscal adjustment as they are not subject to a review and do not compete for funds with other programs.
- *Multiyear planning.* Expenditure efficiency requires regular medium-term planning frameworks by function, ministry, and (ideally) program. Budgets often focus only on the current year, or are incremental, failing to consider future circumstances. Thus, they cannot be sustained. The multiyear plan should be based on existing policies and should facilitate the evaluation of new policies. It should also be coordinated with debt management operations.
- *Prioritization.* Prioritizing expenditures is critical for meeting deficit or spending targets and helps spending ministries limit their requests. If priorities are not communicated early in the budget preparation process, overspending or arrears are likely.
- *Adequate nomenclature.* Budget classification systems should permit budgets to be adequately designed, implemented, and checked. Without adequate budget classification, it is not possible to understand how expenditures are allocated among different items or programs, and thus how and what to adjust. Spending items should be classified by implementing institution (administrative), purpose of spending (functional),

Box 10. Tracking Poverty-Reducing Spending

Public spending can, and should, play a major role in tackling poverty. But this requires that governments know how much they are spending on poverty reduction and on what items. A basic principle is that all poverty-reducing spending should be tracked. If only parts are tracked, there can be no assurance that poverty-reducing spending is increasing overall. Well-developed budget classification systems can rely on existing systems to identify and track such spending. For others, setting up a "virtual" poverty fund can be a short-term solution. Such a fund is a limited classification designed to provide financial information specifically about poverty-reducing spending. Budget items considered (by the country) to contribute to poverty reduction are "tagged," and these together form the virtual fund. All tagged items are monitored by the ministry of finance as part of overall budget execution.

Separate, institutional, poverty funds, where revenues are set aside in a separate account, with expenditures occurring outside the normal public financial management system, are problematic for the following reasons:

- They do not necessarily capture additional poverty-reducing spending. Resources are fungible, and a country can offset spending by the fund by lowering its own spending in the same area.
- They undermine the comprehensiveness of the budget. Diverting limited technical skills to create and manage these funds aggravates problems of transparency, duplication, and governance in the budget as a whole. Such funds make the budget less flexible without ensuring additional funds for reducing poverty.

Even when poverty-reducing spending is identified, tracking requires effective government accounting, reporting, and audit systems. These systems in many poor countries have serious weaknesses and may not provide adequate oversight. In particular, donor-financed spending may not be covered, and reports on public spending may not be timely or accurate. Devolution of poverty-reducing programs to local governments can also make tracking more difficult.

use of expenditure (economic), and—especially for more advanced public financial management systems—program (e.g., to facilitate the tracking of poverty-reducing spending) (Box 10).

Budget Execution and Reporting

Budgets, once passed, must be implemented to carry out the intended adjustment and to adjust to any within-year shocks. This requires effective budget execution procedures.

Getting the basics right means addressing the problems that result in budget overruns and payment arrears. These include the proliferation of exceptional procedures that bypass expenditure control, and difficulty in reconciling bank statements with budget accounts, partly because of the lack of reliable and timely data on cash expenditure. These problems can be addressed by:

- *Controlling spending during the year.* Controls should encompass all the stages of budget execution (typically, authorization, commitment, verification, payment authorization/order, payment, and accounting). Many cash-based systems do not provide useful information on commitments, and weak expenditure control fosters arrears.
- *Cash planning that ensures the budget is executed as smoothly as possible.* A cash plan should project payments coming due and the availability of cash to meet them. When a shortfall is projected over the next few months, and cash rationing cannot be avoided, authorizations can be reduced accordingly. Unless commitments by ministries are also reduced, however, arrears may result.
- *Reporting and reconciliation.* Timely in-year budget execution reports, systematic data reconciliations, and clarity on the accounting basis is fundamental to ensure that fiscal adjustment is implemented as planned.

Enhancing expenditure efficiency in the execution and reporting process can be achieved mainly by reducing the costs of managing public funds—for example, by establishing a single Treasury account and installing an integrated financial management system. Also important is enhancing the quality of reporting to improve transparency and accountability—for example, by moving toward accrual accounting and improving the management of, and accounting for, aid flows. These problems can be effectively addressed by:

- *Implementing an appropriate institutional framework*. Line ministries and spending agencies should be responsible for budget execution through delivery of services. And the ministry of finance should be responsible for regulatory controls and for cash planning and debt management. To perform these functions, an increasing number of developing countries are strengthening the (typically preexisting) treasury function within the finance ministry.
- *Consolidating all government financial resources in a single account system*. There is a clear, and welcome, international trend toward consolidating all government banking arrangements in a single treasury

account (TSA), controlled by the ministry of finance. The TSA provides complete information for government funds, strengthens control over cash flows (and reconciliation), reduces the cost of borrowing, minimizes idle cash balances, and enhances the efficiency and transparency of budget execution.

- *Integrating the various stages of budget execution into an integrated financial management information system.* This helps manage public monies better, allowing greater financial control, better monitoring of the government cash position and better cash planning, and better fiscal reporting. It also provides better data for budget formulation. Computerization of such integrated treasury systems can further improve efficiency, but it is costly and complex.
- *Internal audits and controls and independent (external) audit*. These can be helpful when the staff is well qualified and compliance with audit recommendations is strong. But it may foster corruption if governance weaknesses are not addressed.

The list of what a public financial management system should ideally do is long, and the resources available in many countries to strengthen such systems are limited. Moreover, what is appropriate in an advanced economy may not be in a developing country. This means that the design and sequencing of PFM reforms should be country specific, depending on needs, the starting point, and on what is practically possible. The guiding principle for many developing countries should be to get the basics right before tackling more sophisticated reforms. Not doing so can result in much financial waste and can even undermine critical parts of the existing PFM system. These issues of sequencing and capacity-appropriate design are particularly important in post-conflict countries (Box 11).

Effective Intergovernmental Relationships

If fiscal adjustment is to work for a country as a whole, subnational finances must be controlled. In particular, experience shows that market discipline by itself does not prevent unsustainable debt accumulation and typically needs to be complemented by other forms of borrowing control (Ter-Minassian, 1997).

Borrowing controls can take the form of rules at lower levels of government or direct controls over subnational borrowing. Under a rules-based approach, debt limits for individual subnational jurisdictions can be set based

Box 11. Rebuilding Fiscal Institutions in Post-Conflict Countries

Weak, or nonexistent, institutions make implementing fiscal adjustment in post-conflict countries particularly challenging. The strategy for rebuilding these institutions must be tailored to the country's capacity, focusing on the basics, yet flexible and consistent with the long-term goal of moving to a modern fiscal system (IMF, 2004b). This strategy entails a three-step process:

- *Creating a legal/regulatory framework for fiscal management.* This means reviewing existing legislation with a view to simplifying tax laws and procedures, or establishing new ones if existing laws are inadequate.
- *Establishing/strengthening the central fiscal authority.* Such an authority usually comprises four departments: a budget department, a treasury department, and separate departments for tax and customs administrations. Some countries have also established an explicit mechanism for coordinating donor assistance. The decentralization that is often needed to secure the peace should not endanger economic reforms and fiscal control.
- *Designing appropriate revenue and expenditure policies while simultaneously strengthening revenue administration and public financial management.* For tax policy, this means, for example, being more open to suboptimal policies—such as export taxes—that generate urgently needed revenue. For revenue administration, it means focusing on basic procedures, such as systems for filing and paying taxes that are easy to comply with. And for public financial management, it means implementing simplified systems, such as budget classifications under broad categories of outlays, to be refined later.

on criteria that mimic market discipline, such as current and projected levels of debt service relative to revenues. Direct controls can also be used. These include annual limits on the overall debt of individual subnational jurisdictions, central government review and authorization of individual borrowing operations, and/or the centralization of all government borrowing.

In countries with autonomous subnational governments, the center may not be able to legislate debt limits, or other requirements. The main leverage in such cases is transfers from the center, in combination with a no-bailout commitment of subnational governments by the central government.

While most countries have some form of revenue sharing (where the central government collects revenue but transfers part of it to subnational levels), excessive reliance on this method of funding subnational governments can hamper fiscal consolidation. For example, the central government may need to raise national revenues by more than the targeted reduction in the overall deficit to accommodate extra spending by subnational governments of shared or earmarked revenue.

Design Issues and the Right Incentives

In theory, assigning expenditure to local levels can raise the efficiency of service delivery, because the provision of public goods is better targeted to community needs and governance can be improved. But the potential efficiency gains can be significantly undermined in practice by the lack of clear and costed spending responsibilities and institutional constraints. In addition, devolution of expenditure responsibility to lower levels of government in countries with regional income disparities will, as a rule, have to be accompanied by income equalization transfers, which may not be politically feasible (Ahmad and Craig, 1997). In such circumstances, decentralization will lead to increased regional disparities in the level and quality of services and thus hurt the poor.

On the revenue side, the main objectives are accountability on the use of public funds while leaving the central government with sufficient instruments for stabilization and redistribution. These point to a system of assignment of own sources of revenue to each level of government—combined with various types of intergovernmental transfers to bridge any resulting gap between revenue and expenditure assignments.

Central government should be assigned taxes levied on the more mobile tax bases (e.g., profit taxes) to avoid tax competition among lower levels of government; taxes that are more sensitive to changes in income (or those that can best be used for stabilization purposes); and taxes that are levied on bases that are distributed unevenly across regions (e.g., taxes on natural resources), for distributional reasons (Norregaard, 1997). Multistage sales taxes, such as the VAT, which are difficult to coordinate and administer at the subnational level, are also best collected centrally. By contrast, single-stage sales and excise taxes are generally good candidates for assigning to regional governments. Property taxes, business license taxes, and various types of user fees for local services are ideal candidates for local taxation, since their base is relatively immobile. The personal income tax is also suitable for partial assignment—through "piggy-backing"—to the subnational level.

Most tax assignments are likely to cause large vertical imbalances—that is, fiscal imbalances between the subnational government level and the national level—as well as horizontal imbalances across jurisdictions, because the capacity to raise own revenues and spending needs differs across jurisdictions. These imbalances should be addressed through intergovernmental transfers. This is crucial not only to promote a more equitable distribution of resources, but also to ensure that effective limits can be set on the borrowing of subnational governments.

Intergovernmental transfers can be broadly grouped into two main categories: revenue-sharing arrangements and direct transfers (grants). Transfers can be grouped into general-purpose (unconditional) grants and specific-purpose (conditional) grants. The latter may be open-ended or subject to a cap. Both revenue-sharing arrangements and grants can be tailored to distributional purposes. In general, transfers based on objective criteria, such as population and per capita income, maintain incentives for efficient use of resources and tax effort. Gap-filling transfers, on the other hand, generate perverse incentives that can lead to budget overshooting and cost overruns.

Key Institutions

Achieving the potential benefits of devolution of spending responsibilities requires strong institutions and a high degree of transparency at all levels of government. In most developing and emerging market economies, this requires the administrative capacity of subnational governments to be upgraded substantially. To coordinate overall fiscal policy, it is also necessary to have timely and complete reporting and control systems at all levels.

Poor oversight of subnational governments and soft budget constraints have led to weak governance and to lack of accountability in many countries. In such cases, decentralization has had disappointing results in improving the efficiency and equity of public spending, while weakening the overall fiscal position. In this context, several countries have been improving their budget processes and developing fiscal responsibility legislation and internal stability pacts, which include fiscal targets or limits on subnational governments. These changes, to be effective, must be accompanied by credible sanctions and enforcement mechanisms when subnational governments breach the rules or do not meet reporting requirements.

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