The Acting Chair's Summing Up

Evaluation Report on Fiscal Adjustment in IMF-Supported Programs

by the Independent Evaluation Office

Executive Board Meeting 03/83
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Executive Directors welcomed the report of the Independent Evaluation Office (IEO), which draws valuable lessons for fiscal policy, a central element of Fund-supported programs. They agreed that the report has a number of constructive recommendations whose implementation would enhance the Fund's advice and programs in the fiscal area. Most Directors were encouraged that some of the common criticisms of fiscal adjustment in Fund-supported programs—notably that Fund-supported programs adopt a "one-size-fits-all" approach, are inflexible, and cause a decline in social spending—were not supported by the empirical evidence presented in the report. A few others felt that the evidence in the report does not fully answer criticisms of the Fund's approach. Directors also noted that the report found significant weaknesses in the results of fiscal adjustment in programs, noting that fiscal targets were not met in a large number of cases. However, they cautioned against drawing conclusions based on generalizations across a large number of countries, and stressed that the appropriateness of the size, pace, and results of fiscal adjustment can only be assessed against the specific circumstances of each individual country.

Directors reviewed the report's extensive evidence that addresses the concern that Fund-supported programs always involve fiscal austerity often associated with a contractionary bias. They agreed with the report's finding that Fund-supported programs vary across countries and are also in many instances revised when necessary to incorporate changing realities. They welcomed the conclusion that there is no evidence that Fund programs are uniformly contractionary, but noted that a contractionary bias could exist in certain circumstances. Some Directors considered that a closer investigation of the appropriateness of the fiscal stance in relation to programs' goals for individual countries could have shed more light on the report's conclusions.

Directors took note of the report's finding that, while growth does not typically decline in program years compared to trend, programs' projections of economic growth rates and private investment tend to be overoptimistic. They agreed with the report's conclusion that this forecasting bias has at times led to a contractionary bias in fiscal design. Many Directors, however, cautioned that less optimistic growth projections would not necessarily call for a less contractionary fiscal stance, especially in cases in which financing constraints and debt sustainability concerns are paramount and may be exacerbated by lower growth. In such cases, further strong fiscal adjustment may be needed to maintain market confidence and achieve desired levels of investment. Some Directors believed, however, that where debt sustainability is the primary objective, additional capital spending on productive assets would not necessarily jeopardize the program's objectives. Directors believed that the downside risks to growth projections should be weighed more systematically in program documents, and that the scope for countercyclical fiscal policy should be assessed if these risks were to materialize. Directors also noted the finding that most of the progress in fiscal adjustment took place in the first year of the programs with little progress thereafter, and emphasized the need for a better understanding of this phenomenon.

On the qualitative aspects of fiscal adjustment, Directors noted the report's finding that Fund-supported programs are not associated with lower public education and health spending than would have occurred in a nonprogram situation. However, they agreed with the report's assessment that this evidence did not allow them to conclude that the most vulnerable social groups are protected from the economic shocks they may suffer during program years. Directors underscored the need to shield the poor from economic downturns and called for Fund-supported programs to incorporate, to the extent possible, the cost of social safety nets, which should be

developed in advance by the authorities in collaboration with the World Bank.

Directors also agreed with the report's finding that there is scope for greater attention to reforms to improve tax performance and spending composition in Fund-supported programs. They considered that greater efforts are needed to increase tax compliance, curtail exemptions, and improve collection efficiency, but cautioned against overestimating the yield of revenue administration measures, at least in the short run. In this context, Directors noted the important role of technical assistance in achieving improvements in this area. On expenditure, Directors agreed that programs should put more emphasis on lasting improvements in expenditure patterns, such as by focusing on medium-term civil service reform.

Directors commended the report for crystallizing the issue of the mismatch between the period covered by a single Fund-supported program and the time required to complete structural and institutional reforms. They noted the report's findings that, in several instances, surveillance has drawn too few lessons from past failures and has not forcefully flagged the need to accelerate key structural reforms in the fiscal area. Directors agreed that programs should focus on key fiscal reforms that can improve the sustainability, efficiency, and equity of the adjustment, even when their adoption requires a longer period than that covered by the Fund-supported program. Most reforms would need to be broken down into discrete steps, and these intermediate targets could be included in program conditionality, while respecting the key principles of the conditionality guidelines. The reforms would also need to be appropriately prioritized and sequenced. Directors stressed the need for fiscal targets to respect existing capacity constraints, or at least to indicate clearly those cases where fiscal adjustment, while required by macroeconomic circumstances, might be beyond the country's implementation capacity. Directors also noted that successful fiscal reform would require that the authorities have strong ownership of the process.

Directors commented on the specific recommendations in the IEO report.

Recommendation 1: Program documentation should provide a more in-depth and coherent justification for the magnitude and pace of the fiscal adjustment and how it is linked with assumptions about the recovery of private sector activity and growth.

Directors supported this recommendation, and deemed that this initiative would instill greater discipline in program design, enhance transparency, and provide the public and the private sector with a more convincing rationale for the program, thereby helping to overcome political obstacles to implementation. Nevertheless, they recognized that uncertainties regarding key macroeconomic variables, particularly in countries in crisis, and concern about the implementation of policy measures and reforms complicate this task. A few Directors cautioned against spurious precision in such justifications, and others noted that the magnitude and pace of programmed fiscal adjustment may also reflect political constraints. Several Directors stressed the importance of better integrating debt sustainability analyses into program work. Directors looked forward to further staff analysis of the issue of growth projections in the context of the program design discussions.

Recommendation 2: The internal review mechanism should place relatively more emphasis on the early stages of the process.

Directors supported this recommendation. They welcomed Management's recent initiative aimed at enhancing the effectiveness of the review process, which, inter alia, encourages early consultation between departments.

Recommendation 3: Programs should give greater emphasis to the formulation and implementation of key institutional reforms in the fiscal area, even if (as is likely) they cannot be fully implemented during the program period.

Directors agreed that key institutional reforms can be more critical for fiscal sustainability than short-term expenditure and revenue measures. However, they recognized that short-term measures are hard to avoid in many cases, especially if the immediate objective is economic stabilization. Medium-term institutional reform may be of particular relevance in countries that have achieved macroeconomic stability and where "second generation" reforms are necessary to foster growth and reduce longer-term vulnerabilities. Some Directors agreed with the report's suggestion that reforms should be broken down into those that require executive action, legislation, and capacity building.

Directors, however, pointed out that in crisis situations, the pressing need to resolve the crisis may pose serious constraints on a medium-term approach. They reiterated the conclusion of the discussion on the Evaluation of the Role of the Fund in Recent Capital Account Crises that a crisis should not be used as an opportunity to force long-awaited reforms, however desirable they may be, in areas that are not critical to the resolution of the crisis or to address vulnerability to future crises. Careful judgment will continue to be needed to focus conditionality on those reforms judged critical while at the same time ensuring that adequate progress is made in address-

ing vulnerabilities and achieving the program's goals during the period of the arrangement, thus safeguarding the Fund's resources.

Recommendation 4: The surveillance process should be used more explicitly to provide a longer-term road map for fiscal reforms and to assess progress achieved.

Most Directors agreed that Article IV consultations should play a stronger role in identifying longer-term reform priorities and the causes of past failures in addressing fiscal problems, and that these analyses should inform subsequent program design. In this respect, the various initiatives to distinguish Article IV surveillance from program work are aimed at providing fresh perspectives. Some Directors considered the current framework of surveillance to be adequate for achieving the objectives of the IEO's recommendation. Directors also called for staff reports to set out in more detail the progress in implementing the recommendations of ROSC and technical assistance missions, as well as key reform priorities. Nevertheless, they underscored that the ultimate responsibility to develop a fiscal reform agenda resides with the individual country authorities, while the Fund should stand ready to provide advice.

Directors also stressed that, consistent with the Fund's mandate, surveillance needs to focus on key issues of macroeconomic relevance, which will be different in each country, and should draw on the expertise of other institutions as appropriate. They encouraged the use of cross-country experiences and comparisons, including inputs from regional and multilateral surveillance, to assist in program design. Most Directors viewed Article IV consultations as the appropriate vehicle for staff to identify countries in need of an in-depth fiscal review, stressing that this identification process should be applied uniformly to all member countries of the Fund. In most cases, these needs could be accommodated through technical assistance and ROSCs.

Recommendation 5: The IMF should clearly delineate the operational framework in which social issues will be addressed within program design in non-PRGF countries. This should include a clear indication of the IMF's responsibilities and activities in this area.

Directors agreed that an important aim of program design should be to protect critical social expenditures. However, they stressed, as recognized in the report, that the Fund should not become involved in the detailed selection and design of social policy; this task is outside both the Fund's mandate and its expertise. A number of Directors supported the IEO's call for updating of the 1997 guidelines that direct IMF work in the social area, in order to improve their clarity and effectiveness as an operational tool in protecting the most vulnerable from economic shocks and budgetary retrenchment. Other Directors, however, viewed the existing guidelines as adequate, and a few considered that the annual and medium-term budgets of non-PRGF countries already adequately identify critical social sector programs. These Directors recalled that the new framework for Bank-Fund collaboration on public expenditure issues should enhance countries' public expenditure reform strategies, including measures to protect critical social spending. Many Directors agreed with the recommendation that staff should inquire, during Article IV consultations, whether the authorities have identified social programs that they would like to protect in the event of a crisis, as they believed this would help dispel the criticism that Fund programs unduly curtail social spending. A few others considered this recommendation impractical, as it would create significant costs and pressures for the authorities with little benefit.

Directors looked forward to two evaluations that the IEO is conducting: those on the Fund's technical assistance and on the PRSP/PRGF initiatives. Directors stressed that, as the Fund provides extensive technical assistance on fiscal issues, the findings of the first report will be an important complement to the conclusions of the present one. Likewise, Directors anticipated that the forthcoming IEO's evaluation of PRSP/PRGFs will supplement the report under consideration in the lessons it holds for low-income countries and how they can be implemented.

Directors looked forward to receiving a report from IMF Management on how the report's recommendations might be addressed and followed up on in the period ahead.