



FISCAL CONSIDERATIONS IN POLICYMAKING

During 1995/96 the Board examined three issues with important implications for fiscal policy in member countries as well as for Fund surveillance—the budgetary consequences of the quasi-fiscal operations of central banks and other public financial institutions; the anticipated strain on pension schemes caused by aging populations; and the impact of taxation on labor markets, particularly on unemployment.

Quasi-Fiscal Operations of Public Financial Institutions

In some Fund member countries, public financial institutions use quasi-fiscal operations (for example, multiple exchange rates, exchange guarantees, subsidized lending, and central bank rescue operations) as instruments of policy. In light of the sizable impact these operations may have on the public sector's financial balance, in May 1995 Directors considered the desirability and feasibility of taking better account of their magnitude and cost in the design and monitoring of Fund programs.

Directors agreed that quasi-fiscal operations should be analyzed in a more disaggregated way than in the past, both to facilitate identification of whether a particular operation gave rise to an implicit net tax or subsidy and to ensure a more comprehensive and comparable assessment of fiscal policies. It was recognized, however, that some types of quasi-fiscal operations were difficult to quantify, either because of their complexity or because of the lack of data; in these cases, a qualitative approach would be necessary. Many Directors emphasized the importance of making quasi-fiscal operations transparent within a budgetary framework. They noted, however, that although quantification and analysis could shed light on the macroeconomic and allocative effects of quasi-fiscal operations, the ultimate objective was to eliminate such harmful practices as multiple exchange rates and directed lending.

With respect to Fund programs, Directors encouraged the staff to proceed on a case-by-case basis, focus-

ing on quasi-fiscal operations that gave rise to significant distortions or budget costs. They noted the importance of contingent liabilities but accepted that it might be difficult to assess them accurately. Nevertheless, even when quantification proved difficult, it would be valuable to draw attention to the existence of a particular practice. A number of speakers supported stricter accounting of quasi-fiscal operations in Fund-supported programs, provided that this could be done in a consistent manner and that changes in practices would apply to both program and nonprogram surveillance.⁵

Aging Populations and the Fiscal Impact of Public Pension Plans

In February 1996 Directors examined the macroeconomic and fiscal implications of aging populations and the potential impact of pension reform on national saving and growth, with particular reference to the major industrial countries. They agreed that projected demographic changes would pose serious challenges to policymakers. While the full impact of the aging problem in most industrial countries would probably not be felt for another 15 years or so, Directors urged that reforms begin as soon as possible, given the long lead times required for changing pension arrangements and the costs of postponing reform. Without any change in current pension arrangements, aging populations would become a significant financial burden on the public sector in many countries, particularly if the impact of aging on other public expenditures, notably medical outlays, was taken into account. More broadly, Directors noted that population aging and associated policy responses could have important repercussions on national saving, labor markets, employment and income levels, as well as on countries' external positions.

⁵The staff background paper will be published in the Fund's Occasional Paper series.

Directors underscored the usefulness of long-term quantitative assessments of the financial viability of public pension schemes and the importance of increasing public awareness of the future fiscal costs of today's pension benefit promises. Directors noted that the relative importance and characteristics of public and private pension schemes differed considerably among countries, making it difficult to formulate universally applicable advice on pension reform. However, substantial reform of existing schemes was unavoidable in many industrial countries; at a minimum, the terms of such schemes would need to be changed significantly, even if the structure remained the same. Directors agreed that "piecemeal" reform should focus on reducing pension replacement rates and increasing retirement ages.

Discussion of whether fully funded schemes were superior to pay-as-you-go schemes was not conclusive. Many Directors emphasized that a pragmatic approach was needed in advising on pension reform, that reforms needed to be tailored to the specific circumstances of individual countries, and that the main consideration should be long-term sustainability and minimization of distortions. A number of Directors cautioned against a wholesale shift from pay-as-you-go to fully funded schemes in view of the sizable transition costs. Others underlined the distortions in incentives to save and work associated with pay-as-you-go schemes.

Most Directors agreed that the development of a network of private pension plans could, over time, lead to an increase in saving. Some Directors advocated promotion of private pension schemes, coupled with a gradual scaling back of existing public schemes. With regard to tax incentives to promote an increase in occupational plans, however, some Directors were concerned about the distortive impact and budgetary implications of a proliferation of schemes. Directors emphasized that the Fund should focus on the macroeconomic implications of issues such as saving, growth, budget positions, and labor markets. These matters could usually be pursued in the context of work on the world economic outlook and in Article IV consultation reports. Specialized work and detailed advice to members on pension systems could best be handled by the Organization for Economic Cooperation and Development (OECD) and the World Bank. Some Directors also suggested further analysis of these issues for countries in transition and developing countries.

Taxation and Unemployment

In February 1996, in a seminar on taxation and unemployment, Directors emphasized the variety and complexity of the structural determinants of unemployment and the difficulty of relying on a single instrument to

achieve policy objectives in this area. The alleviation of unemployment required a combination of sound financial policies to foster a stable macroeconomic environment, and appropriate microeconomic policies to ensure market flexibility and efficient resource allocation.

Some Directors stated that structural rigidities had been the primary cause of high unemployment in the industrial countries, but that distortionary taxes exacerbated the effects of those rigidities. Although it was difficult to ascertain empirically the magnitude of the impact of taxation on unemployment, Directors agreed that taxation was one of many factors that could affect labor market conditions. Policy should emphasize the identification of elements in the tax system that would minimize labor market distortions, while taking into account the need to raise sufficient revenues.

Relatively high payroll taxes and generous unemployment benefits were seen as contributing to labor market rigidities and creating adverse work incentives in many industrial countries. As to the possibility of reducing payroll taxes by substituting other forms of taxation, Directors observed that there was limited scope for switching to consumption taxes, which were already high in many industrial countries. Alternatively, shifting the tax burden to capital required an evaluation of the trade-offs between possible short-term gains in employment through changes in the structure of relative prices and long-term losses through adverse effects on capital formation and growth. "Green" taxes were found desirable by some Directors for correcting negative externalities, but the base of these taxes was considered too narrow to fully replace payroll taxes; moreover, energy taxes were already high in many industrial countries.

Directors noted that unemployment problems in developing and transition economies were different from those in industrial economies. In developing economies, the formal urban labor market was often small and was influenced by activities in the agricultural and informal sectors; this made it important to adopt appropriate agricultural tax and pricing policies and to extend taxation to the informal sector. Directors agreed that unemployment in the transition economies was affected more by the reform process than by tax policy, which had been preoccupied with the need to generate revenues to narrow budgetary imbalances. High payroll taxes were nonetheless seen as having a negative impact on the reabsorption of the unemployed and should therefore be reduced as soon as possible. Pension reform was also essential. Reliance on the excess wage tax, considered distortionary by Directors, should be reduced in the medium term.

Directors agreed that the most useful role for tax policy was in minimizing tax-induced distortions in markets in general, and in labor markets in particular. The Fund's policy advice in the area of taxation and

unemployment should emphasize enhancing the neutrality of the tax system, ameliorating structural rigidities in labor markets, and better targeting benefit programs at sustainable levels.

