# The Quality of Fiscal Adjustment and Growth

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Fiscal adjustment is usually the first step on the road to macroeconomic stability. But sustained growth requires that as much attention be paid to the way the government's deficit is cut as to the size of the cut.

PRINCIPAL objective of HE adjustment programs is to foster sustained economic growth. Because countries beginning adjustment usually suffer from a combination of a balance of payments crisis and domestic financial instability, and because of the key role fiscal policy plays in eliminating these disequilibria, a substantial reduction in the size of the budget deficit is typically at the core of adjustment programs. However, the way the deficit is reduced-the quality of fiscal adjustment-can also affect growth, since some components of government expenditure are more productive than others, some tax reforms more beneficial in their impact on resource allocation than others, and some types of fiscal adjustment more sustainable than others.

## Growth-friendly policies

The magnitude of the change in the fiscal balance is relatively easy to measure. The same cannot be said of the overall quality of fiscal adjustment—it is not easy to tell exactly what combination of tax and expenditure reforms best promotes growth. Nevertheless, as a general rule, public sector activities will best achieve that end when they complement, rather than compete with, what the private sector does. They would include:

• Primary education, basic health care, and basic infrastructure, which are activities with a high social rate of return that are typically not supplied in adequate quantity by the private sector;

• Basic administrative and regulatory services to protect private property and promote a stable, predictable climate for entrepreneurial activity. This requires a well-functioning and adequately remunerated civil service;

• A cost-effective basic social safety net to foster acceptance of adjustment programs when these are necessary and increase the human capital of the poor; and

• Efficient and effective public expenditure management, without which even the best-designed expenditure policy will not be well executed. This entails the use of a consistent macroeconomic framework in preparing the budget; an effective ceiling and control mechanism on overall expenditure; a budget reporting system that produces reliable, comprehensible, transparent, and timely data; and the use of project appraisal techniques where appropriate.

These activities must be financed by a tax system that does not impede growth. While all—or virtually all—taxes are distorting and entail some loss of welfare, a growth-promoting tax system is one that exercises the least distorting effects on work effort and the quantity and allocation of investment and saving, and minimizes reliance on scarce administrative resources and demands on taxpayers' compliance. Such a system would have the following characteristics:

• A company income tax with a uniform and moderate rate, and a personal income tax with a moderate top rate and few exemptions;

• A general sales tax, like the valueadded tax (VAT), preferably with one rate and minimal exemptions;

• A customs tariff with as low an average rate as possible, and limited dispersion of rates;

• Export taxes only as a proxy for income taxes in hard-to-tax sectors; and

• An efficient tax administration that encourages "voluntary compliance" (e.g., by designing simple forms), effectively monitors tax payments, promptly follows up on late payment or nonpayment, and discourages evasion and fraud by means of an adequate program of audits and an appropriate penalty system.

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## Adjustment in practice

Although we know roughly what a growth-promoting public sector should look like, knowing the desired destination of economic policy cannot give us a road map that a country can use to get there. To improve understanding of this issue, a recent IMF study analyzed the nature of the fiscal adjustment and public sector reform efforts of eight countries-Bangladesh, Chile, Ghana, India, Mexico, Morocco, Senegal, and Thailand, For most countries, an observation period of about 15 vears-usually from 1978 to 1993-was divided into three subperiods; that is, a pre-adjustment period and, for analytical purposes, two subsequent adjustment periods. (There was only one adjustment period in India.)

*Initial adjustment efforts.* All the sample countries reduced their primary deficits (their overall deficits excluding interest payments) over the whole period by an average of 6.5 percent of GDP, ranging from 1.1 percent of GDP in Ghana to 10.6 percent in Morocco. But most of the decline

occurred during the first adjustment period, reflecting the urgency of restoring macroeconomic stability. The adjustment in the first period was achieved mainly by a reducion of non-interest expenditure (3.6 percentage points of the 4.6 percent decline in the primary deficit occurred during the first adjustment period). In the second period there was a more balanced mix of expenditure reductions and revenue increases (excluding the large adjustments in Chile).

Non-interest expenditure bore the brunt of the early adjustment because there was only limited scope for raising revenue. Tax rates were already high and probably quite distorting, and the scope for broadening the base of existing taxes was limited by, among other things, the difficulty of taxing agriculture and services, retroactively rescinding tax incentive schemes, and the increased cascading that broadening the base of the existing sales tax would have entailed.

This left no alternative but fundamental reform—introducing new and more broadly based taxes, like the VAT. Mexico and Senegal had already introduced VATs with multiple rates prior to their first adjustment periods, though the revenue yields were relatively limited; in contrast, Chile, which had a relatively efficient tax administration, successfully introduced a single-rate VAT early in the first adjustment period. For reasons that included the extensive administrative preparations necessary for its introduction, none of the five remaining countries introduced a VAT during the first adjustment period. Of these countries, only Ghana substantially increased revenue, and this was mainly attributable to the effect of the exchange rate devaluation on the effective tax rates on existing major tax bases.

Not only were the initial adjustments primarily focused on non-interest expenditure, but the cutbacks were not spread equally. The scope for quick but substantial and lasting reductions in the civil service wage

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bill and in subsidies and transfers proved limited. This left two vulnerable forms of expenditure that were cut in virtually all countries to enable them to realize budget savings quickly: other current goods and services, and capital expenditure. Reductions in capital spending that cut sharply into productive capital expenditure would have eventually reduced medium-term growth prospects if they had not later been reversed. Similarly, over time, underspending on operation and maintenance would sharply reduce the productivity of the public capital stock, while cuts in expenditures for other goods and services would contribute to a growing imbalance between labor and materials and supplies.

The study was mindful of this initial fiscal rigidity, since it was experienced to some extent by all eight countries. Thus, each country's performance was evaluated not simply from the point of view of how close it came to the growth-fostering ideal but also on the basis of the direction, depth, and sequencing of its reforms. One basic question the study posed was how quickly a country undertook reforms that enabled it to accomplish some reversal of the initial cuts in expenditure on capital and other goods and services. More generally, countries with the best adjustment profiles would be those that

• reallocated expenditure priorities toward, or at least preserved, the most productive areas;

• minimized reliance on indiscriminate expenditure cuts, which would typically prove to be temporary;

• took early action to reform the tax system;

• strengthened expenditure and tax administration, so as to improve the efficiency of expenditure, increase the tax yield over time, and allow for the adoption of a less distortive tax system; and

• reformed public enterprises to increase their operational efficiency and eliminate uneconomic subsidies.

*Later adjustment efforts.* While all eight countries adopted policies along these lines, there were distinct differences within the group.

After making disproportionately large cuts in capital expenditure and operations and maintenance in the initial adjustment period, almost every country increased government investment in the second period, in reaction to growing bottlenecks and less budgetary stringency. Chile, Ghana, Morocco, and Thailand appear to have best preserved investment in the more productive areas.

The shares of total education and health expenditures in GDP decreased only marginally during the adjustment period. Primary education standards, of particular importance for growth, were protected and improved in Chile and Thailand, but not in most of the other countries. Although in general there was some improvement in primary health care, the countries with the poorest health indicators at the outset of the adjustment effort—Bangladesh, Ghana, and Senegal—made less progress than the others in this respect.

Overall, the budget-cutting ax fell less heavily on the civil service wage bill. Wage freezes were tried in almost every country—especially in the early years—but were usually reversed. Hiring freezes proved ineffective, because the policy made it difficult to fill more senior and professional positions. A growth-enhancing policy to reduce employment at the unskilled level, combined with increased pay and employment for skilled workers, was followed by only two countries—Chile, toward the end of the first adjustment period, and Ghana during the second.

Some success was achieved in cutting subsidies and transfers, in part through better targeting of commodity subsidies toward the poor. Transfers to enterprises were decreased mainly by price adjustments.

All of the countries achieved some ratio-

nalization of income taxes. The top personal income tax rate was reduced and the minimum taxable income, an indicator of the administrative burden of the tax, was increased in most. Company income tax rates were also reduced and unified in a few countries. Efforts in most countries to widen the income tax base were confined to the introduction of a minimum corporate tax and to some rollback of tax holidays. Exemptions and preferences in most income tax codes remained extensive.

Reforms of indirect taxation were more substantial. Bangladesh, Chile, Morocco, and Thailand all introduced VATs, which tended to raise domestic sales tax receipts as a share of GDP. The VATs in Bangladesh, Morocco, and Senegal excluded the retail and/or wholesale sector, while in Morocco, Senegal, and, initially, Mexico, the VAT had up to five rates, which made it more distortive, harder to administer, and less elastic than it could have been. Governments usually switched from specific to ad valorem excise rates, which increased their elasticity, but the excise tax structure often remained complex.

The dispersion and maximum rates of import duties declined in all countries—and in consequence their complexity and distortive effects were diminished-—though the extent and pace of these reforms varied, being most substantial and rapid in Chile, India, Mexico, and Morocco. Export taxes were virtually abolished during the adjustment efforts, except in Ghana.

In Chile, India, Mexico, Morocco, and Thailand, the public expenditure management systems were relatively strong, in contrast to the corresponding systems in Bangladesh, Ghana, and Senegal; of the latter group, only Ghana improved its system during the adjustment effort. The most substantive improvements were undertaken by countries that had already achieved reasonably effective basic systems. Countries with strong public expenditure management systems seemed to have more efficient expenditure programs.

More efforts were undertaken to improve tax and customs administration systems. Like public expenditure management, the most substantial reforms were undertaken in countries—for example, Chile, Mexico, and Thailand—that started with a solid base. Ghana also made substantial reforms. Bangladesh and India did not achieve substantial improvements, and in Senegal, reforms were begun but not sustained. In some countries, administrative efficiency and effectiveness were hampered by inflexible public sector pay and employment policies, inadequate equipment and supplies, the complexity of the tax code, and the constraints imposed by fiscal federalism (for example, in India).

Although the data are incomplete, the operating position of the public enterprise sector improved and the cost of budgetary support declined during the adjustment period in all countries but Bangladesh. Enterprise reform was typically limited to increases in tariffs during the initial adjustment years; reforms to increase productiv-

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ity were generally delayed until later in the second adjustment period. Reform took a variety of forms including outright privatization, establishment of performance contracts for enterprises remaining in the public domain, and private sector involvement in public enterprise operations.

### Lessons

The study suggested a number of conclusions for a growth-enhancing fiscal adjustment strategy:

• Stabilization need not play havoc with a growth-friendly fiscal policy regime. As shown in Chile and Thailand—whose growth-enhancing policies stood out relative to those of the other countries—it is possible to protect a core program of the most productive expenditures.

• Whatever the pattern of expenditure reduction and/or tax increases initially adopted, structural reform will, for most countries, be an essential part of growthoriented fiscal adjustment. Ad hoc approaches, though they may cut the deficit, fail to address more basic problems and are thus prone to reversal. Some measures—like civil service and enterprise reforms—important though they may be, yield little budgetary savings in the short run. Reform in these areas needs to start as soon as possible to reap savings and enhance growth prospects over the medium term.

• The countries that either have basically good public expenditure management systems to begin with or that improve a deficient system are on the whole more successful in protecting expenditure with a high social rate of return. In general, the better the system is in permitting the government to set priorities and then enforce changes in the composition of expenditure that are consistent with them, the more productive the ultimate outcome will be.

 Major tax reform, such as the introduction of a VAT, requires either a reasonably well-functioning tax administration or a concurrent effort at administrative reform. At the same time, tax design must be cognizant of the limitations of tax administration. As is true of public expenditure management, early action to reform tax administration will be necessary for most countries to achieve a growthenhancing fiscal structure.

• Increases in revenue are possible without higher average tax rates. With the exception of Ghana, the countries achieving substantial increases in the ratio of taxes to GDP

did so by broadening the effective base of the tax system, usually with the introduction of a VAT.

• A reorientation of social expenditure toward primary education and public health and clinics is doubly desirable, since it boosts human capital formation and reinforces the social safety net.

• Certain reforms—such as an ambitious reform of the civil service—can entail a trade-off between deficit reduction now and deficit reduction in the future, which can be an issue when there is some flexibility in the timing of fiscal adjustment. In such cases, the budget needs to be viewed in a multiperiod, rather than a single-period, framework. **F**&D

This article is based on a longer paper by the authors, "The Quality of Fiscal Adjustment and Growth," forthcoming in the IMF's Occasional Paper series.