BACK TO BASICS

Pedantry or
How Does the IMF Account

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TO MEET the Millennium Development Goals (MDGs), politicians and economists agree that developing countries need more financial help, especially in the form of grants and concessional loans. Yet some in the development community have expressed concern that stringent IMF accounting standards block higher spending financed by additional grants and concessional loans. The fear is that IMF programs focus on limiting the size of the fiscal deficit, exclusive of grants, and also do not take account of loan concessionality, thus preventing a country from using all grants and loans offered to it.

This article examines how the IMF accounts for loans and grants in a country's budget, not only in terms of how they affect the fiscal balance but, more importantly, in assessing fiscal policy.

Making room for grants

When analyzing the macroeconomic implications of a country's fiscal policy, the IMF usually looks at fiscal balances both *including* and *excluding* grants on the revenue side. Its concern with deficits arises because deficits financed by borrowing can prove a source of inflationary pressure, crowd out credit to the private sector, engender imbalances in a country's external accounts, and lead to a public debt level that cannot be financed sustainably, thereby hurting growth, and ultimately undermining efforts to reduce poverty.

In this light, expenditures financed by external grants create fewer difficulties than expenditure financed by borrowing. Thus, where a country's main macroeconomic concern is debt sustainability, grant-financed expenditure does not create debt. This argues for using a deficit measure inclusive of grants as the fiscal target (see table).

However, it is also important to consider the fiscal deficit exclusive of grants. In many countries, a fiscal policy relying too heavily on grants may prove unsustainable. One issue is whether grants can be depended upon in making expenditure decisions with recurrent implications. For example, suppose a government receives a one-time $10 million grant and proceeds to hire, on a permanent basis, an additional 10,000 workers. In the absence of a guarantee that the grant will be provided again in future years, one would be concerned that if the government continues to employ the workers after spending the original grant, the higher spending on wages would need to be financed by borrowing from the nonbank private sector or by money creation. Another concern, if a country is aiming to contain demand pressures, is that expenditure financed by grants may have a more expansionary effect on aggregate demand than spending financed by domestic taxes. The fiscal deficit excluding grants will provide a better measure of the impact of fiscal policy on aggregate demand.

Thus, in IMF operations, *both* measures of the deficit—inclusive and exclusive of grants—are normally considered. In general, more weight is put on the grant-inclusive measure when grants are likely to be recurrent and stable, but on the grant-exclusive measure of the fiscal deficit if grants are likely to be volatile or large enough to create demand pressures.

Of course, fiscal deficit indicators are only one building block in the IMF's analysis of fiscal policy. For instance, fiscal analysis should consider the composition of a government's expenditure program. Spending that is heavily weighted toward highly productive, growth-engendering investments in physical infrastructure and human capital is viewed more positively than outlays tilted toward unproductive forms of spending.

More generally, experience suggests that a full assessment of a country's fiscal position must be based on a number of other factors as well, including

- a country's macroeconomic capacity to absorb additional external flows—whether additional external grants can be spent without putting too much pressure on domestic resources in short supply (nontradables), thus avoiding inflation or upward pressure on the real exchange rate;
- the prospect of a sustained stream of grants and concessional loan inflows;
- the potential for future increases in government revenue (to gradually replace nonsustainable grants) and any volatility associated with the revenue structure; and
- the sustainability of a country's fiscal policy in terms of debt service capacity—if, even with grants and concessional loans, a government becomes unable to service its future debt, it will need to reduce its fiscal deficit.

The IMF has recognized the importance of a nuanced and flexible approach to fiscal targeting. Reviewing recent programs in low-income countries, Martin and Segura-Ubiergo (2004) found that the IMF has accepted increases in average external assistance (including both grants and concessional loans) and has even helped countries attract extra assistance. In the first year of programs supported by the IMF's Poverty Reduction and Growth Facility (PRGF), average external assistance was about 7 percent of GDP—some 1 percent of GDP higher than in the year preceding the program. External grants rose by more than ½ percent of GDP to 4 percent of GDP during the first program year. Increases in grants were especially sharp in Malawi and Uganda (over 2½

Prudence:

for Grants and Loans?

Varied accounting

Concessional loans have different effects on the fiscal deficit, depending on how the grant element in the loan is treated.

(million dollars)

	Original budget	Budget with a grant of 10	Budget with a concessional loan of 10 (IMF's approach)[1]	Budget with a concessional loan of 10 (critics' approach)[1]
Total spending	123	133	133	133
Total revenue (excluding grants)	120	120	120	120
External grants	0	10	0	4[2]
Concessional loans	0	0	10	6[3]
Total revenue (including grants)	120	130	120	124
Fiscal deficit (excluding grants)	3	13	13	13
Fiscal deficit (including grants)	3	3	13	9

Source: Author.

[1]Assume a concessional loan with a grant equivalence of 40 percent.

[2]Grant equivalent element of concessional loan.

[3]Commercial equivalent element of concessional loan.

percentage points of GDP). Also, in cases where grants have proven unexpectedly high and can be readily absorbed, the IMF's Executive Board has often waived program targets, allowing for higher-than-programmed expenditure and deficits (excluding grants).

Concessional lending

A second concern often raised is the possibility of a bias by the IMF against concessional loans. These are loans that are subsidized so that the borrowing terms are less costly than commercial loans, with a lower interest rate and grace period and maturity extended beyond the commercial norm. Such loans can be viewed as the equivalent of the sum of a grant element and a commercial loan element. Yet, since concessional loans are still borrowing, accounting conventions require all of the loan to be placed "below the line"; thus, the full amount of expenditure financed by such a loan unambiguously increases the deficit (see column 3 of the table). Critics of the IMF's approach argue that the grant element of the loan should be treated like any other grant; thus, for a $10 million loan with a grant element of 40 percent, the grant-inclusive deficit would rise from the original program level by only $6 million (table, column 4), rather than the $10 million implied by the conventional accounting approach.

Such an accounting procedure, however, ignores a crucial difference between a grant and a concessional loan, which is that the latter must be fully repaid. The effective grant embodied in a concessional loan is the interest subsidy, the present value of which is larger the longer the grace and maturity periods of the loan. Thus, the grant is effectively provided in fractions *over the lifetime of the loan* instead of up front. The IMF's approach to fiscal accounting treats it accordingly.

Some critics of the IMF have argued that the grant element—arising from the combination of lower interest rates and long grace and maturity periods—should be taken into account in formulating fiscal policy and assessing fiscal sustainability. In fact, the IMF's approach to fiscal accounting does this in two ways: first, as explained, by reflecting the lower interest payments (relative to commercial terms) *explicitly in subsequent year* fiscal accounts; and second, by focusing principally on the *net present value* of debt (a measure that takes into account the concessionality of the lending), rather than the *nominal* size of the debt, in assessing a country's debt burden (a crucial factor in determining deficit limits). Thus, between two countries with the same nominal debt-to-GDP ratio, the country with largely concessional debt would be judged as having a more sustainable fiscal position, with consequently more room for spending or cutting taxes.

Conclusion

The IMF is working closely with developing countries, donors, and other international agencies to achieve the MDGs. It seeks to facilitate financial help from abroad. However, the IMF must also help ensure that additional assistance does not endanger the fundamental macroeconomic goals of member countries—growth, price stability, and debt sustainability, which form the basis of any meaningful poverty reduction. The IMF's treatment of grants and loans in its analysis of fiscal deficits aims at ensuring these goals are preserved. ■

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References:

Martin, Ricardo, and Alex Segura-Ubiergo, 2004, "Social Spending in IMF-Supported Programs," Independent Evaluation Office Background Paper 04/1, available on the Internet at www.imf.org/external/np/ieo/index.htm.