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FISCAL ADJUSTMENT IN IMF-SUPPORTED PROGRAMS

ISSUES PAPER FOR AN EVALUATION BY THE INDEPENDENT EVALUATION OFFICE (IEO)

I. INTRODUCTION

Fiscal adjustment is a key component of IMF-supported programs. It has been the subject of criticism from academics and civil society representatives, especially that it imposes unnecessarily high social costs. The subject, including points raised by external critics, has also been studied by IMF staff in a number of reviews of past programs. The proposed study will take a fresh look at the design of fiscal adjustment in IMF-supported programs to see what lessons can be learned for the future.

The evaluation will employ two levels of analysis. The first level will consist of an examination of patterns of fiscal adjustment drawn from IMF arrangements in the 1990s. The analysis will focus on issues related to the context, magnitude, broad composition, and pace of fiscal adjustment in programs and aims at identifying some stylized facts, and possible patterns across countries (i.e. are the facts different for different groups of countries?). The second level will consist of detailed case studies of four recently completed arrangements. The case studies will cover the issues emerging from the first level in greater detail and also address additional country specific issues, including issues of process, capacity building, and governance which are important for the successful implementation of programs.

The choice of countries for the case studies reflects decisions regarding the other elements in the work program of the IEO. Since capital account crises cases are being separately studied and fiscal dimensions of programs will be examined in those studies, we have not chosen any capital account crisis case for this study. Instead, we have chosen one PRGF case and three non-PRGF cases, drawn from middle-income countries that have encountered a mixture of current account and capital account problems, emanating basically from the public sector.

The rest of the issues paper is organized as follows. Section II starts with a summary presentation of concerns about fiscal adjustment in IMF-supported programs which takes into account external criticisms of such programs as well as results of internal reviews by IMF staff. Section III identifies the major areas of inquiry. Section IV sets out the methodology of the evaluation. Sections V and VI spell out in greater detail the issues to be addressed principally through the case studies. They are organized around two themes: (i) issues related to the rationale and process of program design; and (ii) issues related to the quality of fiscal adjustment, with a special emphasis on social issues. Finally, Section VI discusses the rationale for the four countries selected for the case studies.

II. Issues Concerning Fiscal Adjustment in IMF-Supported Programs

This section provides a summary of issues related to fiscal adjustment in IMF-supported programs as they have surfaced in work by external commentators and also in findings and lessons from internal reviews and studies by IMF staff. [1]

External comments and criticisms[2]

The thrust of most criticisms by outside observers is that fiscal adjustment in programs tends to be "excessive" (too large and/or too fast), with detrimental social and growth effects. Representatives of civil society groups (especially NGOs engaged in monitoring welfare indicators at the field level) tend to focus on government expenditure cuts and their impact on social spending and on indicators of well-being. Although much of the criticism has focused on programs in low income countries supported under the IMF's concessional facilities (SAF, ESAF, PRGF), they are also emerging from NGOs monitoring developments in other countries.[3]

Specific issues raised in this context include the following:

- Excessive fiscal adjustment in the low-income countries reflects too cautious an assessment of potential donor financing. Where countries have attained some measure of economic stability, some domestic financing of the deficit should also be considered.

- In middle-income countries—where private sector external indebtedness can be important—fiscal programs may have been too contractionary by not fully predicting the collapse of private spending resulting from the impact of the external crisis on the balance sheet of the private sector. This has been particularly true during the East Asia crisis of 1997/98 but it is also relevant in other countries.[4]

- Too much of the adjustment burden falls on government spending, with adverse effects on the poor. Programs have not paid enough attention to protecting critical social spending (e.g., spending on primary education and primary health and other

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[1] This section reports on the views of critics and staff while making no judgment on the validity of opinions expressed.

[2] See for example, Center of Concern (1998); European Network on Debt and Development (2001); International Financial Institutions Advisory Commission (1997); Oxfam (2001a&b, 1995); World Development Movement (2000 a&b); Watkins (1999); Kanbur (2000); Collier (1999); Collier and Gunning (1999); Stiglitz and Furman (1998); Feldstein (2002); Bandow (1994); Schultz, Simon and Wriston (1998).

[3] See for example, SAPRIN (2000), Oxfam (1995), Social Watch (2001).

[4] The specific experience in East Asia will be dealt with in the evaluation of capital account crises.

spending aimed at reducing poverty). On some occasions donor's offers to step up aid to these sectors have been constrained by fears of "dutch disease" effects.

- Programs have not been aggressive in implementing compensatory measures to protect vulnerable groups from the adverse effects of reforms undertaken as part of the program. Furthermore, some programs entail measures that hurt the poor and undermine the prospects for long-term growth (e.g., cost recovery in primary education).

- Some structural reforms contained in programs put additional strain on the budget. For example, trade liberalization and financial sector deregulation can reduce tax revenues and increase the cost of domestic financing of the deficit, respectively. Programs could pay more attention to sequencing and timing of such measures to ensure that critical social spending is not pre-empted.

- A segmentation remains between the aggregative "top down" process of financial programming in IMF-supported programs and "bottom up needs approaches" that try to cost out basic social programs and services to the poor.

- Some critics have taken a different angle—that IMF programs unduly prescribe tax increases as a major vehicle to reduce fiscal deficits, with adverse effects on welfare and future growth.

- Over-optimism in key program projections (e.g., output growth and tax revenue), combined with inadequate (or nonexistent) contingency financing mechanisms to respond to shocks, often lead to situations where the ex-post pattern of adjustment has unduly adverse consequences for social welfare and growth.

- The process under which trade-offs and fiscal options are evaluated remains opaque and restricted. The lack of consultation and more explicit dialogue on the tradeoffs reduces the ownership of programs, intensifies resistance to reform and increases the possibility of reversals.

Findings and lessons from reviews and studies by IMF staff [5]

Several reviews and studies by IMF staff have addressed a number of issues raised by critics of IMF-supported programs. Key findings and lessons from these reviews are:

- Programs have typically underestimated the short-term contraction of private investment during a crisis. By not incorporating this development, fiscal designs may

[5] See, for example, Abed et al. (1998), Bredenkamp and Schadler (1999), Schadler et al. (1995 a&b), Goldsbrough et al (1996), Mackenzie et al. (1997), IMF (1997), Gupta et al (2000), Bulir and Hamann (2001) and Musso and Phillips (2001).

have given crisis programs a contractionary bias. However, a statistical analysis comparing program targets and actual outcomes on the basis of a large sample of programs during 1993-97 found no statistically significant evidence of bias in the growth forecast in the overall sample, although there was evidence of considerable upward bias for programs involving large access (i.e., the major capital account crisis cases).

- The mix between revenue and public expenditure changes envisaged in programs seemed to have been influenced by pre-existing revenue efforts and public spending needs, not by the scale of deficit reduction. For example, revenue increases are programmed where revenues are low, and expenditure increases are targeted where expenditure levels are relatively low.

- In general, revenue increases fell short of program targets and expenditure cuts were larger than envisaged. Furthermore, in the very short run, most of the adjustment has taken place on the expenditure side—only in the outer years do improvements in revenues begin to emerge.

- The public sector wage bill has been relatively protected—subsidies and transfers taking a large part of the cuts in current spending. When the public sector wage bill was adjusted it was through reductions in real wages rather than employment, which may be less sustainable.

- In the 1990s, spending on education and health as a share of GDP has, on average, increased in countries with IMF-supported programs and this has been accompanied by improvements in a range of social indicators. A comprehensive review of social issues in IMF-supported programs, covering 77 countries with programs during 1985-97, found that an increasing number of programs have made provisions for social safety nets and have increased public spending on basic social services when this spending was low.

- Protecting education and health spending has not been sufficient to protect pro-poor spending in those sectors because of the propensity to spend a higher share on tertiary education and curative health. Due to institutional and administrative weaknesses and political constraints from vocal middle class groups, existing social policy instruments could not be quickly adapted and targeted to protect those affected by reform, who may be different from those protected by existing arrangements.

- Shortcomings in expenditure management systems have persisted and impeded fiscal adjustment and growth-promoting structural reforms. Countries with the most successful fiscal adjustment were those that already had well established basic budget systems prior to the adjustment effort (in particular ability to protect high priority spending in spite of cuts in total spending).

- A statistical analysis of programs in 75 low income countries in the 1975-97 period showed concessional aid to be more volatile than fiscal revenues. Aid cannot be predicted reliably on the basis of donor commitments, and there is a tendency to systematically overestimate aid disbursements.

- IMF-supported programs may not have sufficiently considered and presented the costs and implications of second-best policies emerging from political pressures or administrative constraints. Moreover, fiscal adjustment in programs was not routinely presented in an explicit medium-term framework. This may have contributed to the impression that programs perpetually rely on fiscal restraint without a clear view of the end point of the process.

- A recent staff review of the PRGF concludes that in all three fundamental areas for change—program content, country ownership, and the Fund’s role—there has been substantial progress, but there is still more that can and should be done.

III. Areas of Inquiry

The concerns about fiscal adjustment in IMF-supported programs raised by both outside critics and internal reviews and studies can be organized into five major areas—three regarding program design and two regarding process issues.

(i) The first issue relates to what might be called the "quantitative" dimension of the fiscal adjustment, i.e. whether the fiscal component in programs is excessively contractionary, with an unintended depressive effect on output. This could arise because the programmed reduction in the current account deficit was too large in that external resources to support a higher current account deficit could have been mobilized—a result of underestimating concessional flows or not fully mobilizing market financing due to an excessively cautious approach to debt sustainability. Second, the fiscal correction could also be excessive because it fails to anticipate contractionary developments on the (effective) demand side, such as the impact of a crisis on private investment or unplanned cuts in public spending to compensate for lagging revenue increases during the early phases of a program. Finally, there may be situations where projections are correct, but the fiscal stance need not have been as restrictive because other instruments could have been deployed more intensively to achieve the current account adjustment i.e. an exchange rate depreciation or monetary tightening.

(ii) The second issue regarding program design is to what extent, given the time path of fiscal deficit reduction, Fund-supported programs could improve the efficiency, sustainability and equity of that fiscal adjustment by using different mixes, (also over time) between revenue and expenditure changes as well as intra-revenue and intra-expenditure reallocations. Can these goals be made compatible with the latest trends at streamlining conditionality? These issues will be referred to as the “qualitative” dimension of the problem.

(iii) The third issue is whether accompanying reform policies (e.g. trade liberalization, financial sector liberalization, recapitalization of banks, etc.) could be sequenced differently in order to minimize their possible additional demands on the budget. Where delays in these reforms are costly, in terms of restoring macro-stability and growth, how could the budget be used more aggressively to compensate for the social cost of such policies?

With regard to process, the key issues are:

(iv) The design of a program involves tradeoffs that need to be addressed under severe political, institutional and time constraints. A crisis environment and sense of urgency usually permeate the negotiations. Within this context, how can the Fund promote a process of interaction that is more cooperative and transparent at all levels—between the IMF and the authorities and within the country?

(v) There are limits to what can be achieved in a typical 12 to 18 months SBA (particularly under crisis conditions) if fiscal systems do not have the institutional flexibility or key instruments of social policy to allow important spending reallocations in the short run. How can the IMF encourage long term sustained fiscal reforms and reductions of fiscal threats from contingent liabilities as part of surveillance and outside the framework of a Fund-supported program? How can cooperation and coordination with the World Bank in this area be improved? This is not only important in its own sake, but it also provides the flexibility for an appropriate fiscal adjustment under stress.

IV. Methodology

The evaluation will start with a statistical analysis of a cross section of programs during the 1990s to establish some key stylized facts on patterns of fiscal adjustment according to program context and country typology (PRGF countries; emerging market economies facing classical BOP difficulties; capital account crises cases). The cross section studies will be based on readily available data for all these programs while a desk study of about 10 programs will also be looking at some of the qualitative issues described above. This analysis will be basically positive and will serve as background for the in-depth four case studies. It will provide the factual basis to corroborate past findings, discuss rival claims on trends and outcomes, and sharpen up some of the issues to be addressed by the more normative analysis being carried out by the case studies. The cross section review will address:

- The magnitude and pace of fiscal adjustment e.g., change in fiscal deficit comparing both envisaged and actual magnitudes. Various definitions of the deficit will be considered: with and without grants; primary; operational; overall.

- Size and composition of external financing.

- The distribution of the adjustment between the private and public sector—what share of the current account adjustment was borne by a reduction in public sector deficits.

- The composition and time dynamics of actual fiscal adjustment (revenue changes, different expenditure items, etc.). A special effort will be made to assess how social spending has evolved during programs, within the limits of available data.

- Overall deviations of projections of key variables from outturns (e.g. output growth, revenues, etc.). A special effort will be made to assess unforeseen developments of key components of aggregate demand that may give programs an unplanned contractionary impulse.

- For a smaller sample, patterns of fiscal conditionality and deviations between original targets and outturns as well as how program conditionalities/targets were revised as part of the review process.

To address the normative questions regarding program design, governance, implementation, and process issues raised in Section III, the evaluation will rely on four program case studies. This work will focus on two major areas:

(i) First, understanding the ***rationale behind the fiscal design of the program and the process of consultation and negotiation***, e.g., in what areas have authorities differed with staff and how were the differences resolved?

(ii) Second, investigating ***how to improve the "quality" of the fiscal adjustment, with a special emphasis on social issues***. Improving the quality of the fiscal adjustment requires important changes in the composition of revenues and expenditures—both of which are constrained by the fiscal institutions inherited from the past and by budgetary information systems available to stakeholders. The case studies will look into the role that the IMF (and its collaboration with the World Bank) had during the pre-program period in encouraging long term reforms in fiscal institutions as well as encouraging more open and transparent budget systems.

The detailed questions to be explored in the case studies are outlined in the next two sections below.

V. Rationale of Program Design and Negotiation

The rationale and process of program design and negotiations will be organized around four main issues.

1. The magnitude and broad composition of the envisaged fiscal adjustment

- How were the relative magnitudes of external financing and current account adjustment arrived at? How was the amount of borrowing from the Fund determined?

To what extent were they drawn from a medium-term framework incorporating debt sustainability considerations?

- What was the role of fiscal adjustment in the overall adjustment strategy? To what extent was the envisaged fiscal adjustment derived from a medium-term fiscal framework? What was the composition of budget financing, including privatization receipts?

- On what basis was the envisaged adjustment in the external current account distributed between the private and public sector? What assumptions underlay the projections of: (i) private and public saving; and (ii) private and public investment?

- In the case of financing from donors, were there discussions about long term commitments and enhanced flexibility (e.g., less tied aid, budgetary rather than project financing, etc.)?

- Were interest payments on public debt are an important burden in the fiscal accounts, how were real interest rates projected and how crucial was that path in the expected fiscal success of the program?

2. Deviations between program projections and outturns. Program revisions

- Were contingent policies to cope with shocks incorporated in the initial design?

- How did fiscal outturns compare with original program projections? What were the main sources of deviations: (i) assumptions about the evolution of key macroeconomic variables and the external environment; and (ii) implementation problems, including realism of expectation regarding capacity to implement.

- What major revisions in fiscal projections and targets were introduced over the life of the program? What was the rationale behind the revisions (unforeseen shocks, optimism of fiscal projections even when policies are implemented, optimism regarding capacity or willingness to implement the policies, etc.)? What was the process of negotiation and the authorities' views regarding revisions of the program?

3. Consideration of alternatives for the path of fiscal adjustment and for sequencing accompanying policies with significant fiscal impacts

- Fiscal adjustment is clearly one part of an integrated policy package. On what basis was the mix between fiscal adjustment and monetary tightening derived? Were alternative fiscal adjustment paths considered? What were the major perceived trade offs?

- How were accompanying policies (of a macroeconomic nature such as a devaluation, or structural, such as privatization, bank recapitalization, etc.) with important fiscal implications factored into the analysis? To what extent were the pros and cons of alternative sequencing of these policies and their links to other parts of the program considered? Did Fund staff discuss these alternatives with the authorities?

4. Consultation process and ownership

- What were the major differences between the original program designed by staff and the program finally negotiated with the authorities? In what specific areas and why did authorities differ with the original design (program projections, evaluation of trade offs, political/institutional constraints, etc.)? What was the process through which these differences were resolved?

- Were there major differences within the government (e.g. Ministry of Finance, Central Bank, and spending Ministries) on the composition of the envisaged fiscal adjustment? If so, what were they and how were they resolved? To what extent did these differences influence the design of the fiscal program?

- To what extent was the formulation, implementation, and monitoring of fiscal policy transparent and open to the public? Could better communication by the IMF of its views (e.g., on policy options, tradeoffs, and constraints on available financing) have strengthened policy debates within the country and hence country ownership[6]

VI. IMPROVING THE "QUALITY" OF THE FISCAL ADJUSTMENT

Questions related to the scope for improving the quality of fiscal adjustment will be organized around three main areas.

1. Addressing major inefficiencies in revenues and expenditures

- Did programs address major distortions on the revenue side (e.g., tax exemptions, trade distorting taxes, nuisance taxes, non-transparent rules, selective enforcement, etc.) whose removal would have promoted equity and efficiency goals? What efforts were made to reduce some taxes while increasing the tax base, including bringing into that base the shadow economy? Did programs over promise what could be achieved in the short term to remove such distortions and how could implementation have been improved?

- To what extent were programs able to identify major misallocations of resources on the expenditure side? What were the constraints on actions? What was the state of knowledge on spending patterns, and on the cost of interventions to support social policy goals? What was the collaboration with the World Bank and other international agencies in supporting improvements to public spending and public expenditure management issues?

[6] This issue has recently been taken up in a Board Paper (IMF, 2001).

- How was the tradeoff between speed/expediency and the “quality” of the fiscal adjustment handled? How much of the budget was pre-committed even before the fiscal year? How rigid was the legal and institutional structure of public finances (earmarking, revenue sharing formulae) preventing reallocations in the short run? Did a shift of spending from fiscal to quasi-fiscal components take place jeopardizing sustainability? How sustainable was the fiscal adjustment if it relied heavily on lower public sector wages rather than permanent reduction in public sector employment?

2. Social policy concerns

- How do components of social spending adjust under fiscal stress and sharp devaluations? Do operation and maintenance expenditures—particularly imported inputs in the health sector—get preempted relative to salaries expenditures?

- Could programs have played a more forceful role in directly setting priorities for critical social spending and compensatory policies to protect vulnerable group from the adverse effects of adjustment? Could programs have established quantitative targets for primary education and basic health based on input from other external partners and NGOs? How could the IMF have promoted social sector reform using the country’s own targets? How could this have been done without hampering program ownership?

- Could the IMF have encouraged a more open debate on spending priorities and the need for reallocation toward critical social spending? Could the IMF have asked for the disclosure of budget information as well as publicizing beneficiaries of present programs and subsidies (whether explicit or implicit) in order to promote a broader and more informed discussion on expenditure priorities?

- To what extent did Fund staff collaborate with staff of the World Bank and other international agencies in the social policy aspects of the program and how could such collaboration be improved?

3. Surveillance and technical assistance activities supporting long term institutional reforms

- What role have IMF surveillance and technical assistance activities played in pointing out major problems in fiscal systems prior to the program? Did surveillance document major areas of tax evasion—particularly those adversely affecting both efficiency and equity—and ways to improve collection prior to recommending new taxes? Did surveillance identify major fiscal threats from contingent liabilities and financial sector vulnerabilities? How were these subsequently built into program design? What was the collaboration with the World Bank in this area?

- To what extent have IMF surveillance and technical assistance focused on improvements in the areas of governance, accountability and transparency of public accounts? To what extent has surveillance focused on and monitored the implementation of fiscal standards and codes?

VII. Country Selection

Fund-supported programs involve a wide range of country taxonomies and contexts (e.g., a short term crisis situation, longer term chronic fiscal problems that periodically erupt, or long term developmental challenges). As mentioned earlier, one of IEO's ongoing evaluations is looking at capital account crises, including situations where the origin of the external indebtedness stems from the private sector. IEO also plans to evaluate the PRGF arrangements as part of its work program for next year. Consequently, the present evaluation will focus primarily on non-PRGF countries where the specific program responds to a mixture of current account and capital account problems emanating basically from the public sector. In these situations, the typical program aims at re-establishing a sustainable current account and external position—in the short run the adjustment usually requiring a reduction in both absorption and public sector deficits. This context is still the basis for most Stand-By and Extended Fund Facility Arrangements (SBAs and EFFs).

Moreover, many SBAs have to be implemented in environments where poverty is still quite extensive (particularly due to very uneven income distributions) and institutions for public sector management remain weak. It is important to recognize that there is a continuum in such an environment and that the threshold at which countries exit the PRGF arrangement and move into the SBA is somewhat arbitrary. Hence, many of the concerns from external observers on the ability of fiscal adjustment to incorporate social concerns—most vividly articulated in the context of PRGF programs—are equally valid for SBA arrangements in countries with relatively high levels of poverty.

In light of these considerations the evaluation will be based on four case studies—three Stand-by Arrangements (Ecuador, the Philippines, and Romania) and one PRGF (Tanzania). The SBA programs are drawn from countries in the lower per capita income range ($1,000 to $2,000 per capita) of middle income countries. Tanzania has recently completed an ESAF program and is now relatively advanced in the implementation of a PRGF program—which will allow some comparison between the two types of arrangements. The case studies will involve a collaborative effort with a local consultant and will involve staff visits to interview key players and collect information.

The specific non-PRGF programs to be evaluated represent different contexts of a typical SBA. The Romania standby of 1999 and the Ecuador standby of 2000 were designed in the context of economic crises, targeting significant upfront fiscal measures to reduce the fiscal deficit. During the first year, these programs envisaged a reduction in the primary fiscal deficit by 4.1 and 2.5 percentage points of GDP respectively. In addition, in both countries the program included significant accompanying policies, particularly large devaluations and actions on the banking sector.

The Philippines SBA of 1998 was of a different character. It responded to a chronic public sector problem in the context of fears of contagion from the crisis in other Asian countries rather than to a major short term macroeconomic crisis.[7] The 1998 standby envisaged a primary fiscal deficit reduction of about 1.9 percentage points of GDP by the second year of the program (relative to the pre-program year).

The Tanzania ESAF of 1996-2000 will be the basis for the fourth country study. Tanzania shares many development features with other low-income countries, especially in Africa. However, its recently completed arrangement displays significant fiscal adjustment and successful stabilization. Nevertheless, there are significant remaining challenges and debates including with respect to the fiscal stance, the scope for increasing aid-financed spending, as well as public expenditure management issues. Tanzania is also among the few countries that have completed Poverty Reduction Strategy Papers (PRSPs) on which the PRGF arrangements are to be based. Hence Tanzania is a good candidate to examine how the process of program formulation has changed with the new PRGF/PRSP arrangements, and how the process is working now in the light of learning.

[7] The Philippines is also included in the ongoing IEO evaluation of prolonged use of IMF resources.

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