

INTERNATIONAL MONETARY FUND

**Follow Up on the Recommendations of the Independent Evaluation Office Report on
Fiscal Adjustment in IMF-Supported Programs**

Prepared by the Policy Development and Review and Fiscal Affairs Departments

In consultation with other Departments

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I. INTRODUCTION

1. At the time of the Board discussion of the Independent Evaluation Office (IEO) report on fiscal adjustment in IMF-supported programs, Directors endorsed most of the IEO's recommendations.¹ They agreed that the implementation of these proposals would enhance the Fund's advice and the programs it supports, and looked forward to a report from management on how the recommendations might be operationalized.
2. This paper presents work that the staff is undertaking to implement the IEO recommendations, as well as additional initiatives that are being considered. The planned response has emerged from a wide consultation process within the Fund.
3. The paper proposes a substantive response to the IEO report which at the same time recognizes the need for prioritization. While the IEO's recommendations in each evaluation concentrate on a specific area, the institution as a whole has to address multiple goals and issues under tight resource constraints (including limits on the length of staff papers). In light of this, and because the shortcomings identified by the IEO in the fiscal area suggest a need for improvement rather than for a fundamental redirection of the staff's efforts, the response emphasizes the generalization of best practice, and avoids introducing new formal requirements for the staff's work or for Board papers.
4. Ensuring effective "absorption" of the IEO lessons will require, among other things, dissemination of information within the Fund. The challenge is for the institution as a whole to incorporate these lessons, and those of other internal and external evaluations, into its work, while also assimilating the various new requirements and new analytical tools that have been introduced in recent years. Staff is experimenting with a range of dissemination modalities, including seminars, workshops, written materials including guidance notes, via the ongoing dialogue at all levels of the review process, and through the use of internal websites.
5. The issues considered in the IEO report also dovetail with several areas of current focus for the Fund. Notably, considerable work is underway to improve assessments of public debt sustainability. In addition, and encouraged by a previous IEO report, the Fund is making greater efforts—in Article IV consultations and by means of ex post assessments—to step back and reflect on strategy in countries with Fund-supported programs, and particularly in those with a sustained history of program engagement. This work will provide important additional leverage to address the issues identified by the IEO in the fiscal area.

¹ *Independent Evaluation Office—Evaluation of Fiscal Adjustment in IMF-Supported Programs, and Summing Up of the IMF Executive Board Discussion by Acting Chair*, September 9, 2003.

II. ACTIONS TO ADDRESS THE IEO RECOMMENDATIONS

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.

6. The IEO report has helped sensitize both area department staff and reviewing officers to the need to articulate clearly in Board documents the considerations that have informed the proposed fiscal adjustment in Fund-supported programs. Although the mapping of an appropriate adjustment path is inevitably subject to uncertainty, particularly when it requires judgments of market perceptions and political realities, improvements in presentation should aid the mission, the internal review process, and the Board's assessment, and thus enhance the advice provided to member countries. To help bring about such improvements, a guidance note for staff on the presentation of the rationale for the magnitude and pace of fiscal adjustment is being prepared, drawing on extensive in-house knowledge on the subject and on best practice country papers. This note is not intended to provide a one-size-fits-all template, but to bring out some of the considerations that can help present the case for the chosen adjustment effort and to showcase some examples of how this has been done in existing country papers. Efforts to implement the 2001 *Government Finance Statistics Manual* will also help improve the presentation of fiscal operations.

7. The IEO drew attention to some outstanding conceptual issues in the determination of fiscal adjustment. The staff will intensify its efforts to bring analysis based on cross-country experience to bear on these questions. In particular, the paper on selected aspects of the policy content of Fund-supported programs (part of the 2004 Conditionality Review) will, inter alia, examine the scope for countercyclical fiscal policy in the context of financing constraints and debt sustainability concerns. It will also attempt to shed light on what may be driving the IEO finding that fiscal adjustment tends to take place almost entirely during the first year of a Fund-supported program.

8. The IEO report found further evidence of the well-documented phenomenon of overoptimism in projections of growth and private demand, and work on this issue is underway. An analysis of the Fund's track record in growth projections and their implications for Fund-supported programs is being carried out as part of the work on the framework for program design, which will be included in the documents leading up to the 2004 Conditionality Review.

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

9. Management's recent initiative aimed at enhancing the effectiveness of the review process (in effect since last July for a nine-month trial period) addresses the concerns expressed in the IEO report in this area. In particular, it encourages early consultations between the originating department and reviewing departments: pre-brief meetings were held for about 60 percent of program countries for which briefing papers were reviewed in the September-November 2003 period.²

10. Recommendations 3 and 4 are addressed jointly, as they both concern medium-term fiscal reforms, in programs and related conditionality on the one hand and in surveillance on the other.

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. 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.

11. The IEO drew attention to the fact that both programs and surveillance sometimes pay insufficient attention to reforms to effect permanent improvements in revenue performance and spending composition, and do not identify clearly the constraints on the implementation of such reforms. Directors agreed that, in the context of programs, key institutional reforms can be more critical for fiscal sustainability than short-term measures, and most Directors also called for surveillance to play a stronger role in identifying longer-term reform priorities and the causes of past failures in fiscal reform.³

12. The staff proposes to aim at attaining current "best practice" standards regarding the presentation of structural and institutional fiscal reforms in cases in which such reforms are critical. Some staff reports already contain a fairly extensive prioritized roadmap of fiscal reforms. They analyze the shortcomings in the fiscal system, pinpoint a few priority areas for reform, and specify some concrete implementation steps, including those that could be taken in the short term. Some staff reports also "unbundle" the constraints on reforms, distinguishing among reforms that require executive action, legislation, and capacity

² This figure includes only cases of multidepartmental meetings, and not countries for which there were extensive bilateral consultations between the area department and review officers before a brief was circulated. Comparable data on pre-brief meetings before management's recent initiative are not available, but these meetings have become much more frequent.

³ A stronger focus on the fiscal reform agenda would also help provide a medium-term framework in which technical assistance strategy can be integrated.

building; and some undertake a useful assessment of performance relative to past program expectations, which enhances the design of future reform efforts.

13. In some cases, attaining best practice standards in staff reports will require primarily improvements in presentation. For example, structural fiscal issues, including the required policies and institution building, may have been dealt with in detail in a selected issues paper or in an internal document not submitted to the Board, and this analysis could be more fully reflected in the staff report. Dissemination efforts have started with a view to raising awareness of the need for a comprehensive presentation in staff reports, along the lines of current best practice. Staff is also being made aware of Directors' call to report on the progress in implementation of recommendations of fiscal technical assistance (TA) and ROSC missions—although the need for conciseness in staff reports can sometimes restrict the degree of coverage.

14. In other cases, improved coverage of structural and institutional fiscal issues may be achieved by helping country teams make better use of available fiscal information and expertise. In this context, area departments are being encouraged to make more active use of the Fiscal Strategy Briefs (FSBs) that FAD has prepared for selected countries.⁴ The FSBs are internal notes that aid FAD in the prioritization of TA, and in discussion with area departments and the World Bank. Based on past TA and ROSC recommendations, the FSBs discuss priority areas for reform and in some cases the broad sequencing of measures. They have largely been prepared for countries where it is possible to draw on extensive FAD TA, as well as in-house knowledge of FAD economists assigned to the countries and of reviewing officers.

15. With a view to ensuring better coverage of the fiscal reform strategy in cases where a particular focus on structural fiscal issues is most needed, a few countries (2-3 per area department) are being selected for which these issues will be given prominence in the Article IV consultation to be conducted over the next year. For these countries, FAD will prepare, in consultation with the area department, a revised FSB ahead of the Article IV briefing paper which would provide early input for discussions with the authorities and for the staff report. Area departments would have flexibility in how best to use the information in the FSB in both discussion and presentation of the fiscal structural reform agenda. Depending on experience, the exercise could be extended to other countries in subsequent years.

16. The proposed approach could be accommodated within existing resources, provided it is limited to countries where there is a substantial base of information, particularly in terms of an existing FSB, the current assignment of a FAD economist, and previous TA.⁵ The

⁴ FAD has currently prepared FSBs for some 40 countries.

⁵ For countries that meet these criteria, FSBs have been produced at a cost of some four weeks of staff time. Revising these FSBs in the context of Article IV consultations would involve a cost of about one week of staff time.

countries selected should satisfy these criteria, since the cases with the most pressing fiscal reform needs are also likely to be ones in which FAD has already invested substantial resources. Preparing FSBs in cases where FAD does not have substantial prior knowledge would require significantly more time and effort.

17. More generally, the staff proposes to continue to determine the coverage of structural fiscal issues on a case-by-case basis. Both surveillance and Fund-supported programs need to keep a clear focus on issues of critical macroeconomic relevance in each country, and differences in the coverage of fiscal reform reflect in part the varying importance of these issues in different countries. In addition, in determining the appropriate degree of detail to be presented, a tension may arise between providing detailed proposals and allowing adequate room for home-grown reform agendas. Thus, no new formal requirements are proposed regarding fiscal reform coverage in staff papers.

18. FAD, PDR, and other departments are also working on widening cross-country analyses and making them more readily available. Notes on fiscal issues will help country teams in advising the authorities on their fiscal reform efforts. Cross-country notes are posted on internal websites.⁶

19. As emphasized by the IEO, there is a strong case for incorporating in Fund-supported programs and in conditionality medium-term reforms that can improve the sustainability, efficiency, and equity of adjustment. However, there is a tension between this objective and the need for streamlined conditionality. At times fiscal reforms with a longer time horizon may be more important than short-term measures to ensure the sustainability of the fiscal adjustment and the reduction of future vulnerabilities; but short-term measures are sometimes unavoidable. Moreover, it can be difficult to specify institutional reforms with sufficient clarity and specificity, or to identify individual steps in a long and complex process of reform as sufficiently critical and urgent, for conditionality to be applied. Staff should continue to be guided by the 2002 Conditionality Guidelines—which will be reviewed in 2004—in subjecting to conditionality those reforms that are critical to meet the program's objectives.

⁶ In some cases, such notes have also been circulated to the Executive Board and published—for example, Gupta, S. et al., *Equity and Efficiency in the Reform of Price Subsidies. A Guide for Policymakers*, December 15, 2000, International Monetary Fund.

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.

20. Although social issues often raise important questions of country ownership and the World Bank is the lead agency in this area, the Fund does have a role to play in the social sector. In the Board discussion of the IEO report, Directors underscored the need to protect critical social spending and to shield the poor from economic downturns by incorporating the costs of social safety nets in Fund-supported programs.

21. While the Board did not support a suggestion by the IEO that the 1997 guidelines on social expenditure be revisited, it is worrisome that the IEO found uncertainty among staff as to their responsibilities in the social area. To address this uncertainty, steps are being taken to disseminate better within the staff the existing guidance from the Board on social sector issues. Moreover, work that is underway to improve reporting on progress toward the Millennium Development Goals will enhance the social sector information that is routinely provided in staff papers.

22. In addition, in considering the scope of surveillance in the 2004 Biennial Surveillance Review (BSR), the staff intends to consider when and how social issues should be dealt with in Article IV consultations. Even in non-PRGF countries, there might be cases where inadequate social protection undermines a country's resilience to macroeconomic shocks or its ability to undertake or sustain needed adjustment policies by eroding political support for them. These failures can often be remedied at relatively low cost, and early action in these areas would obviate the need for stopgap measures and increase the authorities' room for maneuver in the event of a crisis.

23. The BSR will also consider the specific IEO suggestion that staff—without entering into the detailed design and selection of social policies—should inquire during Article IV consultations whether the authorities have identified critical social programs and social services that they would like to protect in the event of a crisis. While many Directors supported this specific proposal, a few commented that it was impractical. The staff recognizes that authorities may be unlikely to precommit to—as opposed to prepare—difficult actions before being forced by circumstances to implement them, and care would have to be taken by the authorities to ensure that the ground is prepared for any fiscal adjustment that might potentially be required.

III. ISSUES FOR DISCUSSION

24. Do Directors agree with the approach taken in this paper? Do they view it as an appropriate response to the IEO evaluation, consistent with the guidance they gave in their discussion in August?