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Guidelines for Fiscal Adjustment

Fiscal Affairs Department

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The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

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Preface

This pamphlet is the product of a collaborative effort of the staff of the Fiscal Affairs Department (FAD). The final version of the pamphlet was prepared by Jeffrey M. Davis and James Daniel, drawing on substantial input from a large number of colleagues in FAD. Peter S. Heller was particularly helpful in providing guidance and comments on earlier drafts of the pamphlet. Advice and encouragement from Vito Tanzi (Director of FAD) is gratefully acknowledged. The pamphlet also benefitted from comments by staff of other departments and was edited by Gail Berre of the External Relations Department.

Guidelines for Fiscal Adjustment

Introduction

Fiscal policies are a key determinant of both national and international economic developments, and provision of advice on these policies plays a major role in the IMF's activities. This advice reflects the IMF's responsibility for undertaking surveillance of the policies of all member countries and of the international monetary system.¹ At the individual country level, surveillance encourages countries to adopt policies that provide the basis for sustained economic growth and price stability. IMF surveillance of the global monetary system aims at promoting the balanced growth of world trade and an orderly and stable system of exchange rates.

The two main ways the IMF carries out its surveillance activities are through regular—usually annual—bilateral consultations with individual member countries (known as Article IV consultations) and through multilateral discussions held in the context of the World Economic Outlook (WEO) reviews conducted twice a year. The Article IV consultations always include a full assessment of the overall stance of fiscal policy, as well as of developments with respect to the government's tax, expenditure, and borrowing activities. Assessment of fiscal policy in the WEO emphasizes the multilateral effect of members' policies and their impact on the prospects for the international economy.

In the specific circumstances when the IMF provides financial support to a member undertaking economic reforms, it must be assured that the country is pursuing policies aimed at correcting economic and financial imbalances within a reasonable period of time. Substantial changes in fiscal policy are usually required to achieve growth-oriented adjustment and, as such, form a major part of the commitments a member country is required to make when receiving financial support from the IMF.²

This paper aims to acquaint policymakers with some of the issues and concerns that underlie the IMF's approach to fiscal adjustment—namely, the ways governments can use their fiscal stabilization and structural policies to achieve macroeconomic objectives relating to growth, inflation, and the balance of payments. As such, it covers issues related to governments' taxing, spending, and borrowing activities, as well as some fiscal aspects of institutional change. The focus is on the broad issues and

practical policy options that need to be considered, rather than on the more technical or theoretical aspects of the literature on fiscal policy.

In keeping with its practical emphasis, the discussion is organized around four basic questions.

- Why may fiscal adjustment be needed?
- How should the fiscal stance be assessed?
- How much fiscal adjustment is required?
- How should fiscal adjustment be effected?

These questions are addressed in the following sections. A brief list of references is provided at the end.

Why May Fiscal Adjustment Be Needed?

The need for fiscal adjustment may be seen in the context of the impact of fiscal policy on stabilization and growth objectives, the sustainability of the fiscal policy stance, and the linkages between fiscal and other policy instruments.

The Impact of Fiscal Policy on Macroeconomic Policy Objectives

In most countries the government sector is directly responsible for a large part of economic activity and, through its spending and resource mobilization, indirectly influences the way resources are used in the private sector. Substantial evidence exists that, in many cases, poor fiscal management has been a major factor underlying such problems as high inflation, a large current account deficit, and sluggish or negative output growth. In such circumstances, fiscal policy is usually at the center of an overall adjustment strategy.

Fiscal adjustment attacks these problems in two major ways: (1) through its impact on broad macroeconomic variables, such as the level and composition of aggregate demand, the national savings rate, and the growth of monetary aggregates; and (2) through its more microeconomic impact on the efficiency of resource allocation in the economy and the buildup of essential institutions and infrastructure.

Inflation

Government spending that is not financed by tax or nontax revenue can contribute to excess aggregate demand and thus inflation. This is particu-

larly likely when government spending is financed through the creation of money. A certain level of monetary financing of the fiscal deficit may be noninflationary. Specifically, to the extent that growing economies need more money to facilitate transactions, that interest rates are falling (and other assets becoming less attractive), and that financial markets are developing (and the economy becoming increasingly monetized), the money supply can be expanded in a noninflationary way to meet increasing money demand. The government is said to be deriving resources from seigniorage when it finances a deficit in this way.

However, the scope for noninflationary financing is usually limited. Once the private sector is content with its money holdings, increasing the supply of money in the economy will encourage the private sector to spend more. This drives up prices until the desired ratio between money and spending is restored. To the extent that government borrowing from the banking sector contributes to an excessive rate of monetary growth, it will have inflationary implications. When a government finances its deficit by inflation-inducing monetary creation, it is said to collect an “inflation tax.”³

In the short term, a government may be able to resort quite extensively to financing its operations from the inflation tax, since prices do not immediately adjust fully to an increase in money growth. However, over time, the scope for collecting the inflation tax is limited, since, when inflation rises, households and businesses will tend to decrease their real money holdings as they seek alternatives that hold their value better in such an environment. Moreover, high inflation can also have a negative impact on real tax revenue from explicit taxes if there are collection lags, and the net resource gain may not be great.

External Current Account

Residents of a country can spend more than the value of their production only by absorbing another economy’s goods, that is, through a current account deficit in the balance of payments. Thus, if a government increases its spending, without taxes or other measures to restrain private sector demand, imports are liable to grow relative to exports of goods and services, and the current account tends to deteriorate. A simple accounting relationship can be established between fiscal and external current account balances. Gross national income (GNI) can be defined in terms of expenditure components or income uses (Equation 1).

$$GNI = C_p + I_p + G + X - M = C_p + S_p + T + R \quad (1)$$

where,

- C_p = private consumption;
- I_p = private investment;
- G = government spending;
- X = exports of goods and services;
- M = imports of goods and services;
- S_p = private savings;
- T = government revenue; and
- R = net current transfers to abroad.

Rearranging,

$$(I_p - S_p) + (G - T) = (M - X + R). \quad (2)$$

Equation 2 shows the external current account balance as the counterpart of the sum of the private sector's investment-savings balance and the fiscal deficit. Thus, a fiscal deficit must be matched by a domestic private sector that saves more than it invests and/or by an external current account deficit.⁴

Considerable caution is required in moving from the above accounting identity to the assumption that a simple causal relationship exists between fiscal and external deficits. A widening of the fiscal deficit may be reflected in an increase in the current account deficit, but it could also lead to a reduction in the private sector investment-savings balance through a crowding out of private investment (for example, when public and private investment are close substitutes, when the availability of credit to the private sector to finance investment is rationed, or when higher interest rates lower private investment). Similarly, an increase in the fiscal deficit may lead to a rise in the private savings rate, as individuals recognize that future tax burdens may be higher as a consequence of the need to service the prospective growth in public debt. Thus, the extent of linkage between fiscal and external deficits depends on any impact of fiscal policy on private sector savings and investment behavior; moreover, fiscal deficits may respond to, as well as influence, external balances.

Growth

There are two interrelated channels through which fiscal policy can affect the aggregate supply of an economy: (1) through its contribution to saving and investment, and thus on the long-run growth rate of capacity

output, and (2) through its effects on the efficiency with which resources are allocated among competing uses, and thereby on the level of current output and future growth.⁵

To the extent that the government is a major source of dissaving in the economy (that is, its consumption exceeds its current revenue), it may have an adverse impact on growth. This would be particularly likely if the consumption is unrelated to the production of human capital and/or the maintenance of physical infrastructure. Less obviously, the government's taxing and spending decisions may change the way resources are used in the economy in a way that is detrimental to growth. An example of such effects would be taxation policies with adverse supply-side effects, such as exemptions or special tax rates that encourage investment in projects with low (or even negative) returns. Similarly, excessive marginal income tax rates may reduce the incentives for saving and high payroll tax rates may deter employment creation. The costs of such policies can be high.

Especially at times of economic recession, expansionary policies may increase output in the short run. The scope for expansionary fiscal policies in these circumstances is liable to be greatest in countries that had previously adopted conservative fiscal strategies. However, capacity constraints, a low responsiveness of domestic supply, and the inability to sustain an adverse balance of payments position are likely to limit the positive effects of demand expansion on output in most countries. Indeed, it is likely that overly expansionary fiscal policies may lead to increased distortions in the economy and, ultimately, a reduction in growth (see Box 1). For some countries, fiscal expansion could well prove contractionary even in the short run because financial market participants quickly raise interest rates in response to the expected higher rate of inflation and the prospect of financial instability.

Fiscal Adjustment to Ensure Sustainability

An important responsibility of economic policymakers is to ensure the longer-term viability of a noninflationary growth path for the economy. Governments may promote high growth in the short term, while sowing the seeds of future difficulties in terms of an unsustainable growth in public debt or the creation of an unfinanceable future external position. Thus, fiscal consolidation initiatives may be necessary in the short term to prevent the occurrence of an unsustainable fiscal position in the future. These issues may be considered in relation to the current account, government

debt, and the impact of unfunded liabilities arising from current fiscal policies.

- *Current account.* A current account is unsustainable if it cannot be financed on a lasting basis with market-based capital inflows and it is not consistent with adequate growth, price stability, and the country's ability to service fully its external debt obligations. Assessing the medium-term sustainability of the current account is complex, requiring projections of such variables as trading partner demand, world prices of exports and imports, the future supply of exports and the demand for imports, market-based capital flows, the size of external debt and its servicing cost, and the prospects for private investment and savings. Since forced adjustment—such as would arise from a cutoff in foreign financing—is very costly, concerns over current account sustainability are typically a central rationale for fiscal stabilization.

- *Government debt.* Governments frequently resort to borrowing to finance their operations. The danger in relying on debt emerges when the

Box 1. Adverse Consequences of Excessive Fiscal Expansion for Growth

Excess demand, originating from overly expansionary fiscal policies, often underlies problems of adjustment and growth. Such policies usually lead to inflation and a deterioration in the external current account. The government's response to this situation is often to impose domestic price controls, and trade and foreign exchange restrictions. These measures, however, exacerbate supply shortfalls, as resource misallocation increases and lack of imported inputs limits domestic capacity utilization and exports. The continued fiscal expansion leads to further deterioration in the underlying balance of payments, with accelerating inflation. Loss of confidence contributes to reduced capital inflows or capital flight, increasing the resource constraints. A vicious circle can then arise whereby these policies lead to an erosion of the tax base (particularly imports) and the difficulty of containing the fiscal deficit increases. At this point, the country has both problems of low, or negative, growth and underlying external adjustment problems. This scenario has close approximations to reality in many countries.

ratio of public debt to gross domestic product (GDP) is allowed to rise over time. Such dangers are several and are a function of both the type of debt and the level of the debt-to-GDP ratio. Clearly, countries with high government debt have less scope to run deficits, which makes fiscal adjustment more urgent when macroeconomic imbalances begin to threaten stability. Nonetheless, they are more likely to run deficits, since their interest bill quickly becomes a large (and nondiscretionary) component of government expenditure. Issues related to the sustainability of government debt are further discussed in the following two sections.

A high or rising debt level can, of itself, be a source of macroeconomic difficulties and create imbalances. High external debt increases the vulnerability of the fiscal position (and the exchange rate) to developments in international capital markets. Expectations of the future consequences of servicing substantial domestic debt—in particular, the prospect that a government might substantially increase the tax burden or might inflate debt away through money creation—could lead to a loss in confidence. This is related to the more general issue of credibility and the increasing importance attached not only to debt but also to fiscal deficits as indicators of the anti-inflationary resolve of policymakers.

At the extreme, government debt becomes unsustainable either if it is projected to rise indefinitely as a share of GDP or if the cost of debt servicing absorbs an excessive amount of resources. Assessing the sustainability of a government's debt position is not clear cut, but depends on projections of such variables as interest rates, economic growth rates, and government revenues and expenditures. However, sustainability is likely to become a particular problem when the growth of government interest payments exceeds that of government revenues.

- *Unfunded liabilities.* Often, governments introduce current fiscal policies that have limited short-term costs but that, over the medium to long term, may imply a substantial and possibly unsustainable increase in outlays. Sometimes the implications of such policies may be readily anticipated: pension commitments in the context of an expected increase in the elderly portion of the population are one obvious example. Often, there may be significant uncertainty as to whether a given policy may provoke unsustainably high growth in outlays (for example, the effect of commitments to hire all university graduates, or the uncertainty about the prospective increases in medical costs in a publicly funded medical insurance system). Policy actions may be necessary in the short run to avoid the

need for drastic, and consequently more difficult, policy changes in the future.

Links to Other Policy Instruments

While the above discussion has focussed on the importance of fiscal policy for achieving macroeconomic policy objectives, it is important to see fiscal adjustment in the context of other macroeconomic policy instruments. Important interactions may be illustrated with respect to the exchange rate, monetary policy, and selective structural reforms.

- *Exchange rate*. Fiscal stabilization cannot be relied upon to achieve both internal and external objectives of adjustment. Relying entirely on fiscal retrenchment to eliminate a current account deficit may result in domestic problems such as unemployment and low growth. To avoid these imbalances, fiscal stabilization may need to be accompanied by policies that increase the price of goods that are, or could be, internationally traded (tradables) relative to the price of goods that can only be sold domestically (nontradables); in other words, policies to achieve a real exchange rate depreciation. Such policies allow a stronger current account balance for a given level of output and typically take the form of a devaluation of the nominal exchange rate.

Fiscal policy initiatives both affect and are affected by exchange rate policies. A nominal depreciation will, itself, have a significant effect on the fiscal balance, and this can be either positive or negative, depending on the structure of the budget. If, for example, foreign-currency-based expenditures (such as interest payments on foreign debt) outweigh foreign-currency-based revenues (such as customs duties and oil revenues), the net effect of a depreciation would be to increase the fiscal deficit. Conversely, fiscal stabilization initiatives may affect the exchange rate, although the specific effects (in terms of an appreciation or depreciation) are likely to reflect the underlying economic situation (see Box 2).

Fiscal policies are also likely to be necessary to support policies to adjust the real exchange rate. For example, under a fixed exchange rate system, a nominal devaluation will immediately increase the prices of tradable goods, but if the prices of nontradables also rise by a similar amount, the real exchange rate will not change. To prevent the price of nontradables from rising, it is usually necessary to introduce measures that dampen aggregate demand, of which the most important is often fiscal stabilization.

Box 2. The Exchange Rate Effects of Fiscal Policy

For industrial countries with developed capital markets and market-determined exchange rates the impact of fiscal policy on the exchange rate is ambiguous in the short run. In some cases, an increase in the deficit has been associated with an appreciation of the exchange rate, because fiscal expansion increased output, interest rates, imports, and capital flows; this assumes an unchanged stance of monetary policy and reflects the high mobility of capital among industrial countries. However, in other cases, fiscal deficits have been associated with a depreciating exchange rate. This may be explained by expansionary fiscal policies raising perceived exchange rate and political risks and lowering the credibility of both monetary and fiscal policies.

A similar uncertainty surrounds the exchange rate impact of fiscal consolidation. In textbook models, fiscal contraction leads to an exchange rate depreciation. However, it is possible that fiscal contraction can lead to an appreciation of the exchange rate in the short run if the fiscal measures alleviate a significant fraction of the existing budgetary imbalance, are viewed as being permanent, and are adopted following a period of loose policies that have generated perceptions that domestic assets are risky and the exchange rate will continue to depreciate because of these policies.

Over the long run, a sustained improvement in the fiscal balance that raises national saving and reduces the ratio of government debt to GDP will very likely lead to a real exchange rate appreciation. Thus, a country that saves more than its trading partners will ultimately find that its currency will strengthen relative to other currencies.

In developing and transition economies with limited capital flows, fiscal deficits tend to be monetized to a much greater extent than in industrial countries. Consequently, fiscal consolidation (expansion) is much more unambiguously likely to lead to an exchange rate appreciation (depreciation) even in the short run.

- *Monetary policy.* Government borrowing from the banking system is usually a key factor influencing the overall rate of credit and money expansion. Consequently, fiscal adjustment is often a crucial element of policies to achieve monetary restraint. Failure to adjust the fiscal position can

result either in an excessively expansionary monetary policy or in the achievement of monetary restraint at the cost of undesirable reductions in credit to the private sector. Fiscal policies may also be affected by the monetary policy stance. A tight monetary policy, perhaps pursued with an eye toward the maintenance of a particular nominal exchange rate, may (at least in the short run) result in high real interest rates that impinge on the cost of debt service to the government and the viability of the fiscal position.

- *Structural policies.* Structural adjustment policies are a central task of policymakers seeking to achieve higher rates of real economic growth or address problems of high unemployment. Such policies are most likely to achieve success in an environment of macroeconomic stability. In this broad sense, fiscal stabilization may be a necessary condition for structural adjustment. Specific structural measures may also require complementary changes in the fiscal system. For example, a reform of the tariff structure—vital for opening up an economy—is likely to reduce fiscal revenues and thus require compensating changes in other taxes. Similarly, the reform of the public enterprise sector may have important ramifications, often both positive and negative, for the budget, reflecting the importance of enterprises as sources of government tax revenue and recipients of transfers in many countries.

How Should the Fiscal Stance Be Assessed?

Given the size and complexity of most government budgets, it becomes important to develop broad indicators that convey a sense of the impact of fiscal policy on domestic demand and financial resources. Ideally, such indicators should reflect a comprehensive coverage of the government's activities and be easily derived from budget documents and other available statistical sources. The reality is often different; considerable efforts are frequently required to piece together accurate and conceptually appropriate indicators of the impact of fiscal policy. Usually, this requires analysis of policies effected both inside and outside the budget. Also, taking into account the way in which the budget affects, and is affected by, other economic variables can require important adjustments to official data.

A commonly used indicator to assess the stance of fiscal policy is the overall balance, which measures the difference between revenues and grants, and expenditure and net lending.⁶ This balance may be in surplus

or deficit. As a starting point for analysis, an overall deficit (surplus) would suggest an expansionary (contractionary) fiscal stance on the basis that the negative impact of taxes and other revenue on aggregate demand is more (less) than offset by the positive effects of government spending. Developments in the overall balance over time, particularly when related to GDP (or GNI), provide an indication of the changing impact of the government sector on the economy.

While the overall balance is an important indicator for assessing fiscal policy, it is a measure that needs to be judged with caution. Since it offers a perspective on the aggregate demand effects of fiscal policy, it is, not surprisingly, deficient as an indicator of the impact of fiscal actions on other policy variables of concern (growth, monetary stance, sustainability, etc.). Moreover, as a simple indicator, it abstracts from the range of items that comprise government operations—importantly, the way the deficit is financed—as well as from the particular institutional and other factors that affect the impact of fiscal policy in any country. These complexities are discussed below in relation to the effect of the way a deficit is financed, special measures of fiscal impact that may complement the overall balance, the time frame of analysis, and possible alternative definitions of the government sector and fiscal balance.

When attention shifts to the supply side of the economy, the structure of fiscal policy takes on greater significance, and simple indicators of fiscal policy stance become less useful. Indeed, structural fiscal adjustment may be needed even when stabilization is not an issue. This is because high taxes can foster a misallocation of resources and create work and savings disincentives, and government spending at the margin may be less productive than private spending. Issues relating to the appropriate structure of fiscal adjustment are addressed in the last section.

Fiscal Impact of Alternative Methods of Deficit Financing

A deficit may be financed from domestic (bank and nonbank) or external sources. Any assessment of fiscal policy stance would need to take account of the way the deficit is financed, since each method of financing has particular macroeconomic effects and costs. However, for countries without capital controls there is little distinction between domestic and foreign nonbank financing—governments cannot control (or in most cases monitor) the purchase of government securities or the capital flows that occur in response to changes in domestic interest rates.

- *Monetization of deficits.* As previously discussed, government borrowing from the central bank directly increases the monetary base, and thus the money supply, and may be a source of inflationary pressure. Reliance on commercial bank financing may have similar effects if banks are not forced to limit credit to other borrowers. Where overall credit ceilings apply, borrowing from banks may not be monetized but may absorb credit that could otherwise be available to the private sector.

- *Reliance on nonbank financing.* The scope for domestic nonbank financing is usually a function of how far capital markets have developed and whether there is public demand for government bonds. In addition to market-based security purchases, nonbank borrowing may reflect direct government intervention in the capital market. Thus, the government may require public sector institutions to hold government bonds for liquidity management purposes or may mandate heavily subsidized government savings programs. Such interference in the financial intermediation system is likely to adversely affect the efficient use of financial savings.

Deficits financed by borrowing from the nonbank private sector may have a more limited impact on aggregate demand than direct monetary financing, insofar as there is a compensating reduction in spending by the private sector.⁷ Government borrowing may increase domestic interest rates and reduce private investment; alternatively, when interest rates are controlled, private investment may be more directly reduced through credit rationing. Thus, while nonbank borrowing is likely to have the considerable advantage of being less inflationary than monetary financing, this may well come at the cost of “crowding out” productive private sector activities.

- *Borrowing from abroad.* Liquid resources obtained from abroad can be used to expand domestic demand as well as imports. However, to the extent that external borrowing facilitates the importation of additional resources from the rest of the world, the impact of a deficit on excess demand for domestic goods and services is reduced. Concessionality is important: for developing countries, foreign financing often contains a grant element, and the larger it is, the more the government can borrow without jeopardizing the sustainability of the fiscal position. In effect, concessionality reduces the effective interest rate. External grants are the ultimate form of concessional financing, although they are formally treated as revenue. Reliance on nonconcessional external financing leads to an accumulation of debt, which needs to be serviced and eventually repaid; it

makes the economy potentially vulnerable to changes in the exchange rate and world interest rates. Such financing also facilitates the maintenance of a more appreciated exchange rate, damaging exports and encouraging imports. Deficits financed in this way, therefore, need to be assessed in the context of the external debt position of the country, the medium-term balance of payments prospects, the terms under which borrowing takes place, and the uses to which external borrowing may be put.

- *Accumulation of arrears*. Delays in payments on debt service, or on goods and services purchased, are considered a particularly costly means of financing budgetary commitments. Such arrears are likely to have similar macroeconomic consequences to other forms of public borrowing, as well as jeopardizing future financing, government credibility, and the integrity of the budgetary system. For example, the impact on prices and the balance of payments would be essentially the same whether a deficit is financed by borrowing from the domestic banking system or by accumulating domestic arrears to public enterprises and the private sector, which then borrow from the banking system.

Other Measures Used to Assess the Fiscal Stance

A number of other fiscal indicators are often used to provide additional insights into the impact of a government's fiscal policy stance. Most relate to special issues or circumstances and are only partial approaches and indicators for assessing complex situations. The following provides some examples of commonly used measures:

- *The current fiscal balance* represents the difference between current revenue and current expenditure. It provides a measure of the government's contribution to national savings. When positive, it suggests that the government can at least finance consumption from its own revenue. A fundamental concern with this measure is the implicit assumption that all current expenditure is of a consumption nature that does not contribute to growth. By implication, the measure also assumes that all outlays categorized as investment do not have the attribute of being consumption in character. Yet many examples can be found of unproductive capital spending that does not augment the real capital stock of the economy (or does so inefficiently); conversely, some forms of current expenditure, for example, spending on health and education or on the operation and maintenance of infrastructure, may be highly productive and contribute either to human capital formation or to the slowing of capital depreciation.

- *The primary balance* excludes interest payments from expenditure. It can be said to provide an indicator of current fiscal effort, since interest payments are predetermined by the size of previous deficits. For countries with a large outstanding public debt relative to GDP, achieving a primary surplus is normally viewed as important, being usually necessary (though not sufficient) for a reduction in the debt/GDP ratio.⁸

- *Cyclically adjusted or structural balances* seek to provide a measure of the fiscal position that is net of the impact of macroeconomic developments on the budget. This approach takes account of the fact that, over the course of the business cycle, revenues are likely to be lower (and such expenditure as unemployment insurance benefits higher) at the trough of the cycle. Thus, a higher fiscal deficit cannot always be attributed to a loosening of the fiscal stance, but may simply reflect that the economy is moving into a trough. Essentially, calculation of a cyclically adjusted or structural balance involves an estimation of what revenues and cyclically adjusted expenditure (and thus the deficit) would be if the economy were at its potential or—for some measures of the structural balance—its trend output, rather than its actual output.⁹

The usefulness of these indicators is limited by difficulties in identifying potential and trend output, and, consequently, in distinguishing cyclical and underlying elements of the fiscal deficit. Moreover, it is important to distinguish normal tendencies in the business cycle from those arising from external developments. Particularly, when the cyclical downturn reflects adverse external developments, the scope for accepting a large deficit may be limited. Unless there has been a substantial prior accumulation of international reserves, a negative external shock is likely to require a fiscal contraction to reduce absorption and facilitate adjustment to changed production and income prospects.

- *The domestic fiscal balance* includes only those components of the conventional deficit that arise from transactions with the domestic economy and omits those transactions directly affecting the balance of payments. The measure is used to identify the direct expansionary impact of government on the domestic economy. This has proved a particularly useful indicator for some oil producing economies, where government revenues from exports do not reduce domestic absorption.

- *The operational balance* has been devised to take account of the fact that the high interest rates paid on government debt during times of very high inflation effectively compensate purchasers of government debt for

the reduced real value of the debt principal caused by inflation. In such inflationary circumstances, both the ratios of interest outlays and the deficit, relative to GDP, are very high; a fortiori, the deficit-to-GDP ratio significantly overstates the extent of the deficit that would prevail in a low inflation rate environment. The “operational balance” excludes that part of interest outlays that compensate debt holders for the impact of actual inflation; in effect, this component of interest is treated as though it were amortization in order to maintain an unchanged real value of the debt. Use of the operational deficit concept facilitates an analysis of the underlying stance of fiscal policy by adjusting for this inflation-interest rate nexus.¹⁰

The Sensitivity of a Fiscal Assessment to the Time Frame of Analysis

The short-term fiscal balance can prove misleading for the purpose of assessing the sustainability of a government’s fiscal position. This may be illustrated by the following problems:

- The annual balance may show receipts from privatization and the sale of other assets as revenues, and thus mask a higher deficit exclusive of such receipts. Receipts from market-based privatization sales do not change a government’s net worth if it is assumed that the cash receipts equal the market value of the privatized assets. Indeed, the divestiture of government assets may imply that in subsequent periods revenues will be diminished to the extent that the receipts from the asset sale have not been reinvested in an equivalent yielding asset (or, to the same effect, used to repay outstanding government debt). However, insofar as privatization leads to improved economic performance, it may boost the tax base. More generally, in evaluating the fiscal position at a given point in time, it is necessary to be particularly cautious in interpreting revenues or outlays that arise from changes in the government’s net wealth position.

- The annual fiscal balance includes both revenues that are associated with a future obligation by the government to make payments (such as social security expenditures) and expenditures that arise from previous obligations of this type. Government guarantees may also have no costs in the present but could imply large future outlays.

Such problems have led to a substantial academic literature exploring the replacement of the annual deficit with a measure of changes in the government’s discounted net worth. Operationally, such measures have proven difficult, and more partial approaches have been followed to take account of these factors. For example, where significant, privatization

receipts should be excluded from revenue when assessing the appropriateness of the fiscal stance; that is, they should be treated as contributing to the financing of the overall deficit. Similarly, fiscal analysts often assess the magnitude, probability, and likely timing of contingent liabilities, including government guarantees that may well be called upon in the future.¹¹

Consideration of the annual fiscal balance may also need to be supplemented by longer-term analysis to assess the future impact of current fiscal policies. For example, countries with aging populations are likely to find that pension schemes financed on a pay-as-you-go basis are placed under growing strain; increasing expenditure needs may require high payroll taxes and possibly budgetary transfers. A longer-term assessment would provide a basis for assessing such budgetary implications and guiding possible changes in underlying policies.

Definition of Government Accounts for Macroeconomic Analysis

Efforts at assessing fiscal policy lead to important questions about the institutions comprising the government, the time when a fiscal transaction impacts on the economy, and the transactions to be included when determining the overall fiscal balance.¹²

Coverage of Government Operations

Fiscal policy (namely the use of the government's taxing, spending, and borrowing powers to attain public objectives) may be effected by different levels of government and through a range of institutions. Definitions of government are best distinguished by the function performed, rather than by legal or institutional criteria. On this basis, the following government sectors may be distinguished, with correspondingly different measures of fiscal deficits:

- *Central government* refers to the activities of the central authority of a country. Importantly, transactions at this level should not only reflect the legal budget of the central government but also the fiscal actions of any extrabudgetary funds or autonomous agencies relevant to central government policies or under the central authorities' effective control.
- *General government* includes, in addition to the central government, the budgetary and extrabudgetary activities of governments operating only in parts of the country (state and local governments, etc.). Note that social security funds form part of the level of government at which they operate.

Based on a functional definition of government and fiscal policy, the following two further sets of activities may be considered in defining alternative measures of the deficit:

- *Nonfinancial public sector enterprises* (NFPEs) are government-owned and/or controlled corporations whose activities may be significantly influenced by nonmarket factors, often including application of a “soft budget constraint.” The operational balance of NFPEs and their investments can be consolidated with the activities of the general government to form a broad measure of the fiscal operations of the nonfinancial public sector.

- *Quasi-fiscal operations* of public financial institutions are tax and subsidy operations that may take place through the activities of this sector, the most important of which are undertaken by the central bank. As discussed in Box 3, such activities may have a fiscal impact comparable to that of more traditionally defined government activities and measures.

In principle, an assessment of fiscal policy should be based on the most comprehensive definition of government possible. Considering only the central government fiscal balance may provide a distorted picture of the fiscal stance when subnational fiscal authorities and a social security fund carry on substantial fiscal operations, or when quasi-fiscal activities are important. At the same time, for fiscal assessment to be of the most value, it should be based on data that are regularly and quickly available. This need, combined with the view that central government policies are easier to change quickly, creates a tendency to focus analysis on developments in the central government accounts. Also, if certain levels of government are constrained in their borrowing capacity and thus forced to run balanced budgets, it may be possible to abstract from these levels of government in considering the aggregate demand effects of fiscal developments. Reconciling these conflicting perspectives requires that systems be established to carry out the periodic monitoring of financial developments at subnational levels of government and in the public enterprise sector. It also requires an attempt to measure at least the most important types of quasi-fiscal activities.

Timing of the Impact of Fiscal Transactions

Normally, governments commit resources before they are actually disbursed on a cash basis. Some tax liabilities may also accrue for a considerable period before a taxpayer has to make a payment. This gives rise to

Box 3. Quasi-Fiscal Activities of Public Financial Institutions

In many countries, central banks and other public financial institutions (PFIs) play an important role in fiscal policy. By undertaking financial transactions that serve the same role as taxes and subsidies, they increase the effective size of the fiscal deficit. These so-called quasi-fiscal activities (QFAs) can have a significant allocative and budgetary impact in many countries.

In the case of a central bank, the majority of QFAs arise from its dual roles as regulator of the exchange and financial systems and as the banker to the government. QFAs can involve multiple exchange rate arrangements (typically a tax on exporters and a subsidy to importers), exchange rate guarantees (a contingent subsidy to the borrower of foreign exchange), interest rate subsidies and sectoral credit ceilings, central bank rescue operations, and lending to the central government at below-market rates. Other PFIs often undertake QFAs by imposing restrictions on financial markets (such as interest rate subsidies and credit ceilings), or by providing government-mandated special treatment for specific classes of borrowers (for example, the agricultural sector) and lenders.

There are a variety of reasons why central banks and other PFIs may engage in QFAs. QFAs may allow the government to hide what should essentially be considered budgetary activities in the accounts of PFIs. Such QFAs may not receive equivalent legislative or parliamentary scrutiny compared to budgetary operations. Another rationale for some QFAs is that it may be more convenient to administer them relative to budgetary operations.

Clearly, QFAs ought to be explicitly considered in the formulation of fiscal programs. As a first step, any quantifiable QFAs should be added to the fiscal balance to provide a broader and more appropriate measure of the deficit. To the extent possible, these should then be transformed into normal budgetary operations by replacing quasi-fiscal taxes and subsidies with explicit taxes and subsidies. While this would bring them out into the open, their distortionary effects on the economy would remain. More fundamental action—namely, structural reform—is required in order to achieve a long-term solution.

the question as to whether the fiscal balance is to be assessed on a commitment basis—since these implicit transactions may affect activity in the economy—or only on the basis of cash transactions (and the cash balance).¹³ A cash-based measure of the fiscal balance has the advantage of emphasizing links with financial developments, particularly in the monetary accounts. In a number of countries, however, governments have resorted to not meeting their commitment obligations, either due to a lack of liquidity and/or to meet targets for cash-based deficit reduction. A cash-based deficit will then underestimate the extent of a government's pre-emption of real resources. Indeed, when the arrears are to enterprises, which, in turn, borrow from the banking system, a cash-based deficit concept will also underestimate the government's contribution to the growth of monetary aggregates and demand. In these circumstances, where possible, the budget should be presented on both a cash and a commitments basis, with changes in arrears providing the principal link between the two concepts.¹⁴

Defining the “Overall Fiscal Balance”

On a cash basis, total incomings and outgoings from the budget must always balance. A deficit (or surplus) is determined by drawing a balance among a subset of receipts and payments (classified “above the line”), which are then financed by other transactions (shown “below the line”). The delineation is based on the analytical needs sought from the measure of the fiscal balance.

As noted earlier, a common measure of the fiscal balance is the overall balance, namely, the difference between revenue and grants, and expenditure and net lending (all of which are thus above the line).¹⁵ Viewed from below the line, a deficit in the overall balance is financed by a drawdown in cash assets (and use of other financial assets acquired for liquidity purposes) and by an increase in the government's debt liabilities through borrowing from external and domestic sources—the latter encompassing non-bank and bank financing. This definition emphasizes the extent to which the financing of government expenditure and net lending requires the assumption of debt obligations for future repayment and/or a rundown in the government's holding of liquid financial assets.

There are at least two areas in which this definition can be adapted.

- *External grants*. These are included with other government revenue on the grounds that they do not add to debt and may finance expenditures

that would otherwise not take place. However, grants reflect discretionary financing by donors that can change significantly from year to year. Their inclusion may mask their possible impermanence and may elicit a structural increase in expenditure, which may subsequently prove difficult to reverse. Consequently, in assessing the fiscal position, the deficit is normally calculated both inclusive and exclusive of grants.

- *Net lending.* By placing net lending above the line, there is an asymmetry between the treatment of changes in government financial assets (acquired for policy purposes) and liabilities. In effect, the former are placed above the line, the latter below. Net lending is primarily composed of direct capital infusions of funds to public (and sometimes private) enterprises (for example, when the government acquires equity) and of government credit programs undertaken for policy purposes.¹⁶ Given its implicit subsidy element and the possibility that some of the loans will never be repaid, net lending cannot be defined as pure financial intermediation. This usually justifies its treatment as a deficit-determining item above the line. However, a deficit concept that was based on determining changes in a government's net financial worth or indebtedness would place net lending activities below the line. Emphasis on the government's net financial worth would support placing privatization receipts below the line, with some measure of the reduced value of equity holdings offsetting the increase in cash deposits. This would be consistent with the treatment recommended in the section on the sensitivity of a fiscal assessment to the time frame of analysis.

How Much Fiscal Adjustment Is Required?

Fiscal adjustment policies should be designed within an overall methodological framework that links the implementation of a comprehensive set of policy measures to the achievement of the economy's objectives for inflation, growth, and external balance. Policy-setting within this framework requires decisions about the appropriate amount and form of fiscal adjustment, including the desired level of the fiscal deficit. A key link between the deficit and macroeconomic goals is through its financing. The use of bank credit, as well as nonbank domestic and foreign borrowing, to finance the government's operations must take account of the impact of each financing option on aggregate demand and prices, interest rates, the exchange rate, and the external balance.

A fiscal adjustment strategy may, in principle, require either a more restrictive or expansionary fiscal policy stance. Large structural deficits, rising government debt, and the need to address domestic and external constraints have emphasized the crucial importance of fiscal consolidation in many countries. The subsequent discussion largely focuses on such cases. However, there are also countries where domestic demand is weak and the underlying fiscal and external situation sufficiently strong, where fiscal stimulus may be appropriate.

This section considers the overall framework within which fiscal policies are formulated and some criteria for determining the amount of fiscal adjustment within this framework. Specific tax and expenditure strategies to achieve the required fiscal adjustment are reviewed in the following section on how fiscal adjustment should be effected.

A Framework for Fiscal Adjustment

For adjustment programs that qualify for financial support from the IMF, the methodological framework within which fiscal policies are designed is sometimes referred to as “financial programming.” A n essentially similar framework is used by policymakers for domestic policy formulation. Some key elements of a financial program are as follows:

- *Objectives.* The objectives of a financial program are usually specified in terms of the targets for growth, inflation, and the balance of payments position over the medium term. A sustainable current account in the balance of payments is considered as one that can be financed on a lasting basis with expected capital inflows and which, at the same time, is consistent with other macroeconomic targets and the country’s ability to service its external debt obligations.

- *Policy options.* Four main types of policy options are usually considered:

- (i) *demand management:* measures to affect domestic demand, including fiscal, monetary, and incomes policies, with a view to achieving the highest level of noninflationary output that is consistent with a sustainable external position;

- (ii) *expenditure switching:* measures to provide incentives for external adjustment by changing the relative price of foreign and domestic goods, most obviously exchange rate policy;

- (iii) *structural measures:* measures to increase potential output and facilitate a rapid growth in productivity (including encouragement of

investment and savings, and reduction of allocative distortions that limit current output through their effects on allocative efficiency); and

(iv) *financing*: the attempt to attract a sufficient capital inflow to sustain a current account deficit without running into debt-service problems.

- *Procedures*. A financial program is formulated within a set of economic and financial accounts (including the national income and product accounts, the balance of payments, and the budgetary and monetary accounts), which provides a consistent framework for policy analysis. Policy formulation and forecasting require that the accounting framework be complemented by an understanding of key aggregate behavioral relationships in the economy. These allow policymakers to assess the reaction of the main macroeconomic aggregates to changes in key policy variables, for example, the impact of different levels of income and taxation on private sector spending.

- *Uncertainties and choices*. Behavioral relationships are often difficult to estimate, particularly when major policy shifts and structural reforms are being undertaken. Further, even if the direction of the effect of some policies is known with some confidence, the timing of their impact may be more uncertain. Policymakers face difficult choices with respect to the weight to be placed on different policy objectives (for example, supply-side measures to liberalize trade may result in an initial deterioration of the balance of payments). Choices may also exist in the use of policy instruments (such as the extent of reliance on demand restraint or exchange rate depreciation).

Determining the Amount of Fiscal Adjustment

The amount of fiscal adjustment needed is usually discussed in relation to the desired reduction in the overall fiscal deficit; often, possible trade-offs are suggested between the quantity and quality of adjustment measures.

Reducing the Fiscal Deficit

In general, when macroeconomic imbalances are pronounced, the need for fiscal adjustment is not in question. The desired amount of deficit reduction must be assessed in the context of overall macroeconomic policies and constraints. An issue that usually arises is the amount of reduction that is needed and the possible time period over which such adjustment can be achieved. Some more general factors affecting the re-

quired amount of deficit reduction are indicated below.¹⁷ In some circumstances, it may even be appropriate for a country to run a fiscal surplus (see Box 4).

- *Cause and seriousness of imbalance.* If analysis suggests that the root of a macroeconomic imbalance is a large fiscal deficit, it will need to be reduced (or eliminated). Where external sources of imbalance are of concern, such as may arise from a deterioration in the terms of trade, fiscal retrenchment may be required to complement external policy efforts — specifically, to ensure a real depreciation in the exchange rate when the nominal rate depreciates. Short-lived problems that are clearly self-correcting are less likely to require fiscal correction than more permanent imbalances. Policies to achieve a reduction in the fiscal deficit will be most urgent when the resulting macroeconomic problems are serious, and there is less scope for deficit financing.

- *The needed reduction in the current account deficit.* The section dealing with why fiscal adjustment may be needed presented a simple identity linking the fiscal deficit to the external current account deficit. As stressed there, the link between fiscal adjustment and achievement of a current account target requires consideration of the impact of fiscal policy on private sector saving and investment. This impact will depend on the mix of fiscal measures adopted and the accompanying stance of other macroeconomic policies. For example, fiscal restraint is far more likely to lead to current account adjustment if accompanied by an appropriate change in the real exchange rate.

- *Debt dynamics and sustainability.* A strategy for fiscal stabilization normally implies the targeting of a time path over which fiscal deficits will be reduced. The deficit that must be financed during this period will thus need to be serviced from future public sector resources. Although governments can borrow indefinitely, in the long run they must have the financial capacity to meet at least part of their interest costs without borrowing, namely, the primary balance should be in surplus. Otherwise, the level of debt will continually rise as a share of GDP. The only exception to this requirement is when the resources the government borrows are used so effectively that the economy's growth rate persistently exceeds the real interest rate on government debt; but this is unlikely, because when the growth rate exceeds the real interest rate, the increasing level of debt will push up interest rates, which, in turn, dampens growth.

Box 4. When Should a Country Run a Fiscal Surplus?

There are certain circumstances when the appropriate balance for a country is likely to be a surplus.

- *To finance productive expenditure.* When governments provide “lumpy” goods, for example, large investment projects, it makes sense to finance them through borrowing rather than by raising tax rates. This borrowing can then be repaid from a fiscal surplus when public spending is low. If the private sector has the capacity, but not the funds, to provide certain productive goods, the government can step in by on-lending funds it has borrowed, which, when repaid, may lead to a surplus; the government may also choose to run a surplus in order to increase savings available to the private sector through the capital market.

- *To stabilize the economy.* To reduce inflation and/or the current account deficit, fiscal contraction is usually necessary and may imply a surplus. To dampen business cycles, governments can smooth aggregate demand over the cycle, which may imply a surplus during a boom. A negative supply shock (such as a drought), a positive demand shock (such as a property boom), or large capital inflows also justify a fiscal contraction, which may imply a surplus.

- *To sustain the debt.* If government debt is unsustainable, a primary fiscal surplus will, in general, be necessary, and the debt problem may be so severe as to require an overall surplus. Indeed, a surplus itself may increase the sustainability of government policies by sending a highly visible signal to economic agents of the government’s prudence.

- *To build up wealth.* When certain proceeds, such as mineral income, foreign grants, or privatization receipts, are exceptionally high, governments should save a portion for future use. To the extent that these receipts are classified as revenue, this may imply a surplus. Similarly, with an aging population, a PAYG (pay-as-you-go) pension scheme should run a surplus, which, if consolidated into the budget, may imply a fiscal surplus.

- *Financing.* The determination of the required amount of adjustment may also be viewed by evaluating the appropriate level of financing items. Normally, adjustment programs seek to sharply curtail the

rate of expansion of money and credit in order to reduce inflation. Given a growth in overall bank credit considered consistent with inflation and international reserve objectives, a limit may then be established on the amount of bank credit that can be provided to the government; this limit should ensure that adequate resources are available to finance the private sector. A ceiling may also be placed on government borrowing from abroad in order to ensure consistency with external and domestic debt-servicing capacity, respectively. Access to nonbank borrowing is often limited and again constrained by a desire not to “crowd out” private sector activity.

Quality of Adjustment

The required amount of fiscal adjustment is not independent of the quality of the specific measures chosen for its implementation. An assessment of quality would focus on the sustainability and the durability of the measures being considered and on the relative impact of alternative policy options on investment and production incentives as well as on the external account.

Specifically, short-term reduction of deficits through measures that cannot be sustained, or which may have adverse effects on growth over the medium term, should be viewed critically. Temporary surtaxes, tax amnesties, sales of public assets, and other measures may allow a country to stay within an agreed ceiling, but without doing anything to reduce its underlying deficit. Similarly, the postponement of essential operations and maintenance spending or inevitable wage increases, and even the deferral of payments, will be only of temporary value and may do more harm than good over the medium term. This argues for measures that are likely to be durable over the longer term, which do not diminish the efficiency of public sector operations and are the least costly in terms of their effects on growth in the rest of the economy.

Indeed, particular fiscal instruments may, over time, induce an important enough supply response in the economy to reduce the magnitude by which the deficit needs to be shrunk. For example, elimination of an export tax may, over the medium term, generate an expansion in output and export earnings, which increases revenue from other tax sources. Similarly, a policy to reduce employment in the public sector, especially in unprofitable public enterprises, may contribute to increased efficiency and lower costs in the medium term even though in

the short-run fiscal deficits may increase due to the need for outlays on separation and unemployment benefits. Consequently, such measures need to be implemented as part of an overall policy package that provides for an appropriate degree of reduction of government absorption in the short run.

How Should Fiscal Adjustment Be Effected?

Undertaking fiscal adjustment often requires difficult decisions involving increasing government revenue and reducing spending.¹⁸ Expenditure reductions often tend to be stressed in the initial stages of adjustment, with particular emphasis on cuts in capital spending and current outlays on other goods and services (excluding wages, subsidies and transfers, and interest payments). Cuts in productive capital spending and essential operations and maintenance spending are liable to be damaging to growth. Consequently, countries need to move quickly on structural reforms affecting expenditure, revenue, and public enterprises in order to allow a more balanced approach to fiscal adjustment and to generate the resources necessary to support spending that addresses social and productive needs. As noted in Box 5, strengthening policy design and institutional capacity has been a major part of the Fiscal Affairs Department's technical assistance effort in recent years.

In designing fiscal adjustment strategies, policymakers often face short-term costs and constraints. Such concerns include the output and employment losses that may be incurred in rationalizing expenditure, the possible short-term negative effect on growth of raising taxes, and the difficulties in modifying implicit social contracts by altering the role of government. Experience with adjustment in many countries has, however, shown the high costs of delayed or disorderly adjustment. Inflation and overvalued exchange rates hit the poor hardest, as their incomes are often fixed in nominal terms or may depend on the production of tradable goods and services.

Attention to a proper mix and phasing of policy instruments is essential to minimize harm to the very poor and to provide social support for adjustment programs. Nevertheless, in many cases adverse effects still remain, and vulnerable groups need to be protected through well-targeted social safety nets. Some aspects of the design of social safety nets are discussed in Box 6.¹⁹

Box 5. Technical Assistance

Technical assistance by the IMF supports fiscal structural reform. The central objective is to assist member countries in the detailed design and implementation of fiscal policies needed for macroeconomic and structural adjustment and for sustainable growth. Considerable emphasis is placed on institution building. Technical assistance by the IMF's Fiscal Affairs Department (FAD) has traditionally focused on tax policy, tax and customs administration, and public expenditure management (budgeting, control of budget execution, reporting, and government accounting). More recently, FAD has expanded the scope of technical assistance to include Treasury and public debt management; expenditure policy, including the reform of social safety nets and social security; intergovernmental fiscal relations; and strengthening institutional capacity for fiscal analysis and fiscal management. Technical assistance on government finance statistics is provided by the IMF's Statistics Department.

Measures to Improve the Tax System and Increase Revenue

In some cases, revenue can be increased by raising rates within an existing system. However, the ability to generate increased revenue in this manner may be limited. This is particularly likely when an economy is undergoing substantial structural change, traditional tax bases are declining, and there are fundamental weaknesses in the tax system. Structural problems in the tax system may well be a major factor underlying not only fiscal deficits, but also poor growth and employment performance. Consequently, programs of fiscal adjustment are often accompanied by an effort to improve or even restructure the tax system.

This section focuses on questions relating to tax policy design during a reform period. It must be emphasized, however, that improvements in tax policy are more likely to be successful when they are accompanied by measures to strengthen tax administration. A brief overview of key issues in the administration area is provided in Box 7.

Major reforms in tax design and administration take time to implement. New legislation is often required, and basic systems and procedures frequently need modification. In addition, reform may lead to changes in the relative tax burden of different groups and economic sectors. Short-term

Box 6. Social Safety Nets

Importance of Social Safety Nets (SSNs)

SSNs are a combination of measures aimed at mitigating the short-term adverse effects of economic reforms on the poor. Without SSNs, economic reform may, in the short term, lower the poor's living standards; it may also weaken the political sustainability of reform. Typical reforms with important consequences for the poor include reduction of generalized price subsidies on basic necessities; reform and restructuring of state enterprises and the civil service; and reduction of cash benefits.

Common Elements

Because SSNs need to work quickly and reliably, they have to be tailored to the specific circumstances of each country, including its administrative capabilities, the strength of its informal and formal social support systems, and the characteristics of the poor. Typically, the major components of SSNs have included the following:

- *Targeted commodity subsidies and cash compensation.* These schemes have sought to protect the consumption of basic food items by the poor in the face of rising prices, while reducing budgetary expenditure.

revenue requirements must also be addressed during the reform process. In developing short-term tax policy packages, particular consideration needs to be given to the revenue productivity of proposed measures, their administrative feasibility, and their likely consistency with the desired direction of more fundamental tax reform. On the basis of such criteria, the most promising short-term measures may emphasize increases in the rates of indirect taxes (particularly broad-based sales taxes and excises) and expansion of the tax base by eliminating exemptions.

Characteristics of a Desirable Tax System

The characteristics of a desirable tax system outlined below represent a blend of both macroeconomic and microeconomic considerations. In the

- *Adaptation of permanent social security arrangements.* The existing social security system, to the extent that it reaches significant portions of the poor, can be bolstered and its targeting and incentive/equity structure improved. The major schemes used are pension and disability insurances, and child allowances.

- *Unemployment benefits, severance pay, and public works schemes.* Because reforms usually involve a temporary increase in unemployment, an important aspect of SSNs has been enhanced unemployment benefit schemes, the provision of severance pay, and low-wage public works schemes.

Major Issues in Design

- *Targeting.* To contain fiscal cost, social benefits should be limited to those most in need. Sophisticated means testing is generally not possible. Many countries rely on categorical targeting, such as limiting benefits to children or pensioners, or to households in certain regions. Commodity subsidies can be limited to goods consumed disproportionately by the poor or limiting the quantity that each household can consume, for example, via coupons.

- *Incentives.* The fiscal cost of an SSN is reduced the more sharply benefits are phased out with household income. This, however, is at the cost of increasing the implicit marginal tax rate facing beneficiaries, and thus the potential adverse impact on incentives.

former case, a tax system's responsiveness to GDP growth and its revenue-generating capacity are paramount. But since overall economic growth may be affected by the microeconomic allocative effects of a tax system and the post-tax distribution of income and wealth, the system's efficiency and transparency, for example, are also critical.

- *Revenue-generating capacity.* A central objective of the tax system is to raise revenue to finance government spending, without resort to inflationary financing. This suggests the importance of a tax system that can generate revenue increases—at least in line with the growth in nominal income—without frequent changes in tax rates or introduction of new taxes. In this regard, reliance on specific (quantity-based) taxes in times of inflation, or on tax bases that are shrinking in relation to the rest of the

economy, should be avoided because they contribute to low tax responsiveness (or elasticity).

- *Efficiency.* Taxes influence relative prices in the economy and, therefore, have an impact on the pattern of production, consumption, and income. A desirable tax from the point of view of efficiency is one that min-

Box 7. Reforming Tax Administration

The essential elements required for successful tax administration reform include: an explicit and sustained political commitment; a team of capable officials dedicated to tax administration reform; a well-defined and appropriate reform strategy; relevant training for staff; additional resources for the tax administration or, at least, some reallocation of resources; and changes in incentives for both taxpayers and tax administrators.

Tax administration reform must strive to enhance both its effectiveness and efficiency. Interventions to improve effectiveness include promotion of taxpayer self-assessment, provision of taxpayer education, adoption of procedures for minimizing the cost of compliance, implementation of systems for tax returns processing and accounting that quickly detect noncompliance and take appropriate actions, and establishment of an audit plan to detect violations as efficiently as possible. Also needed are adequate penalties for violations that strike at the heart of the tax system, such as failure to file returns and to pay taxes on time.

Along with a strategy for enhancing effectiveness, tax administrations can adopt a number of measures to focus their scarce resources in the most efficient manner for revenue collection and enforcement. These measures include establishment of a large taxpayers' unit; adoption of a threshold for tax registration that exempts small enterprises from major taxes; the imposition of an alternative tax on small enterprises with limited revenue potential; use of final withholding of taxes on individual taxes; and use of banks for receiving tax payments.

The above measures for improving the effectiveness and efficiency of tax administration suggest an organization of the tax administration to support five principal functions: taxpayer education; registration, accounting, and returns processing; collection enforcement; auditing; and legal services and appeals.

minizes its impact on relative prices, thus leaving the allocation of resources essentially undisturbed. Too heavy a tax on a particular commodity will tend to reduce its production and consumption and may, therefore, result in a loss of efficiency if scarce resources are diverted from their most productive use, in turn compromising growth. In practice, efficiency is achieved by levying taxes on as broad a tax base as possible and at fairly low and uniform rates. This also implies keeping tax exemptions to a minimum.

- *Equity.* Taxes should be levied in a fair and equitable manner. The decision on what distribution of the tax burden is fair and equitable is something for each country to decide for itself, preferably through a democratic process. A distinction may be drawn between vertical and horizontal equity. The former refers to differentiation of the tax burden according to ability to pay (as measured by income, wealth, or consumption), while the latter refers to equal treatment of those in similar economic circumstances. Certain types of taxation may affect income distribution—for example, a progressive income tax or an excise on luxuries. However, expenditure policy is likely to be a more efficient instrument than taxation for influencing income distribution, through transfers and expenditures on social services, and targeted social assistance programs.

- *Transparency.* Tax codes should be clearly drafted, well defined, and easily understood by the tax-paying community. For private investment, it is especially important to have tax rates that are both stable and predictable. Once tax laws are established that can generate buoyant revenue growth, it is preferable to minimize the frequency of discretionary modifications to these laws. If changes are planned over a reform period, taxpayers should ideally know in advance the tax implications of their production and consumption decisions. A simple, transparent tax system is also relatively easy to administer and promotes compliance.

- *Reasonable overall tax burden.* There are constraints on how much a government can raise in taxes. Even if all the above criteria are met, too high a tax burden will undermine the system's effectiveness by encouraging tax evasion and distorting the structure of relative prices in the economy. One measure of the tax burden is the ratio of tax revenue to GDP, a ratio which varies widely among countries. An "acceptable" level of this ratio will be determined to some extent by public choices concerning the level of government expenditure or by other factors such as the need to service a large public debt.

Design of Major Taxes

Drawing on the above criteria, the following design features for major taxes are often recommended:

- *Sales tax/value-added tax (VAT)*. This should be a broadly based tax on final domestic consumption that does not tax intermediate consumption (thereby minimizing cumulative taxation as goods move through successive stages of production and distribution) or exports, and one that does not differentiate by source of production (foreign or domestic). Because of its efficiency and revenue security, the ideal instrument to achieve this objective is a VAT at a single rate, with crediting provisions and zero rating of exports.

- *Excises*. A selected number of excises can be introduced to discourage consumption of particular items (for example, alcohol and tobacco); to link tax payments to the existence of negative externalities (for example, a gasoline tax as a means of pollution abatement); or to tax certain luxury goods. Excises should be levied equally on domestic production and imports and, particularly in an inflationary environment, on an ad valorem basis.

- *Customs duties*. If a moderate level of protection is thought desirable to encourage local industry, a low uniform customs duty, when properly coordinated with a VAT and excises, is the preferred instrument. Duty drawback or suspension schemes are needed to relieve exporters of the anti-export bias caused by customs duties on inputs. To the extent such schemes are difficult to administer, particular importance attaches to maintaining a low tariff rate. Exemptions from customs duties should be limited and clearly defined to avoid abuse. A low across-the-board tariff may also be justified for revenue reasons in countries where other (and preferable) taxes may prove difficult to administer.

- *Export taxes*. Export taxes should generally be avoided, since they tend to cause an outflow of resources in the export sector toward less efficient uses, thus compromising growth objectives. However, they can sometimes be used on a limited basis to reach hard-to-tax activities (common in the agriculture sector) as a temporary substitute for income taxation and to absorb one-time windfall gains, for example, from a devaluation or from exceptional movements in world commodity prices.

- *Profit Taxes*. A tax on profits should ideally be levied at a single rate comparable to the top marginal rate of personal income tax. This minimizes the likelihood of tax-induced shifts between personal in-

come, partnerships, and corporations. Deductions, allowances, and credits are best applied neutrally across sectors and assets to foster efficiency. Tax incentives (such as investment allowances and, particularly, tax holidays), if used at all, should be strictly limited in terms of coverage and duration. A minimum profits tax based on gross assets may be used in some circumstances to promote compliance and equity.

- *Income Taxes.* A basic personal income exemption should be set high enough to exclude the very poor, and sufficient progressivity can be achieved with only a few income tax brackets. Tax brackets should be adjusted periodically in situations of high inflation to avoid the tendency for “bracket creep,” and supply-side considerations argue for keeping rates as low as possible. Ideally, income taxes should be levied on a globalized income tax base (including all forms of income). However, it is often administratively necessary to establish schedular taxes on different sources of income. Final withholding taxes for wage (and possibly interest and dividend) income have proven successful in curtailing revenue leakage.

Rationalization of Expenditure Policies

Expenditure reduction measures have to be pragmatic, adequate to achieve the intended stabilization, but nonetheless economically, politically, and socially feasible. Several types of expenditure measures can be adapted quickly to contain a deteriorating fiscal situation. Sustainable expenditure reform, however, requires a review of underlying government policies, the composition of spending, the coverage of activities by the public sector, and the modes of delivery of public services. Quite often, a thorough structural reform of government expenditure policies can be done only in a medium-term framework.

Similar to the importance of tax administration in tax reform, efficient spending reduction usually requires improvements in systems of budget design, preparation, and execution. The broad direction of such reforms are reviewed in Box 8.

Expenditure Reduction in the Short Run

There are no hard and fast rules about how public expenditure should be cut. This will depend partly on the factors driving the growth in spending (for example, wages and salaries or the capital program), as well as on the social and political constraints facing policymakers. However, experience suggests some guidelines.

Box 8. The Budget and Expenditure Control

A government's ability to identify and execute expenditure cuts will depend on the quality of its budget—the primary instrument of expenditure management—and of its Treasury, which is responsible for the financial management of government operations. Budget design, preparation, and execution are all important elements of expenditure control.

- *Design.* The budget should be (i) comprehensive—hidden off-budget outlays reduce the effectiveness of budgetary policy; (ii) realistic—based on a solid macroframework; (iii) fully financed—based on expenditure policies that are genuinely consistent with reasonable revenue projections and financing provisions; and (iv) forward-looking—taking into account future costs, as well as immediate expenses.

- *Preparation.* The review of government priorities can often be strengthened through improvements in budget preparation. For instance, budget circulars may require (i) the strict costing of existing policies at existing standards of service; (ii) that no new policy be introduced without identifying offsetting savings and fully evaluating the full year's cost of the policy change for later years; and (iii) that each ministry identify how it would spend any additional specified percentage increase or decrease in its present ceiling.

- *Execution.* Aflexible and responsive execution of the budget is necessary if fiscal policy is to be an effective demand management tool. Needed inputs include (i) a timely and comprehensive monitoring system, which provides early warnings about expenditure pressures, and revenue and financing shortfalls; (ii) an effective cash management system to contain gaps between resources and spending requests; and (iii) a broader financial management function, which projects fiscal needs and coordinates government operations with monetary and balance of payments policies. The organizational structure of these functions differs widely from country to country; however, experience suggests that a strong Treasury can play a decisive role in effective budget management.

The important functions of the Treasury include (i) cash management—the control of all flows to and from government accounts, either directly or through banks; (ii) financial planning—the projection of inflows and resource requirements; (iii) public debt management; and (iv) the control of government financial assets.

- *Avoid across-the-board cuts.* Across-the-board cuts often seem attractive; this approach allows each individual operating ministry to decide how to cut its budget—whether to delay the purchase of goods and services, run down stocks, cut back on temporary staff, etc.;²⁰ and it appears to imply equal hardship for all and is thus seen as equitable. But there is little rationale for assuming that cuts in dissimilar programs (such as education and defense) will have the same economic consequences. An across-the-board approach also has other disadvantages: it can quickly lead to the accumulation of payment arrears; it may add to long-term costs—for instance by postponing maintenance; it avoids the responsibility of looking at priorities; and it can lead to inefficiencies by disturbing work patterns (for example, no gasoline for tax inspection vehicles or ambulances). Last, it defers a more in-depth restructuring that preserves an efficient ratio between personnel, operations, and capital outlays. In the absence of such restructuring, any savings are usually quickly reversed.

- *Identify specific program reductions.* Programs often can and should be dropped, pruned, or consolidated, as economies develop and government priorities change. For instance, free milk distribution may become unnecessary when income levels rise above a certain level. Effective price liberalization can eliminate the need for subsidies. The end of the “cold war” has permitted many military bases to be closed, with associated cutbacks in weapons development. Program elimination usually leads to effective savings, because it requires governments to redefine their priorities and is, therefore, a first step toward the more fundamental expenditure review discussed below. Moreover, program elimination tends to preserve the efficiency of operations elsewhere in the public sector.

- *Cut the public sector wage bill.* Wage restraint in the public sector can be a major source of savings. There is, however, a limit on how far wage standstills, freezes, etc., can be made to operate effectively. Any prolonged disparity between public and private sector wages may result in a loss of high-quality staff, as well as increased risks of moonlighting and corruption. Cutbacks in civil service numbers are often a more appropriate reform, especially since many countries have in the past overexpanded their public services to absorb a growing labor force.

Ceilings on total employment or the specification of downward targets for the wage bill can be enforced through measures such as hiring bans, the elimination of vacant positions, a freeze on staff complements, the cessation of automatic hiring practices (for example, of university graduates),

voluntary and early retirement programs, and reorganization. However, with time, managers can often circumvent such controls. Thus, while such measures can be effective in the short-term, they should be seen as interim substitutes for a deeper review of personnel policies and program staffing needs.

- *Target social programs narrowly.* Transfers can be made more efficient by targeting eligibility and by reducing income replacement rates. Income redistribution programs cannot be used to raise average incomes—rather they seek to ensure that the incomes of targeted individuals do not fall below a minimum income. Means testing is the ideal method of targeting, but is often not possible in countries with limited administrative capacity and a high share of nonwage income. Instead, targeting may be improved by concentrating transfers on identified vulnerable groups (such as pensioners living alone, disabled veterans, or single mothers). Where possible, multiple programs for social protection should be consolidated into more global schemes of income transfers, because there can be significant overlap in entitlements provided by uncoordinated agencies. To the extent possible, price subsidies should be replaced by targeted income transfers, since access to subsidized goods can rarely be confined.

- *Review the capital program.* The capital program has often been a prime target for short-term retrenchment. Postponement of projects not yet begun can save resources with relatively little disruption of day-to-day government operations. However, if a program has an important infrastructure component, its deferral may lead to a lower growth rate and consequent future fiscal costs. Moreover, if capital expenditure is cut by eliminating or slowing down projects already under way, there may be a substantial loss of sunk costs. Hence, capital programs are best cut in the context of an overall public investment review—often possible only as part of a medium-term strategy.

- *Raise fees and charges.* Governments are often reluctant to take actions that will reduce volumes or standards of delivery in high-priority areas like education and health. Hence, savings in these areas may best be achieved by raising cost recovery through an increase in the fees and charges for services. Since the government is a full or near monopoly supplier of many services, it has substantial scope for raising fees and charges, subject to social and political considerations. In general, where the government provides services, its broad objective should be to cover

costs: activities that generate profit could probably be privatized (and, if necessary, regulated); and, conversely, any subsidy element built into the charges to protect poorer groups could better be provided transparently by targeted income support.

- *Seek least-cost debt service.* The interest bill is often the most inflexible component of expenditure. Moreover, when it is large, shocks to the terms of debt service can seriously destabilize the budget. Experience suggests several rules of thumb. Where possible, governments should avoid indexing domestic debt service either to the price level or to a foreign currency. Appropriate compensation should rather be provided by a market-based domestic interest rate and credibility established by a prudent fiscal stance. The currency composition of foreign borrowing should, to the extent feasible, correspond to the composition of export and other external receipts in order to minimize exchange risks. More generally, governments should aim to borrow abroad in currencies that do not fluctuate widely vis-à-vis the domestic currency, and should actively monitor and manage their portfolios to avoid incurring higher-than-market interest or exchange costs. Finally, governments should try to avoid guaranteeing nongovernment borrowing, since it creates incentives for default; when access to necessary foreign borrowing would be impossible in the absence of a government guarantee, the criteria for granting guarantees should be transparent and based on an objective assessment of the recipient's ability to repay.

- *Reform public enterprises.* Public enterprises should, in general, not be a drain on the budget. If they are in deficit, pricing structures should be adjusted, the scope of activities redefined, their employment policy reassessed, and their capital program rationalized. Preferably, they should be privatized and fully exposed to a competitive market environment.

Structural Public Expenditure Reform

Fundamental structural reform requires consideration of basic questions on the need for different government activities, the appropriateness of their provision in the public sector, the importance of their provision by public institutions (as opposed to contracting out), and the possibility of introducing a market framework for their provision, even when public institutions are responsible for delivery. For activities selected to remain in the public sector, specific objectives need to be set, desired outputs

quantified (where possible), inputs determined, and managerial freedom given to pursue the most efficient delivery of services.

The tools for expenditure rationalization are long established, but growing in sophistication—particularly in a relatively small number of OECD countries. They include program- and zero-based budgeting, “value-for-money” audits, fundamental reviews, etc., which are being increasingly used to require ministries to demonstrate the need for individual programs and to evaluate the efficiency of service delivery.

Certain requirements are key: the assessment should start from a zero base—questions must be posed about why an activity is being undertaken, rather than just about the standards and efficiency of the current service; the evaluation must be patently objective, which requires either an external review, for instance by value-for-money auditors, or a review by central (independent) ministry officials; and it should likewise be comprehensive so that no ministry escapes review over time. Finally, the government’s long-term commitment to a reform and review process needs to be clear.

A comprehensive review might generate the following types of reforms:

- The elimination of unproductive or very low-priority services.
- Privatization of activities that can, and should, be carried out in the private sector.
- The introduction of a more commercial approach to public activities, including: competitive tendering, the contracting out of some services to the private sector, and the use of commercial accounting techniques to set the basis for full cost recovery.
- The wider use of improved accounting techniques, not just by presenting accounts on a commercial basis where appropriate, but also by using balance sheets to improve the analysis of the long-term implications of existing and new expenditures.
- The simulation of market discipline, including separate assessment of its application to the government’s role as purchaser and provider of services (for example, in health care).
- For those services that are to remain in the public sector, measures designed to improve managerial performance, efficiency, and effectiveness, including establishing cost centers—which combine under a unified management the costing of interlinked activities; setting objectives, output requirements, and inputs for each center; more devolved managerial authority for the centers; and the linking of managers’ salaries to performance.

Endnotes

Introduction

1. More precisely, the IMF has a mandate under its Articles of Agreement to “exercise firm surveillance over the exchange rate of members” and to adopt “specific principles for the guidance of all members with respect to those policies.” The IMF carries out this mandate by examining international monetary issues and by analyzing all aspects of member countries’ macroeconomic and related structural policies, since these policies, taken together, have important implications for the exchange system.

2. For a description of Fund facilities and conditionality, see International Monetary Fund (August 1994).

Why May Fiscal Adjustment Be Needed?

3. This means that the government obtains resources at the expense of the reduced purchasing power of those with fixed nominal assets or incomes. As such persons are often among the poorer groups in society, the inflation tax is usually a highly inequitable means of financing government activities.

4. Similarly, a fiscal surplus must have a counterpart in the domestic private sector’s investment-savings balance and/or in an external current account surplus.

5. The term growth is used in this section to refer to longer-term increases in output that reflect increases in aggregate supply.

How Should the Fiscal Stance Be Assessed?

6. See International Monetary Fund (1986, pp. 106–108). The Manual uses the term “lending minus repayments” rather than “net lending.”

7. The demand effects of deficits financed by debt issuance may, to a limited extent, be offset by increases in private sector savings in anticipation of future taxation to finance debt service.

8. If nominal interest rates on government debt are not greater than nominal GDP growth, a primary surplus will imply that the share of government debt in GDP will fall.

9. In its World Economic Outlook exercise, the IMF also provides an estimate of the *fiscal impulse*, the initial stimulus to aggregate demand arising from fiscal policy from whatever source, whether discretionary or otherwise, during a given period.

10. This indicator has been criticized for imparting an inflationary bias to fiscal policy, since unexpected inflation may reduce the inflation-adjusted deficit substantially. Moreover, it assumes that bondholders will save 100 percent of the inflationary component of their nominal interest earnings. While flawed, the operational deficit concept is a useful complementary indicator of fiscal policy in a high inflation rate environment.

11. A further illustration of partial approaches would be the exclusion of the surplus of a public pension fund that did not operate on a pay-as-you-go (PAYG) basis and accumulated funds from contributors in excess of payouts to current retirees when assessing the sustainability of the central government's deficit.

12. These issues are addressed in some detail. See International Monetary Fund, (1986, pp. 106–108).

13. Even when expenditure is measured on a commitments basis, revenue is normally calculated on the basis of actual receipts. The reason is that estimates of unpaid tax liability are usually much higher than the amount that will actually be collected.

14. Arrears are usually defined as payments which have been overdue for a period greater than the lag normally associated with a country's payments process. There may sometimes also be a significant increase in budgetary commitments that, while not having yet given rise to arrears, may still lead to a divergence between the magnitude of recorded outlays on a cash and commitments basis.

15. Net lending (above the line) includes only transactions in debt and equity claims undertaken for purposes of public policy, rather than for liquidity management.

16. Since government investment outlays generate physical assets, inclusion of the acquisition of such financial assets above the line contributes to a uniformity of treatment with regard to asset acquisition.

How Much Fiscal Adjustment Is Required?

17. Analogous factors will affect the required amount of fiscal stimulus in countries where an increase in the deficit (or reduction in the surplus) is in order. However, in this case the emphasis is likely to be on the strength of the underlying fiscal and public debt position, the needed stimulus in domestic demand, and the desired adjustment in the external current account surplus.

How Should Fiscal Adjustment Be Effected?

18. Comparable decisions have to be made by countries undertaking fiscal stimulus. Factors influencing the choice of measures should include, inter alia: the effects of different tax and spending measures on private sector demand (for example, tax cuts are liable to have greater impact on modifying the expenditure decisions of households if they are viewed as permanent); the productivity of proposed increases in government spending; and the likely difficulty of reversing the stimulus measures in the event of the need for future fiscal consolidation.

19. The more general issues of the impact of fiscal and other adjustment policies on income distribution were presented at a conference on "Income Distribution and Growth," held at the IMF, Washington, June 1–2, 1995.

20. Squeezing of cash limits is an extreme variant of an across-the-board approach. It is often applied by deliberate underprovisioning for inflation in setting annual budget ceilings.

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