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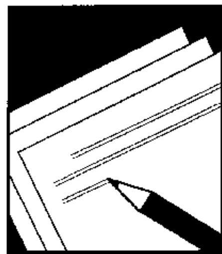

IMF Policy Discussion Paper

Considering the IMF's Perspective on a "Sound Fiscal Policy"

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Abstract

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This paper provides a perspective on how the IMF assesses a "sound fiscal policy," focusing principally on industrial and emerging market economies. It observes six central criteria: the short-term fiscal policy stance, with greater emphasis on automatic stabilizers than discretionary fiscal policy; relevance of medium- and sometimes long-term issues; fiscal sustainability; capacity for aggregate fiscal policy implementation (including political economy factors); structural content of fiscal policy (tax efficiency and public expenditure quality); and institutional, governance, and process issues associated with budget implementation and revenue collection. Greater emphasis could be placed on an adequate margin to deal with uncertain long-term challenges.

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I. Introduction

This paper examines how the International Monetary Fund (IMF) has assessed, in recent years, what would constitute a "sound fiscal policy." The focus is principally on the issues that influence the consideration of fiscal policy for industrial and emerging market economies. Most of these issues are also, in principle, relevant to the IMF's approach to fiscal policy analysis in its less developed and transitional economy members. However, for these latter countries, the IMF's involvement with fiscal policy is operationally intertwined with its adjustment program efforts in working with country officials to implement policies to foster macroeconomic stability, promote a growth-supportive environment, and achieve progress in poverty reduction and structural transformation. In such countries, fiscal policy options are typically fewer, reflecting more severe financial constraints and macroeconomic absorptive capacity constraints, so that fiscal policy formulation largely revolves around the availability of nonmonetary and monetary financing in the context of an overall macroeconomic and financial programming framework. And implementation issues are more difficult—reflecting limitations of data and weak administrative and fiscal management capacity.[1] The paper also does not address the complex issues associated with setting the fiscal policy stance in the midst of a capital account crisis.

One should emphasize at the outset that the IMF's characterization of what constitutes a sound fiscal policy in one country will differ from that in another, though this point is not often well recognized by critics of the IMF. This is more than a question of the basic characteristics of a country's economy; its level of development; whether it is at peak output or in a recession; whether there is inflation or deflation; and whether its external position is sustainable or not. A number of other considerations would also be brought to bear, including the nature of its monetary or exchange rate policy regime that prevails; whether the capital market is open or closed; whether the expenditure and tax structure is supportive of economic

[1] A synthesis of the IMF's approach to assessing fiscal policies in the context of adjustment is contained in International Monetary Fund (1996b).

growth or not; the historical legacy of past fiscal policies (for example, the amount of outstanding public debt); and the factors likely to influence the future fiscal situation.

The IMF's perspective would also be influenced by the quality and transparency of a country's fiscal institutions and governance structure, its budget processes, and its budget data; by its understanding of the probable reaction by a country's citizens to a change in tax or expenditure policies; and by its perception of how external creditors assess the risk premium for sovereign lending to the country.

In other words, while there may be many commonalities in the IMF's approach to fiscal policy, there are also many differences between the issues that receive prominence among countries. In what follows, this paper seeks to describe the principal criteria that the IMF uses in assessing the soundness of a country's fiscal policy in the context of surveillance (recognizing, of course, that the formulation and implementation of fiscal policy is the clear responsibility of country authorities). Three important caveats should be mentioned. First, the IMF does not have a monopoly of expertise in terms of its understanding of the role of fiscal policy. While the IMF has certainly contributed to the literature on the economic and financial impact of fiscal policy, it is not its own insights that principally distinguish the IMF's perspective. The IMF is clearly a user of the body of theoretical and empirical analysis that has been elaborated over the last half-century— by Keynes, Musgrave, Lindbeck, Barro, Auerbach, Blanchard, Buiter, Alesina, Sandmo, Sinn, Tanzi, and others—and thus much of its views are likely to be seen as in the mainstream of conventional wisdom on fiscal policy.

Where it has, perhaps, a comparative advantage is in the accumulation of first-hand, in-depth experience with the operational issues of fiscal policy formulation and implementation in many countries over many years. That cross-country, practical perspective is of considerable value. It has led the IMF, in its appraisal of a country's fiscal policy, to focus on many detailed issues that might not normally have been addressed within that country. It has also meant that the IMF, from its longstanding multicountry experience, is very much aware of the risks and consequences of not erring on the side of fiscal caution or, indeed, of pursuing *unsound* fiscal policies. Often countries may be forced to undertake procyclical fiscal

corrections that could have been avoided if earlier policies had been more risk-averse and more mindful of issues of fiscal sustainability over the medium-to-long term.

Second, IMF economists, as individuals, have written many research papers on fiscal policy that have addressed many issues in fiscal policy formulation. Yet it would be misleading to look to these contributions in characterizing the actual approach of the IMF, as an institution, in its interactions with countries. For this, one would wish to examine how the IMF, in its official country papers and its dialogue with countries, judges a sound fiscal policy. Thus, in preparing this paper, an inductive approach has principally been used, drawing in part on the Public Information Notices (PINs) of the Executive Board related to the economic policies of a number of countries over the last three years, the concluding statements made by IMF missions following their annual surveillance of a country's economy (the so-called Article IV consultation missions), and from the staff appraisals of IMF consultation mission reports.[2] All these references are publicly available on the IMF's website.

Even these formal "appraisals" need to be seasoned by the recognition that the IMF, while conscious of the importance of providing a realistic and frank assessment, is nevertheless aware of the sensitivity of its members to public criticism by the IMF. In the words of the former Director of the IMF's Research Department, Michael Mussa, "even the industrial countries that no longer expect to make much use of financial support from the IMF, do not usually appreciate criticism, especially public criticism, of their policies."[3] So in capturing the IMF's views on a sound fiscal framework, it is important to be aware of the nuances in

[2] From the IMF's public website, PINs, Article IV Consultation Staff Reports, or Concluding Statements were obtained for the following countries with respect to the year noted in parentheses: Austria (2001), Belgium (2001), Brazil (2002), Canada (2001), the Czech Republic (2001), Denmark (2002), the Euro Area (2001), Finland (2001), France (2001), Germany (2001), Greece (2001), India (2001), Italy (2001), Japan (2001), Korea (2001), Lithuania (2001), Luxembourg (2002), Malaysia (2001), Mexico (2001), the Netherlands (2002), New Zealand (2001), Norway (2001), the People's Republic of China (2001), Poland (2002), Singapore (2000), the Slovak Republic (2001), South Africa (2001), Spain (2001), Sweden (2001), Switzerland (2002), Thailand (2001), Tunisia (2001), the United Kingdom (2001), and the United States of America (2001).

[3] Mussa (2002), p. 37.

the public assessments of the IMF. The author's perspective is also informed by his experience over more than two decades in the IMF's Fiscal Affairs Department.

Third, the characterization of what constitutes a sound fiscal policy which emerges in this paper reflects an idealized "best practices" view, pulling together a perspective that is neither realized in any one country nor advocated comprehensively by the IMF in all of its Article IV discussions (which inevitably focus on the key priorities for policy attention and medium-term reform facing a country). Thus, while many countries may be pursuing sound fiscal policies in the eyes of the IMF, they nevertheless have scope to make further improvements.

II. Common Elements of a Sound Fiscal Policy

In order to illustrate some of the common themes that emerge in IMF assessments of fiscal policy, it is useful to begin by citing some recent elements of the Concluding Statement by the IMF's mission team in the recent Article IV consultation mission to one of its industrial country members—Denmark—in January 2002.

- "The government's stated intention to maintain a broadly neutral budget in 2002 is appropriate. Neutrality is interpreted as no significant change in the underlying surplus."
- "Automatic stabilizers should be allowed to operate in the event that economic growth deviates from the projected path for 2002…. [Thus] the surplus could fall below the 2 percent of GDP floor of the medium-term target…This would not by itself be a cause for alarm, but it could mean that some tightening of fiscal policy will be necessary after this year to keep the surplus within the targeted range if the loss in pension yield tax receipts prove more permanent."
- "Denmark is setting an admirable example internationally by its forward-looking fiscal policy. To meet the challenges of an ageing population and the associated longer-term strains on the welfare system, Denmark has been running sizeable

surpluses and paying down the public debt. Targeting surpluses of 2 to 3 percent of GDP through 2010 should continue.

- "To sustain budget surpluses, ...at a minimum, the target for real public consumption growth of 1 percent a year should be observed... But there is a need to find additional control mechanisms."
- "The high tax burden is at best not conducive to increasing labor supply and could become a constraint on economic growth...[it] may not be sustainable in the face of tax competition from abroad...there is a good case for building more room into medium term plans for tax cuts."
- "Meeting a more stringent expenditure target while accommodating higher spending in priority areas would require a critical review of other areas, including social spending, where spending is relatively high by international standards."
- "Welfare traps are not solely an immigrant issue and should be addressed through a general review of the structure of benefits."
- "Denmark has an outstanding record in providing assistance to developing countries of about 1 percent of GDP. It is hoped that this record is maintained and that ODA is exempted from efforts to meet public spending restraint targets."

In a nutshell, these citations illustrate many of the elements that characterize the IMF's perspective on a sound fiscal policy. One observes a Keynesian perspective on how fiscal policy can influence economic activity, including acceptance of the role of automatic stabilizers; attention to issues of long-term sustainability and of the importance of placing fiscal policy in a medium-term framework; recognition of the longer-term factors influencing the economy; a political economy perspective on the difficulties of limiting fiscal aggregates; acknowledgement of the importance of the allocative and thus the growth effects of specific expenditure and tax policies; a cross-country perspective on a country's fiscal parameters;

and finally, acknowledgement of Denmark's contribution to global welfare through its ODA contributions.

More generally, one can observe six central threads in the IMF's view on what constitutes a sound fiscal policy fabric: its approach to assessing the short-term fiscal policy stance; the attention paid to medium and sometimes long-term issues; a focus on sustainability; recognition of the factors determining the successful implementation of a desired aggregate fiscal policy stance (including political economy matters); the importance placed on the structural content of fiscal policies (the efficiency of the tax system and quality of public expenditures); and finally, the relevance of institutional, governance, and process issues associated with the implementation of a budget and the collection of government revenues.

1. **Pursuing an appropriate short-term fiscal policy stance.** The IMF's perspective on a country's short-term fiscal policy stance inevitably derives from a careful assessment by the IMF staff of a number of factors, all of which should be obvious to any seasoned macroeconomist.[4] The starting point for any assessment should be a clear and comprehensive assessment of what the present fiscal stance is, taking account of various current fiscal indicators—the overall balance, the primary balance, the structural or cyclically neutral balance, and in some cases, the operational balance (for high-inflation countries)—as well as the net debt or asset position of the government. The term "comprehensive" is used in recognition that an adequate assessment needs to consider not only the position of the central government, but also that of sub federal levels of government, extra budgetary agencies, and public sector enterprises (to the extent that they are engaged in non-commercial activities that could be considered as quasi-fiscal activities of the government).[5]

[4] This is laid out in International Monetary Fund (1996b).

[5] The choice of indicators to assess would depend on what would appear appropriate. Thus, the operational balance would not normally be estimated in the case of a low or even moderate inflation economy. The assessment of the fiscal stance is also sometimes hampered by the availability and quality of data, particularly for less developed countries.

With the objectives of growth and macroeconomic stability dominating the IMF's objective function, the appropriateness of the fiscal stance—whether expansionary or contractionary—then needs to be considered in light of both the current macroeconomic situation (the stage of the cycle, the nature of any exogenous factors impinging on the economy, the global economic situation) and the nature of the macroeconomic policy regime (fixed or flexible exchange rates; open or closed capital market; monetary policy regime, all of which would influence the size of any theoretical multiplier effect).[6] The feasibility and potential macroeconomic effects of financing a fiscal imbalance from domestic and external sources may temper a decision to use fiscal policy to stimulate the economy. Crowding-out concerns particularly weigh in with respect to the domestic economy; vulnerability and long-term sustainability concerns, while also potentially of concern with respect to domestic financing, are particularly sensitive considerations when external financing is being considered.[7]

The potential macroeconomic impact from the use of fiscal policy instruments is an equally obvious and important consideration: if there is a strong belief that potential offsetting reactions (e.g., Ricardian equivalence effects or a rise in the external debt premium) or low or negative multipliers are likely, this would qualify any policy judgment. And lastly, what may

[6] IMF economists certainly start with the standard macroeconomic policy framework which emerged with Keynes and which was elaborated by Mundell and Flemming in addressing the role of aggregate fiscal policy in an open economy. Thus, the effect of fiscal policy will be more moderate in a relatively open economy, where the potential multiplier leakages are greater, than in an economy where trade is a relatively small part of the overall economy. The exchange rate regime matters in terms of the potential impact of fiscal policy, with the recognition that fiscal policy is likely to have a more significant impact on domestic economic aggregates in a fixed rather than a flexible regime. The extent to which the monetary policy regime accommodates an expansionary fiscal policy, as opposed to forcing interest rates to adjust to crowd out private sector demand, will influence the size of the likely Keynesian multipliers one would observe.

[7] In assessing the fiscal policy of a specific country, IMF economists are likely to draw on both the existing empirical literature on fiscal policy effectiveness, and more specifically, on any country-specific empirical studies that have been undertaken on the country in question, whether by the country authorities, academics, or other international agencies. Often as background for carrying out an Article IV consultation, the IMF staff may undertake its own empirical analysis for the country (which, if sufficiently formalized, would be presented as an study supplementary to the Article IV consultation staff report). The IMF staff would also be expected to put together as comprehensive a picture as possible of the fiscal situation, including a judgment on any contingent risks or potential fiscal commitments not taken into account in the formal budget.

be an appropriate short-term fiscal response may be inappropriate if it may exacerbate concerns for the long-term sustainability of a country's fiscal policy (e.g., if there is a high burden of public debt, and relevant borrowing rates are significantly above projected potential growth rates).

Obviously, the key operational issue is whether a government's fiscal policy stance, as measured, is appropriate. Should the budget balance be increased, decreased, or left unchanged, relative to that proposed by the authorities? As with the profession in general, the IMF has long accepted the importance of separating out the underlying structural budget balance from the fiscal effects that are a consequence of the stage of the business cycle. In recent years, the IMF has also clearly signalled the importance of "letting automatic stabilizers work" (both on the revenue and expenditure side). Rare is the IMF Article IV document for an industrial country that does not accept the fact that in a period of economic slowdown, one should accommodate the higher fiscal deficit and not seek to achieve annual balance budget targets that may risk being pro-cyclical. This argument has, in some European countries, been extended to include the cautionary emphasis that even pay-as-you-go social insurance funds may give rise to pro-cyclical effects. Two qualifications can be noted with respect to the advice on automatic stabilizers.

First, the emphasis has principally been on allowing revenue stabilizers to operate, these being inherently larger than expenditure stabilizers (given progressive tax systems, and the more limited elements of public expenditure responsive to changes in output). In a number of countries, the IMF has argued that aggregate expenditure policy should be set according to medium-term targets, rather than allowing them to be significantly higher (lower) in weak (boom) periods. Indeed, one often sees the IMF expressing concern that countries should be cautious, in boom periods, not to allow expenditures to creep up as a consequence of the much higher revenue that may build up over and above what would be attributed to cyclical factors. This reflects a concern that higher expenditure shares may be more difficult to trim once an economy slows again.

The second qualification is that "automatic stabilizers" are likely to be far more relevant in industrial economies, particularly with respect to the sensitivity of revenues to cyclical fluctuations in output.[8] They are less significant quantitatively in emerging market and developing countries, particularly for expenditures (given the absence of developed unemployment insurance programs). The definition of an automatic stabilizer is less obvious in such cases where, in a formal sense, it may require discretionary policy actions to ensure the same effective "cyclical" response that, in an industrial economy, would happen automatically as a consequence of legislatively embedded social insurance or tax policy legislation.[9]

In contrast to the position on automatic stabilizers, the IMF appears to be more cautious with respect to the active use of discretionary fiscal policy to stimulate an economy, particularly in the industrial economy context. While it has supported their use in the case of the US and Japanese economies, one finds only tepid support in the IMF's recommendations for active discretionary policy in the case of the European industrial economies.

Three arguments support this position in general. First, active use of discretionary fiscal policy may prove difficult to time appropriately, reflecting the lag that may emerge between the decision to impart a stimulus and the actual passage of legislation and the implementation of the policies that would give rise to it. The fiscal policy stimulus may thus prove poorly timed, possibly coming after the economy has come out of a recession; conversely, the consolidation may come on the heels of the economy already being in a trough.

Second, even in the more general case of an insufficiency of demand, the empirical evidence suggests that discretionary fiscal policy is likely to have only a modest impact, with multipliers fairly small in size and principally influenced by the source of the fiscal

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[8] It is often more difficult to identify a discrete cycle in developing countries.

[9] Thus, during the Asian crisis, there was a recognition that beyond being sensitive to output fluctuations, one needed to take account of the reaction of fiscal variables over the cycle to changes in key price variables (the exchange rate, inflation, interest rates, and commodity prices), and to policy changes that probably should not be considered as discretionary (e.g., adjustments to maintain real wages in the face of significant inflation). See Lane and others (1999).

stimulus—whether from the tax or expenditure side (and also influenced by the type of expenditure or tax policy used) (see Hemming and others, 2002). But the positive effect on economic activity is not likely to be large in most cases, and even this is subject to considerable uncertainty. Even with respect to the same type of fiscal instrument, one may observe different effects across countries. Thus, in Japan, the IMF is currently arguing that investment outlays have a far weaker multiplier effect than transfers; an opposite position has been taken in other countries. Also, even though expenditure multipliers tend to be larger than revenue multipliers, the IMF tends to be cautious on the use of the former, given the difficulty of cutting back on expenditure programs once they are established. Third, active use of discretionary fiscal policy would be inappropriate if there is uncertainty as to whether an economy's weakness stems from structural supply-side rather than demand-side factors.

There have also been some cases where fiscal policy multipliers have been *negative*. Enough experience has been gleaned from episodes of an "expansionary fiscal contraction" to at least make the IMF sensitive to the underlying conditions (high debt/GDP ratios, external perceptions of unsustainability, etc.) which can give rise to such a contrary reaction (see International Monetary Fund (1996a), Hemming and others, 2000). The IMF has equally taken on board the possibility that private sector reactions may temper the impact of fiscal policy, though the strength of Barro or Ricardian equivalence type reactions is not likely to be very strong. In a few instances, the IMF's analysis of a fiscal policy initiative has been to caution that the private sector reaction may be offsetting (notably in the case of some recent industrial country tax reduction initiatives).

This last insight on negative multipliers is important even to the extent that they are not seen as very likely. For it suggests that for countries with access to external financing, perceptions of long-term fiscal sustainability can influence the size of the risk premium attached to a country's sovereign borrowing efforts. Thus, the possible scope for using debt-financed fiscal policy to provide a stimulus to the economy, or even as a means of financing public investment may be limited by the vicious circles that can arise if interest rate premia start rising as a consequence of a high public debt burden. The latter may also affect the capacity

of a country to manage its public debt flexibly, limiting the scope for extending debt maturities at low cost.

Thus, the arguments for using fiscal policy to provide a stimulus need to be clearly articulated, preferably with empirical backing. One such argument reflects the fact that where automatic stabilizers tend to be smaller (e.g., in the United States and Japan, reflecting a lower overall tax ratio in GDP), there is more support for the use of discretionary policy than where they are larger (the Nordic countries and Western Europe). Another argument that has been used has reflected a concern for the difficulties that a weak or even declining economy can have in terms of realizing long-term fiscal sustainability. One such case has been Japan. Despite a high public debt burden and concerns for the burden of implicit and explicit public debt liabilities, the IMF has supported a modest fiscal stimulus, albeit within the framework of an eventual medium-term fiscal consolidation.

The reasons appear two fold. First, without positive real growth, it would be difficult to envisage Japan's fiscal position becoming ultimately sustainable. Any gains to be achieved by short-term fiscal consolidation in terms of reduced debt would be offset by the likely effect of a contractionary fiscal position worsening the prospects for real growth (and thus of the debt to GDP ratio). Second, given the size of the Japanese economy, weak or negative growth could be damaging, both for the prospects of a still recovering East Asian region, and more recently with the softening of the global economy.

In like manner, the IMF has recognized the role that a supportive fiscal policy could play in a number of East Asian economies (within the bounds of maintaining a reasonable external position). Since 1998, the IMF has often expressed concern that precipitous fiscal consolidation might have an adverse effect on weak corporate and financial sectors. Thus, in recent years, the IMF has cautioned Korea that its tendency to over-perform on fiscal policy targets has imparted a contractionary impulse to the economy.

The cases of Japan and Korea also illustrate one of the many difficult trade-offs—and potential controversies with country authorities and outside commentators—that can arise in

balancing the desirability of short-term fiscal stimulus with longer-term considerations of sustainability in the formulation of fiscal policy. Other sources of tension in appraising the fiscal policy stance can emerge. For example, the IMF may differ with a country as to the likelihood that an expansionary fiscal policy may give rise to the emergence of widened risk premia in its debt financing. As another example, in recent years, critics have argued that the IMF has been too cautious in not allowing much larger external aid-financed fiscal deficits or even monetary-financed deficits that may give rise to some limited degree of inflation. The IMF has cautioned that estimates of external aid (ODA) often prove optimistic, or that ODA that is not matched by higher imports may lead to expansionary pressures that can result in an excessive real appreciation of the exchange rate, either through inflation or nominal appreciation. This could weaken the prospect of export industries and raise the spectre of inflation (both of which are adverse to growth and the welfare of the poor). Similar issues have arisen in a number of countries where strong fiscal positions have derived from a drawing down of natural resource assets (e.g., in oil rich economies).

2. **Placing fiscal policy in a medium-term framework, and with an eye to the long-term.** In the context of IMF-supported programs, IMF economists typically seek to place fiscal policy in the context of a medium-term framework, reflecting that fiscal sustainability is directly linked with external viability in many developing countries. Increasingly, this focus has also been emphasized in industrial and emerging market economies, complementing the emphasis on automatic stabilizers. The goal is to ensure that short-term cyclical fluctuations in the fiscal balance—the reliance on automatic stabilizers—do not detract from the appropriate fiscal policy trajectory over the medium term. That trajectory should be keyed to whatever would appear to be the appropriate objectives for fiscal policy, which may need to take account of potential longer-term developments or of a concern for sustainability. In some cases, those objectives may be reflected in specific fiscal rules that set the targets operative over the medium term.

The IMF's focus on a medium-term fiscal framework is also linked to its recognition that long-run factors, particularly the aging of industrial country populations, is likely to pose serious threats to long-term fiscal sustainability, given the extensiveness of social insurance

commitments. Rare is the Article IV consultation report for an industrial country without a reference to "ensuring high living standards over the long run" or the need to "address long term demographic pressures." As noted below, these issues weigh heavily in the IMF's judgment as to what should be the objectives in terms of the targeted budget balance.

It is worth noting that the IMF's focus tends to be significantly more long-term oriented than that of most governments, with IMF economists viewing the value of measures more in terms of their long-term impact, whereas some policy makers are more interested in the short-term impact. This focus on the long term also has implications on the role of the IMF for advanced and emerging economies. In some of the emerging economies, the IMF provides the long-term analysis to the governments, and thus improves their ability to focus on the longer term. In the more advanced economies, the value added by the IMF is less in providing the analysis, which is often done better by the governments or the private sector, than in helping to focus the nature of the public debate.

Finally, it is worth mentioning that there is another motivation for the IMF's emphasis on placing fiscal policy in a medium term framework. Beyond providing a mechanism for promoting the realization of aggregate targets, such a framework can serve an important allocative and institutionally disciplining role as well. Anchoring annual budgets within an aggregate, multiyear framework can thus allow for the sorting out of priorities among competing budgetary objectives as well as facilitating consideration of intertemporal budgetary tradeoffs (a point made by Christou and Daseking (2002)).

3. **An emphasis on fiscal sustainability.** The capital market crises of the last few years have led the IMF to put increasing emphasis on countries addressing sources of external vulnerability. One source would be a perceived lack of fiscal sustainability. Besides the obvious risks of default and macroeconomic instability, an unsustainable fiscal position exposes a country to other potential risks and costs. Its capacity to use fiscal policy as a counter-cyclical instrument would be weakened; its access to external financing may be subject to high-risk premia; and its ability to attract potential foreign investors would be impaired. Thus, this issue is increasingly intrinsic to the IMF's judgment of fiscal soundness.

There is as much art as science in the discernment of fiscal sustainability (see Cheasty and others, 2002). Obviously, one starts with an assessment of a country's explicit public debt burden (both its size and the terms of its debt service) and its likely dynamics over the medium to long term. Estimating the former requires a broad perspective, taking account of the debts not only of the central government but of regional and local authorities and conceivably public enterprises, given that central governments may find that defaults by these entities lead to pressures to absorb some of these debts. The IMF would also recognize the strength of a country's net asset position in considering sustainability, whether in terms of its holdings of financial assets or in reasonably proven reserves of natural resources.

The likely dynamics of a government's debt relates in part to the expected fiscal policy stance over time, but this will be heavily influenced both by underlying policy commitments (particularly in the social insurance sphere), by potential contingent fiscal liabilities (e.g., explicit and implicit guarantees by the government with respect to the financial sector), and by assumptions as to what may feasibly be mobilized in additional revenues if needed. If an aging population were likely to result in a significant increase in the overall expenditure share, an explicit balanced budget target would require a higher tax share. The political feasibility of such burdens would need to be realistically considered in assessing the viability of the budget target and the associated assumptions about a likely debt path. The dynamics of government debt will also be influenced by the expected cost of servicing the debt, and this itself would be influenced by the market's perceptions of fiscal sustainability. The IMF would thus expect realism in a government's assumptions on growth and interest rates.

The IMF would also assess the resilience of the fiscal position to potential shocks; whether a country has realistic options in the financing of its debt, whether from domestic or external sources; whether the assumptions on the underlying fiscal policy regime for specific expenditures and revenues appear consistent with the overall policy stance being targeted; and whether the assumptions underlying the projected elasticities for revenue and expenditure appear plausible.

Beyond the obvious cases where a forecast for a country's fiscal position would appear unsustainable, the IMF has never formally taken a position that there is one explicit level of the debt burden that should be construed as excessive. But once explicit debt-to-GDP ratios appear to be on an upward trajectory and particularly once they start exceeding 60, concerns are generally raised. In the case of most European countries, the IMF has been supportive of the idea of targets being set under the Maastricht Treaty and the Stability and Growth Pact (SGP). Although the original motivation of the SGP was grounded in concerns for ensuring macroeconomic stability within the Euro zone, an important additional benefit from targets of balanced or surplus budgets was that it would lead to a reduction in both the nominal size of the debt burden and the ratio of debt to GDP. This would create room over the long term to finance projected social insurance commitments in the context of aging populations. A similar fiscal policy stance appears to be guiding other non-Euro based, EU countries as well as the U.S., Canada, and Japan.

4. **Having the capacity to ensure the successful implementation of a country's fiscal policy objectives.** Having set its fiscal policy objectives, governments should have a demonstrated capacity—analytically, legislatively, and institutionally—to coordinate, manage, and implement aggregate fiscal policy to achieve them.

- **Analytically, a government should be working with an accurate picture of its fiscal situation.** As noted earlier, this requires that governments, in their fiscal analyses, use a comprehensive measure of the government sector.[10] This is particularly critical in situations where local or regional government entities have sufficient autonomy that they can pursue policies that may undercut the fiscal policy objectives of the central government. It is also germane when public enterprises are being used to pursue public policy objectives through quasi-fiscal activities and in the process, are increasing the public sector borrowing requirement or creating potentially costly contingent public liabilities. Likewise, the IMF has encouraged governments to strengthen their accounting of government transactions to facilitate

[10] This is frequently the case and explains why the IMF definition of the deficit is more comprehensive than the government's.

both an assessment of the impact of fiscal variables on the aggregate economy, while also providing a clearer picture of a government's economic position.[11] Thus the IMF has strongly supported recent moves to revise the methodology underlying its Government Finance Statistics to allow for an accounting framework consistent with that used in the estimation of the National Accounts. This requires a presentation of the government's operating balance on an accrual as well as on a cash basis, as well as a balance sheet and net worth statement.[12]

- **Also analytically, the IMF would expect a government to have a realistic understanding of the factors (e.g., the aggregate price level and interest rates, key commodity prices, aggregate economic activity, imports and exports, demographic variables, etc.) that determine the dynamics of key fiscal variables.** There is much uncertainty in these relationships; even in the United States, budget analysts have significantly underestimated revenues. Issues of uncertainty are magnified when one seeks to assess the financial impact of changes in tax and expenditure policies, reflecting the difficulty of fully knowing the likely reaction of private agents to policy changes. But to pursue a sound fiscal policy requires that a government has a reasonable capacity to understand the factors that influence the fiscal outcome in the absence of policy interventions, and to formulate a well-calibrated response appropriate to the policy objectives. Governments also should assess the relative likelihood and implications of alternative fiscal scenarios.

- **Governments should have the capacity, within the framework of budgetary legislation, to intervene in a flexible and timely manner to influence the broad fiscal aggregates and in particular, to correct deviations as they may emerge.** Mechanisms should be available to deal with unexpected outcomes. Governments need to be able to move quickly to curtail or expand expenditures or adjust tax rates.

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[11] This would also include a quantification of tax expenditures and contingent liabilities in the budget.

[12] See the revised Government Finance Statistics Manual, International Monetary Fund (2001).

At times, the IMF has argued that beyond this, countries may need to introduce institutional mechanisms to ensure that overall budgetary discipline is imposed on all fiscal entities (e.g., setting limits on the fiscal operation of sub Federal entities).

- **Increasingly, the IMF has recognized that institutional "rules" can play an important role in the achievement of broad fiscal policy objectives.** Political economy factors can often undermine well-thought out policies. Various institutional rules and mechanisms—aggregate fiscal policy rules, use of trust funds, expenditure ceilings and targets, earmarking, and international peer group surveillance—have proven useful in a number of cases in limiting the potential for a backsliding on policy commitments that can arise with changes in political regime. Thus, in the context of the EU, the IMF has supported the SGP and the use of specific targets by countries within the context of the SGP; it has also supported the U.K.'s use of a Golden Rule with respect to running a surplus on the operating balance, and with independent limits on the aggregate debt to GDP ratio. But it has also gone beyond that to advocate, in a number of countries, reliance on medium term expenditure ceilings as an additional policy instrument.[13] The intention is to prevent the kind of expenditure creep that can occur in boom situations when revenues over-perform, thus enabling political decision makers to finance higher expenditures consistent with aggregate fiscal policy targets. One interesting example of this is the Budgetary Stability Law recently proposed by Spain, which not only includes aggregate expenditure ceilings but also addresses issues of intergovernmental finance.

5. **The importance of the structural content of fiscal policies.** In its policy advice to countries, the IMF has long realized that one cannot abstain from assessing the *content* of fiscal policy, if the concern is to maximize economic growth, pursue sustainable fiscal policies, or promote poverty reduction and an equitable distribution of income. Even if the narrow objective is simply to achieve budgetary consolidation through expenditure restraint, reliance on across-the-board expenditure cutbacks is unlikely to be sustainable over the

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[13] These may be stated in real or nominal terms or in terms of real growth rates. The IMF has been particularly supportive of such ceilings in the context of a multiyear fiscal framework.

medium term. Although the IMF's influence is greater with respect to macroeconomic aggregates, and less on specific tax or expenditure measures, IMF economists necessarily pay attention to the specifics of a country's expenditure or tax policies, with the focus on considering how to strengthen the efficiency and effectiveness of a country's public expenditure program and to minimize the deadweight efficiency losses associated with the mobilization of tax revenues.

In its discussions with governments, the IMF thus tends to provide policy advice on the desirable thrust for reforms of expenditure policies or tax legislation. In general, it is more likely to abstain from detailed specification of measures (unless a country explicitly seeks technical assistance from the IMF for this purpose).[14] Thus, on the revenue side, while the IMF has no ironclad rule of thumb on the issue of the maximum tax burden that a country should adopt, when faced with the issue of fiscal consolidation, the IMF has had a bias towards expenditure reductions rather than tax increases, particularly for more advanced economies with already high tax rate burdens.[15] Moreover, with a concern to minimize adverse allocative effects and to instill an investment and growth-supportive environment, the IMF often advises countries to both reduce expenditure shares *and* reduce the overall tax burden. It argues for reductions in excessively high marginal tax rates, a broadening of the overall tax base, and preservation, if possible, of relative neutrality in the tax system. Concern for high levels of unemployment may lead the IMF to support policies that reduce excessively generous unemployment benefit schemes that imply high implicit negative tax rates for unemployed workers.

Likewise on the expenditure side, the IMF has emphasized the importance of paring expenditure programs that are relatively unproductive or of achieving higher efficiency in

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[14] The IMF has more expertise on taxation, and thus its recommendations are often more specific regarding taxes than regarding expenditures. In addition, improvements to the expenditure side of the budget are intrinsically more difficult to achieve.

[15] In contrast, in many developing countries, the tax ratio is often so low that necessary public goods cannot be financed. In such cases, the IMF typically emphasizes the importance of revenue mobilization efforts.

spending rather than an increase in the expenditure level. For example, for a number of industrial countries, the IMF has emphasized the importance of reform in sickness and disability programs, cutbacks in public jobs programs, limits on any expansion of employment insurance benefits, reduced employment subsidies, and civil service reforms. In other countries, the focus has been on cutbacks in housing and agricultural subsidies as a means of finding budgetary room to facilitate budget consolidation and a lowered tax burden.

In many countries, a concern for long-term fiscal sustainability (and possible adverse effects on market risk premiums and allocative efficiency) has led the IMF to urge countries to address the potential dynamics of expenditure commitments in the context of aging populations. Recognizing that to be politically viable, such reforms require a long lead time, the IMF has supported pension and health care policy reforms that can forestall the likelihood of future increases in tax or payroll contribution burdens. As an institution, the IMF has no set explicit view on the approach that a country should take in, say, reforming a pension system, e.g., the pros and cons of parametric changes to pay-as-you-go pension systems (changes in replacement rate, rates of indexation, age of eligibility for retirement benefits, etc.) versus a change toward a defined contribution, fully funded system. In its technical assistance advice, it has been supportive of both approaches depending on the country context. In the area of health care reform—unlike pension reform—the IMF has essentially refrained from providing even technical assistance advice, reflecting that it has very little institutional expertise in this area. Rather, its emphasis is on ensuring an adequate assessment of the macroeconomic and financial implications of whatever reform is adopted.

In developing countries and emerging market countries, efforts to pursue fiscal consolidation have often led the IMF to focus on more efficient targeting of subsidies in order to reduce the budgetary cost of generalized subsidies. Equally, the IMF has often advocated expanded outlays on education and health programs in developing countries, recognizing the importance of human capital investments.

6. **The importance of high quality, transparent budget processes, good governance, and a well managed expenditure and revenue administration.** It should be no surprise

that the IMF has long recognized that a sound fiscal policy should be supported by an efficient system for managing public expenditures and collecting revenues. This point is linked to the emphasis on the importance of a government's capacity to implement its fiscal policy intentions, whether in terms of expenditure actions or revenue collections.

But it is important to note that in recent years, the IMF has made a major effort to encourage far greater transparency and good governance in both the presentation of budget data and in the budget process itself. The basis for the IMF's guidance draws from its "Code of Good Practices on Fiscal Transparency." Quoting from the IMF website, the Code:

> "is based around the following key objectives: roles and responsibilities in government should be clear; information on government activities should be provided to the public; budget preparation, execution, and reporting should be undertaken in an open manner; and fiscal information should attain widely accepted standards of data quality and be subject to independent assurances of integrity. The Code sets out what governments should do to meet these objectives in terms of principles and practices. These principles and practices are distilled from the IMF's knowledge of fiscal management practices in member countries... The Code acknowledges diversity across countries in fiscal management systems and in cultural, constitutional, and legal environments, as well as differences across countries in the technical and administrative capacity to improve transparency. Most countries have scope for improvement in some aspects of fiscal transparency covered in the Code."

What is important to emphasize is that the IMF's efforts to promote transparency have not been focused only on developing and emerging market countries. Recent IMF missions have indicated the prevailing weaknesses in budget transparency (both in the quality of the data and in the timeliness of its publication) in some of the largest industrial countries. Particularly for countries where there is no expenditure rule, the IMF has underscored the importance of transparency in accounting procedures, and the importance of regular reporting, monitoring, and assessment of fiscal projections and outturns. Enhanced transparency also facilitates greater congruence between what a comprehensive assessment

of the fiscal picture for a country would show and the capacity of a government to ensure that this comprehensive focus is translated into budgetary action.

The IMF believes that greater transparency will yield important benefits, not only in terms of greater domestic ownership of the budget process, but also in a reduction in the market premia attached in international capital markets to a country's sovereign borrowing.

III. Concluding Thoughts

Are there ways in which the IMF's approach to the assessment of a sound fiscal policy might be strengthened? First, at the most basic level, there is variance in the quality and depth of analysis in the underlying fiscal background work carried out by the IMF. For any country, one would want to be certain that the IMF's fiscal policy advice flows from an understanding of the nature of the institutional fiscal framework and the likely private sector reaction function, in that country, rather than only from experience more generally. Equally, one would want to see that IMF staff indeed derive their assessments from a comprehensive perspective on the overall fiscal position, from coherent and quantified medium-term frameworks, and with long-term sustainability considerations in mind. Achieving best practice is a continuing goal, and one that reflects the nature of the challenging interaction over time between the work of the IMF staff and country authorities.

Second, the IMF will increasingly be challenged to validate its perspective on the magnitude of the macroeconomic absorptive capacity of countries for enhanced external financial assistance. The IMF's concerns about the importance of maintaining macroeconomic stability are appropriate, but there is inevitably much uncertainty, in any country context, about *where* the limits should be placed on the amount of external assistance that is compatible with financial stability.

Third, and harking back to the remarks by Mussa cited earlier, one could question whether the IMF Executive Board's assessment of the fiscal policies of some of its major

shareholders is sufficiently independent.[16] Concerns of the staff may be expressed inside the Fund and informally to government officials, but these are often subject to considerable nuancing when expressed by the IMF as an institution.

Finally, the IMF's perspective on a sound fiscal policy more generally could be strengthened as it relates to how the IMF addresses long-term issues. There can be no doubt that the IMF as an institution has become mindful of the long term. Aging populations are on everyone's screen, whether at the OECD, the EU, or the IMF, and this is clearly recognized in the preponderance of the policy advice proffered with respect to the importance of firming up the fiscal position in anticipation. But the world of the 21st century will involve far more than simply aging populations.[17] Technological change may offer prospects of higher productivity growth, but equally may prove a source of added expenditure pressures, for example, in the medical care sector. The forces of globalization can only intensify—this includes not only the greater openness to trade and the movement of factors of production but also the greater degree of interconnectedness that ensures that aggregate shocks quickly ripple through the global economy and affect economies that would formally have been relatively insulated.

And the world of the twenty first century may have considerable potential for aggregate shocks. While the industrial and emerging market economies may be aging and their populations shrinking, the world's population is expected to almost double over the century, with increases focused in South Asia, the Middle East, and sub-Saharan Africa, where there will be a large youth bulge. Scarcities of resources—of water and possibly petroleum products—may become acute, particularly in these same parts of the world. Potential security threats, of the kind signaled by September 11, cannot be dismissed out of hand.

At the same time, global climate change will occur over the next century, even if the Kyoto Protocol is fully implemented and extended to developing countries. Although the principal

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[16] This issue was also raised in a recent external evaluation of IMF surveillance (International Monetary Fund, 1999).

[17] See United States, Central Intelligence Agency (2001) and Heller (2002).

adverse burdens of the uncertain changes that will occur will emerge in the equatorial and subtropical zones, all countries, even net beneficiaries among the industrial countries, will need to adapt to the climate changes likely to occur.

An important question, then, is whether, in considering the appropriate fiscal stance for industrial and emerging market countries, enough consideration has been given to the potential risks and uncertainties. Is the amount of fiscal margin that is being targeted, in terms of the net debt or net asset positions, sufficient to handle the potential fiscal costs that may arise? This is an area where the IMF might provide greater guidance, possibly through greater emphasis on stochastic forecasts of the fiscal position. Specifically, beyond carrying out deterministic scenario analyses and stress tests, it would be important to have a sense of the probability that is associated with the occurrence of alternative potential outcomes.

Equally, the IMF should, given its multilateral responsibilities, and given the global financial impact of these potential outcomes, be providing its own perspective on what posture governments should be taking in the face of uncertainty in the formulation of their fiscal position. Should not the IMF urge governments to be risk averse in their exposure to potential adverse outcomes? In some cases, it would be a big improvement if governments took into consideration the medium-term risks that are quantifiable, given that the planning horizons of many governments rarely exceed two or three years.

Finally, more thought needs to be given to the appropriate approach to closing the clear and evident fiscal gaps that are already obvious in the fiscal positions of most OECD countries. Recent European Commission studies (see EC (2001), OECD (2001), and Frederiksen (2002)) suggest that primary fiscal gaps would need to be immediately and sustainably adjusted by between 2 and 3 percent of GDP in order to finance commitments associated with aging populations (and this ignores the fiscal consequences of the other risks mentioned earlier). But such an action, which would imply significantly more rapid debt paydown or

asset accumulation for the largest economies of the world, would have significant global macroeconomic effects and might not even be sustainable in political economy terms.[18]

This underscores that a sound fiscal position may entail closing the gap via reforms that significantly reduce the extent of a government's social insurance commitments beyond what has already been accomplished in the last decade. Weighing in on the balance between aggregate fiscal adjustment that affect the size of the fiscal balance (and resulting net debt/net asset position) versus adjustments in a government's future fiscal commitments or receipts realized by policy reforms will be increasingly important in any judgment by the IMF of a sound fiscal position.

[18] Politicians would have great difficulty maintaining fiscal discipline in the context of rising asset positions—witness the strains already emerging in Norway regarding its Government Petroleum Fund.

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