

# IMF Policy Discussion Paper

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## Understanding Fiscal Space

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**IMF Policy Discussion Paper**

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**Abstract**

**This Policy Discussion Paper should not be reported as representing the views of the IMF.** The views expressed in this Policy Discussion Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Policy Discussion Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

With new initiatives to provide low income countries with external assistance in support of the Millennium Development Goals (MDGs), donors and NGOs are seeking to understand whether “fiscal space” can be provided in the context of IMF-supported programs to support these initiatives. This paper defines the concept of fiscal space and its link to fiscal sustainability, describes alternative ways in which fiscal space can be created, and notes how the IMF can support appropriate efforts to create fiscal space. The paper underscores that the issues that arise in creating fiscal space are not novel, but have *always* confronted governments in judging whether there is scope for additional expenditure.

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## I. INTRODUCTION

A number of factors have provoked the question of whether “fiscal space” can be created, in the context of IMF-supported programs, for spending on investments and social programs that are perceived as particularly meritorious. Initially, Latin American and European governments in particular argued that fiscal constraints should be relaxed to accommodate additional borrowing to finance infrastructure projects, which create productive assets that pay for themselves over the long term. It was in this connection that advocates of increased public investment in the World Bank argued that there was available fiscal space for such borrowing (particularly from the Bank itself). The discussion of fiscal space has subsequently been broadened, with many in the Bank, bilateral donor community, and NGOs arguing that current spending for health and education, which adds to human rather than physical capital, also has a valid claim on any available fiscal space because such outlays can pay for themselves over the long term.

Yet the concept of “fiscal space” remains fuzzy—the term is now frequently used in current policy debates but without clarity as to its meaning. In what follows, I will provide a definition of this term, including its linkage to the concept of fiscal sustainability; describe alternative ways in which fiscal space can be created; indicate what approaches do not create fiscal space; note how the IMF can support appropriate efforts to create fiscal space; and, finally, discuss the relationship between the concept of fiscal space and that of absorptive capacity. An illustration of the issues with reference to Malawi, Tanzania, and Zambia is included (see Appendix Box). Ultimately, the discussion should make it clear that most of the issues that arise in creating fiscal space are not novel, but rather are those that have *always* confronted governments (and the IMF) in judging whether there is scope for additional expenditure.

## II. WHAT CREATES FISCAL SPACE?

In its broadest sense, fiscal space can be defined as the availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government's financial position. Usually, the idea is that in creating fiscal space, additional resources can be made available for some form of meritorious government spending (or tax reduction). The incentive for creating fiscal space is strengthened where the resulting fiscal outlays would boost medium-term growth and perhaps even pay for itself in terms of future fiscal revenue. In principle, there are different ways in which a government can create such fiscal space. Additional revenues can be raised through tax measures or by strengthening tax administration. Lower priority expenditures can be cut in order to make room for more desirable ones. Resources can be borrowed, either from domestic or external sources. And, finally, governments can use their power of seignorage (that is, having the central bank print money in order to lend it to the government). Governments may also benefit from any fiscal space arising from the receipt of grants from external sources.

Explicit in the definition is the link to the concept of fiscal sustainability. This relates to the capacity of a government, at least in the future, to finance its desired expenditure programs, to service any debt obligations (including those that may arise if the created fiscal space arises from government borrowing), and to ensure its solvency.<sup>2</sup> The link to fiscal sustainability has a number of implications.

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<sup>2</sup> In considering fiscal sustainability, it is necessary to consider issues of debt sustainability (see below), the nature of a government's expenditure structure in terms of constructive budget obligations (continuing recurrent expenditures of high priority, such as education, medical care, national security, etc; implicit social insurance obligations associated with civil service pensions, public pensions), its exposure to other fiscal risks (e.g., from government guarantees, public private partnerships), and the elasticity of government revenue (see Hemming and Chalk, 2000; Baldacci and Fletcher, 2003).

First, it suggests that exploitation of fiscal space requires a judgment that the higher expenditure in the short term, and any associated future expenditures, can be financed from current and future revenues. If debt financed, the expenditure should be assessed in terms of its impact on the underlying growth rate or by its impact on a country's capacity to generate the revenue needed to service that debt.

Second, sustainability concerns force attention on the medium-term implications of the spending programs for which fiscal space is created in a given year. Are the expenditures for which fiscal space is created, likely to be concentrated in the immediate term? Or are the desired expenditures likely to require future expenditures, in which case some fiscal space will be needed in the future as well? To illustrate, budgetary room could be made available in a given budget year to finance a meritorious objective—say, a one-time training program for government civil servants. Yet there are many types of government expenditures—infrastructural investments, establishment of primary clinics or schools—where the initial spending has clear implications for subsequent spending on operations and maintenance that would require the availability of *future* budgetary resources. Similarly, for many of the programs for which fiscal space is now being advocated, the desire is for higher expenditures to be sustained for a long period of time. In either case, it would be insufficient to create fiscal space in the first year without ensuring the creation of similar fiscal space in future years to cover these requirements.

Third, this last point underscores that any consideration of fiscal space must be made in the context of at least a medium-term expenditure framework that has a comprehensive perspective on the government's expenditure priorities. If there is a possibility that the fiscal space that allows for today's additional expenditure will not be replicated in the future, governments may find that they are forced to either under-fund the new initiative or cutback on other expenditure areas in the future. Thus, fiscal space should not be seen strictly as an issue associated with a specific sector. While the impetus for the debate over fiscal space may have emerged in terms of the perceived value of spending on health, education, or infrastructure, it is necessary to assess the scope for higher spending within the context of a

comprehensive and forward looking fiscal and budgetary framework. Governments have an obligation to weigh the relative merits of spending across different sectors, since initiatives in one sphere may ultimately have crowding-out effects on others.

For developing and emerging market countries, the issue of fiscal space arises in the immediate term. There is a pressing need for expenditure today, and the challenge is how to find the resources for their financing. The recourse to considerations of fiscal sustainability recognizes that with growth, additional fiscal resources will become available to governments, reflecting the normal buoyancy of revenues, particularly if expenditures rise less rapidly.

But the availability of fiscal space over the medium to long term can be a policy issue worth addressing. Many industrial governments have effectively precommitted their future budgetary resources in the context of social insurance programs and their promises (e.g., with respect to a government's assumption of responsibility for post-retirement health benefits). In such cases, it is important for governments to ensure that there is scope, whether in the context of available future budgetary resources or with the prospect of an increase in the revenue share, to respond to unanticipated fiscal challenges. If much of the resources of a government's budget are tied up in nondiscretionary spending categories, there is obviously not much fiscal space for discretionary programs. This suggests that in carrying out projections of future budgets, governments should seek to ensure that future budgetary resources are not exhausted by projected government expenditure commitments—which, in effect, may imply the creation of “negative” fiscal space on future budgets. Fiscal space or leeway should thus be ensured so that a government can meet unanticipated challenges.

This last type of issue can equally apply in developing countries. To the extent that countries receive significant flows of external resources dedicated to a specific sector, there may be counterpart requirements for future spending that may essentially “preempt” a share of the growth of future domestic budgetary resources. Also, to the extent that a country perceives some limits on the extent of external resource inflows that are compatible with a stable

macroeconomic policy framework (taking account of positive supply-side effects from the resource transfer) an externally-financed expansion in the growth of a specific sector (e.g., in health) may imply limits on the magnitude of external resources that can be absorbed by other sectors (and may ignore the potentially beneficial effects for that sector from spending on other sectors, see Leipziger et al, 2003). An analogous issue arises to the extent that a government receives money in the present, but acquires a liability for future payouts that are highly uncertain in magnitude and timing (e.g., with respect to external resources that finance a pension reform that includes the prospect of minimum guarantees by government; or the assumption of post-retirement health benefits).

This suggests the importance of ensuring that a medium-term perspective on the pros and cons of external resource inflows to a country across the different sectors, and within the public sector, more specifically, is critical. Ideally, this should be reflected in a country's poverty-reduction strategy and its medium-term expenditure framework.

### **III. ISSUES THAT ARISE IN THE CREATION OF FISCAL SPACE**

The challenge of determining whether a government has scope to raise additional resources for meritorious spending is one that has confronted the IMF for many years. A key objective of the IMF's work on fiscal policy has been to determine (1) the scope for increased public saving through tax reform and expenditure rationalization; and (2) the additional resources that can be mobilized from borrowing and grants, consistent with maintaining macroeconomic stability and debt sustainability. In effect, policies in these two spheres determine the true measure of potentially available fiscal space.

#### **A. Raising Revenue**

Increasing the revenue share in GDP is an obvious option for countries with low tax shares. For low income countries, raising the tax share to at least 15 percent of GDP should be seen

as a minimum objective. International experience suggests that some increases beyond this are certainly reasonable and desirable, but this does not render the task easy, either on administrative or technical grounds.<sup>3</sup> Even the most ambitious African countries have taken a number of years to raise their tax shares by several percentage points. For many industrial countries, tax shares are already very high—above 40–45 percent of GDP—and, faced with tax competition pressures, further increases are politically and economically hard to justify.

Mobilization of revenues for earmarked purposes may be seen as an important vehicle for raising fiscal space, but such earmarking also creates rigidities—preempting scarce tax bases for expenditures that may have a lower return than other possible expenditure purposes. Earmarking may thus have the effect of crowding out other expenditures such that the fiscal space that is created may, in net terms, be significantly reduced.

### **B. Reprioritization of Expenditure**

Reducing unproductive expenditures, particularly those of a recurrent nature, should be the first option for a government seeking an expansion of meritorious programs. This may require a revision of existing subsidy programs, spending cutbacks on defense and internal security, or police, reduced foreign travel or embassy expenses, or rationalization of elements of the civil service that are of low (or zero) productivity (e.g., the frequent problem of overstaffing or even ghost workers). For example, IMF-supported programs often confront the dilemma that overall wages and salaries of a government have reached an unsustainable level, and yet there is a high return to employing additional staff in certain key sectors (e.g., education and health). Often this can be reconciled through restraint or reduction in wage and salary spending in the non-key sectors as well as by reduction in rigidities, such as impediments to mobility of civil servants, while allowing expansion of spending for key policy programs.

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<sup>3</sup> See Heller (2003) for a discussion on why the political economy challenges of shifting to a tax burden that is significantly higher than in the past may not be easily overcome.



Fiscal space can also be created by achieving efficiency gains in how expenditure programs are implemented. This would be appropriate even in favored sectors (e.g., achieving minimum pupil-teacher ratios and rationalizing the approach to delivering medical care). Policies that reduce corruption and improve governance also can create fiscal space. In a similar vein, the donor community is increasingly recognizing the fiscal resource potential associated with greater “alignment and harmonization” of donor resources. To the extent that external resources can be delivered and used with greater efficiency (the paring down of donor conditionality, the elimination of aid-tying; any reduction in the donor administrative overheads associated with spending on an external assistance program; greater consistency in the meshing of program spending by donors in a given sector; any reduction in the administrative overload imposed on the limited number of recipient country program managers, etc.), the more fiscal space can be created.

Government policies that foster significant improvements in the efficiency through which the *private sector* allocates its resources may have the impact of facilitating higher and more effective spending in both sectors. In the health sector, for example, if a government can strengthen the quality of the health services it provides, households, even if required to pay user fees, may be able to *save* resources by reducing spending on inefficient private sector health providers. Similarly, the provision of infrastructure may strongly enhance the returns to private investment, both in terms of growth and poverty reduction (a point made by Calderón and Servén (2003)).

There is another intertemporal aspect of expenditure policy decisions that affects fiscal space. Not spending an adequate amount in a sector (say, health) may weaken the sector to the extent that it would, in the future, be costly and time consuming to “rebuild” the sector. Creating fiscal space by allowing cutbacks in a sector may be ultimately more costly in fiscal space over time.

**Borrowing** represents another option for the financing of additional expenditure. Both domestic and external borrowing imply the need to repay, thus raising the question of whether the return on the expenditure justifies the cost of borrowing, and perhaps even more strongly, if the spending will enhance government revenues to finance the repayment of the borrowing. Governments may choose to borrow without taking specific account of the direct returns from the particular expenditure item, but then must do so in the context of an assessment of the overall sustainability of a government's borrowing program, given the size of the government's existing obligations for debt service and principal repayments. Such assessments typically need to consider inter alia, an economy's prospective growth rate, its potential for exports and remittances, the prospective interest rate environment, revenue elasticities, the composition of existing debt (in terms of interest rates, maturity, currency of borrowing), and the terms of new debt being considered (see IMF, 2004a, b).

**Printing money to finance additional government spending** is not a desirable option. A government's borrowing from the central bank should be driven by monetary policy objectives, viz., the creation of sufficient liquidity to support an economy's real growth, preferably on a relatively noninflationary basis. Even if a government were to explicitly seek to rely on the possibility of money creation to facilitate a somewhat higher level of government expenditure, there are clear limits, given the potential impact that this would have on inflation in the domestic economy. Given the money multipliers in most developing countries, the scope for additional expenditure that can be financed in principle by money creation is rarely above 1 percent of GDP, unless a clear and relatively quick supply-side impact can be obtained from the higher level of expenditure. Except in situations where inflation is being gradually brought down from hyperinflationary levels, it would be unusual for the IMF to endorse a program that consciously targeted an inflation rate above 10–12 percent (Khan and Senhadji, 2000). Long experience suggests that high inflation is not conducive to sustained rapid growth, private investment (Fischer, 1993), or distributional equity, as the poor are most heavily taxed in an inflationary environment.

### C. External Grants

For many developing countries, the possibilities of higher external grants is increasingly plausible given the strengthening consensus on initiatives to reach the MDGs. Grants can clearly provide some fiscal space, in contrast to borrowing, where debt sustainability considerations are relevant even when loans are on highly concessional terms. But a *sustained and predictable* flow of grants is particularly important, since it creates the potential for a scaling up of expenditure that can be maintained in the future and reduces the uncertainty as to whether the grant is simply of a one-time character. Greater fiscal space is implied by a commitment by external donors to provide a given flow of resources over a number of years, as opposed to the provision of the same amount of such resources over time but subject to uncertainty each year as to its provision. Indeed, *greater predictability and reduced volatility is enormously important in creating fiscal space.*

When external assistance cannot be assumed to be available beyond the medium term, the fiscal space established by additional grants (or concessional loans) is more limited. Expanding programs on a permanent basis carries the risk that further assistance may not come or that the additional fiscal space from any growth-engendered increase in domestic revenues is insufficient. Assuming there is scope for easy downsizing of a program or cutbacks elsewhere is also risky. Temporary employment contracts or the design of programs that may facilitate flexible downsizing may be necessary. But when programs are implemented that have high costs of downsizing (e.g., antiretroviral treatment of HIV/AIDS patients), caution may be required in exploiting readily available, but only short-term, assistance.

Are there limits to the amount of grant inflow that a country can or should absorb?<sup>4</sup>

Economists and policymakers grapple with judging the impact of higher external aid flows

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<sup>4</sup> A recent IMF conference on Foreign Aid and Macroeconomic Management sheds light on these issues. See <http://www.imf.org/external/np/seminars/eng/2005/famm/index.htm>

on the real exchange rate and the size of the traded goods sector, taking account of the use to which the external assistance is put (in terms of spending on traded and nontraded goods and in the relative impact over time on productivity and productive capacity in the traded and nontraded goods sectors). Countries may be loath to allow a significant real appreciation of the exchange rate because of the impact it might have on their export industries. The result may be that some amounts of external assistance are not allowed to be converted into higher imports but are sequestered as higher external reserves. By its mandate, the IMF would be concerned with policies that could threaten the sustainability of a country's external position. It would thus certainly have views as to the long-term sustainability and growth impact of a significantly appreciated exchange rate, and would seek to clarify for country authorities the policy tradeoffs that might arise from accepting a higher flow of donor assistance.

Presently, the empirical evidence is mixed as to whether Dutch Disease constitutes a significant problem for low income countries. Part of the difficulty relates to insufficient experience with aid inflows that would constitute a very substantial share of total GDP (as might emerge from new aid initiatives related to the effort to achieve the Millennium Development Goals). Even if it does exist, Dutch Disease effects must be weighed against the long-term benefits of the associated spending, though these are not easy to measure in terms of the probability of successful outcome and social return.

External grants and loans may also reduce the incentive of governments to improve their revenue mobilization efforts and may create dependency and rent-seeking effects within government bureaucracies. Assessments of fiscal sustainability necessarily must gauge such disincentive effects, particularly given uncertainties on the long-term sustainability of external assistance inflows. In effect, the fiscal space created in the short term may have a negative impact on available fiscal space in the future if it reduces domestic resource mobilization efforts.

**The impact of sound macroeconomic policy management:** Fiscal space can be created by the pursuit of consistent and effective macroeconomic policies. Some of the volatility in

external assistance experienced by many countries has arisen from the failure to implement agreed macroeconomic policy programs with the IMF. Delays in satisfactory IMF program reviews or cessation of IMF-supported programs can have an adverse multiplier effect in terms of their impact on other donor assistance. Certainly, countries that manage their macroeconomic policies well have far greater potential for creating additional fiscal space.

### **How do IMF-supported program seek to create fiscal space?**

The IMF has emphasized its flexibility in terms of allowing the absorption of additional external grant inflows for spending on productive programs. Often IMF-supported programs set limits on net domestic borrowing, thus allowing for accommodation of foreign-financed infrastructural investments and social expenditures in priority sectors. “Adjusters” may be used in the context of IMF-supported programs to adjust the overall budget ceilings upward in the event of the receipt of unanticipated external grants for meritorious expenditure programs, say in the health or education sectors.

Supply-side issues are clearly critical, and the IMF recognizes the importance of working with its development partners to clarify and recognize the ways in which higher government spending may relax key bottlenecks or create additional productive capacity in an economy. Such positive supply-side effects provide scope for higher spending without adverse consequences for macroeconomic stability. However, the arguments for such investments need to be analytically well-grounded and consistent with fiscal sustainability, with clarity as to the time frame over which the productive capacity is raised.

While open to the creation of fiscal space, IMF staff would raise red flags when higher spending is likely to raise macroeconomic stability or medium-term sustainability concerns. Also, in assessing the overall fiscal framework, the IMF must perforce take account of the possibility that higher levels of spending in a sector, even if financed from external grant flows, may have ripple effects on spending in other sectors. Thus, if a spending program leads to higher wage rates in one part of the public sector, it may create irresistible pressures

for wage increases in other parts of the public sector for which external grant flows are not available. Finding the financial resources to fund these other programs may bump against fiscal resource ceilings.

**Do public-private partnerships create fiscal space?**

Governments may believe that public-private partnerships constitute a mechanism for inducing the private sector to finance infrastructure investment that normal budgetary ceilings would limit. There may be some truth to this, particularly if the private sector is more efficient than the public sector in creating and operating infrastructure and public services. Such efficiency gains would imply some additional fiscal space; but for the most part, the savings on infrastructure expenditure will be offset in future years because the private sector would naturally build in the cost of capital into the leasing costs associated with the infrastructure. At a minimum, a government needs to ensure its capacity to absorb the higher expenditure costs in future years, and may need also to take account of the potential contingent risks that may arise in the case of the bankruptcy of the private sector agent.

**Do absorptive capacity constraints limit the possibility for exploiting fiscal space?**

The question is often raised as to whether a government can absorb a higher level of external resource inflows for spending in a sector. The precise meaning of absorptive capacity is itself murky, extending to many separate concerns ranging from the availability of the required skilled manpower to deliver services, to the availability of managerial staff to organize the scaling up of programs, to the existence of critical physical infrastructure. Ultimately, this is a less an issue of fiscal space, and more one of the increasing inefficiencies associated with a rapid scaling up of expenditure, and the implied reduced cost-effectiveness of such spending.

### **The creation of fiscal space cannot be the product of changes in accounting rules**

Changes in accounting rules cannot, in themselves, create additional scope for expenditure on the provision of basic social services or infrastructure. The issues that arise in considering the productivity of expenditure, the sustainability of a given level of debt, or the solvency implications of a medium-term expenditure program are relevant, no matter how an expenditure is classified in terms of the current or capital budget, or whether it contributes to an increase in the overall deficit. For example, some countries have adopted budgetary rules where the focus is on maintaining a balance or surplus on the current account (e.g., current revenues less current expenditures), and capital is financed from government savings and borrowing (the so-called “golden rule” approach to budgetary policy). This may suggest the possibility of a looser criterion for spending on capital expenditures. But governments, such as the United Kingdom, that have followed such an approach take account of the productivity of their capital spending program and recognize the need to prevent debt rising above a specified ratio to GDP. The IMF’s *Government Finance Statistics Manual 2001* is well suited for facilitating a full analysis of the impact of government expenditure programs on net worth and the overall sustainability of a government’s balance sheet.

### **Concluding remarks**

One final and important message needs to be conveyed. Judgments on fiscal space are inherently country specific, requiring detailed assessments of a government’s initial fiscal position, its revenue and expenditure structure, the characteristics of its outstanding debt obligations, the underlying structure of its economy, the prospects for enhanced external resource inflows, and a perspective on the underlying external conditions facing an economy. It is reasonable for donors and governments to ask the IMF to carry out detailed and transparent assessments of the factors determining fiscal and debt sustainability. If donors are willing to commit to a substantial increase in grant assistance, say, for a scaling up of the health sector—recognizing the specific dynamics associated with the building of a cadre of trained health personnel and the long-term recurrent character of spending in the sector—this

should receive particular focus by a country in the context of its efforts in formulating a poverty reduction strategy and medium-term expenditure framework. Governments can and should ask IMF staff to assess the fiscal implications of such a scaling up and to discuss with all interested parties the various factors that would determine the prospects for ensuring overall fiscal sustainability. They should also ask the IMF to identify the potential macroeconomic management challenges and policy tradeoffs that may arise, particularly with respect to the consequences for the real exchange rate. They should clarify with donors the likely availability of external assistance over the medium- to long-term, and structure their expenditure program in the light of such uncertainty. But, no simple mechanistic formulas can be offered that bypass this kind of detailed, country-specific, macroeconomic, and fiscal policy assessment.

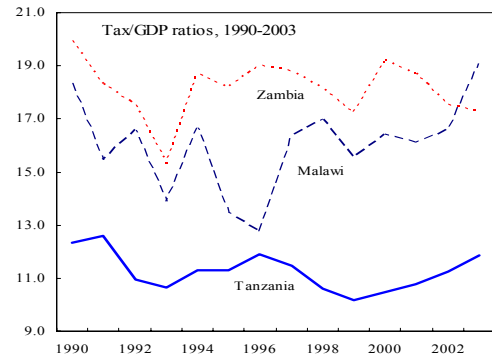


### Is There Room for Additional Spending? The Cases of Malawi, Tanzania, and Zambia\*

A number of options could be available to increase funding for needed programs.

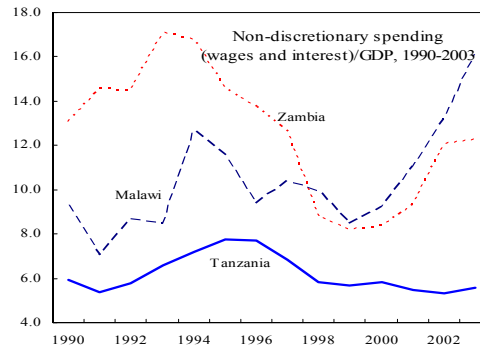
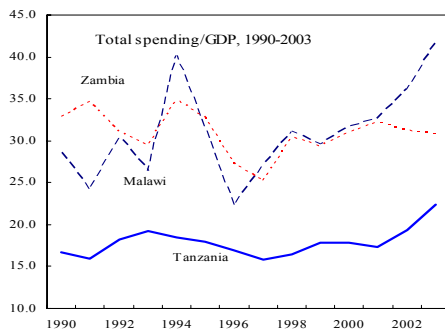
#### Can additional spending be financed by additional revenue?

Tax/GDP ratios in Malawi and Zambia are high by regional standards, but remain low in Tanzania, despite recent increases. There may not be scope to increase tax rates, but possibly to broaden the tax base by modernization of tax administration and customs procedures. For example, VAT rates are already quite high, at 17.5 percent in both Malawi and Zambia, and at 20 percent in Tanzania.



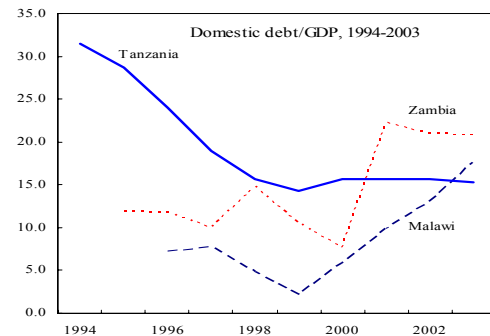
#### Can it be accommodated by reprioritizing expenditure?

Spending levels are already quite high in Malawi and Zambia. Reflecting a more judicious fiscal policy, expenditure has progressively increased over the last few years in Tanzania, but has remained below 25 percent of GDP. Within this large expenditure envelope, however, in the short term, the room for reprioritization may be limited. For example, if we proxy “non-discretionary spending” as the sum of interest payments and wages, in both Malawi and Zambia this has absorbed a large amount of resources—and increasingly so. In both countries, interest payments have soared reflecting an increasing domestic debt burden (see below); in Malawi, interest payments more than doubled from less than 4 percent in 1999 to more than 9 percent in 2003, but are coming down with the new government’s commitment to fiscal stability; in Zambia, the wage bill increased by over 3 percent of GDP over the period 2000–2003. On the contrary, Tanzania not only displays lower overall spending levels, but the share of non-discretionary spending has declined, therefore leaving more flexibility within the available budgetary spending envelope to devote more resources to priority sector.



#### Can it be financed by additional domestic

**Borrowing?** There is not much room to borrow domestically in Malawi and Zambia, where domestic debt, as a share of GDP, has been increasing and remains high relative to the degree of monetization of the economy. Not surprisingly, domestic debt is less costly and more stable in Tanzania, despite some recent recourse to domestic financing.



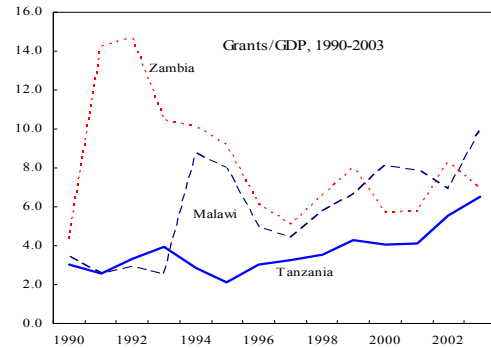
#### Can additional spending be financed by printing money?

Given the low degree of monetization, there is limited scope for seignorage: the stock of broad money over the GDP is about 21 percent in Zambia, but remains well below 20 percent in both Malawi and Tanzania, largely reflecting the large share of the subsistence economy. Inflation has been declining in all countries, but only in Tanzania has it remained stable at below 5 percent; in Zambia, it was still above 20 percent at end-2003, and around 10 percent in Malawi, although a poor harvest has temporarily pushed up inflation to around 14 percent.

*Prospects for additional external borrowing?* In Malawi and Zambia, the stock of external debt relative to GDP remains high, since as of end-2004, these countries have yet to reach the HIPC Completion Point; in Tanzania, which graduated from the HIPC Initiative at end-2002, this ratio has been steadily declining. A better measure of external indebtedness is the ratio of the net present value (NPV) of the external debt over exports—considering that most of these countries' borrowing is on highly concessional terms. Once again, Tanzania is in much better shape: its NPV of debt/exports was less than 120 percent at end-2003, while it was more 220 percent in Zambia.

*Could additional spending be financed by additional grants?*

All these three countries rely heavily on grants, which however have been volatile. Not surprisingly, the volatility of grants has been higher in Malawi and Zambia, also reflecting policy slippages; the standard deviation of grants over the period 1990–2003 was 3.2 in Zambia, 2.5 in Malawi, but less than 1.2 in Tanzania. The lower volatility in Tanzania reflects the strong donor response to this country's successful macroeconomic stabilization and reform efforts. This is also shown by an increasing share of budget support grants within increasing grants, which provides greater flexibility to the authorities in determining budget priorities and thus managing fiscal space



Securing room/funding for additional spending is only one part of the story. Can additional money/resources be put to proper use and can the macroeconomic framework can absorb the additional spending?

*Prospects that additional spending can be properly managed.*

The Fund and World Bank have assessed the quality of public expenditure management systems in HIPC countries, with a particular focus on their ability to track poverty-reducing spending. The exercise, originally undertaken in 2001–2002, was based on 15 indicators covering budget formulation, execution, and reporting. Initially Tanzania fulfilled 8 of the 15 indicators, while Malawi and Zambia met only 4 and 3, respectively. The exercise was recently updated (and extended to include a 16<sup>th</sup> indicator on procurement). Limited progress has been made in both Zambia and Malawi (although efforts have strengthened recently), while Tanzania has further strengthened its position.

*Can the macroeconomic framework withstand significant increases in demand pressures?*

A detailed answer to this question can only be provided on a case-by-case basis. For simplicity, two possible channels are considered here. The first is whether there is room to allow a healthy growth in credit to the private sector—the risk is that the need to sterilize the liquidity created by additional government spending (unless it all went into imports) may push up the level of interest rates and therefore crowd out borrowing from the private sector, with adverse implications for future investment and growth. In fact, credit to the private sector has been steadily growing in Tanzania, while it has declined in Zambia and remained stable in Malawi—largely reflecting sizeable real interest rates driven by the government borrowing needs. The second channel is the current account deficit—a high level would exacerbate these countries' external vulnerability. Again, Tanzania has been reducing its current account deficit as a share of GDP, while the current account deficits in Malawi and Zambia have displayed a much larger—and much more volatile—behavior. In case of large aid flows, there may also be a risk of Dutch disease (that is, appreciating pressures on the exchange rate that would put exports at a competitive disadvantage). These pressures could be offset if spending were directed to enhance the supply response of the economy, for example by removing transportation bottlenecks, building up productive infrastructure, and increasing access to markets. Again, the potential role and size of Dutch disease effects, if any, can only be assessed on a country-specific basis.

*Conclusion.* The analysis in this box—while cursory—may provide a useful illustration of some of the challenges these—and other—countries face in attempting to expand their spending levels on priority sectors.

\*This box was prepared by Annalisa Fedelino of the IMF's Fiscal Affairs Department.

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