I.
When Is Fiscal Adjustment Needed?

Governments are necessarily continuing concerns. They have to keep going in good times and in bad. They therefore need a wide margin of safety. If taxes and debt are made all the people can bear when times are good, there will be certain disaster when times are bad.

—Calvin Coolidge (1872–1933)

Fiscal adjustment may be necessary to achieve longer-term goals, such as economic growth and poverty reduction, while heading off such fiscal vulnerabilities as the buildup of public debt. Shorter-term fiscal objectives should be pursued within this longer-term framework.

Fiscal Adjustment for Growth and Poverty Reduction

Governments typically aim to promote strong and sustainable economic growth, and lasting poverty reduction. Research indicates that a sound fiscal position is key to achieving macroeconomic stability, which is increasingly recognized as critical for sustained growth and poverty reduction. High-quality fiscal adjustment can also mobilize domestic savings, increase the efficiency of resource allocation, and help meet development goals.

Achieving Durable Macroeconomic Stability

Loose fiscal policy, on the other hand, can lead to inflation, crowding out, uncertainty, and volatility, all of which hamper growth (Gupta, Clements, and Inchauste, 2004).

- *Inflation.* Loose fiscal policy, especially when financed by printing money (see Section I, Fiscal Adjustment for Short-Term Macroeconomic Stability), can lead to high and volatile inflation. In addition to other costs, this undermines the efficiency of the price system as it leads firms and households to make incorrect decisions, confusing move-

ments in the price level with changes in relative prices. This in turn reduces overall productivity (Fischer, 1993).

- *Crowding out.* When the government borrows to finance a looser fiscal position, the greater demand for loanable funds can reduce private investment (and other interest-sensitive components of private spending) by raising interest rates.[3] Under a floating exchange rate, higher interest rates will also tend to attract foreign capital, leading to an appreciation of the exchange rate, which will also crowd out exports.
- *Uncertainty and volatility.* Loose fiscal policy may not be sustainable. It implies, for example, continuously rising debt levels, which creates uncertainty as to how and when the loose policy will be corrected (e.g., through a burst of inflation, a disorderly depreciation, price and foreign trade restrictions, or large tax increases). These circumstances reduce private investment as they cause investors to wait and see how the uncertainty will be resolved and they prompt capital flight. Loose fiscal policy may also make the economic environment more volatile (e.g., by recurrent, and ill-timed, bursts of fiscal contraction and expansion), which can weaken investment by increasing risk and focusing investment on the short run (Bernanke, 1983).[4]

Indeed, in situations of high debt and deficits, fiscal consolidation can immediately expand output (see Section I, Fiscal Adjustment for Short-Term Macroeconomic Stability). In such situations, fiscal consolidation can reduce the risk premium on interest rates, catalyzing higher private investment and raising asset values. This boosts private consumption and eases supply constraints. The expectation of lower government spending can also lead the private sector to reduce its estimates of current and future tax liabilities, further boosting consumption and investment. It is not only the size of the fiscal deficit and the initial debt reduction that matter, however, but also the composition and the perception of the sustain-

[3]If, however, the government "represses" financial markets by controlling domestic interest rates, more government borrowing will result in either higher inflation and low (even negative) real interest rates or reduced financial intermediation—a reduction in the share of savings channeled through formal financial institutions to private investors. The quality of private investment suffers too: with credit rationed, governments typically end up choosing who gets credit and choosing less well than the market would.

[4]Excess economic volatility can also cause irreversible losses in human capital—including through the effect of more frequent spells of unemployment on learning-by-doing opportunities—compounding the negative effect on growth (Martin and Rogers, 1997).

ability of the adjustment effort (see Section III, Quality and Durability of Adjustment).

Mobilizing and Allocating Resources

Economic growth and human development critically depend on accumulating physical and human capital, which in turn requires an adequate level of national savings. As private sector savings are often low in developing (especially low-income) countries, fiscal policy can play a central role in mobilizing resources by raising revenue and reducing less productive spending. But the mobilized resources must be invested productively, and history is littered with examples of poor government investments. Indeed, a key channel through which expenditure consolidation in developing countries can spur growth is higher factor productivity, as public sector resources are freed up for the more efficient private sector. The impact of government spending on improving human development and growth depends on the efficiency of these outlays and how well they are targeted at the poor, not just on the level of spending.

Efficiency arguments suggest that public spending should be directed to areas with the highest social return and should complement, rather than compete with, the private sector. This involves either financing or supplying directly needed public goods that the private sector will not supply adequately because of market failure. Several categories of public expenditure can influence long-term growth—especially spending on education, health, and infrastructure—although what will work best depends on specific country circumstances. Higher growth, in turn, generates increased fiscal resources to finance productive spending, further bolstering the dynamism of the economy. Governments have, however, often tried to spur growth through producer subsidies and the tax system by, for example, imposing high tariffs or offering generous tax holidays (rather than the better method of reducing distortionary taxes; see Section IV, Improving the Tax System and Mobilizing Revenue). These have generally created inefficiencies and administrative complications, as well as larger fiscal deficits, and have not resulted in the anticipated growth benefits.

Meeting Development Goals

In recent years, fiscal policy in low-income countries has been increasingly geared to meeting the Millennium Development Goals (MDGs). These goals grew out of the agreements and resolutions of world confer-

ences organized by the United Nations since the early 1990s. They have been commonly accepted as a framework for measuring development progress, and indicators of achievement of these goals are being monitored by the international community. The goals are directed at reducing poverty in all its forms. They include halving global poverty, achieving universal primary education, reversing the spread of HIV/AIDS, reducing child and maternal mortality, and ensuring environmental sustainability.

Fiscal policy can play a pivotal role in achieving the MDGs by fostering robust economic growth, which is critical for sustainable development and for improving social outcomes. For example, research suggests that growth usually benefits the poor and that there is a strong link between economic growth and improvements in nonincome dimensions of poverty, such as infant mortality and female literacy (IMF, 2002). Meeting the MDGs will also generally require changes in the structure of the budget to include higher outlays on productive social spending, a scaling up of aid, and more efficient government spending (see Section III, Size of Fiscal Adjustment).

Fiscal Adjustment to Reduce Vulnerability

A country's public finances may appear sound now, but may be vulnerable if underlying weaknesses threaten its future fiscal position and limit the government's ability to respond to fiscal policy challenges. Reducing fiscal vulnerability allows fiscal policy to respond countercyclically to downturns or shocks.

All countries, but especially developing ones, face shocks (e.g., terms-of-trade shifts, "sudden stops" in capital inflows, natural disasters, and aid shortfalls) that undermine, directly or indirectly, their public finances. Such shocks can reduce revenue, generate pressing expenditure needs, and make financing more difficult and expensive. Countries that have built up reserves in good times can draw on these resources during bad times. And those with low levels of debt may be able to increase their fiscal deficits, including through borrowing, during a downturn or even a crisis, without losing market confidence. But countries without such buffers are often forced to take emergency fiscal measures and have limited scope for countercyclical fiscal policy. Emergency fiscal tightening measures are more likely to damage investment, growth, and social indicators, as they can be less well planned and are often based on measures that produce short-term financial gains at the expense of longer-term efficiency.

The most common fiscal vulnerabilities stem from public debt—its sustainability, its structure, and the degree to which vulnerabilities are hidden (as through contingent liabilities). Rigidities in the structure of the fiscal sector can also undermine fiscal policy, as do longer term fiscal pressures. Globalization too heightens the importance of sound fiscal policy.

Debt Sustainability

Public debt is sustainable when the government can continue servicing it without requiring an unrealistically (from a social and political point of view) large correction to its future revenue or primary (noninterest) expenditure path. This broad definition implies that, at credible levels of primary balances, the government is both solvent (discounted future primary balances exceed the current net debt stock) and liquid (able to meet obligations as they come due; see Section III, Size of Fiscal Adustment).

In addition to fundamentals, market expectations play an important role. Even when debt is stable or declining under current policies, markets may be concerned about the government's continued ability to generate the requisite primary balances. This, in turn, raises risk premiums on public debt and can cause it to become unsustainable. Managing expectations thus becomes important: when countries are able to assure markets about future fiscal policies, they may be able to maintain larger debt levels than otherwise. Governments should be able to demonstrate that their overall debt burden is manageable and is likely to remain so under a range of plausible scenarios. Medium-term fiscal frameworks, which set out government targets and projections for fiscal policy, and strong fiscal institutions, such as effective tax administrations and expenditure management systems, may help improve both policies and expectations (see Section V).

Contingent Liabilities and Debt Structure

Contingent liabilities are financial obligations that are triggered by certain events, and are not readily captured by standard fiscal statistics and analysis. Contingent liabilities fall under two main categories: those that become due if certain events materialize, such as defaults on government-guaranteed debt that the government must then assume; and those that result from the government's implicit or "moral" commitment, for example, to protect depositors after a bank failure or to pay pensions if the pension

scheme goes bust. Because their fiscal cost is typically invisible until they are triggered, contingent liabilities are a hidden subsidy, blur fiscal analysis, and can drain future government finances.

Debt contracted by public enterprises, local governments, and extrabudgetary funds often carries an explicit or implicit guarantee by the government. When such debt is not repaid, it has to be assumed by the government. Similarly, in public-private partnerships—such as build-operate-transfer contracts—the government frequently offers assorted guarantees (e.g., of minimum revenues). When market conditions prove to be unfavorable, liabilities for the government are triggered.

The structure of debt can also be an important source of vulnerability and risk. For example, when government debt is short term, indexed to short-term interest rates, or foreign-exchange-denominated/linked, pressures in the money and foreign exchange markets can rapidly translate into debt-servicing problems. The "balance sheet approach," which looks at links between the balance sheets of the various sectors of the economy, can help identify vulnerabilities and potential pressures stemming from balance sheets (Allen and others, 2002).

Active management of government liabilities can help address these problems. By reducing the risk that the government's debt will become a source of instability for the private sector, prudent policies in this area—as well as with respect to contingent liabilities—can make countries less susceptible to contagion and financial risk.

Fiscal Rigidities

Experience suggests that rigidities in the structure of the fiscal sector may undermine the government's capacity to adapt to changing circumstances. By ossifying current fiscal structures, rigidities can undermine future macroeconomic stability, debt sustainability, and fiscal policy. For example:

- Earmarking revenues for certain expenditures hampers the government's ability to adjust the revenues, or to spend them on changing priorities (e.g., schools rather than roads). If fiscal consolidation is needed, raising earmarked revenues is of little use as they automatically lead to higher spending.
- Constitutionally, or otherwise, mandated spending, employment levels, or taxation rates, impinge on governments' ability to adjust fiscal policy. Numerical fiscal rules, such as debt or deficit limits, especially if set in

the constitution, may also have the (in some cases, desired) effect of reducing a government's room for fiscal maneuver.
- Large shares of nondiscretionary spending (e.g., interest payments or spending on entitlement programs) in total expenditure complicate expenditure adjustment and can force cuts on higher-quality discretionary spending.
- Some fiscal federalism arrangements can undermine fiscal control. For example, arrangements that require certain revenues to be shared are likely to make fiscal consolidation more difficult (see Section V, Effective Intergovernmental Relationships).

Globalization

The importance of sound fiscal policy is further heightened by globalization. The credibility that derives from successfully maintaining, or restoring, sound fiscal policy can help emerging market economies (and developing countries more generally) exploit open labor and capital markets and free trade—including in services facilitated by modern communication systems. But if poor fiscal discipline compromises stability and growth objectives, access to international capital will likely be reduced. Tax competition has also become a fact of life, and tariff reductions have resulted in some loss of revenues, at least until the positive effects on growth materialized.[5]

Emerging Fiscal Pressures[6]

Developing countries in particular face many fiscal challenges that may lead to acute resource needs and require government intervention.
- In some parts of the world, the spread of HIV/AIDS and other pandemics inflict a high cost in terms of human suffering, loss of human capital, and need for more public sector support. More generally, ongoing technological innovations in health care, while effective in raising life expectancy, are likely to be financially costly.

[5]The initial stages of trade liberalization—which typically involve replacing nontariff barriers, such as quotas, with tariffs—tend not to be associated with revenue loss (IMF, 2005a). But many low-income countries seem to have had difficulty in replacing any revenue loss resulting from trade reform. Those that succeeded (1) sustained efforts, over several years, to broaden tax bases, including by improving revenue administration; (2) strengthened the domestic consumption tax system, through excise taxes and especially by a simple, broad-based, VAT; and (3) increased income taxes.

[6]See Heller (2003) for a fuller discussion of long-term fiscal challenges.

- Demographic changes, mainly aging populations, are likely to pose increasing burdens on public finances of some developing—as well as industrial—countries. Pension reforms may necessitate transitory financing requirements and higher explicit public debt when countries shift from public to private plans.
- Financial liberalization that frees banks from providing directed credit to favored sectors and enterprises may shift this burden onto the government by way of budgeted or unbudgeted credit subsidies channeled through public banks.
- Environmental degradation and global climate change may have wide-ranging implications that require government intervention.

Fiscal Adjustment for Short-Term Macroeconomic Stability

Short-term fiscal policy should be consistent with longer-term goals. Within this longer-term context, fiscal policy can contribute to short-term macroeconomic management. Most traditionally, fiscal adjustment can help mitigate cyclicality (recurrent recessions and booms), reduce large external current account imbalances, and contain inflation. In capital account crises, fiscal adjustment can restore confidence, ease financing constraints, and support growth.

Conducting Countercyclical Policy

Countercyclical fiscal policy—that is, adding to aggregate demand during downturns and withdrawing demand during upturns—can potentially play a role in responding to both normal variations in aggregate demand and larger aggregate demand shocks (supply shocks would typically require a neutral or procyclical fiscal response as the economy has to adjust to a lower level of potential output). For countercyclical fiscal policy to succeed, however, certain requirements must be met (Hemming, Kell, and Mahfouz, 2000).

Fiscal policy should be well coordinated with monetary policy. Monetary policy is generally a more effective countercyclical policy instrument because interest rate changes can be made in days and can be quickly reversed. But monetary policy adjustments may take longer than fiscal policy adjustments to affect aggregate demand. Moreover, fiscal policy contributes to broader-based stabilization through the impact of taxes and government spending on income-sensitive (in addition to interest-sensitive) components of aggregate demand.

When monetary policy is constrained in responding to output variations, fiscal policy should take a more central role. This may be the case if the mandate of the central bank focuses on securing low inflation, rather than stabilizing output. Also, if nominal interest rates are close to zero, monetary policy options are limited as interest rates cannot be lowered further. The relative effectiveness of fiscal and monetary policies will also depend on the exchange rate regime. Fiscal policy is relatively less effective under a flexible exchange rate regime and more effective under a fixed rate regime.

In some circumstances, the usefulness of countercyclical fiscal policy during downturns and recessions is limited. Most notably:

- If domestic and external imbalances are large, countercyclical fiscal policy may be inappropriate. Even though the economy may be turning down or in recession, avoiding or responding to rising inflation and a weakening balance of payments may be paramount.
- Financing constraints may place an upper bound on the fiscal deficit. Many emerging market and low-income countries face constraints on their borrowing, owing to undeveloped financial systems and a limited ability to tap external financial markets.

Even if countercyclical fiscal policy is appropriate, it may not have the desired impact on aggregate demand. Some factors could contribute to the impact being quite small. Moreover, in certain circumstances, fiscal contractions can be expansionary (Box 1).

- Fiscal expansions may be crowded out, at least partially. This happens when increased borrowing causes interest rates to rise and the exchange rate to appreciate. Fiscal expansions will therefore tend to be relatively ineffective in open economies with flexible exchange rates.
- In response to a debt-financed fiscal expansion, individuals who are not liquidity constrained may increase their saving so that they (or their children, via bequests) can pay the higher taxes that will be needed in the future to service the debt (the "Ricardian equivalence effect"). The offset is, however, likely to be partial and will depend on the extent to which consumers can borrow and lend to smooth consumption, as well as their degree of time preference (desire to consume now rather than later) relative to that of the government.
- The composition of measures may be inappropriate. For example, increases in transfers that benefit high-income individuals with relatively strong tendencies to save additional income would be less effective in influencing demand.

Box 1. Expansionary Fiscal Contractions

Fiscal tightening may expand the economy in the short term. The consolidation episodes of Denmark and Ireland have been particularly well documented, and there is evidence of expansionary fiscal contractions elsewhere—in particular, in such high-debt emerging market economies as Turkey. These episodes have a number of features:

- *They are associated with fiscal adjustment in high-debt countries.* As the government gains credibility in being able to service its debt and the threat of higher taxes and default subsides, risk premiums on interest rates fall, confidence rises, and aggregate demand is stimulated.
- *They are a function of the size and composition of fiscal adjustment and deficit financing.* In particular, consolidations based on cutting transfers and government wages tend to be associated with better growth outcomes, as are those that lead to lower domestic financing (see Section III, Quality and Durability of Adjustment).
- *They can manifest themselves either through changes in private consumption and investment or through factor productivity.* Changes in consumption and investment occur primarily through the credibility and wealth effect channels. The factor productivity channel is more important in developing countries (owing to the lower productivity of public spending).

- There may be long implementation lags, for example, because tax and expenditure measures are held up by the political process and budget procedures.

Where countercyclical fiscal policy is appropriate, research suggests that it may best be implemented through automatic stabilizers (IMF, forthcoming). Automatic stabilizers derive from the responsiveness of tax revenue and certain categories of spending (e.g., unemployment benefits) to output, which means that they take effect quickly and are self-reversing. However, automatic stabilizers are somewhat arbitrary, reflecting past decisions about the structure of taxation and spending, and are typically weak in emerging market and low-income countries.

Discretionary tax and spending measures may also have a role to play. They can be used to routinely bolster weak automatic stabilizers or offset strong ones, or they can be held in reserve to respond to larger aggregate demand shocks. The advantage of discretionary measures is that they can be tailored to stabilization needs, in particular by directing them to where

they will have the largest impact on spending. Their main shortcomings are that they can be subject to long implementation lags and are not quickly reversible, and that they have been a particular source of procyclicality, especially in upturns.

Reducing External Current Account Imbalances

Fiscal adjustment may be needed to facilitate external adjustment, especially to reduce excessive current account deficits or surpluses (Easterly, Rodriguez, and Schmidt-Hebbel, 1994). As an ex post identity, a fiscal deficit must be matched by either net domestic private sector savings (the excess of private savings over private investment), an external current account deficit, or a combination of both.[7] But cutting the fiscal deficit (surplus) will not generally result in a one-for-one cut in the current account deficit (surplus), as the private sector's saving-investment balance will be affected too. For example, the lower fiscal deficit could spur private investment, as credit becomes cheaper and more plentiful, and reduce private sector savings.

Fiscal adjustment can also support current account adjustment through its effect on the real exchange rate.[8] Fiscal consolidation, for example, will tend to depreciate the real exchange rate by reducing the demand for, and thus the price of, nontradables, thereby increasing the relative profitability of the tradable sector and boosting (net) exports. And devaluing the nominal exchange rate without correcting fiscal disequilibria may primarily affect inflation rather than the real exchange rate, thus failing to bring about significant external adjustment.

Tackling Inflation (or Deflation)

Fiscal policy can affect inflation through many channels. In the short run, it can affect the price level through its impact on aggregate demand. Specifically, government purchases of nontradable goods and services add to aggregate demand, while transfers and tax changes affect private

[7]More formally: $CA = (S_{priv} - I_{priv}) + (S_{pub} - I_{pub})$, where CA is the external current account balance; S_{priv}, private sector savings; I_{priv}, private sector investment; S_{pub}, public sector savings; and I_{pub}, public sector investment. $S_{pub} - I_{pub}$ is a measure of the overall fiscal balance. The precise definition of each sector is critical (see Section III, What Makes Fiscal Adjustment Successful?).

[8]The real exchange rate is the relative price of tradables (such as televisions) to nontradables (e.g., haircuts). A real exchange rate depreciation (appreciation) improves (worsens) the external current account by diverting resources from the nontradable (tradable) to the tradable (nontradable) sector.

demand. Administered price rises also affect the price level, and public sector wage increases can induce cost pressures.[9] Sustained inflation, however, generally requires an ongoing increase in the money supply that outstrips money demand. Fiscal policy can play a central role to the extent that money creation is due to deficit financing. Monetary financing of the deficit is a cheap source of financing in the short run, but once it goes beyond accommodating the increase in money demand, it contributes to excess money supply and inflation.

Fiscal adjustment can also affect inflation via the demand for money, including through inflation expectations, interest rates, and confidence. For example, if monetary policy is seen to be accommodating, fiscal expansion—even if initially not financed by the central bank—can quickly lead to expectations of future money supply increases, and thus to inflation (Sargent and Wallace, 1981).

Financing deficits by relying on high inflation is particularly pernicious but increasingly rare. It means obtaining resources at the expense of those with fixed nominal assets or incomes, usually among the poorer groups in society. Over time, the scope for collecting the inflation tax narrows: when inflation rises, households and businesses reduce their holdings of domestic currency (after adjusting for inflation) as they seek alternatives to preserve the value of their assets (such as foreign currency). High inflation can also undermine revenue from explicit taxes if there are collection lags (the "Tanzi effect") or heavy reliance on specific taxes.

Similarly, expansionary fiscal policy can help tackle deflation. A well-timed tax cut will increase disposable incomes, encouraging consumption, and higher government spending can help boost production and reduce unemployment. But fiscal policy must be tailored to credibly boost aggregate demand. Spending programs and tax relief should ideally target low-income consumers and good-quality projects that boost the return to private investment.

Managing Capital Account Crises

Capital account crises—that is, a loss of investor confidence manifested in rapid capital outflows—can severely constrain fiscal policy. Once such

[9]Public sector wage increases could increase private sector wages by, for example, forming a benchmark for private sector wage increases or by raising the wage the private sector would need to offer to be competitive.

a crisis hits, fiscal consolidation becomes unavoidable as the deficit is constrained by a lack of financing. More generally, fiscal consolidation is important in those emerging market countries where crises originate mainly in market perceptions of fiscal profligacy and in unsustainable debt dynamics. In these countries, the direct contractionary impact of fiscal tightening on demand is likely to be offset by the beneficial effect of fiscal consolidation on market access and the cost of borrowing.

But where fiscal problems are not the root cause of the loss of confidence, fiscal retrenchment may be counterproductive, as the dampening effect on growth exacerbates the loss of confidence. A more relaxed fiscal stance, in this context, could offset the weakening economic activity (Ghosh and others, 2002). Moreover, to the extent that such weakening is in itself a concern to investors, too tight a fiscal stance risks eroding, rather than enhancing, confidence. This underlines the more general point that prudent fiscal policies during "good" times greatly increase the room for maneuver during "bad" times.