III.
What Makes Fiscal Adjustment Successful?

If it were done when 'tis done, then 'twere well it were done quickly.
—William Shakespeare (1564–1616)

Successful fiscal adjustments durably and efficiently improve the fiscal position while minimizing any welfare costs. Success depends on a range of variables, especially the timing and speed, size, and quality of adjustment.

Timing and Speed of Adjustment

The timing of adjustment is critical, although governments sometimes have little room for maneuver. For example, severe financing constraints may leave governments little choice but to consolidate, and political considerations may prevent consolidation until the problems posed by current policies result in a crisis. But when governments do have room to maneuver, as a rule, fiscal consolidation should occur during good times. More specifically, key considerations could usefully include the following.

- *The point in the domestic business cycle*. Fiscal consolidation (on a cyclically adjusted basis) should ideally begin to kick in as the economy starts the expansionary phase of the business cycle, which would mitigate any contractionary first-round effects. Similarly, fiscal loosening is most appropriate as the economy enters the contractionary part of the cycle.
- *The point in the global business cycle.* A worldwide recovery phase offers a window of opportunity to substitute rising external demand for any fiscally induced slowdown in domestic demand.
- *The stance of monetary policy*. Adjustment will be more successful when it is well coordinated with monetary policy. For example, to minimize any output loss, monetary conditions should ideally relax when fiscal policy contracts, the macroeconomic and public debt situation permitting.

Spreading any social costs over time may help reduce political resistance to fiscal consolidation. And it takes time to design and implement good-quality measures. Together, these factors may also make consolidation more credible. That said, frontloading is at times needed, for example, when a government must show a decisive break with the past or to seize the opportunity of political support, which may wane over time. Resistance to a gradual approach may also flare up at some intermediate stage, leaving the process incomplete, and a prolonged period of austerity can build up discontent.

Size of Fiscal Adjustment

The exact amount of fiscal adjustment needed depends on individual country circumstances, objectives, and constraints, and should be assessed relative to a baseline (unchanged policies) scenario. A decision-tree approach can help pin down the needed magnitude of adjustment. (1) Is debt sustainability (or financing) binding? (2) If not, does the macro-economy need stabilizing? (3) If the answers to (1) and (2) are "no," then fiscal policy has more space to maneuver to directly meet development goals.

Ensuring Public Debt Sustainability

For countries with public debt sustainability problems, the need to achieve fiscal sustainability should anchor the medium-term fiscal path. In these cases, the overriding objective is to improve the primary balance so that it is consistent with debt sustainability. The slower the improvement, the greater it will need to be, as the debt-to-GDP ratio will continue to increase in the meantime.

In theory, solvency requires that the present discounted value (PDV) of a government's current and future primary expenditure be no greater than the PDV of its current and future path of income, net of any initial indebtedness (Chalk and Hemming, 2000). In practice, solvency is typically assessed by checking whether the public debt–to-GDP ratio is stable or declining. Broadly speaking, the debt-to-GDP ratio increases owing to the sum of its own dynamics (the product of its initial value and the excess of the real interest rate over the real growth rate) and the primary deficit.[16] Thus, when the real interest rate exceeds the real growth rate, a primary surplus is needed to stabilize the debt-to-GDP ratio.[17]

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[16]In algebraic terms: $\Delta b = d + (r - g)\, b$, where b is the ratio of government debt to GDP (with Δ indicating the change in the ratio from one year to the next); d, the primary deficit ratio to GDP; r, the real interest rate; and g, the growth rate of real GDP.

[17]More sophisticated versions of the formula differentiate between domestic currency debt and foreign currency debt, while also taking into account non-debt-creating deficit financing (e.g., privatization receipts) and debt-creating items (such as the recognition of contingent liabilities), which are not captured in the deficit.

The main drawback of this approach is that it is silent on whether the initial, or targeted, debt-to-GDP ratio is appropriate. For example, even though the debt-to-GDP ratio might be falling, the debt may still be excessive as it may be causing high interest rates and crowding out private investment. Critically, solvency assessments ignore short-term liquidity issues. For example, a government may be solvent but unable to raise the financing necessary to meet a lumpy repayment. Solvency and liquidity are often interlinked: concerns about a country's solvency may lead to financing problems, and financing problems may induce insolvency, as larger primary surpluses are required to meet the higher interest bill.

Estimates of "safe" levels of government debt vary greatly and depend on individual country circumstances. Liquidity crises and sovereign debt defaults have occurred at very different public debt levels. Safe levels of public debt for low-income countries depend especially on the quality of a country's institutions. Countries operating in a weaker institutional and policy environment are likely to experience debt distress at significantly lower debt ratios. This is because such countries tend to have more difficulty raising revenue or cutting expenditure and are more prone to misuse and mismanage funds. Governments with more volatile revenue bases and primary balances will also tend to be able to sustain only lower levels of debt, especially if their economies are also volatile. As much of low-income-country public external debt is concessional, the PDV should be used, rather than nominal amounts, in calculating public debt ratios (although this requires a judgment on the appropriate discount rate).

Projected primary balances are another useful tool for assessing sustainable debt levels. If the PDV of the projected primary surpluses is below the current debt level, the government will not be able to repay its debt. A key decision is what levels of primary surpluses to project and the following are two useful approaches:

- What average, or peak, primary surpluses were generated in the past. While readily ascertainable, and a valuable reality check, the past may not reflect the current or future policymaking environment.
- What primary balances could the country generate given its institutions and other fundamental factors, derived from a cross-country model. This approach has the advantage of relying less on the country's historical performance. But it requires consideration of factors specific to other countries and may also not reflect a changed policymaking environment.

Recognizing that countries will always face shocks, that projections are necessarily uncertain, and that there is no single measure of debt sustainability, debt sustainability projections should be subjected to stress tests and assessed from different angles. Stress tests should be tailored to risks facing individual countries, but typical risks include lower growth, higher interest rates, sharp depreciation, lower primary surpluses, debt recognition, and market financing constraints. Comparisons to historical levels and past volatility can help gauge the degree of risk. Other useful indicators of sustainability include the ratios of external debt service to exports of goods and services, debt (or debt service) to revenue, gross new borrowing to amortization coming due (the "rollover" ratio), and domestic debt to broad money.

Stabilizing the Macroeconomy

Determining the exact amount of fiscal adjustment depends critically on the quality and type of fiscal adjustment measures. It ideally calls for a full-fledged macroeconomic model, where fiscal policy is linked to macroeconomic objectives through a set of well-defined equations. Such models are rarely available in practice, however, especially in developing countries.

For IMF-supported adjustment programs, the standard methodological framework within which fiscal policies are designed is generally referred to as "financial programming" (Ghosh and others, 2005). The objectives of a financial program are usually specified in terms of the targets for growth, inflation, and the balance of payments. The program is individually formulated within a set of economic and financial accounts (mainly the national income and product accounts, the balance of payments, and the fiscal and monetary accounts), which provides a consistent framework for policy analysis.

A central constraint driving financial programs is that the financing of the fiscal deficit should be consistent with macroeconomic objectives and constraints. Most critically:

- External borrowing should be based on an assessment of the balance of payments, the market's appetite for sovereign bonds, prospects for other official borrowing, and expected inflows through the banking system.
- Domestic borrowing should be based on assumptions about changes in broad liquidity, which in turn depend on money demand developments

(given macroeconomic parameters such as growth and inflation), net foreign asset projections consistent with balance of payments projections, and assumptions regarding credit to the private sector that are consistent with the growth projections.

Meeting Development Goals and Creating Fiscal Space

Countries without binding debt sustainability, financing, or macrostability constraints have more scope to increase government spending to meet development goals. In particular, in many low-income countries, the government plays a central role in providing infrastructure, education, and health services and public spending needs are large. The quantity and quality of these services are critical not only for achieving higher growth but also for human development. The twin goals of higher growth and human development are interrelated, as human capital can be a powerful engine of economic growth.

Fiscal scope for higher government spending on such priority needs can be created by reprioritizing nonproductive spending, increasing revenue, stepping up borrowing, and attracting larger external grants (Heller, 2005a). Public-expenditure-tracking surveys in some low-income countries reveal substantial waste and leakage that could be reduced by better public financial management and improved project selection. Tax revenue can be raised from a low base, but an excessive tax burden will hurt private sector activity. Excessive domestic borrowing will also crowd out the private sector and could lead to debt sustainability problems. Concessional external borrowing is an option, but it may not be available or sustainable. External grants, however, can be a convenient and effective way around these constraints.

That said, grants can complicate fiscal policy, especially when they are large and volatile. In particular, rapid increases in aid could (1) result in inflation and exchange rate appreciation ("Dutch disease") when spent on nontradables; (2) crowd out the private sector, for example, as central banks sell domestic debt to offset ("sterilize") the impact of aid inflows on the domestic money supply; (3) strain the limited absorptive capacity[18]

[18]Absorptive capacity typically refers to limits on a country's ability to use aid effectively owing to the quality of a country's policies and institutions and lack of administrative capacity in the form of specific skills or, more generally, of insufficient human resources and physical conditions (infrastructure and equipment) for policy and program implementation.

(especially if spending is increased rapidly) and impair governance; (4) undermine efforts to enhance the domestic revenue base; and (5) give rise to ongoing current spending requirements that cannot be met when aid flows decline (Heller, 2005b).

These potential adverse effects can be mitigated through such domestic policy responses as smoothing out aid fluctuations through international reserve cushions, strengthening public expenditure management, improving governance, easing supply bottlenecks, and addressing constraints faced by entrepreneurs. Donors can help by making their grants less volatile, more predictable, and less tied to specific projects. They can also usefully channel them through the budget and coordinate better with recipient country development frameworks and other donor countries.

Central to managing a scaling up in aid inflows is the coordination of fiscal policy with exchange rate and monetary policy (IMF, 2005b). From a fiscal perspective, the issue is whether to spend or save the additional aid. From a central bank perspective, the issue is whether to absorb the incremental aid by allowing the current account deficit (excluding aid) to widen, including via exchange and monetary policies.[19]

Absorbing and spending are the most appropriate responses to aid over the long run—the government increases expenditure and aid finances the resulting rise in net imports. Some real exchange rate appreciation may be necessary to enable this reallocation of resources. In the short run, other responses may also be useful:

- Saving incremental aid (i.e., neither absorbing nor spending it) may be a good way to smooth volatile aid flows and their effect on spending, build up international reserves from too low a level, and avoid real exchange rate appreciation.
- Absorbing but not spending substitutes aid for domestic financing of the government deficit. Where the initial level of domestically financed deficit spending is too high, this can help stabilize the economy, reduce government debt, and lower interest rates, thus "crowding in" the private sector.

To spend and not absorb is problematic, often reflecting inadequate coordination of monetary and fiscal policies. This response is similar to

[19]Absorption in this context measures the extent to which aid engenders a real resource transfer through higher imports or through a reduction in domestic resources devoted to producing exports. If the incremental aid directly finances imports, or is in-kind aid, spending and absorption are equivalent.

a fiscal stimulus in the absence of aid. The aid goes to reserves, so the increase in government spending must be financed by printing money or through government borrowing from the domestic private sector. There is no real resource transfer given the absence of an increase in net imports. In other words, a given aid dollar can be used to build reserves or to increase the fiscal deficit—but not both.

Quality and Durability of Adjustment

Research indicates that the success of fiscal adjustment, especially the growth response, depends on the quality and durability of the specific measures underpinning it. Government expenditures that are productive and a tax system that is efficient and broad based contribute to growth and development. And measures perceived as durable allay concerns about debt sustainability and alter people's behavior. Fiscal responsibility laws, transparency, and good governance can also play an important role in achieving high-quality and durable adjustment.

Quick Fixes

In reality, policymakers face constraints that can preclude smooth and timely implementation of high-quality reforms. This may be especially true when immediate fiscal tightening is needed to avert an impending crisis. In such cases, policymakers may opt for short-term reduction of deficits through measures that cannot be sustained or that hamper growth ("quick fixes")—which are typically spending cuts. If they cannot be avoided, they should at least be quickly replaced with better-quality measures.

- Across-the-board cuts often seem attractive; this approach allows each individual operating ministry to decide how to cut its budget and it appears to imply equal hardship for all. But cuts in dissimilar programs will not have the same economic consequences. Such cuts can also quickly lead to arrears, add to long-term costs (e.g., by postponing maintenance), avoid having to revisit priorities, and lead to inefficiencies by disturbing work patterns (e.g., no gasoline for tax inspection vehicles or ambulances). In the absence of a more fundamental review, any savings are likely to be reversed sooner or later.
- Across-the-board cuts in nonwage current spending can result in less funds for highly productive nonwage social sector inputs, such as medicines or textbooks.

- Spending financed from privatization proceeds may need to be reversed once this one-off source of financing dries up.
- Financial transactions taxes can drive financial transactions underground, especially if set at relatively high levels. Fewer financial transactions result in falling revenue yields, the economy loses productivity, and the banking system suffers.
- Export surcharges undermine the competitiveness of the critical export sector, reduce the country's access to foreign exchange, and weaken growth.
- Repeated tax amnesties—apart from raising fairness issues—erode taxpayers' incentives to comply with tax laws and damage the credibility of tax authorities. This results in lower revenues over the longer term, with the benefits typically accruing to the better-off in society.

Durable Adjustments

Durable expenditure reductions in industrial countries typically involve tackling the wage bill, subsidies, and transfers (Alesina and Perotti, 1997). Evidence also suggests that emerging market economies with lower subsidies and transfers or higher revenues are more likely to sustain consolidations. Similarly, developing countries that cut selected current spending while protecting capital expenditures tend to experience longer-lasting adjustment. For countries with low revenue-to-GDP ratios (most developing countries), revenue increases can also lengthen the duration of fiscal consolidation (Gupta and others, 2004).

Higher-quality and more durable reforms typically take time to implement and to yield budgetary benefits. This is true, for example, for broadening the tax base or shifting from trade taxes to broad-based sales taxes, especially when administrative capacity is weak. Civil service reform requires prior groundwork preparation, such as civil service censuses, and may also require severance outlays (Box 4). Such measures should therefore be implemented as part of an overall policy package that provides for an appropriate degree of short-run deficit reduction.

Fiscal Responsibility Laws

Fiscal responsibility laws aim to impose durable fiscal discipline and overcome the problem of "deficit bias" (IMF, forthcoming). Such laws attempt to impose an underlying constraint, of varying degrees of formality, on fiscal policy and often on those that make it. Fiscal responsibil-

Box 4. Civil Service Reform

Civil service reform often plays a central role in fiscal adjustment programs. Such reforms typically aim to reduce high wage bills (which they have often failed to do), improve productivity, and lessen incentives for corruption. A centralized reform strategy is based on a functional review that identifies unnecessary programs and positions. A decentralized strategy focuses on changing the incentive structure (freedom in hiring/firing/pay decisions and performance-based budgeting and assessment of top personnel). The prerequisites for a successful decentralized reform are a high degree of transparency and accountability.

Civil service reform is particularly difficult but careful sequencing helps.

- Civil service censuses and functional reviews should precede the design of retrenchment programs. In Cambodia, for example, a civil service census and the fingerprinting and registration of civil servants in all provinces reportedly eliminated thousands of ghost workers.
- Civil service wages should be set within the budget process (rather than independently by parliament), and monetization and consolidation of benefits should precede reforms of pay structures. In Honduras, for example, before reforming the salary structure, a new wage policy law had to be passed. The law eliminated special wage regimes and gave the ministry of finance (rather than congress) the power to determine government wage increases.

ity laws can entail numeric rules, such as a balanced budget, or impose procedures focusing on enhancing transparency and accountability. They typically require that the government commit to a monitorable fiscal policy strategy or to specific fiscal targets.[20] Some contain well-defined sanctions for noncompliance. Fiscal responsibility laws generally include explicit escape clauses that suspend their application during exceptional circumstances, such as natural disasters or severe recessions. They can also define fiscal targets in terms of multiyear horizons or structurally adjusted indicators.

[20]Independent fiscal authorities are an alternative to numerical rules to depoliticize fiscal policy decisions, but devolving such authority can be politically difficult. Fiscal councils that provide independent analysis are a less politically difficult option, but they are less binding on policy.

Because in most countries fiscal responsibility laws have not been around for more than a few years, evidence on their effectiveness remains preliminary. But some tentative lessons seem to be emerging:

- *Institutions should be sufficiently developed to support the requirements included in the legal framework*. Public finance management systems, in particular, should be sufficiently advanced to credibly implement, and enforce, the procedural and fiscal rules.
- *Fiscal responsibility laws require broad political consensus to be successful and are not a substitute for political commitment.* While the adoption of such laws can potentially catalyze meaningful reforms promoting fiscal prudence, experience suggests that broad support for fiscal prudence is a precondition for their success. Designing the framework takes time and should be aimed at addressing country-specific weaknesses in fiscal management that underlie poor fiscal outcomes. These requirements may not be met in countries facing large macroeconomic imbalances or political instability.
- *Fiscal responsibility laws should cover a broad definition of government.* Those with broader coverage of the public sector tend to be more successful than those more narrowly focused (e.g., only on the central government).
- *In countries with a weak track record of policy implementation, procedural rules may work better than numeric rules.* Under these circumstances, procedural rules[21] can often be beneficial by promoting fiscal discipline through increased transparency and accountability.
- *Numeric fiscal rules, if included, should be carefully designed.* Numerical rules can be helpful, for instance, in containing a deficit bias, but they are not in themselves the solution to structural fiscal problems. Numeric fiscal rules can even foster creative accounting and low-quality measures.
- *While fiscal rules have worked in particular cases, the evidence on their effectiveness in improving fiscal outcomes remains tentative.* If adopted, fiscal rules should be (1) well-defined regarding the specific fiscal indicator to be targeted, the institutional coverage, and, if any, escape

[21]Procedural rules aim to enhance transparency, accountability, and fiscal management. They typically require the government to commit up-front to a monitorable fiscal policy strategy, usually for a multiyear period, and to routinely report and publish fiscal outcomes and strategy changes.

clauses; (2) simple and transparent, to serve as an effective instrument of communication of government policy objectives; and (3) monitorable, so that noncompliance can be easily detected and addressed. Their credibility ultimately depends on the government's track record and on political and social consensus.

- *Enforcement mechanisms should be credible and effective.* Escape clauses should be reduced to a minimum to ensure the credibility of the process. These frameworks should also define enforcement mechanisms that could include financial or administrative sanctions for responsible government officials.
- *Fiscal responsibility laws should enhance transparency*. Countries with poor transparency and budget procedures are also unlikely to effectively monitor a meaningful quantitative fiscal target or enforce accountability.

Transparency and Governance

Fiscal transparency can support fiscal adjustment by contributing to better and more sustainable policies, and by strengthening accountability. Fiscal transparency seeks to enhance the public's understanding of the structure and functions of government, fiscal policy intentions, the soundness of public sector accounts, and fiscal projections (Box 5). It should contribute to a more balanced adjustment, especially in the short term, since targets can only be set on activities that are reported fairly reliably.

Fiscal transparency should make adjustment measures more durable by generating broader public support and understanding; by facilitating donor support through credible assurances about the use of donor funds; and by increasing predictability for, and confidence in, financial markets. Transparency also makes officials more accountable and reduces the scope for circumventing the declared adjustment effort by, for example, thwarting attempts to shift activities off budget. Parliaments can play a particularly important role in enforcing transparency.

Globalization has increased the pressure on, and rewards for, countries to be more transparent and accountable in managing their economies. It creates incentives for policymakers to reform policies and institutions to enable their countries to benefit from the rising international flows of capital, technology, and information. Increasingly, attracting foreign direct investment and accessing financial markets at reasonable rates requires

Box 5. Fiscal Transparency

The IMF's Code of Good Practices on Fiscal Transparency (IMF, 2001b) is a set of good practices that can be implemented by most countries over the medium to longer term. It presents a standard of fiscal transparency that provides assurances to the public, to donors, and to markets that a sufficiently complete picture of the government's structure and finances is available to facilitate a reliable assessment of the soundness of a country's fiscal position. The code is based on four general principles.

- The principle of *clarity of roles and responsibilities* requires specifying the structure and functions of government, responsibilities within government, and relations between government and the rest of the economy.
- *Public availability of information* emphasizes the importance of publishing comprehensive fiscal information at clearly specified times.
- *Open budget preparation, execution, and reporting* covers the type of information made available about the budget process. Budget documentation should specify fiscal policy goals, and the macroeconomic framework, and should clearly describe new policies and identify major fiscal risks.
- *Assurances of integrity* stress the quality of fiscal data and the need for independent scrutiny of fiscal information. This includes an external audit by a national audit body and assessment by independent experts of fiscal forecasts, the macroeconomic forecasts on which they are built, and all underlying assumptions.

not only sound macroeconomic policies but also more transparent and accountable public institutions.

Governance plays a critical role in determining the quality of fiscal adjustment, especially in scaling up expenditure in low-income countries. Good governance is generally recognized as a core ingredient of successful development. It is pivotal for translating resources into outcomes, given the strong link between the quality of a country's governance system and its development performance. And in an aid environment that increasingly rests on mutual accountability between donors and recipient governments, governance plays a vital role in stimulating and maintaining donor flows.