Fiscal Policies, Adjustment, and Stabilization

Reconciling fiscal measures with adjustment and stabilization goals under Fund-supported programs

Fiscal measures adopted in many Fund-supported programs have frequently been chosen to meet a fiscal deficit target. Sometimes these measures have not been consistent with longer-term efforts at reform of the tax system or restructuring of expenditure policies to ensure durable adjustment with growth. This apparent conflict of objectives has prompted Fund staff to examine closely efforts to reconcile the aims of structural adjustment, stabilization, and fiscal policy.

In recent years, the Fund has increasingly recognized that fiscal measures can also significantly shape the process of macroeconomic adjustment, the rate of economic growth and capacity utilization, and a country’s external account position. The character of tax and expenditure policies pursued by a government can give important signals to economic agents and can have pervasive effects on many aspects of the economy. They influence commodity and factor prices, savings and investment incentives, external capital flows, the level and structure of capital accumulation, the effectiveness of markets, the volume of transactions in the official sector, and patterns of consumption (see accompanying article by Gray and Linn). Furthermore, in countries with unprofitable public enterprises that dominate the production (thereby improving aggregate supply) and enhance the revenue elasticity of the tax system by making it broader-based and more efficient.

Taxes influence relative prices through their differing impact on supply and demand for different products or factors of production. Depending on demand and supply elasticities, taxes may affect individual markets and sectors of an economy very differently. Thus, over time, the choice of tax measures under a Fund-supported adjustment program importantly affects resource allocation and growth prospects. In the short run too, given different supply elasticities of the production factors, increases in the rates of different taxes, though they may raise the same amount of revenue, can have very different effects on aggregate supply and the balance of payments.

Indirectly, tax reforms can depoliticize the tax system by making it transparent and by signaling equal treatment of, for example, public and private enterprises or domestic and foreign investors. Generally, lowering taxes on businesses and capital incomes, and harmonizing them with the taxes prevailing in other countries can contribute to the elimination of disincentives to investment or of incentives to capital flight. In general, appropriate, consistent, and credible tax measures help create confidence in the authorities’ commitment to an adjustment program.

On the expenditure side, the effects of specific measures on aggregate demand and on the external account will depend on the type of expenditure involved. A cut in, say, the purchase of military hardware, will directly affect the balance of payments, while salary reductions for government officials may only have an indirect effect, depending on those employees’ marginal propensity to import.

For public expenditure policies to increase aggregate supply in the short run, they must support production and improve the institutional environment for business. Government capital expenditures may not seem to have a significant effect on production in the short run, but they may be important for increasing the productive capacity of the economy over the longer run. This effect, however, will depend on whether or not aggregate demand policies permit use of the increased capacity. This underscores the importance of appraising the contribution of particular expenditures—capital or current—to increased efficiency and capacity in an economy. It also requires attention to sources of low productivity in government, which may also directly affect the quality of its operations.

The success of an adjustment program rests on a government’s policy package and its ability to implement the needed reforms.

This article is drawn from a longer report prepared by members of the staff of the Fund’s Fiscal Affairs Department, including M. Blejer, M. Casanegra, V. Gandhi, P. Heller, A. Premchand, and C. Yandle.
The creation of institutional support for their implementation can, therefore, enhance this ability. Otherwise, fiscal performance may fall short of targets and adversely affect the process and pace of adjustment. Improvement of the tax administration machinery is a vital component of any such effort. Revenue will not be collected as planned without strong tax administration, simple tax codes, effective penalty systems, the use of modern information technologies, and the adoption of administrative shortcuts, such as the presumptive taxation of small taxpayers, farmers, traders, and professionals. The mere announcement of the passage of a tax law (sometimes required as a “prior action” under Fund-supported programs), will have little or even a negative fiscal effect if the appropriate administrative machinery to implement the policy is not in place.

Similarly, a strong budgeting and expenditure control system is critical, and this can be achieved by making its objectives clear and by improving fiscal reporting mechanisms. Timely fiscal data are necessary for effective fiscal management and to monitor the performance of government and public enterprises (see article by Blondal, in this issue). In this regard, the restructuring of the public enterprise sector can not only improve the efficiency of governmental expenditures but also provide a signal to investors and creditors (domestic and foreign) about the economic policies and growth potential of a country.

Bearing in mind the potential impact of structural fiscal measures, briefly discussed above, a government can begin to measure the potential interaction of specific fiscal policies with adjustment and stabilization goals.

**Structural fiscal measures**

The appropriate mix and sequencing of fiscal measures in a Fund-supported program will differ according to the situation of a particular country. The choice of measures for a given adjustment program is likely to be determined by a number of factors.

First, individual measures may be chosen according to the nature, magnitude, and timing of their impact. Some directly affect the external balance while others operate indirectly to affect the size and composition of aggregate demand, savings and investment, or the operational efficiency of particular markets (e.g., road maintenance facilitating the marketing of export crops). Measures also differ as to the size of their fiscal impact or the period over which they may achieve the desired effects. A few structural revenue measures tend to be time-consuming to implement (e.g., a comprehensive value-added tax), but their ultimate impact on revenue and its elasticity as well as on the efficiency of resource allocation can be considerable. Some measures may have a transitory impact (e.g., the increased revenues derived from the sale of assets) whereas others may have a more permanent impact on the revenue base.

Second, the economic, political, and institutional costs of implementation create significant differences among fiscal measures. Correcting distorted commodity or factor prices that affect the profitability of public utilities and nonfinancial public enterprises may be administratively simple, but in some cases may be politically costly. Similarly, elimination of redundant civil servants or cuts in selected ministry budgets may be politically sensitive, may even increase expenditure in the short run, and may need a long time to implement. While some structural tax measures may not require much administrative or legislative action, implementation of others may involve considerable institutional changes. These may include a strengthening or redeployment of tax administration efforts, possibly necessitating computerization, additional training of personnel, and the institution of new collection procedures and tax returns.

Third, concern for the sustainability of fiscal measures over the medium term suggests the need for measures that are unlikely to be reversed by authorities or rendered irrelevant by external events. Fiscal measures vary in their durability. A decision to defer particular government expenditures, whether current or capital, can be readily and quickly reversed at the conclusion of an adjustment program. It may, therefore, have little medium-term impact on the structural fiscal balance. On the other hand, measures that reduce the number of government employees or that remove price controls or subsidies may prove more durable on the expenditure side. Measures that enlarge the tax base, or that shift particular taxes from a specific to an ad valorem basis, may also be more durable and less susceptible to change or to being nullified by inflation.

Fourth, some structural measures can be more easily planned and monitored than others, and this can influence their chances of success. For example, the size of the government’s work force cannot be reduced without adequate and accurate personnel information.

Finally, structural fiscal reform can succeed only if there is strong political commitment and perseverance on the part of the authorities. In most cases, the success of fiscal measures will depend upon the implementation of other appropriate policies aimed at removing significant nonfiscal distortions.

This discussion suggests some of the difficulties that confront the Fund staff and the country authorities in the design of a package of structural fiscal measures within a short-term adjustment program. It also stresses that structural measures that have a significant impact on medium-term external viability can be implemented only gradually.

**Quality of fiscal adjustment**

The effects on aggregate demand and supply of individual revenue and expenditure measures can be quite varied. As a result, a change in the fiscal deficit, brought about without taking into account the nature of the instruments used to change government revenue and spending, might not provide a clear indication of the net impact on aggregate demand. Also, fiscal measures that reduce the fiscal deficit in the short run may not always improve the quality of medium-term adjustments or achieve a durable macroeconomic equilibrium. The latter can be achieved only by measures that improve the efficiency of the fiscal system. However, structural fiscal measures may well take longer to implement and some of them may not be compatible with the short-term fiscal deficit target, set within the financing constraints of a financial program. Some structural measures may also be costly in the short run. By reducing revenues or increasing expenditure, they may run counter to the need for reduced government absorption.

The elimination of an export tax, for example, may reduce government revenues and increase the deficit in the short run. In the medium term, however, such a policy should generate an expansion in output and export earnings, and add to revenue from other tax sources. Another example that illustrates the conflict is a policy to reduce employment in the public sector, especially in financially unprofitable public enterprises. Such a measure may produce positive results in the medium term by making these enterprises efficient, and by reducing their costs and thus their dependence on government support. However, in the short run, it may increase separation and unemployment benefits, thereby adding to the government budget and increasing the deficit.

In summary, the structural fiscal measures lead to three areas of concern:

- they may have direct budgetary implications which may not be affordable in the short run;
- the medium-term efficiency gains to be derived from such measures are sometimes of uncertain magnitude or are likely to arise with a time lag, so that they cannot be easily embodied in a medium-term fiscal policy; and
- many structural measures may promote economic growth while worsening the exter-
nal account (e.g., increased growth that may lead to increased imports) in the short run.

Addressing the issues

In order to pre-empt many of the preceding problems and concerns, several important issues need to be recognized in formulating fiscal policies under Fund-supported adjustment programs. The direct budgetary costs of structural fiscal measures should be absorbed within the overall financial framework of an adjustment program. If the macroeconomic effects of these budgetary costs are higher inflation, a rundown of international reserves, or a crowding-out of private investment, the chances for success of the structural reforms would be largely weakened. However, the manner in which the financing gap is closed is also very important.

Experience shows that, at the margin, structurally valuable elements of the budget (e.g., operations and maintenance expenditures or high-quality capital projects) are often the most susceptible to the cuts required to realize the desired budgetary targets. Meanwhile, less productive elements remain protected because of their perceived political and social implications. Similarly, at the margin, revenue measures may adversely affect production and investment patterns. In the final analysis, the private sector will have to bear the burden of the fiscal choices made, and the important task is to consciously determine the choices that are least detrimental to the external adjustment process and growth.

Evaluating these choices is obviously difficult but essential. It requires an in-depth analysis of relative rates of return at the margin of fiscal policies, as the allocation pattern of private credit is most important.

Further, the increased uncertainty associated with the effects of structural fiscal measures may argue for caution in the reliance on such measures to close a short-run external financing gap. It may also lead to a reluctance to take account of the effects of some structural measures in the formulation of a medium-term financial scenario. While it may be appropriate for governments and the Fund to minimize the risk associated with an adjustment strategy, it may be important to consider whether structural fiscal measures—regardless of their short-term risks—could provide greater flexibility in making macroeconomic policy over the medium term.

While some structural fiscal measures may contribute little to external adjustment, others could help ease the external constraint. The latter include measures that may directly influence the trade account by encouraging exports or reducing imports (either directly by cutting government imports or by influencing the private sector's marginal propensity to import). Other measures may improve the capital account by inhibiting capital flight, attracting capital repatriation and foreign investment, or reducing foreign interest payments. Structural fiscal reforms may also provide the bilateral and multilateral donors with greater confidence in the quality of an adjustment program, perhaps encouraging them to provide more assistance in the early stages of reform. Thus, structural fiscal reforms can play a significant and positive role in ensuring the medium-term viability of a country's balance of payments. Efficient and growth-oriented structural fiscal measures are preferable to ad hoc distortionary policies, provided the added burden of short-run adjustment can be reduced by the application of other policy instruments.