The Fiscal Dimensions of Adjustment

How do we judge the overall fiscal performance of low-income countries that have undertaken adjustment?

Sanjeev Gupta and Karim Nashashibi

Fiscal adjustment—comprising both stabilization and structural reform—is at the core of most IMF-supported programs. But how have countries that have made sustained use of concessional IMF resources actually fared in meeting these dimensions of adjustment?

This is the focus of a recent IMF study that assessed fiscal developments in 23 low-income countries in Africa, Asia, and Latin America that implemented IMF-supported programs during 1986–91. The study contained two components. First, it compared the fiscal performance in the latest year of the program with (1) a base year (1984 or 1985, or an average of the two); and (2) one year prior to the program, which often coincided with a worsening of the economic situation. These comparisons provide a guide to the actual "adjustment effort." Second, it looked at structural reforms, which are meant to strengthen the institutional capability to undertake good economic management and mobilize public resources.

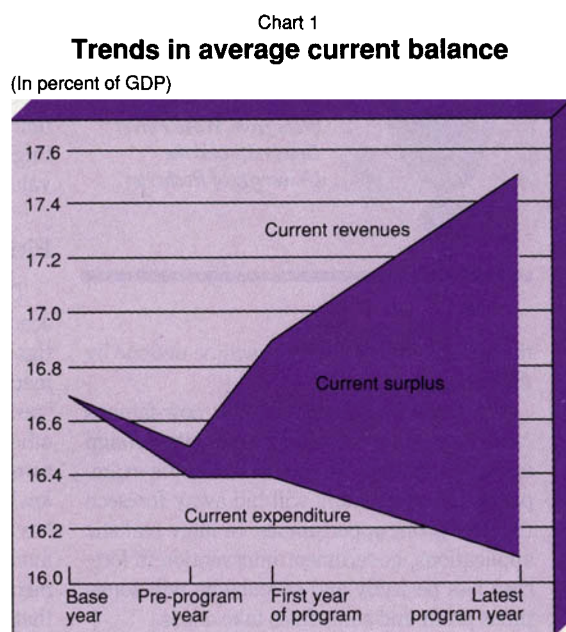
The results of the study show relatively small improvements in key fiscal indicators. But these fiscal developments should be interpreted with caution, because the structural changes—which lay the ground for better fiscal performance in the future—are not yet fully reflected in the quantitative measures.

This article is based on IMF Occasional Paper No. 95, "The Fiscal Dimensions of Adjustment in Low-Income Countries," by Karim Nashashibi, Sanjeev Gupta, Claire Liuksila, Henri Lorie, and Walter Mahler, available from IMF Publication Services, Washington, DC 20431, $15.

Chart 1

Trends in average current balance

(In percent of GDP)



Sources: Data provided by the authorities; and IMF staff estimates.

Magnitude of fiscal adjustment

A key objective of all adjustment programs has been to strengthen public sector savings, with the twin aims of making additional domestic and foreign resources available to develop the private sector and supporting productive public investments (particularly in infrastructure and human capital). One way of measuring public sector saving is to examine the *current balance* of government operations—that is, the difference between total current revenue, excluding external grants, and current expenditure. However, caution must be exercised in using this concept of current balance because of the possibility of misclassification of expenditures.

For the countries studied, the current balance on average improved, but by less than expected. Compared with the base year and the pre-program year, this balance strengthened by around 1.3 percent of GDP (see Chart 1). Only about 20 percent of the countries improved their current balances by more than 2–3 percent of GDP at the end of the program compared with the pre-program year.

A measure of the overall net impact of fiscal policy on aggregate demand and of the absorption of foreign and private domestic savings by the government is the *overall balance* of government operations—that is, total revenue, excluding grants, minus total expenditure. The study showed evidence of some improvement, with the average overall budget deficit falling by around 1.1 percent relative to the base year and by 0.9 percent relative to the pre-program year.

Sources of fiscal adjustment

How a government reduces the budget deficit and how it finances the overall deficit is just as important as the magnitude of the adjustment. A reduction in the fiscal deficit achieved through cutting investments for productive infrastructure or trimming expenditures on operations and maintenance, for example, may not be sustainable over time. It may even be counterproductive, if the cuts lead to a deterioration of infrastructure, education, and health.

In the sample studied, many countries reduced their deficits by both revenue-enhancing and expenditure cutting measures.

Revenue. More than half of the countries increased their ratio of tax revenue to GDP vis-à-vis the base or pre-program year (see Chart 2). The actual increase in tax revenue, however, fell short of the program objectives

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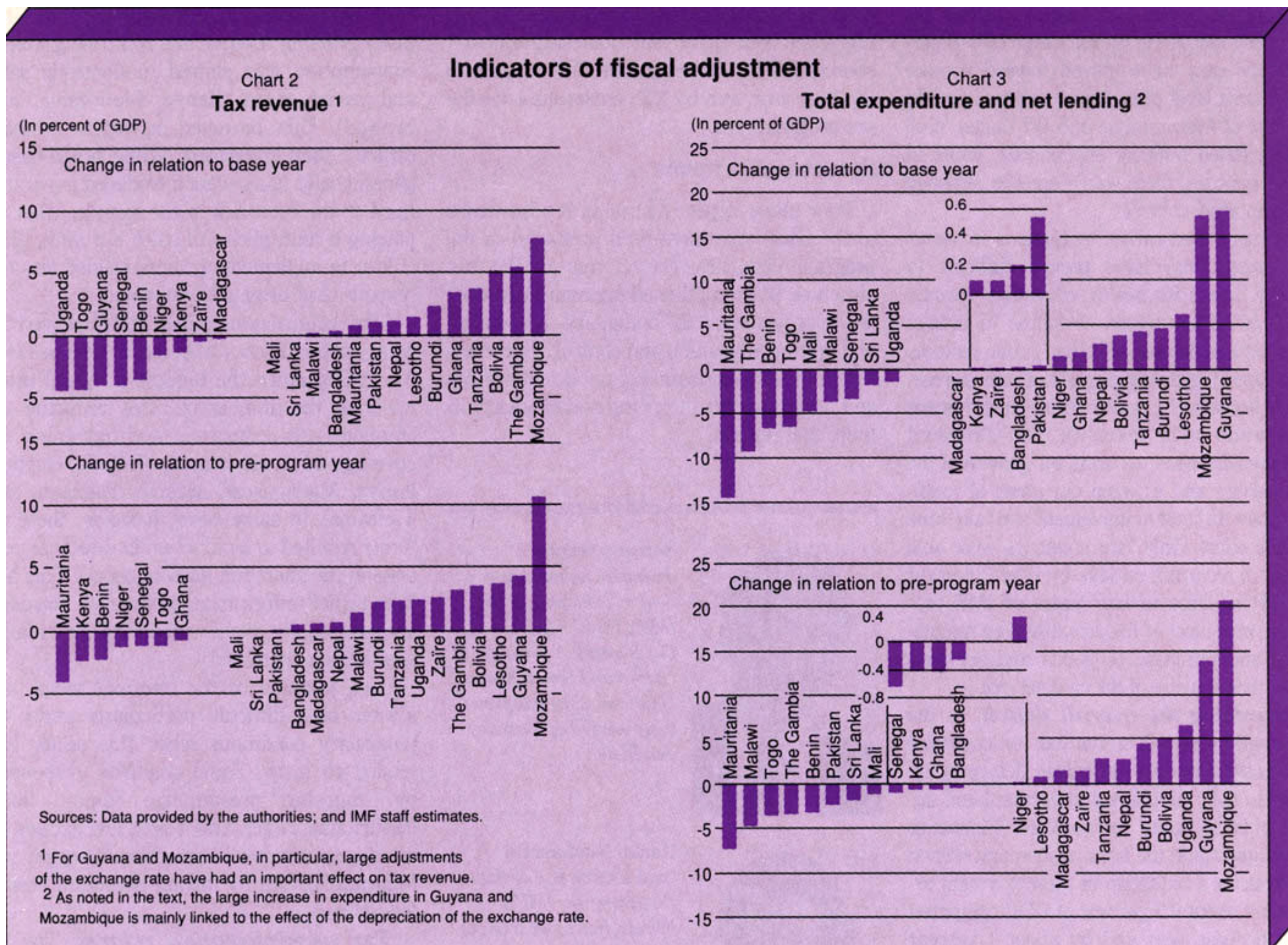

Sources: Data provided by the authorities; and IMF staff estimates.

[1] For Guyana and Mozambique, in particular, large adjustments of the exchange rate have had an important effect on tax revenue.

[2] As noted in the text, the large increase in expenditure in Guyana and Mozambique is mainly linked to the effect of the depreciation of the exchange rate.

in most countries, partly because of deficiencies in the design, implementation, and sequencing of tax structure and reform.

The tax ratio averaged 13.7 percent of GDP in the base year, declined to 13.4 percent in the pre-program year, and increased to 14.1 percent in the latest year of the program. This modest increase over the program period reflects in part the difficulty of raising the ratio of tax revenue during a period of deteriorating terms of trade and widespread efforts to reduce tariffs. The 12 countries that increased their tax ratio relative to the base year did so by an average of 2.8 percent. The increase exceeded 5 percent of GDP in Bolivia, The Gambia, and Mozambique, and more than 3 percent of GDP in Ghana and Tanzania. Relative to the pre-program year, only nine of the 23 countries succeeded in raising their tax ratio by 2 percent of GDP or more, suggesting that substantial increases in tax revenue take time.

Tax ratios increased significantly in countries that embarked on comprehensive reforms of their tax systems (for example, Bolivia and The Gambia) or implemented policies that reduced domestic distortions and realigned relative prices (Bolivia, Ghana, Mozambique, and Tanzania) by adopting a more realistic exchange rate and freeing some administered prices. The tax base shrank in most of the countries in Africa that peg their currency to the French franc (CFA franc zone), a reflection of the recessionary conditions induced by a sharp decline in terms of trade, combined with an appreciation of the real effective exchange rate, import liberalization, and tariff reform. Average revenue from nontax sources (e.g., interest, rent, profit, and dividends) also improved slightly, reflecting in part windfall gains on domestic sales of imported commodities and an increase in public utility rates.

Expenditure. Total expenditure remained virtually unchanged at around 25 percent of GDP during the program period. This underscores the difficulty of lowering the largest components of recurrent expenditure, such as wages and salaries, while attempting to enhance fixed capital formation (see Chart 3). Average capital expenditure remained steady at 8 percent of GDP during the program period. When comparing the latest program year with the pre-program year, about half of the countries increased their capital expenditure to GDP ratio with the aim of increasing productive investment. Of these, four countries (Bolivia, Ghana, Tanzania, and Uganda) started off with very low public investment ratios (2–4 percent of GDP), while other increases were quite modest. In some countries, such as The Gambia, Sri Lanka, and Togo, where capital spending was unusually high, a part of the fiscal adjustment was secured by weeding out unproductive investments. But in most cases, despite the objective of promoting growth through higher productive investments, capital expenditure was lower than programmed, enabling the overall deficit targets to be attained.

Current expenditure, on average, declined only marginally—from 16.4 percent of GDP in the pre-program year to 16.1 percent in the latest year of the program. Relative to the pre-program year, recurrent expenditure declined in 13 countries, with particularly large adjustments in Kenya, Lesotho, Malawi, and Mauritania. Of the ten countries that increased their recurrent expenditure,

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Bangladesh, Nepal, and Uganda started off with very low levels (in the range of 6–8 percent) and may have moved toward a more sustainable level of recurrent expenditure. In the case of Mozambique and Sri Lanka, civil strife inflated military expenditure, while in other countries, there was a marked slippage in expenditure control.

As mentioned earlier, reductions in recurrent expenditure have proved difficult to achieve. Needs for health, education, maintenance of infrastructure, measures to protect the poor, and delivery of other public services for a rapidly growing population are increasing. Alternatively, government employment often tends to be excessive, and structural measures designed to curtail the growth of the civil service and to weed out areas of inefficiency are difficult to implement and take time to have effect. Only four countries were able to reduce recurrent outlays by over 2 percent of GDP in three to four years of IMF programs, with most of the cuts affecting maintenance and purchase of goods and services, rather than the size of the civil service.

Financing the overall deficit. In the pre-program period, a number of countries facing severe budget difficulties delayed payments to their suppliers and accumulated unpaid bills to cover expenditure. Financing data suggest that the fiscal adjustment helped to accelerate a reduction in these payment arrears, by about 0.5 percent of GDP compared with the base year and by about 1 percent with respect to the pre-program year. The proportion of the deficit financed through foreign sources rose to 8 percent of GDP from 6 percent during the program period. On its own, this increase is not an indication of rising dependence on foreign financing, because of significant exchange rate devaluations in many of the countries in the sample. However, estimates of foreign financing expressed in US dollars, comprising grants and loans (the latter adjusted for repayments), show that the average flow of foreign resources to each of these countries increased from an average of $165 million in the base year to $311 million in the latest program year.

Averages, however, conceal marked variation across countries. For instance, Bangladesh, Pakistan, and Zaïre each received over $350 million more in the latest program year than in the base year. These resources helped finance an increasing proportion of total expenditure in the sample countries, from an average of 23 percent in the pre-program year to 31 percent in the latest program year. While this increase in external financing was not matched by higher public investment, it did help countries to undertake structural reforms and to resort less to inflationary borrowing from the banking system. The average financing from both bank and domestic nonbank sources fell by 2.8 percent of GDP relative to the base year, and by 2.2 percent vis-à-vis the pre-program year.

Structural reforms

Four major types of structural adjustment in the fiscal area have been promoted in the program countries: (1) reforms of the tax structure; (2) strengthened tax administration; (3) improvements in budgetary accounting and in the composition and control of expenditure; and (4) privatization of public enterprises and improvements in pricing and efficiency in those that remain.

Sanjeev Gupta
an Indian national, is a Senior Economist in the IMF's Fiscal Affairs Department. A graduate of Oxford and Simon Fraser Universities, he has previously worked in Germany and India.

Karim Nashashibi
from Jordan, is Assistant Director of the IMF's Fiscal Affairs Department. He has a PhD from the University of California at Berkeley.

Tax system reform. In general, to broaden the tax base and to promote efficiency, the countries under review reduced their reliance on international trade taxes in favor of domestic taxes. Export duties on primary products, therefore, were reduced or eliminated in most countries, except for environmental considerations—a move that was also necessitated by the sharp fall in world commodity prices. In most programs, there were attempts to simplify the tariff structure, reduce exemptions, and make customs duties responsive to price changes. Thus, in many countries, the number—as well as the highest levels of import duty rates—were reduced, a minimum import duty imposed, duty exemptions reduced, and specific rates converted to an *ad valorem* basis.

Since these reforms tended to reduce revenue from taxes on international trade, the task of raising revenue and controlling luxury consumption was shifted to domestic sales and excise taxes (Kenya, Mauritania, and Senegal). This, however, proved to be more difficult than envisaged. While broad-based, general sales taxes were introduced in about a third of the countries in the sample, often replacing a multiplicity of sales tax rates, difficulties in implementing them yielded less tax revenue than originally estimated.

Some countries simplified and improved the equity and efficiency of personal income taxes by scaling down the highest marginal rates, lowering the number of rates, reducing exemptions and deductions, and tightening the coverage of fringe benefits (Bolivia, Guyana, Kenya, Madagascar, Malawi, Pakistan, and Tanzania). In some cases, however, these reforms resulted in a reduction in direct tax revenue in the short run (Madagascar). This has been rather unfortunate, because, on considerations of equity, the revenue from direct taxes should have increased.

Last, taxation of the informal sector has always been difficult, particularly under recessionary conditions when this sector has tended to grow. Some countries responded by imposing presumptive import taxes (Mauritania, Niger, and Togo), low excises on mass consumption commodities (Senegal and Mauritania), and by raising minimum license fees (Niger).

Tax administration reform. The reform of the tax system has been supported by stronger tax administration, including better training, salaries, and conditions of service of revenue collection personnel. Ghana improved the efficiency of its revenue collection by establishing a new revenue secretariat, with better salaries and special bonuses for meeting specified revenue targets. Benin, Bolivia, and Tanzania introduced special incentive schemes for revenue collectors. Uganda is establishing a well-paid revenue collection entity, separate from the civil service. In Kenya, to simplify the administration and rationalize the structure of the value-added tax, the number of rates was halved, while in Sri Lanka the penalty and appeals system was strengthened and a special unit set up for the largest payers of income and business turnover taxes.

Budgetary reform. Many countries have attempted to improve the transparency of budget accounts and extend the coverage of basic fiscal accounts to encompass most public activity. For instance, Ghana, Guyana, Tanzania, and Uganda reduced or eliminated the implicit subsidies resulting from undervalued interest rates or exchange rates. In other countries, special and extrabudgetary accounts have been consolidated into the gen-

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eral fiscal accounts (Mali, Mauritania, and Senegal), and foreign financed project aid has been integrated into the general budget (Benin, Madagascar, and Mozambique). Some improvement in the composition of expenditure across and within major components was achieved, although the impact on the budget balance has tended to be modest.

A number of countries (The Gambia, Ghana, Lesotho, and Malawi) managed both to reduce the civil service wage bill as a percentage of GDP and to reform its structure. A few also made efforts to contain or reduce military expenditure and other forms of relatively unproductive expenditure (Mozambique and Pakistan), but little progress was achieved. In addition, countries have paid more attention to the design of measures to cushion the impact of economic adjustment on the poor (see "Poverty Concerns in Fund-Supported Programs" by the authors, in *Finance & Development*, September 1990).

Public enterprise reform. A number of programs (Madagascar, Mali, Senegal, and Togo) sought a comprehensive reform of public enterprises. Plans were drawn up identifying enterprises to be liquidated, privatized, or rehabilitated. While progress has been achieved, almost all efforts at restructuring the public enterprises sector proceeded more slowly than initially planned. Substantial delays were encountered in the liquidation of nonviable public enterprises and also in attempts at privatization (Madagascar, Mali, Senegal, Sri Lanka, and Togo). This delay was due to the legal and technical complexity of such a process, weak administrative capacity, lack of credible private sector purchasers, and above all, weak political commitment.

Togo was one of the few countries to generate a significant amount of funds from privatization. Bolivia, by combining flexible pricing policies, privatization, and reductions in employment, was able to eliminate almost all budgetary transfers to public enterprises. For those enterprises that remained in the public sector, there was an effort to improve the quality of management by granting them some autonomy and providing incentives through a variety of performance contracts specifying clear objectives (The Gambia, Senegal, and Togo).

Efforts to improve the financial situation of existing public enterprises also focused on ensuring that appropriate pricing policies were in place. It proved to be more difficult, however, to devise mechanisms to improve efficiency and reduce costs. Excessive employment remained a common source of inefficiency, and cumbersome labor and price regulations impeded progress. Monopolistic marketing boards, which extracted an implicit import tax, were abolished in some countries (e.g., rice imports in Senegal and Togo). In others (Ghana, Kenya, and Tanzania) processing and exporting activities were handed over to the private sector, which was allowed a greater role in trading primary products and foodgrains. Attempts were also made to improve the accounting systems of public enterprises and to make their financial relations with the government and the banking system more transparent.

Conclusion

In sum, caution must be exercised in relying on a quantitative picture to judge the overall fiscal performance of countries undertaking sustained adjustment. The relatively small improvements in fiscal aggregates have to be viewed against the background of the significant strides made in restructuring the economies of these countries during the program period. These lasting achievements should provide the institutional basis for a much stronger fiscal performance and sustained economic growth in the future. ■

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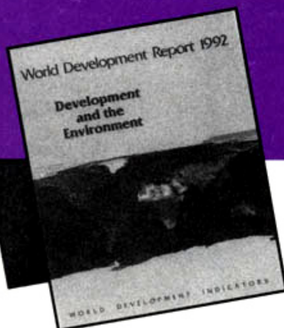

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