

**INDEPENDENT EVALUATION OFFICE
of the IMF**



**EVALUATION OF FISCAL ADJUSTMENT IN
IMF-SUPPORTED PROGRAMS**

<http://www.imf.org/external/np/ieo/2003/fis/index.htm>

Objectives in view of IEO mandate

- Derive operational recommendations to improve the fiscal design in IMF-supported programs
- Examine areas of controversy
 - The quantitative dimension
 - The qualitative dimension

Issues in two dimensions

- **Quantitative dimension.** Fiscal adjustment as “one size fits all” leading to excessive adjustment. Why?
 1. Unnecessary reduction in programmed public spending in countries relying on concessional flows
 2. Overly optimistic projections of private demand leads to premature concerns about crowding out and tight fiscal stance

Issues in two dimensions

- **Qualitative dimension.** Efficiency, sustainability, and equity of fiscal adjustment
 - Trade-offs:
 - Between quality and quantity
 - Between quality and speed/expediency
 - Mismatch of Timeframes
 - “High quality” fiscal reforms require time—beyond the horizon of typical SBAs

Methodology and Database

- 133 arrangements in 1993-2001 containing program projections of basic macro variables
- 15 in-depth case studies of programs including:
 - Surveillance activity for the prior 3 years
 - Analysis of the implementation of 153 specific fiscal reform measures
- Ad hoc samples
 - 20 concessional programs in Sub-Saharan Africa
 - Social spending in years with and without programs in 140 countries in 1985-2000

Quantitative Findings Re Fiscal Targets

- No support for “one size fits all” criticism (significant variability)
- No evidence that programs always involve austerity
- Variability systematically related to initial conditions and financing prospects
- But program documents do not clearly explain how the pace and magnitude of adjustment is determined (lack of “story line”)

Quantitative Findings, cont'd

- Are fiscal targets flexible?
 - Yes. 2/3 of programs revise (T+1) targets by the 2nd review
 - Revisions are linked to revisions in growth prospects
 - Asymmetry: Targets are revised downward when growth is below expectations; less often the other way around
 - Rationale for revision is not clearly brought out in documentation

Quantitative Findings, cont'd

- Did programs achieve fiscal targets?
 - On average, programs achieved ½ of targets in a 2-year period
 - Almost all achieved by the first year
 - Significant variability: 60% of programs underperformed
 - Features of programs that underperformed:
 - No improvement in fiscal balances
 - Shortfalls reflect weak performance, not ambitious targets
 - Growth overoptimism explains adjustment optimism (expenditures are sticky, expenditure ratios increase).
 - However, in episodes of large fiscal adjustment (>3% of GDP) revenue shortfalls explain most fiscal shortfalls

Quantitative Findings, cont'd

- What happens to economic recovery under programs?
 - On average, growth rates do not decline during program years*
 - But significant variability; capital account cases had the worst performance
 - However, significant optimism (private activity and growth), particularly when the program commences in an adverse situation

**Before/after comparison. Cannot be attributed to IMF presence*

Is there a contractionary bias on the demand side?

- Overoptimism regarding private demand may prevent considering a countercyclical fiscal impulse
- Evidence of over performance on the external side (CA and reserves)—financing available at the margin
- This may signal an understatement of the countercyclical component of the fiscal stance
- However, the fiscal stance cannot be determined solely by short-term countercyclical considerations. We need also to consider market reactions and debt sustainability concerns--particularly in emerging markets
- Thus, to make a judgment on the appropriateness of the overall fiscal stance of a program we need to consider how all these factors interact with each other.

Quantitative Findings, cont'd

- The problem, however, is that program documents do not explicitly discuss these factors
 - Linking fiscal stance to private sector recovery
 - Basis for private sector recovery assumptions
 - Tradeoffs between aggregate demand and market response/debt sustainability.

More explicit discussion would:

- Reduce overoptimism in projections
- Provide a framework for sensitivity analysis
- Alert staff early on corrective actions

Social Spending: Three Issues

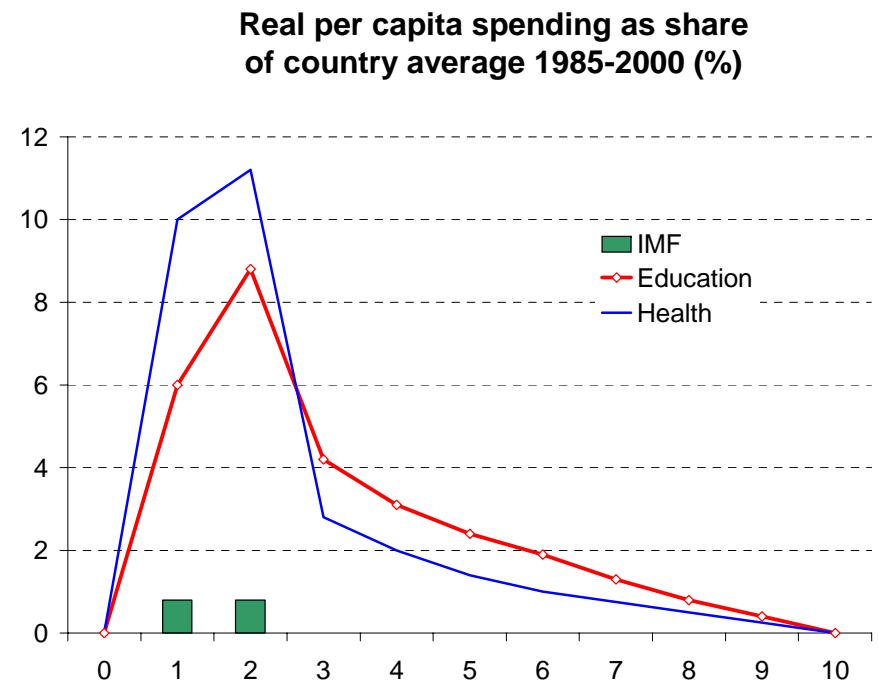
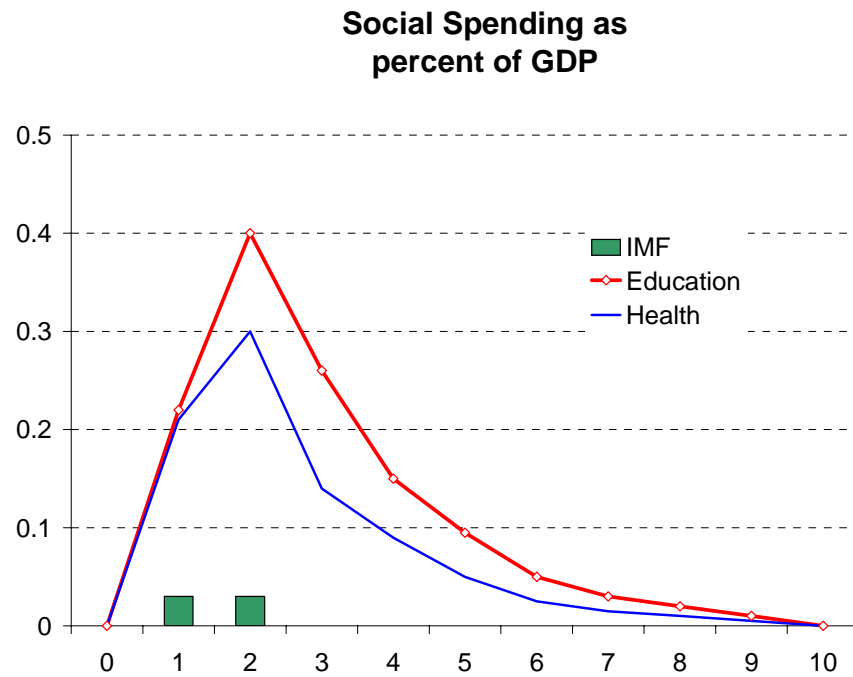
1. Do aid projections “taper out” too quickly relative to what donors provide, forcing an unnecessary cut in social expenditures?
 - Cross section of PRGF programs shows tapering out of projections
 - In-depth analysis of 20 programs in Africa does not show that projections underestimate actual flows in the outer years

Social Spending, cont'd

2. What is the net impact of an IMF program on public sector social spending? (controlling for other factors and the endogeneity of IMF presence)
 - No reduction in health and education spending as a share of GDP or of total expenditures
 - In fact, expenditures temporarily increased by 0.3-0.4 percentage points of GDP

Social Spending, cont'd

Estimated Impact of a Two-Year IMF-Supported Program



Social Spending, cont'd

3. Social Concerns in Program Design

- Non-PRGF programs follow 1997 Guidelines: to track health and education spending and monitor basic social indicators, and encourage authorities to incorporate spending targets in LOIs.
- Guidelines are broad in scope and the staff is uncertain how to apply them given the new initiatives on streamlining
- A detailed examination of 15 programs shows significant variability. A review of 8 more recent programs finds only limited improvement in this area.

Social Spending, cont'd

Findings from case studies:

- Specific spending categories/programs critical to the most vulnerable come under pressure during shocks or budgetary retrenchments
- Preempted by personal expenditures
- Case study: How hospitals in Ecuador adjusted during the 1999-2000 crisis

- IMF needs to move from tracking long-term/aggregate trends to assisting countries in protecting these expenditures under shocks (true role of the IMF given its mandate)

- These budgetary and tracking systems need to be in place early. But this takes time.
 - Initiatives must come from countries
 - IMF does not have the comparative advantage (key role of World Bank)
 - New agreements on PEM provide opportunities

Fiscal Reforms

Three aspects of fiscal reforms under IMF-supported programs:

1. Balance among policy measures, eg: do programs tilt toward specific areas while neglecting others?
2. Progress in implementation
3. Learning from the past and the role of surveillance in supporting reform

Methodology: For 1 and 2 we identified and tracked 153 specific fiscal-related reforms in the 15 programs. For 3, we examined 33 pre-program Article IV documents

Fiscal Reforms, cont'd

1. Balance among policy measures

- Programs focus more on the revenue side than the expenditure side
- Accent on the VAT, particularly on increasing VAT rates.
- Less attention to other taxes and efforts aimed at reducing evasion in customs, income and corporate taxes
- Not forceful enough in collecting from well-known tax payers with arrears, particularly if they are powerful (actions here will increase support for the overall reform agenda of programs)
- Tax administration has focused more on the technology side than on politically difficult actions to empower tax agencies and make them less prone to political interference
- Expenditure side: Programs have focused on short-term quantitative targets to reduce the wage bill rather than on a reorientation of public spending or medium-term civil service reform. Hence, progress has been easily reversed.

Fiscal Reforms, cont'd

2. Progress in implementation during programs

- In no reform area was implementation satisfactory in more than 40% of cases
- Most difficult areas: Measures to reduce the wage bill, achieve civil service reform, and social security systems
- Limited progress results from an emphasis in short-term qualitative targets relative to institutional reforms that may require time beyond the horizon of the program
- Critical: Unbundle reforms into several steps
 - Those that can be implemented in the short run with enough determination of the executive
 - Those that require more time, e.g. legislation
 - Those that may require even more time, e.g. improving implementation capacity of agencies
- Surveillance should provide such a road map. But does it?

Fiscal Reforms (contd.)

3. Learning and the surveillance process

- Program documents often fail to evaluate past fiscal performance, and to an even lesser extent, policy failures under the previous arrangement
- Link between surveillance and programs:
 - Surveillance is not forceful enough in flagging the need to accelerate reform where implementation was lagging
 - A large share of policy measures included in programs were not previously flagged by surveillance
 - This is also true in self-standing surveillance, e.g. surveillance not associated with a program
- In summary, surveillance is not effective enough in providing a clear road map of structural reforms to be followed, with or without a program

Recommendations

1. Documents should provide a clear justification for the magnitude and pace of the envisaged fiscal adjustment
2. The internal review process should focus more on early brainstorming
3. Programs should give greater emphasis to institutional reforms in the fiscal area
4. The surveillance process should be used more explicitly to provide a longer term road map for fiscal reforms and to assess progress
5. The IMF should focus on assisting countries in preparing systems to protect the most vulnerable in case of crisis
 - Invite countries to identify critical programs under surveillance
 - Formulate a work program with the World Bank on budgetary systems able to protect these programs in real time in case it is needed