

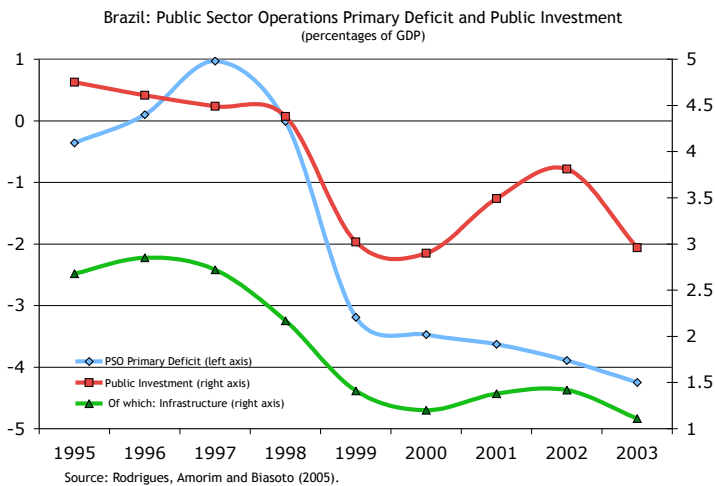
# Fiscal Policy for Growth

*This brief discusses some implications of the recent Development Committee communiqué that entrusted the Bank with the development and operationalization of growth-oriented, country-specific approaches to fiscal policy design (DC communiqué of April 15, 2007).*

“The very minimum that a government is expected to do nowadays in any country is to remove or cut down the obstacles to economic growth met by the private sector and, much more frequently, it is deemed to have the task of striving for growth in a positive manner both by example and by precept.”  
 —A.R. Prest (1972), *Public Finance in Underdeveloped Countries*, p. 17

WHILE THE TERM ‘FISCAL SPACE’ IS NEW, THE ISSUE IS QUITE OLD. Fiscal space refers to availability of budgetary resources for a specific purpose—typically growth-enhancing investment uses—without jeopardizing the sustainability of the government’s financial position, or the stability of the economy.

The recent interest in fiscal space originated as a reaction to IMF-supported fiscal-adjustment programs that by focusing too narrowly on fiscal-deficit targets often ignored the quality of the underlying adjustment. Affected countries meanwhile advocated for fiscal space for investments in physical and human infrastructure crucial for economic growth. The IMF Independent Evaluation Office, in their study on *Fiscal Adjustment in IMF-Supported Programs* acknowledged this problem: “(...) much of the fiscal adjustment achieved is through measures that do not assure long-term sustainability and flexibility of fiscal systems to future shocks.”<sup>1</sup>

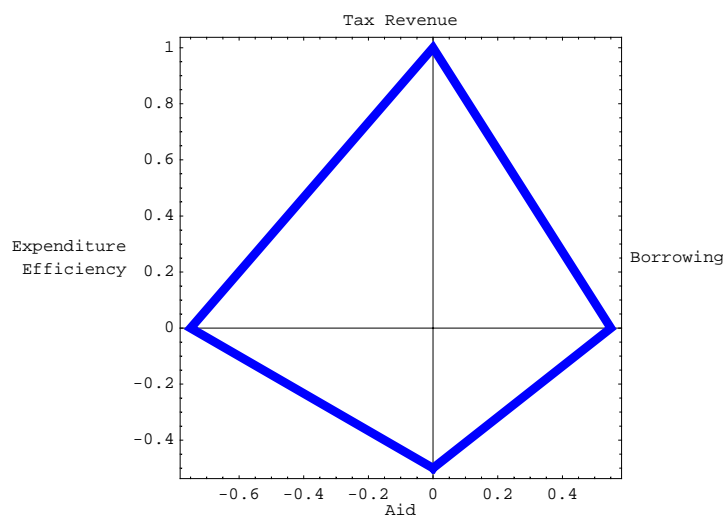


**Fig. 1.** Brazil: Fiscal adjustment and Public Investment

In effect, the improvement of the fiscal balance in the context of Fund-supported programs too often relied heavily in cuts in public investment that improve today’s government cashflow at the expense of future economic growth. Figure 1 shows the effects of fiscal adjustment on infrastructure spending in Brazil: “If economic policy has been successful in attending to the immediate goal

<sup>1</sup> IEO (2003), *Evaluation Report—Fiscal Adjustment in IMF-Supported Programs* (Washington DC: IMF); quote in text is from page 9. Report available at: <http://www.imf.org/external/np/ieo/2003/fis/index.htm>

of sustaining monetary stabilization, it has also resulted in low levels of GDP growth, lack of investment in basic infrastructure and deterioration in the quality of urban and social services.”<sup>2</sup> “Fiscal adjustment becomes like walking up the down escalator when growth-promoting spending is cut so much as to lower growth and thus the present value of future tax revenues to a degree that more than offsets the improvement in the cash deficit.”<sup>3</sup>



**Fig. 2.** The Fiscal Diamond—An example

Responding to a request from the Development Committee, in April 2006, the Bank produced an interim report on *Fiscal Policy for Growth and Development* (DC2006–3), followed, in March 2007, by a subsequent report (DC2007–4) furthering the analysis on the basis of several case studies. The DC2006–3 report identified four broad ways to obtain fiscal space: (1) improving allocative and technical efficiency in government spending; (2) raising more revenue, or raising same revenue at lower economic cost; (3) borrowing; and (4) aid. This approach is illustrated in Figure 2 which displays different options for obtaining fiscal space—measured as percentage points of GDP. The DC2007–4 report advocates for the application of sound public finance principles to articulate country-specific growth perspectives to fiscal policy.

*The Development Committee entrusted the Bank to develop and operationalize growth-oriented, country-specific approaches to fiscal policy design, and endorsed the need for effective Bank-Fund collaboration to ensure consistent policy advice to member countries* (DC communiqué of April 15, 2007).

<sup>2</sup> J.R. Rodrigues Afonso, E. Amorim Araújo and G. Biasoto Júnior (2005), “Fiscal Space And Public Sector Investments in Infrastructure: A Brazilian Case-Study” (IPEA Working Paper 1141).

<sup>3</sup> W. Easterly, T. Irwin, and L. Servén (2007), “Walking Up the Down Escalator: Public Investment and Fiscal Stability” (World Bank Policy Research Working Paper 4158).

## 1. Operationalizing Growth-Oriented Fiscal Policy

Fiscal sustainability is a good starting point for the discussion of growth-oriented fiscal policy if only because unsustainable public finances—if uncorrected—inevitably lead to crises. Indicators of **fiscal sustainability** are thus constructed to inform the following questions: “Can the current course of fiscal policy be sustained, without exploding debt? Or will the government have to sharply increase taxes, decrease spending, have recourse to monetisation, or even repudiation?”<sup>4</sup> Fiscal sustainability is thus associated with solvency—and must be distinguished from transitory liquidity difficulties. Given a stock of debt,  $d$ , expressed as a fraction of GDP, the debt-stabilising primary balance,  $b^s$ , is given by  $b^s = [(r - g) \div (1 + g)]d_{-1}$  where  $r$  is the real interest rate and  $g$  represents the rate of real GDP growth.<sup>5</sup> Fiscal sustainability requires the ability to eventually maintain a balance  $b^* \geq b^s$ . This condition can be expressed in terms of (tax) revenues,  $\tau$ , and non-interest (primary) expenditures,  $e$ :

$$\tau^* \geq e^* + \frac{r - g}{1 + g} d_{-1} \quad (1)$$

Which simply states that revenues must cover spending and the costs associated with servicing debt obligations, appropriately scaled. It is apparent from this equation that *transitorily* raising the primary balance at the expense of *permanently* contracting future growth,  $g$ , and future tax revenues,  $\tau$ , will depress, rather than enhance, long-term sustainability (*i.e.*, ‘walking down the up escalator’). It must also be noted that all variables involved in equation (1) are endogenously determined—including the ‘policy handle’  $e$ , since it is a ratio to GDP.

*This suggests: (i) to frame fiscal-sustainability analysis within growth analysis, and (ii) to refocus attention away from the net balance and onto the gross flows—i.e., government expenditure and revenues—critically reviewing the composition of these categories from a growth perspective, as well as from other public policy objectives—e.g., social protection and poverty alleviation.*

### 1.1. Growth Analysis

The DC2007–4 paper stressed the usefulness of performing growth analysis before critically assessing the government budget. This can rely on explicit country-specific modeling of the growth process<sup>6</sup> or some disciplined growth analytics, that could include, among others, the the growth-diagnostics approach.<sup>7</sup>

The goal of a HRV Growth Diagnostics study would be to identify the most important constraints on economic activity, to determine the set of policies (some fiscal and some not) that is likely to

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<sup>4</sup> O.J. Blanchard (1990), “Suggestions for a New Set of Fiscal Indicators,” OECD Dept. of Economics and Statistics Working Paper no. 79. Available from <http://www.oecd.org> and reprinted in H.A.A. Verbon and F.A.A.M. van Winden (1993), editors, *The Political Economy of Government Debt*, New York: North-Holland.

<sup>5</sup> E. Ley (2006), “Fiscal (and External) Sustainability,” <http://econpapers.repec.org/paper/wpawuwppe/0310007.htm>

<sup>6</sup> A. Estache and R. Muñoz (2006), “IMF Financial Programming vs the Growth-Enhancing Power of Education, Health and Infrastructure Investment: Lessons from Senegal and Uganda (unpublished); P.R. Agénor and B. Moreno (2006), “Public Infrastructure and Growth: New Channels and Policy Implications,” (unpublished).

<sup>7</sup> R. Hausmann, D. Rodrik, and A. Velasco (2005) “Growth Diagnostics” (JFK School, Harvard University).

provide the biggest bang for the reform buck. Special attention is thus paid to private investment as a driver of growth; let  $r$  denote the private return to investment,  $r = (1 - \tau)\rho(a, \theta, x)$ , where  $\tau$  represents taxes,  $a$  is an indicator of total factor productivity,  $\theta$  is an index of externalities, and  $x$  represents the availability of complementary factors of production, such as infrastructure or human capital. A number of things may be responsible for low private returns and, hence, low investment and growth. For instance, a high  $\tau$  may be driven by high tax rates, an inefficient tax structure, and high expected expropriation risk; high  $\theta$  may be due large externalities, spillovers, coordination failures; low  $a$  because of low productivity, too little technology adoption or self-discovery; low  $x$  as a result of insufficient human capital, inadequate infrastructure, high transport, telecommunications or shipping costs. Of course, this is just one way to organize growth analysis—and its usefulness is controversial.

### 1.2. Fiscal Policy—Expenditure and Tax Policies

The fiscal-policy operational framework requires (i) formulating a fiscal plan determining policies and objectives, and the resources needed; (ii) formulating a budget which is the operational legal framework that determines the allocation of resources to attain the policy objectives; and (iii) implementing a budget with the assurance that specific tasks are carried out economically, efficiently, and effectively. The use of public finance instruments to influence the working of the economic system to maximize economic welfare thus requires the use of ex-ante cost-benefit analysis (in (i) and (ii)) to appropriately account and balance costs and benefits (encompassing both revenue and expenditure instruments), and the use of ex-post assesment to evaluate public policies as part of (iii), including benchmarking and efficiency analysis.<sup>8</sup> Rajaram *et al.* (2006) offers guidance to country teams relevant to forming a pragmatic and objective assessment of the quality of public investment efficiency in a context where governments are seeking to mobilize additional fiscal resources for investment.<sup>9</sup>

### 1.3. Fiscal Transparency

Fiscal Transparency consists in openly showing to the public the structure and functions of government, the fiscal policy objectives, the public sector accounts, and the fiscal projections. It requires ready access to information of government activities—that is reliable, comprehensive, timely, understandable and internationally comparable—so that the electorate can assess the government’s financial position and the true costs and benefits of government activities. Fiscal transparency consequently makes a major contribution to the cause of good governance as (i) it leads to better-informed public debate about the design and results of fiscal policy; (ii) it makes governments more accountable for the implementation of fiscal policy; and (iii) thereby it strengthens credibility and public understanding of fiscal policies.<sup>10</sup>

*Prepared by Eduardo Ley with comments from Vikram Nehru.*

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<sup>8</sup> S. Herrera and G. Pang (2005), “Efficiency of Public Spendinfg in Developing Countries: An Efficiency Frontier Approach,” (World Bank Policy Research Working Paper 3645).

<sup>9</sup> A. Rajaram, T.M. Le and N. Biletska (2006), “Public Investment Efficiency: Guidance Note on an Indicator-Based Approach” (unpublished).

<sup>10</sup> The IMF code of good practices on Fiscal Transparency is available at <http://www.imf.org/external/np/fad/trans/>