

## MADAGASCAR ECONOMIC UPDATE: FISCAL POLICY - MANAGING THE PRESENT WITH A LOOK AT THE FUTURE

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*At the end of 2010, the fiscal situation appears under control with a relatively small deficit estimated around 2% of GDP. This is good news in a country that still suffers from uncertainty about its political future. Yet, this fiscal stability was the result of a severe decline in public spending that accounted for only 12 % of (official) GDP –one of the lowest ratios in the world. The weak share of public investment has become especially alarming (equal to only 3 % of GDP), because it may further exacerbate the existing deficiencies in both physical and human capital that are observed in Madagascar. This development raises fundamental questions about the conduct of future fiscal policy and its contribution to economic growth.*

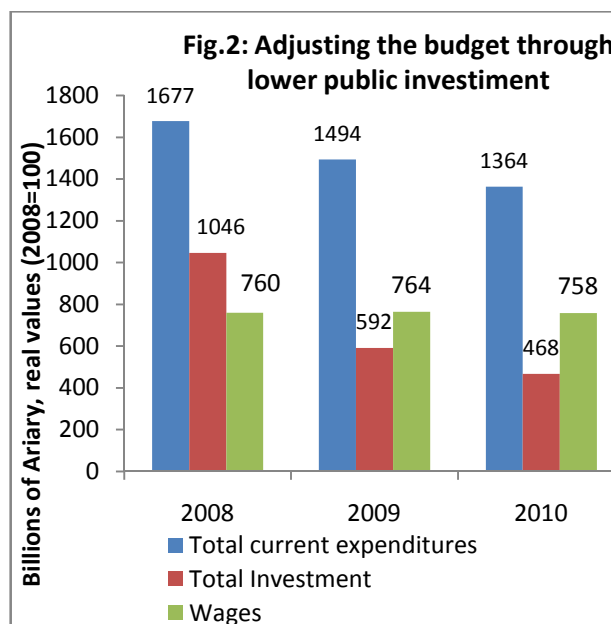
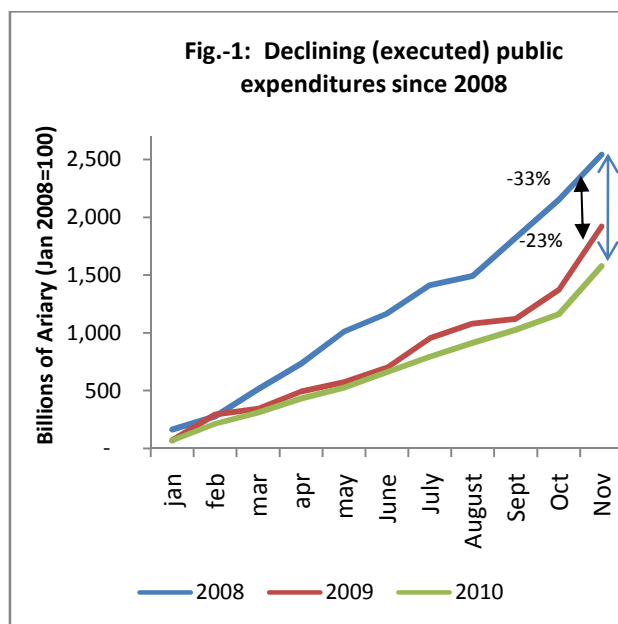
After two years of political crisis, the authorities seem to have kept the fiscal situation under control. The public deficit is estimated around 2 % of GDP in 2010 – lower than the level reported in 2009. While fiscal data are still incomplete, such result is confirmed by the stability of most financial variables (interest rates, inflation) that would have moved upwards if the Government had financed its expenditures by excessive borrowing and/or monetary financing.

This positive news needs to be interpreted in light of the adjustment that has taken place in public expenditures. The incapacity to collect additional fiscal revenues and the limited option to use the local and international financial markets have forced the authorities to cut their public investment program by more than half so that it has become almost marginal in 2010. Such an adjustment has and will influence the role of the Government/State in the local economy, especially its capacity to contribute to the stock of physical infrastructure and the provision of social services that were already sub-optimal before the crisis.

This economic update is organized as follows. First, it shows that the authorities pursued the same fiscal policy in 2010 than in 2009 by aligning their expenditures on fiscal revenues and, so, kept the public deficit under control. The second part seeks to explain why the Government had to cut their spending that are now equivalent to only 12% of (official) GDP or perhaps 6-7% of total economy activities in the country when the world average is almost 30% of GDP. The third and last part discusses some of the implications that the low level of fiscal spending might produce on the role of the public sector and the use of effective fiscal policy in Madagascar.

### *Fiscal developments in 2010*

Fiscal policy remained unchanged in 2010. Public expenditures declined by about 12% (in real terms) compared to 2009 and as much as one-third with respect to 2008 as they continued to be adjusted to lower domestic fiscal revenues and external aid (Figure 1).



Source: Ministry of Finance

Domestic fiscal revenues continued to lag behind their pre-crisis levels. The tax revenue performance was almost at par (in real terms) with the one reported in 2009 but 20% lower than in 2008 (Table 1). The main decline was observed in customs due to lower imports, while taxes collected on domestic transactions were only

	2008	2009	2010 (p)	2009/2010	2008/2010
DGI	1,079.8	941.6	966.4	2.6%	-10.5%
Customs	1,007.9	697.6	700.3	0.4%	-30.5%
Total	2,087.7	1,639.2	1,666.8	1.7%	-20.2%

Source: Ministry of Finance.

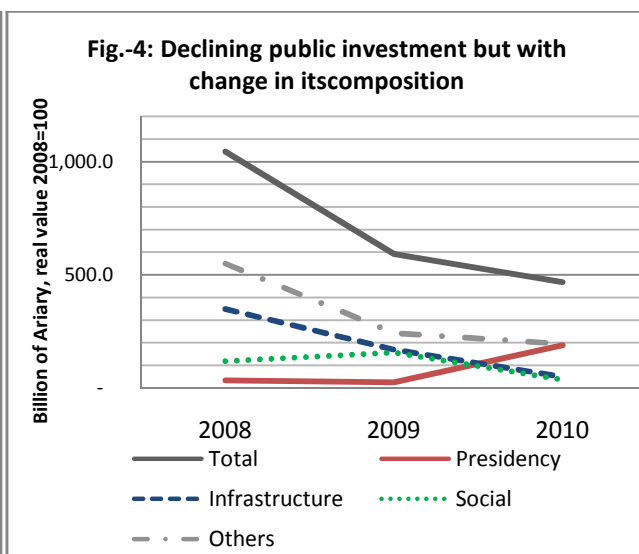
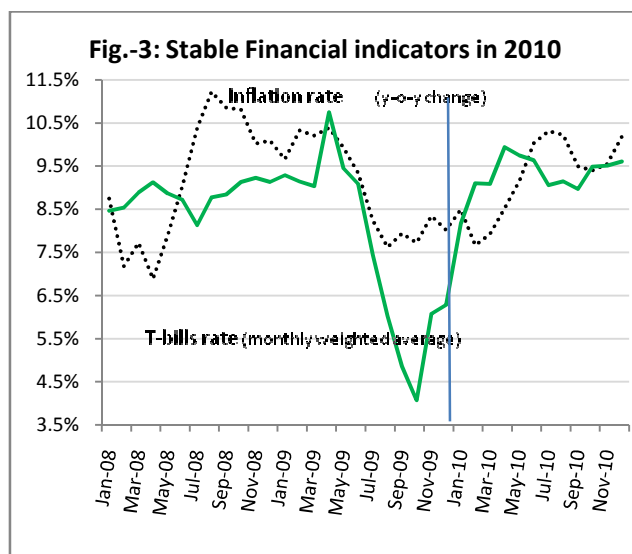
10% lower than in 2008 showing some resilience in tax administration. All taxes reported lower revenues except for the VAT on domestic transactions. The level of non-tax revenues should attain 270 billion Ariary, as projected in the revised Law of 2010 Finance, and close to historical figures, except for the exceptional payment of US\$100 million (or approximately 200 billion Ariary) made by one Chinese company in the mining sector.<sup>1</sup>

Over the course of the years, including in 2010, the authorities have managed the budget by following a dual approach. They have used their domestic fiscal revenues to maintain in priority wage payments and basic functions within the public service. The investment budget has been the adjusting variable, subject to the availability of external funds and the eventual surplus in domestic revenues. Such a behavior has been especially visible over the past two years since public investment declined by 55% in real terms between 2008 and 2010 following cuts in official aid (Figure 2). Concurrently, other expenditures only slowed down by 18%, including the wage bill

<sup>1</sup> China's third largest steel company Wuhan Iron and Steel Corporation (WISCO), in a joint venture with two others companies, received approval from China's National Development and Reform Commission to explore for iron ore deposits in Madagascar's southwest (Soalala project).

that remained almost flat (down by only 1%). This behavior is also reflected in the execution rates, which were only of 56 % for investment outlays but close to 97 % for all current expenditures.

The key advantage of this dual approach is that the fiscal adjustment has been almost automatic. The public deficit, estimated around 2% of GDP by the authorities in 2010, is down from 2.8% in 2009. This figure should be seen as indicative because the coverage of the budget is incomplete, leaving aside some important public transactions between the central administration and public agencies as well as public enterprises.<sup>2</sup> Furthermore, it reflects the fiscal situation in the middle of the chain of expenditures, at the stage of execution, which can still differ from payments and (eventually) hide a significant amount of arrears with private suppliers. Yet, domestic financial variables remained stable during 2010, reflecting the market confidence in the fiscal policy followed by the Government (Figure 3). The use of monetary financing was limited since the total domestic (net) borrowing of the Government vis-a-vis the domestic banking system declined by 237 billions of Ariary between December 2009 and 2010. At end 2010, the cumulative T-Bills outstanding amount due by the Government reached about 800 billion of Ariary, up by 14% (in nominal terms) compared to end-2009, but the stabilization of the T-Bill yield around 9.5% reflected the absence of significant pressure since March 2010. Similarly, the inflation rate remained under control, reaching 9.7% at the end of the year 2010 –slightly higher than a year ago.



Source: Central Bank and Ministry of Finance.

The severe fiscal adjustment was concentrated in public investment (cut by more than half since 2008) and occurred uniformly across all Ministries, with the notable exception of the Presidency (Figure 4). The investment budget executed by the Presidency increased by seven times between 2009 and 2010, accounting for almost half of total public investment in 2010. At this stage, there has been no detailed public information released on the budgetary and procurement procedures

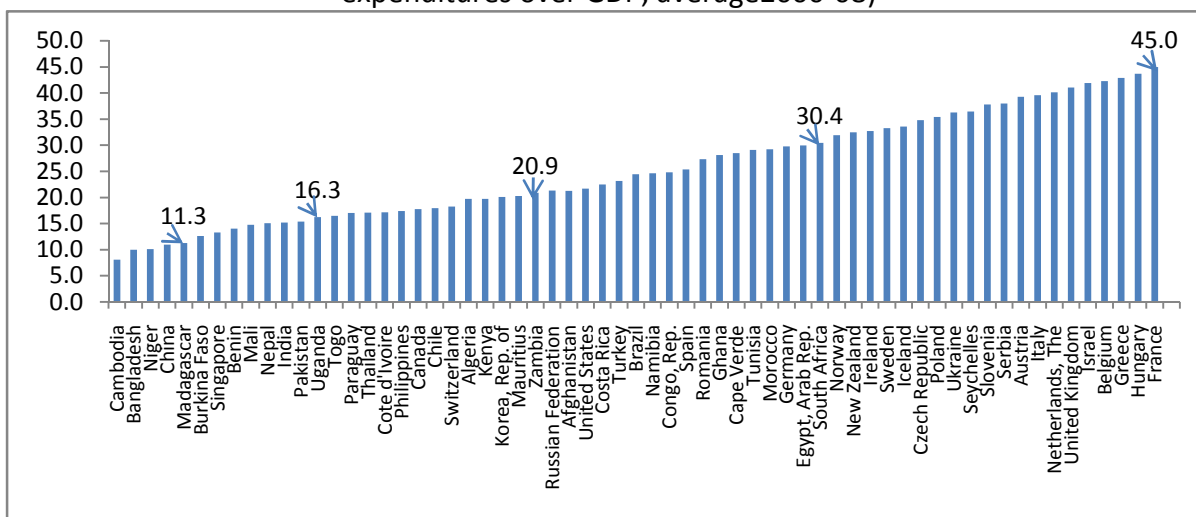
<sup>2</sup>For example, it is difficult to collect financial data on the transfers between the JIRAMA, the Social Security System and other bodies.

used for these projects. Equally worrisome is that public investment in infrastructure (road, public work, electricity, and water) was equivalent to only 49 billion of Ariary (US\$25 million) in 2010, or nine times lower than the level reported in 2008. Similarly, social sectors (health, education, sports and cultures) saw their investment-spending cut by three between 2008 and 2010. Also revealing is that 2/3 of the Ministries executed less than US\$1 million in public investment! Because such figures are exceptionally low by regional and world standards, their implications will be further analyzed in the next sections.

### Why is the Government's size low in Madagascar?

The brutal fiscal adjustment that occurred over the past couple years, led to the further marginalization of the Government within the local economy. The ratio of total expenditure to GDP was only equal to 12 % of (official) GDP at the end of 2010,<sup>3</sup> which is an overestimation of the reality since about 40% of economic activities are not reported in the official national accounts of Madagascar.<sup>4</sup> As a result, today, the Government contributes for less than 6-7% of total economic activities in the country through its direct expenses.

**Fig.5 :** The size of the Government in Madagascar is one of the lowest in the world (% of public expenditures over GDP, average2000-08)



Source: World Bank, World Indicators. 2010

The marginality of the State within the economy has been exacerbated by the current crisis but this trend has been historic. Over the past decade, the size of the public has averaged only 11.3% of GDP (peaking to 16% in 2008), which is extremely low compared to international standards (Figure 5). The variations around this average are mostly explained by the changes in aid inflows received by the Government, funding more or less investment projects depending on their

<sup>3</sup> Measuring the size of government as a share of GDP is an imperfect measure because it does not measure counterproductive regulation, restrictions on liberty and other factors, but is a reasonable approximation.

<sup>4</sup> For some estimates, see, Andreas Buehn and Friedrich Schneider, Shadow Economies and Corruption All Over the World: Revised Estimates for 120 Countries, *Economics: The Open-Access, Open-Assessment E-Journal*, Vol. 1, 2007-9. The share of the informal sector was estimated equal to 39.7 % of official GDP in 2000,

availability. Consequently, the weak contribution of the public sector has to be understood in light of structural rather than transitory factors.

Below are proposed three complementary explanations. The first one, already well documented,<sup>5</sup> is the low level of fiscal pressure, around 10 % of GDP, which has prevented a sustainable increase in expenditures (the average for Sub-Saharan African is above 20%). A series of recent reforms in tax policy and administration, including in customs, led to an increase from 10.4% to 12.9% in the tax revenues over GDP ratio between 2003/4 and 2008, but those gains proved to be short-lived. This ratio reverted to 10.8% in 2010. There is ample room for reducing further tax evasion and broadening the tax base even though gains might be hard to achieve as long as the economy will continue to be dominated by primary activities (that generally escape to taxes) and that 2/3 of households will live below the poverty level (poor households are unlikely to pay large amount of direct taxes).

The second explanation has received much less attention from the authorities and donors – the surprisingly low level of nontax revenues. Again, an international comparison reveals that the current level in Madagascar is one of the lowest of the world (averaging 0.4% of GDP against over 9 % around the world).<sup>6</sup> Here the structure of the local economy should have benefited the Government since substantial nontax revenues are generally collected from mining, forestry, and fishery activities. Significant evasion, illegal trading, and the lack of tracking in the budget of revenues collected by government agencies, public enterprises and even sectoral Ministries explain the low level of nontax revenues.

The third and last explanation lies in the quasi-impossibility for the Government to finance itself on private capital markets –both domestically and internationally. There is no need to document that international financial markets are closed for a country like Madagascar that lacks creditworthiness and visibility (credit rating agencies, as Moody's and Standard & Poor do not even have Madagascar on their radar screen). While the use of domestic financing might remain a temptation for policy makers, recent experiences have reminded them its limitations and risks. The narrowness of the domestic monetary and credit markets represents a natural barrier against such policy as illustrated by the following example. If the Government was to borrow from domestic banks, say, US\$100 million, which would only finance a deficit equivalent to 1,5% of GDP, it would automatically increase the stock of total domestic credits by 10%, which might rapidly crowd out private sector credit or lead to further monetary expansion, and ultimately to an acceleration of inflation. These lessons seem to have been learnt the hard way by the authorities, notably in 2004 when excessive monetary financing translated into a sudden jump in the inflation rate (up from -0.2% in 2003 to 24% in 2004) and a 68 % loss in the value of the local currency (vis-à-vis the US dollar). More recently, during the first quarter of 2010, the authorities were unable to issue a larger amount of T-bills despite higher rates of return.

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<sup>5</sup> For a detailed discussion, see World Bank: *Public Expenditure Review*, 2007 and recent IMF staff reports (up to end 2008).

<sup>66</sup> A country like Mali is able to collect over 2% of its GDP in non tax revenues, while other African countries record between 3 and five time more than in Madagascar such as South Africa (3%), Lesotho (6%), and Cape Verde (7,5%).

## *What is the future of fiscal policy?*

Over the last few decades, many studies have sought to determine the "optimum" size of Government.<sup>7</sup> For the most conservatives, the risk is that the State could easily become too large, which would diminish the liberties of the people and crowd out private sector activities. On the other extreme, others have argued that the State should dominate the economy to provide social and physical infrastructures and distribute wealth equally among the population. Beyond this ideological debate, most economists agree that the Government should be large enough to play its role of providers of basic services and infrastructure as well as to protect people and coordinate and regulate private activities. In that context, its optimal size—the one that should lead to higher economic growth and job creation over time—is estimated around 20-25% of GDP.<sup>8</sup>

This figure is of course illustrative, and might differ greatly depending on national conditions. The Government's size in Singapore is less than 15% of GDP but it would be hard to argue that it is less efficient than in Russia or Egypt where it weights more than 20 and 30%, respectively, of GDP. The issue should be viewed more in terms of who is capable to deliver the necessary infrastructure and protection in the country than in the magnitude of public expenditures. Nevertheless, when the private sector is nascent like in most African countries, including Madagascar, it is generally accepted that the Government should play this role predominantly, suggesting that it should be able to count on some minimal financial capacity to deliver those goods and services.

The call for a larger role for fiscal policy in Madagascar can be justified on two additional grounds. First, the effectiveness of any fiscal policy is likely to be marginal in a country where the weight of total expenditures is less than 10% of (official and non-official) GDP, especially when public investment represents only 1,5% of all economic activities. Even if Madagascar decided to double the amount of public investment in physical infrastructure (i.e., from the current level of 50 to 100 billion of Ariary), the impact of such a move would be limited almost mathematically, in particular to boost the global demand (through the standard Keynesian multiplier)<sup>9</sup> and to upgrade significantly the stock of physical capital and so catch up international (or even regional) standards. As an illustration of this gap, the density of paved roads and the number of internet lines (per person) are respectively 10 and 40 times lower in Madagascar than in Mauritius. Second, a Government too small is also unable to establish the rule of law and protect people and their property, which is increasingly perceived as an issue by private investors operating in the country. The last World Bank's Business Environment Survey showed that about half of the surveyed firms identify crime, theft and disorder as a major constraint, which is much higher than the regional average.

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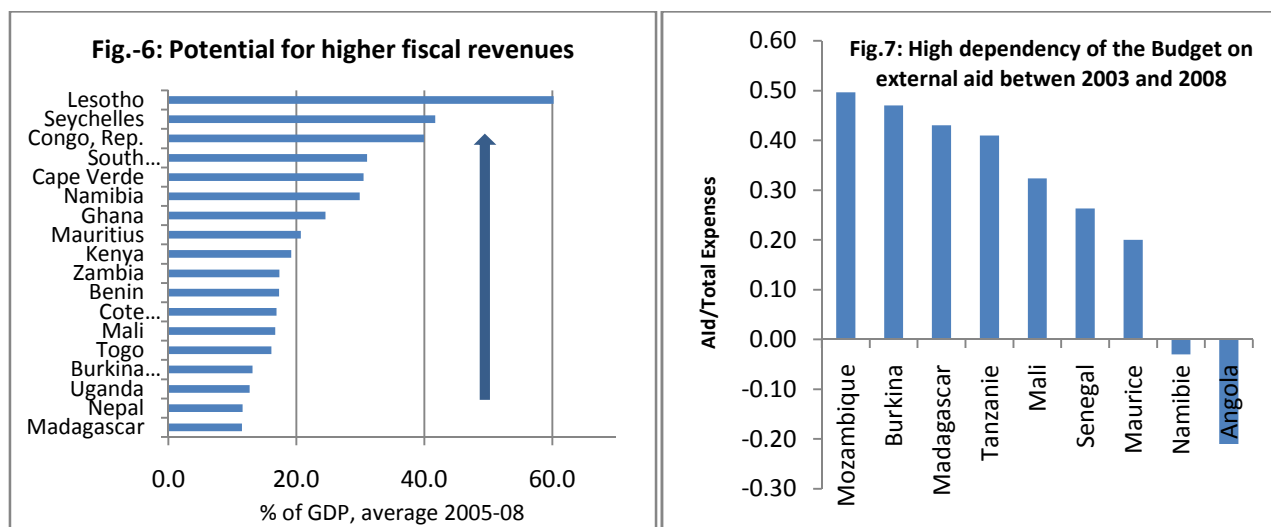
<sup>7</sup> The seminal paper is Grossman, P. (1987). "The optimal size of government," *Public Choice* 53:131-147. For a recent review of this literature, see D. Chobanov and A. Mladenova, *What is the optimal size of Government?*, *Institute for Market Economics*, Bulgaria, August 2009.

<sup>8</sup> Most empirical studies of the optimum size of government have found that total government spending (federal plus state plus local) should be no lower than 17 percent, nor larger than about 30 percent of GDP.

<sup>9</sup> In the short term, such an increase would be equivalent to a 0.5% increase of GDP and, in the long run, assuming a multiplier equals to 0.9, it would lead to 5% increase in global demand. This estimation supposes that prices are constant.

With the objective in mind to improve the effectiveness of future fiscal policy, a series of three complementary principles are proposed below. Those should be seen together because, if there are important taken individually, it is their combination that will make fiscal policy more efficient and sustainable over time.

The first principle is that any increase in public expenditure *should follow rather than precede an increase in financing*; otherwise, fiscal sustainability might be lost creating instability and possibly financial distress. The obvious channel would to increase domestic fiscal revenues that are currently much lower than regional standards (Figure 6). Tax collection must be improved through the modernization of tax administration and the use of incentives and sanctions to motivate taxpayers. This effort will nonetheless require a significant change in the culture of both taxpayers and public administration and strong leadership. A more promising venue, at least in the short term, would be to shed light on the existing nontax revenues, which are not only evaded but also not traced back adequately in the budget when they are collected by governmental agencies and/or public enterprises. The potential for more revenues is high and should retain the immediate attention of any policymakers in the future.



Source: World Bank Indicators, 2010

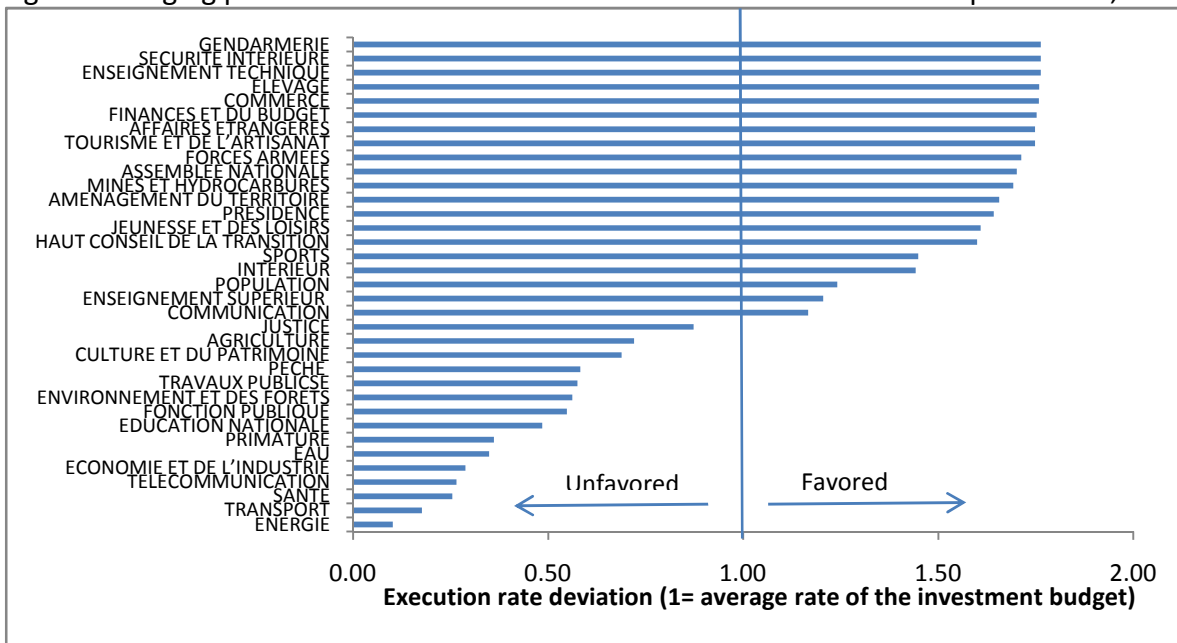
Until the Government can count on sufficient domestic resources, it should rely on official aid, including from non-traditional sources. A boost in public investment will be closely linked to the availability of this source of financing, and its utilization (see below for fuller discussion on this last issue). However, the Malagasy Government (and donors) should recall that external financing, while useful, is not a perfect substitute for a sustainable effort to increase domestic fiscal revenues. As argued by Paul Collier: “both theory and evidence suggest that beyond some point, aid becomes subject to diminishing returns”.<sup>10</sup> Between 2003 and 2008, the Government became highly dependent on aid (Figure 7 shows that the share of external financing within the budget was almost at the level of Mozambique and Burkina but much higher than in Senegal, Tanzania

<sup>10</sup> Paul Collier, *African Growth: Why a ‘Big Push’?* Journal of African Economies, 2006, p.195.

and Mali that have been traditionally supported by donors).<sup>11</sup> Too much aid might have discouraged the Government's tax effort. Furthermore, those flows were only executed by half every year because of the lack of capacity within public administration, and proved extremely volatile –moving from 530 billion of Ariary in 2003 to 1029 billion in 2008 but passing by 970 billion in 2004 and 560 billion in 2007, thereby making difficult the implementation of the Government's long-term strategy. Although the magnitude of those negative effects is difficult to quantify in Madagascar, their presence explains the current debate around aid effectiveness not only in the country but also in the international community (see Paris Declaration).

The second principle is to give emphasis to the *quality of public expenditures, including those funded by external resources*. When resources are scarce, it is imperative to use them the most effective way. Today, the effectiveness of fiscal policy is low, but its damages are limited because of the lack of magnitude in its expenses. The worst case-scenario for the future would be to increase public expenditures, without any improvement in quality, leading to even worst negative consequences for the whole economy.

Fig.-8: Changing priorities between the voted and executed investment expenditures, 2010



Source: Ministry of Finance

Several deficiencies have already been identified in the financial and economic management of the budget by a number of past studies.<sup>12</sup> The allocative efficiency of investment spending is low because most projects are not properly evaluated and, above all, not compared within each sector (health centers vs. hospitals) and across sectors (roads vs. stadiums). The authorities are often unable to define what are the best projects for the country according to their expected rates of

<sup>12</sup> For a recent assesment, see *Mesure de la performance des la gestion des finances publiques en République de Madagascar*, PEFA, mai 2008.

return (economic and social), and political interferences (as well as conflict of interests) accentuate the misallocation of public resources.<sup>13</sup> Even when the projects are relatively well aligned with national priorities in the Law of Finance, their execution is low, often too centralized, and variable so that the reality does not correspond to what was planned initially. In 2010, significant variations in the investment execution rates contributed to modify significantly the allocation of those expenditures across Ministries (see Figure 8). On top, there are the traditional losses linked to procurement practices that suffer from the lack of competition between bidders and the frequent use of non-competitive procedures. Those issues are not new but they should at the top of any agenda aimed at reforming public finances in Madagascar.

The third principle would be to encourage *synergies between the public and private sectors*. Limited public resources can be compensated by private investment, as experienced in many countries around the world, even in traditional public areas. First, the role of the State should be to promote the general business climate and thus encourage private operators to invest on their own. In most sectors, the optimal allocation of resources is obtained when barriers at entry and bureaucratic controls during operations are minimized (this does not mean nonexistent). Second, the State should develop partnerships with private investors in areas where the Government is expected to play a dominant role because of the public nature of goods/services (infrastructure, education and health) and/or their strategic consequences for the country (communication, transports). The role of the authorities could vary but in all cases, they should establish the appropriate legal and institutional environment so that private firms are offered the right incentives to participate. Rules and strong institutions are also necessary to regulate them when needed. Unfortunately, in Madagascar, the Government has frequently interfered with private sector activities when there is no clear reason for it and failed to make attractive the general investment climate.<sup>14</sup> Concurrently, the legal and institutional framework is still missing in, among others, the water and telecommunication sectors. Such a confusion of roles by the Government, often due to conflicts of interest, will need to be addressed with a sense of urgency if fiscal policy is to become effective in Madagascar.

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<sup>13</sup> Such a failure also reflects the lack of coordination between donors and between donors and public administration.

<sup>14</sup> As a reminder, Madagascar is 140<sup>th</sup> out of 183 countries in the 2011 Doing Business ranking.