Fiscal Space and National Development Strategies

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To

United Nations – ECOSOC member country delegates in preparation for the annual meeting of ECOSOC with the leadership of the IMF, World Bank, WTO and UNCTAD

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Review of Fiscal Space and National Development Strategies.

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1. **Good morning.** Before expanding on the subject at hand, may I say how very pleased I am to be given the opportunity to address this distinguished group.

2. With new initiatives to provide low income countries with external assistance in support of the Millennium Development Goals (MDGs), an understanding is being sought as to whether "fiscal space" can be created, in the context of IMF-supported programs, for spending on investments and social programs that are perceived as priority. Initially, Latin American and European governments in particular argued that fiscal constraints should be relaxed to accommodate additional borrowing to finance infrastructure projects, which create productive assets that pay for themselves over the long term. It was in this connection that advocates of increased public investment in the World Bank argued that there was available fiscal space for such borrowing (particularly from the Bank itself). The discussion of fiscal space has therefore subsequently been broadened, with many in the Bank, bilateral donor community, and NGOs arguing that current spending for health and education, which adds to human rather that physical capital, also has a valid claim on any available fiscal space because such outlays can pay for themselves over the long term.

3. **Fiscal space** can be defined as room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy. Fiscal space must exist or be created if extra resources are to be made available for worthwhile government spending. A government can create fiscal space by raising taxes[1], securing outside grants, cutting lower priority expenditure, borrowing resources (from citizens or foreign lenders), or borrowing from the domestic banking system. But it must do this without compromising macroeconomic stability and fiscal sustainability [2]- ensuring that it has high capacity in the short term and in the longer term to finance its desired expenditure programs as well as to service its debt.

4. **How is this done?** The government in question must ensure that the higher expenditure on the short term, and any associated future expenditure- including any recurrent spending on operations and maintenance required by an infrastructure investment, or by the establishment of a school or hospital- can be financed from current and future revenues. If debt financed, the expenditure should be assessed by reference to its effects on the underlying growth rate and the revenue-gathering capacity. The government needs to be sure, in particular, that an increase in one worthwhile area--- health, for example— will not ultimately crowd out productive spending elsewhere.

See Heller (2003) for a discussion on why the Political economy challenges of shifting to a tax burden that is significantly higher than in the past may not be easily overcome.[1]

When looking at fiscal sustainability it is necessary to consider issues of debt sustainability.[2]

5. **For developing and emerging market countries**, fiscal space may seem a more immediate issue than in advanced economies because they are pressing needs for expenditure today. But longer-term issues are also involved, even for lower-income countries, because of the need to ensure that there will be room to respond to unanticipated fiscal challenges. For example:

    a. Countries that receive significant flows of foreign resources for a specific sector (such as health care) may, as a result of the associated expansion of the sector, face additional future spending needs that may essentially preempt a share of the growth of future domestic budgetary resources.

    b. Foreign resource inflows, such as aid, may hurt a country's macroeconomic situation (for example, by raising its real exchange rate and thus reducing its international competitiveness) or cause excessive aid dependency, so that such inflows may need to be limited. A foreign-financed expansion of a specific sector (for example, education) may then imply limits on the magnitude of foreign resources available to other sectors.

    c. Resource inflows may finance a government activity, such as pension reform, that creates a liability in the form of future payouts that are highly uncertain in magnitude and timing.

6. **What is the practice?** When the macroeconomic situation is evaluated, it is open to the creation of fiscal space through higher foreign grants inflows for spending on infrastructure or social programs. But the evaluators would flag a concern if the higher spending jeopardized macroeconomic stability and debt sustainability. Such precautions particularly extend to the use of central bank credit, given the concerns of inflation and its damaging effects on growth and poverty. Moreover, higher spending in a sector, even if financed from external grant flows, may have implications for other sectors that will need to be taken into account. The potential fiscal space is therefore determined by looking at both the scope for greater public saving through expenditure rationalization and tax reform, and the extra resources that can be mobilized from borrowing and grants. It also appraises underlying factors that affect the outcome of government policies.

7. **Repriotizing expenditure.** Curbing unproductive spending should be an important objective. This may require cuts in subsidies or military outlays, wage restraint, or rationalization of elements of the civil service (including by tackling the common problem of ghost workers). But at the same time, productive spending needs to be protected: not spending enough on a sector(say, education) can have damaging social effects and prove to be a false economy, raising future spending requirements by weakening the sector so much that it would be costly and time consuming to "rebuild" it. We should also recognize the substantial role that a better allocation of existing resources can play to help increase fiscal space. Underlying reforms could involve better public expenditure management and improved project selection. There is reason to emphasize the need for low-income countries to bolster domestic revenues in order to provide more

room for public expenditures. In this context, the governments should recognize the importance of expanding the tax base through reductions in exemptions and improving compliance, while taking account of the impact on poor households and avoiding tax regressiveness.

8. **Boosting efficiency.** Other aims should be to streamline the implementation of programs, reduce corruption, and improve governance. Donors can help by, eliminating aid-tying, reducing administrative overheads, better coordinating spending in a sector, and reducing the administrative overload imposed on the limited number of recipient country's low human capital.

9. **Raising revenue.** For countries with low ratios of government revenues to GDP, broadening the tax base and improving tax administration are likely to be important objectives. For low-income countries, a tax ratio of 15% of GDP should be seen as a minimum objective.

10. **Absorbing Higher Aid Inflows -** Higher aid inflows is considered an important complement to domestically-generated funds for financing poverty-reducing expenditures. There is stronger prospects for increases in aid inflows to low-income countries in the coming years. These inflows could help underpin macroeconomic stability, by financing fiscal deficits and crowding on private sector investment through lower interest rates. Nevertheless, in the long run countries should aim to reduce their dependence on external assistance. Emphasize should be placed on the importance of aid coordination among donors and on donor alignment of their aid programs with national budgets and priorities. Effective management of these resources will be critical for the achievement of the MDGs.

    a. There is need to underscore, in particular, the importance of monetary and fiscal policy coordination in managing a surge in aid inflows. In this context, there is need to note the useful distinction between aid-related "spending"—i.e., the accompanying increase in government expenditures—and "absorption"—i.e., the resulting widening of the current account deficit (excluding aid). There is need to note that, given a large increase in aid inflows, if absorption capacity is adequate and adverse effects on the tradables sector are contained, a spend and absorb strategy would be appropriate. In that case, the government increases spending, and aid finances the resulting rise in net imports. Consideration should be made that, within this scenario, IFI's programs should have adjusters to allow higher-than-anticipated aid inflows to be spent, when countries have finance-constrained plans for productive spending. A key challenge will be identifying the point beyond which real appreciation associated with this strategy is likely to become problematic. However, a more restrained spending policy could be in order if the effectiveness of higher spending is constrained by absorptive capacity, if there is a tension between aid volatility and spending rigidities, or if there is an unacceptable erosion of competitiveness. In this context, caution should be against a policy of aid-financed public spending that is offset by a more restrictive monetary stance. Sterilization—while limiting the inflation and real appreciation pressures—would raise interest rates and heighten the crowding-out of private investment, while raising public domestic debt.

b. Countries should ensue that where higher aid-based spending poses a serious threat to competitiveness, the aid should be used for enhancing productivity and/or removing domestic supply constraints. To help limit concerns about aid volatility, donors should increase the predictability of aid while countries whose budgets are more dependent on aid consider maintaining a relatively large reserve buffer. Program design should also provide greater leeway to draw down reserves when shortfalls in aid materialize, through adjusters on domestic financing, unless reserve levels are inadequate.

11. **Increasing Borrowing.** Given that domestic and foreign borrowing must be serviced and repaid, policymakers need to evaluate whether the social return from the uses to which the borrowing is put justifies the cost. Governments may choose to borrow without taking specific account of the direct returns, but then must do so when assessing the overall sustainability of a program. Such assessments typically weigh an economy's prospective growth rate, potential for exports and remittances, prospective interest rate environment, revenue elasticities, composition of existing debt (in terms of interest rates, maturity, and currency of borrowing) and terms of new debt being considered.

12. **Monetary expansion**. This is not a desirable option! A government's borrowing from the banking system should be driven by monetary policy objectives- namely, the creation of sufficient liquidity to support an economy's real growth, with no more than low inflation. Even if a government were explicitly to rely on money creation to facilitate somewhat higher government expenditure, there are clear limits, given the potential inflationary impact. Continuing to target single-digit inflation is desirable, as higher inflation levels tend to depress economic growth, and hurt the poor disproportionately. As low-income countries are prone to exogenous shocks, targeting an inflation range, supporting a focus on core inflation where this concept is feasible and acceptable is important. Although, at the same time, it should be kept in mind that the appropriateness of single digit inflation will need to be examined on a case-by-case basis, taking into account possible exchange rate appreciation effects and the stance of fiscal policy.

13. **Macroeconomic challenges of scaling- up aid or securing more external grants -** For many developing counties, this is increasingly feasible given the global commitment to help countries reach the Millennium Development Goals (MDGs). Grants can clearly provide more fiscal space than borrowing, where debt sustainability considerations have to be taken into account even when loans are highly concessional. But only a sustained and predictabl*e* flow of grants can create the potential for a scaling up of an expenditure that can be maintained, and reduce the uncertainty as to whether a grant is simply of a one-time nature. Also, countries will need to take account of the potential macroeconomic consequences in terms of a country's real exchange, exports and international competitiveness that may arise from a significant scaling up in absorption of external resource inflows. Therefore, for countries with little debt, external borrowing can be an efficient route to finance development expenditures. However, it should be noted

that even concessional borrowing can lead to an excessive build-up of debt, and most low-income countries already have a rather high public debt burden. Countries should therefore monitor the pace at which they accumulate new debt in order to avoid the emergence of debt problems. For those countries in an IMF program, the recently-operationalized framework for debt sustainability analysis in low-income countries could be the main vehicle for assessing their appropriate fiscal path. In countries with a moderate debt burden, including as the result of further debt relief that was recently considered, the pace at which new debt is being accumulated will need to be monitored carefully through the debt sustainability framework. For those countries with debt burdens close to or above the agreed policy-dependent debt thresholds, grants rather than loans should help finance MDG-related spending.

14. **Pursuing sound macroeconomic policies.** A country's failure to implement appropriate macroeconomic policies-can affect assistance from lenders and donors, and result in volatile flows. Countries that can manage policies are likely to have greater potential for creating extra fiscal space. Governments' need to clarify with donors the likely availability of foreign assistance over the medium to long term and structure their expenditure programs accordingly.

15. **In conclusion,** the fiscal space debate has been proven useful, reflecting on the importance of clarifying ways to facilitate expanded spending by governments to foster growth through higher infrastructure spending and to finance programs vital to the achievement of the MDGs, particularly those related to HIV/AIDS. The IFIs are committed to working with countries to explore the scope for expanded fiscal space. There is therefore, demand for increased spending in many low-income countries, in particular for public investments, health care and education, if these countries are to meet the Millennium Development Goals (MDGs). However, we also understand that progress towards the MDGs is not contingent on higher public expenditures alone, there is need to recognize the potential tensions between higher government spending and both debt sustainability and private sector activity, which could be crowded out. We must also consider that while increased aid inflows, in particular grant support, could relax the constraints relating to taxation, private sector credit, and debt sustainability, real currency appreciation could still give rise to loss of export competitiveness that dampens growth in a country. Lastly, it is clear that if Low Income Countries are to meet MDGs, more investment resources will be necessary. On the other hand these countries must also put appropriate macroeconomic environment in place including strategic measures to address structural and governance issues more forcefully.

Thank you.