Remarks on “Fiscal Space and National Development Strategies”

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Central to the discussion of “fiscal space and national development strategies” is the increasing awareness that long-run economic growth needs to play a central role in informing all types of economic policy choices. This includes macroeconomic policy choices that have traditionally been weighed on the basis of just their short-term impact. I see this as a positive trend. It is my view that achieving progress in international development requires a sharp focus on measurable results, and that sustainable long-run economic growth is among the most salient of results on which to focus.

In operational terms, fiscal space is a country-specific matter of assumptions and accounting, so I think it would be hard, if not impossible, for us to have a meaningful discussion about what constitutes an “accurate” or “appropriate” amount of fiscal space for developing countries. But the ongoing debate over fiscal space has also stirred up some important conceptual issues, and I’d like to briefly touch on three of these.

The first point I want to emphasize is that public spending has a key role to play in facilitating economic growth, but it is the quality rather than the level of that spending that is the more important determining factor. This is obvious as a matter of common sense, but also well-documented by the enormously uneven cross-country empirical evidence on the relationship between *levels* of public spending and growth. This is not to say that evaluations of aggregate expenditures have no role to play in the debate over fiscal space. But any evaluation of aggregate expenditures has to go hand in hand with an evaluation of the composition of those expenditures. I would emphasize here that the elimination of waste from a government’s budget and fighting corruption in government procurement can help to create new fiscal space.

Fiscal space is created not just through the direct channel of freeing up resources, but also indirectly, by enhancing the government’s credibility and therefore its ability to borrow on the market. I think the contrasting experiences of Belize and Thailand provide a good example of the market’s responsiveness to the quality of public spending. In both cases, the government made a choice to embark on an ambitious 5-year program of public spending designed to boost growth. While GDP growth in Belize responded in the short term, evidence of mismanagement, poor prioritization, lack of transparency, and corruption began to surface. Rating agencies responded by uniformly downgrading Belize, and the net result was that Belize’s debt doubled to over 100% of GDP over the course of its 5-year investment program, leaving little hope for additional borrowing. Thailand, in contrast, has maintained both its fiscal prudence and its external credibility while carrying out an investment program on the order of 5 percent of GDP annually to upgrade its infrastructure. Thailand’s credit rating remains at 2 notches above investment grade and country spreads remain unchanged.

This said, fiscal policies supportive of growth cannot be sustained unless there is also efficient management on the revenues side. Frankly, I think some of the discussions

taking place about various creative ways to increase fiscal space are a bit premature when we consider the fact that, in many developing countries, and throughout much of Latin America for example, less than 10 percent of the population pays taxes of any kind. So we are talking about a situation where many developing countries have the opportunity to increase their fiscal space simply by doing a better job of enforcing revenue collection rules that are already in place. There is encouraging evidence that increased effort can yield significant results in this vein. Ethiopia and Mongolia, for example, have each succeeded in increasing their domestic revenue mobilization by over 5 percent of total GDP.

There are of course numerous other factors that help to determine a country's success in achieving fiscal space and making the most out of it, and this brings me to a second point, which is that many of the keys to achieving and effectively utilizing fiscal space are also keys to sustaining long-run economic growth. This is certainly the case with efficient public financial management. Another key that I would highlight is the quality of the business environment and how this affects the ease of doing business.

The financial and social returns to most types of public investment depend on how private sector parties respond to and make investments that complement the initial public investment. And in the case of infrastructure investment especially, this private sector response is determined in large part by the quality of the business and regulatory environment.

To give a concrete example, a recent paper by the world bank finds that the time in days that it takes to move goods to port has a powerful effect on a country's trade prospects, with each day of delay causing an average 1 percent decline in the country's overall exports and an average 7 percent decline in the country's exports of perishable agricultural goods. While this would seem to present a compelling case for carving out additional fiscal space to finance investments in trade infrastructure, the survey data used in the study reveals another striking fact: on average, survey respondents attributed only one quarter of export delays to poor road or port infrastructure, while attributing the remainder to regulatory hurdles and bureaucratic red-tape.

Two country examples illustrate the point. In Denmark, an exporter needs three documents (exports declaration form, bill of landing, and a commercial invoice) and two signatures (one by a customs official and one at the port) to complete all requirements for shipping cargo abroad. The process takes an average of 5 days from the time he starts preparing the first document to the time the cargo is ready to sail. In contrast, it takes 11 documents, 17 visits to various offices, 29 signatures, and an average of 67 days for an exporter in Burundi to move his goods from his factory onto a ship. I think all of this provides a simple but very illustrative example of why the quality of the business environment needs to figure in to the debate over fiscal space.

The third and final issue I want to address is the common perception that fiscal restraints act to constrain public investments in productivity-enhancing infrastructure, and that as a result, fiscal restraints should be loosened as a general principle. From an empirical point

of view, it is true that when countries have committed to reduce overall spending, they have often reduced infrastructure investment disproportionately relative to other types of spending. As we saw in the 1990s in several emerging market regions, many of the first spending programs to be slashed in response to calls for increased fiscal discipline were programs aimed at what we would think of as true public goods, including numerous types of infrastructure.

All of this is well-recognized, and there is a fairly common perception that the blame lies squarely with the fiscal restraints. What I would emphasize, in contrast, is what this evidence reveals about the spending priorities of many developing countries. Why are so many countries willing to cut capital investment first despite its proven ability to generate growth and reduce poverty? I think the answer has a lot to do with the political economy of the fiscal policy-making process, and how this relates in turn to the quality of a country's accountability institutions. In the absence of measures to address these deeper, and deeply challenging obstacles to efficient fiscal policy, it is my view that many countries will be insufficiently prepared to fully exploit the growth potential of whatever fiscal space becomes available to them.