



Fiscal Policy for Growth

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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 Undeveloped 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, observing that “much of the fiscal adjustment achieved is through measures that do not assure long-term sustainability and flexibility of fiscal systems to future shocks” (IMF-IEO, 2003, p. 9).

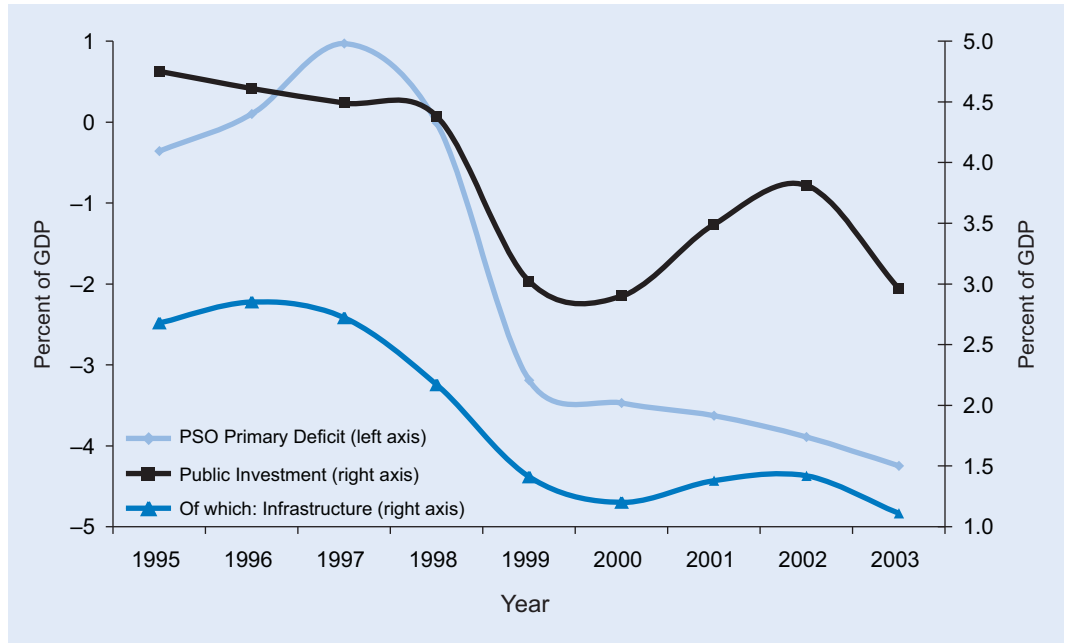
In effect, the improvement of the fiscal balance in the context of IMF-supported programs too often relied heavily in cuts in

public investment that improve today’s government cash flow 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 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” (Rodrigues Afonso et al., 2005). “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” (Easterly et al., 2008).

Responding to a request from the Development Committee, in April 2006 the World 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.

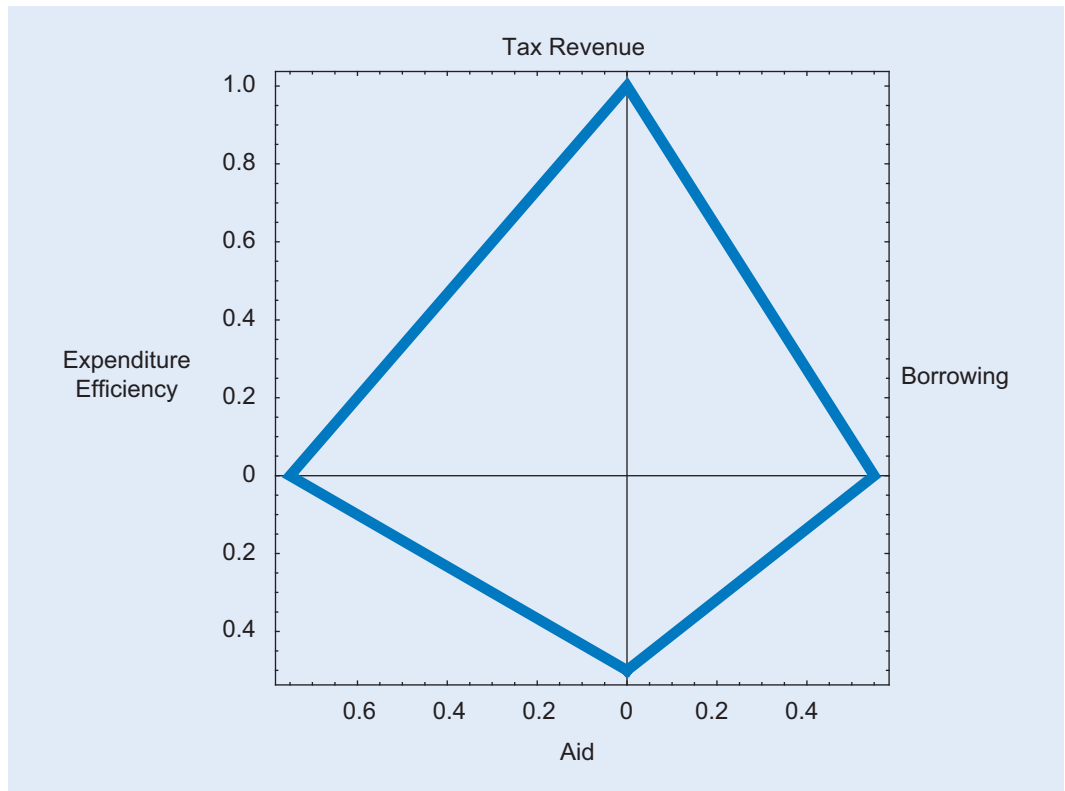
* I received useful comments from Carlos Braga, Milan Brahmbhatt, Tuan Minh Le, Blanca Moreno-Dodson, Vikram Nehru, and Marijijn Verhoeven.

Figure 1. Brazil: Fiscal Adjustment and Public Investment



Source: Rodrigues, Amorim and Biasoto (2005).

Figure 2. The Fiscal Diamond—An Example



Source: Author.

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 the 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-IMF collaboration to ensure consistent policy advice to member countries (Development Committee communiqué of April 15, 2007).

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 monetization, or even repudiation?* (Blanchard, 1990).

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-stabilizing primary balance, b^s , is given by equation 1

$$(1) \quad b^s = \frac{r-g}{1+g} d$$

where r is the real interest rate and g represents the rate of real GDP growth (Ley, 2009).

Fiscal sustainability requires the ability to eventually maintain a balance $b^* \geq b^s$. This condition can be expressed in terms of (tax) revenues, τ , and noninterest (primary) expenditures, e (equation 2):

$$(2) \quad \tau \geq e^* + \frac{r-g}{1+g} d_{-1}$$

This simply states that revenues must cover spending and the costs associated with servicing debt obligations, appropriately scaled. It is apparent from equation 2 that a fiscal adjustment that *transitorily* raises the primary balance at the expense of *permanently* contracting future growth, g , and future tax revenues, τ , will depress, rather than enhance, long-term sustainability—that is, walking down the up escalator. It must also be noted that the key variables involved in standard the debt-dynamics equation (equation 3)

$$(3) \quad d = \frac{1+r}{1+g} d_{-1} - b$$

are jointly determined—which implies that a policy intervention affecting the government balance b will generally also lead to new equilibrium values for the interest rate, r , and real growth, g .

This suggests that it would be useful to (i) frame fiscal-sustainability analysis within growth analysis, and (ii) refocus attention away from the net primary balance and onto the gross flows that comprise it—that is, government expenditure and revenues—critically reviewing the composition of these categories from a growth perspective, as well as from other public policy objectives—for example, social protection and poverty alleviation. Of course, all this analysis must be immersed in a medium-term expenditure framework that has a comprehensive perspective on the government’s priorities.

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 (for example, Estache and Muñoz, 2006; and Agénor and Moreno-Dodson, 2006), or some disciplined growth analytics that could include, among others, the Hausmann-Rodrik-Velasco (HRV) growth-diagnostics approach (Hausmann et al., 2005).

As an example, the goal of a HRV growth diagnostics analysis would be to identify the most important constraints on economic activity, and to determine the set of policies (some fiscal and some not) that is likely to provide the biggest growth bang for the reform buck. Special attention is often paid to private investment as a driver of growth. Let γ denote the private return to investment, $\gamma = (1 - \tau)\rho(a, \theta, x)$, where τ represents taxes, a is an indicator of total factor productivity, θ 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 τ may be driven by high tax rates, an inefficient tax structure, and high expected expropriation risk; high θ may be due to large externalities, spillovers or coordination failures; low a because of low productivity, too little technology adoption or self-discovery; and 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 still open to debate.

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 efficiently and effectively.

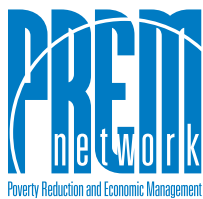
The use of public finance instruments to influence the working of the economic system to maximize economic welfare thus requires the use of ex ante cost-benefit analysis (in (i) and (ii) above) to appropriately account and balance costs and benefits (encompassing both revenue and expenditure instruments), and the use of ex post assessment to evaluate public policies as part of (iii), including benchmarking and efficiency analysis (Gupta and Verhoeven, 2001; Herrera and Pang, 2005).

Rajaram et al. (2006) offer guidance 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.

Finally, all this must be embedded in an environment of 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—information 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 it leads to better-informed public debate about the design and results of fiscal policy; it makes governments more accountable for the implementation of fiscal policy; and thereby it strengthens credibility and public understanding of fiscal policies (IMF, 2007).

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