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**FISCAL POLICY FOR GROWTH AND DEVELOPMENT:
AN INTERIM REPORT**

Attached for the April 23, 2006, Development Committee Meeting is a background report entitled "Fiscal Policy for Growth and Development: An Interim Report."

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**FISCAL POLICY FOR GROWTH AND DEVELOPMENT:
AN INTERIM REPORT**

**POVERTY REDUCTION AND ECONOMIC MANAGEMENT
WORLD BANK
April 6, 2006**

ACRONYMS

AIDS	Acquired Immune Deficiency Syndrome
CPI	Consumer Price Index
DEC	Development Economics, World Bank
EMU	European Monetary Union
EU	European Union
FAD	Fiscal Affairs Department
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFS	Government Finance Statistics
HD	Human Development Network, World Bank
HIPC	Heavily Indebted Poor Country
HIV	Human Immunodeficiency Virus
IEO	Independent Evaluation Office
IMF	International Monetary Fund
INF	Infrastructure Network, World Bank
Lao PDR	Lao People's Democratic Republic
LICs	Low Income Countries
LMICs	Lower-middle Income Countries
MDGs	Millennium Development Goals
MDG-1	Target 1 of Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MAMS	Maquette for MDG Simulations
MENA	Middle East and Northern Africa
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
PER	Public Expenditure Review
PPP	Public Private Partnership
PREM	Poverty Reduction and Economic Management Network, World Bank
SGP	Stability and Growth Pact
U.K.	United Kingdom
UMICs	Upper-middle Income Countries
WDI	World Development Indicators
WDR	World Development Report

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EXECUTIVE SUMMARY

(i) In a development context, fiscal policy serves both as an instrument of macroeconomic stabilization and as an instrument to achieve growth and poverty reduction objectives. In many developing countries, however, the challenge of high deficits, rising debt and bouts of inflation in the 1980s and 1990s led to fiscal policy focusing largely on the goal of stabilization. Correspondingly, growth and poverty reduction objectives were under-emphasized.

(ii) With the general success of stabilization efforts, and given the indispensability of economic growth for the millennium development goal of poverty reduction (MDG-1), there is renewed interest in ensuring that fiscal policy also serves its growth objective.¹ The debate over fiscal targets and rules and a number of reassessments of fiscal policy reveal a consensus that the growth consequences of fiscal policy must be explicitly taken into account, balancing the continued concern for macroeconomic stability. This paper, prepared at the request of the Development Committee to identify “fiscal space for growth”, provides an interim report on how the practice of fiscal policy could be adapted to strengthen its role with respect to growth and achievement of the MDGs.

(iii) Although stability is necessary for growth, it is not sufficient. The design of fiscal policy needs to identify and also incorporate the transmission channels through which fiscal policy influences long-term growth. This requires that attention be focused on the likely growth effects of the level, composition and efficiency of public spending and taxation. Fiscal policy that neglects these effects runs the risk of achieving stability while potentially undermining long-term growth and poverty reduction. The evidence from countries that stabilized their economies by reducing their deficits indicates that countries often did so by cutting public capital formation significantly, despite its potential negative impact on growth and poverty reduction. While in many cases the decision to cut investments reflected a political preference, the absence of domestic fiscal institutions that would have enabled governments to take a medium term perspective may have contributed to such short-sighted decisions.

(iv) In part the problem of fiscal policy design is a reflection of the choice of the fiscal deficit as the policy target. The fiscal deficit is a useful indicator for purposes of stabilization and for controlling the growth of government liabilities, but it offers little indication of longer term effects on government assets or on economic growth. Conceptually, the long-term impact is better captured by examining the impact of fiscal policy on government net worth. While there are practical challenges to accurately estimating a government’s net worth, there is clearly a need for fiscal policy to incorporate, as best as possible, the likely impact of the level and composition of expenditure and taxation on long-term growth while also maintaining a focus on indicators essential for economic stabilization.

¹ MDG-1 refers to the goal of reducing by 2015 the number of people living on less than \$1 (PPP) per day to half the 1990 level.

(v) The concepts of fiscal solvency and macroeconomic stability help to clarify the concern for fiscal space and provide some insights on designing a growth-oriented fiscal policy. “Fiscal space” exists when a government can increase expenditure without impairing its fiscal solvency, i.e. without impairing its capacity to service its debt.² “Macroeconomic space” exists when a government can increase expenditure without impairing macroeconomic stability. Since both solvency and stability must be safeguarded for long-term growth, a government can undertake additional public expenditure when there is both fiscal and macroeconomic space.

(vi) To the extent a country can rely on private sector initiatives to finance and provide services, it both reduces the need for fiscal resources and is also preferable from a welfare perspective. Even in those sectors where private participation is possible, often pricing or regulatory policies or concerns about expropriation may be a binding constraint to private participation. In such cases, it would be preferable to undertake the reforms to attract private interest in financing and provision of specific infrastructure services, including through risk-sharing arrangements reflected in public private partnerships (PPP). Nevertheless, experience shows that private sector interest is often not forthcoming or is confined to a limited number of sectors. It needs to be recognized that some public infrastructure is a necessary complement to private investment and has the effect of “crowding in” private investment. Thus for a broad range of countries, public financing remains the principal means to provide public goods and services needed for growth and poverty reduction.

(vii) This paper therefore addresses the specific question of how governments may create fiscal space for growth. Fiscal space can be created through measures that do not require borrowing – specifically through: (a) improvements to the efficiency of public expenditure that release resources for reallocation, (b) efficient revenue enhancement measures including tax measures and user charges, and (c) through access to external grant aid. Alternatively, governments may try to create fiscal space through new borrowing. A country’s initial fiscal conditions – the level and efficiency of its existing expenditure, its revenue effort, its access to aid and its ability to access borrowing from financial markets – determines its scope for creating fiscal space from any of these measures. The ease and cost of raising resources through any of these means will vary, depending on structural and institutional features of the economy.

(viii) The efficiency and effectiveness of public expenditure is critical to outcomes, including growth. A country that spends resources in a way that does not complement private sector initiatives or in a cost-effective way will undermine its growth prospects. In many developing countries, cost-overruns, poor project management, and poor maintenance of new assets result in inefficient creation and maintenance of infrastructure assets. Leakages and waste may imply that increases in health and education spending do not necessarily translate into better outcomes. Typically these reflect underlying

² This would require that a government generate, in present value terms, future primary surpluses and seignorage revenue higher than the value of the out-standing debt.

problems of capacity for budget management and, in some cases, of governance. If institutional weaknesses and problems of governance that cause poor outcomes are not addressed, even spending on potentially high return programs will have little impact on growth. The net impact will be to erode the government's solvency and reduce its fiscal space.

(ix) Country specific conditions are therefore important in the design of fiscal policy for long-term growth. Creating fiscal space will depend on initial conditions in a country and the strengths of its public sector institutions and the likely trajectory of ongoing reforms to improve their performance. While recognizing that each country is distinct, this paper identifies some broad fiscal typologies using “fiscal space diamonds” which visually depict initial fiscal conditions and help identify the options available to a country – some countries have access to borrowing, others have access to aid, some can raise revenue effort and most can improve the efficiency of expenditure. Two broad types can be distinguished in terms of whether the country has access to international market borrowing or whether it has access to external grant aid.

(x) Market perceptions of solvency and macro-economic stability matter for countries that have access to international financial markets. Governments can either create or diminish fiscal space through their actions. Countries with an established track record of prudent fiscal management, low debt ratios and macroeconomic stability have been able to borrow from international markets. Markets rate such countries favorably by keeping sovereign interest spreads low and improving their access to borrowing, thereby expanding potential fiscal space. Some countries have made use of this space to finance large infrastructure programs. How effectively they manage such programs in terms of solvency and stability has determined whether the markets continue to rate them favorably. Other countries have limited their borrowing even where access was available, preferring to reallocate budget resources from lower priority programs to meet public and human capital objectives or choosing to raise revenues.

(xi) Countries where past fiscal management has resulted in poor outcomes in terms of macroeconomic stability and growth will find reduced access to borrowing or high interest rate spreads. A country with a history of macroeconomic instability will find it more difficult to borrow because markets may be wary of a recurrence and attribute a high risk of default. Countries that have used initial access to debt to finance a large public investment program, but failed to subsequently maintain macroeconomic stability and solvency, have faced ratings downgrades and a loss of fiscal space. Other countries have retained access to borrowing despite a high debt ratio because of the absence of previous defaults on debt and the perception that the government has the room to generate future primary surpluses by enhancing revenue and expenditure efficiency. However, there are clear limits beyond which countries will not be able to access markets if their debt level and the default risk rises.

(xii) For countries that rely on external grant aid, fiscal space requires ensuring that domestic revenue mobilization efforts and the efficiency of spending are improved both to ensure adequate resources to sustain recurrent spending (especially for health and

education programs and infrastructure maintenance) as well as to enhance credibility necessary to sustain grant aid flows. Both revenue measures and efficiency in public expenditure are under-emphasized as sources of fiscal space in developing countries. Among low income countries, fragile states have limited options to create fiscal space and will have to be sustained in the medium term with grant aid flows until a domestic revenue base can be established. For countries relying on grant flows to finance recurrent spending programs linked to MDGs, there is clearly a need for donors to ensure predictable, flexible flows of grant aid. There are particular concerns of countries with high aid inflows such as the risk of Dutch disease that are only briefly addressed in this paper but have been discussed in recent IMF papers on the topic.

(xiii) Moving forward, some general directions can be identified at this stage. **First**, as countries seek to achieve higher growth and the MDGs, the design of fiscal policy will need to incorporate both the stabilization and growth objectives explicitly. **Second**, the composition and efficiency of expenditure is a key to achievement of outputs and outcomes, including growth and the MDGs and knowledge from the analysis of these channels of transmission should be incorporated in policy design. **Third**, because each country is unique in terms of the levels and composition of spending and sources of financing, a growth oriented fiscal policy must take account of initial fiscal and macroeconomic conditions, including the constraints to growth, the efficiency of expenditure and the institutional capacity to make effective use of existing and new resources. **Fourth**, where capacities are weak, countries should prioritize improvements to their fiscal institutions, especially those entrusted with budget management and revenue mobilization.

(xiv) There are a number of important operational implications of the directions identified above for the Bank's analytical work in country programs. First, it raises the significance and the need for the Bank to address the link between spending and outputs and outcomes more substantively in Public Expenditure Reviews (PER). Second, it will require PERs to take a more comprehensive view of public finance, paying closer analytical attention to the financing side of the budget including all instruments of public financing identified by the "fiscal diamond". Finally, the attention to budget systems, development of medium term expenditure frameworks and institutional capabilities for budget management remains important but should be enhanced by more explicit consideration of how the system serves policy objectives and how those objectives are influenced by the political economy of the country. More substantive focus on these issues will enable the Bank to contribute, jointly with the IMF, to the design of growth-oriented fiscal and public expenditure policies.

(xv) This is an interim report to the Development Committee on a fairly complex set of inter-related issues and a large program of work which has been initiated. Further country specific analysis is necessary to develop our understanding and to be able to provide guidance on how long-term growth can be effectively promoted by fiscal and public expenditure policy while maintaining macroeconomic stability. The Bank plans to undertake a number of pilot country case studies to apply the proposed analytical framework and to derive conclusions that may help guide fiscal policy design. The

country studies would involve analyzing the scope to create fiscal space along each of the four axes of the fiscal diamond including the scope to improve the composition and efficiency of expenditure, to improve revenue and aid mobilization and to develop a prudent debt strategy, particularly in countries receiving debt relief under the Multilateral Debt Relief Initiative (MDRI). The review would take into consideration the quality of budget institutions and any reforms to strengthen capacity for medium term fiscal and expenditure planning. The country studies would help clarify how fiscal space and macroeconomic space considerations could be assessed to provide consistent policy advice on growth with stability.

(xvi) This work will be undertaken in consultation and collaboration with the IMF. Continued collaboration with the Fiscal Affairs Department (FAD) of the IMF and other development partners is envisaged. A seminar to report on progress on this work will be held in September 2006. A full report is expected to be completed by early 2007 and its findings and recommendations will be disseminated through seminars in the various regions, targeted to policy-making, academic and civil society audiences.

I. Background to the Issue

1.1 “Fiscal space” has emerged as a major concern for policy makers in recent years. The term initially applied to the view that fiscal deficit targets limited the ability of a government to borrow to finance productive, growth-enhancing infrastructure projects. The term has now gained wider currency, however, and can be seen to refer to constraints to public expenditure which have the potential to raise productivity and yield returns in the future or which would serve to achieve social goals (such as the MDGs). In 2005, the Development Committee requested a report from the Bank on the impact of fiscal space on growth and achievement of the MDGs,³ complementing earlier IMF Board reports on public investment and fiscal policy.⁴

1.2 The discussion over fiscal space has taken on renewed importance in the context of identifying the constraints to higher growth rates needed for significant poverty reduction. It is particularly relevant because the level of private sector investment is increasingly seen as a complement to rather than a substitute for public investment. Expectations regarding the extent to which private initiatives can take on the responsibility for key infrastructure investments in developing countries have become more realistic, after a period of optimism during the 1990s. The rapidly growing economies, such as China and Vietnam, provide support for the view that higher levels of efficient public expenditure have been important contributors to economic growth and poverty reduction. On the other hand, evidence from Latin America over the past decade has shown the crowding out of infrastructure spending by governments in favor of entitlement spending, revenue sharing, and in some cases debt service, with a resulting low level of economic growth performance. Given the high level of ambition of MDG 1, it is appropriate that fiscal policy be re-examined with respect to its contribution to growth and development.

1.3 In the 1980s and the 1990s the principal challenge for fiscal policy was economic stabilization. Many countries experienced high inflation and debt crises brought on in part by large fiscal deficits. Accordingly, and appropriately, fiscal policy focused on stabilization which entailed a preoccupation with inflation management and a revival of private investment. Fiscal policy thus focused on the fiscal deficit as one way to restrain aggregate demand and to control inflation and the further growth of debt. It is also worth noting that other trends in many developing countries over this period added to demands for additional expenditures, such as the trend towards decentralization, which increased claims on central government budgets, as well as some constitutionally mandated expenditure in countries like Brazil. In order to accommodate these additional demands in the absence of newly generated tax revenues, governments were under increasing pressure to reduce other expenditure categories.

³ Development Committee Communiqué, September 25, 2005

⁴ See, IMF (2004) and IMF (2005a).

1.4 Fiscal policy has been broadly successful in achieving economic stabilization in part through reductions in fiscal deficits. The median fiscal deficit in developing countries was reduced from 6 percent in the early 1980s to 2 percent in the late 1990s and median inflation was reduced from 15 to 5 percent over the same period. As can be seen in Figure 1 the quality of macroeconomic management has improved in the majority of countries and there is relatively less debate about the necessity of stable economic fundamentals as a prerequisite for economic success. This recognition by policy makers is seen in many international pronouncements about the indispensability of macroeconomic stability to foster both private and foreign investment, to shield the poor from the ravages of inflation, and to try and embed in political transitions the indispensability of sound macroeconomic management. Figure 2 (a-c) confirms that fiscal balances improved across most income groups through the late 1990s.

1.5 The success of fiscal policy in relation to its stabilization objective may have come at the cost of long-term economic growth. Reduction of the fiscal deficit was largely achieved through expenditure adjustments (as seen in Figures 2 (a-c)). Low-income countries (LIC) and middle-income countries (LMIC, UMIC) relied on expenditure reductions rather than revenue enhancement as the principal means of fiscal adjustment over this period. Alesina and Perotti (1996) suggest that expenditure based adjustments are more sustained relative to those relying on revenue enhancement, but that conclusion assumes cuts to public consumption and transfers, not to public investments or other productive expenditure. Figure 3 (a-c) indicates that the largest share of expenditure adjustment in LICs, LMICs and UMICs was accomplished by cuts on infrastructure in all three income groups. There are no clear trends in the share of public expenditure allocated to education in any of the three income groups – they appear to have been protected from cuts - but expenditure on health as a share of GDP shows a clear and sharp increase post-1990 in the upper middle income countries, reflecting other (including demographic) pressures that drive budget decisions.⁵

1.6 Across regions the pattern is that a disproportionate share of fiscal adjustment was borne by infrastructure. There is strong evidence from Latin America's adjustment as well as stabilization efforts in Africa and South Asia that the expenditure category suffering the greatest reductions in order to achieve fiscal stabilization objectives was public capital formation.⁶ A similar pattern was also observed for the EU where primary deficit reductions for major members in the period 1993 to 2000 were highly correlated with reductions in transport investment. While there may have been a reversal recently in the case of the EU, the weighted average of public investment in infrastructure for 7 Latin American countries fell from 3% of GDP in 1980 to 2% of GDP in 1990 and to less than 1% of GDP in 2001, leading some to speculate that the stock of public capital actually declined in Latin America, net of depreciation. Thus, it is not surprising that many of the concerns about the lack of fiscal space have emanated from Latin America.

⁵ Cuts in productive expenditure may also reflect political economy choices that reflect a preference for current expenditure over long gestation investment projects.

⁶ See Serven and Calderon (2003) for Latin America and Estache (2005) for Africa.

Figure 1: Trends in Fiscal Deficits and Inflation by Income Group, 1980-2005

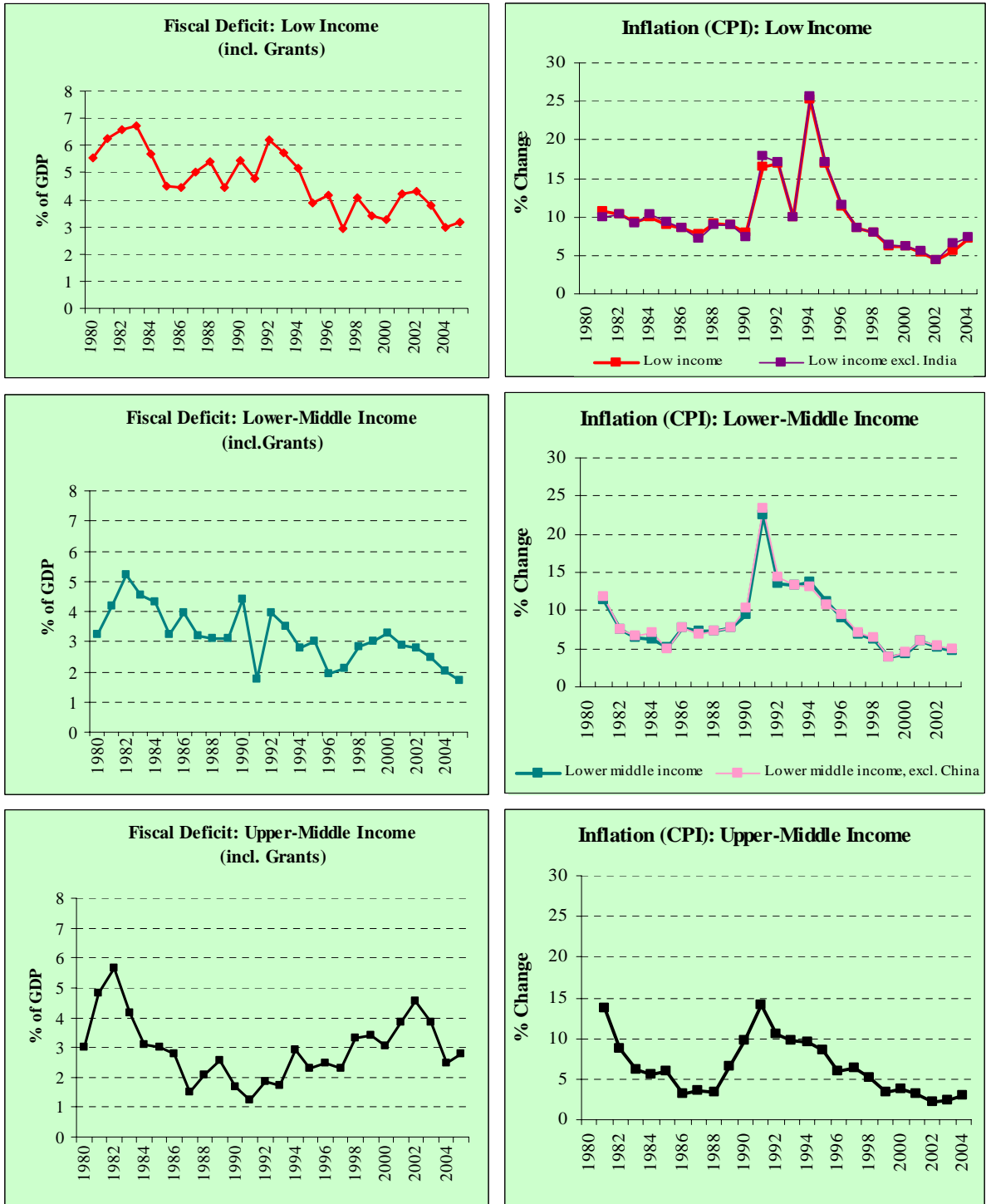


Figure 2 (a-c): Fiscal Trends

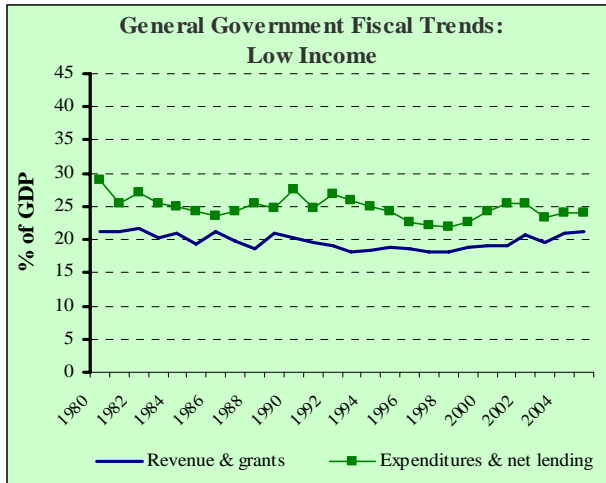
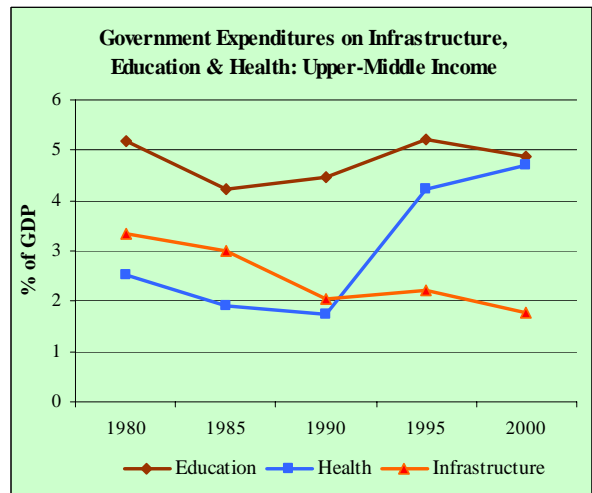
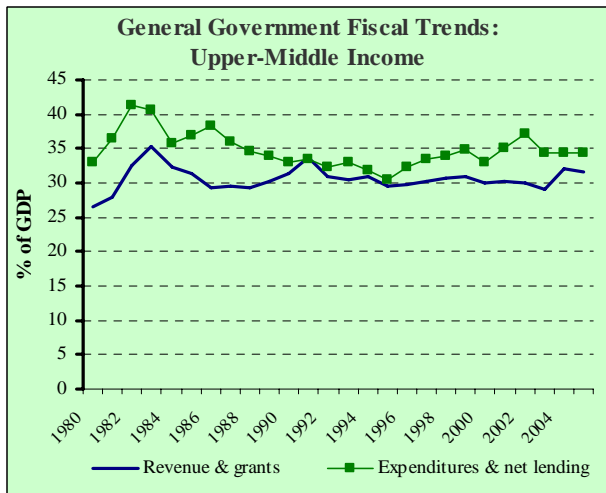
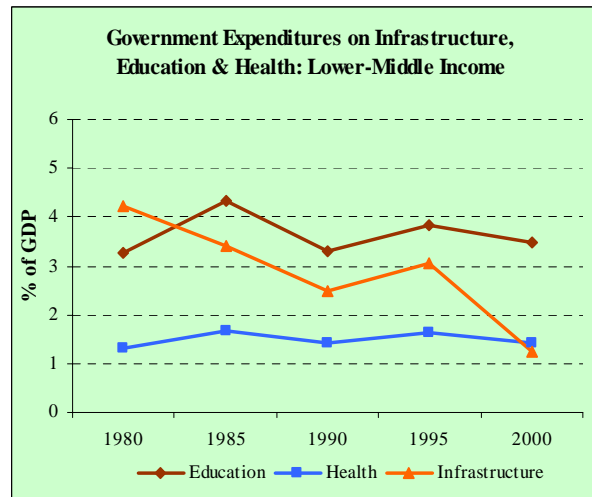
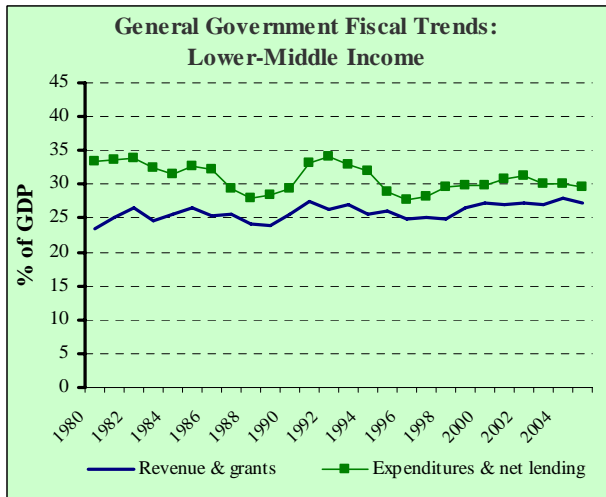
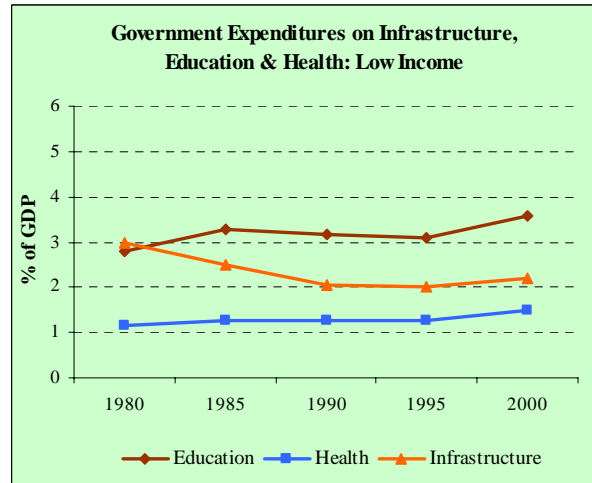


Figure 3 (a-c): Functional Expend. Trends



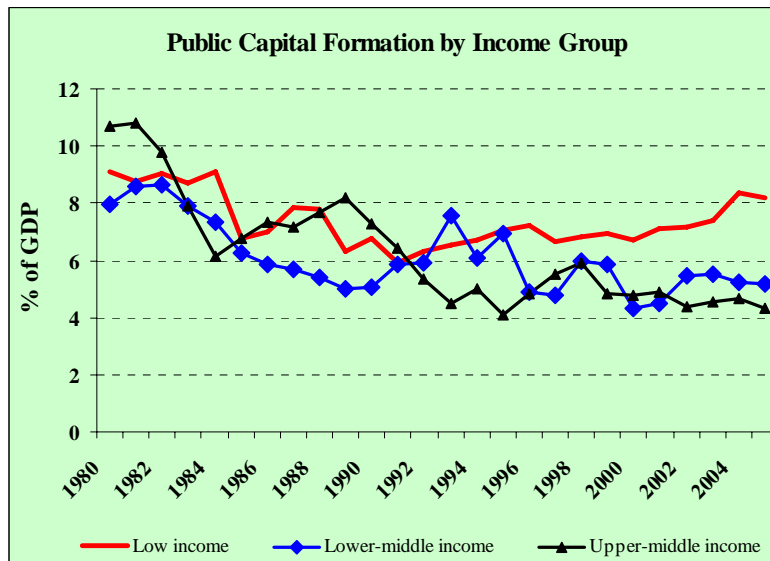
Data sources: Figure 2. World Economic Outlook, IMF, September 2005.

Figure 3. Government Finance Statistics (based on 1986 GFSM), IMF, October 2005; World Bank Public Expenditure Reviews (various); IMF Selected Issues and Statistical Appendices (various), 1999-2005.

Infrastructure includes GFS categories of transportation, communication, and energy and fuel.

1.7 Domestic public capital formation declined for most income groups, suggesting that public finance for this purpose has been constrained. As seen in Figure 4, national accounts data on public capital formation, which includes both government and public enterprise investments, confirm a declining trend in the three income groups. In Latin America, with the exception of Colombia and Ecuador, most countries cut infrastructure expenditure, a major component of capital expenditure. The primary deficit for these countries was reduced from 5 percent of GDP in the early 1980s to zero in 2000 and about 40 percent of the deficit reduction was achieved by cuts in infrastructure investment.⁷ India cut its public capital expenditure by almost 3 percent of GDP in the first half of the 1990s, cutting expenditure on irrigation, power and transport.⁸ In Africa, while aid appears to have sustained capital expenditure in a number of countries such as Uganda and Tanzania, in others, such as Burundi (1985-98), Cameroon (1980-1990), Lesotho (1990-2000), capital expenditures fell sharply over a number of years. In Egypt, Jordan and Tunisia, public investment shares in GDP have declined since the late 1980s.

Figure 4: Public Capital Formation, 1980-2005



1.8 A decline in aggregate public investment or infrastructure investment may not be problematic if private investment replaces public spending. However, in many countries pricing or regulatory policies may discourage private participation in infrastructure financing and provision. Relaxing this constraint would be an efficient way to address infrastructure needs rather than increasing public spending. This appears to be the case in many countries in the MENA region.⁹ In India, concerns about government pricing and

⁷ Easterly and Serven, (2003).

⁸ Pinto and Zahir,(2004).

⁹ Agenor, Nabli and Yousef (2005) point to the unfavorable policy environment for private sector activity in the region. Private participation in infrastructure projects in MENA for 1990-2001 was less than in all other regions, including sub-Saharan Africa. Thus policy reforms that encouraged private infrastructure

regulation limit private interest in the power generation sector and increase the need for power sector subsidies, limiting the resources available for capacity expansion. However, in other sectors, innovative institutional approaches have expanded the scope for private participation, as in highway financing and provision. A decline in investment may also not be a concern if it was inefficiently deployed. In East Asia, despite the fact that Cambodia, Indonesia, Lao PDR and Philippines have under-invested in infrastructure, efficiency enhancement, cost reduction and better maintenance and management may be necessary before further investments are appropriate.¹⁰

1.9 While focusing on stabilization, the design of fiscal policy must also take account of growth. While stability is important for economic growth, the quality of fiscal adjustment and the growth consequences of fiscal policy merit greater attention in a world of greater demonstrated stability. In a review of IMF-supported adjustment programs, the Independent Evaluation Office (IEO) of the Fund noted that adjustment program design was characterized by “growth-optimism” and that there was inadequate analysis of how the fiscal stance would impact on economic growth.¹¹ The review of fiscal policy and public investment by the IMF concluded that the current approach to fiscal policy formulation was broadly appropriate in countries with high debt and macroeconomic vulnerability but acknowledged the importance of country specific conditions (see Box 2). The current paper develops the idea of country specificity and considers how fiscal policy design could be strengthened to incorporate growth objectives while preserving the concern for macroeconomic stability.

investment, cut wasteful spending, and limited the public sector to expenditures which corrected for market failures, would be overall efficiency enhancing for the economy.

¹⁰ Countries in East Asia that have under-invested in infrastructure may have undermined economic growth, poverty reduction and even long-run fiscal solvency. Nevertheless, the assessment of the Bank is that higher investment expenditures would not be appropriate without improvements to expenditure efficiency in a number of these countries. World Bank (2005).

¹¹ “IMF (2003).

Box 1. Recent Debates on Fiscal Targeting and Rules

There are a number of arguments that underpin the view that fiscal policy has been seen primarily as a short run stabilization instrument rather than as a broader economic policy instrument. Fiscal policy is seen by some as not yet having incorporated the implications of endogenous growth theory into policy design, thereby limiting the focus on growth.¹² Other criticisms have to do with fiscal targets and design of fiscal rules.

Fiscal rules implemented by a number of countries and regional groupings to discipline fiscal policy have been critiqued for constraining investment. In the EU, adherence to rigid fiscal deficit targets (such as the 3 percent deficit target of the EMU Stability and Growth pact) was seen to constrain governments from addressing critical investment needs. The SGP fiscal rule has been criticized for focusing on the net figure of the deficit which provides “no pressure on EMU members to reduce current government spending, so as to lower tax rates and make room for higher public investment.”¹³ Fiscal policy that emphasizes the cash deficit target has also been criticized as encouraging “fiscal gimmickry”. Governments can achieve the cash deficit target while undertaking actions that have adverse economic effects.¹⁴ As noted, public investment cuts were made to reduce fiscal deficits as part of stabilization programs.¹⁵ Public investments and maintenance of infrastructure have often been deferred in the interest of achieving annual deficit targets. It has been argued that the cash deficit is an inherently myopic target that attaches no value to productive expenditures that may contribute to future growth and to improved public sector solvency.¹⁶ Some countries have tried to correct for this myopia by adopting the “golden rule”, allowing borrowing only to finance investments, and supplementing it with a debt ceiling.¹⁷

Despite the criticisms, transparent, flexible and well-designed fiscal rules can aid fiscal policy, helping to restrain political pressures for expansionary policy. Numerical targets such as the EU 3 percent target provided incentives for aspiring new member states to undertake fiscal consolidation. Where fiscal consolidation has been achieved, rules that emphasize transparency in fiscal reporting allow some flexibility while retaining incentives for fiscal credibility (New Zealand, Australia, and U.K.). Rules defined in cyclically-adjusted terms allow for automatic stabilizers but restrain pro-cyclical tendencies. Since 2000, Chile uses a structural surplus target of 1 percent of GDP over the medium term. Brazil has used a fiscal responsibility law to improve sub-national fiscal discipline.

1.10 Growth and development oriented fiscal policy must take into account the composition and efficiency of public expenditures. Fiscal policy design that emphasizes the deficit but ignores the composition of spending effectively ignores an

¹² Tanzi and Zee (1997) observe that “from the perspective of the new endogenous growth theory, fiscal policy could play a fundamental role in affecting the long-run growth performance of countries.”

¹³ Blanchard and Giavazzi (2004).

¹⁴ Koen and van den Noord (2005).

¹⁵ See IMF (2004).

¹⁶ If the borrowing is used to finance an investment which yields a rate of return in excess of the cost of borrowing, then it would have the impact of improving the government’s net worth and solvency. Easterly and Serven (2003).

¹⁷ The U.K., for instance, adopted the golden rule in 1997 together with a ceiling of 40 percent on the net public debt to GDP ratio. For a discussion of fiscal rules see Banca d’Italia (2001) and OECD (2002).

important transmission channel for the growth impact of fiscal policy. There is a rich but not uncontroversial literature, for example, on the relationship between public investment and growth.¹⁸ The sustainability of a fiscal deficit itself depends on the productivity of the expenditure. By allowing a fuller consideration of the growth effects of fiscal decisions, an explicit focus on the composition of expenditure would allow both stabilization and growth objectives to be addressed in more sustainable ways.¹⁹

1.11 The need for infrastructure for economic growth and poverty reduction is often overlooked. Countries need transportation and telecommunication infrastructure to sustain commerce and trade, the more so in a globalized competitive world. Fuel and energy services are necessary for agriculture and modern industrial functions. Water and sanitation services are essential to support population settlements in both urban and rural areas. Whether provided by the public or the private sector, the extent and quality of infrastructure services is critical for growth and development. For most of the 20th century, it was assumed that these services would be provided by the public sector because of the prohibitive size of the investments required and the problems of pricing for services where exclusion costs were high. Starting in the 1980s, changes in technologies and regulatory approaches have allowed countries to get private participation in provision of some infrastructure services, notably telecommunication and electricity generation. But hopes for large scale transfer of responsibilities for public infrastructure to the private sector have become more realistic, as both the regulatory challenges and the fiscal risks have become more evident.²⁰

1.12 Empirical evidence confirms the high returns and externalities due to public infrastructure. The rigorous study of the link between infrastructure and economic performance did not commence until the seminal paper by Aschauer (1989). Since then a large number of studies have estimated the relationship both in developed and developing countries. Given the lower stock of infrastructure assets in developing countries, it is often a serious constraint to growth and the marginal productivity of infrastructure investment and maintenance is high, when such investments are effectively implemented.²¹ What infrastructure services are most binding will differ across countries.

¹⁸ While cross-country regression analyses can be used to bolster either the argument in favor or opposed to additional capital expenditures, this tends to show the limitations of cross-country regression analysis rather than the absence within individual country contexts of the determinants of growth. IMF (2005) find mixed results from a review of the literature on public investment effects on output, productivity and growth. Calderon and Servén (2005) review a large number of studies that show that infrastructure investments specifically have a positive impact. The issue remains open for further study.

¹⁹ In the Ethiopia MAMS exercise, for example, the model incorporates the feature that additional infrastructure investments raise the efficiency of aid to the social sectors and enable an earlier achievement of MDGs to materialize. See MAMS Model for Ethiopia, Lofgren (2004).

²⁰ Guasch (2004) highlights the fact that 1 in 2 PPP contracts need to be renegotiated, a complicated and costly process. Estache (2005) notes that only 230 foreign partner PPPs were generated in Africa and about half of these were limited to South Africa.

²¹ Estache and Liu (2003) estimate social rates of return on World Bank infrastructure projects in excess of 20 percent for telecommunication, transport and urban projects over 1964-2003 and find evidence that returns may have increased in recent years. See also Canning and Bennathan (2000) and Briceno et. al. (2004)

Easterly, Serven and Calderon (2003) provide a detailed assessment of the growth in infrastructure assets in a number of countries in Latin America and derive the implications for competitiveness relative to other regions. They conclude that over a third of the output gap between Latin America and its East Asian comparators over the 1980s and 1990s was due to the decline in infrastructure quantity and quality.²²

Box 2. IMF Review of Fiscal Policy and Public Investment

The IMF prepared a number of papers on the topic of public investment and fiscal policy in 2004 and 2005 to respond to concerns about the impact of the latter on growth. Acknowledging the decline in public investment in the OECD countries and in Latin America, the paper noted that fiscal adjustment (among other factors) had contributed to a decline in public investment in infrastructure in a number of regions, particularly as a result of rigidities in expenditure composition. The paper noted the need for fiscal policy to continue to target the overall balance and gross public debt, but also to improve the quality of fiscal adjustment, in particular through increased focus on the composition and efficiency of public expenditure.

Some modifications were proposed to the design of fiscal policy. The IMF considered the proposal to target the current (instead of the overall) fiscal balance, thereby allowing public investments to be financed through borrowing, but concluded that this could give rise to significant risks in terms of macroeconomic stability and public debt sustainability and would not promote a focus on the quality of public investment. Therefore, it proposed instead that the current approach to fiscal policy be supplemented by increased attention to the quality of fiscal adjustment and its prospective impact on growth by the use of the current balance as a supplementary fiscal indicator and by adopting structural fiscal indicators with a view to limiting the pro-cyclicality of fiscal policy, which had contributed to the decline of public investment, especially in Latin America. With regard to identifying productive public investment, the papers acknowledged the need for projects to meet microeconomic cost benefit criteria as well as macroeconomic considerations with respect to financing and absorptive capacity.

Pilot application to some countries suggested the scope for fiscal space was limited. In a set of papers published in 2005, the IMF reported on a pilot project to apply the proposed approach to eight countries, to assess how fiscal policy might better accommodate productive public investments in infrastructure. The IMF concluded that there was little scope to substantially relax the overall fiscal balance target in most of the countries in the pilot, which were characterized by high debt levels and continuing vulnerability to macroeconomic shocks.

“A proper assessment of the scope for increasing investment spending in any particular country requires a careful analysis of aggregate demand conditions, absorptive capacity, short-term financing constraints and medium-term public debt dynamics, as well as trade-offs with other types of expenditure in that country.” (IMF (2005a), p.4).

The papers concluded that additional room for public infrastructure spending cannot be created by changes in fiscal accounting, and that Public Private Partnerships (PPPs) offered a limited avenue to increase infrastructure investment, provided that they are appropriately structured. The papers also identified the need to capture and assess more consistently the extent of fiscal risks posed by public sector activities, including public enterprise operations and by PPPs.

²² Easterly et. al (2003). The IMF (2005a) pilot studies of the effects of public infrastructure investment in Brazil, Chile, Colombia, Ethiopia, Ghana, India, Jordan, and Peru concluded that “infrastructure bottlenecks seem most acute in the road transport sector, but they are also present in the ports, energy, telecommunications, and water and sanitation sectors” (p. 7).

1.13 Human development goals as well as long-term growth objectives justify emphasis on health and education . The role of education has been widely recognized as critical for ensuring good quality growth, giving people the assets required to improve their economic and social status and to allow sustained poverty reduction.²³ Health is often thought to be a consequence rather than a cause of economic growth. However, there is growing evidence of better health contributing to growth, for example, through its contribution to improved learning of school age children, higher productivity of workers and longer working lives.²⁴ Conversely, diseases such as HIV/AIDS have rapidly diminished human capital.²⁵ Thus, both from the positive perspective of encouraging the growth of human capital and from the perspective of minimizing the impact of AIDS, education and health are important for long-term growth, sustained poverty reduction, and achieving the MDGs.

1.14 The multi-sectoral nature of many MDG goals is well understood, but complementarities between social and infrastructure expenditure much less so.²⁶ The health MDGs relating to child mortality and malaria require improved water and sanitation services, which would also provide substantial social benefits to the population at large. Reducing maternal mortality requires improvements to road infrastructure in rural areas. In general, the quality of rural infrastructure (roads, telecommunications, electricity, water and sanitation) has to be upgraded if public sector teachers, doctors and nurses are to be encouraged to stay and provide public education and health services in rural areas.²⁷ These complementarities are being acknowledged in empirical models that are used to consider the expenditure requirements for the MDGs but public expenditure planning and budget allocations often seem to pay little regard to managing these complementarities.

²³ Cross-country studies (Barro (1991), Benhabib and Spiegel (1994), Barro and Sala-i-Martin (1995), Sala-i-Martin (1997) and others) have found schooling to be positively related to per capita GDP growth. See also Pscacharapoulos and Patrinos (2004) on rates of return to education across regions.

²⁴Bloom, Canning and Jamison (2004).

²⁵ Early studies estimated the loss of GDP annually to be about 1 percent. More recent studies that have considered the human capital consequences and the impact on transmission of knowledge have concluded that the impact is likely to be much more significant and may even result in economic collapse. See Clive Bell, Shanta Devarajan an Hans Gersbach, 2003.

²⁶ See Leipziger, Fay, Wodon and Yepes (2003) for a discussion of the infrastructure requirements for improved child health outcomes under the MDG.

²⁷ World Bank (2004). The WDR highlighted the problem of absentee teachers and health care workers, a problem that in part reflects the difficult living conditions and poor transport in many rural areas.

Box 3. On Governance, Budget Institutions and Public Expenditure Efficiency

Countries can vary greatly in the efficiency of their resource use, ranging from those where there is high efficiency and good impact to those where resources seem to have little impact on outcomes.¹ This is one reason for the weak link between spending and outcomes. Poor outcomes attract attention and, in the context of national and international goals for development, often result in initiatives to devote more resources to address the problem. However, unless the impediments to efficiency and effectiveness are addressed, there is little reason to believe that more resources will result in the achievement of the desired outcomes.

Differences in efficiency across countries are due to differences in governance and accountability, and in particular, in the quality of budget institutions and public sector management. All countries have elites, interest groups and lobbies seeking to control and divert public resources to their advantage. But in some countries the allocation of resources is determined by a legitimate and effective political and budget process while, at the other extreme, in other countries resources may be diverted wholesale from government functions to the private use of the politically powerful. The countries that do better in terms of resource management have evolved political processes and budget and public sector institutions that establish some rules of the game which restrain selfish behavior, protect the public interest and enforce accountability for resource use.

In managing public spending governments need to be mindful of fiscal discipline, allocative efficiency and operational efficiency, i.e. they need to ensure that public spending is macro-economically appropriate and fiscally sustainable, expenditure is allocated to functions, programs and projects that are priorities for government policy, and those resources are used efficiently and effectively. Good institutions help a government accomplish all three functions.

Of these three, operational efficiency depends most on the rules and incentives that motivate and guide the performance of government employees. Good management is critical to staff motivation and government efficiency. Effective internal controls and audits can support effective management. A good ex-ante process for evaluating projects for costs and benefits and a system for evaluating ex-post impact will minimize resource waste. An active legislature aided by a diligent supreme audit institution can monitor government performance and respond to evidence of corruption and inefficiency. But all such institutions require a degree of public consensus and supportive political economy to be effective. An active civil society can help put pressure on public officials to ensure performance. Many countries have these management and oversight institutions but their functioning can be frustrated by political interference, non-cooperative behavior and by a general climate of disregard for the rules. In such situations, it is questionable whether outcomes could be achieved through larger budget allocations. Thus, as questions of fiscal space for productive expenditures are considered, the issue of efficiency and the quality of budget systems and public sector management processes must be addressed to provide assurance that such expenditures will in fact be productive.

¹ The WDR2004 pointed to the very different impacts of an increase in spending on education and health on primary school completion rates and child mortality in a number of countries and concluded that the effectiveness of public spending varied tremendously. (World Bank 2004, p.35-38). The example of Uganda where only 13 percent of allocations intended for district schools reached their destination in the early 1990s is an illustration of the weak link between allocation and outcomes. If resources do not reach the target, it is not surprising that outcomes are not improved. (See Reinikka et.al.)

1.15 Governance is a key determinant of the efficiency and effectiveness of public spending. Box 3 identifies weak governance and accountability as a principal reason for inefficiency and why public expenditures often fail to achieve outcomes. Anecdotal evidence for this is plentiful in the development literature, and it is also confirmed by recent studies that document that corruption and poor management can create the wrong incentives to increase public investment.²⁸ Rent-seeking behavior may result in higher levels of public investment in countries where political checks and balances are weak, expropriation risk, contract repudiation risk and corruption are high and the quality of bureaucracy and law and order are low.²⁹ However, the real value of such public investments is likely to be low and it raises a warning flag regarding excessive zeal to create fiscal space for public investment in countries where the governance conditions are weak.

1.16 Improving governance is critical for productive public spending in health, education and infrastructure. Baldacci et. al. (2004), find that governance has a significant direct effect on the link between public spending on health and education and other social indicators, with the link being particularly sensitive for health expenditures. They find that public spending on health has essentially no effect on health indicators in countries with poor governance, and that the effect of spending on education on educational attainment is also greatly reduced in such countries. A recent Bank review underlined the challenge of addressing corruption risks at the procurement stage in infrastructure projects.³⁰ Thus, social returns from public expenditures devoted to activities that improve the quality of governance may have multiple benefits: they increase welfare directly, they contribute directly to economic growth, and they contribute to growth indirectly by enhancing the efficiency of other forms of productive public expenditures.

1.17 Aid flows increasingly seek to influence the composition of expenditure. In recent years, donors have sought to directly influence the composition of public expenditure, targeting aid to categories of expenditure thought to be closely aligned with poverty reduction or to specific MDGs.³¹ These flows pose a challenge both to fiscal policy and to public expenditure policy since they create a new paradigm of aid within which fiscal policy must be managed.³² Specific sectors lay claim to fiscal space based on earmarked aid flows. Should the composition of expenditure shift towards programs for

²⁸ Klitgaard (1990) and Easterly (2001) provide anecdotes of projects undermined by poor governance. Also see Tanzi and Dawoodi (1996), and Mauro (1998).

²⁹ Philip Keefer and Stephen Knack (2006).

³⁰ World Bank (2006) .

³¹ The HIPC initiative sought to earmark the resources released by debt relief to “pro-poor” expenditures and while countries were free to designate the categories of expenditure that met this criteria, in general the initiative led to a significant allocation of resources to the health and education sectors. More recently, in light of the focus on the MDGs (many of which are health related goals), significantly larger volumes of ODA and private flows are being directed through vertical funds for specific disease control programs (AIDs, malaria, etc.).

³² Other recent papers by the IMF have discussed issues with regard to managing large aid inflows to developing countries, addressing the challenge of coordinating fiscal, monetary and exchange rate policies. See IMF (2005b) and IMF (2005c) and Heller (2005b)..

which low cost grant resources are available or to other high return investments for which financing will have to be sought? What are the trade-offs implicit in such a shift in the composition of expenditure? What are the implications for sustainability and solvency? These issues require further examination.

1.18 Summing up. The debate over fiscal space is in effect a debate over the need for an approach to fiscal policy design that enables both the short-term stabilization objective as well as longer-term growth and poverty reduction objectives to be achieved. Fiscal policy is important because of its impact on (i) physical and human capital formation and the economy's long-term potential growth trajectory, (ii) the efficiency of expenditures and complementarities among productive expenditure categories, and (iii) receptivity to increases in foreign assistance as epitomized by scaling up efforts of donors to help countries achieve poverty reduction and MDG objectives. For these reasons, further exploration of both the concept of fiscal space, as well as country experiences in recent years in the conduct of fiscal policy, is instructive. Sections II and III of this Interim Report addresses these issues, while Section IV proposes an agenda for further work.

II. Clarifying the Concept of Fiscal Space

2.1 While the term has achieved widespread use, it is important to define what is meant by “fiscal space” and to clarify its relationship to the macroeconomic context.

Fiscal space refers to a government’s ability to undertake spending without impairing its solvency, that is without impairing its present and future ability to service its debt.³³ Since the resources that the public sector can use to service debt consist of primary fiscal surpluses plus seignorage,³⁴ its solvency simply requires that the present value of primary surpluses plus seignorage revenue should be at least as great as the face value of its outstanding debt.³⁵ Fiscal space is therefore the gap between the current level of expenditure and the maximum level of expenditures that a government can undertake without impairing its solvency.³⁶

Creating Fiscal Space Without New Borrowing

2.2 The most attractive way for countries to create fiscal space is within existing borrowing parameters.

Fiscal space can be created without the issuance of new debt by (i) improving the efficiency of public expenditure; (ii) increasing revenue mobilization; or (iii) mobilizing grant aid. Another theoretical possibility is seignorage, but this is not a practical option for most countries.

i. Improving the efficiency of public expenditures. Except for grants, all other options for creating fiscal space will ultimately involve a *social* cost in the form of higher taxation, or reductions in other forms of productive expenditures, either in the present or in the future. Reducing wasteful public expenditure should be the first priority since the elimination of waste in the government’s budget not only directly frees up resources that can be devoted to productive public expenditures, but may also do so indirectly, by enhancing the government’s credibility and thus its ability to borrow. Reallocating expenditure from a lower to a higher value use also improves the overall efficiency of public expenditure. Governments can also create fiscal space by improving technical efficiency, i.e. ensuring that resources are allocated to stated public spending goals and that these are achieved at minimum cost.

³³ Heller (2005a).

³⁴ Seignorage can be significant in a low-inflation economy growing and monetizing rapidly. Outside this exceptional case, it is not a significant source of revenue.

³⁵ See Agenor and Montiel (1996) or Easterly and Serven (2003).

³⁶ Many public expenditures are welfare enhancing because the social benefits of the expenditure may be larger than the social cost of the project. However, if the financial costs of the project or program are greater than the financial returns then its effect on the government net worth and solvency is negative. From a purely financial perspective such expenditure cannot be sustained without a subsidy. The justification for the subsidy would be that such expenditure enhances welfare and helps a government achieve social objectives. A number of MDGs fall under this class of spending.

ii. Increasing revenue mobilization. Governments can create fiscal space through increased revenue efforts, using tax and non-tax instruments. It would only be welfare-enhancing for governments to do so, however, if the collection costs and the welfare costs of the distortions induced by higher levels of taxation or user charges are lower than the social benefits of the public spending. Thus, tax reforms that improve tax administration and reduce reliance on distortionary taxes will enhance the attractiveness of raising tax revenue as a way to generate fiscal space.

iii. Attracting Grant Aid. From the pure solvency perspective, the receipt of grants is an attractive way to finance productive public expenditures since it allows new productive expenditures at no cost to the government solvency. There are challenges, however. One problem arises from the possibility that the grants available may be insufficient (in a present value sense) to finance the desired public projects. If so, and if the cost of completing a specific project by relying on other sources of financing proves to be prohibitive *ex post*, projects financed by grants may fail to be completed, possibly representing pure waste. Thus, even where grant resources are available, the amount of effective fiscal space that can be created through grants will in general depend on the predictability of such grants and whether such resources can be appropriately complemented with other sources of financing. In this context, the recently launched debt relief initiative (MDRI) provides the equivalent of a predictable flow of grant aid which enhances fiscal space for recipient countries.

Creating Fiscal Space Through New Borrowing

2.3 Governments can generate fiscal space by increasing their un-utilized borrowing capacity. Fiscal space can be created by exploiting a government's unused borrowing capacity, that is the difference between the maximum level of net debt that it can sustain (on the basis of the maximum present and future primary surpluses it can generate) and its current level of net debt. The maximum level of debt that a government can sustain can be increased by: (i) enhancing public sector fiscal credibility, (ii) enhancing the growth of the revenue base, and/or (iii) "locking-in" future fiscal resources.³⁷

i. Enhancing the government's fiscal credibility. Improving the government's credibility can improve the costs at which it issues debt. Actions that the government can take in the present to influence perceptions of its future ability and willingness to service its debt include "fiscal rules," (e.g., measures that impose quantitative limits on public sector deficits and/or debt/GDP ratios), reforms of the budget process, or enhanced fiscal transparency. Such measures can enhance fiscal credibility and creditor confidence, and hence reduce the public sector's borrowing costs, thereby increasing its borrowing capacity.

³⁷ Projects that are "self-financing", i.e. with a present value of an expected revenue stream adequate to cover the cost of the project, should not be constrained by concerns for fiscal space since, by definition, they do not impair solvency.

ii. *Enhancing growth of the revenue base.* Faster revenue growth imply larger primary surpluses, and hence an increase in a government’s maximum sustainable level of debt and borrowing capacity. Such measures need not be fiscal in nature – structural policies that affect the economy’s long-run growth rate (for example, policies directed at the financial sector, external trade, labor markets, industrial competition, or FDI) would tend to also affect the government’s tax base. But purely fiscal measures could have this effect as well. Such fiscal measures could be of two types:

- Measures that operate through their effects on the economy’s long-run growth rate.³⁸
- Measures that affect the buoyancy of expenditures and revenues, such as the progressivity of the tax system.

iii. *Implementing measures that “lock-in” an increase in the future resources that the public sector can command.* Given the rate at which the public sector can borrow, its borrowing capacity depends on the maximum resources – as a share of GDP – that it will be able to mobilize in the future to service debt. Measures that governments undertake in the present that have the effect of increasing such resources – even if they are only expected to do so in the future- would thus tend to raise the debt ceiling faced by the public sector. Such measures would include, for example, managing the growth of entitlements such as pensions, privatization of loss-making state enterprises, civil service reforms that increase the flexibility of the government’s wage bill, and tax reforms that reduce distortions and increase the political feasibility of increasing tax revenues.³⁹

Assessing Options to Create Fiscal Space

2.4 Creating fiscal space will depend intrinsically on individual country circumstances. How practically a country can create fiscal space will depend on its initial conditions, and the strengths of its institutions, particularly the institutions that influence the quality of its spending. In a country where the Government can build and maintain infrastructure efficiently, increasing borrowing to finance new high-return infrastructure would enhance government solvency. In a country where the government can efficiently deliver health and education services, it would be reasonable to increase fiscal revenues to expand such delivery—if that expansion is needed. However, if debt levels are already high, or if taxation levels or user charges are already high, these options would need to be weighed against their costs.

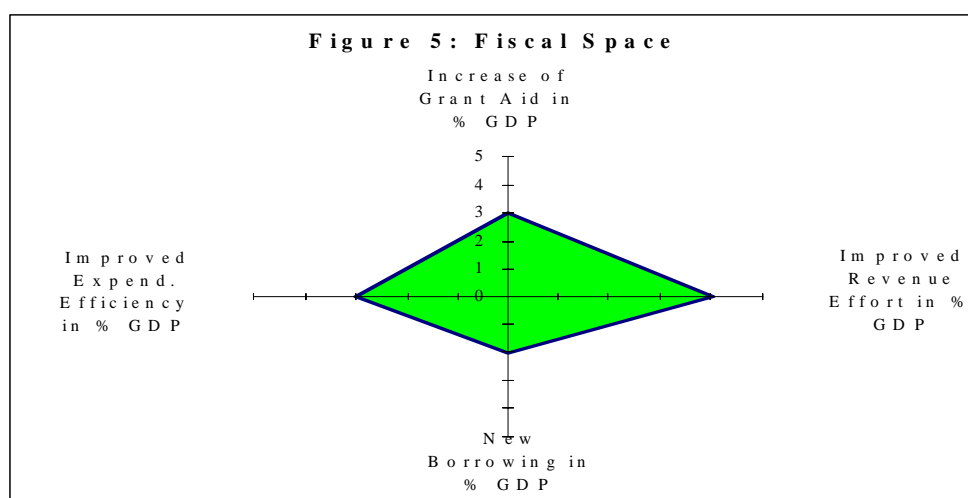
³⁸ These include the level and composition of productive public expenditures themselves (suggesting that fiscal space can be self-reinforcing, as in Serven (2005)) as well as the allocative efficiency of the tax system.

³⁹ Debt forgiveness and debt relief initiatives by creditors has the effect of creating fiscal space for developing countries. Governments can reduce net debt by other means within their control. For example, if the public sector holds assets that have a higher value in private than in public hands, then selling these assets and using the proceeds to retire debt could help to create fiscal space (e.g., privatization of public enterprises, debt-for-nature swaps).

2.5 The different ways to create fiscal space can be conveyed visually with the use of “fiscal space diamonds.” The box below provides a visual representation using the four axes to describe the four options –to raise revenue **R**, to increase borrowing **B**, to access external grant aid **A**, or to generate fiscal savings through improved expenditure efficiency **E**. Each of the four axes could be scaled in percent of GDP (in present value terms) and describes the potential of a country to create fiscal space, relative to the initial position of government. The fiscal diamond is a simplified representation of fiscal space since all four quantities are mutually related through the solvency constraint. If taxes go up, room for borrowing goes up. The same holds true if the efficiency (and growth impact) of spending goes up. It is nonetheless useful to provide a visual comparative static representation of the initial conditions and to consider different ways in which fiscal space can be created –see box 4 below.

Box 4. Visualizing Fiscal Space

Consider a country planning its medium term budget and attempting to assess its resource mobilization potential over a three year period (this could also be in the context of an annual budget). Estimates of its revenue effort may suggest that an additional 4 percent of GDP could be raised through base broadening and tax administration measures.¹ Negotiations with its development partners may elicit indications of an additional 3 percent of GDP in grant aid over the planning period. A public expenditure review may have identified areas for rationalization that would release 3 percent of GDP in resources for reallocation. And macroeconomic and debt management concerns may indicate that borrowing over the period should be limited to 2 percent of GDP. These figures are plausible and allow us to illustrate the fiscal space that a hypothetical country could use.



The purpose of the graph in this paper is principally to distinguish country typologies according to the options for creating fiscal space (see section III for its use). The value of the graph is that by putting all 4 instruments in view, it forces us to acknowledge that borrowing is only one of the ways to create fiscal space – that there are three other instruments (ignoring seignorage). It also then allows a consideration of the marginal cost of each of the options, and a ranking of the ways to create fiscal space relative to the uses to which the resources would be put.

¹ There are various methods to estimate tax potential and to estimate tax effort as the ratio of the actual to the potential. A ratio less than 1 would suggest room for additional revenue mobilization. See Tanzi and Davoodi (1997) and Kaiser and Le (2006). Most governments undertake a revenue estimation exercise using either bottom up estimation or other more sophisticated techniques. Expenditure reviews such as the UK Spending Review and the PER undertaken by the Bank can help identify low productivity programs and fiscal savings for reallocation.

Macroeconomic Considerations

2.6 Macroeconomic space exists when a country can increase public expenditure without compromising short-term macroeconomic stability. Public expenditure has to be accommodated within the fiscal as well as the macroeconomic constraints faced by the countries undertaking them. The level of productive public expenditures that a government can undertake is constrained both by public sector solvency considerations as well as by considerations of macroeconomic stability. These are separate constraints. A public expenditure program that can be safely accommodated within the government's inter-temporal budget constraint, for example, may prove macro-economically destabilizing (for example., by expanding aggregate demand during cyclical peaks) and thus be undesirable, while a public expenditure boost that may be desirable from a macroeconomic perspective (for example, in cyclical downturns) may not be feasible if it threatens the government's solvency. Therefore, both balance sheet solvency considerations and fiscal deficits with their short-term impact on aggregate demand will influence decisions on public expenditure.

Box 5. Alternative Scenarios of Macroeconomic and Fiscal Space		
	Solvency is improved (Fiscal space exists)	Solvency is impaired (Fiscal space does not exist)
Macroeconomic Stability is sustained	A	B
Macroeconomic Stability is Compromised	C	D

2.7 Effective fiscal policy should integrate both macroeconomic stability and solvency considerations. The simple, heuristic 2X2 table above brings together both macroeconomic and solvency considerations.⁴⁰ It recognizes that solvency is not the only constraint on public expenditures, because changes in fiscal policy have macroeconomic effects. There is room for an increase in productive government expenditures both when the increase in expenditures is consistent with solvency, and when it does not undermine macroeconomic stability (quadrant A above). This is the situation a country would face when there is a cyclical downturn, and the government undertakes high return—hence solvency enhancing—expenditure. By contrast, in quadrant C, an expansion in spending would be undesirable because the economy may be at full employment and fiscal expansion may be destabilizing, even if it strengthens solvency. In situations such as quadrant C, where expansion of public spending strengthens solvency but undermines macroeconomic stability, it may be necessary to deploy other policies (e.g., restrictive

⁴⁰It builds on the work of Easterly and Serven in looking both at the short-term and long-term viability of public expenditure levels. See Easterly and Serven (2003), *ibid*.

monetary policy) to ensure that a fiscal expansion is consistent with macroeconomic stability.

Dutch Disease Considerations

2.8 There has been considerable discussion and apprehension as to whether the expansion of aid inflows will create a “Dutch disease” in recipient countries. While a theoretical argument can be made that an expansion in aid need not reduce the competitiveness of tradeables, the empirical evidence is inconclusive. Recent work by the IMF reviewed the experience of several countries in Sub-Saharan Africa, and concluded that in most cases there had been no “Dutch disease” effect because recipient countries used enlarged inflows of aid to build up reserves, thus avoiding pressures on the real economy. Continuation of this trend would defeat the purpose of increased aid, and donor countries cannot be expected to provide resources primarily for the build up of reserves. Managing effectively enlarged volumes of aid will require ensuring gains in productivity that offset pressures on non-tradeables—while this is possible in theory, it is a challenge in practice.⁴¹

Summing up

2.9 The concepts of fiscal and macroeconomic space help us clarify the challenges involved in designing fiscal policies that support long-term growth. The discussion below provides applications of these concepts to a range of country experiences—which highlight, *inter-alia*, the importance of the institutions influencing the efficiency of public spending, as well as that of other factors, such as initial conditions, potential trade-offs between solvency and macro stability, and the role of taxation and grant aid.

⁴¹ IMF (2005c).

III. Fiscal Space in Practice: Some Illustrations

3.1 A number of factors come together in determining whether and how fiscal space can be created and sustained, including initial fiscal conditions, the track-record of past fiscal management, the efficiency of public expenditure and credibility of government policies. Initial conditions matter and an important consideration for some countries is whether they can borrow internationally. Some countries have market access, others aspire to or are near-market access, and some others depend on external aid to supplement domestic resources. Market rating agencies influence the terms at which governments can borrow and so understanding the basis for their assessments and whether they focus on macro-economic stability or also take into account growth effects is important. For aid-receiving countries, the predictability and flexibility of aid has an impact on its contribution to fiscal space.

Creation of Fiscal Space—Illustrations from Market Access Countries

3.2 The efficiency of spending within a framework of macroeconomic stability is critical to growth. Chile, Thailand and Belize are interesting examples of how countries have used or misused available fiscal space, either creating the potential for future borrowing or diminishing it. In particular, they illustrate the importance of high quality spending and sustained macroeconomic stability.

3.3 Chile followed very prudent fiscal policies through the 1990s, running central government fiscal surpluses of about 1 percent, on average, and reducing public debt significantly. Within this overall framework of fiscal responsibility, which contributed to macroeconomic stability, Chile increased expenditure on government investments.⁴² It is notable that this was achieved before the adoption of the structural balance fiscal rule in 2001 which formalized the commitment to fiscal discipline that was already in place. As a result of confidence both in the country's macroeconomic stability and efficiency of spending, Chile's market rating has increased, and spreads on its debt have declined. Thus, the country enlarged its unused borrowing capacity (its fiscal space), giving it greater fiscal flexibility for potential future use. Figure 6 (a) represents indicatively the current fiscal space options for a country such as Chile. Revenue effort in Chile is only moderate for its income level (about 24 percent for general government revenue), and debt levels are low (less than 20 percent of GDP in 2002). Aid inflows are negligible and the scope for fiscal space through improved expenditure efficiency is low because initial levels of allocative and technical efficiency in government are judged to be high so that gains from further efficiency improvements are small. Thus, the potential for creating fiscal space exists in terms of the ability to raise revenue and to increase borrowing.

⁴² Efforts to improve the efficiency of public spending through program evaluations and management improvements through the 1990s have also contributed to a positive perception of government, complementing a well-regarded and long-standing process of investment evaluation and selection. See Marcel and Tokman (2001).

3.4 In the case of **Thailand**, fiscal credibility based on a track-record of prudent past fiscal policy and steady decline in public debt enabled the country to create fiscal space through expanded borrowing. In 2005, the government initiated a large five-year public investment program of 2.5-5% of GDP annually to upgrade and improve infrastructure, addressing inter-alia widely recognized bottlenecks such as Bangkok's mass transit and inter-provincial highways. A recent rating agency report⁴³ indicates that the investment program will be an important driver of growth over the medium-term. Against this background, the government's rating remains unchanged at two notches above investment grade, and spreads have so far been unchanged. However, even with this generally favorable base of fiscal and debt positions, both the IMF and the rating agencies recognize that infrastructure mega-projects carry risks and therefore the effective implementation of the projects will be important to avoid adverse creditor reaction.⁴⁴ If the projects improve growth prospects while maintaining macroeconomic stability, Thailand would have successfully used (and enlarged) its fiscal space.

3.5 The case of **Belize** illustrates how a large debt-financed but poorly managed public investment program led to a downgrade in credit ratings and contributed to bring the country to the brink of default. As part of the government's strategy to boost the country's growth prospects, Belize undertook a massive public investment program averaging 13% of GDP between 1999 and 2004, mostly involving housing and construction activities. Output responded with average GDP growth of 6.5%, supported by favorable developments in agriculture and tourism. However, evidence of gross mismanagement, poor prioritization, lack of transparency and corruption started to emerge, and was compounded by the loss of credibility of macroeconomic policy. Fiscal deficits shot up with six consecutive years of deficits over 8% of GDP and public (mainly external commercial) debt increased four-fold in dollar terms and more than doubled to over 100% of GDP in 2004. With mounting concerns, rating agencies downgraded Belize⁴⁵ because debt dynamics were considered unsustainable with an increased risk of default. Thus both macroeconomic stability and the efficient use of resources to improve solvency and growth are critical to the use of any available fiscal space. Belize had unused borrowing at the beginning of the period but appears to have reduced its fiscal space through the loss of confidence in its macroeconomic and resource management capabilities.

⁴³ See Moody's report (April 2005)

⁴⁴ The IMF's recent Article IV consultation noted that the mega-projects should be carried out so that excessive pressure on inflation and the external balances was avoided and so that debt-to-GDP could be reduced. It also underlined the need for transparency in financing and the need to sustain revenue effort.

⁴⁵ S&P's, which first rated Belize BB+ (one notch below investment grade) in 2000, started downgrading in 2001 at an accelerating pace to currently CCC; Moody's, which assigned its first rating of Ba2 in 1999, started downgrading in 2003 to currently Caa3.

Box 6. What do Rating Agencies consider in their Rating Decisions?

The sovereign credit ratings issued by the credit rating agencies reflect their opinions on the ability and willingness of sovereign governments to service their commercial financial obligations in full and on time. As they represent a forward looking estimate of default probability and involve both quantitative and qualitative assessments, a certain amount of judgment is by necessity involved in these ratings. The analytical framework underpinning the analysis is similar across rating agencies, and ultimately also underpins analyses carried out by investment banks active in international capital markets. The rating methodology identifies 10 components: *political risk, income and economic structure, economic growth prospects, fiscal flexibility, general government debt burden, offshore and contingent liabilities, monetary flexibility, external liquidity, public sector external debt burden and private sector external debt burden*. How rating agencies and financial markets more broadly would react to a government's interest in creating fiscal space for infrastructure investments would ultimately depend on the confluence of all of the ten categories for a particular country at a particular point in time. All other things being equal, fiscal space for infrastructure is an issue that affects five out of the ten categories directly and thus has the potential of having a major impact on a rating decision.

In practice, rating agencies often recognize explicitly in their reports the infrastructure needs and the constraints to growth they imply in emerging market economies. They distinguish countries, where strong fiscal tightening in the aftermath of crises or in the face of threatening crises, has taken the form of cut-backs in public investment, which in turn are contributing to emerging infrastructure constraints to medium-term growth prospects (see S&P's May 2005 Argentina report, which points to similar issues in Bulgaria, Peru, and – to a lesser extent – in Russia and Uruguay). The concern is, however, not restricted to countries that were forced to undertake fiscal adjustment, but is also noted in countries that in the general course of economic development face infrastructure constraints (see S&P's reports on India, April 2005, and China, July 2005).

Rating agency reactions to plans or actions by emerging market economies to create fiscal space for infrastructure depend in the first instance on the policy options that countries choose to create fiscal space and in the second instance on specific country circumstances. To the extent that countries resort to fiscally and debt neutral means to create fiscal space (for example through expenditure re-prioritization, enhanced efficiency or revenue increases, and appropriately structured private sector involvement) rating outcomes will often be strengthened either explicitly, or, more often, implicitly. A simple way of thinking about this is in terms of the main rating components discussed above, where economic growth prospects would be expected to improve in the future as a result of the better infrastructure, while all other components would at least not deteriorate. Of course, this grossly simplifies a fairly complex interaction of factors, and specific country circumstances could still lead to different results. For example public infrastructure expansion in countries with notoriously inefficient public sectors and major governance issues are unlikely to be rated favorably as they would exacerbate an already existing rating weakness and increase the uncertainties over the ultimate growth pay-off; and similarly infrastructure investment that leads to significant tax increases in countries with already high tax burdens that are impairing private sector growth would be a negative rating factor.

3.6 Initial fiscal conditions matter. The Panama Canal expansion project is estimated to cost over 50% of GDP, but holds the potential of being a major source of growth for the country. While recognizing this, credit rating agencies consider that Panama's indebtedness has reached excessive levels, and there is little unused borrowing capacity to draw on. The rating agencies have explicitly linked a stable rating outlook to the expectation that any expansion project would be managed in a fiscally prudent manner that imposes little pressure on government finances.⁴⁶ Given the significant cost of the project, it is unlikely that fiscal savings from revenue or expenditure measures could be found to cover the cost of the project. The option will be to rely extensively on private sector financing which would be an appropriate choice if in fact the project was commercially viable without significant uncertainties or risks.

3.7 Risk of macroeconomic instability limits the creation of fiscal space, even when it is an economically sound option. Over the last twenty years, Brazil has witnessed sharp declines of investment in infrastructure. As a result, investment projects—whether new or rehabilitation and maintenance—have extremely high rates of return. Solvency would improve if the government were to finance such projects. However, Brazil has a long history of debt and fiscal crises, and this influences access to debt. While recognizing infrastructure deficiencies and policies as a constraint to growth⁴⁷, rating agencies focus on the recent history of instability. Brazil's current rating of BB (two notches below investment grade) reflects its large general government debt burden that is highly sensitive to interest rate movements. Graph 6 (b) describes the fiscal space options for a country such as Brazil. Given the relatively high revenue share, further revenue effort is likely to be costly in terms of dampening investment and production incentives, although improvements in the efficiency of taxation would have a positive effect on growth. Aid flows are minimal and borrowing is also limited except for projects that are self-financing. Thus the option for creating fiscal space is largely limited to improving the efficiency of spending, including through greater discretion in budget allocation through a relaxation of restrictions due to earmarking.

3.8 Institutions governing the efficiency of public spending are critical. India has been able to grow notwithstanding critical gaps in infrastructure.⁴⁸ India would be able to increase public borrowing at favorable terms – reflecting the market judgment that India will be able to service its debts.⁴⁹ The problem, however, is the inefficiency of government spending which reduces its impact. Government programs in India carry the weight of unproductive subsidies, and low technical efficiency. Therefore, there is uncertainty that an increase in spending would yield high returns, and creation of fiscal space could be counter-productive in the long run. Figure 6 (c) describes such a case. In theory, fiscal space could also be created through additional revenue mobilization, given the relatively modest revenue share at present, but given evidence of low technical and

⁴⁶ S&P's (February 2005).

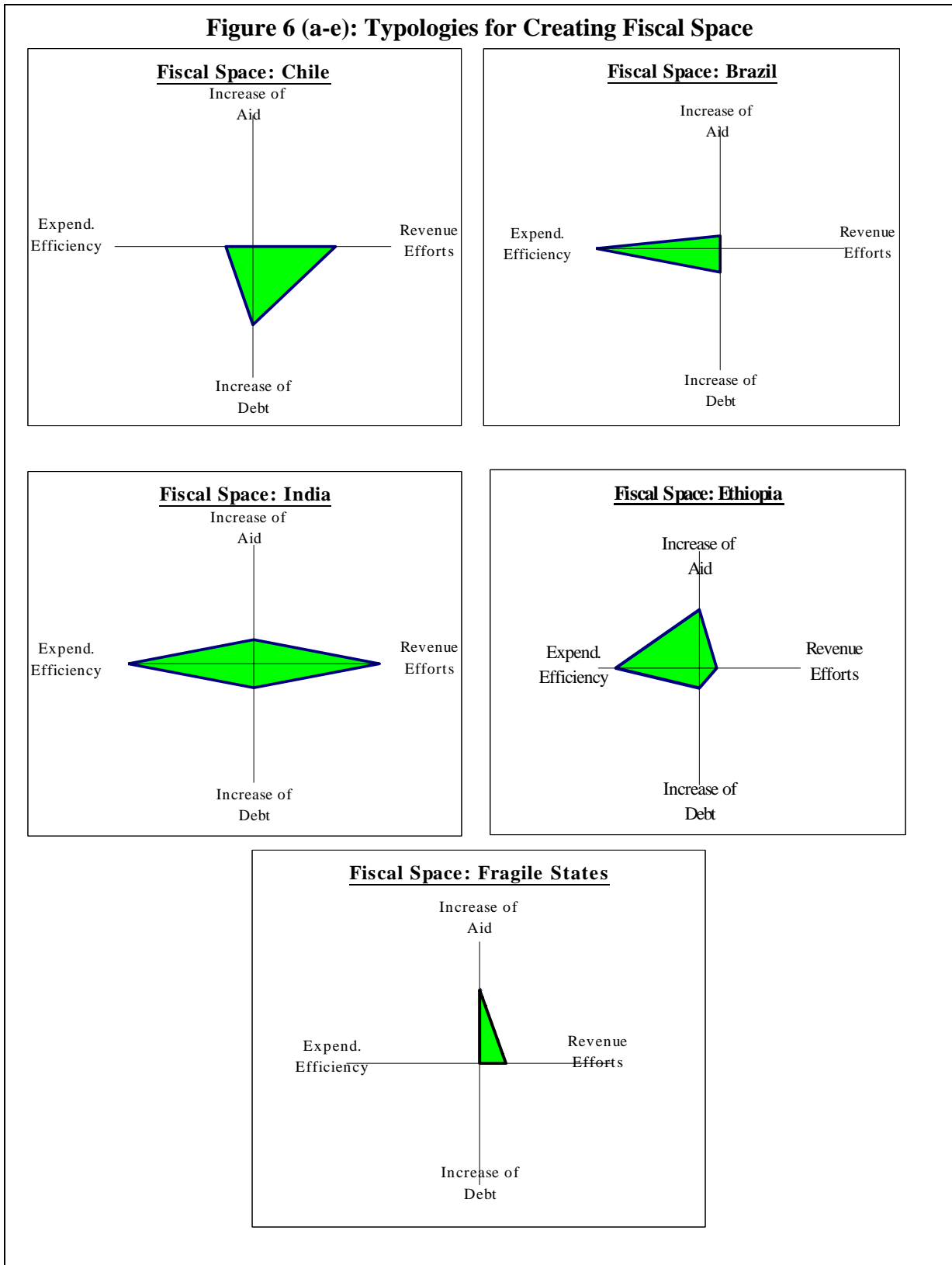
⁴⁷ S&P's November 2005.

⁴⁸ See India Infrastructure Report 2003.

⁴⁹ This may reflect a favorable view of India's history of never having defaulted on its debt, its large international reserves and the belief that India has room to increase revenue effort.

allocative efficiency of public expenditure, this may also be counterproductive. In such a situation, improvements in expenditure efficiency may need to be sequenced ahead of, or at least in parallel with, any other means of increasing fiscal space.

Figure 6 (a-e): Typologies for Creating Fiscal Space



Creation of Fiscal Space—Illustrations from Aid Dependent Countries

3.8 The considerations governing decisions related to the creation and use of fiscal space in aid-dependent countries are not very different from those guiding decisions in market access countries. Whereas market borrowing options are more limited in the case of aid-dependent countries, aid flows are an option that can offset the impact of limited market access. Aid-dependent countries illustrate the importance of predictability in grant aid flows, particularly where these are necessary to undertake MDG-related recurrent spending, for domestic revenue mobilization to finance recurrent spending (including on infrastructure maintenance), and also the importance of efficiency in spending.

3.9 Increasing revenue is an under-used source of fiscal space. On average, as shown by Annex Table 1, LICs collect less than 20 percent of GDP in revenue. Ethiopia and Mongolia are some of a few countries that achieved a significant (more than 5 percent of GDP) improvement in revenue mobilization over the past two decades. A number of countries (e.g., Guinea, Cote d'Ivoire, and Madagascar) have actually reduced the share of revenue intake over this period, a worrying development that in some cases reflected political disturbance and a resulting decline of economic activity in the country. The large majority of low-income countries have made little progress on increasing the share of revenue in GDP. Whereas it would not be efficient to increase taxation to finance infrastructure spending, it may be economically more productive for domestic taxation to finance a raising share of recurrent spending, and for aid to concentrate on supporting infrastructure investment and providing predictable funding for recurrent programs specifically related to the MDGs.

3.10 Improvement in the efficiency of spending is another under-used source of fiscal space. Bank work on Public Expenditure Reviews reveals that few governments systematically review their expenditures with a view to reducing low return spending, and identifying resources for re-allocation.⁵⁰ In fact, in many countries, little is known on the economic or technical efficiency of spending. When governments overlook efficiency improvements and look to grants or concessional loans as a way to finance priority expenditure, they reduce the probability of effective utilization of aid.

3.11 When revenue is already high, aid may need to play a stronger role. The fiscal space diamond for Ethiopia (see Figure 6(d)) suggests that additional aid and improved expenditure efficiency are two ways to increase fiscal space. With a tax effort at 20 percent of GDP, Ethiopia has been successful at mobilizing domestic resources for public spending. Ethiopia has an expenditure level of 30%, and access to grant aid equal to 5% of GDP. Although debt service takes up about 8 percent of its expenditure, its potential

⁵⁰ The UK has a Spending Review which is undertaken periodically as part of the budget preparation process. Despite this, an independent review of public sector efficiency (the so-called Gershon report) was commissioned in 2003 and identified L20 billion pounds in efficiency improvements of which 60 percent was “cash releasing” and therefore available for re-allocation. It also identified potential reductions in staffing across the public service. See Gershon (2004). Such reviews are the exception in most governments and follow up to recommendations differ across governments.

in terms of borrowing is limited given its recent history of HIPC debt relief. However, Ethiopia may potentially have access to additional grant aid.⁵¹ With primary expenditure to GDP share of 22 percent, there is a presumption (based in part on Bank PER work) that fiscal space can be found through improved expenditure efficiency.

3.12 Fragile states have limited options. A low revenue base limits the scope for revenue enhancement in the medium term and the limited functions of government offer little scope for fiscal savings through improvements in efficiency. The government also has no capacity to borrow. Predictable and untied external grant aid is then the only reasonable way to create fiscal space for the medium term until such time as the domestic revenue base is developed. Figure 6 (e) describes a generic fragile state, where the principal means to create fiscal space is grant aid with very limited scope to raise revenue, with no scope for borrowing or domestic revenue mobilization.

3.13 Summing up. Recognizing the importance of fiscal space for growth and development is only part of the challenge facing developing countries. Creating and using fiscal space in a manner consistent with stability and long-term growth is a formidable challenge. The examples above which highlight some of the risks, and some of the opportunities, in fragile states, in LICs that receive aid, and in countries with access to market finance, also demonstrate that the challenge can be addressed.

⁵¹ We are ignoring, for the purpose of this illustration, recent concerns over governance that may reduce the grant aid available to Ethiopia.

IV. Conclusion and Issues Requiring Further Investigation

4.1. Moving forward, some general directions for improving the growth and development-orientation of fiscal policy can be identified at this stage. **First**, as countries seek to achieve the MDGs, the design of fiscal policy should incorporate both the stabilization and growth objectives explicitly. **Second**, the composition and efficiency of expenditure is a key to achievement of outputs and outcomes, including growth and the MDGs, and analysis of these channels of transmission should be incorporated in policy design. **Third**, because each country is unique in terms of the levels and composition of spending and sources of financing, a growth oriented fiscal policy must take account of initial fiscal and macroeconomic conditions, including the constraints to growth, the efficiency of expenditure and the governance conditions and institutional capacity to make effective use of existing and new resources. **Fourth**, where capacities are weak, countries should prioritize improvements to their fiscal institutions, especially those entrusted with budget management and revenue mobilization.

4.2 There are a number of important operational implications of the directions identified above for the Bank’s analytical work in country programs. First, it raises the significance and the need for the Bank to address the link between spending and outcomes more substantively in Public Expenditure Reviews (PER). Whether public spending actually impacts on outputs and outcomes and the efficiency with which such impact is achieved will have to be assessed for key sectors related to growth and the MDGs. Pragmatic benchmarking of expenditure efficiency for key public sector outputs would provide some guidance for governments seeking to improve resource use. Whether fiscal space can be found by reallocating resources from low-value programs to higher priorities would also be a key objective of such reviews. PERs could also serve to link the ongoing work on constraints to growth to a discussion of how budget policy can help address the constraints. Second, it will require PERs to place closer analytical attention to the financing side of the budget including all instruments of public financing identified by the “fiscal diamond”, including the impact of debt relief via the MDRI. The challenges of managing budgets where aid volumes are high and/or unpredictable will need to be addressed in PERs and the scope to raise revenues through tax and non-tax measures will require the estimation of marginal costs of taxation. Finally, the attention to budget systems, development of medium term expenditure frameworks, and institutional capabilities for budget management remains important but should be enhanced by more explicit links to how the system serves policy objectives and how those objectives are influenced by the political economy of the country. More substantive focus on these issues will enable the Bank to contribute, jointly with the IMF, to the design of growth-oriented fiscal and public expenditure policies.

4.3 This is an interim report to the Development Committee on a fairly complex set of inter-related issues. Further analysis is necessary to be able to provide guidance on how long-term growth can be effectively promoted by fiscal and public expenditure policy while maintaining macroeconomic stability. PREM is involved in a collaborative cross-network work program with DEC, HD and INF that includes further investigation into a number of issues including: the relationship between the functional and economic composition of spending and outcomes; consideration of complementarities across functions; detailed microeconomic analysis of the efficiency of public spending on selected outputs and outcomes in the health, education

and infrastructure sectors; and estimation of revenue potential in countries based on benchmarking techniques. The fiscal and public expenditure issues will be linked to the ongoing work on the binding constraints to growth to make the link between expenditures and growth. A major challenge for all this work will be the creation of a statistical database on public expenditure and outputs in key sectors, given the limitations of GFS in this regard. Pilot country case studies will be undertaken to consider the scope to improve the composition and efficiency of expenditure and revenue mobilization and to review how fiscal space and macroeconomic space considerations could be addressed to provide consistent policy advice on growth with stability.

4.4 As this work on the design of growth- and development-oriented fiscal policy is undertaken, it will clearly be important to work closely with the IMF. Continued collaboration with the Fiscal Affairs Department (FAD) of the IMF and other development partners is envisaged. There is considerable interest among many development partners in supporting the cross-network agenda of analysis described above, given its importance for the MDGs, for the “scaling-up” agenda, and its relevance for the ongoing work on growth diagnostics. A number of bilateral agencies have expressed interest in supporting this work.

4.5 A seminar will be held in September 2006 to report progress on the country studies. A full report is expected to be completed by early 2007 and its findings and recommendations will be disseminated through seminars in the various regions, targeted to policy, academic and civil society audiences.

Annex Table

Table 1: General Government Revenue and Expenditures by Income Groups

(in percent)

	1980-84	1985-89	1990-94	1995-99	2000-05	Average
Total revenue and grants/GDP						
Low-income group	21.0	20.0	19.1	18.6	20.1	19.8
Lower-middle income group	25.1	25.1	26.4	25.5	27.3	25.9
Upper-middle income group	30.9	29.9	31.5	30.2	30.5	30.6
High income, non-OECD	29.3	32.3	32.5	32.9	37.7	32.9
High income, OECD	41.0	40.5	43.2	44.1	44.8	42.7
Total expenditures and net lending/GDP						
Low-income group	26.4	24.5	26.0	22.6	24.4	24.8
Lower-middle income group	33.0	30.1	32.4	28.9	30.3	30.9
Upper-middle income group	37.4	35.9	32.7	33.0	34.7	34.7
High income, non-OECD	31.3	36.8	37.8	36.2	33.1	35.0
High income, OECD	44.9	43.6	46.1	45.2	44.9	44.9
Fiscal Balance/GDP						
Low-income group	-6.1	-4.8	-5.5	-3.7	-3.6	-4.7
Lower-middle income group	-4.3	-3.3	-3.3	-2.6	-2.5	-3.2
Upper-middle income group	-4.2	-2.4	-1.9	-2.8	-3.4	-2.9
High income, non-OECD	0.2	-1.3	-3.6	-3.5	-1.6	-1.9
High income, OECD	-3.9	-2.6	-3.8	-1.6	-0.4	-2.4
Interest payments/GDP						
Low-income group	1.9	2.8	2.5	2.0	1.9	2.2
Lower-middle income group	0.4	1.4	1.8	1.9	2.1	1.5
Upper-middle income group	1.6	2.6	2.2	2.5	3.2	2.4
High income, non-OECD	0.3	0.5	1.9	3.0	2.2	1.6
High income, OECD 2/	..	3.3	3.3	3.0	2.4	3.0
Primary balance/GDP						
Low-income group	-4.3	-1.9	-2.9	-1.7	-1.7	-2.5
Lower-middle income group	-3.9	-1.9	-1.4	-0.7	-0.4	-1.7
Upper-middle income group	-2.5	0.2	0.4	-0.3	-0.2	-0.5
High income, non-OECD	0.5	-0.8	-1.7	-0.5	0.6	-0.4
High income, OECD	..	0.7	-0.5	1.4	2.1	0.9

Sources: "World Economic Outlook," IMF, September, 2005, and "OECD Economic Outlook," OECD, 2005.

Notes:

1/ The data in the columns are period average. They are averaged by using annual median for each income group.

2/ In the column "1985-89" for high income OECD, the data is the average for 1988 and 1989.

Table 2: GDP Growth and Inflation Rate by Income Group
(in percent change)

	1980-84	1985-89	1990-94	1995-99	2000-04	Average
GDP, growth rate						
Low-income group	3.8	5.0	3.4	5.4	5.1	4.6
<i>(Low-income group, excl. India)</i>	2.5	4.0	2.1	4.2	4.4	3.4
Lower-middle income group	3.8	5.0	4.1	4.5	5.7	4.6
<i>(Lower-middle income group, excl. China)</i>	2.7	3.8	1.9	2.4	4.0	3.0
Upper-middle income group	1.9	1.4	0.9	2.6	3.3	2.0
World	2.2	3.8	2.3	3.1	2.8	2.9
GDP growth rate, per capita 1/						
Low-income group	1.4	2.6	1.2	3.3	3.2	2.3
<i>(Low-income group, excl. India)</i>	-0.1	1.3	-0.3	1.8	2.0	1.0
Lower-middle income group	2.1	3.2	2.7	3.2	4.8	3.2
<i>(Lower-middle income group, excl. China)</i>	0.7	1.9	0.4	1.0	2.3	1.3
Upper-middle income group	0.4	0.0	-0.2	1.7	2.5	0.9
World	0.5	2.0	0.8	1.7	1.6	1.3
Inflation rate 2/						
Low-income group	10.1	8.7	15.3	10.2	5.7	10.0
<i>(Low-income group, excl. India)</i>	9.9	8.6	15.6	10.3	6.0	10.1
Lower-middle income group	7.9	7.0	14.5	7.4	5.2	8.4
<i>(Lower-middle income group, excl. China)</i>	8.3	6.9	14.9	7.5	5.3	8.6
Upper-middle income group	8.6	4.5	10.8	5.8	2.9	6.5

Sources: "World Economic Outlook," IMF, September 2005, and the WDI, the World Bank, August 2005.

Notes: 1/ GDP per capita growth rate for the last period is 2000-03.

2/ The first column is for the period of 1981 to 1984.

Note: Data Sources

1. The data used in the paper is a consolidation of data from a number of sources including, for recent years, Bank Public Expenditure Reviews. In general, it is difficult to find a consistent source of data to track the functional allocation of expenditure over time and across countries. GFS provides some data but these do not allow a consistent tracking of a representative group of countries. Also some countries provide general government information while others provide only central government information. Many countries do not provide the functional breakdown. In addition, because the difference between central and general government aggregates is small for most low and lower middle income countries, we pool the two levels of government to derive a reasonable sample size by income group to estimate patterns in public expenditure. Cross checking with individual countries was used to ensure that the pattern was broadly representative of the income group. While not entirely satisfactory, the limited availability of data forces such an approach to make inferences about patterns of expenditure.

2. The countries included in the total sample for each income group is indicated below. Because of data availability, the number of countries included differs for each income group and for individual years.

Low-income group (general and central governments): Total sample - 38 countries
Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Chad, Comoros, Cameroon, Cote d'Ivoire, Ethiopia, Gambia, Republic of Congo, Guinea-Bissau, Haiti, Guinea, India, Lao PDR, Lesotho, Liberia, Madagascar, Malawi, Mali, Moldova, Mongolia, Myanmar, Nepal, Nicaragua, Níger, Pakistan, Rwanda, Senegal, Tajikistan, Tanzania, Togo, Uganda, Yemen, Zambia, Zimbabwe.

Lower-middle-income group (general and central governments): 34 countries
Albania, Azerbaijan, Belarus, Bolivia, Brazil, Bulgaria, Colombia, Djibouti, Dominican Republic, Ecuador, El Salvador, Egypt, Georgia, Guatemala, Guyana, Indonesia, Iran, Jamaica, Kazakhstan, Maldives, Morocco, Namibia, Paraguay, Peru, Philippines, Romania, Sri Lanka, Suriname, Syrian Arab Republic, Thailand, Tonga, Tunisia, Ukraine and Vanuatu.

Upper-middle-income group (general government): 16 countries
Argentina, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malaysia, Mauritius, Panama, Poland, Russia, Slovak Republic, South Africa, Uruguay, and Venezuela.

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