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Statement by Managing Director
IMF Staff Response
IEO Comments on Staff Response

Summing Up of IMF Executive Board Discussion by Acting Chair

Statement by the Managing Director on the Evaluation by the Independent Evaluation Office of Fiscal Adjustment in IMF-Supported Programs

Executive Board Meeting
August 29, 2003

The Independent Evaluation Office (IEO) is to be commended for its well-researched and insightful account of fiscal adjustment in IMF-supported programs. Circulation of this report within the Fund has already been helpful in disseminating the lessons for Fund practice and enhancing the learning culture for the institution.

On the whole, I welcome the recommendations in the report. I have asked staff to prepare a statement indicating how we envisage taking up the report's recommendations in the period ahead, subject to the conclusions of the Board discussion.

I look forward to Board discussion of these papers, which will provide the opportunity to draw out their implications for the Fund's policies and procedures.

STAFF RESPONSE TO THE EVALUATION BY THE INDEPENDENT EVALUATION OFFICE OF FISCAL ADJUSTMENT IN IMF-SUPPORTED PROGRAMS

Executive Board Meeting
August 29, 2003

1. The staff welcomes this report (SM/03/291), which provides valuable insights on the challenges of fiscal reforms in Fund policy advice and program design. Among many useful contributions, the paper brings careful scrutiny to concerns that the Fund's policy advice in this area follows a "one-size-fits-all" approach that tends to result in a contraction in economic activity, and it concludes that these are not valid. The staff supports most of the recommendations put forward. This statement elaborates on some of the analytical underpinnings of the report, and discusses how its recommendations can be put in practice, building on the work already under way in the Fund.

2. While the report presents extensive statistical findings on the size and composition of fiscal adjustment, its treatment of the appropriateness of the fiscal stance and its effectiveness in achieving program goals is somewhat limited. The fact that a significant share of programs envisaged an increase in the fiscal deficit may counter critics' arguments that the Fund always recommends tighter fiscal policy, but provides little indication of the extent to which programs were successful in achieving their goals. Moreover, beyond the "headline" overall deficit, other measures such as changes in the primary balance or in the cyclically adjusted deficit may be of importance in analyzing adjustment effort and the economic impact of fiscal policy. In a similar vein, the analysis should not be confined to central or general government: in many countries, operations of the wider public sector, including quasi-fiscal activities, entail sizable deficits and contingent liabilities that can be as important as core fiscal operations.

3. The role of financing constraints in determining the size of the fiscal adjustment receives less attention in the report than we feel would be warranted. For countries that have limited access to private capital, such constraints are often binding. Conversely, for countries with access to capital markets, debt sustainability considerations play a key role in influencing the scale and terms of financing from private creditors, and the appropriate path of the fiscal balance. These factors, which are central to determining the stance of fiscal policy, would have benefited from fuller treatment in the report. Given the often present financing constraints and debt sustainability considerations, the staff would question whether the fiscal stance could realistically have been more accommodating in many cases, and there is some basis for concern in the opposite direction.

4. The report rightly urges staff to endeavor to project realistic growth rates to correct the positive bias observed in Fund-supported programs. The sources of this bias are varied but familiar. In some instances, it may be due to the assumption that the program will be fully implemented as designed. Often the overoptimism reflects the fact that program assumptions must be agreed with the authorities, who are trying to maximize support for the program and hence project a quick return of investor confidence and a rapid pickup in growth. While a more comprehensive analysis of the demand components of growth is desirable, it is unlikely to correct the bias by itself. Moreover, the implications for fiscal policy are not always clear-cut: weaker-than-projected activity might argue for a looser fiscal stance, but in cases where financing constraints are paramount, it could dictate stronger measures to achieve the needed amount of adjustment. Similarly, in those cases in which the external objective is just met, while growth turns out weaker than projected, a significantly looser fiscal policy may not have been appropriate.

5. The report suggests there is scope for greater attention to reforms to improve tax performance and spending composition in Fund-supported programs. Measures aimed at strengthening tax administration are already part of most programs where such issues are prominent. The fundamental task of tax administration is to strengthen revenue collection, and technical assistance and measures aimed at improving organizational effectiveness address tax evasion, either directly or indirectly.[1] On the expenditure side, public

[1]The present report chooses not to deal with technical assistance, arguing that a forthcoming IEO report will address this topic. This is an important priority for the Fund, and it commands a substantial amount of resources and attention.

expenditure management (PEM) has been growing in importance: in many programs, PEM measures have played a key role, aimed at strengthening expenditure control and improving the timeliness and accuracy of fiscal information. Such reforms, backed by technical assistance, include reforms in accounting, budget classification, financial planning, and cash management. PEM, an area of joint responsibility between the Fund and the World Bank, has important implications for the implementation of fiscal adjustment envisaged in Fund-supported programs. The development of social safety nets is an area in which the World Bank has lead responsibility, while Fund-supported programs integrate the envisaged cost of safety nets into fiscal targets.

6. The report provides a valuable perspective on the time frame mismatch between the duration of programs and the time required to adopt structural reforms. Clearly, this mismatch is of varying importance for different types of reform. The collection of tax arrears—in many cases mainly a question of political will—and the elimination of tax exemptions can often generate revenues quickly. On the other hand, experience suggests that other reforms, such as more general improvements in tax administration, or civil service reform, can take many years to obtain results. The staff agrees that this reality should not discourage the inclusion of key structural reforms in Fund-supported programs even when they require a multiyear effort, provided they are critical to the macroeconomic challenges facing the country. Finally, the limited success in the implementation of these types of measures is unlikely to be largely the result of the excessive focus on short-term quantitative targets of programs as the report maintains, but rather of political resistance, especially when reforms attack entrenched vested interests.

7. Recommendation 1: Program documentation should provide a more in-depth and coherent justification for the magnitude and pace of the fiscal adjustment and how it is linked with assumptions about the recovery of private sector activity and growth. The staff supports this recommendation. At the same time, it cautions that attempting too much precision in this area could lead to spurious justifications, given the inherent difficulties in forecasting the response of economic actors to policy changes and recognizing the difficulties in calibrating the appropriate degree of fiscal resilience against shocks or adverse economic outcomes against the challenges in building political support for those policy choices. Finally, after a crisis large uncertainties may remain regarding the pace of recovery in private sector demand and particularly investment. The latter depends on investor confidence and financial market conditions, which in turn are a function of the perceived degree of commitment of the authorities to adhere to the program.

8. Recommendation 2: The internal review mechanism should place relatively more emphasis on the early stages of the process. The staff supports this recommendation, and this is an important feature of recent changes to the review process. Early meetings between the area department and functional departments provide critical input to initial decisions on program design, and the issues and trade-offs raised in this context should inform the presentation in program documents. The report correctly notes that Fund-supported programs evolve greatly during the course of their implementation, and for this reason comments raised during the review process on the occasion of the program reviews are often extensive.

9. Recommendation 3: Programs should give greater emphasis to the formulation and implementation of key institutional reforms in the fiscal area, even if (as is likely) they cannot be fully implemented during the program period. The staff supports this recommendation and welcomes the clarification that the attention to key structural reforms could not substitute for short-term quantitative targets. Staff will have to continue to use careful judgment in identifying fiscal reforms that need to be sustained over time and how to design quantitative performance criteria to safeguard the Fund's resources. While the staff agrees that structural reforms are, in many cases, more important to fiscal sustainability than short-term expenditure and revenue measures, conditionality needs to focus on actions or quantitative targets that can be monitored during the period of the arrangement. The same considerations apply to strengthening market confidence: market participants need to see signs of progress in the short run to be convinced that a country's fiscal problems are being addressed. The need for action to be monitorable in the short run is particularly acute during a crisis.

10. Recommendation 4: The surveillance process should be used more explicitly to provide a longer-term road map for fiscal reforms and to assess progress achieved. The staff supports this recommendation with some qualifications. Given that fiscal reforms are already covered in broad terms in Article IV consultations, the report appears to be arguing for a deeper and more comprehensive analysis across countries. This sits somewhat uncomfortably with the Board's instructions regarding the focus of surveillance as reflected in the 2002 Biennial Surveillance Review. Consistent with these instructions, staff would propose to continue with an approach under which, during Article IV consultations, staff examine those aspects of fiscal policy and its institutional underpinnings that are material to the assessment of macroeconomic policies—following up as needed (and as requested by the authorities) with fiscal Reports on the Observance of Standards and Codes (ROSCs) and technical assistance. Such follow-up, combined with advice from the World Bank and other agencies as appropriate, would assist the authorities in formulating or enhancing a detailed road map for fiscal reform and help guide implementation in specific areas. Any further expansion of the Fund's role in this area would also, of course, have resource implications that would need to be addressed.

11. Recommendation 5: The IMF should clearly delineate the operational framework in which social issues will be addressed within program design in non-PRGF countries. This should include a clear indication of the IMF's responsibilities and activities in this area. The staff recognizes the importance of social issues, particularly to the extent that they frequently have implications both for fiscal policy and for program ownership. For instance, it is essential to understand the key social programs and their implications for the sensitivity of public expenditure to macroeconomic developments. Moreover, the experience of some crisis cases, in which it proved difficult to introduce effective and well-targeted social safety nets in the midst of a downturn, supports the suggestion that staff should be open to discussing with the authorities how their existing social protection systems, or those to be designed, would operate under conditions of financial stringency. Given that, under the existing framework, the World Bank takes the lead in designing social safety nets and in identifying high-priority spending, it is essential for Fund staff to collaborate effectively with the Bank on these issues, including by supporting efforts to design social safety nets that are effective in a crisis. These are issues that we will continue to explore and, to the extent possible, take into account in program design in each case.

IEO Comments on Staff Response to the Evaluation of Fiscal Adjustment in IMF-Supported Programs

Executive Board Meeting
August 29, 2003

Paragraph numbers refer to the Staff Response on pages 110–12; bracketed chapter and page numbers refer to the main report on pages 3–106.

Paragraph 2: The staff has commented that the evaluation's "treatment of the appropriateness of the fiscal stance and its effectiveness in achieving program goals is somewhat limited." Program goals cover a wide variety of objectives and are influenced by the whole set of macro and other policies in the program—not only fiscal. To disentangle the impact of the fiscal stance alone on these overall program objectives would have meant estimating the effects of a counterfactual program, which is beyond the scope of this evaluation.

The evaluation discusses extensively the extent to which programs were able to achieve typical goals such as fiscal deficit, current account deficit, GDP growth, and investment targets. In addition, the case studies provide an evaluation of implementation of fiscal reforms.

Paragraph 3: The staff response states that the role of financing constraints in determining the size of the fiscal adjustment receives less attention than warranted. The evaluation does examine the impact of projected financing on the fiscal adjustment, including an econometric estimate of the magnitude of the link [Chapter 2, page 20]. In addition, the evaluation explicitly recognizes that the fiscal stance cannot be determined solely on countercylical grounds, but must also take account of its impact on market confidence and debt sustainability, particularly in emerging markets ["Summary of Findings and Recommendations," pages 6–7; and Chapter 5, pages 47–48].

Paragraph 4: We agree with the staff that there are many causes for overoptimism in projecting growth. We also agree that the fiscal response to weaker growth is not clear-cut and depends on financing constraints. However, one of the key findings of the evaluation is the reluctance to project growth slowdowns, let alone negative growth, in programs ["Summary of Findings and Recommendations," page 6]. This result, together with the finding that program documents often do not discuss the rationale behind the fiscal stance, implies that the pros and cons of a countercyclical fiscal stance in such cases are rarely addressed explicitly ["Summary of Findings and Recommendations," page 7].

Paragraph 5: The staff response stresses the extensive technical assistance activities to improve tax administration and public expenditure management systems. The evaluation acknowledges these efforts, including preprogram activities. However the point made by the evaluation, based on the programs examined, is a different one: notwithstanding efforts at technical assistance, there is little observable policy action and limited impact during program implementation, particularly in reduction of tax evasion and reallocations of spending (Chapter 7 of the report).

Paragraph 10: The staff response states that Recommendation 4 of the evaluation ("Surveillance should be used more explicitly to provide a longer-term road map of fiscal reforms and to assess progress achieved") sits somewhat uncomfortably with the Board instructions regarding the focus of surveillance as reflected in the 2002 Biennial Surveillance Review. We do not feel there is any inconsistency. The new guidelines on surveillance that have emerged from the 2002 review (SM/02/292) explicitly stress macro relevance, sustainability, and sound economic growth as the principles for selectivity. In the opinion of the IEO this means that surveillance should focus not only on the magnitude of the short-term fiscal adjustment, but also its sustainability and its quality in terms of efficiency and equity. This is precisely what is recommended by the evaluation ["Summary of Findings and Recommendations," page 12].

Paragraph 11: The staff response indicates that it "supports the suggestion that staff should be open to discussing with the authorities how their existing social protection systems, or those to be designed, would operate under conditions of financial stringency." This falls short of the evaluation's recommendation. In fact, this evaluation recommends that "the IMF could invite the authorities regularly during Article IV consultations to suggest what are the existing critical social programs and social services they would like to see protected in the event of adverse shocks."