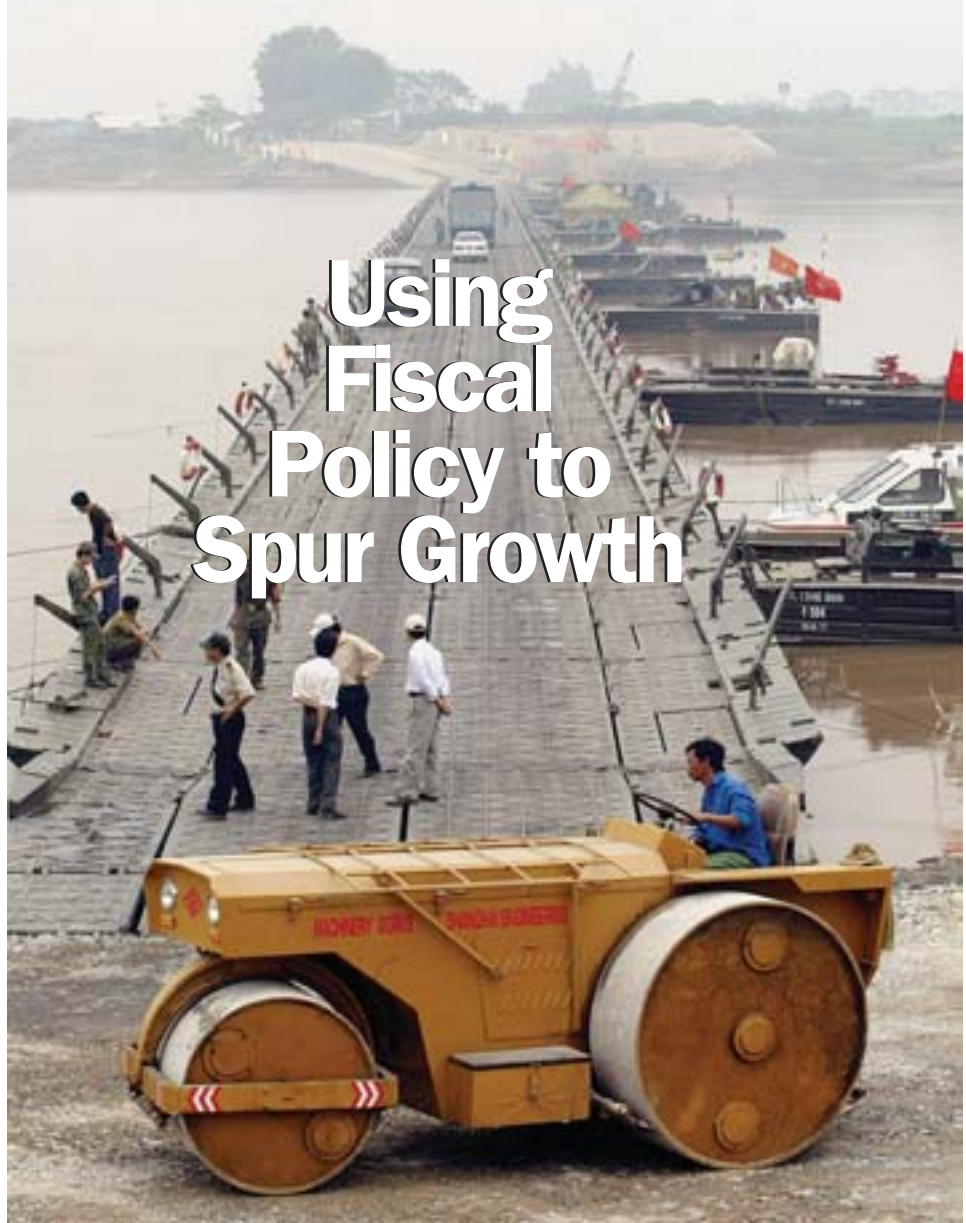


Hanoi: Government engineers inspect a floating bridge being constructed across the Red River

Using Fiscal Policy to Spur Growth



When reducing fiscal deficits makes sense for low-income countries

Emanuele Baldacci, Benedict Clements, and Sanjeev Gupta

ONE OF the central tenets of macroeconomics is that fiscal policy can be effective in stimulating aggregate demand and reviving a stagnant economy. At the same time, a growing body of research—based primarily on industrial countries—suggests that there are circumstances in which expansionary fiscal policy cannot be used to pull an economy out of a recession. In particular, when levels of public debt are already high, increasing the budget deficit may lead to lower private sector investment and private consumption, negating the effect of higher public sector spending or tax cuts on aggregate demand.

In fact, several studies of OECD countries have shown that reducing fiscal deficits can *accelerate* growth when the level of public debt is high and unsustainable. Reduced government borrowing to finance deficit

spending pushes down interest rates generally, thereby encouraging investment. Lower interest rates also raise asset values, and this “wealth effect” encourages private consumption and investment. Furthermore, shrinking deficits lead the private sector to reduce its estimates of current and future tax liabilities, providing a further boost to investment and consumption.

These studies also indicate that *how* deficits are reduced is important. Fiscal tightening that is achieved primarily by cutting subsidies, transfers (such as pensions), and the government wage bill tends to last longer and can be expansionary, while fiscal tightening achieved by increasing taxes and cutting public investment tends to be contractionary and unsustainable.

What has yet to be explored in depth in the literature is how relevant these concerns

are to developing countries, and low-income countries in particular. For example, do these findings imply that lower budget deficits are good for growth? Should low-income countries cut public spending, which typically represents a relatively low share of their GDP? These issues have taken on greater prominence in recent years, as some have argued that fiscal policy in IMF-supported programs is too tight, causing low-income countries to forgo economic growth in the name of fiscal austerity.

These questions are not easy to answer because the channels through which fiscal policy affects growth are complex, and other factors—especially macroeconomic policies and the quality of governance—also enter into the equation. Unfortunately, empirical research on the relationship between fiscal policy and growth in low-income countries has been scant, in large part because of limited data. We therefore studied 39 low-income countries with IMF-supported adjustment programs during the 1990s, addressing the following questions:

- What was the impact of the fiscal stance, expenditure composition, and budget financing on economic growth in low-income countries with IMF-supported programs?
- How did these and other factors affect the persistence of fiscal adjustments?
- Through which channels did fiscal consolidation affect growth?

In our sample, the IMF-supported programs targeted relatively small reductions in budget deficits, on average, and sought, among other things, to improve the composition of public expenditure and revenues. On average, budget deficits were reduced by less than one-half of a percentage point of GDP during the period, with cuts in government spending—particularly current expenditures (such as spending on wages and salaries)—accounting for most of the reduction. Overall, government revenue collection remained stable over the period. On average, the countries in the sample experienced annual per capita income growth of 0.5 percent during the 1990s.

Public finances and growth

What is the causal relationship between expenditure composition, fiscal adjustment, and growth? Using an econometric model (see box on page 30) that examined the impact of several fiscal variables (such as the fiscal deficit and budget composition) and other control variables (including private investment, school enrollment, and labor force participation) on real per capita GDP growth in the 39 countries, we found that, on average, fiscal adjustment did not

dampen growth. A 1 percentage point of GDP improvement in the fiscal balance had a significant positive impact on the rate of GDP growth, raising it by at least one-fourth of a percentage point (Chart 1).

Expenditure composition was critical. An increase in spending on government wages and salaries had a negative impact on growth, while expenditures on other goods and services and capital projects tended to raise the growth rate significantly. Quality fiscal adjustments, based on the reallocation of public expenditure to more productive uses and the reduction of budget deficits, were thus conducive to higher growth in countries with unfavorable macroeconomic conditions.

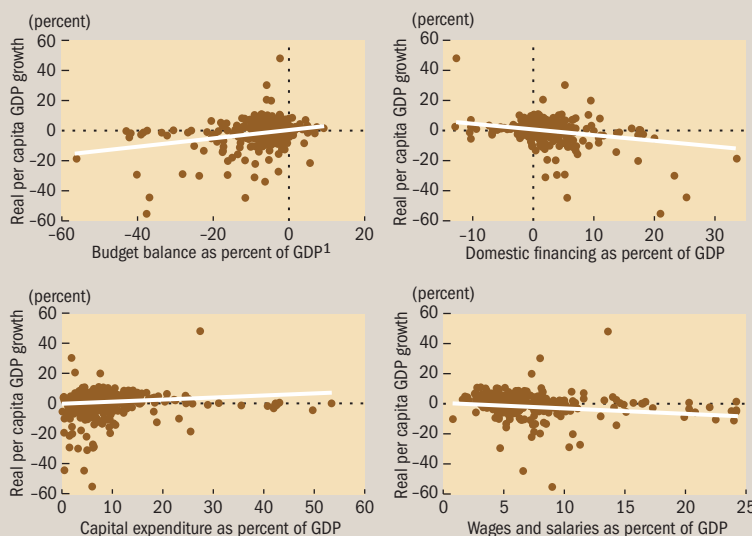
How deficits were financed also mattered. Domestic financing tended to hamper growth. A 1 percentage point of GDP increase in domestic financing reduced the per capita growth rate by one-third of a percentage point. The estimated effect of financing a fiscal deficit with external (mostly concessional) funds was smaller and could be offset by directing spending toward externally financed capital projects.

These results did not hold for all the countries in our sample, however—in particular, those that had already achieved a modicum of macroeconomic stability (including low inflation). For example, we did not find a positive relationship between fiscal consolidation and growth in Benin, The Gambia, Lesotho, the former Yugoslav Republic of Macedonia, Senegal, or Tanzania, which all had fiscal deficits (after grants) of less than 2.5 percent of GDP in the 1990s.

Chart 1

Growth increases as the budget moves into surplus

Capital spending increases also boost growth, but increases in domestic deficit financing and in the government wage bill depress growth.



Source: Authors' calculations.

Note: Data are for 39 countries with IMF-supported programs, 1990–2000.

¹Budget balance equals revenues minus expenditures; negative balance is a deficit, positive balance a surplus.

Methodologies used in the studies

The results are based on different econometric methods. Data for the studies comprise “pooled” information (both time series and cross section) for 39 countries during 1990–2001. A number of issues arise when such pooled data are used in a regression framework. First, there is a need to account for unobserved country-specific factors. Second, there may be two-way causality between fiscal policy and growth because, when economic growth slows down (and GDP declines), the ratio of government spending to GDP may increase if spending is fixed in nominal terms in the budget. To control for the above-mentioned issues and check the robustness of the results, we used different econometric techniques. In particular, we used the general method of moments (GMM) estimator to address two-way causality, as well as a method to control for the presence of outliers (robust regression) to check the sensitivity of the results to these extreme observations.

For the study on the transmission channels, a recursive system of equations was estimated using GMM. This system allows a decomposition of the total effect of fiscal variables and other determinants of growth into their direct and indirect components. To study the persistence of fiscal consolidations, we used a relatively new approach—survival analysis. This technique attempts to estimate the probability of ending a fiscal consolidation episode. We then regressed this probability on various factors that have an impact on the persistence of adjustment. To assess the robustness of these results, we checked the consistency of the results under alternative estimation techniques.

In these countries, increases in selected expenditures—such as nonwage current spending on operations, maintenance, and public investment—were compatible with higher growth, and, more important, domestic financing of deficits did not hamper economic growth, in contrast with countries that had not yet achieved macroeconomic stabilization.

The longer-lived, the better

A fiscal consolidation that persists over time has the greatest positive effect on growth. In general, longer-lived fiscal consolidation helps secure macroeconomic stability by reassuring investors that taxes and interest rates will not rise to finance future fiscal imbalances. A short-lived fiscal consolidation, in contrast, is less likely to have a payoff for growth, because it signals that the initial improvement in public finances cannot be maintained and might be reversed in the medium term. An understanding of what makes fiscal consolidation persistent is therefore essential to unraveling how it influences growth.

Our study attempted to assess this by estimating the duration of fiscal adjustment episodes—periods in which the fiscal deficit was reduced by at least 1.5 percent of GDP a year. We found that most fiscal consolidation episodes lasted only a year, and only one-fourth of them lasted more than two years (Chart 2). The short duration of most fiscal adjustments had unfortunate consequences for fiscal sustainability and economic growth.

The greater the shift in public spending from current expenditures to capital investment, the longer the adjustment

lasted. Higher wages and salaries and larger transfers and subsidies increased the probability that a fiscal adjustment would be short-lived, while allocating more public spending to capital outlays raised the odds that adjustment would be maintained. This finding is consistent with our econometric results on the impact of expenditure composition on growth.

The size of fiscal adjustment also mattered. In particular, countries with larger cumulative reductions in the deficit were more likely to continue their adjustment efforts than others. There appeared to be little evidence of “adjustment fatigue,” perhaps because a larger fiscal adjustment signaled the authorities’ commitment to continuing fiscal consolidation.

Initial conditions also tended to be important. Countries with the most unfavorable initial fiscal conditions—precisely the countries that needed adjustment the most—were the least likely to be able to sustain fiscal consolidation. In a similar vein, we found that countries with a history of fiscal consolidation failures were more likely to end fiscal adjustment than countries with a more credible history of sustained fiscal deficit reductions. This is because it takes time for countries to build the credibility of, and gain support for, their policy stance. Finally, countries that experienced slower growth were more likely to end a fiscal adjustment, demonstrating the difficulty of sustaining fiscal consolidation in a weakening economy.

Governments that supported fiscal consolidation by strengthening revenue efforts were less likely to end a fiscal adjustment. This result is at variance with the findings for OECD countries, where adjustments based on higher tax revenues were less successful. However, the low-income countries in our sample that accelerated the pace of tax revenue collection—countries can increase their tax revenues by improving tax administration, eliminating exemptions, and curbing tax evasion, as well as by increasing tax rates—had more persistent deficit reductions.

Channels

The estimation of the direct and indirect effects of fiscal deficit reductions on growth suggests that these channels in low-income countries are different, in many respects, from those that operate in OECD countries.

In low-income countries, fiscal adjustment leads to higher growth rates mostly through increases in factor productivity. Fiscal consolidation also tends to stimulate private investment, as in OECD countries, but for different reasons.

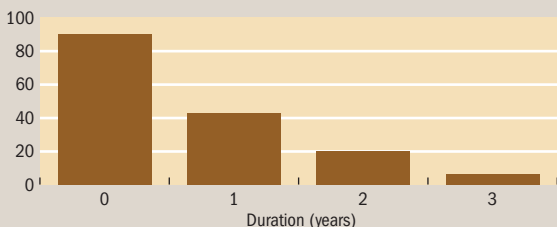
- The most important transmission mechanism through which fiscal adjustment stimulates growth in low-income countries is factor productivity. When public funds are not used efficiently and public sector productivity is low,

Chart 2

Short-lived measures

Most fiscal consolidation episodes do not last more than one year.

(percent of fiscal adjustment episodes)



Source: Authors.

Note: Data are for 39 countries with IMF-supported programs, 1990–2000.

improving the composition of spending can spur economic growth.

- Low-income countries rely largely on external concessional funds for financing their deficits. This means that private investment in these countries is less responsive to interest rates. Fiscal consolidation can stimulate private investment by reducing the size of government when governance is poor. Poor governance undermines the ability of the government to provide public services efficiently.

- In low-income countries, initial macroeconomic conditions play a critical role. In countries that have not yet achieved macroeconomic stability, reining in inflation and narrowing budget deficits are paramount for promoting growth. In our sample, fiscal consolidation had an indirect impact on private investment (and thus growth) by slowing inflation in countries with inflation rates exceeding 20 percent a year.

Conclusion and policy implications

The results of our studies demonstrate that fiscal policy has to be tailored to country-specific conditions to foster growth. That is, a uniform approach to fiscal policy—in which all countries are counseled to reduce their deficits under all circumstances—is not appropriate. In practice, the IMF’s fiscal policy advice does recognize the heterogeneous conditions of different countries, as confirmed by a recent study on fiscal adjustment in IMF-supported programs by the IMF’s Independent Evaluation Office.

Although fiscal policy works differently in low-income countries than in OECD countries, fiscal adjustment can also spur growth in the former. Given that a reduction of 1 percentage point in the ratio of the fiscal deficit to GDP led to an average increase in per capita growth of at least one-fourth of a percentage point in the countries we studied, it is possible that a reduction in the average deficit in low-income countries from about 4 percent of GDP to 2 percent of GDP could boost per capita growth by about ½–1 percentage point a year in fiscally vulnerable countries.

Expenditure composition also plays an important role in promoting economic growth: fiscal adjustment that reduces

unproductive expenditures and protected public investment has proved to be more sustainable and more likely to result in faster growth. Another important factor is how deficit spending is financed: in our sample, fiscal adjustment based on reducing domestic financing had about one and a half times the effect on growth as adjustments based on reductions in both domestic and external financing. However, low-income countries that already enjoy macroeconomic stability can afford to increase selected current expenditures, provided that concessional financing is available and that resources are spent productively—for example, on infrastructure and poverty reduction projects.

Finally, given the impact of governance on productivity and the importance of increases in total factor productivity in boosting economic growth, institutional reforms that foster good governance are critical to achieving sustained growth. Sound fiscal and macroeconomic policies can contribute to improving governance. However, expenditure reforms need to be sequenced correctly to ensure that such policies support faster growth. For example, civil service reforms entailing a decompression of the pay scale to attract more skilled staff could be too costly for countries with large fiscal imbalances but may have a positive payoff for growth once a country has achieved a sound fiscal position. ■

Emanuele Baldacci is an Economist, Benedict Clements a Deputy Division Chief, and Sanjeev Gupta an Assistant Director in the IMF’s Fiscal Affairs Department.

Suggestions for further reading:

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