

Lessons of Fiscal Adjustment

Selected Proceedings from
a World Bank Seminar

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Foreword

Fiscal reform has been a crucial component of the World Bank's structural adjustment lending. In 1997 the Operations Evaluation Department (OED) published an assessment of Bank-supported fiscal adjustment in 26 countries (Jayati Datta-Mitra, *Fiscal Management in Adjustment Lending*).

Among the report's important findings were that fiscal adjustment was attained more readily through raising revenue than through cutting public spending; that fiscal difficulties were due to economic mismanagement, not necessarily to terms of trade shocks or external indebtedness; and that reducing the fiscal deficit is indeed associated with improved external balances and faster economic growth. Budget deficits in the countries studied, however, remained high, and there were some reversals in fiscal conditions, particularly in Africa, in low-income and heavily indebted countries, and in primary commodity exporters. The report proposed specific recommendations for the Bank and its borrowers to improve this record.

To amplify the study's findings and recommendations, in April 1997 OED convened a seminar of experts, drawn from academia and government in the Bank's member countries, the Bank's operational departments, and the International Monetary Fund and other multilateral financial institutions. Panelists focused on two aspects of fiscal adjustment: the political economy of fiscal reform and budgetary decisions; and the incentives for, and outcomes of, fiscal discipline.

On the first score, participants stressed the necessity for a "critical mass" within the government of political support for reforms, particularly at top levels. It was found that often, at early stages of adjustment, governments make the mistake of cutting expenditures that will eventually prove to be productive, thus achieving the illusion of adjustment. Evidence was presented showing that political disruptions do not necessarily follow on fiscal reforms; that success-

ful adjustment implies reductions in the public sector wage bill; and that adjustment succeeded more often under a strong government than under a coalition government.

As regards the importance and effect of incentives for fiscal reform, the panelists examined the role of foreign aid in budgetary issues; the internal incentives for fiscal discipline, as embodied in fiscal institutions and the instruments of fiscal policy; the merits of an outcome-oriented approach to expenditure policy; and the critical balance between a government's allocation of expenditures and its ability to manage its own fiscal processes and institutions.

Lessons of Fiscal Adjustment documents these discussions. It is presented with the view to improving both the Bank's effort in assisting members to undertake, achieve, and sustain fiscal adjustment and OED's evaluation of that effort.

Robert Picciotto
Director-General
Operations Evaluation Department

Background

All seminar participants were given a copy of *Fiscal Management in Adjustment Lending*,¹ as the starting point for the seminar. The following background summary provides a short listing of the many conclusions of the report.

In the early 1980s the World Bank began its program of structural adjustment lending to developing countries suffering from economic crises caused by external shocks and macroeconomic mismanagement. A decade later, nearly two-thirds of the Bank's clients had instituted reforms supported by structural or sectoral adjustment loans (SALs/SECALs), and about 250 of these loans, to 86 countries during the period 1979–94, had components supporting fiscal reforms.

The Bank recently assessed progress in fiscal adjustment in a sample of 26 of these countries. It found that, contrary to the view prevailing in the early years of adjustment operations, fiscal mismanagement, not exogenous shocks, was the primary cause of persistent budget deficits. Reduction of fiscal deficits was associated with improved external balances and economic growth, but sustaining deficit reduction required vigilance and long-term effort. Where a sustained lowering of the deficit was achieved, it was accomplished more readily through revenue enhancement than through lower capital spending, and targeted cuts in current expenditure proved particularly elusive. Revenues increased, not by imposing higher tax rates, but by broadening and simplifying the tax base.

On the whole, the fiscal reform component of Bank-supported adjustment lending was found to have had only limited success. In the sample of countries studied, budget deficits remained high, and there were some reversals—in Africa (in low-income and heavily indebted countries and exporters of primary commodities). Fiscal success was limited in part because reform programs (a) failed to address the role of the state, a critical factor determining the level of public finances; (b) treated fiscal issues separately from other

macroeconomic reforms and ignored fiscal sustainability and solvency;

(c) paid scant attention to fiscal deficit coverage, measurement, and data; and (d) were couched in conditionality that was too soft, ambiguous, or inconsistent. Tax conditionality, for example, was imprecise and did not build in performance monitoring indicators. And expenditure conditions focused on shifts in expenditures, not outcomes.

Several recommendations emerged from the review, for both the Bank and its borrowers:

- Estimate the level of the sustainable deficit and provide guidelines for achieving it.
- Improve the sequencing of tax reform.
- Explicitly consider the role of the state, and the appropriate mix of public and private service provision, in recommendations of public expenditure reform.
- Include poverty alleviation and equity considerations in public expenditure reform.
- Construct adequate indicators for monitoring and performance, for both tax and expenditure reforms, and build them into reform programs.

¹ Jayati Datta-Mitra, 1997, *Fiscal Management in Adjustment Lending*, World Bank Operations Evaluation Studies (Washington, D.C.).

Prerequisites for Sustainable Fiscal Reform

Juan Cariaga

Robert Picciotto, director-general of Operations Evaluation at the World Bank, opened the seminar and introduced the first speaker, Juan Cariaga. Mr. Cariaga, noted Mr. Picciotto, was uniquely qualified to introduce the subject of fiscal adjustment, having served as the finance minister of Bolivia during its fiscal turnaround, the most remarkable in Latin American history.

When Bolivia's octogenarian president asked me to help him design a stabilization program to curb hyperinflation, which had reached an annual rate of 23,500 percent in 1982, my first reaction was to ask him, "Mr. President, with all due respect, do you believe that, after having nationalized the tin mines, instituted a controversial agrarian reform program, and established an economy based on state capitalism back in the 1950s, your government will be able to undertake and implement a neoliberal-type program designed to deregulate markets and to make the economy market-oriented? What is more," I said, "Mr. President, do you believe your government will be able to do this even though you don't have a parliamentary majority and most of the unions are against the government?"

"Son," said President Paz Estenssoro, "the answer is right there in your question. Precisely because my government was able to carry out those measures in the 1950s, I will now be able to bring hyperinflation to a halt and free the economy from state controls. As to the second part of your question, what we will do is apply a little bit of political economy in the sense of making economic policy."

The next day I was sworn in, with no further explanation of what lay ahead, in a ceremony that my own father didn't attend because he had lost all his lands in the agrarian reform back in 1950. Not only

did he decline to attend the ceremony, he also ordered that not a single television be turned on anywhere in the house that night.

Behind the reform was the iron will of the president.

I recount this anecdote to explain how Bolivia's economic program, frequently cited in international forums and the international press, proved successful. Behind the reform, sustaining it, was the iron will of the country's president. He firmly intended to carry the economic program through to its ultimate consequences, and he made a great effort to apply the basic principles of political economy in the implementation of his program.

Political Commitment and the Role of Political Economy in Successful Adjustment

The Bolivian program succeeded because the president forged a political allegiance with the main opposition party, leading to the laws needed for the program to be carried out.

Bolivia's economic program was successful because it was driven by an unwavering political will—the desire in the top-most level of government, in this case the president of the republic, to carry it out all the way to its very last consequences. Other programs implemented in the same period, although theoretically well designed and conceived, were not as successful as the Bolivian program because the political will to carry them through was lacking in the highest echelons of government.

In addition to political will, economic programs also require political capacity—that is, the ability to convert this political will into instruments, such as allegiances and coalitions with the political parties and other power groups, that would ensure good governance and the effective implementation of the program. The Bolivian program was successful because President Paz Estenssoro, even though he did not have a parliamentary majority, managed to forge a political allegiance with the main opposition party, which led to the approval of the laws that were necessary for the program to be carried out.

It was also successful because President Paz Estenssoro was able to knit together a set of coalitions with power groups—the regions, municipal governments, employers’ associations, the military, and others—without whose active participation (or, at the least, tacit acquiescence) the economic program could not have been implemented.

Credibility

In the application of the principles of political economy, the Bolivian economic program enjoyed something more than just political will and the capacity to put it into practice. Bolivia’s program was also credible, consistent, and comprehensive. It was credible because it was implemented by the same man who had carried out the bold measures of the 1950s, and because he had proposed things that had been considered impossible—for example, eliminating price and exchange controls; opening up foreign trade; and, most important, doing away with the abused tenure entitlement that had made unions invulnerable for 40 years. Still more important, like the economic programs attempted by his predecessors, it did not include a compensatory wage increase, which frequently undercuts the effect of the initial measures of an adjustment program.

The credibility shock generated by the program was so great that the mere announcement of the measures abruptly halted the depreciation of the currency. Although the tax and the monetary measures were not put into effect for a number of weeks, maybe months, after the stabilization, the package was approved.

The program was tough but necessary—it was consistent throughout.

Weekly inflation rates were consistently negative from week 3 to week 15 following announcement of the program. Moreover, the program demonstrated a consistent line of thinking from the initial proposal through its execution. It called for liberalization of markets and governance of the economy by the laws of supply and demand,

two key requirements that were maintained throughout the implementation process.

Unlike the Bolivian program, many other programs of the time leaned toward so-called heterodox models. By their very nature, these programs lacked the fundamental component of consistency, which easily led to a lack of credibility, because inconsistency caused market operators to perceive that the rules of the game were not clear.

Finally, the Bolivian program was also comprehensive. In contrast to other programs implemented in the same period, it sought to encompass all possible areas of economic activity. In other words, the more sectors of the economy the program included and the greater the effort applied to make it comprehensive, the greater was the success of its implementation.

Shock Value

The keys to success—secrecy, surprise, and determination—marked the development content and implementation of the Bolivian program.

Another tool of political economy—the element of surprise—was also applied in the Bolivian economic program. Paz Estenssoro assigned the preparation of the program to a small group of Bolivians; they were instructed to work in secret for 20 days without losing an hour—or a single minute, as he pointed out. Once this work was completed, he specified that the Supreme Decree that was to implement the program be drafted in a single copy. After he had reviewed and approved the final document, he convened his cabinet, cut the telephone lines, and kept the group in session, nonstop, until the decree was approved.

This element of surprise was vital in the president's effort to prevent his own staff from losing their nerve when confronted by such important decisions or from being subject to external influences, both of which would have complicated the decisionmaking process. In addition, the president chose the shock route rather than the

gradual approach. When asked why he had opted for the shock method, he paraphrased Machiavelli, replying: “Good news is let out little by little, but bad news is conveyed at one blow.”

Negotiations and Social Safety Nets

The Bolivian economic program included other elements of political economy, including negotiations and agreements, both domestic and international. Any economic program, however well-designed or conceived, remains greatly vulnerable to the effects of bungled negotiations. Governments accordingly engage in domestic and international negotiations to ensure the viability of their programs.

Internal negotiations on wages and services are crucial.

In the domestic area, wage negotiations with the unions are the most important. The negotiations with the regions and municipal governments that want to see investment expenditures stepped up are also important. Finally, the negotiations on military expenditures and with public employees (especially teachers), who are a major social force and whose salaries are a significant item in the central government budget, are no less important.

In the external sphere, negotiations with the International Monetary Fund (IMF) are vital to open the way for multilateral credit, negotiations for debt relief, and the restructuring of debt with international banks. For their part, the Paris Club negotiations are also essential in opening up bilateral credit, as are the meetings of the Consultative Group organized by the World Bank. Here, again, incompetent negotiations will have a negative impact on the success of the economic program.

Success Is in the Execution

Finally, as part of this effort to apply the principles of political economy, the government of President Paz Estenssoro invented—or

reinvented—the so-called Emergency Social Fund and the Social Investment Fund. These were to serve as safety nets by providing temporary employment and investment relief in social areas, mitigating the impacts of adjustment.

The success of an economic program is largely determined by the commitment of those who will execute it.

Years later, like many technocrats who leave the government, I ended up working as a consultant, which gave me the opportunity to visit a number of countries affected by instability and lack of structural adjustment. I found that everyone wanted to learn about Bolivia's experience—how a country like Bolivia, beset by extreme political and social problems, had been able to implement a tough program of reform and structural adjustment. They wanted to hear it from the lips of a Bolivian, and not from the experts of the IMF or the World Bank.

It was also during this time that I understood that President Paz Estenssoro had been absolutely right. The answer was right in my question. The success of economic programs is largely determined by the personal commitment of those at the highest level who execute them. The design of the program is also a major factor, but its success essentially depends on how it is executed.

I remain convinced today that—at least in the case of Bolivia—the way in which the program was undertaken played a preponderant role in its success. This case would appear to breathe new life into the concept of political economy in the making of economic policy, a concept that tends to be forgotten or underestimated by the many economists who concentrate primarily on theoretical research.

Mr. Juan Cariaga is an executive director of the World Bank.

Session One:
The Political Economy
of Budgetary Issues

Following Mr. Cariaga's comments, the first panel was opened by Isabel Guerrero, division chief in the Economic Development Institute, the World Bank. Ms. Guerrero introduced the speakers for the panel: Manuel Penalver, senior operational advisor for the South Asia Region, the World Bank; William Easterly, lead economist in the Macroeconomics and Growth Division, the World Bank; Robert Peroti, Columbia University; and Vito Tanzi, director of the Fiscal Affairs Department, the IMF.

The Bank's Work in Fiscal Adjustment

Manuel Penalver

Let me start by acknowledging the point made by Mr. Cariaga: fiscal and policy reforms are, in the end and in the beginning, the role of government. International and aid organizations are only minor players in the process, which is something those of us working for these institutions may tend to forget.

Nevertheless, it is important to find a balance between the belief that we are always in the lead and, at the other extreme, that we have no role to play. I will focus on a few points that came to mind as I read the successive drafts of *Fiscal Management in Adjustment Lending* as it was being prepared, which touch upon what the Bank did, did not do, could have done better, and perhaps should do in the future.

The first point—one of the main findings of the report—is that sustained deficit reductions were found to have been generated from revenue increases in the majority of the cases; that in a minority of the cases, reductions in capital expenditures were also achieved; and that current expenditures were generally unaffected or not reduced as a result of the programs.

Sustained deficit reductions were generated from revenue increases in most cases.

This is a statement of fact. It does not say whether this is good, bad, or indifferent. It was certainly unexpected; it wasn't part of the plan. Nevertheless, the question is, was this an intended effect? Was it the right way to go about it?

Areas for Improvement

Let me go back one or two steps in the process and briefly recall that the results of many of these structural adjustment and sectoral adjustment programs were not—in the context of achieving our targets—terribly impressive regarding fiscal adjustment. The report

notes that in the majority of the cases, reductions were achieved, but they were not of the anticipated magnitude.

In my previous job in the Bank's Operations Evaluation Department (OED), and following work on the *Fiscal Management* report, we did another paper on adjustment lending in Sub-Saharan Africa. We looked at 35 countries, and in those 35 countries we found much the same picture. We classified the countries in three categories of compliance with policy reforms: the good compliers, the medium compliers, and the poor compliers. We then looked at how these countries had done.

If my memory serves me correctly, 10 of the 35 countries were in the good-compliance category, and of these 10, only 5 had implemented fiscal reforms and deficit reduction plans that put them on a path toward maintaining debt at a generally constant share of GDP. In all the other cases, the deficit reductions were insufficient even to achieve the objective of maintaining the debt within manageable levels. Among the medium performers and the poor performers, the situation was worse. So the results in Africa are not terribly impressive.

The question then emerges: Could we have done better? Could the countries have done better if we had done things differently? Are these results inevitable, because if there is no willingness on the part of the government to foster faster change, is there nothing we can do about it?

My conclusion is that we could have done things better in several areas, and I think the *Fiscal Management* report summarizes very clearly where improvements could be made. The *first* area is in the definition of the deficit. The *second* is the concept of the sustainability of deficits and the dynamic implications of deficits. The *third* is the sources of the fiscal deficits. The *fourth* is the solutions we proposed. The *fifth*, something of a side comment, is our ability to

coordinate and to work closely with other international and multilateral and bilateral institutions, or the lack of ability to do so.

Defining the Fiscal Deficit

On the first point, our definitions of fiscal deficits have left much to be desired, and particularly left much to be included. This is not a proposal or a recommendation for becoming overly technically sophisticated in the analysis, but rather for counting the things that matter. One of the approaches that impressed me was a study that Homi Kharas did on the Philippines. He calculated the implicit deficits by looking at the changes in the level of government debt over a selected period and extrapolating the deficit that would have generated those changes. He then checked these figures with the published budget deficit figures, and the official deficit was much less, which tells us that most of the time we are looking at about half of the deficit that's actually being experienced in a country.

Our definitions of fiscal deficits need revisiting.

Doing better work in this area, understanding it better, and discussing it with the authorities would enable us to have a much clearer picture and to offer a better set of recommendations to governments.

Sustainability of Fiscal Deficits

The second area for improvement is in the concept of sustainability and sustainable deficits. I find that when we talk about this in the Bank, we rapidly move to a highly sophisticated set of technical concepts. We then often lose ourselves, we certainly lose our government audiences, and the net result is that we drop the issues altogether. The dynamic implications of fiscal deficits for indebtedness and related issues is something that in our work—as country economists, for instance—we should maintain at all times in the discussions with governments.

Sources of Deficits

The third point is our understanding of the sources of deficits (which is linked, of course, to the definition of the deficit), whether they come from the operations of the central government, the operations of the central bank through quasi-fiscal deficits, public enterprises, or from other sources that are not initially obvious. An area in which, I think, we could have done much better is the analysis of revenue and expenditure measures, both for their impact on growth and for their impact on income distribution and poverty alleviation.

Proposed Solutions

When we consider the solutions the Bank has offered, I return to the points of my first proposition, the proposition in the report: revenues, capital expenditures, and current expenditures moved in very different directions.

Now, my provocative statement here is that whatever happened in the area of revenues—in the end, we found this to be the major source of sustainable reductions in the deficit—had very little to do with the Bank's work. In most cases, these revenue increases came about because of IMF programs, not because of Bank programs. Perhaps even before that, we should recognize the merit of the governments that achieved these increases.

Capital expenditure is one of the traditional areas of our involvement. Nevertheless, there is an inherent contradiction in the way we organize our reviews of public investment programs. The same people who evaluate capital expenditures in public investment programs are often the sector specialists who are looking to expand Bank lending in their sectors. This contradiction often prevents us from making the best recommendations for capital expenditure cuts.

But even when we do make good recommendations, we have found that many of the countries that introduce capital expenditure reforms only sustain them for a very short period of time. Another investment boom then arrives, and a feast-and-famine cycle is seen. One can see the fluctuations in fiscal performance closely correlated with the ups and downs in public investment in many countries.

Current expenditures would appear to be the area of greatest importance for future and improved work by the Bank. This is the area where we have done far too little work, and where the analytical aspects of the Bank's work requires a quantum and a qualitative jump.

More attention to current expenditures is the key to improving the Bank's work.

Again, my recent work on adjustment in Africa led to an examination of the sources of the data in the Bank covering public expenditures in the 35 countries included in the study. There was far less material than one would have wished to find, in both the availability of data and in its analysis. This is another area where we need to do a lot better.

Coordinated Efforts

Finally, I will simply add the fifth point, the area of coordination with other donors—not just with the IMF, but, in many countries, with bilateral donors as well—and their respective contributions. Should we not have spent a much greater amount of time and resources in working together with other donors in reaching solutions?

I haven't touched the issue of the role of government here, but when I look at the numbers and the percentages of revenues, and the disposition of those revenues per capita by categories of expenditure, I am sometimes struck by the patterns. In a country such as Pakistan, which is one of the countries I deal with now, with \$450 in

per capita income, government revenues are hovering around 18 percent—that means \$84 per capita yearly in revenues to the government. About one-third of that sum is allocated for military expenditure; one-third for interest payments; and what is left—\$28 per capita yearly—has to pay for everything else: health, education, infrastructure, maintaining other public services, the civil service, and the rest of it. We do have to improve and rationalize expenditures, but what can we expect from \$28 per capita per year?

Figures for Uganda can be used as a comparison. Uganda has a per capita income (1993 data) of \$180. Revenues and grants together—and grants are probably about 40 percent of the total—represent 14 percent of that sum, revenues are only around 8.3 percent. What does that yield in total revenues for the government to spend on health, education, and filling the potholes in Kampala?

In conclusion, although we often say we have to reduce the role of government in the economy, and that leads us to say that these percentages of revenues to GDP may be too high, when we couch them in dollars per capita yearly, we may find that we have to rethink some of our ideas.

The Illusion of Fiscal Adjustment

William Easterly

Let me first commend the authors of the OED report; it is excellent. One of the interesting statistics it offers is that the low-income African countries, after fiscal adjustment, actually wound up with higher deficits than they had before fiscal adjustment—from an average deficit of -8.3 in the preloan period to -9.1 in the most recent two-year period. For all low-income countries in the study, the deficit moved from a preloan average of -8.2 to -8.4 in the most recent two-year period.

Low-income African countries had higher deficits than they had before fiscal adjustment.

How could such a phenomenon come about? I think there are many possible stories, and I'm going to tell you one. Let me illustrate with a little parable.

A Parable: My Visa Card and Cousin Ken

Suppose I'm consuming more than my income as an individual, and suppose that I finance the excess of consumption over income with the use of my Visa credit card. Every month I continue to run up a Visa bill, and the Visa Corporation is monitoring my deficit, which is the excess of consumption over income that is funded by these increases in my outstanding Visa balance. After a while, the Visa Corporation becomes increasingly restless. Visa sends a representative to tell me that they will no longer allow me to run such high deficits, and that they have designed a payback program for me that will gradually reduce my deficit, eventually turn it into a surplus, and enable me to repay the outstanding debt to Visa.

I begin that program, and I seem to follow exactly the path they have set out for me. What they do not know is that I have another source of financing, which I'll call my cousin Ken. My cousin Ken draws up a legal agreement lending me money at an interest rate that turns out

to be even higher than Visa's interest rate—which is quite an achievement.

I am now maintaining the deficit reduction that Visa has set out for me by substituting another source of finance. I'm substituting my cousin Ken's loan for Visa's loan. And my financial position has actually gotten worse because I am now paying a higher interest rate on the debt that I have substituted for the Visa debt.

What in the world does this have to do with fiscal adjustment? The answer is, quite a bit—it has to do with cases in which fiscal adjustment is really an illusion.

Present Consumption versus Future Earnings

How could fiscal reduction be an illusion as my Visa payment was an illusion? The key point in the Visa story, of course, is that I am an individual who is highly disposed to treasure present consumption over future consumption. So, too, for governments that look for means of trading present consumption against future earnings to enable them to avoid reducing present consumption.

There are many such means available in government budgets. One example would be to eliminate road maintenance to pay back an IMF loan with an 8 percent interest rate. But five years later, lack of maintenance has made a new road necessary, at a cost *four times* the amount of the road maintenance spending that was eliminated, and with an implied interest rate of 30 percent.

Now, this set of transactions is exactly analogous to what I did with Visa and my cousin Ken. One form of trading off the future against the present has been substituted for another, and the tradeoff chosen is even steeper, with an interest rate of 30 percent. The government has actually worsened its fiscal position. In the end, fiscal adjustment in this case was an illusion, and this is actually an example of fiscal *unadjustment*.

Box 2-1. The Illusion of Fiscal Adjustment

Example 1

1. Elimination of scheduled road maintenance enables one to eliminate the deficit.
2. Eliminating the deficit eliminates borrowing at 8 percent interest.
3. Because road maintenance was eliminated, a new road has to be built five years later at a cost four times the initial savings in maintenance spending (implied annual interest rate: 30 percent).
4. End result: borrowing at 8 percent has been replaced with borrowing at 30 percent
⇒Fiscal adjustment was an illusion—this is fiscal **un**adjustment

Estimates of rates of return of road maintenance:

Africa. New construction is four times more expensive than maintenance: reducing road maintenance by \$12 billion led to \$45 billion in road reconstruction costs.

Latin America. For every dollar not spent on road maintenance, \$3 to \$4 in premature reconstruction was required. Road maintenance has a 70 percent rate of return.

Example 2

1. Privatization: has neutral fiscal impact if the price is “fair” and if proceeds repay other debt.
2. Privatization has negative fiscal impact if part or all of the proceeds are consumed.

⇒Fiscal adjustment was an illusion—this is fiscal **un**adjustment because part or all of the privatization revenues are consumed.

Example 3

Borrowing is reduced by reducing new infrastructure construction.

Rate of return estimates:

Roads: 20–29 percent. Telecommunications: 19 percent. Ports: 20 percent.

⇒Fiscal adjustment was an illusion—this is **un**adjustment if the rate of return of the cut expenditure exceeds the rate at which the government is borrowing.

The *World Development Report 1994* was the source of this example. The *Report* concluded that reducing road maintenance by \$12 billion in Africa had led to \$45 billion in road reconstruction (see Box 2-1).

In Latin America, direct rates of return to road maintenance have been estimated at about 70 percent, which certainly enables one to conclude that the intertemporal tradeoff of cutting road maintenance today in order to build new roads tomorrow is a very steep one—and one that is likely to worsen the government's financial position in the future, not improve it (see Box 2-1).

Another example of illusory fiscal adjustment detailed in the OED study is that fiscal deficits are often reduced by postponing or canceling infrastructure projects. The estimated rates of return to infrastructure projects are on the order of 20 percent, and the same is true for telecommunications and for ports. When one of these activities is under way in the budget, and it is canceled to repay an IMF loan or to reduce the deficit, then again the financial position has been worsened because revenue that would have been gained from user fees and the like, which would have yielded a 20 percent rate of return, has been forgone to repay a debt at 8 percent interest. These illusory forms of adjustment are outlined in Box 2-1.

If borrowing is unavailable, governments cut high payoff items such as education and health.

In conclusion, when a government is already running a deficit and needs to undertake adjustment, it is highly likely that the government will value present consumption very highly compared with the future. And if one eliminates one means of borrowing against the future—a formal loan—it is very likely that this government will turn to other means of borrowing against the future that involve cutting categories of spending that have high payoffs in the future in order to maintain private consumption today. Thus, one ends up with an illusory fiscal adjustment, which is exactly what the OED report, unfortunately, has found in many low-income countries.

Fiscal Adjustment in the OECD and Latin America

Roberto Peroti

The main point I want to discuss is what makes fiscal adjustments in Organization for Economic Cooperation of Development (OECD) countries successful. The second point, and one more closely related to the issues of this seminar, is whether the outcomes for OECD countries apply to Latin American countries. I focus on Latin America because, with Mike Gavin at the Inter-American Development Bank, I have just put together a database of fiscal outcomes in Latin America, and we have some preliminary results that I would like to report.

Fiscal Adjustment in OECD Countries

There are three main conclusions from our study on OECD countries. The first, which I think is the most important from our point of view, is that if one looks at successful—that is, persistent, long-lived—fiscal adjustments and unsuccessful fiscal adjustments in OECD countries, what one clearly sees is that what distinguishes them is their composition. Successful consolidations tend to be based mainly, almost exclusively, on expenditure cuts, particularly in two items (or combination of them)—the wage bill and transfers. In unsuccessful, short-lived consolidations, most of the action tends to be on revenues, particularly labor taxes.

Durable consolidations are usually based on expenditure cuts.

The second conclusion, which is also strong, is that it is not true that successful fiscal consolidations—even though they rely mainly on expenditure cuts, in particular transfers and current consumption, the wage component of current consumption—are associated with major macroeconomic disruptions. They are not generally associated with major recessions, and certainly not the bad performance in private consumption. The evidence is that they are associated with booms in investment and in the external sector.

The third conclusion, which is relevant from the point of view of a policymaker, is that successful adjustments are not necessarily associated with major political disruptions. They are not associated with government turnover (the fall of the government that carried out the program) more frequently than other types of adjustments. It thus appears that there is not necessarily a political cost in attempting what turns out to be a successful fiscal adjustment.

A few figures may be helpful in our discussion. In the case of successful adjustments in OECD countries, the cyclically adjusted budget deficit is reduced by 2.9 percent of GDP; in the case of unsuccessful adjustments, by 2.4 percent of GDP. It is clear that the difference in the two outcomes is not the size of the adjustment, but that in the successful case all the action is in government expenditure. In the unsuccessful adjustments, most of the activity is in government revenues.

If what happens to expenditures during successful and unsuccessful adjustments is further disaggregated, one can see that during unsuccessful adjustments, most of the action is on transfers and government wages. As shares of GDP, they fall by a total of more than 1 percent. In unsuccessful adjustments, there is virtually no movement, no cut in expenditures except for public investment, which drops by an average of almost 7 percent of GDP.

Successful adjustment does not entail higher taxes on labor.

Something interesting arises from the disaggregation on the revenue side. During successful adjustment, there are essentially no increases in taxes on labor. And taxes on labor are essentially taxes on households and social security contributions. In the unsuccessful adjustments, most of the action comes from these two items.

In our study we divided successful and unsuccessful adjustments and looked at a range of macroeconomic variables before, during, and after the adjustment. The first of these is growth relative to the G-7

countries. We found a fairly sizable increase in growth during the successful adjustments, and the opposite during unsuccessful adjustments. We also found that an investment boom is associated with the successful kind of adjustment's expenditure cuts. Nothing happens to investment during unsuccessful adjustment.

Finally, we discovered something of interest in unit labor costs relative to trading partners—which give an idea of the competitiveness of the countries. Except for the United States, these are generally very open economies, so relative unit labor costs are vital.

During successful adjustments, there is a big fall in relative unit labor cost, and an increase in competitiveness of almost 4 percent, while nothing of the kind happens during unsuccessful adjustments. To understand this, it must be remembered that during successful adjustments there was no increase in labor taxes, whereas during unsuccessful adjustments there was a large increase in labor taxes. These are highly unionized economies. If one increases labor taxes, unions will demand higher wages, and that will show up in unit labor costs immediately.

With higher labor taxes, unions will demand higher wages.

In what was probably the most successful example of major fiscal adjustment in OECD countries—Ireland at the end of the 1980s—there was clearly an agreement between the government and trade unions. The government implemented fiscal consolidation by reducing expenditures, and it refrained from increasing taxes under the agreement that the unions would refrain from asking for higher wages.

The last finding I would like to discuss concerns the share of wages. There is a large increase in profitability (measured approximately by the ratio of value added in manufacturing to unit labor costs) in the manufacturing sector during successful adjustments, but not during unsuccessful adjustments, as well as a fairly significant fall in the

share of wages. These are fairly big numbers. A 3 percent fall is large because these are numbers that normally do not move much.

Again, this is consistent with the evidence we found that during successful adjustments there is no increase in labor taxes, and therefore wage moderation is seen. The opposite is not true during unsuccessful adjustments.

Another issue, mentioned at the beginning of my presentation, was the political consequences associated with fiscal adjustment. A strong government is needed for a successful adjustment. Here we looked at the probability that the successful adjustments, the expenditure cuts, are implemented by single-party majority governments (strong governments) or coalition governments. We found that the probability of a single-party majority government, a strong government, accomplishing a successful adjustment was 35 percent, and that coalition governments were unable to achieve successful adjustments.

No cause and effect link.

We are working on another kind of evidence that offers insight on what may be the most important question for policymakers. If I enact an expenditure cut, does that increase my probability of being voted out of office next year? And, again, fairly preliminary results assembled from the experience of OECD countries indicate that there is absolutely no evidence that governments that managed successful adjustments were worse off than governments that presided over unsuccessful adjustments.

Implications for Latin America

Are these results applicable to Latin America? Again, the results are a bit more preliminary than for the OECD countries because we have just put together the database, which refers not only to the central

government but also to local governments and nonfinancial public enterprises. The comprehensive database on the nonfinancial public sector enables us to study this issue in Latin America.

The main picture that comes out of Latin America is that the results we have seen for OECD countries do not necessarily carry over immediately to Latin America. If one looks at successful and unsuccessful consolidations, the difference is not really in the composition of expenditure cuts versus revenue increases.

I think that the reason for this difference, which has been mentioned by other panelists, is that for many Latin American countries, the big problem historically has been how to raise revenues on a consistent basis. That, I think, explains why, in Latin American countries, a more persistent fiscal adjustment might be achieved through an increase in the ability to increase tax revenues rather than necessarily decreasing already low levels of transfers.

There is one exception to this conclusion, which is the wage component of government consumption, the wage bill. In many Latin American countries, that is a very rigid and extremely large component. The example of Brazil comes immediately to mind. Here one still observes, exactly as in OECD countries, that fiscal adjustments that have managed to put a lid on the increase in the wage bills tend to be successful.

Elements of Sustainable Fiscal Adjustment

Vito Tanzi

First of all, fiscal reform is never very easy. This is one thing one learns. There are relatively few fiscal reforms that have been successful in a sustainable way. There have been many compressions of fiscal deficits in one year, and then the fiscal deficits simply come back the following year.

Four aspects of a major fiscal adjustment are of critical importance. One is political commitment, and Mr. Cariaga made this point very strongly. A second is technical expertise. The third aspect must be supporting institutions, because one can make all the changes one wants at the very top, but if there are not institutions to support these changes, then adjustment does not get very far. The fourth aspect is the importance of rules. There are tradeoffs among these four elements—if a country excels in one of them, perhaps it will need less of another—but all of them, particularly the first three, are important. Also, luck always plays some role. Sometimes things just work well for a variety of reasons that one cannot really identify; at other times, they do not work well at all.

To have only a minister of finance who wants fiscal reform is not enough.

A final point I want to make—and this is related to what Roberto Peroti was saying, although he has put it a little bit differently—is that there are fiscal reforms that try to change the role of the state, and there are fiscal reforms that simply try to reduce the fiscal deficit. And these are two very different things. One has to keep this in mind.

Political Commitment

When it comes to political commitment—Mr. Cariaga was the one who emphasized this in the strongest way—involvement at the

highest level is necessary. To have only a minister of finance who wants fiscal reform is simply not enough. I have seen too many countries where the minister has made all kinds of promises, but he was, as I always put it, a Scrooge in a world of Santa Clauses. And when you are the only Scrooge in town and everybody else wants to be Santa Claus—well, you don't succeed in restraining spending.

The involvement of the president and the prime minister is essential, and this involvement must be explicit, and unqualified. One must not be able to hide—to claim the successes, but when failure comes, to say, well, I was not involved, it was the IMF that was pushing us, or the like. Support must be unqualified and transparent.

It is also important to have a critical mass of support within the government. As I said a minute ago, it is not sufficient for one minister to want the reform. In the countries where reforms have succeeded, some sort of critical mass usually has been created: the minister of finance wanted it; the governor of the central bank wanted it; maybe one or two other powerful, articulate ministers wanted it. And support, of course, was present at the top.

Programs without a critical mass of government support tend to falter.

The question also must be asked whether the reform attempts to change the role of the state or whether it will simply squeeze the fiscal deficit. There are lots of horror stories of how the deficit can be squeezed without accomplishing adjustment. I will take about 30 seconds to speak about two of them.

In one case, a country I will not name, the government sold its embassy in Tokyo in order to reduce the fiscal deficit and meet an agreement with the IMF. The government received 0.5 percent of GDP, counted this toward revenues, and satisfied the IMF program. And, of course, the embassy was then rented right back.

I will name the country of the second case—Zaire, under Mobutu. Mr. Mobutu was convinced to sell his plane and rent it back, and the

revenue from the plane was counted toward the fiscal adjustment, and the program was satisfied.

Clearly, this is not what we mean when we talk about fiscal reform. We are talking about something much more fundamental.

It is also important to have what I have called a strong mentor, someone who makes the reform his own—such as Domingo Cavallo—somebody who can articulate the objective of the reform, can explain the many aspects of the reform to the public, and can put the critics on the defensive. This is really very important. If everybody says, well, the reform is okay, but let somebody else deal with it, then reform does not work.

The mentor must possess economic sophistication, or at least basic understanding.

Also in keeping with Mr. Cariaga's remarks, the intelligent lobbying of parliament and of other powerful political groups is needed. I remember Mr. Klaus from the Czech Republic commenting that he really didn't want to spend his time on the technical aspect of things. He thought that his time would be best used talking with groups, trying to convince them of the need for reform.

Technical Expertise

Reform requires a working group with a clear mandate, time, and relevant expertise.

The mentor in the reform process must possess some economic sophistication, or at least some basic understanding. If the minister of finance is a physician who has only taken care of patients and has never seen an economy before, there are going to be problems. Countries that have generally been successful in their reform efforts have had two or three major ministers with basic economic understanding.

Second—and this is very important because people do not pay much attention to it—reform requires a competent working group with a clear mandate, time, and some relevant expertise. One thing

I've learned is that the ministers are very busy. To expect a minister—on his own, maybe with his assistant, who also has a great deal to do—to deal with a major reform in addition to all his other responsibilities is a formula for failure. It is essential to have a group of three or four trustworthy, bright people, and that they be given the time and the mandate to spend all their time on planning the reform. Mr. Cariaga said the group in Bolivia worked for 20 days—I was surprised how short a time it took. This same group must not only formulate the reform, but also follow up with implementation. Many of these reforms will require solutions to many technical problems, and someone must be there to deal with that.

The group must have the total confidence of the mentor, who in turn must have the confidence of those higher up in the government, the president and the prime minister, and they must report to the mentor. He must listen to them, but the mentor himself should not spend too much time on details.

The development of transparent policy is also an important requirement. The question of transparency is of concern to us in the IMF. On theoretical grounds, an argument can be made against transparency. There has been a lot of literature on fiscal illusion, the importance of surprising, presenting hard medicine in a way that is palatable, and so forth. But I am not convinced of this. I think the best approach is to explain transparently what you want to do, to try to make the adjustment in a transparent way.

Finally, somebody has to worry about the details of policy. I share completely in what Bill Easterly was saying. One of the tragedies in this argument has been that it was easy to postpone certain expenditures—operations and maintenance—and then to spend the money for a project later on. Perhaps he should have added an even nastier comment. Some of this may have been done because bribes could be more easily obtained in a new project, but not in operations and maintenance.

There is always a great deal of conflict between the short-run result and the long-run result—again, the main point of Bill’s presentation, and a view that I share completely. To see immediate results—in the next three to six months—sometimes the wrong things are done, things for which the economy pays a high price in the next two or three years. We see this all the time.

The quality and the durability of fiscal action should be of concern, and this is a matter that has been of concern to me. The first time I wrote on this subject, about 12 years ago in the IMF, it created a bit of a storm there because people had never thought about it. But now I think these things are much better understood.

Supporting Institutions

If there is one thing I have learned in my work during all these years, it is the importance of institutions. One can plan all the reform one wants at the very top, but somebody has to carry out this decision. I have always argued that the institutions are the vehicles that carry out the policies. If the vehicles have no gasoline, or they are out of order, then it does not matter what decision is made at the top. We have seen too many reforms that have been planned at the top. Maybe the best experts in the world have been hired, but the reforms never go any farther because the institutions cannot carry them out. Here one encounters all the problems of principal agents—when the signal goes from the minister down to the tax administration, to the customs administration, to the budget office, what happens on the way? I think we should worry much more than we have about the process that allows these signals to become distorted by interference, such as rent-seeking at lower levels.

In other words, the executive, the top people, must have control over the fiscal tools. When they lose control of the fiscal tools, it doesn’t matter how much they plan.

The Importance of Fiscal Rules

Extrabudgetary accounts create a lot of problems. Decentralization creates a lot of problems. There is not the time for me to go into all the problem areas, but a few comments on fiscal rules are in order.

There is a great deal of interest in fiscal rules at the moment because of Maastricht and because some countries are planning to introduce them. In my view, if a country is serious about reform, it does not need a fiscal rule. Some of the major adjustments that have occurred in the past few years—in the United States, for example, and in Ireland, as Roberto mentioned—have taken place in countries that did not have fiscal rules.

In contrast, a country can have all the rules in the world, but if the institutions and the setup are not the right ones, reform will not work. Many Latin American countries have balanced budget rules, but the rules never have worked because they simply were ignored, or games were played to push things out of the budget.

If the institutions and the setup are not right, reform will not work.

I am still not convinced that fiscal rules can have sufficient impact in the long run. Over the short run, of course, in Europe we see the fiscal deficit coming down, but at the same time I see Italy—and, by the way, France and Germany—introducing all sorts of measures that I am not sure will improve the situation over the long run. But the deficit, in a measured sense, is going down.

Summing Up

Isabel Guerrero

I see six themes that have been mentioned by the panel. In addition to the issue of competency, transparency, and the issues already raised in the report on *Fiscal Management in Adjustment Lending*, I will go through the six.

The first, which has been pointed out by Vito Tanzi and by Juan Cariaga, is unqualified support from the top, a critical mass, a clear mandate. The second, which was raised both by Bill Easterly and Vito Tanzi, is that it's easy to have the illusion of fiscal adjustment in the short term. The third theme, raised by Roberto Peroti, is that political disruptions don't necessarily follow fiscal adjustment. The fourth, also raised by Mr. Peroti, is that successful adjustment does imply a decrease in the wage bill, at least in the OECD and Latin American contexts. The fifth theme is that successful adjustments are more likely with a strong government, or the reverse, which is that they are more unlikely with coalition governments. And the sixth, which has been raised by Vito Tanzi, has to do with corruption, rent-seeking, and the importance of institutions to carry out policy.

With that framework, I open up the floor for discussion.

Floor Discussion

Mr. Ramachandran, of the World Bank's South Asia Region, expressed the opinion that adjustment programs tend to be Bank and IMF programs, rather than programs of the countries themselves. He noted that many programs did not have the critical mass of support within a government—an essential element according to Mr. Tanzi—required for success. He also commented that frequent changes at the ministerial level argue against the continuity of commitment also emphasized by Mr. Tanzi. He suggested that the Bank assess the question of what can be achieved within a selected period of time, given the available institutions and the technical capability of the government, and that realistic targets be set accordingly.

In light of Mr. Penalver's presentation, Ramachandran also noted that well-conceived programs should limit capital expenditures while providing for as much nonwage current expenditure as possible, allocated according to a well-planned program that will support such important efforts as operations and maintenance, health, and education.

Question: A member of the audience requested that Mr. Tanzi and Mr. Easterly discuss a matter not covered in their remarks. He noted that the sustainability of deficits is related not only to expenditures and revenues, but also to the denominators—GDP and its growth rate. His point was that it is difficult to find systematic evidence for a short-run link between fiscal adjustment and growth rates, but that the sustainability of deficits is related to what happens to GDP growth rates immediately following adjustment and whether there are the supplementary policies embedded in the economy that ease the constraints imposed by adjustment and allow the economy to move to a high-growth path.

He noted that a high-growth path allows two things to happen: first, revenues increase, independent of tax effort, which is buoyancy;

second, it becomes much easier to implement the expenditure cuts when the rest of the economy is growing.

Now, in all the discussions, he commented, we really have not looked at what happens to the growth rate. We have some evidence that when growth rates were very high, programs succeeded. He pointed out that the evidence in some areas, such as in many African countries, shows that, with the initial reforms, the growth processes that were supposed to be almost automatic did not happen. Some of the more diversified economies, which had the capacity to switch from one policy to another without significant negative impact on output, probably had a better revenue base.

The participant also noted the importance of understanding where the countries are coming from. He pointed to the case of Zambia, which has had a 3 percent decline in per capita GDP for 25 years and an infrastructure that was built in a much earlier period. He asked that the discussion move from the subject of instruments to the most important element of success, which is what the growth rate is going to be and why it is that way, or why it is not.

Mr. Tanzi responded: First of all, we do know that higher fiscal deficits do not lead to higher rates of growth. We know that. We know that higher fiscal deficits lead to lots of problems—inflation, Cariaga would tell you. So that is one point.

But another point is that if one can influence the rate of growth, by all means one should do it. This ties in with my point that there are certain fiscal reforms that question the role of the state, and so bring lots of other change to bear—such as liberalization of the economy, reform in the labor market, reform in the exchange market, and so forth.

When fiscal adjustment is accompanied by this sort of reform, then probably a higher rate of growth will result, as it did in Chile, and

eventually the fiscal adjustment will be even greater. If one does not do those other things, but only fiscal adjustment and nothing else, then you might be right.

Mr. Easterly responded: I think the reason we do not talk a lot about what happens to the growth rate is that we do not know how to change it. There is a lot of evidence about what influences growth rates over long periods of time, on the order of decades, but there is very little that we know about how one can reliably increase a growth rate over the next three or four years. There is simply nothing in the economic literature that can give us any confidence that we know how to do that.

We do not really know how to increase a growth rate over the next three or four years.

So one is better off worrying about the fiscal, the numerator, and not counting on anything magical to happen in the denominator, because we do not know how to make the denominator respond to make things easier.

Question: A member of the audience pointed out the importance of looking at the details of both revenue and expenditure, and not only on the aggregations. The issue of how the deficit is financed—whether it's by printing money or through external grants, for example—makes a very big difference. His operational question, directed particularly to Mr. Tanzi, was whether the IMF will move a step beyond looking at the aggregates to consider, for example, a temporary increase in the deficit in order to stimulate growth if this is done in an efficient way, both on the side of expenditures as well as the side of revenues, and obviously with a view to the way in which this deficit is financed.

Mr. Tanzi responded: I agree that the composition of taxes is very important. I have spent a good part of my life fighting against export taxes, and so I have thought it an achievement that these taxes are on their way out around the world. I agree with that completely.

Question: A participant stated that he would like to elaborate a little bit on an aspect that has not received much attention—the time aspect of fiscal adjustment. He noted that the IMF has just done a study that looked at fiscal adjustment in eight countries, a sort of mix of the better performers and the weak performers, that reached two major conclusions. The first was that, in all but one of the countries, the initial fiscal adjustment—the way the deficit reduction was achieved—was exactly the same. These countries all cut capital spending, and they all cut expenditures on nonwage goods and services, particularly operations and maintenance.

But it was also found that the countries had no other choice if they wanted to get the deficit down quickly, because on the tax side the rates were already high, bases were narrow, but there was no tax administration capacity to administer more broadly based taxes such as value added taxes (VATs) and so forth.

On the expenditure side, he noted, we all know that reform of wages and salaries takes a great deal of time and can initially cost money. Similarly, on subsidies and transfers, it takes a long time to restructure public enterprises; subsidies can be reduced, but there is an initial cost to social safety nets. Two other forms of expenditure remain if one wants to have an initial adjustment: capital and nonwage goods and services.

The second conclusion, and what distinguished between countries that have successful fiscal adjustments and those that experience unsuccessful fiscal adjustments, is whether countries use this initial interlude to start aggressive reform: aggressively improving tax administration in order to bring in more broadly based taxes; aggressively starting a civil service reform in order to move toward a lower wage bill; and proceeding similarly on the public enterprise side. He noted that the study also found that when success is considered, it is judged on the basis of which countries had subse-

quent high growth. And the ones that did have high growth have all followed this sort of pattern.

He posed the question of whether we are too hard on countries when we say that, look, you have initially all cut back on capital, operations and maintenance, and so forth. What else can they do if they have to get the deficit down quickly? The real criterion, he noted, is how quickly can they start moving on these other aspects, because that will define whether they have a successful or unsuccessful fiscal adjustment.

Ms. Guerrero responded: The OED report actually finds that most of the countries that do fiscal adjustment successfully do it through revenues, through revenue increases. And it also finds that the successful adjustment does not happen in the first years, it happens after three or five years. So in that sense, the cutting of capital expenditures does not matter either way, except in the sense that Bill was talking about.

Most countries that use fiscal adjustment successfully do so through revenue increases.

The participant responded that successful countries also then reversed their initial capital spending cuts and cuts to operations and maintenance, because, of course, they had more revenues from these other reforms that they had done.

Mr. Easterly responded: The cuts in operations and maintenance and investment that we see in most countries are not just a matter of getting a year of breathing room. One sees a long, declining trend in operations and maintenance and in public investment extending over six, seven, or eight years, and that is what really gets the countries in trouble. So I think we wind up agreeing that whatever happens in one year doesn't matter all that much to the long-run future of the economy, but if there is a trend toward cutting operations and maintenance and investment as the main vehicle for fiscal adjustment, then the country is really unadjusting, not adjusting. It's just getting worse, not better.

Cutting operations, maintenance, and investment is not adjustment.

Mr. Picciotto responded: I think this particular issue should also be viewed in the broader context of adjustment more generally, and in response to some of the questions that have been raised, I would refer you to the second overview of adjustment that OED put together, as well as the social impact of adjustment. And this work brings out that, in general, fiscal reform as part of an adjustment program works, even in poverty reduction. But I also agree that there are some interesting outliers, particularly in Africa and some countries in Latin America. In these cases, the sectoral policies are very often crucial. Dealing with agriculture, in particular, is an intelligent way in which one can make a difference on the supply side. So adjustment is mostly fiscal, but it's not only fiscal.

As far as the question of ownership is concerned, I also refer you to an OED study that, again, tried to define ownership in operational terms; that is, where does the idea for reform originate? The issue is: Is reform Bank-centered or IMF-centered, or is it owned by the government, are we making a deal with a single minister or with the entire leadership, have vested interests been properly consulted and accounted for, and will we get front-end actions that reflect intellectual conviction?

If one takes account of these factors that define ownership, an operational ownership, one finds a very good correlation with successful adjustment. If we do our part in this, practice selectivity and take ownership as part of selectivity, then I think we will get significantly better results. Design is very important, but so is assessment of the political economy, which was the subject of this panel.

Mr. Tanzi responded: I want to make the point that there is a difference between operations and maintenance and investment. Some of the greatest waste I have seen in the world has come with investment expenditure. At the same time, it is very unlikely that

there will be a lot of waste when one maintains the plan already in place. So the point that Bill was making is strongly valid for operations and maintenance. It is less valid for investment.

Mr. Shah responded: While discussing the political economy of fiscal adjustment, I think we also need to look more closely at the aggregate burdens and benefits of the public sector. What is the role of the state? Is it the role of the state to command and control, or to provide services to the people? And in countries where it is command and control, one needs to look at the system of rent-seeking and bribes and corruption. In an example this morning, it was noted that public revenue was 18 percent of GDP in Pakistan. But if one looks at these other elements I mentioned, the effective burden of the state on the common citizen in Pakistan is close to 45 percent of GDP. So I think these prescriptions on revenue enhancement need to be looked at again in the context of what people receive in public services.

For example, in Pakistan, 87 percent of the consolidated expenditure goes to military spending and (from the federal budget) transfers to the provinces. The remainder is 13 percent, and public sector wages alone are greater than 13 percent. What is left to provide real services from the federal government is unclear.

What is left to provide real services?

If one takes this comprehensive view of the role of the state, in many cases, fiscal adjustment may require downward adjustments in both revenues and expenditures because the state is involved in many private activities, many rent-seeking activities, obstructing private sector development and the way the citizens want to participate in their own affairs. One needs to look at these issues in the context of political economy.

Question: Ms. Mona Haddad noted that she was a bit puzzled by the OED finding that sustainable adjustments were mainly the result of

increased revenue, because sometimes increased revenue allows the maintenance of a distorted role of the government by allowing it to sustain bad expenditures more easily. She asked that the panelists elaborate.

Ms. Datta-Mitra responded: If one looks closely behind what happened in these countries where revenue increases did take place, it turns out that they were not really so much the product of increases in tax rates, specific rates per se, but of improvements in efficiency: base-broadening, simplification of taxes, and rationalization of tax structures, which generally ensure an increase in efficiency.

Comment: A member of the audience noted that we think too much of the role of government in the context of the share of revenue in GDP, and of expenditure as a share of GDP. But there are many other ways in which the government plays a role in the economy—regulation, mainly quasi-fiscal activities. And so we should shift our emphasis from tax and spending to this whole range of activity.

A large part of the increase in revenue in some countries, he commented, has been simply a consequence of stopping inflation. In Argentina, the share of tax to GDP went up sharply when inflation was stopped. In Peru, it went from 4 or 5 percent to 13 or 14 percent. He noted that the increases did not come from reform of the tax system, but because macroeconomic conditions had changed.

Question: A member of the audience raised the broad question of the political context of adjustment. He noted that adjustment is often undertaken in crisis conditions, and consequently the focus is on reduction of the fiscal deficit in the short term. He asked that the panel say something about the context in which needed structural reforms can be undertaken and offer examples of how it might be successfully introduced in a noncrisis context.

Comment: A participant noted that the results of the OED study are very similar to what *Bureaucrats in Business* found, as well as what the study of the social impact of adjustment found: social expenditures are sometimes cut, but what really has been cut very deeply (and this is Bill Easterly's point) is infrastructure. The impact of this kind of fiscal adjustment on growth is not yet known. The speaker continued that the role of the state is clearly the issue, and that a great deal of work remains to be done to change that role.

Mr. Tanzi responded: The point you have raised is clearly a very important one because to have really good fiscal adjustment takes time. So if an economy is in the middle of a crisis, and if the horizon of ministers is six months, and they are negotiating a program with the IMF, what counts is what can be done in six months, what results can be shown in six months.

The reforms that have been successful over the long run may have started in a crisis period, but they have been associated with governments that were in power for a certain period of time. I think that when Menem made the famous speech in Argentina that he was going to perform surgery without anesthesia, the inflation rate was 60 to 70 percent each month—not each year, each month. But then he was there with Cavallo for four or five years. In Chile, there was a government in the middle of a crisis, but then Pinochet provided the continuity. This is where the reforms have been successful. If the government tries to do a lot of things, but six months later is replaced, it is much less likely that the reforms will succeed.

Crisis is needed
to create
mandate for
change.

Ms. Guerrero commented: We had a seminar with OED on listening to the policymakers that had undertaken adjustment. I think they were quite unanimous in saying that a crisis was necessary in order to gather the political will and the mandate to make changes, because the crises demonstrated that things could not continue as they were.

Session Two: Incentives and Outcomes in Fiscal Adjustment

Mr. Picciotto introduced the moderator for the second panel of the seminar, Shanta Devarajan of the Policy Research Department of the World Bank. The panelists included David Sahn, professor of economics, Cornell University; Elliot Berg, professor, University of Auvergne, Clermont-Ferrand; Michael Gavin, research economist, Office of the Chief Economist, the Inter-American Development Bank; Anwar Shah, principal evaluation officer, Operations Evaluation Department; and Salvatore Schiavo-Campo, manager, Public Sector Management Team, the World Bank.

The Effect of Fiscal Reform on the Poor in Africa

David Sahn

In my remarks I will draw primarily on my more recent experiences in Africa, both because my knowledge of that region is greater than elsewhere and because the issue of achieving and maintaining fiscal balance is arguably not only the most elusive, but also the most vexing of the policy issues raised by the tension between the need to move rapidly toward fiscal discipline and the acute need to maintain expenditures for both infrastructure and human resources. I will also focus my remarks on the issues of welfare and income distribution, not issues of macroeconomic management.

Distributional Consequences of Fiscal Adjustment

I think the major question that was absent from the OED study of fiscal adjustment, which was the impetus for holding this meeting, is the issue of the distributional consequences and implications of fiscal policy. Most forums that address the issue focus primarily on the expenditure side of the equation. Rarely, particularly in developing countries, is much attention given to issues of tax incidence. If one looks at the detractors of the role of the Bank and the IMF in developing countries—the great critique of adjustment policies harming the poor—I rarely hear people say, well, the poor got hurt because taxes went up or the poor got hurt because there was a change in the sources of revenue. We hear quite frequently, of course, that the poor get hurt because social sector expenditures decline and poor babies no longer have access to good health care, young children no longer have access to government schools, and so forth.

But if one looks at the reality confronting the poor in developing countries, particularly in Africa, some of the most harmful dam-

age—both in the overall growth consequences of bad fiscal policy and the deleterious distributional consequences—has been on the revenue side. And those, of course, are primarily in the form of trade taxes. So I think we need to keep a close focus on the tax side as well as the expenditure side.

The absence of fiscal retrenchment in government.

One of the most remarkable things about Africa's experience over approximately the past 15 years, since the beginning of adjustment operations in the early 1980s, is the absence of fiscal retrenchment, the absence of any sort of discernible belt-tightening or contraction in the size of government. And in large measure, that is attributable to foreign exchange inflows from institutions such as the World Bank and the IMF.

The reason I would argue that this has generally been for the worse is not because the size of government necessarily is too large, but because the nature of government's involvement in the economy is misdirected. That nature goes beyond the normal kinds of complaints or the liturgy of concerns over the role of the state in Africa—excessive defense spending, bloated bureaucracies, corruption, and so forth—and filters down to the actual incidence of expenditures within the sectors that one would have expected to help the poor or to help promote development, both by promoting growth and empowering the poor to participate in that process.

The Incidence of Expenditures and Taxes

When one approaches the incidence questions—essentially, who is benefiting from public expenditures—it is an extremely difficult proposition to assess incidence analytically, particularly for expenditures that have large public goods content, such as expenditures for defense; law and order; and, to some extent, certain types of infrastructure.

The issue becomes a bit more tractable when one looks at the incidence of expenditures for social services, public sector wage payments, and transfers in the form of pensions, social security, child payments, child allowances, and the like. What I would like to share with you is that the experience from Africa—in contrast to what we find in the Caribbean region and in much of Asia, and to a lesser extent in Latin America—is extremely disconcerting and suggests that the maintenance of social sector spending should not be an objective in and of itself, given how those expenditures are allocated.

The poor benefit very little from public expenditures.

The bottom line is this: if one looks at the composition of transfers, wage payments, and social sector expenditures, for the most part the poor are very minor beneficiaries of these kinds of government expenditures. Most of these expenditures are aimed toward the betterment of the elite or the urban, politically empowered, and the poor rely largely on private services, particularly in health and education, but also on transfers. There is an enormous amount of private transfers in African economies; there is also a large amount of public transfers, but transfers that benefit the poor are primarily limited to the private sector.

At the same time, if one looks at the levels or distribution of wage payments, whether in the form of public sector wage payments to government workers or people engaged in parastatal organizations, the poor are virtually excluded as beneficiaries of these expenditures.

Unfortunately, the analytical work that needs to be done to look at some of these questions is often not done. With the growth of the availability of household survey data, one can go a long way in looking at the distributional incidence of social sector spending. I am just going to give a few examples from some of the work that we are doing in this area.

When one looks at the concentration curves for public and private health services throughout Africa, the general pattern is that most government services are not only poorly targeted but largely benefit people at the upper end of the income distribution. The two exceptions are spending for primary education and certain types of primary health care.

One can see from the distribution of various services delivered both by the private and the public sector in Madagascar, for example—and this is somewhat typical of what occurs in half a dozen other African countries—that quite often what we call *other public services*, which are essentially primary health care services, are quite well-distributed in most African countries, in contrast to public hospitals and certain types of private care.

Again, in Côte d’Ivoire, the data suggest that primary education represents a well-targeted type of intervention, while secondary education and tertiary education are much more poorly targeted.

The problem is that if one looks at the allocation of the budgets in the health and the education sectors, in general, primary health care and primary education represent a relatively small portion of the total budgets. So if one looks at the overall incidence of expenditures, even within the social sectors, the poor receive, on average, on the order of only 5 to 10 percent of total expenditures. That is to say nothing of the other sectors, where it would be expected that the poor are lesser beneficiaries.

The same kind of analysis, looking at tax questions, and also done in Madagascar, found that many of the excise taxes—these are automobile excises—are quite progressively targeted to the nonpoor. To sum up this body of research, it was found that, with the exception of trade taxes, most taxes in Sub-Saharan Africa are quite progressively targeted (the other main exception is the tax on kerosene). Taxes that

Higher tax revenues go with increased progressivity of taxation.

people often think are not going to be quite as progressive, such as the VAT and taxes on gasoline products other than kerosene, are actually quite progressively targeted.

In the countries that have made successful efforts at increasing their tax revenues, such as Ghana and Uganda, not only have the overall levels of revenues increased, but the progressivity of taxation has increased as well.

Intersectoral Allocation of Public Spending

To reach some closure on these points, I think we generally find that in most African countries there has been very little progress in changing both the overall level of spending and the intersectoral allocation of spending. Moreover, despite the numerous adjustment operations, there has been very little change in the incidence of public expenditures. These seem to be very resistant to change at any level, despite the considerable rhetoric to the contrary from critics of both adjustment and the role of the Bank and the IMF in fostering changes in fiscal policies.

For the most part, it is difficult to conclude that very much of government spending, as it presently is configured, is worth maintaining. What is required is not incremental change, but drastic and dramatic changes in how spending is allocated, both among and within sectors. In the absence of dramatic and rapid changes, all of our work strongly suggests that the poor in particular, but the economies as well, would be far better off if there were a quite dramatic fiscal contraction in most African countries, because the major gainers would be the poor. They would see increases in their earnings and incomes and would experience very little loss in valuable services. Conversely, of course, the urban middle- and upper-income households would be the big losers on both counts.

The Practitioner's View: The Process and Instruments of Reform

Elliot Berg

I am going to focus on expenditures, and mainly on the low-income countries, particularly in Africa. I will also speak from a somewhat different perspective than most of the others who have spoken to you this morning, from the perspective of a practitioner. Not much of a practitioner, I hasten to add, but I have actually run two budget reform projects at various points in my career—both of them, I must also say, failures—and have done a lot of evaluation of expenditure reform programs.

Failure of Fiscal Reform

From a practitioner's point of view, there are four or five points that are striking about the discussion so far and about the report itself, which is the original stimulus of the panel. The first surprising point is the rather astonishing sangfroid of the discussants. We have in expenditure reform one of the great failures of the World Bank. After all, there are more than 219 projects in 83 countries. There are over 50 public investment programs (PIPs), public investment reform programs. There were, at last count, 115 or 113 public expenditure reviews. And whether one looks at the measures of output that are harder, such as changes in levels and composition of expenditure, or, much more difficult, attempts to seize the intangibles—whether the budget process has improved as a result of all this money and all this activity—the almost universal opinion is that there has been extremely little positive impact. So we have here a major failure in World Bank programming.

Expenditure
reform—a
major failure.

I say World Bank programming because, as someone earlier mentioned, the World Bank is the architect, with the IMF, of almost all of these programs. The ideas have come from inside this building; the people who executed and crafted most of the reforms and who have implemented and supervised them for the past 20 years or 15 years have come from inside this building.

Sources of Failure

The second surprising point is the discussion of the sources of the failure in our efforts at public expenditure reform. Everybody agrees that we have not done very well. Some people say it's a catastrophe. Some people say it is just not up to expectations. But the discussion about why this failure has occurred tends to focus on some rather unexpected items. Few people mentioned what Vito Tanzi did this morning, which is that budget reform, expenditure reform, is extremely difficult to do anywhere in the world.

But the major source of failure seems to be analytic. Many people comment that the analytic foundations of the reforms were poorly constructed. We had considerable discussion by Manuel Penalver and the report itself on the poor definition of the deficit. Of course, to someone who has watched people work on crafting a public expenditure reform program, that has to be a most unkind observation. Most of these people are out there, with their heads barely above water, and usually in unmanageable circumstances. To think that they should be able to grab hold of municipal or noncentral government and parastatal spending—and not only that, but also do projections of sustainable expenditure estimates—represents an extremely unrealistic view of how these reforms unfold or have unfolded. The analytic deficiencies are minor compared with others.

Bill Easterly pointed to a behavioral explanation when he talked about the illusion of fiscal adjustment. It does not take much shift in

assumptions to make Easterly's illusory adjustments quite rational. All one has to do is to have a heavily aided country, in which case governments know that they can let maintenance go because sometime down the road the chances are much better than 50-50—they are probably closer to 80-20—that a donor is going to pick up a major road rehabilitation project. And if one looks at any PIP, the second point is that capital expenditures are cut, giving up high returns, present returns, and future projected returns for present consumption.

Anyone in this room who has ever looked at a PIP knows that even after six or seven or eight years of cutting, a third of the items in that expenditure program can be cut without much effect on output. There are extensions of electricity grids to rural areas because that's the social policy of government. There are roads being built to somebody's farm. There are all kinds of projects that have to be judged to be of low priority, even at this point. And so the cutting of those projects is not such an irrational or illusory means of fiscal adjustment.

Where to cut
and how
much?

Instruments of Fiscal Reform

The third surprise in the discussion and in the report is that there is no discussion of the Bank's role as chief architect, and there is little discussion of process and instruments.¹

We have used three main instruments on the expenditure side in fiscal reform: civil service reform; public investment programming, the introduction of three rolling PIPs everywhere; and a more informal but omnipresent public expenditure review that brings together donors to look at total public spending in the client countries.

I will not talk about civil service reform. I think by and large the numbers are clear that this has had an extremely slender impact.

But let us look at PIPs, a favored instrument of the Bank for 15 years. What went wrong with PIPs? First, there was a conceptual problem that was never resolved: what do you put in an investment program? In the early days everybody tried to protect high-priority expenditures. The question was how to save good projects and good spending from the budget ax that would fall across the board when expenditures were cut.

And so a development budget was created that might only include projects supported with foreign aid, the presumption being that they were more carefully selected. But after a while, it became clear that there were a lot of recurrent items that were of high priority, and so foresters' salaries, schoolteachers' salaries, and the like began to find their way into PIPs.

What went wrong with PIPs?

In the end, as a result of dual budgeting through the PIP, there was looser budgeting, less fiscal discipline, and less careful selection of expenditures in a great many countries. It's easier to get an appropriation into the development budget in most countries than it is to get it into the ordinary budget, because procedures are less well defined. This problem has not been resolved to this day.

The second problem is that there was a conflict throughout, and there still is, between comprehensiveness and reform. If we wanted to reform public expenditure, public investment spending, we should have concentrated on the crucial and more expensive items. In many countries there was an ongoing conflict between a PIP that included all projects, including technical assistance projects, and one that tried to concentrate, for example, on those amounting to over \$5 million. That battle was never won; most public investment programs I know of still include everything.

The third thing that went wrong with PIPs is that the project selection process did not improve significantly, in part because the

budget reform came in under the umbrella of an adjustment, a conditioned lending program. Monitoring devices and conditionalities were introduced, which tended to become quantitative as things evolved. For example, the classic case is that 80 percent of projects included in the PIP should have at least a 10 percent internal rate of return. Well, anyone who has ever sat in an office watching how that process is done has to know that something went dreadfully wrong, since nobody ever looked at any of the input data. Nobody ever looked at any of the output, of the benefit projections. Everybody ran up a simple program with a little calculator and found a 10 percent rate of return. And so that process did not improve the quality of project selection.

Finally, the PIP was a great idea for one major reason. It gave planners and people charged with overseeing responsible public spending a chance to discuss elements in the investment program with the spending ministries. It offered a chance for delay, although in most countries that was not exploited. It would have been possible to put a program or project that merited argument with the technical ministries in the third year of the program. But in many countries, once it was written, the PIP was regarded as practically law. In some countries—the Francophone countries in Africa, for example—it *was* a law that was passed by the legislature. In this way, the opportunity to recast a third-year program in the light of cooler analysis was lost.

My only comment about public expenditure reviews is that 113 were done, and of those, there were only 3 up to 1993 that included local participation. There was never any local ownership of this process; instead, it was always regarded as an audit, a way for donors to find new conditionalities. The public expenditure review has never found a home in the countries that have been subject to such reviews, and it has not been fundamentally changed.

There was no local ownership of the PER process.

Time to assess
the values of
conditionality?

The final surprise is that, when the reform effort in this field is reviewed, one would expect certain conclusions to be drawn. One of these might be greater modesty. Another might be to question the utility of conditionality, since the report and most other studies do not show that conditionality yields a great deal. One might think that we would consider separating reforms of the institutional kind from conditioned lending. There are a lot of other ideas we also might think about, but what we have on the table, as far as I can tell, is more intensive intrusiveness, more analytic work, and greater conditionality. And these do not seem likely to get us very much further in expenditure reform.

¹ These issues are analyzed in a follow-up OED study, *The Impact of Public Expenditure Reviews: An Evaluation* (forthcoming).

Fiscal Outcomes in Latin America

Michael Gavin

I would like to discuss some lessons from a set of research projects that have been under way in the Office of the Chief Economist of the Inter-American Development Bank (IDB) for the past two-and-a-half years, but primarily from work that I have done with Roberto Perotti quite recently.

Roberto and I pulled together a data set of fiscal outcomes in Latin America, and the first thing we decided to do was have a look at the data the way a Martian might, and simply ask, from a crude look at the data, what stood out. What is obviously different about fiscal outcomes in Latin America? Are governments bloated? Not really. This is not to deny that they might be inefficient and that important restructuring is required. But if one looks, one sees that governments in Latin America are about half the size they are in the industrial countries.

Are deficits big, on average, over long periods of time? Well, once again, although one must qualify this—yes, they are big relative to the size of the domestic financial system. Yes, they are big relative to government's tax capacity. But in relation to the size of the economy, over a two-and-a-half-decade period, they look quite similar to the deficits that one sees in the industrial economies.

Fiscal deficits are more volatile.

So what is strange or surprising about fiscal policy in Latin America? The first thing that jumps out is the volatility of fiscal outcomes. Fiscal deficits are two to three times as volatile in Latin America, measured as a share of GDP, as they are in the industrial economies; they are five to ten times as volatile, measured as a share of the tax base or measured as a share of the domestic financial system. This, we would argue, indicates the procyclicality of fiscal outcomes in Latin America.

We simply regressed the change in the fiscal deficit measured as a share of GDP on a number of measures, including real GDP growth. In the industrial countries, there is a strong positive relationship between output growth and realized fiscal deficits. An amount on the order of 35 cents of every dollar of increased income shows up in an increased surplus in the short run. In Latin America, the point estimate is zero, and one cannot reject that there is no effect of output growth on the deficit. What that means is that when output increases, the extra income that accrues to the government gets spent. When output declines, the loss of income results in sometimes brutal reductions in the real value of total spending.

Deficit Bias and Procyclicality

The evidence is even more striking if one distinguishes between what we call good times, which are times of normal growth, and bad times, which are times of slow growth. A bad time is when output growth is less than one standard deviation lower than that country's average rate of growth. So think of it as recession. In the industrial countries, the impact of a GDP shock or an output shock to the surplus is particularly large in bad times. Big recessions are accompanied by large countercyclical movements, stabilizing movement of the deficit. In Latin America, we see just the opposite. In good times, there is some evidence that the surplus tends to increase along with the business cycle.

What might explain this procyclicality, especially in bad times? What the evidence indicates is that, during bad times, some kind of shock hits the tax base of Latin American economies, and it creates a fiscal gap, which in turn creates a panic, and governments lose access to the financial markets that they need to finance a stabilizing fiscal policy.

This results from some kind of a combination of deficit bias and procyclicality. We have looked at deep recessions. A deep recession

in Latin America is when output falls by at least 4 percent; in the industrial countries, by 1.5 percent. In the industrial countries, the total fiscal surplus moves roughly one for one with the change in output growth. In Latin America, there is nothing like that. There are many episodes of deep recession that are accompanied by a movement into fiscal surplus. This is a combination of volatility in the tax base and deficit bias that we argue accounts for the procyclicality, and we have some direct evidence that it is the case.

We have distinguished not between good times and bad times, but between times when countries go into a period with a high deficit—we've arbitrarily defined it as 3 percent of GDP—and times when governments go into a period with a low deficit, which is smaller than 3 percent of GDP. In the industrial countries, the distinction essentially does not matter. Their fiscal policy doesn't seem to be affected by this vicarious creditworthiness. In Latin America, however, there is a big difference. Countries that enter a period with a low initial deficit have a countercyclical fiscal response to output shocks; countries that go into a period with a large fiscal deficit have an average procyclical fiscal response to output shocks.

What institutional arrangements can reduce deficit bias and permit stabilizing fiscal response to bad times?

Institutions and Instruments

If the problem is this combination of volatility and deficit bias, the question becomes what to do. Mere exhortation or scolding is not enough. The question becomes whether there are institutional arrangements that can alleviate the problem of deficit bias, and thereby permit a more stabilizing fiscal response, especially to bad times.

In Latin America and elsewhere, one popular institution for this purpose is the fixed exchange rate regime, which arguably ties the hands of fiscal policymakers. We've put together some evidence on whether such regimes work in Latin America, and we found that the answer seems to be a strong *no*.

We constructed a dummy variable that is “1” under a fixed exchange rate and “0” under all other arrangements. We have a fairly strict definition of what a fixed exchange rate regime is. The surplus tends to be systematically lower—that is, the deficit tends to be bigger—when countries are operating under fixed exchange rate regimes. Our estimates are from 1 to 3 percentage points larger under fixed exchange rate regimes than under flexible exchange rate regimes. This does not mean that the fixed exchange rate regime is causing the larger deficit, but it certainly is evidence against the idea that simple implementation of a fixed exchange rate regime or currency board will solve the problem.

In work done by my colleagues in the Office of the Chief Economist (IDB), we looked at whether fiscal institutions bear any relationship with fiscal outcomes. The index of fiscal institutions used is essentially a qualitative measure of the strength of agencies of restraint. For example, if the finance ministry is relatively strong compared with the spending ministries, the index would be higher. If the executive is stronger than the congress in budgetary matters, the index would be higher. Then we found that there is some evidence that institutional reforms that strengthen this budgetary index are associated with better fiscal performance. Not only average deficits, but also the countries with better fiscal institutions, by this measure had less procyclical fiscal policies as well.

My message is a qualified optimistic one, that something can be done to improve fiscal management in the countries that we worry about, but that to do so one is going to need to focus on fiscal behavior during good times, because conservative fiscal policy during good times is what is required to permit the counterstabilizing fiscal response in bad times. That means, first, that conditionality is unlikely to solve the problem, because governments do not need conditional lending programs during good times. Second, it is going to be a politically difficult matter to achieve this, because it is very difficult to tell populations that when times are

good, the money should not be spent. What is required is institutional reforms that change the rules of the budgetary game, the terms of the fiscal debate, including such things as mandatory multi-year budgeting and the like.

We currently have a program under way that will be a little bit of a natural experiment, or a not so natural experiment, in Venezuela. Under a technical cooperation agreement, we have set up centralized institutions—one in the Congress and one in the executive—that are charged with responsibility for making multi-year forecasts. Before any law is passed, these institutions must give it a fiscal bill of health, that is to say, must provide multi-year estimates of what the law will cost. Maybe five years from now we can sit down and find out whether Venezuela's fiscal ills have been helped by this approach.

Public Expenditure Reform and Bank Conditions on Adjustment Lending

Anwar Shah

In most expenditure categories, World Bank conditions have targeted expenditure and public sector employment levels. Such targets may invite accounting responses—accounting changes and the shifting of departmental resources—rather than improvements in the delivery of public services. I would like to outline a few examples where conditions on outputs would have helped to improve the effectiveness of Bank lending.

Education and Health, Safe Water, and Nutrition

Educational programs to teach poor or rural households about safe practices are effective.

The Bank, and donors in general, have focused on the role of health and education services as necessary foundations for economic development. Donor efforts have sought to improve indirect measures of public sector efficiency, such as the number of teachers or allocations to nonwage operations and maintenance, rather than direct measures of public service delivery, such as literacy and mortality rates. It would be more effective to mandate an improvement in outcomes and to provide guidance on possible ways to achieve the desired results. In education, for example, mandates for improvements would include raising primary enrollment rates in the short run and a reduction in illiteracy rates over the longer term. In health, mandates would include reduced infant mortality rates in the short run and increased longevity over the longer term. Such targets would create the incentive needed for governments to reallocate funds across activities.

Ancillary activities to improve sanitation and health need further encouragement. Activities such as educational programs to teach

poor or rural households about safe practices have proven effective and should not be overlooked. In Bangladesh, for example, a project to increase the use of safe water combined the distribution of hand pumps and latrines with hygiene classes, resulting in significant improvements in public health.

Alternatives in the improvement of nutrition have not been explored, and conditions have not dealt with the problems of improving the private supply network or encouraging the design of educational programs to develop nutritious eating habits. To reach the objective of greater nutrition for the poor, the Bank needs to expand the scope of its advice. Program design should be emphasized, rather than simply broad subsidy cuts. Education programs and technical assistance to the private sector are options that could be explored.

Civil Service Reform

A major difficulty in Bank-sponsored reductions in public employment has been that these reductions did not address the realignment of the role of the public sector. A closer examination of public activities would have suggested deeper cuts in areas where the public sector was involved in a private sector role, or in roles detrimental to an effective public sector, such as national planning, while strengthening public roles in justice, basic education, and health. Further, Bank conditions did not address the appropriate roles of various levels of government, which has implications for public employment and wages. Thus, while Bank conditions were well-intentioned, they may not have contributed significantly to the enhanced effectiveness of the public sector.

Bank conditions that reduce subsidies have mainly been imposed on smaller countries.

Subsidy Reductions

Despite the potential short-run efficiency gains of conditions that reduce subsidies, Bank conditions have primarily been imposed on

smaller countries. Sri Lanka, for example, faced a condition to eliminate, and not reinstate, subsidies for rice, wheat flour, fertilizer, and transport. India, the Bank's third-largest borrower, has not faced Bank conditions to reduce or eliminate any subsidies. The adoption of worldwide standards for subsidy reductions would help to strengthen the negotiating position of the Bank and would encourage a stronger determination among developing countries to undertake fundamental reforms.

Private Sector Participation

The private sector may be willing to assist the public sector in the provision of some public services, permitting expanded access to such services. In general, Bank conditions could encourage such private sector participation, especially when a country's public sector is not reaching important segments of the population, such as rural residents. The supportive role of the private sector in retraining for employment has also received inadequate attention. This would be important in integrating the poor into the private market.

Governance Issues

The institutions of governance in many developing countries do not allow the matching of public services with the preferences of citizens. Frequently this is because the political and bureaucratic system favors narrow special interests over the common interest. Political and bureaucratic power in some countries may be vested in certain groups. Such vestiges of power may block the incorporation of citizen preferences into public decisionmaking. A lack of transparency in public sector decisionmaking processes, as well as corruption, compounds the problem. The lack of transparency, accountability, and the rule of law encourages the creation of a web of bureaucratic processes and lowers bureaucratic incentives for efficiency.

Dimensions of Fiscal Federalism

In the multi-tier structure of most governments, it is important to clarify the taxing and spending responsibilities of various levels of government and their respective roles in areas of shared responsibility. In developing countries, ambiguity in such roles leads to duplication and overlap, as well as the total lack of provision of certain basic services. In addition, higher-level government often encroaches on the roles of lower-level government. In this multi-tier structure, it is usually not possible to match perfectly the revenue means of the different levels with their expenditure needs. Transfers thus assume an important role in ensuring regional fiscal equity, bridging fiscal gaps, ensuring minimum standards, fulfilling the redistributive function of the national government, and preserving an internal common market. In developing countries, inappropriately designed higher-level transfers contribute to fiscal mismanagement. A striking example is deficit grants in China, India, Pakistan, and Sri Lanka, which led to increasing subnational deficits during the late 1980s. A typical developing country also has many specific-purpose grants for which objectives are either not specified or quite vague. For example, in 1988, Brazil had 5,000 *convenios* with unspecified and vaguely specified objectives. These issues have not been addressed in the adjustment lending programs.

Instruments of Reform

Salvatore Schiavo-Campo

At the close of these very stimulating and interesting presentations, I would like to come back to the question of instruments, and move away from the issues of policy that have been so ably summarized. I take my lead both from Elliott Berg's points—hard-hitting, but I think largely quite valid—and from Anwar Shah's point about the importance of institutions and the price that is paid when they are disregarded.

Tax Administration

There is a high risk for poor countries in following a supply-driven approach to information technology.

Let me address three basic issues. The first is tax administration, which has only been touched on briefly. I want to mention only one aspect. It is clear to all of us that in the absence of a reasonable revenue base, appropriate public expenditure management, let alone fiscal policy, is impossible. My more recent experience has been largely in Eastern Europe and the former Soviet Union, where the dramatic collapse of revenues, particularly in the latter, has made budgeting a sad joke, and where the key method of financing is through arrears. This carries all the costs of inflationary financing plus the additional cost of destroying the credibility of all government institutions, because revenues relative to GDP are now perhaps 15 to 20 percent in real terms, and that is optimistic, of their level of five or six years ago. The clear priority is to pay attention to tax administration in both the aggregate and the distributive aspects.

I would like to underline the specific connection between information technology and tax administration procedures. I mention this because, again, particularly in Europe and Central Asia, but elsewhere in the world as well, we have seen the substantial costs and the dangers of looking at the user side of technology separately from the technical side, and hence the importance of an integrated treatment of the two sides. You do not have to feel that Bill Gates is the Satan of

the twenty-first century in order to understand the dangers of a supply-driven approach to information technology for poorer countries that cannot afford mistakes.

I would suggest that the major risk of looking at information technology in tax administration exclusively from the technical side is the computerization of inefficiency. Not paying attention to the procedures—to the basic rules by which taxes are administered, collected, and so forth—simply means mechanizing, automating, very inefficient and inequitable procedures. That can hardly be called progress, but we have seen it happen in several cases.

On the other side, if the phenomenal positive potential of information technology is not understood, and if tax administration and information technology issues are left to the economists, to the users, reform attempts are very timid and ineffective. At the same time, technical solutions can breed technical problems that mushroom if informatic solutions are advanced piecemeal by persons without the requisite technical knowledge. We have seen even in the United States, where enormous human and technical capacity exist, that attempts to modernize the informatics of the U.S. Internal Revenue Service have been a spectacular failure.

Solutions can generate problems.

Public Expenditure

On the expenditure side, I will start with a modest and humble suggestion that fits Elliott Berg's advice about modesty. All those engaged in international assistance have a long history of disasters and problems caused by heavy-handed external intervention without sufficient thought beforehand. This is perhaps especially true in the management of public expenditures. We don't have to go back to program budgeting in the 1960s, in the Pentagon sense, and the shambles that this approach brought to the accounts of a number of developing countries, which were rudimentary but could at least be

understood and read. I think we are all familiar with what can happen in these cases.

It is also useful to remind ourselves that external agents do tend to be vulnerable to fashion at times, especially when there is a very large and very robust international consulting network that is always looking for new things because new markets are the avenue to new profits. It is perhaps important for us to think of ourselves as having a different sort of fiduciary responsibility, not only for the monies that are provided to us by our contributing countries, but also to protect our clients from rash innovations that may leave them worse off than when they started.

Another consideration, of course, is that these are extremely complex issues, in part because they depend largely on informal rules and habits, on informal institutions, and they generally should be approached with great caution, and always with a cost-benefit view in mind.

Let me very briefly touch on Elliott Berg's points about public investment programming (PIP). Elliott might not remember, but some 13 or 14 years ago, we had a quick conversation in Madagascar, when I asked, "What is this stuff about PIPs? What is this big fat document? What good does it do?" (You will have to forgive me—I was with the IMF at the time. I did not understand the importance of such things.) And Elliott explained to me, very convincingly, all the advantages of a PIP. He was right then, and I think his points remain valid today. At the same time, most of us would agree with him that the practice has been vastly, vastly different from what could have been the positive uses of this instrument.

If you will allow me a personal reference, after several attempts to explain to the Minister of Planning of Somalia—this was a long time ago; it was a different Somalia—the importance of including recurrent cost calculations in the decisions about investment, he

finally lost his patience and took pity on me, explaining that a project had achieved its purpose the moment it was completed. And then I understood.

So there is really no gainsaying Elliott in the practical criticisms. At the same time, there is a great danger of throwing the baby away with the bathwater, and we do know that whenever we are looking at some unpleasant realities, we ought to keep in mind what the counterfactual may be. We do know that before PIPs were invented, we had many more white elephants than we have today. We do know that even though we focus on the deficiencies, weaknesses, and wastes of investment expenditures in any number of countries, a fair examination of current expenditures will show much more serious examples, particularly in subsidies, although the distributional aspects are probably even worse.

I'm not saying all this to try to rescue PIPs from valid criticisms, but to say that it is useful for us to try to strengthen an instrument that has had some positive effects, and can have many more, rather than to declare the battle lost and go home, to paraphrase inversely Senator Aiken's prescription about Vietnam a long time ago.

The next point has to do with the new public management, as in Australia and New Zealand. The institutional and capacity requirements for such reform are extraordinarily heavy. For most developing countries, they cannot possibly apply. What we are talking about in performance-oriented budgeting is a shift from input controls to either output or outcome controls. This is possible only if there is an ironclad, efficient system of input controls in the first place; otherwise, it is tantamount to giving away the store, especially in many of the countries that are familiar to us. Moreover, even if very strong cash management systems are in place, with good compliance, auditing, and other mechanisms, without a minimum amount of human capacity and healthy governance in the country, a move toward performance-oriented budgeting must be looked at with

Even with strong cash management systems, good compliance, and regular auditing, without healthy governance, performance-oriented budgeting is to be approached with extreme caution.

enormous caution. Such a move may be extremely positive in Australia, New Zealand, Canada, or the United Kingdom, but for the Mauritians and the Cambodias of the world, it may be counterproductive.

Let me conclude with my own personal suggestion of how to view the debate between output orientation and outcome orientation. The advantage of an output orientation is that there is greater accountability about a narrower objective because outputs are better defined, they are less dependent on external forces, and they typically come to fruition in a shorter period. Outcome orientation, in contrast, has the advantage of greater relevance, but the disadvantage of looser accountability, because almost anything can be justified under that rubric.

My suggestion is to get away from this dichotomous discussion and to think in terms of the specific country, sector, and even expenditure in question, and to think of a rule that performance ought to be measured according to the mix of outputs and outcomes that are relevant to the specific country and sector under consideration.

Floor Discussion

Following the completion of the final presentation, Mr. Devarajan opened the floor for questions and comments.

Question: Mr. Mohsen Fardi, of the Policy Support Unit in the Corporate Secretariat, directed his question to Elliott Berg. Given the realities that Mr. Berg portrayed, he asked, how should one go about doing public expenditure reviews, particularly in light of this lack of ownership and analytical structure and given the short-term interests of the staff and the mission?

Mr. Berg responded: Frankly, I would not do public expenditure reviews. The environment is not right. The public expenditure review is regarded by all of the actors, at least in the host country, as an exercise designed to root out expenditures that, for political or historical reasons, they think are important, but outsiders do not. That has got to be a conflict situation. Not only that, we on the outside do not have all that many instruments. I do believe that one can have a dialogue about the really big white elephants and perhaps have some effect.

Question: Mr. Ramachandron, of the Bank's South Asia Region, noted that past adjustment programs did not reduce the size of the state sector, but that this was not their objective. Instead, the goal was to optimize and maintain levels of public investment. This idea of the private sector versus the public sector is a more recent development. He added that it is easy to say that the government must get out of areas where the private sector can come in, but in practice the government would argue that the private sector is not forthcoming.

As regards the participatory aspect mentioned by Elliott Berg, Mr. Ramachandron noted that many have tried to involve governments in this exercise, but the technical capacity within governments is still lacking. On Mr. Berg's point about the usefulness of deciding, he commented that there are sometimes conflicts, a tension among the different ministries, and that the public expenditure review is a very

useful instrument in strengthening the hand of one agency against another. Because of this role, Mr. Ramachandron expressed the opinion that it should be retained.

Comment: A participant noted that public expenditure reviews have negative effects, among them the undermining of the general credibility and acceptability of reform.

Mr. Berg responded: I wonder if it would not be better to try to approach public expenditure reviews from the back door, to define a certain amount, a size of “black box” that is considered acceptable, because people in power will need some financial discretion, whether it is in this country or anywhere else. Second, this would allow one to be sure that the largest inefficient, lumpy expenditures are not undertaken and that certain expenditures with particularly high rates of return or good distributive effects are at least encouraged.

No passing
marks
awarded.

Mr. Shah responded: If our focus shifts from public expenditure reviews to public output reviews, our dialogue with the government would be much more productive. First, a public expenditure review questions the legislative authority of the government and the elected representatives in their decisions about the priorities of the country. External priorities might be quite different, as Professor Berg outlined, from internal priorities. And I do not know of any country, including the United States, that would receive a passing mark on its public expenditure allocation priorities.

But if we shift the focus to output reviews and then work backward, and engage in a dialogue concerning the fundamentals, we can bring into the discussion what kind of program and what kind of spending patterns would produce that output response (to the extent that there is some relationship between spending and outputs). But I think our focus must shift to output, and that also answers the question Mr. Ramachandron raised.

Question: Mr. Ataman Aksoy, of the Bank's Southern Africa Region, added that we have to be realistic about what the public sector can deliver in very poor countries. If per capita income is \$100 or \$150, and 15 percent is already being collected, even if some aid is available, as Manuel Penalver was saying, it really does not amount to a great deal. Nevertheless, we have very high expectations of what the system should deliver in primary education, infrastructure, and the like. Although there are inefficiencies in the system, there has to be a sense of realism in what the public sector can deliver.

Mr. Askoy agreed with Mr. Berg that public expenditure reviews have essentially stopped. He expressed the opinion that they are an intrusion on the sovereignty of countries. He urged that attention be paid to budget systems, that it is the information and control systems that will enable the government to make decisions. He also noted that outcomes should not be the focus, but rather the processes by which budgets are formed and information is supplied.

Question: Mr. Luis de Azcarate pointed out that there had been an evolution in the kinds of exercises known as public expenditure reviews. Although initially the process was a very cumbersome one, with a mission of some 25–30 people attempting to look at every item of capital expenditure (which he likened to carrying a minigovernment into the country), the process has changed. What is now being done—in Mozambique and Ghana, and in several other countries, for example—is much more in the areas of process and management. He noted that there was a rediscovery in progress of the very basic principles of public finance of unity, universality, and reality of the budget.

Mr. Shah responded: While the public sector revenues are quite small, and it seems like a difficult, monumental task in some cases to provide even the basic public services, the fundamental difficulty is that even those minimal amounts of revenues raised by the public sector are not directed toward providing the basic public services

that are of the utmost priority. Instead, the funds go to military spending and public sector wages, the public sector purse, and what have you. If the focus of those same expenditures were moved to basic education, basic health, the rule of law, and other similar issues, the funds would be more productive.

Simply focusing on budgetary processes and related issues would not achieve this goal. Budgetary processes matter only if the fundamental institutions of participation and accountability are strong. As long as that fundamental, basic institutional structure is weak, improving budgetary processes will not accomplish much.

Summing Up

Shanta Devarajan

The overarching theme of this panel is related to incentives, both the importance and the effect: the importance of the effect of our intervention on incentives and how incentives determine outcomes. Elliott Berg mentioned the issue of foreign aid, how foreign aid to recipient countries has an effect on incentives in those countries, and that in turn has an effect on the incentives to undertake budgetary reform because the foreign aid is a budgetary supplement.

Mike Gavin has raised the issue of the incentives for fiscal discipline in Latin American countries. Everyone there could tell you the importance of fiscal discipline. The question is whether there are internal incentives in the government, supportive institutions and suitable instruments within the government. And we know that the fixed exchange rate regime may not qualify, but there may be others, such as the effort in Venezuela, that can create the incentives for fiscal discipline.

I think the most important area is incentives for an appropriate outcome of public expenditure policies. David Sahn spoke about the African countries, where the allocation of public expenditures, even in the social sectors, was not what we could consider desirable for poverty alleviation.

There is also an incentive problem within governments. The public sector acts under a set of incentives (about which we know very little, incidentally, but we are getting there) that has a bearing on public expenditure outcomes even in the traditional area of public goods. Therefore, even the dividing line between a public good and a private good may have to change, depending on the incentives framework in the public sector.

I very much agree with what Luis de Azcarate had to say about public expenditure reviews. Just as a point of information, we no

longer do the 25-person, mammoth reviews. We do a great deal of public expenditure analysis that has to do with evaluating institutions, because we are convinced that knowing the right expenditure allocation is insufficient. What is really important is whether the government itself can manage with its own processes and its own institutions.

Closing Remarks

Robert Picciotto

Thank you very much, Shanta. I would like to thank all the panelists and all the participants for two reasons. First, evaluation benefits from this kind of transparency and debate. Even evaluators must be evaluated. We very much appreciate the comments on the report. Second, the market works better if stubborn facts are put on the table, and this is the role of evaluation. For both reasons, I think this panel was very helpful, certainly to OED. Thank you very much.