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IMF Advice on Fiscal Policy

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Abstract

IMF advice on fiscal policy is given within a strong accounting framework. Published sources in the last ten years show the direction and change of advice. The treatment of central bank losses, government arrears, and credit subsidies are discussed as examples. Advice on taxation, expenditure, growth, prices, and distribution is examined. Some broad lessons are drawn on sustainability of policy, short- versus long-run policies, and objectivity of advice.

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Contents

Summary

The paper emphasizes the strong accounting framework within which Fund fiscal advice is offered. It reviews sources published within the last ten years, which, in turn, form a substantial bibliography.

Central bank losses, government arrears, and credit subsidies provide examples of problems in assessing the scope and definition of the public sector. The paper examines advice on taxation, expenditure, growth, prices, and distribution.

On the whole, extensive and continuing academic and applied analysis is the source of the Fund's fiscal policy advice described in this paper. Staff have no particular axe to grind, and changing policy advice reflects changing academic and administrative perceptions (e.g., on progressive income taxation, indexation, and value-added taxes). Staff seek to put on budget what is off budget and try to encourage transparency in government accounts. On this basis, evaluation of the overall fiscal adjustment needed and the alternative policy mixes to achieve that adjustment are discussed without political bias or any hidden agenda.

The paper mentions some problems. Perhaps the size of fiscal adjustment needed is overemphasized and the "how" is underemphasized, giving rise to unsustainable policies. In addition, a desire for quick results may concentrate attention on the short run and allow insufficient time for fundamental changes, especially structural tax reforms and basic changes in administration. Fund fiscal advice is typically criticized as being insufficiently "political." In fact, this should be viewed as an advantage and not as a weakness; the objectivity of Fund staff in their advice should be their strength.

I. Introduction

IMF advice is given not only in the context of Fund-supported programs but also in the annual economic assessments (known as the Article IV consultation missions), in the ongoing surveillance function of the Fund, through its technical assistance program, and in the semiannual World Economic Outlook. Plenty of published sources describe Fund advice, both at the country level and more generally. Less widely understood perhaps is the framework within which Fund fiscal advice is given and the reasons why certain fiscal issues are important to Fund economists. This paper tries to fill these gaps with the illustration of a number of topics exemplified in the various sources mentioned above and in the numerous articles and working papers of the IMF staff over the last ten years. I hope that by the end of this paper it will be appreciated that the complex issues of fiscal policy require complex responses and that given the huge differences in economic systems of Fund members advice must always be country specific. It should also be emphasized that Fund advice is just that--"advice." Advice can be accepted, rejected, debated, and changed. Typically, fiscal policy advice to be effective must have the backing of the authorities who are to carry it out. Effective advice is arrived at through mutual understanding.

The next section examines the IMF's view of the concept of fiscal policy and its advice on adjustment programs. Section III looks at advice on the revenue aspects of fiscal policy and Section IV at advice on expenditure. Section V considers some of the implications for growth, prices, and distribution of the IMF advice in those areas. The last section tries to evaluate the strengths and weaknesses of this advice.

II. The IMF Interest in Fiscal Policy and Adjustment

1. The accounting framework

The IMF's prime responsibility centers around the balance of payments. The Fund exists to provide surveillance and promote international cooperation. It also provides short-term finance to help cover a temporary balance of payments deficit while the country adjusts its domestic policies to move toward a long-term sustainable equilibrium. The Fund examines economies and devises adjustment programs by creating an integrated system of national income and expenditure accounts and their associated financial flows. Those of you who have worked with the Fund missions will know the time Fund staff spend putting national accounts into a Fund format and then ensuring that the external, monetary, and fiscal accounts reconcile. These accounting relationships (which are merely identities) emphasize that any sector that spends more than its income must be financed by savings in other sectors. Excess spending by the whole economy is only possible when it is financed by savings from the rest of the world--a balance of payments deficit.

It is this concentration on financing that leads backwards from the balance of payments to fiscal policy. The ex-post identities (IMF, Occasional Paper 55, September 1987, pp. 12-18) show that the change in net foreign indebtedness may be divided between the changes in the private sector's and public sector's net foreign financing; the change in domestic financing is the sum of changes in credit channeled to the private and public sectors. It is also clear that any budget deficit must be financed by increased net borrowing from abroad, from the banking system, or nonbank public. Hence, one way to control the country's external position, and its domestic price level, is to establish program ceilings on government foreign borrowing, and bank financing of the public sector deficit. Typically, Fund advice initially establishes an overall desired rate of credit expansion, based on assumptions about acceptable price changes, targeted rate of credit expansion to the private sector, and, as a residual, the amount of credit available to the public sector that is consistent with the achievement of the credit and price targets. The private sector credit is determined to ensure that government claims do not crowd out the private sector. For instance, taking into account the sources of growth in the economy and, depending on the complexity of the economy, there is plenty of room for debate on the appropriate allocation of credit between the public and private sectors.

In this accounting framework there lurks the danger that fiscal policy could be caricatured "as an aspect of monetary policy and presumed to have no independent effects on aggregate demand and the balance of payments" (IMF, Occasional Paper 55, September 1987, p. 25). However, the Fund has long recognized (after all, the Fiscal Affairs Department was created in 1964) that in reality measures affecting the fiscal deficit, taxes, and government expenditure are frequently the most crucial ones in altering the level of aggregate demand, the current account balance, and the current level and future growth of output.

Of course, the literature is replete with debate on the effects (or lack of effect) of fiscal policy on demand, but in many, indeed in most, countries seeking a Fund program it is clear that there has been an excessive monetary expansion. This monetary expansion stems from a fiscal deficit that the authorities are unwilling to close; that is, unwilling to finance except through central bank credit. So Fund fiscal advice, first, is likely to concentrate on the size and direction of change in the overall fiscal deficit. For the good reasons described above, Fund-supported programs nearly all contain a ceiling on bank credit to government (unfortunately, it is kept in only about 40 percent of the programs--see Beveridge and Kelly, 1980, and Doe, 1985).

2. The definition of the public sector

Control of the fiscal deficit can be adequate only if the extent of the public sector is correctly identified and monitored. Fund fiscal economists are often in a good position to do this and staff research has dealt copiously with issues of public sector definition and growth. I will describe a few of the issues in more detail. But first I must stress that, while the size and change of the fiscal deficit are crucial preoccupations of Fund advice, the absolute size of the public sector is not (Tanzi and Blejer, June 1983, p. 18). How could it be otherwise? The Fund holds policy discussions with countries in Europe, Asia, the Middle East, and in the Western Hemisphere in which the state plays the major role in supplying goods and services. Interestingly enough, this, naturally, greatly increases the potential scope and effectiveness of fiscal policy, but despite such attractive leverage the Fiscal Affairs Department would hardly advise an expansion of the public sector to increase the impact of fiscal policy.

The growth of the public sector, however, is of continuing interest. Staff have examined the growth of government expenditure and consider that the evidence suggests a major influence has been the willingness of elected officials to promise the electorate that various social problems can be solved through additional public spending (Tanzi, February 1986). An eclectic view of the determinants emerges including both the state as an agent of the people and the state-bureaucracy growth models (Tanzi, May 1986). Having identified the sources of growth the economists' next step has to be to ask carefully whether the higher spending has brought what it promised. "When we compare some of the countries in which the level of public spending has recently approached 60 percent of GDP with, say, Switzerland, where it is still around 30 percent, can we identify the social goods that these countries have purchased with the extra 30 percent points of spending? Are such indexes as life expectancy, health, literacy, job security, unemployment, income distribution, which governments try to manipulate through spending, clearly better in those countries than in Switzerland?" (Tanzi, February 1986).

All budgets and all Fund programs must draw up priorities for the use of scarce resources and assess the effectiveness of public expenditures. With respect to the definition of the public sector, the Fund would advise putting all government transactions through the budget because only in this way can a reasonable assessment be made of the claims by and on the government, and the overall impact of fiscal policy and its financing on the economy. Basically, the staff prefers to have transparency in the budget accounts with no extrabudgetary accounts, arrears clearly dealt with, and few implicit subsidies or tax expenditures. Hardly any country achieves these standards. Yet it is interesting that Fund support for clarity, common sense, and truthfulness in budgeting is so frequently controversial. It suggests governments frequently prefer fog to a clear view.

Off-budget items are always a potential source of difficulty. They tempt the authorities to create personal fiefdoms, which circumvent the usual budgetary channels and cannot be controlled or monitored as instruments of fiscal policy. Frequently, off-budget accounting practices build up claims that eventually have to be met by the government in timing and circumstances not of its choosing. This destroys attempts at prudent budgeting and credible longer-run government.

Work done by Fund economists to clarify the scope of government can be illustrated by three further cases where the impact of government on the economy is hidden and difficult to control. These may not seem the most obvious problems but they are ones which have cropped up frequently in the last few years and ones in which the staff has been obliged to take a position. First, central banks may perform governmental functions which should be defined as fiscal policy though carried out by the monetary authority; second, government arrears may allow the Treasury to maintain a healthy bank balance while pursuing unhealthy tax and expenditure policies; and, third, credit subsidies in budgetary lending create a subtle and difficult problem of valuation of government's control over resources.

a. Central bank losses

Central banks are not expected to make deficits. In industrialized economies central bank profligacy is rare. However, in the last few years, significant central bank deficits have become not uncommon in developing countries (in 1982, central bank losses in Costa Rica were 5.6 percent of GDP; in the Philippines, 5.2 percent in 1984; in Uruguay, 7.6 percent in 1983; and, in Argentina, 2.5 percent in 1984).

If a central bank undertakes only monetary activities it should be profitable, with profits (from seigniorage, etc.) accruing to the government. This is also true of a profitable central bank if it undertakes quasi-fiscal activities that only affect its profit and loss account. Difficulties occur if it undertakes other types of quasi-fiscal activities (e.g., net lending or guaranteeing foreign exchange losses) that show up, initially, as a change in the composition of the central bank's assets. Ideally, "government accounts should incorporate quasi-fiscal revenues and expenditures, leaving the central bank accounts covering only monetary activities (Robinson and Stella, IMF, Occasional Paper 59, p. 30).

The Fund would suggest some supplementary indicators to try and anticipate the impact on fiscal policy of central bank losses. Central bank losses in the profit and loss account could be amalgamated into "an adjusted fiscal deficit by the addition of a transfer from government to the central bank financed by credits to the central bank" (Robinson and Stella, IMF, Occasional Paper 59, p. 30). Although this might seem a simple accounting device, it puts the problem firmly through the budget and does not hide it in an off-budget account in the central bank. Also, an estimate of the size of central bank and quasi-fiscal activities could be made and shown in the adjusted fiscal deficit. Finally, further indicators could show some estimates of the value of, say, exchange rate guarantees outstanding and the losses that would result if they had to be met at the current exchange rate.

It is clear there is no straightforward solution to such problems but the Fund is very aware of the inadequacies of conventional accounting in these circumstances and it is only reasonable to try to anticipate the difficulties. The Fund is also conscious of the difficulties such switching of claims causes for setting credit ceilings. Of course, the real answer is that central banks should stick to traditional activities and be contributors, not potential claimants, on the budget.

b. Government arrears

Government arrears are a growing, persistent, and rapidly changing problem in many countries. Obviously, any delay in a government payment reduces the apparent government deficit on a cash basis and forces creditors to finance government for a time. Persistent arrears cause numerous distortions in the economy. Suppliers often respond to government payment arrears by reciprocal arrears on their tax liabilities or on their payments to government state bodies (e.g., utilities or even payroll taxes already withheld). If these arrears persist, suppliers react by increasing the prices at which they are prepared to provide goods and services to government. This, in turn, increases the size of the government's cash deficit (and the general price level). Demands for credit may increase and, hence, interest rates. "From the financial programming viewpoint, the build-up of arrears, by disguising the level of government's use of resources, lowers the recorded cash deficit and, hence, also the recorded credit to government" (Diamond and Schiller, IMF, Occasional Paper 59, p. 46). In the long run the government's very legitimacy may be threatened.

The Fund advice would be to undertake a firm commitment to reduce arrears as quickly as possible; because data is often confused, incomplete, and inaccurate, and due to political and administrative constraints, "the programming of arrears reduction should be combined with an appropriate monitoring system for broad aggregates of government expenditures, with arrears prevention as the primary concern" (ibid, p. 47).

c. Credit subsidies

An even more complicated problem is presented by the difficulty of dealing reasonably with credit subsidies. Official credit programs frequently allow borrowing at more lenient terms than those in the market. They contain a pure loan component reflecting the government's role as a financial intermediary, and a pure grant component, reflecting the government's role as a distributional agent.

The scale of such lending is not widely appreciated. For instance, even in an economy as strongly committed to the market as the United States, the Government has influenced the allocation, on subsidized terms, of $1,322 billion of outstanding credit, equivalent to 29 percent of GNP in 1987 (see, Wattleworth, 1988, p. 57). "Depending upon how these credit subsidy schemes were financed, they would generate either a larger or smaller supplementary fiscal deficit, which should be added to the conventionally-measured deficit to capture the true aggregate demand impact of fiscal operations" (ibid, p. 57).

The concealed nature of such credit subsidies does not make them any less subsidies, and, of course, they must be financed by taxes, borrowing, or monetary growth at levels higher than would otherwise have been necessary or, of course, by expenditures being lower (consider the current savings and loan controversy in the United States).

This is a complex problem. But, again, the Fund would suggest that the true magnitude of such subsidies (i.e., the present discounted value of the subsidy stream) should be entered explicitly in the budget in the originating year as an expenditure item (ibid, p. 68). This is not to say that countries do this but it shows that the Fund appreciates the problem, has thought about it, and has come to a recommendation which reflects a consistent attitude in the context of the Fund's general fiscal position as far as the budget is concerned.

That is, the Fund prefers to have items on budget, explicitly entered, and fully valued. In this way, the budget accounts become the mirror and the measure of government policy choices.

III. Advice on Taxation

Such advice is given frequently in the context of short-run "emergency" measures when a premium is put on revenue. Typically, structural measures involving equity, incentives, and resource allocation are considered when advice is given in the context of technical assistance. Fiscal policy advice on taxation is a vast subject. Fund economists are conscious that, even when the fiscal deficit remains unchanged, changes in the policy mix of expenditures and revenues may have important consequences for aggregate supply and demand. I will consider, briefly, examples of advice on the revenue mix, tax structures, and administration. Effects on efficiency, growth, and employment will be mentioned later.

Traditionally, the Fund tacitly appeared to accept the Musgrave hypothesis about the growth of tax handles from primitive taxes on trade to sophisticated comprehensive income taxes. Over the past 20 years, for both stabilization and equity, the Fund has generally advised in favor of globalized income taxes. It has supported the movement from schedular income taxes to global (Goode, Chapters 4, 5, and 6, 1984). It has supported a more unified tariff structure and the removal of exemptions from customs duties. It has advised in favor of broader, preferably single rate, general sales taxes (Tait, 1988; Casanegra, 1986; Lopez-Claros, 1988). It has encouraged concentration on the five principal excises (alcohol, tobacco, automobiles, petroleum, and automobile spare parts) and the removal of vexatious minor excises in favor of the general sales tax. In more recent years, reflecting preoccupations in North America and Europe, the staff has shown more interest in the so-called supply-side (Gandhi, 1987). Empirical assessment of the supply-side advantages of tax reductions yielded inconclusive answers (Ebrill, December 1985). However, in general, the Fund's advice has been to reduce very high marginal personal income tax rates, remove special exemptions, and to stop using the tax system to achieve numerous objectives. The tax base should be indexed for inflation. Double taxation of dividends should be eliminated. Export duties should be used sparingly to catch "windfall" gains (Gandhi, 1984), often acting as a proxy for direct taxation of agricultural income (notoriously difficult to tax).

Not only has concern increased about the disincentive effects of traditional income taxes, but also many suspect that income for taxable purposes in any country is so skewed (e.g., by tax loopholes, favorable treatment of capital gains, use of bearer shares, etc.) that substantial inequities are created. Would it not be better to focus on the taxation of personal expenditure? 1/ The Fund's advice, on the whole, is not (Goode, 1984, pp. 143-46). The transitional difficulties of moving from income to expenditure taxation and the probable intergenerational inequities suggest sticking with the devil you know.

Broadly speaking, I think you would find the Fund preferring to see a corporate tax rate not too far from the maximum marginal rate for personal income tax so that tax-induced movements between personal income, partnerships, and incorporations will be minimized. In the same way, I think there is a move to prefer that this rate should also be close to the capital gains tax rate. Progression is introduced through substantial differential individual allowances and this has distributional and administrative advantages. I think most Fund staff would sympathize with progression at the top end of income and wealth ownership achieved through wealth taxation, especially the transfer of wealth at death or through gifts intervivos. In developing countries wealth taxation should probably be concentrated on land and buildings and items of conspicuous consumption. However, those same staff recognize that in reality wealth taxation is effective in no developing country and that, if anything, effective wealth taxation in developed countries has rolled back rather than forward in the last 15 years (Tait, 1983).

1/ This refers to schemes to tax, progressively, personal expenditure (subtracting savings from income). This would be a replacement for personal income taxation and does not refer to sales taxes.

This brings us to a further and, in my mind, a most important point. Fund staff, because they deal on a daily basis, with real life problems that demand urgent solutions, are pragmatists. In taxation they recognize that taxes as legislated are not necessarily those that are administered in practice. There is little point in the President, Governor, or Minister of Finance signing a letter of intent including significant fiscal policy initiatives (e.g., to reduce the fiscal deficit by increasing revenue collection) if the Commissioners of Revenue and other administrators are incapable of implementing those decisions, or of implementing them only in ways that greatly exacerbate many inequities. For instance, elaborate legislation to tax capital gains or property, will do little for equity, in practice, if the income taxes as already administered affect the wealthy in a haphazard manner. For instance, estimates of untaxed income range from 2.3 percent (in Norway) to 80 percent (in Indonesia (Richupan, 1984)).

In developing countries "because the personal income tax is in practice mainly a tax on wages, companies using more labor-intensive productive methods are at a disadvantage. Large companies are forced to pay tax, whereas small companies and retailers can avoid taxes." On a more general basis "one can say that selective administration of the statutory tax system in developing countries systematically discriminates against the modern sector of the economy" (Mansfield, 1988, pp. 194-95). Not to mention employment in the public service where the withholding tax is applied rigorously.

Extraordinary measures, such as tax amnesties, are treated with circumspection. "An amnesty in the absence of an increase in expected future tax enforcement is unlikely to generate a significant positive impact on revenue" (Stella, 1989). That is, emphasis is put on the quality of administration.

Much of the theory underlying fiscal policy assumes that tax administration is perfect. To the extent that it is imperfect then so are the effects of fiscal policy and the nature of the advice must change (Tait, 1989). Fund advice would concentrate heavily on improving administration. This is true whether we speak of tax, expenditure, or budgetary administration.

IV. Advice on Expenditure

The Fund has no over-arching theory of the determinants of government expenditure. Indeed, its most recent paper on this subject emphasizes how little can be said in this debate (Diamond and Tait, February 1988, and Tait and Diamond in Aspectos del Presupuesto Público (Premchand and Antonaya, 1988)). However, it has monitored and recorded the shifts in expenditure in countries and regions (Heller and Diamond, 1989) and it recognizes that within programs the overall fiscal position deteriorates more frequently because of spending overruns than revenue shortfalls (Doe, 1983). Let us consider the conventional categories of public sector spending on goods and services, transfers, and interest. The broader question of whether government should provide goods and services is dealt with later.

1. Expenditure on goods and services

Government demand for goods and services is an addition to aggregate demand and, in conditions of excess demand, the Fund advice might well be to reduce government purchases of goods and services. This would be especially so if tax ratios are already high and if the recent record of government administrative efficiency in tax collection is suspect. Indeed, in many recent instances preferred fiscal advice has been for a reduction in government expenditure on goods and services (rather than an increase in taxation) precisely because this might be more directly under government control and more exactly monitored. However, this, in turn, often requires improved budget expenditure control and this is a subject to which the Fiscal Affairs Department has devoted considerable energy (Premchand, 1983).

While the distinction between purchases of current and capital goods is useful analytically and is used, frequently, for the authorities' own decisionmaking process, it is not one that, in practice, the Fund finds particularly useful. The number of subjective discretionary evaluations of what is capital and what is current are so many that the borderline between "above and below the line," "consumption," and "investment" shifts frequently. To use such a distinction to justify current financing or borrowing puts too much weight on a fragile definition. The temptation to represent current items as capital, or vice-versa, as a way to justify convenient political financing decisions is all too attractive (Yandle, 1976; Gandhi, 1976). In practice, we are interested initially in the overall deficit. Moreover, if we are interested in real adjustment the focus should be on the overall deficit excluding nonrecurring grants.

The indirect impact of government expenditure on goods and services can occur through crowding out (or in). Public sector purchases may displace private spending, or government investment could improve the productivity of the private sector capital stock (Blejer and Khan, 1984); it could even exert a negative influence on real growth (Diamond, 1989). Again, household decisions can be affected by the increased expenditure and changed private sector perceptions of the taxes or debt needed (the Ricardian equivalence debate) and, again, desired real balances could change if interest rates changed (Khan and Knight, 1981 and 1982). These impacts have all been discussed by Fund economists and, depending on which economy is under scrutiny, may well form part of the debate with the authorities (IMF, Occasional Paper 55, September 1987). While the theoretical impact may be fairly clear, each analysis remains country-specific.

The largest component of government expenditure on goods and services is the wages and salaries bill. Most authorities will subscribe to the idea that they prefer a small, well-educated, highly motivated, efficient, popular, and well-paid civil service. The less desirable option is a large, ill-educated, indolent, inefficient, unpopular, and badly paid service. The question is why do we so frequently end up with a civil service that tends toward the less desirable option? The answer is often because of political patronage, the use of the civil service as a way to reduce unemployment of either the uneducated (labor gangs) or the educated (employment of university graduates), and a political willingness to court popular votes by denigrating the civil service and its pay (Schiller, 1988). I am convinced that one, if not the most, important way to improve economic efficiency in general is to improve the efficiency of the civil service in particular. This should mean fewer people at higher salaries and not more civil servants at lower salaries. The issue should be seen clearly as one that involves not reducing the standard of living of government officers but rather improving the quality of the civil service, reducing its size, and increasing its efficiency (Heller and Tait, 1983 and 1985).

Occasionally, when discussing alternative fiscal packages, the Fund will be asked to comment on expenditure priorities and may debate the issues (De Masi and Lorie, 1989), but discussions about the details of specific functional expenditures and investment projects and their relevant priorities is more the traditional role of the World Bank.

2. Transfer expenditures

Transfer expenditures are often the most politically sensitive policy problem. Contrary to a popular canard the Fund is not in favor of lower subsidies. It is in favor of making subsidies explicit and ensuring that they are properly accounted for through the budget where an annual debate can take place on their merits, size, and direction of change. Advice would concentrate on the efficiency of, say, food subsidies; how to ensure that the really poor household receive the subsidized commodities and not, say, the urbanized middle class or the armed forces. It is not the absolute size of such transfers but their sustainability and appropriate use that is the issue (Namor, 1987, and Schneider, 1984 and 1985).

In the longer run the Fund is also concerned about issues such as social security in both developing countries (Mackenzie, 1988) and in industrialized countries (IMF, Occasional Paper 47). The implications for and constraints on fiscal policy of the demand for social services on a pay-as-you-go financing are profound for some countries. The Fund is concerned to anticipate the future budgetary consequences of present commitments which institutionalize and commit a large portion of future government expenditure (Heller, 1989).

3. Interest

Foreign interest payments represent a withdrawal from the economy and a drop in its present purchasing power to pay for past excesses of expenditure over production. Domestic interest payments exercise their effects on aggregate demand by influencing spending decisions in the private sector. Both kinds of contractual commitments are payments over which the authorities have no discretion (although, of course, the form in which the debt is issued and hence the frequency of payment and rate of interest are part of monetary policy).

In the last few years, particularly in Latin American countries experiencing high inflation, it has been argued that the inflationary element of interest payments is a payment to compensate debtholders for the erosion of the capital value of their bond, and that this will not affect aggregate demand. The assumption is, of course, that the private sector rolls over its government bondholding and demand is unaffected or that it affects aggregate demand less than, say, wage payments since it is a return of capital and not a return to capital (Tanzi, Blejer, and Teijeiro, 1987; Bierman, 1985). "It is nevertheless doubtful, especially in circumstances of high inflation, that the inflationary component of interest payments is entirely neutral in its effect on aggregate demand, because of changes in the terms and 'moneyness' of government debt that are likely to occur in such a situation, especially if acquisition of foreign assets is a feasible alternative to holding government debt" (IMF, Occasional Paper 55, p. 26).

The Fund's advice in this contentious debate is that each measure of the fiscal deficit, conventional or cash basis, the operational or the primary deficit, adds to the information needed to make policy decisions and the consideration of all measures is better than looking at one alone. However, the conventional measure of the overall deficit retains a special importance as it represents the inescapable financing needs of the government.

V. Advice on Growth, Prices, and Distribution

1. Growth

The first Article of the Fund makes it clear that promoting output growth and trade is the primary objective of economic policy for the Fund. The emphasis on the balance of payments is to be seen in the context of the overriding concern with growth. The principle is that sustained growth depends on adjustment.

The main thrust of fiscal policy advice to achieve growth is on the more efficient use of labor and capital in both public and private sectors. Advice has concentrated more on the efficient allocation of savings and investment than on their level; tax reform at the micro-economic level to increase the amount of savings has not received much attention but Fund economists see that government deficits "appear to have significantly reduced national saving in a number of countries during the 1980s" (Smith, 1989). For the private sector, the state is to stop distorting relative prices whether by the exchange rate, taxation, subsidies, or controls and regulation (Ize, 1989). For the public sector, the state should anticipate the profound changes implied from long-run demographic trends (Heller, 1989) and try to ensure that savings and investment are not distorted through shortsighted monetary and fiscal policies.

I think experience has taught the staff over many years that bureaucrats do not necessarily make superior industrial managers. However, this does not mean that the Fund is automatically in favor of, say, privatization of publicly-owned production of goods and services. It is not so much the ownership that matters but the exposure of all companies to competition. "One should stress the importance of competition policy and the modest efficiency gains that could result from privatization alone." Moreover, "in developing countries. . . market failure is usually more prevalent than in industrial countries and greater importance is attached to social and other noncommercial objectives. . . . These considerations would seem to suggest that privatization may be less appropriate in developing countries than in industrial countries" (Hemming and Mansoor, January 1988, pp. 19-20). However, public enterprises do impose substantial budgetary burdens (Short, 1984) and contribute to inflationary monetary expansion. Access to credit should be more carefully controlled. Public enterprises should not have privileged access to credit and they should achieve returns that cover the opportunity cost of capital (Floyd, 1984). Various indicators of efficiency and performance have been devised (Gray, 1984) and expansion of private sector provision of services recommended (Berg, 1983).

Frequently, the public sector has undertaken massive investment programs, often with an eye on the symbolic need to "think big." But some of this investment may prove unproductive if the initial capital commitment is not followed up by maintenance. Donors will give capital but not fund maintenance costs.

Fund advice may well be to forego some large new projects for the sake of maintaining and operating efficiently the existing capital stock. In recent years much interest has been shown in the supply-side effects of fiscal policy for growth (Gandhi; IMF, Occasional Paper 55, p. 29). In general, the Fund supports the removal of exemptions, the elimination of rules that discourage the inflow of foreign capital, and the rationalization and lowering of the tariff structure.

2. Prices

Efforts to finance the deficit by borrowing from the central bank may result in rapid, and escalating, price increases. The government's reaction is often to try to suppress this by price controls. The easiest prices to control are those of publicly-owned producers and user charges for government-provided services (telecommunications, electricity, education, health) that lag behind the inflation rate. This may help consumers in the short run but leads to reduced incentives for producers to produce, an increase in the fiscal deficit, a reduction in managerial responsibility, false signals to industrial consumers of the price-controlled output, and, eventually, rationing of output by lines, allocations, or impaired efficiency (e.g., "brownouts").

Governments also resort to direct control of prices in the private sector. Many of the same results occur and, in addition, the vast bureaucratic control apparatus needed to define and monitor price controls imposes substantial costs on society. Inevitably black markets impose further inequities.

Fund advice is to try to phase out both sorts of price controls and to control inflation by macro monetary and fiscal policy and not through suppression.

Of course, this is easy to say and difficult to do. The greatest problems occur when inflation is high and accelerating. Inflation is sometimes justified as the only way to finance public expenditure when tax bases are inadequate, tax administration is inefficient, and political constraints do not permit higher taxes (Tanzi, 1978, p. 417). The inflation tax is certainly an easier political option than higher taxes or lower expenditures and some Fund staff have argued that if the benefits from additional future consumption (from the additional government expenditure) outweigh the cost of the inflationary finance this may be the relevant or appropriate comparison (Aghevli, JPE, Vol. 85, December 1977, pp. 1295-1307). Others have argued that the "existence of lags in tax collection implies that a government's gains from the pursuit of inflationary finance are likely to be lower than has commonly been assumed. If the lags are long and the initial tax burden is high, the loss in revenue may be substantial, and it may neutralize any gain coming from the central bank financing of the deficit" (Tanzi, 1978, p. 444). The Fund has shown considerable sensitivity in trying to come to grips with the problems of moving from high to low inflation (Blejer and Cheasty, 1987; Blejer and Liviatan, 1987). It recognizes that "when inflation becomes ingrained, it acquires its own dynamics" (Blejer and Liviatan, 1987, p. 435). Indexation (which is usually only partial) is unlikely to be helpful; a policy that institutionalizes a rapid pass-through of, say, exchange rate changes is not going to accomplish the transfer of resources to satisfy external demand. The final message is that shock programs and expectation changing policies "are not a substitute for fundamental adjustment through an appropriate fiscal and monetary stance;" they "may only be successful in conjunction with traditional demand-management policies" (Blejer and Cheasty, p. 25).

3. Distribution

Adjustment cannot take place without affecting the distribution of income and wealth. If Fund-supported adjustment programs "imply that specific income classes (and, in particular, the poor) inevitably bear the brunt of the economic costs involved, then those programs would be both less acceptable and, in the long run, less effective than the available alternatives" (IMF, Occasional Paper 46, p. 1). The issues are far from simple. An alternative to an orderly adjustment program is often a disorderly adjustment through inflation or other economic imbalances suppressed through controls and black markets in goods and currencies (IMF, Occasional Paper 58, p. 32). Devaluation is seen to impose significant short-run costs on the urban poor and on the rural poor where land ownership is concentrated and where there is urban/rural mobility, and where nontradable production is labor-intensive. It also imposes costs on small farmers whose short-run supply elasticities are small relative to those of large farmers.

Policies to help the poor look to a better allocation of credit, the expansion of labor-intensive programs, better targeted government expenditures for the poor, rationing schemes for the poor, and changes in the composition of social expenditures, e.g., skewing health and education expenditures to help the rural poor rather than the urban affluent (IMF, Occasional Paper 58, pp. 33-34). Direct taxes have little role to play in helping the poor; indirect taxes should be applied to goods and services (electricity, telecommunications, petroleum, hotels and restaurants) consumed by better-off households; expenditure management is probably one of the most potent weapons of poverty alleviation (IMF, Occasional Paper 46, pp. 36-37).

VI. Strength and Weaknesses of the Fiscal Advice

The discussion above emphasized the strong accounting framework within which Fund advice is offered. On the whole, the fiscal policy advice described derives from extensive and continuing academic and applied analysis (often published to ensure wider discussion). The staff have no particular axe to grind and policies reflect changing academic and administrative perceptions (e.g., on high marginal rates of personal income taxes, value-added taxes, indexation). Objectivity and pragmatism might be two slogans for this fiscal policy advice.

There are problems. First, there is perhaps too much emphasis on the size of adjustment needed and not enough on the "how." The emphasis on large reductions in the overall budget deficit as a percentage of GNP can lead the authorities to adopt policies that are not sustainable. Yet, for the economy's viability over the longer term, precisely what is needed are policies that can be maintained. Such policies must be acceptable. More important they must be administratively practical.

Second, the time needed to adjust is sometimes underestimated. In early Fund-supported programs one or two percentage points of GDP was considered a major budget deficit adjustment. Today programs can contain adjustments of 6-8 percentage points. Even though programs may be longer (up to three years), or successive one-year programs stretch out the effective time horizon, nevertheless the emphasis on annual programs may focus attention on "quick and dirty" fixes. Of course, more time for adjustment requires more finance, and it is precisely the constraints on finance that is contentious.

Third, the complex economic consequences of alternative mixes of revenue and expenditure measures may not be sufficiently analyzed. Sometimes policy packages are negotiated within the second week of a two-week mission. However, in most countries, the discussions on optimal policy mixes continue from one mission to another and the eventual outcome is the result of prolonged and in-depth analysis by all parties. Undoubtedly, the efficiency of the impact of changes in fiscal deficits depends on the quality of the measures. If less efficient fiscal measures are used the required reduction in the fiscal deficit will be larger and more severe. The Fund should integrate the traditional macro adjustment program with a carefully articulated micro fiscal structural program, and also with an "investment case" (often elaborated on the basis of World Bank advice (Tanzi, 1987)).

Finally, the great strength of Fund fiscal policy advice is, at the same time, its greatest weakness. The Fund staff is objective. Their initial analysis is based firmly on an accounting framework. They seek to put on budget what is off-budget and to try to encourage transparency in government accounts. On this basis, evaluation of the overall adjustment needed and the optional mixes to achieve that adjustment are discussed without political bias and without any hidden agenda.

It is often precisely these characteristics that are the foundations of criticism of policies suggested by the Fund. Fund staff are not elected by anyone and perhaps underestimate the constraints on politicians who are. Even in countries where the electorate is not appealed to very often, those in authority frequently "buy" political power through indulgent economic policies that cause economic collapse.

Obviously, it is unrealistic to argue that the Fund must be completely apolitical. In the final analysis agreement to programs may involve political judgments. However, such judgments are made at the level of the Executive Board. It is the function of staff to evaluate policy options and present the evidence in a dispassionate manner to enable the Board to reach its decisions on the best evidence available. Therefore, the objective and independent fiscal policy advice of the staff, described in this paper, remains a major strength and one to be valued rather than criticized for not being what it should never be--politicized.

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