At issue: The elusive quest for 'fiscal space'

The World Bank, the IMF and the UNDP

For the last several years the World Bank and IMF have squared off against governments, NGOs, UN agencies and even each other over the concept of 'fiscal space'. This often nebulous and ill-defined term has caused much confusion. Nancy Alexander finds that at the heart of the matter is a difference of opinion over how and when governments should be allowed to invest in both infrastructure and basic services.

The IFIs and the UN Development Programme (UNDP) have contrasting views on how to increase fiscal space, meaning how to enable governments to spend and invest more. The core of the disagreement is how fiscal space should be viewed. The UNDP views increasing fiscal space as a means to combat poverty and achieve the Millennium Development Goals (MDGs), so that any assessment of fiscal space would start with calculating the resources necessary to meet the MDGs. The IFIs generally start by analysing the resources already available and then calculate fiscal space. The biggest areas of concern in increasing fiscal space are inflation management; infrastructure expenditure; the impacts of trade liberalisation; and the use of public-private partnerships.

Why now? A fiscal space storm

In March 2004, presidents Lula of Brazil and Kirchner of Argentina met and signed the Copacabana Act, which calls for high-level cooperation in financing infrastructure. They proposed that they be allowed by the IFIs to account for investment in infrastructure over the life of the asset rather than in the year in which government expenditure is made. While deficit reduction curbed inflation and freed up resources to service debt, they denounced the IMF for imposing such strict deficit reduction targets that public investment, particularly in infrastructure, had plunged.

At the same time as southern countries are waking up to the long-term development costs of under-investment in infrastructure, northern donors are under pressure to increase ODA to meet their global commitments, and multilateral finance agencies are returning to infrastructure as both a key part of the development puzzle and, conveniently, the fastest way to increase their lending portfolios at a time of increased competition in the world of development finance.

The Development Committee – the highest body of the board of governors of the Bank and Fund – asked the Bank in 2005 to analyse "how the practice of fiscal policy could be adapted to strengthen [the Bank's] role with respect to growth and the achievement of the MDGs". In an interim report entitled *Fiscal Policy for Growth and Development*, released at the 2006 spring meetings, the Bank chose to focus almost exclusively on fiscal space for economic growth, based on the assumption that a pro-growth fiscal policy framework is the same as a pro-poor or pro-MDG fiscal framework. The Bank defined fiscal space as "a government's ability to increase expenditure without impairing its capacity to service its debt." The report states that governments can expand fiscal space by a) improving the efficiency of public expenditures, b) increasing revenues, or c) attracting grant aid or borrowing. It excludes the option of writing off or cancelling debts.

The UNDP criticised the Bank's failure to fully address the second half of the Development Committee's question, namely the achievement of the MDGs, in its report *Fiscal space for public investment: Toward a human development approach*. In their definition of fiscal space, the UNDP stresses the *quality* of public expenditure since productive expenditures will foster growth and human development, a larger 'budget pie', and more fiscal space in the long-term. Thus, any definition of fiscal space should distinguish between the short- and long-term impacts of spending. The UNDP report acknowledges the importance of macroeconomic stability but weighs its value against the growth potential of expansionary fiscal policy.

The Bank will issue its final report on the fiscal space issue at the upcoming 2007 spring meetings. Preliminary information about the final report indicates that the Bank will be working to ascertain the likely *impact of the level and composition of expenditure and taxation on long-term growth on a country-by-country basis.* This would affect the institution's deficit targeting and bias against expansionary fiscal policy but it leaves open the question about whether it will be enough to meet the MDGs.

Inflation target mania

Structural adjustment programmes sought to achieve stabilisation – interpreted as price stability – by taming inflation. However, the Bank's interim report concedes that: "The success of fiscal policy in relation to its stabilisation objective may have come at the cost of long-term economic growth." According to Bank vice president for Poverty Reduction and Economic Management Danny Leipziger, "the key issue is that fiscal adjustment biased against infrastructure accumulation can be largely self-defeating" as the effect of spending cuts diminishes output growth and competitiveness. Indeed, growth rates in the developing world sharply declined in the period 1980-2000 compared to 1960-1980.

Declines in growth were sharper as a result of World Bank and IMF promotion of the misguided view that public investment always "crowds out" private investment. The IFIs heavily touted this policy in Africa, where the formal private sector is either risk averse or altogether absent. Now, the institutions have reversed themselves and espouse the view that public investment can "crowd in" private investment. The cost of their wrong-headed theory to human and capital investment is incalculable.

Stabilisation need not come at the expense of other goals. University of Massachusetts professor of economics Gerald Epstein recommends a "real targeting" approach in which central banks are given a country-appropriate target such as employment growth, unemployment, real GDP or investment, but subject to an inflation constraint (see At issue, *Update* 52). Given these two targets – the real target and the inflation constraint – central banks are encouraged to employ multiple tools such as credit allocation, interest rate ceilings and capital management techniques, in addition to the traditional lever of interest rates.

Targeting employment growth is doubly appropriate, since investments in labour-intensive sectors are particularly effective in expanding fiscal space. Only through broad-based opportunities for decent work can households and economies prosper and build a solid tax base. The UNDP suggests that the rate of job creation could constitute a "sustainability indicator" in the quest for achieving the MDGs. The Bank's Independent Evaluation Group, in its 2006 *Annual Review of Development Effectiveness*, criticised the institution's failure to foster more job-intensive growth, saying that worsening inequality has dampened the poverty-reducing effect of growth, particularly "where growth was concentrated in sectors that generated little employment".

Infrastructure accounting

The attention placed on fiscal tightening in the 1980s and 1990s led to widespread deterioration of infrastructure throughout Latin America and Africa. According to *Infrastructure compression and public sector solvency*, a study by Calderón, Easterly and Servén, cuts in infrastructure investment in Latin America accounted for *more than half* of the total fiscal belt-tightening between the early 1980s and the late 1990s. In other words, in response to structural adjustment, developing countries cut public expenditure on infrastructure deeply.

By 2003 the World Bank had become a debt collection agency – taking in over $8 billion more than it extended in loans. In that year, a new 'high-risk, high-reward' infrastructure era was initiated. At its low point in the 1990s infrastructure lending accounted for just over 20 per cent of Bank lending; today it accounts for 42 per cent of new commitments. However, to sustain these levels of lending for infrastructure, the Bank needs governments to free up fiscal space for investment.

One way to free up space for infrastructure investment would be to distinguish between current (wages, transfers and interest payments) and capital (economic and social infrastructure) expenditures . Currently fiscal indicators treat current and capital expenditures in the same way. This is inappropriate because investments in capital yield long-term economic and social benefits. The UNDP suggests excluding capital expenses from public expenditure ceilings set by the IMF so that fiscal restraints will not discourage growth in capital stock or yield the deterioration in infrastructure seen in the late 20th century.

All this leaves economists at the Fund, fixated as they are with macroeconomic stability, decidedly nervous. How much fiscal space? And what kind of infrastructure will governments invest in? Civil society observers will want to know who prioritises between 'hard' infrastructure such as power grids, roads and ports, and 'soft' infrastructure such as schools and hospitals? The links between the current mania for trade-related infrastructure, such as ports, and poverty reduction are tenuous.

Furthermore, there is a debate about whether current spending can be labelled as investment, particularly in the areas of health and education. The UNDP paper asked why the salaries of teachers or nurses should not also be treated as capital expenditures since they are investments that yield returns into the future. The IMF has repeatedly said that changing accounting rules does not create fiscal space, but if externally imposed fiscal and macroeconomic constraints are limiting investment, then redefining expenditure within those constraints can allow governments to undertake investment that they would not formerly have been able to do.

Trade liberalisation shrinks space

When reporting on the costs and benefits of liberalising trade, the Bank and Fund typically do not take into account the losses to governments of trade taxes sometimes equivalent to a third or half of their budget revenues. Nor do they take into account whether premature trade liberalisation can cause domestic businesses and industries to wither in the face of international import competition. Trade liberalisation can doubly constrain fiscal space by eliminating a source of government revenue and shrinking the domestic base of taxation. Harvard professor Dani Rodrik finds that, more often than not, successful liberalisation is the "fruit" not the "root" of development. That is, liberalisation can expand growth and fiscal space, but only after countries strengthen manufacturing sectors and banking systems.

Costs of public-private partnerships

One impact of the fiscal constraints imposed by the IFIs was a search for alternatives means to finance investment. Public-private partnerships (PPPs) in infrastructure, where the government contracts out selected functions to the private sector (such as management, operations and/or construction), became popular with governments. PPP liabilities and risks appear off-budget. This appears to free-up fiscal space; however the appearance and the reality are light years apart.

World Bank researcher Antonio Estache found that globally over the last decade, the fiscal exposure of governments increased significantly when they offered corporate investors costly off-budget guarantees and financial supports to ensure their profitability. The IMF reached a similar conclusion that PPPs should not be used to by-pass spending controls and move public investment off-budget and debt off the government balance sheet while the government still bears most of the risk involved and faces potentially large fiscal costs.

Estache found that efficiency gains were often "at the expense of poor people and poor areas". This is due to the fact that most PPP contracts for infrastructure are renegotiated shortly after they are awarded, leading to price rises for consumers. For instance, 74 per cent of water and sanitation concessions were renegotiated within 1.6 years of being granted. After years of IFI-financed PPPs in infrastructure, 80 per cent of the public in Latin American oppose their use. Notwithstanding this background, the Bank's 2006 interim report stated that, "To the extent a country can rely on private sector initiatives to finance and provide services, it both reduces the need for fiscal resources and is also preferable from a welfare perspective."

Conclusions

Scholars, policy-makers and activists have focused on how to mobilise resources, or create the 'space' in national budgets, to invest in achieving the MDGs. To secure fiscal space and give 'teeth' to the notion of country ownership of development, governments and citizens should demand that the Bank address the question of how countries can achieve the MDGs when assessing its policies on fiscal space. The Bank should allow governments to:

- set inflation rates independent of the IMF – that is, in a range that will serve national growth and employment goals;
- promote capital accumulation to relieve countries from excessive reliance on external financing;
- obtain policy guidance and cross-country experience from sources other than the IFIs regarding the costs and benefits of liberalisation and privatisation;
- balance the needs for human development and environmental sustainability with the need for infrastructure and gear infrastructure to promote domestic production as well as trade; and
- where PPPs go forward, insist on transparency, ensure that governments do not bear an undue level of risk, and protect the rights of the poor.

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A longer, fully-referenced version of this article is available at:
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