BUDGETING FOR FISCAL SPACE

Allen Schick

Asian OECD Senior Budget Officials Meeting

Bangkok, Thailand

January 2008
Alternative Concepts of Fiscal Space

**Sustainability**
The availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government’s financial position.

*Peter Heller, IMF 2005*

**Development**
The financing that is available to government as a result of concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional, and economic environment for these policy actions to be effective for a specific set of development objectives.

*Rathin Roy and others, UNDP 2007*

**Budgeting**
The money available for policy initiatives within an annual or medium-term budget framework.
How the Fiscal Space Concept is Applied

All Countries
To measure the money available for policy innovation consistent with medium to long term fiscal sustainability

Low Income Countries
To assess the opportunity for additional spending to promote development, thereby stimulating future economic growth and increases in government revenue

Middle Income/Developmental Countries
To promote rapid development without undue risk to the government’s future fiscal position

Highly Developed Countries
To assess the resources available for allocation through annual or medium-term budget decisions
Fiscal Space has Different Meanings to Countries at Different Stages of Development

**Low Income Countries**
- The key question is how to create fiscal space for countries that have inadequate tax bases, chronic financial imbalances, and compelling need to invest in human and physical resources.
- The concept of fiscal space was devised in response to discredited policies of international organizations that required poor countries to adopt austerity programs when they faced economic stress.
- Fiscal space justifies policies that may worsen current financial imbalances but would promote growth and thereby enlarge the future scope of public expenditure.

**Developed Countries**
- The key question is how to rationally allocate the space that is available through economic growth, revenue policy and savings.
- The opportunity to enlarge future space through growth-stimulating budget policies is limited.

**Middle-Income Countries**
- The opportunity to create fiscal space depends on variables such as the tax revenue/GDP ratio, spending on infrastructure and other investment, and budget rigidity.
- These variables differ greatly among middle-income countries, and so too does their capacity to create space.
Fiscal Policy for Growth

• Growth-promoting fiscal policy in developed countries generally is counter-cyclical, and focused on remedying short-term economic weakness
  – In poor countries, economic weakness may generate a procyclical response under pressure from international organizations (stabilization) or capital markets (lack of funds)

• Many developed countries recognize that investment in human and physical capital and increased savings can raise the long-term potential of the economy
  – Many poor countries under spend on investment and have inadequate savings, leading to deterioration of long-term growth potential

• Recent work by the World Bank and IMF have suggested that some poor countries would benefit from fiscal policy that emphasizes both stabilization and growth
  – But case studies of various countries suggest that inadequate investment/savings is not a hindrance to growth in all countries

• Fiscal policy for growth must be country specific and take account of existing impediments to growth
  – It must also take account of whether there would be payback from additional expenditure
Budgeting is the Process of Allocating Fiscal Space

• The fiscal space concept is based on what budget makers actually do when they allocate money.
  – It makes few changes in the practice of budgeting.

• It recognizes that budgeting is inherently incremental, allocating resources that are available for policy initiatives.
  – Although the budget covers all expenditures, decisions are made at the margin.

• If there were no fiscal space, there would be no need for budgeting.
  – Government could continue what it did the previous year without all the stresses of budgeting.

• The fiscal space concept adds a medium or longer term dimension to budgeting.
  – It requires consideration of how future space would be impacted by current decisions.
Incremental Budgeting and Fiscal Space

- Major reforms during the past half century attempted to uproot budgetary incrementalism
  - The fundamental aim was that existing and proposed programs should compete on an equal footing for limited resources
- Zero-based budgeting was the most far-reaching effort to uproot incrementalism
  - As applied, ZBB was more a form of marginal analysis
- Incrementalism has triumphed in every country
  - Incrementalism has survived because it reduces conflict and eases the task of compiling the budget
- Incremental budgeting focuses on allocating additional resources and marginal reallocations in ongoing programs
  - Over time, incremental budgeting does accumulate to major changes in government policy
- MTEF has the potential to institutionalize incremental budgeting
  - This explains why MTEF, in contrast to previous reforms, has been successful
- The starting point for budget decisions in the MTEF is the baseline (or estimates)
  - The baseline projects future budgets assuming no change in current policy
Fiscal Space is Measured in Terms of Fiscal Sustainability

• In assessing “room” for policy initiatives, it is necessary to consider the long-term impact of additional expenditure, not only whether space is available in the annual budget.

• In the absence of a medium-to-long-term horizon, politicians may take actions that deprive future governments of fiscal space.

• The critical question is whether creating space (low-income countries) or spending space (high-income countries) will impair the long term sustainability of public finance.

• Governments can measure space and sustainability by projecting future conditions or by estimating the present value of future conditions.

• Baseline projections can be extended to the long-term, using methods similar to those applied in MTEF.

• Discounting entails measuring the current fiscal balance by estimating the present value of future revenues and expenditures.

• Measuring sustainability is especially important when low-income countries debt finance spending increases in the expectation that doing so will create future fiscal space.
The Shrinkage of Fiscal Space in Developed Countries

- Fiscal rules that constrain budget aggregates
  - The potency of fiscal rules depends on how they are enforced

- Political resistance to tax increases
  - The recent trend in most developed countries has been to reduce taxes

- Baseline projections protect existing programs and built-in increases
  - This tendency is strongest when the baseline is adjusted for projected price changes

- Growth of entitlements and other mandatory spending
  - In many countries, expenditures are more rigid than in the past

- Demographic trends compel government to spend more on pensions and health care
  - The problem is greatest in countries that do not prefund future obligations

- The spread of fiscal decentralization
  - This trend requires central governments to transfer a large portion of revenue to subnational governments

- Ad hoc budget decisions
  - Political pressures and other factors now impel governments to allocate money yearround, not only during budget season
Enlarging Fiscal Space

• Many tactics for creating space are perennial features of budgeting
  – Enlargement is likely to be marginal in high-income countries, potentially very significant in low-income countries

• Generating additional revenue through changes in tax policy
  – The lower revenue is a proportion of GDP, the greater the prospect for boosting revenue

• Reallocation from lower to higher priorities
  – This is difficult in all governments, including those that invest in program evaluation, but spending units often adjust expenditures without vetting the changes through the budget process

• Asset sales and privatization
  – When these transactions are booked as current revenue, government may actually shrink future space

• Public-Private Partnerships
  – These transactions can enlarge space for investment provided they are well structured, risks are assessed and limited in advance, and there are genuine efficiencies in relying on private providers