BUDGETING FOR FISCAL SPACE

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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

<u>All Countries</u>

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

<u>Low Income Countries</u>

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

<u>Middle Income/Developmental Countries</u>

To promote rapid development without undue risk to the government's future fiscal position

<u>Highly Developed Countries</u>

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

<u>Low Income Countries</u>

- The key question is how to <u>create</u> 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

<u>Developed Countries</u>

- The key question is how to rationally <u>allocate</u> 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

<u>Middle-Income Countries</u>

- 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