Fiscal space and development strategies

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In this paper, I am going to attempt to set the scene for a debate amongst participants about the question on how countries can create fiscal space to support growth and poverty reduction. I will mainly draw on a publication of the World Bank *("Fiscal Policy for Growth and Development"*), and one by Peter Heller *("Fiscal Policy for Growth and Development: The Fiscal Space Debate"*).

Setting the scene will require a brief discussion of the concept of fiscal space, considering alternative ways in which fiscal space can be created and linking this to enhanced growth and poverty reduction.

Before we get into the concept of fiscal space, let us observe the international consensus that fiscal policy cannot just be about macroeconomic stabilization, but that it needs to balance such stability with growth consequences. Stability is indeed a necessary condition for growth, but it alone is not sufficient and fiscal policy therefore needs a focus on the likely growth effects of the level, composition and efficiency of public spending and taxation. The evidence from countries that stabilized their economies by reducing their deficits indicates that countries often did so by cutting public capital formation significantly, despite its potential negative impact on growth and poverty reduction. Part of the problem is the dominant focus on fiscal deficit as a primary policy target. Whilst fiscal deficit is a useful indicator for purposes of stabilization and for controlling the growth of government liabilities, it offers little indication of longer term effects on government assets or on economic growth.

Turning to "fiscal space" – in the World Bank paper it is defined to exist "*when a government can increase expenditure without impairing its fiscal solvency, i.e. without impairing its capacity to service its debt*[1]." Heller defines "fiscal space" as "*the capacity of a government to provide financial resources for a desired purpose, subject to the constraint that the fiscal position is sustainable, both over the medium- and long-term*." In both the definitions, the fiscal sustainability constraint is clearly critical and this implies that a government's expected future revenue stream must be sufficient to allow it to finance both its future expenditure requirements and to pay back its existing stock of public debt. Another

[1] This would require that a government generate, in present value terms, future primary surpluses and revenue higher than the value of the outstanding debt.

critical consideration is that of “macroeconomic space”, which exists when a government can increase expenditure without impairing macroeconomic stability. Since both solvency and stability must be safeguarded for long-term growth, a government can undertake additional public expenditure when there is both fiscal and macroeconomic space.

Let’s now consider some alternative ways in which “fiscal space” can be created. But we need to upfront qualify the generic mention of these measures, since their application should be highly country specific. The need for fiscal space may arise for several quite different reasons - new public investments may be needed for changing infrastructure demands, brought about by issues such as climate change; failure to adequately maintain existing infrastructure; additional outlays may also be needed to alleviate bottlenecks to realizing a higher economic growth rate; it may also be needed to mitigate the risk that a government’s future fiscal position will be unsustainable.

Fiscal space can firstly be created through measures that do not require borrowing – for example through: (a) improvements to the efficiency of public expenditure that release resources for reallocation; (b) efficient revenue enhancement measures, including tax measures and user charges; (c) public private partnerships (PPP); (d) through access to external grant aid; and (v) addressing inefficient and loss-making state enterprises. Alternatively, governments may try to create fiscal space through new borrowing. A country’s fiscal conditions – the level and composition of public debt, the level and efficiency of its existing expenditure, its revenue effort, its access to aid and its ability to access borrowing from financial markets – determines its scope for creating fiscal space from any of these measures. In both cases the opportunity is in using fiscal space to raise the potential growth rate of the economy, without compromise to macroeconomic stability.

Let us take a closer look at some of these measures –

a. **Efficiency and effectiveness of public expenditure.** This is critical to outcomes, including growth. In many developing countries, cost-overruns, poor project management, and poor maintenance of new assets result in inefficient creation and maintenance of infrastructure assets. Leakages and waste may imply that increases, for example in health and education spending, do not necessarily translate into better outcomes. Typically these reflect underlying problems of capacity for budget management and, in some cases, of governance. If institutional weaknesses and problems of governance that cause poor outcomes are not addressed, even spending on potentially high return programs will have little impact on growth. The net impact will be to erode the government’s solvency and reduce its fiscal space. In addition, approaches to rationalize expenditure must always be on the table.

b. **Tax measures.** Countries having a relatively low tax burden have an opportunity to explore measures to increase revenues. In general approaches that seek to broaden the tax base and strengthen tax administration are preferable to higher rates.

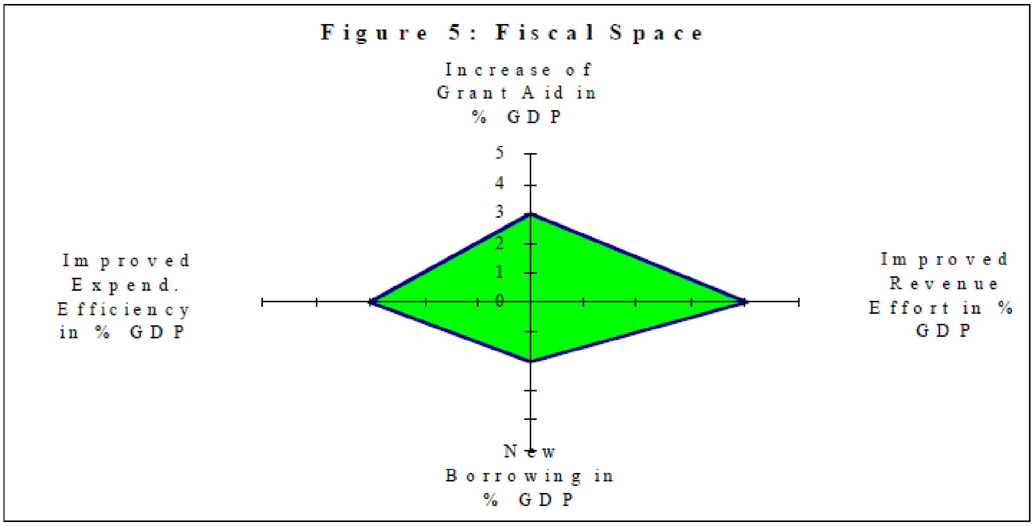
c. **Private sector initiatives.** Relying on private sector initiatives to finance and provide services reduces the need for fiscal resources and is also preferable from a welfare perspective. However, concerns about expropriation, pricing and regulatory policies are often a binding constraint to private participation. This then often requires reforms to attract private interest in financing and provision of specific infrastructure services, including through risk-sharing arrangements reflected in public private partnerships (PPP). According to Heller *"the real fiscal space created by a PPP hinges on two properties: first, will the private sector producer be more efficient than the government in the production or provision of the given type of services? And, second, might there be greater scope for an infrastructural project to be financed by capital markets if undertaken by the private sector rather than by the government."* Experience shows that private sector interest is often not forthcoming or confined to a limited number of sectors, and that some public investment is a necessary complement that may has the effect of "crowding in" private investment.

d. **External grant aid.** Among low income countries, fragile states have limited options to create fiscal space and will have to be sustained in the medium term with grant aid flows until a domestic revenue base can be established. For countries relying on grant flows to finance recurrent spending programs linked to MDGs, there is clearly a need for donors to ensure predictable, flexible flows of grant aid. On the side of Governments there is clearly a need to ensure that domestic revenue mobilization efforts and the efficiency of spending are improved, both to ensure adequate resources to sustain recurrent spending as well as to enhance credibility necessary to sustain grant aid flows.

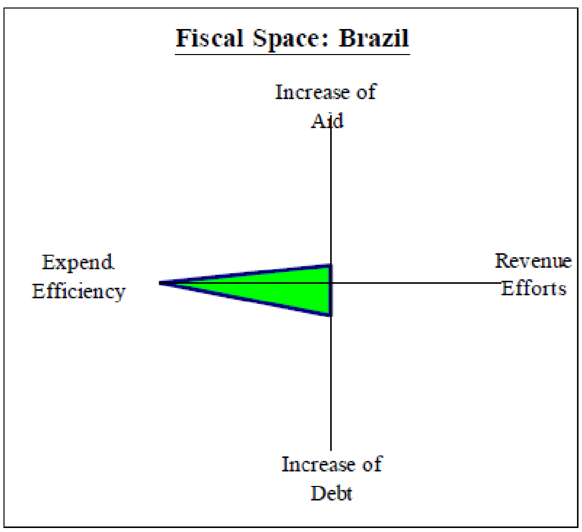
e. **State enterprises.** Inefficient and loss-making state enterprises are costing budgetary resources that could be used for more productive purposes. The loss in fiscal space that this entails may be direct—requiring current budgetary transfers—or indirect, adding to the overall general government public debt burden and limiting the potential new borrowing capacity of the government in terms of its fiscal sustainability position.

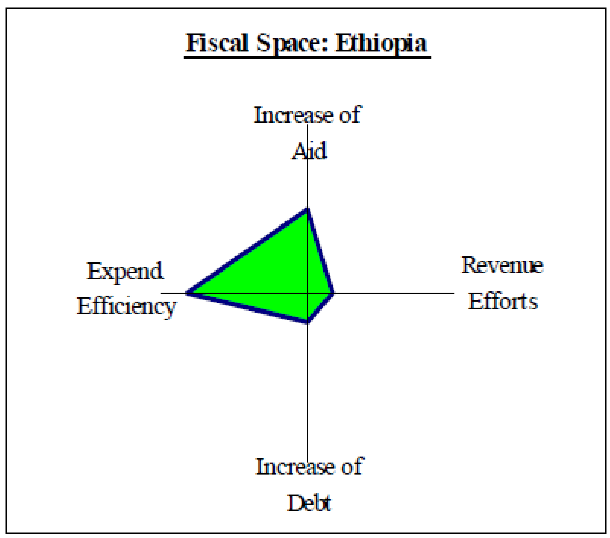
f. **New borrowing.** A further source of fiscal space is the capacity of a government to borrow resources. Such borrowing is normally limited by extent of existing debt, contingent liabilities and guarantees. The stronger an economy's growth prospects, the greater the debt servicing capacity and thus the possibilities for obtaining fiscal space in this way. In addition, governments with a track record of prudent fiscal management, low debt ratios and macroeconomic stability have been able to borrow from international markets at low interest spreads, which also helps to further create fiscal space. However, the capacity to borrow is also influenced by market perceptions of political risk, solvency and macro-economic stability - governments can either create or diminish fiscal space through their policies and actions.

A useful broad fiscal typology using four "fiscal space diamonds" is used in the World Bank paper, which helps to visually depict fiscal options available to a country across the following dimensions – new borrowing, access to aid, the ability to raise revenue and improving the efficiency of expenditure. This is demonstrated in the Fig. 5 below -



Applying this to specific country cases provides some visual examples of fiscal space options – for example, for a country such as Brazil with a relatively high revenue share, minimal increase in aid flows and borrowing limited (except for self-financing projects), creating fiscal space is largely dependent on improving efficiency of spending. Ethiopia on the other hand clearly finds itself in a different position, with fiscal space options largely in additional aid and improving expenditure efficiency.





But identifying the options for increased fiscal space is only a necessary first step. Linking it to enhanced growth and poverty reduction is, so to speak, where "the rubber hits the road". Again the generic examples below should be qualified, because country-specific circumstances and issues dominate.

In reflecting on the priorities for using any available fiscal space by G20 members, Heller concludes that some common themes do emerge – (i) Infrastructure needs appear to be an important priority, including investment in infrastructure that will be responsive to new challenges, such as climate change, and technologies that will facilitate productivity in the 21st century, such as the telecommunications sector; (ii) research and development outlays appear under-funded, particularly in light of the global challenges of climate change, possible future water shortages, and limits on energy resources from conventional sources; (iii) addressing prevailing generational imbalances, including what appear to be excessive existing formal commitments on pensions and medical care and inadequacy of current spending on the younger generation; and (iv) addressing poverty challenges.

In conclusion, let’s consider the attention to budget systems, development of medium term expenditure frameworks, and institutional capabilities for budget management in this context. It most certainly remains important, even more so because of the remaining challenge in many countries to improve linkages with policy objectives and more explicit consideration of how those objectives are influenced by the political economy of the country. Much remains to be done, and it certainly provides countries working with the IMF, World Bank, other development partners and CABRI with ample fertile ground for their interventions.

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