

Adam, Christopher S.; Bevan, David L.

**Working Paper**

## Fiscal policy design in low-income countries

WIDER Discussion Paper, No. 2001/67

**Provided in Cooperation with:**

United Nations University (UNU), World Institute for Development Economics Research (WIDER)

*Suggested Citation:* Adam, Christopher S.; Bevan, David L. (2001) : Fiscal policy design in low-income countries, WIDER Discussion Paper, No. 2001/67, The United Nations University World Institute for Development Economics Research (UNU-WIDER), Helsinki

This Version is available at:

<https://hdl.handle.net/10419/52768>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*



United Nations  
University

**WIDER**

World Institute for Development Economics Research

Discussion Paper No. 2001/67

## **Fiscal Policy Design in Low-Income Countries**

Christopher S. Adam  
and David L. Bevan\*

August 2001

### **Abstract**

For many low-income countries, there has been an extended period in which fiscal policy was not a choice, or was a choice made by authorities external to the country. For a number of them, this situation is now changing. Their own success in stabilising the economy, coupled with a shift in the stance of the international community (most notably the IMF), has placed fiscal choices back on the domestic agenda. However, the scope for choice may be heavily circumscribed by the legacy of past fiscal laxity. There are two challenges to the domestic fiscal authority in these circumstances. First they must gauge how best to manage the transition from the immediate post-stabilisation period to the longer term (post-post-stabilisation). Second, they must see how these longer term fiscal choices can best accommodate the requirements of preserving macroeconomic stability with the encouragement of growth and poverty reduction.

Keywords: fiscal policy, macro-economic stabilization, sub-Saharan Africa

JEL classification: O23, O55, H62

Copyright © UNU/WIDER 2001

\* Department of Economics, University of Oxford

This study has been prepared within the UNU/WIDER project on New Fiscal Policies for Growth and Poverty Reduction which is directed by Tony Addison.

This paper was presented at the project meeting in Helsinki, November 17-18, 2000.

UNU/WIDER gratefully acknowledges the financial contribution to the project by the Government of Italy (Directorate General for Development Cooperation).



## **1 Introduction**

The design of fiscal policy in low-income countries has recently become a much more active focus for debate within and between the international financial institutions and the donors, as well as in the countries themselves. There are three reasons for this increased attention.

### **Successful stabilisation**

The first reason is that a number of governments have largely succeeded in stabilising and disinflating their economies, often making use of a rather draconian device for controlling aggregate spending, the ‘cash budget’. This success means that, within the set of possible policy choices, there is now a range of viable (sustainable) alternatives. One choice may be judged better than the others, but there is a choice. Previously, a history of fiscal indiscipline had often yielded high inflation, depleted foreign exchange reserves, a private sector starved of credit, a flight from domestic currency, foreign exchange rationing, and an overvalued exchange rate. In these circumstances, rapid reduction of the fiscal deficit became an imperative. There might have been limited room for manoeuvre on the speed of adjustment, provided donors were content to supply the accommodating finance, but there was none on the direction of change. Fiscal policy had simply become a matter of progressively lowering the deficit, and there was little scope for discretion. In effect, governments had placed themselves at a boundary of the possible policy space; they were at a corner solution. Post-stabilisation, they are once again in the interior of the viable policy space, and can exercise choice.

### **The IMF**

The second reason is that the IMF has also been rethinking its position. In the circumstances described in the previous paragraph, it had often found itself in the position of a crisis manager. The lack of discretion available to the government was equally binding on the Fund in its role as the international community’s watchdog on fiscal probity. Fiscal policy had to be directed at stabilisation, and it was incumbent on the Fund to insist on this. As a number of governments succeeded in stabilising their economies, alternative fiscal choices could again be contemplated. The Fund was often slow to acknowledge this, and came under increasingly heavy criticism for inflexibility.<sup>1</sup> Academic observers, NGOs, and also several of the bilateral donors became concerned that this inflexibility was pre-empting policy debate (IMF 1998). Recently, the Fund has been undergoing a major rethinking of its role. This has involved a shift towards recognising the desirability of greater flexibility in fiscal targets coupled with greater national ‘ownership’ of policy. This confers increased scope but also greater responsibility on governments to examine the options and choose between them.

---

<sup>1</sup> The Fund is often portrayed as being exceptionally monolithic. In fact, there was considerable variety in the extent of its inflexibility/flexibility, depending on the make-up of different country teams.

While the primary dialogue on fiscal matters will remain one between the government and the Fund, it should also involve other donors, especially to the extent that they commit to budget support or otherwise embrace the Medium Term Expenditure Framework as the organising principle. Increasingly, they will need to become comfortable not only with issues of budget composition, as previously, but also on the stance of fiscal policy. For example, if the Fund is no longer insisting on a particular number for the budget deficit, so that this is not pre-empted from consideration by anyone else, it becomes a matter for choice and dialogue, and will involve weighing up alternatives. In the past, even though some of donors adopted positions critical of Fund recommendations, it was nonetheless possible for them and, to an extent, the government to abdicate from the issue of choosing the macroeconomic stance of the budget. The relative non-negotiability of the IMF's position—often fully justified by a lack of real room for macroeconomic manoeuvre—pre-empted the macro policy debate. In light of the changes noted above, a broader dialogue is now required.

### **Long run development goals and institutional changes**

The third reason is that donors, international institutions, and in many cases governments have recently articulated their objectives much more clearly than hitherto, so that most policy components and aid initiatives are to be assessed against their contribution to poverty reduction and growth. This refocusing of objectives has been accompanied by changes to the instruments relating aid flows to the policies of the recipient governments. While different countries are at different stages in the process, the intention is that the key document will be the government's Poverty Reduction Strategy Paper (PRSP), which will replace the Policy Framework Paper (PFP). Unlike the PFP, which was often supposed to have been drafted in Washington, it is intended that the PRSP be 'produced by the country authorities...in a transparent process involving broad participation, including representatives of the poor' (IMF 2000a). Given a satisfactory PRSP, the Fund will then provide support through the Poverty Reduction and Growth Facility (PRGF), the successor to the Extended Structural Adjustment Facility (ESAF). The main features of PRGF-supported programmes must be seen to be drawn from the country's PRSP. Similarly, the World Bank will base its lending around the programme embodied in the PRSP, and has introduced a new instrument, the Poverty Reduction Support Credit (PRSC) which can provide associated budgetary support. Other aid flows, such as those arising from the enhanced HIPC provisions for debt reduction, and much of that provided bilaterally by donors, will also reflect the provisions of the PRSP. The preferred vehicle for implementing the macro/budgetary aspects of the programme remains the Medium Term Expenditure Framework (MTEF) (see Foster and Fozzard 2001).

This renewed emphasis on poverty reduction and growth is taken to include fiscal policy. The primary role of fiscal policy remains that of maintaining a stable macro economy, since it is accepted that macroeconomic instability is generally bad for growth and for the poor. Within the set of fiscal policies that are consistent with achievement of that primary target, choice should emphasise poverty reduction and growth. However the links between (sustainable) alternative fiscal policies and changes in poverty or growth are not well understood.

The upshot of these three related developments is that fiscal policy choices are not only on the agenda in a way they were not a few years ago, but also that they need to be analysed thoroughly, since their consequences for the outcomes of interest are not clear-cut. This paper examines some aspects of these choices in the case of countries where stabilisation has been achieved or is otherwise not a problem. This still leaves an important distinction between those countries which have only recently achieved stabilisation following a period of severe instability (such as triple digit inflation), and those which either have had a reasonably extended period of adjustment following stabilisation, or had never suffered from severe instability in the first place. The former group will face a transition period during which the system's *stocks* (for example, foreign exchange reserves and real money balances) remain at disequilibrium levels for a time even when the flows have been brought under control. The flows (for example, the domestic budget deficit after grants) must then be chosen in a way that permits appropriate stock adjustment. The latter group will have the relative luxury of stocks near their equilibrium values and so will have greater discretion over the level at which flows can be set. For convenience, we refer to the first circumstance as 'post stabilisation' and the second as 'post-post stabilisation'.

The paper is organised as follows. Section 2 briefly reviews the evolution of fiscal and related magnitudes in a range of developing countries between the mid 1980s and the late 1990s, paying particular attention to the low-income economies of Sub-Saharan Africa. Section 3 then discusses fiscal issues, which are specific to the post-stabilisation phase, that is to say those associated with stock imbalances and private sector demoralisation. Section 4 turns to post-post stabilisation issues, that is to say those which are relatively permanent features of fiscal management, such as any trade-offs between growth, inflation and poverty reduction, and the design of flexibility, for example in response to shocks. Section 5 discusses the mechanisms for implementing policy, including the cash budget and what may be introduced to succeed it. Section 6 concludes.

## **2 Fiscal characteristics of low-income stabilising countries**

In order to appreciate the specific characteristics of low-income post-stabilisation economies we examine the evolution of the principal fiscal variables in these countries both during and after stabilisation and compare this pattern with that experienced by other developing countries. Table 1 provides summary evidence on key fiscal stocks and flows for a range of countries during the late 1980s and 1990s. Countries are classified into four groups. The first two groups comprise countries which have successfully undergone aggressive price-stabilisation aimed at eliminating chronically, and often exceptionally, high rates of inflation. These two groups constitute 32 separate stabilisation episodes, specific details of which are provided in Appendix Table 1. Of these, 12 are in Sub-Saharan Africa and 5 from other low-income countries. The remaining 15 are middle-income economies, particularly those in Latin America and

Table 1. Stock-flow characteristics of stabilisation episodes

<u>Annual Change during Stabilisation</u>			<u>Control Group</u>		
	<u>High - Inflation</u> <u>Low-Income Countries</u>	<u>High - Inflation</u> <u>Middle-Income Countries</u>	<u>Low-Inflation</u> <u>African Economies</u>		
Median duration of stabilisation	4 years	3 years			
Inflation	-15.58%	-21.83%	-0.42%		
Primary Budget Balance (% GDP)	0.34%	0.47%	0.09%		
Overall Budget Balance after grants (% GDP)	0.13%	0.30%	-0.92%		
ODA (% GDP)	-0.03%	-0.05%	-0.41%		
Domestic Debt (% GDP)	-0.54%	n.a.	2.03%		
Domestic Interest (% GDP)	-0.01%	-0.04%	0.11%		
External Debt (% GDP)	0.33%	-3.51%	1.88%		
External Debt Service (% GDP)	-0.43%	-0.05%	-0.28%		
Foreign Reserves (% GDP)	0.51%	0.25%	0.81%		
Money, M2 (% GDP)	-0.63%	-0.01%	0.12%		
Dom Credit to Govt (% GDP)	-0.75%	-1.38%	0.23%		
Dom Credit to Pri. Sec (% GDP)	-0.48%	0.21%	0.08%		
Total Tax Revenue (% GDP)	-0.04%	0.20%	0.08%		
<u>Post-Stabilisation Characteristics</u>			<u>Control Groups</u>		
	<u>Low-Income Countries</u>		<u>Middle-Income Countries</u>		
	<u>At Stabilisation</u>	<u>Stabilisation plus 5 years</u>	<u>At Stabilisation</u>	<u>Stabilisation plus 5 years</u>	
Annual Inflation	9.6%	10.0%	13.4%	7.1%	<u>Low-Inflation African Economies</u> 7.8%
Primary Budget Balance (% GDP)	-1.3%	-1.1%	2.2%	4.0%	7.2%
Overall Budget Balance after grants (% GDP)	-3.0%	-2.9%	-0.7%	-1.0%	-2.1%
ODA (% GDP)	18.0%	12.6%	1.3%	0.7%	-3.8%
Domestic Debt (% GDP)	4.5%	6.3%	n.a.	n.a.	7.4%
Domestic Interest (% GDP)	1.1%	2.0%	1.5%	1.4%	1.1%
External Debt (% GDP)	95.8%	80.8%	40.2%	39.0%	32.2%
External Debt Service (& GDP	4.1%	2.0%	3.8%	5.5%	1.0%
Foreign Reserves (% GDP)	7.1%	8.9%	10.6%	13.0%	87.3%
Money, M2 (% GDP)	11.2%	11.2%	29.7%	35.5%	2.1%
Dom Credit to Govt (% GDP)	5.4%	11.5%	7.7%	6.2%	5.7%
Dom Credit to Pri. Sec (% GDP)	5.7%	10.1%	27.1%	33.5%	12.0%
Total Tax Revenue (% GDP)	12.2%	12.2%	15.9%	15.5%	20.7%
					2.3%
					16.0%
					29.0%
					26.7%
					24.0%
<b>Memo Items:</b>					
Inflation rate prior to stabilisation	83.0%		128.0%		15.0%
Average GDP growth prior to stabilisation	1.5%		3.3%		
Post-stabilisation GDP growth	3.6%		3.7%		2.6%
					3.1%

Source: World Bank World Development Indicators 2001

Notes: [1] Data reported in this table are derived from Appendix Table 1. Changes (top panel) and stock and flow levels (bottom panel) are unweighted sample medians  
[2] The changes in Inflation (top panel) is expressed in percentage points. All other changes and levels expressed in percentage points of GDP  
[3] The sample for the control groups is 1980-1998 (see also Footnote 3 in text—p. 5)  
[4] Because of aggregation across countries, implicit balance sheet constraints (for example the domestic monetary survey) do not necessarily hold.  
[5] Pre-stabilisation growth computed over 5 years prior to start of stabilisation episode  
[6] n.a. denotes data not available

the Caribbean.<sup>2</sup> Two control groups are also identified. The first is a set of African countries which have enjoyed relatively low inflation over the last two decades,<sup>3</sup> and the second consists of a set of 57 other low- and middle-income countries (excluding those counted elsewhere).

In this paper our interests lie principally with the group of ‘successful’ stabilisers, those countries which have restored price stability starting from a position of severe macroeconomic disequilibrium, in which price instability frequently represented a threat to the economy as a whole. This category is of relevance not only because it includes many countries where the question of fiscal management is the subject of active debate, but also because the experiences of this group of countries trace out plausible trajectories for a number of other countries still in a state of macroeconomic instability such as Zimbabwe and Nigeria. Included in the group of successful stabilisers are a set of well-known high or hyperinflation economies—Nicaragua at the end of the 1980s, Ghana in the early 1980s, and Uganda, Mozambique, Sudan, Sierra Leone and Zambia in the early 1990s, all of which managed to bring inflation down from triple-digit levels in a short period of time. But the group also includes countries where the initial inflation was lower but where stabilisation efforts were directed towards the elimination of chronic but relatively moderate official inflation rates, often in cases where price and other controls served to repress domestic inflation. This latter group includes countries such as Tanzania, Kenya, the Gambia, Honduras, and Guinea.

As Appendix I clearly illustrates, our data necessarily embrace an extremely large range of experience, reflecting both differences in the origins of the economic crises precipitating stabilisation, and the political and institutional context against which the stabilisation efforts took place. Thus our data set includes countries in which economic crisis can be traced to external trade or climatic shocks, to domestic policy failures, or to conflict. However, it is not our intention to examine either the origins or the particular anatomy of stabilisation episodes. Rather, our concern is with the legacy of stabilisation and its implications for post-stabilisation policy choices. In this respect the data suggest a number of important stylised facts.

Consider first the actual process of stabilisation, which is reported in the top half of Table 1. The first important feature to note is the fundamental link between the budget, its financing, and inflation. Although the relationship is non-linear, inflation control has typically been associated with a sharp reduction in domestic credit to the government, in the order of 0.75 percent of GDP *per annum* during the stabilisation period amongst low-income stabilisers and 1.4 percent of GDP *per annum* in middle-income stabilisers. In a number of countries where the stock of credit to government was already low, such as Haiti, Mozambique and Tanzania, the squeeze has been even larger, averaging closer to 2.0 percent of GDP *per annum*. A number of factors have helped finance this contraction in credit, most notably an improvement in the primary fiscal balance, which

---

<sup>2</sup> ‘Successful’ stabilisation episodes consist of all countries which have seen domestic price inflation fall from high levels to rates less than 15 percent per annum, where the latter are sustained for at least two years, and for which there exist sufficient data on key fiscal aggregates. Data limitations mean that the set excludes a number of stabilisations experienced by transition economies as well as in Laos and Cambodia.

<sup>3</sup> This group consists of Botswana, Lesotho, Swaziland, Namibia, Comoros, Djibouti, Ethiopia (1985-94), Liberia (1980-89), Mauritius and the Seychelles.



increased by 0.3 percent of GDP *per annum* in low income countries and almost 0.5 percent *per annum* for middle-income stabilisers. This adjustment to the primary balance was accompanied on average by a modest increase in domestic revenue generation in middle-income countries but by a slight fall in low-income countries, implying a significant role for expenditure reduction in achieving stabilisation. Just how significant this adjustment in public expenditure was can be seen if we compare the experience of the low-income countries with the first control group, those (African) economies which, for whatever reason, managed to maintain a fair degree of fiscal control over the 1980s and 1990s. Relieved of the need to lean heavily on fiscal policy levers, this group enjoyed a looser overall fiscal stance (funded in part by a slight increase in the tax yield, higher domestic borrowing, and by higher external assistance), and at the same time a modest ‘crowding-in’ of credit to the private sector.

The withdrawal of government from the domestic credit market during stabilisation has not, in general, been accompanied by a crowding-in of credit to the private sector, which rather has been squeezed on two fronts, particularly in low-income countries. On the one hand the legacy of high and variable inflation, combined frequently with financial liberalisation, has reduced the private sector’s willingness to hold domestic money. Real money demand fell on average by 0.6 percent of GDP *per annum* during stabilisation in low income countries (but by notably less in middle-income countries). On the other hand, stabilisation episodes have seen governments re-building their net international reserves, by around 0.5 percent and 0.25 percent of GDP *per annum* in low- and middle-income countries respectively. The net effect of the decline in the demand for money and an increase in net *foreign* assets has been an offsetting reduction in total domestic credit available to the economy. Thus despite the reduction in the public sector use of domestic credit, credit to the private sector also fell, particularly in low-income stabilising economies where the absolute volume of credit going to the private sector fell by an average of 0.5 percent of GDP *per annum* through the stabilisation process.

What is more important from the perspective of this paper is the state in which countries undertaking stabilisation exited from the stabilisation phase. This is summarized in the bottom panel of Table 1 that details the immediate ‘post-stabilisation’ fiscal configuration and, in the case of the stabilising economies, the configuration five years after price stability had been achieved (where data are available to do so). Again a number of common themes can be identified. Overall, stabilising economies have emerged from the period of fiscal contraction with a relatively tight fiscal stance and, for the low-income countries at least, a marked recovery in average GDP growth. For low-income stabilisers the overall budget deficit averages around 3 percent of GDP and is sustained in large measure by high levels of concessional aid flows.<sup>4</sup> For middle-income economies with less access to concessional development assistance the fiscal balance is tighter by around two percentage points of GDP

The key feature of the post stabilisation configuration is, arguably, the disposition of the stocks of aggregate assets and liabilities. On the basis of our data it would appear that low-income economies emerge from stabilisation with low levels of domestic debt; high net external liabilities (i.e. external debt net of reserves); low levels of monetisation; and

---

<sup>4</sup> The lack of accurate data on *domestic* debt makes it difficult to fully reconcile reported stocks and flows in Tables 1 and A1.

hence limited domestic credit to the private sector, even though domestic credit to the government is relatively tightly reined in. Importantly, these stock positions are low relative not only to their own history, as implied by the top panel of Table 1, but also relative to those African economies that have enjoyed more gradualist stabilisation experiences, relative to middle income stabilisers, and also relative to other low- and middle-income countries outside Africa. Thus although inflation has been brought in line with rates experienced elsewhere in Africa, and the domestic tax effort edged up marginally during stabilisation, domestic revenue rates, the demand for money, and domestic credit to the private sector remain exceptionally low, at levels that are less than half the level enjoyed by other African economies, and as little as a quarter of the levels enjoyed in other low- and middle income countries

Moreover, as the (admittedly limited) data presented in columns 2 and 4 of the lower panel suggest, despite having successfully tackled high inflation, the recovery of key asset stocks in the post-stabilisation phase is unlikely to be as rapid. Although the time-span of our data is typically short, a consistent message emerges: although our set of ‘successful stabilisers’ have sustained reasonable low-inflation growth post-stabilisation, neither domestic resource mobilisation nor domestic asset stocks (of the government, the private sector, and the banking sector) have recovered in the post-stabilisation period to any measurable degree so that the post-stabilisation ‘gap’ remains wide even after a sustained period of fiscal control. Reaching the post-post-stabilisation phase appears to be a very protracted business.

In the remainder of the paper, we examine the reasons for the persistence of this low post-stabilisation stock configuration and consider the implications this has for the conduct of fiscal policy in a post-stabilisation phase.

### **3 The post-stabilisation phase**

We begin by considering a country that has recently emerged from an extended period of severe disequilibrium, the government having brought the budget under control, and reduced inflation, let us say, to a single digit rate. As noted in the introduction, there are likely to be a variety of stock and other consequences that will take time to correct, and which will limit fiscal policy options in the short run. There are seven major (related) categories of ‘hangover’ to consider. They are the levels of domestic and external government debt; the partitioning of domestic credit between the private sector and the government; the level of foreign exchange reserves; the private sector’s demand for real money balances; the state of the private sector in respect of confidence, entrepreneurial capacity, and institutional capacity; and the capacity of the government itself to spend productively. While the impact of these factors on fiscal policy is likely to be intertwined, it is helpful to consider them sequentially.

#### **External debt**

For the large class of highly indebted poor countries, the financing of external debt service is a major issue. Either the government must run unacceptably high domestic primary surpluses, or a major part of the current gross aid inflow is pre-empted to service the debt. The HIPC initiative is designed to reduce external debt to a level that is

deemed sustainable relative to some indicator of capacity to pay (GDP, exports or government revenue). Since the nominal value of debt is a poor indicator of the debt service burden (because of varying degrees of concessionality), the present value calculated at some benchmark set of discount rates is used instead. The intention is to maintain the gross inflow in face of debt reduction, so that the net inflow is enhanced. There has been some dispute about how this enhanced inflow should be used, whether to reduce the government's domestic debt, or to raise government spending in the social sectors. The third possibility, that of permitting a reduction in domestic tax effort, has rarely been treated as a serious option as concerns about the adverse (permanent) effects on domestic tax effort have tended to outweigh counter arguments concerning the distortionary effects of high domestic taxes. In any event, the stock adjustment problem implied by the excessive level of external debt is universally perceived to be an issue for the international community to resolve, not the domestic government through its own budgetary process.

However, it is less commonly understood or accepted that the revaluation of debt stocks in present value terms should logically imply a comparable redefinition of the budget deficit. Current practice is to distinguish between the deficit before and after grants, and the latter has increasingly been seen as more appropriate for countries which will effectively rely on grants and concessional finance into the long term (see Stiglitz 1998). However, just as the stock of concessional debt can be split into its implicit grant and market loan components (as in the HIPC present value calculation), so can the current flow of loans. A measure of the budget deficit can then be calculated after 'augmented' grants, i.e. grants plus the grant element in soft loans. The effect on the numbers may be quite substantial. For example, over the next three years in Uganda, the deficit before grants is projected to average 8.9 percent of GDP, that after grants 2.5 percent. However, the net inflow of loans is projected to average 3.5 percent. If, for illustration, we assume a grant element of 70 percent in these loans then the deficit after augmented grants would be zero (70 percent of 3.5 = 2.5). Since discussions of fiscal prudence so often centre on the size of the deficit, it is important to ensure that the most appropriate measure (or set of measures) is used.

### *Domestic debt*

Whereas the external debt of low-income countries is typically high relative to GDP, the position in respect of domestic debt is much more varied. In some cases, the level is low and there is no need to reduce it; of course, this may itself reflect a history of high inflation. In other cases, it is high, and the level of domestic debt service is also a problem. Frequently, this difficulty was concealed by financial repression which kept the domestic interest rate below market levels. The problem then became acute during the process of financial liberalisation. A particularly striking example of this effect was seen in Zimbabwe during the early 1990s. Throughout the 1980s the government had financed a large fiscal deficit through the sale of domestic debt at highly repressed interest rates. The liberalization of interest rates in 1991, in circumstances of a continued lack of fiscal control, saw domestic interest costs increase by almost 5 percent of GDP in the space of three years, as the government rolled over the large domestic debt stock at very high domestic interest rates (see, for example, IMF 1998).

In a post-inflationary situation in a closed economy, the only way to reduce domestic debt is to run a budget surplus by increasing domestic revenue and/or reducing

expenditure. However, in an open economy, domestic debt can be reduced without impacting on these domestic magnitudes, either by incurring more external debt—necessarily in a concessional form under the HIPC rules—or, preferably, by an increased flow of external grants. Thus the implications of excessive domestic government debt for fiscal policy depend on whether there exist willing donors who will finance the reduction. Of course, under the usual accounting rules, the domestic budget will be by-passed by the external financing if this takes the form of loans, but will record a domestic surplus if it takes the form of grants.

### *Domestic credit*

A previous history of fiscal indiscipline, directed credit, and financial repression is likely to have left as a legacy a very unbalanced use of domestic credit, with the private sector having been crowded out by the public sector. It will then be necessary for the public sector substantially to withdraw, permitting increased access to the private sector. There will not be a one-to-one relation in this process, because the total volume of domestic credit is not fixed. In particular, it will change over time in conjunction with the evolution of the demand for money and the rate at which foreign exchange reserves are rebuilt. The position may be further complicated by the need to write off bad debts incurred by parastatals, and to re-capitalise parts of the banking system (including the central bank). In addition, while it is emerging from an extended period of financial repression, the banking system will often be poorly equipped in the skills of risk assessment. It may therefore be difficult to sustain a rapid expansion of credit to the private sector without sacrificing prudence. If the government organises a very rapid reduction in its use of credit, this may therefore lead not to a correspondingly rapid rise in private credit, but to a reduction in the total. It is then possible that the laudable objective of making room for a resurgent private sector may actually inhibit the recovery, by reducing government demand without replacing this with private demand.

### *Foreign exchange reserves*

Once again, these may be at a severely depleted level in the immediate post-stabilisation phase. There are two issues, one being the choice of an appropriate target level, and the other being the speed at which reserves are re-built to this target level.

The target is usually expressed in months of imports, with four or five months being typical. Using import value as a base may seem logical, since foreign exchange reserves could be used to buy imports, and we might envisage a scenario where there was a temporary interruption to exports or aid receipts, and would wish to use reserves to cover imports during the interval. The appropriate level would then depend on the likely scale and frequency of these interruptions, coupled with a calculation as to the relative costs of managing them by tying up resources in the form of reserves, as opposed to fluctuations in the exchange rate (and consequently in the flow of goods). From this perspective, and on the most casual basis, the 4-5 month target seems plausible.

However, the case for using imports as the scaling factor may not be so overwhelming as appears at first sight. They are clearly there to provide accommodation, either in response to unforeseen events, or to relatively predictable volatility. However, in practice, their role may be more to insulate domestic monetary and budgetary policy from aid and domestic revenue volatility than the flow of imports from export

volatility.<sup>5</sup> When anticipated revenue and aid inflows do not materialise, or do not materialise on time, the government faces a choice. It could (temporarily) cut expenditures, with all that that would imply for disruption and ultimately increased costs. Or it could allow its deficit to increase, and find a way of financing this. Low-income countries typically have little capacity to vary the non-bank financing of government in the short term, so financing will have to found within the monetary system. If we rule out the expedient of an inflationary increase in the money supply, or any renewed attempt to pre-empt private sector access to credit, this can only be achieved by running down foreign exchange reserves. From this perspective, the real value of these reserves is to permit government to finance the revenue shortfall caused either by delays in donor disbursements or in domestic collections, rather than to guard against instability in export earnings. The most appropriate scaling factor would then be government expenditure rather than imports.

Whatever the target, it will be necessary to decide how rapidly it should be achieved. This will involve balancing the risks of inadequate cover against the costs of reduced levels of other desirable activities, such as concurrent expenditures or the adjustment of other stock imbalances, for example excess domestic debt. In IMF programmes in the recent past, the appropriate horizon was often taken to be 2-4 years. In other words, reserves were to be built up at the rate of 1-2 months of imports per annum. Of course, in an economy undergoing real growth, and especially if this were accompanied by rapid increases in imports (due both to increased aid flows and increased openness), this would all be relative to a moving target.

### *Demand for real balances*

It is a central tenet of monetary economics that the demand for real balances will decline in the face of inflation, and this is well substantiated by the evidence. There is in consequence an expectation that this demand will recover during the post-stabilisation phase. What is much less clear is the dynamics of this relationship. In particular, how long will it take for demand to recover following a successful and sustained disinflation? The evidence here suggests that the recovery is likely to be very long-drawn out and may be unpredictable. It does however potentially offer quite substantial opportunities for enhanced seigniorage in the medium run. For example, the demand for money in Uganda fell very substantially during the civil war and the associated triple digit inflation. Stabilisation was followed by a slow—and in this case fairly steady—recovery, worth about three-quarters of one per cent of GDP per annum. Failing to allow for this recovery would have meant that monetary policy was substantially more disinflationary than intended. This is the analogue of the possible disinflation associated with the attempted realignment of domestic credit discussed earlier.

There is a cautionary note to be entered here. The retreat from domestic currency during an extended episode of high inflation may be partly irreversible. Part of it may represent a conventional (and costly) process of economising on liquidity, which will be reversed when it is believed that it is safe to do so. The issue is then largely one of policy credibility. But another part may represent substitution of other means of payment, for

---

<sup>5</sup> Bleaney *et al.* (1995) argue that revenue instability is significantly higher in low-income countries than in more developed economies and is particularly severe in Sub-Saharan Africa.

example by dollarisation of transactions. Once private agents have invested in the necessary know-how and currency stocks, these alternatives may remain perfectly viable after the inflation rate has been reduced. There would now be no incentive to adopt these alternatives, but there is no incentive to abandon them either.

### *The state of the private sector*

The initial, post-stabilisation configuration of the private sector is also an important determinant of fiscal policy options. This has already been a recurrent theme in the discussion of money demand and domestic credit. But there is the more general issue of the state of the private sector, and its capacity rapidly to make use of the post-stabilisation opportunities offered it. A major component of the conventional wisdom of the last couple of decades is that for improved performance of the real economy, and in particular growth, it will be necessary to rely on the private sector. The role of government is to be restricted to provision of an appropriate ‘enabling environment’ and of suitable human and physical infrastructure. Given this type of policy stance, there may be an extended and uncomfortable period while a private sector which has become demoralised and unaccustomed to dealing with market forces gets its act together. This period may be particularly extended in post-conflict environments where basic market institutions are likely to take longer to recover (Addison and Murshed 2001).

There are likely to be a number of ways in which governments can respond to these difficulties, for example by ensuring that information and advisory services are widely available. It will also be important to maximise policy credibility, possibly by some pre-commitment devices. But realistically there is likely to be a recovery phase in which the private sector occupies less ‘economic space’ than it would in a more equilibrium configuration. The balance between government expenditures and any associated deficit financing may be struck differently during such a phase than they will be subsequently.

### *Absorptive capacity*

Running in the opposite direction to the previous point is the possibility that the government itself has low capacity, following a period when it had become distanced from its primary functions, including those as a service provider. Indeed this has often been the express rationale of NGOs in setting out to provide public services via parallel systems rather than through the budget and via the public sector itself. In turn, this response has often exacerbated the problem, starving the public sector provider of funds and simultaneously setting up a better-resourced and more credible alternative. The consequence of these developments is that the public sector not only has been under-resourced but also that its capacity to use additional resources has become compromised. In the short-term, these problems of public sector capacity may be exacerbated in a number of countries by the process of rapid decentralisation of responsibility for social services. There is therefore the possibility that the limit on what can fruitfully be spent in some sectors is limited more by absorptive capacity than by available resources. In that case, there is a risk that incremental resources will be wasted. While this is clearly conceivable, it seems more appropriate to respond to it if there is evidence that it is happening, rather than pre-empt the problem *ex ante* by withholding funds against the possibility that it might.

## *Summary*

There are three principal points to note about this discussion of issues. First, the severity of these various legacies from the past is likely to vary substantially between countries. Second, in varying degrees, they will require early and systematic attention. In consequence, fiscal policy in the post-stabilisation phase is likely to be heavily conditioned by the country's specific legacy and may differ markedly between countries. Third, the issues of growth and poverty reduction have not featured explicitly in the discussion. Of course, any rectification of problems that opens up the range of future policy options has considerable implicit relevance for achieving these goals. But the *direct* connection between these goals and the post-stabilisation restrictions discussed here appears to be slight.

## **4 The post-post-stabilisation phase**

The issues discussed in the previous section will be resolved at very different rates. So, for example, the initial imbalance in foreign exchange reserves is likely to have been rectified within a very few years of stabilisation, while full recovery in the demand for money might take a decade. Thus the transition between these two phases is likely itself to be protracted. For purposes of exposition, we ignore this complication and proceed to consider an economy for which none of the preceding seven issues remains a serious problem. Hence, fiscal choices can be made in the light of long run rather than short-run considerations. Since the economy is certainly going to continue changing over time, these considerations are still dynamic rather than static ones, but in many cases these can usefully be thought of in a context of (more or less) balanced growth. In this section, we examine five of these; the target level of domestic revenue mobilisation; the composition of government spending; the target inflation rate; the associated domestic financing; and the problem of fiscal shocks. Two assumptions are made about aid inflows. First, it is assumed that the level of concessional aid flows available to the country is non-negotiable (though it clearly might vary in response, for example, to a perceived decline in the quality of policy). Second, it is assumed that absorptive capacity is not a problem, so that all available aid should be accepted.

### *Domestic revenue mobilisation*

During recent decades, a powerful consensus has developed as to the appropriate design of tax systems and other devices for generating government revenues (Heady 2001). This has included not only the structure of taxes, but also the level of tax rates. This conventional wisdom is probably pretty soundly based, and so to refuse to subscribe to it would be imprudent as well as incurring disapproval from the International Financial Institutions. There also appears to be a consensus that this structure should lead to revenues on the order of 15-20 percent of GDP. Remarkably enough, however, very similar tax structures and tax rates seem to generate very different revenues in different countries. The reason presumably lies in different levels of taxpayer compliance and of the efficiency of tax administration, and this is where a government's discretion to increase revenue mainly lies.

Some of the most salient recent examples of successful stabilisation have been poor performers relative to the conventional benchmark (for example, both Uganda and

Tanzania at 11-12 percent of GDP). Since another conventional assumption is that government expenditure in low-income countries should reach 20 percent of GDP or so, this raises a major issue. Will donors be prepared to find the missing 8-9 percent of GDP into the long haul? If not, how can domestic revenue be raised, by how much and over what time-scale? If a sufficient increase can be achieved by improved administration and a broadening of the tax base, this might not be too damaging. But if it can only be achieved by substantial rate rises on the existing, often narrow, tax base with a continuing inefficient administration, the increasingly distortionary tax structure might be severely inimical to growth. However, if donors progressively withdraw from the very high current rate of supplementation of government resources, and there is no improvement in domestic revenues, a severe squeeze on spending will ensue. Unless social sector spending can be ring-fenced in the face of severe aggregate cuts, poverty reduction is likely to be seriously compromised.

#### *Composition of government spending*

At first sight, this appears to be the area in which local discretion and participation would have their clearest purchase. However, in practice it has become in part a donor prerogative. In some cases, there appears to be common ground between the two groups in the wish to shift the composition of spending towards the social sectors and other categories perceived to be pro-poor, such as infrastructure spending on water supply and rural roads. In other cases there is more of a tension. When donors are financing a large proportion of total expenditures, it would be too much to hope that their compositional preferences would always coincide with local wishes—or indeed that either group of preferences would even be internally coherent. Nor is it reasonable to expect donors to abdicate from any responsibility as to how their funds are spent. In consequence, the process of arriving at the composition of spending is necessarily a political process, involving a certain amount of horse-trading. What is crucial is that this be done in a reasonably coherent and transparent way; sequential dialogues over the poverty reduction strategy paper, culminating in agreement of a medium term expenditure framework, seem to offer sufficient scope for this. However it is very important for all the major donors to buy into this process and to live with it subsequently. This implies an incomplete form of local ownership, and a three way participatory process.

It is at the level of budget composition that the relationship between budgets and poverty reduction is most apparent. The conventional wisdom is that poverty reduction is best served by shifting resources from other sectors, such as defence and general administration, towards the social sectors, especially primary education and primary health care, and towards certain types of infrastructure provision, such as rural roads and water supply. This is intuitively appealing, but it has to be said that the evidence is somewhat mixed, and it is worth sounding a few cautionary notes. For example, the extensive efforts at consultation with rural inhabitants in Uganda, during preparation of the current poverty eradication action programme, revealed that concerns about insecurity were central to their perceptions of the causes of poverty (Government of Uganda 2000). Similarly, it is widely believed that both corruption and difficulties in enforcing contracts retard growth and hence poverty reduction, but the fight to rectify these defects is likely to require increased spending on administration (to improve monitoring and audit) and legal institutions such as courts. At the other extreme, little poverty impact is achieved by increasing the drug budget for the health system if drugs are routinely sold on illegally by corrupt employees. Hence it may be more difficult than popularly supposed to identify sectors or line items in the budget that have especial leverage on poverty.



### *The target inflation rate*

The target rate of inflation is fundamental to the macroeconomic framework. Even setting aside the operational issue of how the authorities go about hitting a target for the inflation rate, the prior question of what that rate should be has generated extensive debate. However, the evidence on this point is actually relatively clear and entirely consistent with intuition. Since this section focuses on a situation where high inflation has already been removed from the system, it does not explore the dynamics of disinflation, but restricts attention to two issues. The first concerns the relationship between inflation and aggregate economic growth over the medium term, and the second concerns whether the inflation-growth trade-off is characterised by particular distributional biases. Specifically, are there points on the trade-off where lower aggregate growth is compensated for by higher growth amongst the poor?

On the first issue, the consensus evidence from cross-country data is strong (see Ghosh and Phillips 1998). The key point is that for very low values of inflation (i.e. less than 3 percent per annum) higher inflation is associated with higher growth, reflecting the fact that very low rates of inflation limit the scope for efficient relative price and real wage adjustment. Above this level of inflation, and certainly by the time inflation reaches double digits, the relationship is negative: higher inflation is associated with lower growth, but at a reducing rate. This convexity in the relationship<sup>6</sup> implies that the inflation-growth trade off is at its most severe in the region of chronic moderate inflation of between 10 percent-40 percent per annum. These empirical estimates of the inflation-growth trade off appear to be robust in the relevant dimensions. Even allowing for some variation around the central point estimates, we can say with a fair degree of confidence that the growth-maximising rate of inflation will lie somewhere in range of 5 percent to 10 percent per annum for developing countries.

These figures hold for average growth only. A natural question is whether there is a systematic pro- or anti-poor bias associated with inflation and its trade-off with growth. Although this issue has been examined less extensively in the literature, there is a strong consensus that higher inflation is at least as costly to the poor as it is to other sections of the population, reflecting mainly the lesser ability of the poor to protect their factor incomes and asset portfolios from the effects of inflation. At the least, there is nothing to suggest that targeting a low rate of inflation for macroeconomic policy reasons would be contra-indicated when the interests of the poor are taken into account.

### *Deficits and domestic financing*

For low-income countries that are constrained in their access to international finance, the overall budget balance is not of great interest. What matters is the decomposition into its external and domestic components. The external deficit (absorptive capacity issues apart) should consist only of concessional finance and, broadly, should be as large as the providers of concessional finance are prepared to make it. The domestic deficit (once the underlying stocks have been equilibrated) is a different matter. The appropriate level will reflect the target values of the three other macroeconomic

---

<sup>6</sup> This implies that the proportional reduction in the average growth rate is greater for an increase in inflation from 10 percent to 20 percent, say, than for an increase in inflation from 70 percent to 80 percent.

magnitudes with which it is tied in the monetary balance sheet. Specifically, the government will have a target rate of growth of nominal money that will be consistent with the target inflation rate, given the forecast growth in real income and any anticipated changes in the velocity of circulation. Second, it will have a target increase in the domestic currency value of foreign exchange reserves, consistent with the projected growth in the dollar value of imports and any anticipated movement in the exchange rate. Third, it will have a target for the increase in domestic credit to the private sector, consistent with the projected expansion of that sector and its associated financing requirements. This essentially leaves the government's recourse to domestic credit as a residual. Since its ability to place longer-term interest bearing debt is typically very limited, at least at the margin, there is little scope to set the domestic deficit independently. Of course, if this 'residual' approach produces outcomes for government spending which are unacceptable, the other target values will need to be revisited.

### *Coping with revenue shocks*

The preceding paragraph sketched how the government's fiscal stance might be determined *ex ante*, on the basis of best projections and judgement. In practice, low-income countries face unusually high resource volatility, both in the domestic revenue component and in the net aid inflow. They are also relatively poorly equipped to cope with it, given their lack of financial depth. These features are very likely to continue long into the post-post-stabilisation phase. One extreme response, embodied in the strictest form of the cash budget, discussed in the next section, is simply to maintain budget balance by forcing aggregate expenditure to fluctuate with revenue. However, this is extremely costly to the delivery of services, so ways of smoothing expenditure are important. If donors are unable to help by providing (external) compensating finance—and indeed they are often a major part of the problem—then this accommodation has to be found internally. Given the tenderness of a financially narrow system to large swings in purely domestic financing, foreign exchange reserves may have a serious role. If so, their target level needs to be set with this role in mind, as noted earlier.

## **5 Policy implementation**

Institutions of fiscal policy management should be capable of fulfilling a number of functions. The first is the *ex ante* function of tracking and coordinating resource flows to the government (from taxation, aid, and domestic financing) and aligning them with expenditure priorities within a sustainable macroeconomic framework which balances the benefits of public sector expenditure with the costs of resource mobilisation from the domestic private sector and donor community. A second is the *ex post* function of revenue and expenditure tracking and control, required to allow the authorities to identify and respond to changes in domestic revenue and aid flows or other eventualities. Finally, in harness with monetary policy institutions, in particular the central bank, budgetary institutions can play an important political role, signalling in a transparent fashion the stance of public policy to both donors and the domestic private sector, and thereby serving as an effective agency of restraint on discretionary behaviour.

In Sub-Saharan Africa, and particularly amongst those countries with a history of high and persistent inflation, new budgetary institutions have emerged in recent years as a direct response to the over-riding need to reduce the domestic budget deficit. Hence, the emphasis has tended to be on meeting the second, control, function noted above. Thus we have seen the emergence in a number of countries such as Zambia, Tanzania, Uganda and Mozambique, of highly restrictive budgetary mechanisms with a very short-run focus, often tightly linked to IMF ESAF or Rights Accumulation Programmes, at the expense of broader-based institutions capable of articulating the wider resource mobilisation and allocation objectives of government. More sophisticated budgetary institutions have been limited, in the main, to countries with a history of low inflation and the luxury of long fiscal horizons—the prime example being Botswana where rolling medium term budgetary frameworks have been a feature of the public policy landscape since the mid 1960s.

Given the severe fiscal disequilibrium in which such countries found themselves, this focus on short-run fiscal deficit reduction was entirely correct. Institutions such as rule-based cash budgets have proved to be successful in reducing inflation. For example, in Zambia the authorities adopted cash-budget rules which essentially ‘zero-based’ public expenditure: no expenditure was possible without the accumulation of sufficient revenue to finance it. The cash budget was enforced by denying line-or spending ministries direct access to the central bank overdraft facilities, effectively placing ministries and government as a whole on a cash-in-advance constraint subject to the overall control by the Ministry of Finance. These mechanisms, binding government to a balanced domestic budget (and hence limiting the growth in the monetary base) in the face of high and rising inflation, reflected the diagnosis that inflation was symptomatic of a lack of fiscal discipline and a tendency for opportunistic fiscal behaviour. This was also the diagnosis in Uganda, which adopted a somewhat more flexible system, the ‘cash flow’, which permitted a greater degree of within-year smoothing, while still being designed to maintain detailed control of monthly releases and ensure that they remained within the available resource envelope.<sup>7</sup> The diagnosis was proved substantially correct in both countries as inflation was brought to a shuddering halt almost overnight as soon as the cash-budget mechanisms began to bite. In both cases the strict enforcement of the rules, combined with the creation of quasi-autonomous revenue authorities, represented the central spar of the fiscal control regime in the immediate post-stabilisation period. Why these institutions were successful is a question of some debate (see Adam and Bevan 1999). In large part their principal role was technical, providing a crude but effective operational framework against a background of a history of weak fiscal control and limited technical capacity. Cash budget rules tended to strengthen the hand of central agencies against that of the spending ministries and consolidate fiscal control in the hands of those institutions and technocrats, arguably those institutions most committed to donor supported macroeconomic programmes. In addition to embedding day-to-day fiscal management within the culture of public policy, the cash budget mechanism allowed governments to signal (and report in a timely fashion on) the stance of fiscal policy, allowing aid flows to be sustained from an otherwise sceptical donor community. To the extent that the successful

---

<sup>7</sup> The greater flexibility in a system of the Ugandan type means that it is not rule-based to the same degree as the Zambian type; but both systems have the common feature of renouncing a substantial part of fiscal discretion. For simplicity, we here refer to all systems of this type as rule-based cash budgets.

operation of the cash budget under-pinned credibility, it also supported the downward adjustment of inflation expectations (and hence expected nominal domestic interest rates) held by the private sector.

Although rule-based mechanisms clearly played a central role in restoring price stability, they were maintained not without costs. Given the counterfactual of a continued lack of aggregate fiscal control, these costs were worth paying in the short run, but as aggregate fiscal discipline is progressively entrenched the costs of preserving it through inflexible budget rules become more significant. Aside from the operational problems of maintaining too narrow a focus on the short-run cash balance, fiscal rules of this type generate at least three other problems, each of which undermines efficient fiscal policy. The first is that tight adherence to a cash-budget rule places the burden of adjustment to short-term revenue fluctuations squarely onto expenditure and especially on the operational and maintenance vote (since salaries are frequently ring-fenced). In addition, in cases where revenue shortfalls do occur, cash-budget rules tend to favour politically powerful ministries at the expense of weaker but no less important ministries (see Stasavage and Moyo 1999). Second, in a growing economy with rising real money demand by the private sector, the authorities, through the central bank, must be able to supply the base money by running a fiscal (or quasi-fiscal) deficit. Limiting the growth of base money through a cash budget in these circumstances represents an inappropriately deflationary stance. The third general problem is that the cash budget can back governments into adopting a possibly inappropriate stabilisation anchor in the medium term. Given the relatively under-developed nature of monetary policy, pursuit of a cash budget binds a government into a money-based stabilisation. However, there is a general shift in thinking away from quantity-based towards price-based stabilisation, for example in the form of direct inflation targeting for example. In the presence of the short-run volatility in real money demand characteristic of a post-stabilisation environment a money-based stabilisation rule is likely to be a relatively poor anchor for domestic prices. However since pursuit of a strict cash budget requires governments (and indeed the central bank) to forego other forms of intervention, including in domestic asset and foreign exchange markets, the strict form of the rule can lead to a higher than desired degree of volatility in domestic prices and the nominal exchange rate.

## **Graduation**

The appeal and strength of rule-based fiscal institutions lies in their simplicity and transparency. In the spirit of the literature on central bank independence this creates the basis for an effective agency of restraint, a relatively clearly observed rule, deviations from which signal a loss of control, a confusion of objectives, or opportunistic behaviour. However, with a measure of price stability achieved, the challenge for countries that have adopted such instruments is to graduate to a broader discretionary system that locates the control function of the cash budget within a more flexible framework for budget management but does so without losing the key agency of restraint function provided by simple policy rules.

Such a budgetary framework is envisaged in the current debate on the reform of IMF and World Bank lending operations, (see IMF 2000) which goes some way to reversing the orthodoxy of the financial programming approach. Instead, the fiscal balance, rather than the external balance, is placed at the heart of a poverty-reduction focussed

macroeconomic framework. To some extent the prototype for this framework is currently being developed in Uganda. Since its inception in the early 1990s as an instrument for crisis management, the cash-flow has evolved into an integrated system in which the control function of the rule is now only one element in the Medium-Term Expenditure Framework (MTEF). The MTEF explicitly sets out to meet the criteria noted at the beginning of this section. While the cash-rule is preserved as a key operational tool, a defining feature of the MTEF is the weight placed on reversing practices which have evolved during periods of poor fiscal control by bringing *all* donor resource flows within the budget coordination framework. Although only time will tell whether these reforms will succeed, early evidence suggests that the transparency and domestic ‘ownership’ of the MTEF and PRSP process has helped support the emergence of informed domestic constituencies capable of limiting fiscal indiscipline (see Fozzard and Foster 2001).

## 6 Conclusion

For many low-income countries, there has been an extended period in which fiscal policy was not a choice, or was a choice made by authorities external to the country. For a number of them, this situation is now changing. Their own success in stabilising the economy, coupled with a shift in the stance of the international community (most notably the IMF), has placed fiscal choices back on the domestic agenda. However, the scope for choice may be heavily circumscribed by the legacy of past fiscal laxity. There are two challenges to the domestic fiscal authority in these circumstances. First they must gauge how best to manage the transition from the immediate post-stabilisation period to the longer term (post-post-stabilisation). Second, they must see how these longer term fiscal choices can best accommodate the requirements of preserving macroeconomic stability with the encouragement of growth and poverty reduction.

## References

- Adam, C.S. and D.L. Bevan (1999). ‘The cash budget as a restraint: the experience of Zambia’, in Collier, P. and C. Pattillo (eds) *Investment and Risk in Africa*. Basingstoke: Macmillan.
- Addison, T. and S.M. Murshed (2001). *Fiscal Dimensions of Conflict and Reconstruction*. WIDER Discussion Paper 49, Helsinki: UNU/WIDER. From the WIDER project meeting on New Fiscal Policies for Poverty Reduction and Growth, November 2000.
- Bleaney, M, N. Gemmell and D. Greenaway (1995). ‘Tax revenue instability, with particular reference to sub-Saharan Africa’. *Journal of Development Studies* vol 31, no 6.
- Foster, M. and A. Fozzard (2001). *Changing Approaches to Public Expenditure Management in Low-Income Aid Dependent Countries*. Discussion Paper, processed, Helsinki: UNU/WIDER.
- Ghosh, A. and S. Phillips (1998). ‘Warning: inflation may be harmful to your growth’ *IMF Staff Papers*, vol 45, no 4.

- Government of Uganda (2000). *Learning from the Poor*, Uganda Participatory Poverty Assessment Report, June.
- Heady, C. (2001). *Taxation Policy in Low-Income Countries*. WIDER Discussion Paper, processed, Helsinki: UNU/WIDER. From the WIDER project meeting on New Fiscal Policies for Poverty Reduction and Growth, November 2000.
- International Monetary Fund (1998). *External Evaluation of the ESAF*. Washington, DC.
- International Monetary Fund (2000). 'Macroeconomic issues' in *IMF Sourcebook for Poverty Reduction Strategies*. Draft, April.
- International Monetary Fund (2000a). *Key Features of IMF Poverty Reduction and Growth Facility Supported Programs*, August, p. 2.
- Stasavage, D. and D. Moyo (1999). *Are Cash Budgets a Cure for Excess Fiscal Deficits (and at What Cost)?* CSAE, Oxford Working Paper 11.
- Stiglitz J.E. (1998). *More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus*, WIDER Annual Lecture 2. Helsinki: UNU/WIDER.

Appendix Table 1. Characteristics of Stabilisation episodes

A. Annual Change During Stabilisation															
		(1)	(2)	(3) Domestic Fiscal Adjustment			(4) Change in Domestic and External Debt				(5) Change in Financial Asset Stocks				(6)
Country	Stabilisation Episode	Initial Inflation	Inflation change per annum	Primary Balance as % of GDP	Overall Balance as % of GDP	GDA as % GDP	Domestic Debt as % of GDP	Domestic Interest as % of GDP	External Debt as % of GDP	External Debt Service as % of GDP	Foreign Reserves as % GDP	Money Stock M2 as % GDP	Ban. Credit Govt. as % GDP	Ban. Credit Private Sec. as % GDP	Total Tax Revenue as % GDP
1. Low Income Stabilisation Episodes															
Gambia	1988-89	57%	-22.4%	0.40%	0.47%	-11.76%		-0.23%	-11.90%	-1.16%	-0.13%	-0.51%	-5.74%	-1.63%	0.25%
Ghana	1983-85	125%	-56.3%	-0.47%	-0.68%	0.82%		-0.01%	4.51%	-1.39%	4.78%	1.04%	-0.62%	0.78%	2.44%
Guinea	1987-93	37%	-5.0%		0.01%	0.30%			-1.37%	-2.70%	0.62%	0.15%	-0.15%	0.33%	-0.54%
Guinea Bissau	1988-98	81%	-5.2%		-0.41%	-1.74%			0.33%	-1.17%	-0.27%	-0.87%	-0.75%	-1.41%	-0.34%
Haiti	1994-97	39%	-4.5%						0.50%	0.30%	0.25%	-1.80%	-1.80%	-0.90%	
Honduras	1991-93	34%	-7.7%						2.10%	-3.40%	-0.20%	0.50%	0.80%	0.30%	
Kenya	1993-95	46%	-22.2%	-0.76%	3.11%	-5.10%		-2.94%	-30.74%	-0.73%	0.10%	-2.82%	2.14%	1.92%	-1.06%
Malawi	1995-97	63%	-37.1%	0.52%	-0.20%	-7.90%		-1.32%	-32.76%	-2.62%	0.16%	-1.08%	-0.90%	-0.87%	-1.19%
Mongolia	1993-97	268%	-30.1%		0.13%			0.44%	-0.90%	0.18%	1.80%	-0.51%	-0.13%	-2.00%	-1.51%
Mozambique	1987-97	164%	-15.8%	0.49%	0.47%	-0.03%		-0.03%	-0.10%	0.45%	1.15%	-0.52%	-1.62%	-0.84%	0.22%
Nicaragua	1988-91	10205%	-1815.0%	2.80%	7.40%	11.60%		0.20%	9.60%	8.40%	1.20%	-5.40%	-14.30%	7.20%	-0.10%
Sierra Leone	1987-97	138%	-12.8%	0.26%	0.62%	0.78%	0.0%	-0.03%	1.58%	0.19%	0.37%	-0.05%	-1.09%	0.10%	-0.19%
Sudan	1991-97	123%	-15.1%		2.43%	-0.98%			4.78%	0.07%	0.04%	-1.35%	-1.06%	-0.35%	0.13%
Tanzania	1990-98	27%	-3.2%	0.05%	-0.38%	-2.03%	-1.1%	-0.01%	-7.92%	-0.43%	0.56%	-0.58%	-1.84%	-1.38%	0.01%
Uganda	1987-94	217%	-30.0%	0.05%	-0.01%	2.01%		0.03%	7.68%	0.18%	0.96%	-0.63%	-0.68%	0.13%	0.54%
Yemen	1993-95	56%	-10.1%		3.83%				-28.60%	-3.10%	3.34%	-3.80%	-0.15%	-3.84%	
Zambia	1988-95	188%	-15.6%	0.42%	-0.01%	8.21%		0.12%	4.87%	0.41%	0.51%	-1.14%	-0.44%	-0.48%	0.07%
2. Middle Income Stabilisation Episodes															
Argentina	1989-92	3079%	-763.7%	1.0%	0.2%	0.0%		0.0%	-13.9%	-0.9%	0.2%	0.1%	-2.5%	-6.1%	0.6%
Bolivia	1985-90	11750%	-1955.4%	-0.7%	-0.3%	0.8%		0.0%	-11.0%	-0.6%	-0.9%	2.4%	3.3%	0.8%	-0.1%
Brazil	1989-95	1431%	-195.0%	0.5%	1.4%	0.0%		-0.2%	-0.4%	0.0%	0.8%	0.3%	-8.2%	-6.7%	0.8%
Chile	1988-92	31%	-2.7%	0.7%	0.4%	0.0%		-0.1%	-4.4%	-0.7%	0.3%	-0.3%	-3.2%	0.2%	0.7%
Costa Rica	1982-83	90%	-28.8%	1.8%	0.6%	2.5%		0.0%	-3.4%	6.4%	0.7%	0.0%	4.5%	1.3%	2.0%
Dominican Rep	1990-91	51%	-1.7%	-1.3%	-0.2%	-0.3%		1.4%	-1.4%	0.1%	2.7%	-1.5%	-0.9%	-1.4%	-0.3%
Israel	1984-91	374%	-44.4%	-1.0%	1.5%	-0.2%		-0.6%			-0.3%	-2.2%	-13.8%	-3.2%	-2.8%
Jamaica	1991-94	77%	-10.6%		-0.3%	-0.3%			-7.2%	-2.0%	2.4%	1.4%	-0.3%	1.2%	
Lebanon	1988-92	128%	-9.4%			-0.4%			0.6%	-0.1%	-12.3%	-8.7%	1.8%	-0.6%	
Mexico	1987-91	132%	-21.8%	0.1%	3.4%	0.0%		-0.5%	-8.4%	-0.9%	-0.8%	0.6%	-1.4%	1.6%	-0.3%
Paraguay	1989-94	38%	-1.0%	-0.2%	-0.2%	-0.2%		0.0%	-4.9%	0.0%	0.5%	1.7%	0.0%	2.1%	0.0%
Peru	1988-94	3398%	-562.5%	1.7%	1.2%	-0.1%		0.0%	-2.0%	0.1%	1.5%	1.0%	-1.5%	0.5%	1.1%
Poland	1989-94	245%	-35.2%			-0.1%			-1.5%	0.2%	0.5%	-1.0%	-0.9%	1.6%	
Syria	1987-88	60%	-12.5%		1.9%	-2.1%			9.2%	0.6%	-0.1%	-5.7%	-7.4%	-0.3%	-0.3%
Uruguay	1990-95	112%	-11.7%	0.6%	-0.3%	0.0%		-0.1%	-3.6%	-1.1%	-1.1%	-2.1%	-2.3%	-1.3%	0.4%
3. Group Medians															
High-Inflation Low Income		83%	-16%	0.34%	0.13%	-0.03%	-0.54%	-0.01%	0.33%	-0.43%	0.51%	-0.63%	-0.75%	-0.48%	-0.04%
High-Inflation Middle Income		128%	-22%	0.47%	0.30%	-0.05%		-0.04%	-3.51%	-0.05%	0.25%	-0.01%	-1.38%	0.21%	0.20%

B. Immediate Post Stabilisation Stocks and Flows															
Country	End of Stabilisation	Inflation	Primary Balance as % of GDP	Overall Balance as % of GDP	ODA as % GDP	Domestic Debt as % of GDP	Domestic Interest as % of GDP	External Debt as % of GDP	External Debt Service as % of GDP	Foreign Reserves as % GDP	Money Stock M2 as % GDP	Dom. Credit Cost, as % GDP	Dom. Credit Private Sec. as % GDP	Total Tax Revenue as % GDP	
1. Low Income Stabilisation Episodes															
Gambia	1989	11.7%	10.5%	6.3%	31.9%		1.2%	122.0%	6.7%	7.1%	11.9%	1.7%	11.8%	19.8%	
Ghana	1985	10.3%	-1.5%	-3.0%	4.3%	4.3%	0.6%	90.1%	7.5%	7.6%	11.2%	14.0%	3.1%	9.5%	
Guinea	1993	7.1%	-2.4%	-3.7%	12.5%	3.2%	0.0%	86.9%	4.4%	4.0%	8.3%	1.5%	4.2%	10.5%	
Guinea Bissau	1998	8.0%		-16.2%	46.7%			346.2%	3.9%	5.6%	9.9%	1.7%	5.7%	3.7%	
Haiti	1998	10.6%			22.00%			27.0%	8.1%	3.1%	28.3%	9.4%	14.3%	13.2%	
Honduras	1984	10.7%			18.00%			117.0%	10.6%	8.0%	26.2%	4.8%	22.3%		
Kenya	1995	1.5%	7.3%	-2.5%	8.1%	28.9%	5.9%	81.5%	6.5%	3.9%	14.9%	13.9%	25.2%	24.8%	
Malawi	1997	9.1%	-5.1%	-6.9%	13.8%	9.4%	2.2%	87.6%	3.1%	6.4%	7.7%	3.0%	3.9%	14.8%	
Mongolia	1998	9.5%	-4.20%	-10.00%				70.0%	3.5%	9.9%	19.2%	9.8%	3.3%	19.1%	
Mozambique	1997	6.4%	-1.3%	-2.6%	28.0%	4.5%	0.1%	174.2%	4.1%	15.0%	17.1%	-10.5%	13.0%	10.7%	
Nicaragua	1991	23.7%	1.80%	-2.00%	36.60%		1.6%	606.4%	6.8%	15.7%	17.3%	20.9%	33.1%	22.1%	
Sierra Leone	1997	9.6%	-5.0%	-7.2%	15.8%	0.0%	1.1%	139.6%	2.4%	4.4%	10.3%	6.6%	3.4%	4.8%	
Sudan	1998	32.0%		-0.7%	1.9%			162.1%	0.6%	0.4%	6.3%	4.7%	2.5%	5.8%	
Tanzania	1998	10.4%	2.2%	0.2%	13.6%	16.6%	1.1%	89.4%	2.2%	7.3%	10.8%	8.7%	4.8%	11.2%	
Uganda	1994	6.5%	-2.3%	-3.8%	18.8%	1.3%	0.2%	84.4%	2.9%	8.0%	8.3%	4.8%	4.0%	7.7%	
Yemen	1988	7.9%	1.30%	-2.60%				95.6%	3.2%	23.4%	24.5%	6.2%	6.8%	19.8%	
Zambia	1995	34.2%	3.8%	-4.3%	58.6%	6.9%	2.6%	197.7%	7.3%	8.4%	7.6%	5.4%	8.5%	18.2%	
2. Middle Income Stabilisation Episodes															
Argentina	1993	10.6%	-0.9%	0.7%	0.1%		1.0%	27.6%	2.5%	6.5%	16.2%	7.4%	18.3%	13.6%	
Bolivia	1991	21.4%	-3.6%	-0.1%	9.5%		0.8%	76.0%	6.2%	7.9%	24.8%	4.0%	28.7%	9.2%	
Brazil	1996	15.8%			0.0%			23.3%	3.2%	7.7%	26.2%	7.7%	30.4%		
Chile	1993	12.7%	9.0%	2.0%	0.4%		0.6%	45.4%	6.3%	22.8%	36.3%	10.6%	52.8%	19.6%	
Costa Rica	1984	12.0%	2.9%	-0.7%	6.9%		1.5%	109.0%	11.6%	11.3%	37.4%	20.5%	19.9%	20.0%	
Dominican Rep	1992	4.3%	7.2%	3.1%	0.8%		4.3%	96.4%	4.1%	6.1%	21.1%	-2.4%	14.5%	14.6%	
Israel	1992	11.9%	0.8%	-4.3%	3.1%		4.2%			7.8%	61.2%	28.2%	58.2%	33.3%	
Jamaica	1995	19.9%			3.1%			121.2%	17.0%	19.4%	44.7%	-3.8%	26.2%		
Lebanon	1993	15.7%	-8.4%	-7.6%	1.9%		3.6%	17.6%	1.8%	77.8%	104.6%	23.3%	45.3%	9.2%	
Mexico	1992	15.5%	1.5%	4.2%	0.1%		2.3%	30.9%	6.7%	5.3%	23.7%	3.3%	28.1%	13.7%	
Paraguay	1995	13.4%			1.5%			24.9%	3.2%	11.6%	25.7%	-5.1%	27.1%		
Peru	1995	11.1%	3.9%	-1.3%	0.6%		1.4%	52.3%	2.1%	14.7%	16.6%	-4.4%	14.9%	13.5%	
Poland	1995	26.8%	16.1%	-1.9%	3.0%		1.8%	35.0%	3.3%	11.8%	29.7%	20.3%	12.0%	34.5%	
Syria	1989	11.4%	1.1%	-0.6%	1.3%			176.5%	10.2%		50.8%	96.7%	7.7%	17.1%	
Uruguay	1996	28.3%	13.4%	-1.6%	0.2%		0.6%	31.2%	3.6%	10.0%	35.9%	6.8%	28.8%	27.7%	
3. Group Medians															
High-Inflation Low Income		9.6%	-1.3%	-3.0%	16.0%	4.5%	1.1%	95.6%	4.1%	7.1%	11.2%	5.4%	6.7%	12.2%	
High-Inflation Middle Income		13.4%	2.2%	-0.7%	1.3%	n.a.	1.5%	40.2%	3.8%	10.6%	29.7%	7.7%	27.1%	15.9%	



C. Post-Post Stabilisation Stocks and Flows																
Country	End of Stabilisation	No. years post Stabilisation	Inflation	Primary Balance as % of GDP	Overall Balance as % of GDP	ODA as % GDP	Domestic Debt as % of GDP	Domestic Interest as % of GDP	External Debt as % of GDP	External Debt Service as % of GDP	Foreign Reserves as % GDP	Money Stock M2 as % GDP	Dom. Credit Govt. as % GDP	Dom. Credit Private Sec. as % GDP	Total Tax Revenue as % GDP	Post-stab GDP Growth
1. Low Income Stabilisation Episodes																
Ethiopia	1996	5	4.3%	-1.5%	-3.0%	7.0%	26.9%	0.7%	136.0%	8.6%	7.3%	17.9%	16.3%	25.3%	11.9%	2.4%
Ghana	1992	7	7.6%	-8.3%	-10.4%	10.1%	8.7%	1.3%	73.8%	2.8%	4.3%	13.2%	16.5%	5.2%	10.5%	5.0%
Guinea	1998	5	4.6%	-1.8%	-3.1%	9.6%	4.7%	0.2%	90.3%	-3.4%	3.6%				10.0%	7.3%
Gambia	1998	8	1.1%	2.9%	-2.5%	10.2%		4.1%	100.9%	8.7%	25.5%	14.2%	-0.6%	11.5%	17.0%	3.7%
Mauritius	1997	4	10.5%	0.6%	-2.2%	0.8%	26.2%	2.3%	31.5%	6.2%	23.7%	13.2%	16.1%	42.4%	19.2%	5.4%
Uganda	1998	4	5.7%	1.1%	0.1%	13.0%	1.4%	0.4%	60.8%	2.7%	11.6%	8.5%	2.7%	5.2%	9.8%	9.5%
Zambia	1998	4	22.8%	-0.5%	-3.3%	14.7%	12.7%	0.7%	200.1%	2.3%	0.5%	6.6%	7.0%	5.9%	17.1%	3.7%
2. Middle Income Stabilisation Episodes																
Argentina	1996	5	0.9%	-1.2%	-1.5%	0.0%		1.5%	48.3%	7.2%	6.3%	27.4%	7.8%	24.2%	12.4%	3.9%
Bolivia	1998	7	7.7%	0.0%	-2.3%	7.3%		1.0%	70.8%	5.5%	13.5%	45.1%	-4.9%	63.5%	15.1%	4.7%
Brazil	1998	2	3.2%			0.0%			29.8%	6.2%	5.6%	29.8%	15.2%	34.6%	20.1%	0.2%
Chile	1998	5	5.1%	8.2%	0.4%	0.1%		0.3%	46.1%	5.7%	20.3%	41.9%	2.7%	61.6%	18.4%	3.4%
Costa Rica	1997	3	16.8%	5.1%	-2.9%	5.0%		1.3%	104.2%	7.4%	11.5%	35.0%	17.8%	19.0%	21.4%	4.8%
Dominican Rep	1998	6	4.5%	4.7%	4.0%	0.9%		3.1%	32.0%	2.5%	3.6%	27.9%	0.3%	21.8%	15.5%	0.1%
Israel	1998	6	5.4%	3.1%	-1.2%	1.1%		3.7%			22.6%	83.7%	7.0%	81.9%	36.4%	3.3%
Jamaica	1998	3	8.6%			0.4%			75.7%	8.6%	13.4%	40.6%	9.9%	32.4%		0.0%
Lebanon	1998	5	6.8%	-7.7%	-15.1%	1.4%		5.8%	39.0%	3.1%	53.5%	143.0%	60.9%	74.0%	12.7%	5.0%
Mexico	1994	2	7.0%	-0.1%	0.0%	0.1%		1.6%	33.0%	5.2%	1.5%	26.3%	-4.2%	38.7%	13.0%	4.4%
Paraguay	1998	3	11.5%			0.9%			26.8%	2.5%	9.1%	28.4%	-4.4%	27.5%	9.1%	-0.4%
Peru	1998	3	7.2%	4.0%	-0.2%	0.8%		0.9%	51.6%	3.9%	15.7%	26.5%	-3.7%	25.4%	13.7%	0.3%
Poland	1998	3	11.7%	14.8%	-1.0%	0.6%		1.4%	30.1%	2.9%	17.3%	36.0%	16.8%	19.6%	32.7%	4.8%
Syria	1998	9	-1.2%	-0.2%	2.9%					2.1%		34.0%	20.0%	8.9%	16.4%	0.1%
Uruguay	1998	2	10.8%	15.6%	-0.6%	0.1%		0.6%	36.9%	5.5%	12.6%	40.7%	5.3%	34.6%	30.0%	4.5%
3. Group Medians																
High-Inflation Low Income			10.0%	-1.1%	-2.9%	12.6%	6.3%	2.0%	80.8%	2.0%	8.9%	10.9%	11.5%	9.4%	12.2%	3.6%
High-Inflation Middle Income			6.9%	5.5%	-1.0%	0.8%	n.a.	1.6%	42.6%	5.2%	13.4%	34.5%	7.4%	29.9%	15.5%	3.4%

Source: World Bank World Development Indicators 2000

Notes: See Notes to Table 1

*UNU World Institute for Development Economics Research (UNU/WIDER) was established by the United Nations University as its first research and training centre and started work in Helsinki, Finland in 1985. The purpose of the Institute is to undertake applied research and policy analysis on structural changes affecting the developing and transitional economies, to provide a forum for the advocacy of policies leading to robust, equitable and environmentally sustainable growth, and to promote capacity strengthening and training in the field of economic and social policy making. Its work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.*

UNU World Institute for Development Economics Research (UNU/WIDER)  
Katajanokanlaituri 6 B, 00160 Helsinki, Finland

Camera-ready typescript prepared by Adam Swallow at UNU/WIDER  
Printed at UNU/WIDER, Helsinki

The views expressed in this publication are those of the author(s). Publication does not imply endorsement by the Institute or the United Nations University, nor by the programme/project sponsors, of any of the views expressed.

ISSN 1609-5774  
ISBN 952-455-258-2 (printed publication)  
ISBN 952-455-259-0 (internet publication)