Chapter 2
BASIC ISSUES IN FISCAL STABILIZATION

2.1 INTRODUCTION

Dealing with fiscal deficit remains one of the most vexing problem for the majority of developing countries. For many, growing fiscal deficits led to money creation as the main source of financing followed by rising inflation, an erosion of tax base, and even larger fiscal imbalances.

While the need for fiscal reform is now widely recognised, the experience of many countries indicates that fiscal reform is very difficult. The difficulties are partly political, partly institutional, and partly conceptual. Unfortunately, a not rare outcome is that countries often pursue fiscal reforms that are ad-hoc and inadequate, after some initial success, the situation relapses to a position at times more serious than the one that had prevailed before the adjustment.

Many of the issues that arise in pursuing fiscal stabilization can be conveniently discussed under five headings: (i) Fiscal trends - a look at the evidence, (ii) The Fiscal deficits, (iii) Effects of specific policy moves, (A) Fiscal effects of Devaluation, (B) Expenditure cuts, (C) Tax increases, (D) The Role of Domestic Debt, (iv) The quality of fiscal stabilization, and (v) The sequencing of fiscal reforms.

2.2 FISCAL TRENDS: A LOOK AT THE EVIDENCE

The immediate origins of the fiscal crisis was the assumption by governments of privately contracted debt. Governments also faced internal pressures caused by the effects of short-run adjustment (stabilization)
policies involving sharp devaluations required to raise foreign exchange to service the external debt. The ensuing sharp depreciations of the real exchange rate helped to generate the needed foreign exchange but resulted in capital losses for foreign denominated debt holders. As a result the external debt problem became first and foremost a fiscal problem.

Turning to fiscal revenues, they too have been insensitive to the fiscal crisis. Since the onset of the crisis, neither low income countries nor middle income countries have been able to significantly raise fiscal revenues. Moreover, both groups have registered a declining share of income taxes in total revenues. Direct taxes being typically the most progressive and buoyant component of the tax system, this trend may signal both, efficiency loss, and equity deterioration. For low income countries, trade tax revenues continue to be the most important source of tax revenue. With import growth effectively constrained by foreign exchange earnings, the reliance on trade taxes further reduces the buoyancy of the tax system for this group of countries. At the same time, the role of foreign grants in helping alleviate the crisis has been relatively small even for low income countries.

Stagnant revenues coupled with difficulties in compressing expenditures, implies limited progress towards reducing fiscal imbalances. With foreign borrowing foreclosed, this meant that governments had to rely on domestic sources of financing. For countries with relatively underdeveloped capital markets, borrowing from the central bank was the only remaining option. The ensuing increase in liquidity could only result either in run away inflation, or in capital flight, or a combination of both.
The debt and fiscal crisis combined to force many countries to undertake adjustment programmes. Fiscal policy came to be an essential component of adjustment programmes. On the one hand the recovery of fiscal discipline was viewed as a pre-requisite for fiscal stabilization, On the other hand, the reform of existing fiscal incentives.

2.3 THE FISCAL DEFICITS

Fiscal difficulty is conventionally defined as a large and/or increasing public sector deficit. To start with, how does a government get into fiscal difficulty has to be understood. Three views predominate in the literature. They can be labelled as political deficit, the structural deficit, and the inflation tax approaches respectively.

Blaming political forces for fiscal expansion is an old tradition in economics, shared by conservatives such as Schumpeter and radicals like O'Connor at different places and times. The general view is that to maintain its political legitimacy, the state is forced toward taxing too little or spending too much, both to pay off specific interest groups and to sustain the level of employment via aggregate demand. This policy bias leads ultimately to increasing external deficits and/or inflation, requiring stabilization through deficit reduction sometimes in long run.

In one example of this line of thought, the Mexican crisis after 1982 is attributed by some analysts to politically driven expansion by a government which overestimated its spending power from the oil and foreign borrowing booms of the nineteen seventies. Inflation did not accelerate dramatically until after 1982, but before that unsustainable
levels of imports were said to be the result. Finally, politically directed redistribution plus expansionary fiscal policy in the stagnationist economy of Chile stimulated output to the point at which capacity limits bound, triggering inflation and external imbalance.

Structuralist economists are by no means opposed to invoking politics to explain deficits, but also suggest other reasons for them to exist. One is an external shock-falling terms of trade, an export supply shortfall, or an interest rate excursion on external debt. Such shocks are contractionary most government try to offset them in the short-run by fiscal means. Casualty runs from the external to internal deficit leads to reversal of the usual political link.

Besides external shocks, other structural factors may force fiscal expansion. They include natural disasters, financial turmoil, ongoing inflation with government debt, and foreign payments obligations.

The disaster scenario is familiar. It requires little comment beyond the observation that relief efforts have both a supply and demand dimension. Not only must commodities be supplied to victims, they must also be in demand. For example A.K. Sen attributes famine largely to a demand collapse induced by rising food prices in the face of fixed nominal incomes. Restoring demand involves fiscal deficit spending to transfer income to the groups hit hardest by the price increases.

Financial collapse lies at the root of many stabilizations. The typical scenario begins with a surge in speculation involving shares and/or real estate. A bubble is most likely to blow itself up when potential saving
is high, productive investment outlets do not seem to be available, and when deregulation of the financial system opens possibilities for manipulation. This situation reminds us of recent experiences in East Asian countries.

The collapse leaves firms and banks with badly compromised balance sheet positions. The subsequent bail-out involves fiscal outlays and heavy rediscounting by the central bank of commercial bank loans. The government may also issue its internal obligations in exchange for the private sector's foreign debt, and may have direct problems with the balance sheets of public enterprises. Finally, disruption in local financial markets provokes capital flight. It tends to be more serious under deregulated financial regimes in which exchange controls have been weakened or removed. Most of these interventions increase the state's deficit.

The next structural case of a fiscal deficit is monetary indexation under continuing inflation. Structural inflation theory argues more from the side of costs than demand, emphasizing distributional conflict and indexation mechanisms. An initial price excursion say from a supply shock, a period of forced saving in response to expansionary policy or an increase in local spending power as from an export price increase, or a cost shock such as devaluation, reduce some income flows in real terms. The shock marks the first stage of inflation.

If inflation is structural, it steadily erodes the real value of the money supply, the inflation tax begins the bite. One way to avoid this
problem is to index money by paying interest on all state obligations. In principle, such a policy is fiscally neutral. The inflation tax cuts demand and interest payments on government debt offset the tax. However, when inflation reaches triple digits, nominal government outlays for interest payments soar.

2.4 EFFECTS OF SPECIFIC POLICY MOVES:

The above discussion suggests that fiscal deficits have numerous causes; not all deficits are irrational, and not all add to aggregate demand. Nonetheless, deficit reduction is the main objective of orthodox stabilization packages of the type usually proposed by the World Bank and IMF. How does such austerity affect the economy's chances of achieving normal policy goals?

Most governments share at least four economic targets:

* to maintain socially acceptable levels of capacity utilization and growth, especially in sectors and regions dominated by their political base,

* to keep inflation down to a rate tolerable in terms of the country's own history of price increases,

* to alter wealth and income distributions in line with the regime's ideological predilections and political constraints, and

* to maintain a degree of self-reliance in trade and external financial relationships.
The question at hand regards the likely effects of fiscal and other measures under such circumstances. There are several relevant policy linkages;

First, one must be aware of specific effects of different policies. As we have seen, cutting public investment may also lead private capital formation to decline. Increasing indirect taxes will drive up costs, possibly accelerating a structural inflation. Successful anti inflation policies are likely to lead to more efficient tax collection as the effects of payment lags on real revenues are reduced. Hence, more fiscal demand contraction may occur than had been planned.

Second, inflation reduction will have other macro effects that have to be taken into consideration. Monetary correction was never completely effective. As a consequence, dramatically slower inflation made velocity fall or money demand rise. Room was opened for money creation, either by fiscal deficit spending or reserve increases from capital inflows. Reducing inflation also got rid of the inflation tax. The fiscal restraint implicit in more effective direct and indirect tax collection was offset by the expansionary effect of undoing the erosion of real wealth by steadily rising prices.

Third, prices charged or offered by public enterprises are an important component of fiscal policy in many countries. Changes in prices charged for essential services or food may have strong distributional repercussions. If public enterprises sell intermediate goods, then increasing their prices will have ambiguous effects on inflation.
Producer's costs will rise. They may well pass them along to final commodity prices, provoking structural inflation. On the other hand, the consolidated public sector deficit will be reduced, leading to less state borrowing from the central bank and money creation. The inflation rate may decline for monetarist reasons.

Manipulations of consumer prices, for example, via food subsidies can also have important fiscal and balance of payments effects. With supply elasticities in the usual empirical range, for example, an increased subsidy rate on food purchases will create inflationary pressure unless stocks are run down or imports brought in to meet the additional demand the subsidy creates. If new supplies do not materialize, then prices will go up enough to offset both the direct demand increase and the fiscal injection it embodies.⁸

Fourth, the observation is that fiscal measures should not be undertaken independently of other policy moves. Devaluation, for example, may at times lead to output contraction in developing economies through well known channels.⁹

Fifth, fiscal measures may substitute for other policies. Devaluation stimulates, but so do favourable producer prices and/or subsidies. The latter, directed interventions do not share devaluation's unpleasant economy-wide effects and may well be the preferred option for the reason.

Finally, the fiscal position will influence private actions in external capital market. Restrictive policy makes repatriation of flight
capital or emigrant remittances more likely by bidding up interest rates. On the other hand, financial incentives alone are not likely to draw external resources toward stagnant economy.

2.4.1. Fiscal Effects of Devaluation

Devaluation is also likely to have fiscal effects. First is the capital loss resulting from a real exchange rate depreciation. Consider the case of a small debtor country. Most of its foreign debt is in the hands of the public sector. This is a realistic feature of most highly indebted developing countries. The economy faces a double transfer problem, resources must be transferred abroad to service the foreign debt, but first the public sector must obtain the required foreign exchange from the private sector. A real depreciation, i.e. a fall in the relative price of non-traded goods, will facilitate the external transfer, but may exacerbate the problem arising from the required internal transfer. Consider the case where non-traded goods are a net source of revenue for the government. A real depreciation will then worsen the governments terms of trade with respect to the private sector. If the government relies at the margin on a distortionary tax to meet its revenue needs, it will need additional revenue with detrimental effects on the economy. Debt service therefore entails a "secondary burden", beyond the resource loss caused by transferring resources abroad, because of deteriorating internal terms of trade.

2.4.2. Control of Public Expenditure

Stagnant economic growth and the limited progress toward fiscal stabilization, in particular the inability to raise significantly government
revenues, brought to the forefront the need to introduce radical reforms in
developing countries' fiscal systems, with the dual objectives of
improving resource allocation and avoiding indiscriminate expenditure
cuts.

Widespread reforms could no longer escape the issue of which
expenditures to cut and which taxes to raise. Public investment took the
brunt of expenditure cuts. How to evaluate a reduction in capital
expenditures is a difficult, and yet, largely unresolved issue. On the one
hand, inefficient public enterprise investments can, and should be, cut. On
the other hand, public sector investments that generate externalities and
that are largely complementary with private sector investments should be
maintained.

Most experts agree that current expenditure should also share
some of the cuts. They often disagree, however, on the distribution of
these cuts across expenditure categories. Vito Tanzi\(^1\), for instance, agrees
that cuts in public employment should be preferred to reduction in public
wages. His argument is that the latter are not sustainable and will be soon
reversed when the economic emergency subsides. Also, wage cuts may
lead to loss of motivation and lower productivity.

Cornia and Stewart\(^2\), on the other hand tackle the issue from an
equity point of view. They argue that cuts in public wages will not have a
regressive distributional impact to the extent that public employees belong
to the upper middle income scale. Instead reductions in public
employment are likely to reduce the provision of public services with a
negative impact on the poor.
A further area of disagreement involves the extent to which consumers' subsidies should bear the consequences of fiscal restraints. Finally, all agree that military expenditure should not be spared.

On the basis of empirical evidence, it is said that poverty alleviation and fiscal expenditure discipline are not incompatible. The issue arises at two levels. First, regarding the intersectoral allocation of public expenditure. Second, is the issue of the intersectoral allocation of public spending.

In recent fiscal stabilization programmes expenditure reductions have been more significant than revenue increases. However, the approach followed in cutting expenditures has been far from efficient.

If public sector wages are high in comparison of the private sector, their reduction could be part of a fiscal stabilization package. Real wages can obviously be reduced quickly and can, thus, result in rapid expenditure reductions. Over a longer period, however, it is the size of the public sector workforce that will be the major determinant of public expenditure for wages and salaries. The reduction of public employment is difficult and may even be financially costly in the short-term, but it must be pursued vigorously if a durable stabilization is to be achieved. Over the long run, this effort will pay off.

The second important category of public expenditure that must receive early attention is the investment budget. A close evaluation of all the planned as well as the ongoing projects is necessary. Projects planned for the period ahead but not yet initiated, should be carefully scrutinized
regardless of whether they have foreign financing or not. Only if their expected rate of return is very high they should be retained. For the ongoing projects, considerations of sunk costs will be important as well as costs associated with the process of stopping these projects and restarting them at a later time. In some cases this stop-go can be very costly.

The third obvious expenditure area for close scrutiny and quick expenditure reduction is subsidies. Some subsidies may be very important to the poorest groups and must be retained. Others could be important in subsidising activities that generate significant positive externalities. When subsidies are of a general nature and especially when they encourage the consumption of a traded good the existence of inefficient enterprises, they must be cut.

Obviously, the defence budget must not escape close scrutiny. Unfortunately, this expenditure has been very resilient during stabilization programmes so that one should not be excessively optimistic. But the government should attempt to put downward pressure on this spending.

In most countries there are many activities which for historical or political reasons have been taken over by the government, perhaps for reasons that appeared legitimate at the time. Vested interests and pressure groups will argue for the status quo but a determined government with a clear sense of direction can show the absurdities of many regulations and governmental activities and can make a concerted effort to get rid of many of them.
2.4.3. Tax Reforms

Equity and efficiency issues arise also in the design of taxation reform. Usually the stimulus for tax reforms came from large and unsustainable fiscal deficits. Tax system in many developing countries was heavily influenced by their colonial legacy. This influence was reflected in a very complex tax structure with emphasis on progressive income taxes. Other major features of typical tax systems included: a cascaded structure of indirect taxes; a schedular system for direct taxes; and, a proliferation of exceptions and exemptions. The resulting system were much too complex for the administrative capabilities of developing countries. They encouraged too many arbitages which eroded the tax base. A lack of constituency in favour of tax reforms and the existence of powerful vested interests in support of the status quo perpetuated the existing system untill large fiscal deficits provided the required stimulus for tax reforms.

Recent experience of a number of developing countries shows how tax reforms were typically designed to minimise the incentive for tax avoiding resource shifts. They did so by applying the company tax to all forms of business organization, by aligning personal and corporate tax rates, by broadening the personal and corporate tax bases, and by mitigating the tax bias in favour of debt finance. Other major features of the reformed systems included the lowering of direct tax rates, the introduction of a value added tax and extensive inflation adjustment measures.
A perhaps more fundamental issue is the basic inspiration behind tax reforms. Optimal taxation theory concludes in favour of non-uniform tax rates. Also, equity motive may clash with the desired for simplicity. An equitable system may indeed require sophisticated distinctions. Again the issue is difficult to settle, in so far as complex tax systems tend to offer a wide set of opportunities for tax evasion that benefit rich people. Yet, a larger weight to the equity motive in the design of tax reforms seems warranted.

A measure that can be introduced relatively quickly and can have several beneficial effects in addition to providing additional revenue is an increase in public utility tariffs. However, it is important, to take steps that prevent the benefits from the increase form being dissipated in higher salaries, higher employment or in unnecessary investments by the public enterprises. If the central government is unable to control the behaviour of the public enterprises, only their privatization might reduce the fiscal disequilibrium. Provided that the spending by the public enterprises can be controlled, the tariff increase can be larger than it would be necessary if other measures were in place. For a while, the government can exploit the monopoly power of these enterprises to raise needed revenue.¹⁶

If the government is able to legislate the needed changes quickly, on the revenue potential of particular excises should be fully exploited. Increases in taxes on tobacco, alcoholic beverages, and a few other commodities can be justified on various efficiency grounds. But once again the initial increases must be protected against the eroding influence
of future inflation. Once again until the fundamental reforms are in place, these excises can be made to generate more revenue than might be desired over the long run. On the basis of information as to the demand elasticity of these products, taxes that would maximise their revenue generation could be imposed.

Some administrative changes for raising tax revenue in the short-run can also be considered. For example, in situations of high inflation, collection lags can be shortened administratively. This reduction can raise revenue by significant amounts.\textsuperscript{17} Tax evasion can be reduced by the judicious use of penalties. Postponement in tax payments can be discouraged by raising steeply, to a high positive level, the interest charges on delayed payments.

The introduction of a value-added tax (VAT) with the widest base and with possibly one rate should be a central element of a fundamental reform. Studies on the estimation of the size of the potential VAT base will be necessary in order to determine the rate required to raise the desired revenue. The introduction or the broadening the scope of the VAT will often have beneficial effects on revenue from other taxes and especially from the income taxes.

The reform of income taxes (personal and corporate) will also require time but less than the introduction of a VAT. Most developing countries already have income taxes so that it will be mainly a matter of modifying the existing structure. For the personal income tax, the main policy changes will concern: (a) a reduction in the often very high level
of personal exemptions; (b) the elimination of many deductions and special treatments of particular income; (c) a change in the rate structure probably by raising the first rate at least 10 per cent if it is lower, and reducing the highest rates to perhaps the 30-40 per cent range after careful analysis; (d) the forceful use of presumptive taxation in connection with hard-to-tax activities. A serious effort should also be made to improve the administration of these taxes by relying on all the information available to the government to reach potential tax payers and to determine their income.

Changes in corporate income taxes can also be introduced relatively quickly although as for taxes on the income of individuals, the revenue effects may not be felt for perhaps two years. The basic changes relate to wipe out the tax base; the lowering of the rate; and better administration. In some recent reforms, these minimum taxes have been based on (a) the imports of corporations; (b) their turnover; and (c) their gross assets.

Changes in import taxation can also be made relatively quickly once the legislation is approved. The most important and quick change would be the imposition of a minimum tax on all imports. This change would also improve the efficiency of the economy by reducing the dispersion in effective protection.

2.4.4. Public Debt

The fiscal deficit constitutes most important link between fiscal policy and indebtedness. It was suggested that the existing debt level is
sustainable if it is being fully serviced. Whereas this rationale is an oversimplification of the concept of sustainability and in particular does not identify Ponzi financed debt as unsustainable, it does imply that countries receiving external debt relief are in a situation of 'excess' debt. That is, the current debt level is higher than the sustainable one. Relief on external debt is typically provided in the face of a balance of payments crisis, and so the existence of excess external debt can be identified with the lack of foreign exchange for debt servicing. A sustainable foreign debt level would be one that could be financed within a realistic balance of payment scenario.

A determination of excess domestic debt is more tricky. The definition of sustainable debt as freely marketed government debt is appealing but would imply unrealistically low domestic debt ratios for most countries in the medium term. An alternative is to include sustainable domestic debt that is mobilised by long standing institutional arrangements with domestic financial institutions. Government domestic debt that results from exceptional financing schemes, such as arrears or domestic loan counterparts to IMF credits, would be excluded and considered excess debt.

Once a 'sustainable' deficit has been achieved and the 'excess' debt has been paid off, a country may want to move toward a 'desirable' debt, which would be lower, and a compatible 'desirable' deficit. Criteria for setting the desirable debt level might include primary reliance on voluntary placement of government debt at moderate real interest rates and
limits on foreign debt servicing as a percentage of exports and/or government revenues.\textsuperscript{19}

The cost of a 'desirable' deficit would be higher taxes or lower expenditure during the stabilization period. The rewards would be: (i) a more comfortable budgetary debt service burden, (ii) less pressure on the balance of payments and the exchange rate, as a result of the lower external debt burden, and (iii) lower domestic interest rates and/or more credit available for private sector investment.

On average, the estimated sustainable deficits were higher for the high-debt countries than for the low-debt countries. Thus, although substantial fiscal adjustment was undertaken in both groups, low debt countries exceeded their sustainable deficits during this period by more than high debt countries. Their fiscal position contributed, in turn, to their relatively faster accumulation of total foreign debt.

In some respects, the similarities between the two groups are as interesting as the differences. Both groups faced similar real interest rates on foreign debt. And both groups experienced similar growth rates in real GDP - a factor that can be at least partly explained by the stimulating effect on GDP of the export drive in several countries included in the high-debt group and the depressing effect on GDP of the export slump in several low-debt countries. The favourable export drive in the high debt countries helped to offset the depressing of debt overhang and high real costs of foreign borrowing. Meanwhile, the poor export performance in the low debt countries was partly offset by the stimulating effects of foreign capital inflow.
2.5 THE QUALITY OF FISCAL STABILIZATION

The focus of this section will be upon the kind of fiscal stabilization that a country should introduce. In recent years we have become progressively more aware of the fact that a given reduction in the fiscal deficit may be genuine and of good quality or of a largely cosmetic kind and of poor quality. The economic effects of the two are likely to be widely divergent. Unfortunately, cosmetic changes are often easier and politically less costly to make. This fact, coupled with the realization that the time horizon that is most important to policy makers often leads to a preference for cosmetic over genuine adjustment. Policy makers tend to follow the line of least resistance.

A reduction of certain magnitude in the fiscal deficit is in most cases, not the result of a single policy decision as would be, say, a devaluation or an increase in interest rates but the summation of many specific policy decisions, both on the revenue side and on the expenditure side.20

A high quality fiscal stabilization must be associated with measures that individually are efficient, durable, and equitable. In other words, these measures must not introduce avoidable distortions; they must not self-destruct in the near future; and they must not eliminate expenditures that are important for economic or social reasons when alternatives are available. The public spending to be reduced must be the one that contributes the least to the efficiency and the fairness of the economic system.
On the revenue side, and broadly in order of preference but not in order of facility of introduction, the following measures could be chosen: First, the broadening or the introduction of a general consumption tax, possibly one with characteristics of a value-added tax. Value added taxes are now important sources of revenue in a relatively efficient way and with relatively short lags.

Second, the government should fully explore the revenue possibility of excise taxes. These excises should be imposed on commodities with inelastic demand, or on those whose consumption generates substantial negative externalities. Third, important changes can be introduced to the personal income tax. Personal income taxes contribute still very little to total revenue in developing countries. If basic changes are made, the threshold of the tax can remain generous, and high marginal tax rates can be cut, without much revenue loss and with potential gains in work effort and tax payers' compliance.

For taxes on corporations, similar considerations apply. Corporate income taxes are often eroded by excessive incentives and complex laws. In particular circumstances, and especially when the rate of inflation is high, alternative forms of taxing corporations may need to be introduced.

The next measure, which especially in the short run can be very important from a revenue point of view, is the raising of public utility prices and the introduction of user charges for particular services provided by the public sector, such as higher education and health. The
real prices at which electricity, water, telephone, transportation and other public sector services are sold normally fall, at times quite drastically, during inflationary periods. This fall increases the demand for these services. Because of losses experienced by the public enterprises, it becomes difficult to expand capacity. Enterprises have also difficulties in providing the funds necessary for operation and maintenance, especially in view of the more intensive utilization of their plants. Thus, capacity will decline and the quality of the service will deteriorate. The greater is the fall in the real tariffs charged by the public enterprises, and the greater is the demand response to that fall, the greater will appear to be the need to expand investment in those activities. Thus, an artificial justification for capacity expansion will be created especially at a time when the resources to satisfy that expansion are sharply reduced.\textsuperscript{21}

A correction of these prices will thus : (i) generate more revenue; (ii) reduce the need for additional investment to expand capacity by lowering demand; and (iii) by reducing overuse, it will reduce maintenance costs. Finally, imports can be made to generate larger revenues either by dismantling quotas and other quantitative restrictions and replacing them by import duties or by removing the excessive erosion of the import tax base created by incentives and special exemptions, and by introducing a minimum tax on all imports. In both cases the additional revenue would be accompanied by improved efficiency. On the expenditure side, a variety of steps can be taken:

First, and most importantly, unproductive investment projects must be eliminated. The argument often heard that investment must be
protected during adjustment is simply misguided. While productive investment is an important source of growth and must be protected, unproductive investment especially if associated with imported machinery and capital equipment, is a major burden on the economy. In most developing countries the investment budget is padded with many politically motivated and unproductive investments which can, and should be eliminated. Unlike consumption expenditure, it may contribute little to the welfare of the country's citizens.\textsuperscript{22}

Furthermore, if it is obtained with foreign credit, it becomes a long-term drag on the economy. Hence, unproductive investment must be the first area where cuts should be made. Some of the saving from this source could be allocated to operations and maintenance expenditure, which would increase the efficiency of the existing capital structure and would permit that structure to support a higher level of income.

A second area where reductions could be made is in the wage bill of the public sector. During stabilization many countries have in fact, attempted to reduce the wage bill of the public sector. However, policy makers have generally preferred to reduce real wages rather than public employment. There is evidence, from some countries, that cuts in real wages have been even accompanied by expansions in public sector employment. Since the marginal cost of hiring extra workers falls with the fall in real wages and since adjustment often increases unemployment in the short-run, pressure is put on the government to be the employer of last resort. Such a policy does not have much chance for success in reducing
the wage bill over the long run and it is likely to increase the inefficiency of public sector employees, especially at a time when the public sector is expected to play a larger role in restructuring the economy. The cut in real wages, unless they were high to start with, almost guarantees that the efficiency of the public sector will fall. Furthermore, a drastic fall in real wages guarantees that they will bounce back as soon as the government is no longer able to withstand the pressure of public sector unions. In other words, excessive reduction in real wages will increase fiscal tension. The reduction in real wages, at a time of high unemployment, will generate pressures on the government to increase its employment. In many developing countries the public sector is clearly overstaffed. Therefore, fiscal stabilization that hopes to reduce the wage bill permanently must reduce in some cases quite considerably, the number of public employees. This may require privatising some activities.

The third important area for reduction, although a politically difficult one, is defence expenditure. Defence expenditure remains excessive in developing countries. Unfortunately, this spending has been able so far to withstand the downward pressures in public expenditure that accompany stabilization programmes.

Fourth, many countries engage in various forms of unproductive expenditure, from the building of monuments to the subsidization of unnecessary activities. In many developing countries, for example, a large number of public cars (often expensive ones) are purchased. In many of these countries the enforcement of useless regulations also requires
substantial public sector resources. Reducing some regulations will reduce public spending. In conclusion, in most countries there is scope for pruning the budget of many of these activities. Subsidies must be closely scrutinized. Those which are essential, because of social objectives, or because of significant externalities, should be protected. But generalised subsidies, provided through the artificial reduction in the prices of products of general consumption, should be eliminated. Many subsidies, even when defended on the grounds that they protect the poor, just subsidise the middle classes.

2.6 THE SEQUENCING OF FISCAL REFORMS

A fundamental and common conflict that arises in adjustment programmes is the one between the need to achieve quick results and the time necessary to develop, legislate, and implement sound policies. The need for quick results is often promoted by: (a) the precariousness of the economic situation; (b) the fear that if changes are not made immediately, they will not be made; and (c) by arrangements with international institutions which are often time constrained.

While changes in interest rates, in exchange rates, and in other areas of economic policy can be made relatively quickly and often do not require legislative approval, good fiscal reforms, that include tax reform, public sector reorganizations including privatization, reform of public expenditure programmes, and so forth, require time and, in many countries, must be legislated. As a consequence, countries have often gone for 'quick fixes' that is for fiscal reforms that reduce the fiscal deficit in
the period immediately ahead with policy changes that are neither durable nor efficient. Common elements of these 'quick fix' solutions have been: (a) sharp reductions in public sector real wages to levels below their likely long-run equilibrium; (b) sharp and indiscriminate cuts in investment expenditure without much assurance that the projects that are eliminated are least productive; (c) sharp cuts in expenditures on operation and maintenance leading to a faster deterioration of the existing capital infrastructure and to reduce capacity utilization; (d) emergency tax legislation, including the temporary introduction of very distortionary taxes such as those on exports and financial instruments, and of temporary surtaxes on import duties, income taxes, and others; (e) excessive increases in some excises; (f) anticipation of tax payments, sometimes by providing discounts for anticipated payments to tax payers, thus reducing further tax collection; (g) tax amnesties; (h) quick sales of some assets; (i) delay in making payments, (j) various imaginative maneuvers aimed at 'parking' the deficit in parts of the public sector not covered by the programme.

Most of the above measures are either self-destructing, or of questionable quality, or both. They are not the kind of measures that one would want in a good programme or that will result in durable stabilization. They will cause a rise in fiscal tension, increasing uncertainty and sending negative signals to investors, thus discouraging capital repatriation, or encouraging capital flight. Given the measured fiscal deficit, the expected rate of return on private investment is likely to be negatively related to the degree of fiscal tension while private investment is positively related
to the expected rate of return. Therefore, a deficit reduction achieved through these means should not be expected to bring about an improvement in economic conditions. Such a reduction can only be justified if it is clearly announced and believed to be a transitory step toward a more durable and higher quality package. Unfortunately, these measures often exhaust the political will of the government to make the more basic reforms or are seen as the only way to reduce the fiscal deficit.

Sustainable fiscal policy requires, almost by definition, measures that will survive the test of time and that will not put additional impediments on the efficient allocation of resources. It must involve good macroeconomists working in close cooperation with public finance specialists experienced in both policy and administration.

This chapter has surveyed some major issues that arise in trying to bring the fiscal situation of countries under control. It emphasised the much greater complexities and difficulties that arise in the fiscal area as compared to other areas of economic policy. In recent years there has been a lively discussion among economists and policy makers on whether countries should go for shock therapy or for gradualism. This, however, is not a meaningful debate if applied to fiscal policy since as argued above, good fiscal measures always require time.
REFERENCES


2. Ibid., pp. 5-6.


7. Ibid., pp. 70-72.

8. Ibid., pp. 75-76.


22. Ibid., pp. 29-30.

23. Ibid., p. 30.