Primer: Fiscal Space for MDGs

Prepared for eDiscussion "Securing Fiscal Space for the MDGs" **June 2007**

What is fiscal space:

The IMF's approach to fiscal space is reflected in the following definition: fiscal space is *"room in a government´s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy."* (From Quarterly newsletter: Finance and Development, IMF).

Governments can create fiscal space through the following types of fiscal instruments: 1) external grants, 2) domestic revenue mobiisation, 3) deficit financing and 4) reprioritization and raising efficiency of expenditures. (See Box 1).

UNDP's approach to fiscal space is embodied in the following definition: *"Fiscal space is the financing that is available to government as a result of concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective, for a specified set of development objectives."* (Roy, Heuty and Letouze, 2007, forthcoming).

Key differences in approaches:

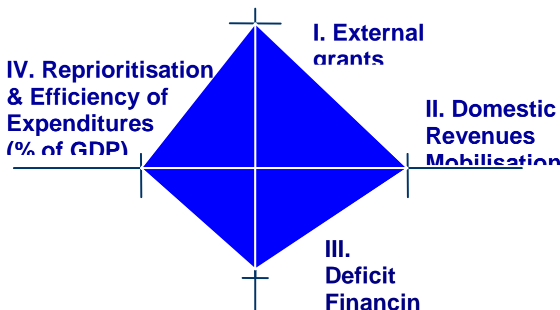
- In the IMF's approach, short-term **fiscal solvency and macroeconomic stability considerations** are primary considerations that determine the possibility of mobilizing additional resources for development. In UNDP's approach, the long term benefits of securing **human development outcomes (such as the MDGs)** are the primary considerations, which need to be weighed against fiscal sustainability and macro stability considerations.
- In the IMF's approach, the emphasis is to ensure that expanding fiscal expenditures does not harm fiscal solvency and macroeconomic stability in the **short-term**. UNDP's approach calls for a need **to consider the long-term impact** on fiscal sustainability and macro stability, and **to relax fiscal requirements in the short term**.

Fiscal Space and the MDGs

Why is fiscal space important for MDG achievement?
The achievement of MDGs, and any development transformation, requires significant scaling up of resources for public investment. The extent of fiscal space available to governments determines their ability to mobilize these resources. [Continued on the next page]

Box 1. Fiscal space analysis tool:

Fiscal space diamond is a tool (explained in Roy, Heuty and Letouze, 2007, forthcoming) that builds on the initial fiscal space diamond introduced in WB/IMF Development Committee Interim Report, 2006. It visualizes the potential **increases** (not total values) in resources through various fiscal instruments along 4 scales (as % of GDP):



In analyzing the country's fiscal space, each of the four pillars of the fiscal space diamond needs to be analysed to determine its potential for resource mobilisation:

I. External support - includes grand aid and debt relief:

- What is the medium and long term debt sustainability? Is the country benefiting from a debt relief programme? At what point does the country qualify for debt relief?
- What have been the patterns (level, nature –project vs programme-, origin, predictability) of aid and what can it be like in the foreseeable future?

II. Domestic resource mobilization - includes privatization receipts, tax and non-tax revenue collection:

- Should/can tax/GDP ratio be increased? If so, how can this be done while ensuring that the burden on the poor is minimized?
- Should VAT be introduced if absent?
- To what extent is privatization of public assets feasible without undermining MDG achievement?

III. Deficit financing - includes net domestic financing, net foreign financing:

- What are the needs for public investment? What is the case/room for additional borrowing in relation to point/pillar 1? What is the level of internal and external debt? Access to international capital market?
- What is the level of investments and savings? To what extent do the savings contribute to investments?
- If savings are low, why? How to reduce obstacles to savings? How to improve channelling of savings for public investment?

IV: Reprioritization and efficiency - includes reprioritization based on the extent the expenditures contribute to MDGs; and value-for-money considerations:

- What is the ratio of current/capital expenditures?
- What is the share of expenditures that can be classified as pro-poor?
- To what extent can the government enhance the value for money for goods and services it provides?

Relevant Terms and Definitions:

- **'Dutch Disease'** is an economic condition that refers to negative consequences arising from large inflows of foreign currency leading to appreciation of the domestic currency. As a result, the country's exports become less competitive. This phenomenon was named so after the decline of the manufacturing sector in the Netherlands following the discovery of natural gas in the 1960s. 'Dutch disease' can also emerge due to other reasons leading to large inflows of foreign currency, such as substantial increases in foreign aid or a significant increase in natural resource prices.
- **'Crowding Out'** refers to the displacement of private investment by government spending at a time when the economy is already producing at its full capacity. In this case, higher government spending (and higher borrowing) leads to rising interest rates and to increasing demand for goods and services. Since the economy is already at its full capacity, the additional goods and services need to be procured through external sources (imports).
- **'Crowding In'** of private investment occurs when the increase in government spending stimulates the domestic economic activity.
- **'Fiscal Rules'** are statutory or constitutional restrictions on fiscal policy that set a specific limit on fiscal indicators such as the budgetary balance, debt, spending, or taxation.
- **'Medium-term Fiscal Framework'** is a 3-year, rolling forecast of key macro-fiscal aggregates such as tax/GDP ratios, current and capital spending and the fiscal deficit. It draws on the overall '**Macroeconomic Framework'** which provides forecasts of relevant macroeconomic variables such as growth, inflation, etc.
- **'Savings'** – refers to the portion of income that is not spent. Savings (domestic) are the key source of investment in an economy. Domestic savings can also be supplemented by capital from foreign savers.
- **'Capital Accumulation'** – refers to the acquisition of capital goods (mostly productive assets) as opposed to consumption goods. Because capital accumulation is made possible by investment, these two terms tend to be used interchangeably.