

Evaluation of Fiscal Adjustment in IMF-Supported Programs:

Some Comments

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It is a pleasure to comment on Marcelo Selowsky's presentation and the report on fiscal adjustment by the IMF's Independent Evaluation Office. The report sets a high standard for work of this kind. It is comprehensive, careful, and balanced in its judgments. The reader gets a sense of the interaction between IMF staff and the government of the country in adjusting fiscal adjustment programs to events both foreseen and unforeseen at the time of the initial program. This is a very different picture than one gets from, for example, Joseph Stiglitz's book on globalization and one with much greater verisimilitude and supporting evidence.

Those who do empirical work learn early and often that, no matter how careful the study, there is always reason to ask for tests of alternative and supplementary hypotheses. I don't think that's the purpose of today's forum, so I will confine my comments of that kind to one broader point. Let me add that no study of this kind can settle issues permanently. As the report notes at several places, we cannot construct a counterfactual to learn what would have happened without the program.

Nevertheless, there is an obvious alternative. How did countries fare if faced with similar crises but no IMF program? A commonly cited example is Malaysia following the Asian crisis of the late 1990s. It rejected IMF assistance and introduced exchange controls. Malaysia is alleged to have recovered as rapidly as countries with IMF programs, for example Korea or Thailand, and more rapidly than Indonesia.

Is it true that exchange controls, temporary exchange controls, can substitute for IMF adjustment? If so, this would be an important finding and highly relevant to the design of fiscal adjustment programs. We should pause before jumping to that conclusion.

Paul Krugman and others who cite Malaysia do not pause. They neglect the role of world demand for the exports of troubled countries. During the Asian crisis, the United States's current account balance fell from about \$-128 billion in 1997 to \$-411 billion in 2000. Few would deny that this large growing increase in global demand made a major contribution to the recovery experienced by Malaysia and other Asian countries. Perhaps it had more to do with Malaysia's recovery than the particular policies chosen by Malaysia. Perhaps Malaysia recovered despite exchange controls. Perhaps it would have done better, if it had adopted an IMF program. Once again the counterfactual problem appears, but the comparison is still information.

The same is likely to be true of other countries. Rising world demand certainly influenced the speed of recovery in Korea and other parts of Asia. The only way this shows up in the report is in the country's growth rate or its current account position. This helps but it would help more if world demand were held constant.

I want to now discuss the director's response to the report and the report's implications for the IMF. While reading the report and the response, I asked myself what would I want to know next. The question that jumped out at me was: what causes the lack of success in explaining the difference between the planned or envisaged and actual fiscal adjustment? The report finds that nearly 80 percent of the variance of this difference is not explained. Simply put, we don't know why countries miss their planned fiscal adjustment.

The report offers some guidance. It tells us (p. 61) that "insufficient progress in structural reforms in the fiscal area is an important factor behind shortfalls in fiscal adjustment." Or, (p. 64) "revenue shortfalls seem to be associated with weak implementation". Later, discussing why economic growth outcomes might be less than projected it offers four reasons of which one is that (p. 75) "policies ... may not be implemented effectively." This message recurs several times, for example when discussing effective collection of delinquent taxes.

My favorite analogy about economic reform is that reforming countries has something in common with raising children. It doesn't do much good to want for your children what they don't want for themselves. The same is true of countries. For example, compare the success of economic reform programs with Carlos Belongia in the early Fujimori government in Peru and Minister Lavagna in the Argentine government currently. Minister Belongia was committed to reform and reforms were made. He was able to marshal the necessary support to succeed in transforming Peru's economy. The quotations I read from the IEO report speak to the

importance of political support in successfully implementing reform. I believe that represents the critical difference in whether fiscal targets, growth targets, and structural reforms are achieved. Of course, outside events matter also.

The directors make a few passing remarks along these lines, but they strike me as lacking curiosity about why many programs do not succeed and what might be changed to make more of them succeed. For example, the directors noted (p. 165) that fiscal targets “were not met in a large number of cases” and asked for better understanding of the reasons that (p. 166) “most of the progress in fiscal adjustment took place in the first year of the programs with little progress thereafter.” But they did not direct the staff or the IEO to find the reason.

Again, the directors (p. 166) “noted that successful fiscal reform would require that the authorities have strong ownership of the process” and that the (p. 168) “ultimate responsibility to develop the fiscal reform agenda resides with the individual country authorities.” If these are to be meaningful statements, they have to be implemented by reforming IMF procedures.

The principal change has to be a shift away from current command and control procedures, tied to dollops of money conditioned on the promise to make reforms. The report, and much else, tells us that the reforms are not made in the majority of cases and that most conditional programs do not survive into the second year.

The problem is to decide what should replace these procedures. My answer is that the IMF must shift to an incentive system where payments are made for performance, not for promises. There is much talk of country “ownership” – countries choosing the reforms. This is a good step, an appropriate and desirable step, if the country actually makes the reforms and keeps them. As the report recognizes at several places, structural reform takes longer than most crisis programs.

Doesn't anyone at the IMF wonder why countries like Turkey, Pakistan, Argentina, and Ecuador and, in the past, Mexico and India have had frequent problems that got IMF support. Could it be that they never made the reforms? Isn't it instructive that Turkey took implementation more seriously when it had the incentive of joining the European Union and would not get invited unless it made the reforms? India got its incentive from comparing the Hindu rate of growth to China's vastly more successful program. Reforms that were previously politically impossible became distinctly possible.

The main lesson of the IEO report is that the IMF is not very successful. To be more successful in reforming fiscal (and other) policies in the client countries, the IMF must reform itself. I have written and spoken enough about how to increase incentives for reform, that I will not repeat these proposals. Let me say that the CCL was a start toward reform, but the IMF let it die. The CCL contained an incentive; it rewarded actual, not promised, reform. The incentive could be strengthened. Its counterpart—no assistance to countries that get into trouble because they do not make reforms, could supplement it. One thinks of the Turkish or Korean financial systems or the rigid Argentine labor and product markets.

Recent research in economic development asks why does development occur in some countries but not others. The answer in the current literature is that institutions matter. Unless countries adopt supporting institutions, sustained development does not occur. See, inter alia, much recent work by Daron Acemoglu and his collaborators. I believe that crisis reform and crisis avoidance also depend on institutional reforms that require local leadership, sustained commitment, and the ability to maintain support for reform during the often costly adjustment period. The IMF cannot bring a country to do what the citizens or their representatives do not want to do.

For me the most striking aspect of the IEO evaluation of fiscal adjustment is the lack of curiosity by the directors about how the IMFs record could be improved. After 60 years, it should be time to answer that question. Like Alice the more I think about it, the more it grows curiouiser and curiouiser that they don't ask.

Shifting more decision-making authority to client countries facilitates their ownership of the program and reduces the IMFs perceived responsibility. The IEO report expresses concern about maintaining the social safety net during periods of adjustment and distress but says little about the effect of shifting the burden of adjustment up the income distribution. Welfare decisions of this kind should be made locally, not in Washington. It would seem to be in the IMFs interest to tell its many, vociferous critics that it provides incentives for reform and adjustment and leaves welfare and distributional decisions to the countries.

But that hasn't happened. It grows curiouiser and curiouiser.