

Fiscal Policy in Developing Countries: summary document

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These brief comments are based on notes taken during the workshop, both by us and by Guido Cocco of IGC. They can therefore in no way attempt to comprehensively cover all the issues discussed in the workshop. We are also deliberately omitting extensive coverage of the material presented by the participants who gave formal presentations, as these are available on the IGC website. Similarly, we do not refer here to background material contributed by participants, which can also be found on the IGC website.

1. Goals of the Researcher

Several participants voiced an inherent difficulty with the notion of “optimal” fiscal (or any other) policy in countries where political economy considerations loom large and governing elites are often motivated by considerations other than social-welfare maximization. It was acknowledged that often policy advice is requested by “enlightened” members of these elites, who however are severely constrained in their actions by the necessity to compromise with other, less enlightened members. It was suggested that in these cases researchers should give advice that fully takes into account such constraints, which could be quite different from the advice one would give to a benevolent social planner.

2. Goals of Fiscal Policy

The discussion distinguished between the cyclical component of fiscal policy, the role of fiscal policy in fostering long-term growth, and the role of fiscal policy in alleviating poverty. In the rest of the summary we separate these various issues.

3. Fiscal Policy and the Cycle

There was general agreement that we know even less about the short-run impact of changes in fiscal policy in developing countries than we know in developed ones, and that good empirical research in this area is a priority. However, aside from the difficulties of coming up with compelling identification strategies, there is a massive constraint in the form of a paucity of quarterly macroeconomic data for developing countries. Poor data quantity and quality quickly emerged as one of the most urgent problems in macro research in developing countries.

It was reaffirmed that for various reasons fiscal policy in developing countries is believed to be too procyclical, though some participants reminded others that procyclicality may be optimal in certain circumstances. In order to deal with this excess procyclicality there was a lot of discussion of fiscal rules, which limit the discretion of fiscal policymakers. Fiscal rules have been successful in some countries and are now being rolled out in others. Research on fiscal rules is in its infancy, and an important area for further work. A key question is why and when do they work, given the potential for reneging by the fiscal authorities. In turn, answers to these questions are only possible starting from a much more rigorous understanding of what problem do they solve. It was pointed out that

the game-theoretic literature on procedures may shed light on this. In this regard, the process by which the rules are introduced and selected may be as important as the rules themselves, as it can create more political support for sticking to the rules. There is also scope for borrowing from the literature on monetary-policy rules. Another key set of questions is the optimal design of policy rules. In particular, what macroeconomic variables should the fiscal rule be conditioned upon. It was also noted that the optimal fiscal rule would likely depend on whether the country enjoys financial market access or not (and on country-specific factors more generally). Finally, it was noted that fiscal rules may also have a role at the level of individual projects, particularly to make sure that projects that are initiated are brought to fruition.

On the cyclical role of fiscal policy there was also a very lively discussion on the role of **DSGE models**. This discussion continued and was perhaps more systematic during the workshop on monetary policy, on October 22 (see summary for that day). There was disagreement on whether DSGE models for developing countries should be developed from scratch or should be arrived at by incrementally modifying DSGE models currently used for developed countries. There was consensus, however, that the end result needs to be very different as the structural features of developing countries are too different from those of rich countries for minor modifications to be sufficient. A few participants, however, felt it was premature to try to bring the DSGE methodology to developing countries.

Some participants went further and argued that there should be different class of models not only for developed and developing countries, but also a separate one for **emerging markets**, which in turn are structurally different from either of the other groups.

4. Fiscal Policy and Long-Run Growth

This topic received less attention during the workshop, though some participants felt it was as important as the topic of cyclicity. There was a consensus that we know very little about this. In particular, the appropriate boundary between private and public provision of goods and services (including in education, health, and infrastructure) is still an issue dominated by ideology rather than compelling evidence. On the point above an under-researched topic is the topic of Private-Public Partnerships (PPP). They may have very high institutional requirements and there are important hold-up problems to be thrashed out. In thinking about the role of fiscal policy in long-run growth it is clearly essential to also take a view on the **optimal size of debt**, which in turn links to the classic, but still unsettled, topic of **debt sustainability**.

5. Fiscal Capacity and the Composition of Revenues

It was reiterated that fiscal capacity remains very limited in many developing countries and that research on how to foster fiscal capacity remains very important. Related, the optimal composition of tax revenues, including the role of seignorage and reserve management, should continue to attract research attention. The perception is that for various reasons many governments rely on very distortionary taxes and fees and that guidance is needed on ways to shift to less damaging systems.

6. Aid

Aid did not figure prominently in the discussion but it was reiterated that assessing the appropriate role of aid remains a priority for research.

7. Poverty alleviation

It was noted that work fare programs and other conditional cash transfer schemes seem to be generally regarded as success stories and hence an important function for fiscal policy.

8. Monetary-Fiscal Interaction

It was noted that the game between different macro policy institutions is different in developing countries than it is in developed ones, suggesting scope for novel research in this area. It was also noted that fiscal policy may have negative (unintended) effects on the real-exchange rate, affecting export performance. Research should provide guidance on how to avoid these effects.