EAGER Policy Brief

NUMBER 51 / JUNE 2001

Criteria for Sound Macroeconomic Management: A Governance Perspective

This policy brief draws on the results of the study "Restarting and Sustaining Growth and Development in Africa" to highlight the principal criteria associated with sound macroeconomic management.

One of the basic requirements for sustained growth and development is macroeconomic balance. Key relationships upon which macroeconomic balance depends are:

- government revenue and expenditure,
- savings and investment,
- imports and exports, and
- debt and productive capacity.

Imbalances or gaps in any of these relationships create "spillovers." The spillovers can be positive or negative. For example, when government recurrent revenue exceeds recurrent expenditure, government savings are positive. These savings help finance the government's capital expenditure thereby easing the pressure on domestic capital markets and reducing the stock of government debt. Positive public sector savings also reduce the rate of monetary expansion. This moderates the growth of nominal income thereby reducing the demand for imports and freeing a larger share of domestic production for export. These changes improve the balance of trade (i.e., the ratio of exports to imports), raise the level of foreign reserves, and help stabilize the exchange rate.

A major problem in African countries has been that most of these spillovers have been in the opposite direction. Due to large budget deficits government savings have been negative. This has raised the rate of monetary growth, increased the growth of nominal income, widened the gap between imports and exports, diminished foreign reserves, increased the level of foreign debt, and intensified dependence of African countries on foreign aid.

The main challenge for macroeconomic managers is to restore balance among the above variables in ways that minimize the costs of the making the transition. Some costs are inevitable — lost output, higher unemployment, changes in asset

Equity And Growth through Economic Research– an activity of USAID, Bureau for Africa, Office of Sustainable Development, Strategic Analysis Division

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values, and shifts in the distribution of income. These costs arise because the removal of macroeconomic imbalances requires fundamental restructuring of key economic relationships. Many of these costs have been well documented. Indeed, there is now a large literature highlighting the *costs of adjustment.* By contrast, far less attention has been given to the costs of not adjusting. That has been a major mistake. Across Africa, the principal cost of *not* adjusting has been economic collapse, rising poverty and increasing "marginalization" of the continent within the global economy.

One approach that might help African governments break out of the cycle of limited and often hesitant adjustment is to recognize that the principles of prudent macroeconomic management are critical to good governance. These principles relate to issues such as macroeconomic stability, the efficient allocation of government expenditure, sustainable levels of public debt, a high degree of tax compliance, avoidance of aid dependence, and a pro-active approach to policy.

Macroeconomic Stability: One of the most robust results of econometric research of the last decade has been the growth-inhibiting and destabilizing effects of persistent budget deficits. No developed or developing country has sustained high rates of growth and development by running persistently "large" budget deficits. Most OECD countries have undergone broad-based structural adjustment designed to reduce their deficits and revive their prospects for sustained growth.

For developing countries, the lesson is clear. Despite their deep financial systems, access to international financial markets, effective tax departments, and robust institutions, the rich countries cannot promote sustained economic growth through deficit financing. With few of these advantages, poor countries will invariably fail if they attempt to grow and develop by running deficits.

Over recent years, African governments have taken steps to narrow their public sector deficits. Together with the liberalization of the local financial markets, they have also attempted to finance the deficits in non-inflationary ways. These improvements aside, most African governments have continued to run deficits. This has maintained pressure on prices, exchange rates, and interest rates.

Efficient Allocation of Government Expenditure: A common feature of all high-level decision making is the acceptance that "political factors" invariably require the waste of (some) national resources. In advanced democracies, the general public expects the ratio of "waste" to socially productive expenditure to be small. An important function of the many oversight agencies in developed countries is to hold their politicians and bureaucrats accountable. Ultimately, if the voters believe there is too much "waste" they have the option of turning irresponsible politicians out of office.

African countries have few equivalent oversight agencies and their fledgling democracies have a limited record of political competition and successful changes of government. Furthermore, most African governments have a deeply ingrained antipathy to close scrutiny of their operations. The result is that large amounts of socially unproductive expenditures—official travel, representation abroad, military outlays, and wages and salaries—are given priority in the budget.

This is not a new problem. Efficiency and effectiveness in government expenditure have been stressed for as long as public budgeting has been a coherent field of study. Africa's difficulties in this area have been widely examined as well. This has been reflected in studies of the "recurrent cost problem," extensive technical assistance for budget and tax reform, and donor/government collaboration in preparing "public expenditure reviews." Most countries have now had several such reviews. All of them reiterate the basic principles of efficiency, effectiveness, and equity upon which public sector decision-making should be based.

Properly acted upon, these exercises could have radically transformed most government budgets in Africa. Results have been disappointing. The (almost) universal response to the recommended changes has been that they are too difficult politically. This response implies that few governments perceive important political advantage from taking measures that fundamentally improve the allocation of government expenditure.

A common feature of government expenditure across Africa is the high cost of the civil service. In many countries, the government wage bill frequently absorbs 6-8 percent of GDP. Most African governments have formally admitted that their civil services are overstaffed and inefficient. The difficulties almost invariably start at the top. State Houses and Prime Minister's offices are over-staffed and there are far too many ministers and deputy (or vice) ministers. These appointments have nothing to do with effective government. The rhetoric on public sector reform, now well worn across Africa, is that the process will create a leaner, more efficient government. Two dozen (and often more) cabinet ministers are the antithesis of that idea.

It is a major challenge to reform civil services across Africa even though large parts of them have become dysfunctional. No one doubts the difficulties involved. Yet, without major cuts in the civil service, resources cannot be freed up, efficiency will not improve and growth will not revive.

Sustainable Levels of Public Debt: A major budgeting problem has been the general unwillingness of African governments to act as though real resources are limited. Their expenditure plans typically require far more resources than are available. The resulting deficit raises the level of public debt. One problem is that debt dynamics tend to be ignored in official policy statements. Most budgeting exercises tend to only highlight revenue and expenditure flows. Far less attention than is warranted is given to the government's asset account, its debts, and contingent liabilities.

Properly conceived, all budgeting exercises would begin from the resource and debt side of the accounts to determine the maximum level of expenditure that could be supported from existing revenue and net changes in debt. A prudent debt strategy would ensure that net additions to the debt stock do not unnecessarily restrict the ability of the government to raise resources in the future.

Such an approach, while always desirable, has become essential now that financial markets are globalized. It is no longer feasible to set domestic expenditure targets and then attempt to cobble together a package of domestic revenue and financial support from the multilateral and bilateral donors to cover this expenditure. Though this been the most common approach to budgeting across Africa, it is a fundamentally wrong-headed approach to economic policy. The *domestic* budget exercise should begin with the constraints imposed by *external* resources. Such an approach would have the beneficial effect of focusing the attention of African governments on the policies needed to ensure that external resources supplement rather than supplant local resource mobilization efforts.

Governance issues arise at a number of levels. Fiscally responsible governments do not incur deficits that push a country beyond its sustainable debt servicing capacity. Economic "shocks" might require temporary increases in debt. Responsible governments, however, make the necessary adjustments to ensure that their debt servicing capacity remains unimpaired. Furthermore, responsible leaders do not assume that, because debt is repayable over time (often at points beyond their tenure), the amortization of that debt is "someone else's problem". In earlier times, African governments established "sinking funds" so that debt repayment would remain a charge against the current budget. That practice was progressively dropped as budgets came under pressure and governments sought additional ways of raising their access to current resources. Well-governed countries would restore that practice.

High Degree of Tax Compliance: A high degree of tax compliance is an essential dimension of a well-governed society. For governments that depend heavily on donor assistance to "close" the financing gaps in their budgets and balance of payments, a high degree of tax compliance should be a major priority. Foreign taxpayers cannot be expected to continue supporting African governments that do not require their citizens to share the burden as well. African leaders dedicated to improved governance would ensure that the maximum effort has been made to fairly and effectively raise revenue (and economize on expenditures) *before* turning to the international community for support. To date, the typical pattern has been the reverse: tapping external sources of finance has been a substitute for local revenue mobilization.

One feature of responsible governance is that a government will mobilize resources adequate to cover projected expenditures in a non-inflationary way.

One of the most important means of providing those resources on a sustained basis is to enact *and* administer legislation that ensures a high degree of tax compliance.

This has several tangible benefits for an economy. First, ensuring that taxes are paid are required by the law puts to rest one of the principal criticisms of "soft," or dysfunctional states. Second, better tax compliance improves efficiency throughout the economy implying that a given amount of revenue can be raised with fewer distortions to economic behavior. Third, a high degree of tax compliance improves equity. It requires all citizens who have the capacity to contribute to the cost of maintaining the State.

Avoidance of Aid Dependence: There are now literally hundreds of studies dealing with the positive and negative aspects of foreign assistance. Many of the issues associated with aid — the addition to national resources, fungibility, distorted incentives, artificial appreciation of the real exchange rate, the resentment of aid recipients, and moral hazard — were raised in the debates about the Marshall Plan over half a century ago. Subsequent discussions have highlighted the complexity of the interaction of motivations and expectations associated with aid. The intersecting interests cover a broad spectrum — politics, economics, diplomacy, international security, and humanitarian concerns. For many commentators, particularly senior representatives of the major aid organizations, foreign assistance is seen as part of the solution to pressing problems of development. By contrast, there has always been an undercurrent of criticism that aid is part of the problem. More recently there has been a growing recognition that the pathologies generated by "aid dependence" need to be addressed directly.

There is no doubt that discussions about ending aid dependence in Africa have elements of "blaming the victim." Aid has been provided to African countries for many reasons, most of which had little to do with sustained economic growth and development. Since the mid-1980s there has been the net transfer of billions of dollars of financial and commodity support of around 10 percent of the combined GDP of Sub-Saharan Africa excluding Nigeria and South Africa. These transfers have been so large and so persistent that they have dominated the development agenda across Africa. Even without the various "games" which emerge between donors and aid recipients, transfers of these magnitudes distort incentives and maintain the chronic over-valuation of most African currencies.

In order for African governments to begin determining and implementing their own development agendas, they have to honestly and openly face the destructive dynamics of their aid dependence. So far, African governments and aid agencies have been unwilling to acknowledge the counter-productive dimensions of their mutual dependence. Accordingly, neither party has taken steps to develop "aid exit" strategies.

Additional aid will not solve Africa's present problems. Solutions when they are found will involve the recommitment to the structural adjustment and reform programs that heretofore have only been partially implemented. Additional aid at this point would only confirm what most African leaders have come to believe, namely, that when conditions become "too tough" the donor community will "come through." This, however, is not a responsible way to manage an economy or govern a country.

Pro-active Approach to Policy: Another dimension of macroeconomic management that is consistent with good governance is the creation of conditions that enable governments to take a proactive approach to policy. The details are covered in policy brief number 53, so are passed over here.

Overview: This policy brief has argued that prudent macroeconomic management is a crucial dimension of good governance. Macro economies that are properly managed reflect a balance between resource availability and resource use and the efficient allocation of resources. These, in turn, require that governments restrict their agendas consistent with their capacities and act in ways that ensure resources are effectively, efficiently and fairly mobilized and disbursed. Particular attention needs to be paid to the dynamic consequences of deficits and debt so that these do not unnecessarily foreclose future options for rapid growth and development.

This policy brief is based on EAGER Discussion Paper Number 52, *Restarting and Sustaining Growth and Development in Africa: The Macroeconomic Dimension,* 2001, by James S. Duesenberry [jduesenberry@harvard.edu] and Malcolm F. McPherson [Malcolm_McPherson@harvard.edu], Belfer Center for Science & International Affairs, John F. Kennedy School of Government, Harvard University.

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