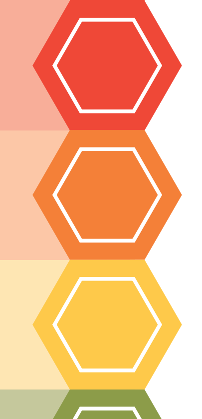

International
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Towards the right to work

A GUIDEBOOK FOR DESIGNING INNOVATIVE PUBLIC EMPLOYMENT PROGRAMMES

EMPLOYMENT INTENSIVE INVESTMENT PROGRAMME
EIIP

Guidance note 3

Creating fiscal space for PEPs

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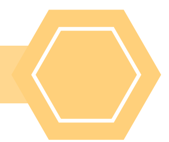

Guidance note 3

Creating fiscal space for PEPs

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Guidance note 3

Creating fiscal space for PEPs

Objective

The objective of this note is to better understand how the concept of 'fiscal space' is used, how it can be created, and how it impacts on the scope of public employment programmes[1] (PEPs).

Defining fiscal space

The concept of 'fiscal space' has been described as 'fuzzy'[2]; its definition is also certainly contested within the public finance literature. According to Heller[3]:

> Fiscal space can be defined as the availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government's financial position. Usually, the idea is that in creating fiscal space, additional resources can be made available for some form of meritorious government spending (or tax reduction). The incentive for creating fiscal space is strengthened where the resulting fiscal outlays would boost medium-term growth and perhaps even pay for itself in terms of future fiscal revenue.

The International Monetary Fund (IMF) definition of fiscal space can be characterized as "...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."[4]

The United Nations Development Programme (UNDP) definition of 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

1 M. Lieuw-Kie-Song; K. Philip; M. Tsukamoto; M. Van Imschoot: *Towards the right to work: Innovations in public employment programmes (IPEP),* ILO Employment Working Paper No. 69 (Geneva, International Labour Organization, 2011).

2 P. Heller: "Back to basics – fiscal space: what it is and how to get it", in *Finance and Development* (Washington, DC, International Monetary Fund, 2005) Vol. 42, No. 2.

3 Ibid.

4 Ibid.

economic environment for these policy actions to be effective, for a specified set of development objectives."[5]

The UNDP has criticized the IMF approach for placing fiscal concerns ahead of development objectives: for prioritizing short-term fiscal targets such as debt/GDP ratios and fiscal deficit/GDP ratios at the expense of longer term development objectives. This, it is argued, has translated into the reduction of public investment as a share of GDP in developing and middle-income countries, damaging the prospects for long-term growth and the attainment of the Millennium Development Goals (MDGs). By contrast, the UNDP's emphasis is on the mobilization of resources to finance public investment to support long-run growth – with such long-run growth providing the key to long-term fiscal sustainability (Islam, 2009). While fiscal sustainability is a key goal in both cases, it is as contested a concept as 'fiscal space'.

Debates on the meaning of fiscal sustainability

Debates over what constitutes fiscal sustainability hinge on how the following relationships are understood:

- the relationship between fiscal policy and economic growth;
- the relationship between social investment and growth outcomes;
- the conditions under which growth outcomes translate into sustainable development outcomes.

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There are arguments over whether fiscal solvency is an appropriate indicator of financial sustainability. These focus on the extent to which financial sustainability can be achieved outside of the achievement of wider development outcomes, and on the extent to which disregard for issues of fiscal solvency will impact on inflation, interest rates and capital flows in ways that jeopardize the sustainability of development gains made.

Economic theory does not provide any precise level at which public debt is sustainable or unsustainable. If an expansionary fiscal policy increases government deficits and debt but also provides positive stimulus to economic activity, then a rising fiscal deficit and growing debt need not pose a grave danger to the solvency

[5] R. Roy; A. Heuty; E. Letouzé: *Fiscal space for public investment: Towards a human development approach* (New York, NY, United Nations Development Programme). 2006.

constraints of the government. In fact, such a growth-stimulating fiscal policy would help improve solvency constraints in the longer run. Conversely, if an expansionary fiscal policy fails to stimulate economic growth or such growth cannot be translated into a rise in revenues, a point of crisis may be reached. What matters, therefore, is not just whether fiscal policy is expansionary, but the content and quality of the investments made with resources provided.

Recent literature on the economics of public debt also argues that a high debt to GDP ratio may not by itself be a matter of concern provided it remains constant. This constancy provides a country with the scope to debt finance the deficit without encountering the risk of high inflation[6]. Even if the debt keeps growing, a country can still run fiscal deficits for many years without reaching a crisis and, unless the deficit level is very high, the point of crisis may take a long time to reach[7].

In the 1940s, Wright[8] argued that even though debt-servicing obligations can impose a real burden on society, it can be reduced if a proper tax policy is pursued. But for the taxable capacity to grow national income must grow. While commenting on rising debt and interest payments, he took this view:

> Even though interest charges and consequent tax friction are rising absolutely, the relative tax friction may be decreasing, if the national money and real income is increasing at a faster rate. Thus if we have a genuine growth in the taxable capacity of the country, a rising interest bill is not a matter of immediate concern. Nor it will be matter of concern as long as the taxable capacity of the country continues to grow, as fast, or faster than the taxes.

Consequences of debates

Taking a similar line of reasoning[9], Domar argued that the 'burden of debt', if it has any meaning, refers to the tax burden which must be imposed to finance the service charges and only if the tax required to meet interest charges is high, does the question of sustainability of debt arise.

However, these are not the arguments that have tended to inform fiscal policy in the developing world over the past two decades. Instead, public investment as a share of GDP fell during this period, with negative impacts

[6] T. Congdon: "The link between budget deficits and inflation: some contrasts between developed and developing countries", in M. Boskin, J. Flemming and S. Gorini (eds.): *Private saving and public debt* (New York, NY, Basil Blackwell, 1987:72–92).

[7] M.V. Posner: "A survey of the debate", in M. Boskin, J. Flemming and S. Gorini (eds.): *Private saving and public debt* (New York, NY, Basil Blackwell, 1987).

[8] D.M. Wright: "The economic limit and economic burden of an internally held national debt", in *Quarterly Journal of Economics* (Cambridge, MA, Harvard University, 1940).

[9] E.D. Domar: "The burden of the debt and the national income", in *The American Economic Review* (Nashville, TN, American Economic Association, 1944), Vol. 34, No. 4.

on economic growth as well as on development outcomes. Critics of IMF policies blame the first generation of 'structural adjustment programmes' promoted by the Bretton Woods Institutions for this outcome:

In the quest to attain fiscal consolidation, the IMF, within the framework of structural adjustment, has exhorted developing country governments to focus on attaining overall fiscal targets. Little attempt was made to distinguish between the composition of the public budget, or current vs capital expenditure, and its overall size. The consequence was that capital expenditure pertaining to spending on infrastructure was cut to meet overall fiscal targets as it is politically difficult to cut current, non-discretionary expenditure pertaining to wages and salaries of civil servants as well as income transfer programmes. The expectation of BWI's was that private investment would increase to compensate for the shortfall in public investment, but this did not happen.[10]

The first generation of structural adjustment policies were also associated with slimmer states and cuts in expenditure on social services such as health and education. In a context of mounting evidence of the negative effects of this on human development, the second phase of structural adjustment included the introduction of poverty reduction strategies (PRSs). However, as an outcome of low growth in this period, the revenue share of GDP fell to below the 15 per cent benchmark in many low-income countries, severely constraining their capacity to finance these strategies within a framework that continued to give priority to fiscal solvency.

With the financial crisis of 2008, the policy pendulum has, for the time being, swung decisively in favour of counter-cyclical fiscal policies, with the G20 putting its weight behind the most ambitious set of fiscal stimulus packages ever marshalled to address a global economic crisis. The great irony is that the bulk of the funding aimed at supporting developing countries is being channelled through the IMF – to the dismay of its critics.

While the scale of the stimulus packages may induce shock and awe, it is the composition of this spending that will determine its impacts on poverty and employment outcomes, amongst other key indicators of success:

> There is a consensus that spending multipliers have higher values than tax multipliers. Moreover, public investment in infrastructure has a very high impact on output and employment. Yet most countries went for a 'diversified' approach, that is, the fiscal packages have entailed a combination of tax cuts and public spending programmes, a proportion of which was devoted to investment in infrastructure. (Islam, 2009)

[10] I. Islam: *The global economic crisis and developing countries: Transmission channels, fiscal and policy space and the design of national responses*, ILO Employment Working Paper No. 36 (Geneva, International Labour Organization, 2009).

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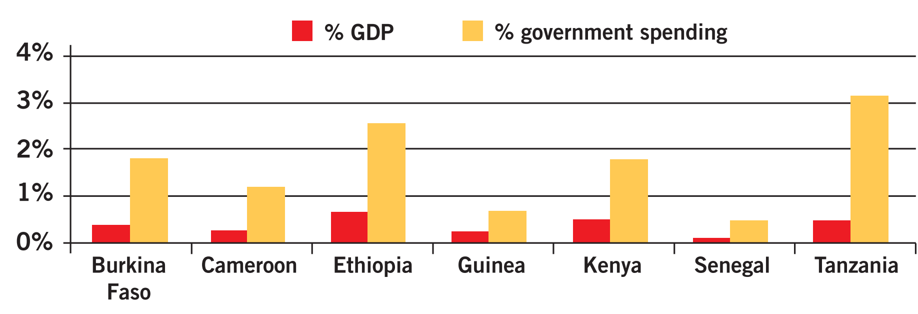
In addition, Islam highlights that fiscal stimulus packages require complementary labour market and social policies to offset the impacts of the crisis; it should be noted here that PEP have a role in enhancing the employment intensity of infrastructure development, as well as forming part of the latter set of initiatives.

For developing countries, however, the scope to initiate fiscal stimulus packages and embrace counter-cyclical fiscal policies in response to the crisis remains constrained by the challenge of resourcing such interventions in a sustainable way, whichever way they choose to define the concept. Many developing countries were already in a vulnerable position before the crisis and it is likely to have further constrained their options.

Alternative modes of budget financing

Public employment programmes and employment guarantee schemes are not standalone programmes independent of the wider government budget; their 'affordability' will be weighed in relation to the overall scope governments have to set and to meet their priorities. Depending on the country context, a critical set of policy decisions will be required on the relative priority to be given to different forms of social and/or income transfers, and on how access to 'work' is to be complemented by other forms of social support for those too weak or vulnerable to work (Figure 1).

Figure 1. Cost of a national social transfer programme (equivalent of US$ 0.50 per day to the poorest 10 per cent)



Source: Pal, K et al. 2005. *Can low-income countries afford basic social protection? First results of a modelling exercise*, Issues in Social Protection Discussion Paper 13 (Geneva, Social Security Department, ILO).

Within this wider context, the financing options available to fund PEP/EGS are critically important to the scale, scope and sustainability of the options, and may determine whether a short-term public works programme is all that is on the table rather than a demand-driven employment guarantee.

The government budget is financed through a combination of alternative revenue sources, including taxation, borrowing, monetizing the deficit (printing money) and grant-in-aid. Excessive dependence on any of these modes of financing can have serious implications for incentives to work and invest, and for fiscal sustainability and autonomy.

Many low-income countries are dependent on foreign aid for significant parts of core government spending, and the scope for PEP depends in part on their ability to access donor support. Such flows are, however, notoriously volatile, they tend to be short-term, subject to changing priorities in donor institutions, and limit the fiscal autonomy of the state.

However, if the government budget is financed through large-scale borrowing, there may be doubts about the long-run fiscal sustainability of a programme because of rising debt and debt-servicing obligations. The capacity to service these depends in turn on the levels of available domestic revenue.

Monetizing the deficit is an option open to those countries that control their own currency. While this is associated with rising inflation – and rampant inflation as seen in Zimbabwe – the composition of spending is critical. An approach called 'functional finance' advocates the use of this mechanism to fund employment guarantees, arguing that where such funds are applied

in ways that unlock labour productivity and create public goods and services, the risks of this stimulating inflation can be avoided[11].

In the case of Sierra Leone, Weeks[12] makes a case for a counter-cyclical labour-intensive public works programme to be financed by monetizing deficit complemented with some external assistance via an 'aid fund'. Based on modelling calculations, this would help return the economy to its pre-crisis levels and attain significant poverty reduction. Exchange rate management and currency depreciation would need to be used to contain inflationary pressures.

The greater the share of domestic resources in financing the budget, the greater the fiscal and policy space government has to set its own priorities, and deliver on them. The mobilization of domestic resources can take a variety of forms, but an effective and efficient tax system needs to be at the heart of a domestic resource mobilization strategy.

Securing increased revenues from taxation does not, however necessarily mean increasing the tax rate; it can also be achieved by enhancing the tax base through appropriate tax policy and an effective tax administration.

> Effective tax systems are central to promoting economic growth, tackling climate change and achieving the MDGs. Taxes, raised in ways that encourage economic growth and promote political accountability, tackle inequality, build the political legitimacy of the state, provide the resources to cope with the current financial crisis, and offer the eventual 'exit from aid'.[13]

However, there are social and economic constraints on the level of the tax burden that can be placed on individuals and enterprises, beyond which taxation can create adverse incentives for work and investment, with impacts on growth.

Developing countries have very different constraints on their capacity to mobilize their own resources for the purpose of fiscal autonomy. The informal economy constitutes a much larger fraction of GDP and, as a consequence, a higher fraction of revenues comes from a few large firms. There is lack of information on potential tax payers, which in turn results in

11 See for example the writings of Willam Mitchell, Randall Wray, Fadhel Kaboub and Dimitri Papadimitriou who have written extensively about the options for financing an ELR without fuelling inflation. A full list of their publications as well as other relevant publications is available at: http://www.economistsforfullemployment.org.

12 J. Weeks: *The Impact of the global financial crisis on the economy of Sierra Leone*, Country Study No. 18 (New York, NY, United Nations Development Programme, International Policy Centre for Inclusive Growth, 2009).

13 United Kingdom. Department for International Development (DFID). *Effective tax for effective states: Improving development outcomes through stronger evidence. Terms of reference for a Research Programme Consortium* (London, 2009). Available at: http://www.dfid.gov.uk/Documents/procurement/ojec-5114-tors.pdf [22 May 2011].

substantial use of non-traditional sources of revenue: seignorage[14], tariffs, and fees. The size of the untaxed economy is, however, also in part a function of the tax policy.

> Currently, tax regimes in many developing countries constrain economic growth, and undermine governance. Excessive tax rates (theoretically up to 200% of profits in some countries) reduce incentives for investment and expansion and force companies to operate in the informal sector. Informal companies must remain small to avoid detection. Excessive and non-transparent tax rules increase incentives to remain informal, and force companies to negotiate tax liabilities with officials, raising the likelihood of corruption. A large informal sector and low levels of taxation from the formal sector combine to severely limit the amount of revenue available to the government to invest in equality, growth and development[15].

Many low-income countries have historically relied on taxes that are 'easy to collect', such as production taxes and import duties, administered at centralized locations such as ports and airports. International trade rules have, however, reduced the policy scope to use these. Yet, substantial capacities are needed for the state to collect and manage taxes, such as value added tax (VAT) and personal income, and are often beyond existing institutional capacities. This constrains the ability of weak or poor states to mobilize domestic revenues.

It is not only the level of resources that can be mobilized that matters for sustainability, but also the predictability of such resources. In many developing countries, due in part to weak tax administration and a narrow tax base, governments depend on non-traditional sources and on the natural resource base to collect revenues. For example, Nigeria's primary source of revenue derives from its oil resources and is dependent on the movement of crude oil prices outside the control of the Nigerian government. Excessive dependence on volatile sources of revenue can pose serious challenges. Where revenue sources are not predictable, the budget process can be ad hoc with unpredictable expenditure cuts seriously constraining planning and programme spending.

It is within the framework of these financing options that the debate over affordability of PEP falls and within which the case for these programmes

[14] The amount of real purchasing power that a government can extract from the public by printing money. See A. Cukierman; E. Sebastian; T. Guido: "Seignioriage and political instability", in *American Economic Review* (Nashville, TN, American Economic Association, 1992), Vol. 82, No. 3, pp. 537–555.

[15] UK. Department for International Development (DFID): *Effective tax for effective states: Improving development outcomes through stronger evidence. Terms of reference for a Research Programme Consortium* (London, 2009). Available at: http://www.dfid.gov.uk/Documents/procurement/ojec-5114-tors.pdf [22 May 2011].

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will have to be made. While additional resource mobilization may be required to fund PEPs, the scope may also exist to re-prioritize and reallocate from within existing budgets. This will require a clear case for PEPs to be made, relative to the existing applications of such funds.

Towards an enabling fiscal framework for PEP

All forms of PEPs benefit from a fiscal framework that provides a medium-term expenditure structure within which to plan, and ensure consistency and predictability of funding flows.

Beyond this, however, there is an important distinction to note with regards to the fiscal implications of an employment guarantee scheme (EGS) as opposed to a more conventional form of PEP (as outlined in the accompanying policy paper[16]).

Public employment programmes are generally financed from a specific budget allocation authorized by a government as part of its normal budgeting process and the scale of the programme. The way it is targeted is determined by budget allocations. The implication is that a programme's scale is not determined by the demand for work, but by the supply of funds.

Conversely, an employment guarantee scheme requires that the scale of the programme and the amount of employment it offers be based on the actual demand for work. Hence, the budget for the programme will need to be

16 M. Lieuw-Kie-Song; K. Philip; M. Tsukamoto; M. Van Imschoot: *Towards the right to work: Innovations in public employment programmes (IPEP),* ILO Employment Working Paper No. 69 (Geneva, International Labour Organization, 2011).

adjusted to meet this demand; increased if demand is high, but also decreased when demand is low. This has implications for the government, as it is not able to fully control its expenditure on an EGS. It can be expected that budgets will be higher in recessions because of higher demand for these programmes, and lower in times of employment growth in line with the counter-cyclical nature of the programme.

This important distinction can be used as a basis to categorize programmes. On the one hand, the scale of supply-driven programmes is defined by a specific budget, which may not be able to grow even if there is demand from people to work. On the other hand, the scale of demand-driven programmes is determined by the demand for the work, which can be expanded to meet demand if more people request work.

In order to ensure that funds are available for an EGS, enabling fiscal regulations would be required commiting the government to make funds available according to the demand for employment.

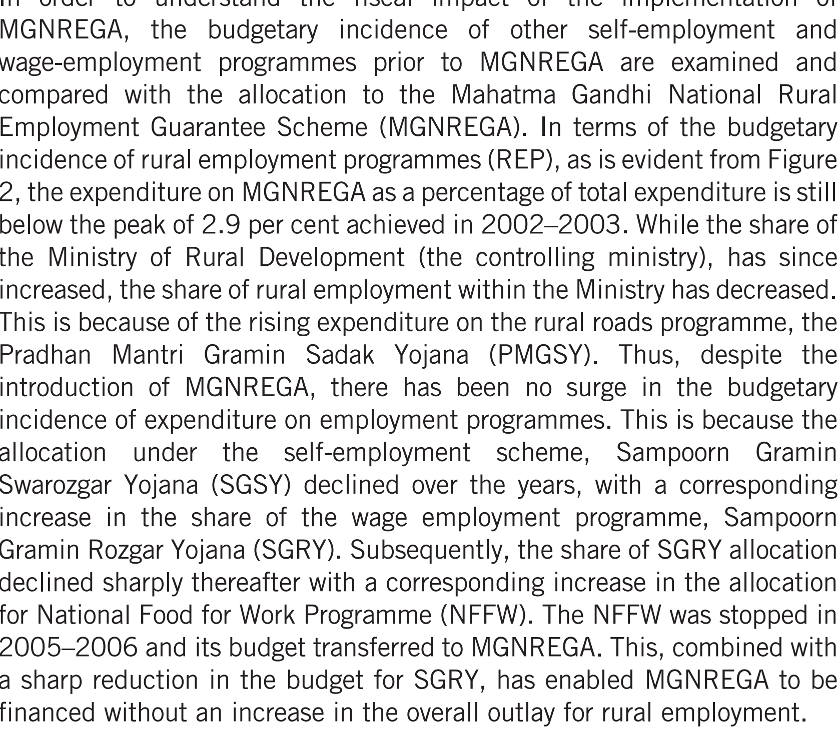
Creation of fiscal space for MGNREGA in India

Economic reforms began in India in 1991 with the introduction of the structural adjustment and stabilization programme targeting fiscal deficits. Efforts to contain deficits resulted in a decline in developmental public spending. During this period, there was a significant decline in public investment on capital expenditure and also a heavy decline in social sector spending and spending on rural development.

The introduction of rule-based fiscal controls put a further cap on the government‘s expenditure programme. The Fiscal Responsibility and Budget Management Act of the central government fixed a numerical target to reduce the fiscal deficit to 3 per cent of GDP by the end of 2008–2009 and eliminate the revenue deficit by 2008–2009. The state level Fiscal Responsibility Act also compressed the level of deficits and the ability to spend.

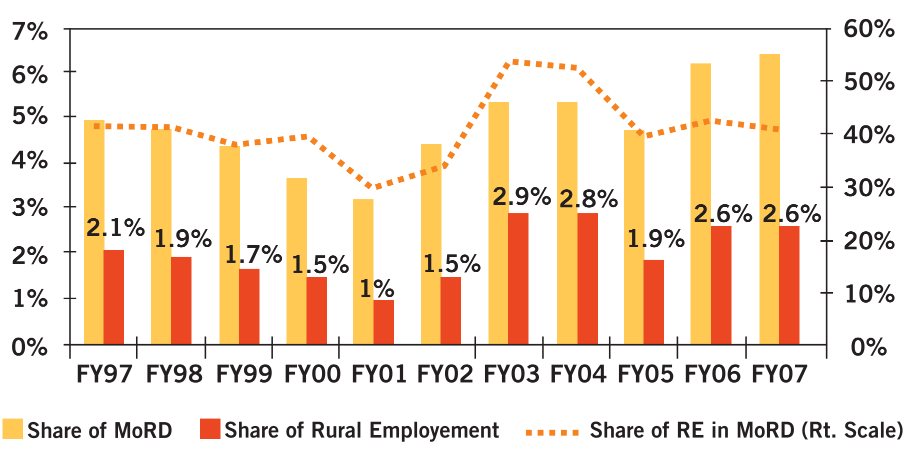
Despite this rule-based framework, the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) did not experience a resource crunch; instead, it has been implemented in a context of significant fiscal space due to rapid increases in the tax to GDP ratio during the same period.

The increase in the tax to GDP ratio occurred in a period of high growth, as there have been growth-induced increases in revenues at both the central and state levels. A favourable macroeconomic environment facilitated improved fiscal management and created resources for spending. In this regard, the timing of MGNREGA was perfect, be it from a fiscal space or policy space perspective, as it was introduced in a period of high economic growth, high tax buoyancy, and low fiscal imbalances.



In order to understand the fiscal impact of the implementation of MGNREGA, the budgetary incidence of other self-employment and wage-employment programmes prior to MGNREGA are examined and compared with the allocation to the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGA). In terms of the budgetary incidence of rural employment programmes (REP), as is evident from Figure 2, the expenditure on MGNREGA as a percentage of total expenditure is still below the peak of 2.9 per cent achieved in 2002–2003. While the share of the Ministry of Rural Development (the controlling ministry), has since increased, the share of rural employment within the Ministry has decreased. This is because of the rising expenditure on the rural roads programme, the Pradhan Mantri Gramin Sadak Yojana (PMGSY). Thus, despite the introduction of MGNREGA, there has been no surge in the budgetary incidence of expenditure on employment programmes. This is because the allocation under the self-employment scheme, Sampoorn Gramin Swarozgar Yojana (SGSY) declined over the years, with a corresponding increase in the share of the wage employment programme, Sampoorn Gramin Rozgar Yojana (SGRY). Subsequently, the share of SGRY allocation declined sharply thereafter with a corresponding increase in the allocation for National Food for Work Programme (NFFW). The NFFW was stopped in 2005–2006 and its budget transferred to MGNREGA. This, combined with a sharp reduction in the budget for SGRY, has enabled MGNREGA to be financed without an increase in the overall outlay for rural employment.

Figure 2. Budgets for rural employment programmes, India, 1997–2007



Left scale: share of total government expenditure; right scale: share of MoRD total expenditure; abbreviations: FY = Financial Year; MoRD = Ministry of Rural Development; Rt Scale = Right Scale.

Reprioritization of government expenditure and consolidation of employment programmes has provided a way to ensure that fiscal space is maintained for the MGNREGA. Consolidation of all other PEPs into MGNREGA also means better monitoring, better outcomes and a reduction of overlapping functions by the Ministry of Rural Development. Despite the increase in the tax/GDP ratio, the actual MGNREGA expenditure as a percentage of the fiscal deficit, revenue receipts and total expenditure did not show an increase between the years 2006–2007 and 2007–2008. However, a significant increase in the share is evident in the revised estimates (RE) of the budget for 2008–2009 and the budget estimates (BE) for 2009–2010. This increase in the share of MGNREGA allocations in the years of global economic downturn is quite significant.

As evident from Table 1, there has been a doubling of the fiscal deficit in the years of crisis. The general consensus in government policy is to aim to come back to the pre-crisis level of fiscal deficit as early as possible, the 'sustainable path' set by the fiscal responsibility and budgetary management (FRBM) target. Also in the context of the crisis, it is recognized that the government needs to spend more in the context of the slowdown in the economy. Even the opponents of MGNREGA are not talking about reductions in MGNREGA expenditure. Thus, the crisis has, in fact, expanded the policy space for guaranteed public employment in India.

Table 1. NREG expenditure and fiscal space: A few key ratios (per cent), India, 2006–2010

	2006–2007	2007–2008	2008–2009 BE	2008–2009 RE	2009–2010 BE
Rural employment as percentage of total expenditure	4.2	1.9	1.6	3.3	2.8
NREG expenditure as percentage of total expenditure	1.2	1.5	1.6	2.7	2.8
NREG expenditure as percentage of revenue receipts	1.6	1.9	2	4.4	4.1
NREG expenditure as percentage of fiscal deficit	6.1	10	10.8	9.2	9
Fiscal deficit as percentage of GDP	3.44	2.69	2.46	6.02	5.53
Revenue receipts as percentage of GDP	12.7	13.8	13.5	12.6	12.2

Source: Government of India budget documents.

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The big question remaining is whether MGNREGA can be used as an instrument of fiscal stimulus? Is there a space for extending the scope of the programme?

The policy space for EGS is vast as it has paid significant political dividends. It was introduced when the government was trying to follow the path of rule-based fiscal control. Now, given the downturn, when FRBM is not the priority, the policy space exists to extend the programme, and there is discussion on extending it to urban areas. As the total allocation in MGNREGA is roughly 0.5 per cent of GDP (2008–2009), it can safely be assumed that the budgetary cost of extension to urban areas would not be huge. There is also discussion on increasing the number of days of employment that is provided in rural areas

The central allocation for MGNREGA has increased exponentially. In the years 2006–2008 and 2007–2008, the increase was 46.52 per cent, and in 2007–2008 and 2008–2009, it was 136.94 per cent. However, the fund utilization ratio remains poor in many states, especially in poorer regions. There are issues related to access that go beyond the question of fiscal space. Many people still do not know that it is a legal right. This issue of ‘demand side vulnerability’ needs to be addressed more effectively, which would increase the demand for work, thus taking full advantage of the fiscal space available.

Further reading

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Checklist

CREATING FISCAL SPACE FOR PEPS	
Respond to the following questions	☑
Does the government have fiscal sovereignty or are budgetary allocations dependent on external debt or to conditionalities set by international monetary and financing institutions?	
Has the government assessed the 'affordability' of a PEP weighed in relation to the overall scope it has to set and to meet its priorities?	
Has the government assessed the financing options available to fund a PEP? The scale, scope and sustainability of the options will determine whether a short-term public works programme is all that is on the table rather than a demand-driven employment guarantee	
Are there national funds available (through a combination of alternative revenue sources, including taxation, borrowing, monetizing the deficit and grant-in-aid)?	
If only foreign aid is available for significant parts of core government spending, has the government assessed the scope of the PEP and how it will deal with the potential unpredictable flow of funds?	
Is there an efficient tax system or tax policy providing for a resilient domestic resource mobilization strategy?	
Has an employment impact assessment been carried out on government's public investments to identify which sector has the largest potential to maximize the employment content of that sector? It would be useful to estimate the direct, indirect and induced impacts, and multipliers of the jobs to be created	
Has an estimate been made on the economic, financial and social costs of unemployment?	
Is there a medium-term expenditure structure within which to plan, and ensure consistency and predictability of funding flows for a PEP?	
If implementing an employment guarantee scheme (EGS), has the government considered how to finance the budget for the programme based on the potential demand for work? The budget will need to be adjusted to meet this demand; increased if demand is high, but also decreased when demand is low.	

Notes

Notes

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