BOX 3.1 Fiscal Policy in Low-Income Countries[1]

Fiscal policy in low-income countries (LICs) has been largely acyclical over the past two decades as shown by very low correlations between the cyclical components of government consumption and GDP during this period (Figure B3.1.1, panel A). This suggests that LICs do not systematically use fiscal policy to stabilize the business cycle. But when they do, how effective is fiscal policy? Empirical estimates of the multipliers in LICs are few, partly because the identification of an exogenous fiscal shock imposes stringent data requirements.

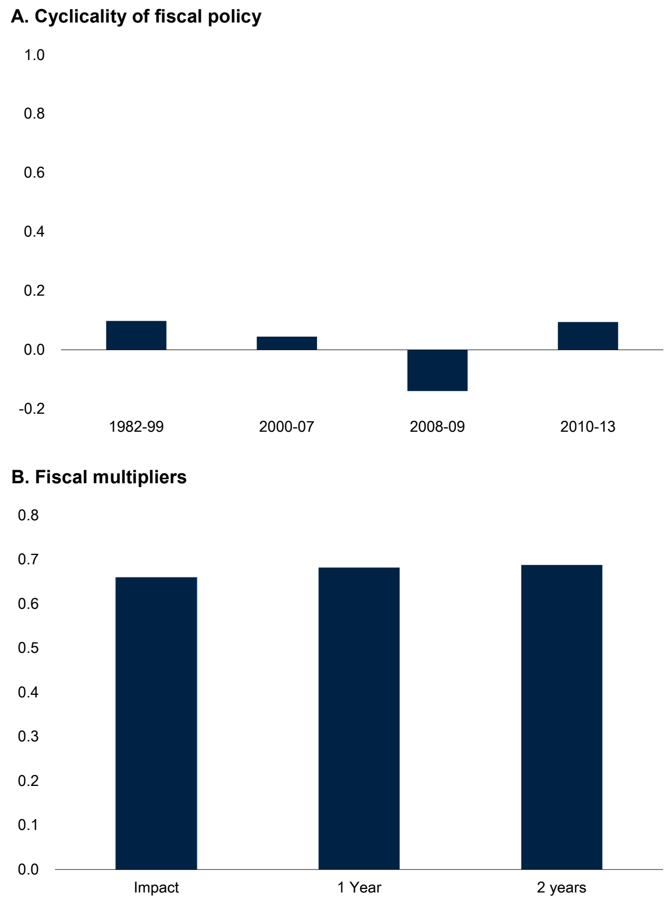
One approach, used in Kraay (2012, 2014), is to identify a fiscal shock using World Bank loan disbursements. First, loans disbursed by the World Bank are a major source of finance for government spending in LICs. Second, the timings of approval and disbursement of such loans are not systematically related to cyclical macroeconomic conditions in recipient countries. This makes World Bank loans a good instrument for exogenous government spending, unrelated to cyclical macroeconomic conditions in LICs. Using this approach, the average (one-year) fiscal multipliers in LICs are estimated to be small at about 0.5.

The second approach is to apply a panel structural vector auto regression (SVAR) model to annual data—the only frequency available for LICs on a comparable cross-country basis—for government consumption and GDP. A fiscal shock is identified by a similar timing assumption used in Blanchard and Perotti (2002) except that now it is assumed that discretionary fiscal policy takes at least a year (and not a quarter) to respond to macroeconomic conditions. Such a prolonged lag in the response of discretionary fiscal policy may be justified in LICs on two grounds. First, LICs often rely on concessional loans to finance government spending and these are disbursed less frequently than every quarter and may discount macroeconomic conditions. Second, GDP data is extensively revised in these economies so that the government would likely take more than just one quarter to gather reliable GDP data (Ley and Misch, 2014). This then implies that discretionary fiscal policy aimed at stabilizing the economy would take more than just one quarter to implement. Fiscal multipliers are estimated using annual data for 34 low income-economies and a panel SVAR following the methodology of Ilzetzki, Mendoza, and Vegh (2013). The multiplier estimates are just above 0.6 (Figure B3.1.1, panel B), closely in line with the results from Kraay (2012, 2014).

Government financing in LICs is mostly concessional and not market based. Hence, market concerns about government solvency that underpin the relationship between fiscal space and multipliers are expected to be less relevant in LICs than in EMEs and FMEs. Therefore, fiscal multipliers likely do not vary significantly with fiscal space in LICs. That said, fiscal space remains important in LICs, because it ensures that countercyclical fiscal policy is available when needed.

FIGURE B3.1.1 Cyclicality and multipliers in LICs

Fiscal policy is acyclical in LICs and multipliers are relatively small.



Source: World Bank estimates.

Note: Panel A shows the correlation between the cyclical components of government consumption and GDP. The correlations are all statistically insignificant which suggest that fiscal policy is acyclical in LICs. Panel B shows the fiscal multipliers based on a panel SVAR model. See Annex 3A for the details.

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