The IMF and Fragile States

Evaluation Report 2018

Financial stability and the IMF[1]

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- No universal common definition of “fragile state” or a fixed list (IEO’s evaluation report).
- **Several factors creating fragile states**:

(i) states at war or post-conflict states (threat to the international community);

(ii) states that are incapable of making collective decisions and enforce them for the wellbeing of their citizens (poverty reduction, employment, public health, environment, education, etc.);

(iii) states with economies less diversified and more susceptible to shocks (lower growth rates, higher inflation and huge government debt).

- Some countries not on the official list may share elements of fragility, countries may exit while others may slip into fragility.
- Capacity building and good governance are unlikely to be met until financial stability has been achieved.
- IMF and stakeholders should focus on policies and guidance that promote financial stability such as: (i) resilience to shocks; (ii) growth and job creation; (iii) financial sector and monitory policy; and (iv) policies to promote fiscal reforms and sustainability.
- Fiscal policy is a major key issue to maintain financial *s*tability.

A- Fiscal Policy and Guidance as a key issue for stabilization.

- From 2008 onwards, after the financial crisis → reduction in aid flows accompanied by a call for developing countries to strengthen their revenue raising capacity and ensure transparency and accountability in their use of public funds (expenditures).

- The IMF policy paper released on May 2017 highlighted the importance of targeting fiscal and expenditures reforms to achieve stability and help countries exit fragility.

1. Revenue Policies and Reforms.

- IMF's approach to building fiscal capacity in FS differs depending on the stage of fragility and country-specific circumstances.

- **The first stage** (following the immediate post-conflict/disaster) focuses on tax revenue collection to cover urgent needs targeting on easy-to-collect taxes (customs duties and excise taxes).

- **The second stage** (once countries become more stable but still vulnerable) targets the modernization of fiscal institutions through medium-term revenue and expenditures strategies.

- Several measures may be adopted:

1-1 Improving revenue collection by broadening the tax base:

Increasing the number of registered taxpayers and improving compliance with tax obligations but is conditional of:

- political support and commitment;
- simple procedures and automated systems;
- financial resources;
- cooperation by local authorities or municipalities for accurate information on taxpayers;
- Waiving bank secrecy;
- activity generating the tax base should be within the reach of the authority of the state.

1-2 Simplify tax collection and make it more efficient:

Rely on simple regulations and abandon tax and/or penalties' rebates (discounts) and amnesty which affects equity and fairness since tax gap makes it necessary to raise future tax rates or borrow additional funds → compliance should improve with a perception that most are complying and those who do not comply experience adverse consequences.

1-3 Reviewing the fundamentals of the tax system and adopt more efficient taxation:

- Changing the whole regime of tax exemptions that has caused serious distortion and imbalance between taxpayers → provided non-transparently with discretion or that became obsolete.

- Adoption of the general personal income tax on the whole revenues laying on progressive rates which is less prone to evasion and fraud.

- Other noteworthy reforms → broad-base consumption taxes (VAT) easy to collect and hard to escape or avoid (tax evasion) + custom reform to fight corruption and improve collection.

1-4 To give due consideration to equity and fairness in both the making and administration of tax laws:

- Building trust and sense of 'fairness" will encourage all citizens to contribute willingly in the financing of state expenditures and activities → could help building public support and provide legitimacy to tax reforms.

- Tax revenues must be pooled to fund essential shared services and/or invested in long-lived assets (infrastructures) → fiscal policy is a key lever to ensure that the benefit of growth is shared more broadly.

- The quality of public services should be continuously improved and its access broadened.

- Frequent changes to the tax law affect equity and fairness by disrupting taxpayer ability to evaluate the long-term impact of the tax law.

1-5 Expend the use of earmarked taxes:

Increases the tax payers' knowledge of how taxes are channeled, which in-turn could increase taxpayers' vigilance over the efficiency of the service provided and influence for its improvement.

1-6 Revenues generated by the development of international cooperation and exchange of information in tax matters:

Upon application the of the CRS, the MDR and the BEPS package some FS will have the necessary tools to ensure that profits are taxed where economic activities generating the profits are performed → provide a strong handle to address evasion by the wealthiest.

2- Expenditures policies and reforms.

Structural reforms enhancing accountability and transparency should be undertaken in both national budget and expenditures to promote credibility and sustainability.

Glimpse of the main issues at stake:

2-1 Change in the composition of public expenditures:

Less spending on wages and subsidies and more on capital expenditure and public services for greater inclusiveness and higher growth.

2-2 Strengthen and improve the internal procedures of control:

strengthening internal control framework (Audit Office notably) to manage the budget execution and reporting process as well as to reduce budget overruns and unauthorized expenditures.

2-3 Improve the accountability for execution of the budget:

The concept of performance budgeting should be introduced whether through Organic Budget laws (LOLF in France, Tunisia and Morocco) or the top-down budgeting system, in order to take into account both the economic forecasts and the fiscal target and hold the government responsible of the outcomes.

2-4 Abide with the principle of unity in the Budget preparation:

Fully integrated Budget → Budget coverage of all revenues and expenditures in order to ensure the proper acknowledgement and authorization by the Parliament → inclusion of Extra-Budgetary Funds (EBFs) in the budget since the said funds may become a channel for non-transparent expenditures.

2-5 Establish budget framework and implement IT systems that takes into account the impact of policies over the longer-term and adopt adequate planning.

B- IMF's engagement and expectations.

The IEO's evaluation report has straightforwardly recognized the important contribution that the IMF has made in fragile sates on the one hand and the failures to meet the expected or targeted objectives.

1. IMF should strive to provide training to a wider range of stakeholders (MPs) to ensure the effectiveness of the intended policies and programs.
2. IMF should increase visits by experienced staff to gain in-depth knowledge and provide appropriate, tailor-made support.
3. IMF should help in establishing (and/or financing) a program of on-line learning and to diffuse it widely as part of the financial literacy.
4. IMF should attach the greatest importance to the fact that external efforts to strengthen states with institutional reform are often destabilizing, not improving, because of the political implications of those reforms for local actors → huge list of demands on weak governments.
5. Many policies in conflict with each other and in some cases with their stated goals (ex: deadlock on decision-making policies owing to ethnic conflicts and minority rights protections).