

TECHNICAL COOPERATION DOCUMENT

I. BASIC INFORMATION

Country/Region:	Regional
TC Name:	Construction of a Fiscal Policy Quality Index for Latin America and the Caribbean (LAC) countries.
TC Number:	RG-T2329
Team Leader/Members:	Gustavo Garcia (IFD/FMM), Team Leader; Maria Cecilia Deza (IFD/FMM); Luis Marcano (IFD/FMM); Diego Valenzuela (LEG/SGO); and Marina Massini (IFD/FMM).
Date of TC Abstract authorization	June 26, 2013
TC Type:	Research and Dissemination.
Beneficiary:	Latin America and Caribbean Countries.
Executing Agency:	The Bank, through IFD/FMM
Letter of Donor's pre-approval:	IDBdocs38087054
Donors providing funding:	Public Capacity Building Korea Fund for Economic Development.
IDB Funding Requested	US\$ 145,000
Execution Term:	24 months
Disbursements Term:	24 months
Required Start Date:	November 1, 2013
Types of Consultants:	Individual (international)
Prepared by Unit:	IFD/FMM
UDR:	IFD/FMM
Included in Country Strategy:	Not applicable
Priority Sector GCI-9:	Institutions for Growth and Social Welfare
Included in CPD:	Not applicable

II. OBJECTIVE AND JUSTIFICATION

- 2.1 **Objective.** This TC will produce a Fiscal Policy Quality Index for Latin American and the Caribbean (LAC) countries, which could be used as a comparable, summarized and integrated indicator across the region. This index will be constructed following the technique of composite indicators.
- 2.2 **Justification.** Fiscal policy affects economic growth and development through a wide range of channels and dimensions. Progress in some areas of fiscal policy could reinforce, neutralize or counteract gains in others. This complexity makes necessary to assess and measure through an integrated indicator the quality of fiscal policy and more importantly, to use this indicator to test the effect of fiscal

policy on long-term economic growth. This TC will support the construction of such indicator as a useful instrument to gauge the overall performance of public finances as well as its main weaknesses, strengths and opportunities.

- 2.3 The TC will seek to answer the following questions, among others: What is the overall quality of fiscal policy in LAC countries? Which are the main drivers of the current state of fiscal policy quality in each country and how do they compare across the region? Does the quality of fiscal policy have an impact on long-term growth? If so, what are the direction, magnitude and significance of that effect? How do the different fiscal policy mixes (taxation, spending, budgeting, financing, etc.) affect the overall quality of fiscal policy and its impact on growth?
- 2.4 This TC will strengthen IDB's knowledge on how fiscal policy affects long-term growth and therefore would lead to a better focalization of Bank's fiscal policy advice and the quality of its operations with member countries of the LAC region. It will also support other activities of the Bank, such as the preparation of sector notes and country strategies for country dialogues. Moreover, this TC will be a key input in the preparation of the Fiscal Sector Framework to be delivered by IFD/FMM in 2015, which will be focused on fiscal policy and management and its links to long-term economic growth and social development in LAC.
- 2.5 **Background.** There is a widespread knowledge about the multidimensional features of fiscal policy and the wide range of channels through which public finances can impact economic growth¹. Additionally, there are broad sources of information on fiscal data: quantitative indicators are available for relatively long time horizons and different levels of public sector coverage. Additionally, organizations like Multilateral Financial Institutions (MFIs), private institutions, think tanks, NGO's, the academia, among others, have developed qualitative indicators that intend to measure the perception of economic agents about a country's economic and fiscal management and how it affects private behavior. This production of fiscal statistics has supported the growth of a literature that tests empirically the relationship between fiscal policies and macroeconomic aggregates, using statistical and econometric tools.
- 2.6 However, most of the research on this topic has been done considering the isolated effects of different sides of fiscal policy (fiscal revenues and taxation structure, public expenditure composition and efficiency, budgetary institutions, debt sustainability analysis, etc.). The analysis through separate and isolated indicators, however, makes it difficult to build up an integrated assessment regarding the quality of the fiscal policy in a given country and period, its consequences on long-term growth and development and how it compares with its

¹ See Ter-Minassian (2013, forthcoming) for an overview of the theoretical and empirical contributions regarding fiscal policy and growth. Also see: Barrios, S. and Schaechter, A. The quality of public finances and economic growth. EC Economic Papers 337. September 2008.

regional peers. Moreover, a one-dimensional perspective would overlook the contribution of the elements analyzed in isolation.

- 2.7 To tackle this omissions and limitations, a composite indicator of the quality of fiscal policy emerges as an interesting option since it would summarize and integrate the country's underlying multidimensional fiscal structure and capture the fact that fiscal policymaking is a complex process in which various elements are strongly related and where progress in some aspects could reinforce -or be made at the expense of- others.
- 2.8 The indicator to be produced under this TC will be one of the few existing efforts that apply the concept of composite indicators to measure the quality of fiscal policy and the first one that focuses entirely on the LAC region. Barrios and Schaechter (2009) have used this tool to construct Quality of Public Finances (QPF)² indicators for the EU. The authors chose a set of 66 variables and collapsed them into 12 composite indicators (although those components are not compiled into an aggregate index): size of the government; fiscal results and sustainability; composition, efficiency and effectiveness of expenditure; composition of expenditure; education; health; R&D; public infrastructure; public order and safety; general public services; structure and efficiency of revenue systems and fiscal governance.
- 2.9 **Methodology.** This TC will rely on the well-known methodology of composite indicators (index). Interest on composite indicators is growing as well as the aspects of economic and social development it covers, including competitiveness, ease of doing business, central bank independence, technological progress and even specific areas of fiscal policy (fiscal rules, efficiency of public investment, budgetary institutions and processes, among others). A noticeable advantage of composite indicators is that it enables summarizing and integrating complex, multidimensional realities, easing its interpretation and the decision-making process as well as the communication to the public. At the same time, adequate composite indicators should also permit to go "back to the data", which means that it must be possible to profile country performance at the indicator level so as to reveal what is driving the composite indicator results, to identify if those are overly dominated by few indicators and to explain the relative importance of specific sub-components. Additionally, it becomes possible to establish comparisons and rankings among countries based on defined benchmarks.
- 2.10 Due to this increasing appealing and the existence of a wide range of approaches, the EC jointly with the Organization for Economic Cooperation and Development (OECD) have prepared the Handbook on Constructing Composite Indicators³ which compiles the theoretical background, methodological steps and

² Barrios, S. and Schaechter, A. Gauging by numbers: A first attempt to measure the quality of public finances in the EU. Directorate-General Economic and Financial Affairs. European Commission. Economic Papers 382. July 2009.

³ OECD and EC. Handbook on Constructing Composite Indicators. Methodology and User Guide. 2008.

recommendations required to properly construct composite indicators. It summarizes the task in 10 stages: (i) theoretical framework; (ii) data selection; (iii) imputation of missing data; (iv) multivariate analysis; (v) normalization; (vi) weighting and aggregation; (vii) robustness and sensitivity; (viii) back to the data; (ix) links to other variables; and (x) presentation and visualization.

- 2.11 The data type that will be used for this TC will be both quantitative and qualitative. Most of the quantitative variables come from official sources and are disseminated through MFIs such as the IMF (World Economic Outlook-WEO and Articles IV), the World Bank (World Development Indicators-WDI), and IDB (Latin Macro Watch). Other sources include the Economic Commission for Latin America and the Caribbean (ECLAC), the Inter-American Center of Tax Administrations (CIAT, for its acronym in Spanish), the United States Agency for International Development (USAID), Bloomberg and IDB's own calculations. Numeric data will be cross-checked between different sources to account for consistency and comparability. Qualitative data, on the other hand, basically include perception surveys among executives or private agents regarding the performance of the government in fields associated to fiscal policy, public financial management and budgetary institutions. Information will be collected from trustworthy sources, including the World Bank (Doing Business and World Governance Indicators-WGI), World Economic Forum (WEF), Transparency International, International Budget Partnership, Latinobarometro, among others.

III. DESCRIPTION OF ACTIVITIES

- 3.1 **Component 1. Construction of the Fiscal Policy Quality Index; and statistical and econometric exercises to assess the impact of the composite indicator of long-term growth.** The first output involves the construction of a database of fiscal variables and a study describing the process of constructing the Fiscal Policy Quality Index. This output requires the execution of the following activities: (i) compilation of variables and construction of a database distinguishing four areas of public finances: a. fiscal revenues and tax administration, b. public expenditure and financial management, c. budgetary policies and fiscal institutions, and d. macro-fiscal results, debt sustainability and liabilities management; (ii) analysis of the consistency and coherence of the selected indicators, with special attention on the identification and control of outliers, structural breaks and policy changes, that could introduce distortions on the indicator; (iii) construction of sub-indexes in the four areas above stated and the composite indicator following the guidelines of OECD (2008); and (iv) sensitivity analysis of the composite indicator to methodological changes. The second output will be a study describing the results of the statistical and econometric exercises performed to quantify the impact of the Fiscal Policy Quality Index on long-term economic growth.
- 3.2 **Component 2. Dissemination of preliminary and final results.** The outputs associated with this component are: (i) one internal Brown-Bag Lunch (BBL);

and (ii) one seminar. The BBL will be organized to discuss the preliminary results of the composite indicator and the econometric exercise, and to get feedback from fiscal specialists at FMM, RES, and Country Economists to refine the calculations. In the seminar, the final results of the TC will be released to a wide variety of relevant stakeholders beyond the IDB (other MFIs, think tanks and scholars).

- 3.3 **Component 3. A working paper.** This document will present the theoretical and methodological foundation and the empirical results of the composite indicator, gathering up the recommendations from the BBL and the seminar, and will be available for download through the Bank's web page. The activities required to produce this output are: (i) preparation; (ii) edition; and (iii) publication.

IV. BUDGET

- 4.1 **Indicative Budget.** The total amount of the Bank financing is up to US\$ 145,000 to be financed on a non-reimbursable basis chargeable to the resources of the Public Capacity Building Korea Fund for Economic Development. The budget is laid out in the following table (see link to the [Detailed Budget](#)):

Components	Costs (US\$)
1. Component 1. Construction of the Fiscal Policy Quality Index; and economic exercises to assess the impact of the composite indicator of long-term growth	130,000
2. Component 2. Dissemination of preliminary and final results	10,000
3. Component 3. A working paper	5,000
Total	145,000

- 4.2 **Results Matrix**

Results Matrix				
Indicators	Unit	Base	Target	Verification Method
Outcomes				
Use of the Index as input in country strategies, sector notes and sector framework	#	0	4	IDBDocs
Use of the Index by a wide audience (think tanks, scholars, other MFIs, among others)	#	0	4	IDBDocs
Outputs				
Component 1	#	0	3	IDBDocs
Complete database on fiscal variables	#	0	1	IDBDocs
Discussion paper on the construction of the Fiscal Policy Quality Index	#	0	1	IDBDocs
Discussion paper on the statistic and econometric tests of the impact of the Index on long-term growth	#	0	1	IDBDocs
Component 2	#	0	2	IDBDocs
Brown-Bag Lunch	#	0	1	IDBDocs
Seminar	#	0	1	IDBDocs
Component 3	#	0	1	BRIK/IDB web
Working Paper	#	0	1	BRIK/IDB web

4.3 Expected Results. At the end of this TC, the Bank:

- i. Will have strengthened its knowledge regarding the quality of fiscal policy in the LAC region and the specific determinants of it in each country with a multidimensional and comparable approach, integrated and summarized in a composite indicator that could be used in country strategies, sector notes and sector frameworks.
- ii. Will be able to keep track of changes in the quality of public finances in LAC over time, facilitating the identification of vulnerabilities that would led the Bank to give appropriate policy advice to the local authorities.
- iii. Will have contributed to widen the number of statistical inputs available to conduct further research on fiscal policy.

4.4 In summary, the Bank would have strengthened its position to provide better and integrated policy advice to member countries of the region on fiscal policy.

V. EXECUTION AGENCY AND STRUCTURE

A. Executing Entity

- 5.1 The TC will be executed by the Fiscal and Municipal Management Division of the Bank (IFD/FMM). The project team for this TC will be headed by Gustavo Garcia, Principal Technical Leader Fiscal Economist and Coordinator of the Fiscal Cluster at IFD/FMM, who will lead and supervise the execution of the deliverables. The team members for this TC possess specialized academic and professional knowledge on fiscal issues and quantitative methods (database management, statistics and econometrics).

B. PROCUREMENT

- 5.2 The Bank will hire the required individual consulting services, according to the Bank's current procurement policies and procedures (GN-2350-9).

C. OPERATIONAL STRUCTURE

- 5.3 The development of the activities related to this TC will be headed by a team leader who is Principal Technical Leader Fiscal Economist and Coordinator of the Fiscal Cluster at the Fiscal and Municipal Management Division (FMM) of the Bank. The team leader will coordinate the work of two individual consultants, who will be, respectively, in charge of the two activities involved in Component 1. Both consultants will be HQ-based. The consultant in charge of the first activity must hold a Master's degree and have relevant work experience in the field of public finances, while the econometric consultant will be a specialist with

high academic qualifications (Master's or PhD degree) and demonstrated expertise in economic theory and quantitative methods. Additionally, the team is reinforced by the participation of a senior associate of FMM, who will give support in issues related to database quality, organization and management.

VI. RISKS AND ISSUES

- 6.1 This TC could face two main implementation risks: (i) the compilation and construction of the database, sub-components and the composite indicator could take more time than initially expected; and (ii) the results of the econometric tests may not be satisfactory.
- 6.2 As mitigation measures for the first risk, previous exercises of identification of available statistics, sources of information and time coverage for a sample of countries are being performed; moreover, some preliminary calculations of the sub-components and the composite indicator have been done with promising results. As an additional mechanism to lessen this risk, the data-development phase will be eventually reinforced by similar initiatives undertaken by IFD/FMM in this field, such as the TC proposal to construct a regional consistent database on public expenditure, the development of a set of indicators on public financial management and budgetary institutions, among others.
- 6.3 The second risk is mitigated by the ample evidence provided in the literature about the impact of fiscal policy on long-term growth. Moreover, as with the previous risk, correlations and graphic analysis have been conducted, suggesting an expected positive association between quality of fiscal policy and indicators of long-term economic growth (GDP).

VII. EXCEPTIONS TO BANK'S POLICY

- 7.1 No exceptions to Bank policy have been identified.

VIII. ENVIRONMENT AND SOCIAL STRATEGY

- 8.1 It is expected that the project will not generate any environmental and/or social impact. This TC has been rated as "C" based on the [Safeguard Filters](#).

IX. ANNEXES

Annex I	Letter of Request	IDBdocs38087054
Annex II	Terms of Reference	IDBdocs38087077
Annex III	Procurement Plan	IDBdocs38087065
Link 1	Detailed Budget	IDBdocs38087085
Link 2	Safeguard Filters	IDBdocs38087109

**CONSTRUCTION OF A FISCAL POLICY QUALITY INDEX FOR
LATIN AMERICA AND THE CARIBBEAN (LAC) COUNTRIES**

RG-T2329

CERTIFICATION


I hereby certify that this operation was approved for financing under the Public Capacity Building Korea Fund for Economic Development (KPC) through a communication dated June 26, 2013 signed by Minseok Hong, ORP/GCM). Also, I certify that resources from the Public Capacity Building Korea Fund for Economic Development (KPC) are available for up to US\$145,000 in order to finance the activities described and budgeted in this document. in order to finance the activities described and budgeted in this document. This certification reserves resources for the referenced project for a period of four (4) calendar months counted from the date of eligibility from the funding source. If the project is not approved by the IDB within that period, the reserve of resources will be cancelled, except in the case a new certification is granted. The commitment and disbursement of these resources shall be made only by the Bank in US dollars. The same currency shall be used to stipulate the remuneration and payments to consultants, except in the case of local consultants working in their own borrowing member country who shall have their remuneration defined and paid in the currency of such country. No resources of the Fund shall be made available to cover amounts greater than the amount certified herein above for the implementation of this document. Amounts greater than the certified amount may arise from commitments on contracts denominated in a currency other than the Fund currency, resulting in currency exchange rate differences, for which the Fund is not at risk



Sonia M. Rivera
Chief
Grants and Co-Financing Management Unit
ORP/GCM

10/18/2013
Date

APPROVAL

Approved: 

Vicente Fretes Cibils
Division Chief
Fiscal and Municipal Management Division
IFD/FMM

10/18/2013
Date