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Smart thinking for fiscal balance

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COMMENT

It is common for a government or state to embark on a fiscal consolidation exercise during a period of slow economic growth or lower revenue collection. A government does this because expenses exceed what it can raise and so has to reduce the fiscal deficit.

Fiscal consolidation, if not carefully thought through, could result in undesired outcomes such as exacerbating slow economic growth or delaying its recovery. Policy-makers thus must identify consolidation measures that are either growth-promoting or less growth-retarding. Mostly, the more appropriate consolidation measures are those that reduce expenditures with minimal effect on government objectives. The fruitful mix between tax increases and spending cuts is central to the design of smart fiscal consolidation.

Since the advent of the 2008-2009 global financial crisis, the government has not been able to raise enough revenue to fund its planned programmes and has opted for foreign borrowing. Having recognised an increasing gross national debt as a share of the gross domestic product (GDP), the government prioritised tackling excessive public deficits. Some of the measures to reduce public deficits included fiscal consolidation since 2012 by decelerating the rate of expenditure growth and raising taxes. Although this fiscal consolidation trajectory has achieved some success, there has been a sustained increase in government debt as a share of the GDP because economic growth deteriorated and new spending pressures emerged.

But the reality of the situation is that endangered debt sustainability and disappointing growth necessitate continuing the course of fiscal consolidation. It thus became important to pursue smart ways of fiscal consolidation to foster long-term growth and minimise potentially harmful short-term effects on economic activity and contribute to income equality.

Some of the main instruments of fiscal consolidation include government expenditure cuts and revenue increase, which include increasing taxes. On the government expenditure cut, one of the key issues that should be considered is the reduction of the wage bill. The public sector wage bill remains higher than private wages. There was a reduction to the public sector wage bill in 2016 and 2017 but not in 2018. This means that the fiscal consolidation exercise is not reaping the full benefits accruing from several advantages of aggressively cutting the wage bill.

On the revenue side, potential measures to fiscal consolidation include increasing tax rates but these measure could choke growth. Progressive income and corporate taxes, for instance, could be distortive, thus hurting growth with reduction in incentives to work or to invest. It could also represent a reallocation of resources from the private to the public sector, where they are likely to be used inefficiently. Nevertheless, despite these efficiency losses, progressive income taxes could be used as a vital tool for redistribution. Therefore, revenue neutral tax reforms, which lower marginal tax rates and broaden tax bases, could be considered for smart fiscal consolidations.

But revenue increases have recently been achieved mainly by increasing personal income tax, by indirect taxes such as excise duties, a general fuel levy and environmental taxes, as well as value added taxes. Increasing tax rates appears to have been prioritised over the smarter option of broadening the tax base. This means the fiscal consolidation efforts on the revenue side could be hurting growth.

The world-wide experience (Hungary, Canada and Sweden) shows that spending cuts tend to be less growth-retarding than revenue increases.

Moreover, spending-based consolidation is associated with an enduring firmness of public finances.

The 2015 budget announced baseline expenditure reductions of R10-billion, together with an increase in personal income tax rates and the general fuel levy, raising an additional R16.8-billion in 2015/2016. The spending cuts were less than the revenue increases.

The 2016 budget increased revenue with tax policy measures that raised an additional R18.1-billion in 2016-2017. Expenditure cuts for 2016-2017 as announced in the previous budget amounted to R15-billion. Therefore, spending cuts were again less than the revenue increases.

Last year, tax policy measures to generate an additional R28-billion in revenue in 2017-2018 and the lowering of the spending ceiling by R10.2-billion for the same financial year were announced. The most recent budget announced tax policy measures to raise an additional R36-billion in tax revenue and a reduction in the Medium Term Budget Policy Statement baseline expenditure by R26-billion.

Fiscal consolidation measures therefore appear to rely more on revenue increases than spending cuts. This suggest that they are neither growth-promoting nor less growth-retarding. For the government to be less growth-retarding it should explore implementing fiscal consolidation more on expenditure cuts than on revenue increases. The effective mix between tax increases and spending cuts is at the heart of the design of smart fiscal adjustments.

Over and above fiscal consolidation measures, structural reforms of labour and product markets support long-term productivity and thus economic growth, and their short-term effects can also be positive. For instance, lowering entry barriers could raise productivity and attract the inclusion and participation of small and medium enterprises in sectors such as telecommunications, energy and transport.

In times of low economic growth and fiscal constraint the government should do two things:

• Use an effective mix between tax increases and spending cuts other than relying more on revenue increases, because this is more growth-retarding; and

• Bolster credibility with broad structural reforms.

Otherwise fiscal consolidation will exacerbate slow economic growth, which necessitates continuing the course of fiscal consolidation.

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