

Fiscal Irresponsibility and Fiscal Illusion

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Working Hypothesis

A government forced by external agents to reduce its deficits – specifically its debt accumulation will reduce its asset accumulation or increase its hidden liability accumulation by an equal amount leaving its ‘true’ net worth unchanged. An implication of this hypothesis (proposition) is that conventional fiscal adjustment is an illusion.

The intuition is very simple – a fiscally irresponsible government wants to have high present consumption at the expense of lower future benefits. If such a government is constrained in only one form of shifting revenue and expenditure over time (public debt), it will find other ways of shifting revenue and expenditures across time so as to leave its high present consumption unchanged. Any improvement in the measured fiscal position due to this is illusory. These kinds of fiscal tricks invariably show up as a later reversal of the progress made on the deficit.

Fiscal adjustment is an illusion when it lowers the budget deficit or public debt but leaves government net worth unchanged (or worse). Conventional measures of the deficit mostly capture the change in government assets or the change in implicit liabilities. A more appropriate measure of the deficit would be the change in public sector net worth.

The net worth definition of the deficit will only improve if the government has a change of heart (internalizes the discipline/assumes ownership of the adjustment process) that places more value on future relative to present consumption – become less fiscally irresponsible by lowering its discount rate.

Anecdotes and empirical results confirm that asset decumulation, hidden liability accumulation, and revenue/expenditure switches take place during

fiscal adjustment programs agreed with the Breton Woods Institutions (BWIs) in developing countries. To enhance transparency would call for scrutiny of expenditures for signs of any asset decumulation or hidden liability accumulation.

The problem is with the construction of an appropriate and relevant balance sheet. And consequently, a net worth deficit is difficult to measure operationally. But what is operationally difficult is still relevant for predicting how governments behave. Barring any reduction in the government discount rate, by hypothesis, the government will respond to a mandated deficit reduction by:

- cuts in public investments;
- cuts in operations and maintenance;
- fiscally motivated privatization;
- expenditure or revenue shifting over time;
- high pension liabilities despite current pension surpluses;
- shifting expenditure and debt off-budget.
- cutting public investment;
- privatization;
- shifting revenue and expenditure over time (sleight of hand operations); and
- running up implicit liabilities.

Reducing Off-Budget Transactions and Quasi-Fiscal Deficits

Search for and institute indicators that reveal the level of the discount rate of government and measures that promotes a lowering of the rate. The example of New Zealand shows that with a low discount rate government can try to bind its own hands with accrual and balance sheet accounting. "*The balance sheet ... can provide an indicator of whether the Government is running down its estate in order to maintain current consumption.*"

A practical but sub-optimal (not the ideal, or third best) approach is to estimate the change in whatever can be measured in a comprehensive balance sheet by monitoring all asset sales and changes in asset decumulation and all new liability accumulation, implicit or explicit, certain or contingent.

This third best solution is the minimum for any government that takes seriously the objective of growth with poverty alleviation and the importance of ownership of the adjustment effort and effective management of the development process. The more comprehensive the monitoring of the public sector assets and liabilities, the greater the assurance that fiscal adjustment is the real thing not an illusion.

The most transparent means of reducing government assets is divestiture.

Divestiture often makes possible significant efficiency gains, but something is amiss when governments develop a sudden interest in divestiture during fiscal austerity. The Nigerian experience – over the 1989-93 period when agreements with the BWIs placed constraints on its budget deficit and public debt, government sold equity shares in upstream oil ventures of US\$2.5 billion; this was at the peak of the Persian Gulf War oil boom; and a government commission found that US\$12.2 billion of oil money had disappeared. Divestiture by a corrupt government is likely to end up in the consumption of the ruling class, thus lowering public sector net worth.

The economics profession has not been consistent on whether to treat divestiture proceeds as revenue, in which case they directly reduce the deficit, or as financing, in which case they could be applied to reduce debt but not the deficit. The Government Finance Statistics (GFS) Manual of the IMF (1986) treated divestiture as revenue but Fund practice has changed over time to treating it as financing. The deficit definition for the Maastricht convergence criteria treat divestiture proceeds as financing, but these proceeds can be applied to reduce the gross public debt to reach the Maastricht debt/GDP ratio target. The net worth definition of the deficit would treat divestiture as financing and could, moreover, use net debt rather than gross debt as a policy target.

In the United States, the Gramm-Rudman-Hollins process reportedly encouraged "transparent budget gimmickry". And in Europe, one commentator noted about Maastricht – which disallowed applying divestiture receipts to deficits but did allow applying them to reducing debt – that Maastricht encourages financial engineering to avoid underlying real fiscal adjustment. Even when divestiture is "desirable for efficiency reasons, it is bad economic policy to do the right (structural) thing for the wrong (financing) reasons".

A second well-known means of reducing asset accumulation when forced to reduce debt accumulation is to reduce public investment – budgetary capital expenditures comprising net lending and equity, the development expenditure, and transfers into the District Assemblies Common Fund (DACF). It has been widely noted that in periods of restrictive fiscal policies capital expenditures have been the first to be reduced and often drastically.

The World Development Report (1988) of the World Bank found that governments cut capital spending by far more – about 35 percent – than the other public sector categories like wages – about 10 percent.

- There is research evidence that in countries with declining government expenditure in the period 1970-84, governments cut capital expenditures by more (27.8 percent) than current expenditures (7.2 percent);
- Latin American public investment fell 2.5 percentage points of GDP

- from the 1970s to the 1980s when the region was adjusting;
- The World Bank Report – Adjustment in Africa (1994) – found that when African countries lowered their budget deficits from 1981-86 to 1990-91, most of the cuts were in capital spending.

Admittedly, public investment contains "white elephants" but it also contains investment that would pay government future returns. The World Bank has estimated rates of return to infrastructure investment during 1983-92 ranging from 19 percent (telecommunications) to 29 percent (highways). And even some state enterprise investments are quite profitable.

Zambia: Government withdrew money from the state company (ZCCM) to meet deficit targets instead of profitable reinvestment in the company. This no doubt contributed to the production fall – from 700,000 tons in 1972 to 300,000 tons annual average in the 1990s. Revenue from mining fell from 10.8 percent of GDP in 1970-74 to 1.6 percent of GDP in 1990-94.

Zaire: Mineral production by the state company (GECAMINES) fell from 500,000 tons in 1985-89 to just over 40,000 tons in 1994-95. Insufficient lending to obsolescence and decay of equipment, and cave-in of major mining site (Kamoto mine) in 1990 was cited by the IMF in its 1996 Staff Country Report No. 96/28 of April 1996.

Stabilization – more from an unsustainable to a sustainable position or path

The objective of an effective stabilization program can be regarded as being to choose a policy package whose impact effect returns the economy directly to a sustainable path. The critical point to observe is that the reforming country must take responsibility for the management of the development process. This is because in the absence of a policy initiative when required, disequilibrium will generate endogenous adjustments which may deepen the malaise or which may be socio-politically not feasible