Public Sector Financial Management

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OUTLINE

- Part 1: Scope and principles of public finance
- Part 2: Managing revenues, expenditure and debt
- Part 3: Performance based budgeting
- Part 4: Budget Execution / internal controls
- Part 5: Cost benefit analyses

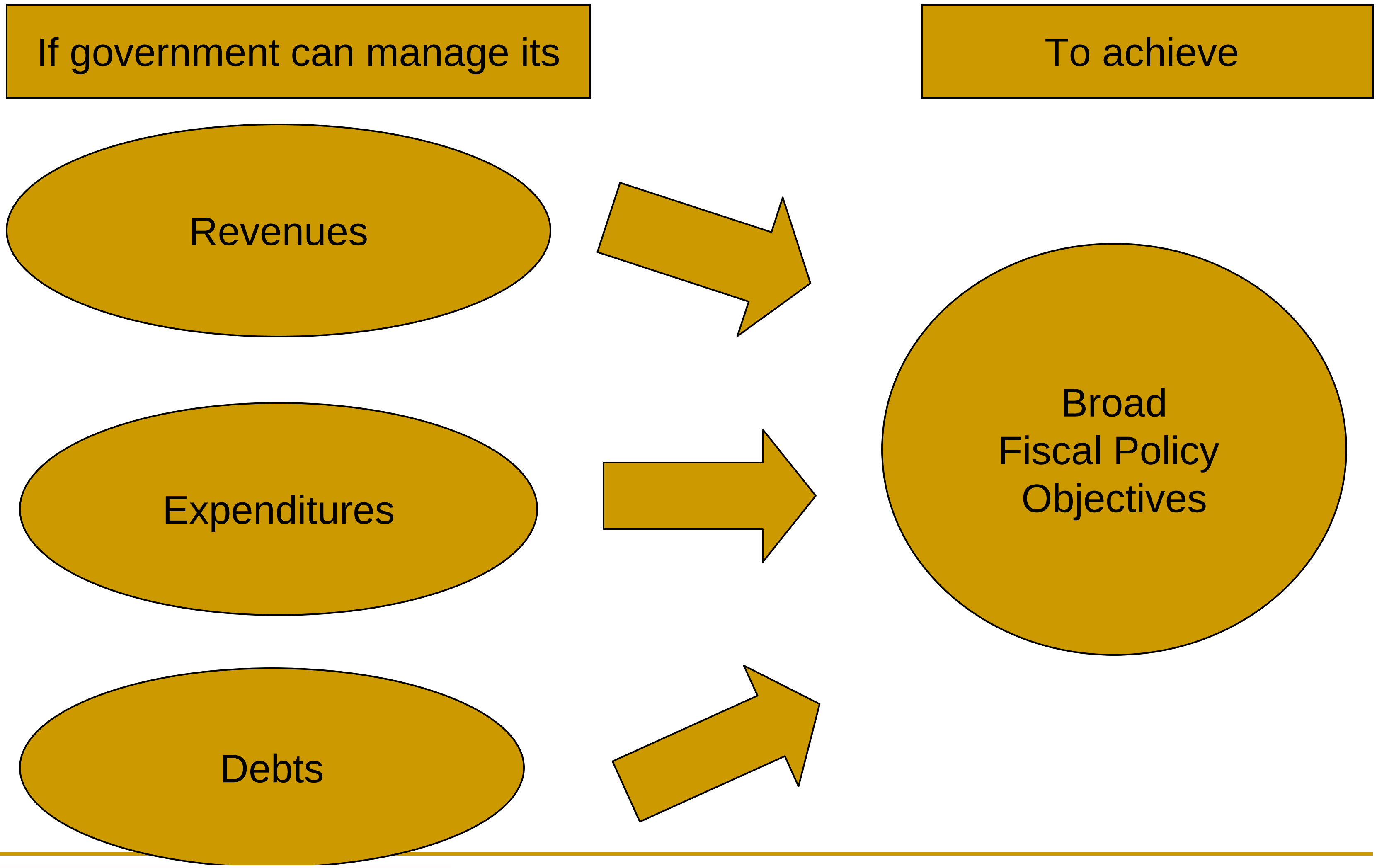
Lecture 2

Fiscal Discipline:
Managing revenues, expenditure and debt

Learning objectives:

- Understand the concept of fiscal discipline and its importance in macroeconomic policy;
- Understand key concepts such as comprehensiveness, sustainability, predictability and transparency

Fiscal Discipline



Fiscal Policy Objectives

1) Set expenditure priorities effectively to meet development objectives both with respect to current service delivery and new investment in the future;

2) Keep taxation and other revenue in a stable relationship with total economic activity;

Fiscal Policy Objectives

3) Fund debt in a way which does not create undue pressures on financial markets and is sustainable in the long term;

4) Behaving in a way which is predictable while providing full information so that other sectors of the economy are able to make their own plans accordingly

Fiscal Policy Objectives

5). Achieve a size of government that meets the government allocation and distribution requirements and will achieve its stabilisation objectives.

Conditions for Fiscal Discipline

- Fiscal transparency: regularly updated and publicly available information on the government's view of the development of the economy and its fiscal plans and policies;

- Fiscal targets: specific objectives -- generally expressed as a percentage of GDP -- for revenue, expenditure and debt, set for a medium term such as 5 years;

Conditions for Fiscal Discipline

- Comprehensive budget: a budget which covers all revenue and expenditure and other financial activities for which government is responsible;
- Measuring and reporting fiscal risks: clear and regularly updated statements of the major risks to the achievement of these fiscal targets;
- Regular and timely reporting on all aspects of the government's budget implementation;
- Independent monitoring and evaluation of budget performance and financial management.

Fiscal Sustainability

- A budget is “fiscally unsustainable” if it adds to the risk of an explosive growth in the cost of servicing government debt so that an increasing proportion of the budget (or taxation revenues expressed as a percentage of GDP) must be devoted to interest payments in future years.

- A simple rule for fiscal sustainability is based on the “primary balance”: that there should be sufficient cash surplus in each annual budget to pay interest on debt.

Fiscal Sustainability

- Simply balancing cash budget may be a myopic view:
- government may borrow to create assets that increase economic growth and thereby increase “taxable capacity”.
- The “golden rule” : new borrowing should be matched by new government investment in real “productive” assets.

Fiscal sustainability and fiscal space

- Significant problem – meeting needs with limited resources
- Fiscal space – a room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy.

- Governments can create fiscal space by raising taxes, getting more foreign aid, cutting lower priority expenditure, borrowing from domestic or foreign lenders, or borrowing from the banking system

Fiscal space and how to achieve it

Pros and cons

- Raising taxes increases the fiscal burden on the economy.
- Additional foreign aid
- Cutting low priority expenditure can run into resistance from existing interests.
- Borrowing domestically or overseas must be done in a fiscally sustainable way.
- Borrowing from banking system jeopardises macroeconomic stability, generally not supportable.

Reprioritising expenditure:

- Curbing unproductive spending should be an important objective.
- Requires cuts in subsidies or military outlays, wage restraint, or rationalization of elements of the civil service …”.
- Productive spending needs to be protected. education, health transport and agriculture.

Boosting efficiency

- Streamline the implementation of programs, reduce corruption, and improve governance.
- Donors coordinate their programs and reducing the burden of administration on recipient governments.

Increasing borrowing:

- Needs to be fiscally sustainable (ability to pay)
- Example: If the government is borrowing to finance high priority social programs, there must be realistic expectation that outcomes will contribute to economic growth and hence to tax revenues which can be used to service the debt.

Raising revenue

- For countries with low ratios of government revenue to GDP
  - broaden tax base
  - improve tax administration
- For low-income countries, a tax ratio of 15 percent of GDP should be seen as a minimum objective."

Reasons for taxation

- Provide revenue to fund the activities of the State such as defence, law and order, or the provision of public services;
- Redistribute income and wealth to help address poverty, through graduated taxes on personal income or real property, gift or inheritance taxes.
- Discourage specific activities such as smoking tobacco or consumption of alcohol;

Alternatives to taxation

- charging fees or levying specific earmarked taxes
- fees can be charged when the state has a monopoly on a particular service
- Projects which benefit specific groups of users, such as national highways, may be funded by a specific tax on those users, perhaps through fuel consumption taxes, vehicle licence fees or tolls on highway usage.

Alternatives to taxation

- If primary objective of policy is to discourage or encourage specific activities, regulation may be considered as an alternative to a tax.
- Air pollution from a factory smokestack could be reduced by a specific tax on the emissions, or passing a law restricting the emissions
- Local authority might fund a general rubbish collection service through property taxes but require large factories to dispose of their own waste in designated landfills.

Properties of good tax systems

- *Principles of benefit and ability to pay*:
  - a benefit principle says that the consumers of a service ought to pay for it -- an example is highways taxation through a specific earmarked fund;
  - an ability to pay principle says that relative tax burden ought to fall more on richer people than poor -- an example is graduated rates of income tax.

Tax administration reforms

- Tax mapping
- Large tax payers unit
- Use of IT
- Tax fraud units / lifestyle investigations
- Tax courts

Other revenue generation options:

- Increasing user charges
- Intergovernmental assistance
- Use of financial reserves
- Making policy changes
- Combination of above options

Applicability of revenue options

Table 2.3

Applicability of Revenue Options According to Activity Type

	Revenue shortage caused by	
	Governmental activities	Business-type activities
Taxes	Applicable	Not applicable
User charges	Not applicable	Applicable
Borrowing	Applicable	Applicable
Intergovernmental aids	Applicable	Questionable
Financial reserves	Applicable	Applicable
Institutional/policy changes	Applicable	Applicable

Table 2.4

Applicability of Revenue Options According to Time Frame

	Revenue shortage is	
	Short term (< 3 years)	Long term (≥ 3 years)
Taxes	Applicable	Applicable
User charges	Applicable	Applicable
Borrowing	Questionable	Applicable
Intergovernmental aids	Applicable	Not applicable
Financial reserves	Applicable	Not applicable
Institutional/policy changes	Not applicable	Applicable

Discussion Question

- What are some of the tax administration challenges faced by your country?

Group Discussion

- What are the prospects for fiscal space in your country?

- Where are the options for increasing fiscal space?