Fiscal deficits matter for macroeconomic stability

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Governments of developing countries typically run significant fiscal deficits to finance priority development spending that cannot be fully funded from the limited government revenues.

The economic rationale for this method of financing government expenditure is that revenue mobilisation is presently constrained by limited national income and administrative capacity

constraints. Yet development needs for financing essential infrastructure and human capital are large, as these are under-funded by the private sector.

In the absence of government investment in these areas, the rate of growth of the economy will suffer. By financing these critical investments through fiscal deficit, the government is assuming that the economy will grow at a healthy pace and the debt service burden can be managed through higher revenue mobilisation from this growing economy.

The downside of fiscal deficit is that this might become a soft option and lead to an unsustainably large public debt burden that would hurt fiscal discipline and long-term economic growth. Additionally, fiscal deficits financed through bank borrowing could contribute to inflation or crowd out private economic activity through a reduction in the availability of bank credit.

So, the level of fiscal deficit and the way it is financed are both important elements of sustainable fiscal policy management.

In the present development context of Bangladesh, when viewed in the long-term context, large fiscal deficits have been managed prudently and kept at below 5% of GDP. Public debt as a share of GDP and debt service are both within prudential limits as confirmed by debt sustainability analysis.

However, the inability to mobilise adequate revenues despite securing rapid GDP growth has weakened the quality of fiscal management. This issue has become important over the past several years as the tax to GDP ratio continues to fall, whereas fiscal deficit, public debt and interest cost as shares of GDP and total revenue are rising (Table 1).

A particular cause for concern is the rapid increase in interest cost as percentage of total revenue. Clearly, the government’s debt servicing capacity has not increased in line with GDP growth, owing to the inability to increase tax revenues.

On top of this longer-term concern, a matter of immediate concern is the ongoing macroeconomic instability, reflected in persistently large inflation rate and pressure on the balance of payments. In this environment, the government needs to reduce aggregate

demand to reduce inflation and contain the pressure on the balance of payments.

Yet, the data shows that the fiscal deficit has increased from 3.7% of GDP in FY2021 to 4.7% of GDP in FY2022, and is estimated to rise to 5.1% of GDP for FY2023. Furthermore, a growing share of this deficit is being financed through bank borrowing.

As a result, government credit grew by 30% in FY2023.

The new proposed budget for FY2024 proposes to keep the fiscal deficit at 5.1% of GDP and further increase the use of bank financing to a massive 3% of GDP. The actual fiscal deficit for FY2024 could even be higher, since the lofty target of increasing tax revenues by 37% in FY2024 will not likely be achieved. Evidence shows that revenues grew by an average of 10% annual between FY2017 to FY2023.

This approach to fiscal policy management is clearly inconsistent with the task of restoring macroeconomic stability. Growing fiscal deficit and use of bank financing will both put additional pressure on aggregate demand, which will fuel inflation and put pressure on the balance of payments.

The correct policy stance should be to reduce fiscal deficit to around 4% of GDP by cutting subsidies and rephasing spending on large infrastructure projects. The financing of the deficit should largely be based on mobilising low-cost foreign loans from multilateral development institutions and direct borrowing from the market through creating a secondary market for T-bills. Infrastructure spending could pick up in the next 9-12 months once macroeconomic stability is restored.

Urgent attention should be given to establishing a modern tax system based on the findings of an expert tax reform committee (TRC). Asking NBR to reform itself and generate substantial additional tax revenues does not appear to be a credible solution. India benefitted substantially from TRCs and lessons can be learnt from that experience.

Additionally, substantial revenues can be mobilised through corporate governance and pricing reforms of the state-owned enterprises. Total assets of SoEs are conservatively estimated at around 20% of GDP. A 10% rate of return on these assets should yield a

revenue of 2% of GDP, as compared with an actual average return of a mere 0.3% of GDP over FY2017-FY2021 periods.

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