Michael C Bonello: Fiscal reform - an imperative for sustainable growth and development

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Institute of Financial Services Annual Dinner, St Julians, 11 November 2004.

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I should first of all like to thank you, Mr. President, for inviting me to your annual dinner and for the opportunity to share my thoughts once again with such a distinguished audience. I must also congratulate you on your recent election as President of IFS - Malta and wish you and your Committee every success in your endeavours to ensure that the Institute's educational programmes remain relevant in today's complex financial services environment. As you rightly pointed out in your first message to your members, in a situation which is rapidly evolving, "we must be prepared to embrace change."

I have a similar message to convey tonight. Inspired by the words of George Washington that "There is no practice more dangerous than that of borrowing money", mine is essentially an appeal to the country to leave behind its spendthrift ways and to learn to live within its means. I shall therefore make a case for fiscal reform.

Now some might wonder why a central bank governor should be so concerned about the state of the country's public finances. Put simply, the reason is that a persistent excessive deficit situation represents a potential threat both to price and financial stability, which are key objectives of most central banks today. The Central Bank of Malta seeks to achieve these objectives through the operation of an exchange rate peg. The Bank's ability to maintain the peg in an environment where capital flows freely across borders, however, depends crucially on financial market perceptions regarding the effectiveness and sustainability of macroeconomic policy, particularly fiscal policy. In this context, the present deficit scenario is not helpful and, if not corrected, could oblige the Bank to raise interest rates.

The role of governments

How and why have fiscal deficits become a problem? In the first decades after the Second World War, governments came to play a key role in promoting economic growth and social development. In today's free-market economies, moreover, they provide indispensable support to the activities of the private sector and also play an important role in curbing its excesses. Another function of governments concerns economic stabilisation. They can intervene to stimulate aggregate demand in periods of recession and to restrain it at times when the economy is booming. Under appropriate demand and supply conditions, such intervention can contribute to a more favourable investment environment and, in turn, to growth.

Perhaps the most important tool Governments use to pursue these objectives is public expenditure. Taxation and borrowing may be viewed as ways of financing such expenditure, but they also constitute important tools in their own right.

Effectiveness of government intervention

Government intervention in the economy has important implications not only for competitiveness and growth, but also for the promotion of the social dimension of development. It is thus essential to ensure that society obtains full value for the resources devoted to public sector activities, both in terms of the quantity and the quality of the outputs produced.

Now whereas in the private sector failure to deliver value for money eventually results in bankruptcy, there exists no such effective sanction in the public sector. This is partly because expenditures are typically financed through general taxation and borrowing, and the funds thus raised are not directly earmarked for specific expenditures. Inadequate enforcement of accountability standards is another reason. It is also the case that industrial relations and human resource management in the public sector are often undertaken without sufficient consideration for budget constraints, while job security and tenure are taken for granted irrespective of performance or productivity levels. A further dimension of this problem is the fact that the success of government spending tends to be measured more in terms of its potential to produce electoral dividends than in a longer-term growth perspective. All of these factors reduce the incentive to use resources efficiently.

Similar arguments apply to the welfare system, where the size of the expenditure can easily exceed that required to maintain social cohesion and the focus be diverted away from genuine needs. This situation has materialised in a number of countries, including the more advanced economies in the EU, which are now facing hard choices regarding the future of health and pension systems. Invariably, the most difficult challenge in implementing reforms in these areas is to convince people that services which were hitherto provided by government for free, or at a subsidised cost, are no longer affordable by the country.

There are, therefore, a multitude of pressures to increase government expenditure over time. And as tax revenues often prove unable to keep pace with such commitments, fiscal deficits emerge leading to an accumulation of debt. In turn, this produces a growing debt-servicing burden, creating a vicious circle in which unproductive outlays effectively crowd out the scope for productive expenditure.

Fiscal deficits are also the result of inadequacies in the design and implementation of tax structures. In this regard, supply-side economics advocates shifting the focus of taxation from income to consumption in order not to discourage work effort, saving and investment. Tax systems should also be simple and transparent so as to facilitate their implementation and enhance compliance. When these norms are ignored, the end result tends to be pervasive tax avoidance or evasion, resulting in lower levels of revenue.

Continued fiscal deficits and increasing public debt levels are thus a symptom of inefficiency or inappropriate policy choices. This is the reason why modern market economies are advised to contain their fiscal deficits and debt within prudent levels by subjecting their policies to critical review and by raising the efficiency of public sector operations, rather than through new taxes or short-term palliatives such as one-off revenue inflows.

A further reason for tackling the problem at its roots is that the inefficient use of resources in the public sector can have serious long-term repercussions. At best, these include a growth rate below the economy's potential because the private sector is deprived of resources it could use more profitability; and, because of the persistence of the deficit, the loss of fiscal policy as a counter-cyclical stabilisation mechanism. At worst, the inefficient use of resources can threaten the viability of the economy itself. Many a financial crisis has been sparked off by the behaviour of profligate and inefficient governments. In today's globalized financial markets, the retribution for such excesses is quick and unforgiving.

Implications for fiscal management

It would appear that, like all human endeavours, the benevolent, interventionist role of governments was developed with the best of intentions but, as often happens, something went wrong along the way. Judging by the present state of its public finances, Malta is no exception. For a start, fiscal deficits have become a permanent feature of the economic landscape, which suggests that they do not reflect temporary slippages or cyclical downturns, but rather fundamental policy choices and inefficiencies. Since 1990 the annual shortfall between revenue and expenditure has averaged 6% of GDP, or Lm1 out of every Lm16 earned by the economy.[1] There were periods when the deficit tended to fall, but these were not sustained. This year, as explained in Malta's Convergence Programme 2004-2007, the general government deficit is expected to fall to just above 5% of GDP, which is still, however, one of the highest ratios in the EU.

The persistence of the fiscal deficit has resulted in a rapid accumulation of government debt, which as a percentage of GDP trebled between 1990 and last year to around 70%. There is clearly no alternative to the fiscal consolidation envisaged in the Convergence Programme because, if the deficit is left unchecked at this year's level, the debt to GDP ratio would exceed 80% by 2010. The fact that this heavy burden of debt has been accumulated to a large extent to finance recurrent spending rather than to build up income-generating assets is a matter of some concern.

[1] Except where otherwise specified, fiscal data refer to the Consolidated Fund.

A further undesirable consequence of this behaviour is an increasingly unmanageable debt-servicing burden. This year the Government is spending Lm1 out of every Lm8 of tax revenue merely to service its debt. Put differently, the fiscal deficit would be just one-tenth of its actual level were it not for debt-servicing costs, which now amount to around 95% of expenditure on health and 90% of that on education.

This is not a healthy state of affairs. Not only does interest on the debt increase the fiscal deficit, but it also crowds out those expenditures which should be receiving priority. If the deficit were left unchanged at this year's expected level of Lm95 million, it is estimated that debt service costs would rise from Lm85 million today to almost Lm120 million by 2010. In other words, the Government would have to register a surplus on its recurrent operations and borrow money just to service the debt.

This unsustainable situation is a symptom of another feature of our economy, the high level of government expenditure. At 51% of GDP, this is the sixth highest in the EU. Government, moreover, employs 27% of the labour force, which is somewhat higher than the EU average, while the entire public sector absorbs over one-third of Malta's labour supply.

This is not to say that nothing has been done. Fiscal consolidation and structural reform have indeed in recent years become key features of the Government's drive to enhance the productive potential of the economy. This awareness is reflected in the Convergence Programme, which targets a fiscal deficit of 1.4% of GDP by 2007, compared to 5.3% this year. This improvement is to be attained mainly through a reduction of about six percentage points, to 44%, in the ratio of government expenditure to GDP.

What does this target mean in terms of the savings that need to be made? During the past five years government expenditure has been increasing by an annual average of Lm55 million. At this rate, it would exceed Lm1.1 billion in 2007. But the total contemplated in the Convergence Programme for that year is about Lm950 million. In other words, the average annual increase in expenditures during the next three years must not exceed Lm5 million, which is just one-tenth of the present growth rate. This implies that measures must be put in place now that would by 2007 reduce expenditures by Lm150 million.

Required expenditure and taxation reforms

The attainment of this objective clearly requires extensive reforms. In this context, I would like to propose some policy orientations which would help to reduce the deficit to the planned level. For this purpose, it is useful to look at government expenditure from two perspectives. The first is in terms of what it is buying. The second focuses on what such expenditure is achieving.

The first of these approaches helps to identify the potential for savings. This year over 20% of total spending, some Lm200 million, will go towards wages and salaries and another 10% will go to public sector bodies, again largely to finance human resource costs. In short, the public sector wage and salary bill absorbs close to one-third of total budgetary expenditures.

Against this background it is imperative that the current negotiations for the renewal of collective agreements in the civil service and in the public sector recognize the need to cut spending. It is important that any wage increases be matched by measurable productivity improvements. It is equally necessary to make better use of the human resources available by strengthening both the management culture and work practices. It must also be accepted that the public sector cannot continue indefinitely to carry the cost of employees who are effectively redundant. A time limit must be set beyond which this burden will no longer be carried, and training and redeployment schemes should be strengthened in the meantime to facilitate the transition.

Another third of government expenditures is absorbed by social security benefits, a category whose growth over time is conditioned by increases in wages and prices, demographic pressures and the need to preserve the social fabric. Along the way, however, the original priorities seem to have been lost sight of. As a result, Malta has a welfare system which is certainly generous, but which is not socially just in the sense that it does not allocate the relatively larger share of resources to those who are most in need.

The time has clearly come for a radical welfare reform which reconciles the objectives of social cohesion and intergenerational equity with financial sustainability. Non-essential transfer payments, especially those which are of a universal nature and which do not represent a response to a proven need, should be cut. Means-testing in the provision of social benefits should not be ruled out on the grounds of possible abuse - rather, the information technology available today should be used to ensure effective implementation. Consideration should also be given to indexing all benefits to inflation, including those currently linked to wages. The system for granting certain benefits should be reviewed to prevent abuse, especially in the case of invalidity pensions. This will also help to retain older workers in the labour market. It is furthermore essential to speed up a review of the unemployment benefit system to transform it into an effective instrument of employment creation rather than of social dependence. Finally, the range of services offered by the public health system should be critically assessed in the light of budget constraints. Beneficiaries should be required to shoulder part of the costs involved. Free medicines and free medical services induce waste and abuse.

So far we have seen that outlays on wages and salaries and on social security benefits together account for fully two-thirds of government spending. A further tenth is absorbed by the interest on the public debt. Here it is well to recall that this cost is currently restrained by the prevailing low level of interest rates. With a global recovery under way, however, this favourable interest rate scenario is unlikely to last much longer. And since a one percentage point rise in the rate of interest is estimated to increase debt-servicing costs by some Lm3 million, it is clear that slowing down the pace of debt accumulation should be a priority. Any receipts from the privatisation programme should be used for this purpose.

Under present conditions, therefore, the only elements of government expenditure which are susceptible to a measure of discretionary control are capital outlays, operational expenditures and other programmes, mainly consisting of Malta's contribution to EU-funded projects. Indeed, the Convergence Programme indicates that around one half of the required cost savings during the next three years will come from a reduction in capital expenditure. This, however, still leaves the need for expenditure cuts by 2007 of around Lm70 million. This is more than one third of what the Government spends on operational expenditures and programmes. And while economies should be sought in these areas too, it is unrealistic to expect that these can produce all the required savings. Unpalatable as it may sound, the truth is that difficult but crucial decisions must be made without delay regarding the size and the cost of both the public sector and the welfare state.

In this context, I propose to examine government expenditures from the perspective of what they are achieving as a guide to understanding whether the allocation of resources resulting from choices made in the past is optimal in today's circumstances. Let us first look at how recurrent expenditure, which this year amounts to almost Lm740 million when the interest on the public debt is excluded, is distributed. Education, health and activities related to the promotion of economic growth, such as co-financing of EU projects and expenditure on tourism, information technology, infrastructure and communications account for some 39%. Outlays on welfare benefits will absorb a further 43%, more than the combined amount dedicated to the three crucial areas just mentioned. The remaining 18% represents the cost of general administration.

The imbalance evidenced by these shares raises serious questions about the rationale governing the use of public funds, a fair proportion of which are borrowed not earned. We need to ask, for example, whether the allocation of such a substantial budget to social security is promoting a culture of dependence rather than self-help, and of reliance on the State rather than the kindling of economic initiative. And this within the context of an educational system which, despite its merits, continues to produce one of the highest early school leaving rates in the EU and one of the lowest rates of science and technology graduates, and which dedicates a substantial portion of its budget to a subsidy system with questionable educational value. One could also ask whether enough resources are being allocated to priority areas such as tourism, IT and the development of industrial areas, which are vital for the creation of jobs and wealth that would in turn lessen the dependence on welfare payments and subsidies.

Returning Malta's public finances to a sustainable basis also requires careful consideration of the revenue generation mechanisms. The ratio of taxation to GDP stands at around 32%, which is one of the lowest in the EU. This can of course be viewed as one reason for the relatively high fiscal deficit. On the other hand, it can also be interpreted as evidence that the fiscal burden is relatively low, which would be conducive to economic expansion.

It is, however, probable that the moderate tax ratio does not reflect low fiscal pressure as much as the use of inappropriate mechanisms which yield insufficient revenues. One reason for this is that direct taxation is rather progressive, which creates a disincentive for work, or at least for work in the formal economy. At the same time, it is common knowledge that tax evasion is still widespread. These phenomena may well be compounded by distortions inherent in the system, among them the charging of a minimum national insurance contribution on part-time work. All of this suggests that the taxation system should be further refined in order to enhance the degree of compliance and to shift the tax burden away from productive activities.

Conclusion

On this same occasion five years ago my analysis of the country's economic condition led me to conclude that the status quo was not sustainable. I expressed the view that the time had therefore come for us as a nation, not as followers of narrow sectoral interests, to revisit the choices made in the past and to establish new priorities commensurate with the prevailing economic realities, with the limited resources available to us and with our core values.

The situation we face today compels me to reiterate this appeal with greater conviction. For we have clearly not done enough. Speaking in April 2002, a year after the collapse of the high-technology boom and looking ahead to the next upturn in the economic cycle, I observed that when the tide eventually rose, it would not necessarily raise all boats. Countries which benefited most would likely be those who made the greatest effort to adapt to evolving market conditions.

The tide has risen, even higher than expected. Global GDP is likely to increase by up to 5% this year, its strongest pace for a generation. This growth is being largely led by robust consumer spending in the United States and booming corporate investment in China, but Japan is also growing fast and even the euro area is showing signs of recovery, while emerging economies as a group are enjoying their fastest growth for at least twenty-five years. In sharp contrast, the Maltese economy is again this year likely to post one of the slowest growth rates in the EU.

Returning the economy to a sustainable growth path closer to its potential rate must, therefore, be a priority objective. How should it be pursued? In today's highly competitive global economy, there are no quick fixes or painless options that will produce greater economic efficiency, enhanced welfare and higher living standards. We must simply work harder and longer, and give more value for money.

The temptation to postpone decisive action must be resisted. We should be encouraged by the knowledge that other countries have succeeded in overcoming similar, even tougher challenges. In all cases, an indispensable ingredient of success has been an honest acknowledgement of the problem accompanied by the genuine desire of all the social partners to work out an effective solution in the national interest.

In the current circumstances, sitting on the fence is not a responsible option. Not only does it become an uncomfortable position to maintain, but it also becomes less credible with time. There is indeed the danger that anybody who is not willing to be part of the solution will be perceived to be part of the problem. I, therefore, feel obliged to call on all the social partners to adopt a long-term perspective and sign up to a substantial reform package which would lay the foundations for renewed growth and sustainable development. A thriving economy is the best social policy.