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The Administration’s objective to reduce the fiscal deficit to 3% of GDP by 2028: why and how?

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By Jesus Felipe

A FEW WEEKS AGO, I attended a presentation on the Philippine economy and prospects for 2023. A discussant from the Department of Finance indicated that the Administration aims at reducing the fiscal deficit from 8.6% of GDP in 2021 (the result of the COVID pandemic) to 3% by 2028. She referred to this reduction as “solid fiscal management” that “will promote long-term growth.”

In this article, I will argue that this is a dubious target because the government cannot control the deficit. Moreover, claiming that this reduction will promote long-term growth is poor economics. So is the idea of “fiscal responsibility,” based on the false premises that sovereign governments have limited financial resources (operate with financial constraints) or that risk “running out of money.”

A responsible government ought to focus its efforts on attaining desirable objectives such as full employment, price stability, poverty alleviation, income inequality, financial stability, environmental sustainability, and the overall standard of living. Certainly, some of these are in the Administration’s agenda. However, setting a fiscal deficit target for 2028 obscures things and may end up affecting the achievement of the more meaningful targets.

Confusion about how government finances work is a result of three mistakes and fallacies. First, from the wrong analogy of equating government finances with those of a family or firm (the latter two do have a budget constraint). Second, from not recognizing that governments do not use your taxes to make payments but instead use fiat money. This is the national currency (Peso in the Philippines), not pegged to the price of a commodity such as gold or silver. The government issues it (foreign currency is a different matter).

The value of fiat money is largely based on the public's faith in the currency's issuer, which is normally the country's government or Central Bank. It is true though that many governments sadly self-impose constraints on their ability to issue fiat money. Third, and more complex, from a poor understanding of the operational realities of how Central Bank and Treasury coordinate their actions.

Let's start by clarifying how governments make payments. Governments spend by crediting private bank accounts with Central Bank reserves. The payment of taxes leads to private bank accounts being debited. Then, if government spending is greater than taxes, there is a net crediting of reserve accounts at the Central Bank (an increase in the monetary base). Normally, the reserves created are greater than what banks need to hold, whether or not there are legal reserve requirements. Banks with excess reserves at the Central Bank will try to lend them on the interbank overnight lending market. However, when the overall banking system has excess reserves, there will be no demand for them. No individual bank can solve the problem of a system-wide excess of reserves. There must be a system-wide solution.

Before outlining the solution, it is important to appreciate the two pieces around which Central Banks and Treasuries organize their coordination. One is that the key policy tool of the former is the overnight interest rate. Once announced, the Central Bank needs to ensure that it stays within the set corridor (until there is a decision to change it). The other one is that government spending, tax revenues, and bond sales, all occur on the Central Bank's balance sheet because the government's account is a liability of the Central Bank.

What is the solution to the excess supply of reserves? This will cause the Central Bank's overnight rate to fall. Once it has fallen below the target rate, the Central Bank will respond by selling bonds. In normal times, the Central Bank will have a limited supply of government bonds, and hence it can only sell the bonds that it has previously bought. So, in the presence of a fiscal deficit, the Central Bank would need the Treasury to create and sell more bonds in the primary market. The two institutions coordinate their operations to ensure that fiscal operations have minimal undesired impacts on banking system reserves. Hence, bonds will be issued more or less in line with the fiscal deficit in order to drain from the banking system excess reserves that result from spending above taxes.

What is the result of the Central Bank and Treasury coordinating operations? At the end of the year, one would find that government spending less taxes will be exactly equal to the change in base money, that is, the change to banking system reserves, plus the change in private sector holdings of cash, and the change in non-government holding of government bonds.

I must stress that tax revenues, bond sales, and issuance of base money are not alternative methods to finance the difference between government spending and taxes but different pieces of the process of conducting fiscal policy. Treasury cannot decide ex-ante the fiscal outcome (balance, deficit, surplus) since this depends on tax revenue generated over the course of the year, plus unplanned spending as a result of unforeseen events.

If the fiscal outcome (government spending minus taxes) of a nation could be known in advance, it would be possible to decide how to accommodate (finance) the gap via three options: taxes, selling public debt (an interest-earning alternative to money), or creating additional monetary base. In reality, the fiscal outcome is not under the control of the government and it is not even a useful target for policymaking. Rather, the fiscal outcome is determined by a combination of factors.

The fiscal outcome of a nation is the result of a combination of the discretionary policy choices taken by the government and the spending and saving behavior of the non-government sector (outside the power of the government). In other words, the government can decide how much it can increase spending and, ex-post, we will observe some combination of increased tax revenue (the degree to which taxes rise will depend on the responsiveness of tax revenue to rising aggregate spending and income), increased bonds held by the private sector, and increased monetary base (money holdings, or reserves held by banks and cash held by the non-banking private sector). The latter two will be identical to the fiscal deficit, and the split between the two will depend on the preferences for interest earning assets, given the overnight interest rate set by the Central Bank policy.

For these reasons, targeting in 2023 a fiscal deficit of 3% of GDP by 2028 is adventurous. It may indeed materialize, or it may not. Moreover, note that pursuing a 3% fiscal deficit objective is tantamount to claiming that, at the end of 2028, the Philippine non-government sector (domestic private plus external sectors) will run a surplus (net save) of 3%, since the three sector balances (domestic private plus government plus external) add up to zero. Note that this fiscal deficit represents a smaller surplus for the domestic plus external sectors than that provided by the current larger fiscal deficit. This deficit might be what the other two sectors desire in 2028. However, imagine that in 2028 the Philippines runs a current account deficit (the external sector) of over 3% of GDP. To constrain the fiscal deficit to 3% of GDP, will imply that the domestic private sector will be forced to run a deficit. If this materializes, I predict trouble.

To end: will the fiscal deficit of 3% of GDP materialize in 2028? It is impossible to know today. As noted above, the fiscal outcome is not under the control of the government. The fiscal deficit is, from an accounting point of view and ex-post, the difference between government spending and tax revenues. Yet, behaviorally, it depends on the saving desire of the domestic private and external sectors. In fact, it makes no sense to speak of the government's balance without reference to the other two balances; and the sector balances do not tell us the complex causalities that lie behind the resulting outcome (that they add up to zero). What we know is that the fiscal outcome for a currency-issuing government like the Philippines is largely residual, rising when private domestic and foreign demand shrink and falling when demand rises. In other words, the fiscal deficit finances the desire by the non-government (domestic and foreign) sector to save overall. This is achieved by maintaining sufficient demand to produce a level of income that will generate the desired level of net saving. Consequently, a responsible government would seek to meet the desirable national objectives, and whether these require a larger deficit, a smaller deficit, or even a surplus in some circumstances, should not be the concern because such a government understands how its own finances work.

Let’s see what happens between now and 2028 and, in the meantime, dispel the idea that reducing the fiscal deficit is necessarily good for the Philippine economy.

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