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Cutting Budget Deficits in Sub-Saharan Africa without Undermining Development

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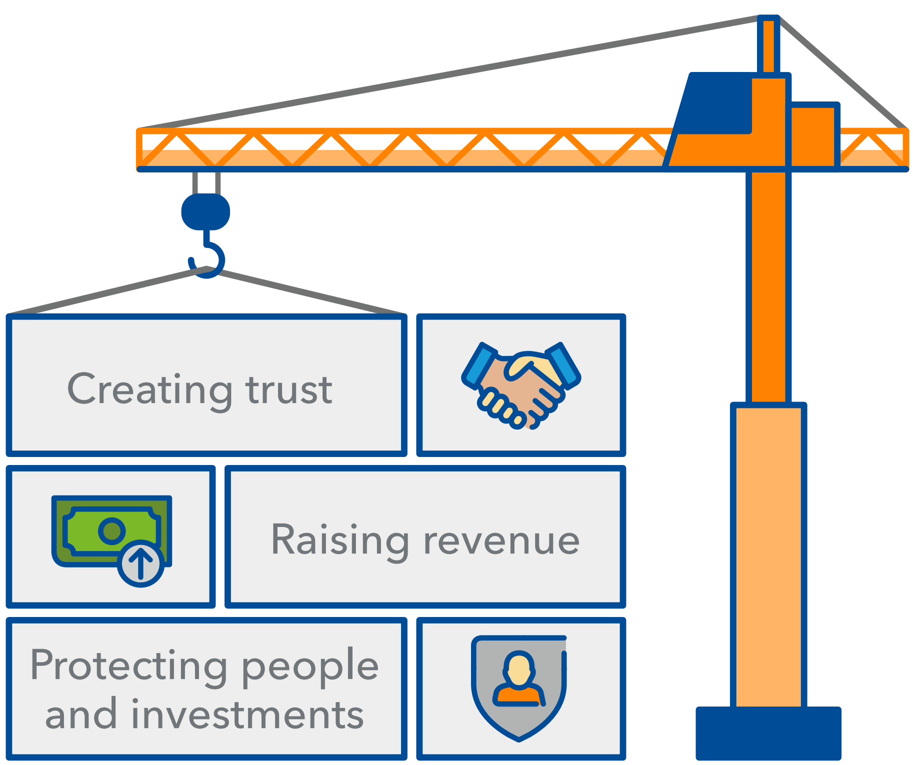
Cutting Budget Deficits in Sub-Saharan Africa without Undermining Development

After more than a decade of rising public debt and following the degradation of fiscal positions during the COVID-19 pandemic and in the aftermath of Russia's invasion of Ukraine, about two-thirds of sub-Saharan African countries have embarked on sizable fiscal tightening plans, aiming at narrowing primary deficits by about 3 percent of GDP over the near-term. First, to implement the necessary adjustment while limiting the negative effects on economic development and social conditions, it is crucial that policymakers rely more on revenue-enhancing measures than cuts to investment and other priority spending. A careful selection of instruments can mitigate the adverse consequences of revenue increases on inequality and poverty. Second, in many countries, there is limited room for gradually reducing deficits given tight financing conditions. Finally, effective strategies to build public trust around fiscal consolidation plans, such as using compensatory measures (including targeted transfers) or adequate sequencing, are essential to ensure a successful and durable implementation of these adjustments.

Sub-Saharan African countries can rebuild their public finances and preserve stability



Most sub-Saharan African countries have already started tightening their budgets…

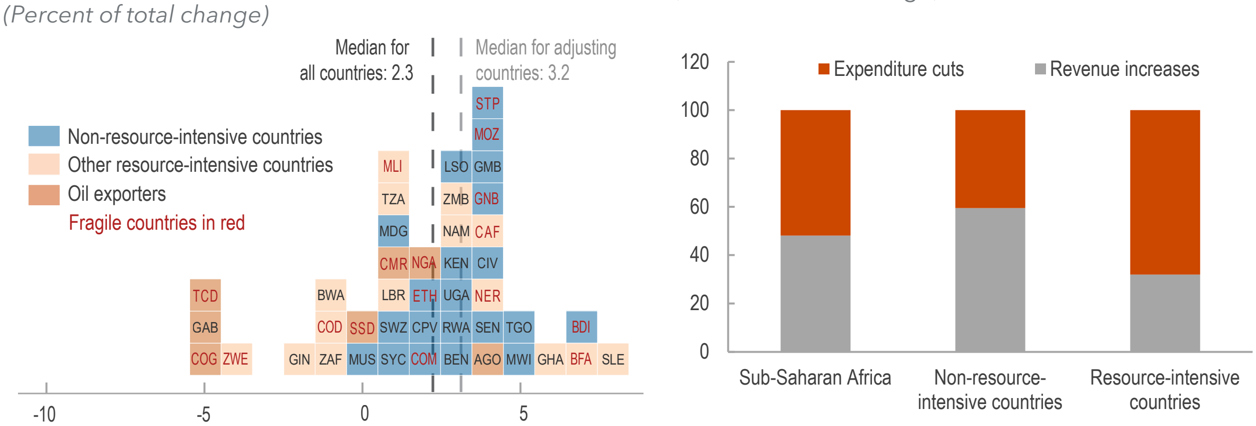
The fiscal position of many countries in sub-Saharan Africa has deteriorated over the past decade or so, partly because of repeated negative shocks and the ensuing need for fiscal support, but also due to policy slippages. As a result, debt vulnerabilities are now elevated in the region. To reduce them and avoid a systemic debt crisis, policies are being re-oriented towards rebuilding buffers. The need for fiscal tightening is further precipitated by the recent funding squeeze that has made financing constraints more binding and elevated the costs of servicing debt (April 2023 *Regional Economic Outlook: Sub-Saharan Africa*).

Most sub-Saharan African countries have announced and started implementing sizable deficit reduction plans. About two-thirds of countries in the region improved their fiscal balances in 2023, and further efforts are expected in 2024 and 2025 (Figure 1, panel 1). Zooming-in on the subset of countries that are consolidating, the median total planned improvement in the primary balance amounts to 3 percent of GDP, and about 40 percent of the countries are implementing frontloaded adjustments with 60 percent or more of the total fiscal effort concentrated in 2023.[1] The ongoing consolidation seems to be broadly balanced between expenditure cuts and revenue increases (Figure 1, panel 2). But, under existing plans, the composition of the expenditure reduction is quite heterogenous. About half of the countries among those adjusting intend to preserve the investment-to-GDP ratio almost entirely (and thus rely on cuts in the current expenditure ratio). These include Botswana, Cameroon, and Kenya. The other half plans to reduce capital expenditures by an average of 1.4 percent of GDP over the period with potential negative implications for medium and long-term growth.

Figure 1. Sub-Saharan Africa: Planned Fiscal Adjustment

1. Planned change in primary fiscal balance ratios between 2022 and 2025
(Percent of total change)

2. Decomposition of Adjustment Plans
(Percent of total change)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 2, fiscal adjustment plans are defined as the change in primary fiscal deficit between 2022 and 2025. SSA = sub-Saharan Africa. Country abbreviations are International Organization for Standardization (ISO) country codes. Country groupings are detailed in the April 2024 *Regional Economic Outlook: Sub-Saharan Africa.* SSA = sub-Saharan Africa.

…and more may be coming over the medium-term.

Assuming that current fiscal plans are fully implemented, countries across the region will be in different positions by 2025 regarding the need for further adjustment (Figure 2). About three quarters of all sub-Saharan African countries will have reached primary fiscal balances that would be compatible with a stable debt-to-GDP ratio.[2]

[1] Regarding the countries that are not planning to reduce their primary deficit between 2022 and 2025, most of them had primary balances in 2022 that were already above their debt stabilizing level, a sign that they might not need to adjust.

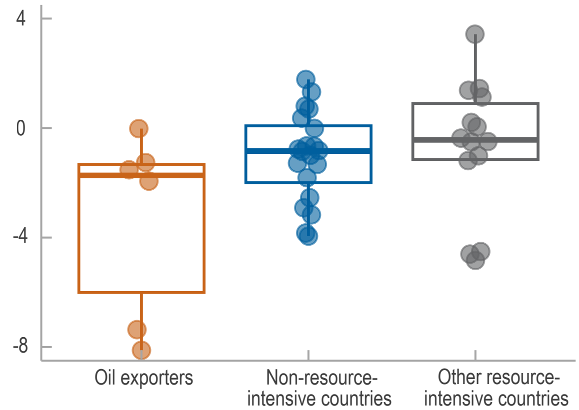
[2] Assessing fiscal adjustment needs is a complex exercise. This Note uses the debt-stabilizing primary balance as a simple benchmark, but a comprehensive assessment requires a much deeper country-specific analysis (see, for example, IMF 2016).

Hence, about one-quarter of countries may need additional fiscal efforts to stabilize debt over the medium-term. For these countries, further fiscal tightening amounting to about 1 percent of GDP would be required to stabilize their debt ratios at end of 2025 levels.[3] Looking at the issue from a different perspective, close to one-third of countries would still have debt ratios above the benchmark of 70 percent of GDP at that time (with 70 percent being the most prevalent ceiling for debt rules in the region).

Overall, although most countries have already started to adjust, more fiscal tightening is expected in the near term. This brings to the forefront of policy discussions the issue of how to implement fiscal consolidation packages adapted to the sub-Saharan African context that can soften the pain in terms of adverse effects on economic and social development. This Note tackles this question partly building on the analysis presented in David and others (2023), but refrains from examining issues related to debt restructuring, which were addressed in a previous note (IMF 2023).

Figure 2. Additional Fiscal Effort Needed as of 2025

(Gap relative to debt stabilizing primary balance, percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: A positive value indicates a need for more fiscal effort to reach the debt stabilizing primary balance. Dots denote individual countries. Box plots portray the median country effect as the thick horizontal line and the first and third quartiles as hinges. Whiskers extend in both directions by the closest of the maximum or minimum value and 1.5 times the interquartile range. Country groupings are detailed in the April 2024 *Regional Economic Outlook: Sub-Saharan Africa.*

Deficit reduction plans appear feasible, but there are implementation risks.

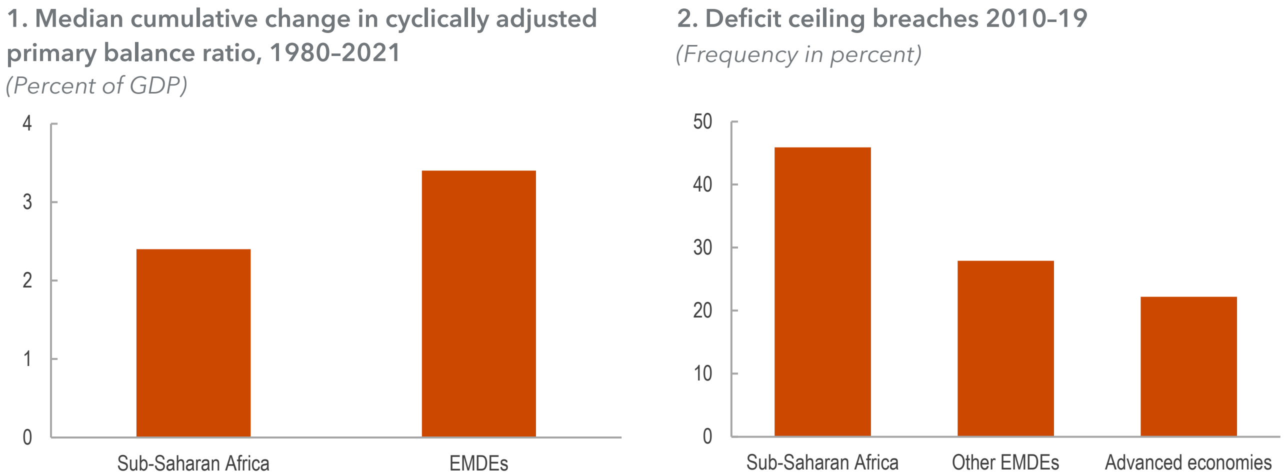
A historical database of fiscal consolidation episodes in sub-Saharan Africa covering 82 episodes over the period 1980–2021 offers several interesting insights to guide future policies.[4] In the past, countries in sub-Saharan Africa have been able to improve their fiscal positions by 1 percent of GDP a year over two to three years. The median cumulative improvement of the cyclically adjusted primary balance during a consolidation episode in Africa was about 2½ percent of GDP (Figure 3, panel 1). Historically, this represents substantial adjustment, although lower than in other emerging markets and developing economies (which have typically implemented cumulative improvements of about 3½ percent of GDP across episodes). Hence, the currently envisaged deficit reduction plans in sub-Saharan African countries appear to be ambitious yet feasible, when compared to past episodes.

Experience also suggests that implementation risks to fiscal adjustment plans in the region have been high. These risks materialize when policymakers are unable (or unwilling) to implement key fiscal reforms that are necessary to put public finances back on a sustainable path. As illustrated in Figure 3, panel 2, although fiscal rules are very common in sub-Saharan Africa, they are rarely binding for public finances. Countries in the region with fiscal deficit ceilings have breached this type of rule about half of the time, on average—a much higher frequency than in other country groups (the median size of such breaches is about 2 percent of GDP for sub-Saharan African countries). Moreover, deviations from fiscal plans can also be significant and countries tend to have optimistic fiscal balance projections that do not materialize ex-post (David and others 2023). Regarding past consolidation episodes, less than a third of them were considered as being "sustained" (that is, not reversed in immediate subsequent years).

[3] Additional adjustment needs for 2025 are measured as the gap between the 2025 debt-stabilizing primary balance and the planned primary balance in 2025.

[4] The identification of episodes is based on a mix of "mechanical" methods (relying on changes in the cyclically adjusted primary balance) and an examination of IMF staff reports (following the "narrative" approach) to ensure that the episodes included capture genuine fiscal consolidation efforts. See further details in David and others (2023).

Figure 3. Sub-Saharan Africa: Size of Past Fiscal Adjustments and Implementation Risks



Sources: IMF, World Economic Outlook database; IMF Fiscal Rules dataset (Davoodi and others 2022); and IMF staff calculations.
Note: In panel 1, the cyclically adjusted primary balance is constructed following the methodology of Fedelino, Ivanova, and Horton (2009) to correct for the cycle and the Hamilton Filter. Moreover, large increases in commodity-related revenues or in grants were also excluded (see David and others 2023 for details). EMDEs = emerging market and developing economies.

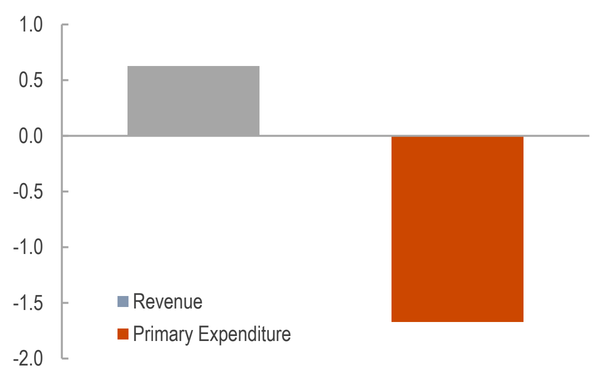
Implementation risks are particularly salient in the near term, given the large number of elections scheduled to take place in the region over the course of 2024 (18 presidential or general elections). In light of these challenges, policymakers should elaborate contingency plans in case ongoing ambitious consolidation efforts do not materialize. Furthermore, to ensure tangible results, it is essential that fiscal consolidations be accompanied by the elaboration of medium-term fiscal strategies and reforms to strengthen supporting fiscal institutions and build public support.[5]

Breaking an entrenched habit: why adjustment should rely more on revenues.

In the past, efforts to reduce deficits in sub-Saharan Africa have been primarily based on (investment) expenditure cuts (Figure 4), with the median decrease in expenditures over an episode amounting to 1.7 percent of GDP, while the median increase in revenues has been substantially lower (at half a percent of GDP). In addition, reductions in the capital expenditure ratio accounted for a large share of spending cuts during consolidation episodes (more than 60 percent) in sub-Saharan African countries. In other emerging markets and developing economies (EMDEs), the composition of expenditure ratio cuts was more balanced between current and investment spending. This may be explained by the fact that cuts to physical investment spending are more politically palatable than cutting sensitive items such as public employment, wages, or untargeted subsidies. But reductions in investment spending may have negative implications for growth both in the short and long terms.

Figure 4. Sub-Saharan Africa: composition of Past Fiscal Adjustments

(Cumulative change in the ratio to GDP between the beginning and end of episode; median across episodes)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Dataset based on 82 episodes over 1980–2021.

[5] See "How to Avoid a Debt Crisis in Sub-Saharan Africa", IMF Country Focus September 2023.

Therefore, the composition of adjustment could be improved in the region. Revenue-based fiscal consolidation could play a greater role in sub-Saharan Africa for two main reasons. First, domestic revenue mobilization is still relatively low, hence there is more room to raise revenues through tax policy or revenue administration reforms than to cut government spending, which is frequently insufficient in key areas such as infrastructure, health, and education. For example, Benitez and others (2023) estimate the tax gap (relative to potential) in sub-Saharan African countries to amount to 5 percent of GDP, on average. Second, the negative growth effects of revenue-based adjustments seem to be less acute in sub-Saharan Africa. Some prominent features of sub-Saharan African economies such as high levels of informality and relatively low tax levels, attenuate the pain caused by tax hikes on growth (a smaller so-called "multiplier" effect on output), when compared to other regions (Gunter and others 2021; Colombo and others 2022). In fact, Arizala and others (2021) found that fiscal consolidations based on revenue mobilization are less harmful to growth in sub-Saharan Africa. In addition, Balasundharam and others (2023) underscored that revenue-based consolidations tend to be more durable in settings where the revenue-to-GDP ratio is lower, as is the case in sub-Saharan Africa.

On the expenditure side, while there is certainly room to reprioritize and increase "value for money", the case to protect efficient infrastructure investment and social spending on education, health and social protection is strong given their implications for growth and poverty reduction (see Analytical Note "Building Tomorrow's Workforce: Education, Opportunity, and Africa's Demographic Dividend").[6]

Nonetheless, revenue-based adjustments can be challenging, and policymakers need to select tax instruments carefully to avoid negative effects on poverty and inequality. First, raising revenue can be politically more difficult than cutting expenditures, especially in countries with a weaker culture of tax compliance. Second, some revenue measures, including increases in consumption taxes or import tariffs for essential goods, could have negative effects on poverty and inequality (Woo and others 2017) and need to be accompanied by compensatory measures to protect vulnerable populations, like cash transfers or simpler solutions when the necessary infrastructure (such as an up-to-date national register) is missing (Prady 2020).[7] In contrast, adjustments that rely on increases to progressive income taxes and taxes on immovable property tend to have less detrimental effects on social indicators.[8]

Promising avenues to boost revenues in several sub-Saharan African countries include reforms to: 1) simplify the tax system while reducing exemptions thus broadening the tax base (as successfully done in Rwanda and Uganda in the first part of the 2010s); 2) enhance tax compliance, including by tailoring enforcement to different taxpayer segments (small, medium, and large); and 3) promote digitalization to increase the efficiency of internal tax administration processes and interactions with taxpayers. On the latter, there is encouraging empirical evidence on the positive effects of information technology solutions (for example, the use of electronic sales register machines in Ethiopia) on revenue mobilization in sub-Saharan African countries (Oyebola and Santoro 2023).

Finally, formulating a medium-term revenue strategy (MTRS) that focuses both on tax policy and revenue administration reforms can be useful to adequately identify and sequence reform measures, facilitate their implementation, and improve credibility of the adjustment process. With the support of IMF technical assistance, several countries in the region are designing and adopting medium-term revenue strategies. According to the Platform for Collaboration on Tax, Benin, Cameroon, Ethiopia, Kenya, Rwanda, and Togo were at MTRS pre-formulation or formulation stages, while Liberia, Senegal and Uganda were at the implementation stage.

[6] In countries with insufficiently developed public investment management systems there might be scope to reduce poorly-designed projects, especially if governance issues are a concern.

[7] The progressive nature of the fiscal system depends on the joint effects of tax and expenditure policies and cannot be assessed in isolation. A regressive tax system financing well-targeted social spending could still reduce inequality.

[8] In several sub-Saharan African countries, reliance on these more progressive taxes is likely to be insufficient to address adjustment needs given their relatively small tax bases. Thus, consumption tax measures may still be required.

The scope for gradual adjustment is limited.

Fiscal tightening is likely to cause some negative effects on economic activity in the short term and policymakers will try to smooth the adjustment over time to the extent possible to avoid abrupt disruptive changes. Moreover, a more backloaded adjustment path would allow for more time to implement important reforms to fiscal institutions and develop compensatory measures to support consolidation efforts, especially revenue administration reforms (Balasundharam and others 2023). In the past, sub-Saharan African governments have typically implemented gradual or backloaded consolidations, with only about one-third of fiscal adjustments episodes (30 out of 82) being frontloaded.[9]

At the current juncture, given tight financial conditions, both globally and domestically, a more frontloaded deficit reduction path is likely to be unavoidable in many countries. Most sub-Saharan African economies do not have access to or have lost access to international capital markets. Therefore, in these cases, the availability of donor financing or external commercial borrowing and the absorption capacity of domestic financial markets will be crucial determinants of the feasibility of a smoother adjustment, but both sources of financing are limited. In addition, the ability of some countries facing high liquidity risks to undertake liability management (reprofiling) operations is also more constrained at the moment, which may precipitate frontloaded adjustments.

In advanced economies, standard policy advice on the appropriate timing of fiscal retrenchment is predicated in part on whether a given economy is in a period of slow economic growth or not. To the extent possible, larger fiscal efforts should be concentrated in years in which the economy is doing better. But in sub-Saharan Africa there is evidence that the effects of fiscal policy on output tend to be smaller and vary less significantly across the economic cycle (David and others 2023). Hence, while consolidations will pose some drag on growth, in sub-Saharan Africa there are likely to be fewer benefits of delaying fiscal adjustment until economic conditions improve, while a frontloaded approach may boost the credibility of adjustment plans.

But the optimal pace of adjustment is likely to differ across country groups in the region. For instance, in resource-rich countries, the adequate pace of consolidation is partly dictated by the stage of the commodity price cycle and whether resources from a stabilization fund are available to smooth out fluctuations in revenues. Periods of favorable terms of trade (when resource prices are above trend) are usually a more opportune time to build up fiscal savings in a frontloaded and painless manner. Conversely, periods of low natural resource prices may call for more gradual adjustment if financial conditions permit.

Building public trust and support around fiscal adjustment plans is essential.

The successful implementation of plans to improve the budget position of sub-Saharan African economies will depend on the ability to secure support by the population. Resistance to fiscal consolidation is difficult to overcome since the costs of the status quo are not always visible, while the measures underlying the adjustment often have, at least temporarily, a negative impact on some segments of the population. Possible measures to enhance buy-in include:

- An effective communication strategy aiming at ensuring that the public understands the need for adjustment is crucial. The dangers of excessively high deficits and ever rising debt levels, especially the risk of facing a devastating crisis in the absence of corrective measures should be highlighted. There are a few recent examples of countries undergoing painful debt restructuring operations in the region. Policymakers should explain the benefits of sustainable fiscal policies in terms of continuous access to public services or investments in essential

[9] As mentioned previously, frontloaded adjustments are defined as episodes in which 60 percent or more of the total fiscal effort is undertaken in the first year.

public goods. In the case of revenue-based adjustments, authorities can also communicate how higher domestic revenue mobilization efforts will be used both to reduce the deficit and preserve or expand development and social spending over time as fiscal space is rebuilt.

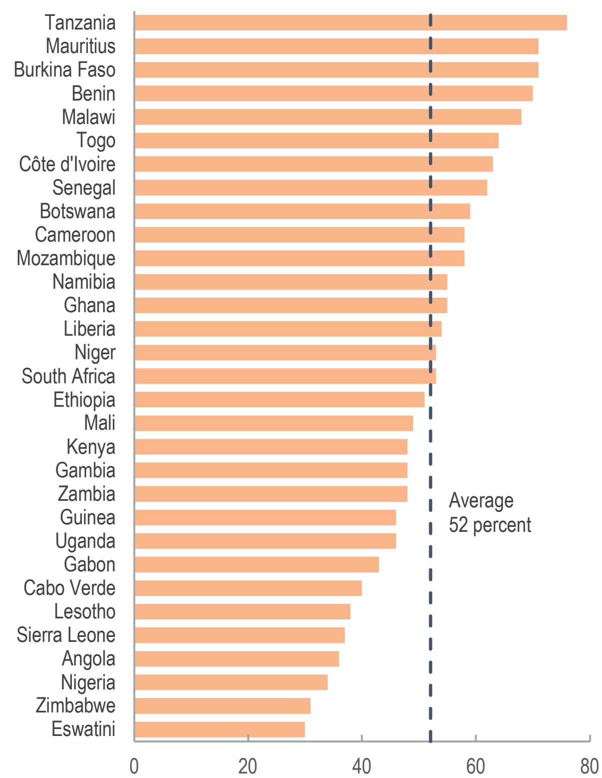
- Introducing compensatory measures, which provide immediate and salient benefits to the most vulnerable, is also important for getting political buy-in. Such measures could comprise targeted cash transfers to alleviate the effects of fiscal tightening on the most vulnerable or other visible policies such as reductions in public school or health-related fees.[10]

- Appropriate sequencing of fiscal reforms may help in overcoming resistance. If possible, more politically difficult reforms (such as the removal of large energy subsidies) should be undertaken when economic conditions are relatively favorable. Another effective strategy could be to first implement reforms that affect the relatively well off. For example, when removing fuel subsidies, several successful efforts started by focusing initially on products consumed by higher-income groups, such as gasoline and jet fuel (Alleyne and others 2013).

- Public acceptance of fiscal adjustment depends on the ability of policymakers to convince the population that the government will manage public finances in an efficient, fair, and transparent manner. Trust in the government's ability to use public resources to promote the population's well-being is still relatively low in many sub-Saharan African countries (Figure 5). Hence, institutional reforms aiming at improving public financial management should be undertaken in parallel with the implementation of fiscal adjustment plans. This notably means improving the management of public investment, for instance by ensuring "value for money" in the selection of investment projects and stronger governance rules around public procurement. On the revenue side, reforms to strengthen revenue administration to broaden the tax base, improve interactions with taxpayers (notably through digitalization) and ensure that the most well off pay their fair share of taxes, have also the potential to increase public trust, while contributing to the mobilization of domestic revenue.

Figure 5. Sub-Saharan Africa: Government Use of Taxes for the Well-Being of Citizens

(Percent of respondents who agree/strongly agree)



Source: Afrobarometer Policy Paper No. 78, February 2022.

[10] In contexts where targeted cash transfers cannot be easily scaled up, an alternative solution could consist in providing universal transfers, which are much simpler to implement but potentially costly. Their amount should be limited to reflect the impact on the poorest (Coady and Le 2020).

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