

PUBLIC EXPENDITURE REFORM

By
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Public expenditure reform is one of the key elements of the strategy for alleviating resource constraints in the aftermath of the Asian financial crisis. As a former minister of planning and finance it seemed logical for me to choose this area given my involvement in the preparation of various federal budgets and annual plans of Pakistan during the last few years. In addition, this gives me an opportunity to present a distinctly South Asian perspective at the forum where much of the focus is on post-crisis developments in the relatively high income economies of East and South East Asia.

The Asian financial crisis largely had indirect or 'contagion' effects on the South Asian economies. The primary transmission mechanism was the fall in international prices which affected the export earnings of most of these economies. For example, India's exports which had grown at the rate of 11 per cent between 1990 and 1996 showed growth of 4 per cent only in 1997 and a decline of over 3 per cent in 1998. Pakistan had averaged a growth rate in the 90's prior to the crisis of 10 per cent in its exports, which declined by 3 per cent in 1997 and showed only a modest recovery of 4 per cent next year. The consequence of the fall in export earnings was some loss of growth momentum. The average growth rate of South Asian economies fell by almost 1 percentage point in 1997 from the long term growth rate of 5.5 per cent of the region.

Public finances were adversely affected in a number of ways. First, the fall in GDP growth was inevitably accompanied by a loss of buoyancy in tax revenues. Second, in most South Asian economies, taxes on international trade which include customs duties, sales taxes, etc., are the major source of revenue. The fall in international prices led to a major contraction in the tax base of imports. For South Asia as a whole the value of merchandise imports increased by only 3 per cent in 1997 and

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remained stagnant in 1998 as compared to the rapid growth rate of 20 per cent in the previous six years.

The consequence of these adverse developments in the wake of the Asian financial crisis was a worsening of the fiscal situation in most South Asian economies. Fiscal deficits which were already high in some countries, increased further to virtually unsustainable levels. This was largely the result of the fall in the ratio of revenues to the GDP while the share of public expenditure in the GDP remained sticky downwards. For example, the central government budget deficit went up in 1997 by over 3 per cent of the GDP in India, by 2 per cent of the GDP in Pakistan and by 5 per cent of the GDP in Bangladesh.

The inability to bring down the level of public expenditure in order to restrict the size of the fiscal deficit demonstrates not only how difficult it is to implement reforms in this area but also why such reforms are essential if a modicum of macroeconomic stability is to be restored.

CONSTRAINTS TO PUBLIC EXPENDITURE REFORM

The failure in public expenditure reforms can be attributed to a number of factors. Public expenditure allocations generally reflect the roughest aspects of the political economy and problems of governance in developing countries where priorities are distorted by strong constituencies and lobbies in their favour. Politicians and senior bureaucrats frequently use the levers of concessions, subsidies, special expenditure allocations and subventions for the purposes of patronage and in many cases for personal gratification in the form of bribes. Rent seeking activities flourish within the ambit of the budget making process, whereby groups which are favoured are unwilling to give up a privilege once granted even in times of financial stringency while simultaneously new groups continue jockeying for special treatment irrespective of the overall macroeconomic situation. In some respects, this is what democracy is all about and the quality of governance hinges crucially on the ability of an administration to resist the pressures of special interest groups and cater for what can be considered more broadly as the general public interest.

Rent seeking behaviour is perhaps most acutely manifest in the granting of subsidies and tax concessions (which can be viewed as tax expenditures), all of which erode the budgetary position of government but remain largely invisible from the public eye. Recent research has demonstrated that subsidies granted by the central and state governments add up to a staggering 10 per cent to 12 per cent of the GDP in India. These include subsidies on energy consumption, agricultural inputs, social and economic services, bank credit, etc. In Pakistan, the corresponding estimate is about 4 to 5 per cent of the GDP while the cost of tax expenditures is about 3 to 4 per cent of the GDP. The irony of all this is that only a small component of the subsidies are targeted to the provision of 'merit' goods while the fiscal concessions primarily benefit the richer segments of society. The political economy in most South Asian countries has led to the capture of the state by the most influential, vocal and organised interest groups like large farmers, big business (like the textile and steel lobbies), public enterprises and the military establishment. While there is considerable rhetoric on the need to protect the 'common man' and to focus on poverty reduction, in practice the actual benefits of public expenditure are skewed towards the rich and powerful.

The recent experience has also demonstrated why rationalisation of public expenditure is particularly difficult when the economy is experiencing a downturn. Whatever cuts are achieved are essentially in the domain of social sectors and development expenditure, which are more discretionary in character but retard the future growth potential. What explains the stickiness of public expenditure during times of recession?

First, there is the legacy of the historical process following independence of most countries of South Asia which, in the presence of an underdeveloped and nascent private sector, saw the public sector as the prime agent of nation building and promoting economic development on top of the traditional role of the colonial administration of maintaining law and order and collecting revenue. Paradigms of the 'welfare state' and 'central planning' still linger in the minds of the people. This has implied that when a negative shock (like the Asian financial crisis) is experienced, the general expectation is that the brunt of the shock will be borne by the government and the people insulated to the extent possible from the immediate and direct consequences of the shock. Consequently, public sector employment is seen as

a kind of social safety net during periods of recession (when the private sector is not expanding jobs) and it has been extremely difficult at such times to downsize the government by trimming the labor force in the public sector.

On top of this, there is even the view that fiscal policy should be counter-cyclical in character to take the economy out of a recession. As such, the level of public expenditure should be enhanced to raise the level of aggregate demand. Not only is there a danger that such a policy would add to the waste in public expenditure by encouraging programs/ projects with doubtful economic merit, but also that, given the already high fiscal deficits in most South Asian economies (as opposed to the East Asian countries), it would exacerbate inflationary pressures and raise interest rates which would 'crowd out' private investment and largely neutralise the fiscal stimulus.

Second, the pursuit of rent seeking and patronage activities is largely independent of the state of the economy. If any thing, demands for concessions and incentives become more vocal at times when real incomes are not rising and profitability is being eroded by a downturn in economic activity. The government of Pakistan had to bring down income tax and sales tax rates sharply in 1997 and implicitly subsidise exports after the fall in international prices through mechanisms like higher duty drawback rates and cheaper export finance to protect exporters. Given this reluctance on the part of politicians and senior bureaucrats to abandon the role of patronage even in difficult times, it has not been possible to trim the functions of the public sector and focus more on its role as an enabler and facilitator. This represents one of the biggest challenges for improved governance in developing countries.

Third, even if decisions could be reached on privatising some of the activities of the public sector relating to manufacturing or provision of services, the overall climate is not conducive for privatisation during periods of recession. Private investment, domestic and foreign, is generally shy and capital markets are experiencing a downturn. It is not surprising that despite ambitious plans the process of privatisation has been severely retarded since 1997 in Pakistan.

PROBLEMS OF THE PUBLIC SECTOR

The failure in public expenditure reform has meant that the public sector has become increasingly bloated and overextended in most countries of South Asia. The presence of large fiscal deficits has sharply highlighted this feature of the economies. Overall, the public sector today misallocates resources, manages poorly and inefficiently spends scarce public resources. The long list of problems includes the following:

Misplaced priorities: The fundamental problem is that high priority social and physical infrastructure investments and transfer payments for poverty reduction have increasingly been ‘crowded out’ by growing interest payments (due to the persistently large fiscal deficits) and military expenditure. It is truly tragic that the region which has the largest concentration of the poor (almost 500 million) in the world has military expenditure in excess of \$ 15 billion, with India, Pakistan and Sri Lanka devoting more than 3 per cent of their respective GDPs on defence. For the current fiscal year, India has increased its defence allocation by as much as 28 per cent while Pakistan has raised it by 11 per cent. An indication of misplaced priorities can be had from the fact that in Pakistan military expenditure is more than twice the total public expenditure on education.

Improper utilisation of scarce funds: This is the consequence of faulty institutional structures for service delivery, poor financial management practices and defective planning. Service delivery is mostly by line departments and parastatal organisations which are characterised by over-centralisation of management and a supply-driven approach rather than by responsiveness to effective demand. There is over-emphasis on salary payments (given the employment fixation) in relation to non-salary inputs, which reduces the effectiveness of spending. Lumpy capital expenditures are generally preferred over operations and maintenance because of the greater scope for ‘commissions’.

Financial management practices have led to loss of control and leakages because of the absence of proper accounting systems, appropriate reconciliation procedures and audit. The reliance only on cash flow accounting means that there is inadequate knowledge of public assets and of contingent liabilities. The planning process has been rendered ineffective by too much ‘politicisation’ of project selection and

execution. This has also contributed to a ‘spreading too thin’ of the development program in order to accommodate competing claims. The consequence is delays, cost overruns and the stretching of the limited implementation capacity. Overall, the improper utilisation of funds has implied less and wasteful delivery of services. Program initiatives pursued by governments with populist agendas have the greatest potential for eroding the normal budgeting process and distorting priorities. Programs like subsidised urban housing and transport have been demonstrated to be notoriously prone to leakages and defective implementation. Such programs have frequently been abandoned eventually because of lack of financial sustainability. The careers of many senior officials have been sacrificed at the altar of such programs.

More recently, the launching of poverty reduction strategies has increased somewhat the outlays for social safety nets including generalised food subsidies, targeted food support programs, transfer payments in cash, enhanced social security and labor-intensive public works programs. But the institutional arrangements for the anti-poverty interventions are generally fragile and underdeveloped. Consequently, overhead costs are high, targeting is poor, coverage is limited, leakages are common and negative incentive effects frequently the result. A lot more needs to be done to effectively implement poverty reduction strategies.

Absence of transparency and accountability: Large components of public expenditure remain outside the realm of public scrutiny. For example, the military budget which consumes over 20 per cent of federal resources in Pakistan is presented as just a one line item in the budget documents. There is also a lack of explicit accounting of subsidies and tax expenditures. The problem of absence of adequate information dissemination is especially acute in the case of statutory corporations and utilities, which account for the major part of the ‘quasi-fiscal’ deficit. There is a virtual absence of effective oversight mechanisms of the legislature, consumers and civil society at large.

The consequences of misplaced priorities, lack of responsiveness to needs and preferences, ineffective and wasteful delivery is a growing disillusionment of the people with the provision of goods and services by government. There is a search for alternatives and greater reliance on the private sector and non-

profit organisations. This is most evident in the areas of education and health where, especially in the urban areas, much of the demand has moved away from the government and most public service facilities lie underutilised.

A stage has also been reached where in the absence of reforms public sector entities have begun to collapse. Closure has been forestalled temporarily by the building up of large overdrafts with the banking system and by deferring payments of liabilities with suppliers, contractors, etc. In the case of many of the large public utilities which provide vital services like power, water, transport, etc., government has had to step in and bail out these entities by effectively writing off their debts through debt-equity swaps.

Physical indicators of the crisis of the public sector include the lack of improvement in coverage and deterioration in the level of service, for example, high incidence of outages in the case of power utilities, supply interruptions in the case of drinking water and breakdowns in telecommunication services. Also, there is visible depletion of physical infrastructure in the absence of adequate repairs and maintenance.

A particularly worrying consequence of growing public perception of waste, corruption and inequity in public expenditure is the resulting breakdown of taxpayer compliance. Given the absence of any visible link between tax payments and benefits received, citizens are inclined to withhold their due tax contributions and defy tax laws through higher levels of tax evasion. This reinforces the need for greater accountability of public expenditure, greater exercise of economy and in some cases for earmarking of revenues if the process of development of a tax culture is to be promoted.

Altogether, a stage has been reached when unless there is radical reform of the public sector the process of growth and development in many South Asian economies will be retarded by the lack of social and physical infrastructure, which has begun to hinder the process of production and investment by the private sector.

CHALLENGES CONFRONTING THE PUBLIC SECTOR

The process of reform of public expenditures will have to recognise the many major challenges confronting governments in developing countries today, including those in South Asia. These include the following:

Rise of the private sector: one of the more favourable developments is the emergence of a stronger and more mature indigenous private sector in most countries with the capacity to perform most trading and manufacturing functions and even develop and manage infrastructure. This has been facilitated partly by the failure of the public sector. There is need, therefore, to create more space for private sector participation through deregulation and privatisation.

Process of globalisation: The rapid on-going process of globalisation requires that trade and investment be increasingly liberalised and deregulated. In addition, greater emphasis must be placed on rapid human resource development and on cost effective provision of non-tradeable services in order to preserve and enhance international competitiveness.

Emergence of the informal economy: An important development in most South Asian economies is the rapid spread of the informal, black or underground economy. This has led to increased erosion of the tax base, theft or non-payment of utility bills, resort to illegal activities (smuggling and sale of arms and drugs), etc., and is reaching a scale where it now poses a serious threat to the writ of the state. Governments will have to seriously work towards enforcement of law and regulation of various activities without fundamentally jeopardising the ground level dynamism which characterises the informal economy.

Severe fiscal constraint: The existence of large unsustainable fiscal deficits, the inability to raise the tax-to-GDP ratio drastically in the short run and the decline in levels of concessional development assistance, imply the need to focus only on key core functions and to shed peripheral activities.

Rapid technological change: The rapid process of technological change (including the advent of information technology) and increasing complexity of macroeconomic policy making in more 'open'

economies will require the adoption of more modern management practices, induction of professional skills into civil service cadres and development of appropriate management information systems, especially to avert and manage crises.

Meeting these challenges will require a new vision of the public sector as '*small but effective, decentralised, responsible, customer-oriented and managed professionally*'. This will imply a change in the emphasis of governance from direct provision to that of an effective facilitator and regulator, concentrating only on the provision of public goods, services which confer significant positive externalities and on the important task of poverty reduction.

AREAS OF PUBLIC EXPENDITURE REFORM

What are the key reforms required to realise this new vision of the public sector as compared to the traditional view of government as an all-pervasive entity, employer of last resort and shock absorber?

It appears that there at least eight major directions of reform, as follows:

Rethinking the role of government: Based on the new vision, there will have to be fundamental rethinking of the role of government. Each function (and the entity discharging it) will have to be studied carefully from the viewpoint of the following: Is the public entity producing a public good or a purely private good? Is the entity facing competition from the private sector? Is the entity surviving only because of some special protection or preferential treatment? Is the entity so overextended that all it can do is to cover the cost of its own establishment? Has the mission of the entity disappeared? Is there a duplication of activities with other agencies? Does the entity represent encroachment upon functions of a lower level of government? If it is a public commercial venture, is the entity making losses?

Based on the above assessment, a decision will have to be taken whether the entity should be retained in its present form or closed, downsized, privatised or devolved to a lower level of government. Such an audit will not only have to be undertaken of government ministries and departments but also of statutory corporations, public enterprises, autonomous bodies and attached departments. This is clearly

a mammoth task and may have to be undertaken in phases starting first with the more peripheral activities. The body charged with the responsibility of conducting this review will have to be seen as independent and impartial and made immune from the inevitable lobbying pressures. Fortunately, in most South Asian countries, commissions or high-powered committees have already looked at the role of different entities. The problem is not so much one of identifying the nature of the restructuring program but of implementation, for which the requisite political will be required.

Improving transparency and accountability: This will require development of proper budgetary classification systems; institution of information disclosure requirements especially for parastatals, corporations and security agencies; setting up of proper oversight mechanisms with requisite powers and representation from the legislature, consumer bodies and civil society at large; mechanisms to ensure that spending is only for authorised purposes and establishment of a strong and independent legal and institutional framework for accountability of corruption and inefficiency.

Prioritising effectively among broad expenditures and programs: This will require focusing, first, on increases in non-wage operations and maintenance spending in key sectors, second, on rehabilitation of infrastructure and consolidation of existing investments through better utilisation of available capacity rather than expenditure on new investments in expansion of capacity, third, an increase of public expenditure in high priority areas like social development and poverty reduction. Somehow, through international diplomacy, bilateral dialogue and general public pressure, the costly and unsustainable arms race in South Asia will have to be stopped and military expenditure diverted to these high priority needs.

Decentralising management of public sector activities: Efforts will have to be made towards handing over functions to state / provincial and local levels wherever appropriate to achieve more efficient allocation of expenditures which more closely reflect peoples' preferences and to ensure greater beneficiary and community involvement in the management of the process of delivery of services. This, of course, implies that emphasis will also have to be placed simultaneously on developing the institutional and financial capacity of sub-national governments and borrowings by such agencies regulated in order to ensure that they face a hard budget constraint and do not engage in

profligate spending financed by accumulation of unsustainable levels of debt. It is of some significance to note that the Government of Pakistan has recently launched a major devolution plan for strengthening local governments.

Restructuring public sector institutions and service delivery: wherever possible the approach should be one of commercialising and corporatising public service delivery agencies. Greater autonomy will need to be granted to management boards of such entities and representation on these boards broadened to allow for greater civil society and consumer representation. There will also have to be more emphasis on cost recovery to create financial sustainability and degree of market based accountability. Simultaneously, independent regulatory entities will have to be set up for prescribing minimum service standards and tariff setting rules.

Reforming the civil service: The objective here is to develop a leaner, more effective civil service equipped with needed skills, facing an appropriate incentive structure and less vulnerable to political pressures. The remuneration structures will also need to be made more market-based. These will require changes in eligibility criteria for initial entry, greater role of public service commissions in the recruitment process, strengthening of public training facilities, introduction of ‘filters’ for movement to higher grades, improvements in the system of performance evaluation, independent process of confirmation to top level appointments and granting of tenure in such positions, development of more specialised cadres and so on. The experience is that civil service reform will be a slow and difficult process. Elements of the existing civil service who enjoy elite positions will form strong coalitions to resist change. Entry points into the process of reforming the civil service will need to be carefully identified which are less contentious in character but can make a significant contribution in the medium to long term to improving the quality of the service.

Strengthening monitoring and evaluation: systems will have to be established for monitoring impact on key output and performance indicators based on better, more timely information flows and a meaningful feedback into subsequent public expenditure decisions. Wherever possible, independent third party monitoring will need to be encouraged, for example, in the area of social services to

determine whether actual site selection of facilities adheres to certain pre-specified objective criteria, whether teachers, doctors, etc., are absent or present on a full-time basis and so on. In Pakistan, district level monitoring teams set up by the army have contributed to an improvement in the quality of services, but the issue remains one of long run sustainability of this approach.

Integrating planning and budgeting in a medium-term framework: Annual budgets and program allocations should be consistent with a medium-term planning framework and projections of fiscal resource availability. This will ensure that sustainable levels of recurrent expenditure drive sectoral investment programs rather than vice versa. This is especially true in the context of basic social services like primary education and health, which are intensive in operations and maintenance costs that are largely financed from tax revenues. In Pakistan, the rapid construction of primary schools and rural health facilities in the first phase of the ambitious Social Action Program, supported liberally by donors, has now run into serious problems of staffing and recurrent funds, especially for non-salary inputs. A balance will, of course, be required in the implementation of the medium term planning framework. On the one hand, there will be need for sufficient flexibility to adapt to changed circumstances while on the other hand there will have to be enough commitment and discipline in adherence to the targets and allocations in order to preserve credibility of the process.

Therefore, as identified above, key areas of public expenditure reform will include rethinking the role of government, improving transparency and accountability, prioritising effectively among broad expenditures and programs, decentralising management of public sector entities, restructuring public sector institutions and service delivery, reforming the civil service, strengthening monitoring and evaluation and integrating planning and budgeting in a medium-term framework.

Critics of the role of the public sector have suggested even more extreme solutions. These include, first, legislation (of the Gramm-Rudman type in USA) to preclude the possibility of deficit budgets or limit the deficit to a maximum level (as a percentage of the GDP). The intention here is to force an automatic downward adjustment in public expenditure in the event of a fall in revenues. Second, it has been proposed that as a rule no new projects should be undertaken unless all on-going projects have been

completed. Third, that a compulsory recruitment ban be imposed to prevent any increase in employment in the public sector and so on.

While there may be some merit to these proposals which highlight the growing frustration with the quality of governance, it needs to be emphasised that the intention of public expenditure reform should not be to put governments in a 'straight jacket'. The balanced budget amendment runs the risk that in order to satisfy this constraint governments may opt to make even deeper cuts in allocations to the social sectors or development. Inability to take on new project initiatives will reduce the flexibility of governments to respond to new situations and challenges. For example, the recent drought in parts of South Asia highlights the need to raise allocations quickly for achieving faster development and better exploitation of water resources. Institution of recruitment bans could frustrate the process of modernisation and better service delivery by governments. For example, there is clearly a need for more IT specialists and experts in other fields in most governments today. The overriding objectives of public expenditure reform must be to promote the process of institutional change which enables more rational budget making, more efficient utilisation of scarce public resources and improvements in governance that increase the responsiveness to the needs of the citizenry at large and reduce vulnerability to the pressures of powerful special interest groups.

In conclusion, it needs to be reiterated once again that while public expenditure reform remains one of the most difficult areas of reform, it perhaps constitutes the ultimate litmus test of improved governance and promises maximum gains to the economy and society at large. Therefore, it must continue to receive highest priority in any comprehensive structural reform agenda.

SUMMARY

The paper argues that while public expenditure reform remains one of the most difficult areas of reform, it perhaps constitutes the ultimate litmus test of improved governance and promises maximum gains to the economy and society at large. Key elements of the reform agenda are described in the paper including rethinking the role of government, improving transparency and accountability, prioritising effectively among broad expenditures and programs, decentralising management of public sector activities, restructuring public sector institutions and service delivery, reforming the civil service, strengthening monitoring and evaluation and integrating planning and budgeting in a medium-term framework.

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