

Public Expenditure Reform

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Public expenditure reform is a key element of the strategy for alleviating resource constraints in the aftermath of the Asian financial crisis. As a former minister of planning and finance, the present author has extensive experience in this area through his involvement in the preparation of various federal budgets and annual plans of Pakistan during the last few years. In addition, this topic affords 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 Southeast Asia.

The main effects of the Asian financial crisis on the South Asian economies were indirect or “contagion” effects. 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 an annual rate of 11 per cent between 1990 and 1996, showed growth of only 4 per cent in 1997 and a decline of over 3 per cent in 1998. Pakistan’s exports grew at an average rate of 10 per cent in the 1990s prior to the crisis, but declined by 3 per cent in 1997 and showed only a modest recovery of 4 per cent the following year. The consequence of the fall in export earnings was some loss of growth momentum. The average growth rate of the South Asian economies fell by almost 1 percentage point in 1997 from the long-term regional growth rate of 5.5 per cent.

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 — customs duties, sales taxes and so on — 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 remained stagnant in 1998, as compared to the rapid growth rate of 20 per cent over the previous six years.

The consequence of these adverse developments was a worsening of the fiscal situation in most South Asian economies. Fiscal deficits, which were already high in some countries, rose to virtually unsustainable levels, largely because the ratio of revenues to GDP fell while the GDP share of public expenditure remained sticky downwards. In 1997, for example, the central government budget deficit rose by over 3 per cent of GDP in India, by 2 per cent of GDP in Pakistan and by 5 per cent of GDP in Bangladesh.

Governments' inability to bring down the level of public expenditure in order to contain 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 of public expenditure reforms can be attributed to a number of factors. In developing countries where priorities are distorted by strong constituencies and lobbies in their favour, public expenditure allocations generally reflect the thorniest problems of the political economy and governance. 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 gain in the form of bribes. Rent-seeking activities flourish in the budget preparation process: once a privilege is granted, the favoured groups are unwilling to give it up even in times of financial stringency, while simultaneously other groups continue to jockey 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 on the ability of an administration to resist the pressures of special interest groups and to pursue what can be considered 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 the government but remain largely invisible to the public. Recent research has demonstrated that subsidies granted by the central and state governments in India — on energy consumption, agricultural inputs, social and economic services, bank credit, etc. — add up to a staggering 10 to 12 per cent of GDP. In Pakistan, the corresponding figure is estimated at 4 to 5 per cent of GDP, while the cost of tax expenditures is about 3 to 4 per cent of GDP. Ironically, only a small share of these subsidies is 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, such as large farmers, big business (e.g. the textile and steel lobbies), public enterprises and the military establishment. Despite considerable rhetoric on the need to protect the “common man” and to focus on poverty reduction, in practice the benefits of public expenditure are skewed towards the rich and powerful.

The experience of recent years has also demonstrated why it is particularly difficult to rationalise public expenditure when the economy is experiencing a downturn. Whatever cuts are achieved are essentially in spending on social sectors and on development, areas which are more discretionary in character but where budget cuts impair the country's future growth potential. The stickiness of public expenditure during times of recession is due to several factors.

First, there is the legacy of the post-independence historical process of most South Asian countries. In the presence of an underdeveloped and nascent private sector, the public sector was seen as the principal agent of nation building and promoting economic development, in addition to the colonial administration's traditional role of maintaining law and order and collecting revenue. Paradigms of the welfare state and central planning still linger in the minds of the people. As a result, the general expectation is that the brunt of any negative shock (like the Asian financial crisis) will be borne by the government and that the people will be insulated to the extent possible from the immediate and direct consequences of the shock. Public sector employment is thus 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 labour force in the public sector.

Furthermore, many actors hold the view that fiscal policy should be counter-cyclical in character to pull the economy out of recession, and hence that the level of public expenditure should be enhanced to raise the level of aggregate demand. Not only might such a policy add to the waste in public expenditure by encouraging programmes and projects of doubtful economic merit, but there is also a risk 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, thus crowding out private investment and largely neutralising the fiscal stimulus.

Second, the pursuit of rent-seeking and patronage activities is largely independent of the economic situation. If anything, demands for concessions and incentives are voiced more strongly 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 after the fall in international prices it implicitly subsidised exports 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 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 to privatise some of the public sector's manufacturing or service activities, the overall climate is not conducive to 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 to reform public expenditure has led to an increasingly bloated and overextended public sector in most South Asian countries. The presence of large fiscal deficits has sharply highlighted this feature of these economies. Overall, the public sector today misallocates resources, manages poorly and spends scarce public resources inefficiently. 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 world's largest concentration of the poor (almost 500 million) spends more than \$15 billion annually on the military, with India, Pakistan and Sri Lanka devoting more than 3 per cent of their respective GDPs to defence. For the current fiscal year, India and Pakistan have increased their defence allocations by 28 per cent and 11 per cent respectively. An indication of misplaced priorities is 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. Services are delivered mostly by line departments and parastatal organisations which are characterised by overly centralised management and a supply-driven approach rather than by responsiveness to effective demand. As a result of the priority given to employment, there is over-emphasis on wage payments in relation to non-wage inputs, which reduces the effectiveness of spending. Lumpy capital expenditures are generally preferred over operational and maintenance spending because the former leave 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 auditing. Reliance on cash-flow accounting alone means that there is inadequate knowledge of public assets and of contingent liabilities. The excessive "politicisation" of project selection and execution has rendered planning ineffective and has contributed to the process whereby development programmes are spread too thinly 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 reduced delivery of services and increased waste. Programme initiatives pursued by governments with populist agendas have the greatest potential for eroding the normal budgeting process and distorting priorities. Programmes like subsidised urban housing and transport have been demonstrated to be notoriously prone to leakages and defective implementation. They have frequently been abandoned owing to lack of financial sustainability, and the careers of many senior officials have been sacrificed at the altar of such programmes.

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

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 inadequate dissemination of information is especially acute in the case of statutory corporations and utilities, which account for the bulk of the “quasi-fiscal” deficit. Effective mechanisms for oversight by the legislature, consumers and civil society are virtually inexistent.

The consequence of misplaced priorities, lack of responsiveness to needs and preferences, and ineffective and wasteful service delivery is growing popular disillusionment with the provision of goods and services by government. Alternatives are being sought, and greater reliance is placed 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 are 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 accumulation of large overdrafts with the banking system and by deferring payments of liabilities to suppliers, contractors and so on. Government has had to bail out many of the large public utilities which provide vital services such as power, water and transport 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 the deterioration in service levels (frequent power outages, interruptions in drinking water supply and breakdowns in telecommunication services). In addition, the lack of adequate repairs and maintenance has led to visible deterioration of physical infrastructure.

A particularly worrying consequence of the 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 to defy tax laws through higher levels of tax evasion. This highlights the need for greater accountability of public expenditure, greater exercise of economy and in some cases earmarking of revenues in order to promote the development of a tax culture.

Altogether, a stage has been reached where, without radical reform of the public sector, the growth and development process in many South Asian economies will be retarded by the lack of social and physical infrastructure, which has begun to hinder private sector production and investment.

Challenges Confronting the Public Sector

The reform of public expenditures will have to take into account the many major challenges confronting developing country governments today, including those in South Asia. These challenges 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 to develop and manage infrastructure. This trend has been facilitated by the failure of the public sector. It is therefore necessary to create more space for private sector participation through deregulation and privatisation.

Globalisation. The rapid, ongoing 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. The rapid spread of the informal or underground economy in most South Asian economies has led to increased erosion of the tax base, theft of utilities or non-payment of utility bills, resort to smuggling or the sale of arms and drugs, and so on. The informal economy is reaching a scale where it now poses a serious threat to the writ of the state. Governments will have to devote substantial efforts to law enforcement 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 that governments need to focus on core functions and to shed peripheral activities.

Rapid technological change. The rapid process of technological change (including the advent of information technology) and the 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 professionally managed”. This will imply a change in the emphasis of governance from direct provision to effective facilitation and regulation, concentrating only on the provision of public goods, services which confer significant positive externalities and the important task of poverty reduction.

Key Areas of Public Expenditure Reform

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, reforms are required in at least eight major areas:

Rethinking the role of government. Implementing the new vision will require fundamental reconsideration of the role of government. Each function (and the entity discharging it) will have to be studied carefully from the following viewpoints: Is the public entity producing a public good or a purely private good? Is the entity facing competition from the private sector? Is it surviving only because of some special protection or preferential treatment? Is it so overextended that it can do no more than 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 encroach upon the 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 as to 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 have to be undertaken not only for government ministries and departments but also for statutory corporations, public enterprises, autonomous bodies and attached departments. This is clearly a mammoth task and may have to be undertaken in phases, starting with the more peripheral activities. The body charged with conducting this review will have to be seen as independent and impartial, and must be 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 various entities. The problem is less one of identifying the nature of the restructuring programme than of implementation, which will require substantial political determination.

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

Effective pursuit of priorities among broad expenditures and programmes: This will require focusing on increases in non-wage operations and maintenance spending in key sectors; on rehabilitation of infrastructure and consolidation of existing investments through better utilisation of available capacity rather than expenditure on new investments to expand capacity; and on increasing 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 to devolve central government functions to the state (or provincial) and local levels wherever appropriate, in order to allocate expenditures more efficiently, to ensure that spending more closely reflects the preferences of the people and to promote greater beneficiary and community involvement in the management of service delivery. This implies, of course, that emphasis will have to be given simultaneously to developing the institutional and financial capacity of sub-national governments and to regulating borrowing by such agencies, 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 that the government of Pakistan 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 entities. Greater autonomy will need to be granted to the 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 make these entities financially sustainable and introduce a degree of market-based accountability. Simultaneously, independent regulatory entities must be set up to prescribe 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. Remuneration structures will also need to be based more on market practices. These goals will require changes in eligibility criteria for initial entry, a greater role of public service commissions in the recruitment process, strengthening of public training facilities, the introduction of “filters” for movement to higher grades, improvements in the system of performance evaluation, an independent process for confirmation of top-level appointments and granting of tenure in such positions, development of more specialised cadres and so on. Experience suggests that civil service reform will be a slow and difficult process. Those who enjoy elite positions in the existing civil service will form strong coalitions to resist change. It will be necessary to identify entry points into the process of reforming the civil service, i.e. measures which are not excessively 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 meaningful feedback into subsequent public expenditure decisions. Wherever possible, independent third-party monitoring should be encouraged. In social services, for example, such monitoring could be used to determine whether actual site selection for facilities adheres to certain pre-specified objective criteria, whether teachers, doctors, etc. are 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 long-run sustainability of this approach remains in doubt.

Integrating planning and budgeting in a medium-term framework: Annual budgets and programme allocations should be consistent with a medium-term planning framework and projections of fiscal resource availability. This will ensure that sectoral investment programmes are driven by sustainable levels of recurrent expenditure, instead of having expenditure levels determined by the investment programme. This is especially true in the context of basic social services like primary education and health, which are intensive in operational 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 Programme, supported liberally by donors, has now run into serious problems of staffing and recurrent funds, especially for non-wage inputs. A balance will, of course, be required in the implementation of the medium-term planning framework: on the one hand, sufficient flexibility is needed to adapt to changing circumstances, while on the other there must be enough commitment and discipline in adherence to the targets and allocations to preserve the credibility of the process.

Critics of the role of the public sector have suggested even more extreme solutions than those enumerated above. These include legislation (along the lines of the Gramm-Rudman initiative in the United States) to preclude the possibility of deficit budgets or to limit the deficit to a maximum level as a percentage of GDP. The intention here is to force an automatic downward adjustment in public expenditure in the event of a fall in revenues. It has also been proposed that as a rule no new projects should be undertaken unless all ongoing projects have been completed, that a compulsory recruitment ban be imposed to prevent any increase in public sector employment, and so on.

While there may be some merit to these proposals, which reflect 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 straitjacket. The balanced budget amendment entails the risk that governments, in order to satisfy this constraint, may opt to make even deeper cuts in allocations to the social sectors or development. The 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 in order to achieve faster development and better exploitation of water resources. The institution of recruitment bans could frustrate the process of modernising government and

improving service delivery; in most governments today, for example, there is a clear need for more IT specialists and experts in other fields. 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 governments' responsiveness to the needs of the citizenry and reduce their vulnerability to the pressures of powerful special interest groups.

In conclusion, we should reiterate that while public expenditure reform remains one of the most difficult areas of reform, it may constitute the ultimate litmus test of improved governance and promise the greatest gains to the economy and society at large. It should therefore continue to receive top priority in any comprehensive structural reform agenda.