Policy Research Institute

Institutions matter for development

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It is commonly agreed that good governance is needed for development. There is less clarity on what good governance in terms of measurable indicators is and how best policy might be focused to improve governance. In an important piece of research, Daniel Kaufmann, Art Kraay and Massimo Mastruzzi of the World Bank seek to provide quantifiable measures of governance. The authors construct six aggregate indices of governance by which they are able to rank groups of countries by governance performance. These indices are updated on an annual cycle to measure progress. While laudable, the research has come under sharp criticism on both analytical grounds and measurement problems. As a result, there are doubts about their usefulness either for cross country comparison or for inter-temporal measure of progress. More importantly, the implications of these indices for policy dialogue and specific policy reforms at the country level are not clear.

My own view is we do not need sophisticated statistical techniques to measure governance as an input to policy reforms. Policy makers who are serious about seeking better development outcomes from improved governance may be well advised to take a much more pragmatic approach. In my view the main way governance affects development outcomes is through its impact on institutions. There is adequate empirical evidence that good institutions or lack thereof can boost or hurt progress with long term development measured in terms of rate of per capita income growth, reduction in poverty and improvement in human development. So, countries with strong institutions are likely to be strongly correlated with measures of good governance howsoever defined. These countries are also likely to have better long-term development outcomes than countries with weak institutions. Development partners likethe World Bank will get better results from their efforts to help client countries in improving governance by focusing attention on institutional development.

Webster Dictionary defines institutions as "an established order, principle, law or usage as an element of organised society or of civilisation". This definition essentially emphasises the elements of social order and rules for collective behaviour as opposed to individual behaviour for self maximisation. A wide domain of public interest fits this definition. So priorities need to be set to allow focus on a few key institutions that are likely to have the most impact on development at any point in time.

In the Bangladesh context, I believe there are four major economic institutions that, among others, have a huge impact on development. These are: (1) the national budget; (2) the banking system; (3) local government; and (4) land administration. It can also be argued that much of the concern with one critical dimension of governance, "the corruption problem", in Bangladesh is directly correlated with weaknesses in these institutions. So, a strategy for corruption reduction is not likely to work over the longer term unless the underlying weaknesses in these institutions are tackled. Each topic can be the subject of substantial discussion. Given space limitation, I will focus briefly on each of these institutions individually in a series of write ups. These brief articles draw on more detailed research I have published in the recent years. In this first article, I will talk about the national budget.

Impact of government budget on growth and poverty reduction: Arguably, the government budget is probably the most powerful established order, principle or law that affects the functioning of the modern society. The budget provides the government legal authority to tax earnings of a private citizen. Budgetary principles and laws influence the functioning of the markets in ways that no other single institution can possibly do in today's modern economy. Formulation of the budget reflects the multitude of political interests and coalition that underlie the political governance of a society. Having a voice in budget formulation and implementation is perhaps the most effective way of giving voice to the civil society to affect its well-being. It is therefore hardly surprising that the government budget is perhaps the single most important public policy instrument for influencing growth and poverty outcomes in modern economies, especially in developing countries.

The various ways through which the budget affects growth and poverty reduction are well recognised in the economic literature. For example, budgetary decisions through taxation, borrowing and spending affect incentives for business and household decisions in such key areas as savings, investments, exports and imports that have implications for employment and growth. Budgetary spending can also affect poverty through the direct provision or funding of core services and targeted poverty reduction programs. There is a rich body of empirical research that one can draw upon to illustrate the role of the budget in affecting growth and poverty reduction.

Management of the government budget has been an important challenge in Bangladesh. While there have been periodic slip ups, on the whole Bangladesh has maintained generally prudent budget management, financing fiscal deficits through concessional foreign assistance and avoiding major build up of expensive foreign and domestic debt. Nevertheless, the rising cost of the public debt needs to be watched and managed to avoid problems in the future. Regarding the structure of the budget, Bangladesh has done reasonably well in setting up its broad expenditure priorities with emphasis on human development and agriculture, but spending levels for human development and especially on infrastructure are woefully inadequate. This is a direct outcome of the fact that public resource mobilisation, especially tax resource mobilisation, has been chronically weak. Bangladesh has among the lowest tax effort, measured in terms of tax to GDP ratio, in the developing world. This, coupled with poor non-tax revenue performance, has resulted in very low total revenue for the government. This has constrained the ability of the government to adequately fund many of the core public services in health, education, water and infrastructure. At the same time, there is considerable scope to enhance the effectiveness of public spending. Expenditure management is weak in terms of public procurement, assignment of responsibilities by levels of government, expenditure tracking, monitoring and evaluation, and financial controls and accountability.

Link between weaknesses in budgetary management and corruption: Poor tax administration, especially income tax, controversial public procurement decisions, and weak monitoring of public spending can provide huge sources of rent. The scope for damage to the economy is enormously large. On the tax front, Bangladesh collects only 9.0 percent of GDP as taxes as compared with 17 percent in Sri Lanka and 18 percent in India. Even allowing for its lower level ofper capita income , the true tax potential in Bangladesh is likely to be in the range of 14-15 percent of GDP at the present time. The gap between this potential and actual collection is an indication of poor tax administration. Much of this loss is from income taxes, which is a mere 3.0 percent of GDP. The collusive behaviour between the income tax payer and tax administration officials is well known.

Regarding expenditure management, Bangladesh spends some 16 percent of GDP through the government budget. Excluding wages, interest and other transfer payments, an estimated 10 percent of GDP passes through public procurement. Sound procurement decision is essential to ensure that this money is well spent. There is substantial controversy about many procurement decisions irrespective of the government in power. The potential for corruption, especially in large procurement decisions, is large. Related to that is the limited ability to trace where the publicmoney goes in order to ensure that the money is spent well and on the intended purpose. Similarly, despite improvement in financial management, follow up to reports of financial irregularities is inadequate.

The Way Forward: Clearly, among the highest priority for better Budget Management is to sharply accelerate the revenue mobilisation effort through a well-thought out and comprehensive tax reform program. The recent effort to raise revenues and modernise the tax department is welcome, but much more bold reforms are needed. Careful thought needs to be given to the idea of an autonomous tax department in order to substantially strengthen tax collection and protect it from adverse political influence. Over the longer-term much of the tax collection should come from consumption (VAT) and income taxes and the reliance on trade taxes needs to be reduced to a minimum to avoid distortion of production and investment decisions and to promote export diversification. Within the tax department, highest priority needs to be given to the modernisation of income taxes. The incentive for corruption will be vastly reduced if the direct interface between tax payer and tax collector is eliminated through a system of self assessment, automated tax payments and rigorous audits

Procurement problems have been recognised by successive governments and a new Procurement Law was enacted in 2006 to streamline procurement procedures and install better safeguards. But implementation has been a problem. There is a controversy whether the focus on safeguards conflicts with flexible and timely implementation of procurement decisions. With careful management, there need not be any trade-off between these key aspects of a sound procurement policy. The key issue here is the government’s commitment to ensure that every taka it spends is spent well. A good procurement decision is a critical element of this commitment and the issues of flexible and timely procurement can be reconciled with this commitment.

Ensuring better accountability for public spending and stronger relationship with outcomes requires efforts to strengthen local governments and to assign them the responsibility for such services as basic health, education, water and sanitation. Related reforms include ensuring their financial solvency, ensuring that these governments have adequate capacity, establishing a system of accountability between beneficiaries, service providers and local governments, establishing performance monitoring and evaluation system, and oversight by the higher levels of government. This is a major challenge for Bangladesh as the conflict of interest between the parliamentarians and local government members is a serious political constraint to effective decentralisation.

Regarding public expenditure management, efforts underway to prepare a Medium-Term Expenditure Framework (MTEF) is a welcome development. The strategic content of the MTEF needs to be properly aligned to the government's poverty reduction strategy (PRS). The implementation of the MTEF, however, has a long way to go. International experience suggests that this can be a powerful tool to improve the effectiveness of public spending provided it is well implemented. This requires a serious effort, including enhancing the capacity of the Ministry of Finance and other line ministries to undertake this exercise, especially regarding ability to link the MTEF to the PRS, and update this as necessary. The underlying data needs (e.g. costing of sectoral programs) are quite substantial.

The effort to improve monitoring and evaluation (M&E) as a part of the PRS is a positive development, although progress is very slow. M&E needs are substantial and required for all government departments. Finally, despite recent progress with financial management, there remains a long-term agenda for strengthening financial management and accountability, especially at the local levels. Establishing adequate oversight of parliamentary committees and follow-up to the recommended actions are particularly important.

o conclude, a well managed national budget is a key institutional development challenge in Bangladesh. Ongoing reforms in taxation and expenditure management are welcome, but there is a long way to go. Bold reforms are needed to put this core institution on a truly sound footing. (The writer is a former Director, South Asia Region of the World Bank and now vice-chairman, Policy Research Institute, Bangladesh. He can be reached at e-mail: sahmed1952@live.com)