Proposed budget for FY2015-16 and public enterprise reforms

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The focus of this last of a three-part analysis of the proposed national budget for the fiscal year (FY), 2015-16, by this writer, is on the important issue of public enterprise reforms. Such state-owned enterprises (SOEs) present a substantial challenge to budget management by running large deficits, requiring substantial budgetary transfers. While much of these transfers go to the non-financial SOEs, more recently the state-owned banks (SOBs) are also encroaching on the limited budgetary resources to stay in business. The diversion of resources to finance these deficits has limited the ability of the budget to finance essential development programmes for infrastructure, human development and social protection. A reform of SOEs is therefore essential to achieve the growth and equity targets of the Seventh Five Year Plan.

The financial performance of SOEs is summarised in Table 1. Instead of earning a positive rate of return on assets, the SOEs have been running large operational losses. Much of the losses occur at the two energy enterprises: Bangladesh Power Development Board (BPDB) and the Bangladesh Petroleum Corporation (BPC). The only redeeming feature is the surplus earned by the Bangladesh Telecommunications Regulatory Commission (BTRC). But this is the outcome of monopoly rent it gets from control over the telecommunication air space and is not performance-driven.

As result of the rapid accumulation of deficits and investment financing needs, the outstanding debt liability of the SOEs has climbed from Taka 981 billion (10% of gross domestic product (GDP) in FY2012 to Taka 3254 billion (24% of GDP). This is a huge contingent liability of the Treasury emerging from the inability of the SOEs to cover operational deficits and finance own investments. In recent years the sharp deterioration in the non-performing loans (NPLs) of the SOBs is another source of contingent liability of the Treasury. The NPLs soared to Taka 308 billion in FY2014

Operational deficits of the SOEs and NPLs are causing a serious drain on the limited Treasury resources. Every year the budget is setting aside resources to finance the deficits of SOEs (Table 1). As an example, energy subsidies alone climbed to Taka 204 billion in FY2013 (1.7% of GDP). In the last few years, the Treasury has also been setting aside substantial resources to recapitalise public banks.

The adverse consequences for economic outcomes are obvious. In FY2013, total subsidy on energy was almost equal to the spending on education. Should Bangladesh spend scarce public resources for financing oil subsidies that are regressive in nature (the richer population gets a larger share of the subsidy than the poorer population) or for educating the children? Should Bangladesh divert tax payers' money to fill the hole left by bad lending decisions, theft and other corrupt practices in public banks or use those resources for financing social protection programmes for the poor? These are tough policy and ethical questions that need substantial debate in the national parliament, the cabinet and in public domain for speedy resolution.

Against the backdrop of these long-standing weaknesses of the SOEs, it is unfortunate that the FY2015-16 budget does not propose any reform. There is not even recognition of the need for addressing this major policy agenda. This lack of focus on public enterprise reforms in the FY2015-16 budget is a serious gap in policy-making and must be addressed in the future budgets. Below, I highlight the main points of what these reforms might be.

BPC REFORMS: The international crude oil price fell by more than 50% from its peak of about US$ 115/barrel in late June 2014 to below US$ 50 in January 2015. It has since recovered to US$ 63 in late June, 2015, but still remains significantly lower. This sharp reduction in global oil prices has provided an unanticipated bonanza to Bangladesh as its oil import bill has nearly halved and the operational deficit of the Bangladesh Petroleum Corporation (BPC) has been converted to a substantial surplus. While this is a comfortable situation, there is no room for complacency.

History suggests that international commodity markets including oil fluctuate substantially over time. The global food and fuel price crisis of 2008-09 is a stark reminder about the fragility of commodity markets and there is no guarantee that the present low international fuel prices will hold for ever. Importantly, the present comfortable situation, where domestic oil price exceeds the international oil prices, provides the government a unique opportunity to reform the oil subsidies in a sustainable manner. The risk of political backlash is minimal since the immediate effect of reform may well be a reduction in the average price of oil.

A primary reform objective would be to set up an oil pricing mechanism that is market-based. Domestic oil prices should be set in a way that allows the BPC to earn enough resources to meet all operating costs and earn a positive rate of return on assets. These earnings can then allow the BPC to meet its debt service obligations and finance investments from own resources. The resulting reform will essentially delink the BPC operations from the Treasury and thereby free up resources for priority spending in social sectors. If the government wants to protect the fuel oil consumption of the poor from the large upswing surges of global prices, mechanisms need to be developed that provides a limited amount of subsidy to the poor.

A second, longer-term objective would be to gradually free up the domestic oil market from state ownership and control. The strategic importance of fuel oil for the Bangladesh economy is not an issue. But this does not necessarily suggest state monopoly in the fuel oil market. In the early years after independence when private sector was undeveloped, private investment was limited and foreign reserves were low, there was a stronger economic rationale for state oil monopoly. Now that Bangladesh has graduated to low-middle income status, private investment accounts for 80% of total investment and 95% of domestic value-added, the capabilities of the private sector and the underlying domestic economic environment are vastly different.

As such, gradually but progressively Bangladesh can liberalise the oil market by allowing entry of private suppliers. This will not only reinforce the pricing reform and help delink the budget fully from domestic oil operations but also bring about important efficiency gains in domestic oil supplies. The strategic considerations and risk management can be done through proper regulatory policies including price setting through Bangladesh Energy Regulatory Commission (BERC). Bangladesh can learn from the experience of other middle income oil importing countries in this regard.

REFORM OF OTHER SOEs: Bangladesh has invested a substantial amount of resources in a large number of commercial enterprises dealing with a diverse number of goods and services. Except in the case of pure public good, the case for public provision of commercial goods and services is weak. Yet, if the government wants to continue with the SOEs, it must impose a hard budget constraint and require them to earn a rate of return on invested assets. Subsidies must be limited to a few strategic services (e.g. mass transit, water supply, sewerage) and most enterprises, especially manufacturing enterprises, should be converted to profit-making ventures through proper restructuring.

REFORM OF PUBLIC BANKS: International experience shows that in an environment of weak governance, state ownership of public banks will lead to serious misuse of these banks. In the absence of ownership, the bank management does not have any stake in its performance. Lack of accountability makes it even worse. The transitory owner of these banks (the government of the day) often finds it convenient to use them for dispensation of political favours or for financing loss-making enterprises and/or other politically motivated programmes. There is no incentive to improve performance because the burden of NPLs can always be shifted to the tax payers or to the next transitory owner (the next government).

In this environment of perverse incentives, the best course of action would be to privatise all public banks except one bank that would primarily handle Treasury functions. If privatisation is not a practical option, the next best option is to convert public banks into narrow banks that can mobilise deposits but cannot do any lending functions. They can use the deposits to invest only in safe assets, such as T-bills. The third best option is to keep them functioning as commercial banks but they should be required to perform on strict commercial principles and earn profit. The bank management should be held accountable for performance. These banks must be fully supervised by the Bangladesh Bank and required to comply 100% with all prudential regulations.