



Public expenditure strategy with focus on FY2015-16 Budget—I&II

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By *Dr. Sadiq Ahmed*

Seventh Plan fiscal policy: Setting the tone

Sadiq Ahmed in a paper presented at a seminar titled 'Fiscal Policy for 2015-16 Budget in the Context of the Seventh Plan' organised by the Policy Research Institute (PRI) on May 09, 2015 in Dhaka. The Financial Express was the media-partner of the event. This is the first instalment of the paper

The Sixth Five Year Plan is coming to a close on June 30, 2015. The Sixth Plan is the first

medium-term government strategy for implementing Vision 2021 and the Perspective Plan 2010-2021. The implementation of the Sixth Plan has important implications for defining the goals, targets and strategy of the Seventh Five Year Plan scheduled to start from July 01, 2015. The upcoming FY2015/16 Budget is the first national budget under the Seventh Plan.

In a market economy like Bangladesh where over 90% of the economy is owned and managed by the private sector and it accounts for 80% of total investment, government regulatory policies and the annual National Budgets are the two key instruments for implementing the five year plans. The annual Budget for the first year of a new five-year plan not only defines the government's current economic and social policies but also provides the most explicit statement of the government's medium-term strategic directions. In that regard, the forthcoming FY2015/16 National Budget is of paramount importance to setting the tone and directions of the fiscal policy for the 7th Plan.

This paper looks at expenditure management aspects of the Seventh Plan and the implications for the FY2015/16 Budget. The main objective of this paper is to provide some constructive inputs to the Finance Minister as he prepares to present the FY2015/16 Budget next month. The inputs are evidence-based, drawing from the lessons of experience of implementation of the annual expenditure programmes over the five years of the Sixth Plan (FY2010/11-FY2014/15).



RESOURCE AVAILABILITY AND BUDGET SPENDING: The trend in actual budget spending as compared with the budgeted level and the level projected in the Sixth Plan is shown in Figure 1. It is important to note that the GDP (gross domestic product) was revised upwards by about 15% by the Bangladesh Bureau of Statistics (BBS) in 2014 due to the rebasing of GDP estimates. As such, to enable a meaningful comparison, the government spending as a share of GDP that was projected in the Sixth Plan is adjusted with the revised GDP base.

The comparison shows some interesting results:

1) Total budget spending during the Sixth Plan more than doubled in nominal terms, growing from Taka 1015 billion in FY2009/10 to taka 2309 billion in FY2014/15, which suggests an

average annual growth rate of 18% in nominal terms and 10% growth in real terms. As a share of GDP, spending grew from 12.7% to 15.1% over the same periods.

2) Actual budget spending was in line with the Sixth Plan and the Budget target for the first three years of the plan period.

3) The Budget and Sixth Plan targets were consistent with each other in FY2013/14, but actual spending fell way short.

4) The Budget target and actual spending are both considerably below the Sixth Plan target for FY2014/15.

5) Actual spending is significantly below the Budget and the Sixth Plan for both of the last two years of FY2013/14 and FY2014/15.

Source: Ministry of Finance

In addition to implementation constraints, a major reason for the expenditure shortfalls in the last two years is the inadequacy of available resources (Table 1). Total budget resources grew by 2.4% of GDP between FY2009/10 (base year of the Sixth Plan) and FY2014/15 (final year of the Sixth Plan). As compared with this, the Sixth Plan projected an increase by 4.4% of GDP, which is 2% higher than actual. The shortfall happened owing to the inability to increase tax revenues to the extent necessary.

From the macroeconomic stability point of view, it is to the government's credit that they maintained fiscal discipline by adjusting expenditures to the revenue shortfalls. Fiscal deficit increased modestly and the sustainability of public debt is not an issue in Bangladesh (Figure 2). This contribution of fiscal policy to macroeconomic stability is a huge plus that must be acknowledged and celebrated. South Asian countries (Pakistan mainly but also India and Sri Lanka) have suffered considerably from long episodes of macroeconomic instability owing to lack of fiscal discipline and a growing burden of public debt.



Source: Ministry of Finance

Yet, the shortfall in budget spending is a part of the reason for the shortfall in the actual growth rate of GDP over the Sixth Plan target. Much of the spending shortfall happened in the area of development spending (Figure 3). While the Sixth Plan aimed at expanding the development spending by 2.7% of GDP (from 4.1% of GDP in FY2009/10 to 6.8% of GDP in FY2014/15, actual development spending increased by only 1.1% of GDP over the five year period of the Sixth Plan.



Sixth Plan and Annual Budgets

Another important issue on the financing side is the declining contribution of foreign financing along with growing volume of unused foreign aid pipeline (Figure 4) at a time when there are domestic revenue constraints to the expansion of the development spending. The more rapid use of the aid pipeline can help finance core public investments without creating inflationary pressure or crowding out effects of budget deficit.



Source: Ministry of Finance

SPENDING PRIORITIES: Along with the size of development spending and the way that public investment is financed, the composition of government spending and how well it is implemented are important determinants of the effectiveness of public spending on economic growth and poverty reduction. While development spending helps economic growth as well as human development through supportive public investments in physical infrastructure and human capital, current public spending on teachers, medical personnel and social security transfers can all have major positive impact as well. In this sense, the distinction between development and current spending is often not helpful. Yet, it is also recognised that some areas of public spending such as interest cost, general purpose subsidies, transfers to finance the deficits of state-owned enterprises and transfers to cover the non-performing loans of state-owned commercial banks do not normally contribute to

long-term development. These spending trade-offs can be specially challenging in an environment of resource constraints.

ECONOMIC COMPOSITION OF GOVERNMENT BUDGET: The economic composition of budget spending during the Sixth Plan is shown in Table 2.

* On the positive side, the wage bill and interest costs have basically remained under control, although a wage surge is expected in FY2015/16 with the implementation of the new wage award. Since this will add 1.3% of GDP, its management will present a challenge in the coming Budget.

* The subsidy budget has grown over the years. Much of the subsidy is on account of energy sector, fuel oil and electricity. At its peak energy subsidies reached 1.8% of GDP in FY2012/13. Price adjustments brought it down in later years. The recent large decline in international oil prices has given the budget a boon and oil subsidies have turned into a sizeable surplus for the Bangladesh Petroleum Corporation (BPC). The government has rightly decided to use the surplus for retirement of the large outstanding deficits of BPC. A major policy challenge for the 7th Plan will be to convert this into an opportunity to depoliticise oil prices and move to a market-driven pricing mechanism along with a competitive market for oil supply over the longer term.

* The financing of state-owned enterprise (SOE) deficits and budget transfers to cover the non-performing loans and thefts from public banks is taking a sizeable amount of budget resources (included in others and net lending component). This is a major policy challenge for the Seventh Plan. The government has invested a lot of money in SOEs. It is high time that a hard budget constraint was imposed on these enterprises and the government should require these enterprises to earn a positive rate of return on investment. Similarly, banking is a profitable enterprise and there is no reason why public banks should require transfers from the budget to stay afloat. The government can either require them to operate as commercial enterprises and be financially solvent or privatise them.



SECTORAL COMPOSITION: From a development perspective, the sectoral composition of

government spending provides important insights about the likely development impact of the budget. The main sectoral priorities of the expenditure programmes during the Sixth Plan in terms of actual implementation are indicated in Table 3.

Table 3 is a powerful indicator of the government's spending priorities reflected in the actual pattern of spending. It conveys a number of important messages:

- * On the whole, actual public spending during the Sixth Plan was broadly focused on sectors that are likely to have the most impact on growth, human development and poverty reduction. Thus, on average, the expenditure share of these sectors was around 70% of the total budget. This is reassuring.
- * Government spending on infrastructure has grown significantly from a low of 1.2% of GDP in FY2009/10 to 2.1% of GDP in FY2014/15. This is a positive development and reflects the high priority accorded to infrastructure. Yet, this is very inadequate compared to needs. The ability to increase GDP growth rate from the present 6.0 per cent level to 7-8 per cent range in the Seventh Plan will critically depend upon the ability of the government to increase development spending on infrastructure as a share of GDP.
- * Notwithstanding the priority given to human development, government spending on human development is very low and falling as a share of GDP. Instead of growing, spending on human development has fallen from 2.8% of GDP in FY2009/10 to 2.4% of GDP in FY2014/15. Education spending has fallen from 2.0% of GDP to 1.7% and health spending remains less than 1.0% of GDP. This compares rather unfavourably with other Asian developing countries like Vietnam, India, Philippines and Indonesia and quite poorly with advanced Asian countries like Korea, Malaysia and Thailand (Figure 5).
- * Spending on social protection increased during the 2000s from the low levels of the 1990s. But it stagnated at around 2% of GDP during the Sixth Plan, with a slight downward trends (1.7% of GDP in FY2014/15), as compared with the Plan target of raising it to 3.0% of GDP by FY2014/15. If the spending on civil service pensions is excluded, which is not really social protection spending for the poor and vulnerable, social protection spending declined to only 1.3% of GDP in FY2014/15. This is rather low for a country with an estimated poverty rate of 24.9% (39 million people) and extreme poverty rate of 12.6% (20 million people) in

FY2014/15.

* The main reason for these low levels of spending in priority sectors is the inadequacy of revenue resources. Under a tight resource situation, expenditure trade-offs become a real challenge. The policy choices can be illustrated from the experience of FY2012/13, when the spending on fuel subsidies soared to Taka 204 billion while spending on education was Taka 182 billion and health spending was a mere Taka 88 billion. Should the government spend scarce resources on oil subsidies that benefit the rich more than the poor or on health and education? Similarly, transfers to cover deficits of state-owned enterprises and public banks divert resources from expanding spending on education, health and infrastructure.

* The expenditure challenge for the Seventh Plan is obvious.

Source: World Bank Database and Ministry of Finance

Dr Sadiq Ahmed is Vice Chairman of the Policy

Research Institute (PRI). sadiqahmed1952@gmail.com

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Public expenditure strategy with focus on FY2015-16 Budget - II

Budget implementation challenges

Sadiq Ahmed in a paper presented at a seminar titled 'Fiscal Policy for 2015-16 Budget in the Context of the Seventh Plan' organised by the Policy Research Institute (PRI) on May 09, 2015 in Dhaka. The Financial Express was the media-partner of the event. This is the concluding installment of the paper

The inability to implement the budgeted ADP (Annual Development Programme) is partly

due to resource constraint but also a reflection of implementation constraints in line ministries. Similarly, the growing foreign aid pipeline is partly due to harmonisation issues relating to government expenditure policies and donor fund release policies, but also due to implementation constraints in the government.

IMPLEMENTATION CONSTRAINTS: The best reflection of this challenge is from the experience of the roads and railways sectors. Even though in FY2010/11 and FY2011/12, roads and railway sectors both received ADP resources as envisaged under the Sixth Plan, they spent significantly below their allocations. This improved in FY2013 and FY2014, but the expenditures still fell short of the allocations.

The Road sector is critical for ensuring the growth targets of Bangladesh. For example, a project like “4 Laning of the Dhaka-Chittagong Highway” should be considered as one of the transformational investments for taking Bangladesh to a higher growth trajectory. Yet the slow pace of implementation of such a transformational project is pulling back the GDP (gross domestic product) growth. As reported in the IMED (Implementation Monitoring and Evaluation Division) evaluation, this high priority project, which started in January 2006, was originally supposed to be completed by December 2013. However, as per IMED report, until June 2012 only 18.4% physical progress was achieved. This is due to over-programming of the roads sector. The roads division has 156 projects under implementation. The task of managing and monitoring such a large number of projects at the same time is stretching the implementation capacity beyond the road division’s limit.

The above example illustrates a major challenge facing the government for improving the planning, budgeting and implementing the ADP. The government needs to ensure that high-priority projects get completed on time and should require ministries to demonstrate satisfactory progress with physical implementation of ongoing projects before allowing new projects.

UTILISATION OF AID PIPELINE: As was shown in Figure 4, some \$17 billion of ODA (official development assistance) is available for use by Bangladesh. This stock of committed but undisbursed ODA involves highly concessional terms (long repayment schedule and low interest cost, estimated at about 1.0% on average). A major budgetary management challenge for the Seventh Plan is to accelerate the use of these resources. A focused review

of the main constraints can be used to inform the main policy needs for unlocking a more rapid use of these resources to serve the investment needs of Bangladesh. From past experience, government procurement and implementation capacities are important constraints to faster use of the aid pipeline that require quick resolution. The Annual Development Programmes (ADP) would also need to be made consistent with the availability of the ODA pipeline. Where the constraint involves development partners' policies, the government should engage in an open and constructive dialogue to resolve them. Finally, donor-funded older projects that no longer serve the development needs of Bangladesh could be restructured and the saved resources recycled to serve the current investment priorities.

EXPENDITURE MANAGEMENT CHALLENGES FOR THE SEVENTH PLAN: The experience of the Sixth Plan provides evidence on the need for some important areas for policy and expenditure management reforms during the Seventh Plan. A quantitative framework is provided in Table 4 to illustrate these reforms.



a) Size of government spending: As noted, the level of government spending increased substantially during the Sixth Plan in both real terms and as a percent of GDP. Despite this progress, total spending fell short of the Plan targets in the last two years. Given the large development requirements of the country, the size of government spending needs to increase substantially by six percentage points of GDP between FY2014/15 estimated actual and the target for FY2019/20. This is ambitious, but necessary, to achieve the development goals of the 7th Plan. Needless to say, the increase in spending should be financed within a consistent macroeconomic framework. Much of the additional spending will need to go to high priority spending on infrastructure, agriculture and rural development, human development and social protection.

b) Spending priorities- Increase spending on infrastructure: The infrastructure constraint to growth is well known. Therefore, infrastructure spending should grow by at least 2.0% of GDP, of which some 1.4% should come through the budget and an additional 0.6% should come from private contribution to the PPP initiative.

c) Spending priorities-Increase spending on agriculture and rural development: The high

priority given to this sector is appropriate. This needs to be pushed further to support the ongoing rural transformation in Bangladesh that has been highly supportive of poverty and extreme poverty reduction. This spending should be increased by 0.7% of GDP.

d) Spending priorities- Increase spending on human development: This is probably the highest priority spending item to achieve the Seventh Plan's goals relating to empowering people and reducing income inequality. Given the very low level of human development spending currently, this spending should increase by at least 2.6% of GDP, from 2.4% in FY2014/15 to 5.0% in FY2019/20. Without faster progress with human development, especially education, long-term income equality will not fall. Improvements in human development are also essential to secure and sustain GDP growth acceleration to 7.0% and beyond. International experience shows that the production base of a middle income economy entails higher capital intensity and skill intensity relative to a low-income economy.

e) Spending priorities-Increase spending on social protection: The government has adopted a new National Security Strategy. This is an excellent win-win initiative and the FM (Finance Minister) should be commended for his leadership role on this. The sound implementation of this is the highest priority during the Seventh Plan. Yet, it is recognised that even after best possible prioritisation of beneficiary selection, the size of the poor and vulnerable group is large and the average benefits are low. So, an important spending priority for the Seventh Plan would be to implement the government's unmet Sixth Plan commitment to increase the social protection spending to 3.0% of GDP by the end of the Seventh Plan.

FINANCING OF THE PROPOSED SPENDING STRATEGY: Any proposed government expenditure strategy must be financeable. The suggested financing plan is shown in Table 4 above. The bulk of the additional resources must come from government revenues in order to ensure the consistency of the spending strategy with macroeconomic stability. As during the Sixth Plan, the proposed expenditure strategy cannot be implemented if the required revenue mobilisation does not happen. In that event, there will also be corresponding shortfalls in the Seventh Plan's targets for GDP growth and human development as happened during the Sixth Plan.

In addition to tax revenue mobilisation, which is the key, the government should also consider reforming the oil pricing and market deregulation which will help delink the budget

from BPC (Bangladesh Petroleum Corporation) deficits, and reform state-owned enterprises and state-owned banks to earn a profit instead of requiring budget subsidies. These policies will free up scarce budget resources for use in education and health sectors where the spending gap is huge.

IMPROVING EXPENDITURE MANAGEMENT: There is a range of expenditure management issues. A few of the important ones were highlighted earlier. One important reform is to improve expenditure allocation mechanism by focusing initially on the full implementation of projects that are considered transformational in nature. Their timely implementation must be given the highest priority in both management and budget allocation. Secondly, implementation capacity constraint at the ministry/agency level must be considered as a critical variable for budget allocation. Third, the practice of allocating resources to the 1200 plus projects in the development pipeline should be revisited. Projects that are no longer a priority or have been in the pipeline for long period with little progress might be closed down. Fourth, a system of six monthly review of the foreign aid portfolio chaired by the Finance Minister and involving high-level decision makers of the main development partners might be undertaken for a few years until all outstanding portfolio issues are sorted out and foreign project aid utilisation improves. Finally, to avoid disruptive procurement problems for large infrastructure projects and recognising the prevailing governance problems that will not likely go away in the near future, the government might think of resorting to turn-key procurement arrangements for large projects involving multilateral donor funding.

IMPLICATIONS FOR THE FY2015/16 BUDGET: The spending reforms are not one-time quick fixes and involve major sustained progress over the medium term. Yet, the coming FY2015-16 Budget is the first year of the Seventh Plan implementation and needs to provide the signal about the government's thinking and strategy for expenditure reforms during the Seventh Plan.

A first recommendation is that the FY2015-16 Budget should provide the broad policy framework underlying the medium-term expenditure strategy for the next five years. This will reflect the government's own thinking but might also pick up some of the suggested policy reforms regarding oil pricing, public enterprise management, management of public banks, emphasis on transformational projects, use of implementation capacity as an instrument of expenditure allocation and the use of turnkey procurement for large multilateral donor-

funded projects.

Second, the size of the Budget will likely go up by about 1.0-1.3 % of GDP owing to the implementation of the wage increase award. There should be at least another 1.0% of GDP increase in spending on priority sectors. In nominal terms, the FY2015-16 Budget should grow to about Taka 3000 billion, as compared with Taka 2300 billion spent in FY2014/15. To avoid an adverse effect on domestic inflation, these proposed increases in total budget and high priority sectors should be financed by a strong tax mobilisation effort, through better utilisation of foreign aid pipeline, and by reducing low-priority spending (transfers to public enterprises and public banks, block allocations for unplanned spending, etc.).

Third, the Budget should give a clear indication of government's spending priorities by increasing the shares of resources allocated to priority sectors. Energy and transport have already been the focus of past few budgets and their expenditure allocations as a share of GDP have been growing. Also, the allocations for agriculture and rural development have not fallen as a share of GDP. These priorities should be maintained in the forthcoming Budget. But allocations for education, health and social protection have been falling as a share of GDP and as such these should be increased as a percent of GDP. The additional 1.0% of GDP increase in spending outside the wage increase should mostly be provided to these three priority areas.

Fourth, the Budget should seek to increase the use of foreign aid pipeline. For example, the annual disbursements are around \$2.0 billion as against a growing pipeline of \$17 billion. Using an average project life of five years, it should be possible to increase annual disbursements to at least \$3.0 billion. The additional \$ 1.0 billion of aid use will help increase development spending on priority sectors by 0.5% of GDP in FY2015/16.

CONCLUDING REMARKS: The government's prudent fiscal management is commendable and has contributed to macroeconomic stability. Another positive aspect of the budgetary management is the relatively low cost of government employment and public debt. These have helped preserve the limited fiscal space in a very tight resource situation. The government's spending priorities are well founded, although there is scope to do better by delinking oil transactions from the budget and requiring state-owned public enterprises and state-owned commercial banks to earn a profit instead of subsidies. The very low level of

spending on priority sectors is more a reflection of inadequacy of resources rather than absence of political commitment. For FY2015-16 Budget the four main recommendations are (a) to raise public revenues; (b) increase spending on health, education and social sectors as a share of GDP; (c) increase the use of foreign aid pipeline and (d) provide a clear statement of expenditure reforms for the Seventh Plan along the lines suggested in this paper.