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# FEATURES

## Cutting Government Expenditures in LDCs

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*In this paper Hicks and Kubisch working in the Country Policy Department of the World Bank, summarize a longer study they carried out entitled "The Effects of Expenditure Reductions in Developing Countries".*



In times of economic austerity, governments are often faced with declining revenues and political constraints on increasing taxes. Thus, the overall need to reduce consumption and investment is often reflected as a need to reduce government expenditures. However, relatively little is known about how governments make expenditure decisions, or how they trade off between consumption and investment or between sectors and categories of expenditures. Anecdotal evidence suggests that officials follow rather ad hoc rules for making large contractions in a short period of time cutting new rather than ongoing projects, new rather than present employment, materials and travel expenses rather than personnel, and favouring ministries that are politically powerful or reducing those that had expanded most rapidly in the past. Some sectors are often thought to be more vulnerable than others to reductions; social sectors, particularly, are usually considered more, and defense sectors less, susceptible. In general, programs, once enlarged, seem difficult to reduce, particularly if they generate large employment benefits. Likewise, governments appear unwilling to reduce areas that are supported by foreign assistance, both because they fear antagonizing aid donors and for the more practical reason that the savings from such expen-

diture cuts are significantly less, since aid is also reduced prorata.

Despite these generally rather strongly held views and such circumstantial evidence, little empirical investigation has been made on the vulnerability of different sectors to reductions in public expenditures.

### The Study

In an attempt to identify a common pattern in budgetary cuts, this study used a simple formula to isolate sectors that suffered cuts either less or more than the average in countries where bad times had led to budget reductions. Using data from the Fund's Government Finance Statistics Year book for 1972-80, 37 cases were identified (involving 32 countries) where real expenditures declined in one or more years.

The results, based on an aggregation of the results from 37 observations, showed an average decline of 13 percent in real government expenditures, while the decline for the social sectors was only 5 percent, producing a vulnerability index of 0.4. By contrast, the index is 0.6 for administrative /defense sectors and over 1 for production and infrastructure. The social sectors were less vulnerable to cuts than defense

and administration, and considerably less vulnerable than production and infrastructure - contrary to the generally accepted view. The fact that social sectors and defense were both relatively protected suggests that there were high political costs associated with reducing spending on them. On the other hand countries appeared to have been more willing to cut spending on infrastructure and production, which had adverse implications for long-term growth prospects, but clearly fewer direct and immediate political costs.

These conclusions were not very different for countries belonging to different income groups. The low-income countries appear to have afforded slightly more protection to the social sectors and production, and slightly less to administration and defense but the differences were marginal. The middle-income countries, by contrast, gave more protection to administration and defense and less to the productive and infrastructure sectors.

### Political and economic costs

The apparent bias toward maintaining expenditures in the social sectors may reflect a preference for present consumption over investment and future consumption, since social sectors typically have a heavy bias toward recurrent expenditures, and within these there is a sizable employment component. Politicians may find it more acceptable to reduce investment, growth, and future consumption, particularly if these reductions are uncertain and far off, than to make politically difficult cost reductions in present consumption. Since the social sectors are relatively labor intensive, with high recurrent costs, reducing expenditures on them not only cuts basic services highly valued by the public, it also causes relatively high unemployment per unit of reduction.

By contrast, recurrent expenditures can often be reduced in the productive sectors and infrastructure by eliminating subsidies rather than jobs. In times of economic stringency, governments often adjust pricing mechanisms to eliminate the budgetary burden of subsidies for such items as food, fertilizer, and electricity. Thus, cuts in productive areas may not reduce actual output. Eliminating subsidies, however, does carry its own political costs—the reduction in food subsidies led to demonstrations in Egypt, Morocco, Sudan, and Turkey, for instance.

On the other hand, underfunding recurrent expenditures in infrastructure and production could lead to considerable real economic costs in underused or poorly maintained infrastructure, such as roads or irrigation works. In Zambia, for instance, total government expenditure declined by 38 percent in real terms between 1975 and 1981.

The traditional reason given is that recurrent items are viewed as consumption expenditures taking away from savings and investment; foreign donors, particularly, prefer projects that promote investment and growth, emphasizing capital rather than operating costs. When donors require matching funds from local governments, these are also directed to capital expenditures, which exacerbates this bias. Further, donors invest in areas with high future recurrent costs—health, education, transport, and communications—that cannot usually be funded from foreign assistance. This frequently creates new capital capacity, while existing capacity remains underused because of recurrent cost underfunding.

The results of this study indicate that when faced with difficult choices in reducing public expenditures, governments consider a wide range of factors, including political and economic costs, present versus future consumption, and the potential impact on employment, distribution, and welfare. The empirical evidence suggests that when governments in developing countries implement austerity programs, they do not apply across-the-board reductions in expenditure. Generally, capital expenditures are reduced more than are recurrent expenditures. Within both capital and current budgets, the social and administration/defense sectors appear to be relatively well protected, while infrastructure and production absorb disproportionately larger reductions.