

HOW SHOULD THE STATE REACT TO THE CURRENT PUBLIC FINANCE CRISIS: CUTS VERSUS EFFICIENCY IMPROVEMENTS?

Markéta Šumpíková – Marta Orviská – Juraj Nemec

Abstract

The world economy and particularly the advanced economies had slowed substantially in 2008, but have gone into deep recession in the following years. Some signs of returning to positive growth are visible from 2010, but recent fiscal problems of many countries signalise that “the problem might not be over”.

In our paper we first try to show the principles and character of the current crisis. Then we focus on its current phase that might be named “public finance crisis”. The core part indicates that between many existing solutions the states shall focus on improving efficiency and effectiveness of public expenditures. Too many “black holes” still persist in all areas of public financing, “fixing” at least some of them may significantly help to balance fiscal results of market economies. But far above all these affairs stays a question about the moral principles and the inner values of the economic agents (of us), which are the true causes of the actual state.

Key words: public finance crisis, reactions, cuts, efficiency, moral principles

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Introduction

Massive government interventions to cope with the economic crisis, decreasing governmental revenues during the economic crisis and long term non-sustainability of public finance systems (pending pension reforms, increasing health care expenditures, etc.) opened the trap, where first small economies have fallen.

Hoggart, Reis, Saporta (2001) estimated the fiscal costs related to the financial crisis, mainly systemic as 12.1 per cent of GDP in the developed countries and 17.6 per cent of GDP for transition and developing countries. In case of the Asian financial crisis they estimate these costs on the level more than 40 per cent of GDP for Indonesia and Thailand. However,

that was then, that was a financial crisis largely limited to emerging economies in Asia and South America. This current crisis is different, different in its impact and different in its scale.

The future in this complicated situation is non-predictable, but at least it is now visible that not only symptoms, but core problems need to be treated in the world economy (our simplified model in the next part indicates several risks if such treatment will not occur).

1 What responses to crisis and what are their results?

The future in this complicated situation is non-predictable, but at least it is now visible that not only symptoms, but core problems need to be treated in the world economy. EU and its member countries adapted in 2011 – 2013 several political and legal documents with focus on fiscal discipline – however, their future impacts are questionable, if economies do not start to grow.

The response to the economic crisis has been partly a global one, through measures such as increased resources for the IMF and policy co-ordination between central banks on monetary policy and to an extent between national governments on fiscal policy.

But, this deficit spending and process of quantitative easing cannot carry on indefinitely. It will have to be paid for and that means constraining spending and increasing taxes in the years to come. This will have an impact, in some countries a very large impact, on all areas of government spending in all countries. This problem was largely hidden at the moment, as the emphasis was on avoiding a prolonged economic recession, but many authors (for example (Dvorak, 2010) in our conditions) immediately warned that it will have an increasing effect. Today we can clearly see that the negative estimates of future trends are to large extend a present reality (see more for example (IMF, 2013)).

2 The most important available choices and their potential impacts

Two standard types of measures (and their combinations) are hypothetically available for any government to cope with the fiscal problems (plus several “non-standard” tools, like inflation or property sale): increasing taxes and decreasing expenditures.

Both of them have been and are used by almost all governments involved. However, from the point of view of a standard economic theory it is not very advisable to increase the level of taxation during the recession or early recovery period. Moreover tax increases might be even more unpopular than well argued and realized expenditure cuts. Thus, our meaning is that the main focus should be on expenditure side, where again, according to the

theory, two options exist (i) lump sum (cross-sectional) expenditure cuts and (ii) efficiency and effectiveness improvements.

The hypothetical choice between these two options is very simple – focus on efficiency, because of the large scale pervasive effects of any lump sum cuts (limiting consumption, scale of services provide, etc.). If such assumption is accepted, than two important questions appear: (A) Could efficiency improvements really help to balance public finance system? (B) Do governments have capacity to realize large scale efficiency gains in the public sector? In this paper we focus mainly on the first issue, our goals is to bring the evidence that very important sums could be saved by improving the performance of our governments.

Improving efficiency should mean to work simultaneously (as minimum) in two directions (see for example (Stiglitz, 1997)): (i) improving allocative efficiency of government – to use “proper amount” of public resources for “proper goals” (effectiveness); (ii) improving technical efficiency of government – minimization of inputs for planned outputs or optimizing the relation between inputs and outputs (economy and efficiency). Both directions are necessary and “technically possible”.

“Allocative efficiency”

Improving allocative efficiency might be the core but also really difficult goal, because of many facts. First, as of today, almost in all CEE (and not only CEE) allocative decisions are based on political arguments and not on evidence based policy making processes (discontinuity of government policies after changing governments, creating new and new “reform” strategies always when new “bosses” enter the office may be some facts underpinning such statement). Second, a large proportion of CEE (and not only CEE) citizen is still much close to paternalistic attitudes, not ready to bear needed individual responsibility for their decisions and situation. Third, many allocative decisions will be painful – for example many CEE governments promised to citizen “free and excellent health care for everybody” for many years of transition – how to explain to citizen today that this goal cannot be achieved (and was not realistic all the time)?

We argue that all existing public expenditure programmes have to be re-evaluated and all newly proposed public expenditures (including indirect and non-monetary) carefully ex ante evaluated (Stiglitz, 1997). Many of them are not necessary and just increase financial

burdens both for the state and the private sector. In any case all major expenditure areas should and would change in short future.

Pension systems have to be reformed to respect basic economic precondition of their existence that is not respected now by most of them (see for example Barr and Diamond, 2006):

$$\Sigma \text{ of economic active citizen } \times \text{ level of contribution} = \Sigma \text{ of pensioners } \times \text{ level of pension benefits}$$

Health care system asks for more and more resources – one of solutions is increased proportion of private finance involved to finance health care. It is difficult to estimate what should be the future optimum ratio of the involvement of the state; moreover such global and universal ratio does not exist. Health systems in Europe should guarantee universal access to “basic package” of care to all and such goal can be financed only by combining public and private resources on the base of principle of solidarity between rich and poor and between healthy and ill. In any case, functional private finance based co-insurance schemes still need to be developed in most CEE countries – as discussed for example in summer 2011 in the Czech Republic.

Higher education is still formally free for example in the Czech Republic or Slovakia. We feel that such solution would be not sustainable in future – moreover, if the high education is “only” positive externality, the role of the state is to provide subsidies and not public schooling (see for example (Stiglitz, 1997)).

The current situation could be documented by the following examples of allocative inefficiency: the Czech and Slovak Army purchasing not needed technologies; the Czech Railways reconstructing local rails that will not be used for transport (at least during next few years); almost 20 per cent of GDP spent for health care in US, etc.

“Technical efficiency”

Improved technical efficiency might be simpler to achieve – many important discussions in this direction already started. As of today too many standard mechanisms, supporting economy and effectiveness are not properly implemented in CEE region, especially: (i) improving public procurement systems (our estimate is that only this source can provide extra 1 – 2 per cent of GDP in the form of savings); (ii) modern accounting systems, based on accrual and full costs approaches, providing fair data about real economic situation of public bodies, allowing for cost centers management to be able to compare full real costs to outputs (if possible also outcomes and results); (iii) improved financial management; (iv) real public

private civil sector mix; (v) modern e-governance tools and effective implementation of modern, results based methods of public sector control and audit are core elements of the infrastructure for such changes.

Public procurement

Public entities spend on public procurement large sums to purchase goods, services or to construct public works. The possibility to supply to the state is very good chance for private suppliers to sell their products or capacities in relatively “safe market” (in all developed countries the business with the state is the most safe part of the commercial operations – the state may be late, but will pay). Supplies are not only with limited risk but also normally have repeatable and predictable character what is really important for economic operators.

The data (OECD, 2011) show the largest shares of public procurement market in Netherlands, the Czech Republic and Slovak Republic. They spent over 15 % of GDP by way of public procurement transactions in 2008 year (excluding state – owned utilities) and around 25 % of GDP when state – owned utilities are taken into account. The data indicate that transitional economies spent via public procurement more than more developed states.

As response to the economic downturn, the majority of OECD member countries launched fiscal stimulus programmes often related to the infrastructure projects. It increased procurement activities between 2006 and 2008 relative to their GDP in many of OECD countries, except the Czech Republic, Slovak Republic, Hungary, Turkey, Switzerland and Luxembourg, where the proportion stayed unchanged.

The size and character of public procurement market makes this market very popular and interesting to all economic operators, to large extent also in developing countries (where the state might be less stable compared to developed world). Private firms want to supply to the government and might be ready to compete for public orders also in unfair way.

The existence of corruption in public procurement is more or less natural feature of all modern societies. The question is not “yes or no”, but the size and scale of corruption in public procurement. The purposes of corruption in public procurement have natural but also subjective character.

Public officials are normally not very well paid in developing economies and may need extra incomes to “safe” their living standard. With this, private interest may outweigh public needs and public services principle, especially in less developed public procurement systems that are not transparent enough. Or just effective incentives to motivate public

servants to serve to public interest might not be in force. In such situations allocative (what to buy) and technical (for how much to buy) efficiency of public expenditures cannot be achieved.

Private firms and public officials have very good chance to share so called “volume discount” and not to leave it to the state. The normal level of volume discount in private business might be 10 per cent from desk/list price or even more. In private business this discount is kept by purchaser, in public procurement should be revenue of the state, but this does not often happen. Situations when the prices achieved by large procurer (the state) by any procurement method are on the level (or above) of basic desk/list prices indicate that something went wrong. However such situations are still really frequent and normally not reported (simple probity audit cannot recognize them).

The last objective purpose of corruption in public procurement (all these purposes cannot be fully eliminated) is connected with the fact that procurement official and representative of supplier do not have incentives to report corruption. They both infringe the law (directly or indirectly) and both benefit. In situation of sophisticated public procurement corruption (corruption occurs but the law is not broken) only dissatisfied suppliers may have some interest to touch the problem. If economic subjects are afraid to do this (loosing chance to win next tenders as unofficial “black list” members) there is almost no chance to discover that something went wrong.

Except of many objective and not fully eliminable reasons for pertaining corruption in public procurement there are also many subjective purposes why corruption might flourish. Most important of them are gaps in legislation (primary and secondary); non-existence of guidelines and standard forms; lack of experience of all actors of public procurement process; insufficient use of project management methods and approaches in public procurement; lack of interest of general public to public procurement problems; underdeveloped market environment; underdeveloped legal environment; old-fashioned public financial management methods; old-fashioned public financial audit methods, especially dominance of probity audit and lack of value for money audit; lack of political support to clean procurement, etc.

The interesting estimations for public procurement losses in the Czech Republic have been published in connection with preparation of new public procurement law in 2011. The experts expect that 10 - 20 per cent savings in public procurement are target that can be very simply achieved by improving the system. This may mean that about 3 per cent of GDP is available for more effective use. Transparency International Czech Republic estimated the losses in public procurement already in 2007 on the level of 1.6 bil. USD. The unpublished

research data of the Transparency International Slovakia suggest that the risk of corruption in the realization phase of the process is over 90 per cent.

Improving financial management in the public sector

The reference book for many aspects of public financial management in CEE is (Allen & Tommassi, 2001). It is already ten years old, but not much really improved. Moreover, several mechanism implemented at least in some countries of our regions do not deliver expected results. Program performance budgeting, benchmarking, outsourcing and contracting and performance evaluation and financing are still really underdeveloped.

For example (Merickova, 2010) provide in depth analysis about contracting of local public services in Slovakia. Their data indicate (as confirmed by (Pavel, 2009)) that municipalities do not decide about contracting properly, also because they do not have real data to be used.

With respect to the performance financing, we provide one example – financing of universities in Slovakia. The expectation was that the switch to financing by the allocation formula would motivate schools to focus on quality and not so much on number of students. Reality was fully different; all schools reacted by the significant increase of newly accepted students. Significant increase of newly accepted students might be the positive fact, but because the total amount of allocated resources increases very slowly, marginally “faster” than inflation, the outcome is tragic – the grant per student decreased significantly during last 5 years. “Performance trap” was established. With less unit resources the quality was sacrificed (well documented by the national ranking agency ARRA). The government reacted ex-post and started to increase weight of scientific results in the formula (from 5 per cent at the beginning to 40 per cent today).

The explanation of purposes for such failure is simple. The management of a university was allowed to maximize the level of the public grant by maximization of a number of accepted students. This also really happened. The only open question is – was such planning mistake by the government intentional or caused by the lack of experience?

Real public private civil sector mix

The basic theoretical ideas connected with pluralisation of delivery of public services were described already in late nineteen’s (see for example (Cullis & Jones, 1992)). The main principle is careful move from classical system of delivery of public services by enabling

private (for profit and not for profit) sector to be involved into all processes connected with provision of public services, and to some extent also with provision of social welfare.

Traditional delivery when the service was financed from public funds and produced by public institutions (A) is replaced by more tier system, with clear border between financing, procuring and producing functions. The basic principles of modern public – private (- civil sector) partnerships in delivery of local public services and other public tasks thus are: (i) the state remains responsible for delivery of public services or for public infrastructure – responsible for provision; (ii) financing of public services or infrastructure can be partly or fully switched to private sources (consumers, private firms and financial institutions); (iii) potential suppliers of any ownership type have the right to compete for the right to deliver/ produce the public service or to build and maintain public infrastructure; (iv) there is no one uniform solution how to deliver public tasks valid infinite and everywhere. Concrete decisions for concrete environment shall be made.

Purposes of limited success

The need to improve the public sector performance is critically obvious already for more 5 years, but not much has been done. Almost all governments have really capacity to realize large scale efficiency gains in the public sector. Why? We provide two possible arguments.

For any government it is difficult to realise efficiency measures that impact the situation of electorate. Because of fiscal illusion factor, citizens are ready to oppose most changes and block them.

May be the most important issue today is lack of morality. The very failures in morality are exactly the same failures which caused the financial crisis, the corruption and other above described negative affairs, just on a much larger scale. In compliance with Adam Smith (1784, 1759), if every economic agent would manage himself properly within his small sphere of influence, the cumulative effect would be profound.

Conclusions

The recent global crisis will be not so simple to “overcome”, especially if voices of “pessimists” about systematic crisis are close to reality. In any case, most governments in the world, and all governments in our region have to revitalize their public finance.

Our paper argues that the best way to balance revenues and expenditures are efficiency improvements. According to our estimates up to 5 per cent (or may be even more with more

pessimistic approach) of GDP is wasted because of allocative and technical inefficiencies in our public sectors. Possible solutions are very well described by the standard literature; the core problem will be morality and implementation capacity of respective governments.

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Contact

Marketa Sumpikova

University of Economics in Prague

W. Churchill Sq. No. 4, Prague, Czech Republic, CZ – 130 67

Mail: sumpik@vse.cz

Marta Orviská

Matej Bel University in Banská Bystrica,

Tajovského 10, Banská Bystrica, Slovak Republic, SK – 975 90

Mail: marta.orviska@umb.sk

Juraj Nemeč

Faculty of Economics and Administration, Masaryk University in Brno

Lipová 41a, Brno, Czech Republic, CZ - 602 00

Mail: juraj.nemec@umb.sk