

Overcoming Obstacles to Macroreform

- 38 The previous section dealt with some institutional, political and social obstacles to the reform process. However, at the heart of the reform process itself are fiscal and monetary issues which themselves present their own difficulties. This section discusses some attempts to overcome these difficulties.
- 39 Governments have had to reduce aggregate spending and fiscal deficits due to serious macroeconomic imbalances. The reform record shows particularly disappointing fiscal outcomes in sub-Saharan Africa. A World Bank review concluded that over 60 per cent of the countries had a poor or very poor fiscal stance, defined in terms of sustainable fiscal deficits. Only a few African countries made some progress in improving allocative efficiency and equity of expenditure composition. The evidence also points to gross technical inefficiency in the use of expenditures, manifested in the widespread incidence of 'ghost' workers, moonlighting and the collapse in the delivery of basic services, etc.
- 40 At the same time, reviews of budget reforms in OECD countries point to two key Commonwealth countries – New Zealand and Australia – as being at the cutting edge of these reform efforts. Their reform experiences illustrate how institutional arrangements – rules, norms and procedures – governing the budget process affect incentives governing the allocation and use of resources. These countries have been found to be successful in slashing expenditures and deficits where most have failed.
- 41 An examination of how these two countries reformed their institutional structures to achieve their fiscal objectives could be beneficial to other members of the Commonwealth. Malawi is reportedly making efforts to emulate the Australian experience.
- 42 Expenditure outcomes can conveniently be categorised into three basic objectives that any system needs to achieve:
- (i) to instill aggregate fiscal discipline;
 - (ii) to facilitate strategic prioritisation of expenditures across programmes and projects; and
 - (iii) to encourage technical efficiency in the use of budgeted resources, i.e. achieve outputs at the lowest possible cost.
- 43 Aggregate fiscal discipline is impeded by the "tragedy of the commons." The several claimants to the budget – interest groups, legislators, line ministries – each exert pressure to bias spending in direction of their preferences. Each demands a level of spending in excess of what is socially optimal. In the absence of constraints on the aggregate level of spending and deficits, meeting the demands of disparate claimants will result in large unsustainable deficits that translate into an unstable macroeconomic environment which can ultimately retard growth.

- 44 New Zealand, on the eve of reforms, has been described as a heavily interventionist state not dissimilar to the former Eastern European centrally-planned economies with a socialist-leaning party in office. The initial conditions and the bold reforms confirm the oft-made observation and common experience that macroeconomic crises generally induce governments to confront and scale down the deficits.
- 45 In four general stages embodied in the State-owned Enterprise Act (1986), the State Sector Act (1988), the Public Finance Act (1989) and the Fiscal Responsibility Act (1993), New Zealand embarked upon radical institutional reforms that sought to completely redefine the role and revamp the functioning of government. In the process, New Zealand provides arguably the most dramatic example of accountability and transparency mechanisms which bind the government to aggregate fiscal discipline.
- 46 The defining characteristic of the new system of financial management is the distinction between the government's ownership interests in state agencies and the 'purchase' of specified outputs. A steady shift to accrual accounting for public sector agencies was envisaged. Input controls were relaxed in favour of increased accountability for meeting agreed objectives. The reform of the institutional arrangements for state involvement in the economy increased the credibility and medium-term focus of macroeconomic policy, enabling the rapid attainment of macroeconomic stabilisation at minimum cost.
- 47 The contract of the Governor of the Federal Reserve Bank of New Zealand with the Minister of Finance is explicitly linked to inflation. The Fiscal Responsibility Act in turn binds the Minister of Finance to aggregate fiscal discipline – cutting the deficit to 1 per cent of GDP. Further, the Act requires the government to commit itself to aggregate fiscal targets through full and frequent disclosure of information. The Act thus provides the basis upon which performance is to be judged and thus upon which both compensation and tenure of the Minister depend. Moreover, the open financial market serves as a disciplinary force in a way comparable to the effect of stock markets on corporate management.
- 48 Given aggregate fiscal discipline, the next key challenge is the strategic prioritisation of the competing claims on resources. Prioritisation is essentially a political process. Politicians may attempt to set priorities on the basis of their understanding of the preferences of their constituencies. Unavoidably the underlying problem is again the tragedy of the commons which creates demands in excess of available resources. This creates a situation in which individuals and groups strive to restructure coalitions in order to enlarge their share of the 'fixed pie.' A way out of this is institutional arrangements that help build consensus among the competing groups on resource allocation.
- 49 The Australian reforms were launched after a preceding administration had been unsuccessful at reducing public spending by identifying redundant functions. A centralised, top-down Commonwealth Review of Functions had failed to identify egregious anomalies in the role of the state. Clearly overall fiscal discipline was not the issue at stake. Australian reforms consequently sought to rely on "a more

nuanced and finely surgical process of identifying savings.” They did so by focusing the budget process on changes in strategic priorities, and relying heavily on line agencies themselves to identify savings options. The underlying philosophy behind Australian reforms placed faith on trust and consensual relationships.

- 50 Australia thus offers perhaps the best example of a priority setting process. The process engenders strong focus on strategic outcomes that expenditure programmes are seeking to achieve. It also incorporates a medium-term framework linking allocations to the achievement of these outcomes.
- 51 Finally, given that aggregate fiscal discipline and prioritisation have been dealt with, there remains the principal agent problem within the government hierarchy. Information asymmetries and incentive incompatibilities can be impediments to the efficient delivery of public services.
- 52 New Zealand offers the most dramatic example of institutional reform to achieve technical efficiency. Permanent secretaries in line agencies have been removed and replaced by chief executives on fixed-term, output-based contracts. The budget is based on a purchase of output rather than inputs, and the move to accrual accounting makes transparent the assets, liabilities and net worth of line agencies on which the chief executives are evaluated. At the same time, chief executives have complete autonomy over the allocation of resources, including the right to hire and fire employees.
- 53 The examination of the reform experience of Australia and New Zealand must be placed in context. It is not meant to recommend these reforms for adoption en masse. Indeed, whilst the two reform

episodes shared some common characteristics – both sought to alter the incentives that affect the size, allocation, and use of resources, and to improve transparency and accountability by binding key players to particular fixed outcomes and making it costly for them to misbehave – they also took dramatically different paths reflecting the particular backgrounds and historical conditions driving each reform. Even if the extent of adherence can be a matter of serious disagreement, the Bretton Woods institutions have given explicit recognition to the reality of different structures and institutions in member countries. The guidelines on conditionality for the use of the Fund’s resources and for stand-by arrangements, for example, state: in helping members to devise adjustment programmes, the Fund will pay due regard to the domestic, social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems.

- 54 These considerations raise the obvious question: under what conditions could better institutional arrangements and mechanisms for greater accountability and transparency be transferred to other settings? Learning from experience is essentially an exercise to determine what can be borrowed with profit from others and what modifications may be necessary. This naturally is a complex issue which requires in-depth comparative analysis of such fundamental underpinnings like the relative independence of the judiciary. Political factors are also clearly important. In fact, it has been stressed that in order to understand why governments behave the way they do, one necessarily has to delve into politics.

- 55 But while politics is important, institutions also matter. Institutional arrangements have been shown to systematically influence fiscal outcomes. For example, constitutional constraints to the deficit or the public debt have been shown to reduce deficits. The effect of budgetary institutions is, however, predicated on the applicability of the rule of law. The rule of law has varied adherence in developing countries – being more binding in some and less so in others. As a result, the institutional arrangements that govern the budget process in Australia or New Zealand, if transplanted, may not have comparable effects and in some countries may even be irrelevant. A possibility that can be examined, in such contexts of weak adherence to the rule of law, is the liberalisation of financial markets. An environment in which fiscal mismanagement is decisively punished by capital outflows, currency devaluation, imported input cost increases, rising inflation and high interest rates ensures that a heavy price may be demanded of fiscal mismanagement by investors requiring a risk premium to put or return their funds into the country's financial markets. Open financial markets may, as a result, serve to discipline governments by increasing the political cost of fiscal imprudence. In this way, appropriate institutions for the stated fiscal objectives may be made to function better.
- 56 Malaysia has been carrying out reforms designed to improve strategic prioritisation (the Australian reform path) since the late 1980s. These reforms have included the establishment of a budget dialogue group with business, labour and other stakeholders from civil society, greater devolution of decision making to line agencies and associated accountability mechanisms similar to those implemented in New Zealand. Malawi is initiating a coherent programme to institute a strategic approach for expenditure planning through a medium-term expenditure framework (MTEF). A systematic bottom-up process is being implemented focused on four pilot ministries – agriculture, health, education and public works/roads. The results so far on expenditure prioritisation are mixed: successful in education but weak in health. Moreover, the MTEF is, so far, restricted to recurrent expenditures only, with the recurrent cost implications of the development budget not factored in.
- 57 Aside from the fiscal issues presented above, the problem of central bank independence presents some difficulties in monetary management. Allowing autonomy to the monetary authorities to undertake monetary policy is increasingly accepted as one of the more effective means of de-politicising economic decision making.
- 58 Central bank independence (CBI) connotes two basic ideas. First, there is the freedom of the central bank to decide how to pursue its goals. This, however, does not extend to the setting of goals on its own. In a democracy, it is virtually obligatory that the political authorities set the goals and instruct the central bank to implement. Giving the central bank authority over its goals would amount to delegating excessive power to unelected bureaucrats which may be considered incompatible with democratic rule.
- 59 A second idea of CBI is that normally no other branch of government can countermand the decisions of the central bank. In the US, for example, neither the President nor the Supreme Court can

reverse a decision of the Federal Reserve Board's Open Market Committee. The Congress can, but only if it passes a law that the President will sign (or by overriding a presidential veto). Thus for all practical purposes the Federal Reserve Board's decisions are immune to reversal; and indeed have never been reversed. If a central bank's decisions stand only as long as they do not displease someone more powerful, the bank cannot be considered independent.

- 60 An important empirical finding is that, at least for the industrial countries, CBI has shown a strong positive influence with low inflation. Proffered explanations are that far-sightedness and patience (no strong suits of the political process in a democracy) are absolutely essential for effective monetary policy. The requirement for success is to look far into the future and wait patiently for results because of the lags involved. Furthermore, inflation-fighting is akin to long-term investment. The costs of disinflation are upfront, the benefits (low inflation) accrue only gradually through time. Consequently, given the temptations to reach for short-term gains at the expense of the future, it is better to depoliticise monetary policy by delegation to unelected bureaucrats with long and secure tenure of office and clear instructions to fight inflation.
- 61 The main effect of CBI is not principally to constrain the central bank to act in accordance with the government's objectives but rather to constrain the government by increasing the difficulty of its bringing pressure to bear on the central bank. This is deemed of critical importance because of the short-run trade-off between price stability and employment generation although there is no such perceived trade-off in the long-

run. Price stability has been deemed so important as to make it the only policy goal of central banks. The argument is that the short and long run trade-offs between inflation and growth differ in ways that make inflation tempting to start and costly to stop. A recent study of disinflation episodes in industrial countries concluded that a higher degree of CBI leads to both higher sacrifice ratios (output change per unit change in trend inflation) and stronger recessions. These results were attributed to the tremendous difficulties encountered in lowering wages below contract levels during disinflations especially in low average inflation economies.

- 62 Given the short-run trade-off and an initial situation of low inflation, it is claimed that a government that would prefer output growth to be above the natural rate may be tempted to run an expansionary monetary policy – making policy subject to an inflationary bias. Private agents understanding the temptation facing government will adjust upwards their inflationary expectations. In the event, inflation will rise to a level at which its cost at the margin, given that it is expected, is high enough to force the government to abandon the gamble. The outcome, however, is that the economy ends up with no gain in output but with an inflation rate that is higher than socially optimal. CBI provides society with an institutional device to avoid this self-defeating temptation.
- 63 Some have argued, however, that concentrating monetary policy on price stability is, in effect, 'throwing in the towel on unemployment.' The basis of this position is that, as Keynes observed in the 1930s, modern industrial economies are not sufficiently self-regulating. While in principle either fiscal

or monetary policy can serve as the balance wheel to keep aggregate spending in line with productive capacity, the need to reduce fiscal deficits (in the industrial countries) 'will leave fiscal policy as a drag on total spending for the foreseeable future regardless of the state of the economy.' The public, that the central bank exists to serve, cares about fluctuations in the pace of economic activity and well-executed monetary policy does have the power to mitigate such fluctuations.

- 64 Questions have also been raised as to the compatibility of central bank independence with democracy. In this regard, it has been observed, however, that democracy, at least in practice, often allows for certain provisions of law to be enshrined in Constitutions and, as it were, thus excluded from "the daily legislative struggle." These fundamental provisions are deliberately made hard to reverse because it is not deemed in the public good to be revisiting them frequently.
- 65 The insistence that CBI does not imply a right to choose goals is again of critical importance, as noted above, in a democratic polity. The goals of such a society must be left exclusively to elected politicians and not unelected bureaucrats.
- 66 Compatibility also requires credibility – matching deeds to words – on the part of the central bank. This obligation to the body politic is in return for the broad grant of power the central bank enjoys.
- 67 CBI in a democracy must require public explanation of what the bank is doing, why it is doing that, and what it expects to accomplish by its actions. Such accountability is required to remove some of the mystery that surrounds monetary policy, enable interested parties to

appraise the bank's decisions contemporaneously and allow outsiders to judge the bank's success or failure after the fact. It is after all, accountability that legitimises independence within a democratic political structure. An inability of the bank to articulate a defence of its actions may be an indication that maybe those actions are not as good as the bank thinks.

- 68 Governors of central banks in democracies must be appointed by the political authority. The elected political leadership has political legitimacy directly from the electorate. Governors, as political appointees, have political legitimacy conferred upon them by virtue of their appointment, i.e. through their holding of delegated authority.
- 69 Perhaps, most importantly, central bank decisions, in a democracy, must be reversible even if only in extreme circumstances. Reversals, however, must never become routine occurrences. Governors must also be removable from office for good cause. Delegated authority must be retrievable, not absolute.
- 70 In the context of the proposed European Central Bank, it has been argued that a successful European Monetary Union (EMU) cannot be envisaged without a political union. Without that 'no government could expect its citizens to accept the fiscal implications of the Maastricht blueprint for monetary union in the name of an inflation objective for which neither it nor any other government felt wholly responsible.' In other words, independence for the ECB would be undemocratic and as a consequence the bank is likely to find the odds stacked against it sustaining its independence in the conflict that would result inevitably from this fiscal resistance.

- 71 Given the fact that ECB would have to start with little moral authority or political legitimacy, any perception that it is the source of fiscal difficulties for the national member governments can only spell trouble for itself, European economic integration and political amity. The fragile politics of EMU are unlikely to permit either bond market discipline (by way of high interest premia on issues of deficit countries) or binding collectively agreed rules to bear on national fiscal authorities. Yet, without that fiscal discipline there would always be suspicion in financial markets that political pressures would force the central bank to ease monetary policy inappropriately, in a bid to ease any fiscal pressures on national member governments. But mere concerns
- about such pressures will push real interest rates up, further intensifying fiscal problems as growth falters.
- 72 Even though the empirical record shows that CBI in industrial countries achieves its objective, i.e. low rates of inflation, there are nonetheless concerns about whether society is best served if price stability is at the expense of painfully high unemployment. Issues have also been raised about the necessary conditions required to make CBI compatible with democratic rule. Some of these issues have also been noted in the context of the proposed European Central Bank (ECB), leading to speculation that such a central bank cannot have the political legitimacy to be independent.