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ECONOMIC AND FINANCIAL ASPECTS OF PROJECT SUSTAINABILITY

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One obvious, necessary condition for sustaining a development project is adequate finances. Only with the wherewithall to finance development projects on a continuing basis can there be any hope for project sustainability. Resources must be available to obtain school supplies and pay teachers; maintenance of roads requires both labor and nonlabor inputs; medical supplies are necessary if a health center is to produce health services; spare parts must be purchased for pumps used in rural water projects.

The issue here is, of course, the problem of meeting the recurrent costs of development projects and programs, including technical assistance programs. Meeting these costs entails both mobilizing the necessary resources and ensuring that the resources are, in fact, used to operate and maintain the project. While the issue is not unique to developing nations (witness the problems in the United States of maintaining the interstate highway system), the severity of the problem is undoubtedly greater in the Third World where overall availability of resources falls far short of the many needs. In what follows we first focus on the financial and economic problems that lead to lack of sustainability of development projects in developing countries. This is followed by discussions of the reasons for these problems and a review of the means available to address them. We focus here primarily on local governments since they are likely to have the broadest resource mobilization powers of any local level institution and, therefore, can cope with the widest range of developmental projects; nevertheless, the issues addressed here are also applicable for nongovernmental institutions.

It must be emphasized that the economic and financial problems addressed here are not independent of the other issues raised in this Report. Mobilization of resources is certainly not independent of the problems associated with local participation and involvement in project planning and implementation. Furthermore, resource mobilization is not feasible without concurrent development of organizational and institutional capacity to carry out the effort.

The Recurrent Cost Problem

The "recurrent cost problem" is not a new one; however, it has only been during the past decade or so that the issue has become a major topic of policy concern to donor organizations. One review of the issue was made in 1982 by USAID's Bureau of Program and Policy Coordination.[1] Other nontechnical general papers on the subject include those by Heller and Meerman.[2] Probably the most complete review of project-level recurrent

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[1] U.S. Agency for International Development, Recurrent Costs, AID Policy Paper, (Washington, DC, 1982).

[2] Peter Heller, "The Underfinancing of Recurrent Development Costs," Finance and Development (March 1979), pp. 38-41; and Jacob Meerman, "Minimizing the Burden of Recurrent Costs," Finance and Development (December 1983), pp. 41-43.

cost needs was that conducted by the CILSS/Club du Sahel Working Group on Recurrent Costs.[3] The project investigated 29 development projects in the Sahel region of Africa as well as the projected fiscal deficits associated with optimal coverage of recurrent costs associated with current and planned development projects. While there is obviously some difficulty concerning the most appropriate definition or measure of what constitutes the desirable level of recurrent costs of a development project, only one of twelve agricultural projects--a cotton production scheme in Chad--was found to yield revenues in excess of annual recurrent expenditures.[4]

While donor-aided project sustainability is linked to the recurrent cost problem, it should be emphasized that recurrent costs of public services not directly tied to externally-funded projects can affect the quantity and quality of services provided. For example, an examination of education spending in Latin America during the 1970s revealed that, in the face of fiscal pressures, governments responded by allowing enrollments to increase without a parallel increase in spending, at least at secondary and tertiary education levels. Furthermore, "underfinancing of the recurrent costs associated with newly completed capital projects also appears to nave occurred."[5]

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[3]CILSS/Club du Sahel, "Recurrent Costs of Development Programs in the Countries of the Sahel," Working Paper (English translation), 1980.

[4]Ibid., pp. 69-70.

[5]Peter S. Heller and Adrienne Cheasty, "Sectoral Adjustment in Government Expenditure in the 1970s: The Educational Sector in Latin America," World Development 12 (1984), p. 1047.

Reasons for Recurrent Cost Problems

Why is it that a project can be initiated in a developing country, operated successfully for a short period of time and then cease to function due to a lack of the inputs necessary for continued operation? At one level, the problem can simply be attributed to the lack of adequate resources. There are, however, probably other root causes which contribute to this phenomenon. In addition to the overall paucity of wealth there are problems associated with: (1) weak budgeting and financial administration practices in Third World countries; (2) poorly designed resource mobilization instruments at both the central and local levels; (3) incentives, including those associated with donor policies, which can lead to myopic decisions which favor capital construction at the expense of operating and maintaining capital already in place; and (4) weak macroeconomic policies and practices.

Budgetary Practices. Capital construction decisions are commonly made without concern for their longer term recurrent cost implications. Meerman's description of the decision-making process in many developing countries is particularly apt. "The ministry of planning concerns itself with investment and its finance, frequently relying on extrabudgetary resources such as foreign loans, while the Ministry of Finance may be quite unaware of the new recurrent costs that it will later be called upon to cover once the capital is invested."[6] Even if the longer term recurrent

[6] Meerman, "Minimizing the Burden of Recurrent Costs," p. 41.

cost implications of projects or programs are estimated, seldom do developing countries engage in any serious long-term forecasts of revenues and expenditures and then make decisions in light of these projections.

It is often also the case that central government rules regarding local budgeting practices can exacerbate the recurrent cost problems associated with local projects. For example, local governments in the Philippines are greatly constrained in responding to specific spending needs by a long list of rules which essentially determine the way localities must allocate their resources.[7] Similarly, in Burkina Faso the central government requires that local revenue projections include previously uncollected tax revenues thereby resulting in overly optimistic spending plans. When revenues do not reach their projected levels, labor inputs are essentially maintained at their budgeted levels with nonlabor spending cut to meet the revenue shortfall.[8]

Resource Mobilization Instruments. The evidence is quite clear that many developing countries utilize a combination of resource mobilization instruments not ideally suited to promote private-sector led economic growth nor to finance recurrent costs most efficiently. Central

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[7]Roy Bahl, David Greytak, Larry Schroeder, Kenneth Hubbell and Benjamin Diokno, Strengthening the Fiscal Performance of Philippine Local Governments: Analysis and Recommendations, Metropolitan Studies Program Monograph No. 6, The Maxwell School (Syracuse, NY: Syracuse University, June 1981.

[8]Local Revenue Administration Project, Local Revenue Administration in Burkina Faso. Phase II. Final Report, Metropolitan Studies Program Monograph No. 17, The Maxwell School (Syracuse, NY: Syracuse University, January 1986), pp. 219-231.

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government revenue systems commonly create disincentives to private sector investment and work effort while creating strong incentives to avoid taxes.[9] Also common is the expectation that local institutions will cover a major portion of the recurrent costs associated with development projects; however, these institutions are not provided with adequate resource mobilization instruments necessary to raise the needed revenues. Furthermore, the administrative structure in place to carry out this resource mobilization effort is often weak and inefficient, yielding revenues which fall far short of the needs to sustain capital projects.

It is also the case that user fees are commonly rejected as an appropriate cost recovery instrument in developing countries in spite of the fact that such charges can provide for efficient outcomes. The argument often given for such rejection is based on equity considerations. Such an argument ignores the fact that the choice may actually be between having a project that is sustainable but which excludes the poorest segment of the population versus having no project at all or, worse still, spending resources to put a project in place only to have it inoperable due to the lack of sufficient operating and maintenance revenues.

Incentives. Any consideration of recurrent cost problems must include an examination of the incentives which may lead to these

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[9] Roy Bahl, Ved Gandhi, Malcolm Gillis, Charles E. McLure, Jr. and Larry Schroeder, Tax Reform and Private Sector Growth: Proceedings of a Conference Held July 10, 1986, Washington, DC, Metropolitan Studies Program Monograph No. 18, Local Revenue Administration Project, The Maxwell School (Syracuse, NY: Syracuse University, March 1987).

difficulties. At the top of this list is obviously the political preference for additions to the capital stock rather than allocating resources to the operation and maintenance of those projects already in place. National level politicians commonly promise large scale local projects for the short-term political advantages they might yield without regard for their longer term cost implications. Local politicians, too, engage in such short-term optimizing behavior.

In addition to these political incentives which contribute to the recurrent cost issue (and for which there are few obvious antidotes), budgeting and revenue systems may also provide inappropriate incentives which add to the problem. Local governments are often heavily reliant upon centrally-funded grants that can be used for development purposes without regard for their longer term recurrent cost implications. Commonly such grants are restricted to new capital schemes so as to avoid the possibility that grant recipients will use the funds to support "unproductive" current spending, e.g., on administrative overhead. Even if local resources are available, when recipients expect a continuation of the flow of such grants into the future, the incentives are strong to allow the capital projects to run down rather than be maintained in expectation that subsequent grant flows can be used to replace the then depleted capital stock.

A similar dilemma regarding allocation of funds for new capital versus "consumption" spending for recurrent costs face donors as well.[10] Limiting assistance to new capital expenditures may indicate that the donors "are suffering from conceptual tunnel vision" since the dichotomy between these forms of spending is not that clear cut.[11] Much current spending in developing countries does, in fact, add to the capital stock, particularly the stock of human capital.

The same set of incentives are also encountered by recipients of donor funds as face recipients of central government grants; the short-term advantages of accepting new infusions of capital projects may outweigh their longer term potential cost implications. While cost sharing is proposed in many instances for grants from central to local governments and is commonly mandated for donor-sponsored projects, insuring that the recipients in fact comply with these requirements can be administratively difficult. Again, there may be few incentives for those administering the flow of funds (either from international donors to recipient countries or

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[10]There is some indirect evidence that suggests governments of developing countries do not necessarily regard recurrent spending as consumption and therefore more easily cut in response to revenue contraints than is capital spending. In an investigation of spending in 54 developing countries David Lim found, "that the majority of LDCs did not experience a secular decline in total government recurrent expenditure over the period 1965-1973" (p. 378) as might be expected under the "consumption" hypothesis. While he found that recurrent spending was more unstable than capital expenditures in the education and health sectors, the reverse was true in the agricultural and transport and communications sectors. See David Lim, "Government Recurrent Expenditure and Economic Growth in Less Developed Countries," World Development, 11 (1983), pp, 377-380.

[11]USAID, Recurrent Costs, p. 4.

from higher to lower levels of government) to ensure that the cost sharing actually occurs.[12]

Macroeconomic Policies. Here we mean the set of national policies, including those regarding parastatals, public sector wages and employment, pricing and trade, that create major macroeconomic difficulties and may ultimately result in austere national budgets. Indeed, Gray and Martens argue that,

> Perhaps the key accomplishment of the CILSS/Club du Sahel Working Group on Recurrent Costs in the Sahel was to prove to the satisfaction of the donor agencies that supported it, as well as most of the Sahelian officials and consultants who took active part in it, that the region's 'recurrent cost problem' cannot be resolved in isolation from the phenomenon of economic stagnation that has afflicted the Sahelian countries and the macroeconomic policies that are in large part responsible for it, or at the very least have failed to overcome it.[13]

Broad policy reforms constitute the primary approach to these issues.

Means to Address Recurrent Cost Problems

In spite of the continuing problem regarding recurrent costs of development projects and programs, there has been some progress made at

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[12] Such noncompliance was emphasized in the recent memo from the Inspector General concerning compliance with sections 110 and 123(g) of the Foreign Assistance Act of 1961 that require cost sharing. See Memorandum from the Inspector General, Herbert L. Beckington regarding "Host Government Failure to Provide Agreed Upon Financial Support to Developmental Projects," February 1987.

[13] Clive Gray and Andre Martens, "The Political Economy of the 'Recurrent Cost Problem' in the West African Sahel," World Development, 11 (1983), p. 116.

understanding and improving the ability of developing countries to address these problems. Since the emphasis here is on the sustainability of local projects, we focus primarily upon locally-oriented policies. This emphasis should not be interpreted to mean that central government policies and policy dialogue is unimportant. Macroeconomic reforms in central government tax systems as well as in employment, wage and pricing policies may be a necessary first step to creation of an economic environment absolutely crucial to economic growth and an increased ability to meet recurrent costs of development projects. Furthermore, many of the locally-oriented policies discussed here will ultimately require that central government policy decisions be made. Indeed, without such concurrent and support from the center, there is little reason to expect that the means discussed below can ever be successful.

With the local orientation of many site-specific development projects it is natural to consider the role of local groups in the planning, implementation and, of most interest here, the financing of these schemes. Such decentralization efforts can certainly improve the likelihood of longer term success of projects by increasing local participation.[14] Still, there is the problem of longer term financing of such projects. While some might argue that all development projects and programs should be self-financing, it is not reasonable to expect full funding in all

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[14]Ronald Dore, Community Development: Comparative Studies (London: Croom Helm, 1981), pp. 75, 131-34; David D. Gow and Jerry Vasant, "Beyond the Rhetoric of Rural Development Participation: How Can it be Done?" World Development, Vol. 11, No. 5 (1983), pp. 427-46, 441-2.

instances, particularly from projects in the education and health sectors or from technical assistance projects.[15] Instead, recurrent cost financing to sustain projects may have to come from centrally-generated funds, from locally-mobilized resource as well as from project-specific revenues generated primarily from user fees. We consider each in turn.

Central Funding of Recurrent Costs. The ability of central governments to support recurrent costs depend, in great part, on their tax and other macroeconomic policies. While such policy changes may constitute the key ingredient to improved abilities to sustain development projects, central government budgeting processes should also be strengthened. While it is commonly the case that investment decisions by central governments are made without regard for their longer term budgetary implications, this need not be the case. Multi-year projections of both revenues and expenditures under well defined assumptions regarding future macroeconomic conditions are certainly possible. Furthermore, constructing and implementing such models are not beyond the capabilities of governments in developing countries; nor do they necessarily entail huge investments in either hardware or software.[16] Such models make it possible for central

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[15]For an elaboration on the World Bank's approach to cost recovery see Jacob Meerman, "Cost Recovery in a Project Context: Some World Bank Experience in Tropical Africa," World Development, 11 (1983), pp. 503-514.

[16]Michael Wasylenko, "Fiscal Planning Model," Fiscal Memorandum No. 14 in Local Revenue Administration Project, Grenada Tax Project Comprehensive Fiscal Reforms for Grenada: Directions for Research and Technical Assistance, Metropolitan Studies Program Monograph No. 16, The Maxwell School (Syracuse, NY: Syracuse University, September 1984; Fiscal Policy and Planning Division, Ministry of Finance, Government of Thailand, Modeling and Forecasting of Central Government Revenue (Bangkok, Thailand: Government of Thailand, 1984).

government decisionmakers to consider the aggregate recurrent cost implications of development projects and to assess their viability in light of the probable future fiscal environment.

Local Coverage of Recurrent Costs. In addition to the utilization of user charges (discussed below), local governments can play a role in the coverage of recurrent costs associated with long-term development projects. Generally such sources of funding must come from some combination of local taxes or fees and intergovernmental transfers. While the record concerning local government resource mobilization in developing countries is not a strong one, the potential is there. Indeed, there are good reasons to think that when local residents are sure that the revenues will be used locally to benefit themselves, willingness to pay is greater than for the case of central government taxes. For example, a survey of villagers in Burkina Faso (then Upper Volta) revealed that 93 percent of the respondents would be willing to pay a tax, the receipts from which would be used to benefit the community, with an additional 5 percent of the respondents saying that their willingness would depend only upon the amount of the tax.[17] Although total potential revenues from such levies are limited by the taxpaying capacity of local residents, these findings support the thesis that greater utilization of local level finance should be considered in the recurrent cost financing issue.

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[17] Local Revenue Administration Project, Local Revenue and Service Provision in Upper Volta, Phase I: Final Report, Metropolitan Studies Program Monograph No. 13, The Maxwell School (Syracuse, NY: Syracuse University, August 1983), p. 208.

Two crucial problems are encountered when considering the possibility of increasing utilization of local taxes and fees to cover recurrent costs. One of these is revenue assignment, i.e., the revenue sources provided to localities. The taxes assigned to local governments tend, in general, to have narrow bases and be quite inelastic; central governments tend to reserve for themselves the more productive tax instruments. Low elasticities mean that even if a development project succeeds in improving local economic conditions, tax revenues will not respond proportionately thereby possibly adding to local financial problems. Just as tax assignments are usually made from above with seemingly little regard given to their yield and elasticity implications, localities are commonly given little or no autonomy in determining the extent to which they can use the assigned instruments. Instead, tax rates are imposed centrally. This can greatly hinder the ability for localities to carry out decision-making in a decentralized manner. If local governments are to be expected to bear a greater share of the burden of recurrent costs, policies must be formulated to provide localities with more productive and elastic revenue sources along with the autonomy to alter tax rates to adjust to local preferences.

A second major problem encountered when considering greater roles for local governments in developing countries is tax and revenue administration.[18] Research of the Local Revenue Administration Project

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[18] Indeed, overall personnel policies at the local government level require improvements if these bodies are to perform their functions more effectively. See Glynn Cochran, Policies for Strengthening Local Government in Developing Countries, World Bank Staff Working Paper No. 582 (Washington, DC, 1983).

undertaken in the Philippines, Bangladesh and Burkina Faso, found that administrative weaknesses abound in the local tax and budgeting systems.[19] Record keeping is poor, incentives for tax compliance are weak and those administering the taxes are poorly trained. Hence, along with policy changes providing greater resource mobilization powers to localities must come an increased commitment towards training and improved, streamlined administrative practices if revenue performance at the local level is to improve.[20]

Even with increased reliance upon local governments to meet recurrent costs of development it is not realistic nor economically efficient to expect local governments be totally self-financing. Some flow of resources from the center must continue. At issue in such instances is that the grant system be designed so as to encourage a positive impact on local resource mobilization. Since intergovernmental aid can be a powerful tool in altering local government behavior, greater attention and analysis ought

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[19] Bahl, et al., Strengthening the Fiscal Performance of Philippine Local Governments: Analysis and Recommendations; Local Revenue Administration Project, Local Revenue Administration in Burkina Faso. Phase II. Final Report; Local Revenue Administration Project, Zilla Roads/Local Finance Project, A Plan for Increased Resource Mobilization by Local Governments in Bangladesh. Volume I: Executive Summary; Volume II: Policy Recommendations. Final Report, Metropolitan Studies Program Monograph No. 14, The Maxwell School (Syracuse, NY: Syracuse University, May 1984).

[20] It should also be noted that these same administrative issues arise in many Third World central government revenue systems. At the same time, investments to improve revenue administration should not be undertaken in absence of improvements to the tax structure. It is counterproductive to strengthen the collection system of taxes which have undesirable economic effects.

to be paid to its effects. Empirical analysis of the grant system (FONAPAR) used in Ecuador revealed that the categorical, cost-reimburseable portion of the grant program did stimulate additional local government spending; unrestricted block-type aid has, however, offset the local resource mobilization incentives associated with the program.[21] The same study shows how further changes in the system could stimulate considerably greater mobilization of local resources. In spite of the fact that grant schemes contain considerable potential for altering local government behavior, developing countries generally have avoided this use of intergovernmental transfers.[22]

User Charges. A natural response to the need for greater mobilization of resources to meet recurrent costs so as to sustain development projects is to rely more heavily upon user fees. This approach has great appeal since it has the advantage of requiring those who directly benefit from the services to share some portion of the costs. One cannot object to this logic, indeed greater reliance upon user fees should be encouraged; yet, some limitations to the utilization of user fees should be

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[21] David Greytak and Victor Mendez, "The Impact of Intergovernmental Grants on Local Governments in Ecuador: A Study of FONAPAR," Ecuador Fiscal Administration Studies Staff Paper No. 4, Local Revenue Administration Project, Metropolitan Studies Program, The Maxwell School (Syracuse, NY: Syracuse University, September 1986).

[22] See, for example, the review of rural development grant programs in four countries of South and Southeast Asia in Larry Schroeder, Rural Development Grants to Local Governments in Asia, Metropolitan Studies Program Monograph No. 19, Local Revenue Administration Project, The Maxwell School (Syracuse, NY: Syracuse University, March 1987).

recognized. As is well-known, user fees are appropriate only when users are easily identified and can be economically excluded from enjoying the service in the absence of compliance with the service charge. Furthermore, projects designed primarily to yield income redistributional benefits are inappropriately financed through user fees. While it may be feasible to design user charges which rely upon discriminatory prices based upon the ability to pay of the user, the administrative costs of correctly applying such prices must also be considered. If such costs are excessive, discriminatory pricing will not necessarily yield the efficient and equitable outcome envisioned.

It should also be recognized that, even though there are very strong arguments in favor of project self-reliance through user charges, one should proceed with caution prior to recommending their use in any and all situations. Operating subsidies of schemes which yield external benefits are economically efficient even if user fees are administratively feasible and abilities to pay can be ignored. Thus, projects which yield totally private benefits should be expected to be self-sufficient, particularly with regards to bearing their marginal operating and maintenance costs; however, it is not desirable to expect the same from socially-beneficial projects.

Summary

Even though coverage of recurrent costs may not be a sufficient condition to sustainability of development projects, it certainly is a necessary condition. Without the resources to provide for the necessary inputs required to keep a project operating and maintained, the project is bound to fail. Here we have considered some of the major problems associated with the coverage of recurrent costs as well as several means by which these problems might be addressed. Project design and implementation cannot ignore these issues.