



The role of public finance in development

Most developing countries have faced a fiscal crisis of one sort or another during the past decade. Until 1982 public sector deficits rose to unsustainable levels almost without regard to economic structure and income level: oil exporters, oil importers, middle-income countries, low-income countries, commercial debtors, aid recipients, and planned and market economies all followed the same course. When the external economic shocks of the early 1980s made it impossible to finance these deficits, a period of severe fiscal retrenchment became inescapable (see Figure 2.1). The reduction in deficits since then has been remarkable, but many countries—still deprived of external financial resources—need to do more. For them the dilemma is how to cut deficits further without sliding even deeper into recession.

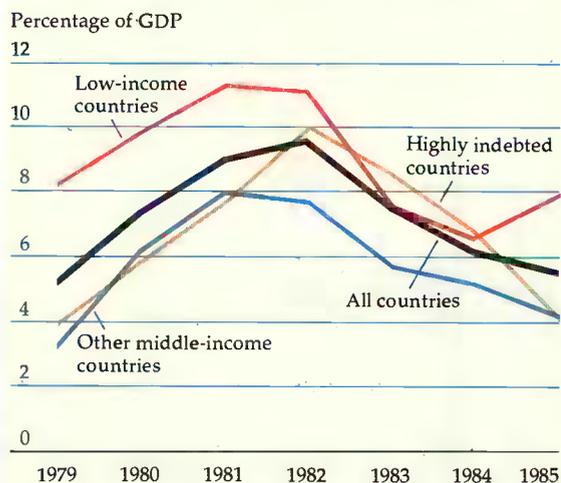
The urgency of this problem has distracted attention from the broader role of public finance in development. The short-term imperative has been to contain fiscal deficits through some mixture of reduced expenditure and higher revenues. The concern for the longer term is that such changes be carried out in ways that promote, rather than hamper, growth. Indeed prudent control of fiscal deficits is just one aspect of sound public finance in the widest sense. Among other things this means confining (or extending) public expenditure to those areas in which the public sector can act efficiently; it also means raising the necessary revenues in ways that distort prices as little as possible. This chapter introduces the broad perspective within which deficit reduction should be viewed.

Governments everywhere play an essential role in allocating resources—in influencing what gets

produced, how it is produced, who receives the benefits, and who pays. They do so both directly and indirectly. For instance, all *directly* provide defense and social infrastructure; most supply power and telephone services; a few produce industrial and agricultural goods. Often governments create state-owned enterprises (SOEs) to carry out these functions. But governments also *indirectly* influence the production and allocation of privately produced goods through subsidies, taxes, and a wide range of regulatory tools such as price controls and quantitative restrictions. In centrally planned economies governments rely mainly on direct intervention; in market economies they tend to favor the indirect approach. Both modes of intervention involve public spending and revenue and are thus equally subject to the strictures of sound public finance.

Public finance affects economies in many different ways. Revenue, expenditure, and the public sector deficit they imply are essential tools for macroeconomic stabilization: they help to determine the inflation rate, the current account deficit, the growth of the national debt, and the level of economic activity. They also affect adjustment and growth by influencing the rates of consumption, savings, and investment in both physical and human capital. At the microeconomic level, taxes, subsidies, and government purchases of commodities encourage the production and consumption of some goods and discourage the production and consumption of others. Public finance policies can, in principle, affect all sectors of the economy, and they typically do so in developing countries as in industrial countries.

Figure 2.1 Public sector deficits in selected developing countries, 1979 to 1985



Notes: Data are unweighted annual averages. The low-income sample includes Bangladesh, India, Kenya, Malawi, Zaire, and Zambia. The highly indebted sample includes Argentina, Bolivia, Chile, Colombia, Côte d'Ivoire, Dominican Republic, Ecuador, Jamaica, Mexico, Nigeria, Peru, and Venezuela. The other middle-income sample includes Indonesia, Malaysia, Poland, Thailand, and Turkey. The twenty-three countries were selected on the basis of available data.

However, three factors complicate any analysis of public finance policies, whether in developing or industrial countries.

- The dividing line between “public” and “private” is unclear. This is especially true for SOEs. For example, does an enterprise that is jointly owned by both the government and private individuals fall into the public or the private sector? What about a publicly owned enterprise that operates on commercial principles? Two criteria can help distinguish public from private activities: whether profits and losses accrue to the state and whether the state directly controls the allocation of resources of the enterprise. Even these tests are of only limited use, because ownership and control by the state vary in degree and over time. The definition of what is part of the public sector thus remains a matter of judgment. By necessity this Report relies on the conventions of each country to distinguish between the public and private domains.

- Governments are not monolithic entities, but consist of many agencies with varying degrees of

autonomy. The structure of the public sector has both vertical and horizontal dimensions. The vertical dimension includes the central, state or provincial, and local government levels. The horizontal dimension reflects the division between government, SOEs, and other autonomous or semiautonomous entities, often grouped under the heading of “off-budget” accounts or agencies. The relations between these different branches of the public sector are usually complex.

- There is a lack of accurate public finance data for developing countries. For most developing countries consistent data are available only for the past decade or two and often cover only the central government. Comparable data on state and local governments and on SOEs are patchy across countries and over time (see Box 2.1). Because of this, much of the cross-country analysis in this Report focuses on central government finances. Where possible the analysis is extended to include state and local governments and SOEs, but conclusions based on data for the entire public sector have to be treated with caution. The weakness of public finance data has complicated the design and implementation of public finance policies. This is all the more troublesome in view of the rapid increase of the public sector worldwide.

Patterns of public finance

The pervasive growth of the public sector in the past half century represents a fundamental struc-

Table 2.1 Share of government spending in GNP or GDP in selected industrial countries, 1880, 1929, 1960, and 1985 (percent)

Year	France	Germany ^a	Japan	Sweden	United Kingdom	United States
1880	15	10 ^b	11 ^c	6 ^d	10	8
1929 ^e	19	31	19	8 ^d	24	10
1960	35	32	18	31	32	28
1985	52	47	33	65	48	37

Note: Includes central, state, and local expenditure except where noted. For 1880 and 1929 data are the share of GNP; for 1960 and 1985 the share of GDP.

a. For 1960 and 1985, Federal Republic of Germany.

b. 1881.

c. 1885.

d. Central government only.

e. The year 1929 was chosen as a representative year before the disruptions of the Great Depression and World War II.

Sources: For 1880 and 1929: France, André and Delorme 1983, p. 723; Germany, Andic and Veverka 1964, p. 244; Japan, Ohkawa and others 1965-79, vol. 1, p. 200, and vol. 7, pp. 170-71; Sweden, Mitchell 1975, pp. 699 and 782; United Kingdom, Peacock and Wiseman 1961, p. 164; United States, Peltzman 1980, p. 239. For 1960: Saunders and Klau 1985, p. 29. For 1985: OECD 1987, *Economic Outlook* 42 (December), p. 187.

Box 2.1 Sources and limitations of public finance statistics

To be effective, public finance policies must be based on accurate and comprehensive statistics on the financial transactions of public agencies. For intercountry analysis, fiscal data also need to be compiled on a comparable basis across countries. Although much progress has been made during the past three decades in improving both national and international statistics, public finance analysis is still hampered by serious data limitations.

Public finance statistics are currently assembled on an internationally comparable basis in two systems: the *Government Finance Statistics* (GFS) of the IMF and the *System of National Accounts* (SNA) of the United Nations. The GFS focuses solely on government transactions, whereas the SNA considers government transactions as a component of the economy as a whole.

The GFS compiles national public finance statistics according to the standard specifications of the IMF's *Manual of Government Finance Statistics*. It distinguishes among the central government account, social security and other extra budgetary accounts, state and local accounts, and state-owned enterprises (SOEs). The first two accounts are grouped together in the "consolidated central government" account. When data for the first three groups are available, the accounts are consolidated in the "general government" account. Because of the difficulty of collecting consistent and accurate SOE data, only data on transactions between the general government and SOEs are currently recorded in the GFS. The GFS does not report asset or liability positions of the government, nor does it report depreciation for fixed assets owned by the government. Accounts are recorded on a cash, not an accrual, basis. GFS coverage is most complete for central government accounts, but more limited for general government accounts.

The SNA framework is designed to measure income, production, consumption, savings, and investment to

aid economic analysis. The SNA accounts are recorded on an accrual basis and include depreciation. For national aggregates the SNA consolidates transactions between all sectors and eliminates intersectoral transactions, so that only final demand and value added are aggregated. (The GFS framework, in contrast, eliminates only transactions between parts of government.) National accounts data compiled within the SNA framework lack the detail required for many aspects of public finance analysis. The consolidated accounts omit some important financial flows, such as all domestic transfers, including interest. Moreover up-to-date national accounts data are not available in many developing countries.

These limitations of international statistics mirror the weaknesses of national data sources. Delays in auditing, weak administrative systems, and incomplete reporting of subnational government and SOE accounts combine to make it very difficult to get a timely, complete, and accurate picture of the main sources and uses of public funds. Therefore it is generally difficult to assess recent trends in major fiscal aggregates or to project and plan future financial flows. Fiscal planning, consistent fiscal policy design, and financial accountability by decisionmakers are thus significantly impeded. Improving the national and international fiscal data systems deserves a high priority in developing countries.

Lack of data has hampered the analysis of public expenditure, revenue, and financing in this Report. The discussion relies mostly on GFS data but for selected countries adds data from national sources for the total public sector, including available SOE statistics. Inferences drawn from these data need to be treated with caution, because the sample of countries is small and not necessarily representative, the coverage of SOEs may be incomplete and may differ across countries, and definitions may not always be strictly comparable.

tural change comparable in scope with such other basic transformations as industrialization and urbanization. The long-term evolution of public finance in the industrial countries provides a reference point for the experience of the developing world.

Industrial countries

The scale of public finance has increased dramatically in the industrial countries during the past century. Table 2.1 shows trends in government spending for six of them. In 1880 the (unweighted)

average of their public expenditure as a share of GNP was about 10 percent. By 1985 the average share had reached 47 percent. Much of the increase occurred after World War II. Although the overall trend has been common to all six countries, some of the differences are significant. For example, Japan's share tripled during the century, while that of Germany and the United Kingdom increased almost fivefold.

Historically the growth of public revenue kept pace with that of public spending, but during the past two decades expenditures have tended to grow more rapidly than revenues. So govern-

Table 2.2 Central government total expenditure, current revenue, and deficit as a share of GNP, 1972 and 1985
(percent)

Country group	Total expenditure		Current revenue		Deficit ^a	
	1972	1985	1972	1985	1972	1985
Developing countries	18.7	26.4	16.2	22.7	-3.5	-6.3
Low-income ^b	..	20.8	..	15.4	..	-5.1
Middle-income	21.7	27.5	19.1	24.0	-3.3	-5.8
Industrial countries	22.2	28.6	21.6	24.1	-1.8	-5.1

Note: Data are based on a sample of ninety countries.

a. Deficits are defined as current and capital revenue and grants received, minus total expenditure, minus lending minus repayments.

b. Excluding China and India.

ments increasingly have become net borrowers. By the early 1980s sizable budget deficits prevailed in most industrial countries. Many have since made efforts to cut spending. These efforts have been motivated by the inflationary pressures that fiscal deficits can generate, by the perception that private sector activity was being displaced by public intervention, and by concern over the distortions resulting from efforts to raise more revenue. Gov-

ernments have largely failed to lower the absolute level of public spending in real terms, but they have managed to slow or reverse the trend of rising spending as a share of GDP.

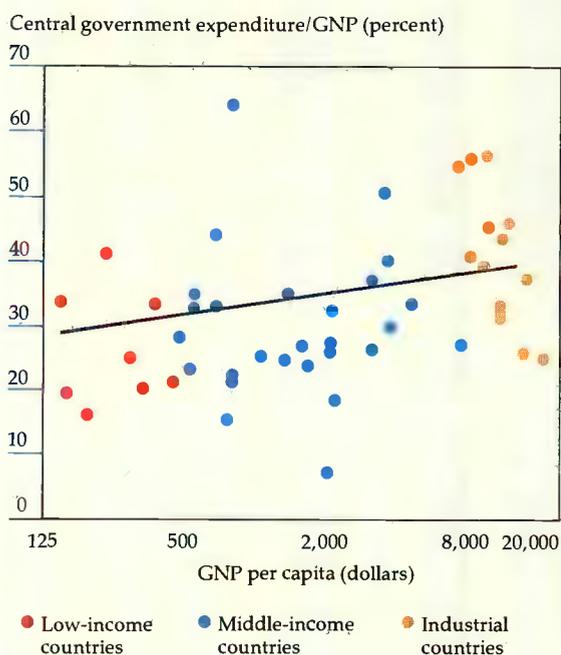
Developing countries

Before 1940 public finance in the developing world was in a similar condition to that of the now-industrialized countries during the latter half of the nineteenth century. According to one study, colonial administrations and independent governments alike raised about 5 percent of GNP in taxes, spent the same amount on government consumption, and made only limited public investments, mostly in transport infrastructure (especially railways). After World War II the situation changed dramatically. Central government spending alone rose to 19 percent of GNP by 1972 and to 26 percent by 1985 (see Table 2.2).

The trend has not been uniform, however. In at least ten developing countries (such as Burma, Chile, the Dominican Republic, Peru, and Yugoslavia) central government expenditure as a share of GNP was substantially lower in 1985 than in 1972, and reductions in real government spending (often following rapid increases) have been quite common during the past decade. Some of these reductions reflect shifts in responsibility for expenditure from central government to state and local governments; more often they have been genuine cuts, prompted by economic crises or changes in political regime.

The most striking feature of public spending in developing countries is the variation in the share of government expenditure in GNP (see Figure 2.2). For example, in 1985 the central government shares for developing countries ranged between 7 percent (Yugoslavia) and 64 percent (Nicaragua). The correlation between central government expenditure shares and per capita income explains

Figure 2.2 The relation between per capita GNP and the share of central government expenditure in GNP, 1985



Note: The horizontal axis is in log scale.

Source: IMF, *Government Finance Statistics*, 1987.

only about 10 percent of this variation. Even when total public spending is considered (that is, including the expenditures by state and local governments and SOEs) the variation remains (see Figure 2.3).

Despite this some general conclusions may be drawn. First, in most developing countries the share of central government spending in GNP remains below that of the industrial countries. Much of the difference, though, is due to the industrial countries' higher level of transfers for social security and welfare. Excluding these expenditures, central government spending as a percentage of GNP is higher in low- and middle-income countries than in the industrial countries (see Chapter 5).

Second, in developing countries the public sector tends to play a greater role as an investor than in industrial countries. The share of total public investment (including investment by SOEs) in total investment was higher for a sample of twelve developing countries than the average for a sample of thirteen industrial countries (see Table 2.3). This may in part be explained by the fact that developing countries tend to need more investment in infrastructure than the industrial countries—and government investment is bound to play a large role in infrastructure development.

Third, in most developing countries SOEs account for important shares both of total public spending and of GDP. Data are limited, and the variation is again large. For the sample of thirteen developing countries shown in Figure 2.3, the capital outlays of SOEs (that is, their spending on final

Table 2.3 Public sector investment as a percentage of total investment for selected developing countries, averages for 1980 to 1985

Turkey ^a	68	Peru	29
Egypt ^b	65	Philippines ^b	26
Côte d'Ivoire	61	Dominican Republic	24
Argentina	58		
Botswana	45	<i>Average (unweighted)</i>	
Colombia	40	Twelve developing countries	43
Korea, Republic of ^c	35	Thirteen industrial countries ^d	30
Thailand	33		
Mexico	31		

Note: Data include investment by central, state, and local governments and SOEs.

a. 1983–85.

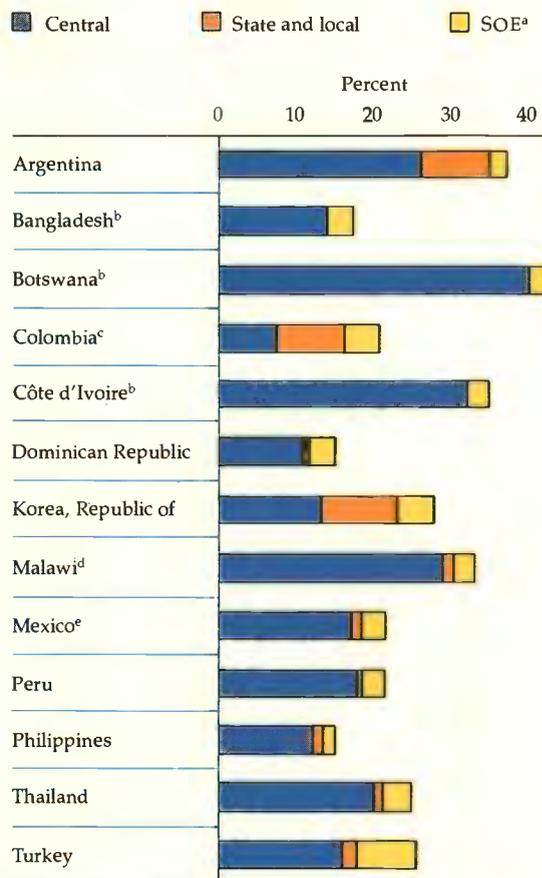
b. 1981–85.

c. 1982–85.

d. 1980.

Sources: Industrial countries, adapted from Saunders and Klau 1985; developing countries, World Bank data.

Figure 2.3 Total public sector expenditure as a share of GDP in selected developing countries, 1985



Notes: Except where noted, the expenditure figures represent total spending by central, state, and local governments minus transfers, plus fixed capital outlays by SOEs. Countries were chosen on the basis of available data.

a. SOE capital expenditure.

b. State and local data are not available.

c. State and local data include SOEs operating at the state and local levels.

d. 1982.

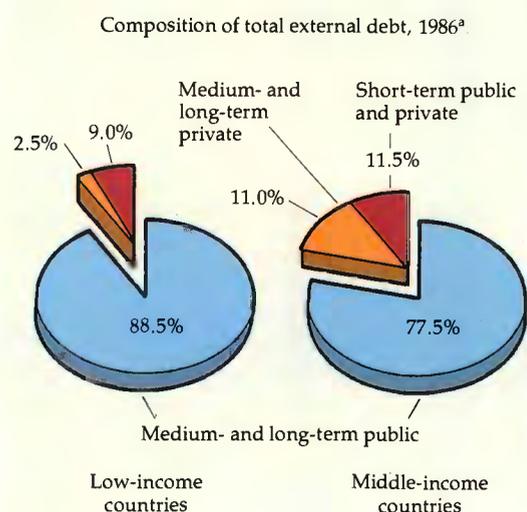
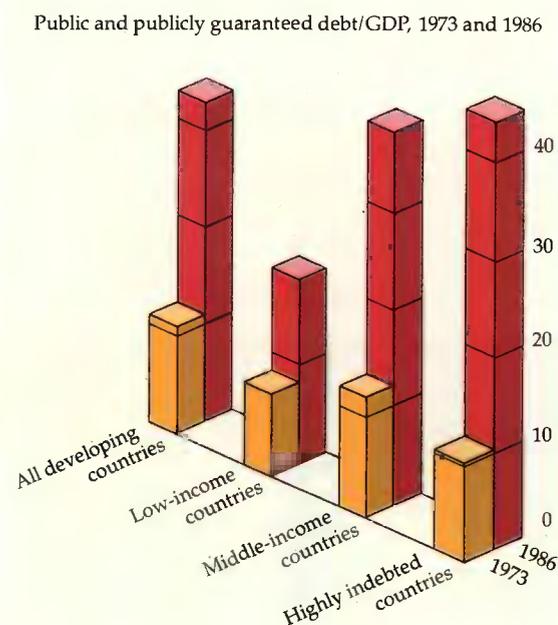
e. State and local data cover only the Federal District of Mexico.

demand) was typically in the range of 5 to 7 percent of GDP in 1985. Since the coverage of SOEs and off-budget funds is incomplete, these figures understate the role of nongovernmental public entities. By comparison, in industrial countries the (unweighted) average share of SOE capital spending in GDP was only 3.6 percent during the late 1970s; in the United States it was as low as 0.9 percent.

Fourth, state and local governments appear in

general to have a smaller role in developing countries than in the industrial world—although, again, data are incomplete. Subnational governments are important in some developing countries, however, including Argentina, Brazil, Colombia, India, Re-

Figure 2.4 Growth of public debt and the composition of total external debt (percent)



a. Does not include the use of IMF credit.

public of Korea, and Nigeria (see Chapter 7).

Public expenditure is only one aspect of public finance; revenue also needs to be considered. The ratio of central government current revenue to GNP in developing countries increased from 16 percent in 1972 to 23 percent in 1985 (see Table 2.2). Despite this, spending has tended to outstrip revenue, and the prevailing methods of collecting revenue have often resulted in unnecessarily severe losses in economic efficiency. Chapter 4 examines the costs of revenue raising and how to reduce them.

The excess of expenditure growth over revenue growth has led to fiscal deficits in developing countries, just as in industrial countries (see Table 2.2). Because developing countries have less scope for domestic financing, however, their fiscal deficits have tended to spill over more readily into domestic inflation or external imbalances (see Chapter 3).

One consequence of the fiscal deficits has been the public sector's contribution to the accumulation of foreign debt. Public and publicly guaranteed foreign debt tripled as a percentage of GDP between 1973 and 1986 for all developing countries and nearly quadrupled for the highly indebted, middle-income countries (see Figure 2.4). Moreover, in 1986 medium- and long-term public debt accounted for some three-quarters of total foreign debt in middle-income developing countries and for 89 percent of total foreign debt in low-income countries. The current debt overhang in developing countries is thus in part due to past fiscal policy failures and is at the core of the current fiscal crisis in the developing countries (see Chapter 3).

Expenditure, revenue, and deficit shares in GNP provide an incomplete picture of the public sector. They do not measure the full extent to which governments affect the private sector because they ignore regulations and other controls. Such policies, widely applied in developed and developing countries, are difficult to quantify. Scattered evidence suggests that the developing countries saw an increase in regulations and controls in the 1970s, although some of these were reduced as part of the adjustment efforts of the 1980s. Overall, however, there is little doubt that the role of the public sector has greatly expanded in the developing world during the past four decades.

Evolving views of the public sector

Since World War II the growing importance of the public sector has been seen by many development

economists and policymakers as a natural and even necessary ingredient of development. In what can be called the "public interest" view, governments must intervene to foster development: the unmodified interaction of private agents will not achieve the goals of economic efficiency, growth, macroeconomic stability, and poverty alleviation.

According to this view, free markets underprovide "public" goods such as national defense, law and order, primary education, basic health, infrastructure, and research and development—goods that benefit people other than the producers or consumers. Equally, markets can overproduce goods that impose costs beyond those borne by the producer: traffic congestion, pollution, the depletion of natural resources, and so on. In addition the existence of monopolies, the lack of fully developed markets (especially for capital and insurance), and gaps in the supply of information may result in inefficient resource allocation and yield savings and investment rates that are less than optimal. Market mechanisms may thus produce insufficient growth as well as macroeconomic imbalances, such as balance of payments deficits and unemployment. According to the public interest view, these market failures need to be corrected by governments—through public provision of goods and services, through public savings and investment, and through taxes, subsidies, and regulations.

This approach reserves a special place for government in influencing the distribution of income and alleviating poverty. Some argue that the incidence of poverty determined by the market is not usually just or appropriate, so that government may—and should—step in. It might do so through the degree of progressivity of taxes and through expenditures targeted to the poor. Governments often design poverty programs to ensure that the poor are able to consume a minimum level of certain "merit" goods, such as food or shelter.

In the developing economies the unmet backlog of physical and social infrastructure, the low levels of savings and investment, the need to foster economic growth through modernization, and the availability of concessional foreign funding for public projects explain the rapid expansion of public finance that is consistent with the public interest view. While considering the growth of government to be appropriate in general, the public interest view also recognizes that the growth in government spending may at times have been excessive. Mistakes by government are seen as a serious

problem in practice, but not as inevitable or irreversible. Policy and administrative reforms have commonly been proposed to correct such "government failures."

During the late 1970s and 1980s concern about the expansion of the public sector arose in the industrial and developing countries. Slow growth, lagging private savings and investment, high inflation, balance of payments deficits, heavy debt burdens, continued poverty, and unemployment began to be seen, at least in part, as the result of the excessive growth of the public sector. Even when external events beyond the control of individual countries were the immediate cause of many of the difficulties, the actions of governments were often blamed for having left the developing countries poorly prepared. The late 1970s also marked an important turning point in the centrally planned economies, where reliance on direct command by government was increasingly seen as a drag on economic growth; during the 1980s several of these countries have increased the role of markets.

These concerns found an intellectual underpinning in the reemergence of what can be called the "private interest" view of the public sector. Tracing its roots back to the classical liberal economists, especially Adam Smith, the private interest view starts with the presumption that individuals, whether in or out of government, use the resources and influence at their disposal to further their private interests, rather than any abstract notion of the public interest. Although the pursuit of private interests allocates resources efficiently in competitive markets, this generally does not occur when individuals use the monopolistic powers of government to their own advantage. Politicians, bureaucrats, and many private interests gain from a growing government and greater government expenditure. So, it is argued, the government's necessary role as provider of public goods needs to be carefully circumscribed. Otherwise, inefficient public and private provision of goods and services is sure to follow.

The emergence of persistent fiscal imbalances and the difficulties of implementing effective stabilization and adjustment programs in developing countries have also been explained by the private interest view (see Box 2.2). Exponents of the private interest view commonly suggest balanced budget laws to prevent the emergence of fiscal deficits. Experience with such laws in developing countries suggests, however, that they are unlikely to be effective (see Box 2.3).

In their extreme versions the public interest and

Box 2.2 Political interests and economic reform

Effective stabilization and structural adjustment programs require political support. This is especially true of public finance policies, because they generally affect the distribution of income. A recent study by Stephan Haggard and Robert Kaufman highlighted four main aspects of the political process.

Interest groups

Economic policies are heavily influenced by the balance of power among competing interest groups, especially business, labor, and agriculture. Reforms are unlikely to succeed without the backing of some of these groups. For example, the support of business groups—and their confidence that reforms will be sustained—is vital for a successful reallocation of resources. Labor unrest over wage restraint, for instance, can undo reforms, as has been demonstrated in several developing countries, including Argentina, the Dominican Republic, Egypt, and Jamaica.

Type of regime

Authoritarian regimes have not always been better at imposing economic austerity than democracies. A distinction between different types of democracies and authoritarian regimes is more useful. Strong democracies, such as Costa Rica, have a tradition of consultation with business and labor; this facilitates acceptance of economic programs. In contrast, where policymaking is conducted by technocrats behind closed doors, reform may succeed in the short term but may be difficult to sustain. Strong authoritarian governments—characterized by continuity in leadership, insulation from societal pressures, well-established and integrated interest groups, and the power to enforce decisions—tend to be relatively successful in imposing the short-term costs of economic reform. The Republic of Korea in the early 1980s has been cited as an example. Weak authoritarian governments, which maintain political authority through personalistic patron-client relations, tend to be bad at economic reform. Several of the small, ethnically fragmented, Sub-Saharan states fall into this category. Here the maintenance of political power often depends on the discretionary use of public funds, and the reform of public finances, while economically rational, becomes politically irrational. Such regimes are likely to have greater difficulty imposing

reform than either strong authoritarian regimes or consultative democracies.

Political cycles

The time horizon of a government may influence its decisions. This will differ according to whether countries have a stable electoral system. In a stable system the period before elections is characterized by expansionary policies, the period after by retrenchment—as in Mexico during the past twenty years. In contrast, when transitions are insecure, uncertainty affects policy choices. New democratic governments are likely to pursue expansionary programs early in office—as in Argentina in the early years of Alfonsín, Brazil under Sarney, and Turkey after the succession of the civilian government. New authoritarian regimes tend to follow the opposite path. Typically the military seizes power in the midst of a crisis and attempts to restore order and rationalize the economic system. Although circumstances differed, Argentina (1966 and 1976), Bolivia (1971), Brazil (1964), Chile (mid-1973), Indonesia (1966), Turkey (1971 and 1980), and Uruguay (mid-1970s) all serve as illustrations.

The bureaucracy

The government's administrative capacity is crucial to its ability to organize and carry out a program of economic reform. In some countries, such as Korea, this capacity is well developed. In others, including many low-income African countries, it is not. Moreover, in most developing countries the bureaucracy forms an influential interest group that may oppose stabilization and structural reform. Economic reform often requires reducing the size of the public sector through government employee layoffs and privatization of SOEs. Such policies are at odds with the interests of the bureaucrats.

Politics and "first-best" policies

Political factors are important in developing a program of economic reform. "First-best" policies may not always be achievable because of political constraints. Indeed, failed attempts to pursue first-best policies without considering the political dimensions may make matters worse. "Second-best" policies will prove more successful if they respond better to political reality and thus are sustainable in the long term.

private interest views of the public sector are irreconcilable. It is therefore only natural to seek an empirical validation of either view. One approach is to ask whether the growth of government has helped or hurt economic growth: the former finding would tend to support the public interest view;

the latter would buttress the private interest view. At the simplest level a scatter diagram for a sample of countries shows a lack of any significant correlation between the growth of GDP and the share of government spending in GDP (see Figure 2.5). Some researchers, after allowing for other factors

that may influence growth, have found that economic growth and the *share* of government spending in GDP are negatively related; others have found that economic growth and the *growth* of government spending are positively related. In any case serious questions remain about the analytical approaches and data used. The evidence is thus inconclusive.

A pragmatic approach to public policy

Rather than pursuing this line of inquiry, it is more fruitful to consider the public and the private views as contributing complementary perspectives to an understanding of the public sector and public finance. The public interest view stresses the potential benefits of government intervention when it is effectively deployed to correct market failures. It also provides a framework for identifying the conditions under which market failure is likely to oc-

cur and for designing the appropriate policies to offset these failures. The private interest view emphasizes the potential for failure and cautions against an overly sanguine view of government as the impartial guardian of the public interest. Box 2.4 provides an example of how the correction of market failures must be accompanied by efforts to minimize government failure in the environmental field.

Pragmatic policy design can draw on the strengths of both the public interest and private interest view by:

- Considering both the benefits and costs of government involvement
- Asking which groups in society are likely to receive the benefits and which to bear the costs
- Recognizing the institutional and political constraints that are likely to be encountered in implementing a particular policy

Box 2.3 Balanced budget laws

Some developing countries have adopted laws that require the national budget to be balanced. The economic rationale for these laws is shaky. What is intended is a budget consistent with targets for inflation, public debt, and private sector growth (see Box 3.2). A budget to achieve these targets need not necessarily be balanced. Experience has also shown that these laws are very hard to implement. A principal difficulty is defining "budget balance." To do this one must first define the "government." This is not straightforward, because most countries have a multiplicity of state-owned enterprises (SOEs) and extra-budgetary accounts. Then one must decide what constitutes revenue and expenditure for the purposes of the budget. For example, it is sometimes difficult to distinguish between asset sales, loans, and genuine revenue items. Finally, one must specify the period over which the budget is to be balanced.

Balanced budget laws in Colombia and Indonesia illustrate these difficulties. In both countries governments are required by law to prepare a balanced budget for each fiscal year. Colombia has an additional restriction that revenue must not increase by more than 10 percent over the level of the previous year. In both countries "revenue" is defined to include aid and loans already contracted by the government. "Expenditure" is defined to include debt amortization payments. The budget balance does not correspond, therefore, to the economic definition of government surplus or deficit (where loans are treated as financing items), and it provides little insight into the significance of the

budget for inflation and debt. Colombia and Indonesia have run significant central government deficits and surpluses in recent years when defined in economic terms.

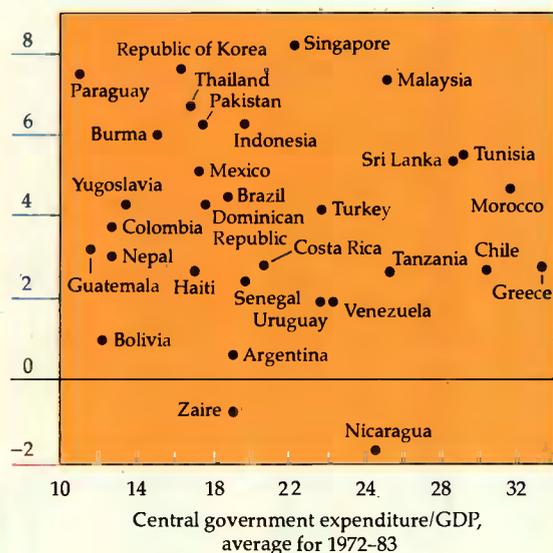
Other problems arise. It is relatively easy to keep important public sector agencies out of the budget and thus achieve the required balance. In Colombia, SOEs and other off-budget entities receive earmarked taxes directly and can borrow and spend without the sanction of the budget. Indonesia also has many SOEs that are not covered by balanced budget requirements.

Balanced budget laws can complicate fiscal planning. In Colombia supplemental budgets have had to be prepared during every fiscal year as extra revenue becomes available. These supplemental budgets disrupt expenditure planning, because little effort is made to check for consistency with overall spending goals. As many as five supplemental budgets have been prepared in a year. This increased the original budget by up to 50 percent.

Although balanced budget laws are in practice easy to evade, they can be useful to fiscally conservative governments. They allow the finance ministry to invoke the constraint of the "balanced budget" when resisting calls for more spending. Indeed, Colombia and Indonesia have on balance followed prudent fiscal policies since the laws have been in force. But balanced budget laws are more often a symbol of a fiscally conservative state than an effective restraint on a spend-thrift one.

Figure 2.5 Relation between central government expenditure as a share of GDP and the growth of GDP in developing countries (percent)

Growth of GDP, 1973–84



Sources: IMF, *Government Finance Statistics*, 1987, and World Bank data.

- Searching for ways to ensure that the public sector operates efficiently within these constraints.

A pragmatic approach to public policy analysis might begin by ranking areas of economic activity according to the extent to which government intervention is desirable. Plausible criteria for ranking would be the scope for government to promote efficiency, growth, poverty alleviation, and stabilization. Accordingly a stronger case can be made for government involvement in some areas than in others.

First, governments have certain core areas of responsibility. The public goods that only the public sector can effectively provide include defense, diplomacy, macroeconomic management, and a legal and institutional system that defines and enforces the rules of justice, property, and commerce. Second, governments need to help provide social, physical, and information infrastructure: education, health, transport networks, public utilities, technology development and dissemination, and environmental protection. Market failures are common in these areas, and many of the merit goods required to meet basic needs are

found there. Elsewhere the case for government involvement is weaker on economic or equity grounds, and the costs of intervention threaten to outweigh the benefits. For example, in agriculture, industry, energy, mining, and many services—although some support may be needed—governments are generally not well equipped to play a major role.

Where exactly the line should be drawn between government involvement and private sector responsibility depends in principle on an evaluation of the costs and benefits of government intervention. Where the system for collecting revenue allows additional resources to be raised with little distortion of private sector activity, greater government involvement may be appropriate—perhaps because market failures and poverty problems are especially severe or because the civil service is effective in providing the needed public goods. Elsewhere the same level of involvement may be too high because the revenue collection is already highly distortionary, because private markets are operating efficiently, or because the bureaucracy is ill equipped to intervene.

This suggests that what matters is the quality of government, more than its size as such. Quality might be defined broadly to cover five factors.

- *Prudent fiscal policy.* The need to improve fiscal policy has already been pressed upon most developing countries. Excessive fiscal deficits and the resulting financing requirements of the public sector have often been at the root of macroeconomic imbalances. Bringing expenditures more closely in line with revenues to ensure that the resulting deficits are consistent with other macroeconomic policies and objectives is an essential element of improving the quality of government (Chapter 3). The harder question is how to go about this. The goal is to raise additional revenue in the most cost-effective way and to cut spending, where necessary, in the least damaging way

- *Efficient revenue mobilization.* The cost associated with raising a given level of public revenue can generally be lowered by reforming the tax system so as to reduce the distortions and inefficiencies that taxes generate. Revenue can also be raised efficiently by raising prices or user charges for publicly provided goods and services when these are set below cost, as is frequently the case. Tax systems and user charges may be structured so as to minimize the burden on the poor without causing significant efficiency losses (Chapters 4 and 6).

- *Priorities for public expenditures.* For a given size of government as measured, for example, by the

Box 2.4 Public finance and the environment

Economic activity depends heavily on the natural resource base in most developing countries. Countries must increase the productivity of that base if their growing populations are to attain substantially higher living standards. Public finance policies designed to promote stable economic growth and to alleviate poverty have an important role in this effort. Without government intervention individuals may not adequately consider the long-term environmental effects of their collective actions. But inappropriate government interventions have sometimes aggravated environmental problems.

Lack of protection by free markets

Most resource degradation results from the cumulative activities of farmers, households, and industries, all trying to improve their economic well-being. There are several reasons why their efforts may actually work against them. First, people may not completely understand the long-term consequences of their activities on the natural resource base. Second, ill-defined or badly enforced property rights may result in environmental losses. For example, vaguely defined rights over communal grazing lands, tree crops, or water resources have discouraged soil, forest, and water conservation, because individuals are not certain they will benefit from their investment in conservation. Third, poverty can undermine the efficiency of market processes in accounting for long-term environmental concerns. In many cities around the world, in order to reduce housing costs and travel time, many people live in the shadow of factory walls where they are constantly exposed to pollution or industrial accidents.

In combination with other policies public finance instruments can be used to change the economic incentives to promote sustainable productive uses of natural resources. On the revenue side, taxes, subsidies, and price interventions can be designed to ensure that the private costs of resource use accurately reflect long-term economic costs. Education, family planning programs, and the enforcement of property rights can encourage people to think further ahead.

Well-designed environmental policies can add to government revenue while conserving natural resources. Between 1979 and 1982, for example, the Philippine government collected only about \$140 million of a potential \$1.5 billion in timber royalties; it left the remainder to favored concession holders. Because of such policies productive virgin forests in the Philippines have been reduced by nearly 90 percent, and

the logging of upland forests has contributed to severe erosion.

Failure of public finance policy

Many countries follow policies that aggravate rather than correct the market failures described above. Inefficient incentives may result from public finance policies that were designed without adequate recognition of environmental effects. The link between policy and the environment is often difficult to trace; sometimes the problem is a lack of influential environmental interest groups. In these cases there is no tradeoff between increasing efficiency and preserving the resource base.

In some cases there are tradeoffs between long- and short-term considerations. This is particularly true when economic problems are extreme and urgent. Often, however, the policies that accelerate resource degradation and reduce economic productivity also increase the fiscal burdens on government, distort short-term efficiency, and benefit relatively well-off groups at the expense of the disadvantaged.

The environmental effects of poorly designed public finance policies are well illustrated in the energy sector. In most developing countries energy prices have until recently failed to reflect opportunity costs. At the same time low prices have reduced returns to investments in energy conservation, perpetuated inefficient fuel use, and, in turn, caused environmental problems. For example, in countries where coal is an important fuel, prices have often been below economic costs, so that many mines operate at a loss and require government subsidies. Yet each step in using coal (mining, washing, transporting, and burning) also involves potential damage to land, water, and air quality. Similarly, subsidized electricity prices intended to promote industrialization in many developing countries (including Bolivia, China, Peru, and Uganda) have led to uneconomic growth in electricity demand and inefficient levels of public investment in power-generating capacity. This, in turn, has led to excessive or premature development of hydro resources and unnecessary pollution from oil or coal-fired power plants.

Limiting the risks for the future

Economic activities are bound to have environmental side effects. Public finance policies provide a set of effective instruments to limit the damage and reduce the risks, often without having to confront major tradeoffs between economic growth and poverty alleviation.

share of public spending in GDP, government spending may be devoted to sectors or activities of low priority, while high-priority sectors or activities get insufficient attention. Shifting public resources from low- to high-priority areas can significantly improve the effectiveness of the public sector in supporting long-term growth and poverty alleviation (Chapters 5 and 6).

- *Appropriate structure of government.* The quality of the public sector hinges on the effectiveness of its constituent parts—central, state, and local governments and SOEs. A combination of excessive control by the central government, poor accountability of decentralized agencies, and unclear fiscal relations among the different parts of the government have often contributed to an ineffective mobilization and use of public resources in developing countries. Improving the structure of government can significantly increase its quality (Chapters 7 and 8).

- *Good administration.* The administrative capabilities of government are an important constraint on its ability to design and implement high-quality expenditure and revenue programs. Improving the quality of administration is an essential part of improving the quality of government. (Public administration reforms are addressed in this Report only insofar as they relate directly to public finance.)

Placing stress on the quality of government is compatible with the view that the public sector in many developing countries in recent years has become overextended and has taken on responsibilities it is ill equipped to handle. As a result expenditures and available resources have been balanced poorly. The challenge for governments is to examine their priorities and policies in the light of experience and limited resources. Often this will point to a reduced role for government and a greater reliance on private initiative. In some countries or sectors, however, more public spending may be appropriate—especially where protracted fiscal austerity has led to deep, across-the-board cuts in public spending. The rest of this Report explores these choices and indicates ways to improve the quality of public finance so that developing countries can respond to their present fiscal emergency without seriously harming the prospects for long-term growth. Although the focus is on public finance policies in developing countries, there is no doubt that many of the lessons for policy apply with equal force to industrial countries. The main difference is that developing countries can even less afford to waste their extremely scarce resources than can the better-off industrial countries.