



Directions for reform

The public sector has grown rapidly in almost all countries during the past few decades. This Report has shown how the poor conduct of fiscal policy has contributed to serious economic problems in parts of the developing world. Unsustainable budget deficits have led many countries into heavy foreign borrowing, high inflation, and stagnant private investment. Public revenues have failed to match spending. They have also been costly and inequitable, relying too much on trade, excise, and turnover taxes and not enough on broadly based domestic commodity and income taxes or user charges. Too many public funds have been spent on unwise investment, costly subsidies, and excessive public employment; too few have been spent on investment to support development.

The Report has pointed to many examples of sound public finance policy. Some developing countries have managed to avoid serious fiscal problems. Others have taken bold steps toward reform. Reform is clearly possible, although institutional change is difficult and takes time. The experience of the past few decades suggests five broad policy prescriptions. These are not unattainable ideals, but practical goals. Some countries have already taken steps in their direction.

- Adopt prudent budget policies.
- Reduce the cost of raising revenue.
- Increase the efficiency and effectiveness of public spending.
- Strengthen the autonomy and accountability of decentralized public entities.
- Design public finance policies consistent with poverty alleviation goals.

Prudent budget policies

Moderate and sustainable public deficits, with some allowance for cyclical ups and downs, are far preferable to successive phases of rapid fiscal expansion followed by sharp fiscal contraction. Debt accumulation, capital flight, and loss of confidence during the expansion ensure that the ensuing contraction will be all the more severe. The poor then bear the greatest burden. They are unable to shield income by moving assets abroad, and they are often the first to lose their jobs in times of recession. What then are “moderate and sustainable” public deficits? They are deficits at levels consistent with low and stable inflation, an acceptable external debt service burden, and reasonable real interest rates. A higher rate of domestic saving and more productive use of public resources will permit higher deficits consistent with prudent fiscal management.

Countries that depend on commodity exports face a particularly difficult fiscal environment. Their safest strategy is to treat commodity revenue as inherently volatile. Mistakenly treating a temporary boom in revenue as permanent carries heavy long-term costs, because it can take years to cut spending and reverse the accumulation of debts incurred during the boom. By contrast, erring on the side of caution—treating a permanent boom as temporary—is easily put right later. Boom revenue can then be used to accumulate external assets or repay debt, thus avoiding the risk of inflation and an appreciating exchange rate.

If a deficit becomes unsustainable, macroeconomic stabilization is a top priority. Structural eco-

nomical adjustment cannot happen alongside major macroeconomic imbalances. At the same time stabilization without structural measures to support growth may itself prove unsustainable. Stabilization and structural adjustment must therefore be coordinated to avoid inconsistency in policy. Adjustment that relies on lowered tariffs and import barriers, unified exchange rates, and deregulated financial markets can be destabilizing because of its fiscal implications. Adjustment should therefore allow for complementary fiscal reform to replace any lost revenue. Conversely, stabilization that relies on higher tariffs, restricted imports, and reduced public and private investment can stifle structural reform and growth. In fiscal retrenchment the choice between higher revenue and lower spending will vary; it will depend on the size of the public sector and the efficiency of both its revenue gathering and its spending. Regardless of that choice, special short-run measures may be needed to cushion the effect of stabilization on the poor.

Reduced costs of raising revenue

Raising public revenue is expensive. The costs include not just the direct costs of administration, but also the indirect costs that arise from distortions in economic activity. Some methods, though, are far costlier than others. Certain principles should guide governments in reforming their revenue systems.

As far as possible the costs and benefits of public services should be linked through user charges. These might be charges related to consumption (public pricing) when specific consumers can be identified or charges related to benefits (such as valorization schemes in Latin America) when the benefits of a public service are concentrated in a particular area. User charges can promote greater economic efficiency by making beneficiaries weigh the economic cost of a good or service against its benefit. Users are also more likely to oversee the performance of suppliers when they have to pay. Many public services for which charges are both feasible and appropriate are often provided free or at highly subsidized prices to all users. As a result there is significant scope for raising additional public revenue from higher user charges—especially for services such as higher education, hospital care, electricity, water supply, and urban transport. Far from hurting the poor, evidence shows that cost recovery can help them by producing the

financial resources necessary to expand the supply of basic services. Subsidies can still be targeted to the poorest groups to alleviate poverty and to meet basic needs for education, health, and sanitation.

Even though user charges can often be increased, general taxes will continue to be necessary to finance public goods that benefit the citizenry at large. Although some tradeoffs among objectives remain unavoidable, taxes can be reformed to raise revenue while reducing economic distortions and the burden on the poor. Simplicity in tax design is essential, because developing countries have severely limited administrative resources. Thus administrative feasibility and better tax administration should be basic concerns of any tax reform.

Tax systems satisfying these criteria will typically include more streamlined company and personal income taxes, a value added tax (often at the manufacturer's level only, for simplicity), and a few excise taxes on luxury or socially undesirable goods. Where import duties are judged to be necessary, they should be low and more uniform. Marginal tax rates should be low to minimize distortions and to promote compliance. Taxes should be simply structured, with few rates and few exemptions. Extensive use of tax incentives to achieve particular social goals rarely works in practice, since it tends to create or exacerbate economic distortions and severely complicates tax administration. High threshold exemptions in the individual income tax and exemption of unprocessed products from the VAT will go far toward reducing taxes on the poor while concentrating administrative resources where they are most productive in raising revenue.

Efficient and effective public spending

A guiding principle for public investment is that it should complement, rather than compete with, private investment. Government involvement is clearly needed to supply public goods, such as defense and law and order. It is also needed where the private sector would undersupply goods or services that benefit society at large, such as primary education, basic preventive health care, transport infrastructure, and agricultural research. Public intervention can also be appropriate for utilities that monopolize a single source of supply or that face large economies of scale. But governments need not spend scarce, costly resources on activities that the private sector—if allowed to—can

do better. For example, they need not try to produce or market most agricultural and industrial goods, nor to provide services such as urban bus transport.

Spending needs to follow sound priorities. Priorities emerge more forcefully when all parties are aware of their specific resource constraints. Setting overall spending limits means balancing needs against the cost of raising revenue. It is best achieved through a coordinated process of medium-term fiscal planning, annual budgeting, and regular monitoring of revenue and expenditure. Binding spending limits should apply not just to finance and planning ministries, but also to sector ministries, subnational levels of government, and SOEs.

The effectiveness of each item of spending is critical in determining its effect on development. Each major project should be carefully appraised, not only for economic viability (using cost-benefit or cost-effectiveness analysis), but also for technical, administrative, and financial feasibility. A distorted policy environment may cause even the best projects to fail. They need the support of appropriate pricing, trade, and credit policies.

Among recurrent expenditures, adequate allocations for operations and maintenance are essential for efficient use of the existing capital stock. Governments often face a tradeoff between maintenance and new investment, but the former is usually the more efficient. The cost of rebuilding roads can be three to five times that of timely maintenance. Adequate civil service salaries are also needed to attract and motivate qualified policymakers and administrators. The common practice of cutting salaries and narrowing pay differences while expanding total employment is bound to produce poor administration. Developing-country governments cannot afford to be employers of last resort for the entire labor force. Finally, subsidies for poverty alleviation should be aimed at those most in need.

Strengthened autonomy and accountability of decentralized public entities

Decentralized decisionmaking and accountability can help to link costs and benefits, and thus improve efficiency. Local decisionmakers can be more flexible and responsive to the needs and preferences of their constituents; equally, citizens can better watch over local entities than over central ones. The extent of feasible decentralization varies

from sector to sector. Urban infrastructure—roads, water, and sewerage—is best handled by local governments and financed as far as possible through user charges. In rural infrastructure a greater role can also be played by village-based community groups, such as water user associations in irrigation. Social service providers, such as schools and clinics, can usually be given greater responsibility for delivery and for cost recovery, although some degree of central control is needed to maintain standards and to provide targeted subsidies where necessary. SOEs should be granted the autonomy to cover costs through pricing, with managers held accountable for the quality of services and for the financial viability of their enterprises.

Local entities and SOEs will require financing other than user charges if they supply public goods or subsidies. Local governments can streamline their tax systems and—through more accurate property valuation and better administration—broaden the base and improve the collection of property taxes. Borrowing by local governments or SOEs may be warranted for capital spending whose benefits occur in later years, but major borrowing throughout the public sector should be subject to central approval, especially when government guarantees are given. Central government grants and subsidies are often justified, usually on equity grounds, but they should be designed to provide incentives for efficient cost recovery. Regular and reliable auditing by central authorities can increase local accountability for the use of borrowed funds, grants, or subsidies.

Financial flows within the public sector are usually complex and often confusing. Transparency in these transactions can be increased by accounting explicitly for all subsidies, equity injections, dividends, taxes, payments for goods and services, borrowing, or debt guarantees. Financial obligations between agencies should be enforced. Arrears in one account jeopardize the financial stability of the creditor and often lead to compensating arrears in other accounts. This causes greater confusion and lack of control.

Like most of the other reforms suggested in this Report, strengthening local government requires improved administration and management. Efforts to upgrade the quality of public sector employees through recruitment, training, and performance incentives will always be critical in fiscal reform. For many commercial SOEs greater competition from private providers or increased private sector involvement—through private manage-

ment contracts, leasing, or outright divestiture—can help to reduce inefficiency as well as the budgetary burden.

Public finance policies consistent with poverty alleviation

Reducing poverty remains the ultimate challenge of development policy. Public finance can be a powerful tool for this purpose if the prescriptions described above are borne in mind. Fiscal prudence sets the groundwork for growth—the precondition for defeating poverty in the long run. Moreover the poor often bear the biggest direct burden of imprudent policies.

On the revenue side the poor can be exempted from income and property taxes. Exemption of unprocessed products (particularly food) from sales taxes softens the effect of such taxes on the poor. Targeted subsidies can be used to exempt the poor

from user charges. In some cases modest user charges on higher cost services may actually help the poor by permitting increased investment in, and thus expanded access to, publicly provided essential services, such as potable water, primary education, and basic health care.

The most important instrument for directly relieving poverty is public spending. Expanding the resources devoted to low-cost urban and rural infrastructure can lead to immediately improved living standards, even if they are financed through user charges. Strengthening local governments is crucial because they are usually the main providers of urban services. Subsidies targeted for the poor can be maintained even in times of fiscal austerity. In the long run, investment in human resources—including basic health care and nutrition, primary education, and family planning—can significantly improve the lot of the poor and support growth in developing countries.