



## *Public finance in development: an overview*

Public finance shapes the course of development. It affects aggregate resource use and financing patterns and, together with monetary and exchange rate policies, influences the balance of payments, the accumulation of foreign debt, and the rates of inflation, interest, and exchange. Public spending, taxes, user charges, and borrowing also affect the behavior of producers and consumers and influence the distribution of wealth and income in an economy. Balance of payments crises and foreign debt problems are at least aggravated, and are often caused, by imprudent fiscal policy. Their solution almost invariably involves some combination of cutting public spending and raising additional revenue, thus freeing resources for exports and debt service. Careless fiscal austerity can lead to prolonged recession, however, and can place a disproportionately heavy burden on the poor. For this reason the structural aspects of public finance policy—how spending is allocated and revenue raised—matter as much as the overall macroeconomic balance.

*World Development Report 1988* examines public finance in developing countries against the backdrop of today's uncertain economic outlook. The Report's main concern is how appropriate public finance policies can improve the quality of government. The discussion is timely for two reasons. First, budget deficits and external debts pose a dilemma for many governments: how can they achieve short-term stabilization without retarding long-term development? Second, the perception of government has shifted during the past decade; where government was once commonly seen as

a catalyst of development, many now think it an obstacle.

The Report is in two parts. Part I explores recent developments in the world economy, including the emergence of severe macroeconomic imbalances among industrial countries and the effect of these imbalances on the developing world. It concludes that a significant reduction in the budget deficit of the United States, together with stronger domestic demand in the Federal Republic of Germany, Japan, and the newly industrialized economies (NIEs), is necessary to reduce today's sizable current account imbalances and avoid the risk of a slowdown in the world economy. Developing countries must continue to reform domestic policies, while the net resource transfers from the developing countries must be reduced if these countries are to resume sustained economic growth.

Part II concentrates on public finance in developing countries. Five broad conclusions emerge.

- Prudent and stable macroeconomic fiscal management is far preferable to successive phases of extreme fiscal expansion and contraction. Modest and sustainable fiscal deficits promote growth, while shielding the poor from the heavy burdens of fiscal austerity.
- Greater reliance on user charges and simplified, restructured general tax systems can increase public revenue and reduce economic distortions.
- Clear priorities and concentration on quality are necessary for efficient and effective public spending. Priorities tend to emerge more forcefully if decisionmakers are aware of their specific

**Table 1 Growth of real per capita GDP, 1965 to 1995**  
(annual percentage change)

Country group	Actual			Projected, 1987-95	
	1965-73	1973-80	1980-87	Base	High
Industrial countries	3.6	2.1	1.9	1.8	2.6
Developing countries	3.9	3.2	1.8	2.2	3.6
Exporters of manufactures	4.8	4.0	4.6	3.4	4.9
Highly indebted countries	4.2	2.9	-1.3	1.0	2.5
Sub-Saharan Africa	3.8	0.5	-2.9	0.0	0.7

Note: All growth rates for developing countries are based on a sample of ninety countries.

resource constraints and expect to abide by them in planning and budgeting.

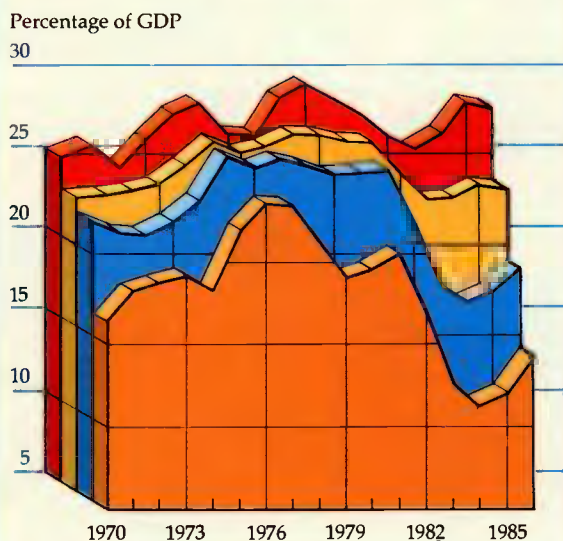
- Autonomous and accountable decentralized public entities, including subnational levels of government and state-owned enterprises, can improve the efficiency of both spending and revenue gathering. But administrative constraints limit the scope for speedy decentralization; increased private sector involvement in the provision of public services should therefore be explored wherever feasible.

- Well-designed public finance policies can be powerful tools for relieving poverty.

Although the focus of Part II is on developing countries, many of the issues addressed are also problems for the industrial countries. Solving these problems is a difficult task for any government. Reform must span the full range of macroeconomic and microeconomic concerns as well as deal comprehensively with all parts of the public sector: central, state, and local governments and state-owned enterprises. The relations between fiscal and other policies are pervasive and complex. The lack of accurate fiscal data in developing countries further complicates the task of policy design. In addition public finance reform usually involves politically sensitive tradeoffs that most governments, whether in developing or industrial countries, would rather avoid. Yet the many examples of fiscal policy cited in this Report indicate that reform is both possible and highly beneficial.

**Figure 1 Ratios of investment to GDP in developing countries, 1970 to 1986**

■ Exporters of manufactures  
 ■ Highly indebted countries  
 ■ Developing countries  
 ■ Sub-Saharan Africa



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

### Policy options for global adjustment

As the 1980s draw to a close, economic turbulence and uncertainty persist. Since 1983 governments in industrial countries have managed to reduce inflation and maintain a positive rate of growth. But significant problems remain: high real interest rates, declining investment rates, volatile exchange rates, growing current account imbalances, rising protectionism, and—in Europe—high unemployment. These problems are mainly the legacy of past inflationary policies and structural rigidities. But they are also a consequence of the mismatch of macroeconomic policies during much of the 1980s—expansionary in the United States and contractionary in Europe and Japan—and of the combination of loose fiscal policy and tight monetary policy, particularly in the United States. This has led to slowed growth of both production and trade. As a result, the world economy faces continuing risks.

Growth has also slowed substantially in the developing countries. Some African and highly indebted, middle-income countries have suffered



significant declines in per capita income (see Table 1). Their investments have fallen to levels at which even minimal replacement may no longer occur in important sectors of their economies (see Figure 1). Their debts are growing, but they still face negative net resource transfers because debt service obligations exceed the limited amounts of new financing. In some developing countries the severity of this prolonged economic slump already surpasses that of the Great Depression in the industrial countries (see Figure 2), and in many countries poverty is on the rise (see Box 1).

To improve the economic outlook for industrial and developing countries alike, policymakers must achieve progress toward three related goals:

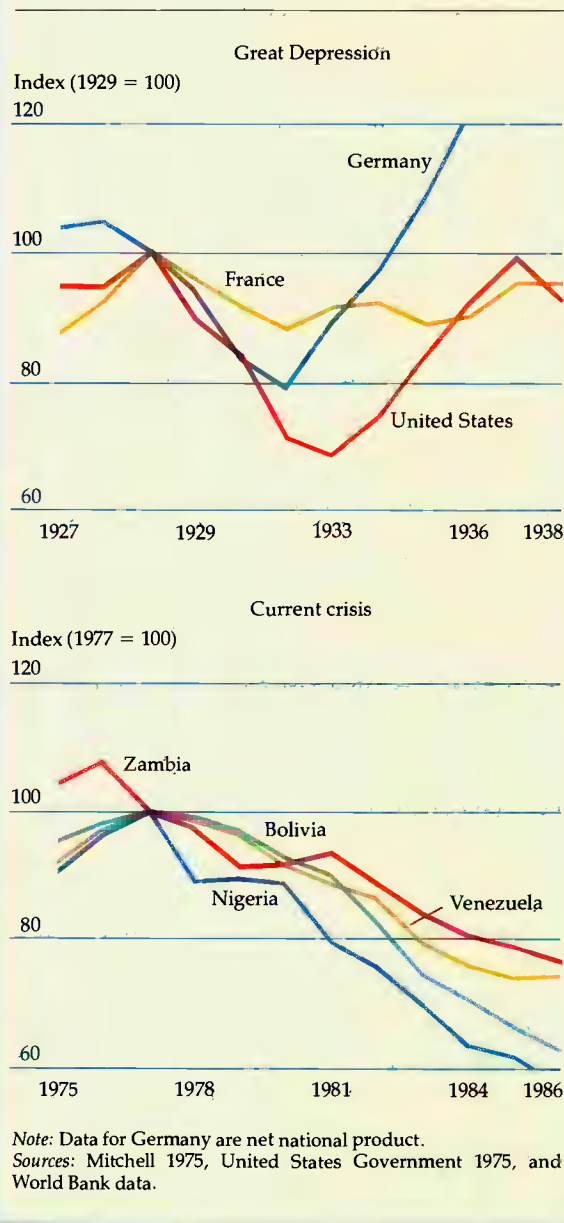
- Reducing economic imbalances among industrial countries
- Restructuring economic policies in developing countries
- Reducing the net transfer of financial resources from developing countries.

*Reducing economic imbalances among industrial countries*

While the immediate outlook in mid-1988 is for continued modest world economic expansion, three main steps are needed to enhance growth prospects and reduce the risks of further instability in the financial market and, possibly, a sharp slowdown in activity beyond the near term. The first is credible action to reduce the U.S. federal budget deficit. This is essential to bring about a lasting reduction in the country's current account deficit and to lower real interest rates. Second, Japan should maintain, and Germany accelerate, the growth of domestic demand through appropriate macroeconomic and structural policies. Third, those NIEs of East Asia that are running sizable current account surpluses could do even more to accelerate the growth of domestic demand, appreciate their currencies against the dollar, and reduce the degree of protection of their domestic producers.

In the present climate of economic uncertainty, judging the appropriate stance of macroeconomic policy will be unavoidably difficult. However, concerted and credible change along the lines suggested here would help reduce the sizable current account imbalances among industrial countries (and the East Asian NIEs) and lessen the risks of a recession. It would also stabilize exchange rates. Economic growth, moreover, could be faster, as indicated in the "high-case" scenario of Table 1.

**Figure 2 Per capita GDP during the Great Depression and the current crisis in selected countries**



These policies should also be accompanied by a reduction of protection. The current Uruguay Round of the General Agreement on Tariffs and Trade (GATT) negotiations provides a timely forum to promote multilateral reductions in the barriers to trade.

Without concerted policy action by the industrial countries, the global economic outlook is more likely to conform to the "base-case" scenario of

## Box 1 The continuing need to alleviate poverty

Poverty in the developing countries is on the rise. Between 1970 and 1980 the number of people with inadequate diets in developing countries (excluding China) increased from 650 million to 730 million. Since 1980 matters have turned from bad to worse: economic growth rates have slowed, real wages have dropped, and growth in employment has faltered in most developing countries. Precipitous declines in commodity prices have cut rural incomes, and governments have reduced their real spending on social services.

Comprehensive data on poverty are lacking, especially for the most recent years, but scattered information from individual countries confirms the general impression of deteriorating social conditions in many developing countries. A recent study found that the number of people below the poverty line increased at least up to 1983–84 in Brazil, Chile, Ghana, Jamaica, Peru, and the Philippines. It also found that there has been a sharp and widespread reversal in the trend toward improved standards of child health, nutrition, and education. Other sources show that in twenty-one out of thirty-five low-income developing countries, the daily calorie supply per capita was lower in 1985 than in 1965. Between 1979 and 1983 life expectancy de-

clined in nine Sub-Saharan African countries. In Zambia deaths from malnutrition among infants and children doubled during 1980–84, and in Sri Lanka the calorie consumption of the poorest tenth of the population fell 9 percent between 1979 and 1982. In Costa Rica falling real wages during 1979–82 increased the incidence of poverty by more than two-thirds. Real per capita public spending on health and education in low-income developing countries stagnated between 1975 and 1984. For six low-income countries the number of physicians per capita decreased between 1965 and 1981, and enrollment ratios for primary education declined in twelve low-income Sub-Saharan African countries.

In the aftermath of the second oil price shock, the subsequent worldwide recession, and the debt crisis, it is not surprising that governments have focused their attention on stabilization and adjustment and that fiscal austerity has reduced spending on the relief of poverty. However, increases in the incidence of poverty make it essential for the issue to move again into the forefront of policy design—and especially the design of public spending programs.

Table 1. Per capita incomes in many parts of the developing world would continue to stagnate or, at best, reverse only very slowly the dramatic declines of the past few years. Trade would remain sluggish and commodity prices depressed. Negative net resource transfers would continue to drain financial resources from the highly indebted countries. More serious downside risks would persist. Further disruptions in financial markets, higher interest rates, and a more severe slowdown of the world economy would all be possible.

### *Restructuring economic policies in developing countries*

The responsibility for the second task of policy adjustment lies with the developing countries. Their pace of development depends greatly on the effectiveness of the domestic economic policies that each government pursues. Those policies can be effective even in a generally unfavorable international environment. Examples go beyond the East Asian NIEs, whose achievements are so often cited: they include Botswana, China, Colombia, India, Indonesia, Thailand, and Turkey. In each of these countries strong economic performance in recent years can be traced to sound policies—not

just to special factors such as external aid or natural resource endowments.

### *Reducing the net resource transfers from developing countries*

Finally, the net resource transfers from developing countries to the rest of the world need to be reduced to improve the debtor countries' economic performance. Improved policies in industrial countries could lower real interest rates and improve trading prospects for the highly indebted developing countries. This, in conjunction with sound policies in the developing world, would enhance the creditworthiness of the highly indebted countries and help them to attract new capital. Combining better policies and inflows of new capital with various available methods of stretching out or reducing debt repayments would reduce the resource drain and allow increased investment to support growth. Finally, there is the challenge for most highly indebted, middle-income countries to find new financial options, including ways to pass on current market discounts on debt to the debtor countries under case by case, market-based approaches. For the debt-distressed, low-income



countries of Sub-Saharan Africa, proposals to ease their debt burdens by official support need careful consideration.

Concerted action in all three areas—industrial country policies, developing country policies, and resource transfers—provides the best chance to avoid a worldwide economic downturn and to return developing countries to a level of growth comparable with that of the 1950s and 1960s. However, inaction on any front should not become an excuse for inaction elsewhere. Developing countries can still do much to influence their own economic prospects, regardless of the international economic environment. This is true especially in the area of public finance.

### The role of public finance in development

Many of today's public finance issues have troubled policymakers for centuries—how to raise and allocate public funds effectively while limiting budget deficits and how to delegate authority while

maintaining accurate accounts and financial discipline, for example (see Box 2). But these issues are of even greater importance now because of the expansion of the public sector during the past 100 years—beginning in the industrial countries around 1880 and in the developing countries after 1940. From a share of 5 to 10 percent of gross national product (GNP), central government spending has grown to an average of about 25 percent of GNP in developing countries and 30 percent in industrial countries. In some countries the share exceeds 50 percent of GNP. The public sector affects the economy not only through its taxation and spending, but also through interventions such as price controls and licensing. Although country experiences vary widely and rigorous assessment is difficult, the public sector now appears to be as important in developing countries as in the industrial countries.

The expanded role of the public sector carries with it risks and opportunities, however. The risks

### Box 2 Insights from the history of public finance

From the earliest days of recorded history one of the principal challenges to government has been the management of public finance. In their book, *A History of Taxation and Expenditure in the Western World*, Carolyn Webber and Aaron Wildavsky explore taxation and expenditure policies from ancient times to the present. In the final chapter they concluded:

No matter what a society's patterns of taxing and spending are, supporting government has always been problematic. In this respect, at least, past and present merge.

Virtually every aspect of modern budgetary behavior that we regard as especially distinctive has its analogue in ancient practices. Governments, from the Mauryan kings of ancient India to early Roman emperors to the feudal monarchies of medieval Europe and the new nation-states of the early-modern era, have tried to maintain accounts of tax receipts, and sometimes (but never successfully) to keep records of spending for different purposes. Though the technology differs, the results are often the same: as with the off-budget trust funds in modern governments, detailed line-item accounts of spending did not help much if receipts in a given fund were insufficient to cover mandated spending.

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Ancient, medieval, and early-modern governments certainly lacked effective technical and administrative instruments, but they did use expedi-

ents to help stay afloat. They taxed the land and necessities; they debased currency and confiscated as much as possible; they sold offices, crown lands, and sometimes the king's jewels; they conquered and pillaged. When officials could not get inside houses, they taxed columns, windows, and doors. They levied hundreds of taxes on the production and sale of commodities and services. In doing this, governments alienated their subjects, debased public morality, and wrought havoc with trade. But, for the most part, they got by. And when, after centuries of reform, such venal and inefficient practices were abolished, governments still faced financial crises. The big difference today is that crises take place at much higher levels of expenditure and revenue.

What stands out in the ebb and flow of financial tides is problem succession: old solutions give rise to new problems that are in their turn superseded. No policy instrument is good for all seasons.

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Whether or not governments stay solvent, at the very least our lengthy chronicle of the difficulties continuously associated with efforts by governments at diverse times and places to raise and spend revenue should convey the message that taxing and expenditure are never a straightforward matter.

arise from the ineffective use of public resources and from the overextension of government into areas that are better left to private markets. The opportunities arise from the government's power, in principle, to allocate resources efficiently when markets fail to do so and from its ability to provide relief to those in poverty. It is the task of public finance to balance the opportunities and the risks, and thus improve the quality of government. The most important aspects of public finance within which pragmatic policies should be pursued are the management of public deficits, revenue mobilization, allocation of public spending, and decentralization of public functions.

### **Fiscal policy for stabilization and adjustment**

Large fiscal deficits are often at the root of both external and internal macroeconomic imbalances. External imbalances express themselves as current account deficits, capital flight, and rapidly expanding external debts. Internal imbalances take the form of high real interest rates, falling private investment, and rising inflation. Prudent fiscal policy—that is, fiscal deficits consistent with low and stable inflation, a sustainable level of foreign debt, and a favorable climate for private investment—is indispensable to stabilization and adjustment. Furthermore, reforms in many other areas—financial liberalization, currency devaluation, price deregulation, trade reform, and so on—can work only if the fiscal implications are taken into account.

With a few exceptions, the fiscal deficits of today's "problem debtors" increased significantly in the late 1970s and early 1980s. Current account deficits widened in step with fiscal expansion, and the ratio of public debt to gross domestic product (GDP) increased correspondingly. Capital flight worsened the debt problem as domestic savers responded to unsustainable fiscal deficits by sheltering their assets abroad. Unlike the problem debtors, other countries (such as Indonesia, the Republic of Korea, and Thailand) had more sustainable fiscal policies during the 1970s. They accumulated smaller stocks of public debt in relation to their capacity to service it. They also adjusted their fiscal policies quickly in the early 1980s and took steps to prevent their real exchange rates from rising excessively. As a result these countries—which might easily have joined the problem debtors—steered clear of debt troubles.

Countries with commodity booms are a special

example of the importance of prudent fiscal policy. In many countries public revenues accelerated rapidly as the export prices of commodities soared in the 1970s. The windfall encouraged governments to increase spending—sometimes by more than the windfall, as higher domestic revenues were leveraged through foreign borrowing. However, much of this spending went to higher consumer subsidies or investment projects of dubious economic merit. After the boom, spending kept rising while revenue contracted sharply. The resulting fiscal deficits led to fiscal and external debt crises that finally forced spending cuts. Some commodity exporters—Botswana, Cameroon, and Indonesia, for example—managed to avoid destructive boom and bust cycles by cautious fiscal management of the boom revenues. They moderated spending increases during the boom and used the rise in public savings to accumulate external assets or repay external debt. They also adjusted rapidly to the end of the boom by cutting spending and maintaining low inflation, stable exchange rates, and solid performance in other exports. These contrasting country experiences demonstrate that erring on the side of caution is less costly than falsely assuming a temporary boom to be permanent.

Low-income Africa faces even greater difficulties than the middle-income debtors. It depends heavily on erratic flows of concessional and nonconcessional lending; the public revenue base is narrow and volatile. After borrowing heavily to finance fiscal expansion in the 1970s, African countries have been forced to adjust as lending has been cut back. Adjustment has been complicated by dual exchange rate systems, which are especially common in low-income Africa and which, in effect, tax exports. Removing this tax through exchange rate unification and devaluation helps the export sector, but the temporary loss of revenue can lead to bigger fiscal deficits and higher inflation. These countries therefore need to synchronize exchange rate reform with fiscal reform.

Prudent fiscal policy guards against the risks of excessive foreign debt and overvalued currencies. But sound macroeconomic policy is not enough. Many developing countries need to make structural changes if they are to resume satisfactory long-term growth. Public finance offers many opportunities for reform of this kind. The ways in which governments raise revenue can substantially affect economic efficiency. Similarly, the quality and composition of public spending strongly influence development. This Report considers each side of the budget balance in turn.



## Reforming tax systems

When public deficits need to be reduced, the economic cost of raising more revenue must be weighed against the cost of cutting public spending. More revenue and less spending will both be needed as a rule. The temptation in the short term is to rely on ad hoc increases in revenue because they are administratively and politically convenient. But in many countries this approach has led to complex and highly distortionary revenue systems that not only fail to collect sufficient revenue but also damage long-term growth. Most of today's systems could be restructured to increase yield, reduce distortions, and minimize the burden on the poor.

The two main types of public revenue are general taxes (compulsory charges unrelated to particular expenditure items) and user charges (payments from beneficiaries in exchange for goods provided by public agencies). General taxes make up the bulk of central government revenue, whereas user charges are the main source of revenue for state-owned enterprises. State and local governments commonly collect both.

Tax revenue as a share of GNP has increased during the past decade in many developing countries in response to the need for fiscal adjustment. Taxes on international trade are still the largest source of central government revenue in low-income countries, particularly in Sub-Saharan Africa. But the revenue share of trade taxes has been declining, since most developing countries are shifting gradually to domestic taxes. Among the domestic taxes, commodity taxes such as sales, excise, and value added taxes are more important than income taxes. In industrial countries, however, income taxes are often the more important source of revenue.

In general, the economic cost of taxation increases with the tax rate and is higher when the base is narrow, as is the case in most developing countries. Recent reforms in developing countries such as Colombia, Indonesia, Jamaica, and Malawi have rightly concentrated on expanding the base, thus avoiding higher tax rates and adverse effects on incentives. To make the tax structure more transparent and to ease administration and enforcement, the reforms have also favored fewer rates and fewer exemptions. They have tried to promote equity by improving the collection of taxes from the wealthy through limited exemptions and improved tax administration and by avoiding taxes on the poor. Progressive income

taxes are hard to collect in developing countries.

Successful tax reforms have also demonstrated that variants of the value added tax (VAT) can generate substantial revenue with fewer distortions than import, turnover, or excise taxes. Joint reform of trade and commodity taxes is particularly effective in meeting the dual goals of raising revenue and reducing inefficiency.

Many developing countries have a limited capacity for administration, so tax reform must be confined to what is administratively feasible. In most developing countries, especially the poorer ones, simplicity is essential. However, modern techniques, such as the use of computers and tax identification codes, can make it easier to collect most taxes.

## Improving the allocation of public spending

Central government spending grew substantially until 1982 in many developing countries but then tended to decline as a percentage of GDP until 1985 as resources grew tighter. Although the breakdown of spending by category varies tremendously among countries, some generalizations are possible. For example, industrial countries spend much more (as a share of both total spending and GDP) on subsidies and transfers, primarily for health and social security, while developing countries tend to allocate more of their spending to investment.

Governments can promote both economic growth and equity by supplying the physical infrastructure needed for productive private investment and by providing social services to meet the basic needs and improve the productivity of the population. But the high cost of raising revenue means that it is vital to set priorities and attain quality in public spending. Priorities can be set by considering what governments do best and what markets do best. Governments must provide "public goods" that benefit all citizens, such as law and order and national defense. They should also be involved in providing goods and services with large external benefits to society, such as primary education, basic health care, and immunization programs. Direct investment or regulation is needed to control monopolies caused by a single source of supply or large returns to scale relative to the size of the market—water supply, sanitation, and power, for instance. Finally, government subsidies on goods and services consumed by the poor are sometimes justified, but, to contain the cost, they should be accurately targeted.

These criteria help to explain the widespread public provision of infrastructure for transport, communications, power, water supply, and irrigation—areas critical for growth in the early stages of development. They also support public spending on basic education and health, which has been instrumental in producing higher literacy rates and skill levels, reducing mortality and morbidity, and lowering fertility rates. In contrast, these criteria generally do not support direct public production or marketing of industrial or agricultural products, or direct public provision of bus transport or housing.

Setting priorities is only the first step. All dimensions of investment projects—economic, technical, administrative, and financial—must be appropriately designed and implemented in a policy environment that provides incentives for good performance. Priorities and quality must also be considered in allocating recurrent public spending: adequate spending on operation and maintenance will often be more important than new investment, hiring fewer civil servants and paying them competitive wages will generally be preferable to using the government as the employer of last resort, and subsidies will be more efficient when targeted to the poor rather than dispersed across the entire populace.

Improving the efficiency and effectiveness of public spending requires reform of fiscal planning, budgeting, implementation, and monitoring. Fiscal planning ideally involves formulating a phased investment program, projecting current spending needs, and assessing revenue availability and borrowing requirements for three to five years, all set in the context of a consistent macroeconomic framework. The annual budget would then be a comprehensive one-year slice of the medium-term plan. For plans and budgets to promote effective decisionmaking by individual public agents, the tradeoffs among agencies, programs, and projects must be explicit, and the budget constraint for each agency, once set, must be firm so that an agency may not exceed a budget on its own initiative.

Although the capacity to carry out medium-term fiscal planning and comprehensive annual budgeting is limited in most developing countries, some have coped well. Botswana, for example, has developed procedures to ensure that careful attention is paid to the recurrent cost implications of its investment spending. Chile has used economic analysis—primarily cost-benefit analysis—to screen potential investments thoroughly. Others

are trimming government payrolls through hiring freezes, civil service censuses, and voluntary retirement schemes; a few countries are trying to rationalize the civil service wage structure. Mexico is moving toward targeted food subsidies. These and other examples show that it is possible to improve the efficiency and effectiveness of public spending.

### **Spending priorities and revenue options in selected sectors**

Sectoral perspectives on public finance highlight the need to consider revenue and spending jointly. Similar problems—insufficient spending on cost-effective activities, inefficient public programs, and limited access by the poor—beset current public involvement in education, health, urban services, and rural infrastructure in many countries. Solving these problems calls for three sorts of public finance reform: redirecting spending toward activities in which government participation is most critical, increasing the reliance on user and other benefit-related charges to finance such spending, and decentralizing some public responsibilities to those in closer touch with local needs and conditions.

Spending should be more sharply focused within each of the sectors mentioned above. In education, a pressing need exists to expand and improve primary schooling, particularly in the poorest countries. In health, more public resources should be allocated to basic health measures such as immunization and prenatal care. Public spending on these basic services is not only socially more profitable than spending on higher education, nonessential drugs, and expensive curative hospital care, but it is also more equitable, because the more expensive services are used primarily by the relatively wealthy. In urban services, public provision of roads, water, electricity, and sanitation is critical, whereas bus services and housing infrastructure can often be more efficiently provided by the private sector. In rural infrastructure, roads, potable water, irrigation, and electricity are areas in which the public sector has been, and should continue to be, involved; but in each case spending can often be shifted toward more cost-effective techniques. Such reforms can expand the access of the poor to basic services, while increasing the contribution of the public sector to economic growth and development.

User charges provide the link between spending and revenue decisions for many sectors. Unlike



taxes, user charges can raise revenue to finance the expansion of priority services, while increasing rather than decreasing efficiency. Publicly provided goods and services will be used efficiently if they are priced to reflect the cost of production as well as externalities and other market imperfections. In contrast, subsidized (that is, underpriced) services result in excessive consumption and demands for additional spending, and the taxes needed to pay for such subsidies create distortions elsewhere in the economy. User charges thus lead to a double efficiency gain: they allocate the supply of public goods and services efficiently, and their use avoids the need for distortionary taxes.

The case for user charges is well established for public utilities such as gas, water, power, and telephones. But selective user charges can be increased even in health and education. Although sound economic and social reasons exist for continuing to subsidize primary education and basic health programs, whose benefits spill over to society at large, the generous subsidies so common for other education and health services in developing countries can be reduced. Charging users of public facilities that have large private benefits—including curative outpatient hospital care and university education—will increase efficiency in production and consumption. It will also mobilize resources to finance the expansion of priority services, many of which are used primarily by the poor. This is an important goal during times of severe budgetary restraint. Some subsidies will likely have to remain, but these need to be carefully targeted primarily to the poor. Selective scholarships, for example, are one way to give poor students access to higher education, for which others would have to pay at least part of the cost.

For some public services, such as the distribution of irrigated water and the maintenance of local feeder roads, shifting some responsibilities to local providers will free central authorities to focus on priority tasks. With appropriate training, regulation, and monitoring from the center, many local initiatives can identify needs and mobilize resources more easily. Where services are already provided locally, the decentralized agencies need to be strengthened, as discussed below.

### **Financing local government**

Many developing countries would benefit from an increase in the responsibility of state and local governments for certain public functions. Decentralization is advisable for goods and services that are

regional or local, rather than national, in character, such as water supply and sanitation, transport, and even some health and education services. In such cases it can increase public accountability and responsiveness to local preferences. The scope for decentralizing is greatest in urban areas, but broadening the involvement of rural communities in water supply, irrigation, and rural roads can also improve the quality of public services.

Despite these benefits, state and local governments frequently face restrictions in raising resources to finance present or potential spending. Central authorities often regulate the few local sources of revenue by controlling tax rates, prohibiting increases in user charges, and limiting the means for revenue collection and enforcement. As a rule these restrictions can be safely eased, which increases the revenue-raising capability of subnational governments and reduces their dependence on central transfers.

User charges are especially helpful at the local level because local governments generally concentrate on services whose direct cost can be recovered. Although central government restrictions, lack of local technical expertise, and political opposition may limit the extent of charging, local governments in some developing countries have managed to develop successful cost recovery programs, usually in conjunction with improved service.

Among local taxes the property tax has many desirable features but is often administratively and politically difficult to collect. Even so, property tax reform should be considered as part of any broader local finance reform. Other local taxes, which are often complex and excessive in number and thus costly to collect and poorly enforced, can generally be streamlined to reduce administrative costs.

Central or state government grants are also common sources of local finance. If properly designed and administered, such grants can adjust for income differences, ensure national benefits from certain local public functions such as education, and provide incentives for greater local fiscal effort.

Credit can provide an alternative way to finance local capital investment. Municipal development funds have been successful in some developing countries in channeling credit, training, and technical assistance to local governments. Raising more revenue locally remains desirable in order to increase the debt service capacity of local government and to complement or replace grants from higher tiers of government.

Weak administrative capacity limits the ability of local governments to raise and spend revenue effectively. Efforts to increase this capacity—including training, technical assistance, and even central government staff deployed at the local level—is an essential task for the central authorities.

### **Strengthening public finance through reform of state-owned enterprises**

State-owned enterprises (SOEs) were usually established either to decentralize some key public sector activities or to move others from the private sector to the public domain. In some developing countries certain SOEs have succeeded as commercial ventures, contributing to public revenues and playing important roles in nation-building. In most countries, however, the achievements of SOEs have fallen short of what was hoped for. Their success has been hampered by a multiplicity of conflicting objectives and a lack of fiscal discipline.

Many SOEs are expected to finance themselves through internally generated funds or nongovernmental borrowing. In practice, however, the need to finance persistent gaps between SOE saving and investment has added greatly to the public deficits and public indebtedness in developing countries. Direct budgetary subsidies to SOEs have substantially increased central government deficits. Furthermore, direct foreign borrowing by SOEs typically has grown faster than that of the private sector. Governments frequently guaranteed these borrowings without overall borrowing strategies or controls, and poor SOE performance forced many governments to assume debts that SOEs could not service.

Many governments now see the critical importance of reforming SOE finance as part of the broader task of fiscal reform. The first step is to reduce SOE claims on the government budget by improving operational efficiency and ensuring that charges cover costs. Transparency in financial relations between the government and SOEs is also critical. If all subsidies to SOEs are explicitly budgeted, their cost can be subject to annual review, rather than hidden or simply forgotten. Increasing the availability of reliable information on SOEs' financial and operational performance, eliminating arrears between public agencies, and controlling government guarantees of SOE borrowings will also help to restore fiscal discipline. Finally, private sector involvement can often improve the efficiency of SOE operations and reduce their drain on fiscal resources. Because the barriers to full and rapid privatization are often daunting, intermediate solutions—such as subcontracting, leasing, or allowing private competition—are often more feasible.

### **Directions for reform**

Prudent budget policies, reduced costs of raising revenue, efficient and effective public spending, strengthened decentralization in government, and public finance policies consistent with poverty alleviation—these are the five broad directions which public finance policies should strive to pursue. Progress simultaneously on all fronts will be difficult to attain in most countries. Nonetheless, neglect of any one area can easily lead to problems in the others. A comprehensive approach to public finance reform is therefore essential to produce consistent policy advice and to implement sustainable reform.