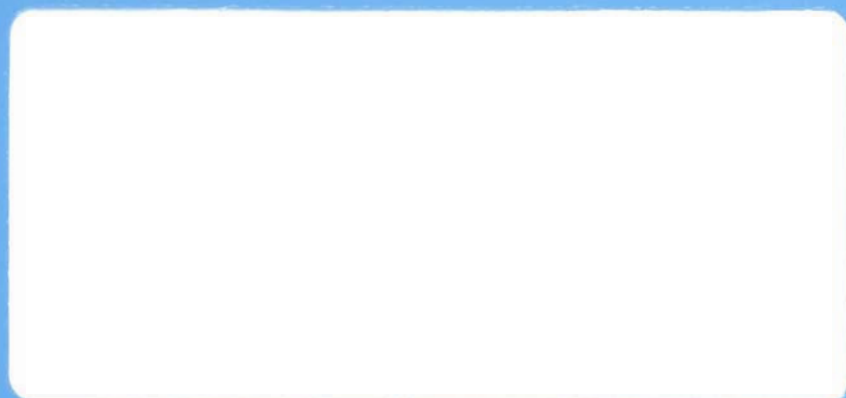




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THE FISCAL SYSTEM, ADJUSTMENT AND THE POOR a/

by

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I. INTRODUCTION

It is now widely accepted that the poor suffered additional deprivation during the stabilization and adjustment that took place in many countries in the 1980s (Cornia et al. 1987a passim, Helleiner 1985, Addison and Demery 1985, World Bank 1989a). Downward pressure on the living conditions of poor groups arose from three sources: reductions in real incomes from employment as employment levels and real wages fell; rapid increases in the prices of the goods the poor consume, especially food, following devaluation, higher producer prices for food and the reduction, or removal of subsidies; and cuts in government-provided health care, education and economic services to which the poor had access.

The aim of this paper is to analyse fiscal changes during adjustment as they affect the poor. Fiscal changes have bearing on each of the three elements just mentioned. The most direct effect is on government expenditure on the goods and services consumed by the poor - especially on health care, education and nutrition - and on subsidies on goods they consume, especially food subsidies. The fiscal system also affects the incomes of the poor through the tax burden and through government-financed schemes to generate employment or raise productivity among the poor (e.g. by public works schemes and credit schemes). The extent to which changes in the fiscal system affect the poor depends not only on the nature of the fiscal system, but also on who the poor are, since, for any given fiscal system, the poor will be affected differently according to their sources of income and their patterns of consumption. It follows that one cannot generalize on how a particular fiscal system will affect the poor because the impacts are likely to differ across societies, just as sources of poverty differ.

This paper is primarily devoted to an analysis of the impact of the fiscal system on the absolute conditions of life of the poor, rather than on their position relative to other groups in society. The primary aim is to show that the impact on the poor of fiscal changes during adjustment, while frequently negative in practice, is not unavoidably negative, but rather that there are a series of choices which governments are able to make that can accentuate or reduce the negative effects. The choices will be presented in general terms, but they will be illustrated by actual choices made in different countries in the 1980s.

Choices can be made at two levels: at the macro-level, in relation to the level of expenditure, taxes and the budget surplus/deficit, and at the

meso-level, in relation to the way the total tax burden is distributed among social groups and the way expenditure is allocated among sectors and, within sectors, in relation to the types of expenditure benefiting different groups. The impact of the fiscal system on the poor is the result of the combined effects of macro- and meso-choices.

The next section focuses on the macro-choices, while the third section deals with meso-expenditure policies, and the fourth, with meso-tax policies. The final section presents some conclusions.

II. MACRO-CHOICES

Macro fiscal variables consist of the total level of public expenditure, "E", the total level of revenue, "R", and the deficit/surplus on the government account, "B". The change in real expenditure per head over time is then:

$$e'/e = E' \cdot y' / E \cdot y = E' \cdot y [1 + g]^t / E \cdot y = [R' \cdot + B' \cdot] y [1 + g]^t / [R \cdot + B \cdot] y$$

where the apostrophes indicate the values at the end of the period and the asterisks indicate that the values are expressed as a proportion of GNP.

The change in real expenditure per head over time depends on the change in per capita income and in the proportion of income going to government expenditure. The latter can be seen as depending on the proportion of GNP collected in taxation and changes in the budget deficit.

A budget deficit may be financed by monetary expansion, or by borrowing domestically, or abroad. Although the focus of this paper is not budget deficit financing, the extent to which a budget deficit is inflationary and the consequences for the subsequent debt burden will depend on the nature of the financing.

For any given meso-choices, the poor are likely to benefit when the choices avoid aggregate expenditure cuts and, where possible, permit expenditure increases. However, IMF stabilization policies are invariably associated with a target reduction in "B", with the prime emphasis on the attainment of this reduction through expenditure cuts, rather than through tax increases. Thus, from 1980 to 1984, a reduced budget deficit occurred in 83 percent of Fund programmes, while 91 percent of the programmes involved restraint on government expenditure. Many of the programmes also included some

tax-raising measures. Still, a detailed study of seven countries following IMF programmes in 1983-1985 found that all but two "focused on expenditure restraint rather than revenue-raising measures" (Heller et al. 1988: page 22).

However, it is possible to make macro-choices which protect real expenditure levels. Relevant macro-policies are those which:

- Avoid falling GNP per capita.
- Avoid ambitious targets for the reduction of "B".
- Place more emphasis on the achievement of target improvements in "B" by raising revenue, rather than by cutting expenditure.

There are constraints on each of these policies. Governments do not have full control over the factors which determine growth. However, particularly when they are supported by external donors, they do have some control over the speed of adjustment and the extent to which adjustment is "stagnationary", or growth-oriented.

It is generally believed that budget deficits generate inflationary pressures and that "the poor suffer worst from inflation" (Toye 1989, see also Johnson and Salop 1980, United Nations 1989). The effects of inflation on the poor depend on, first, whether the goods consumed by the poor rise in price more quickly than do other categories of goods, second, the extent to which the poor have assets which can act as a hedge against inflation, and, third, time lags between price and income increases for the poor.

For each mechanism, the effects vary according to who the poor are. For example, subsistence farmers will be little touched by inflation, while urban informal-sector workers could be badly hit. There is little empirical evidence on these effects. Long-term evidence for Latin America suggests that income distribution is not affected by the rate of inflation. On the other hand, for the Philippines, Blejer and Guerrero (1989) found the inflation tax to be regressive. In the inflation of the 1980s, food prices exhibited some tendency to outstrip other prices (Cornia et al. 1987a: Chapter 2), but this might also have happened with a lower rate of inflation. There is little evidence to suggest that moderate rates of inflation will hurt the poor particularly, but accelerating and high rates of inflation may hurt the poor, especially since they often lead to drastic stabilization programmes, which invariably have negative effects on employment and wages.

It can be concluded that, where the fiscal deficit is high (over 5 percent of GNP), some reduction is generally a desirable element in adjustment. However, the question of the speed and extent of the reduction in

"B" is debatable. From the perspective of the poor, a slower and more limited adjustment might be desirable. Where the fiscal deficit is relatively low (below 2 percent of GNP), reduction may not be necessary in order to control inflation and would only be required if the balance of payments must be improved.

The third policy option mentioned above is to increase revenue, thus permitting a reduced deficit while maintaining expenditure. There are also limits here, including political constraints on possible changes, especially if taxation is already high. However, in countries with a low tax ratio, this option offers a frequently unexploited potential. In general, the poor are likely to benefit more from macro-policies involving increased "R" and stable "E" than from policies which focus on reduced "E", because the poor usually pay few taxes, while they get some benefits from public expenditure, both direct and indirect. For example, Alailima (1984) showed that, in Sri Lanka in 1980, households with the lowest 20 percent of incomes bore 9.4 percent of the total tax burden and received 26.8 percent of the benefits from government expenditure (see also Meerman 1979).

Macro-Choices in Adjusting Countries in the 1980s

In practice, adjusting countries made a variety of macro-choices in the 1980s as shown by changes in the four key variables, "y", "E*", "R*" and "B*".

Table 1 indicates the direction of change between 1980-1982 and 1985-1987 in central government expenditure in 38 countries for which reasonably complete information is available in Government Financial Statistics (IMF 1990). The contrast among regions is sharp. Total government expenditure at constant prices grew steadily in most countries in Asia as a result of growing incomes. The share of government expenditure in GDP rose in one-half the countries and fell in one-half. A similar pattern was observed in the Middle East. However, in Africa and Latin America, the regions most strongly affected by the adjustment crisis, government expenditure decreased in the majority of countries as a result of both declining incomes and a decline in "E*".

Tables 2 and 3 (pages 6 and 7) present evidence of the choices in the fiscal area made by adjusting countries in Africa and Latin America and by selected adjusting countries in Asia and the Middle East. A striking feature of the African experience (Table 2) is the large difference in the variables. For example, in 1987, central government revenue as a proportion of GNP went from 0 percent in Uganda to 75.2 percent in Botswana; Sierra Leone's ratio was just 6.5 percent, while that of Gabon was 47.1 percent. The data illustrate

TABLE 1: INCREASES OR DECREASES IN GOVERNMENT EXPENDITURE */
(Number Of Countries, 1980/82-1985/87)

	Government Expenditure (in constant 1985 prices)			Share of Government Expenditure in GDP		
	Increasing	Constant or Decreasing	No data	Increasing	Constant or Decreasing	No data
Latin America	2	7	0	2	6	1
Africa	4	7	2	4	8	1
Middle East	3	2	1	3	2	1
Asia	9	1	0	5	5	0

Source: Elaboration on IMF (1990).

*/ The countries included are: Latin America: Argentina, Bolivia, Brazil, Chile, Costa Rica, Mexico, Panama, Uruguay and Venezuela (i.e. 72 percent of the population of the region); Africa: Burkina Faso, Egypt, Ethiopia, Ghana, Liberia, Mali, Mauritius, Morocco, Tanzania, Togo, Tunisia, Uganda and Zimbabwe (i.e. 41 percent of the population of the region); Middle East: Bahrain, Iran, Kuwait, Oman, Syrian Arab Republic and Yemen Arab Republic (i.e. 37 percent of the population of the region); Asia: India, Indonesia, Korea, Malaysia, Myanmar, Nepal, Pakistan, Singapore, Sri Lanka and Thailand (i.e. 83 percent of the population of the region).

the macro-choices on the expenditure side also made by the countries. Between 1980 and 1987, real government expenditure per head increased in seven countries, decreased in seven and remained broadly constant in four. Expenditure per head increased in five out of the seven countries which had positive growth and remained constant in two; four of the 11 countries with negative growth managed to maintain or increase expenditure, while expenditure fell in the other seven.

Among Latin American countries (Table 3), the differences in expenditure ratios are less sharp than they are in Africa, with the lowest expenditure ratio in 1987 at 12.4 percent, and the highest, 37 percent. The highest revenue ratio was 30.9 percent (Chile), and the lowest, 3.2 percent (Bolivia, where the government had lost control over the economy, and the inflation rate was over 600 percent in 1980-1987). Between 1980 and 1987, real government expenditure per head fell in two-thirds of the Latin American countries. Only three countries had positive growth in GNP per capita; of these, two increased their real expenditure per head, while expenditure per head in the third was virtually unchanged. Among the 12 countries with negative growth, only three succeeded in increasing government expenditure per head, while a further three maintained expenditure at over 95 percent of the 1980 level.

Fewer countries in Asia and the Middle East followed stabilization and adjustment policies in the 1980s. Among selected adjusting countries in these regions (Table 3), only two had negative growth: Jordan succeeded in raising government expenditure per head, despite negative growth, while, in the

TABLE 2: MACRO-CHANGES IN AFRICAN COUNTRIES, 1980-1987

	E*		R*		B*		GNP per capita % change per year		Inflation Rate % change per year		Index of Government expenditure per head	
	1980	1987	1980	1987	1980	1987	1980-1987	1980-1987	1973-80	1980-87	1987 (1980=1.0)	1987 (1980=1.0)
Botswana	40.0	47.5	40.0	75.2	-0.2	+28.2	+8.0		11.6	8.4		2.04
Burkina Faso	14.5	16.3	14.0	15.3	+0.3	+ 1.6	+2.5		11.2	4.4		1.34
Cameroon	15.4	23.4	16.2	18.8	+0.5	- 3.5	+4.5		10.4	8.1		2.07
Gabon	41.1	45.9	40.0	47.1	+6.9	+ 0.1	-3.5		15.8	2.6		.87
Ghana	10.9	14.1	6.9	14.5	-4.2	+ 0.6	-2.0		45.4	48.3		1.12
Kenya	26.7	25.0	23.2	20.8	-4.7	- 4.6	-0.9		11.6	10.3		.88
Liberia	25.7	24.8	18.5	17.0	-8.1	- 7.9	-5.2		9.1	1.5		.68
Malawi	37.2	35.1	20.5	22.6	-17.2	-10.3	0		8.5	12.7		.94
Mali	21.2	35.5	10.8	15.1	-4.6	-10.0	+0.7		10.8	4.2		1.76
Mauritius	27.4	23.0	21.1	23.3	-10.4	+ 0.2	+4.4		12.5	8.1		1.13
Morocco	39.8 ^a	35.0	25.8 ^a	25.6	-13.6 ^a	- 9.3	+0.3		6.1	7.3		0.90
Nigeria	13.1	27.7	15.2	18.5	-1.6	-10.3	-4.8		16.2	10.1		1.54
Sierra Leone	30.0	13.7	17.1	6.5	-13.3	- 8.9	-2.0		14.5	50.0		0.40
Swaziland	28.2	24.9	35.7	27.3	+6.6	+ 1.8	+1.2		13.3	10.2		.96
Tanzania	28.8	20.9	17.6	16.3	-8.4	- 4.9	-1.7		15.4	24.9		.64
Togo	31.5	41.5	31.1	31.8	-2.0	- 5.0	-3.9		8.2	6.6		1.00
Uganda	0.1	0.1	0	0	0	0	-2.4		45.4	95.2		.84
Zambia	40.0	40.3	27.0	24.4	-20.0	-15.8	-5.6		8.9	28.7		.69
Zimbabwe	35.3	40.3	24.4	28.9	-11.1	-10.8	-1.3		10.6	12.4		1.04

Source: World Bank (1989b).

E* = Central Government expenditure as percent of GNP. R* = Current revenue as percent of GNP. B* = Overall surplus/deficit of Government as percent of GNP. B* is not identical to E* - R* because of omitted items.

a/ 1981.

TABLE 3: MACRO-CHANGES IN LATIN AMERICA AND OTHER ADJUSTING COUNTRIES, 1980-1987

	F*		R*		B*		GNP per capita	Inflation Rate	Index of Government
	1981	1987	1981	1987	1981	1987	% change per year	% change per year	1987 (1980=1.0)
LATIN AMERICA									
Argentina	23.6	25.8 ^a	17.7	22.8 ^a	-8.5	-8.0 ^a	-1.8	78.2	298.7
Bolivia	12.7	37.0 ^a	8.5	3.2 ^a	-4.1	-28.3 ^a	-4.9	15.7	601.8
Brazil	19.5	26.1	23.5	22.1	-2.4	-13.3	+1.0	31.3	166.3
Chile	31.0	31.9	31.8	30.9	+2.7	+0.1	-1.1	129.9	20.6
Colombia	14.0 ^b	14.7	11.7 ^b	13.8	-3.0 ^b	-0.7	+0.9	17.4	23.7
Costa Rica	23.7	28.3	20.1	23.7	-3.2	-4.8	-0.5	11.3	28.6
Dominican Republic	17.0	15.3	14.1	15.5	-2.7	-2.0	-1.5	6.8	16.3
Ecuador	17.1	16.3	12.0	18.5	-5.1	+2.1	-0.5	10.9	29.5
El Salvador	18.5	12.4	12.4	11.6	-7.4	+0.6	-2.0	7.0	16.5
Mexico	20.8	22.7	15.7	13.3	-6.9	-9.5	-1.6	13.0	68.9
Nicaragua	30.2	50.8	23.1	36.8	-6.8	-16.3	-4.7	8.9	86.6
Panama	36.1	34.6	28.1	29.7	-9.1	-4.2	+0.3	5.4	3.3
Peru	20.2	14.7	16.6	11.9	-3.5	0.2	-1.0	20.1	101.5
Uruguay	24.9	23.9	23.2	23.6	-1.5	-0.7	-2.3	57.8	54.5
Venezuela	28.9	22.0	33.0	22.7	-2.6	-2.1	-3.1	10.4	11.4
OTHER ADJUSTING COUNTRIES									
Indonesia	26.4	23.1	27.3	24.0	-2.2	-0.9	+1.7	34.2	8.5
Jordan	35.8	44.6	19.2	30.7	-7.6	-8.4	-0.7	n.a	2.8
Malaysia	40.8	31.9	29.1	24.8	-15.8	-8.2	+1.1	4.9	1.1
Philippines	12.8	13.5	11.7	12.9	-4.0	-5.0	-3.3	11.7	16.7
South Korea	19.0	17.4	20.1	19.0	-3.7	0.5	+7.3	18.8	5.0
Sri Lanka	33.7	32.4	18.3	21.5	-12.8	-8.9	+3.0	9.4	11.8
Turkey	23.3	22.8	22.0	18.5	-1.8	-4.8	+3.0	20.7	37.4
Yugoslavia	8.5	8.0	8.4	8.1	-0.1	0	0	15.3	57.2

Source: World Bank World Development Report (1984), (1985), (1988), (1989). UNDP (1990).

F* = Central Government expenditure as percent of GNP. R* = Current revenue as percent of GNP. B* = Overall surplus/deficit of Government as percent of GNP. B* is not identical to F* - R* because of omitted items.

a/ 1986.

b/ 1982.

Philippines, expenditure per head fell along with negative growth. Of the positive growth countries, two experienced falling per capita expenditure due to sharp drops in the expenditure ratio. The remaining countries show how economic growth can translate into rising expenditure per head so long as the expenditure ratio does not fall appreciably.

By analysing the macro-choices made by adjusting countries, it is possible to pick out types of "good" and "bad" experience (Table 4).

Good Experience. In general, as one would expect, economic growth facilitates growth in public expenditure, although, in some cases, cuts in government expenditure mean that growth is accompanied by falling expenditure per head. Countries which succeeded in combining growth with rising expenditure per head and a falling budget deficit during adjustment include Botswana, Burkina Faso, Colombia, Indonesia, Mauritius, South Korea and Sri Lanka (Category G1).

It could be argued that Botswana is a special case because of the presence of diamonds, and Mauritius is also atypical, being the only country in Africa that has enjoyed a significant rise in manufactured exports. Thus, for Africa, the case of Burkina Faso is especially instructive. With one of the lowest per capita incomes, no minerals and a low manufacturing base, Burkina Faso succeeded in raising per capita incomes over these years, increasing the tax ratio and reducing the inflation rate to very low levels. For Latin America, the case of Colombia shows that it was possible to adjust with growth and higher government expenditure per head; similarly, while South Korea may be a special case, Indonesia shows what a low-income country can achieve.

The difficulty arises where growth is negative. In the 1980s, "bad" experience predominated among negative growth cases. Nonetheless, countries can raise expenditure per head if they increase the expenditure ratio, and they can do so without greatly increasing, or even while reducing, the budget deficit so long as they raise the tax ratio sufficiently (Category G3). Good examples in the 1980s were Costa Rica, Ghana, Jordan and Zimbabwe. In Ghana, this was achieved as a result of the recovery from a very weak tax position of only 6.9 percent of GNP in 1980. On the other hand, Zimbabwe succeeded in raising the tax ratio by 5 percent of GNP, even though taxes already accounted for 25 percent of GNP, showing that it is possible for nonmineral countries in Africa to raise their tax ratio significantly.

Bad Experience. Some countries compounded the effects of negative growth by lowering expenditure ratios, thereby producing large cuts in expenditure

TABLE 4: SUMMARY OF EXPERIENCES WITH MACRO-CHOICES IN ADJUSTING COUNTRIES IN THE 1980s

	GOOD			BAD			
	G1	G2	G3	B1	B2	B3	B4
Growth in per capita incomes	+	+	-	-	-	-	+
Change in real government expenditure per head	+	+	+	-	-	+	-
Expenditure ratio	+/-	+/-	+	-	+	+	-
Tax ratio	+/-	+/-	+	+/-	+/-	+/-	+/-
Budget deficit	reduced	increased and sustainable	reduced or sustainable	reduced large cuts in expenditure	+/-	increased and unsustainable	+/-
Examples	Botswana Burkina Faso Mauritius Colombia Indonesia South Korea Sri Lanka	Cameroon Turkey	Argentina Chile Ghana Zimbabwe Costa Rica Jordan	Liberia Sierra Leone Tanzania El Salvador Venezuela Moderate Cuts Kenya Malawi Dominican Republic Uruguay	Gabon Zambia Philippines	Togo Bolivia Nicaragua Brazil Mali Nigeria	Malaysia Morocco

Source: Tables 2 and 3.

per head (Category B1). In a number of cases, the cuts in the expenditure ratio and in expenditure per head were severe. For example, Liberia, Sierra Leone, Tanzania, El Salvador, Peru and Venezuela each experienced cuts in expenditure per head of over 30 percent. In Sierra Leone, this was due to the collapse of revenue because of the contraction of the formal sector of the economy. In Tanzania, the "informalization" of the economy likewise reduced tax potential. In other cases (e.g. Kenya and Malawi), the cuts in the expenditure ratio and expenditure per head were more moderate. The "classic" IMF stabilization package, with prime emphasis on expenditure reduction, rather than revenue raising, encourages the negative pattern observed in this category. It is noteworthy that this is the largest single category of adjusting countries.

Some countries experienced such severe drops in GNP per capita that, despite rising expenditure ratios, expenditure per head fell. This occurred in the Philippines, Gabon and Zambia (Category B2). Many countries have revenue and expenditure ratios which are low compared with those achieved elsewhere, and, for these countries, an increase in the tax and expenditure ratio represents an important policy option. However, it is more difficult to do this where the tax ratio is already high, as for example in Gabon and Zambia. In these countries, reliance has to be placed on meso-policies, for which the potential is strong because of the high expenditure ratios.

Despite falling incomes, some countries succeeded in raising government expenditure per head by heavy emphasis on deficit finance (Category B3). Consequently, their deficits rose to an unsustainable position, as for example Bolivia, where the tax base collapsed and the deficit rose to 28 percent of GNP. This is not, then, a pattern to be emulated.

A final category of bad experience is represented by countries which exhibited growth in per capita incomes but, because of falling expenditure ratios, failed to translate this growth into increased per capita government expenditure (Category B4). Examples were Malaysia and Morocco.

III. MESO-CHOICES: EXPENDITURE POLICIES

Once the overall level of government expenditure is determined, governments face a number of choices concerning:

- The intersectoral allocation of expenditure among main sectors.
- The intrasectoral allocation of expenditure within sectors.

- The targeting of expenditure on particular population groups.
- The input mix as reflected in the functional distribution of public expenditure on capital and equipment, wages, recurrent inputs, subsidies and interests.
- Changes in public sector pricing policies.

The poverty and efficiency implications of government choices in these five areas are discussed from a theoretical perspective in the next subsection, while the following subsection presents some evidence on the actual choices made during the 1980s.

Poverty, Distributive and Efficiency Implications

The Allocation of Expenditure among Main Sectors. Government sectoral expenditures lead to widely different rates of return and distributional effects. Although systematic evidence is not available, the social rate of return tends to be highest in developing countries for expenditures on education, training, rural infrastructure, health care and selected areas of urban infrastructure. ("Source" rate of return as used here includes direct and indirect benefits and costs, but does not include a distributional weighting.) In contrast, social rates of return are low or negative for expenditures on prestige infrastructure, defence and nonpriority branches of public administration.

The distribution of the benefits of different types of government expenditure also varies considerably. Data from Sri Lanka show, for instance, that expenditure on social services benefited the poorest 20 percent of the population the most, while that on transport benefited them the least (Table 5). Government expenditure was also quite progressive in the case of health care, food and primary education.

During fiscal adjustment, the most rational behaviour of governments would be to distribute cuts so as to equalize the marginal social rates of return of the various sectoral expenditures, weighted by the share of benefits received by the poor. In practice, however, governments have only an imprecise knowledge of the rates of return and the distribution of the benefits of the different types of expenditure. In addition, various groups, such as the armed forces, the middle class, foreign banks and the bureaucracy, often influence government decisions. As a result of imperfect information, political pressures and patronage, governments sometimes cut pro-poor expenditures with high social rates of return and protect others which are less efficient.

TABLE 5: DISTRIBUTION OF GOVERNMENT SUBSIDIES, SRI LANKA
(By Income Groups, 1980)

	Lowest 20%	Highest 20%
1 Food	26.9	10.2
2 Health		
Ayurveda	34.2	11.5
Western	28.6	13.4
Total	28.7	13.4
3 Education		
Primary	26.8	14.1
Secondary	17.0	24.8
Tertiary	12.4	32.2
Total	22.9	18.8
4 Transport		
Railway	3.9	58.4
Bus	9.1	41.3
Total	8.4	43.8
5 Social Services	88.7	1.5
Total	26.8	16.4

Source: Derived from Alailima (1984): Table 5.3.

The allocation of government expenditure also has to be seen in relation to changes in the distribution of household incomes. During periods of fiscal adjustment, low-income households generally face the greatest risk of falling into poverty. To expand expenditure (or to cut it less) on primary education, rural infrastructure, public health, etc., would have a countercyclical (or less pro-cyclical) effect on the welfare of the poor. The failure to do so not only reduces the welfare of the poor, but may also have a negative effect on growth. According to the efficiency-wage hypothesis, a drop in the incomes of the poor below a minimum level reduces productivity below potential and effectively constrains the short-term supply of labour services, thus creating a vicious circle. An increase in the "social wage" can break such a vicious circle. As Blejer and Chu (1990) have shown, well-targeted social expenditure may help to raise not only the living standards of the poor, but also productivity and overall output.

The Intrasectoral Allocation of Resources. Governments also face choices similar to those outlined above when allocating any given envelope among

activities within a sector. The same principle - the equalization of marginal social rates of return weighted by the share of benefits accruing to the poor and the use of public expenditure to offset the most severe declines in private incomes - should guide governments in the selection of the best mix of fiscal retrenchments and expansions within a sector in keeping with an overall sectoral envelope.

Within sectors, rates of return and distributional efficiency differ as widely as they do among sectors. For example, evidence suggests that water pumps are more cost-efficient than piped water systems and that their benefits are distributed more equitably; child feeding and food stamp programmes are more equitable and efficient than urban food subsidies. Similar considerations apply to low-cost housing versus modern-type buildings, primary care versus hospital care, and primary education and adult literacy versus university education. Rates of return on primary education, for instance, have been found to be consistently higher than those on secondary and tertiary education (World Bank 1986).

In view of these substantial differentials, governments have the option to maintain or even increase the level of welfare of the poor and of society as a whole, in spite of declining sectoral envelopes, by shifting resources from programmes with low social rates of return and only modestly benefiting the poor to programmes which are more clearly pro-poor.

The Targeting of Expenditure is, in principle, a further powerful tool to reduce or contain fiscal expenditure and improve the distribution of government subsidies and social welfare. The targeting of expenditure is most common for those basic goods (such as food) which do not have the characteristics of public goods but whose availability has obvious implications for the overall distribution of welfare. The main role of the government in such cases is to correct an inequitable primary distribution of income through an income transfer to the poor. In many cases, however, such a transfer is effected through a generalized food subsidy which benefits the whole population, the rich and the middle class in particular.

The need to target food resources effectively increases during periods of fiscal austerity. However, the concrete application of such a policy often entails problems in costs, information about the eligible population and administration. The problems are generally greater, the narrower is the intended target.

Targeting is distributionally and administratively more effective when it is accomplished according to some objective criteria such as geography (the poorest areas), the type of commodity (subsidies for "inferior foods" not

consumed by the rich), easily identifiable population groups (pregnant women and young children), season, or employment in food-for-work schemes (with real wages set so as to attract only the real poor). It is the least effective when carried out by means-testing or by earmarking individuals.

The Distribution of Fiscal Cuts by Input Type. Within each sector or subsector, funds are distributed among capital expenditure (including new investment and amortization), the wage bill, material inputs, interests and subsidies. Such inputs are combined in relatively fixed proportions, allowing for only relatively limited physical substitution among them. It follows that the least damaging way to effect fiscal cuts is to reduce the volume of the various inputs proportionately. However, this seldom occurs. Previous analyses have shown a marked tendency to cut capital expenditure disproportionately. This may reflect a rational decision to try to preserve current welfare levels, particularly as crises may tend to lower the discounted value of future consumption. However, cutting investments for the creation of new infrastructure in deprived areas perpetuates the marginalization of the people living in those areas. Moreover, when investment consistently remains below the replacement level over a period of years, current and future welfare levels are affected.

In countries where wages absorb a large proportion of overall expenditure, fiscal adjustment will inevitably result in a compression of the wage rate or public employment, or both. When wages are compressed, the burden of austerity falls on the producers of government services, while, if public employment is reduced, the burden falls on the workers who have been made redundant and on those users previously benefiting from the government services involved. The first option is more desirable whenever the average income of civil servants is substantially higher than the overall average income and above a "social minimum" ensuring the efficient reproduction of the labour force in the public sector. In the French-speaking countries of West Africa, for instance, the salaries of primary-school teachers were up to 8.8 times the average GDP per capita in 1978. The same ratio was 2.5 in the OECD countries, in Latin America and Asia (Jespersen 1989). Under such conditions, a cut in the salaries of teachers would permit the output of primary education to be maintained at the cost of a relatively small welfare loss for a group relatively well placed in the overall distribution of income. Reducing the number of teachers employed would, in contrast, be less efficient and equitable. However, where wages in public service are below an "efficiency wage" and employment is excessive (as in the civil services of some African countries), a cut in employment is preferable to a cut in salary levels. For

example, in Ghana in the early 1980s, the wages of even upper-level civil servants were below subsistence (see Cornia et al. 1987b).

Governments can also choose to cut recurrent inputs (such as gasoline, drugs, school meals and teaching aids or supervision), while protecting wages. The savings thus realized are generally limited since nonwage recurrent expenditure rarely exceeds 10-15 percent of overall sectoral expenditure. The loss of welfare by the users of the service, in contrast, is enormous. Because of the limited substitutability among inputs, the decline in real output and welfare will be proportionately greater than the financial savings realized.

Changes in Social Sector Pricing and Regulatory Policy. Another possibility to offset the decline in budgetary resources is the introduction or increase of user fees. In extreme cases, governments may partially or fully privatize the provision of public goods such as water supply, transport, or health care services.

In recent years, the tendency to present such solutions as efficient and equitable has been increasing. However, the potentially regressive nature of user charges should be emphasized, as the need for health care, education, etc., rarely coincides in many developing countries with the ability to pay for the services. While the introduction of nominal charges in some sectors may improve allocative efficiency, raising substantial charges on "public goods" can be expected to have an adverse effect on vulnerable groups in two ways: first, it will provoke a negative demand effect and, second, for those who continue to use the service, the introduction of a fee will have a negative income effect which may adversely influence the ability of households to meet other basic needs. Both these effects are expected to be more pronounced for the poor, so that the introduction of fees on the public services which benefit the poor would have a regressive impact on the distribution of government subsidies. In contrast, changes in social sector pricing can have positive redistributive effects whenever fees are introduced for services which mainly benefit the upperclasses.

Evidence of Changes in Expenditure Policies during the 1980s

This section reviews the evidence of changes in expenditure policies in developing countries in the 1980s, with particular emphasis on those countries which experienced a contraction of public expenditure.

The Intersectoral Allocation of Public Expenditure. Two broad patterns emerge from the analysis of changes in the shares of government expenditure by main sectors over the 1980/81 and 1985/87 period (Table 6).

TABLE 6: REGIONAL SHARES OF TOTAL GOVERNMENT EXPENDITURE */
(By Main Sector, Showing Number of Countries With Shares Declining Or Increasing, 1980-81 and 1985-87)

	Health & Education	1980-81	1985-87	Economic Services	1980-81	1985-87	General Administration	1980-81	1985-87	Defense	1980-81	1985-87	Interest Payments	1980-81	1985-87	Others
LATIN AMERICA																
9 Countries of which with share	24.4	18.4	19.3	13.6	13.1	9.6	7.7	6.8	9.0	19.3	29.4	33.6				
- declining	6			7	6		8		1							3
- increasing	3			1	2		1		7							5
- no data	0			1	1		0		1							1
AFRICA																
13 Countries of which with share	20.2	18.9	21.7	20.6	18.8	17.0	12.7	11.5	7.7	12.5	22.6	22.6				
- declining	8			6	9		7		1							6
- increasing	5			7	4		5		11							5
- no data	0			0	0		1		1							2
MIDDLE EAST																
6 Countries of which with share	14.8	18.9	23.5	20.3	12.5	12.6	27.5	25.0	1.1	1.7	19.2	21.1				
- declining	0			4	4		4		1							1
- increasing	6			2	2		2		3							3
- no data	0			0	0		0		2							2
ASIA																
10 Countries of which with share	14.9	16.7	30.1	27.4	11.1	11.7	18.7	17.1	8.9	14.1	17.7	14.3				
- declining	1			6	6		8		0							5
- increasing	9			4	4		2		9							4
- no data	0			0	0		0		1							0
TOTAL																
38 countries of which with share																
- declining	15			23	25		27		3							15
- increasing	23			14	12		10		30							17
- no data	0			1	1		1		5							6

Source: Elaborations on IMF (1990).

*/ Regional averages are the arithmetic average of country shares. Total by line may not sum to 100 due to rounding. See Table 1 for a complete list of countries.

First, there are some striking similarities cutting across all four regions. These are the decline in the share of military expenditure and economic services, the increase in the share of interest payments and the relative stability in the share of general administration. The share of defence expenditure declined (albeit slowly in some cases) in all regions and in about three-fourths of the 38 countries included in the analysis, regardless of their involvement in stabilization programmes and regardless of the direction of change in overall government expenditure. This drop is the continuation of a less pronounced decline already observed between 1975 and 1980 in about 60 percent of the countries analysed. From this perspective, the process of democratization observed in Latin America and other regions benefited the poor, improving the resource potential for economic growth and social service expenditure. The share of economic services (including expenditure on equipment, as well as on rural and urban infrastructure) also declined on average for all regions and for almost two-thirds of the sample countries. However, in most countries of Asia and the Middle East, absolute levels of real expenditure on equipment and infrastructure continued to grow following the overall expansion of government expenditure (see Table 1, page 5). The share of interest payments rose in each region, increasing markedly in Africa, Latin America and Asia, and moderately in the Middle East. More than 90 percent of the sample countries were affected by this increase; which was particularly sharp in some of the heavily indebted countries, such as Mexico and Brazil where, for instance, interest payments in 1985/87 absorbed almost 50 percent of the total consolidated government expenditure, up from about 10 percent in 1980/81. The observed increase affected all countries, whether they were undergoing fiscal adjustment or not, and was more a reflection of changes in external conditions (such as the rise in interest rates in the 1980s) than of government choices.

Second, there was a marked polarization between Africa and Latin America on the one hand and Asia and the Middle East on the other. As already noted, in the first two regions, there was an appreciable drop in real expenditure on economic services. In contrast, expenditure on these services rose in most countries of Asia and the Middle East. While the share of general administration and other expenditure changed little (except in Latin America, where it fell), the clearest difference between the regions relates to the social sector (health care and education). In economies which underwent adjustment and fiscal retrenchments (broadly, Latin America and Africa), the share of health care and education in total expenditure declined in most cases, while it increased in 95 percent of the cases in Asia and the Middle

East, where overall real government expenditure expanded (Table 1, page 5). The data for the 1980s seem to suggest, therefore, a strong positive association between overall fiscal austerity and the compression of government expenditure on social services or, in more general terms, between the share of social services and the growth rate of overall expenditure.

From the perspective of equity and efficiency, trends in the intrasectoral allocation of resources were positive in the countries of the Middle East and Asia, but negative in much of Africa and Latin America.

In Asia and the Middle East, expenditure on sectors which exhibit high rates of social return and distribute a high proportion of resources to the poor increased in absolute or relative terms, while the share of expenditure on less efficient activities, such as defence, declined, though at a slow pace. However, in these countries, the share of interest payments, an important source of welfare loss, also increased considerably. In contrast, in Africa and Latin America, apart from a moderate decline in the share of defence expenditure, all other intersectoral shifts affected welfare and efficiency adversely.

The ratio of the share of expenditure on health care and education and economic services (Table 6, columns 1 and 2) to that of expenditure on defence and interest payment (columns 4 and 5) eloquently summarizes the changes in the 1980s (Table 7).

TABLE 7: RATIO OF EXPENDITURE ON HEALTH, EDUCATION AND ECONOMIC SERVICES
TO EXPENDITURE ON DEFENCE AND INTEREST PAYMENT
(By Region, 1980/81 And 1985/87)

	Latin America	Africa	Middle East	Asia
1980/81	2.62	2.05	1.34	1.63
1985/87	1.23	1.65	1.47	1.41

Source: Elaboration of data in Table 6.

It is clear that the ratio of resources allocated to productive and poverty-reducing activities versus nonproductive and non-poverty-reducing activities severely deteriorated in Africa and Latin America, while remaining roughly constant in Asia and the Middle East.

The Intrasectoral Allocation of Resources. It is not possible to provide

a comprehensive view of changes in the intrasectoral allocation of expenditure in the 1980s because of the limited empirical information available. Health sector data from 16 African and Latin American countries with relatively complete information on the allocation of health expenditure by levels of care (IMF 1990) show that, despite the overall decline affecting many such countries, hospitals continued to absorb an inordinately high proportion of total health care expenditure, i.e. between 80 percent and 90 percent. In countries with a strong focus on primary health care, such as China, this proportion was around 60 percent.

Thus, the fiscal crisis did not trigger a redistribution of health care resources toward subsectors with high social rates of return, indicating the difficult political and technical problems involved in such a process. However, there are a few positive indications concerning the spread of some low-cost, high-impact and highly pro-poor primary health care interventions, such as child immunization and oral rehydration therapy, in most developing countries, including those affected by fiscal cuts. With rates of coverage for these activities growing on average by 20-30 percentage points between 1981 and 1987, considerable welfare gains were obtained with relatively modest government financial resources and through the support of the international community.

In contrast, the limited data on education suggest that primary education was protected relative to secondary and tertiary education. The share of primary education in the total increased between 1980 and 1987 in 15 out of 22 countries in sub-Saharan Africa, while declining in five and remaining constant in one (Berstecher and Carr-Hill 1990). Similar conclusions emerge from the fragmentary evidence available from Latin America. In Chile, the share of preschool and primary education increased from 48 percent to 57 percent of public spending on education between 1980 and 1986, while the share of educational spending on the poorest 20 percent of the population grew from 33 percent to 37 percent (Castaneda 1987). In Mexico, despite a reduction of expenditure on education of about 50 percent between 1981 and 1988, enrolments in preschool and primary education grew over the same period from 31 percent to 62 percent and from 92 percent to 98 percent, respectively (Valerio 1990).

All in all, while the fragmentary nature of the information presented does not permit firm conclusions, there seems to have been some limited attempts to protect the portion of social expenditure (particularly, that on education) with high rates of social return and beneficial to the poor and to promote low-cost interventions which, although modest in terms of budgetary

outlays, exhibit strong welfare effects. These policies did not offset the overall decline in sectoral expenditures or, in many cases, in expenditures in social welfare, nor did they fully exploit the vast potential for redistribution implicit in the skewed distribution of benefits at the beginning of the period. However, they are indicative of the magnitude of the efficiency and welfare gains obtainable through a better intrasectoral allocation of public funds.

The Targeting of Expenditure. Discussion in this area is limited to food subsidies.

No global estimates of government expenditure on food subsidies are available. However, a recent study (Pinstrup-Andersen et al. 1987) has compiled relevant information on food subsidies for 10 developing countries covering the years 1980-1985, a period during which each of these countries undertook one or more stabilization programmes.

Between 1980 and 1985, the real domestic currency value of the subsidy declined in nine of the 10 countries analysed. Again in nine of the 10 countries, the subsidy also declined as a share of total government expenditure. In addition, none of the 10 countries succeeded in effectively increasing the targeting of food subsidies to the absolute poor, or in improving programme efficiency. Although at least five of the 10 food subsidy programmes were quite regressive, their retrenchment meant a substantial welfare loss for the poor, for whom the subsidies received represented a greater share of overall income than they did for the rich.

Expenditure Cuts by Input Type. A comprehensive analysis of countries whose overall government expenditure fell over the 1970-1984 period indicates that capital expenditure was cut most severely. It fell on average 65 percent more than did overall expenditure (Hicks 1988). Wages and other recurrent inputs were relatively protected since they fell less than the average and in similar proportions (15 percent and 18 percent, respectively), while subsidies declined even less. In contrast, expenditure on interest payments more than doubled, thus confirming the findings for the 1980-1987 period (see Table 6, page 16).

A second analysis covering 36 countries, whether experiencing expenditure cuts or not, over the 1979-1983 period (Pinstrup-Andersen et al. 1987) supports several of these findings, i.e. capital expenditure was the most severely affected (in 70 percent of the cases) followed by expenditure on subsidies. Wages and recurrent inputs were the least affected.

Other detailed analyses confirm this broad pattern of expenditure cuts by type. A study of health care spending in Central America and the Caribbean

in the early 1980s (Musgrove 1987) shows that there was a tendency for fixed capital formation to decline sharply, while no cuts or only modest cuts were apparent for wages and inputs (including medicines).

In conclusion, there is comprehensive evidence that the rise in interest payments increased the inequality of an already skewed international income distribution, reduced the overall level of welfare of debtor countries and contributed in many cases to a worsening of the distribution of welfare within such countries. There is some evidence also that the ways in which cuts were apportioned (i.e. broadly protecting the level and composition of current expenditure) may have limited the short-run negative effects of the decline in overall government expenditure which affected the majority of African and Latin American countries in the 1980s. However, marginal populations not yet reached by public infrastructure and the generations of the future will be affected by the resulting lack of services.

The Introduction of User Fees. Many countries in Africa, Latin America and, to a lesser extent, Asia introduced user fees in the 1980s to help finance government expenditure. A survey of the vast literature on this subject (Creese 1990) shows that a number of efficiency and welfare problems has resulted from the implementation of these schemes.

First, fees contribute a relatively small proportion to the budgets of the ministries involved. In the case of the health sector in Africa, for instance, fee systems currently yield gross-averages of around 5 percent of the total operating costs of the sector, with a maximum of 15 percent in Ghana. If the costs of collecting the fees are included, the yields would be lower and, in some cases, negative. In such circumstances, user fees are clearly inefficient as a revenue-raising device.

Second, in a good number of countries, revenues from fees in the health sector go entirely to the ministries of finance. In this way, fees become a mechanism of fiscal policy, rather than an instrument of health policy; while other sectors consequently receive more funds, the health sector may contract because of the decline in demand for health care services induced by the fees.

Third:

"the bulk of the available evidence appears to confirm that, whilst user-charges for health care can generate additional income, they also deter patients at greatest risks.... Equity in health care is thus deteriorating, measurably, in access to care terms, and probably also in health status differentials between socio-economic groups". (Creese 1990: page 14)

Many of the studies reviewed confirm what has been anticipated on theoretical grounds, i.e. that the price elasticity of demand declines as income rises. An important study on health care financing in Peru (Gertler et al. 1987), for instance, found that demand does become less elastic as income rises, implying that undifferentiated fees reduce the access to health care proportionately more for the poor than it does for the rich. Several recent papers examining the effects of the introduction of user fees on the utilization of health systems support these conclusions for countries as different as Zaire, Ghana, the United Kingdom and Lesotho (Creese 1990). In all of these countries, the introduction of fees has led to a decline in utilization rates.

IV. MESO-CHOICES: TAXATION POLICIES

The ways in which the poor are affected by the tax system during adjustment depend on the design of the tax system and the changes which occur with adjustment.

Taxes can be categorized as direct taxes (levied on incomes and profits), indirect taxes (levied on goods and services) and social security contributions (levied on formal-sector employers and employees). Direct taxes are almost invariably progressive and rarely affect the poor. The distributional impact of indirect taxes depends on their design. The major indirect taxes paid by low-income households are those that affect food, the sources of energy and the transport used by the poor, and drink and tobacco. Indirect taxes can be designed to fall heaviest on luxury consumption goods and thus can be progressive. Indirect taxes on production (normally in the form of export taxes) may fall on the poor when the poor are involved in production for export. Social security contributions are only paid in the formal sector, where, typically, workers are relatively well paid, and thus do not normally fall on poor households. However, with large cuts in real wages of formal sector employees, some poor households may be required to pay social security contributions.

In addition to taxation, many countries receive a significant proportion of revenue from publicly-owned enterprises. The distributional incidence of this depends on what the parastatals are producing and who is consuming the production. It is unlikely to fall heavily on the poor.

A precise assessment of the distributional incidence of the tax system in a particular country and of the way changes over time affect the

distribution of income and the burden of taxation borne by the poor would require a detailed investigation of the country in question, including a precise examination of the tax system, the sources of income and the patterns of consumption of the different groups within the economy. All that can be said in general terms is:

- Poor households are likely to pay a share of taxation that is lower than their share in original income.

- The greater the share of direct taxes in total taxation, the more progressive the tax system is likely to be.

- Indirect taxes can be designed to be more or less progressive. A high proportion of indirect taxes levied on drink and tobacco may be regressive. Across-the-board sales taxes without exemptions are likely to be regressive in their incidence.

This section attempts to provide some insight into the way tax incidence changes during adjustment by examining two sources of data: first, the general information on tax system structure that is available for almost all countries and, second, information on the tax provisions of IMF programmes between 1980 and 1984.

General Information

The ratio between revenue and GDP rose in 22 countries and fell in 17 in a sample of 39 adjusting countries from 1980 to 1987 (Table 8). In the sample, the most significant changes were:

- A fall in social security contributions as a proportion of current revenue.

- A rise in indirect domestic taxes as a proportion of the total in 24 of the 39 countries. Direct taxes as a proportion of the total rose in about one-half the countries and fell in the other one-half.

A comparison of the countries in which revenue was increasing as a proportion of GNP and those in which it was falling (Table 8) shows that a greater proportion of the former raised the proportion of direct taxes and non-tax revenue, while, among the latter, a greater proportion (70.6 percent) raised (domestic) indirect taxes (compared with 54.5 percent of the countries where revenue was increasing). Similarly, a greater proportion of the latter

Table 8: CHANGE IN STRUCTURE OF REVENUE IN 39 ADJUSTING COUNTRIES
(1980-1987)

	Rising share in total taxes	Falling or constant share in total taxes	Average percentage composition of overall taxation	
			1980	1987
<u>Countries with Rising Total Revenue Ratio to GNP</u>				
Income tax, profits tax, capital gains tax	12	10	24.3	24.8
Social security contributions	5	17 ^a	5.7	6.1
Domestic taxes on goods and services	12	10	22.5	23.9
Taxes on international trade	8	14	27.5	22.3
Other taxes	7	15	4.3	4.2
Non-tax revenue	13	9	14.2	19.1
<u>Countries with Falling Total Revenue Ratio to GNP</u>				
Income tax, etc.	8	9	32.8	28.8
Social security	5	12 ^b	3.6	4.2
Domestic taxes on goods and services	12	5	26.0	33.2
International trade	7	10	22.2	20.1
Other taxes	10	7	1.7	1.7
Non-tax revenue	10	7	12.0	12.6

Source: World Bank, World Development Report, (1984), (1985), (1988), (1989).

a/ Includes 10 countries with zero contribution throughout.

b/ Includes nine countries with zero contribution throughout.

raised taxes on international trade. Thus, it appears that falling revenue has a "regressive" effect as countries rely more heavily on less egalitarian indirect taxes.

While the differences are not marked, it also appears that, in countries with rising revenue, there was a relative shift toward direct taxes as opposed to indirect taxes in comparison to the case in countries where revenue was falling. Expressed as a proportion of GNP, direct taxes fell from 7.3 percent to 5.3 percent among falling-tax countries and rose from 4.9 percent to 6.3 percent among rising-tax countries. Domestic taxes on goods and services rose from 4.5 percent of GNP to 6.1 percent among countries where the tax ratio was rising and from 5.8 percent of GNP to 6.1 percent among countries where the tax ratio was falling. Again, the data show the large range among the choices made by countries over this period.

The variance in the proportion of revenue raised in different ways was large (Table 9). In 1987, for example, direct taxes formed only 6.2 percent of total revenue in Argentina compared with 65 percent in Ecuador. The ratio of direct taxes to GNP ranged from 0.2 percent in Bolivia to 28.7 percent in Botswana. Social security contributions represented 27.3 percent of revenue in Uruguay, while they were not levied at all in many countries. Between 1980 and 1987, Ghana succeeded (from a low base) in doubling the proportion of GNP going in direct taxes and more than doubling indirect taxes and other revenue as a proportion of GNP, while, in Bolivia, the ratio of direct taxes to GNP fell to 15 percent of the 1980 value, and other revenue fell by more than one-half as a proportion of GNP. Although the nature of the economy in part determines what taxes are feasible (for example, mineral economies have more flexibility in raising direct taxes than do others), the range of performance among similar economies shows that countries do have options.

The Tax Provisions of IMF Programmes

The data just analysed show some tendency for increasing reliance on indirect taxes during the adjustment process. There is a presumption that this probably worsened post-tax income distribution and raised the tax burden of the poor. However, the impact of this shift on the poor depends on the nature of the indirect taxes being raised. Detailed analysis of the tax provisions of IMF programmes between 1980 and 1984 (Table 10) permits a further breakdown within the broad categories in terms of the number of changes in the programmes (although it is not a guide to the magnitude of the changes, nor to which were actually carried out).

TABLE 9: TAXES DURING ADJUSTMENT IN 39 ADJUSTING COUNTRIES
(As Percent Of GNP, 1980-1987)

	Taxes on incomes, profits and capital gains		Other taxes/revenue	
	1980	1987	1980	1987
<u>Countries with falling tax ratio to GNP</u>				
Kenya	6.8	6.3	16.4	14.5
Liberia	6.1	5.8	12.4	11.2
Sierra Leone	3.8	1.8	13.3	4.7
Swaziland	8.6	10.4	27.1	16.9
Tanzania	5.6	4.2	11.7	12.1
Zambia	10.3	5.7	16.7	18.7
Bolivia	1.3	0.2	7.2	3.0
Brazil	3.1	4.6	20.4	17.5
Chile	5.4	4.3	26.4	26.6
El Salvador	2.6	2.5	13.1	9.1
Mexico	5.8	3.6	9.9	9.7
Peru	2.6	2.9	14.0	9.0
Venezuela	24.8	9.8	8.2	12.9
Indonesia	19.8	11.4	7.5	12.6
Malaysia	10.7	8.4	18.4	16.4
South Korea	4.6	5.4	15.5	13.6
Turkey	11.4	7.9	10.6	10.6
<u>Countries with rising tax ratio to GNP</u>				
Botswana	13.2	28.7	26.8	46.5
Burkina Faso	2.5	3.2	11.5	12.1
Cameroon	3.5	6.4	12.7	12.4
Gabon	16.0	20.8	24.0	26.3
Ghana	1.4	3.1	5.5	11.4
Malawi	6.9	8.0	13.6	14.6
Mali	1.9	1.2	8.9	13.9
Mauritius	2.3	2.3	18.7	21.0
Nigeria	9.1	7.4	6.1	11.1
Togo	10.7	9.7	20.4	22.1
Zimbabwe	11.3	12.4	13.1	16.5
Argentina	1.0	1.4	16.7	20.2
Colombia	2.7	3.7	10.0	10.1
Costa Rica	2.1	2.6	18.0	21.1
Dominican Republic	2.7	2.8	11.4	12.7
Ecuador	5.2	12.0	6.8	6.5
Nicaragua	2.2	5.3	20.9	31.5
Panama	7.0	7.0	21.1	22.7
Uruguay	1.7	1.9	21.5	21.7
Jordan	2.6	3.1	16.6	27.6
Philippines	2.5	3.1	9.2	9.8
Sri Lanka	2.4	2.5	15.9	19.0

Source: World Bank, World Development Report, (1984), (1985), (1988), (1989).

TABLE 10: FISCAL CHANGES IN 78 FUND PROGRAMMES
(1980-1984)

	Number	% of Programmes
<u>Income Tax</u>		
Reduction of personal income tax	5	6.4
Increase/surcharge in personal income tax	9	11.5
Income tax reform or extension	14	17.9
Increase on payroll tax/social security contribution	6	7.7
Action on access	1	1.3
<u>Corporate Tax</u>		
Tax surcharge	10	12.8
Collection of arrears	6	7.7
Shorten time lag	6	7.7
Modify/reduce tax	11	14.1
<u>Property taxes</u>		
Introduce/raise land taxes	4	5.1
Introduce/raise urban property tax	5	6.4
Other property tax	2	2.6
<u>Domestic Taxes on Goods and Services</u>		
Raise excise duty rates (beer, cigarettes, other)	42	53.8
Increase tax on petrol	30	38.5
Raise/modify sales taxes	22	28.2
Temporary tax reduction	1	1.3
Raise other taxes	13	16.7
<u>Import Duties</u>		
General/selective increase in customs duties	25	32.1
Increase in petrol import duty	2	2.6
Reduction/elimination of import duties	10	12.8
Tariff reform (exemptions)	32	41.0
Import duty surcharge	6	7.7
<u>Export Duties</u>		
Increased rates	12	15.4
Extend coverage	5	6.4
Export compensation scheme	6	7.7
Other (reform/reduction)	5	6.4
<u>Other Taxes</u>		
Changes in fees, tariffs, charges	35	44.9
Others	5	6.4
<u>Subsidies</u>		
Capping/reducing food subsidies	27	34.6
Capping/reducing petrol subsidies	21	26.9
Capping/reducing fertilizer subsidies	15	19.2

Source: IMF (1986)

It is clear from Table 10 that the most prevalent increases in these programmes were in indirect taxes. Excise tax increases occurred in 54 percent of the programmes, petroleum tax increases in 38.5 percent, and sales tax increases/modifications in 28 percent, while increases in personal income tax rates occurred in just 11.5 percent of the cases (and, in 6.4 percent of the cases, the latter increases were balanced by rate reductions). Corporate tax rates were raised in 13 percent of the cases and reduced in 14 percent. Land taxes were raised in 5 percent, and urban property taxes in 6.4 percent of the programmes.

On the whole, the tax changes were thus regressive, being weighted toward indirect taxes and, within indirect taxes, toward excise duties on beer and cigarettes. This regressive tendency was accentuated by the action on subsidies: Cuts or reductions in food subsidies occurred in 35 percent of the programmes, on petroleum subsidies, in 27 percent, and on fertilizer subsidies, in 19 percent.

V. CONCLUSIONS

In most adjusting countries, the 1980s saw falling per capita incomes, and this had an important negative effect on the welfare of the poor through declining incomes and employment. Moreover, falling GNP tends to translate into falling public expenditure on goods and services that benefit the poor unless macro-and meso-tax-and-expenditure decisions offset these negative trends. Countries which succeeded in combining adjustment with economic growth, including, for example, Burkina Faso, Colombia and Indonesia, thus provided favourable macro-conditions for the welfare of the poor.

Furthermore, even under conditions of falling per capita incomes, a fiscal system could potentially reduce or even offset negative effects through the public provision of pro-poor goods and services, food subsidies and employment. In a macro-perspective, these offsetting policies require the maintenance of public expenditure levels through adjustments based on increased taxes, rather than on expenditure reductions, or sharp reductions in budget deficits. However, IMF programmes usually encourage expenditure reductions rather than revenue-raising, and the majority of countries experiencing negative growth also suffered cuts in public expenditure. Nonetheless, as has been shown, quite a number of countries succeeded in raising public expenditure while reducing budget deficits, despite negative growth. Good examples in the 1980s included Ghana and Zimbabwe.

Meso-policies permit pro-poor programmes to be protected during adjustment. However, during the 1980s, most adjusting countries saw a fall in the share of government expenditure going to social and economic services. The share of defence also fell. Food subsidies were cut, and the limited evidence suggests that efficient targeting did not protect the poor from the effects of the subsidy cuts. Interest payments took a sharply rising share of government expenditure, with negative effects both on international and national welfare distribution.

Intrasectoral changes were not so negative. While the share of hospitals remained unjustifiably high in the expenditures of most countries, some low-cost health care interventions (e.g. the extension of mass immunization) had positive effects on the welfare of the poor; primary education generally increased as a proportion of educational expenditure. Capital items were cut much more than were current items, so that people in deprived areas and future generations were hurt the most. Efforts to reduce the negative effects on social service financing through the introduction of fees led to rather minor revenue increases and reduced demand for such services, especially among the poor.

On the tax side, Fund programmes emphasized indirect taxes rather than direct taxes, increasing the relative tax burden of the poor. On balance, indirect taxes increased as a proportion of total revenue in the 1980s. However, some countries raised the proportion of direct taxes and reduced the burden of indirect taxes.

To summarize, the choices made in the 1980s and encouraged by IMF programmes compounded the negative effects of falling incomes on the welfare of the poor in many respects. Both theory and experience demonstrate that this is not necessary and that countries can make different choices at macro- and meso-levels that would protect or even improve the condition of the poor during adjustment. The implications for the application of fiscal policies to protect the poor during adjustment are:

1. In reducing budget deficits, it is important to put prime emphasis on revenue increases, not expenditure reductions. In many economies (but especially in nonmineral economies), the fiscal load is much lower than it might be. Moreover, target improvements in budget deficits should not involve large, rapid changes unless there is runaway inflation.
2. In raising taxes, more emphasis should be placed on direct, rather than indirect taxes. Indirect taxes should be reformed to exempt goods and services consumed by the poor. User charges are almost invariably a socially harmful

and ineffective form of finance. Tax increases are normally preferable, except for charges for services consumed mainly by high-income groups.

3. Top priority should be given to the reduction of interest payments, thereby releasing resources for social and economic sectors. Reduced international interest payments may be obtained as a result of changes in monetary policy among the lending countries, bilateral debt negotiations, or, as a final resort, unilateral action. International agreement should be sought to determine the reasonable proportion of the budget that is to be paid as interest, and countries whose liabilities exceed this level should be automatically permitted to reschedule obligations.

4. Public funds should be reallocated among and within sectors toward areas with high social returns and areas where a large share of the returns accrue to the poor. This is already occurring to a limited extent through the fall in the share of defence and the protection of primary education. However, there is potential for much more to be done. International resources and international policy conditionality should be used to support this redirection. From a political perspective, it would be much easier to achieve this within a context of growing levels of total public expenditure, as shown by developments in Asia and the Middle East.

5. To ensure that the distribution of public expenditure cuts is rational, rather than the haphazard result of a bureaucratic struggle, all types of expenditure should be classified into three categories: high priority, to protect the poor and promote growth, low priority and intermediate. Every department of government should then be instructed to seek to finance the maximum high-priority elements and the minimum low-priority elements, while the intermediate category would be subject to negotiation, depending on the financial position.

6. The rationalization of the production of public services, thereby saving considerable resources, is usually possible. Obviously, this should be encouraged. The protection of expenditure on current inputs in social services, e.g. on medicines and school books, is normally important. In countries where public wages are relatively high, wage-cuts may be preferable to reduced employment, but public sector wages should remain high enough for efficiency. Moreover, it is better to support productive employment (e.g. through credit and technology schemes, or efficient public works) than to maintain excess employment in the civil service.

7. The privatization of most social goods should be avoided, as it usually leads to harmful social differentiation and inadequate provision, especially of services for poorer income groups.

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