

Special Issue of Journal of Public Economics

**Cornell-ISPE Conference
on
Public Finance and Development**

Editorial Introduction

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Christopher S. Adam and David L. Bevan, “Fiscal Deficits and Growth in Developing Countries.”

Shahe Emran and Joseph Stiglitz, “On Selective Indirect Tax Reform in Developing Countries.”

Emmanuelle Auriol and Michael Warlters, “Taxation Base in Developing Countries.”

Mark Gersovitz and Jeffrey S. Hammer, “Tax/Subsidy Policies Toward Vector-Borne Infectious Diseases.”

Pranab Bardhan and Dilip Mookherjee, “Decentralizing Anti-Poverty Program Delivery in Developing Countries.”

Emanuela Galasso and Martin Ravallion, “Decentralized Targeting of an Anti-Poverty Program.”

On September 7-9, 2001, a conference on “Public Finance and Development” was held in Ithaca, New York, USA, under the auspices of Cornell University and the International Seminar on Public Economics. The conference was organized by Ravi Kanbur and Michael Keen. The papers included in this special issue were selected from the papers presented at that conference, subject to the usual refereeing and editorial process of the Journal of Public Economics.

One way to structure a discussion of public finance and development is to consider the fiscal balance, and its two component parts, taxation and expenditure, as

applied to the specific institutional constraints and policy problems faced by developing countries. The six papers in this special issue between them address these issues in turn. Adams and Bevan analyze the connection between fiscal deficits and growth. Emran and Stiglitz, and Auriol and Warlters, contribute to the second best (or “nth best”) theory of taxation and tax reform in the presence of an untaxed “informal sector”, which is a central feature of most developing countries. Gersovitz and Hammer consider taxation and subsidy interventions to address the externalities of vector-borne diseases prevalent in many developing countries. Finally, Bardhan and Mookherjee, and Galasso and Ravallion, consider the targeting of public expenditure for poverty reduction.

Fiscal deficits are a common feature in many developing countries, and controlling these deficits is a centerpiece of the policy dialogue not only in the countries themselves, but also between their governments and international agencies such as the IMF and the World Bank. In their paper Adams and Bevan analyze growth models where distortionary taxes, expenditures, and deficit financing are all treated in a common framework. The focus of the empirical estimation is on non-linearities in the relationship between deficits and growth. A central finding is that the growth gains from deficit reduction, while high at high levels of deficit, fall rapidly as the deficit itself falls. Thus reducing a deficit beyond 1.5% of GDP is unlikely to have a positive growth effect and might even have a negative effect. The result is theoretically plausible, since certain types of deficit financing at a low level may well be efficient compared to the alternatives of increases in distortionary taxation, or reduction in productive expenditures. The empirical rule of thumb of 1.5% may well prove useful in actual policy debates.

The most traditional of concerns in public economics and development is taxation policy in a second best world. This traditional area of analysis overlaps with a current “hot” topic in the world of policy—the debate on the move towards a Value Added Tax (VAT) in developing countries. There are clear advantages to a VAT compared to traditional trade taxes, which cascade and hence distort throughout the production structure. These advantages have been demonstrated in the theoretical literature. However, in their paper Emran and Stiglitz stress that the current literature ignores the existence of an informal sector--this lack of completeness in coverage can overturn conventional results. For example, under plausible conditions, a revenue neutral reduction in import tariffs combined with a VAT base broadening can actually reduce welfare. Since the move to a VAT is a staple of World Bank and IMF conditionalities for development assistance, the Emran-Stiglitz paper needs to be considered carefully by all policy economists working in development.

The informal/formal divide is also central to the paper by Auriol and Warlters. The large literature on the informal sector in developing countries highlights the many impediments to enterprise that exist in the formal sector. By definition, government regulation reaches this sector and, it is argued, such regulation imposes costs. Only those firms for whom the benefits of formalization outweigh these costs will choose to come under the formal sector umbrella. Others will choose to stay in the informal sector. The insight offered by Auriol and Warlters is that the government-imposed costs of entry to the formal sector create barriers to entry and hence market power and rents for firms in

the formal sector. These rents can then be taxed. Thus regulations that may on the face of it seem inefficient may be consistent in the short run with a revenue raising strategy (the long run consequences of regulations are noted but not developed in the paper). Cross-country empirical analysis provides preliminary support for this hypothesis. This paper also has potent implications for policy, since, for example, the widespread movement in developing countries towards the adoption of large taxpayer units—focusing collection efforts on the largest enterprises—might in this light be seen as feeding on, and serving to reinforce, a wider inefficiency.

Infectious diseases like malaria are a characteristic feature of developing countries. Indeed, many have argued that such diseases are a leading cause of the lack of development and growth. Clearly, there is a high potential payoff to policy intervention. And, given the externalities and public good characteristics of disease spread, prevention and treatment, it should also be clear that the tools of public economics come into their own in the design of effective intervention packages. Gersovitz and Hammer emphasize the dynamics of infectious diseases in framing the policy problem. They highlight the fact that for anything approaching a realistic modeling of actually infectious processes, the analytics will involve many state variables, and is sufficiently complicated that analytically tractable solutions are unlikely. Numerical dynamic programming will therefore have to be a key technique in the armory of public economists interested in contributing to the policy discussions in this area. Developing intuitions based on the qualitative properties of numerical simulations will be important, and Gersovitz and Hammer illustrate this in the paper. One key generic conclusion is that common distinctions such as “prevention” and “therapy” need to be looked at much more carefully—the central issue is how any intervention impacts the specific dynamics of the spread.

The analysis of tax reform and of the design of taxes and subsidies to correct externalities has a long and distinguished pedigree in public economics, going back to Ramsey and Pigou. The analysis of targeting of expenditure for cost effective poverty alleviation is of more recent vintage, relying on the imperfect information revolution of the past three decades, supplemented by the equally recent literature on political economy based on rational individual choice. The papers by Bardhan and Mookherjee, and by Galasso and Ravallion, are in this emerging tradition. The debates in developing countries on the efficacy of “decentralization” provide the policy background to their analyses.

Bardhan and Mookherjee set out the basic tradeoffs involved in decentralizing poverty alleviation programs to local governments. Presumably local governments have more local information about who the poor are and what their characteristics are. But these same very local governments may be subject to pressures from local elites not to target to the poor. In their model, the anti-poor bias is strongest in poorest regions. A centralized system is subject to its own pressures of political capture and bureaucratic corruption, and these are studied in detail. Decentralization in their model reduces bureaucratic corruption, but in equilibrium may lead to a smaller scale of delivery.

The relative strength of a subset of the range of conflicting forces identified by the theoretical analysis of Bardhan and Mookherjee are tested by Galasso and Ravallion. Specifically, they develop and test measures of inter and intra village targeting using data for Bangladesh's Food for Education Program. They find that while within villages the poor are indeed targeted, more unequal villages have worse within-village targeting, consistent with local elite capture. But at the same time there is little evidence that the centre is targeting poor villages. Overall, then, while each level of targeting can be improved, it is the distribution of resources at the village level that accounts for most of the overall pro-poor targeting of the program.

The papers in this special issue thus address a wide range of theoretical and empirical issues that arise in the public finance of developing countries. Some of these issues, like tax reform analysis, are ones for which long-standing insights from public economics are being developed and sharpened in light of specific policy problems in developing countries today. Others, like targeting of public expenditure under imperfect information and political economy constraints, reflect analytical developments in the past two decades. However, between them these six papers illustrate not only the intellectual fascination of the links between public finance and development, but also the distinct and indeed vital contribution that public economics can make in informing development-oriented policy design. Over the last decade or so, these links seem to have received much less attention in our profession than their importance merits. It is to be hoped that this collection of papers will stimulate others by showing what can be done, and how much there remains to do.