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The Role of the State and the Quality of the Public Sector

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Abstract

<p>The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.</p>
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This paper discusses issues to be considered in designing "second generation" reforms. These reforms should focus on improving the capacity of the public sector to implement economic policies. The paper contrasts these reforms with those known as first generation reforms, which essentially focused on macroeconomic policies. The paper discusses the role of rules and institutions. It concludes that a high-quality public sector is necessary to ensure that good policies generate desirable and durable effects. The creation of such a sector requires many second generation reforms.

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I. THE ROLE OF THE STATE

Human beings are social animals, as a consequence they tend to aggregate in groups. Aggregation generates markets and the need for social institutions. Markets and economic activities are characterized by specialization on the part of the participants. Specialization leads to exchanges, and exchanges involve contracts. Contracts can be implicit or explicit. Implicit contracts prevail in primitive or traditional societies and are largely based on trust. They are often enforced by existing moral and social codes which in some ways provide the needed enforcement mechanism.

As societies develop, they require more explicit or formal contracts. In fact, there is likely to be a close positive correlation between the level of economic development of a country and the number of formal contracts that are required. These, in turn, require institutions to register them, when registration is required, and to enforce them. In market economies individuals also accumulate assets and this accumulation leads to the need for property protection and for the protection of property rights. Furthermore, they need personal protection against criminal elements within their groups or against outsiders. Thus, any aggregation of individuals requires the existence of at least rudimentary institutions that perform these functions and that can be considered a minimal state. This is the essential role of the state in a primitive society or the minimal role in any society.²

As societies become more complex and as the groups that constitute them become larger and less homogeneous, the state must assume additional responsibilities if it wishes to promote fully the welfare of the individuals that comprise it. For example, markets are not efficient when they are distorted by monopolies or when essential information is not available to the participants, or is too costly for them to obtain. This leads to the need for the state to enforce competition and to provide some essential information to the population. Thus, institutions must be created to satisfy these needs. See World Bank (1997).

There are some goods (defense, city streets, etc.) that only the state can provide because private individuals would not find it in their interest to provide them. An important reason is that once these goods are provided, the provider will not be able to exclude from their use individuals who do not wish to contribute to the cost of providing them. Another reason is that once they are produced, they can be consumed jointly by everyone so that it would be inefficient for society as a whole to exclude some individuals from their use. Thus, if these public goods are essential, they must be provided (but not necessarily produced) by the state. These are the public goods of the public economics literature. True public goods must satisfy

² There is now an extensive literature that argues that even gangs or criminal associations of individuals require within themselves some rules and organizations that are a rudimentary form of government. See Skaperdas and Syropoulos (1995), Charap and Harm (forthcoming), and various papers in Fiorentini and Zamagni, editors (1999). For the concept of a minimal or even of an ultraminimal state see Nozick (1974).

both of the conditions mentioned above. Also, the production or consumption of some goods or activities generate positive or negative externalities which are not captured by those who consume or produce them. If the state does not intervene, the market is likely to underproduce or overproduce these goods or activities. Once again, there may be a need for the public sector to intervene.³

All the above are examples of a general role of the state that in the public economics literature goes under the name of allocation. See Musgrave (1959). Although some problems of allocation can be dealt with by the use of regulations, often, if the state must perform this role, it will need resources. In principle the state could directly appropriate these resources by forcing individuals to contribute their time or their wealth for the production of the required goods—as it does, for example, with compulsory military service or with some forms of expropriation. In medieval times roads were often built in this way. However, a more efficient alternative is to use resources raised through taxation. Thus, there is a need for a tax system and for institutions that collect taxes. And, of course, there is a need for institutions that spend the money and keep track of that spending. In all these activities, in a market economy the state is expected to minimize the cost that its activities impose on the market and on society at large. Thus, a public sector of high quality requires an efficient tax system and an expenditure system that minimizes inefficient and unproductive spending. It also requires a budget large enough to allow the state to perform its role in a satisfactory way. See Tanzi and Zee (1998).

In addition to the essential or fundamental role of the state associated with the allocation of resources, a role that has been explicitly recognized and described by economists at least since Adam Smith's *Wealth of Nations*, in this century two or, perhaps, three additional economic roles have been assigned to the state. These are (a) redistribution of income, (b) stabilization of economic activity, and (c) promotion of growth and employment. These tasks are less firmly based in economic theory than the allocation role but they have been important in the practical implementation of policies in the second half of the 20th century.⁴ In fact, they have been largely responsible for the growth of government activities in the past century.

Markets produce goods and services and provide incomes to those who participate in them. Depending on the initial positions of the individuals as to ownership of real assets, of financial resources, and of human capital and talent in general, and depending on effort, propensity to save, luck and risk taking, and government policy, a given pattern of income (and wealth) distribution is determined. This distribution may or may not match the

³ The traditional state intervention is to tax those who generate negative externalities and to subsidize those who generate positive externalities.

⁴ These roles had not affected much the behavior of governments in market economies until this century.

prevailing societal perception of the degree of inequality that is considered acceptable. Furthermore, because of physical or mental handicaps, or because of other characteristics or situations, such as old age, unemployment, number of dependents in the family and so on some individuals may not be able to generate an income sufficient to sustain themselves or their families. In these cases, in this century, and in some countries, the state has been expected to provide them with transfers aimed at raising their consumption over an essential minimum.⁵ Thus, either a concern for equity or the existence of poverty may force the government to intervene.

The assignment of a redistributive role for the state has dramatically changed the character of its intervention in the economy. In fact, while, at least in principle, the state's role in allocation can be derived from technical and objective analysis, the proper redistributive role cannot be established objectively even in principle. It must be based on purely moral or political considerations. For example, there is no objective way to determine the ideal Gini coefficient or the ideal ratio of the top quintile to the bottom quintile of the income distribution of a country. And, it may be very difficult to establish an objective poverty line. Thus, these decisions are unavoidably influenced by the biases of the individuals constituting the government in power and by the prevailing social winds of the time.

Programs aimed at redistributing income often require a lot of resources and the presence of institutions charged with administrating these programs. For this reason, they tend to lead to large increases in public spending and in the level of taxation as they have in the so called welfare states.⁶ At times, the redistribution objective has been pursued through progressive taxation. But more often it has required large bureaucracies and much public spending. In many countries a large proportion of the public employees is now engaged in the provision of public education, public health and other social services and a large share of the total public spending of industrial countries goes for social programs including pensions. In some cases public employment has itself had the objective of redistributing income. See Alesina, and others (1999).

Economies do not operate smoothly but are characterized by fluctuations that at times become recessions or even depressions. These recessions lead to growing unemployment and to a loss of output and, in the second part of the 20th century, they created another major justification for state intervention namely, the maintainment of full or at least high employment and the stabilization of output. The promotion of this Keynesian objective is carried out by government officials and requires some relevant institutions. These officials must have the capacity to change tax revenue and/or public spending in order to influence

⁵ In previous centuries religious groups played a similar role in helping the poorest.

⁶ The World Bank, *op.cit.*, has argued that the process of taking over these new functions has distracted the state from its more fundamental role. Schansberg (1996) has argued that redistribution is often associated with poor policy that harm rather than help the poor.

aggregate demand in desirable directions and must have the information and the technical knowledge and wisdom to make the right decisions.

Finally, in recent decades, governments have also promoted policies aimed at raising the rate of growth or at creating employment. Import substitution and industrial policies have been examples of attempts at raising the growth rate. Manipulation of the work week and public investments in particular activities or regions are examples of attempts at raising employment. Regardless of the wisdom of these policies, particular institutions must be responsible for executing them.

We can summarize the current view of the normative or desirable role of the state in a market economy in the following way:

1. It must establish rules and institutions aimed at the enforcement of contracts and the protection of property rights. Through these rules and institutions the state must help expand the role of the market. It must also establish rules and institutions governing the extraction and the use of public revenue;
2. It must provide a legal and regulatory framework that reduces transaction costs for those who operate in the market and it must promote market efficiency through strategic market intervention in cases of market failure or through the production of some essential information. Once again the objective of this intervention will be to expand the role of the market;
3. It must provide public goods and deal with obvious cases of externalities which cannot be resolved by negotiations between the involved private parties thus complementing the market where it fails;
4. It must promote macroeconomic stabilization; and
5. It must promote a distribution of income that is consistent with the prevailing view of society. It must also provide some safety nets for those in danger of falling below the officially established poverty line.

To perform these functions the state must establish some rules and create some institutions:

The role of the state cannot be static and, in fact, it has changed over time and across countries. See Van Creveld (1999). That role is influenced by changing or different social views and by changing technologies which influence what the state should do. For example, goods that are public in one period may lose this characteristic because of technological changes. Therefore, the quality of the public sector should be assessed in light of the objectives and priorities of the government at any given point in time. These objectives may vary depending on the current needs of a particular country and at times they may even conflict with one another.

The state plays its role through the set of rules, laws, and institutions that guide and make up the public sector. The higher is the quality of the public sector, the easier it will be for the state to promote its role. **The quality of the public sector is defined here as the characteristic that allows the state to pursue its objectives in the most efficient way.**

Although it is difficult to separate the two, the quality of the public sector is not necessarily the same thing as the quality of economic policy. The quality of the public sector is, thus, distinguished from the quality of the policies that a given government may be pursuing at a given moment and those policies may or may not be consistent with the normative role of the state. A high quality public sector is simply the instrument that facilitates the formulation and the implementation of the government's policies. A good public sector makes it easier for the government to pursue good policies. But, even a high quality public sector cannot guarantee consistently good economic policies because it cannot prevent policymakers from occasionally pursuing poor policies. However, one would have some hesitation to call a public sector of high quality if poor policies were **frequently** pursued and one would expect to find a high relation between the quality of the public sector, as defined here, and the quality of economic policy. In other words, over time a high quality public sector is likely to promote good policies and a low quality public sector is likely to promote poor policies.

The definition of high quality public sector used in this paper differs from that of "good government" used by some writers. For example, La Porta et al (1998) define good government as one that is "good for capitalist development." They do not distinguish between quality of public sector and quality of public policy. A poor public sector will, of course, render the pursuit of good policy more difficult because it will not provide the government with the needed information and it will not guarantee that the policy decisions will not be distorted in the implementation stage. See on this, Tanzi (forthcoming).

II. THE IMPORTANCE OF RULES

The broad categories of state intervention in the economy were described in the previous section. Each of these categories requires specific programs and each program requires a legal mandate. In democracies with market economies the mandate for intervention in the economy given to the state is often specified, first, by a constitution and then by many laws and regulations that give a specific content to the normally general principles enunciated by the constitution.⁷ Thus, the constitution and the laws and regulations establish the rules of the game that guide the actions of individuals and enterprises on one hand and public institutions on the other. But, as North and Weingast have pointed out, "[a] critical political factor is the

⁷ For a comprehensive treatment of the role of legal institutions see Davis and Trebilcock (1999).

degree to which the regime or sovereign is committed to or bound by these rules"⁸ (1994, p.312).

A. The role of constitutions

The principles expressed by the **constitution** may be clear but are often not very specific. The constitution must be a living document that guides action but it cannot be one that addresses specific situations or that anticipates activities or situations that do not exist at the time the constitution is written. It has been reported that Napoleon rejected the draft of the constitution that the best legal minds of his time had prepared at his request because he felt that the document was too specific and, thus, potentially too restrictive and likely to become obsolete with the passing of time. He preferred a statement of general principles that could be interpreted with some flexibility over time. To a large extent the American constitution is a good example of such a statement. Only rarely it has required amendments. Furthermore, the role of the Supreme Court in interpreting the American Constitution is unchallenged.

Examples of constitutional principles that are not too clear abound. A well known example is Article 81 of the Italian Constitution that seems to restrict deficit financing but that, over the years, was interpreted in ways that did not prevent the occurrence of large fiscal deficits and the accumulation of a large public debt. See Martino (1989). Examples of too restrictive constitutional limits are also common. An important example is the 1988 Brazilian Constitution. In recent years that document has prevented the national government from making important and badly needed reforms in fiscal federalism and in the pension system. Other examples are, the Indian Constitution that has prevented the introduction of a national sales tax, or the Pakistani Constitution that has limited the scope of any sales tax imposed by the national government to goods only and has prevented the taxation of agricultural incomes. See also Dethier and Shapiro (1998).

A problem with constitutions is that they tend to reflect the preoccupations and the political forces of the time when they are written. A good example of this characteristic is the Italian Constitution which became effective in 1948. Its first article sets the tone by stating that "Italy is a democratic Republic founded on labor." It subsequently states that all citizens have a right to work. See Article 4. The third chapter (Title III) of the Constitution, which specifically deals with "economic relations," lists many **rights** of workers and only **limitations** to property rights of individuals. It specifies that: (a) the state can put limits to the use of property; (b) it can expropriate it for the national interest; and (c) it can impose various limits to the use of property in order to "establish equitable social relations." An Italian author has contrasted this "Republic of the workers" to the old "Republic of the property owners." See Rodotá (1995, p. 352).

⁸ In authoritarian governments or in dictatorships the constitution may play a marginal role. Stalin's constitution for the Soviet Union was a very good one but it did not prevent him from doing whatever he wanted. He was obviously not bound by the constitutional limitations.

These limitations to property rights must be compared with Edmund Burke's opinion that "a law against property is a law against industry" or with Adam Smith's opinion that "[t]he acquisition of valuable and extensive property...necessarily requires the establishment of civil government. Where there is no property...civil government is not so necessary."⁹ If the proper economic role of the state in a market economy requires the protection of the property rights of individuals, as much recent literature has argued,¹⁰ the Italian Constitution, at least in its formal declarations, is surely reluctant to assign that role to the state. It should, thus, not be surprising that economic policies and institutions in Italy have developed in line with the Italian constitution and have, at times, allowed policies (rent controls, expropriation of land with very low compensation, etc.) that are not consistent with the principle of protection of property rights or with the development of the market. This may also explain why Italy has one of the lowest scores, in terms of "economic liberty," among the many countries assessed by the experts of the Economic Freedom Network.

In conclusion, the role that constitutions play in determining the quality of the public sector in democratic, market economies cannot be exaggerated.¹¹ It is the constitution that encourages or allows certain actions on the part of the governing body and on the part of the citizens. Thus, at least in principle, the laws and the regulations that govern a country must be consistent with the constitutional principles as interpreted by a Supreme Court or by an equivalent body. In recent years, there has been a trend in many countries to try to modernize their constitutions. However, the results have not always been very good. At times the revised constitutions have been poorly formulated, complex and confusing.

Some economists, including James Buchanan and Francesco Forte have argued that the economic or fiscal role of the constitution should be one of establishing limits to governmental action as is done, for example, by the Swiss Constitution. According to these authors, the constitution should stress what the state cannot do rather than what it should do. See Forte (1998). These authors might favor limitations to tax rates, to levels of public spending, or to fiscal deficits. The objective is obviously to give the greatest scope to the working of the market. The Maastricht Stability and Growth Pact might be seen as an example of such a limit in a constitution.

⁹ Both cited in Landes (1999) on pp. 32 and 33 respectively.

¹⁰ See, for example, Landes (1999), North and Thomas (1973), North and Weingast (1989), and David and Trebilcock (1999).

¹¹ This, of course, assumes that the rule of law is well established in the country so that the constitution is taken seriously. It also assumes that effective supreme courts exist. In Italy the "constitutional court" started operating ten years after the approval of the Constitution. See Rodotà (1995, p. 353).

In some circumstances, and again Brazil comes to mind, a change in the constitution that removed obstacles to desirable and important reforms may be a necessary condition for raising the quality of the public sector and of public policy.

B. Laws

While the constitution sets, or at least should set, the general principles that guide the country's policies, the latter are permitted and directed by **specific laws**. These laws must, of course, be consistent with the principles set by the constitution. It is possible to generalize that the quality of the public sector is enhanced when the laws are relatively few, are clearly written—and thus not subject to conflicting interpretation—are comprehensive, and are not in conflict among themselves. Difficulties have arisen when the laws are too many, are not clear, do not cover all relevant areas of economic activities, or provide conflicting signals. For example, tax incentives may be spread over many laws that may have little apparent relation to taxes. This makes them not transparent.

It has been reported that while some European countries have only few thousands active laws, others may have tens of thousands. See, for example, Ferro, and others (1999). It may, thus, be difficult to find one's way in this legal jungle. At each time that a new law is enacted, all the existing laws should be scrutinized and, if necessary, revised to make sure that all the elements of these laws are consistent with the new law. This, of course, does not happen. When the existing laws are many, and especially when they are not clear, it is almost impossible to ascertain this. Thus, elements imbedded in laws enacted in the past, but still on the books, at some point, are seen to conflict with the new laws. When this happens the directives to the citizens as well as to the institutions charged with implementing the programs contemplated by the laws get confused. This problem could be referred to as one of **legal inconsistency**. It often characterizes the relations between national and subnational governments, or between, say, pension and health programs on one hand and annual budget laws on the other.¹² Zoning laws, laws dealing with the environment, and tax incentive laws have also suffered from this problem. At times, a law and, thus, a given institution authorizes a certain land use but another law and another institution prohibits its. Or, at times, a tax incentive is given by a ministry other than the ministry of finance and the incentive conflicts with the general tax policy. These conflicts may lead to costly mistakes and to uncertainty about property rights and could affect negatively market decisions.

Thus, to repeat, the quality of the public sector is enhanced when the laws are written clearly and cover all the necessary areas, when they do not lead either the public or the public officials to conflicting interpretations, when their number is as small as feasible, and when they are not in conflict among themselves. Over the years there have been attempts on the

¹² For example, the budget law may assign a given budgetary allocation for the health sector but the laws that determine the performance of the health sector may imply a higher spending level. See Reviglio (1999) for a specific example from Italy.

part of some countries (France, Australia, Italy, New Zealand, Russia) to codify or to simplify the existing tax laws. However, these actions, which would give benefits only over the long run and would make the policies more transparent, do not get much political support. Thus, the attempts are often abandoned before they produce the necessary results. See, for example, Guy (1996), Braibant (1996), Mattarella (1994), Smith and Richardson (1999), and Tan and Tower (1992).

C. Regulations

Laws are often accompanied by specific **regulations**.¹³ These can be classified in three groups: economic regulations, safety regulations, and information regulations. Regulations explain procedures or elaborate on the content of the laws or simply impose specific behavior on individuals and enterprises. At times some laws are so complex that they require a very large regulatory body. For example, the regulations covering the U.S. Internal Revenue Code are reported to cover 18,000 pages while the Code itself is some 2300 pages long. Regulations issued by an executive authority or by a regulatory agency can themselves be very complex, may not be easily accessible by the public, and may overlap with other regulations. In some countries they may not even be published.¹⁴ Yet, as a recent OECD report states: "Regulation is perhaps the most pervasive form of state intervention in economic activity" (1999, p. 179).

Because many forms of regulations do not require budgetary appropriations or formal approval by the legislature, they tend to be less scrutinized. Thus, in many countries, there is an oversupply of regulations. The interpretation of regulations is often left to the bureaucrats who administer them. Therefore, the possibility of confusion or even of abuse is very high. Regulations have been singled out by the relevant literature as one of the major causes of corruption because the bureaucrats in charge may abuse them to derive personal advantage. See Tanzi (1998). They have also been shown to impose very large welfare costs on the economy.¹⁵

¹³ Regulations may be legislated and thus be laws themselves or they may be issued by public agencies.

¹⁴ In a country in which I worked many years ago tax incentives regulations were not publicly available in any form. Thus, the bureaucrats making the decisions had all the knowledge and their decisions could not be challenged by the taxpayers. These cases of asymmetric information between the state and the citizens are quite common.

¹⁵ See 1984 Report of the U.S. Grace Commission; Dixit (1996); Laffont and Tirole (1993); FIEL (1989); and Jacobs (1999). In a recent report, OECD (1999) has ranked the product-market regulations of many OECD countries in terms of their "friendliness...to market mechanism." The conclusion is that the United Kingdom, Ireland, Australia, the United States, and New Zealand have the least restrictive overall regulatory environment while Italy, Greece, and Norway have the most unfriendly environment to competition.

Because of the dynamic character of economies, and because of fast technological change, it is common to find countries with too many anachronistic, useless, or even damaging regulations and too few necessary regulations related to new economic activities.¹⁶ This is an area where excess and scarcity often coexist. Many countries are now struggling to create needed regulations for the financial and banking sectors, for the use of the information superhighway (internet), for genetic research, for the use of some drugs, and for several other important new areas.

In conclusion, a high quality public sector must have enough clear rules to guide economic (and other) activities but not rules that are so many or so vague as to give excessive power to bureaucrats or to create uncertainty among those who make economic decisions. In general, the rules should specify what is not allowed rather than authorize what is allowed. Discretion by bureaucrats should whenever possible be kept to a minimum. It has been reported that, in some countries, particular activities—say, a request for a tax incentive or an application to open a small enterprise—may need 30 or 40 authorizations signed by public employees in as many agencies or offices. See, inter alia, De Soto, 1989. This cannot be consistent with a high quality public sector or with an efficient market.

An important step would be to make a periodic inventory, say, every ten years, of all the existing regulations so that a regulatory budget could be established and could be pruned of redundant and anachronistic regulations while complementing it with new required ones and while clarifying the confusing ones. Such an attempt was made with mixed results by a few countries including Hungary and Argentina. Such a process, while costly, would raise the overall quality of the public sector. Another useful step is the creation of a one-stop, or a "single window," center where individuals can obtain **all** the permits and authorizations they need for their activities. Such centers have been created in a few places and are reported to have led to the elimination of many existing regulations and a reduction in corruption.¹⁷

In addition to the formal, constitutional rules and the rules specified in the laws and in the regulations, the quality of the public sector may be affected by informal norms or arrangements that influence the economic behavior of individuals and the behavior of the public sector. Such norms may (a) influence the choice of presidents, ministers, and other

¹⁶ A couple years ago, it was reported in the American press that in California, bread had to be sold only in pieces of an exactly well specified weight. This regulation, which was still on the book, had been introduced at the beginning of the century when most buyers did not have scales so that they could be easily cheated by unscrupulous bakers. In Italy and Germany discounts on sales by shops must be approved by the municipality and must be limited in time.

¹⁷ Examples of these centers now exist in many places including Bologna (Italy) and Salvador de Bahia (Brazil). In Bologna, an attempt is being made to allow access to this one-stop center through the internet.

high level officials; (b) characterize appointments in the civil service; and (c) influence contacts between the state and the private sector.¹⁸ These informal norms may be based on religious, social, or political considerations. Being of an informal nature and being based on cultural characteristics, they are difficult to change. Still the application of arm's length relationships and the rule of law to all aspects of public sector behavior should be a goal in the search for a higher quality public sector. See Tanzi (1995).

III. POLITICAL AND PROCEDURAL RULES

The constitution, the laws, and the regulations establish the broad legal powers of the public sector and of its institutions; or, putting it differently, they set the rules of the game that should determine the behavior of the public sector and the regulation of the market. The importance of these rules cannot be underestimated. Several authors including Buchanan, Alesina, von Hagen, Poterba, Tabellini, and Persson have argued that, apart from the institutions, political arrangements such as fiscal federalism and fiscal decentralization, proportional or nonproportional representation in parliaments, the frequency of elections, the choice of presidential versus nonpresidential types of governments, the role of the ministry of finance as a super ministry, the rules that apply to the budgetary process—for example, whether it starts with a macroeconomic constraint which reflects a collective view on priorities or whether it allows pressures for spending to be determined through the political influence of each minister—whether parliament can modify the content of budgetary proposals, or whether it must vote on the whole budget, whether the central bank is independent, and so on can have a significant impact on fiscal and macroeconomic outcomes.¹⁹ These situations have been modeled using strong assumptions and sophisticated game theories and have been subjected to some empirical testing. See inter alia, Tabellini and Persson (forthcoming) and Poterba and von Hagan (1998). In some cases they have reached strong conclusions.

I will not review this literature that is still evolving and that, at times, has given conflicting results. While recognizing its importance and its potential contribution to explaining economic policy, in this paper the focus is on other aspects and, specifically, on **the quality of the public institutions**. Political and procedural rules are more likely to affect policies

¹⁸ In some countries high public positions are almost inherited. Some jobs in particular institutions are passed from one to another member of the same family. In others, party affiliation facilitates access to government jobs and a change in government creates a large number of vacancies because many jobs are considered as political.

¹⁹ Eichengreen, and others (1996) have argued in support of a politically independent Fiscal Council that would restrict annual public debt accumulation to agreed levels. The analogy to a central bank independence is obvious. Others have argued for a fiscal policy that to some extent is insulated from political pressures. See, for example, Blinder (1997), and Kopits and Symansky (1998). A discussion along these lines is now ongoing in Australia.

than the quality of the public sector or of public institutions. It is the institutions that confront the citizens and that implement the policies. But, of course, by changing the incentives under which policy makers and institutions operate, the political and procedural rules may affect the behavior and, thus, the quality of the institutions and vice versa. The rules are just a set of instructions. They are not yet the policies. Until the game is played, these rules remain just pieces of papers; and the game is played by the institutions charged with carrying out these instructions.²⁰ They may or may not carry the instructions in a faithful and efficient way.²¹ The public sector is composed of many institutions, some more important than the others. It is the performance and the efficiency of these institutions that, to a large extent determine the quality of the public sector.

IV. THE QUALITY OF PUBLIC INSTITUTIONS

The quality of the public sector may be affected by the absence of some essential institutions or by the poor performance of the existing institutions. For example, in many countries, there are no institutions responsible for enforcing competition or for forcing full disclosure on the part of financial institutions; or for requiring the publication of good accounts on the part of enterprises whose shares are traded in the stock market. As a consequence the market may function less well because of cronyism and monopoly powers or because of lack of essential information.

The performance of public institutions depends on many factors including (a) tradition and reputation, (b) the resources they have available and the discretion over their use, (c) the clarity of their mandate, (d) their organizations, (e) the incentives that they face, (f) the quality of their leadership and staff, and (g) the freedom they have over reorganizational matters.

Take one of the most fundamental institutions as an example, namely the tax administration. Its performance will depend, in part, on its tradition and its reputation. A tax administration that has been efficient, honest, and proud in the past is likely to continue to be so in the future unless it faces truly fundamental shocks. By the same token it is very difficult in the short run to change a corrupt and inefficient administration.²² Its performance will also depend on the resources that it has available to hire capable employees and to pay good salaries, to invest in new computer technology, to carry necessary audits and so on. The clarity of its

²⁰ It can be argued that there are two sets of games taking place. The first is the one that sets the rules and the second is the one that implements them.

²¹ In a recent paper I have argued that public policy is often distorted by the prevalence of principal-agents problems. See Tanzi (2000a).

²² Occasionally countries have closed corrupt administrations and have opened new ones, thus starting from scratch.

mandate—for example, to enforce fairly and objectively the tax laws—is important. Its day-to-day independence from political pressures is essential. When the mandate becomes unclear, either because the laws are not transparent or because the institution is subjected to political interference that forces it to accommodate the special circumstances of some taxpayers, problems develop. This, for example, has been the case in some transition economies and in some developing countries.²³ In these countries, political interference has reduced the quality of the tax administration. The organization of the tax administration is also important and so is the set of incentives that it faces. If an institution is poorly organized, or if good or bad performances are compensated equally, the contribution of this institution to the quality of the public sector will be low.²⁴

There are current attempts at strengthening incentives by making tax administration politically independent like central banks,²⁵ and by negotiating explicit contracts between the government and the tax administration that require quantitatively specified performances. In Australia, for example, the government guarantees to the tax administration a given level of resources over a three-year-period. In exchange the tax administration commits itself to deliver specified outcomes and some quantified outputs.²⁶

This brings into the picture two other important and related aspects of public institutions namely (a) the synergy among public institutions and (b) the enforcement mechanisms. These are treated as two separate aspects although, in some instances, they are two faces of the same coin.

A. Synergy

Like different elements of an ecological system, public institutions work together and support one another so that it may not be possible to have, say, a first-class tax administration in an environment where other institutions, such as the treasury or important ministries or the judiciary, or even the post office, do not function well.²⁷ Often the same weaknesses affect

²³ See for example, Tanzi (2000b).

²⁴ Rules that apply to hiring, promotions, firing and similar issues for public servants obviously play an important role in the determination of the quality of the public sector.

²⁵ In exchange the tax administration receives more discretion over the use of resources.

²⁶ The cost of collection ratio may play some role in this context. See, for example, Highfield (1999).

²⁷ For example, in countries in which tax evaders are not punished by the courts, it will be more difficult for a tax administration to fight tax evasion. In countries where the mail does not operate well, it will be difficult for the tax administration to rely on it to contact the taxpayers and vice versa.

different institutions. This implies that attempting to improve just one institution, when the others need equal attention, is not likely to generate the desired results in the long run. This has been the experience in transition economies where, for example, the establishment of a good treasury system has not improved much the quality of public expenditure management when the budgetary process has continued to generate budgets that were so unrealistic that no treasury could finance or manage them. In some of these cases the result has been the accumulation of arrears on the part of government and, as a counterpart, the accumulation of tax arrears by the taxpayers. See Potter and Diamond (1999).

Inter-institutional externalities (either positive or negative) are very important and must be recognized and dealt with in any attempt at improving the quality of the public sector. Unfortunately, to my knowledge, this aspects has not been addressed in the literature. For example, when the judiciary does not work well, many other institutions suffer. The same could be said for the educational system. A holistic approach that addresses problems in different institutions at the same time is likely to be necessary. However, such an approach, which is inevitably difficult to follow, must be guided by a clear strategy and by the proper sequencing of the changes required and made. If this approach requires more time to implement than the political horizon of the government that introduces it, it is less likely that it will be fully implemented. This is the reason why the quality of the public sector changes only slowly over time.

B. Enforcement mechanisms

The quality of the public sector will depend to a considerable extent on the existence of controls and enforcement mechanisms. Some of these mechanisms must operate within the institutions themselves. For example, **efficient** internal auditors' offices can improve the functioning of the institutions and can provide some guarantees that the latter will not stray away from their basic mandate. But these mechanisms may not be sufficient. In other cases the enforcement mechanisms must cut across institutions. This happens when supreme audit institutions specialized in controls and in enforcement have the responsibility of controlling spending and revenue collection. These institutions often receive their mandate from the constitution and act as independent bodies. They report directly to parliament.

Examples of these supreme audit institutions are the General Accounting Office (GAO) in the United States, the Court des Comptes in France and La Corte dei Conti in Italy, the General Auditor's Offices in Latin American Countries, and so on. Historically, these audit institutions have focused too much on whether the institutions have complied with the letter of the law rather than with the spirit of it. Thus, in many cases, the performance of the institutions in terms of outputs and outcomes has attracted less attention than whether they have complied with legalistic requirements. This kind of auditing is of limited value, except, perhaps, for insuring accountability, because it does not promote the quality of the public sector in its fundamental objective of serving the public. It does not guarantee that the public is getting value for the money spent by the public sector.

In recent years a movement to focus on performance and on output, rather than on formalities and on input, has started. This movement tries to assess public spending in terms of its economy, efficiency, and effectiveness. It requires quantitative indicators of public performance and of the cost of public sector activities. It has had its strongest expression in New Zealand and Australia and, in modified forms, it is spreading to other countries.²⁸ It has brought with it many changes in contractual arrangements and in organizations in public institutions. For example, in the countries that have adopted it, tenure on civil service jobs has gone and many constraints on the actions of those who run departments have been removed. The government, as the principal, now makes contracts with a public agency on what it must deliver and the head of that agency becomes personally responsible for the outcome. If the agreed goals are not met, the contracts of the heads of the agencies are not renewed or their salaries are reduced. Thus strong economic incentives are being linked to performance. The final impact of this change on cultures that are different from those prevailing in New Zealand and Australia remains to be assessed.²⁹ For example, in societies where it is difficult to fire workers, almost regardless of their performance, and where most public employees have tenure on their jobs, it would be difficult to implement these changes. It is easy to see a conflict between this approach and the spirit of the Italian Constitution.

This discussion of enforcement mechanisms and controls would not be complete if two fundamental points were not made.³⁰ The first is the weakness of the cash accounting approach, that has traditionally characterized the measurement of the operation of the government, in providing support for good efficiency controls. The second is the developing field of measuring consumer reactions and preferences with respect to the services rendered by the public agencies. Before addressing these two points, it is important to mention that any concept of quality of government services must be related to the cost of those services and to the resources available to generate them. The higher are the resources available, the better quality one should expect the public services to have. However, given the level of resources available, the higher is the efficiency of the public agency, the higher will be the quality of the services.

²⁸ While the Australian system initially focused on the outcome from public spending, the New Zealand system has always concentrated on **measurable** output. It should be clear that outputs and outcomes are not the same thing. Outcomes may be more difficult to measure and may be affected by public spending only with long lags. For example, educational spending may be assessed in terms of students in school (an output) or in terms of growth in human capital (an outcome). Health spending may be assessed in terms of operations performed or in terms of impact on the length and the quality of life. Obviously, the goal of the government should be to influence outcomes but these are more difficult to measure than outputs.

²⁹ For a skeptical assessment of this change see Schick (1998).

³⁰ I am grateful to Barry Potter for calling my attention to these two points.

The first question, then, is how to measure the level of resources used. Traditionally, the fiscal accounts (and thus the budget) have relied on cash accounting or cash transactions. Thus, the cost of, say, agency X is measured by the cash transfer that agency X receives from the budget. However, accounts based on cash transactions have many weaknesses now better recognized by accountants and economists. The need for accrual accounting is now well established, at least, in principle, although practical difficulties with its use are likely to delay for some time the full transition from cash accounting.³¹ Accrual accounting measures much better the true costs of public sector activities. It would, thus, allow audits that are more meaningful in comparing outcomes to true costs. For example, cash accounting ignores the opportunity cost of using public sector assets such as land and buildings if this use does not result in cash transfers. See Tanzi and Prakash (forthcoming). Thus, an activity that receives little cash transfers but uses very valuable land or buildings is now assessed to have low costs. This is obviously wrong.

The second question relates to the role of citizens, as taxpayers and consumers of public services, in evaluating the latter. Most of the reforms to date, particularly those agency-based reforms that distinguish between principal (the government) and agent (the public agencies), represent actual or implicit **contracts between two producer interests**. An example from the private sector might be the contract between a regulator in the private sector and the monopoly industry that it regulates. The regulator is supposed to represent the consumer in some sense: but his/her direct role is basically the avoidance of excessive profits for the producer rather than specifically consumer interests. What is missing in the arrangements in Australia and New Zealand is the voice of the consumer. Unlike in the private sector where consumers can state their preferences in a direct way (providing there is adequate degree of competition within the market), this possibility is denied in public services. Therefore, some reforms in the 1990s have been directed at trying to find surrogate measures for consumer preferences. At least three approaches are worth mentioning.

- First, some evaluation work has canvassed the views of particular consumers, not in relation to an organized consumer survey, but as part of a wider exercise aimed at understanding what, for example, are parents' view of the education given to their children. Such exercises have tended to be partial and confined to individual sectors.
- A second approach has been that of formal consumer surveys that may cover a number of different services. The World Bank and individual countries or institutions have launched some initiatives in this area.³² While an advance on the past, the limitations of the approach are also significant. First, it is essentially opinion-related rather than measuring

³¹ The Department of statistics of the IMF is in the process of producing a new manual of government finance statistics based on accrual accounting.

³² For example, users of public hospitals have been asked to assess the quality of the services. Or taxpayers have been asked their opinions on some aspects of the tax administrations.

some actions or providing specific responses by the consumer to quality concerns. Second, it is subject to the usual problem that a well crafted survey can produce more positive views than might be justified of public sector provision.

- These weaknesses in both evaluation and consumer survey-type approaches led the United Kingdom in the early 1990s to seek an alternative approach. From this emerged the "Citizens' Charter," which tried to involve the citizens' voice in the setting of standards. This has been done in a number of ways. Citizens' representatives or other consumer interests are involved in the setting of standards and performance contracts between government and agencies rather than just the ministry of finance. Moreover, having set standards, consumers are also given a right and the means to complain through the provision of telephone hot lines, etc. The consumer response is taken into account when assessing the overall performance of an agency's manager. The compulsory use of name badges for officials—so that consumers, through their response, can both reward good and punish bad service—is a small but significant element. This is still another example of how incentives are slowly being introduced in the public sector. Furthermore, in certain cases, consumers are entitled to some form of compensation if the public service provider fails to meet the required standard. The simplest example is that season ticket holders on particular rail services were entitled to refunds if delays in the running of trains exceeded a certain minimum.

None of the approaches is wholly satisfactory. But the injection of a consumer voice in the setting of standards, in commenting upon the observations or otherwise of standards and, thus, in influencing the future allocation of public sector resources, is likely to become a major feature over the next few years. It is also likely that incentives and penalties will play an increasing role in promoting a higher quality public sector.

In addition to the internal controls and those performed by auditing institutions such as the GAO or the Court des Comptes, there are some other institutions whose working and efficiency are an essential ingredient in the quality of the whole public sector. Among these the system of justice is of the greatest importance. The role of the justice system in all its manifestations in enforcing contracts, in protecting property rights, in ensuring the safety of individuals and property, in keeping corruption under control, and in improving the efficiency of other institutions is fundamental. Thus, it is not an exaggeration to state that the quality of the public sector of a country and the functioning of its market depend significantly on the performance of its justice system. It is for this reason that the system of justice is receiving a lot of attention in many countries including European countries, such as, France, Italy, and Portugal, and the majority of Latin American countries.

In many countries the justice system has been in crisis in recent years. Individuals and property rights are not protected, contracts are not enforced, processes take years or even decades to be concluded, and so on. In many cases, individuals who break the law are not punished, or are punished lightly, or are not punished until much later when the deterrent effect of the punishment is lost. In some countries, the slow moving or even corrupt system of justice has provided an implicit incentive to tax evasion, to corruption and to other illegal

activities because those caught committing crimes could count on the inefficiency or the corruptibility of the justice system to escape punishment. In some countries it takes ten years for the government to determine whether someone accused of tax evasion ought to pay the unpaid taxes. Furthermore, often the penalties imposed are insignificant. This is a good example of the cross-institutional externality mentioned earlier. The same may happen with those who do not live up with the terms of contracts. For example, the proliferation of bad loans and of financial crises is in part a direct consequence of the low and much delayed penalties on those who do not live up to the terms of their financial contracts.³³ In some countries apartments or houses are left empty, rather than being rented out, because of the difficulty that the owners would have in reclaiming them at the end of the contract. Obviously, the failure of the justice system encourages the tenants to ignore the terms of their contracts and imposes efficiency costs on society. It also kills some potential markets.

When justice is corrupt or inefficient, it also becomes unjust because some people are or become more adroit at taking advantage of its weak points. Law abiding citizens are the ones who end up paying the cost and economic activity suffers. Equal access to justice, and to a justice that is administered in a timely fashion must be one of the fundamental goals of the state. It is also one of the main requirements of an efficient market. If this goal is not met, the quality of the public sector and the functioning of the economy will remain poor. See Guigou (1999).

V. MEASURING THE GENERAL QUALITY OF THE PUBLIC SECTOR

Although knowledgeable individuals have some a priori notions of the quality of the whole public sector of countries, it would be difficult or even impossible to get objective measures of that quality. In principle one could conduct surveys of perceptions of such quality using the same techniques adopted, for example, in the surveys of corruption. However, the informational requirements on the part of the respondents to give acceptable results would be extremely high; thus, the quality of the responses would be low. It might be easier to evaluate the quality of each of the major institutions that make up the public sector and somehow weigh their importance to the general quality of the public sector. However, given the number of such institutions and the knowledge required to assess them, such an enterprise would also be very costly and not necessarily successful in achieving the desired results. An alternative way would simply measure the economic and social performance of a country. This alternative would focus on the output or better on the outcome of the economy and attribute the results to the quality of the public sector. However, this approach would also have its limitations.

³³ In many countries bankruptcy has become almost a trivial matter with little consequences. Thus, the establishment of bankruptcy laws has become an important issue in many countries.

In recent years some institutions and some scholars have begun to focus on particular features that capture some significant aspects of the quality of public sectors. The IMF, for example has been focusing on data that countries could produce and make available to the public. Some of these data relate to the public sector. The assumption would be that countries that are willing and able to generate good public sector data, and are willing to make them available on a timely basis to the public, have a higher quality public sector.³⁴ The Fund has also started to assess the **transparency** of fiscal policy and fiscal institutions. This evaluation is done against a set of general principles of fiscal transparency. The assumption is that lack of transparency is an indication of a lower quality of the public sector and that this lack of transparency promotes inefficiency, poor policies, and various problems of governance. In time, transparency reports may become available for most countries. If comparable and comprehensive, these reports would provide proxies for informal assessments of the quality of the public sector.

In recent years, there has been a lot of attention paid to issues of governance and corruption in public institutions. These issues also bear on the quality of the public sector. It has been recognized that lack of transparency in the way institutions operate and lack of controls promote inefficiency and corruption. There is now a large literature on transparency and on corruption. Australia and New Zealand have once again led the way in promoting techniques aimed at increasing transparency. The new "architecture" of the international financial system has recommended that countries become more transparent in their policymaking. More transparency would probably mean less corruption and generally a higher quality and better performing public sector. However, much needs to be learned about these relationships. It must also be recognized that tests of transparency may be superficial or deep. Superficial tests would not be very useful in understanding what is going on in a public sector and deep test may require a lot of highly specialized and costly resources.

Corruption is a sign of a public sector's lower quality. Various groups have been generating corruption indexes for a large number of countries. See Tanzi (1998). These indexes purport to measure "perceptions" of corruption. It is likely that to some extent, and assuming that the perceptions reflect reality, these indexes of corruption can also be taken as proxies for the quality of the public sector. However, caution is needed because, quite apart from the quality of the corruption indexes, a country could have a totally honest bureaucracy or even political leadership and very inefficient policies and institutions. While important, corruption is only one aspect of poor public sector quality.

Some authors, such as Rauch and Evans (2000) have provided estimates of bureaucratic performance for many developing countries thus providing measures for yet another variable that has a bearing on the quality of the public sector. On the other hand, Keefer and Knack (1997), after defining institutional quality as "objective evaluations...of the institutions that

³⁴ The data themselves might tell more about the quality of public policy than the quality of the public sector.

protect property and contractual rights" attempt a measurement based on various indicators. It is not clear to what extent they measure the quality of public sector institutions.

There are other variables that may provide information on the quality of the public sector. Some would relate to its efficiency, some to the policies followed. For example, the relationship between spending in a given category—say health and education—and the outcome of that spending—such as lives saved, successful operations, reduction in the incidence of certain diseases, educational achievements—would be an indication of efficiency. See Gupta et al (1997). On the other hand, measurements of fiscal sustainability might be indications of poor policy rather than of poor quality of the public sector.

VI. CONCLUDING REMARKS

The quality of the public sector can be assessed only against the role of the state. If the public sector allows the state to promote its goals in an efficient and successful way, it can be argued that the public sector is of high quality. However, the goals must be realistic because even a very efficient public sector will be unable to cope with unrealistic goals. Thus, in general the quality of the public sector cannot be measured by the quality of the policy outcome although the two are obviously closely linked especially over the long run.

In general, an efficient public sector should be able to achieve the state's objectives with the minimum degree of distortion of the market, with the lowest burden of taxation on the taxpayers, with the smallest number of public employees, with the lowest absorption of economic resources by the public sector, and in general with the smallest constraints on the market. The public sector must be transparent in its processes and in its outcome. Corruption should play no role in the decisions made by the bureaucrats and the political leaders. And the resources in the hands of the public sector should be put to a use that maximizes their social rate of return. Such a public sector would be clearly "market augmenting," using a now fashionable expression. Such a public sector would pay particular attention to the protection of property rights and to the enforcement of contracts thus allowing the economy to perform efficiently.

The quality of the public sector is also important in the pursuit of the equity objective which is now seen as one of the fundamental goals of the state. A public sector that, through all its aspects, facilitates the pursuit of equity by the government must, *ceteris paribus*, be deemed of higher quality than one that doesn't. However, as argued earlier, it is difficult to determine the optimal role of the state in this area and it is easy to identify disincentive effects that may be created by some policies that redistribute income. These effects are more likely to arise when the public sector is of low quality so that the policy objectives can more easily be distorted during the implementation stage thus, allowing more scope for inefficiency and rent seeking. See, for example, Schansberg (1996). In conclusion, a high quality public sector should make possible the pursuit of equity with lower costs in terms of efficiency but it

cannot guarantee that that pursuit will be considered important by the policymakers who make these decisions at a given moment in time.³⁵

Finally, the discussion in this paper should have made it clear that the so-called "first generation reforms," that have been so popular in many countries in the 1980s and 1990s, **have dealt mainly with improvements in policies rather than in institutions.** These reforms did not necessarily improve the quality of the public sector even though they probably improved the quality of public policy. The pursuit of "first generation reforms" have, in fact, highlighted the need to improve the quality of the public sector. For the latter to occur, "second generation reforms" are necessary. Without these second generation reforms, the benefits from the first generation reforms might soon exhaust themselves.

³⁵ An important role in this area has been assigned to the state by Sen (1999) who identifies development with freedom and who assigns to the state the function of providing access to education and health to all. A high quality public sector would facilitate the achievement of Sen's objective.

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