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Too Large and Too Small Governments

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I. Introduction

In today's world, government's intervention in the economy is broad and multifaceted. In particular, one of the important roles of government is to provide social safety nets and avoid excessive market-induced levels of social inequality.

At one end, in most industrial countries, governments try to do too much; their excessive attempts at providing social insurance are becoming counterproductive; in fact, the tax burden required to support these extensive transfer programs reduces growth and increases unemployment. At the other opposite end, many governments of low-income countries do not do enough, either to provide infrastructures or to reduce inequality, and what they do is often inefficient and corrupt. In these countries, governments often cannot even produce the most basic public goods and infrastructure needed for development.

In both these situations governments fail. This polarization on opposite extremes of the spectrum is the result of a tendency to slip into two political equilibria. In advanced industrial economics, an increasingly larger fraction of the population—in particular the unemployed, pensioners, and of course, public employees—relies more and more on government transfers or salaries as a source of income. The larger these groups are, the stronger the political demand for public programs; however, the larger the programs, the higher the tax burden needed to support them. In turn, an excessive tax burden slows the growth of the economy, leading to an increase of the share of the population relying on

government transfers. As a result, we have a vicious circle, which goes a long way toward explaining the so-called *Eurosclerosis*.

Many developing countries, particularly in Latin America and Africa, experience an opposite vicious circle. Inefficient tax systems and a lack of capacity or will to collect taxes lead to rampant tax evasion and the growth of a black economy that operates outside the legal system, without infrastructures and public enforcement of contracts. In turn, the lack of tax revenues leads to poor public infrastructures, reducing the incentives for participants in the black economy to come out and take advantage of the public infrastructures, embrace the legal system and "law and order" and pay taxes. Thus, poor public policies lead to tax evasion, and the reduction of tax revenues makes public policies even worse. In addition, the relatively small tax revenues (and foreign aid) are misdirected or wasted and do not reach the really needy nor support the development of efficient infrastructures. The very poor quality of public institutions and policies in developing countries, coupled with the excessive size but relatively higher efficiency of governments in OECD countries point to an interesting empirical implication: the relationship between the size of government and growth may be complex and not linear. This is precisely the finding of La Porta, and others (1998).

In summary, the picture that emerges of the role of government as a provider of social insurance is rather bleak. In many cases governments do too much—defeating their own purpose—or are incapable of providing a minimum of infrastructure or a well directed system

of social insurance, leading to the appalling phenomena of poverty and income inequality, especially in Latin America and sub-Saharan Africa.[1]

This paper is organized as follows. Section II provides some evidence on the size, composition, and efficiency of government programs in some developed and developing countries. Section III fleshes out the discussion about the "two equilibria" highlighted in this introduction. Section IV discusses policy implications, in particular for the IMF.

II. Size and Composition of the Public Sector

In the last few decades, the size of government has generally increased.[2] The most spectacular phenomenon is the rapid expansion of transfer programs in industrial economies, the so called welfare state. In fact, from the early sixties until today, the composition of government outlays in industrial economies has shifted away from consumption of goods and services in favor of transfers to households and government wages.[3]

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[1]This is, of course, a stylized conclusion. The level of income is not the only determinant of institutional quality and government performance. Important differences on this point remain within the developed and developing countries. For a recent insightful discussion of this issue see La Porta, and others (1998).

[2]See, in particular, Tanzi and Schuknecht (1997) on this point.

[3]Another component of government outlays which has increased in the last two decades is interest payments, due to the accumulation of large public debts in several OECD countries.

Figure 1 shows the evolution of total government outlays, primary expenditures, and total revenues as a share of GDP for an average of 20 OECD countries from the early sixties to 1994.[4] The size of government has increased substantially. Even more striking are the changes in the composition of government outlays. Figure 2 plots several components of government spending as a share of GDP: transfers, government wages, nonwage government consumption and public investment. Figures 3 and 4 plot, respectively, the ratio of transfers to total primary spending and the ratio of transfers and government wages to total primary spending. The picture emerging from these plots speaks for itself: governments in OECD countries are becoming larger, and turning themselves more and more into redistributive machines. While public investment displays a declining trend, transfers show a sharply upward movement. As a result, in the nineties about 3/4 of total spending is transfer and public wages. This implies that an increasingly larger fraction of the population derives its main sources of income (wages, pensions, unemployment compensations, welfare subsidies) from the public sector, and are dependent on it.

The counterpart of this increasingly larger redistributive public sector is a growing tax burden, which reduces growth and thus increases unemployment, as a few recent papers have documented. For instance, De la Fuente (1997) presents convincing empirical evidence of the

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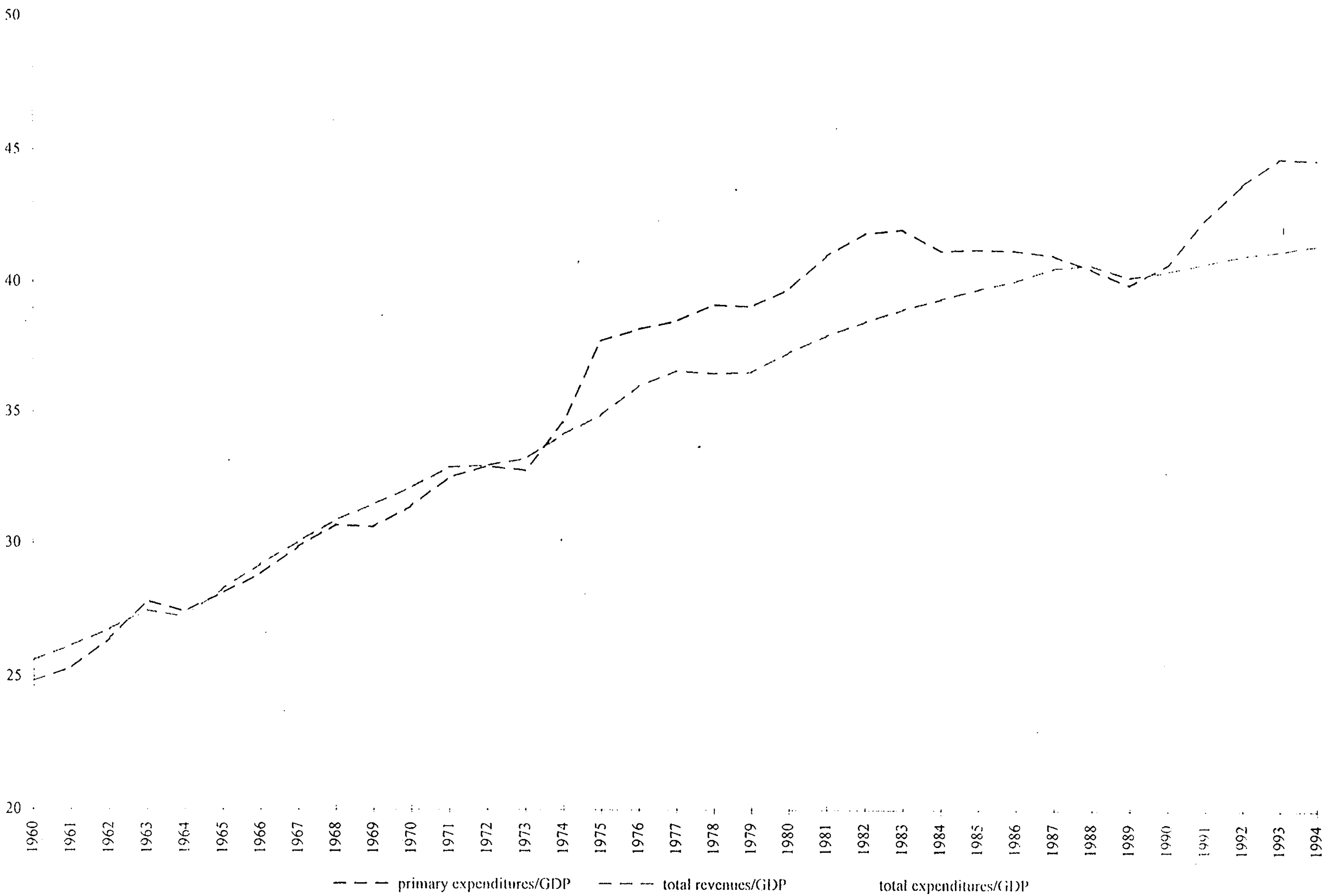
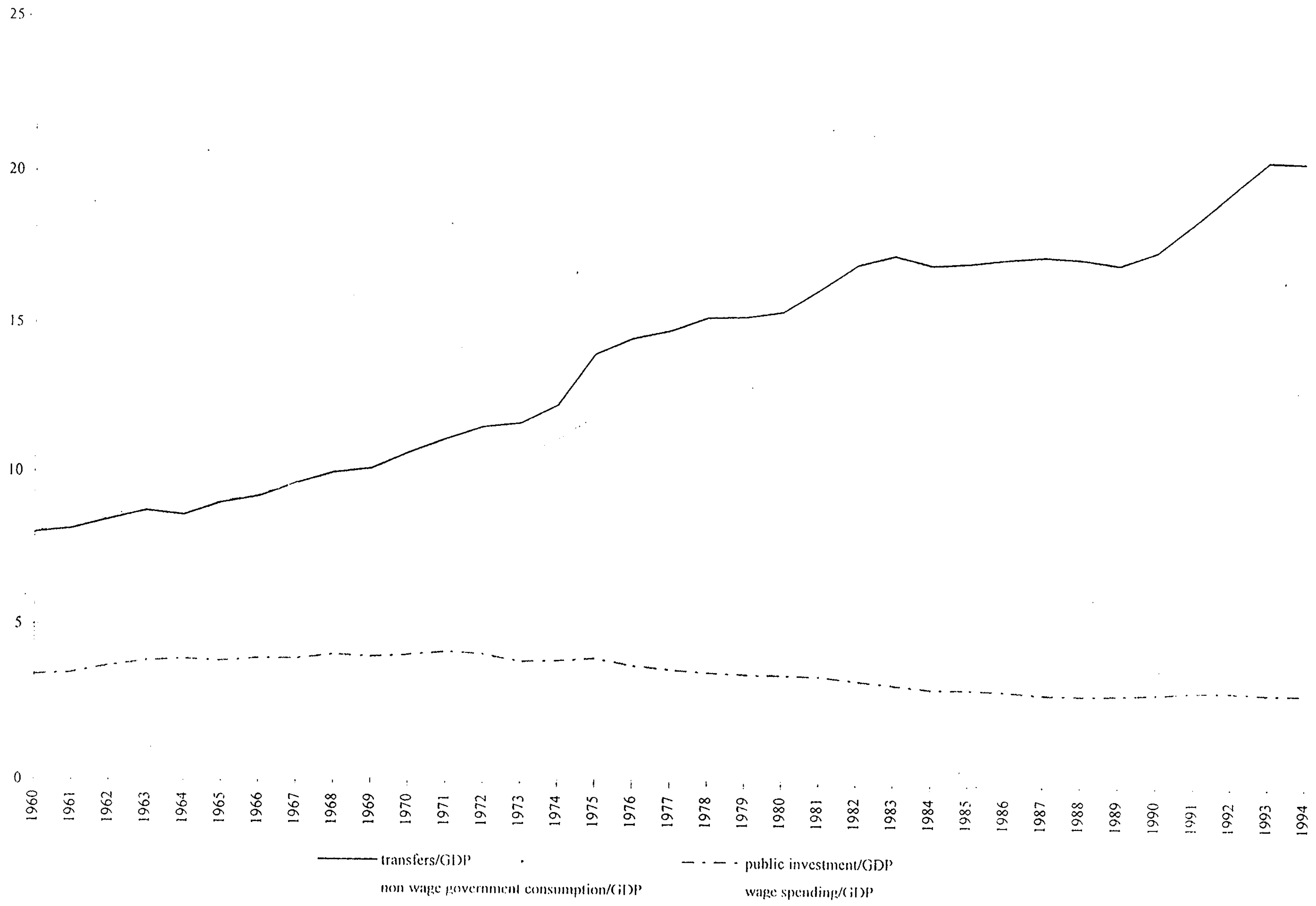
[4]The countries are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States. All the data are from OECD.

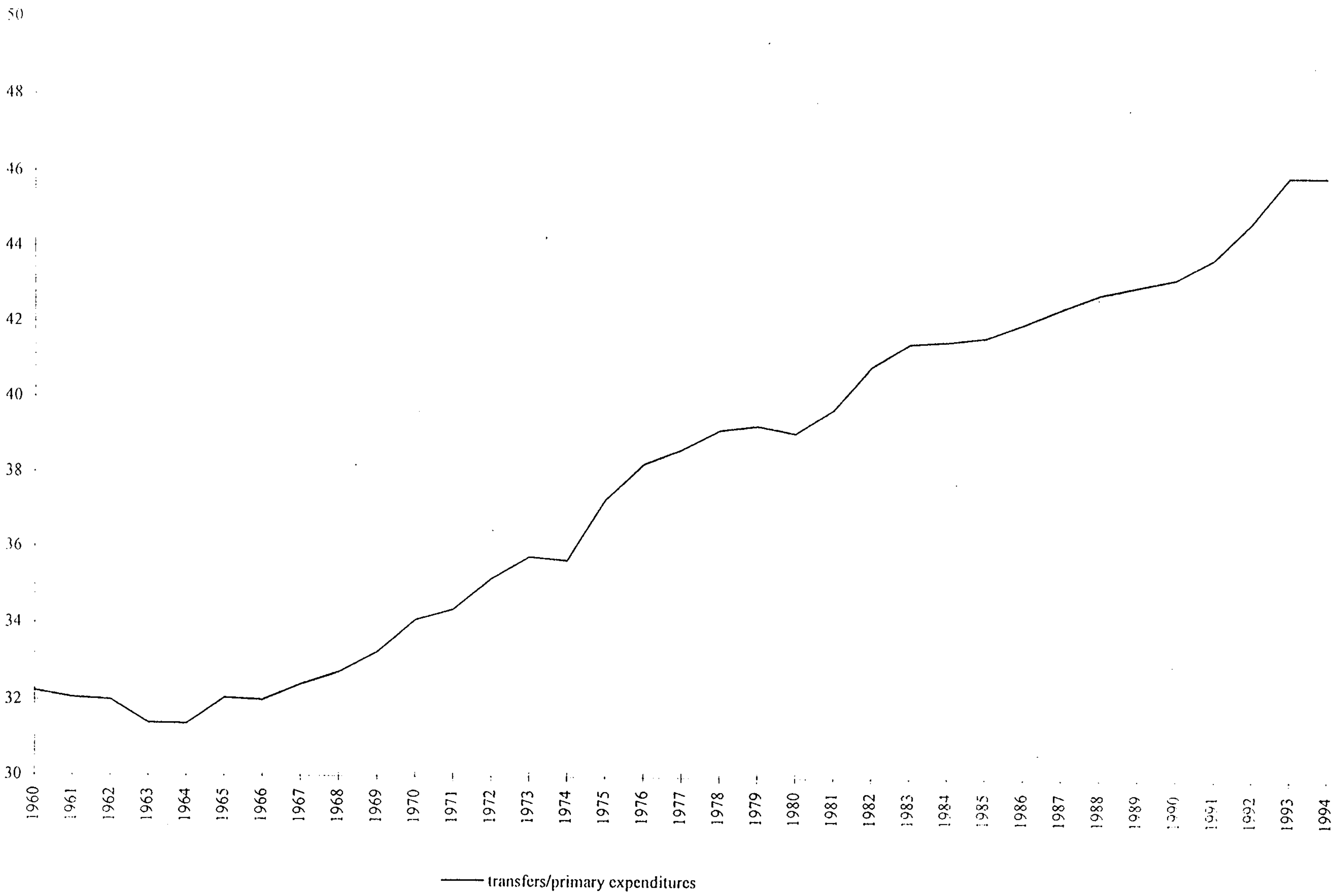
1. Expenditures and Revenues in OECD countries



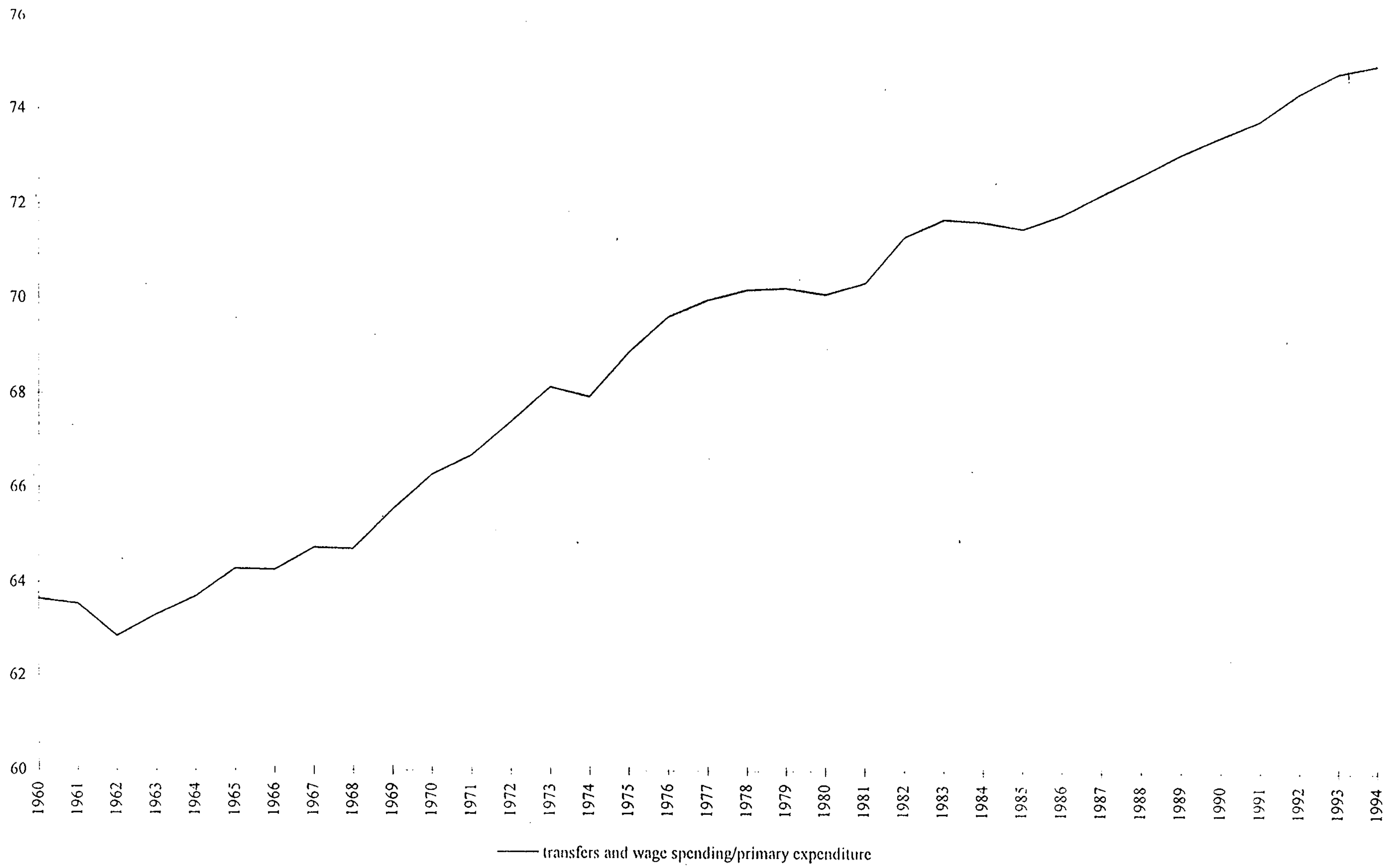
2. Composition of expenditures in OECD countries



3. Transfers in OECD countries



4. Transfers and wage spending in OECD countries



negative effect of larger government size on growth in OECD countries.[5] Alesina and Perotti (1997) show the negative effect on relative unit labor costs (international competitiveness) of high tax rates, particularly in countries with unionized labor markets. These authors show that even though the effects of labor tax increases on labor supply may be small in competitive labor markets, they could be much higher in unionized labor markets, with certain institutional features typical of Western Europe. They compute that a one-percent increase in labor income taxes may lead to up to a two-percent increase in relative labor costs. Unemployment is increased even more by labor regulations and public policies which tend to be overprotective of employed union members, the so called "insiders." The increasing number of 'outsiders' are left in the hands of the government, and the average taxpayer.[6]

A reliable and comparable breakdown of the composition of government spending, along the lines of what is presented above for OECD countries, is not easily available for the developing countries. However, the trend of a large expansion of the welfare state is not prevalent in the developing world. In this large group of countries, the size and composition of government vary and it is difficult to make international comparisons; but in many countries the size of government is quite small, often very small. However, small government does not mean efficient government, at least not necessarily. In fact, the "quality" of spending in many developing countries is quite low. As a result, even the supposedly "pro-poor" types of

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[5]For evidence along similar lines on a larger sample of countries, see Barro (1991), Alesina (1997), and the references cited therein.

[6]For a classic discussion of the 'insiders/outsiders' problem see Lindbeck and Snower (1984).

spending do not do very much to reduce poverty and income inequality, Already, in 1974, Tanzi noted that, in Latin America, ". . .first it appears that even the supposedly pro-poor social type expenditure has little effect on income distribution. Second the group that seems to be getting the greatest advantage from public spending is the urban middle class . . . "(p. 87).

In two recent papers (Alesina 1997, 1998) I have reviewed a large body of literature, which has followed Tanzi's insight of 1974. I reached very similar and disappointing conclusions: in Latin America, sub-Saharan African countries, and even several Asian countries (for instance, the Philippines and Indonesia) public consumption and transfers are often mistargeted, do not reduce income inequality, and largely support *special interest* defined socially, geographically or by occupation.[7] This disappointing conclusion is reached by reviewing several case studies of public spending on health, education, and social security. For example, Pradhan (1996) shows that in a sample of several developing countries,[8] both health and education spending do not reach the bottom share of the income ladder. In most countries the majority of the benefits of these items of social spending benefits the wealthiest 40 percent of the population. Graham (1994) shows how public support of education is highly regressive and ineffective in Senegal. Angell and Graham (1995) reach a similar conclusion for Venezuela. The latter write that "the problem in Venezuela's social sectors stem from decades of resource misallocation rather than from fiscal constraints" (p. 212). Work by Aspe and

[7]Two excellent, recent volumes on this point are Graham (1994) and van de Walle and Nead (1995).

[8]These countries are Argentina, Chile, Colombia, Costa Rica, Dominican Republic, Uruguay, Indonesia, Iran, Malaysia, the Philippines, and Sri Lanka.

Sigmud (1984) highlight the pro city bias in welfare spending in Mexico, which has generated an enormous geographical difference in the coverage and quality of public services and infrastructures.

A recent volume edited by van de Walle and Nead (1995) collects several case studies on the effects of welfare spending, with particular attention to Indonesia, Peru, Pakistan, the Philippines, Sri Lanka, India, and Malaysia. By and large, the conclusion of all these case studies is that even welfare spending in these countries is mistargeted and not particularly progressive—if not plainly regressive—in addition to being inefficiently administered. For instance, in the case of Indonesia, on page 145 of this volume, one reads that spending on various programs in public education in this country "cannot account for a large part of the growth in human capital outcome in Indonesia in the 1980s" (Pitt, Rosenzweig, and Gibbons, in this volume). As for public health spending in Indonesia, on page 283 one reads that "the evidence indicates that increased government expenditure is actually associated with lower use of health services by the children of the poor" (Deolalikar, in this volume). On page 249 of the same volume one reads that health programs in Indonesia "are not particularly well targeted. Indeed the uniform untargeted prevision of lump-sum transfers to the whole population would have been much more progressive" (van de Walle, in this volume). The evidence on all the other countries covered in this volume leads to similar discouraging conclusions.

In addition to the problem of "mistargeting," rampant corruption and bureaucratic inefficiency make the situation even worse. Every available measure of corruption is inversely

related to per capita income, while every measure of bureaucratic efficiency, rule of law and enforceability of contracts is directly related to per capita income (Mauro, 1995, and Barro, 1997). Table 1 shows some simple cross-country correlations for an average of the period 1960–92 between level of income, growth rates, and index of public sector quality. The level of income is very strongly positively correlated with quality of the bureaucracy and measures of rule of law and democracy. Richer countries have also lower levels of corruption,[9] and lower level of ethnolinguistic fractionalization and political instability (revolutions). Political stability and institutional quality is also positively associated with growth.

Tanzi (1998) convincingly argues that corruption imposes significant economic costs, contrary to some economists' argument that some amount of corruption facilitates transactions between the private and the public sectors of the economy. This author, however, acknowledges the difficulty of eradicating corruption, an argument consistent with the view of this paper that a high degree of corruption and tax evasion is a form of inefficient equilibrium.

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[9]Note that in the table the index of corruption is defined in such a way that higher values of the index imply less corruption.

Table 1. Correlations Between Income, Growth, and Government Efficiency

	Growth	Per Capita Income (1960)
Growth	1.00	--
Per capita income (1960)	0.21	1.00
Ethnic fraction	-0.23	-0.54
Rule of law	0.45	0.75
Corruption	0.36	0.77
Bureaucratic quality	0.44	0.77
Democracy	0.22	0.75
Revolutions	-0.27	-0.36

Note: Number of observations: 78.

Sources: Growth: percent growth rate in real per capita GDP (Summers and Heston, 1991); per capita income 1960: log of real per capita GDP in 1960; ethnic fraction: index of ethnolinguistic fractionalization (Mauro, 1995); rule of law: index of enforcement of rule of law from 1 to 6; higher number means more rule of law (IRIS-ICRG); bureaucratic quality: index of efficiency of the bureau; higher values mean more efficiency (IRIS-ICRG); democracy: index measuring the extent of civil and political rights, higher values mean more rights, (Freedom House) revolutions: number of revolutions and coups (Banks). For more details on the data see Alesina (1998).

In an important recent paper, Gupta, Davoodi, and Alonso-Terme (1998) attempt to measure statistically the impact of corruption in a large sample of countries. They show, in particular, that higher degrees of corruption increase income inequality. A striking finding is that "a worsening in the corruption index of a country by one standard deviation . . . is associated with the same increase in the Gini coefficient as a reduction in the average secondary schooling of 2.3 years." This result is quite strong, since secondary schooling is one of the variables most strongly associated with inequality (Perotti, 1996). Note that a vast empirical literature has established that high levels of income inequality are harmful to

growth.[10] Therefore, higher corruption, by increasing inequality, would also have a negative effect on growth.

In summary, poor countries have misdirected spending programs, a relatively high level of corruption, and inefficient bureaucracy. These observations, viewed together, suggest an interesting empirical implication on the economic effect of government size. The larger governments of OECD countries are, on average, more efficient than the smaller governments of developing countries; however, the former impose a higher tax burden. The empirical relationship, therefore, between government size and economic success (say economic growth) is complicated by this direct relationship between efficiency and size of the government sector.[11]

III. Two Vicious Circles

In industrial economies, retirees live longer, are more numerous, and receive an increasingly larger fraction of GDP as their pensions. In several countries, a primary example being Italy, the weight of pensions is the greatest obstacle to achieving a permanent budget consolidation; not only because other forms of social insurance are squeezed by pensions. Pay-as-you-go systems have created a large constituency of elderly always opposed to pension reforms. Older individuals normally are relatively wealthy and have more time to engage in

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[10]See Perotti (1996) for a survey of this literature.

[11]La Porta, and others (1998) develop this point and provide supporting evidence.

political action; as a result, their political influence may actually go beyond their voting share in the population. This effect is reinforced in situations where retirees are active members of the union movement, therefore influencing unions' policies toward welfare reforms.[12]

Similar arguments apply to public employees and bureaucracies. In many cases public employment is used as an indirect mean of distributing resources towards politically influential lobbies.[13] In many industrial countries public employment virtually has permanent tenure and it is often very difficult to dismiss public employees.

Casual observations suggest that public employment unions, like retirees, have a political influence that goes beyond their share of the voting population. Some recent results by Alesina, Perotti, and Tavares (1998) are consistent with this hypothesis. These authors examine the electoral effects of fiscal policy and find that governments of OECD countries that engage in fiscal adjustments are typically not punished by the voters. In addition, fiscal contractions based on cuts in transfers and public wages appear to be electorally rewarded![14] These results are very different from the standard perceptions that reductions in debits are politically costly. One interpretation is precisely that those consistencies who benefit the most

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[12]An extreme case is Italy where the majority of the card-carrying union members are pensioners.

[13]In Italy, for instance, public employment is much larger per capita in the south than in the north. It is widely recognized that most of this public employment in the south is a disguised compensation for permanent unemployment.

[14]Interestingly, very similar results emerge from research focusing on U.S. states (Peltzman, 1992) and in Latin American countries (Kraemer, 1997).

from an overextended public sector and welfare system have enough influence to block any welfare reform and fiscal adjustments; however, those governments that "bite the bullet" and take the risk are not punished at the ballot box, at least not systematically.

The existence of a "blocking coalition" of public sector unions (often supported by other unions) and retirees may be particularly harmful; a recent literature has consistently reached the following conclusion:[15] fiscal adjustments which lead to a more permanent consolidation of public budgets are those that rely primarily or exclusively on spending cuts, and especially cuts in transfer programs and government wages. Therefore, a coalition of retirees and public sector unions would block exactly the type of spending cuts which are really necessary.

In summary, a larger and more politically influential coalition derives its income from transfers and public wages. In turn, the internal dynamics of entitlement programs lead to an increase in the tax burden. The latter leads to a reduction in the rate of growth, making the welfare problem (unemployment and early retirement) even worse, which, in turn, leads to the vicious cycle. Even "culture" and attitudes play a role. In many OECD economies, a culture of welfare leads to an expectation that the taxpayers have to support a large fraction of nonworkers. To the extent that this becomes part of the "norm," it has perverse incentive effects. When it becomes "normal" that a large fraction of the population enjoys a life-long,

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[15]See, in particular, Alesina and Perotti (1997), Alesina, Perotti, and Tavares (1998), International Monetary Fund (1996), and McDermott and Wescott (1996).

public employment, pensions unrelated to their contributions, and generous unemployment compensations, it becomes difficult to eradicate this attitude of dependency.

An opposite vicious circle occurs in several developing countries. In many cases a relevant fraction of the economy operates in the black or, at least, in a gray area. The reason is that many businesses and individuals prefer to escape taxes and regulations, even at the cost of not being able to use many public infrastructures available to the formal sector of the economy. The more inefficient the public sector inefficient, the lower are the benefits for the formal sector, and the more attractive the informal options appear.

Loayza (1996), for instance, studies a two-sector model of economies with the formal and informal sectors. He shows that, depending on parameter values, the economy can converge to an equilibrium with a large informal sector, low tax revenues, low enforcement of tax collection, and poor public services, or to an equilibrium with the opposite features. The informal sector is less productive than the formal one, and specializes in low value-added activities. Thus, the two equilibria with a high or low share of the informal economy can be ranked in terms of efficiency.

The larger the informal sector becomes, the more difficult it is for the government to collect taxes. With low tax revenues, the government is forced to keep spending low. Often, the spending programs which are cut are not the most inefficient ones, but those with no vocal lobbies supporting them. As a result, low tax revenues reduce even more the efficiency of

public goods and infrastructures. Therefore, one obtains a vicious circle of low revenues, leading to an inefficient government, creating an even larger incentive for the economy to become informal, thus lowering tax revenues even more. Johnson, Kaufman, and Shleifer (1997) present a useful model of this interaction and apply it to analyze the emergence of a black economy in Eastern Europe. Among the infrastructures that the informal economy cannot take advantage of, these authors emphasize the provision of "law and order." To the extent that law and order are inefficiently provided for the formal economy, the incentive to go informal is higher.

Tax evasion is not a prerogative of developing countries; it is present in OECD countries as well.[16] However, even the dynamics of tax evasion and tax collection exhibit multiple-equilibrium features. If tax evasion is low, the probability of being caught, for the given enforcement effort, is higher, thus reducing even more the incentive to evade. If tax evasion is pervasive, the probability of being detected is lower, thus increasing the incentive for tax avoidance. Therefore, this is another force pushing toward two polarized equilibria. As for the case of the "culture of welfare," cultural attitudes are important here as well. If the public is used to avoiding payment of taxes, tax evasion loses any socially unacceptable connotation and becomes simply a smart business practice. If this is the case, it becomes particularly costly politically, even for a well-meaning government to persecute tax evaders. When the tax evaders become a majority, or close to it, there is no political support for tax reforms.

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[16]On this point, see Tanzi (1982) and Tanzi and Shome (1995).

In summary, several governments "fail" because they are too large, others because they are too small and inefficient. Self sustained politico-economic forces push governments toward these two "corners," both of which can be inefficient equilibria.

IV. Policy Implications for the International Monetary Fund

The IMF is often involved in advising countries to reduce budget deficits. Often, fiscal stabilizations are the critical components of country programs. Even in countries where the IMF is not directly lending, its judgment on fiscal adjustments is often taken as a critical evaluation of the countries' progress toward fiscal stability.

The IMF traditionally has placed almost exclusive weight on the achievement of a balanced budget; it is much less interested in how this target is reached, namely by increasing revenues, or cutting spending, and in particular, on which spending programs. The evidence discussed above shows that "how" a fiscal adjustment is achieved may be as important as the size of the adjustment itself, measured by the amount of reduction of budget deficits. The IMF should focus just as much (or even more) on the size of taxes and spending over GDP than on the size of the deficit over GDP. Abed (1988) reviews the features of IMF sponsored fiscal adjustments in several developing countries in the last ten years. This report does illustrate some effort at addressing compositional issues, but acknowledges that "some countries with low initial revenue effort failed to improve revenue performance." On the expenditure side "shortcomings in expenditure management has persisted."

In OECD countries, a large body of evidence, recently assembled, show that the fiscal adjustments which are long-lasting and are not contractionary, even in the short run, are those which are based exclusively on spending cuts, particularly on transfers and government wages.[17] For instance, Alesina, Perotti, and Tavares (1998) study the effects of fiscal adjustments in 19 OECD countries from the early sixties to 1995. They define a fiscal adjustment as a year in which the primary cyclically adjusted budget deficits falls by at least 1.5 percent of GDP.[18] Then they define "successful"an adjustment where in the following three years the debt to GDP ratio falls by at least 5 percent of GDP. Successful and unsuccessful adjustments look very different. In the successful cases more than 2/3 of the reduction of deficits comes from spending cuts; in unsuccessful cases only 1/4 of the adjustment is on the spending side. As for the spending cuts, in unsuccessful cases, these are virtually all on public investments, while, in successful cases more than half of the large spending cuts are on transfers and government wages. The authors also show that successful adjustments are not associated with recessions, while unsuccessful cases generate short-run downturns and do not lead to a permanent consolidation of the budget, making, another adjustment unavoidable.

A particularly illuminating example is Ireland. In the early eighties, this country followed a tax-based attempt at reducing budget deficits, which was largely unsuccessful. As a

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[17]For instance, see Alesina and Perotti (1997), McDermott and Wescott (1996), and Alesina and Ardagna (1998).

[18]It turns out that the results are unaffected by the specific type of cyclical correction used.

result, a second attempt was necessary in the late eighties. This time all the adjustment was on the spending side: the ratio of primary spending to GDP fell from 43 percent to 35 percent. The tax burden was actually reduced by 1 point of GDP. Spending cuts were concentrated on transfers and government involvement. For instance, in about three years (1987–89), public employment was reduced by about 10 percent, from 300,000 to 270,000 employees. Since the beginning of this second adjustment, the Irish economy has experienced the highest growth rate in the OECD, and has been nicknamed the "tiger of Europe." In about 10 years the debt to GDP ratio has been almost halved, from 110 percent of GDP in 1987 to about 60 percent currently.

Similar conclusions on the composition of successful fiscal adjustments may not apply to developing countries with "small governments"that experience difficulty in raising revenues. In these cases, fiscal adjustments could provide the opportunity for governments to improve their ability to collect taxes and reduce tax evasion by means of tax and regulatory reforms, thus bringing more of the informal sector into the formal, tax-paying one. Preliminary results by Gavin and Perotti[19] find that in Latin America fiscal adjustments, which are more likely to be successful and long-lasting, are tax-based; this is exactly the opposite conclusion reached by the empirical literature on OECD countries. These preliminary results are consistent with the argument that, while in most OECD countries governments spend too

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[19]These unpublished preliminary results are obtained using the same data set in Gavin and Perotti (1997), but are not published in that paper.

much, in many Latin American countries governments do not collect enough taxes because of tax avoidance.

However, the conclusion that many developing countries have to raise more revenues does not imply that they simply have to increase spending on existing programs. On the contrary, a more daunting task, beyond collecting more revenues, is to reform and redirect spending programs. For example, in many countries public employment (a major component of spending) is an indirect (and inefficient) way of transferring income to certain groups, rather than as a way of producing public services.[20] In fact, La Porta, and others (1998) find that the share of public wages over total spending is inversely related to several measures of quality of public policies and outcomes.

The available evidence on foreign aid, in fact, suggests that simply increasing the revenues of governments in developing countries is not enough. Results by Boone (1996) and Burnside and Dollar (1997) show that foreign aid has largely been wasted, has increased government consumption rather than investment, and has not promoted the adoption of "better" macroeconomic policies.[21]

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[20]In Kenya, for instance, half of the labor force in the formal economy is employed by 93 government agencies (Alesina, Baqir, and Easterly, 1998).

[21]To be fair, donor countries share some responsibility for the failures of the foreign aid effort, as discussed in Alesina and Dollar (1998).

More generally, an improvement in the government's ability to reduce poverty, and income inequality, and increase growth performance should take different forms in different groups of countries. In OECD countries, there is no doubt that these goals are better achieved by a sizable reduction in the extent and coverage of the welfare state.[22] Two areas are particularly important: pension systems and unemployment benefits. A move from pay-as-you-go to fully funded systems is overdue in many OECD countries. This reform would not only improve economic efficiency, but would also be more equitable, in an intergenerational sense. Nontrivial problems of transition have to be solved, and the specifics may vary from country to country, but the general principle is the same. The second critical area is labor market policies. Excessive protection of the employed labor force, together with high levels of unemployment compensation, create labor market rigidities. If governments intervened less in labor markets, and reduced the tax burden, not only would growth performance be superior, but there is no reason why even income distribution would not improve.

Many developing countries have even more difficult problems. Here, better government performance to achieve social goals, implies switching from a tax-evading economy with no infrastructure and with mistargeted safety nets, to a tax-paying formal economy with relatively small, but efficient, social safety nets. The real difficulty lies on the fact that many of these reforms are not likely to be successful without a reduction in the

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[22]The size of the desirable reduction may vary from country to country and may depend on initial conditions. For instance, it is well known that the size of the welfare state is smaller in the United States than in most European countries.

amount of corruption and an increase in bureaucratic efficiency. This is precisely why the IMF and the World Bank have placed much emphasis on "governance" in the last few years.

As noted by Tanzi (1998), improving "governance" is not an easy task, and monitoring of the process from an outside organization is extremely difficult. However, as discussed above, improvement in these dimensions is critical to both reducing inequality and improving efficiency and growth. What can the IMF and World Bank do in this regard? One possibility, discussed in more detail in Alesina (1997) is to impose more stringent institutional requirements on countries that require assistance from IMF and the World Bank. These organizations should consider withdrawing technical and financial assistance to governments that do not satisfy minimum standards of efficiency and transparency and are excessively corrupt. This approach might generate domestic incentives for reform and improvement in governance. The option of continuing assistance may simply be to postpone the necessary "change of regime."

In summary, the necessary fiscal reforms in different countries are very different from each other. The IMF has recently been accused, sometimes justifiably, of always providing the same policy prescription to every country. Even though some of the IMF critics have been too severe, this point has some validity.[23] This paper presents arguments which suggest that the

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[23]I am *not* referring in particular to the recent discussion on the IMF intervention in East Asia. My point is meant to be broader.

IMF should support different fiscal programs in different countries, both in the case of fiscal stabilization and longer-run structural fiscal reforms.

In addition, the IMF's insistence on deficit-reduction policies, although in most cases perfectly appropriate, should not overshadow the level of spending and taxes. In some cases, the cure for the deficit disease may be worse than the disease itself. Consider, for example, the case of the convergence criteria for the Monetary Union in Europe. The entire fiscal criteria were based on deficit targets. These criteria have encouraged (or forced) overdue reductions in deficits. However, an overwhelming fraction of these recent fiscal adjustments have occurred on the revenue side, increasing even more an already high fiscal burden.[24] A case in point is Italy, where almost the entire fiscal adjustment has been on the revenue side: the tax to GDP ratio has increased from 42 percent in 1992 to about 49 percent in 1997. On the spending side, the transfer to GDP ratio has continued to increase throughout the adjustment, and the public wage to GDP ratio has not fallen. In Italy, as in many other OECD countries, the reduction of the size of government is as important, if not more important than reductions of the debt to GDP ratio. In the next decade, the priority should be substantial balanced budget cuts in taxes and spending.

An additional policy implication of these arguments about multiple and inefficient equilibria on government size has to do with the discussion about the "speed" of fiscal

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[24]In addition, several commentators have emphasized the use of creative accounting in order to achieve the targets.

reforms. For both OECD economies and developing countries with large informal economies, a "cold-turkey" approach is probably superior. Both types of governments need to converge to a different equilibrium. In the case of OECD countries, the change of regime has to signal a significant reduction of the role of government as provider of guaranteed income to those not in the labor force or the unemployed. The welfare state, as envisioned in the sixties and seventies in many European countries, simply cannot survive. As for developing countries, a change of fiscal regime is needed so that the incentives for choosing the formal versus the informal economy are reversed. This will require a large effort at improving tax collection, making it feasible for informal members of the black economy to move to the formal sector.

This requires a coordinated effort: governments have to increase their efficiency in providing services and at the same time reduce tax evasion, thereby expanding the tax base without increasing tax rates. This is not easy to do and requires a "change of regime" that makes it credible that the reforms will stick.[25] While engineering a credible change in the fiscal regime is far from easy, the good news is that, if it happens, the convergence to a new equilibrium could be relatively fast. In other words, when the vicious circle of poor public services, tax evasion, even poorer services, black economy, and so forth, is reversed, it can turn into a vicious circle with a fast improvement in government efficiency.[26]

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[25]Argentina, for example, has shown significant success in her recent effort to increase tax collection, in the context of the recent stabilization policies.

[26]See Johnson, Kaufman, and Shleifer (1997), for a discussion of the informal economy in Eastern Europe and the former Soviet Union along this line.

The implementation of drastic fiscal reforms may require the improvement of adequate social safety nets. First of all, one should not make the mistake of overestimating the costs of reforms. Well crafted policy reforms may begin to deliver social returns relatively quickly, as many examples in both Latin America and Eastern Europe show. Thus, one should not become "obsessed" with social safety nets: market opportunities work pretty well and pretty fast. Having said that, a certain amount of social safety nets are necessary to insure a successful reforms package. The economics of the design of social safety nets is relatively well understood; see for instance the recent volume edited by Chu and Gupta (1998). Political economy questions are much more difficult. For instance Graham (1994) documents that even well-intended social programs ended up supporting a few relatively privileged groups rather than the really poor. This author shows how in many cases government bureaucracies and the urban lower-middle class were excessively protected, relative to the rural poor in many Latin American countries. Chu and Gupta (1998, Chapter 2) define this phenomenon the "middle class capture" of social safety nets.

In principle, appropriate targeting could solve the problem; however, in practice, targeting has several limitations. First of all, precisely because of the middle class capture, targeting to the really poor may be politically unfeasible. That is, programs that target disadvantaged small minorities may not be politically feasible, particularly in the presence of ethnic and linguistic diversity within the country. Second, identifying and reaching the very poor, particularly in urban areas and in countries with a large informal economy, may be quite difficult. Very complicated, highly targeted, programs may also be technically difficult to

implement and may create incentives for distortions and corruption because they are more difficult to monitor. In fact, simplicity in the tax-spending schemes is critical and ultimately more efficient. The appropriate choice between simple broad-based programs and targeted ones may vary from country to country. However, the choice cannot be based only on purely economic factors but should take into account the political equilibrium, which should support and implement the programs themselves. In other words, certain programs may have to be more broadly applied and less targeted than "ideally" optimal in order to ensure political support.

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