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How can Financing of Social Services be Pro-Poor?

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Summary

In the first part, a brief discussion of the interactive relationship (synergy) between income growth and social policy is presented. Our model of synergy leads to a set of pro-poor recommendations which explicitly integrate economic and social policies. Social services financing is a critical link between economic and social policies; however, the paper argues that social policies alone cannot be pro-poor; economic policies must be complementary and reinforce that objective. Recent good and bad experiences on financing social policy are presented from various countries and assessed in terms of how progressive and solidaristic they are. From this perspective, recent trends are not very encouraging. Since the inception of structural adjustment programs, there has been a push towards VATs (and other indirect taxes). Indirect taxes are not pro-poor sources of revenue for social polices. Nevertheless, not all reforms have had negative effects. In particular, within the last ten years or so, there has been a growing recognition among policy-makers on the detrimental effects of user fees. Countries should be encouraged to implement direct progressive taxes. The United Nations and the IFIs should take a leading role in terms of capacity building in this area. Donors should help foot the bill in terms of training and the required infrastructure to ensure compliance with these taxes.

Introduction

The mainstream view of development posits that if economic growth is maximised, poverty will be reduced, and increases in welfare will ensue (in a more or less automatic fashion). Thus, much policy-making occurs under a leader/follower hierarchy model, where macro-economic policy is determined first, while social policy is derivative and left to address the social consequences of economic policies (Atkinson, 1999). This separation of the 'economic' from the 'social' discourse is inherent to the Washington consensus and the Neoclassical theory which underpins it. Moreover, under this view, only certain policies ensure economic growth. In contrast, social policy can and should be understood as "collective interventions in the economy to influence the access to and the incidence of adequate and secure livelihoods and income" (Mkandawire, 2004, p.1).

In the first part of this paper (section 1), a brief discussion of the interactive relationship (synergy) between income growth and social policy is presented. Our model of synergy leads to a set of pro-poor policy recommendations which explicitly integrate economic and social policies and which are associated in the economics literature with different heterodox approaches (Post-Keynesian, Evolutionary, Structuralism, and Transformational Growth[1]).

The core of the paper (sections 2 to 4) deals with issues of social services financing, presenting recent good and bad experiences from various countries and contexts and assessing how progressive and solidaristic these reforms have been. Section 2 examines the scope for intra- and inter-sectoral restructuring of expenditures within health and education. Section 3 examines the prospects for mobilizing additional revenues from taxation from domestic sources. Section 4 deals with recent trends in public-private partnerships and section 5 discusses some important issues about the relationship between the individual and the state to be considered when discussing public financing of social services and pro-poor policies. Section 6 concludes the paper by highlighting that social and economic policies cannot be divorced. Taxation should be assessed from the point if view of whether it contributes to a pro-poor policy context. Unfortunately, since the inception of structural adjustment programs most reforms have not been pro-poor, with the exception of the elimination of user fees.

[1] See, among others, Taylor (2006), Nell (1998a), and Chang and Grabel (2004).

1. The synergy between Social Development, Poverty reduction, Economic Growth

1a) Preliminaries

In the positive experience of recently industrialised countries or of high-achieving developing countries, we are struck by the difficulty of establishing causality relationships between human development and economic growth. For example, despite widespread literacy within a population, many countries have not achieved rapid growth, although education is a major determinant of such economic growth[2]. There are also examples of countries with relatively rapid economic growth but persistent income-poverty. Indeed, the relationship between economic growth, income-poverty, and health/education development is a complex one. A framework to describe these linkages is presented below[3].

The lingering question remains: if there are no sufficient or necessary conditions linking these elements, are they unrelated? The answer is, yes they are related, but in a complex way. Although no particular element is necessary or sufficient for the advancement of the other, they help each other. Thus, for instance, the effectiveness of industrial policy in inducing economy-wide productivity growth or non-agricultural employment in rural areas, will be enhanced by the presence of a healthy/educated population, in turn resulting in higher rates of income growth.[4]

1b) Theoretical framework

A synergy or feedback loop can be succinctly expressed as the enhanced impact a change in an independent variable has on the growth rate of a dependent variable, given the presence of a third variable (Haken, 1979)[5]. This leads to several important, and often

[2] The answer is obvious too: because other growth-oriented policies (such as technological change to induce productivity increase, macroeconomic stability,) are not present.

[3] Our framework could be considered a "magnifying lens" view of the Transformational Growth matrices developed in Nell (2005), whereby we introduce less elements (e.g. we do not include youth socialization), but we attempt to provide more detail to the interactions we do explore.

[4] Thus, no single element can be specified as the main cause (or "development magic bullet") for success in all areas. Pritchett (2003), Easterly (2001) and Levine and Radelet (1992) discuss various shortcomings of econometric estimates that attempt (and fail) to establish these relationships.

[5] It should be noted, in order to distinguish from the static influence of multiple factors in traditional economic analysis (e.g. Cobb Douglas production functions), that the synergies take place in terms of rates of change, not levels of activity.

overlooked, inter-related effects in terms of policy. The impact of a policy (e.g. redistribution to directly reduce poverty) on another variable (say economic growth) crucially depends on the level and rate of change of a third variable (e.g. health and educational status). In other words, economic growth will be faster and longer-lasting if (income) poverty is reduced simultaneously through direct policies and the health and educational status of the population is higher and increasing[6]. What we have in mind can be expressed in a set of three relationships (income growth, income poverty reduction, and social development), the determinants of each of which are discussed below.

GNP per capita growth = f_1 (macroeconomic policies, social policy, income poverty reduction, technical/structural change, reproductive labor) (1)

GNP per capita growth is not chosen by governments, but is the result of the combination of public policies and private decisions. GNP per capita growth is influenced by the provision of social services, i.e. social policy and reproductive labor, This does not imply that they are the same or that one is a perfect substitute of the other one. On the contrary, when the government does not provide the services through social policy and women have to provide care, it is a time-burden tax on women. The pace of poverty reduction, the nature of macro-economic policies, and, most importantly in the medium to long run, technological change (i.e. the introduction of value adding activities and productivity increases through technical/structural change) also affect economic growth.

Low unemployment and high wages reduce poverty, leading to higher levels of consumption, internal demand and economic growth.[7] Stable prices and low interest rates also contribute to a favourable context in which firms would want to invest and create

[6] A widely recognized simple example, and one often mentioned even within the Washington Consensus literature, is that economic growth will be more successful in reducing income-poverty, i.e. the elasticity of poverty-reduction will be higher, when human capital is more equitably distributed. We do not deny this. We only stress that this is only one of the many interactions among various interventions. A classic application in economics is Goodwin (1967).

[7] "The liberal reward of labour, therefore, as it is the necessary effect, so it is the natural symptom of increasing national wealth. The scanty maintenance of the labouring poor, on the other hand, is the natural symptom that things are at a stand" Adam Smith (1776, Book I, Chapter 8).

well-paying jobs. However, this does not mean that macroeconomic stability per se results in economic growth, as evidenced by the standard error of the regressions that try, but fail, to establish this point[8]. Nor does this imply that a privately-led boom will not result in imbalances. Here we want to stress that innovations are introduced through investment - which is financed by profits or by inflows from abroad. The latter may be more volatile than the former and both are influenced by macroeconomic policy[9].

In order to understand the engine of growth, i.e. technological change, (Abramovitz, 1989; Chakravarty, 1982; Schumpeter, 1934; Solow 1997), a model such as the evolutionary one, rather than one involving firms with absolute knowledge concerning static production functions, is needed. Such a model would stress that both inventing and adapting new technologies is a process of discovery characterised by uncertainty, rather than by probabilistic risk (Nelson and Winter, 1982). In this case, markets are not efficient and have no tendency to reach equilibrium, as they tend to change (Anderson, Arrow and Pines, 1988; Lesourne and Orléan, 1998, Pack 1992, Verspagen, 1993, Nell 1992 and 1998a and b). This different theoretical perspective leads to alternative policy recommendations.

For instance, if markets are in constant flux as firms try to alter those constraints through innovation, then the very notion that taxes or import restrictions introduce distortions lacks foundation. Taxes do, however, play another (apart from generating revenue) important role that is usually unnoticed. Taxes affect the distribution of income, with concomitant effects on income poverty, as we see next.[10]

We now turn to the determinants of income poverty reduction.

Income poverty incidence reduction = f_2 (GNP per capita growth, social policy, asset re-distribution policies, reproductive labor) *(2)*

As with economic growth, the primary income distribution is not in the hands of governments to decide, but emerges from market results and relative bargaining power

[8] See, for instance, Bleaney (1996), Hausmann et al (2005) and Sirimaneetham, V and J. Temple (2006)

[9] Further, the focus on freeing up financial markets in the Washington Consensus may have had the adverse effect of contributing to macro-economic instability by weakening the financial sector (UNCTAD, 1998, Grabel 2003).

[10] The role of environmental policies on economic growth is discussed later in order to avoid repetition.

between the owners of factors of production. The distribution of income, in turn, affects the incidence of income-poverty. Nevertheless, both through regulation and overall management of macroeconomic conditions (captured in the GNP per capita growth variable), the government can affect income distribution.[11]

Moreover, the distribution of assets can be altered (e.g. land-reform, titling, distribution of shares) which in turn will affect the primary income distribution. It has been argued that the single most important economic factor affecting women is the gender gap in command over property. In rural South Asia, the most significant form of property is arable land, which is a critical determinant of economic well being, social status, and empowerment. However, few women own land and fewer control it (Agarwal, 1994). Women's inheritance claims regarding land are often opposed because they would decrease agricultural output by reducing farm size and increasing land fragmentation. In fact, existing evidence shows that small-sized farms in South Asia continue to have a higher productivity per sown acre than large-sized ones. Evidence from sub-Saharan Africa has also argued that one of the factors constraining growth and poverty reduction is the gender inequality regarding access to and control of a diverse range of assets (World Bank, 1999).

Gender discrimination not only affects ownership of physical assets, it also influences the allocation and pay rates of labor. This explains the need to include reproductive labor in the equation. The negative impact in terms of poverty reduction opportunities can be seen, for instance, in wage differentials by gender for the same job, allocation of time in care (which reduces the available time for earning related activities), and the contribution to production for self-consumption by women rather than for the market.[12]

Finally, a fundamental way in which the government can also influence distribution is through public expenditure on the provision of services and transfers (the tertiary income distribution) – through social assistance and social insurance, i.e. elements of social policy (the final determinant of the level of the income poverty ratio and its rate of change).

[11] For instance Rowthron (1977) and Nell (1992) on relative bargaining and full employment.
[12] In all of these issues, of course, there are great variations across countries.

Finally, we turn to the determinants of social development.

Social Development = f_3 (GNP per capita growth, income poverty reduction, social policy, reproductive labor) (3)

Education, health, sanitation, the elements which enable people to enjoy a life worth living, have myriad interaction effects among them. Obviously, additional resources (at the household level and nationally) through poverty reduction and economic growth helps. However, as many country experiences show, "unaimed opulence" is not sufficient. Public action in terms of social policy is fundamental in this regard.[13]

Our contention is that human development outcomes are the result of synergies between these income poverty reduction, social development, and economic growth. A fundamental point of the notion of synergy between the three types of interventions is that in strategies where one is absent, the effect of interventions in the other three spheres is less than what it would otherwise be. Policies which focus largely on *economic growth* (without much regard for income-poverty reduction or social policy) are doomed to unequal income distribution (and thus higher income poverty) and lower levels of social development which will dampen economic prospects in the long run. See Mkandawire 2006

Policies that focus only on *social policy*, but ignore income-poverty reduction or economic growth are not sustainable. A "growth-mediated" strategy, following Sen's terminology, could be translated into expansion of social services through supportive social policy (e.g. direct provision or transfers) which eventually could lead to income-poverty reduction. A growth mediated strategy may also help people access social services as higher levels of national income are attained may enable command over (social) goods and services. However, a growth mediated strategy is a risky proposition, as many elements may not materialize in this long causal chain. Moreover, it could represent unconscionable delay for those at the bottom of the social pyramid. This is

[13] In addition in must be remembered (see equation 1) that social development influences poverty reduction and economic growth, e.g. as adult women in the household use less of their time to fetch water, their ability to earn incomes (and thus contribute to buying school supplies and books) or help children to study also increases.

particularly important for women and girls who often have to tackle the “gap” created by insufficient government policy.

1c) Fiscal issues

Ultimately, the objective of all policy should be to enhance well-being. The means to pursue social policies which are conducive to reducing income poverty and aligned with macroeconomic policies are basically government expenditures, which in turn are determined by government revenue. How this revenue (including the time-burden tax mentioned earlier is collected has implications both in terms of the level of expenditure that can be financed but also for income distribution, an important element in expanding equality and reducing income poverty. The amount of total government expenditure as well as its allocation among social sectors and the type of policies carried out with these funds also are important – issues which we turn to in later sections

Fiscal policy has many tasks and thus different objectives. One objective is income re-distribution (e.g. taxes and subsidies) and another one is striving for full employment (i.e. through the size and structure of taxation and expenditure). A third objective is the delivery of services (both social and other ones).

All three of these are important components of social development (and social policy) and contribute to the reduction of inequality, decreases in income poverty and acceleration of economic growth. Full employment and stable family incomes are crucial for children’s well being. Income distribution is also related to income poverty. However, as there are non-income dimensions of poverty, the allocation of expenditures among various social sectors is also important within each sector. The level, composition and efficiency of government expenditures are inter-related.

1d) Analysis of revenue for social policy

In this sub-section, we focus on the revenue side of fiscal policy. We analyze various types of revenue generating mechanisms and we assess them in terms of their impact on the synergies described above. In particular we look at how progressivity and solidarity in the revenue generating mechanism affect income poverty and income distribution (which in turn are necessary to help set in motion the synergies). In general, the following sources of financing for social services exist:

- Self-provision (involving a time-burden tax)
- User fees
- Pre-paid schemes
- Generalised insurance
- Indirect taxes
- Earmarked taxes
- Direct taxes

When describing government revenue, it is customary to assess their progressivity. Progressivity measures the percentage of personal income which is used to pay the tax. If the poor contribute 10% of their income as tax and the rich also contribute 10% of their income, obviously, the rich are paying more because their income is larger. However, both of them are paying 10%. In this case the tax is neutral. For the tax to be progressive, the rich must pay a higher *proportion* of their income (not just pay more taxes). It could be the case that the rich pay a smaller *proportion* of their income than the poor, which is a regressive tax, and still pay a higher amount. The focus when we assess the progressivity or regressivity of the tax is the *percentage or proportion* of their income which is being paid in tax.

Another issue relevant to financing of social policy is that of the relationship between the state, individual and society. One approach is to pay for what you get. When an individual is ill, he or she goes to the doctor and pays for treatment. If the individual is feeling well, he or she stays home and saves the money. That is one way of looking at the issue.

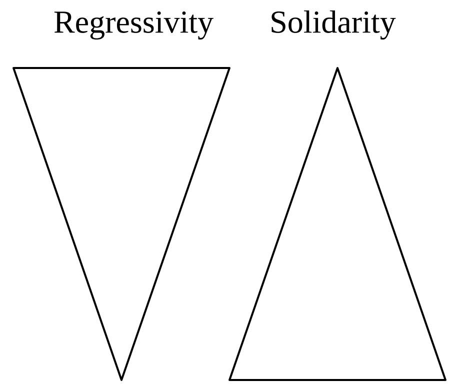
The other way of financing social policy is the solidarity approach. The individual is healthy today but nevertheless contributes to some kind of generalised insurance mechanism which uses the money so whoever is ill today receives health care. The solidarity approach means financing social services through taxes.

Each of the types of revenue mentioned above (user fees, prepaid schemes, etc.) can be classified along these two axes of progressivity and solidarity. In general, the most regressive are self-provision (involving a time-burden tax[14]) and user fees and the least regressive are direct taxes. Assuming that there is a reasonably well functioning direct tax system, the rich tend to pay proportionally more, so direct taxation is the most progressive (i.e. pro-poor) while user fees are the most regressive. In terms of solidarity, self-provision and user fees are the least reflective of the principle of collective solidarity and the direct taxes are at the other end of the spectrum.

Thus, the above mentioned types of revenue can be classified along these two principles of financing social policy (progressivity and solidarity) – wherein the bottom and the peak of the respective pyramids are the goals towards which systems of financing social policy should aim at:

[14] It could be argued that the opportunity cost of wealthier people is higher than that of the poorest, makig self provision a regressive tax. However, in practice, it is poor women who end up doing the work while richer people "avoid" this tax. Thus, we classify it as the most regressive of them all.

Time-burden tax (self-provision)
User fees (most regressive, least solidaristic)
Pre-paid schemes
Generalised insurance
Indirect taxes
Earmarked taxes
Direct taxes (most progressive, most solidaristic)



2. Restructuring of expenditures – Financing pro-poor social policy without increasing revenue

Before analyzing pro-poor financing of social policy and taxation issues, however, a brief review of the possibility of restructuring expenditures in order to increase the provision of social services within a given fiscal envelope is needed. (The next sections deal with taxation issues.)

2a) Inter-sectoral restructuring

What is the scope for increasing public resources for basic services through inter-sectoral resource shifting? It is not possible to pre-judge what shares should go to different government services such as administration, justice, defence, or economic services[15]. Nevertheless, empirical evidence is that two factors are unduly burdening many budgets:, e.g. defence spending and debt payments.[16]

In respect of *defence,* South Asia with the largest number of poor in the world – is the only region where military spending increased while global military expenditures were falling in the 1990s (SIPRI, 2001). Secondly, after the September 11th tragedy this

[15] Even the leading proponents of orthodox general equilibrium and market failure approaches recognize this. See, Diamond (2002), Laffont (2002), and Stiglitz, (2000). In addition, Paternostro et al (2007), address the lack of theoretical foundation in most of the literature on public expenditures.
[16] While health and education expenditures rarely surpass 4 and 6 per cent of GDP respectively, military expenditure is often over 4 per cent (fortunately, in most countries this is lower than in the 1990s) and debt service can easily surpass 8 per cent of GDP.

trend was re-inforced. Since the end of the cold war, military spending in developing countries had declined. Yet despite this peace dividend after the end of the Cold War, in an average year, more than one third of the world's population lives in a country at war (Dreze, 1999) a trend which has unfortunately, been accelerated since 2001.

In spite of the human toll of war, military spending (in peace time) is often claimed to be positive for the economy – encouraging modernisation, supplying technological innovations to civilian industries, contributing to the building of physical infrastructure (e.g. roads), providing modern education and health services at least for defence personnel. But the real issue is whether these positive gains are being purchased at the cost of human development for the majority of the population. Moreover, several authors have argued that the positive externalities of military expenditure are grossly exaggerated (e.g. Smith, 1977 and 1978, Scheetz, 1985).

It should be stressed that many of the conflicts during in the post-Cold War period as well as those conflicts that emerged afterwards, most prominently global terrorism, are partly a response to the despair of the excluded population. Pro-poor social policy and launching the positive synergies and virtuous circles described in section 2 could contribute to reducing some of the sources of global terrorism.

The other major drain on the budget of developing countries is *external debt service*. Often it is a more serious burden on the government's budget than defence expenditure[17]. In many cases, debt service alone surpasses, often by a wide margin, the allocation to ALL social policy items.

International action, thus, is vital on debt relief. Bilateral and multilateral donors, particularly the IMF and the World Bank (which together account for most of the multilateral debt), launched an initiative in 1996 to address the debt crisis of the poorest countries. The inability of the first generation HIPC to address the problem resulted in another initiative in mid-1997 by the G-7 countries. To be eligible for debt relief under the revised HIPC, a country must be very poor (i.e. IDA eligible) and eligible for support under the IMF's Poverty Reduction and Growth Facility (the reformed and renamed Enhanced Structural Adjustment Facility); have an unsustainable debt burden; and pursue

[17] See previous footnote.

good policies.[18] Under the new framework, an unsustainable debt burden is defined as a stock of debt that is more than 150 per cent of exports on net present value basis (not 200-250 per cent as under the previous arrangement).[19] In other words, sustainability is still largely defined in terms of debt-to-export ratios.

However, debt-sustainability should also be considered from the perspective of fiscal balance and the capacity of governments to carry out their core responsibilities. The example of Zambia is illustrative. About 40 per cent of government revenues have been allocated to servicing external debt. This is actually more than the budgets of the entire health and education ministries combined. At the same time, child mortality rates are rising, and only about one third of children are fully vaccinated. The numbers of children out of school are actually increasing. This is an unsustainable situation in terms of human development outcomes, whether or not it is unsustainable in HIPC terms.

In other words, a fundamental problem with debt relief initiatives, including the HIPC initiative, is that they define debt sustainability on the basis of debt-to-export ratios. It is governments, however, that must service debts - not exporters (even though the servicing has to be done in foreign exchange). Most HIPCs have liberalised their trade policies and capital-account regulations, with the private sector now accounting for 80-100 per cent of export earnings. But governments have only limited access to this revenue through taxation. The fiscal burden on governments, using budget revenue as the denominator, would be a more accurate indicator of a country's ability to repay its debts and would also highlight the true cost of debt servicing in terms of human development.

However, the debt relief has not been either fast or deep, and fewer countries have benefited than anticipated. Even the World Bank admits: "Despite the significant

[18] In contrast to the original framework, where debt reduction was calculated on projections of debt stock at the completion point (i.e. completion of full ESAF programmes – six year), relief under the new framework will be committed based on actual data at the decision point i.e. earlier. Now the completion point can be moved up if the country's performance on macroeconomic, structural and social policies is good.

[19] For very open economies, the exclusive reliance on external indicators may not adequately reflect the fiscal burden of external debt. An NPV debt-to-export target *below* 150 per cent can be recommended if the country concerned meets two criteria at the decision point: an export-to-GDP ratio of at least 30 per cent and a minimum threshold of fiscal revenue in relation to GDP of 15 per cent. For countries meeting these thresholds, an unsustainable debt burden is defined as NPV debt-to-revenue ratio of more than 250 per cent at the completion point (World Bank, 2000).

progress in implementing the enhanced HIPC Initiative, challenges remain. In terms of countries reaching decision and completion points, progress has been slower than originally foreseen by the international community and country authorities. Performance under IMF-supported programs has not been even across decision point HIPCs due to problems in program implementation. Some countries have either experienced problems in program implementation or do not have an IMF-supported program in place after having had protracted delays in establishing a satisfactory record of performance. The sunset clause has been extended for another two years to allow these pre-decision point countries an opportunity to qualify for HIPC debt relief." HIPC, which was meant to conclude in 2004, was thus been extended for another two years.

But these are not the only problems. Even after reaching completion point and receiving debt relief, the stock of debt of such countries was higher than the limit of 150 per cent of exports, and they are receiving top ups (e.g. Burkina Faso, Niger). Their exports have not risen as projected, confirming that the projections were over-optimistic. The projections for actual debt servicing over 2004-06 were higher than what they had paid over 2001-03. For these reasons, there was widespread resentment building up among the HIPCs that the international community is being asked to write off Iraq's debt when 100 per cent of the HIPC debt has not been written off. The international NGOs are making a call for revaluing the gold reserves of the IMF (currently valued at around $40 an ounce, when the world market price is over $500) to enable the multilateral institutions to write off their debt to the HIPCs.

Of course, the discussion of HIPC and PRSPs cannot be complete without considering the Medium Term Expenditure Frameworks (MTEF). Excessive defence expenditure and external debt payments, combined with weak capacity to raise genuine and sustainable tax revenues, are the main cause of budget deficits in developing countries. High budget deficits have to be funded with domestic (or foreign) debt - which completes the vicious cycle. High government borrowing pushes up the interest rate for all borrowers – raising the costs for private (and public) investment. Higher economic growth can only be expected if such subsidies can be cut and investment increased. Large budget deficits constrain macroeconomic policy in general and the prospects for increasing pro-poor social expenditure in particular.

The technical issue involves the need for budget reform. Reformers in OECD countries and, in increasing numbers, in developing and transition economies are stressing the need for changes in budget systems, emphasising the three levels of overall fiscal discipline, strategic prioritization, and efficient and effective service delivery (or value for money) (World Bank, 1998). The stress on better public expenditure management had led to the World Bank working with governments – starting the late 1980s – to prepare public expenditure reviews. A two-pronged approach is now developing. One is that central agencies focus on reforming the policy, planning and budgeting systems so that they are more demanding of a performance orientation. In an increasing number of countries - not only those HIPCs which are implementing a Poverty Reduction Strategy Paper[20] - there is gradual introduction of a Medium Term Expenditure Framework (MTEF). The MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term (usually three years) costs of existing policy and finally, the matching of these costs with available resources (World Bank, 1998). Within the MTEF, the second prong is the sectoral MTEF, or the sector-wide approach or sector investment programme (SWAP/SIP).

These reforms are a response to the problems accumulating from the early post-independence decades.[21] Driven by the needs of physical and social infrastructure ('social overhead capital' in terms of Hirschman (1958)), *the capital side of the government budget had led the recurrent*, giving an expansionary bias to government expenditure.[22] In aid-dependent countries (most LDCs), the capital budget is driven by

[20] This is the renamed Policy Framework Paper of the 1980s and 1990.

[21] Earlier reforms had attempted, in the 1970s, zero-based budgeting, but without much success; those efforts were abandoned.

[22] Most countries operated a dual budget system, constituted by a recurrent budget, and a capital or development budget. Development budgets were largely about public capital investments such power supplies, roads and bridges, schools and universities, and hospitals and clinics. Even then they contained activities that were recurrent and capital projects. Donors financed this expansion. (For example, the Indian budgets are divided into Plan and Non-Plan expenditures: Plan expenditures are for new projects included in each Five Year Plan; in the following Plan period, any expenditure on the preceding Plan's projects would be called Non-Plan expenditure. Thus Plan was mostly capital expenditure, but also included recurrent expenditure; Non-Plan expenditure can be both capital and recurrent expenditure.)

donor assistance. However, very little attention is paid to the financial costs the government will have to bear once donor support has ended and to estimates of recurrent costs. This leads in future years to the finance ministry stressing availability of resources while the line ministries stress needs at the time of budget planning. There is greater recognition now that the *recurrent budget should be the starting point*, and the development budget and the recurrent budget should be integrated into some sort of medium term expenditure framework. Such a framework could ease the task of simultaneously addressing the two main sources of budget deficits – defence spending and debt services – that have strangulated government spending.

However, while the MTEF can improve planning once the essentially ‘political’ decisions regarding allocations have been made, it does not resolve the political economy issue of how to cut unproductive subsidies (both for production and consumption) or military expenditures. The underlying problem is the interest groups lobbying for such expenditures. What is needed is political ‘voice’ that can offset the pressure groups whose voices are embedded in the governing elite. Sen (1999) makes the case for democracy, without which participation in civil and political life is limited. However, having the ‘capability’ or freedom to participate and possessing the ‘functioning’ of actual participation does not necessarily translate into influence, even in a democracy; in an authoritarian state such functioning is out of the question. In other words, in addition to democracy, collective voice and collective action would be necessary; just as the trade unions or the confederations of industry or the military establishment or the wealthy farmers have collective institutions to voice their positions – and lobby with the cabinet.[23]

2b) Intra-sectoral restructuring

In the majority of developing countries the intra-sectoral allocation of public spending within health and education is biased in favour of higher level services. In general, it is primary education, preventive primary health care services in rural areas, and low-cost rural water and sanitation services that have been by-passed. This is partly

[23] Issues of political participation and voice are taken up again in section 7.

the result of the lack of voice among the poor and rural population, especially compared to urban and middle/upper class groups with strong links (political, personal, geographical, etc) with policy makers. Nevertheless, donor pressure developing country governments has been maintained to shift resources in favour of basic services throughout the 1990s, which has further intensified with the international (especially donor) consensus around the MDGs.

However, intra-sectoral restructuring of social service expenditures (towards basic services) is likely to be resisted by the non-poor, who benefit from the current pattern of spending. While governments may persistently test the patience of the poor, they must beware the wrath of the rich even in the short-run. Intra-sectoral reallocation in favour of basic services (public and promotive health and basic curative services, basic education, and rural/peri-urban water and sanitation)) is much easier if carried out when the funding envelope for the sector as a whole is increasing. In other words, if governments can shift resources in favour of health or education from other non-social sector uses, such as economic services, defence or debt payments, the politically difficult task of reallocating resources within the health and education sectors towards the basic level services becomes that much easier. Within health and education, there will be less political resistance if higher level services do not suffer from budget cuts.

In addition to this 'political' rationale for creating the right conditions for intra-sectoral reallocation, sound technical reasons for maintaining or increasing overall health or education expenditures while increasing basic level service provision exist. Urban areas are particularly vulnerable to infectious diseases, for example, cholera, which spreads easily in overcrowded locations. University libraries that lack relevant textbooks do need adequate funding. Within the health sector, hospital and clinical services may be stretched to breaking point by HIV/AIDS patients, making it difficult for clinical services to cope with other patients. In Zambia, for example, health systems are being overwhelmed by cases of secondary infections such as tuberculosis, pneumonia and measles to which those living with HIV are vulnerable. And HIV/AIDS claims the lives of over 600 teachers a year - equivalent to half of the graduates from teaching colleges.

There can be little argument about the need to maintain overall health, water and education budgets in the face of such challenges.

In the *education* sector, there are many reasons for a dominant public sector role at lower levels of schooling[24]. Parents are not in a position to finance education by borrowing; a purely private system can only function efficiently with perfect capital markets, and imperfections in capital markets abound in all countries, whether they are middle-income, low-income, or even high income. If education is a normal good, richer parents will buy more education for their children. Thus, without state intervention, inequality may be passed on from generation to generation.

In the *health* sector, the situation is much more complicated. The bias of health expenditures in favour of tertiary level services is more pronounced than in education. Evidence from nearly 20 developing countries indicates that health and education spending discriminates against the poor, but that spending on basic health and basic education is less regressive. The data show that, on average, the richest quintile of the population receive about twice as many benefits from education and health subsidies than the bottom 20 per cent of the population. However, the distribution of benefits depends on the composition of expenditure between basic and non-basic social services. The distribution of benefits from basic social services appear less regressive than those from non-basic social services.[25]

2c) Summary

Two points emerge from this discussion. One is that while inter- and intra-sectoral restructuring can be used to raise expenditures for pro-poor social policies, there are serious limitations in terms of the quantum to be raised. Moreover, in the case of intra-

[24] "Lower" could and should mean post primary in middle income and many low income countries, depending on the context and current education achievement at the primary level. While from a realistic point of view not all countries will achieve full enrolment/attendance for all children under 18 years old in the short run, this should be the goal. Thus, plans, including revenue plans, should be in place to get there (along similar lines to "progressive realization" in the human rights perspective).

[25] For further evidence on this point see Mehrotra and Delamonica, 2007.

sectoral restructuring serious trade-offs appear, which could (and should) be avoided if the total resource envelope was larger.

In addition, many publicly provided services are inefficient. But it is often the case that much inefficiency in public spending stems from resource scarcity. In practice, inadequate resources, inequity, and inefficiency are often intertwined. There are minimum requirements on capital, recurrent, wage and non-wage expenditures to provide essential services. Lack of financial resources invariably leads to meagre allocations to one (or more) of these categories, undermining the efficient utilisation of other inputs. In other words, insufficiency often creates inefficiency. However, research emanating from the World Bank has ceaselessly argued that the problem in the social services is not the lack of resources, but inefficient use of resources. For instance, Filmer and Pritchett (1997), and Filmer et al (1997) emphasise the lack of relevance of public health spending for under-five mortality rate. We have explained elsewhere why these arguments are flawed (Mehrotra and Delamonica, 2007).

Both of this points complement each other in making the case for focusing our attention on taxation. Both inter-sectoral public expenditure restructuring in favour of social services and intra-sectoral restructuring in favour of basic social services would be infinitely easier if the overall resource envelope was growing – an issue to which we now turn.

3. Taxation

In order to provide the context for the discussion of taxation, it has to be remembered that the existence of large budget deficits, however, has forced governments to undertake macro-economic stabilisation and adjustment aiming at cuts in budget deficits and public expenditure. Since the early 1980s, these adjustment policies have unfortunately been characterised by an almost exclusive emphasis on public expenditure reduction in the quest for budget deficit reduction. In a external review of Extended Structural Adjustment Facility (ESAF) programmes, a group of independent experts noted in the late 1990s[26] that public spending limits have often been set too tight, with detrimental effects on human development. This was again the case in the policy conditions laid

[26] The group consisted of Kwesi Botchwey, a former Ghanaian Finance Minister, and others.

down in the IMF's response to the Asian economic crisis (Stiglitz, 2002). Evidence shows that, for all cases, real per capita BSS expenditure only declined when the public expenditure share in total output declined[27]. The ability to undertake public expenditure on social services can be affected by the stability of revenues.

On the tax side, the general approach in structural adjustment was that an increase in tax rates was recommended only if unavoidable. On the assumption that lower rates would ensure better compliance with tax laws, lower rates were expected to raise revenues (Williamson, 1989). When combined with the broadening of the tax base, the tax to GDP ratio was supposed to rise. However, in the vast majority of countries in sub-Saharan Africa and Latin America the tax to GDP ratio stagnated or declined (Mehrotra, 1996, Agbeyegbe et al (2004)).[28] This is not surprising, given that trade taxes account for the largest share of tax revenues in developing countries; and with tariffs declining under the WTO regime, the share of trade taxes was bound to fall. Unfortunately, other taxes have not grown to compensate for the fall in the contribution of trade taxes. Even India experienced a decline in the central government's tax to GDP ratio by two percentage points in the 1990s after the economic reforms – on account of declines in the contribution of trade taxes (Rao, 2005).

Substantively, what has changed generally is that, on average, for the low-income countries PRGF-supported programmes target a smaller and more gradual fiscal consolidation than programmes under erstwhile Extended Structural Adjustment Facility (ESAF), and give more weight to revenue increases than expenditure contraction (IEO, 2004). However, even here the Internal Evaluation Office of the IMF finds that the outcomes are not very different between ESAF loans and its renamed successor, the Poverty Reduction and Growth Facility (PRGF).

Many middle-income countries, particularly in Latin America, undertook reforms in taxes during the 1980s. The initial efforts, consistent with the requirements of the Washington Consensus emphasised lower tax rates, indexing for inflation, and broadening the tax base. These reforms were typically unsuccessful in substantially

[27] See Mehrotra and Delamonica, 2007.

[28] The latter, however, support the notion that trade liberalization accompanied by appropriate macroeconomic policies can be undertaken in a way that preserves overall revenue yield.

increasing revenues (Das- Gupta and Mookerjee, 1998).[29] As a result later in the 1980s and 1990s significant changes in tax administration were introduced in a handful of Latin American countries, and also in Indonesia and the Philippines.

There is an urgent need to reverse this phenomenon of fiscal inertia through a greater focus on revenue generation as a means of increasing social spending. Low revenue collection is the combined outcome of institutional weaknesses, dependence on trade taxes for many developing countries, and low incomes. We recognise that none of these factors can be altered in the short-run. Domestic revenues can only be increased over a longer time horizon. In fact one has to acknowledge that over the short-to-medium-run budgets cannot be balanced via increased taxes.[30]

However, there needs to be more explicit recognition internationally of the fact that adjustment has focused much more on expenditure reduction than revenue generation. As we noted in section 2, a fiscal system can only be progressive and pro-poor if, first, the revenue system is progressive in its overall structure and, second, the revenue base is growing to enable pro-poor expenditures to be undertaken. For this reason, much more could be done to strengthen tax collection to prevent tax evasion and tax avoidance. Moreover, much more could be done to enhance tax collection, by enlarging the tax net to catch those who are currently escaping it. The international financial institutions (IFIs) need to take much more seriously the technical support requirements of most developing countries, but especially those in Sub-Saharan Africa and Latin America, in the area of tax administration and collection.

For developing countries, the total tax revenues are derived almost equally from three sources: domestic taxes on goods and services (general sales tax, excises), foreign trade taxes (mostly import duties), and direct taxes (mostly from corporations, rather than individuals).[31] Wealth/property taxes and social security contributions make a marginal

[29] Also, see Carciofi and Cetrangolo (1994), where evidence is cited that at the end of the 1980s, Latin American countries still had tax to GDP ratios which were well below what might have been anticipated from their level of per capita income.

[30] For the least developed countries, it should be possible for donors to alter their disbursement profiles over time so as to accommodate shocks and to create bigger and better compensatory financing mechanisms.

[31] The IMF notes that for LICs, its 14 per cent tax revenue to GDP is accounted for by foreign trade taxes (4.2 per cent), excises (1.8), general sales tax (3.1), and social security (1.8). For LMICs, their 18.5 per cent tax revenue/GDP ratio is accounted for by a lower share for foreign trade (3.4 per cent), and a higher share

contribution. However, for industrialised countries, income taxes (mostly from individuals) make the largest contribution, with domestic taxes on goods and services and social security contributions accounting for slightly over a quarter each of total tax revenue, with trade taxes quite insignificant (Burgess, 1997, OECD 2005). The question relevant to our purposes is: which kinds of taxes are likely to meet the requirements of implementability, buoyancy and stability for meeting the resource requirements of basic services?

Moreover, how do these taxes fare in terms of promoting solidarity? How do they fit in terms of helping or hindering the unleashing of synergies described in section 1? In other words, are they pro-poor?

3a) Self-provision

When the state fails in its responsibilities to provide for the well-being of the population, the slack is taken up by the individuals and households themselves. This is the way it was done until roughly the end of the XIXth Century when in Western Europe the first steps towards the Welfare State were taken.[32] Under these circumstances, wealthy families could try to avail themselves of the services of private doctors or tutors, as well as buying the minimally necessary infrastructure (e.g. individual dwells). The vast majority of the population, however, lingered in a state of despair. Similar conditions currently exist in most developing countries.

Two important elements need to be mentioned regarding self-provision. First, it is not only iniquitous from a class or wealth perspective, but also from a gender one. In most societies, the burden (of fetching water, taking care of the ill, etc) falls disproportionately on women. Thus, the inability of the state to implement social polices results in a time-burden tax on women.

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of excises (2.3), general sales tax (4.9), and social security (3.7). For UMICs, their 23 per cent tax/GDP ratio has even lower shares for foreign trade taxes (3.1 per cent), and even higher shares for excise (2.5), general sales tax (5.9) and social security (6.4) (IMF, 2004).

[32] Although it was eventually truncated, some earlier steps were taken in the United States. ON the one hand with the universalization (at least among the white population) of schooling since the early 1800s and after the Civil War (1861-1865) with the provision of pensions for widows and orphans (Skocpol, 1995).

Secondly, besides the equity (across class and gender[33]) there are efficiency issues. Self provision (whether directly through "invisible"/reproductive female labor or indirectly the purchase of services or goods) is inefficient. The unit costs are much larger than if it were possible to spread the total cost among more users (e.g. the difference between a private tutor and a teacher for 15 children[34]). Often, these costs would be so high as to make the provision of the service impossible (e.g. sewerage), so they would not be available for anybody.

3b) User fees and pre-paid schemes

The experience of Malawi since 1994, of Uganda since 1996, as well as that of Kenya, Tanzania and Lesotho this decade has been that the elimination of fees has raised enrolments at the primary education level dramatically. Thus eliminating user fees is a pro-poor intervention. Moreover, this may help unleash synergies, e.g. in Tanzania, not only did school attendance increase, but also undernutrition declined between 200 and 2004.

The case for cost recovery in health was strongly voiced in a policy paper in 1987 by the World Bank (see Akin et al, 1987), which called for user charges, insurance, decentralisation, and a greater role for the private sector. It assumed that user charges offered the possibility of reducing excess and unnecessary demand for free services, and a graduated fee-system would encourage citizens to use lower-level health services first. The 1993 *World Development Report* (World Bank, 1993) presented a more refined position. Market failure arguments were used to advocate public financing of public health services and some essential clinical services (see Stiglitz 2000). In countries where the cost of the basic package essential clinical services was financially infeasible for government, selective user charges and targeting mechanisms were suggested. The argument in favour of user charges was that charging fees can improve equity if fees are used to improve quality. [35]

[33] There are also geographic and (often associated with geographical differences) ethnic/linguistic disparities.
[34] This does not consider the socialization benefits of the school environment mentioned in section 2.
[35] For the health sector, a similar argument is often made in relation to the WHO-UNICEF initiative called the Bamako Initiative. However, the argument is made in the context of community pooling of resources to meet a variety of costs, and involves, among other things, improvements in quality of service and local

Nevertheless, cost recovery in some form or other characterises the health systems of most African countries now. Korea, Thailand, Malaysia, Singapore and Indonesia also have some user charge policy in place for health; these coexist as cost-sharing provisions with national or partial social insurance. In Latin America as well, cost-sharing is also an important component of health insurance systems. However, as Creese and Kutzin (1997) rightly point out, establishing or raising fees is not the same thing as getting a user charge system to operate as a means of improving efficiency, nor is it a basis for ensuring equity in the provision of services. Out-of-pocket costs (or private expenditures) account for most of health spending in most developing countries. In India, the majority of contacts between the sick and a health provider are with private providers – a majority of them poorly qualified – at considerable cost, both in financial and health terms, for the populaton (Rohde and Viswanathan, 1995).

In most industrialised countries, user charges are not part of the reform agenda; in fact, performance improvement in the health sector has been seen to depend more upon changing the behaviour of providers rather than consumers. However, this is in a context of universal access to health care (except in the United States). Thus, there is a different "contract" between the individual and the state (see section 7). Not only is there a well implemented scheme for solidarity and redistribution, but there is also the technological infrastructure to easily implement a sliding scale system to maintain the pro-poor aspects of the system even if some type of minimal user fees exist.[36]

Several conditions must co-exist if increased user charges at government health facilities are to lead to an *increase* in access to the poor. Local revenue retention is one. There is evidence that this has led to improved quality in service, and hence greater utilisation of services. Second, appropriate management skills and financial institutions need to be in place for local fee retention to lead to improved quality of service. This involves having staff trained in basic financial management, the existence of banks to

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retention of funds. User charges in health, when they flow to the treasury, barely account for a miniscule proportion of total funds available to the health ministry; thus, without contributing much to resource mobilization, they end up denying services to the poor.

[36] This does not mean that everything is well in such systems. First, there is an issue of stigmatization, even in the presence of the sliding scale. Second, the user fees could be a barrier to access some services (e.g. some specialized tests or treatments). Third, the introduction of the fees could be a first step to unravel the social contract and the society –wide understanding that the components of social policy are a right to which every citizen is entitled.

deposit the funds, use of simple audit procedures, and community committees for oversight over the use of funds (WHO, 1994). Finally, if the increased revenues (from user fees) and improved quality actually *reduces* the cost to the poor of accessing effective care, there could be a basis for levying such fees (Creese and Kutzin, 1997). This last condition may be met if the ‘exit’ option for the poor involves higher payment to a private provider (e.g. as is common in much of South Asia, where private providers are abundant), or if the community in question is relatively isolated (e.g. as in many parts of low-density parts of Africa or even certain parts of South Asia).

There is a qualitative difference between education and health in the nature of demand for them that makes user fees even less suitable for the health sector. For education, parents can anticipate and plan for the costs of schooling. However, costs in health are unpredictable – both in incidence and magnitude (Colclough, 1997a). Catastrophic health costs can wipe out a family’s savings, and a vulnerable family is likely to fall below the poverty line under such circumstances. For instance, in India medical costs are said to be the second most important reason (after dowry for a girl’s marriage) for pushing vulnerable families down below the poverty line. Hence, while user fees at higher levels might be justified as a short-term, temporary measure if a government faces a particularly resource-constrained environment (as in all low-income and most middle-income countries), the case is rather different in respect of basic health services. On account of the unpredictability of health cost, insurance mechanisms or public finance are the appropriate means for financing health services for the majority of the population, and especially for the poor.

The arguments in favour of user fees made by its proponents were the following: they may raise revenue, improve efficiency and quality, and improve access and equity. The evidence, however, suggests that increased use of user fees since the World Bank advocated them has not contributed any of these potential benefits (Barnum and Kutzin, 1993; Creese and Kutzin, 1997; Arhin-Tenkorang, 2000). While the Bank expected that revenues of the order of 10-20 per cent of recurrent expenditure would be raised, net revenues have been much lower than gross revenues on account of collection costs. Second, it does not promote efficiency, since there is little evidence of moral hazard in the form of excess of free facilities; users, particularly poor ones, already have to take account of the cost of time and transportation when visiting a health facility, which minimises excess use. In fact, after the imposition of user fees utilisation actually drops, with adverse equity effects. Nor does the evidence suggest that differential pricing of lower and tertiary facilities has resulted in more effective utilisation of primary, as opposed to tertiary, facilities, as was expected.

However, in the presence of user fees there is no solidarity. Nor is there any progressivity in the financing of social policy. User fees are not pro-poor. This was explicitly recognized by representatives of the World Bank, UNICEF and the UN Economic Commission for Africa at a meeting in Addis Ababa in 1997, which established that no user fees should be charged for (at least) basic education and primary health care (Addis Ababa Consensus, 1997).

3 c Generalised insurance

A widely used alternative to user fees is a system of pre-paid contributions, especially for health[37]. This provides the advantage of not having to wait until the service is needed to pay. Also, by regularly contributing small amounts the impact of the contribution on households' budgets is diluted.

In addition, an insurance system by spreading the risk among a larger number of individuals, lowers the unit cost. Certainly a pre-paid scheme would be much more progressive than user fees. It would also involve the principle of solidarity. However, they cannot be said to really be pro-poor.

At least two reasons support this claim. First, unless the insurance is mandatory and universal, it would cater only to the richer sections of the population. This not only increases the unit costs, but also introduces the possibility of segmenting the market. Thus "premium" policies would exist for the richer members of society while the poorest would receive lower quality services (or none at all). Secondly, if everybody pays the same premium, in essence, the contribution is regressive. As one or the other must be the case, an insurance mechanism cannot simultaneously be based on solidarity and progressivity.

[37] Also for pensions.

3 d Indirect taxes

While sales and excise taxes have accounted for most of the indirect domestic taxes in developing countries, introducing value-added tax as a means of raising revenue is a more recent trend.[38] Burgess (1997) argues that since VAT covers a large share of the value added in an economy, revenue from VAT is bouyant, i.e. tends to rise with (or faster than) economic growth. VAT systems have been introduced in over 30 developing countries, and more are in the pipeline. China introduced one in 1994, and India did so in 2005. To maximise revenues from a VAT, countries need to ensure that the tax base is as broad as possible and the rate structure simple.

It is notable that there is little variation in the role of indirect domestic taxes across different low income countries, but these taxes are substantially more important for middle and high income countries (Dasgupta and Mookerjee, 1997). They have been found to be implementable in countries with low administrative capacity, bouyant and stable.

The buoyancy of VAT can be contrasted with foreign trade taxes, which are known to be sensitive to fluctuations in world prices. Given that for a large number of low income and even middle income countries, the export structure is characterised by a high commodity concentration of exports, excessive reliance on trade taxes can destabilise the revenues and spending of such countries. In Latin America, for instance, the contribution of VAT has been increasing over time, and by the mid-1990s accounted for 1 to 5 per cent of GDP for Uruguay, Peru, Mexico, Guatemala, and Colombia, and for 9 per cent of GDP in Chile. In nearly all developing countries where it has been introduced, its contribution to tax revenues has been increasing (Burgess, 1997).

Excise taxes are another important source of revenues in developing countries. They are levied particularly on a few products – alcohol, tobacco, petroleum, vehicles and spare parts. They exhibit several positive features from a revenue perspective: few producers, large sales volume, relatively inelastic demand, and easy observability. Excises may be levied on the basis of quantities leaving the factory or at the import stage, thus simplifying measurement and collection, enabling extensive coverage, and limiting

[38] By the late 1990s VAT had been introduced in over 30 developing countries in Asia, Africa, Latin America and Eastern Europe. India is about to introduce VAT over the financial year 2003-4.

evasion and better physical monitoring. Currently, excise taxes amount to less than 2 per cent of GDP in low-income countries, compared to about 3 per cent in high-income countries. They have a buoyant base and can be administered at a low cost.

However, VAT and excise taxes, like all indirect taxes tend to be regressive[39]. They are not a pro-poor tax reform. They do not assist with redistribution from the rich to the poor. While efforts have been made to protect the consumption of the poor via exemptions, these are difficult to implement and are easily abused. There is also the argument that the consumption needs of men and women are different and a VAT system (or other indirect taxes) should take this into account. Nevertheless, the logistic of such differentiation are almost insurmountable.

3 e Earmarked taxes

Normally when a new tax is imposed, there is much public resistance. However, when a source of revenue is identified for specific programmes that are known or seen to have a high social benefit the normal resistance of taxpayers' to new taxation can be overcome. This is one major factor in favour of hypothecated taxes. Another factor, discussed below, is that they could be progressive and pro-poor. Such earmarked taxes have been used in many countries at different times in their history. They have taken a variety of forms :

- Taxes on property
- Business
- Certain commodities, especially intoxicants or cigarettes
- Imports
- Interest or dividend.

[39] Gemmell and Morrisey (2005) assert that VAT is not as bad as it is usually assumed to be due to the fact that most of the poor purchase in informal markets where the VAT is not collected. However, were it to be collected properly, it would be regressive. Moreover, Gemmell and Morrisey clearly and honestly caution about te reliability of the evidence in the studies they reviewed.

An argument against them has been that they might not add to resources for the particular purpose they are meant, as the government may simply divert resources hitherto devoted to say, education, to other purposes. Government resources are fungible, and the possibility of diversion has also been the argument made against project aid from external sources. It may simply help the government to divert its own resources, for instance, for military purposes. Clearly, if earmarking is to be used for elementary education, specific safeguards have to be built into the spending mechanism.

Despite the risks associated with it, earmarking of revenues has been implemented in industrialised countries for education. Earmarked taxes have been used for education in the USA at the state level (Lockheed et al, 1991). There are also examples of earmarking from the developing world – in every developing region. The Republic of Korea – which was a high-achiever in terms of mass schooling very early in its development process – has used earmarking to good effect. In 1982 the government was finding that the general budget was being unable to meet the costs of the education system. The government introduced a five-year education tax on spirits (liquor), tobacco, interest and dividend income, and the banking and insurance industry. Five years later the tax accounted for 15 per cent of the education ministry's budget. Other Asian countries – China, Nepal and Philippines – have implemented ear-marking for education. India introduced a surcharge on income taxes of 2 per cent in 2004 to be earmarked for elementary education – the surcharge came after the Indian government committed itself (through a constitutional amendment) to making elementary education a fundamental right of every citizen (Mehrotra et al, 2005).

Earmarked taxes for education have also been used in Latin American and African countries. Brazil imposed a 2.5 per cent salary tax on the wages of employees in the private sector, and the funds are used exclusively for primary education. The federal government collects the tax, two-thirds of which go to the states. Alfonso and de Mello (2000) argue that earmarking of revenues in both education and health have yielded good results in Brazil. This experience from a wide variety of countries seems to suggest, that designed appropriately, earmarked funds for specific purposes for a sector, from dedicated revenues, can play a useful supplementary role in general budgetary allocations to the sector.

Nevertheless, the international experience does point to certain pitfalls that should be avoided if earmarking is adopted. Potter and Diamond (1999) point out that in most OECD countries, comprehensiveness and transparency are achieved by designing a budget system with three key characteristics: annuality[40], unity[41] and universality. The last principle – universality – states that all resources should be directed to a common pool or fund. In general, in other words, earmarking of resources for specific purposes is to be discouraged. The three characteristics are needed to ensure that all proposals for government expenditure will be forced to compete for resources, and that priorities will be established across the whole range of government operations. It will be immediately obvious from these principles that they are derived mainly from the macro-economist's concern for budgetary control, and the fear that extra-budgetary funds (into which earmarked resources are placed) might diminish the Finance Ministry's ability to determine resource allocation. Given the experience of runaway budget deficits since the early to mid-1980s in many developing countries, this concern is by no means illegitimate.

However, if adherence to these principles ignores the institutional development needs of certain sectors – which have tended to get traditionally ignored in many developing countries – then the case for earmarking of resources is a legitimate one. The case for earmarking gains strength also from the proposal that it is not existing financial resources that would be earmarked, but new resources would be mobilised and then dedicated to pro-poor social policy.

Too many extra-budgetary funds should indeed be discouraged.[42] In other words, one cannot make the case that earmarking can be resorted to for ensuring the delivery of *all* basic social services. A lot of the IMF critique of extra-budgetary funds derives from indiscriminate use of funds that was rampant in many African countries as well as countries of the former Soviet Union (after 1991). Nevertheless, a selective use of funds

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[40] Annuality means the budget is prepared every year, covering only one year; voted and executed every year – even though most OECD and some developing countries now develop the annual budget within a multiyear perspective, through the preparation of medium-term revenue and expenditure framework.

[41] Unity means that revenue and expenditure (and borrowing constraints) are considered together to determine annual budget targets.

[42] Curiously, the IMF does not seem to define what 'too many' means. We found little in the literature which might suggest that a certain percentage of public expenditure would be deemed too high for allocation to extra-budgetary funds.

should be encouraged. Thus, it will be appropriate to use, for instance, part of the proceeds from the disinvestment of state owned enterprises for creating a fund for some social service, say, e.g. meeting maternal or child nutritional needs. Similarly, social security funds are a feature of many countries. Second, we have given many examples above of earmarking of funds for education and health services. Third, earmarking of funds for infrastructure, especially road maintenance, is good if it prevents the diversion of resources needed for road maintenance (often seen as not politically attractive) to other purposes; poor road maintenance can lead to higher capital expenditures in the long term. The World Bank has encouraged, as part of its Roads Management Initiativ, a 'second-generation road fund', emphasising their transparency and accountability and their financing by user charges. Gwilliams and Shalizi (1997) note that these funds 'compensate for political and administrative myopia and ensure the allocation of resources to a low profile economic activity with particularly high returns'.

Another advantage, as seen in the above discussion (earmarked taxes on interests, assets, etc) is that they can be implemented in a way which make them inherently progressive.[43] This is important in terms of the distributive function, i.e. taxing the wealthy provides the funds with which to fund universal basic social services, the pro-poor aspect of fiscal policy.

3 f Direct taxes

Atkinson (1989) has argued that in industrialised countries, personal income and social security taxes are normally seen as key instruments for the redistribution of income. However, in developing countries these account for a small proportion of revenues; hence their use as instruments for redistribution of income is likely to be restricted (Burgess, 1997). The IMF (2004) subscribes to this point of view: "In view of the high share of agriculture and informal economic activity in many countries, corporate and personal income taxes are unlikely to be a major source of domestic revenues in the short- to medium-term". However, a growing literature suggests that while social security taxes will remain marginal to the redistribution objective in developing countries, this may not necessarily be the case for income taxes. Thus, we do not subscribe to the

[43] This may not be the case with "sin" taxes, e.g. on tobacco).

pessimism about redistributive income taxes to finance pro-poor social policy and unleash the synergies described in section 2. Burgess and Stern (1993) find that in some countries tax reform has led to significant improvements in the contribution of direct taxes to overall revenue. Moreover, the point is not to improve income distribution per se but because greater equality is important to reduce poverty and promote social development, poverty reduction and macroeconomic growth.

Optimal tax theory (associated with the work of Ramsey, Mirlees and Diamond[44]) is traditionally concerned with the tax structure, and its efficiency and incidence. The traditional approach uses a general equilibrium framework, and is primarily concerned with ‘getting prices right’. While this approach is important, there is almost total neglect here of administrative feasibility (Das-Gupta and Mookerjee, 1998). An alternative, though complementary, approach is to focus on taxpayer incentives and the design of tax administration, where the principal concern is to ‘get incentives and institutional arrangements right’. Issues of administrative feasibility acquire particular significance in developing countries, where corruption in the tax departments of governments is known to be rife. It is useful, therefore, to examine the literature on tax compliance and issues of enforcement of existing tax law.

For instance, the performance of Indian income tax collections is particularly poor. Economic development is normally associated with an increase in the relative contribution of personal income taxes to government revenue. This is caused by factors such as the widening of the taxpayer population, increases in personal income, and improvements in enforcement technology and administration. However, the experience in India (and in many other countries especially Latin America) has bucked this normal trend. In India the share of income taxes in total central tax revenue over 1970-90 actually fell from 14.7 per cent to 9.7 per cent, as did the proportion of personal income tax in non-agricultural GDP.[45] Evidence suggests that the proximate cause for the poor and deteriorating performance of Indian income tax revenues during that period was tax evasion (Dasgupta and Mookerjee, 2000). It was poor revenue performance and a fiscal crisis that had forced Latin American countries to undertake large scale tax

[44] See Ramsey (1927), Mirlees (1976), and Diamond and Mirlees (1971).
[45] Thus in 1989-90 the personal income tax generated less income than the entire amount spent on the fertiliser subsidy that year (Das-Gupta and Mookerjee, 2000).

administration reforms in the late 1980s and 1990s. Countries such as Colombia, Costa Rica, Ecuador, Peru[46], and Jamaica achieved significant gains from comprehensive reforms that included administrative reforms.

Meanwhile, one of the main implications of low (and in certain countries, like India, falling) income tax collection is that the government is compelled to rely on indirect domestic taxes and trade taxes for its revenue. These taxes are regressive (as discussed in the previous sub-sections), hindering the synergies described in section 2. Moreover, in large federal countries they create problems of coordination of indirect taxes between central and provincial governments. The resulting cascading effects distort relative prices, besides encouraging excessive vertical integration. Imports are discouraged by the high levels of tariffs (that must compensate for poor income tax collections) and correspondingly, expenditure on essential infrastructure and basic social services is restricted.

While it is clear we are advocating for a much larger share of direct taxation of wealthy groups through more progressive income taxes, it has to be acknowledged that in developing countries it would be possible to substantially increase government revenue through better compliance with, and higher collection of, currently existing taxes. For instance, as part of comprehensive reform of its tax administration during 1988-92, the Mexican system awards a bonus to the collectors. It represents about 60 per cent of additional collections. As a result of the bonuses the number and yield of audits increased almost overnight. The share of audits generating additional revenue increased from 38 per cent in 1988 to 90 per cent in 1990. Limiting discretionary authority of tax officials would also help improve compliance and reduce evasion. Computerisation of tax administration can help control corruption, as it makes it harder to tamper with records.[47]

[46] Peru managed to increase tax revenues as a whole from 5.4 per cent of GDP in 1990 to 9 per cent of GDP in 1991. Mookerjee (1997) notes that it is difficult to say whether these changes were caused entirely by the tax reform, since other administrative reforms were implemented at the same time.

[47] In developing countries, outside of agriculture, a large proportion of those not in formal, organised manufacturing activities are in the so-called informal sector. However, the tax administration in many countries is either unable to cope with this sector of largely untaxed incomes, or is unwilling, having been coopted in a web of corruption. Dasgupta and Mookerjee (1997; 1998) spell out other reforms on the basis of the international experience. They mention the need for motivating high-level officials to evaluate the performance of their subordinates. This is encouraged by autonomy over budgets, personnel, and control, which were increased in tax administration reforms in Argentina, Colombia, Ghana, Jamaica, and Peru. In

Improved tax administration has also resulted in an increase in the share of personal income taxes in total tax revenues even in India during the 1990s, in contrast to the 1970-90 period mentioned above. A number of innovations account for this shift. Expansion of the scope of tax deduction at source has been very effective in reaching the hard-to-tax group (Rao, 2005). Moreover, every individual living in large cities covered under any one of the six conditions (ownership of house, cars, membership of a club, ownership of credit card, undertaken foreign travel, and subscriber to a telephone connection) is necessarily required to file a tax return .

Thus, as we mentioned above, the international financial institutions (IFIs) must seriously focus technical support for tax administration and collection requirements in most developing countries, but especially those in Sub-Saharan Africa and Latin America, rather than meddling with their expenditure levels, if they intend to help the poor.

3 g Trade taxes

There are many a priori reasons for believing that there may be revenue losses due to trade reforms – and these need to be addressed, if new resources are to be found for social purposes. There are three grounds for this fear: first, capital movements increase opportunities for evasion – because of the limited capacity that any tax authority has to check the overseas income of its residents; evasion is also encouraged since some governments and other institutions systematically act to conceal relevant information. Where dividends, interest, royalties, management fees are not taxed in the country in which they are paid out, they may easily escape being noticed in countries where the recipients of such income live. There have been large non-resident aliens' bank deposits in countries like the US that charge no taxes on the interest from such deposits.[48]

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some cases budgets were linked to revenues collected. Some countries liberalised the rules for contracting out operations to the private sector.

[48] Some suggestions have been made to deal with these problems, based on the following principles. First, withholding-taxes on interest, dividends, royalties,and management fees, if these payments are to cross borders, would be collected universally,at a set of uniform rates which are agreed internationally. Second, there should be a single international code system for identifying payers of individual payers of individual and corporate income tax, so that tax authorities can share information about taxpayers without revealing it

Second, avoidance (as opposed to evasion) may increase, given the differences internationally in tax rules and rates, because of the element of effective choice of tax regime that international-tax-treatment of enterprise income commonly offers (Clunies-Ross, 1999). This is likely for taxation of the profits of corporations and other enterprises that have international operations. Transfer prices for goods, services, and resources, moving between branches of a company, provide opportunities for shifting income for tax reasons to minimise the revenue due.[49]

Thirdly, the competition for international inward investment may lead governments to reduce the income-tax rates, and increase the income-tax concessions, that fall on international investors (Clunies-Ross, 1999). Income tax rates have fallen sharply since the late 1970s. Tanzi (1996) notes evidence that there have been sudden outflows of capital in response to certain changes in tax policy. This suggests that governments find themselves constrained by international competition in the rates that they can apply; that there has been a decreasing readiness of countries to raise rates or to tax dividend and interest income on the ground that to do that would encourage capital flight. Yet it has been well known for a long time that granting of direct-tax concessions has little or no effect even in diverting investment internationally, let alone increasing its global amount. Hence, concessions are an unnecessary loss of revenue. Beggar-thy-neighbour policies will lead to losses of revenue for all developing countries, in a mirror image of the race to the bottom of labour and environmental standards which also negatively affect the possibility of pursuing inclusive, sustainable social development.

The literature is relatively silent on the relationship between trade tax reform and gender (UNDP 2002) Nevertheless, it should be clear, e.g. based on the SAP and gender writings, that when men and women engage in different activities due to culturally imposed restrictions and these activities imply different linkages and interactions with the market and marketing opportunities, any policy initiative affecting the relative rates of

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to others. Third, a tax-return to any tax authority of the income of a corporation or other enterprise would be required to give information relating to the total world income of the firm (Clunies-Ross, 1999).

[49] Tax havens provide the possibility of avoidance by forming holding companies and shifting ostensible residence. Tanzi (1995)

return of these activities (and trade tax reforms is primarily geared towards altering different rates of return) must be analyzed from a gender perspective.

Moreover, trade taxes are a fundamental piece of the industrial policies that are at the core of the synergies described in section 2. Thus, trade tax reforms that result in shifting of output into activities with less employment or less value added per worker (and thus lower wages), are not pro-poor. Sadly, these were typically the reforms implemented since the late 19890s and early 1990s inmost developing countries.

4. Private Public Partnerships

Three factors seem to have driven the private sector's growing role in health and education, and the push to privatise water and hospital services: lack of government resources, low-quality public provision and pressure to liberalize the economy.

One of the reasons why governments have been unable to provide social services effectively or fund large investments in infrastructure is their budget deficits, which grew so large that many governments were forced to adopt structural adjustment programmes. Privatization of public utilities is often pursued with a view towards obtaining revenue, but the biggest returns to government come from eliminating subsidies to loss-making public enterprises.[50] Similarly, public-private partnerships have been encouraged in the hope that private financing might become available for initiating new infrastructure in health, education or water/sanitation services.

Second, the lack of resources for social services is linked to a weak record of public provision in many countries. In India, Bangladesh, Papua New Guinea, Indonesia, Peru, Ecuador, Zambia and Uganda teacher absence are frequent (anywhere from 13 to 26 per cent teachers absent) (Kremer et al, 2004).Poorly-paid public sector doctors often supplement their incomes by selling drugs intended for free distribution (Van Lerberghe et al 2002). As a result poor (and non-poor) people are forced to use private providers,

[50] However, subsidies cannot be critisized i*n toto*, as they often have an important social role to play.

because such providers are more accessible and often dispense drugs as part of their consultations (unlike government facilities, where drugs may not be available (Rohde and Viswanathan, 1995). To access water, poor people often have to pay exorbitant prices to private tankers run by small vendors. Most residents of South Asian cities receive water through the municipal pipes for only a couple hours at a time, and not every day (Leipziger and Foster, 2003).

The third source of encouragement to private provision and privatisation came from the international financial institutions and from donors. The social services are seen as 'frontier areas' in privatisation by the International Finance Corporation.

Before we examine some empirical evidence on PPPs, we must state at the outset that in much of Europe, private providers dominated health, education and water services in the first half of the 19th century. But these services were limited. In the second half of the 19th century public financing and provision became predominant. Indeed, only when governments intervened did these services, especially health insurance and compulsory schooling, become universal in Western Europe and the northern USA – in the last quarter of the 19th and first half of the 20th century. The experience of the now-industrialized countries suggests that the sequence for social services should be comprehensive provision by the state early on, followed by more targeted interventions to reach the un-reached, and then public-private partnerships to serve different markets – depending upon the nature of services in different sectors.

What has been the experience with PPPs in developing countries in South Asia and Latin America? For reasons of space, we will limit this discussion only to the health sector (for an examination of PPPs in water, see Mehrotra and Delamonica, chapter 7; for school education, see Kingdon, 2006). In particular we examine the experience of Latin America with international firms that entered into PPPs. More than any other regions, Latin America has experienced in the 1990s an unprecedented transnationalisation of its health sector. There has been an increase in the export of managed care from the USA, and its adoption in Latin America. Several multinational corporations (e.g. Aetna, CIGNA, AIG, and Prudential) have entered insurance and health services, and they intend to assume administrative responsibilities for state institutions and to secure access to medical social security funds. About 270 million people in Latin America, 60 per cent of the population, receive cash benefits and health care services paid for by, and often delivered by the employees of, social security funds. The three main ways that these corporations invest in Latin American health systems are through: a. the purchase of already established companies in Latin America that are dedicated to the sale of indemnity insurance or of prepaid health plans; b. association with other companies under the framework of a joint venture; and/or c. agreements to manage social security and public sector institutions. Penetration by multinational corporations in health of these social security funds is most advanced in Argentina and Chile, has begun in Brazil and is growing, and is in the process of diffusion in Ecuador (Iriart et al, 2001).

Thus, the concerns about managed care in Latin America are about restricted access for vulnerable groups, and reduced spending for clinical services as opposed to administration and return to investors. In Chile, about 24 per cent of patients covered under the new managed care organisations receive services annually in public clinics and hospitals because they cannot afford co-payments (required under the managed care programme). Public hospitals in Argentina that have not yet converted to managed care principles are facing an influx of patients covered by privatised social security funds. Self-management in Brazil and Argentina’s public hospitals requires competition for capitation payments from social security funds and private insurance, as well as co-payments. To apply for free care at public institutions, poor patients now must undergo lengthy means testing, with rejection rates averaging 30-40 per cent in some hospitals (Iriart et al, 2001). Meanwhile, those public hospitals in Argentina that have not yet converted to managed care principles face an influx of patients covered by privatised social security funds; they had earlier faced barriers to access due to copayments and private practitioners’ refusal to see them because of non-payment by the social security fund. Also, Latin American managed care organisations have also attracted healthier patients while sicker patients shift to the public sector – undercutting the very notion of pooling of health risk and undermining any possibility of cross-subsidy from the healthier to the more vulnerable. Thus, the concerns about managed care in Latin America are about restricted access for vulnerable groups, and reduced spending for clinical services as opposed to administration and return to investors. In Chile, about 24 per cent of patients covered under the new managed care organisations receive services annually in public clinics and hospitals because they cannot afford co-payments (required under the managed care programme). Public hospitals in Argentina that have not yet converted to managed care principles are facing an influx of patients covered by privatised social security funds. Self-management in Brazil and Argentina's public hospitals requires competition for capitation payments from social security funds and private insurance, as well as co-payments. To apply for free care at public institutions, poor patients now must undergo lengthy means testing, with rejection rates averaging 30-40 per cent in some hospitals (Iriart et al, 2001). Meanwhile, those public hospitals in Argentina that have not yet converted to managed care principles face an influx of patients covered by privatised social security funds; they had earlier faced barriers to access due to copayments and private practitioners' refusal to see them because of non-payment by the social security fund. Also, Latin American managed care organisations have also attracted healthier patients while sicker patients shift to the public sector – undercutting the very notion of pooling of health risk and undermining any possibility of cross-subsidy from the healthier to the more vulnerable (Mesa Lago, 2004).

Qadeer and Reddy (2006) trace the growth of privatization in the health sector post-independence culminating with the acceptance of Health Sector Reforms in India. These in their view, contributed to the development of one-sided partnerships. Focusing on this, the paper discusses PPPs that were launched in the health sector around the 90's in Delhi. The tertiary private sector was given various concessions in terms of provision of land (at almost negligible costs), water and electricity at low cost, concessions on import duty on diagnostic equipment. The conditions imposed were the provision in these private health facilities of 30% in-patient facilities and 40% out patient/diagnostic services free of cost for people below the poverty line. The authors suggest that this attempt by the public sector to utilize the yet' untapped resources' of the private sector was just a belated legitimization of an already expanded private sector. A government-appointed committee (Qureshi Committee), which was set up following the filing of court cases at some of the high profile private hospitals (under these PPPs) for their refusal to treat poor patients amongst other issues. The Committee assessed the adherence to conditions of provision of free treatment by a range of institutions, which had received land and other concessions from the Government. These include hospitals like Batra, Escorts, Ganga Ram, G.M. Modi, Apollo, Mool Chand and a range of others. The findings were disturbing, to say the least. Only 80 of the 450 hospitals that were sent a questionnaire responded. Inspection visits were met with great resistance and non-cooperation of managements. Findings related to 27 hospitals showed that the majority of hospitals provided less than 10% of their in patients free care. 13 provided free care to up to 15% of the outpatient department (OPD) cases. Discrimination and rude behaviour towards poor patients was reported. While a range of violations existed the main violation pertained to not fulfilling the agreed quota of treating of poor patients. Qadeer and Reddy suggest that these findings clearly question the notion of 'efficiency' that has been tagged on to PPPs. In fact these PPPs have pushed up prices through high technology and a focus on super specialties. This could therefore result in a monopoly causing smaller hospitals to collaborate, shut down or sell out. This makes the partnerships inefficient at the monetary level and more dangerously at the epidemiological level as they exclude large segments of the population (with common killer diseases).

Drawing on these findings, the authors reach the following conclusions with regard to PPPs:

- Distinguishing between the two types of PPPs (motivated by profit or by public good) is essential. This also requires an understanding of the complex structure of the private sector ranging from untrained allopathic practitioners to hi-tech hospitals along with traditional system practitioners and institutions.
- An essential condition for successful PPPs require is common goal (of the partners).
- Most PPP's appear to be profit-motivated, especially in the tertiary health sector. PPP's however need to be framed at the primary and secondary level, with single

providers (family practitioners) and low cost non-profit institutions or private trusts that have demonstrated an ability to serve public at prices that are affordable.

- It is necessary that the existing government medical colleges and tertiary hospitals are strengthened so as to act as models of standardized basic tertiary level medical care and referral institutions.
- At the tertiary level, PPPs ought to be formed not with the corporate sector, but rather with charitable, private trust or missionary hospitals with a demonstrated goal of public service.
- Standardization of therapeutic strategies and costs for common diseases ought to be made compulsory – at least in the public sector to begin with.
- Regulatory mechanisms pertaining to quality of care and cost in the public sector and self-regulation in the private sector are necessary. Revival of the Medical Council of India could greatly contribute towards this goal. In fact the authors suggest that the 'opening up of medical care to private sector without these essential conditions has been disastrous'.

The authors suggest that strategies of privatization (within the public sector) have not brought any benefit to the poor. These include the granting of institutional autonomy (without any guidelines for basic minimum services), introduction of user fees (without any clarity on its investment and on exemptions), and contracting out.

The combined experience in Latin America and India, where one would expect regulatory capacity to be relatively superior to that in other developing countries (given their level of development), is not promising. The experience with PPPs in water (reported in Mehrotra and Delamonica, 2005 and 2007) also do not seem very promising[51]. This experience is not particularly surprising, given the fact that the same government machinery that has been unable to universalize delivery of basic social services is the one that is intended to supervise the privatized operations or PPPs (Stiglitz, 2002).

5. The contract between the individuals and the state

[51] See also the research by Mackintosh and Koivusalo (2005) and Prasad (2006).

We started the paper with a quote from Mkandawire (2004) defining social policy. It is appropriate, after the review of the taxation issues, to say a few words on other public finance issues regarding pro-poor social policy. In this section we address the "social contract" implicit in social policy. First, we criticize the theoretical foundations of neoclassical models regarding the provision of public goods (i.e. the social services that mainly constitute social policy). This is at the core of the orthodox public finance analysis of social policy and we show that it is deficient both analytically and empirically. Then, as a way to offer a contrasting and constructive view, we highlight the role of the state to ensure a minimum level of income and social services (i.e. the meaning of the social protection "contract").

5a) public goods and pro-poor social policy: which public goods?

In regard to social policy, the neo-classical theory of public finance argues that when there are positive externalities[52], market mechanisms alone will not ensure universal or sufficient provision of social services. Rather, there will tend to be an under-supply of goods and services that have positive externalities and an oversupply of goods that have negative externalities. Theoretically (in a tradition which dates back at least to Pigou), it would be possible to estimate the social benefit of the goods. The social benefit could be compared with its private one in order to calculate the amount of the subsidy required to bring the total quantities demanded and supplied equal to the social optimum. For instance, with immunisation, assuming that the price (i.e. the cost to the consumer) of a vaccine equals the perceived private benefits (i.e. the utility of reducing the risk of infection), one segment of the population will buy the vaccines, while others will not (based on needs and budget constraints).

However, the benefits of immunisation not only transcend one's own protection against the disease (the private benefit), but also extend to the lesser possibility of contagion among the general population (the social benefit). Because individuals do not

[52] Positive externalities occur when the consumption of a good or a service has positive effects on people who do not use them directly. For example, immunisation not only protects the individual who gets the vaccine, but also prevents the spreading of the disease, thereby protecting everybody else in society.

need to (and usually do not due to the externality) count these additional social benefits when deciding whether or not to pay for the vaccine, the price in the market is equalised to the private benefit, which is lower than the total benefit. This results in a sub-optimal (from a societal point of view) level of immunisation. To increase this level in order to obtain the total benefits (both private and social), the price would have to be lowered. This could be done by subsidising producers so they charge a lower price, or by providing funds to consumers to alleviate the cost of the vaccine. In both cases, the same subsidy has to be given by the state and would be based on the discrepancy between the private and social benefits, i.e. the size of the externality.

There are, of course, serious limitations to calculating this subsidy in practice in terms of the information requirements. As a result, it has been argued (e.g. by Neo-institutionalist authors who follow R. Coase, 1988) that rather than state bureaucrats calculating the subsidy precisely, the state should allow and promote more complete markets. In other words, people who do not want to be infected would "pay" not only for their vaccines but also for those who find it optimal not to get immunised. The difficulties involved in this approach can be as important as those in the calculation of the subsidy. Moreover, the approach assumes an enormous faith in the capacity of markets to actually perform as well as their theoretical counterparts in a relatively short period of time. Most societies have adopted a different, much more practical route, which is to provide the vaccination for free to everybody and cover the cost through other mechanisms (health insurance, general taxation, donations, etc, as discussed above). Although informed by the model of externalities, this is a simpler approach much closer in spirit to the idea of merit goods.

Another element from the public finance literature that is often invoked for state involvement in the financing and/or provisioning of some services is the concept of "public goods". There are two distinctive characteristics of public goods: non-rivalry in consumption and non-exclusion. The first one indicates that if one person uses the goods, it does not preclude others from also using it. Knowledge, which is not protected by property rights, falls under this category, e.g. once patents expire, its usefulness remains intact and widely accessible on a universal spectrum. The second characteristic means that once the service is provided, consumers who do not pay for it cannot be prevented from consuming it. An example would be street lightning. Once lampposts are installed, they provide light for everybody; non-payers cannot be forced into the shadows.

It is usually claimed that due to the merging of these two components, private suppliers would not be able to generate any substantial profit from providing these goods. Consequently, the state has to intervene and finance their provision.

There are two aspects of public goods worth mentioning in the debate about basic social services (BSS). First, there are few examples of genuinely pure public goods in general, and within the social services in particular. Most public goods are of a mixed character, only partially non-rival or non-excludable. Roads and parks are generally non-rival, up to a congestion point. Fire-fighters potentially protect all of us at the same time, i.e. non-rival. If more than one fire erupts, however, they cannot be at different places at the same time (rivalry in consumption). The same applies to the justice system, which although available for all citizens, can be very slow in imparting justice to any one single individual when the system itself is overburdened, as it is all too often the case in most developing countries. In addition, roads and parks are excludable. Moreover, even some of the most obvious examples of public goods, such as the transmission of signals (whether from lighthouses, radio or television), can clearly be run for profit by the private sector.

When thinking of pro-poor policies, the examples of goods which are really non-rival and non-excludable are harder to find. Basic education, as all education, is obviously non-rival (up to a congestion point in the classrooms), but is certainly excludable. Although the social benefits of immunisation are non-excludable, vaccines are rival in consumption. So are primary health care centres.

The second point is that basing the limits of what goods should be financed/provided by the state on the notion of public good is a narrow view. It is questionable in normative terms and inaccurate historically. Historically, states took up the provision of these goods as the market economy evolved. The state also defined what elements should be provided to all members of society (or the polity, i.e. those with a capacity to participate in political decisions), and how those goods and services should be financed. In other words, there have been other, more important, determinants of public spending and of state involvement than the technocratic definition of public goods. From the normative point of view, the limitation of state intervention, merely as it applies to pure public goods, would reduce state involvement quite considerably. Being descriptively inaccurate, it seems this model should not be the normative basis to guide social polices in developing countries. Moreover, the historical evidence shows (Lindert, 2003) that the need and the capacity to tax its own citizens (and to tax in a progressive way) grew hand in hand with the rise of the welfare social policies we currently identify as pro-poor in developing countries.

5b) On social protection and the social contract between the individual and the state

While the Neoclassical model cannot provide an *a priori* defense of social policy, the historical evidence regarding the rise of the traditional Welfare State can provide an alternative basis for a conceptual understanding of the relationship between the individual and the state in terms of a "social protection contract". This is in sharp contrast to the current views on social protection. For instance, a typical definition of social protection "refers to the public actions taken in response to levels of vulnerability, risk and deprivation which are deemed socially unacceptable within a given polity or society" (Norton and Conlin, 2000)[53].

This definition, while very clear, leaves open the possibility of constructing social protection in very narrow (the predominant view) or very broad terms (the one we espouse below). The focus on "vulnerability, risk, and deprivation" can easily be interpreted to mean that social protection schemes would apply only for the really down-trodden, excluded, and marginalized members of society. This is a very paternalistic view, akin to charity. On the other hand, ensuring that nobody falls below a standard "deemed socially unacceptable" by society may very well imply that policies and institutions ought to be set up in such a way in which every citizen is guaranteed at least this standard[54]. In other words, social protection refers not only to redistribute income, but also to maintain a minimum standard of living for all (or most) of the population

[53] This traditional definition should be contrasted with the one by Mkandawire we introduced earlier. We refrain from doing so for lack of space.
[54] See the Convention Social Cultural and Economic Rights, Art 11.

through their lifecycle. This is the historical struggle of the Welfare State since the second half of the XIXth Century, as we will see below.

The narrow interpretation of social protection comprises all interventions from informal networks and voluntary organizations to private and public institutions, all of which endeavor to support communities, households and individuals in their attempts to deal with risks and vulnerabilities. This could be labeled the “management of risk” approach (Holtzman and Jorgensen, 2001).

As a result of the retrenchment of the welfare state and the increasing acceptance of the Washington Consensus, social protection has tended to be relegated to the category of residual. This is compounded with the donors’ bias towards projects (Tendler, 2004). This “micro” view of interventions is inimical for large policy endeavors such as setting up pro-poor social policies. Inclusive and equitable societies and full citizenship seems unfeasible as long as social protection and social policy focus on vulnerable groups alone, leaving all others to contend as private individuals in the market.

This approach, like the “management of risk”, dismisses one fundamental human rights principle: that all members of society should benefit from social protection[55]. The narrow concept of social protection (to only help the poor and vulnerable) leaves out many members of society and undermines the potential for social protection policies to contribute to building cohesive societies based on rights (Marshall T. and Bottomore T, 1992).

In contrast, the policy discussion should not be about economic risk, but stress the role of solidarity throughout the life cycle. This solidarity is not just an inter-generational issue. A well designed social security system would tend also (albeit indirectly or unintentionally) to further gender equality. A well designed social security system would involve redistribution, as the rich contribute more than the poor but their pensions will be relatively smaller (as a proportion of their life-long earnings) than for the poor. As

[55] Also, it has been labeled “economic protection” rather than social protection by Devereux and Sabates-Wheeler (2004) for its emphasis on income and economic shocks rather than social problems.

women tend to earn less throughout their lifetimes (as a result of the labor market and other gender biases) the pensions will partly redress this disparity[56].

For instance, social security policies can have a dual purpose as both a social means to prevent deprivation (promote living standards) and to lower vulnerability to deprivation (protect against falling living standards) (ILO, 2001, p. 38). Social insurance and social assistance against unemployment represent traditional security mechanisms that remain inaccessible to the high number of persistent poor in developing countries who work in the informal sector. Extending coverage of formal social security to the large numbers of self-employed outside the formal sector has been a major debate in developing countries.[57] ILO points out (2001, p. 68) that "the goal of social protection is not mere survival, but social inclusion and the preservation of human dignity." Indeed, social protection responds to vital basic demands in an individual's life cycle: food, health, education, shelter, safety and wage income security at work, and care for the elderly, among others (ILO, 2003).

Thus social protection policies become pro-porr because they contribute to change society by making individuals' standard of living independent of market fluctuations. The commodification of labor confronted the individual's right to survive outside the market when Welfare State emerged. Marx's concept of de-commodification, "the degree to which individuals, or families, can uphold a socially acceptable standard of living independently of market participation", identified the primary issue of social policy, namely the "degree to which market immunity would be permissible" (Esping-Andersen 1990).

The market economy in the currently industrialised countries would not have come into existence but for the state; the state was critical in establishing key institutions of the market economy (Polanyi, 1947, Barrington Moore, 1968). While the Industrial Revolution began in England in the last quarter of the 18th century, it can hardly be said that an integrated national economic system existed until the second quarter of the 19th century. No market economy was conceivable that did not include a market for labour;

[56] Mesa Lago (2004) provides evidence of these transfers for some Latin American countries.
[57] E.G. SEWA

but to establish such a market a complete transformation of the traditional fabric of society was needed.

The voices of those who opposed the ‘rule of the market’ changed after the implementation of free markets. This growth of administration over the market was reflected in Jeremy Bentham's utilitarianism. When industrial capitalism was in full swing, the liberal creed, intent on the spreading of the market system, was met by a protective counter movement leaning towards its restriction. However, this counter movement did not appear to be due to any preference for socialism or nationalism on the part of concerted interests, but seemed, rather, to be a practical reaction prompted by the expansion of the market mechanism.

Adam Smith (1937) pointed out the role of the state in ‘erecting and maintaining those public institutions and those public works, though they may be in the highest degree advantageous to a great society, are, however, of such a nature, that the profit could never repay the expense to any individual…’ Such works were ‘those for facilitating the commerce of the society, and those for promoting the instructions of the people’ (p.681). Each of the European countries passed through a period of free trade and laissez-faire, followed by a period of 'anti-liberal' or social legislation and measures in regard to public health, education, public utilities, municipal trading, social insurance, trade associations, and factory conditions (Polanyi, 1947). This was as true of Victorian England as of Bismarck's Prussia, of France (3rd Republic) and of the post-bellum United States.

There is an amazing diversity of matters on which action was taken by the state, including basic health, sanitation and education. Herbert Spencer cited a list of interventions when accusing liberals of having abandoned and deserted their principles. In 1860, authority was given to provide ‘analysts of food and drink to be paid out of local rates’. There followed an Act providing ‘the inspection of gas works’ and an extension of the Mines Act ‘making it penal to employ boys under twelve not attending schools and unable to read and write’. In 1861, power was given to ‘poor law guardians to enforce vaccination’. In 1862, there was an Act giving the Council of Medical Education exclusive right ‘to furnish a Pharmacopoeia, the price of which is to be fixed by the Treasury’ and in 1863 came the ‘extension of compulsory vaccination to Scotland and

Ireland'. There was also an Act appointing inspectors for the 'wholesomeness, or unwholesomeness of food'; a Chimney Sweeper's Act meant to prevent the torture and eventual death of children set to sweep too-narrow slots; a Contagious Diseases Act. Spencer used these as evidence of an anti-liberal conspiracy.

Nevertheless, these were helpful both in establishing and strengthening capitalism through the mitigation of social costs (their most visible and direct objective), but also by promoting growth through a healthier, better trained workforce, safer markets for consumers and newer areas of investment. Thus, social and economic development occurred together and reinforced each other as growth transformed societies and states took up different and expanding roles (Nell, 1992).

It is important to stress that the state interventions were due to very different reasons from those proposed by neo-classical models: no rates of return were estimated, no market failures identified and no public goods were defined based on production or commercial properties. Rather, social objectives and political considerations were driving state involvement.

The modern school system developed without much reference to the needs of the industrial revolution, and much after the latter was well under way. There is evidence that 'few intellectual requirements were necessary to make the industrial revolution' in the last quarter of the 18th century (Hobsbawm, 1969). In fact, literacy grew in the European countries in advance of the industrial need for it. 'It was less an effect of industrialisation than a prior-facilitating agent. It was not until the second stage of the industrial revolution that education became more essential for the provision of new skills'. In fact, in the early 19th century a modern schooling system was only emerging for the industrialised countries (other than Prussia where elements already existed). However, by the end of the 19th century, most European countries (except Britain) and the US had consolidated a system of elementary education while secondary education too had expanded. While the beginnings were entirely due to private effort, it was the intervention of the state that led to universal elementary education. This process occurred unevenly and in different forms from country to country, as some made more rapid progress than others did.

Thus, there were a number of measures common to all states. First, the state created a public system of schooling financed by taxes. Second, the state worked gradually towards the elimination of tuition fees. Third, the state made elementary education compulsory. Fourth, varying degrees of centralisation emerged, with bureaucracies running the public school system, the training of teachers and the creation of an education department in government. Countries which developed state-funded systems of public education earlier (e.g. Prussia, northern USA, Switzerland, Holland) achieved higher levels of enrolment and literacy. Countries (e.g. England and Wales) with no public system until quite late fared worse in terms of those indicators. All these policies, systems, interventions, etc, obviously, require financing. As we mentioned at the end of the previous sub-section, a progressive tax system grew hand in hand with the provision of these pro-poor policies.

6. Conclusions

As fiscal policy (both through spending and taxation) affects employment, the distribution of income and, the provision of social services, it is impossible to discuss pro-poor social policies without paying careful attention to their financing. Moreover, the existence of synergies (both within the sectors constituting social policy as well as among poverty reduction, economic growth and social development) requires that a framework making these connection and feedback loops be made explicit. Our argument is that analyzing these synergies point to particular policy recommendations which are at variance from the traditional/orthodox approach of the International Financial Institutions and most governments in developing countries which pursue a liberalization/globalization agenda.

In particular, we posit that social and economic policies cannot be divorced. Thus, when analyzing social policy, for instance, the mode in which it is financed needs to be included. Otherwise, the possibility that the pro-poor benefits of social service provision may be undermined by “anti-poor” revenue raising strategies emerges. Taxation should be assessed from the point if view of whether it contributes to a pro-poor policy context.

In other words the tax structure should be progressive and promote the principle of solidarity.

Since the inception of structural adjustment programs in the early 1980s, the wave of reforms in the 1990s, and even among most recent PRSPs and similar plans, there has been a push towards eliminating trade taxes and promoting VATs (and other indirect, regressive taxes). The shortfalls generated by reductions in trade taxes have not been compensated by increases in other forms of taxation. Thus, from the point of view of solidarity and progressivity, recent trends are not very encouraging.

Nevertheless, not all reforms have had negative effects. In particular, within the last ten years or so, there has been a growing recognition among policy-makers in developing countries as well as among donors and international advisors about the detrimental effects of user fees. Several success stories in education attest to this. In the health and water and sanitation sectors, however, the situation is not as encouraging. In any case, recent attempts at converting the user fees into pre-paid insurance schemes are steps in the right direction. This is specially the case when such insurance schemes are nation-wide and provide for a sliding scale of subsidies to help the poor.

In terms of future steps, countries should be encouraged to implement direct progressive taxes. As it is well known that these taxes are harder to collect, the United Nations and the IFIs should take a leading role in terms of capacity building. Donors should help foot the bill in terms of training and the required infrastructure to ensure compliance with these taxes. External partners and the international community should also strengthen their efforts to provide financing, including through the introduction of innovative sources of funding.

These steps would contribute to adequately finance pro-poor social policies. Moreover, by unleashing the synergies among social development, poverty reduction and economic growth, they would they would also help to construct inclusive societies.

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