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15 Finance and Fiscal Policy for Development

The success of other market reforms depends on the health of the financial system.

—*World Bank,* World Development Report, 1996

Much of the rationale for liberalizing financial markets is based neither on a sound economic understanding of how these markets work nor on the potential scope for government intervention.

—*Joseph Stiglitz, Nobel laureate in economics*

I decided to set up my own bank. The government thought it was a funny idea; poor people cannot borrow money.…Grameen is a mechanism for integrating people back into the marketplace. It opens up opportunities so that you can build your own life. Microcredit brings people together.

—*Muhammad Yunus, founder of the Grameen Bank and 2006 Nobel laureate for peace*

It is increasingly recognized that the financial system plays a crucial role in the process of economic development. The government helps make this possible by adopting sound and stable macroeconomic policies, including strong yet flexible fiscal as well as monetary policy, acting to establish financial markets where they do not yet exist, and providing prudential regulation of the financial system. In this chapter, we consider the role of finance and improvements in the workings of the financial system in the overall process of economic growth, modernization, and development. We examine the difficult road to macroeconomic stability on which many developing countries are now traveling. Then we examine developing-country financial systems in more detail. We take a look at stock markets in developing countries and consider the strengths and weaknesses of their expanding role. We examine special institutions such as development banks and rotating savings and credit associations (ROSCAs). We examine the increasingly prominent role of microfinance in developing countries, particularly the historical barriers to its development, the ways these barriers have been overcome, the benefits of microfinance for addressing problems of poverty and local development, and limitations of the emphasis on microfinance.

In this context, we will examine why it is often so difficult for many developing-country governments to pursue traditional monetary and financial policies, how some financial policies have led to low domestic savings and

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widespread inefficiencies in the commercial banking system, and how poorly designed and implemented tax structures work against attempts to restore fiscal balance through revenue increases. We also take a brief look at problems of public administration (a critical constraint in many developing countries), and examine the debate over the privatization of state-owned enterprises. The chapter's case study examines Botswana, an African country that has achieved one of the world's highest growth rates over the last several decades—leveraging mineral wealth with effective fiscal policies and relatively sound public administration—but still facing significant development challenges.

15.1 The Role of the Financial System in Economic Development

Generally, a distinction is made between the *real sector* and the *financial sector.* This terminology is unfortunate because it suggests that the financial sector is something less than real. This impression has been abetted by the view that the financial sector is a mere appendage to the real economy. As the economist Joan Robinson famously put it, "Where enterprise leads, finance follows."[1] Certainly, there is some truth to this aphorism; to a large extent, demand for financial services is derived from the activities of nonfinancial firms. But there is evidence that finance can also be a limiting factor in economic development. The need for finance can be seen everywhere in the developing world; five basic illustrations are:

- An impoverished mother in Zambia who attempts to feed her family with income from her credit-starved microenterprise and who could be much more productive with more working capital
- A start-up firm in India that cannot get established without private equity capital and may eventually wish to float a public offering
- A farmer on the world's richest soil in Ukraine who cannot plant for want of credit to buy seeds
- A budding family-owned shoe company in Brazil that needs better access to lower-cost loans to begin to export
- An established publicly traded firm in the Philippines that wishes to sell more shares to provide funds for restructuring

Hugh Patrick offers a "stages of development" argument that financial development causes growth at the start of modern development, but once the financial system is established, it mainly follows the real sector. Most likely, the causality runs in both directions.[2]

What is so important about finance? The financial sector provides six major functions that are important both at the firm level and at the level of the economy as a whole.[3]

1. *Providing payment services.* It is inconvenient, inefficient, and risky to carry around enough cash to pay for purchased goods and services. Financial institutions provide an efficient alternative. The most obvious examples are personal and commercial checking and check clearing, and credit and

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debit card services; each is growing in importance, in the modern sectors at least, even in low-income countries. Recently, payments via mobile phones has expanded dramatically in Kenya and is growing rapidly many other developing countries.

2. *Matching savers and investors.* Although many people save, such as for retirement, and many have investment projects, such as building a factory or expanding the inventory carried by a family microenterprise, it would be only by the wildest of coincidences that each investor saved exactly as much as was needed to finance a given project. Therefore, it is important that savers and investors somehow meet and agree on terms for loans or other forms of finance. This can occur without financial institutions; even in highly developed markets, many new entrepreneurs obtain a significant fraction of their initial funds from family and friends. However, the presence of banks, and later venture capital or stock markets, can greatly facilitate matching in an efficient manner. Small-scale savers simply deposit their savings and let the bank decide where to invest them.
3. *Generating and distributing information.* From a society-wide viewpoint, one of the most important functions of the financial system is to generate and distribute information. Stock and bond prices in the daily newspapers of developing countries (and increasingly on the Internet as well) are a familiar example; these prices represent the average judgment of thousands, if not millions, of investors, based on the information they have available about these and all other investments. Banks also collect information about the firms that borrow from them; the resulting information is one of the most important components of the "capital" of a bank, although it is often unrecognized as such. In these regards, it has been said that financial markets represent the "brain" of the economic system.[4]
4. *Allocating credit efficiently.* Channeling investment funds to uses yielding the highest rate of return allows increases in specialization and the division of labor, which have been recognized since the time of Adam Smith as a key to the wealth of nations.
5. *Pricing, pooling, and trading risks.* Insurance markets provide protection against risk, but so does the diversification possible in stock markets or in banks' loan syndications.
6. *Increasing asset liquidity.* Some investments are very long-lived; in some cases—a hydroelectric plant, for example—such investments may last a century or more. Sooner or later, investors in such plants are likely to want to sell them. In some cases, it can be quite difficult to find a buyer at the time one wishes to sell—at retirement, for instance. Financial development increases liquidity by making it easier to sell, for example, on the stock market or to a syndicate of banks or insurance companies.

Both technological and financial innovations have driven modern economic growth. Both were necessary conditions for the Industrial Revolution, as steam and water power required large investments facilitated by innovations in banking, finance, and insurance. Both are necessary for developing countries as they continue their struggle for economic development. But a financial

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system that works for inclusive development and poverty reduction must be designed with equity as well as efficiency in mind. And a well-designed regulatory system is essential to reduce vulnerability to financial crises that can impose high costs on the rest of the economy.

Differences between Developed and Developing-Country Financial Systems

Monetary policy Activities of a central bank designed to influence financial variables such as the money supply and interest rates.

Money supply The sum total of currency in circulation plus commercial bank demand deposits and sometimes savings bank time deposits.

In more developed nations, monetary and financial policy plays a major direct and indirect role in governmental efforts designed to expand economic activity in times of unemployment and surplus capacity and to contract that activity in times of excess demand and inflation.[5] Basically, **monetary policy** works on two principal economic variables: the aggregate supply of money in circulation and the level of interest rates. Expressed in traditional terms, the **money supply** (currency plus commercial bank demand deposits) is thought to be directly related to the level of economic activity in the sense that a greater money supply induces expanded economic activity by enabling people to purchase more goods and services. This in essence is the *monetarist theory* of economic activity. Its advocates argue that by controlling the growth of the money supply, governments of developed countries can regulate their nations' economic activity and control inflation.

On the other side of the monetary issue, again expressed in traditional terms, are the *Keynesian economists*, who argue that an expanded supply of money in circulation increases the availability of loanable funds. A supply of loanable funds in excess of demand leads to lower interest rates. Because private investment is assumed to be inversely related to prevailing interest rates, businesspeople will expand their investments as interest rates fall and credit becomes more available. More investment, in turn, raises aggregate demand, leading to a higher level of economic activity (more employment and a higher GDP). Similarly, in times of excess aggregate demand and inflation, governments pursue restrictive monetary policies designed to curtail the expansion of aggregate demand by reducing the growth of the national money supply, lowering the supply of loanable funds, raising interest rates, and thereby inducing a lower level of investment and, it is hoped, less inflation.

Although this description of monetary policy in developed countries grossly simplifies a complex process,[6] it points out two important aspects that most developing countries lack. First, the ability of developed-country governments to expand and contract their money supply and to raise and lower the costs of borrowing in the private sector (through direct and indirect manipulation of interest rates) is made possible by the existence of highly organized, economically interdependent, and efficiently functioning money and credit markets. Financial resources are continuously flowing in and out of savings banks, commercial banks, and other nationally regulated public and private financial intermediaries with a minimum of interference. Moreover, interest rates are regulated both by administrative credit controls and by market forces of supply and demand, so there tends to be consistency and a relative uniformity of rates in different sectors of the economy and in all regions of the country. Financial intermediaries are thus able to mobilize private savings and efficiently allocate them to their

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most productive uses. This is a crucial ingredient in the promotion of long-term economic growth.

By contrast, markets and financial institutions in many developing countries are highly unorganized, often externally dependent, and spatially fragmented.[7] Many commercial banks in developing countries are overseas branches of major private banking corporations in developed countries. Their orientation, therefore, like that of multinational corporations, may be more toward external and less toward internal monetary situations. The ability of governments in developing countries to regulate the national supply of money is further constrained by the openness of their economies, in some cases the pegging of their currencies to the dollar or alternatively to the euro or a basket of major developed-country currencies, and the fact that the accumulation of foreign-currency earnings is a significant but highly variable source of their domestic financial resources. Even the money supply itself may be difficult to measure and more difficult to control under conditions of **currency substitution**, whereby foreign currencies serve as an alternative to the domestic currency (e.g., U.S. dollars in northern Mexico).[8] This is a particularly important problem when the expected level of inflation is high.

Currency substitution The use of foreign currency (e.g., U.S. dollars) as a medium of exchange in place of, or along with, the local currency (e.g., Mexican pesos).

A majority of developing nations have found that currency pegging presents challenging obstacles; so floating currency or managed floats have become more popular (Chapter 13). But this has also been associated with other forms of instability, including highly volatile exchange rates, even in countries not otherwise in crisis. An example is India in 2013, as economic growth slowed—though to a still healthy 5%. The rupee lost 9% of its value during August alone and faced considerable volatility throughout the year, bringing pressure on the central bank to raise interest rates, which, in turn, threatened to slow the economy further.

Because of limited information and incomplete credit markets, the commercial banking system of many developing countries lacks **transparency** (full disclosure of the quality of loan portfolios) and often restricts its activities almost exclusively to rationing scarce loanable funds to medium- and large-scale enterprises in the modern manufacturing sector that are deemed more creditworthy. Many development economists have concluded that this lack of transparency, and the fact that many borrowers were *not* creditworthy, was a major factor in the 1997 Asian currency and banking crisis, especially in Thailand and Indonesia. As a result, small farmers and indigenous small-scale entrepreneurs and traders in both the formal and informal manufacturing and service sectors have traditionally had to seek financing elsewhere–sometimes from family members and relatives, or from local moneylenders and loan sharks who charge exorbitant interest rates. The growth of microfinance, including its gradual expansion "upmarket" to somewhat more established small enterprises, has made modest but significant inroads toward addressing this problem.

Transparency (financial) In finance, full disclosure by public and private banks of the quality and status of their loan and investment portfolios so that domestic and foreign investors can make informed decisions.

Organized money market The formal banking system in which loanable funds are channeled through recognized and licensed financial intermediaries.

Most developing countries have operated under a dual monetary system: a small and often externally controlled or influenced **organized money market** with binding legal restrictions on nominal interest-rate ceilings, catering to the financial requirements of a special group of middle- and upper-class local and foreign businesses in the modern industrial sector, and a large but amorphous **unorganized money market**, uncontrolled, often strictly illegal, and often usurious, to which most low-income individuals are obliged to turn in

Unorganized money market The informal and often usurious credit system that exists in most developing countries (especially in rural areas) where low-income farms and firms with little collateral borrow from moneylenders at exorbitant rates of interest.

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Financial liberalization Eliminating various forms of government intervention in financial markets, thereby allowing supply and demand to determine the level of interest rates, for example.

times of financial need. This is another manifestation of the dual structure of many developing economies and their tendency, intentional or not, to serve the needs of wealthy elites while neglecting the requirements of the relatively poor. One possible step toward the elimination of this major factor price distortion would be the removal of artificially low nominal interest-rate ceilings in the organized market as well as other related steps toward **financial liberalization** (e.g., loosening of the foreign-exchange rate). Higher interest rates should generate more domestic savings, whereas greater transparency and more market-oriented real interest rates should better allocate loanable funds to the most productive projects. However, liberalization has often been accompanied by new challenges to financial stability. Moreover, such coordinated liberalization of domestic financial and foreign-exchange markets has not adequately solved the problem of channeling credit to small investors and entrepreneurs.[9] That will require more direct new initiatives. We will discuss both financial market reform and measures to improve finance for the informal economy later in this chapter.

In developing nations, investment decisions are often not very sensitive to interest-rate movements. Moreover, a number of larger countries in Latin America (e.g., Brazil and Argentina) have in the past followed a policy of inflation-financed industrial growth, in which expansionary monetary policy in conjunction with large budgetary deficits has resulted in negative real interest rates (inflation rates exceeding nominal interest levels). The basic idea is that artificially low rates encourage investment, finance the fiscal deficit, and promote industrial output growth. But there may be severe structural supply constraints (low elasticities of supply) inhibiting the expansion of output even when the demand for it increases. These constraints include poor management, the absence of essential (usually imported) intermediate products, bureaucratic rigidities, licensing restrictions, and an overall lack of industrial-sector interdependence. Whatever the reasons, structural supply rigidities mean that any increase in the demand for goods and services generated by rapid money creation will not be matched by increases in supply. Instead, the excess demand (in this case, for investment goods) will merely bid up prices and cause inflation. In some Latin American nations, such “structural” inflation has been a chronic problem, made even worse on the cost side by the upward spiral of wages as workers attempt to protect their real income levels by indexing wage increases to price rises. Attempts to control inflation with fixed or slowly depreciating exchange rates led to major financial crises in Brazil in 1999 and Argentina in 2001–2002.

Macro problems were not quite as severe in peripheral Europe as in many developing nations, but there were some analogies to abandoning local currencies for the euro. This was analogous to permanently pegging the currency to the former deutschmark, or rather, to a currency index including the former franc, as Argentina did to the dollar. Or it is like currency substitution, such as the dollarization practiced by El Salvador, Panama, and Ecuador—simply a choice to use a more stable currency as legal tender (medium of exchange). Like currency substitution, it makes adjustment more difficult, because there is no federalized budget and labor mobility is far less than anticipated in the 1992 market integration. Moreover, it is much harder for Eurozone countries to exit, because use of the euro is established by treaty for participating member

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countries, rather than as voluntary euro adoption in countries such as Kosovo and Montenegro. Not so many years ago, Portugal and Greece were classified as upper-middle-income developing countries by development agencies; and recently they, too, have experienced lost competitiveness as their productivity has grown more slowly over a period of years than core euro countries, led by Germany. Without the opportunity to adjust through depreciation of their exchange rate, they have had to adjust through austerity. But the resulting austerity—harsh macroeconomic stabilization, if not structural adjustment—led to high unemployment rates including 27% in both Greece and Spain, 15% in Portugal, and 12% in both Italy and Ireland—the so-called EU-5 crisis countries—in 2013 (This topic was explored from additional perspectives in Chapter 13, section 13.5.)

Nevertheless, financial systems remain an integral component of the general economic system in developing countries. For example, in the context of severe macroeconomic instability with high inflation, accompanied by large budget and trade deficits, they represent a key element in any overall stabilization effort. Moreover, as noted earlier, financial systems provide a variety of needed services, including savings mobilization, credit allocation, risk limitations, insurance protection, and foreign-exchange facilitation. Let us therefore continue our examination of the structure of financial systems with a look at the central bank.

15.2 The Role of Central Banks and Alternative Arrangements

Functions of a Full-Fledged Central Bank

In developed nations, **central banks**, such as the Federal Reserve Board in the United States, conduct a wide range of banking, regulatory, and supervisory functions. They have substantial public responsibilities and a broad array of executive powers. Their major activities can be grouped into five general functions:[10]

Central bank The major financial institution responsible for issuing a nation's currency, managing foreign reserves, implementing monetary policy, and providing banking services to the government and commercial banks.

1. *Issuer of currency and manager of foreign reserves.* Central banks print money, distribute notes and coins, intervene in foreign-exchange markets to regulate the national currency's rate of exchange with other currencies, and manage foreign-asset reserves to maintain the external value of the national currency.

2. *Banker to the government.* Central banks provide bank deposit and borrowing facilities to the government while simultaneously acting as the government's fiscal agent and underwriter.

3. *Banker to domestic commercial banks.* Central banks also provide bank deposit and borrowing facilities to commercial banks and act as a lender of last resort to financially troubled commercial banks.

4. *Regulator of domestic financial institutions.* Central banks ensure that commercial banks and other financial institutions conduct their business prudently and in accordance with relevant laws and regulations. They also

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monitor reserve ratio requirements and supervise the conduct of local and regional banks.

5. *Operator of monetary and credit policy.* Central banks attempt to manipulate monetary and credit policy instruments (the domestic money supply, the discount rate, the foreign-exchange rate, commercial bank reserve ratio requirements, etc.) to achieve major macroeconomic objectives such as controlling inflation, promoting investment, or regulating international currency movements.

Sometimes these functions are handled by separate regulatory bodies.

Currency board A form of central bank that issues domestic currency for foreign exchange at a fixed exchange rate.

Currency Boards A **currency board** issues domestic currency for foreign exchange at a fixed exchange rate. It was the classic alternative arrangement to a central bank. Although it provides exchange rate stability, it does so at a cost of giving up independence to pursue other functional roles of central banks. Many developing countries inherited or adopted a currency board at the time of independence, and others have adopted them to restore stability after periods of high inflation. Currency boards do not create new money, conduct monetary policy, or generally supervise the banking system. In colonial times, they acted as agents for the colonial banks and were charged with the responsibility of maintaining a fixed parity with the colonial power's currency. A more recent example of a currency-based system was found in Argentina from 1991 until 2002, where the peso was pegged one-for-one with the U.S. dollar and was backed in the monetary base with international reserves. When the currency board was established in 1991, the purpose was to reduce inflation by controlling the money supply. A strong dollar and fiscal irresponsibility (possibly compounded by stretching conventional currency board rules) led to its demise. The failure in Argentina by 2002 led to a more general loss of credibility for the effectiveness of this type of system.

Alternatives to Central Banks There are several other alternatives to the standard central bank.[11] First, a *transitional central banking institution* can be formed as an intermediate step between a currency board and a central bank, with the government exerting a strong influence on its financial activities. The range of such activities, however, is checked by statutory limitations on the monetary authority's discretionary powers. Former British colonies and protectorates such as Fiji, Belize, Maldives, and Bhutan provide the most common examples of transitional central banks. Second, a *supranational central bank* may be created to undertake central banking activities for a group of smaller countries participating in a monetary union, perhaps also as part of a customs union (see Chapter 12). Examples of monetary unions with regional, central banks include the West African Economic and Monetary Union, and the Central African Economic and Monetary Community, which use separate but equally valued versions of the CFA franc (African Financial Community). Another is the Eastern Caribbean Currency Union, which uses the East Caribbean dollar (controlled by the East Caribbean Central Bank). Each of these is tied to major currencies (the euro in the first cases and the U.S. dollar in the latter). Establishing new monetary unions is fraught with political and technical difficulties, but there may be new examples in coming years. The Southern

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African Development Community has announced its objective for a single currency by 2018, though this date is in doubt; and the Gulf Cooperation Council announced an objective of a monetary union, but progress has been very slow. Of course, the euro has been adopted as the currency of many European countries, and its management has not been free of problems, particularly in countries that not long ago were included in lists of still-developing countries, such as Greece and Portugal. There are benefits to regional unions, but they must be compared with the costs of reduced flexibility. Third, a *currency enclave* might be established between the central banking institution in a developing country and the monetary authority of a larger trading partner, often the former colonial power. Such an arrangement provides a certain degree of stability to the developing country's currency, but the dominating influence of the partner, with its own priorities, renders the enclave almost as dependent as a colony with respect to monetary policy. Contemporary examples include economies that have *dollarized*, a term for adopting the currency of the U.S. dollar, without a central bank role; examples include Panama, Ecuador, El Salvador, and East Timor. Other currencies such as the euro have been adopted in a similar manner. Finally, in an *open-economy central banking institution*, where both commodity and international capital flows represent significant components of national economic activity, the monetary environment is likely to be subject to fluctuations in world commodity and financial markets. As a result, the central banking institution will be engaged primarily in the regulation and promotion of a stable and respected financial system. Examples of such institutions have included Singapore, Kuwait, Saudi Arabia, and the United Arab Emirates. Table 15.1 summarizes the major features of these four categories of central bank alternatives in comparison with the currency board and the central bank.

In the past two decades, there has been an increase in central bank economic and political independence in a majority of developing countries. Many economists have identified such autonomy as an important precondition to its effectiveness in carrying out traditional central bank roles.[12]

Economic autonomy has been defined as the absence of provision of direct credit to government from the central bank that is either automatic, below market interest rates, or not limited in time or amounts; the absence of central bank presence in the primary market for public debt; the right to set interest rates independently; and holding responsibility for overseeing the banking sector. *Political autonomy of central banks* has been defined as the ability to select final objectives of monetary policy and is measured by whether the bank governor and board of directors are appointed independently and for a long term, whether political representatives are required, whether monetary policies can be implemented without political approval, and whether institutional rules strengthen central banks in conflicts with government.[13]

A 2009 International Monetary Fund (IMF) study, using alternative autonomy indexes, reported a global trend toward relatively higher levels of central bank autonomy and identified four broad patterns over this period:[14]

1. There has been a shift in banking institutions from currency boards to single state central banks or currency unions (supranational central banks).
2. A majority of central banks have been granted the responsibility to set price stability or target inflation as one of their objectives of monetary

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TABLE 15.1 Central Banking Institutions

	Function					
Institution	**Issuer of Currency**	**Banker to Government**	**Banker to Commercial Banks**	**Regulator of Financial Institutions**	**Operator of Monetary Policy**	**Promoter of Financial Development**
Full-fledged central bank	3	3	3	3	3G	1
Supranational central bank	3E	2E	2	2	2E	2
Open-economy central banking institution	3C	2C	2	3	1	3
Transitional central banking institution	3CG	2C	2	1	2G	3
Currency enclave central banking institution	1, 2CE	2CE	2	1	1	3
Currency board	3C	1	1	1	1	1

Source: Charles Collyns, *Alternatives to the Central Bank in the Developing World*, IMF Occasional Paper No. 20 (Washington, D.C.: International Monetary Fund, 1983), p. 22. Copyright © 1983 by the International Monetary Fund. Reprinted with permission.

Key: 1 = limited involvement; 2 = substantial involvement; 3 = full involvement; C = considerable constitutional restrictions; E = considerable external influence; G = considerable government influence.

policy. In addition, most of these countries also have autonomy with respect to setting the policy rate as it concerns the government. (The degree to which this measured autonomy corresponds to actual practice particularly over time and across periods of financial distress will be an ongoing consideration.)

3. There is divergence among central banks on the issue of financial supervision. Many central banks in developing countries have retained their key supervisory role. But the priority of most central banks is achieving medium-term price stability.

4. Participation in currency unions (or supranational central banks) has enhanced the autonomy of central banks in both developed and developing countries. Examples include the European Union of Central Banks (ESCP), the Central Bank of West African States (BCEAO), the Bank of Central African States (BEAC), and the East Caribbean Central Bank (ECCB).

However, central bank autonomy still remains quite limited in many cases.

In the final analysis, however, it is not so much the organizational structure of the central banking institution or its degree of political autonomy that matter. Rather, it is the extent to which such an institution is capable of financing and promoting domestic economic development, through its commercial and development banking system, in an international economic

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and financial environment, characterized by various degrees of dominance and dependence. Commercial banks in developing countries must take a much more active role in promoting new industries and financing existing ones than is usual for banks in developed nations. They have to be sources of venture capital as well as repositories of the commercial knowledge and business skills that are typically in short supply domestically. It is because of their failure to do this that new financial institutions, known as development banks, have become a prominent part of the financial arsenal of many developing countries.

The Role of Development Banking

Development banks are specialized public and private financial institutions that supply medium- and long-term funds for the creation or expansion of industrial enterprises. They have arisen in many developing nations because the existing banks usually focus on either short-term lending for commercial purposes (commercial and savings banks) or, in the case of central banks, the control and regulation of the aggregate supply of money. Moreover, existing commercial banks set loan conditions that are often inappropriate for establishing new enterprises or for financing large-scale projects. Their funds are more often allocated to "safe" borrowers (established industries, many of which are foreign-owned or run by well-known local families). True venture capital for new industries rarely obtains approval.

Development banks Specialized public and private financial intermediaries that provide medium- and long-term credit for development projects.

To facilitate industrial growth in economies characterized by a scarcity of financial capital, development banks have sought to raise capital, initially focusing on two major sources: (1) bilateral and multilateral loans from national aid agencies like the U.S. Agency for International Development (USAID) and from international donor agencies like the World Bank, and (2) loans from their own governments. However, in addition to raising capital, development banks have had to develop specialized skills in the field of industrial project appraisal. In many cases, their activities go far beyond the traditional banker's role of lending money to creditworthy customers. The activities of development banks often encompass direct entrepreneurial, managerial, and promotional involvement in the enterprises they finance, including government-owned and -operated industrial corporations.

The growth and spread of development banks in the developing world have been substantial. By 2000, their numbers had increased into the hundreds, and their financial resources had ballooned to billions of dollars. Moreover, although the initial sources of capital were agencies such as the World Bank, bilateral aid agencies, and local governments, the growth of development bank finance has increasingly been facilitated by capital from private investors, institutional and individual, foreign and local. Almost 20% of the share capital of these banks has been foreign-owned, with the remaining 80% derived from local investors.

In spite of their impressive growth, development banks have come under mounting criticism for their excessive concentration on large-scale loans. Some privately owned finance companies (also categorized as development banks) refuse to consider loans of less than $20,000 or $50,000. They argue that smaller loans do not justify the time and effort involved in their appraisal.

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As a result, these finance companies almost totally remove themselves from the area of aid to small enterprises, even though such aid is of major importance to the achievement of broadly based economic development and often may constitute the bulk of assistance needed in the private sector. We may conclude, therefore, that in spite of the growth of development banks, there remains a need to channel more financial resources to small entrepreneurs, both on the farm and in the marginal or informal sector of urban areas and nonfarm rural activities, who often are excluded from access to credit at reasonable rates of interest.[15] In an attempt to respond to these needs of small-scale borrowers, a whole array of informal credit arrangements has emerged in the developing world. Let us look briefly at some of them.

15.3 Informal Finance and the Rise of Microfinance

Traditional Informal Finance

A 2010 study estimated that 2.5 billion adults do not use formal services to save or borrow.[16] As noted earlier in the text, much economic activity in developing nations comes from small-scale producers and enterprises. Most are noncorporate, unlicensed, unregistered enterprises, including small farmers, producers, artisans, tradespeople, and independent traders operating in the informal urban and rural sectors of the economy. Their demands for financial services are outside the purview of traditional commercial bank lending. For example, street vendors need short-term finance to buy inventories, small farmers require buffer loans to tide them over uncertain seasonal income fluctuations, and small-scale manufacturers need minor loans to purchase simple equipment or hire nonfamily workers. In such situations, traditional commercial banks are both ill equipped and reluctant to meet the needs of these small-scale borrowers. Because the sums involved are small (usually less than $1,000) but administration and carrying costs are high and also because few informal borrowers have the necessary collateral to secure formal-sector loans, commercial banks are simply not interested. Most don't even have branch offices in rural villages, small towns, or on the periphery of cities where many of the informal activities take place. Thus, most noncorporate borrowers have traditionally had to turn to family or friends as a first line of finance and then warily to local professional moneylenders, pawnbrokers, and tradespeople as a backup. These latter sources of finance are extremely costly—moneylenders, for example, can charge up to 20% *a day* in interest for short-term loans to traders and vendors. In the case of small farmers requiring seasonal loans, the only collateral that they have to offer the moneylender or pawnbroker is their land or oxen. If these must be surrendered in the event of a default, peasant farmers become rapidly transformed into landless laborers, while moneylenders accumulate sizable tracts of land, either for themselves or to sell to large local landholders.

Informal finance Loans and other financial services not passed through the formal banking system—for example, loans between family members.

A variety of forms of **informal finance** have emerged to replace the moneylender and pawnbroker in some instances.[17] These include local rotating savings and credit associations and group lending programs. In the case of

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rotating savings and credit associations (ROSCAs), which can be found in such diverse countries as Mexico, Bolivia, Egypt, Nigeria, Ghana, the Philippines, Sri Lanka, India, China, and South Korea, a group of up to 50 individuals selects a leader, who collects a fixed amount of savings from each member. This fund is then allocated (often randomly but frequently also sequenced through internal bidding) on a rotating basis to each member as an interest-free loan. ROSCAs enable people to buy goods without having to save the full amount in advance. With a ROSCA, individuals can make their planned purchases in half the time, on average. Many low-income people prefer to save and borrow this way, repayment rates are extremely high, and participation is very active. Noting that ROSCAs are often formed by married women, Siwan Anderson and Jean-Marie Baland have proposed that they serve another important purpose when wives' bargaining power in the family is otherwise limited. Because the funds made available through membership in the ROSCA cannot be drawn on until the wife wins a turn to receive the kitty, this restriction prevents her husband from demanding access to her growing savings for immediate consumption before enough has been saved to purchase her targeted item, such as a sewing machine.[18] Box 15.1 presents new findings on the surprisingly active financial lives of the poor.

Rotating savings and credit association (ROSCA) A group formed by formal agreement among 40 to 50 individuals to pool their savings and allocate loans on a rotating basis to each member.

Microfinance Institutions: How They Work

Microfinance is the supply of credit, saving vehicles, and other basic financial services made available to poor and vulnerable people who might otherwise have no access to them or could borrow only on highly unfavorable terms. *Microfinance institutions (MFIs)* specialize in delivering these services, in various ways and according to their own institutional rules.[19]

Microfinance Financial services, including credit, supplied in small allotments to people who might otherwise have no access to them or have access only on very unfavorable terms. Includes microsavings and microinsurance as well as microcredit.

In the case of village banking, or **group lending schemes**, a group of potential borrowers forms an association to borrow funds from a commercial bank, a government development bank, an NGO, or a private institution. The group then allocates the funds to individual members, whose responsibility is to repay the group. The group itself guarantees the loan to the outside lender; it is responsible for repayment. The idea is simple: By joining together, a group of small-scale borrowers can reduce the costs of borrowing and, because the loan is large, can gain access to formal commercial credit. With at least implicit joint liability, group members have a vested interest in the success of the enterprise and therefore exert strong pressure on borrowing members to repay on time. The evidence shows that repayment rates compare favorably with formal-sector borrowers. Many NGOs actively coordinate and sponsor this process.

Group lending scheme A formal arrangement among a group of potential borrowers to borrow money from commercial or government banks and other sources as a single entity and then allocate funds and repay loans as a group, thereby lowering borrowing costs.

Economic research has consistently found that availability of credit is a binding constraint for microenterprise development. A majority of microenterprises are operated by women. But lack of credit particularly, though certainly not exclusively, affects women (microentrepreneur) borrowers, for reasons ranging from lack of property rights to local cultural practices, but lack of collateral is arguably the most important. Let's look a little more closely at how this works.

Three related factors have made it difficult to relax credit constraints to low-income female microentrepreneurs. First, poor microentrepreneurs often have little or no collateral. Second, it is difficult for conventional lenders to determine borrower quality. Third, small loans are more costly to process per dollar lent.

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BOX 15.1 FINDINGS The Financial Lives of the Poor

Daryl Collins and her colleagues documented the surprisingly active household financial management of the poor. They interviewed 250 households every two weeks for a year, recording and compiling financial and spending behavior. They found a "triple whammy of incomes that are both low and uncertain, within contexts where the financial opportunities to leverage and smooth income to fit expenditure are extremely limited." Income of respondents was irregular and hard to predict, with few opportunities for insurance. "One of the least remarked-on problems of living on two dollars a day," the authors note, "is that you don't literally get that amount each day. The two dollars a day is just an average over time."

Assets are churning, with high flow into and out of debt and savings. This "cash flow intensity of income" meant that "in India, households shifted, on average, between 0.75 and 1.75 times their incomes.… In South Africa, the monthly turnover in cash flows was…about 1.85 times the monthly income." Even those receiving less than $1 a day do not consume all of it because of the dangers of living hand to mouth. Respondents save by hiding money at home, leaving it with a neighbor for safekeeping, paying into a burial society, giving credit to customers, paying down loans, buying life insurance, remitting cash home they later benefit from, and facing wage arrears. Often at the same time, they borrow by taking shop credit, benefiting from a relative's wage advances, going into rent arrears, getting interest-free loans from neighbors, taking informal loans with or without pawning, selling commitments of future labor, buying from small stores on credit, and topping up loans they otherwise pay down steadily. Over a year, "in Bangladesh the average number of different types of instruments was just under 10, in India just over eight, and in South Africa, 10." No household used fewer than four types.

Households use many techniques to agglomerate large sums (for them), including ROSCAs, informal savings clubs, simultaneous borrowing and saving, and commitment savings products. But the poor most commonly borrow from each other. The authors observed that small withdrawals were far more frequent than deposits into savings, and much more cash flowed into and out of loan balances, even though saving was ubiquitous. "For the poor households in our study the main strategy was to turn to each other, using one-on-one lending and borrowing between friends, family, and neighbors." Although such loans might look convenient and flexible, the authors noted that they lacked reliability, privacy, and transparency and had high transaction costs. Financial instruments were sometimes vaguely defined: In a striking example, money was "placed with" a neighbor. Was it a loan or a savings deposit? The placement could morph as needs changed. People living in poverty often prefer to borrow at high interest than to draw down savings, perhaps for self-motivation: Respondents report that with high interest, they know they will work hard to pay loans down quickly; they recall how difficult it has been for them to save.

The authors conclude that microfinance institutions can use the study's insights to improve the "portfolios of the poor" with new products to help households manage money on a day-to-day basis, build long-term savings, and enable borrowing for more uses. They can help by liberalizing and expanding their products, taking small-scale savings and making small loans for members on demand, expanding the term of commitment savings mechanisms, and allowing nonbusiness loans.

Source: Based on Daryl Collins, Jonathan Morduch, Stuart Rutherford, and Orlanda Ruthven, *Portfolios of the Poor: How the World's Poor Live on $2 a Day* (Princeton, N.J.: Princeton University Press, 2009).

Village banking seeks to solve these problems in part through the "collateral of peer pressure." Small microentrepreneurs are organized into credit cooperatives, to which seed capital is lent. In a traditional model, before qualifying for a loan, each member is required to identify several other members

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or potential members who are willing to cosign loans with them. Often, once a member of a cosigning group receives a loan, no other member may borrow until the first borrower has established a regular repayment record; and in any case, no repeat loans are approved until all members' accounts are satisfactorily settled. Progressively larger loans are approved as borrowers gain experience and a credit history and identify productive uses for larger loans. Members know the characters of the cosigning group members they select and may be expected to join groups with members whom they believe are likely to repay their loans. Thus, the banks make use of the information that is "embedded" in the village or neighborhood about who is a reliable and capable borrower, and induce villagers to reveal this information. At the same time, an implicit collateral is created by the pressure that members would be expected to exert on each member in the group to repay funds. The goodwill of these relatives and friends of the borrower represents part of the borrowers' capital, which failure to pay the loan puts at risk. Finally, village banks extensively use volunteer member labor (as traditional consumer cooperatives do), thus lowering the bank's effective costs. Bank members reveal by participating that the value of the time thus spent is less than the value of the enhanced credit. An example of an MFI that uses this joint liability model is FINCA International.

Another outstanding example of an MFI is the Grameen Bank in Bangladesh, examined as one of the two case studies at the end of Chapter 11. The Grameen Bank uses solidarity groups and takes advantage of opportunities for peer pressure by allowing increases in borrowing limits only if all members repay. But the Grameen Bank currently has no cosigning requirement.

Thus, joint liability can play a key role in lowering interest rates for microcredit borrowers, in some cases, by distinguishing the more creditworthy (reducing adverse selection) and by encouraging more diligent efforts to earn an adequate return and ensuring that borrowers do not feign bankruptcy or abscond (reducing moral hazard). This can be accomplished through either smaller solidarity groups or larger village banking groups. But joint liability also brings costs to borrowers, such as low flexibility, loss of social capital for default beyond a person's control, and peer pressure to undertake excessively risk-averse activities. However, with the increasingly common moves away from joint liability among microfinance institutions such as Grameen, it is clear that other microfinance strategies that do not rely on group lending are at work.

With "dynamic incentives," a microborrower is made eligible for a larger loan in the future if or he or she repays the current smaller loan; indeed, the threat to stop lending if the borrower does not repay can be effective in many circumstances. Another mechanism is the use of frequent repayment installments, even though the return on the investment may be generated over longer intervals. This can essentially tap into nonmicroenterprise household income flows or other borrowing sources that act as implicit guarantees of individual loans (or of group loans that are less than fully secure). Some NGOs use flexible collateral, accepting as a guarantee items that are valuable to the borrower even if they are not so valuable to the lender. Many NGOs use borrower groups for purposes other than joint liability: solidarity, sharing ideas, gaining information about borrower problems, facilitation of provision of other services (such as legal education), and informal pressure to repay. MFIs also publicize successes and failures at repayment to shame defaulters into repaying.

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Finally, NGOs particularly target women borrowers; doing so has development advantages, but practitioners also claim that women are more cautious in investments, more sensitive to public disclosure of default, more likely to help others in solidarity groups, less likely to have outside loan opportunities, and less likely to have outside job opportunities, all of which decrease the incentive to default even without actual joint liability; data show that MFIs with a higher fraction of women borrowers have higher repayment rates.[20]

The growth of microfinance has been dramatic—by one measure, topping 200 million borrowers by 2010—although since then, growth has stalled, at least temporarily, due to several factors. According to estimates by the Microcredit Summit Campaign, in 2011 the sector experienced its first outright decline in the number of borrowers in at least 14 years. About half the drop was attributed to a near collapse of the MFI sector in the Indian state of Andhra Pradesh, due to a combination of aggressive lending and collection practices by commercial MFIs, followed by a sweepingly punitive state government response that may have represented more politics than policy.[21]

Although the considerable success of informal finance programs is impressive, the fact remains that throughout the developing world, the majority of rural and urban poor have little or no access to formal credit. Until legal reforms are enacted, making it easier for small enterprises to gain access to the formal credit system, or more NGO- or government-supported credit programs are established to serve the needs of the noncorporate sector, the financial systems of most developing countries will remain unresponsive to the fundamental requirements of participatory national development.

MFIs: Three Current Policy Debates

Subsidies and MFIs One debate under way in the microenterprise credit community is whether subsidies are appropriate. Known as the "microfinance schism," the debate pits the Consultative Group to Assist the Poor (CGAP), a donor consortium headquartered within the World Bank, and other mainstream donors against some other nongovernmental organizations (NGOs) and academic economists. CGAP has essentially argued that one can reach more borrowers by requiring sustainability so that available dollars go further. This argument is reasonable as far as it goes, but, in general, the poorest borrowers may not be able to afford to pay the high interest rates that this would require with the business opportunities they realistically face. Put more precisely, the interest elasticity of the demand for credit on the part of the poor is not close to zero. And the poor generally lack opportunities to invest in high-return projects. Thus, some subsidy is generally required to truly reach the poorest current and potential microentrepreneurs.[22]

But even subsidized credit is no guarantee of higher productivity and incomes. Some studies have suggested that the poorest of the poor may not be made better off by village banking or other MFI programs and indeed may be made worse off if they take on additional debt that is for them unproductive but for which they must pay interest. Of course, it will be essential to ensure that these subsidized credit programs are run efficiently, that the credit is allocated to appropriate investments, and that credit actually ends up in the hands of poor households.

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Bundled Poverty Services: Microfinance Plus In this regard, a second debate concerns whether to combine microfinance with other programs. Proponents argue that it may be useful to tie credit to social services that are demanded only by the poor and inherently require time for participation, for at least three reasons. First, such required participation can act as a kind of screening mechanism to ensure that nonpoor borrowers are not taking advantage of a subsidy that is not intended for them (analogous to workfare screening, described in Chapter 5). Second, the poor generally cannot make adequate use of business credit without sufficient health and education. There is usually at least some subsidy in programs that offer health or educational services along with credit. Third, many of the poor appear not to recognize the importance of human capital, and the availability of credit may act as a "hook" to get them enrolled in health and education programs. But it may be less costly to keep these programs separate, in accordance with the varying comparative advantage of different NGOs, and some low-income borrowers do not need these services. Accordingly, there is a growing debate in the microfinance community over whether to integrate credit with education, health, or other programs.[23] A study of a program combining microfinance with basic business training shows it may be cost-effective (see Box 15.2). BRAC, the acclaimed NGO examined in the case study in Chapter 11, provides the classic example of a broader, integrated approach with its Microcredit-Plus program.

The Commercialization Debate A third ongoing debate, related to the first two debates, is whether MFIs should undergo **commercialization**, whereby a (not-for-profit) NGO providing microfinance is converted into a for-profit bank. This movement was particularly pronounced in the mid-2000s. Advantages include the fact that the MFI becomes regulated as a bank and so can legally or formally accept savings deposits as well as disburse loans; and that the MFI acquires the discipline of the market and an added incentive to cut costs and expand its scale. Commercialization also furthers the key objective of some in the microfinance sector to make use of MFIs as a vehicle to develop the overall financial system. Disadvantages include the problem that people living in poverty become considered, in some cases, too expensive to serve, or, if they are served, very high interest rates will be charged and aggressive tactics may be used to collect funds. Note that there are some frequently overlooked alternatives, in that to be regulated and accept deposits does not imply a requirement to be a for-profit corporation in most legal systems; for example, the Grameen Bank is a credit union that is mostly owned by its borrowers. Although conversion to, and entry of, for-profit MFIs has become a major trend, most likely microfinance will proceed on multiple tracks, with profit-making or perhaps other commercialized institutions serving those above or close to the poverty line; NGOs providing microcredit to the poor who run a microenterprise with possible subsidies, including external payment of staff time; and transitional services for the ultrapoor who are not ready to run a microenterprise for which credit would be beneficial, but may become so. Ultimately, all people will need financial services, but probably only a minority will need or want a loan to expand a microenterprise or small business. But until regular employment becomes much more widely available as a pathway out of poverty, credit for microenterprises will play a vital role.

Commercialization A process whereby an NGO (a not-for-profit organization) providing microfinance is converted into a for-profit bank.

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BOX 15.2 FINDINGS Combining Microfinance with Training

A 2011 study of FINCA international in Peru by Dean Karlan and Martin Valdivia measured the impact of adding business training to a microcredit program for female microentrepreneurs. Some microcredit solidarity groups were randomly selected to receive 30 to 60 minutes of entrepreneurship training during regular weekly or monthly banking meetings. The training period lasted one to two years. Comparison groups continued to meet as often as the groups that got the training, but only to make loan repayments and savings deposits. The researchers found that the entrepreneurship training led to improved business knowledge, better business practices, and higher microenterprise income. The trained microentrepreneurs reported they engaged more in business activities taught in the training, particularly in "separating money between business and household, reinvesting profits in the business, maintaining records of sales and expenses, and thinking proactively about new markets and opportunities for profits." They also found that there was a positive impact on loan repayment rates and member retention, which had a big enough impact on the banks' performance to effectively pay for the training. This study sheds light on whether basic entrepreneurship skills can be taught or are fixed personal characteristics perhaps due to genetics or early childhood experiences. The answer appears to be that the poor can learn business acumen. In fact, the larger changes in behavior—in adopting the training, increasing repayment rates, and staying longer with the bank—were found among clients who were initially more skeptical about the value of the training.

Source: Based on Dean Karlan and Martin Valdivia, "Teaching entrepreneurship: Impact of business training on microfinance clients and institutions," *Review of Economics and Statistics* 93, No. 2 (2011): 510–527.

Potential Limitations of Microfinance as a Development Strategy

Microfinance has some potentially important limitations. Microcredit was first conceived and is still largely marketed as financing for microenterprises, but most people probably prefer a regular wage and salary to running a risky microenterprise. Although systematic evidence is lacking, interviews with factory workers in developing countries such as Peru and Bangladesh suggest that many are former microentrepreneurs who gave up their enterprises in favor of a regular job. Most people are willing to pay for insurance, and a predictable wage offers insurance against the vagaries of microenterprise proceeds. Typically, even laid-off professionals in rich countries go into self-employment only until they can find a suitable replacement job. Thus, the primary problem may be the lack of available jobs paying a steady wage or salary—a problem compounded further when custom still prevents women from taking on outside employment that becomes available.[24] To this extent, microcredit, as classically conceived, may prove to be in large measure a "transitional institution." A related concern is that few microentrepreneurs ever grow sufficiently to become bona fide small or medium-size enterprises (SMEs). BRAC found that most borrowers from its SME facility were middle-class entrepreneurs, rather than graduates from its microfinance activities. Of course, people will always need other forms of financial intermediation such

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as savings accounts, housing mortgages, and consumption loans. And some microenterprises will go on to generate additional employment.

On the one hand, much funding for microfinance follows from the belief in its value as a poverty alleviation strategy, but the poor face many problems, some of which cannot be solved solely by relaxing credit constraints. With an already sizable fraction of public, philanthropic, and NGO activities geared to microfinance, it is plausible that other activities, such as agricultural training, could become relatively underfunded as a result. On the other hand, some leading practitioners argue that the real purpose of MFIs is not to decrease poverty but to stimulate a better financial system (and hopefully to reduce poverty more indirectly). This is a worthy goal, but microfinance development is not the only way to achieve it. Improved systems for regulation and oversight, upgrading the financial system safety net, training of government financial officials, better tax collection to lower fiscal deficits, focusing financial services on the SME sector, and facilitating participation by foreign banks can all make plausible claims as more cost-effective strategies for improving the functioning of the financial system per se. Microfinance has several worthy purposes, and subsidies may help address market failures and poverty problems, but it cannot be assumed that microfinance is the most effective way to spend scarce poverty reduction funds before a careful analysis of the comparative impacts of alternative activities has been undertaken.

Debate continues over whether a positive impact of microfinance on poverty reduction and household well-being can be established, including a controversy over studies of the Grameen Bank, with some studies finding positive impacts and others finding no impact.[25]

The performance of MFIs may vary substantially, depending on local conditions. In a 2011 cross-country comparison, Christian Ahlin and his coauthors found, among other results, that "MFIs are more likely to cover costs when growth is stronger; and MFIs in financially deeper economies have lower default and operating costs, and charge lower interest rates." In a finding that may be related to preferences for jobs, they also found that "more manufacturing and higher workforce participation are associated with slower growth in MFI outreach." Thus, one implication is that relative MFI performance should be evaluated in the context of local conditions.[26]

In sum, microfinance *is* a powerful tool, but it needs to be complemented with other growth, poverty reduction, financial-sector development, human capital, infrastructure building, and—last but by no means least—conventional job creation policies. In the meantime, hundreds of millions of people depend, in part, on microenterprises, so helping them to become more efficient is an important objective; and the provision of lending, saving, and insurance services can provide broad benefits for people living in poverty.

15.4 Formal Financial Systems and Reforms

Financial Liberalization, Real Interest Rates, Savings, and Investment

The restriction of loans to a few large borrowers, together with the widespread existence of high inflation, growing budget deficits, and negative real interest

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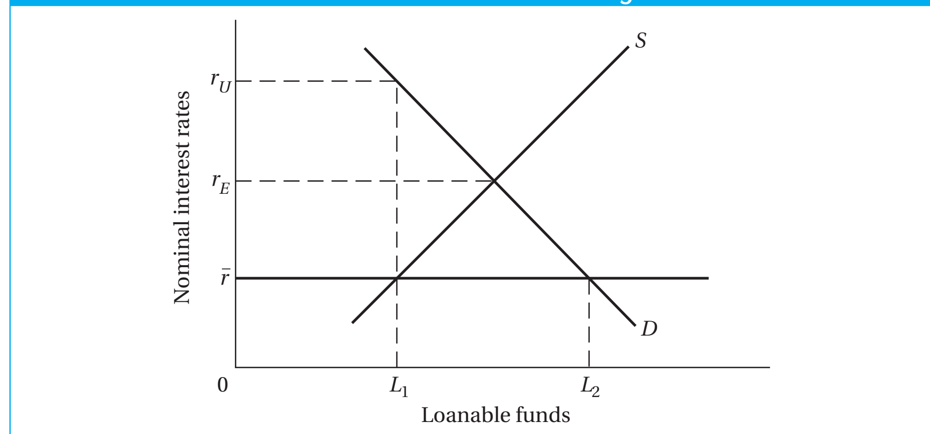
rates, led to a serious "credit crunch" among developing countries during the 1980s. The global recessions of 1981–1982 and 1987 exposed the frailty of many development bank loans so that by the end of the decade, almost half of these banks were reporting 50% or more of their loans in arrears and another quarter had delinquency rates in excess of 25%. With real interest rates on savings deposits in the negative and expectations of continued inflation and exchange-rate devaluation contributing to substantial capital flight, it was not surprising that few individuals were willing to save.

In addition, commercial banks and other financial intermediaries were subject to numerous lending restrictions and faced mandatory interest-rate ceilings on loanable funds at levels well below market-clearing rates.[27] These artificial interest-rate ceilings were often set by governments seeking to finance their budget deficits through the sale of low-interest bonds to private commercial banks. These banks, in turn, had to resort to **rationing** the available credit beyond the normal credit rationing observed in developed economies as a response to adverse selection. Figure 15.1 shows the impact of binding nominal interest-rate ceilings at below-market-clearing levels. With the interest-rate ceiling at $\bar{r}$, which is below the market-clearing equilibrium rate, r_E, the demand for loanable funds, L_2, greatly exceeds the available supply, L_1. This excess demand leads to a need to ration the limited supply—a phenomenon known as **financial repression** because investment is limited or "repressed" by a shortage of savings, which, in turn, results from administered real interest rates below what would occur in a market setting. In the absence of outright corruption in the allocation of L_1 loanable funds, most commercial banks choose to allocate the available credit to a few large-scale borrowers so as to minimize the administrative overhead costs as a proportion of the total costs of lending. Thus, the net effect of government controls over lending rates is that even fewer loans will be allocated to small investors. Banks can cover the additional administrative costs and the added risks of smaller loans only by charging higher interest rates. Hence, small farmers and urban entrepreneurs have no recourse but to seek finance from the unorganized money market, where, as we see from Figure 15.1, they are willing to pay above-market-clearing rates of r_U.

Rationing A system of distribution employed to restrict the quantities of goods and services that consumers or producers can purchase or be allocated freely in the face of excess demand and inflexible prices; can be accomplished with coupons, points, limits on who can borrow, administrative decisions with regard to commodities, industrial licenses for the importation of capital goods, and the like.

Financial repression Constraints on investment resulting from the rationing of credit, usually to a few large-scale borrowers, in financial markets where interest rates and hence the supply of savings are below market-determined levels.

FIGURE 15.1 The Effects of Interest-Rate Ceilings on Credit Allocation



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One suggested solution to the problem is to liberalize the financial sector by allowing nominal interest rates to rise to market-clearing levels. This would cause real interest rates to rise to positive levels and thus remove the explicit interest-rate subsidy accorded to preferred borrowers (rent seekers) who are powerful enough to gain access to the rationed credit. Higher real rates should also generate more domestic saving and investment and permit some borrowers to shift from the unorganized to the organized credit market. The World Bank cites evidence from countries such as Thailand, Turkey, and Kenya, where the liberalization of interest rates generates more saving and investment. However, evidence of the effects of financial reform in Chile during the 1970s revealed many shortcomings of the process. These included the acquisition of numerous banks by large conglomerates, or *grupos*, who used their new financial resources to buy recently privatized firms or to expand their own companies. When many of their firms faced financial losses, these *grupos* had to resort to additional funding to avoid bankruptcy. This made the Chilean financial system particularly vulnerable when the debt crisis struck in the 1980s.[28]

Reform and liberalization of the organized money sector is therefore no panacea for the financial systems of developing nations. The early success of South Korea and Taiwan (and before them, Japan) with financial systems that exhibited many of the attributes of repression demonstrates that judicious and selective government intervention can be a stimulus to industrial development. Although there is some evidence that the elimination of substantial interest-rate distortions can promote greater saving and more rapid economic growth, findings have been mixed.[29] Financial reform must always be accompanied by other more direct measures to make sure that small farmers and investors have access to needed credit. Furthermore, as shown in the next section, careful supervision of the banking and financial sectors is needed to prevent undue concentration by local elites. As we have already pointed out in this text, "getting prices right" is only one step, albeit an important one, in making development serve the needs of the forgotten majority.

Financial Policy and the Role of the State

Does financial liberalization mean that governments in developing countries have no role to play in the financial sector? In an effort to identify how these governments can work effectively within the context of liberalized financial markets, the 2001 Nobel laureate Joseph Stiglitz and his coauthors isolated seven major market failures that imply a potential role for state intervention.[30] His basic argument is "that financial markets are markedly different from other markets," "that market failures are likely to be more pervasive in these markets," and that "much of the rationale for liberalizing financial markets is based neither on a sound economic understanding of how these markets work nor on the potential scope for government intervention."[31] The seven market failures that Stiglitz and colleagues identified and that are likely to be of particular relevance to developing countries are the following:

1. *The "public good" nature of monitoring financial institutions.* Investors need information about the solvency and management of financial institutions. Like other forms of information, monitoring is a public good—everyone

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who places savings in a particular financial institution would benefit from knowing that the institution was prospering or close to insolvency. But like other public goods in free-market economies, there is an undersupply of monitoring information, and consequently, risk-averse savers withhold their funds. The net result is fewer resources allocated through these institutions.

2. *Externalities of monitoring, selection, and lending.* Benefits are often incurred by lenders who learn about the viability of potential projects from the monitoring, selection, and lending decisions of other lenders. Investors can also benefit from information generated by other investors on the quality of different financial institutions. Like other positive (or negative) externalities, the market provides too little information, and resources are underallocated or overallocated.
3. *Externalities of financial disruption*. In the absence of government insurance (whether or not an explicit policy has been issued), the failure of one major financial institution can cause a run on the entire banking system and lead to long-term disruptions of the overall financial system.
4. *Missing and incomplete markets.* In most developing countries, markets for insurance against a variety of financial (bank failure) or physical (e.g., crop failure) risks are missing. The basic problem is that information is imperfect and costly to obtain, so a developing-country government has an important role in reducing these risks. It can, for example, force membership in insurance programs or require financial institutions as well as borrowers to disclose information about their assets, liabilities, and creditworthiness.
5. *Imperfect competition.* Competition in the banking sector of most developing countries is extremely limited, meaning that potential borrowers usually face only a small number of suppliers of loanable funds, many of which are unwilling or unable to accommodate new and unknown customers. This is particularly true of small borrowers in the informal urban and rural sectors.
6. *Inefficiency of competitive markets in the financial sector.* Theoretically, for perfectly competitive markets to function efficiently, financial markets must be complete (without uninsured risks) and information must be exogenous (freely available to all and not influenced by any one participant's action in the market). Clearly, there are special advantages to individuals or entities with privileged information in financial markets in developing countries, and risk insurance is difficult, if not impossible, to obtain. As a result, unfettered financial markets may not allocate capital to its most profitable uses, and there can be substantial deviations between social and private returns to alternative investment projects. In such cases, direct government intervention—for example, by restricting certain kinds of loans and encouraging others—may partly or completely offset these imbalances.
7. *Uninformed investors.* Contrary to the doctrine of consumer sovereignty, with its assumption of perfect knowledge, many investors in developing countries lack both the information and the appropriate means to acquire it in order to make rational investment decisions. Here again, governments

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can impose financial disclosure requirements on firms listed on local stock exchanges or require banks, for example, to inform customers of the differences between simple and compound interest rates or of the nature of penalties for early withdrawals of savings.

In each of these seven instances, Stiglitz and his coauthors argue, governments have a proper role to play in regulating financial institutions, creating new institutions to fill gaps in the kinds of credit provided by private institutions (e.g., microloans to small farmers and tradespeople), providing consumer protection, ensuring bank solvency, encouraging fair competition, and ultimately improving the allocation of financial resources and promoting macroeconomic stability.

As in other areas of economic development, the critical issue for financial policy is not about free markets versus government intervention but rather about how both can work together (along with the NGO sector) to meet the urgent needs of poor people.

Debate on the Role of Stock Markets

Recent years have witnessed enormous growth in developing countries' stock markets. This has resulted in costs as well as benefits for development. It has increased volatility in the economy as funds have flowed in from abroad and even more dramatically flooded out. In this section, we take a look at stock markets in developing countries and consider some proposed policies to get the most benefits from these markets. We also consider some of the limitations of depending too heavily on stock markets as an engine of growth.

Some studies have suggested that stock market development can play a highly constructive role in encouraging growth. These studies show that greater past stock market development (measured by either past capitalization or turnover in relation to gross domestic product, or GDP) predicts faster subsequent economic growth, even after other variables known to influence growth, such as the rate of investment and education, are accounted for. Even more striking, both banking and stock market development were found to have independent positive effects on growth, suggesting that each plays a somewhat different role in the economy. A correlation between stock market development and growth would be expected by many theories, including the view that finance follows industry. Therefore, industrial growth and stock market growth would occur together, but in that case, stock market growth would merely reflect the growth of the real sector. The fact that there is faster growth after greater stock market development has already been realized is suggestive of causality but is not conclusive. This is because past financial depth is correlated with future depth: Countries that had well-developed stock markets in the past usually do in the future as well. So the correlation between growth and past depth could really be driven by a third factor, such as the protection of private property and the rule of law. However, the results suggest that stock markets do have a role to play. Moreover, we can expect that stock markets promote the more general availability of liquidity and risk diversification services, may serve to motivate entrepreneurs who may later go public, and provide incentives for managerial performance that make it easier for firms to raise capital in any form.[32]

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The question, then, is, should government do anything to develop and promote such markets, given the remaining uncertainty about the importance of their role? It makes no sense to actively develop stock markets unless certain prerequisites are met. First, one needs macrostability; investors will not invest in equity without it. Second, policy credibility is needed. How will policymakers keep the economy stabilized, and how will they react in a financial crisis to prevent a meltdown? And third, one needs a solid domestic-firm base; there is no point to opening a stock market if there are few firms in which outside investors would wish to take an equity stake.

Given that these prerequisites are in place, it is reasonable to wonder why a country would need to promote stock markets; wouldn't these markets develop as a result of market forces? One rationale for a public policy promoting the development of stock markets could be to balance the effective tilt toward debt finance that is implicit in policy to date (for example, public deposit insurance, while clearly necessary, functions like an interest subsidy, which tilts the playing field away from equity markets). Although evidence of spillovers or other special benefits for the promotion of stock market development is probably not enough to make a case for public subsidies to create and expand stock markets, in many countries policymakers may conclude that the evidence is compelling enough to eliminate bias, explicit or implicit, that has operated against stock markets in the past.

In this regard, the first type of stock market development policy could be termed *barrier removal*. Rather than promoting stock markets directly, let alone subsidizing their development, this strategy would remove other impediments, generating stock market development on its own. In practice, this usually entails certain forms of deregulation. One must be careful here because, as seen earlier in the chapter, many regulations were put in place, not necessarily because there was government failure, but because of genuine market failure in the financial sector. If some regulations responding to market failure are removed, others may have to be established in their place.

However, certain regulations probably do have the effect of retarding the development and expansion of the stock market. Prime examples are capital repatriation legislation that strongly limits the amount of profit that foreign investors can take out of a country, the existence of restrictions on investing directly, restrictions on foreign broker participation, entry restrictions on investment banking and brokering that are not rational or that encourage rent seeking, and the failure to ensure that regulations are transparent and evenly applied. Changing such regulations has potential costs as well as benefits and should be undertaken carefully.

There are other significant problems with relying too strongly on stock markets as a development strategy. First, stock markets lead to substantial foreign-investor influence over domestic-company operations. In developing countries, a large percentage of shares of listed companies are usually foreign owned. Second, stock markets can lead to short-term speculation that can dominate trading and distort the decision making of managers, often inducing a short time horizon. Third, relatedly, "hot money" that flows in and out of a country to speculate in markets can produce wide currency swings and destabilize the economy.

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Many questions remain regarding the role of financial intermediation, in general, and stock markets, in particular, in economic development. This is sure to be an active area of policy discussion in the years ahead.

15.5 Fiscal Policy for Development

Macrostability and Resource Mobilization

Financial policy deals with money, interest, and credit allocation; fiscal policy focuses on government taxation and expenditures. Together they represent the bulk of public-sector activities. Most stabilization attempts have concentrated on cutting government expenditures to achieve budgetary balance. But the burden of resource mobilization to finance essential public developmental efforts must come from the revenue side. Public domestic and foreign borrowing can fill some savings gaps. In the long run, it is the efficient and equitable collection of taxes on which governments must base their development aspirations.[33] In the absence of well-organized and locally controlled money markets, most developing countries have had to rely primarily on fiscal measures to stabilize the economy and to mobilize domestic resources.

Taxation: Direct and Indirect

Developed countries of the Organization for Economic Cooperation and Development (OECD) collect a much higher percentage of GDP in the form of tax revenue than developing countries do, as can be seen in Table 15.2. According to a 2000 IMF study, in the period 1995–1997, developing countries collected 18.2% of GDP in tax revenues, while OECD countries collected more than double this share, 37.9%. Developed countries may have a higher demand for public expenditures and also a greater capacity to generate tax revenue, and thus, the causality likely runs in large part from greater development

TABLE 15.2 Comparative Average Levels of Tax Revenue, 1985–1997, as a Percentage of GDP

Country Groups	1985–1987	1995–1997
OECD Countries	**36.6**	**37.9**
America	30.6	32.6
Pacific	30.7	31.6
Europe	38.2	39.4
Developing Countries	**17.5**	**18.2**
Africa	19.6	19.8
Asia	16.1	17.4
Middle East	16.5	18.1
Western hemisphere	17.6	18.0

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to higher tax levels. But to the degree that government resources are spent wisely, such as on human capital and needed infrastructure investments, some of the causality may run the other way as well.

Direct taxes Taxes levied directly on individuals or businesses—for example, income taxes.

Indirect taxes Taxes—including customs duties (tariffs), excise taxes, sales taxes, value-added taxes (VATs), and export duties—levied on goods purchased by consumers and exported by producers.

Typically, **direct taxes**—those levied on private individuals, corporations, and property—make up 20 to 40% of total tax revenue for most developing economies. **Indirect taxes**, such as import and export duties, value-added taxes (VATs), excise taxes, and sales taxes, constitute the primary source of fiscal revenue for most developing countries.

As can be seen in Table 15.3, developed OECD countries generally rely more strongly on direct taxes, but this pattern is much less pronounced in Europe, where reliance on indirect taxes is almost as great as on direct taxes. It is not clear whether direct or indirect taxation is better for economic development because their impact on critically important human capital accumulation is so complex. Avoiding extreme overreliance on any one form of taxation is a reasonable approach, given the current state of knowledge.[34]

Regions and nations in the developing world also differ substantially in their rates of tax collection. For example, as of 2011, countries in South Asia collect (collected) very low levels of tax revenue, which is about 10 to 15% of GDP, in comparison with approximately 20% in otherwise comparable developing economies.[35]

The tax systems (direct and indirect taxes combined) of many developing countries are far from progressive. In some, such as Mexico, they can be highly regressive (meaning that lower-income groups pay a higher proportion of their income in taxes than higher-income groups).

The tax system is often used as an instrument for influencing the incentives for the private sector to undertake investment in various activities, such as to implement industrial policy of the type examined in Chapter 12, section 12.6. The main purpose of taxation is the mobilization of resources to finance public expenditures. Whatever the prevailing political or economic ideology of the less developed country, its economic and social progress depends largely on its government's ability to generate sufficient revenues to finance an expanding program of essential, non-revenue-yielding public services—health, education, transport, legal and other institutions, poverty alleviation, and other components of the economic and social infrastructure.

Many developing countries face problems of large fiscal deficits—public expenditures greatly in excess of public revenues—resulting from a combination of ambitious development programs and unexpected negative external shocks. With rising debt burdens, falling commodity prices, growing trade imbalances, and declining foreign private and public investment inflows, developing-country governments have had little choice but to undergo severe fiscal retrenchment. This has meant cutting government expenditures (mostly on social services) and raising revenues through increased or more efficient tax collections.

In general, the taxation potential of a country depends on five factors:

1. The level of per capita real income
2. The degree of inequality in the distribution of that income
3. The industrial structure of the economy and the importance of different types of economic activity (e.g., the importance of foreign trade, the

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significance of the modern sector, the extent of foreign participation in private enterprises, the degree to which the agricultural sector is commercialized as opposed to subsistence oriented)

4. The social, political, and institutional setting and the relative power of different groups (e.g., landlords as opposed to manufacturers, trade unions, village or district community organizations)
5. The administrative competence, honesty, and integrity of the tax-gathering branches of government

We now examine the principal sources of direct and indirect public tax revenues. We can then consider how the tax system might be used to promote a more equitable and sustainable pattern of economic growth.

Personal Income and Property Taxes Personal income taxes yield much less revenue as a proportion of GDP in less developed than in more developed nations. In the latter, the income tax structure is said to be progressive: People with higher incomes theoretically pay a larger percentage of that income in taxes.

It would be administratively too costly and economically regressive to attempt to collect substantial income taxes from the poor. But the fact remains that most governments in developing countries have not been persistent enough in collecting taxes owed by the very wealthy. Moreover, in countries where the ownership of property is heavily concentrated and therefore represents the major determinant of unequal incomes (e.g., most of Asia and Latin America), property taxes can be an efficient and administratively simple mechanism both for generating public revenues and for correcting gross inequalities in income distribution. But in a World Bank survey, in only one of the 22 countries surveyed did the property tax constitute more than 4.2% of total public revenues. Moreover, in spite of much public rhetoric about reducing income inequalities, the share of property taxes as well as overall direct taxation has remained roughly the same for the majority of developing countries over the past two decades. Clearly, this phenomenon cannot be attributed to government tax-collecting inefficiencies as much as to the political and economic power and influence of the large landowning and other dominant classes in many Asian and Latin American countries. The political will to carry out development plans must therefore include the will to extract public revenue from the most accessible sources to finance development projects. If the former is absent, the latter will be too.[36]

Corporate Income Taxes Taxes on corporate profits, of both domestically and foreign-owned companies, amount to less than 3% of GDP in most developing countries, compared to more than 6% in developed nations. Developing-country governments tend to offer a wide variety of tax incentives and concessions to manufacturing and commercial enterprises. Typically, new and foreign enterprises are offered long periods (sometimes up to 15 years) of tax exemption and thereafter take advantage of generous investment depreciation allowances, special tax write-offs, and other measures to lessen their tax burden. In the case of multinational foreign enterprises, the ability of governments in most developing countries to collect substantial taxes is often

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frustrated. These locally run enterprises are frequently able to shift profits to partner companies in countries offering the lowest levels of taxation through transfer pricing (discussed in Chapter 14). Some developing countries use such tax breaks more sparingly and strategically, however.

Indirect Taxes on Commodities The largest single source of public revenue in developing countries is the taxation of commodities in the form of import, export, and excise duties (see Table 15.3). These taxes, which individuals and corporations pay indirectly through their purchase of commodities, are relatively easy to assess and collect. This is especially true in the case of foreign-traded commodities, which must pass through a limited number of frontier ports and are usually handled by a few wholesalers. The ease of collecting such taxes is one reason why countries with extensive foreign trade typically collect a greater proportion of public revenues in the form of import and export duties than countries with limited external trade. For example, in open economies with up to 40% of gross national income (GNI) derived from foreign trade, an average import duty of 25% will yield a tax revenue equivalent of 10% of GNI. By contrast, in countries with only about 7% of GNI derived from exports, the same tariff rate would yield only 2% of GNI in equivalent tax revenues. Although we discussed import and export duties in the context of trade policies in Chapter 12, we amplify that import and export duties, in addition to representing a major source of public revenue in many developing countries, can also be a substitute for the corporate income tax. To the extent that importers are unable to pass on to local consumers the full costs of the tax, an import duty can serve as a proxy tax on the profits of the importer (often a foreign company) and only partly a tax on the local consumer. Similarly, an export duty can be an effective way of taxing the profits of producing companies, including locally based multinational firms that practice transfer pricing. But export duties designed to generate revenue should not be raised to the point of discouraging local producers from expanding their export production to any significant extent.

In selecting commodities to be taxed, whether in the form of duties on imports and exports or excise taxes on local commodities, certain general economic and administrative principles must be followed to minimize the cost of securing maximum revenue. First, the commodity should be imported or produced by a relatively small number of licensed firms so that evasion can be controlled. Second, the price elasticity of demand for the commodity should be low so that total demand is not choked by the rise in consumer prices that results from the tax. Third, the commodity should have a high income elasticity of demand so that as incomes rise, more tax revenue will be collected. Fourth, for equity purposes, it is best to tax commodities like cars, refrigerators, imported fancy foods, and household appliances, which are consumed largely by the upper-income groups, while forgoing taxation on items of mass consumption such as basic foods, simple clothing, and household utensils, even though these may satisfy the first three criteria.

Value-added tax (VAT) Levy on value added at each stage of the production process.

The conventional wisdom in recent years has been that switching to a broad-based **value-added tax (VAT)** would improve economic efficiency; encouraged by development agencies, such tax reforms have accordingly been undertaken in many developing countries. However, this approach has been challenged recently. In particular, welfare may be worsened when the ability

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TABLE 15.3 Comparative Composition of Tax Revenue, 1985–1997, as a Percentage of GDP

Country Groups	1985–1987								1995–1997							
	Income Taxes			Consumption Taxes				Social Security	Income Taxes			Consumption Taxes				Social Security
	Total	Corporate	Personal	Total	General	Excises	Trade		Total	Corporate	Personal	Total	General	Excises	Trade	
OECD Countries	**13.9**	**2.8**	**11.3**	**11.3**	**6.0**	**3.8**	**0.7**	**8.8**	**14.2**	**3.1**	**10.8**	**11.4**	**6.6**	**3.6**	**0.3**	**9.5**
America	14.0	2.5	11.4	7.6	3.4	2.2	0.6	5.8	15.4	3.0	12.3	7.0	3.7	2.0	0.3	6.1
Pacific	17.1	3.9	13.2	7.5	2.3	3.7	0.8	2.8	16.3	4.3	11.4	8.4	4.3	2.6	0.6	3.5
Europe	13.3	2.7	11.0	12.4	6.8	4.0	0.7	10.1	13.7	2.9	10.6	12.4	7.3	4.0	0.3	10.8
Developing Countries	**4.9**	**2.8**	**1.7**	**10.3**	**2.3**	**2.6**	**4.2**	**1.2**	**5.2**	**2.6**	**2.2**	**10.5**	**3.6**	**2.4**	**3.5**	**1.3**
Africa	6.3	2.9	3.1	11.7	3.2	2.3	5.7	0.4	6.9	2.4	3.9	11.6	3.8	2.3	5.1	0.5
Asia	5.7	3.5	2.1	9.5	1.9	2.5	3.6	0.1	6.2	3.0	3.0	9.7	3.1	2.2	2.7	0.3
Middle East	4.7	4.3	1.0	9.1	1.5	2.4	4.4	1.2	5.0	3.2	1.3	10.3	1.5	3.0	4.3	1.1
Western hemisphere	3.7	1.8	1.0	10.6	2.6	3.0	3.7	2.4	3.7	2.3	1.0	10.6	4.8	2.3	2.6	2.5

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of the informal economy to remain effectively untaxed introduces new distortions in the economy.[37]

Problems of Tax Administration In the final analysis, a developing nation's ability to collect taxes for public expenditure programs and to use the tax system as a basis for modifying the distribution of personal incomes will depend not only on the enactment of appropriate tax legislation but also on the efficiency and integrity of the tax authorities who must implement these laws. In other words, as Joel Slemrod has put it, we must consider "optimal tax systems" rather than "optimal taxes" in the abstract. Thus, the "technology of tax collection" must be considered, which includes the cost of tax administration and enforcement of compliance.[38]

The ability of governments in developing countries to expand their tax nets to cover the higher-income groups and minimize tax evasion by local and foreign individuals and corporations will largely determine the efficiency of the tax system in achieving its dual function of generating sufficient public revenues to finance expanding development programs and preventing an undue burden on lower-income groups in order to reduce poverty and income inequality. Much will depend, once again, on the political will to enact and enforce such progressive tax programs.[39]

15.6 State-Owned Enterprises and Privatization

State-owned enterprises (SOEs) Public corporations and parastatal agencies (e.g., agricultural marketing boards) owned and operated by the government.

Associated with the problems of public administration in developing countries have been the widespread activities of **state-owned enterprises (SOEs)**, public corporations owned and operated by the government. In addition to their traditionally dominant presence in utilities (gas, water, and electricity), transportation (railroads, airlines, and buses), and communications (telephone, telegraph, and postal services), SOEs have been active in such key sectors as large-scale manufacturing, construction, finance, services, natural resources, and agriculture. Sometimes they may dominate these sectors, particularly in the areas of natural resources and manufacturing. Despite extensive privatization (described later in the chapter) in Latin America and Eurasia and of smaller SOEs in most countries, state ownership of enterprises remains common, and SOEs account for a substantial share of investment and industrial output in many developing nations, notably in China and India, and in the least developed countries.[40]

SOEs have played a major role in the economies of developing nations, historically contributing an average of 7 to 15% of their GDP. In addition, SOEs account for a substantial amount of investment in developing countries, contributing up to one-fifth of gross domestic investment.

Given the strategic role that state-owned enterprises play in the economies of developing countries and their demands on scarce resources, it is important to understand the reasons for their creation and the measures that might be undertaken to improve their efficiency and to help them meet their economic and social objectives.

Some of the rationale for the creation of SOEs were suggested in Chapter 11. One is the persistence of monopoly power in many developing countries. Direct

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government control has been intended to ensure that prices are not set above the marginal costs of producing the output. Moreover, as was also mentioned, certain goods that have a high social benefit are usually provided at a price below their costs or even free; hence, the private sector has no incentive to produce such goods, and the government must assume responsibility for their provision.

The second rationale for the creation of SOEs is capital formation, which is particularly important at the early stages of development, when private savings are very low. Investment in infrastructure at this point is crucial, to lay the groundwork for further investment. And SOEs remain important at later stages in industries that require massive funds.

The lack of private incentives to engage in promising economic activities because of factors such as uncertainty about the size of local markets, unreliable sources of supply, and the absence of technology and skilled labor is a third major rationale for creating public enterprises. Governments in developing countries may also seek to expand employment and facilitate training of their labor force by engaging in public production. They may desire to increase export earnings by creating export industries, particularly those that might otherwise be unable to compete. For reasons of income distribution, the government may seek to locate enterprises in certain regions, particularly in backward economic areas where there are no private incentives for creating such economic activities.

Other reasons for the creation of SOEs include the desire of some governments to gain national control over strategic sectors of the economy, such as defense, over foreign-owned enterprises (MNCs) whose interests may not coincide with those of the country, or over key sectors for development purposes. Government involvement may also come about as a result of bankruptcy in a major private industry. Ideological motivations may be an additional factor in the creation of state-owned enterprises.

Improving the Performance of SOEs

Despite these arguments, SOEs have come under sustained attack for wasting resources. SOEs make significant demands on government finance, as well as on domestic and foreign credit. In many cases, the level of these demands is related to low profitability and inefficiency. Although it is difficult to generalize across countries, data from the World Bank for state-owned enterprises in 24 developing countries revealed only a small operating surplus.[41] And once factors such as interest payments, subsidized input prices, and taxes and accumulated arrears were taken into account, SOEs in many of these countries showed a large deficit. Turkish enterprises averaged net losses equivalent to 3% of GDP. Mexican SOEs showed a net loss of 1.2% of GDP. A study of SOEs in four African countries (Ghana, Senegal, Tanzania, and Zambia) also revealed generally poor performance. Operating at a deficit, they proved to be a massive drain on government resources. There was also evidence that labor and capital productivity were generally lower than in the private sector. These African SOEs were also found to be less successful in generating employment as a result of their bias toward capital intensiveness.[42]

Several factors contribute to the overall poor performance of SOEs in terms of profitability and efficiency. Perhaps the most important is that SOEs differ

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from private firms in that they are expected to pursue both commercial and social goals. Providing goods at prices below costs in an effort to subsidize the public or hiring extra workers to meet national employment objectives inevitably reduces profitability. Another factor adversely affecting the profitability and efficiency of SOEs is the overcentralization of their decision making, which allows little flexibility for managers in the everyday operation of the firm. An additional problem is the bureaucratization of management; many decision makers are not accountable for their performance, and little incentive is provided for improved decision making. Further, despite the abundant labor supply and the employment mandate, access to capital at subsidized interest rates has often encouraged unnecessary capital intensiveness, as in the cases of the four African nations cited. Finally, in very corrupt regimes, SOEs have provided a "tunnel" through which public assets may be stolen.

One option for reform is reorganization with a greater bottom-line focus for the SOE; another is the transfer of ownership and control from the public to the private sector, a process known as **privatization**. In the former option, decentralizing decision making to allow for more flexibility and providing better incentives for managers could increase production efficiency. Providing capital at its market rate may eliminate the bias toward capital intensiveness. The alternatives include use of management and employee incentives, external management contracts, build-own-operate-transfer agreements with private firms, use of franchises and concessions in some sectors, greater exposure to competition, and partial privatization. The effectiveness of these alternatives to full privatization has been uneven in practice.[43]

Privatization Selling public assets (corporations) to individuals or private business interests.

Privatization: Theory and Experience

The second option, the privatization of state-owned enterprises in the production and financial sectors, hinges on the neoclassical hypothesis that private ownership brings greater efficiency and more rapid growth. During the 1980s and 1990s, privatization was actively promoted by major international bilateral (USAID) and multilateral agencies (World Bank, IMF). Many developing countries have followed this advice, although the extent of their philosophical agreement, as opposed to the financial pressures exerted by these funding agencies, remains unclear. In addition to the belief that privatization improves efficiency, increases output, and lowers costs, proponents argue that it curbs the growth of government expenditures, raises cash to reduce public internal and external debt, and promotes individual initiative while rewarding entrepreneurship. Finally, supporters of privatization see it as a way to broaden the base of ownership and participation in the economy, thereby encouraging individuals to feel that they have a direct stake in the system.[44] The heyday of privatization was during the 1980s and early 1990s. Between 1980 and 1992, more than 15,000 enterprises were privatized throughout the world, more than 11,000 of them in the former East Germany after reunification. In the developing nations, the number of privatized companies amounted to 450 in Africa, 900 in Latin America, and approximately 180 in Asia. Mexico, Chile, and Argentina have led the movement in Latin America. Among low-income countries, the speed of privatization was much more cautious, with the majority of transfers coming in small, low-value firms. Generally, the best candidates for privatization were the ones sold off first.

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Privatization has apparently been successful in promoting greater efficiency and higher output in many cases.[45] But many privatized assets were concentrated in the hands of small groups of local and international elites. For example, many sales of former state-owned enterprises in Latin America were conducted without competitive bidding, often at predetermined concessionary ("fire sale") prices; corruption was often alleged. As a result, small groups of well-connected investors, both domestic and foreign, were enriched by the process. And some privatization merely replaced public monopolies with private monopolies, thereby allowing a few individuals to reap the monopoly profits that formerly accrued to the state while hundreds of thousands of workers lost their jobs.

Privatization has also been resorted to as a quick fix for fiscal deficits, but when the easy candidates for privatization have been exhausted, governments in developing countries have often found that the fiscal problems have returned. Privatization therefore raises many complex issues. There are questions of feasibility, appropriate financing, the structure of legal and property rights, the role of competing elites and interest groups (e.g., public officials and bureaucrats versus domestic and foreign private business interests), and whether or not widespread privatization promotes or ultimately weakens existing dualistic economic, social, and political structures. It is not even sufficient to claim that privatization can lead to higher profits, greater output, or even lower costs. For one thing, while financial performance of firms generally improves after privatization, comparable SOEs in the same country that are not privatized may show similar improvements, and a study of matched firms in Egypt provided evidence for this. But the key issue is whether such privatization better serves the long-run development interests of a nation by promoting a more sustainable and equitable pattern of economic and social progress; the evidence so far is less than compelling.[46] Nevertheless, although the pace of privatization has slowed, few new state-owned enterprises are currently being created.

The need for privatization has posed some difficult questions: Who should be able to purchase SOEs? Whatever party has the most ready cash? Or should market imperfections in who is able to raise immediate capital be taken into account? Does it matter if the purchaser is a domestic citizen or a multinational corporation? Managers and workers in the company or citizens at large? Are some modes of privatization politically easier to carry out than others? Can creative approaches to arranging and financing ownership transfer agreements widen the possibilities? Can privatization be carried out in isolation from other programs, or does it have to be conceived as part of an integrated development strategy? Does privatization simply mean a long-overdue diminution of the government ownership role, or is it optimally implemented as part of a reorganized and renewed nonownership, public role in development? Already by the mid-1990s, there were laws or regulations in 50 developing countries (including transition economies) providing incentives, as well as limitations, for employee ownership (EO), often, but not exclusively, in privatization initiatives. These EO provisions are varied in nature and extent. They range from seeking to restrain employee ownership to modest levels, such as 10%, to encouraging employee ownership participation to as much as 100% of certain companies. Some of the issues are explored further for the cases of Chile and Poland in Box 15.3.

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BOX 15.3 Privatization—What, When, and to Whom? Chile and Poland

Chile and Poland have had sweeping privatization experiences. The pioneering privatization program in Chile remains among the most far-reaching in the developing world. Over an 18-year period, some 550 firms employing 5% of the country's workforce were privatized. The process was sometimes choppy. Many banks that had been privatized in the preceding years had to be renationalized in the 1982 financial crash.

Privatization in Chile proceeded over several overlapping stages. In 1974 and 1975, some 360 firms that had been nationalized in the early 1970s were returned to their previous owners; most of the rest of these were reprivatized by 1978. This was far easier to carry out than the privatizations of long-term SOEs. Of the 110 enterprises divested in 1975–1983, a large share were SOEs founded in the early 1970s. Many others were existing private companies in which that government had bought shares. From 1978 to 1981, privatization of social services took place; the government officially continued to provide social services only for the poorest groups and focused on subsidizing demand rather than supply. By 1981, public enterprises represented 24% of GDP, down from 39% in 1973.

In 1983–1986, many enterprises "rescued" (nationalized) in the 1982–1983 financial crash were reprivatized. Eight of the 15 largest corporations in Chile were privatized in the 1980s.

Privatization from the mid-1980s on was achieved through public auction, negotiation, sales to pension funds, "popular capitalism" (to small investors), and "labor capitalism" (to employees). Sales of the latter two types represented about 20% of privatization. Even SOEs that were not slated for privatization were subject to major internal reorganization, with the result that efficiency and profitability increased.

Popular capitalism was intended to spread ownership among many small individual investors, in part to increase popularity and acceptance of privatization. To become eligible for generous discounts, participants had to be taxpayers with no back taxes owed. Two major banks, Banco de Chile and Banco de Santiago, were privatized under this plan.

Under labor capitalism, workers could acquire a percentage of shares in their own company up to the value of 50% of a worker's pension fund that could be received in advance for this purpose. Retirement funds could be used as collateral for below-market government loans to buy additional shares. At retirement, workers could elect to trade these shares back for the value of their pension fund, so this gave the workers an essentially riskless investment. About 21,000 workers, 35% of those eligible, took part; other shares purchased by groups of workers were organized as investment societies. Between 1985 and 1990, a total of 15 SOEs were sold using some employee ownership, including 3 that became 100% employee owned. Three others became 44%, 33%, and 31% employee owned, respectively, and the remaining 9 had an average of about 12% employee ownership. Results were favorable in increased productivity and attracting foreign investment.

Despite serious socioeconomic problems, Chile began privatization with well-established legal and accounting frameworks; fully functioning labor, capital, and product markets; and many formal and informal socioeconomic institutions that are taken for granted in market economies. But in eastern Europe, these background institutions had been systematically suppressed under Communism. The Polish privatization plan was adopted in the summer of 1990. The first step in privatizing state enterprises, "commercialization," often requires the approval of the relevant ministry, management, and employees to set up a joint-stock company that can be sold. The stock is valued independently, and workers are then allowed to purchase up to 20% of the stock at half price. In capital-intensive companies, a subsidy limit based on the prior year's wages in the company would be set, making somewhat less than 20% of the stock eligible. This is to avoid overly concentrating these subsidies among a few lucky employees.

An alternative strategy that circumvented administrative procedures, applying mainly to smaller firms, was "privatization through liquidation." This

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procedure permitted leveraged buyouts that could include substantial employee and management ownership. The process is initiated when the firm's managing director and the employees' council (an elected representative body) commissions a "preprivatization financial analysis." If financial conditions appear favorable, the firm petitions the government ministry that had control over the company under the central-planning system, which offers an opinion on the merits of the analysis and suggests a strategy for privatization. The old SOE is abolished, and the new firm buys some assets but normally leases others back from the state. The value of these leased assets is determined at the time of reorganization and does not change over the life of the contract (even to adjust for inflation). This constitutes a substantial subsidy to the new owners.

But of some 250 companies representing about 10% of employment commercialized by mid-1992, only 10% were fully privatized. And only about 175 firms had self-privatized by mid-1992, by which time the government was considering a large-scale privatization plan that would organize several hundred companies representing about 10% of industrial employment into a kind of closed-end mutual fund. That plan stalled until 1997, when the government resumed plans to sell 513 small manufacturing, construction, and trading companies to the public. For the equivalent of $7 per voucher, Polish citizens could purchase shares of these companies through listed national investment funds on the Warsaw stock exchange.

The task of privatization in eastern Europe by any means has been daunting, with few resources to spare. In the early 1990s, the Polish privatization ministry had only 200 employees. This compared with 3,500 in the Treuhandanstalt, in charge of privatization in the former East Germany.

Sources: Saul Estrin, Jan Hanousek, Evzen Kocenda, and Jan Svejnar, "The effects of privatization and ownership in transition economies," *Journal of Economic Literature*, 47(2009): 699–728; David Lipton and Jeffrey D. Sachs, "Privatization in eastern Europe: The case of Poland," *Brookings Papers on Economic Activity* 2 (1990): 293–341; William L. Megginson and Jeffry M. Netter, "From state to market: A survey of empirical studies on privatization," *Journal of Economic Literature* 39 (2001): 321–389; Stephen C. Smith, "On the law and economics of employee ownership in privatization in developing and transition economies," *Annals of Public and Cooperative Economics* 65 (1994): 437–468; Stephen C. Smith, Beom-Cheol Cin, and Milan Vodopevic, "Privatization incidence, ownership forms, and firm performance: Evidence from Slovenia," *Journal of Comparative Economics* 25 (1997): 158–179; World Bank, *Techniques of Privatization of State-Owned Enterprises* (Washington, D.C.: World Bank, 1988).

15.7 Public Administration: The Scarcest Resource

Many observers would argue that the shortage of public (and private) administrative capability is the single scarcest public resource in the developing world.[47] The problem is not just a lack of training or experience. It also arises out of the political instability of numerous developing nations. When power is constantly changing hands, considerations of efficiency and public welfare are likely to be subordinated to political loyalty. Moreover, the larger the group of officials affected by a change of power, the more difficult it will be to maintain continuity in the formulation and execution of policy.

Public administration is unlikely to function efficiently when the rule of law is in question, when there is public disorder, or when there is little consensus on fundamental issues. Acute conditions of class, tribal, or religious conflict within a society will usually be reflected in the management and

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operation of government departments and public agencies. In a highly traditional society, where kinship ties are strong and such concepts as statehood and public service have not yet taken firm root, there is little regard for a merit system. Similarly, where the dominant values are sectarian, traditional incentives to perform in the wider public interest may not have much appeal.

Many governments in developing countries may also have civil service goals other than performance: to break up traditional elites, to nationalize the civil service, to conform to ideological correctness, to reflect or favor an ethnic ratio, or to include or exclude minorities. Most governments are also organized in the traditional hierarchical form. But some have experimented with negative hierarchy (from bottom to top), ad hocracy (temporary arrangements), and polyarchy (cooperation with outside organizations), this last being attempted particularly when some special form of expertise is involved.

Some bureaucracies in developing countries are relatively overstaffed at the bottom and understaffed at the top. There is a chronic shortage of skilled competent managers who are capable of independent decision making. The greater the number of parastatal organizations set up—the more state-owned enterprises and nationalized industries, quasigovernmental bodies, development corporations, and training institutions—the thinner this layer of managers is spread.

In the case of nationalized industries, most experiments have been economically disastrous and have resulted in all kinds of strains within the central civil service. Personnel systems in the public service are usually not adequate for the increased management complexities of an industrial enterprise. So parallel personnel systems have been set up, multiplying the public service systems, draining skills, leading to disparities in terms and conditions of service, and resulting in manpower shortages and morale problems. Political considerations often affect the ability to recruit competent managers with special technical skills. In short, nationalization in many instances has often added to the financial burden of the government budget.

The administrative component in economic development—not only in relation to the particular project under consideration but also in relation to the functioning of the entire public and private economic system—should not be underestimated.

For many developing countries, the quality of financial supervision, governance, and fiscal management—the subject of this chapter—has improved markedly over the past couple of decades. This is one factor in improved economic performance of many developing countries, though much remains to be done. At the same time, to be effective, active attention to other constraints on economic development as discussed throughout the text also will be necessary.

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Case Study 15

African Success Story at Risk: Botswana

Botswana is a landlocked country in sub-Saharan Africa with high population growth and a high incidence of disease. Yet it has attained one of the highest average per capita growth rates in the world since obtaining its independence from Britain in 1966.

Botswana shows that mineral wealth can be a benefit in a country that has the appropriate political development in place. Botswana has experienced by far the highest rate of growth in sub-Saharan Africa: 8.4% per year over the 1965–1990 period and a still-high 6.0% in 1990–2005. It is one of 13 countries identified by the Spence Commission as having ever experienced a 25-year period averaging at least 7% growth—and the only one in Africa. According to the United Nations Development Programme, Botswana's per capita income increased ninefold from 1970 to 2010. Since its independence, Botswana has gone from being among the poorest countries in the world to one with a greater purchasing power parity (PPP) per capita income than Thailand or Brazil and similar to that of Malaysia and Mexico.

Botswana has higher income per person than bordering country South Africa. And by sharp contrast, its neighboring country to the east, Zimbabwe, has a GNI of just $640; rather than growing, the economy of Zimbabwe has been shrinking.

What explains Botswana's remarkable success? This is a case in which the benefits of direct foreign investment for spurring growth are very clear. Moreover, success has been based on both favorable geography (huge diamond deposits) and favorable institutions (relatively effective protection of private property, rule of law, checks and balances, and good incentives for government to play a constructive role). Effective governance matters; as noted by the Commission on Growth and Development (Spence Commission) (page 71), "Botswana has a tradition of long-term planning guided by a vision for the future direction of the economy." When all these elements are present, conditions for development are particularly auspicious.

Botswana's diamond wealth is vast, and hence the experience of Botswana shows that the "curse of natural resources" does not haunt all countries equally. Although diamonds have been a dictator's best friend in countries such as the Democratic Republic of Congo (DRC) and Sierra Leone, in Botswana diamond exports have been consistent with democracy and broad-based development. Jeffrey Herbst, a leading expert on African comparative political development, also notes that Botswana is one of the few African countries with a geography that is suitable for consolidating the power of the nation-state. The population is concentrated in the eastern part of the country, where Gaborone, the capital city, is located. In contrast, such countries as Nigeria and the DRC have widely dispersed centers of population.

Botswana is a multiparty democracy, although it has been dominated by one particular party, the Botswana Democratic Party. Elections have been held every five years since 1965. There is a free press, and there are no political prisoners. Botswana accomplished these impressive economic and political results while surrounded by white minority regimes (in South Africa, Zimbabwe, and Namibia) for the first half of its history—and even as nearby civil wars have spilled over into its territory and a steady stream of refugees has threatened to upset the social order.

Botswana has some geographic disadvantages that in other countries can act as a barrier to growth

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and development. It is a landlocked country with no access to seaports, a characteristic that is statistically associated with slow growth. It has generally poor conditions for agriculture. Only about 4% of the land can be easily cultivated. Most of the country is Kalahari Desert land, suitable only for summer grazing (almost all the rainfall takes place during the summer months). The five-year drought of the mid-1980s was very harsh by any standard, and other serious droughts have stricken the country with some regularity. The climate is tropical, and tropical countries have generally fared much more poorly in income levels and growth than temperate-zone countries. Botswana also shows that high population growth need not always forestall rapid growth in income per capita. Thus, Botswana demonstrates that geography is not destiny and that good institutions can take advantage of opportunities of geography (natural resources, in particular) that are squandered or even make matters worse in countries with poor institutions. And it suggests that good institutions can overcome the constraints imposed by geography. Daron Acemoglu, Simon Johnson, and James Robinson attribute Botswana's success in large measure to favorable institutions, particularly protection of property rights.

Successful development requires both private and public goods. There is a need to prevent the government from doing harm, such as engaging in parasitic or predatory behavior, and at the same time to encourage the state to act in support of broad-based economic development, including provision of public goods needed for economic development. For this, minimal requirements are a cohesive society that is able to avoid substantial strife such as civil wars and a government that is both responsive and responsible to society.

As noted earlier, Botswana has been a well-functioning multiparty democracy. Although the Botswana Democratic Party has never lost national power, there is evidence that it responds to electoral threats by delivering improved government services. Government has played a constructive role in the economy by providing infrastructure, extension (information and training) services, and subsidized veterinary services and other support for the development of the cattle industry; these initiatives have been broad-based rather than earmarked for favored clientele. Government has also constructively managed relationships with mining interests, encouraging exploration by foreign companies and demanding and getting a share of profits without driving investors away. For example, favorable contracts were achieved with the De Beers diamond cartel that resulted in fully half of diamond profits going to the state in tax revenue. The government, in turn, managed these resources constructively, smoothing government services from good to bad periods and investing heavily in education. How a country spends its wealth matters, whether that wealth is large or small. Botswana has attained essentially universal primary education, a rare achievement in Africa, and more than half of children enroll in secondary education, twice the average elsewhere in sub-Saharan Africa.

From 1982 to 1987, Botswana suffered a brutal drought that severely affected poor rural peoples. In many countries, their plight might have been ignored until significant starvation began to catch the attention of the world. But Botswana built on its social security system and provided relief to the rural poor through a three-pronged system of maintaining food availability, as detailed by Jean Dreze and Amartya Sen: (1) a guarantee of public employment for cash wages that could be spent on available food, (2) direct food distribution to selected groups, and (3) programs to increase agricultural productivity and restore food availability. Botswana's free press and democratic system seem to be major factors in this response.

On other human development indicators, such as infant mortality and health professionals per capita, Botswana also scores well. However, Botswana ranked only 98th out of the 159 countries listed on the 2010 Human Development Index, 38 points lower than its GDP rank would predict; in other words, Botswana's human development is significantly lower than predicted by its level of real per capita income. Botswana has been affected in these rankings due to mortality from AIDS; the nation has the second-highest HIV infection rate in the world. But in other fields, its human development performance in the context of sub-Saharan Africa is extremely favorable; despite the AIDS epidemic, only two countries in this region rate higher than Botswana on the 2010 HDI. But clear progress is being made; between 2001 and 2011, the rate of new HIV infections dropped by 71% in Botswana—one

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of the greatest improvements in the world in this period.

The deeper question is why Botswana has been able to create and sustain better institutions. Acemoglu, Johnson, and Robinson surveyed Botswana's institutional history and suggest that the juxtaposition or interaction of five factors have been important.

1. Botswana possessed precolonial tribal institutions that encouraged broad-based participation and placed constraints on political elites. Commoners were allowed to make suggestions and criticize chiefs.
2. British colonialization had a limited effect on these precolonial institutions because of the peripheral nature of Botswana to the British Empire.
3. Upon independence, the most important rural interests, chiefs and cattle owners, were politically powerful, and it was in their economic interests to enforce property rights.
4. The revenues from diamonds generated enough rents for the main political actors, increasing the opportunity cost of, and thereby discouraging, further rent seeking.
5. Political leaders made sensible decisions. These included turning over diamond mining rights from tribal (Bangwato) to national control (this transition was initiated in a statesmanlike way by the postindependence leader Seretse Khama, who was himself a member of the Bangwato tribe). Reduction of the powers of the tribal chiefs was another such decision. Each reduced the chances of internecine conflicts that have plagued so many other African countries. It might be said that in Botswana, although elites enjoyed a good share of the diamond eggs, they did not kill the goose that laid them, and they faced real constraints on their ability to take a larger share.

So unfavorable features of geography need not be destiny, natural resources need not be a curse, and good institutions can underpin dramatically superior economic performance.

With a clear, natural-resource-based comparative advantage and the requisite minimally supporting institutions, Botswana successfully struck a deal with foreign investors that was good for the national interest while avoiding serious corruption. As a result, the neoclassical approach—expanded and updated with emphasis on required human capital, the need for good institutions, support for exports, farsighted government policy and shared growth—appears to do a good job of explaining this country's success.

But perhaps the most important question of all is left unsettled. What can countries without the favorable starting economic institutions and factors favoring development of good-quality state institutions do to get better institutions? Officials in other African countries who are seeking to reform their polities can work toward emulating some of the best features of governance in Botswana and publicize government and private-sector failures as well as relative success in neighboring countries. Societies as a whole can find themselves in poverty traps, in which government behavior itself is part of the vicious circle of underdevelopment. The presence of a positive regional role model is of great importance in spreading successful development, as illustrated by the case of Japan in East Asia. One blemish on Botswana's development record is that the minority Khoikhoi, also known as Bushmen, fare worse than the majority Botswana.

Despite its successes, Botswana may be facing its gravest crisis since independence. It now has a relatively high level of income inequality, comparable to that of Latin America, as well as chronically high urban unemployment. But by far the worst problem is HIV/AIDS. According to UN reports, the HIV prevalence rate is as high as 24% of the adult population aged 15 to 99—and a stunning 33% among pregnant women. Fortunately, the HIV prevalence rate among those aged 15 and below is less than 2%, a promising sign *if* new infections can be stopped with lifestyle changes and safe-sex practices. But the United Nations reports that "60% of the youth have no access to youth-friendly reproductive health services." Without AIDS, it is estimated that life expectancy in Botswana would be over 70 today. But as a result of the AIDS epidemic, life expectancy at birth in Botswana was just 55 years in 2010. The United Nations estimates that nearly 20% of children in Botswana have lost a parent. Erika Reynolds found that one-third of the workforce is currently infected, which is apparently having a negative effect on productivity. Still, in the last few years, Botswana has

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had a much more decisive response to AIDS. About 6% of government spending is allocated to HIV/AIDS programs, including free retroviral treatment for all citizens, and life expectancies are now rising.

It is reasonable to ask, if Botswana has such good institutions and government quality, how has the country allowed itself to reach the point at which so much of its prime-age population is HIV-positive? The failure of government to respond as decisively as in Uganda (see Box 8.8 in Chapter 8), despite the epidemic's later arrival in Botswana, may be viewed as a reflection of inconsistent government quality or of cultural characteristics. The test now is whether government quality and social development can halt the spread of HIV to the next generation. Botswana at least responded to the challenge better than its neighbor, South Africa. The last few years have been more encouraging. There is hope that the epidemic is abating somewhat. If it does subside, Botswana can again shine as a beacon of hope for broader development in Africa. ■

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Concepts for Review

Central bank
Commercialization
Currency board
Currency substitution
Development banks
Direct taxes
Financial liberalization
Financial repression
Group lending scheme
Indirect taxes
Informal finance
Microfinance
Monetary policy
Money supply
Organized money market
Privatization
Rationing
Rotating savings and credit association (ROSCA)
State-owned enterprises (SOEs)
Transparency (financial)
Unorganized money market
Value added tax (VAT)

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Questions for Discussion

1. Explain the distinction between organized and unorganized money markets.
2. In the context of development priorities, what are the relative roles of central banks, commercial banks, development banks, informal and unorganized sources of credit, and microfinance such as the Grameen Bank of Bangladesh?
3. What is meant by financial repression, financial liberalization, currency substitution, and unorganized money markets, and how do they relate to financial policy in developing countries?
4. List and briefly discuss the seven market failures that Stiglitz and his colleagues say justify a strong government role in developing-country financial sectors. Do you agree or disagree with this assessment? Explain.
5. What are the principal sources of government revenues in developing countries? Why are many taxes so difficult to collect? Discuss.
6. In what ways do you think taxation and expenditure systems in developing countries could be improved? Be specific.
7. If the scarcity of administrative capabilities is a serious constraint on development policy implementation, what can developing countries do to relieve this constraint? What are the options? Discuss.
8. Summarize the arguments for and against the establishment of state-owned enterprises (SOEs) in developing nations. Do you think that SOEs should be encouraged or discouraged? What are the arguments for and against privatization of the public sector in developing countries? How would you interpret evidence that a majority of privatized enterprises have increased efficiency? Explain your answers.
9. When privatization picked up pace in Poland, some analysts warned that effective privatization first required more developed domestic financial institutions. Comment.
10. What are the pros and cons of encouraging the development of stock markets in developing countries?
11. How have microfinance institutions' strategies differed from those of other lenders in reaching lower-income borrowers?
12. What are some of the benefits of expanding microcredit programs, and what are some of its potential limits?
13. Consider the three recent policy debates concerning microfinance (on subsidies, nonfinancial activities, and commercialization). What kinds of evidence would you seek to resolve these, at least in a localized context?
14. What lessons can be learned for low-income countries from Botswana's successes?

Notes

1. Joan Robinson, "The generalization of the general theory," in *The Rate of Interest, and Other Essays.* (London: Macmillan, 1952), pp. 67–142 (p. 82).
2. See Hugh T. Patrick, "Financial development and economic growth in underdeveloped countries," *Economic Development and Cultural Change* 14 (1966): 174–189, and Felix Rioja and Neven Valev, "Finance and the sources of growth at various stages of economic development," *Economic Inquiry* 42 (2004): 27–40.
3. Some of this discussion is adapted from Ross Levine and Sara Zervos, "Stock markets, banks, and economic growth," *American Economic Review* 88 (1998): 537–558. Other useful references include Rudiger Dornbusch and Alejandro Reynoso, "Financial factors in economic development," *American Economic Review* 79 (1989): 204–209; Panicos Demetriades and Khaled Hussein, "Does financial development cause economic growth? Time series evidence from 16 countries," *Journal of Development Economics* 51 (1996): 387–411;

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6. For an extended but advanced exposition of macroeconomic analysis applied to developing-country contexts, see Agenor and Montiel, *Development Macroeconomics*.
7. See Maxwell J. Fry, *Money, Interest, and Banking in Economic Development* (Baltimore: Johns Hopkins University Press, 1988); World Bank, *World Development Report, 1991* (New York: Oxford University Press, 1991); and Ernest Aryeetey et al., "Financial market fragmentation and reform in Ghana, Malawi, Nigeria, and Tanzania," *World Bank Economic Review* 11 (1997): 195–218. Note that considerable progress has been made since 2000.
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11. Collyns, *Alternatives to the Central Bank*, p. 21.
12. See Maxwell J. Fry, "Assessing central bank independence in developing countries: Do actions speak louder than words?" *Oxford Economic Papers* 50 (1998): 512–529.
13. This schema follows the scoring system introduced by V. Grilli, D. Masciandaro, and G. Tabellini in "Political and monetary institutions and public financial policies in the industrial countries," *Economic Policy* 13 (1991): 341–392. Alex Cukierman introduced a partially overlapping alternative system in *Central Bank Strategy, Credibility, and Autonomy* (Cambridge, Mass.: MIT Press, 1992).
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27. In addition to setting interest-rate ceilings, developing-country governments have often intervened in their financial markets in a variety of other ways. These have included directed credit programs, high bank reserve requirements that effectively tax the financial system, and forced lending to the government to finance high budget deficits—for example, by requiring banks to hold low-yielding government bonds. These and other policies are linked to interest-rate ceilings. In the presence of high and variable inflation and negative real interest rates, they not only lead to lower savings and growth but also can cause the entire banking system to contract. We are grateful to Professor Valerie Bencivenga for these observations.

28. The classic writings on financial repression and the positive impact of financial liberalization on saving and investment are Ronald L. McKinnon, *Money and Capital in Economic Development* (Washington, D.C.: Brookings Institution, 1973), and Edward S. Shaw, *Financial Deepening in Economic Development* (New York: Oxford University Press, 1973). For a classic critique of this approach, see Carlos Diaz-Alexandro, "Good-bye financial repression, hello financial crash," *Journal of Development Economics* 19 (1985): 1–24. For a more recent debate on the merits and limitations of financial liberalization, in general, and the McKinnon-Shaw thesis, in particular, see articles by Maxwell Fry and Ajit Singh in *Economic Journal* 107 (1997): 754–782. See also Bruce Greenwald, "Institutional adjustments in the face of imperfect financial markets," in *Annual World Bank Conference on Development Economics, 1998* (Washington, D.C.: World Bank, 1999).

29. World Bank, *World Development Report, 1987* (New York: Oxford University Press, 1987), pp. 117–122. However, for transnational evidence that interest-rate levels have little or no effect on saving and investment, see Deena R. Khatkhata, "Assessing the impact of interest rates in less developed countries," *World Development* 16 (1988): 577–588; Gerado M. Gonzales Arrieta, "Interest rates, savings and growth in LDCs: An assessment of recent empirical research," *World Development* 16 (1988): 589–606; and Rudiger Dornbusch, "Policies to move from stabilization to growth," *Proceedings of the World Bank Annual Conference on Development Economics, 1990* (Washington, D.C.: World Bank, 1990), pp. 36–41.

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31. Ibid., p. 8.

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47. For an overview of some key issues in public administration and development, see World Bank, *World Development Report, 1997* (New York: Oxford University Press, 1997), and Derick W. Brinkerhoff and Benjamin Crosby, *Managing Policy Reform: Concepts and Tools for Decision-Makers in Developing and Transitioning Countries* (Bloomfield, Conn.: Kumarian Press, 2002). The journal *Public Administration and Development* is a good source for current contributions to this evolving literature.