

# Economic Development

12th Edition

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## Chapter 15

## Finance and Fiscal Policy for Development



# **15.1 The Role of the Financial System in Economic Development**

- Six major functions of the financial system
  - Providing payment services
  - Matching savers and investors
  - Generating/distributing information
  - Allocating credit efficiently
  - Pricing, pooling, and trading risks
  - Increasing asset liquidity
- Differences between developed and developing-country financial systems



## **15.2 The Role of Central Banks and Alternative Arrangements**

- Functions of a full-fledged central bank
  - Issuer of currency and manager of foreign reserves
  - Banker to the government
  - Banker to domestic commercial banks
  - Regulator of domestic financial institutions
  - Operator of monetary and credit policy



# Table 15.1 Central Banking Institutions

Institution	Function					
	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.



## **15.2 The Role of Central Banks and Alternative Arrangements (cont'd)**

- Currency boards
  - Form of central bank that issues domestic currency for foreign-exchange at a fixed exchange rate
- Alternatives to central banks
  - Transitional central banking institution
  - Supranational central bank
  - Currency enclave
  - Open-economy central banking institution



## **15.2 The Role of Central Banks and Alternative Arrangements (cont'd)**

- The role of development banking
- Development banks are specialized public and private financial intermediaries that provide medium- and long-term credit for development projects.



## 15.3 Informal Finance and the Rise of Microfinance

- Traditional informal finance
- Microfinance institutions (MFIs)
  - Microfinance provides financial services to people otherwise with no access or only with very unfavorable terms.
  - Includes microcredit, microsavings, and microinsurance
  - Primary focus: very small loans for microenterprises
  - Microcredit often uses group lending schemes (joint liability)
  - Provides “collateral of peer pressure” to jointly repay
  - An alternative without joint liability: “dynamic incentives,” in which loan sizes steadily increase when loans are repaid
  - Other alternatives to joint liability



## **15.3 Informal Finance and the Rise of Microfinance (cont'd)**

- MFIs: three current policy debates
  - Microfinance schism--Are subsidies appropriate?
  - Should credit be integrated with education, health, or other programs? (See Box 15.2)
  - Should MFIs undergo commercialization, whereby an NGO providing microfinance is converted into a for-profit bank?
- Potential limitations of microfinance as a development strategy
  - Microfinance is a powerful tool, but it needs to be complemented with other development and poverty policies

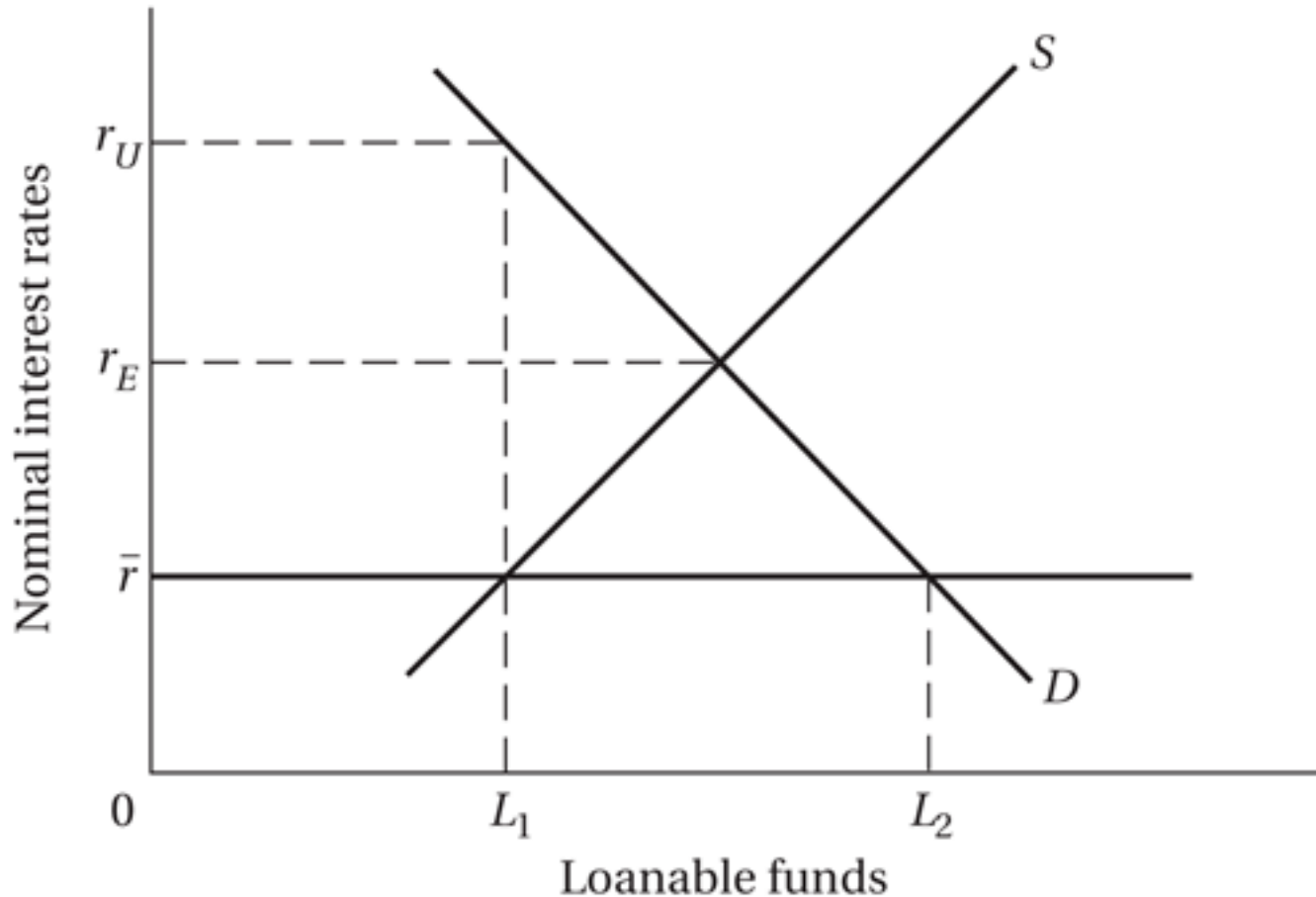




## **15.4 Formal Financial Systems and Reforms**

- Financial liberalization, real interest rates, savings, and investment
  - Rationing
  - Financial repression

# Figure 15.1 The Effects of Interest-Rate Ceilings on Credit Allocation





## 15.4 Formal Financial Systems and Reforms

- Financial policy and the role of the state
  - Stiglitz: seven financial market failures:
    - The “public good” nature of monitoring financial institutions
    - Externalities of monitoring, selection, and lending
    - Externalities of financial disruption
    - Missing and incomplete markets
    - Imperfect competition
    - Inefficiency of competitive markets in the financial sector
    - Uninformed investors




## **15.4 Formal Financial Systems and Reforms (cont'd)**

- Debate on the role of stock markets



## 15.5 Fiscal Policy for Development

- Macrostability and resource mobilization
- Taxation: direct and indirect
  - Five factors of the taxation potential of a country
    - Level of per capita real income
    - Degree of inequality in the distribution of that income
    - Industrial structure of the economy and the importance of different types of economic activity
    - Social, political, and institutional setting and the relative power of different groups
    - Administrative competence, honesty, and integrity of the tax-gathering branches of government



**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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# 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					Income Taxes				Consumption Taxes			
	Total	Corporate	Personal	Total	General	Excises	Trade	Social Security	Total	Corporate	Personal	Total	General	Excises	Trade	Social Security
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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## **15.5 Fiscal Policy for Development (cont'd)**

- Personal income and property taxes
- Corporate income taxes
- Indirect taxes on commodities
- Problems of tax administration





## **15.6 State-Owned Enterprise and Privatization**

- State-owned enterprises (SOEs)—public corporations and parastatal agencies owned and operated by the government.
- Improving the performance of SOEs
- Privatization: theory and experience



## **15.7 Public Administration: The Scarcest Resource**

- Administrative capability is a scarce public resource in the developing world
- The administrative component of economic development should not be underestimated



# Concepts for Review

- Central bank
- Commercialization
- Currency board
- Currency substitution
- Development banks
- Direct taxes
- Financial liberalization
- Financial repression
- Group lending schemes
- Indirect taxes
- Informal finance
- Microfinance
- Monetary policy
- Money supply
- Organized money markets



# Concepts for Review (cont'd)

- Privatization
- Rationing
- Rotating savings and credit associations (ROSCA)
- State-owned enterprises (SOEs)
- Transparency (financial)
- Unorganized money market