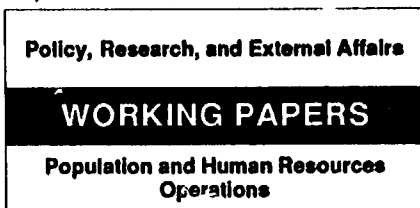


WPS-0274



Country Department I, Latin America
and the Caribbean Regional Office
The World Bank
May 1990
WPS 274

Efficiency and Equity in Social Spending

How and Why Governments Misbehave

Nancy Birdsall
and
Estelle James

FILE COPY

In most countries it is easy to identify reallocations of public spending for social programs that would improve efficiency and simultaneously improve the distribution of income and better serve the poor. The authors suggest why these reallocations are difficult but not impossible to bring about.

Policy, Research, and External Affairs

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A hot issue in development economics is how much to rely on user charges and private organizations to provide such social services as health and education. Most analysts arguing on either side of the issue assume that any policy decisions involve a tradeoff between equity and efficiency.

Birdsall and James argue that in many settings in the developing world that assumption is incorrect. In many countries, they argue, the current situation is inefficient partly because it is inequitable; more equitable social spending would be more efficient in reducing mortality, for example, or in maximizing social returns to spending on education.

The model they use assumes that the degree of efficiency and redistribution is endogenous, so the real problem is: How does one break into the chain of causes and bring about a new, more efficient and equitable equilibrium, when this was apparently not in the interest of the main actors or it would already have happened?

If well-defined groups know they are “losers,” they are more likely to mobilize and foment opposition to existing policies — so the

“gainers” benefit from perpetuating a “veil of ignorance.” Most commonly, some private goods may be publicly provided and oversupplied because they benefit a politically influential group in a nonobvious way — for example, by oversubsidizing colleges and undersubsidizing education at lower levels.

Birdsall and James argue for a policy that concentrates government funding on public goods and encourages the market to do what it does best: fund and produce private goods. With public spending concentrated on services that yield public goods, the poor automatically benefit even if they are not targeted, and since the rich also benefit they may be reluctant to oppose these programs, even if they prefer government spending on private services from which they benefit more.

They recommend ten political strategies for reallocating government funds in the public sector in a way that maximizes the benefits of targeting, reduces costs, and minimizes resistance to change and the withdrawal of the middle and upper classes' political and tax support.

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by
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Original draft prepared for the Conference on Poverty, Airlie House,
Virginia (IFPRI and World Bank), October 1989.

* World Bank and State University of New York at Stony Brook,
respectively. We wish to thank Emmanuel Jimenez, the discussant for
this paper, and other conference participants who made many helpful
comments that we have tried to respond to in this version.

An important current issue in development economics concerns the appropriate degree of reliance on such measures as user charges for publicly-provided health, education and other social services and use of the private sector for the provision of these services. Proponents of user charges and greater privatization claim that these will conserve scarce public funds and promote efficiency in the sense of cost-effectiveness and responsiveness to consumer preferences (Psacharopoulos, Tan and Jimenez, 1986; Akin, Birdsall, and de Ferranti, 1982; Jimenez, 1987). Opponents retort that, because of their reliance on ability to pay as a rationing criterion, user charges for public services and privatization will have negative distributional effects that are likely to outweigh any efficiency gains (e.g. see Gertler et al, 1987, and Gertler and van der Gaag, 1988 on user charges for health care in Peru and Cote d'Ivoire). Most of this literature implicitly accepts the existence of an efficiency-equity trade-off with some people choosing efficiency, others equity.

In this paper we argue that in many settings in the developing world, this presumption of a tradeoff between efficiency and equity is incorrect. We argue that in fact in many countries the current situation is inefficient in part because it is inequitable; greater equity in social spending would also be more efficient (in reducing mortality, for example, or in maximizing social returns to spending on education). Put another way, in these countries there exists an identifiable group of efficient reallocations that would simultaneously improve distribution.

Part I of this paper sets forth the theoretical reasons for predicting that the state will often finance a bundle of social services that is both inefficient and inequitable -- inequitable in the sense that the upper and middle classes rather than lower income groups will benefit therefrom. Part II presents a variety of empirical examples, both from developed and developing countries. Part III points out some of the conceptual problems in measuring the distributional effects of social services, problems which in most cases have led us to overestimate the degree to which government spending redistributes to the poor.

The conclusion summarizes the crux of the political economy problem. Since we start with a model in which degree of efficiency and redistribution are endogenous, the real difficulty is: How do we break into the chain of causation and bring about a new equilibrium, more efficient and more redistributive, when this was apparently not in the interest of the main actors, or it would already have happened?

Section I. Theory

Welfare Theory

Classical welfare theory gives us a normative view of what government should do, focusing on efficiency rather than distributional considerations. The economic role of government is to correct market failure by funding public goods, by subsidizing goods that generate externalities, by compensating for capital market or insurance market failure, and otherwise simply to set the framework within which private enterprise will function. The standard approach is to assume that the efforts of government to correct for market failure in themselves introduce some efficiency losses -- because those

efforts usually require taxes, and nondistorting lump-sum taxes are not feasible. The problem is then one of a tradeoff between the benefits of intervention and the costs.

With respect to distribution, government is viewed as benign or slightly benevolent, having some interest in equalizing income or opportunities. For example, people cannot be excluded from public goods, by definition, so the poor as well as the rich benefit therefrom. (But see a qualification in Part III on the point that they may value these benefits differentially). Some welfare theorists go further and argue that there exists a set of "merit goods" (health, education) which society does not wish to ration according to ability to pay; hence government steps in on efficiency grounds, to impose some alternative criterion (Meade, 1964; Rawls).

And, finally, in classical welfare theory, the "maximum" point of social welfare is acknowledged to depend on distribution as well as efficiency. Opinions vary on whether a "social welfare function" exists, what an "equitable" distribution might be, and how much the government should intervene to alter the distribution determined by pure market forces; but usually the presumption is, if there is to be any politically determined redistribution, it should be from rich to poor and not vice versa. This "Robin Hood" function of government (see Birdsall, 1989) is regarded with some ambivalence, in part because different people disagree on the desired distribution and in part because of the standard assumption that improvements in equity will reduce efficiency. Bourgignon (1989), for example, sets out a model in which the pursuit of equity, either through education and health programs that build human capital, or through transfer programs such as

compensatory nutrition or food subsidies for the poor, requires that government generate tax revenues, which reduces overall efficiency.

In this paper we examine the tendency of governments not to play Robin Hood, even where there seems to be no tradeoff, i.e. where doing so would increase government effectiveness (efficiency) in the context of standard welfare theory. We use the terms "equity" and "perverse redistribution" as shorthand for "redistribution to the poor" and "redistribution to the rich", respectively (while recognizing that these are value-laden terms reflecting value judgments which go beyond the standard use of terms in welfare theory.)

Public Choice Theory

A second, more recent and less benevolent view of government activities stems from public choice theory, which gives us a positive model of what the government will do, under the presumption that the chief agents act to maximize individual utility rather than social welfare. According to this theory, politicians do not seek to maximize efficiency but rather to maximize their own chances of getting reelected, and individuals use governments to maximize their real income via the creation of protected market positions and the direct provision of services and transfers.

Politicians and political parties have some discretionary power because of barriers to entry and because they are in a position to shape as well as respond to peoples' tastes. At the same time, they must also act in a way that deters threats from potential competitors, hence minimizes campaign costs, and this limits the scope of their monopoly power. Viewing the entire spectrum of issues, among which different groups of voters have different trade-offs, politicians who survive to make policy are those who assess those

trade-offs correctly and give influential groups what they want on issues that are most salient to them. Even where democracy does not exist, a similar process often occurs with even fewer political checks on the use of government to benefit the already powerful.

Public policies designed to benefit powerful interest groups will not necessarily be inefficient. Indeed, these groups would have a potentially larger pie to capture if the Pareto frontier were reached. As one extreme example: the economy might operate with perfect efficiency and poll taxes could then be imposed on some, transferred to others. However, the allocation of resources resulting from public choice politics often is inefficient, for the following reasons:

1. In a context of imperfect information, people may not know the degree and direction of redistribution going on. If well-defined groups know they are "losers" they are more likely to mobilize and foment opposition to existing policies; therefore the "gainers" benefit from perpetuating a "veil of ignorance." Suppose that efficient transfers are also more obvious (e.g. transfers in cash are more transparent than those in kind). In that case, efficiency imposes cost to the "gainers" by reducing the amount they will be potentially able to extract; they are therefore likely to choose inefficient mechanisms. Most commonly, some private goods may be publicly provided and oversupplied because they benefit a politically influential group of people in a non-obvious way.

2. Our second point is closely related: imperfect information and uncertainty also surround the relationship between the tax structure and the bundle of public services provided. While these may be interdependent components of a long run political equilibrium, as suggested by discussion in

Part IV, they may appear independent of each other in the short run. In that case, some newly demanded public goods, merit goods or quasi-public goods with large benefits will be undersupplied because their benefits accrue to widely dispersed, less influential individuals and it is uncertain whether the tax burden of these groups will eventually be adjusted upward commensurately with their benefits. Similarly, some goods will be oversupplied because their chief beneficiaries are politically powerful, if taxes are regarded as fixed.

3. The real costs of publicly-produced private goods may be above minimal levels, because government imposes costs of bureaucracy and red-tape (in part as a substitute for the profit motive), often lacks competitive pressures for internal efficiency (perhaps because politicians reap a surplus from monopolistic provision) and uses distortionary tax financing.

4. The diversion of entrepreneurial energies toward extracting a surplus from public agencies rather than toward productivity-enhancing market activities also impedes private sector efficiency and growth. Thus, not only are public resources misallocated, but private resources are misallocated as well, as a consequence of these rent-seeking activities (Krueger, 1974; Buchanan, Tollison and Tullock, 1980).

The resulting distribution of real income will depend upon political power as well as market power. Political power of course will vary across societies and through time depending on the size of different producer and consumer groups, the coalitions among them, and the long run "rules of the game" that have been set up (e.g. through constitutions) for allocating voting rights. In this paper we do not attempt to build a rigorous model of political power determination. However, we do argue that the final distribution of real income is likely to be considered inequitable by

standards that many people hold. For example, since producer groups are likely to be more concentrated and better organized than consumer groups, and since upper and middle income groups are probably more articulate and politically active than poorer groups, public choice theory predicts that producer and upper-middle class groups will benefit disproportionately from government policies. (For an early statement of this point see Stigler, 1971 and Peltzman, 1976).

This is not to say that there will be no redistribution to the poorer classes under public choice theory. In fact, we would expect to find some such redistribution on efficiency grounds, because it makes everyone better off. For example, people voluntarily donate to beggars out of altruism and use the government as an efficient mechanism for transferring income to disadvantaged groups through welfare payments, disability compensation, etc. Along similar lines, the extremes of poverty and socio-economic immobility may raise fears of crime or revolution which will ultimately hurt the rich; historically, the provision of certain merit goods to the poor (e.g. basic education, unemployment or medical insurance) has been viewed as a particularly effective way of combatting these problems.

Also, since there are more poor people than rich, the desire to constrain the popularity of opposition groups in a democracy leads to some distribution to lower income groups on grounds of expediency. Out-of-power groups must be appeased by giving them "just enough" to prevent opposition parties from gaining strong support. Expenditures on high quantity, low cost primary and secondary school systems are common examples. But "just enough" may not be very much. We argue that, in many situations, perverse distributional rather than efficiency or equity criteria determine the

allocation of government funds, and these criteria imply large benefits to powerful upper income groups, combined with small redistributions to the poor. (For this result with respect to public expenditures on education in Brazil, see Behrman and Birdsall, 1988).

Social Choice about Social Services

The social service sector is an arena in which many of these forces play themselves out, as it consists of a variety of quasi-public goods with different mixes of public and private benefits and different beneficiaries. The frequent designation of social services as "merit or externality-generating goods" provides ample justification for government intervention along welfare theory lines. Yet, once this intervention begins, ostensibly to correct for market imperfections and benefit poor consumers, it is often seized by producer groups and the allocation of resources diverted to a more "private" service mix that predominantly benefits the rich, albeit in a somewhat disguised way, as public choice theory would predict. While the rhetoric stresses the importance of avoiding price-rationing in order to provide access to the poor and thereby garner their support, alternative rationing mechanisms used by the government may be equally income-biased. If this is the case, turning provision of these services over to the private sector, or reducing public expenditures on these services by greater reliance on user charges will not only encourage government to concentrate on the financing of goods with a larger "public" or "merit" component, but will at the same time improve efficiency and combat poverty.

Section II. Empirical Examples

In this section we cite numerous examples, from developed and developing countries, which make it clear that allocations within the social services sector often disregard the tenets of welfare theory and instead fulfill the more pessimistic predictions of public choice theory. While these examples are not universal, they are very widespread. We also suggest the reallocations, involving a shift of some financing to private sources, that will increase efficiency and equity at the same time.

The efficiency and equity criteria discussed in Part I and used by us in Part II deal mainly with the question of who finances quasi-public services. Another set of efficiency considerations deal with the question of who provides these services and, how much private choice and public controls are involved. For the distinction and connections between these issues see Birdsall, 1989a and James, 1990. Throughout this paper we focus on the benefits of shifting some of the financing of quasi-public services to the private sector, irrespective of whether the private or public sector manages and provides the service. We also abstract from the possible links between financing and provision that can arise in the real world for institutional or political economy reasons (e.g. the amount raised via user charges may be greater if the provider retains control over the resources, and private provision with partial public subsidy may be more sustainable politically than public provision with partial user charges, and public regulations may accompany public subsidies).

Education. Education is a prime example of a quasi-public good, one which yields a combination of private and external (social) benefits. However, the mix of public and private benefits varies across educational

products. In particular, primary and secondary education, which enhance basic literacy and numeric skills, probably provide larger externalities than undergraduate higher education and generally provide a larger social rate of return as well--an efficiency rationale for public spending. Specifically, the average rate of return in developing countries has been estimated to be 24% at the primary level, 15% at the secondary and 13% at the higher education level. (Psacharopoulos, Tan and Jimenez, 1986). Even if these rates of return are upwardly biased (Behrman and Birdsall, 1987) the ranking of actual returns across levels of education is probably correctly captured. Yet, many countries spend a disproportionate share of their total educational budgets at the tertiary level. This is also the level which heavily benefits upper income groups; a large expenditure is concentrated on a small number of advantaged students in contrast to primary education which disproportionately benefits the poor (Selowsky, 1979; Meerman, 1979).

Public universities typically do not have price barriers to entry. However, they have academic barriers which are more likely to be surmounted by high income families, whose children complete primary school, attend a high quality secondary school, pay for after-school tutoring, and pass the entrance exam to the prestigious public institutions (Armitage and Sabot, 1989; James and Benjamin, 1987).

For example, Brazil spends only 9% of its public education budget (including spending at the federal, state and local level) on secondary education, but 23% on higher education (\$144 per student on the former, \$2536 on the latter). Yet, 95% of all students at public universities come from middle and high income families (James, 1989a, and World Bank, 1988). In India 19% of the total public educational budget is spent on colleges and

universities, while the majority of rural children do not even finish primary school (Tan, 1989). In Africa 22% of the public educational budget is spent on higher education, attended by only 2% of the relevant age group (see Psacharopoulos, Tan and Jimenez, 1986 and Winkler, 1988). In Mexico a person coming from a high income family is 10-20 times more likely to attend a public university than one coming from a low income family (Winkler, 1988 and Quintero, 1978). The top income quintile receives more than 50% of higher education subsidies while the bottom quintile receives less than 10% in Costa Rica, Chile, Dominican Republic and Uruguay (Winkler, 1988 and Petrei, 1987).

One of the most detailed studies of educational subsidies, for Colombia, showed that 60% of all higher educational subsidies were received by the top income quintile, while only 6% went to the bottom two quintiles, and these proportions were exactly reversed at the primary level. Overall, educational subsidy per household was approximately the same for all income groups. But the rich receive most of their subsidies from attending university while the poor receive their educational subsidies at the primary level (Selowsky, 1979). Similarly, in Malaysia 50% of postsecondary subsidies were received by the top quintile, 10% by the bottom two quintiles, the mirror image of the distribution pattern at the primary level (Meerman, 1979).

Within higher education there is an efficiency rationale for public funding of research and graduate training, whether at public or private institutions. These are the activities yielding externalities for society as a whole, that will not be funded privately. In addition, capital market failure may justify public funding for expensive scientific equipment and financial aid for low-income students. On the other hand, at the undergraduate level, private institutions and private funding of public

institutions should be able to provide instruction in the less-expensive labor intensive fields (liberal arts, law, management) to middle and upper class students, where private benefits predominate and tuition can cover the costs.

Yet, most public funds for higher education are spent on undergraduate instruction at public colleges and universities and, as just noted, most of these students come from middle and upper income families. Expenditures on research and graduate training in most developing countries are minuscule and only a few countries have student grants and loans specifically targeted toward the poor (see James, 1988a, 1988b, 1989; James and Benjamin, 1988; Levy, 1986). The beneficiaries of research are widely dispersed and economically disadvantaged students are also likely to be politically disadvantaged, while the middle class clamors effectively for access to higher education for their children. Thus, this allocation of resources within higher education is consistent with the pressure group predictions of public choice theory more than the efficiency or equity rationale of welfare theory.

A more efficient solution would delegate responsibility for undergraduate instruction to the fee-charging private sector and fees would be charged at the small group of public institutions as well. The experience of many countries has shown that when the supply of public university places is limited, private places spring up to accommodate the excess demand. Public funds could then be reallocated toward the primary and secondary levels, or toward research, scientific equipment and financial aid for needy students at the higher level. Moreover, these funds could be awarded, on a competitive basis, both to public and private institutions. Indeed, elements of this pattern are found in countries such as Japan and Korea, which have thereby

achieved high rates of educational attainment, at low cost to the public treasury. For example, in Korea only 9% of the public educational budget is spent at the higher level, but this is heavily supplemented by private resources from those who receive the private benefits (see Tan, 1989; James, 1987, 1988a, 1988b; James and Benjamin, 1988.)

The private provision of education is often criticized on grounds that it is income-biased. However, as just discussed, public universities are also heavily income-biased. In income-biased private sectors the rich pay their own way, while in income-biased public sectors they are subsidized by tax revenues that could more efficiently be spent in other ways. Moreover, to mitigate the distributional problem private universities could be required to reserve some specified proportion of their places for low income students and public student aid could also be provided for this purpose.

In countries where the private sector (often run by religious organizations) is also the elite, preferred sector (e.g. in Peru, Ecuador, Mexico), private institutions combine both academic and price barriers to entry and are therefore more income-biased than public institutions (see Levy, 1986, Winkler, 1988 and Quintero, 1978). But in countries where the public sector is relatively elite and the private sector accommodates the large excess demand, academic barriers keep the poor out of public institutions while price barriers restrict their access to private institutions. As a result, the two sectors are roughly equivalent in degree of income-bias. For example in Japan, where 90% of all undergraduates are in private colleges and universities, a student from a top quintile family is roughly five times more likely to attend university than one coming from the bottom income quintile in both sectors (James and Benjamin, 1987 and 1988). We suspect that in a

country such as Brazil, where public university slots are heavily rationed, and most students attend private institutions, the public institutions are actually more income-biased than private institutions.

In addition, analysis of higher education enrollment rates across twelve Asian countries showed these rates to be highest in countries with the largest private sector share (James, 1989c). Apparently the constraints on quantity stemming from limited public resources are greater than those stemming from limited private resources. When the private sector is encouraged, the latter resources can be tapped. And, since the poor are much more likely to have access to a large than a small tertiary education sector, the distributional consequences are likely to be positive. We would predict that countries with large private sectors and high enrollment rates (for example, Brazil, Colombia and Korea) also have high rates of participation by the poor. This shift of public/private responsibilities is not only efficient, it is equitable as well.

Health. In general, welfare economics criteria would dictate government expenditures to reduce communicable diseases, to carry out immunization campaigns and other preventive services, to improve the water supply, spread information about lifestyles that promote good health (e.g. anti-smoking, pro-nutrition campaigns) and to provide basic health services (a merit good) to (poorer) groups and (rural) regions that cannot support private medical services. Maternity and child care are particularly important examples of the latter since these affect the health of future generations in which there should be a large social interest. It is probable that these services would raise health standards and reduce mortality in the most cost effective way, because they would touch the lives of many people directly and

through the externalities they generate. (See Birdsall, 1989b; Akin, Birdsall and de Ferranti, 1987, Table , for comparisons of the relative cost-effectiveness of these vs. hospital services in reducing mortality.) But, because they have public good characteristics and many of their beneficiaries are poor, they are not likely to be provided by the private market; hence they are a logical candidate for public funding on efficiency grounds.

However, in many countries, we observe relatively little public health money going to these cost-effective programs (where government intervention is warranted because of private market failure) and consequently population coverage is very limited. Instead, a large proportion of public health budgets is spent on hospitals, usually located in urban areas, even in countries where the vast majority of the population lives in rural areas, with high mortality rates caused by diseases that need not be treated in hospitals.

In Bangladesh in 1986 hospitals consumed over 80% of recurrent public health spending. In Brazil in 1982, 78% of public health funds were spent on high technology hospital procedures (kidney dialysis, coronary by-pass, Caesarian sections) for relatively small groups of urban patients , at least some of whom could afford to finance these services out of private medical insurance in fee-charging hospitals. In Zimbabwe, which has tried to make its health sector more egalitarian, two-thirds of Ministry of Health expenditures are for hospital services and 60% of these expenditures were absorbed by four hospitals in Harare. In Tanzania, which has made a special effort to improve rural clinics, 60% of the recurrent health budget was nevertheless spent on hospitals in 1983-84. (These examples are from selected years in the 1980s from Griffin, 1989 and World Bank, 1988).

Typically, these hospitals are located in urban centers of population, they serve the urban middle classes, and superior public hospitals (e.g. armed forces or social security hospitals) serve the elites. Since hospital services get parcelled out to their patients, they have a large private benefit component and could therefore be financed privately. But once government undertakes the task of financing hospitals, this crowds out private resources and absorbs a large share of the public budget, because of the high cost of modern medical technology.

Suppose instead that many hospitals were turned over to private bodies, with fees to be covered by health insurance (which might be administered by the government but financed by premiums paid by the beneficiaries or their employers). Along similar lines, user charges could be instituted at the remaining public facilities. Public funds would then be freed up to provide the externality-generating health service listed above and also to subsidize health insurance for the poor--very likely bringing about a net improvement in health indicators.

Examples of countries with such experiments are Zambia, where the university hospital at Lusaka is being turned into a parastatal that charges clients for services, with public funds thereby released to finance new maternal, child health and family planning services; Zimbabwe, where a fee has been introduced for patients who bypass lower levels of the health system and those who want a private hospital room; and Gambia, where fees charged for drugs are turned over to village development councils for further health improvement (Akin, Birdsall and de Ferranti, 1987). But privatization alone will not do the job, unless public funds are deliberately reallocated. For example, in Brazil about half of health care expenditures are private, many

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private hospitals do exist (70% of the total), and health maintenance organizations (HMOs) privately funded by workers and their employers are a rapidly growing urban phenomenon, demonstrating the viability of the market in health. Nevertheless, most of the public health funds are spent on expensive hospital procedures with a large private benefit component, for upper income groups (World Bank, 1988 and James, 1989a).

Even if public funding continues, competition within the hospital sector and use of privately managed facilities might improve their cost effectiveness. For example, costs declined when housekeeping and food services at public hospitals were contracted out to private firms in Jamaica. In Chile increased reliance on private hospitals during the past decade was accompanied by a shift toward less expensive medical personnel (more nurses and midwives, fewer doctors), by structural changes to improve incentives, and by the targeting of government services toward primary health care and other services for their poor (Griffin, 1989).

Moreover, if reliance on government funds has limited hospital expansion, access to private funds (including insurance reimbursement) may increase hospital services and thereby improve health indicators, similar to private sector expansion in higher education described above. For example, this occurred in the Philippines in the 1970s, and the greatest expansion of hospitals occurred in the poorest served regions (Griffin, 1989). Access to private services for disadvantaged groups can be further encouraged by subsidizing facilities in low income regions or by requiring hospitals to retain a specified proportion of their beds for charity patients.

The availability of medical insurance plays a key role in all these scenarios. Insurance, of course, raises the problem of moral hazard, hence

overspending, which must be addressed or the efficiency gains just described will be wiped out. Indeed, uncontrolled private hospitals together with mandatory medical insurance may be the worst combination of all from this point of view. Common procedures for dealing with this problem are: requiring co-insurance (e.g. an annual deductible and/or a copayment for each treatment), exempting small costs from coverage, paying hospitals on the basis of diagnosis rather than procedures, reviewing recommendations for surgery and unusually high surgical rates, and structuring in competition among insurance carriers -- in general, greater reliance on market incentives to contain costs. At the same time, it must be recognized that cost escalation in the health field is a problem whose first-best solution has not yet been found in any country. Perhaps all that is possible is a second-best solution, in which the burden does not fall on the public treasury or the lowest income groups in society.

In any event, the reallocation of public funds to public goods just described, together with a shift of responsibility for "private" services to the private sector, aided by privately-financed medical insurance, holds out the promise of raising efficiency and health standards at the same time, and the health gains should be particularly great for the poor. Once again, efficiency and equity seem to be complements rather than substitutes.

Social Security and Other Social Programs

Social security programs may be justified on efficiency grounds if the private discount rate exceeds the private, so many people will not voluntarily save for their old age. Society may then make a collective decision requiring people to save, to provide a minimum "safety net" for all. In order to provide the maximum of risk pooling, to avoid adverse selection

and to enable inflation insurance, the compulsory savings may be administered through a public social security program, as it is in most countries.

This "safety net" efficiency-rationale for social security would dictate broad coverage with benefits above subsistence levels but less than wages. The relationship between individual contributions and pay-outs would vary with life span (the insurance function) but the two would otherwise be closely related, unless redistribution was an explicit goal. If redistribution was desired, it would presumably be from rich to poor and not vice versa.

However, the pattern in some countries is quite different. For example, in Brazil social security covers about half the population, mainly urban workers, a high (28%) proportion of total benefits accrue to early retirees, many of whom are from upper income groups, and their benefits are initially almost as high as their wages (in time, however, the real value of benefits declines due to inflation). As a result of these expenditures, for some recent years social security ran a deficit that had to be covered out of general tax revenues and is in danger of doing so again. (See Policies for Reform of Health Care...in Brazil, 1988)

This is another instance where greater reliance on the private sector (personal saving and supplementary private pension plans for the small group of privileged early retirees) would relieve the pressure on the public treasury, permit a "safety net" coverage for the masses, and hence would be more efficient and equitable at the same time.

A similar pattern holds in housing, where public funds are sometimes (e.g. in Brazil and the U.S.) used to subsidize construction or mortgage loans for middle income housing, whose benefits are largely private, while housing

for the poor remains a major problem and the rental market is distorted by price controls (see James, 1989a). A reallocation of public funds toward more public goods, while letting the private market operate freely to provide private goods such as middle class housing and rental housing is recommended on classical efficiency grounds and would also free up resources that could be used to benefit the poor.

Section III. Measurement Problems and Policy Ambiguities

In Section II many examples were given of public interventions that seemed to be unwarranted on pure efficiency grounds and also seemed to have a perverse redistributive impact. However, it is possible that these initial impressions are misleading. Measuring the distributional effects of government spending or its private alternatives poses a host of practical and conceptual problems that will be discussed in this section. It turns out that most (but not all) of these measurement problems require corrections that end up reducing the amount of government spending that can properly be considered "redistribution to the poor."

Resource Inputs versus Willingness to Pay

First, do we measure the benefits to different groups of consumers according to the real resource inputs into the services they receive or according to their willingness to pay for these services? In empirical studies of quasi-public goods, real inputs or physical outputs are almost invariably used as the measure of benefits per consumer, since we do not really know people's willingness to pay for goods that are not rationed by price. For example, calculations of the distribution of educational benefits

are typically based on enrollments and cost per student while medical benefits are based on patient days or types of operations.

However, this understates the consumer surplus received by the rich relative to the poor, and also understates the relative marginal utility to upper income groups of goods whose quantity is fixed for all (such as pure public goods). Environmental conservation is a middle class political issue for this reason; the working class is relatively more concerned about jobs and pecuniary income, while the middle class is concerned about clean air. Because of the positive income elasticity of demand, the rich will benefit more than the poor from (in terms of willingness to pay for) each consumption unit of normal goods, and conventional measures of benefit (e.g. proportion of enrollments or medical operations) therefore understate the income bias inherent in public spending and overstate its redistribution toward the poor.

Consumers versus Producers

Redistribution to the poor is overstated for a second reason as well. Some of the benefits of government spending for social services undoubtedly accrue to producers, and the producers are often from higher income groups than are consumers.

For example, in many countries increases in public spending on primary and secondary education are mainly captured by middle class teachers, in the form of higher salaries, rather than raising the quantity or quality of education. Along similar lines, teacher salaries are usually much lower in private schools but when subsidies are granted these salaries rise to public school levels. Indeed, this is often the *raison d'être* for the subsidies. (See James, 1990).

Teachers are an articulate group better organized than consumers and taxpayers, and their unions are politically skillful at pressing governments to raise spending and salaries. The fact that publicly financed schools are shielded from market pressures gives unions and other professional groups more power than they would have in competitive private markets. If the higher salaries teachers thereby attain attract a more qualified teaching staff this represents a real cost of quality, not a transfer or rent. But if the same teaching staff remains, at a higher salary, a redistribution occurs, from society at large to the producers rather than the consumers of education. If producers of publicly funded social services receive rents, conventional measures which assume that inputs are being paid their opportunity cost understate the benefits of government spending that accrue to the middle and upper classes and overstate the real resource inputs that accrue to lower income groups (consumers).

Difference Between Distribution of Benefits and Redistribution of Real Income

Our third point potentially works in the opposite direction: it is possible that the rich receive a disproportionate share of benefits, yet the service may still be redistributive because they pay an even larger share of the tax bill. This effect is probably more likely to pertain in developed than in developing countries, since in the latter tax systems are often regressive or proportional rather than progressive.

Measuring the distribution of the tax burden is made difficult by the fact that the initial incidence is often quite different from the final impact, once shifting to consumers and/or workers is taken into account. Most empirical studies, therefore, deal only with initial incidence -- and even this cannot be determined with precision. In studies of American and Japanese

higher education, benefits are always skewed toward the upper classes but taxes appear to be even more skewed so higher education is still, in most cases, moderately redistributive. The Japanese public system is more redistributive than most U.S. state university systems because the state sales and property taxes which are used to finance higher education in the U.S. are less progressive than the national income tax system which is used to finance universities in Japan. However, the community college system in the U.S. is the most redistributive of all, because its students come disproportionately from low income groups (see James and Benjamin, 1987 and 1988).

In Selowsky's study of the distribution of health, education and other social services in Colombia, the upper income groups received larger benefits but the benefit distribution was not nearly as skewed as the distribution of income and taxes; hence the overall effect of governmental spending and taxation was mildly redistributive toward the poor (Selowsky, 1979).

In Brazil the bottom income quintile receives 7% of total social benefits while the top quintile receives 41%. This is certainly an income-biased pattern of benefits. If the tax system were progressive or proportional the net impact would nevertheless be redistributive toward the poor, since income is even more skewed (see World Bank, 1988). However, the Brazilian tax system is probably regressive, because of the preponderance of payroll taxes, the flat rate structure, the poor coverage and the existence of hidden subsidized and tax credits (World Bank, 1989). Therefore, it is not at all clear that the public provision of social services increases the real welfare of the lowest income groups, on balance. At the same time, there is probably a redistribution to the poorer regions. For example, social security

benefits urban areas more than rural areas but the former are also taxed more regularly and heavily for social security. Although the rich Southeastern part of the country gets a disproportionate share of social security and medical benefits residents of that region pay an even larger share of taxes, so on balance the system redistributes to the poor Northeast (see World Bank, 1988). This is consistent with predictions from public choice theory that influential middle and upper income groups will benefit disproportionately from public spending, but some redistribution to poor groups or regions will nevertheless take place.

Social Insurance versus Redistribution

Fourth, many programs that look redistributive from an ex post (or transitory income) point of view are really insurance from an ex ante (or permanent income) point of view. For example, unemployment or disability compensation are received by groups with lower temporary income, but much of this transfer is an insurance pay-off in exchange for the earlier payment of insurance premiums by these same groups. It represents a smoothing or maintenance rather than a redistribution of expected lifetime income. Redistribution is correctly measured by the difference between premiums paid and expected insurance returns which may be positive for some and negative for others but is far less than total transfers for all.

We digress for a moment to comment on the relationship between social insurance and redistribution. All social insurance programs have some elements of risk-pooling and some elements of redistribution, since some people are actuarially more vulnerable than others but in a public program premiums are constrained to be relatively uniform and do not reflect differential riskiness. Indeed, one reason for operating such insurance

programs as a public monopoly is to prevent opting out and adverse selection, thereby permitting some redistribution to take place. In homogeneous societies the insurance element predominates whereas in heterogeneous societies definable groups may have large differences in riskiness that are not reflected in differential premiums; hence the redistributive component grows.

Groups that are being "redistributed away from" will oppose a high level of social insurance, since they do not get an actuarially fair return, and will favor a voluntary privatized system. If these groups are politically influential, it follows that heterogeneous societies are likely to have less social insurance, which is necessarily tied together with redistribution in these societies. Unfortunately, private insurance markets may also be non-sustainable because of adverse selection and/or the need for large-scale risk-pooling (e.g. to cover catastrophic risks). So, these societies may end up with individuals bearing a high degree of risk. The U.S. is an example of such a society; it would be useful to test this hypothesis about the inverse relationship between heterogeneity and social insurance across a larger set of countries.

The political pressures against social insurance just described are mitigated by the fact that, for any given level of insurance, middle and upper income groups usually find ways to get a larger share of benefits than their actual life experience warrants, whereas low income groups do not receive all the benefits to which they are entitled (because they do not know all the rules or all the ways around the rules).

In measuring the redistributive effects of these programs, then, one must first eliminate the part that represents insurance, in the sense that

actuarially fair premiums have been paid on the basis of demographic characteristics; and second one must take account of the fact that some groups systematically receive less than their formal characteristics would suggest. Both these adjustments lead to the conclusion that many programs overstate the degree to which they redistribute to the poor.

Life Cycle Income Shifts

Closely related, some programs that appear to be redistributive merely shift income from one stage of the life cycle to another. For example, social security is sometimes thought of as a payment to low income retirees but, to the extent it is actuarially fair, merely represents compulsory savings when young to finance consumption when older and not working. Thus, it is less redistributive to the poor from a life cycle than from a static cross-sectional point of view. Indeed, in some countries people with high lifetime incomes (albeit relatively low current incomes) receive a disproportionate share of total benefits so the net redistribution may actually be perverse. In Brazil, for example, the poor are much less likely to benefit from pension benefits since they are less able to demonstrate the minimum necessary number of years of continuous attachment to the labor force. In 1986, 28% of benefits were absorbed by early retirees in Brazil, who represented just 9% of all recipients, and relatively few of these were poor (World Bank, 1988b).

Another example of a life cycle effect (which creates the opposite kind of distortion) concerns the provision of public education. We may think of people as paying for public education throughout their working lives but receiving the benefits at particular points in time, a life cycle shift in real income. Primary school students usually have young parents, whose

current income understates their lifetime income, while university students have middle-aged parents whose income is at the life cycle peak. University education, of course, is much more expensive than primary education. Thus, if we examine data based on the population as a whole, it may appear that high income families are disproportionately receiving the benefits from public educational spending, particularly from high cost public universities, but in part this is due to the relationship between income and age, not the educational access of different lifetime groups. Higher education distribution figures which do not adjust for this life cycle view will systematically understate the benefits received by low income families. Even if there were no income bias of enrollments within a given cohort based on lifetime income, there would appear to be one because the entire cohort is at a high point in its life cycle income, relative to the population as a whole.

A more appropriate set of data would compare lifetime taxes paid and benefits received by different groups within a given age cohort. As one example: when this calculation was carried out for the case of public universities in Japan and the U.S. it increased the lifetime cohort tax shares of lower income groups but increased their enrollment shares still more, so the income bias in enrollments was cut in half (e.g. the ratio of enrollments from top relative to bottom quintiles fell from 5.8 to 2.6 in Japan, from 4.5 to 2.4 in California) and the redistribution from rich to poor became much more marked (see James and Benjamin, 1987 & 1988).

Taste Change and Information

Some public programs involve information and taste change (e.g. public spending on anti-smoking or anti-cholesterol campaigns). If tastes have been changed, do we measure benefits in terms of ex ante or ex post

preferences? Or do we impose external "objective" benefit criteria, contrary to the usual subjective approach in welfare economics?

It may well be more difficult and/or costly to deliver information to and change the tastes of the poor, particularly the rural and uneducated poor, so their preferences and behavior may remain unchanged. In contrast, wealthier and more educated people are better able to receive and absorb information, unless special efforts are made to target it toward low income communities. The gains in terms of reducing mortality rates and incidence of illness may be greater if information is targeted toward the poor. However, in terms of willingness to pay, the poor may not place a high value on public health campaigns because they are slow to acquire information and their tastes are slow to change.

In this sense, information and taste-changing activities are quasi-public (rather than pure public goods) that get parcelled out between upper or lower income groups, the former are more likely to benefit unless special steps are taken to offset their higher productivity in assimilating information, and conventional measures of distribution are unlikely to capture these biases.

Section IV. Political Strategies

In this paper we have argued for a policy which concentrates government funding on public goods and encourages the market to do what it can do best--fund and produce private goods. A drift away from this policy in the social service sector of many developing countries in recent years has had, we believe, negative distributional as well as efficiency consequences. While efficiency and equity objectives do not always lead to the same set of

actions, numerous examples given above suggest they do coincide in the education and health sectors of many countries today. These actions usually involve increased financial responsibilities for the private sector, combined with a reallocation of government funds within the public sector.

In the absence of political change, however, the shift we are proposing will not be easy to accomplish, since the current situation has come about precisely because people with political power have felt they could benefit therefrom and will resist relinquishing this source of real income. It is important to remember that the current situation is the result of an equilibrium, in which each group is maximizing the utility it can extract from the political system. In this equilibrium, each group with political power gets some pay-off: the rich get university education and superior hospitals while the poor get primary schools and sometimes rural health clinics. In many cases it appears that upper income groups get a disproportionate share of benefits, but since they also pay more taxes, on balance there is often a modest redistribution to the poor. If we now disturb one element of this equilibrium, other elements will change as a reaction, so that the end result may be quite different from the initial step.

For example, suppose the upper classes feel their benefits have declined when a shift is made from funding private to public goods by government (e.g. from financing medical operations to financing malaria control and immunization campaigns); they may then lobby successfully for a corresponding tax cut, so that government has less to spend, or for a shift in the structure of taxes, so that relatively more is collected from the lower classes. (Tax cuts in the Reagan years in the U.S. could thus be viewed as a reaction to the build up of poverty programs in the 1960s and early 1970s.

beyond those of the New Deal years, though other factors obviously also contributed).

Along similar lines, suppose that undergraduates from high income families are charged higher fees for access to superior public universities, in an attempt to capture private revenues for the private benefits they receive. They may respond by switching to the private sector and withdrawing their political support from the public sector facilities. Thus, both the student mix and the resources available to superior public universities may change; and by the final equilibrium they may no longer be superior. In formulating public policy, this chain of responses leading to a new political equilibrium must be taken into account.

Pragmatically, one may have to choose between a smaller public budget targeted toward the poor versus a larger public budget with benefits accruing to the rich, between a benefit pattern that is biased toward the rich but also financed by them on the basis of progressive or proportional taxation, versus a more egalitarian distribution of services financed by a more regressive tax system. (For a discussion of the political equilibrium in Japan and the reactions to educational reform that restored an unexpected new equilibrium, see James, 1986; James and Benjamin, 1988).

Ultimately, large changes in the distribution of benefits from government spending will only occur if there is a corresponding change in the distribution of political power. For example, as the urban working class grew in size and became enfranchised in nineteenth and twentieth century Europe, they also acquired greater power to influence government policies. It is possible that enfranchisement of black voters in the U.S. South, beginning with the Civil Rights Act of 1964, has gradually increased the access of

blacks to the benefits of state-sponsored social programs. Obviously, these changes in internal power structure are very slow and difficult to achieve. On the other hand, a temporary change in power can sometimes be multiplied and become permanent if it is used to alter the long run rules of the game via constitutional change, precedent-setting judicial interpretations, irreversible extensions of voting rights, reapportionment, etc. All these elements were present in the two examples given above. Some now argue (Nelson, 1989) that re-democratization in Latin America will increase the political influence of the urban working poor -- who may then use this power to increase their share of social benefits (though this would not affect the rural poor).

While the above comments sound pessimistic, there are a few sources of hope. First, as discussed in Part I, many of the inefficient inequitable policies we have been discussing are stimulated and perpetuated by imperfect information. The "losers" do not always know how much they are losing and the "winners" incur costs to hide information from them. Spreading more accurate information may then alter the feasible political equilibrium. Along similar lines, politicians do not know peoples' preferences or the intensity of these preferences with certainty, and if their perceptions of preferences are changed, the policies they deem politically optimal will also change. Given the current fiscal crisis in many countries, politicians may be more willing to consider cost-effective reallocations.

Third, the realignment of public and private responsibilities that we have been discussing constitutes a move toward efficiency, thereby generating a productive surplus which can, at least theoretically, make everyone better off. If the surplus is distributed in such a way that there are more winners

than losers, including influential winners, this should help to offset the political resistance to change. The political strategy to follow, then, is one of slow increases in equity, with many groups benefitting but the poor benefitting most of all.

Finally, the power structure may be changed through the intervention of external actors such as local and international NGOs (non-profit non governmental organizations), the World Bank and other aid agencies --although the scope for action here is obviously limited.

Examples of policies that might be adopted to facilitate change are:

1. Concerned internal and/or external actors could initiate a citizens' education campaign, which makes it clear to lower income groups that their needs are not being met and to the middle and upper income groups that if changes are not implemented, the country as a whole will face increasing costs in the future, much of which they will have to pay. Examples of these costs are higher taxes, higher social security premiums, slower income growth, environmental problems, crime and political instability.

2. If changes such as cost recovery schemes are planned for the public sector, the current cohort of consumers should be exempted as much as possible. For example, students currently in public universities should probably be exempted from large fee increases, and fees should be gradually phased in for new cohorts, to minimize the risk for politicians.

3. Rather than withdrawing entirely from a service area (such as higher education or hospitals) in many instances governments should simply halt future expansion, leaving further increases in demand to be accommodated by the private sector. This too should minimize opposition among consumer groups.

4. Governments should be cautioned about starting up new service areas, unless they meet a stringent public good test. It is easier not to start than to cut off services already being provided. New social programs should be carefully scrutinized and should not be undertaken by the government unless it is clear 1) that they have a high social rate of return, 2) will not be undertaken by the private market and 3) do not have perverse distributional effects.

5. On the other hand, government spending should be encouraged for social services that yield a large public good component. If new spending is concentrated on public goods, the poor will automatically benefit even if they are not targeted. And since the rich also benefit they be reluctant to oppose these programs, even though they prefer government spending on other (private) services from which their benefits are larger.

6. Where targeting is done, it is probably more effective to do so by region (although incentives for migration pose a problem) or by easily identifiable population groups (pregnant women and young children) or by subsidizing goods that the poor are likely to consume (e.g. certain foods or community colleges) rather than by means-testing and earmarking of individuals, which has high administrative and political costs.

7. Moreover, a distributional impact analysis can be made (and publicized) of different services, locations, and methods of delivery, bearing in mind that they will be more politically stable if the broad middle class also participates. For example, if public provision of pre-schools is expanded, they are likely to be used primarily by middle and upper income families. But if low socio-economic neighborhoods are selected, the clientele will change accordingly. If these services are targeted strictly toward the

poor, they are unlikely to receive enough political support for a high level of quantity and quality, and will be subject to cut-backs during periods of fiscal stringency, as indicated by evidence from the U.K., Sri Lanka, and other countries (see Goodin and LeGrand, 1987; Besley and Kanbur, 1988). Those shared with the middle classes are more likely to be preserved, which may be one reason why the poor have not been more vociferous in seeking targeted programs. An open discussion of distributional impacts and choices may itself change the feasible political equilibrium.

8. Even where funding responsibility is retained by government, economies of competition may be attained if production and management responsibilities are shifted to the private sector (as in contracting out schemes, done on a competitive basis, or if market approaches are introduced into the public sector (as in voucher schemes where funds follow students or patients within public institutions). These market elements should cut down on rents that often have a perverse distributional effect, and should generate a surplus that can be spent in a more egalitarian manner. Once these possibilities are put on the agenda they may themselves generate new constitutions and coalitions (e.g. from private sector organizations) that alter the political equilibrium -- agenda-setting is thus a powerful tool.

9. Another way of economizing on costs, hence permitting greater quantity for any given budget, is to give modest subsidies to NGOs that provide services to disadvantaged communities and are able to draw on donations of money, volunteer and quasi-volunteer labor. Perhaps more important, NGO advocacy groups might be used to play an important role as informational conduits to disadvantaged groups and as grassroots organizations informing politicians of consumer preferences and stimulating the government

to act. (This is the role they play, for example, in Sweden, where they are built into the political process; see James, 1989). NGOs, thus, can help change the balance of political power, which is both a reason why some groups support them and why many influential groups oppose them.

10. Any structural or other major policy change involves transactions and transitional costs. By covering these costs, in projects that are conditioned on efficiency and equity improvements, World Bank loans can help to diminish the resistance to change.

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