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will be financed, and should be financed, by loan finance.¹

Theory meets Practice
Devarajan, Squire, and Suthiwart-Narueput (DSS) (1997) argue strongly that the marginal social cost of public funds should be taken into account in evaluating projects that call for net flows of budgetary funds. Unless this is done, they argue, the net present value of such projects will be systematically overvalued and hence, as suggested by the textbook wisdom cited earlier, the public sector will be inappropriately expanded. Since even Harberger (1997), long an advocate of the standard convention of much cost-benefit analysis of assuming that the marginal source of funds is borrowing in the capital market, agreed that deadweight losses due to financing should be included as part of project costs, it appears that, at last, theory and practice agree on this point.

But Issues Remain to be Resolved
Before introducing an “MCF factor” in project analysis, however, several important considerations need to be discussed further:

- What precisely is to be included in the “social marginal cost of public funds”? Is it just deadweight losses? Should it include also administrative costs? Compliance costs? Should it be expanded further to include a variety of other costs involved in raising public revenues?³

- While if taxes were set optimally, MCF would be the same for all tax sources, in fact MCF may vary considerably from tax to tax and may, as noted below, even be less than one. One must therefore assume either that the “marginal” expenditure will be financed in the same way as the “average” expenditure is now financed or make some other explicit assumption about the source of finance (such as the traditional assumption that the funds will be borrowed).

- What if the expenditures being considered are funded from taxes that are not distorting? Or from user charges? Or debt? Or from earmarked taxes or other ‘delimited’ taxes, such as those levied by local governments? As Ballard and Fullerton (1992, p. 129) note, “…economists should set aside the apparent presumption that the marginal benefits of a tax-financed public good must exceed its dollar cost.”⁴

- Finally, is it correct to treat the efficiency costs of public revenues as a cost without taking into account any distributional benefits that may be associated with such costs (Kaplow 1996)?

The Wicksellian Connection
Without going into detail, consideration of these and other issues suggests strongly that financing matters in cost-benefit analysis. It matters for two distinct reasons. The first reason is simply because how a project is financed can and should affect the net present value of benefits to be expected from it, and hence whether it is worth doing or not.

² Musgrave (1997) argues that for people to make rational fiscal decisions, they need to be able to compare the benefits and costs of such decisions, which means they have to take into account both the expenditures to be carried out and the way in which they are financed. If the expenditure in question is one that will yield a future stream of benefits—that is, an investment in either physical or human capital—it would be rational for a private individual to borrow to finance it. The same is true for a society, so the use of loan finance for public capital formation—along with procedures such as capital budgeting to make the linkage clear—has much to be said for it as a means of ensuring that the political process through which public goods are provided yields the desired time path of total (public plus private) consumption.

³ Usher (1991) adds such “hidden costs” as the overhead costs of tax collection and provision of services, the concealment costs incurred in tax, and the enforcement costs of dealing with these problems and constraining corruption

⁴ Note, however, that Kaplow (1996) suggests that while such considerations should, if important, be taken into account in appraising particular expenditures, they do not justify any general adjustment of the MCF used in expenditure analysis.
The second reason for being concerned about how public expenditures are financed is more basic. Indeed, it goes to the heart of the central problem of public economics: what should governments do, since what governments should do is inseparably entangled with the question of how whatever they do is to be financed. Not only is the proper treatment of efficiency costs inextricably related to distributional concerns—since one can never assume in developing countries that there is a well functioning tax-transfer system to take care of such issues—but more importantly it is critical to ensure that the linkage between expenditure and revenue decisions is as clearly established in the budgetary and political process as possible. It is not enough to be able to define "optimal" outcomes: if one wants to see those outcomes become reality it is essential to strengthen what has been called the "Wicksellian connection" (Breton 1996) between expenditures and revenues. Taking into account the financing side of public expenditures is not thus simply something that can (or should) be factored into project evaluation by some (non-existent) omniscient observer who will, on the basis of his or her impartial weighing of the evidence, decide what is best for society—and especially not for someone else's society! Rather, it is an essential component of the process by which good budgetary decisions—decisions that, as closely as practically feasible, reflect people's real preferences—can be obtained in any society.

The point is not that user charge financing or capital budgeting is always preferable to general fund financing and budgeting. In many instances, such practices have arguably produced worse results than those that might have emerged with a soundly conceived and executed comprehensive budgetary system and a uniformly applied expenditure evaluation system. However, few developing countries have such systems in place. The fact that something has often been done wrongly in no way detracts from the basic argument that it can be done rightly and that, when so done, it will produce outcomes more in accordance with society's wishes and resources.

DSS (1997) correctly stress the importance for good expenditure analysis of carefully specifying the "appropriate counterfactual." In effect, what is suggested here is, first, that in at least some instances that "appropriate" counterfactual may suggest that one should not automatically apply an MCF correction to budgetary flows, and second, and in many ways most importantly, that thinking through correctly the links between expenditures and revenues is critical not just for good project analysis but more fundamentally for good government. The key to good results in project selection as with governance in general lies not in any particular budgetary or financing procedure but rather in implementing an institutional framework that, to the extent possible, links specific expenditure and revenue decisions as transparently as possible.

References


