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POLITICAL, SOCIAL AND ECONOMIC REALITIES IN DEVELOPING COUNTRIES AND IN COUNTRIES WITH ECONOMIES IN TRANSITION

Report prepared by the Secretariat

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INTRODUCTION

1. In the light of the international community's increasing awareness of slow economic growth in many developing countries and countries in transition from a centrally planned economy to a free-market economy (transitional economy countries) and of the related negative global implications, it is essential that the United Nations should promote and implement action-oriented responses aimed at helping those countries to reduce poverty and achieve sustainable economic growth. In the long run, the eradication of poverty throughout the world will serve the interests of economically developed countries as well as those of other countries.

2. Approximately one third of the total population of developing countries - over 1 billion people - live in poverty according to the yardstick currently applied, namely annual per capita consumption of less than $370. They are the "forgotten people" in the development process, having received little or no benefits from economic growth over the past decades. The poor are unable to achieve a minimum level of living and cannot afford adequate food, clothing or housing. Their life expectancies are low, the death rates of their children are high and about 10 million children receive absolutely no basic education. In fact, some 15 million children under 5 years of age die annually in circumstances that would not normally result in death in economically developed countries.

3. Generally speaking, poverty is more acute in rural areas, although urban poverty has been on the rise. The poor tend to live on marginal rural lands or in shanty towns on the outskirts of cities. The rural poor have little or nor access to government services, technical assistance or sources of credit. The rural poor include large numbers of the landless as well as tenants or sharecroppers with precarious land tenure arrangements. This group of poor has greatly expanded in recent decades; it forms the largest group of potential migrants to urban areas.

4. The most effective means of reducing poverty is the adoption of national development strategies, including sound macroeconomic and structural policies, which encourage sustainable growth that increases income-earning opportunities for the poor and develop the human resources of the poor, particularly through broad access to education, health and family planning services. In a working paper entitled "Approach to overcoming poverty through self-help and target - group - oriented financing instruments" prepared for the Ministry for Economic Cooperation of the Federal Republic of Germany in 1994, it was observed that "the poor in the third world do help themselves:

"- they achieve individually and as groups, a considerable output in terms of savings and labour;

"- they may become creditworthy, obtain, put to good use and repay credit: the poorest people have proved to be particularly reliable clients of banks;

"- they work productively in many different ways and are able to increase their productivity;

"- they form groups, often on a voluntary basis and informally, which arrange their activities: neighbourhood help, labour, amount, purpose and sequence of credits, group security, settlement of conflicts;

"- they contribute to the balanced development of all members of the group without curbing the dynamism of the individual;

"- all these activities help to form the nucleus and points of crystallization for democratic processes of development."

5. The use of public financial resources to improve the health and education of the poor has proved to be an investment that benefits the economy as a whole, for a healthy, well-educated workforce means higher productivity and more rapid economic growth. However, welfare programmes which include no measures aimed at bringing about corresponding increases in the productivity of the recipients are bound to be short-lived and even counterproductive.

6. Generally speaking, the capitalist revolution (free-market reforms and well-conceived and prudently implemented privatization in the post cold war period) has increased foreign investment, streamlined the public sector and reduced inflation, bringing about a significant level of stability and prosperity. However, in countries where objectively justifiable reforms have been marred by cronyism and nepotism and undertaken without a concomitant commitment to justice, solid money, competitive markets and democracy, the result has been unbridled mercantilism, with the vast majority of the population being denied the opportunities and benefits of economic growth. In some cases, populist opposition has emerged in protest against dishonestly implemented privatizations which have simply replaced public monopolies with private monopolies. The inadequacies of the self-offs are being used by enemies of free-market reforms, who claim that such reforms are simply a subterfuge for giving more advantages to the rich while neglecting the poor. Improperly implemented free-market reforms have also sometimes given rise to populist opposition to structural adjustments backed by the International Monetary Fund (IMF), which, while often necessary, are perceived as being harmful to the poor.

7. It is against this background that developing and transitional economy countries must grapple with the problem of maximizing the mobilization of financial resources from both domestic and foreign sources while at the same time ensuring that those resources are used in the most efficient and productive way so as to benefit all classes of the population, including the poor, and that public financial operations are reliably accounted for so as to inspire confidence among both citizens and foreign donors and investors.

8. To that end, the Governments of developing and transitional economy countries, with the cooperation of the international community, in particular the United Nations, should seek to strengthen their capacity in the following areas:

I. Enhanced resource mobilization:

A. Enhanced mobilization of domestic financial resources:

1. Enhanced mobilization of government revenue;

2. Enhanced mobilization of private (business and personal) savings;

B. Enhanced mobilizations of private foreign investment;

II. Improved government financial management (public expenditure planning, budgeting, performance evaluation and accountability);

III. Public enterprise reform and private enterprise development:

A. Public enterprise reform;

B. Private enterprise development.

I. ENHANCED RESOURCE MOBILIZATION

9. Although governmentalism is not the solution, inducing economic and social progress within the free market system, that is through private persuasion, depends to a very significant extent on the efforts of Governments. Government policies should reflect a sustained commitment to improving the lot of the poor. International factors - notably world trade, foreign direct investment, foreign loans and foreign aid - can play an important part in a strategy for reducing poverty. Foreign aid can provide investment capital, foreign technology and skilled personnel. It has sometimes been an effective instrument for alleviating poverty, but it has not always fulfilled its potential, for various reasons. Bilateral donors have many different motives (political, strategic, commercial and humanitarian), the reduction of poverty usually being far from the most important. Furthermore, a number of recipient countries seem to have fallen into what has been referred to as "aid dependency" and many poverty-oriented projects funded by aid have failed to benefit the poor. A solid case for greater amounts of aid could, however, be made if more recipient countries were to concentrate seriously on combating poverty and if donors profited from the lessons of experience. Projection by the Development Assistance Committee (DAC) of the Organisation for Economic Cooperation and Development (OECD) have indicated that aid could increase to $108 billion or $144 billion by the year 2000 if aid/GNP ratios of 0.5 or 0.7 per cent respectively were attained by those donors which are currently below these ratios while donors above them maintain their current levels. However, foreign aid could increase to only $64 billion in the year 2000 if it grows at 2 per cent a year. Foreign aid fosters a prospering and peaceful international environment. When properly used, it is a catalyst for development.

10. Despite the encouraging trend in the international flow of foreign direct investment, net resource flows, particularly to low-income countries and severely indebted lower-middle-income countries, have remained stagnant or declined, highlighting the need for the international community to continue

mobilizing adequate financing in support of developing countries' efforts to move towards external viability combined with sustainable growth. International efforts in the form of increased foreign aid and open trade policies can support and complement the actions of recipient countries, but it is the Governments of the latter countries which bear the primary responsibility for their own economic and social progress.

11. Revitalizing the vision of development requires expanded capital formation through enhanced efforts to mobilize financial resources. This means intensified efforts to mobilize an increased volume of domestic financial resources and attain more private foreign capital.

A. Enhanced mobilization of domestic financial resources

12. No matter how great the contribution of foreign capital, it must essentially serve as a supplement to domestic financial resources if a country is to embark on a self-sustaining development process. Thus the investment requirements of a country have to be met increasingly from the savings of the three major sectors of its national economy: (a) the government sector, whose savings are represented by the excess of tax revenue (including customs duties) and non-tax resources (i.e. grants, property income, sales proceeds of public assets, fines and other government receipts) over current government expenditures; (b) the business sector, whether corporate or unincorporated, which derives its savings from the retained profits of enterprises; and (c) the household sector, which derives its savings from salaries, wages and professional fees in the case of individuals and from profits in the case of family businesses. The savings of the household sector include the savings of property owners or rentiers who do not operate business enterprises and the strictly personal savings of individual households. In most, if not all countries, the household sector currently accounts for the greater part of savings.

1. Enhanced mobilization of government revenue

13. Governments have a broad responsibility for providing services of vital importance for development, including notably education, health, water and sewerage, roads, public transport and essential housing. Certain elements of government current expenditures, notably for such purposes as education and health, are as important to development as capital expenditures on roads and buildings. In addition, the Government may either engage directly in productive activity, if the private sector is unwilling to fill any gap that may exist in the provision of essential services or seek to channel resources to the private sector for the promotion or expansion of enterprises. The ability of the Government to provide necessary services depends on the amount of tax revenue that it is in a position to collect. Failure to raise adequate revenue tends to reduce the amount of services that can be provided or to cause inflationary pressures, which in turn, by generating additional import demand, spill over to the external sector intensifying pressures on the balance of payments.

14. A critical bottleneck in the process of poverty eradication is weak fiscal discipline, which in an unstable economic environment may give rise to large fiscal imbalances that are financed through inflation. Many countries run fiscal deficits to finance their expenditures because their tax bases are too limited to allow a high tax burden. Even when broader tax bases are available, tax administrations are too inefficient to collect the taxes legally due and political realities often make it difficult to increase the tax burden. Owing to the lack of developed capital markets and the non-availability of external borrowing, fiscal deficits are often financed wholly or partly by central banks, that is, through money creation, which increases the general price level, thus reducing the real value of the monetary unit. Greater efficiency in the collection of taxes can reduce deficit financing and the inflationary process. High inflation has critical allocative and distributional implications that impede growth, inter alia by encouraging capital flight.

15. Fiscal policy plays a major role in promoting and sustaining stabilization and growth, given the close interdependence between fiscal, monetary and external sector policies. Specific fiscal instruments affect savings, capital flight, foreign investment and so on.

16. Tax evasion and avoidance at both the national and international levels have serious implications for fiscal policy. They violate the principle of fiscal equity and undermine the concept of voluntary compliance with tax laws. They can greatly diminish the value of codified incentives and thereby affect allocative behaviour to thwart redistributional programmes, create artificial biases in macroeconomic indicators and increase the tax burden when tax rates must be increased in order to offset the revenue losses incurred, thereby imposing an unfair burden on taxpayers who cannot shift their tax liabilities. The greater the extent of tax evasion and avoidance, the more difficult it is to finance government expenditure without inflation or in other words to increase tax revenue adequately, with the result that the excess of expenditure over taxation is positively correlated with the tax burden. Tax paying has, in fact, come to be regarded as unfair, since public expenditure has been increasingly perceived as failing to yield commensurate benefits either to taxpayers personally or to their communities.

17. Tax administrators have adopted various measures to reduce opportunities for tax evasion and avoidance. The scope of these measures varies according to the characteristics of the country concerned, including its legal structure, its political system, its traditions and the psychology of its people. These measures have included reliance on indirect taxes, reliance on declarations and withholding of taxes by third parties, the operation of an efficient system and cross-checking of information, auditing and the unilateral determination of taxable income, the bilateral determination of taxable income (forfeit method) and the use of legislative provision administrative rulings and judicial decisions, as well as the enactment and enforcement of penalties. International tax evasion and avoidance can be combated by the conclusion of bilateral tax treaties providing for mutual assistance and the exchange of information.

18. The proper implementation of the aforementioned measures requires an efficient and effective revenue administration. The need to introduce higher tax rates and/or new taxes can often be reduced or eliminated by strengthening

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the revenue administration. Similarly, the result of attempts to generate additional revenue through higher tax rates or more taxes may prove disappointing unless determined and coordinated efforts are made to enhance the efficiency and effectiveness of the revenue administration. The weaker the revenue administration, the more limited the choice of taxes, and unless the administration is capable of enforcing any new taxes, they may not have a significant impact on tax revenue. Efforts to gear a country's tax structure to the capability of the revenue administration can lead to an increase in revenue by reducing tax evasion and avoidance. Revenue administration constraints tend to determine a country's actual tax structure. Revenue administration performance may lead to the amendment of existing tax laws or the adoption of new laws, so as to introduce more broadly based income and consumption taxes, thus reducing dependence on foreign trade taxes.

19. Action aimed at enhancing the efficiency and effectiveness of revenue administrations has focused on such factors as the institutional framework, management, compliance (including registration) assessment, collection, investigation and audit, revenue accounting, information systems and taxpayer education information and assistance. Furthermore, steps have been taken to make taxes easier to administer, thus permitting more effective application of the tax laws with a more economical use of resources. A revenue administration capable of applying the tax laws efficiently and effectively constitutes a major means of securing additional government revenue without raising taxes and/or introducing new taxes, an unpopular course which many Governments would prefer to avoid. As the Roman Emperor Tiberius observed when advised to raise taxes, "a good shepherd shears his sheep, he does not flay them". In a world environment characterized by disillusionment with governmentalism or state interventionism, a revenue administration of high quality will bolster economic restructuring through entrepreneurial development, with positive effects on both the pattern and the rate of growth.

2. Enhanced mobilization of private (business and personal) savings

20. In the business sector, savings are an essential component of successful business operations. Business profits furnish by far the most readily available source of financing for capital expenditure, and this is especially so in the developing countries, where highly developed capital markets do not generally exist to permit external financing. Business enterprises, both corporate and unincorporate, tend to save and invest a large proportion of their savings - a proportion which is invariably much higher than the corresponding share of wage and salary income savings. Thus, the higher the share of business profits in total income, the larger will the aggregate savings ratio tend to be.

21. Personal savings out of wages and salary incomes largely represent the postponement of consumption, more importantly from the working age to the retirement age. To the extent that the retirement motive predominates, the net contributions of this source will depend on the excess of the income earned by the current generation of working age over the income earned by the generation currently in retirement. It will, therefore, depend on the rate of growth of

real incomes, and particularly on the rate of growth of the number of wage and salary earners and on earnings per head.

22. In some cases a large part of the monetized agricultural output is turned over as payment of rent to owners who are economically passive, for example to absentee landlords. The propensity to save out of such rentier income is likely to be low, since such rentiers normally have little motive for saving. They have no business motive, and since income derived from the ownership of land may be regarded as safe and permanent, there may be little retirement motive for saving either.

23. Personal savings take the form of cash, sight deposits (whether in current accounts or savings accounts), time-deposits, securities, life insurance policies and contributions to pension schemes. Relatively substantial savings in developing countries are held in the form of cash, the most obvious reason for this situation being the inadequacy of the financial intermediation framework. The hoarding of cash and the preference of savers for other highly liquid types of savings may be attributed to a number of factors, including the desire to have cash on hand for use in emergencies or in speculative transactions as a hedge against the gradual depreciation of the real value of savings, indifference to, or ignorance of, the interest that could be earned if the savings were deposited with a savings institution, and even mistrust of financial intermediaries. The development of banking services towards more advanced customer-oriented concepts including payment of wages and salaries, pensions etc. via bank accounts, might increasingly counteract these types of behaviour.

24. Efforts to increase the aggregate volume of personal savings deposited with financial institutions have involved the use of various incentives adapted to the social and economic conditions in the countries concerned. These incentives may be classified into three main categories:

(a) Incentives involving the protection of savings;

(b) Incentives involving higher rates of return on savings;

(c) Incentives involving the offer of credit facilities to savers.

25. The protection of savings may relate to their nominal value, their real value or both. Protection of the nominal value of savings depends on a combination of factors, namely: efficient and prudent internal management of savings mobilization institutions supplemented by efficient government supervisory action; availability of adequate risk-bearing resources, supplemented by the existence of lenders of last resort; and availability of a formal guarantee of all or part of the funds deposited with savings mobilization institutions.

26. With regard to the maintenance of the real value of savings, it is well known that persistent inflation results in a redistribution of real income and wealth which benefits those whose income and wealth increase more rapidly than prices and is prejudicial to those whose income and wealth lag behind the rise in prices. The latter group includes fixed-income groups and pensioners,

holders of bank deposits and holders of fixed-interest securities and insurance policies. Inflationary pressures tend to curb the propensity to save, thus diminishing the volume of voluntary savings available for productive investment. The continuous erosion of the purchase power of money undermines the ability and willingness of households to save in monetary forms and induces a shift to domestic non-monetary assets such as land, housing, precious metal and jewelry, or else to foreign assets. Various techniques have been used to counteract the effects of inflation. They include techniques which do not adjust the value of financial transactions to the actual rate of inflation and the techniques which do. The techniques in the first category involve increasing interest rates on both savings and loans to a level commensurate with the expected rate of inflation. The techniques which adjust savings transactions and loan transactions so as to maintain their real value are known by various names such as indexing techniques, value-linking techniques, monetary correction techniques and purchasing power guarantees.

27. The incentives involving higher rates of return on savings include attractive rates of interest, tax privileges and premiums and bonuses. Concerning incentives involving the use of credit facilities to savers, the promise of liens as a means of encouraging personal saving goes back to the origin of co-operative and mutualist credit, although its use has spread since the end of the Second World War, both geographically and in range of purposes.

B. Enhanced mobilization of private foreign investment

28. In 1995, private capital flows to developing countries exceeded $170 billion. However, 75 per cent of those flows went to just 12 countries. About 50 countries - most of them very poor - received virtually no private flows. Addressing the Board of Governors of the World Bank Group in October 1996, the President of the Bank observed "Our new world of open markets raises the stakes for developing countries. Investment is linked to good policies and good governance, liberal trade regimes and high savings rate, combined with sound legal and judicial systems. Simply put, capital goes to those countries that get the fundamentals right".

29. The internal rate of capital formation in many developing countries and transitional economy countries is far below that necessary for satisfactory development performance. If such a rate is to be achieved, there must be a very large increase in the rate at which capital flows into those countries from outside sources. Private foreign investment may give a great impetus to economic development, as it provides capital-importing countries not only with much-needed capital, but also with managerial and technological know-how. In particular, it may help to diversify the economy and to strengthen exports through improved technology. The attraction of private foreign investment requires a sound understanding of the rights and obligations of capital-importing countries, investors and Governments of capital exporting countries.

30. Joint ventures ideally provide a highly desirable arrangement for bringing together foreign private capital, Governments of capital-importing countries and local entrepreneurs. However, the extent of participation of local capital in individual projects depends on such factors as public policy, local conditions

and the availability of domestic capital and entrepreneurship. There may be a need to reform the tax systems in both capital-exporting and capital-importing countries so as to encourage investment in the latter. Bilateral tax treaties provide an important medium for defining the scope of tax liability in both categories of countries eliminating double taxation and avoiding the negation of incentives afforded by capital-importing countries. International double taxation has a detrimental effect on the movement of capital, technology and persons, as well as on the exchange of goods and services. The removal of this obstacle is highly important for the development of economic relations between countries. In particular, it is most desirable to clarify, standardize and guarantee the tax situation of individuals or enterprises deriving income from, or owning capital in, other countries. Bilateral tax agreements constitute by their very existence a proof of active encouragement of foreign investment. They allay legitimate tax concerns of private foreign entrepreneurs about policy reversals and sudden unexpected decisions prompted by domestic political considerations. They are viewed as placing on an equal tax reciprocity footing countries possessing equal tax sovereignty, but unequal economic and financial status. The constantly evolving nature of fiscal circumstances makes it necessary at the current juncture to revise the 1979 United Nations Model Double Taxation Convention between Developed and Developing Countries to take into account the growing globalization and liberalization of the world economy, the broadening of international fiscal relations, the emergence of new technologies and new methods of effecting cross-border transactions and the increased sophistication of transfer pricing techniques and tax evasion and avoidance practices.

31. Domestic financial institutions have served as a catalyst in attracting foreign capital and the development of capital markets so as to increase the rate at which domestic private capital is generated. Such institutions as the national development banks combine specialist knowledge of finance and industry with an awareness of local conditions and problems. They are, therefore, well placed to deal with questions involving relations with local partners, transfer of technology and the scale of investment required for particular projects. They can also assist in the promotion and organization of other financial bodies such as local stock exchanges and may introduce new forms of investment media.

II. IMPROVED GOVERNMENT FINANCIAL MANAGEMENT (PUBLIC EXPENDITURE PLANNING, BUDGETING, PERFORMANCE EVALUATION AND ACCOUNTABILITY)

32. Developing countries and transitional economy countries must constantly bear in mind that government financial management plays a major role in the implementation of policies aimed at promoting national economic social and other developmental goals. Government financial management encompasses all or part of the processes and functions of planning and programming budgeting, budget execution and accounting audit and evaluation. It is aimed at ensuring that to the maximum practical extent, a government's financial resources are used lawfully, efficiently and effectively and with transparency and accountability to the legislature and the people.

33. Financial management reform typically incorporates the following components:

(a) Use of structured planning and programming as a means of evaluating and selecting ways of achieving desired objectives;

(b) Taking resource allocation decisions within the framework of a unified budget;

(c) Integration of budgeting and accounting;

(d) Use of accounting principles that match service delivery with service costs;

(e) Encouragement of financial accountability;

(f) Measurement of outputs as well as inputs;

(g) Preparation of consolidated reports.

34. As the Group of Experts on Public Administration and Finance noted in the report on its twelfth meeting (A/50/525-E/1995/122, paras. 113-114):

> "In many countries, financial management capabilities have been eroded by the pursuit of financial populism, ineffective and distorted budgetary mechanisms and the breakdown of existing financial management institutions.
>
> "A central concern for all countries is how to harmonize methods of strategic management and control of aggregate financial variables with processes for changing expenditure priorities and enabling effective and innovative management of service delivery institutions".

35. In view of the limited buoyancy of revenue mobilizations, the financial resources obtained, whether from foreign or domestic sources, must be used rationally if development goals or planned fiscal adjustments are to be attained. Accordingly, an increasing number of countries have been re-examining their expenditure priorities with the dual aim of curtailing their fiscal deficits and ensuring that the available financial resources are put to the most effective use. Budget administration and expenditure monitoring and control procedures must be improved. Reduction in the overall budget deficit tends often to be achieved by expenditure-containment measures rather than revenue-increasing measures. Indeed, in the short term, the possibility for substantial increases in term, the possibility for substantial increases in revenue is limited. More emphasis should be placed on controlling expenditure growth, given that the expenditure base is generally larger than the revenue base. Good budgeting is a prerequisite.

36. Budgeting ideally involves:

(a) The appraisal of various governmental activities in terms of their contribution to national objectives;

(b) The projection of government activities over an adequate time period;

(c) The determination of how these objectives can be attained with minimum resources;

(d) The revision of the budget, in the light of changing circumstances and experiences.

All budgets are plans, but not all plans are budgets. Generally speaking, a plan is aimed at identifying and defining the policies best calculated to achieve objectives; it provides guidelines for policies through the translation of these guidelines into physical targets and specific tasks.

37. Numerous countries have adopted the planning-programming-budgeting system, which specifies programme objectives in quantitative terms, measures benefits and evaluates the cost of each programme in the light of the expected results and the results actually achieved. Indeed, the scope of a government budget should not be limited to a statement of the receipts and expenditures of government, but should reflect the overall concerns of development. In order to give a comprehensive picture of government strategy, a central government budget should cover consolidated transactions of the levels of government and of government entities. Similarly, to ensure consistency and balance in the mobilization and use of real resources, the main budget should be accompanied by budgets for foreign exchange, credit manpower and other real and material resources. Multi-year budgeting stimulates the formulation and pursuance of long-term and consistent policies for the mobilization of resources. It brings into focus issues of demand management and real resource balance and enables coordinated and uninterrupted implementation of long-term projects.

38. Programming budgeting is an effective management tool in developing countries and transitional economy countries, it must take into account uncertainties of both external and internal origins, which are likely to increase in the foreseeable future. In order to avoid major economic collapses and setbacks, such countries have to establish reserves not only of foreign exchange, but also of other material resources; they should exert a substantially greater control over income distributions and national flow of funds. Increasing external vulnerability exerts a strong influence on budgeting. Coping with uncertainties calls for considerable innovation and flexibility in budget policies and techniques. Success in the preparation of comprehensive budgets in the formulation of sound budget policies and in the monitoring of budget implementation depends on the availability of required data and information. Measures must, therefore, be implemented for improving the collection and compilation of needed data.

39. In the monitoring of the development process, agencies and officials responsible for budgets and programmes need continuous information on the structure of the economy, the mobilization and use of resources and their costs, the outputs generated and the contribution of outputs to national objectives and goals. Moreover, data is required, not only on the financial aspects of transactions, but also on their economic and physical aspects and performance. In order to achieve consistency and allocative efficiency in the management and implementation of programmes and projects, such data is needed at the national,

sectoral, programme and project levels. It may be difficult to generate such information in many countries because of the weakness of the accounting system. The reforms needed in these systems should include the reconciliation of budget and accounting structures training of accountants, decentralization of accounting responsibilities, proper record-keeping and production of timely and accurate data.

40. The scope of public accounting systems may need to be extended to define and introduce new accounting concepts and to establish multiple accounting structures to generate the various kinds of data required for managing public affairs and measuring the cost, performance and productivity of government programmes and projects. The strengthening of accounting at the project level can improve management of the project and also throw considerable light on the efficient use of resources and on optimal resource mixes.

41. In many countries, there is little liaison among planning, budget, accounting and audit agencies. If accounting is to serve the overall needs of financial management, coordination among all these agencies must be ensured.

42. With regard to public enterprise accounting, management accounting needs must be formulated in terms of sources and use of finance, draft on real resources, value-added in production, outputs generated, rate of consumption, fulfilment of objectives etc. As a first step, it is essential to establish uniform, but practicable definition of concepts. Clarity in concepts is a prerequisite for the development of a methodology and a coherent framework for evaluation. Practical approaches in accounting are flow-of-funds accounting, cost accounting, cash management accounting and depreciation accounting. The principal problem in cost accounting is to strengthen its use and extend its application to various facets of operations.

43. Quite often, the function of traditional audit, which is to verify the legality and financial accuracy of transactions, is not effectively performed, owing to the weakness of the accounting systems that provide the basis for audit, the lack of trained auditors, the insufficiency of the resources allocated to audit, the absence of clearly defined audit standards and, in some cases, the less than full independence enjoyed by audit authorities. Several measures are essential to enable audit systems to participate with other relevant agencies in the task of evaluating the efficiency and effectiveness of government programmes and projects. In the first place, budgeting has to provide a foundation for audit of performance. Planning and budgeting have to formulate clear targets and specific efficiency goals against which performance can be measured. A comprehensive methodology of evaluation incorporating targets efficiency goals, and target efficiency-related reporting and analysis needs to be developed to facilitate the audit of performance and to link it more closely with programme and project implementation. Agencies involved in planning, budgeting, accounting and audit have to collaborate in jointly defining the underlying concepts and units of measurement. They have to agree on their respective roles in performance audit and on the linkages between internal and external audits.

44. A sound public financial management system must be supported by an appropriate audit system which will determine how public resources have been

used, evaluate the results achieved with those resources and verify compliance with legal accounting and administrative provisions and procedures. An adequate integrated public finance management and auditing system is essential to sustainable economic growth and the strengthening of democracy. It ensures that the Government will obtain the necessary resources while satisfying the collective needs of the population through the efficient, economical and effective use of those resources. It strengthens democracy by fostering accountability of government officials and promoting the credibility of the Government through transparency.

45. To facilitate measurement of the efficiency of public commercial and industrial enterprises, there should be clear guidelines on the objectives to be attained at both the sectoral and plant levels. Productive efficiency is a prerequisite for profitability. Precise guidelines should be provided at the plant level and should indicate clearly the goods and services in respect of which subsidies are warranted on grounds of social welfare considerations. Such guidelines should be consistent and apply equally to both public and private enterprises producing the same goods and services. Pricing policies should cover the costs (operating costs, depreciation, interest etc.) and, where feasible, aim at maximizing profits. Instead of concentrating the ownership of assets of non-privatized public enterprises entirely in government hands, workers, farmers, artisans, cooperative societies etc. can be induced to subscribe to the equity and loan capital of such enterprises. Through linkages, public enterprise involvement may induce private sector initiative and investment and an accelerated growth of backward areas.

III. PUBLIC ENTERPRISE REFORM AND PRIVATE ENTERPRISE DEVELOPMENT

A. Public enterprise reform

46. Public enterprises have played an important role in many countries, both developed and developing, notwithstanding differences of political regime and philosophy. In many cases, they were established because private entrepreneurs did not have sufficient capital or incentive to undertake investments of benefit to the economy as a whole or to avoid the establishment of a private monopoly. Other reasons included distributional and allocative considerations, a desire to provide essential consumption goods and intermediate inputs at low prices, and the need to raise government revenue in the face of an ineffective tax system. Constituted as corporations, companies, holding companies, boards, statutory authorities, special accounts and autonomous agencies, they have encompassed not only public utilities and public transport (sectors in which they usually originated), but also other sectors including banking and finance, trading, tourism, agriculture and high-risk sectors such as aerospace. Their functions have included the manufacturing of capital and consumer goods, and mining and extractive industries. In a number of countries, strategic sectors such as energy, transportation, communications and iron, steel and coal productions have been completely operated by State-owned enterprises.

47. In recent decades, however, there has been increasing concern about the financial performance of the latter. Their dependence on the Government for subsidies and other forms of assistance has contributed to deficits in

government budgets and has aggravated inflationary pressures and difficulties in controlling aggregate spending in national economies. As the growing operating deficits of inefficient public enterprises compounded the decline in real fiscal revenues during the recession of the early 1990s in many developing countries, disillusionment with their performance became increasingly common. The World Bank and several members of the Development Assistance Committee of OECD suggested efficiency measures which included closure investment, reduction of functions and private contact management. Western aid agencies generally refrained from financing State industrial enterprises, except where large economies of scale could be achieved only through public corporations, as in the case of certain fertilizers and metal plants in low-income countries.

48. A notable feature of the late 1980s and early 1990s was the ability of some developing countries to accelerate growth or maintain relatively high growth rates in the face of recession in the industrial world. However, in Central and Eastern Europe (including the former Union of Soviet Socialist Republics) the difficulties inherent in introducing viable market and State mechanisms ab initio to replace the defunct system of control and command took a severe toll, with sharp declines in industrial output, shortfalls in agricultural production, disruption of trade flows, external financial strains and fiscal imbalances.

49. The 1990s have seen the public sector in developing countries and transitional economy countries in severe crises, and radical reforms have often been needed. Three major options for reform emerged: restructuring, liquidation and privatization. No single option has been applicable everywhere and much depends on the performance record of a given public enterprise as judged against the objectives set for it. Privatization of enterprises partly or wholly owned by the Government and the restructuring of key strategic entities may be considered the most desirable options, particularly when a public enterprise is plagued by bad management owing to the lack of an effective system of ownership, control and budgeting, or to political pressures and corruption. Often, public enterprises have been pursuing goals having little or no connection with the original rationale for their establishment and some have been allowed to continue operating even when the reason for their existence no longer obtains. Privatization should not be equated with abandonment of all government intervention.

50. In most developing countries, government intervention through the provision of training, collaborative research and sometimes temporary budget support for expanded operations has not been detrimental to private initiative. Governments must, of course, assume their responsibilities by acting to foster financial stability and stimulate the level of economic activity.

51. A healthy dose of public prudence, scepticism and pragmatism is essential in order to achieve a smooth transition from communism to capitalism without reaching too far and going too fast. Public enterprise reform should be introduced thoughtfully on the basis of facts, not fiction. It should aim (a) at improving non-privatized public enterprise performance through the strengthening of management capabilities in corporate planning, performance contracting, financial accounting and information systems and (b) at strengthening the capacity of the overseeing institutions to manage the

performance contracting, financial accounting analysis and public enterprise information systems and assist in the public enterprise reform process.

B. Private enterprise development

52. Private enterprise development can bring about a more widely based and dynamic development process. In developing countries and transitional economy countries there are actual or latent entrepreneurial resources which can be mobilized: there are many individuals who want to engage in activities of their own in which they see a direct relationship between their own efforts and the results achieved and from which they can derive profits and a personal sense of accomplishment. Broader mobilization of entrepreneurial talent can play an important role in exploiting widely scattered raw materials and in providing goods and services catering to local, as distinct from national, market requirements.

53. Entrepreneurship development must be thought of in the foreseeable future as a process in which small capital is allocated in various industrial and commercial fields. Capital is in very short supply and often unavailable through the ordinary channels. Banks are reluctant to incur the risks involved in the financing of indigenous businesses and will ration credit to entrepreneurs despite the desire of the latter to expand their business rapidly. New entrepreneurs may have to start with scarce capital funds and expand only to the extent to which they can generate and reinvest profits. Sometimes the intrusion of political considerations may force banks to provide loans to individuals with little or no capital of their own, who lack the business and technical know-how needed to use the loans wisely. Inadequate pre-investment investigations and the lack of any post-investment supervision will inhibit entrepreneurial development. The establishment of some sort of business extension service and of a proper system for guaranteeing bank loans wholly or partially in cases whose financing institutions do not want to assume the entire risk might promote entrepreneurial initiative and development. The guarantee scheme should stimulate that claims will be honoured within a specified time-limit after defaults are duly certified.

54. Entrepreneurship development can help to mobilize savings which otherwise would not be available for development. At the outset, small enterprises are almost invariably self-financed and can grow only through the reinvestment of internally generated profits. Because of the low capital-output ratios which generally characterize small and medium-sized enterprises, their development tends to bring about more employment in relation to investment than is the case with large enterprises. Practical constraints on the capacity of State and cooperative institutions call for the development of private initiative. The more that is privatized, the more crucial is the role of Government in ensuring that the enlarged private sector, in following its private interests, is also meeting the requirements of society as a whole. While the private sector is the "engine of development", the Government has to lay and maintain the "tracks" that is, create and maintain the legal and regulatory environment for private ownership and fair competition, correct appropriately for market failures, protect the disadvantaged and maintain economic stability, law and order. Similarly, only the Government can lead in envisioning and planning, in

consultation with the business community, the key support institutions and infrastructure - physical and human resources - for business to thrive in an enabling environment conducive to private sector growth and investment support institutions include specialized agencies in fields such as finance, research and development acquisition of technology, export promotion, market intelligence and human resource development. All areas of policy impact on business so their business consequences need to be explored with relevant private sector representatives in a spirit of partnership. Particularly important are policies on trade and liberalization, deregulation, privatization competition, human resource development, labour investment promotion, anti-corruption and bribery action and environmental protection.

55. At the Microcredit Summit held in Washington, D.C. on 2 February 1997 (see A/52/113-E/1997/18), Presidents of the world's poorest nations, development bankers and global corporate chiefs promised that they would work to steer $10 billion in commercial credit to small-business owners worldwide living below the poverty line. Microcredit supporters hope to reach their goal of nurturing prosperity from the ground up by tapping about $10 billion of "private capital flows" from commercial banks and investors. An equal amount of aid money would come from charities and Governments in the next seven years. The conference organizers said that by 2005,they intend to steer some $21 billion into 100 million micro-loans. The organizers of the Summit observed that what is needed for small lending to grow are small institutions through which the credit can be processed and that building them was the goal of the Summit organizers. It was noted that since market-friendly South-East Asian and Latin American countries have posted growth rates outpacing developed country rates in recent years, the idea of shifting into private hands the industries and services formerly run by the State has become popular in development circles. As a result, entrepreneurship is a new buzzword among aid providers. Sheikh Hasina, the Prime Minister of Bangladesh declared that loans as small as $100, often called microloans or microcredit "have the potential to strike a serious blow to poverty, in my country and in countries all around the world".
