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Social polarization, industrialization, and fiscal instability: theory and evidence

Jaejoon Woo

Economics Department, Kellstadt Business School, DePaul University, 1 East Jackson Boulevard, Chicago, IL 60604, USA
Organisation for Economic Cooperation and Development 2 Rue Andre-Pascal, 75775 Paris, France

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Abstract

This paper is motivated by an important puzzle that arises from the contrasting macroeconomic experience across developing regions in the recent decades. In sharp contrast to East Asia, the fiscal policies in much of Latin America and sub-Saharan Africa are characterized by large fiscal deficits and volatilities of fiscal outcomes. In order to address both large deficits and volatile fiscal outcomes, we develop a simple model of endogenous fiscal policy in which government spending is strategically determined by heterogeneous policymakers in a dynamic game. In an economy that is highly polarized due to unequal income distribution, a larger fiscal deficit results, and the intertemporal fiscal policy path becomes more volatile. It is because the polarization of preference leads a policymaker representing each sector to spend more for her favorite sector, collectively contributing to large deficits. This polarization effect implies that a shock to tax revenue is translated into a more than proportional change in spending. Econometric evidence provides support for these predictions. Countries that have suffered from the greatest fiscal instability are those with highly polarized economic societies as measured by indicators of income inequality.

JEL classification: H62; E62; O11; O23
Keywords: Polarization; Fiscal deficits; Volatility; Industrialization; Income inequality

1. Introduction

This paper is motivated by an important puzzle that arises from the contrasting macroeconomic experience across developing regions in recent decades. In sharp contrast

E-mail address: jwoo1@depaul.edu (J. Woo).

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Table 1
Comparison of developing regions: fiscal balance, volatility of fiscal outcomes, and income distribution

	East Asia	Latin America	Sub-Saharan Africa
Fiscal Balance (% of GDP): 1970–1990			
Central Government Balance[a]	−2.34	−3.80	−4.68
General Government Balance[b]	−2.12	−4.52	−5.21
Public Sector Balance[c]	−3.60	−4.89	−6.73
Volatility of Fiscal Outcomes: 1970–1990[d]			
Central Government Balance	2.40	3.47	3.53
General Government Balance	2.75	4.14	3.62
Public Sector Balance	2.53	3.78	4.43
Government Expenditure	2.91	4.15	4.69
Tax Revenue	1.80	2.41	2.62
Expenditure Components			
Wages and Salaries	3.35	5.00	5.19
Purchases of Goods and Services	5.53	7.71	8.20
Subsidies and Transfers	4.09	8.81	4.10
Income Distribution around 1970			
Gini Coefficient for Income[e]	38.99	50.83	49.45
Gini Coefficient for Land Ownership[f]	45.2	81.19	47.91

[a] World Bank (1999).
[b] IMF (various issues).
[c] Easterly et al. (1994).
[d] Averages of country-specific standard deviations are reported. All but expenditure components are measured as a percentage of GDP, and the components of expenditure are measured as a percentage of government expenditure. Data on the central government expenditure components are from World Development Indicators CD-ROM (1999).
[e] Deininger and Squire (1996).
[f] Taylor and Hudson (1972).

to East Asia, much of Latin America and sub-Saharan Africa has often engaged in unsustainable fiscal policies, leading to huge fiscal deficits, external debt crises, or hyperinflation (see Table 1).[1] For instance, Korea's largest public deficit in the 1980s was 4.3% of GDP in 1982 against Mexico's 15.4% of GDP in 1982 or Zambia's 28.5% of GDP in 1986. Despite the substantial progress made on fiscal reform since the late 1980s, many developing countries still suffer from chronically recurrent large deficits. Brazil's recent financial crisis is closely related to its high budget deficit, which is 8.4% of GDP as of January in 1999. (See *Newsweek* of Jan. 25, 1999.) Moreover, past fiscal policies in Latin America and sub-Saharan Africa are characterized by high volatility of

[1] Even in the wake of the recent Asian crisis, most economists agree that it was not caused by irresponsible macroeconomic policy but by heavy, private short-term borrowing, which was compounded by weakness of the financial system (see Radelet and Sachs, 1998, for example). East Asian countries hit by the financial crisis in 1997 showed somewhat declining fiscal surpluses or emerging deficits in 1997–1998, yet the size of deficits is still modest. It ranges from −1.37% of GDP in Korea, −0.87% of GDP in Thailand, −0.67% of GDP in Indonesia, to 2.99% of GDP in Malaysia in 1997, which are the most recent figures available from World Development Indicators (2000).