

**IMPROVING FINANCIAL RESOURCES MOBILIZATION IN
DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION**

By

Suresh N. Shende

**Interregional Adviser in Resource Mobilization
Public Policy Analysis and development Branch
Division for Public Economics and Public Administration
Department of Economic and Social Affairs**

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Introduction

The United Nations Millennium Declaration resolved to create an environment –at the national and global levels alike – which is conducive to development and to the elimination of poverty. Success in meeting these objectives depends, inter alia, on good governance within each country and at the international level and on transparency in the financial, monetary and trading systems, as also in removing the obstacles that developing countries and economies in transition face in mobilizing the resources needed to finance their sustained development.

In the Road Map towards the implementation of the UN Millennium Declaration, it is clearly pointed out that the mobilization of domestic resources, is the foundation for self-sustaining development. Domestic resources finance domestic investment and social programmes which are essential for economic growth and for eradicating poverty. In this context, a sound fiscal policy, responsible social spending and a well functioning and competitive financial system are the elements of good governance that are crucial to economic and social development. Strategies for moving forward include, inter alia, disciplined macro-economic policies and fiscal policy, including clear goals for the mobilization of tax and non-tax revenues and responsible public spending on basic education and health, the rural sector and women.

The primary responsibility for achieving stable growth and equitable development lies with the developing countries themselves. This responsibility includes creating the conditions that make it possible to secure the needed financial resources for investment. It is the actions of domestic policymakers that largely determine the state of governance, macroeconomic and microeconomic policies, the public finances, the condition of the financial system, and other basic elements of a country's economic environment. Achieving such a positive environment is not simply a matter of political will. Capacity building and institutional development are an absolutely essential complement to finance in the effort to improve living standards of the poor. Most developing countries, usually the poorest ones, still lack institutions capable of implementing the necessary actions, and will need to focus major national efforts on capacity building. For this purpose, more and better assistance from the international community is needed; indeed, experience shows that imposing tough policy conditionality on poor countries without assisting them to build their domestic capacity would certainly lead to frustration and unsatisfactory results.

The generation of domestic resources to save and invest productively is the essential foundation of sustained development. A very low domestic savings

rate is the major structural weakness to be overcome in most developing countries and economies in transition. But there will not be enough domestic savings, nor enough high quality national investment, without macroeconomic discipline. Economic policy must be designed to make inflation and the current account balance consistent with sustained growth. For countries with high inflation, this implies that monetary policy should aim to reduce inflation over time, and once it has reached a low level, to hold it there. Monetary policy also needs to be consistent with the chosen exchange rate regime, which must give reasonable assurance that the country will avoid an unsustainably large current account deficit.

Fiscal discipline, too, is required at all times, so as to keep deficit financing small enough to avoid causing inflation, to avoid excessive accumulation of public debt, and to ensure that government borrowing does not crowd out the private sector investment. Almost everywhere the most potent way to empower the poor to integrate themselves into the market economy, and hence to contribute to and benefit from economic growth, is to make public investments in broadly accessible education, health, and nutrition, in other basic social programs, and in the rural sector, where large proportions of the poor typically inhabit. These programs need to have the first call on government resources—they should not be treated as marginal programmes whose budgets can be slashed as economy measures when times are difficult.

Domestic resource mobilization

Developing countries and countries with economies in transition are currently confronting unsustainable fiscal deficits, unabated debt service charges, and declining external assistance seriously affecting their development process. It would be in their interest to overhaul the strategies of domestic and external financial resources mobilization through tax and non-tax instruments that are fair, equitable and create minimal disincentives for economic efficiency, and initiate tax reforms to simplify and rationalize the tax structure. The non-tax revenues include social security contributions, grants from foreign governments and international organizations, property income, interest, dividends from state enterprises, rents from government property, fines, penalties and forfeits and sale of goods and services. There should be greater emphasis on improving the efficiency and effectiveness of the revenue administration, strengthening the institutional framework, selection of taxes and duties which are administratively feasible and lend to realistic collections, widen the tax base and progressively integrate the “informal” sector into the mainstream of the national economy. In the context of international economic relationships, there should be increased stimulus to finalize bilateral tax treaties, protect the interests of national revenue from the adverse effects of operation of electronic commerce, transfer pricing mechanisms, non-cooperative tax jurisdictions and other tax shelters and secure legitimately due tax revenues from income attributable to the new and innovative financial instruments, but avoid harmful tax competition.

The subject of financing for development has engaged the attention of policy makers and development economists since several decades. However, the importance of this topic has acquired new urgency. For most of the 1980s and early 1990s, the approach of the international community to development was dominated by the Washington Consensus, the elements of which incorporated an emphasis on domestic resource mobilization through fiscal restraint and tax reform. The concept of tax reform was to be influenced by the move towards creating a market-friendly policy regime. The reduction of income, corporate and trade-related taxes and a greater reliance on domestic value-added taxes were the major elements of this strategy. Another major element was the liberalization of the domestic financial sector involving, *inter alia*, the deregulation of interest rates, the elimination of directed credit and freedom of entry into the financial sector for both domestic and foreign private investors. To meet import-financing needs, developing countries were to rely on exports and access to foreign private capital as the primary instruments. The above approach to development financing has been seriously questioned. Many developing countries were not adequately prepared in terms of institutional and human resources capacity to deal with the inevitable challenges associated with its implementation, especially against the backdrop of the globalization of financial markets which was occurring with phenomenal speed. The reliance on exports to generate resources also did not evolve in the way anticipated. Concomitantly, aid flows declined and the list of developing countries classified by the United Nations as “least developed” became longer. In the light of these factors, it is necessary to re-examine the issue of resources mobilization for financing for development, using a more holistic approach and reaching agreement on different options appropriate for today’s global economic environment.

The agenda of the International Conference on Financing for Development held in March 2002 at Monterrey, Mexico emphasized the importance of mobilizing domestic financial resources for development; mobilizing international resources for development: FDI and other private flows; trade; increasing international financial cooperation for development through, *inter alia*, ODA; debt; and addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development. . The Monterrey Consensus adopted at the International Conference on Financing for Development has recommended, *inter alia*, that developing countries and economies in transition should set up an effective, efficient, transparent and accountable system for mobilizing public resources and managing their use by Governments as also emphasized the need to secure fiscal sustainability, along with equitable and efficient tax systems and administration, as well as improvements in public spending that do not crowd out productive private investment. It also recognizes the contribution that medium-term fiscal frameworks can make in that respect and has also encouraged strengthened international tax cooperation, through enhanced dialogue among national tax authorities and greater coordination of the work of the concerned multilateral

bodies and relevant regional organizations, giving special attention to the needs of developing countries and countries with economies in transition.

Economic development being basically measured by progress in economic growth remains largely valid although over the last decade, the concept of development has been increasingly accepted as a broader concept incorporating social and environmental dimensions as integral parts. While these aspects are crucial and there needs to be a policy focus on the implied concerns, without economic progress the financial and other resources needed to deal with them would not be available. Thus, the inevitable conclusion is that economic growth is a necessary but not sufficient condition for development. In fact, the development of a country is determined by a multitude of factors, including its natural resource base, its human resources, the state of its physical infrastructure, the technology available, the development strategy of the government, and its openness to the outside world. It can be considered that development, or economic growth, is a direct function of the various investments made in a country. In particular, there are important management and governance issues involved in investment activities within each sector to avoid or minimize wastage and leakage as also questions relating to the inter-sectoral allocation of investment. It can be claimed that when investment decisions are made on the basis of market competition, the relative rates of return over time should determine its allocation and hence inter-sectoral allocation should not be a matter of policy concern. However, there are always market imperfections in many different forms: inadequate information flows; complications due to the structure of industry (monopoly, oligopoly, imperfect competition); and a variety of positive or negative externalities. These make the reliance on relative rates of return of investment as the main determinant of inter-sectoral allocation, and thereby economic growth and development, more than problematic.

There are, in addition, questions relating to the role of the government vis-à-vis the private sector, since some of the development functions traditionally performed by the government, such as the provision of infrastructure, are being increasingly provided or financed by the private sector. When investment is made by the public sector, as often done and needed for, inter alia, providing public goods and alleviating poverty, many issues arise with respect to how the requisite resources are raised and used. These include transparency of government budgets, impact of tax subsidy policies, criteria applied for inter-sectoral allocation within the public sector and efficiency in the use of resources. The emphasis is thus on policy measures to generate the funds required for investments in the variety of sectors crucial to development, both economic and social.

According to the framework advocated by Musgrave (1959), the three main fiscal policy goals are: macroeconomic stability, efficiency in resource allocation, and an appropriate distribution of income. All three objectives should contribute to the ultimate goal of reducing poverty, whether by increasing

disposable income, promoting access to job opportunities and productive assets, ensuring certainty and a stable economic policy environment, or providing protection to the poor. Although the “function” side of the government budget constraint has a more direct impact on the poor, the budget, considered as a whole, remains one of the most pervasive instruments of public policy. In this context, the trade-off among the alternative means of financing public spending must be taken into account when formulating poverty reduction strategies. There are three main ways in which the public sector can obtain resources to finance its actions: levying taxes, contracting debt and creating money. When tax revenues are insufficient to finance government spending, the transfer may occur through issuing high-powered money or/and borrowing.

Broadly speaking, investible resources can be divided into two broad sources: domestic and foreign. Domestic resources comprise household, corporate and government savings. Some of the factors that influence domestic resource mobilization include the level and growth of per capita incomes, savings preferences of individuals in the society, the degree of development of and confidence in financial intermediation, demographic structure, and fiscal/monetary policies. Transforming these resources into investment in productive activities depends on the quality of the macroeconomic fundamentals, including fiscal/monetary prudence, the structure of the financial market, including the regulatory and supervisory framework of the banking sector and the size and quality of the securities and bond markets, and the continuity of a consistent investment policy. Other factors, such as the law and order situation, the availability of an appropriately skilled workforce, the state of development of physical infrastructure, and property rights, also weigh on decisions to convert intermediate savings into investment. The promotion of exports allows countries to generate foreign exchange to pay for import needs, many of which are investment-related. Exports are often crucial to pay for the import of new technologies, capital goods and raw materials not produced at home to improve the productivity and efficiency of investment as well as to take advantage of economies of scale.

The discussion on fiscal architecture is crucial in identifying the revenue capacity of different types of taxes based on the characteristics of a specific country. No one tax system fits all. The fiscal architecture presents a range of alternatives for policymakers to consider in seeking raising revenue to fund government operations. The degree of tax compliance also helps policymakers in designing tax policy. In many countries, tax administration concerns strongly influence tax policy. The structure of the economy of developing countries makes it difficult to collect certain taxes. The module on tax compliance helps identify the limitations of various types of taxes and offers guidance on the design of different tax instruments. Finally, countries no longer can effectively design their tax systems in isolation. The increased mobility of capital and labor requires policymakers to consider the tax systems of other countries. Globalization and reduced trade barriers threaten two major sources of tax revenue for developing

countries: trade taxes and corporate income taxes. The challenge many countries face is replacing those lost revenue sources with taxes that do not disproportionately burden the poor.

Foreign financial resources

Foreign investible resources comprise funds from the international banking system (commercial short- and medium-term loans), from international capital markets (foreign private portfolio investments), from corporations (FDI) and ODA from bilateral donor governments and from multilateral financial institutions, such as, the World Bank and ADB. The factors which influence the size and composition of private external inflows are broadly similar to those for domestic private savings, with the addition that economic factors in the rest of the world, particularly the country of origin of the funds, such as relative growth prospects, interest rates, and tax regimes, also become relevant. Foreign official inflows are more related to political and strategic interests, the relative level of development and the amount of funds allocated to aid budgets by donor countries. In addition, it should be noted that national efforts to mobilize resources are interrelated with the external economic and financial environment: adverse developments in prices of exports, sharp fluctuations in key exchange rates or instability in the international financial system can constrain such efforts severely. In general, the degree of economic security in a country is crucial to its success in raising resources to finance its development. The political and economic environment variables affecting savings and investment decisions include government leadership, the risk of external conflict, corruption, the rule of law, racial and ethnic tension, political terrorism, civil war, the quality of the bureaucracy, the risk of repudiation of contracts, the risk of expropriation by government, political rights and civil liberties.

An analysis of 53 developing countries over the period 1984-1995 shows that the countries with better economic security had significantly high levels of investment and economic growth. Reforms to improve economic security can raise private investment by a half to one percentage point of GDP in the short to medium term, and a half to one and a quarter per cent over the longer term. It is also true that the increasing globalization of the world economy has brought with it serious implications for the economic security of countries. The increasing mobility of factors of production coupled with the lowering of the degrees of freedom for national macroeconomic policy independence has led to the necessity of developing and implementing universal codes of conduct for business and financial markets. Countries which partake in these exercises will certainly be viewed as preferred recipients of investment flows. It is generally agreed that benefits of globalization, being faster and more sustained growth, higher living standards, more employment and large dividends from advances in technology required concerted action, at both national and international levels, and cannot be left to the operation of market forces alone. In fact, globalization and its

accompanying market forces should be properly guided and harnessed to become inclusive forces for sustainable and people-oriented development.

It was considered that while the evidence of the quantitative impact of globalization on public revenues is still limited, there are indications that it may reduce tax revenues due to increased tax competition among jurisdictions to attract foreign direct investment, exponential growth in electronic commerce, increased mobility of factors of production, and growing importance of off-shores and non-cooperative tax jurisdictions. The fall in revenues might further aggravate the problem of budgetary deficits of fiscally-stretched economies. It was observed that globalization may also create pressures for increased spending for education, training, research and development, environment, economic and social infrastructures, and for institutional changes primarily to improve efficiency. While these items of expenditure are consistent with the traditional and basic role of the state in its allocative function, globalization may create additional financial requirements for social protection by way of unemployment benefits to unskilled labour facing retrenchment due to closing down of non-competitive domestic industries. To the extent that globalization is perceived to be a factor in the worsening of the income distribution of countries, it appeared that globalization increased the need for governmental intervention, while, at the same time, it reduced its capacity to intervene due to reduced availability of financial resources.

ODA

Official development assistance (ODA) in recent years has totaled US \$50-60 billion a year. Debt relief under the HIPC Initiative was US\$1.4 billion in 2001. At the same time, trade-distorting policies have prevented the creation of incomes far in excess of these amounts. Estimates of the welfare gains from eliminating all barriers to merchandise trade are substantial, ranging from US\$250 billion to US\$680 billion annually, of which one-third would accrue to developing countries. These benefits would derive in part from the elimination of access barriers to industrial country markets, but also in good part from reform of the trade regimes of developing countries themselves. Determined opening of markets is a win-win proposition—both industrial and developing countries gain.

In some cases, the current trade policies of industrial countries directly neutralize the effectiveness of aid. The dumping of agricultural surpluses, in the form of non-emergency food aid or with the help of export subsidies, has damaged farm production in a number of developing countries, some of which had been carefully nurtured under assistance programs. In other cases, tariff peaks and escalation frustrate efforts by developing countries to diversify their exports. Greater coherence between aid and trade policies is therefore essential. In particular, reducing or eliminating biases against developing country products in industrial country import and agricultural regimes would make both aid including debt relief and trade more effective in promoting development.

Foreign aid has dwindled in the budgets of many donor countries during the past several years, but it continues to loom very large for many of the recipients. In many developing countries, foreign aid receipts are an important source of revenue and thus constitute a key element in fiscal policy. Aid may be an indispensable source of financing, in particular, for expenditures in areas, such as, health, education, and public investment that are essential to raise the living standards of poor people in developing countries. Given that aid is limited, it is particularly important to use it wisely. This requires not only establishing appropriate systems to manage aid funds with a view to avoiding corruption and mismanagement. Important though this aspect is but also designing aggregate fiscal policy to take proper account of the macroeconomic implications of aid-financed spending. Both aspects are essential to maximize the benefits for the recipients and thereby convince donors that aid is money well spent.

In discussing the fiscal implications of aid, a basic question is whether aid receipts are any different from any other source of revenue. The literature has focused on two elements. First, in the long run, aid, unlike, for instance, tax revenues tends to taper off as the economy develops (and in some cases, much sooner); this should be taken into consideration in determining the appropriate inter-temporal fiscal policy. Second, while all revenues are subject to uncertainty, the nature of the uncertainty is somewhat different for aid than domestic tax revenues, as it stems from the spending processes of donor countries and the design of conditionality. An important empirical question is then how the overall degree of uncertainty of aid compares with that of tax revenues. To the extent that aid receipts are relatively uncertain, the issue from the donors' stand-point is how to reduce this uncertainty and, from the recipients, how to take it into account in designing fiscal policy.

The positive impact of aid has been undermined in some cases by the volatility and unpredictability of aid. Aid is significantly more volatile than domestic fiscal revenue and the level of volatility increases with aid dependency. In addition, aid is procyclical vis-à-vis domestic fiscal revenue; rather than smoothing out cyclical shocks, it tends to exacerbate them. Moreover, aid is not well predicted even in countries with on-track programmes and the prediction error is asymmetric: aid commitments are more likely to overestimate disbursements than vice versa.

Many poor aid-recipient countries view foreign aid as a critical ingredient in their development strategy, even though its development effectiveness remains in question among many economists. At the same time, the level and trends of foreign aid are increasingly becoming sensitive issues in donor countries' budgetary discussions, with analysts observing increasing signs of "donor fatigue". In particular, International Financial Institutions have expressed concerns regarding the level of overall development aid and the possible crowding out of poor traditional recipients by former socialist economies.

Whatever the merits of these views, the key issue arises of whether the aid aggregates commonly used by policymakers and researchers in their assessments of development aid provide an accurate measure of true aid flows.

Foreign aid is conventionally measured on the basis of the OECD's ODA, a concept introduced in the early 1970s. ODA comprises official financial flows with a development purpose in the form of grants (inclusive of those tied to technical assistance) and highly concessional loans. Loans are defined as highly concessional when their grant element -- i.e., the subsidy implicitly included in the loan, relative to the loans' face value -- is at least 25 percent. The leading measure of foreign aid flows is the so-called Net ODA, which is the net disbursement amount, i.e., disbursements minus amortization, of those flows classified as ODA.

ODA is based on a sharp distinction between concessional and non-concessional loans, drawing from their respective grant elements. Conceptually, the calculation of the grant element, i.e., the degree of concessionality, involves the computation of the expected present value of the stream of debt service obligations associated with the loan under consideration. To the extent that the discount rate utilized reflects the creditor's opportunity cost, i.e., the return it could make on alternative investments of the same capital, this present value measures the economic value of debt service repayments and, on this account, the financial value of the loan. The grant element of the loan is the portion of the loan that, at a given time, is not expected to be repaid, i.e. the shortfall of the above-mentioned present value relative to the amount disbursed. For the purposes of ODA, loans are classified as concessional if their grant element exceeds 25 percent, and as non-concessional (and hence ignored) otherwise. The grant elements are computed using some special assumptions; however, most importantly, loan interest rates (used to compute interest charges) are assumed to remain constant throughout the life of the loan, and a fixed 10 percent discount rate is utilized in all present value calculations. This methodology for computing grant elements contains a number of shortcomings, which may lead to loan misclassification and distortion of ODA figures across time, donors, and recipients.

Despite the declining share of aid in budget of donor countries, aid continues to play an important role in many developing countries. While the impact of aid is typically divided between supplementing domestic saving and contributing to consumption, there is less agreement on the potential effects of aid on growth. The impact of large aid inflows on the relative price of traded and non-traded goods is well known, and several recent papers confirmed the importance of real exchange rate appreciation for the decline of the traded goods sector in developing countries. But in a dynamic context, the effects of aid depend on how aid-financed spending affects the productive capacity of the economy. While several empirical studies suggest that aid tends to enhance growth, they also

suggest that the linkage is neither direct nor automatic, but depends very much on the environment that influences the use of aid.

MOBILIZATION OF GOVERNMENT FUNDS

Governments in developing countries and economies in transition have been, and still are, an important agent of development. While in most of these countries their role in owning and operating productive enterprises has been declining, mainly through the privatization of state-owned enterprises, they remain suppliers of crucial public goods of various sorts, of physical and social infrastructure and maintenance of law and order. The mobilization of sufficient resources for use by the government for these varied functions has always been rather problematic and many have run up sizeable fiscal deficits over several years. While these countries have not generally suffered prolonged bouts of hyperinflation or fiscal profligacy through the rampant printing of monies, they have not yet reached a stage where regular payment of taxes through voluntary compliance is seen as a social responsibility. This tends to complicate the task of raising resources for the government. **Basically, mobilizing funds for use by governments is undertaken in three ways: through the levying of taxes, through the generation of non-tax revenues and through government borrowing from local or international capital markets.** Most of the off-market resources are raised through taxes, with non-tax revenue being less than 5 per cent of GDP in most countries. For the period 1985-87, the average total tax level in the developing countries was about 17.5% of GDP, and for 1995-97, it was 18.2% while the average tax level in the OECD countries in 1985-87 was more than twice as high at 36.6% of GDP and in 1995-97 at 37.7%. The overall average tax effort level in developing countries is around 20% as against over 35% in the developed countries, although in developing countries, it varies between 10% to 30% as well. While no useful tax performance comparison can be made between developed and developing countries, this proves that in developing countries the tax efforts are low in relation to the amount of tax revenue that could be collected on the basis of voluntary taxpayer compliance

Moreover, these percentages, as illustrated in table below are relatively low by comparison with developed countries. There is clearly room for enhanced revenue collection in almost all developing countries and economies in transition. **However, it should be noted that the capacity of a country to raise tax revenue depends not only on tangible economic factors but also on a variety of non-economic factors, such as, political will, administrative efficiency, and a culture of tax compliance, and as such it is almost impossible to prescribe a priori what proportion of GDP should be raised as taxes in any particular country.** There are several different techniques and measures to evaluate a country's tax system. Tanzi and Zee note that one can estimate a "hypothetical tax to GDP ratio" by isolating several independent variables (such as, per capita income, share of agricultural output, openness of the economy, and ratio of

money supply to GDP) and comparing tax performance to that of similar countries.

Table 1. Comparative Levels of Tax Revenue, 1985-97
(In percent of GDP)

	1985-87	1995-97
OECD countries 1/	36.6	37.9
America	30.6	32.6
Pacific	30.7	31.6
Europe	38.2	39.4
Developing countries 2/	17.5	18.2
Africa	19.6	19.8
Asia	16.1	17.4
Middle East	16.5	18.1
Western Hemisphere	17.6	18.0

Sources: *Revenue Statistics* (OECD); and *Government Finance Statistics* (IMF).

1/ Excludes the Czech Republic, Hungary, Korea, Mexico, and Poland.

2/ A sample of 8 African countries; 9 Asian countries; 7 Middle Eastern countries; and 14 Western Hemisphere countries.

Resource mobilization through taxation

Taxation is used as the main policy instrument for transferring resources to the public sector. It can also assist in creating an atmosphere within which the private sector operates in conformity with national objectives. It has been argued by multilateral institutions, among others, that the tax system should be used only to raise finances that are sufficient for meeting the minimum necessary level of public expenditure, such as, to preserve territorial integrity, to maintain law and order, to provide various public goods and to regulate undesirable activities. From the efficiency viewpoint, it can be said that taxes provide the best means of financing the bulk of public expenditures. However, taxes impose on society three types of cost:

- a) a direct cost or revenue foregone, as taxes, as taxpayers reduce their disposable income by paying the amount due;
- b) an indirect allocative effect, or excess burden, which is the welfare cost associated with the economic distortions induced by taxes as they alter relative prices of goods, services and assets; and
- c) an administrative/compliance cost, since tax forms, tax control, payment procedures and tax inspection are costly.

Not all tax systems have the same distortionary effect. For a given amount of tax revenue, the final burden of taxation depends on a number of features of the tax system, namely, the composition of tax revenues (income versus consumption), the size of the tax base (affected by tax evasion and tax fraud), the tax rates and other factors of administrative nature. Available evidence for

developing countries indicates that corporate and personal income taxes have a negative impact on economic activity, whereas taxes on imports and exports do have a significant, negative effect on investment. On the other hand, non-neutralities in the taxation of savings and investment severely distort capital markets. These distortions become even worse when tax evasion is widespread and the informal sector is large.

Given the disincentive effects of taxes, as showed by empirical evidence, efficiency-oriented tax reforms should be featured by:

- a) reliance on a dominantly consumption-oriented set of broadly-based taxes;
- b) moderate tax rates on labor and capital incomes; and
- c) simple taxation of profits and returns to financial capital, with little incentive schemes, and as neutral as possible.

Regarding the equity aspect, there are very many aspects in the design of a tax system that may affect inequality and poverty. Traditionally, it has been thought that taxing income is inherently more progressive than taxing consumption, since the personal income tax usually implements graduated tax rates and a standard personal exemption, while rate differentiation in consumption taxes according to income or wealth of individuals proves more difficult or even unfeasible.

Countries with different economic and demographic characteristics will have different appetites for different tax instruments. A major purpose of Fiscal Architecture is to provide estimates of the revenue capacity of different taxes given the characteristics of the country. Economic factors include the structure of the economy, the composition of earnings, and resource endowments. Demographic factors include the size of the population, the education level, the age distribution, the relative size between urban and rural population, and family size. In determining the relative tax mix, it is useful to have estimates of revenue potential for each tax instrument. Because the design considerations for each instrument greatly affects revenue estimates, calculations are required for different assumptions as to the design and scope of a particular tax instrument (for example, assumptions as to rates, base, and coverage of a particular tax). For example, revenue estimates for an individual income tax will depend on the percentage of population subject to tax (the choice of the tax threshold or zero-rate band), the income subject to tax and the allowable deductions, and the rate structure.

It is also necessary to have estimates of compliance and enforcement costs for each tax instrument based on different scenarios (as to rates, base, and coverage). Substantial variations in these costs may influence the roles a particular tax instrument plays in the tax system. For example, the collection costs and auditing costs for an individual income tax per unit of tax revenue collected may be much higher than the collection cost and auditing costs for a VAT. In

addition, it is important to estimate the level of tax evasion for different tax instruments and the cost and probability of reducing the level to acceptable levels.

Tax incidence studies of developing countries tend to reaffirm this impression: almost all income tax systems are found to be progressive, while only a minor part of overall tax systems share this feature. This finding comes to no surprise, since developing countries have a tax structure dominated by indirect taxes, with a limited number of capital and wealth taxes. Progressivity is further limited by payroll taxes where they are in place. Besides, when only wage earners pay taxes while there is widespread informality and large taxpayers do not comply with the income tax, payroll taxes become a “tax on honesty” paid by the low and middle income class. Broadly based tax systems, with fewer deductions and exemptions (apart from a personal exemption not larger than per capita income), relatively low tax rates (albeit moderately progressive in the case of the personal income tax), and compatible with administrative capabilities, are likely to provide a stable, reasonably efficient and more pro-poor alternative of financing public expenditures.

However, governments have traditionally used tax resources to finance some of its other development or political agenda. The tax system favoured by multilateral organizations typically is composed of a broad-based sales tax, such as value-added tax (VAT), a relatively low level of import duties for protective purposes only, and simplified personal income and corporate profit taxes. A sales tax, being a tax on consumption of domestic and/or imported products, helps in reducing consumption and, if combined with an excise duty on luxury goods, can also help in reducing conspicuous consumption. While direct taxes are both equitable and elastic, they can reduce incentives to work and, possibly, to save and/or invest. However, empirical evidence is not conclusive regarding their impact on either labour supply or savings. The net effect of a tax change on total savings depends on the relative marginal propensities to save of different groups on the one hand and an increase in public investment or reduction in fiscal deficit on the other. Obviously if the reduction in private savings exceeds the increase in public savings, aggregate savings will fall. The VAT has been introduced in most of the developing countries and economies in transition and usually the tax rate has been uniform, with unprocessed food and exports generally being exempt. The tax does not usually distinguish between domestic production and imports. VAT is considered neutral as the tax burden falls equally heavily on different products and as such avoids the cascading effects of conventional sales or turnover tax. While it is often argued that VAT is subject to less evasion compared with income tax, various studies do not show a better compliance. Experience with VAT taxes has demonstrated that a destination- and consumption-based tax has been the easiest to administer. Import tariffs and export duties have been a major source of government revenue for many developing countries. However, high rates of trade taxes and dispersion in the implied effective protection rates lead to production inefficiencies and can create an anti-export bias. Many of these countries have been able to reduce significantly

their dependence on trade taxes, imposing VAT instead. Some other countries have also started rationalizing their tariff structure.

Similarly, the effectiveness of the VAT system can be determined by computing the “VAT productivity,” a measure that focuses on VAT revenue as a percent of GDP divided by the VAT rate. It is also possible to estimate the amount of various types of income from national income accounts and other data sources. This information allows policymakers to estimate the potential tax revenue from different tax instruments assuming different tax compliance rates. In all these instances, the usefulness and reliability of these estimates are, of course, dependent on the quality of the underlying data. Part of the variation in aggregate tax revenues among countries can be explained by different demands and tastes for government services. The demand for government services tends to increase with per capita income. Countries, and presumably the residents of countries, may also have different views on such important questions as the public versus private provision of education, health, and retirement benefits, and the size and quality of government provisions of defense, transportation and other services. These are primarily political questions to which economic advisors may have little to contribute. As taxes are the primary vehicle to fund government services, higher taxes are required to fund higher level of government services.

It is generally believed that high income and corporate tax rates result in an adverse incentive for work effort, saving and investment. Accordingly, it is often suggested that income tax rates be reduced to improve compliance and lessen the burden of tax administration. In the case of most of the developing countries, average income and corporate tax rates have progressively fallen, taxable income slabs have been narrowed and the minimum threshold of income to be taxed, increased. Obviously if the maximum marginal tax rates have to be reduced and the total tax revenue has to be defended, then the middle rates will have to be increased. Alternatively, the loss of revenue may be compensated by imposing indirect taxes.

While investors, indigenous or foreign, rely on their judgment of the fundamentals of an economy rather than on the incentives offered, most developing countries have been providing fiscal incentives, including reduction in the corporate income tax rates, tax holidays, accelerated depreciation allowances, deduction from social security contributions, specific deduction on gross earnings for income tax purposes, etc. While these may be redundant, a country that does not offer fiscal incentives may lose FDI to the countries that do. Clearly, these tax incentives should be harmonized rather than left to compete with each other.

Land and/or property taxes are levied in many countries with private ownership of land. While land taxes often include agricultural land, property taxes are mainly an urban phenomenon. In addition, the authority to set the rate and collect these taxes is sometimes delegated to local government units in order to provide them with their own revenue collection mechanism.

Two recent studies on tax reforms and their effects in some developing countries in South-East Asia illustrate the enormous difficulties with implementing tax reform. They show the incentives for the government to continue to add taxes rather than rationalize when they face a resource shortage, the administrative complexities of tax collection, the problems of vested interest groups and the difficulty of balancing equity and revenue generation considerations. However, it is interesting that in one country tax collection has never been more than 15 per cent of GDP, that income and profit taxes have always been less than a quarter of tax revenues and that after reform only 2 per cent of the population actually file tax returns. In the other country, tax revenues have grown to around 20 per cent of GDP and income and corporate taxes account for just over one third of the amount raised. In the first country, trade-related taxes still account for almost 40 per cent of revenues; in the other country, the figure is less than 5 per cent. Both have made efforts to widen VAT-type taxes to include the service sector. The taxing of the informal or unregistered sector has proved to be a daunting task, particularly in the first country, where the sector is quite large. The division of tax collection matters between the national government and state and local governments in both countries is a bone of contention; as in most countries, taxes on property are the main source of revenue generation at the sub-national level.

Governments in developing countries and economies in transition which wish to undertake fiscal reforms should also take into account the concomitant tax administration reform, since weak tax administration will make it difficult to achieve the objectives of overall fiscal reform. Tax administration reform should encompass the re-definition of fiscal relationships, and the adaptation, as appropriate, of the organizational structure of tax methods and administration procedures. The organizational structure should be such as to enable the tax administration to achieve the highest possible degree of voluntary taxpayer compliance, and to administer the tax laws efficiently, effectively and fairly, with the highest degree of integrity.

It is commonly held that tax policy and tax administration are intrinsically linked. In this interrelationship, however, formulation of tax policy is generally seen to precede tax administration. This is because only when a tax structure is legislated does tax administration come to play its role in the implementation of the tax law. In developing countries and economies in transition, however, the direction of the link may not be quite so apparent. Indeed, it has been observed that in developing countries tax administration *is* tax policy. This would imply that, however fine the design of the tax structure might be in a representative developing country, it is the manner of interpretation and implementation of the law that counts. These elements reflect the need for adequate capacity of the tax administration in place to implement the law.

In many developing countries, tax laws themselves may be extremely well designed and detailed. But unless the accompanying tax administration is able to handle those laws in terms of having the appropriate staff to interpret and implement them, the field level reality of the actual incidence of the tax system may be quite different from the original objectives. The taxes may be passed on to those on whom they are not meant to fall, and the distribution of the burden may turn out to be indiscriminate. Economists will have a field day carrying out exercises regarding the "true incidence" and "efficiency costs" of various taxes, lawyers will find it easy to litigate tax matters because of the difficulties in interpreting complex tax laws and, accountants, ploughing through a myriad pages of the tax code, will successfully advise clients in careful tax planning such that their tax burden is minimized.

While dealing with the question of the impact of tax policy on tax administration in developing countries and economies in transition, it is not as though the design of tax policy in developed countries does not affect its administration. The complexity in their tax structures has necessitated increasing international cooperation on exchange of taxpayer information, transfer pricing and arm's length rules, and attempts at the development of harmonized rates, accounting rules and executive statutes and action. Thus, the design of tax policy is of paramount importance for tax administration. If efficient and feasible administration is an objective, the structure of all taxes should comprise common elements: low rates, few nominal rates, a broad base, few exemptions, few incentives, few surcharges, few temporary measures; and where there are exceptions, clear guidelines. This is because a simple tax structure induces better tax administration.

Increasing public revenues are key in achieving non-inflationary growth and ensuring enough resources to finance essential public expenditures, including poverty-eradication programmes. Within the constraints imposed by the structure of the economy, the domestic tax system and non-tax revenues should be designed to raise enough revenue to finance public expenditures resulting in sustainable fiscal balances and reduce the need to rely on increasing public borrowing or money creation.

On-going transformations and evolving national development strategies in the context of globalization of the international economy suggest that many developing countries and economies in transition may have to adapt their tax policy, administration and legislation, including the international dimension of national tax systems to the changing domestic and external economic, fiscal and financial environment. Globalization, liberalization, international trade agreements and efforts to attract foreign capital have persuaded countries to lower rates and tariffs, often privileging the mobile factor - financial capital - at the expense of labour and underlining the need to establish or strengthen a progressive tax system.

Past experiences also point to the need to strengthen or put in place a tax system that is fair and equitable, that minimizes disincentives for economic efficiency, that is simple (easy to understand and administer) that eliminates evasion and avoidance, that is flexible enough so as to secure equitable tax revenue from income attributable to the new and innovative financial instruments, that allows for gradually widening the tax base and integration of the informal sector in the mainstream of the economy. The selection of taxes and duties need to ensure that they are administratively feasible and result in realistic collection of revenue. The system should protect national revenues from tax havens and other shelters, and prevent locational competition from becoming a race to the bottom.

A transparent budget process and linking revenues to delivery enhance accountability and legitimize revenue collection. Successful outcomes of public programmes in education and health are a point in case. An efficient and transparent tax administration system, free of corruption, can expand revenue collection. While mobilization of domestic resources is in the long-run a *sine qua non* for sustained development, for a large number of developing countries and economies in transition, in particular least developed countries and other countries that have difficulties attracting financial resources, there will be a need for substantial external resources in order to make major strides in poverty eradication.

Taxes play an important role in any poverty reduction strategy. The most important function is to raise revenue to fund government expenditure programs. Whether taxes can aid in the redistribution of income or providing targeted relief is a difficult question, the answer to which depends on country-specific factors. However, until personal income taxes play a greater role in developing countries, redistribution via taxation will be very difficult. Even then, income tax competition from other countries and limitations of tax administration will limit the ability of using the tax system to redistribute income and wealth. Addressing poverty concerns through the design of specific tax instruments may be more promising. Although any specific proposal needs to be considered in the context of the entire tax system, reducing the number of individuals subject to income taxation and the lower rating of certain basic foodstuffs and fuel merits serious consideration.

Public debt

If public debt is properly utilized, it can contribute to economic growth and poverty reduction and smooth out consumption in response to shocks. However, if inefficiently allocated, the cost of borrowed external resources can contribute to macro-economic management problems in the form of high and unsustainable levels of external debt servicing obligations. External debt management has close links with the management of fiscal budget, foreign exchange reserves and the overall balance of payments. The external debt burden of many low income developing countries increased substantially since the 1970s,

due to, firstly, exogenous factors, such as, adverse terms of trade, shocks and weather; secondly, a lack of sustained macro-economic adjustment and structural reforms; thirdly, non-concessional lending and refinancing policies of creditors; fourthly, inadequate debt management; and lastly, political factors, such as, civil wars and social strife. The institutional arrangements for debt management necessarily differ from country to country but their activities should revolve around: formulation of debt management policies and strategies; providing macro-economic projections and analysis to support policy making; and undertaking operations to implement terms of loan agreements and maintaining loan records (i.e. monitoring and maintaining information on disbursements and debt service payments).

For many countries, even full use of traditional mechanisms of rescheduling and debt reduction - together with continued provision of concessional financing and pursuit of sound economic policies - may not be sufficient to attain sustainable external debt levels within a reasonable period of time and without additional external support. In September 1996, the IMF and World Bank have addressed this problem through a Heavily Indebted Poor Countries (HIPC) Initiative designed to provide exceptional assistance to eligible countries following sound economic policies to help them reduce their external debt burden to sustainable levels, that is, to levels that will comfortably enable them to service their debt through export earnings, aid and capital inflows. This assistance will entail a reduction in the net present value (NPV) of the future claims on the indebted country. Such assistance will help to provide the incentive for investment and broaden domestic support for policy reforms. The HIPC Initiative is a comprehensive, integrated and coordinated approach to debt reduction that requires the participation of all creditors - bilateral, multilateral and commercial. Central to the Initiative is the country's continued effort toward macro-economic adjustment and structural and social policy reforms. In addition, the Initiative focuses on ensuring additional finance for social sector programmes - primarily basic health and education.

Issuing Government bonds to the private sector either directly or through the banking system constitutes a second alternative to money printing, which is available to many developing countries. While avoiding the immediate inflationary impact of money financing, this type of financing of the fiscal deficit puts pressure on real interest rates and/or reduces the credit that would be otherwise available for private sector activities. The final impact on private sector activity and real output will depend on the response of both private saving and private investment to higher real interest rates. A growing body of evidence supports the notion that the relationship between private saving and real interest rates is ambiguous. Although real interest rates affect the way economic agents spread their consumption and saving over time, this effect may be offset due to substitution, income and wealth effects, and to financial market constraints preventing consumers from responding to interest rate fluctuations across time. Most case studies provide little evidence that real interest rates favorably affect

private saving. The effect of higher interest rates on private investment depends to a large extent on the existing degree of financial liberalization. When there is financial deepening and interest rates are market determined, a rise in domestic public debt increases the risk of default and reduces public sector confidence on the sustainability of the fiscal stance, putting pressure on real interest rates. The cost of capital for private users increases, thus contributing to reduce the profitability of private investment. On the other hand, higher interest rates contribute to further deteriorating the fiscal balance, in some cases creating explosive debt dynamics. The Government has to face the direct consequence of serving the domestic debt by making payments of both interest and amortization. For an unchanged level of the primary balance, a rise in interest payments associated with higher domestic debt or a raise in interest rates will increase the size of the fiscal deficit, creating additional constraints to the potential growth of economic activities.

In countries where interest rates are being controlled, excessive internal borrowing to finance the fiscal deficit entails a reduction of the credit available at the banking system, often leading to higher interest rates in the informal market. When interest rates are regulated and the public sector is being given preferential access to credit, the crowding out effect of private investment is exacerbated.

Recommendations

The following recommendations are suggested for mobilization of financial resources through taxation :

- (1) that developing countries and countries with economies in transition will strive to develop progressive and equitable national taxation systems that are consistent with the country's social and economic framework and generating adequate revenues while minimizing disincentives.
- (2) that developing countries and economies in transition will endeavour to ensure that :
 - i) the incidence of taxation falls equitably on labour and owners of financial capital and other assets;
 - ii) the tax base will be extended to cover electronic commerce and innovative financial instruments, but exclude the subsistence sector;
 - iii) indirect taxes will be expanded and made more equitable by targeting the growing service sector, socially undesirable activities as well as focusing on luxury consumption.
- (3) that developing countries and economies in transition will undertake appropriate administrative and legislative measures to combat tax evasion,

prevent tax avoidance and reduce the efficacy of tax shelters and tax havens that undermine national tax revenues.

- (4) developing countries and economies in transition will devise innovative measures, such as, presumptive taxation, to target hard-to-tax groups and will aim to effect progressive transition of the “informal” sector within the mainstream of the economy through reform of labour legislation, the legal and regulatory framework, rationalization of allowances, incentives and exemptions to reasonable levels.
- (5) that countries will strive to simplify tax laws and to improve the efficiency and effectiveness of tax administration and enhance enforcement through the strengthening of institutional, technical and technological capacities, including the development of a transparent and accountable system free from corruption, and to provide better taxpayer services to facilitate compliance.
- (6) enhance multilateral cooperation among national tax authorities to promote conclusion of tax treaties with a view to eliminating double taxation and promoting equitable distribution of taxation among competing jurisdictions and improving international income allocation.
- (7) that countries will strive to supplement tax revenues by exploring sources of non-tax revenues, with due consideration given to equity concerns, including institution users fees or improving the targeting of subsidies for publicly financed goods and services.
- (8) that the developed countries and international financial institutions will provide increasing support, especially in terms of resources for technical assistance in capacity building, to developing countries and countries with economies in transition.

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