

**OECD Development Centre
Development Finance Network (DeFiNe) Meeting**

**Domestic Resource Mobilisation for Development
Policy Solutions in Times of Crisis**

Summary

25th September 2009

Welcome

Guillaume Grosso (DEV): In times of crisis, both external resource flows (ODA, FDI) and domestic revenues become less reliable. Hence there is a need to create more predictability in revenue mobilisation and to take a cohesive approach to resource mobilisation both at home and abroad. While good practices and quick fixes will help overcome the crisis, long-term solutions are needed to build ownership and promote good governance. We wish therefore to look closely at public instruments for DRM, namely Fiscal Policy (Taxation), in line with the Doha Development Agenda and the Monterrey Consensus. DEV is very committed to promoting the Voices of the South in the debate on development and engaging fully in the promotion of policies which enable developing countries to take the ownership of their own development process.

Stephen Groff (DCD): DAC is a forum in which donors discuss how to foster development and reduce poverty. DAC is currently undergoing a transition from being donor-focused to becoming a place for broader conversation. An example of activity of this nature is the Working Party on Aid Effectiveness. DAC aims to promote good practices in development cooperation, in particular making aid more effective and more result-focused, while emphasizing the policy coherence. DRM is currently very high on international agenda, as meeting aid commitments and aid scaling up might be problematic in times of crisis. Aid might also dampen domestic tax efforts. Meantime, taxation itself is central to good governance and bargaining process between the state and its citizens. Moreover, ODA allocated to support DRM is low and this needs to change. Finally, it is vital to counter tax avoidance and tax evasion at the international level, as well as to support local solutions to DRM - hence the OECD's endorsement of the ATAF initiative. After all, DRM is key to sustainability of the development process.

Richard Gallacher (CTPA): Tax policy and tax administration are two connected issues. In fact, tax administration underlines the effectiveness of tax policy. However, effective tax administration is difficult to implement in practice. CTPA works with developing countries in this respect, organizing numerous events as well as training sessions. It emphasizes the importance of the dialogue between the OECD and the developing countries. It is of our interest to look at the tax structures that countries have and to discuss the successes and failures in the domain of tax reforms.

SESSION I: GENERAL

George Mavrotas (GDN) on Revenue Mobilisation: DRM has two building blocks: the first is the *domestic financial system* (the banking and insurance sector as well as the market for equities and public and private debt); the second is the government *revenue mobilisation*. Revenue mobilisation is an important dimension of the overall DRM process. ODA flows usually fund a large proportion of public spending in many low-income developing countries, particularly in countries recovering from conflict. Yet, in order to accelerate progress with the MDG targets, governments need to mobilise more domestic revenues. This requires the governments to undertake considerable institutional investment to improve their tax administrations:

- (i) **The introduction of VAT:** It is important to complement the VAT with either exemptions and/or excise duties to make it less regressive, thereby reducing the burden on poorer households.
- (ii) **Broadening the tax base:** Broadening of the VAT base should be a low priority and should be implemented only in those countries where the net fiscal incidence (i.e. the net impact of taxation and public spending taken together) is favourable to the poor. Priority should instead be given to the divergence between the effective and statutory tax rates. There is considerable scope for raising tax revenue without increasing tax rates by reinforcing tax and customs administration, reducing tax exemptions and fighting fraud and corruption (including within the tax authorities themselves).
- (iii) **Building institutional capacity:** a crucial component in the reform agenda.

Discussion: There is shared agreement that the three issues are important, but it is also necessary to go deeper. Firstly, in the light of trade liberalisation, trade tariff reductions tend to be compensated by the introduction of VAT. However, experience shows that it is very difficult to replace the revenue lost when tariffs are reduced. On the other hand, VAT is more regressive, and hence unfavourable to the poor.

Secondly, tax base broadening is key and this, combined with the introduction of VAT, allows for **lower tax rates**, which is not against DRM - the total revenue collected may increase as a result. Higher duties especially on luxuries are useful. As redistribution and progressivity are vital, one needs to think broadly when designing tax systems. Specifically, **tax benefits** are another side of the story. By strengthening the link between taxes and benefits, making fiscal incidence beneficial to the poor, one can help the most underprivileged part of the society. Thereafter, the broadening of tax base can be introduced more painlessly. Moreover, base broadening cannot be discussed anymore without the mention of tax leakage and tax evasion. Natural resources are another interesting case – it's an example of non-taxation or tax incentives given to specific producers. Hence, one step towards base broadening could be to tax the non-taxed corporations. It goes without saying that business friendly environment for FDI is needed, but it often implies a huge cost in terms of foregone resources.

Thirdly, the strengthening of institutional capacity has actually progressed strongly in recent years due to an improvement in technical capacity (IT) of tax administrations.

Finally, an extremely important second generation issue is **public expenditure management**. There is in fact a complex link between revenue generation and expenditure, and GDN has actually done work on public expenditure management, in the domains of accountability, governance and transparency. Also, by looking at the expenditure side, it is instrumental to consider the perspective of tax payer himself, and the implied social contract between government and taxpayers. Here lies a direct link to governance. The case of Colombia confirms that one cannot talk about taxes without considering expenditure, as the society's incentive for tax compliance is directly proportional to its belief in the efficiency of government spending and the quality of public good and service provision.

Imed Drine (UNU-Wider) on Informal Sector: The informal sector, which constitutes a major portion of the economy in developing countries (20-40% of GDP), seems to be a potential source of funding and a window to enlarging the tax base. Collecting taxes from the informal sector is difficult, but possible gains justify thinking about incentive mechanisms that could improve commitment to pay taxes. Long-term policies to bring the informal sector into the formal sector are indispensable.

The informal sector is often associated with poor economic performance and it expands in downturn. In fact, in times of crises it serves as a **buffer against poverty**. There are plenty of reasons for the existence of the informal sector – excessive regulation, bureaucracy, formalization entry costs, macroeconomic instability and poor public service provision. In itself, the informal sector is large and diverse, mobile, based on cash transactions, characterised by poor record keeping and no culture of tax compliance and financial education.

How to formalise it? What could be the incentives so that the informal firms go formal and gain legitimacy and access to public services? One possible solution is ensuring fewer restrictions on formalisation, lesser legal and regulatory burden, inclusion of the informal sector in decision making (e.g. via trade unions), fostering the accountability and transparency of government in general - including more flexible and adaptive tax system, and a better provision of public goods and services as an encouragement to participate formally.

Discussion: The informal sector is very **often the mainstream of economies** (among others, in Bangladesh, India, Colombia, and the Philippines). One more reason why this sector remains informal is that very often its presence creates a space for extortion on part of authorities; hence the enforcement problem is one of the culprits. The sector is characterized by diversity from the point of tax generation ability. There is a big difference between rural informal sector (including agriculture and non-firm activities) and urban informal sector (encompassing services and production). The question remains how one distinguishes which tax is geared specifically towards the informal sector, and which segment of it. Moreover, when advocating the informal sector going formal, one must not forget a potential loss of flexibility and comparative advantage which go in pair with informality. The peril of the existence of the informal sector is the worst when informality is the only business option for a part of the society.

It is incorrect that the informal sector remains untaxed as it **pays a large share of indirect taxes**. In developing countries, indirect taxes are often the principal taxes and tend to be high. It is direct tax compliance which is problematic. In Africa, the informal sector pays in fact a larger share of taxes than the formal sector, when the levy rate is examined closely. The formal sector benefits from tax exemptions. In the Philippines, 55% of the revenues come from indirect taxation and the informal sector provides a big addition to this revenue. Therefore, at least in some countries, a potential strategy should not be to formalise their informal enterprises, but to increase the taxation inflow from them.

What should be the **entry point** for the informal sector? Should it be taxation or another mechanism, such as licensing, which does not create disincentives to formalization? One argument lies behind VAT broadening as a way of bringing the informal sector into formality. As they pay VAT on inputs, which they cannot claim back from the authorities, informal firms might be inclined to formalise if direct tax rates are favourable. Tax administrations should design their strategies geared towards the informal sector by looking closely at the implicit tax rates paid by it. As another strategy, some countries in Latin America have special tax schemes for SMEs as the first basis for the expansion of tax base. In Latin American MICs, local governments collect license fees, which can give an idea where operations are located. This information remains predominantly in the hands of local authorities; however the communication between local and national administrations is weak. Consequently, a potential entry point could be the dialogue between local and national tax administrations. In India, presumptive taxation is used based on established criteria (e.g. the quality of land). Thereafter, an assessed has the right to contest the assessment, and hence an incentive to formalise. It is possible to create links between informal sector and public sector, instead of strictly formalising it. For example, in Burkina Faso which has a huge informal sector, 50% of GDP, public works are done by those firms.

Generally speaking, the over-reaching aim behind dealing with the informal sector should be to promote jobs and development, as tax policy cannot be separated from development policy. Within the operational framework, it is the local governments' job to implement systems which would bring people into tax compliance, e.g. by giving them access to public services. In Tunisia, the informal sector can benefit from pensions upon a contribution to social security.

It remains very difficult to identify who is actually involved in the informal sector. At the other end, **who are the informally employed?** There are two tiers to that community – the self employed, profiting from informality, and a large majority that earns very little. Therefore, one should carefully target

who to raise taxes for. In the case of Colombia, one could be very sceptical about full-fledged formalisation. In Colombia, 55% of firms are informal - mostly very small firms - and their formalisation might not be the efficient way to significantly raise tax revenues. Firms in the informal sector are often those who do not want to grow. They are temporary projects and formalising them might not be useful. It is necessary to make big firms pay taxes.

Peter Wolff (DIE) on Tax Compact: Tax evasion and tax avoidance are a serious drain on domestic resources. Players involved in tax evasion and avoidance are not only active at the national level but globally. National policies for building the capacity of national revenue authorities and creating an efficient and equitable tax system have to take into account this international dimension. Therefore, action is needed at the national and international level.

The German government has launched the initiative for an 'International Tax Compact' on the sidelines of the Doha conference 'Financing for Development' in November/December 2008, especially with a view to increase the participation of developing countries in international tax cooperation measures and strengthen international support for the creation of efficient and equitable national tax systems. Main working areas are:

- (i) **Activities at the domestic level:** Reinforcing activities in support of tax reform (i.e. tax system development and enhancement) in partner countries.
- (ii) **Activities at the international level:** Support ingdeveloping and transition countries in building the requisite capacity to participate, as equal partners, in international tax cooperation processes.
- (iii) **Analytical Work and Studies:** Closing the analytical gap that still exists with respect to tax evasion and avoidance.
- (iv) **Networking and dialogue:** Facilitating international and regional exchange on how to strengthen national tax systems among partner countries (through forums such as ATAF, CIAT, CATA, the OECD Forum on Tax Administration, etc.) so that best practice experiences may be gathered and refined for the implementation in national policies.

Discussion: All agree that it is crucial to have both developed and developing countries in the Compact. In practice, however, the **resistance to tax compact comes from the developed countries** - this is an issue often forgotten in the debate on global governance. In question is the transparency of the whole global financial sector involved, developed countries included. But the developing countries must be part of the process. If natural resources' taxation makes big sense, since it falls directly on rents, one needs a system that avoids flight of revenues out of the concerned countries via international tax arbitrage. Developing countries demand exactly that, while developed countries demand lower taxes in the developing world for the purpose of rent extraction. Hence, the Compact is a desirable solution. In a broader perspective, how should the problem of illicit capital flight be viewed? It goes beyond tax evasion and avoidance. Within the OECD there is an obvious need for greater transparency.

Could **G20** be a good platform to promote international transparency? Could it be used to first promote the compact among the developed countries, only later to be brought down to the developing ones? What about the strategies to tackle regionally the problem of tax heavens?

SESSION II: ASIA

Yoginder K. Alagh (IRMA) on Tax Rules in India: The problem of domestic resource mobilisation is a part of the policies to stimulate the economy of developing countries to the 'normal growth path' as they recover from the economic crisis since mid-2008. In this context, tax policies, including ongoing efforts at simplifying and widening the tax base, but also better business and technologically efficient models of tax administration play a major role.

To start with, it is worth noting that in globalizing countries like India, a lot of taxation creates a risk of **distortive protection**. In case of a trade reform, this negative protection resulting from tariff policies should be kept at a minimum and harmonized between different industries.

On the other hand, the **informal sector** includes some 92% of total employment in India, and it is expanding. It is largely seen as a sector which needs support and not as a source of fiscal revenue, but econometric studies show that - even if it includes below poverty-level wages - it is resourceful. The difficulty here is assessing the tax base since accounts are not kept. Even a huge, exporting and successful sector like Indian diamonds still remains informal. A solution, at least as a transitory method, could be 'presumptive assessment' for instance based on the electricity consumption, use of purchased inputs or estimation of yields (for agriculture), which could later on be contested by the assessed.

Given the focus on **decentralisation** in implementing rural development, there is wide variation in resource-raising performance between regions. Rule-based devolution should improve the efficiency of expenditures. Investment finance is essential for infrastructure (in agriculture, education, health, rural and urban development, etc.). In this context, in large federal developing economies, domestic resources at the local level not only add to the resource pool but they also give more manoeuvrability to local authorities, which are by nature rudimentary institutions. As a result, local bodies could use tax statements as collateral. Efforts to create healthy balance sheets by local institutions would put them in a position to present a rating that is viable to lending financial institutions.

Moreover, since 2002, the Indian tax system has been implementing **information technology** solutions and introducing business processes into tax administrative processes. This has been considerably helped by the country's prominence in software systems. The main initiatives include the filing of E-returns, E-payment of taxes, etc. Tax administration is also part of a massive exercise of building an electronic personal identification system for India's 1.2 billion population.

Overall, in the past several years, significant progress has been made to improve the tax structure, broaden the base and rationalise the rates. Next year, India will implement a **"dual" Goods and Services Tax**, to be levied concurrently by both the Central and State Governments, which will permit to apply the tax to a comprehensive base of goods and services at both levels, eliminating tax cascading and reinforcing vertical equity in fiscal federalism. Forthcoming changes also include simplification and rationalization of exemptions in direct, savings and corporate taxes. In particular, the corporate tax rate has been proposed to be set at the lower rate of 25%.

Discussion: In the context of fiscal stimulus packages in many Asian countries, fiscal consolidation and tax collection reforms are important issues. Asian countries should take care of their **fiscal deficits**. In India for instance, FDI and exports declined because of the financial crisis and two stimulus packages (one in December, and one now) - in addition to the national rural employment guarantee scheme and food security scheme - created a string of fiscal deficits. Presumptive taxation was considered as an option to tackle this issue: to widen the tax net in order to mobilise additional resources. India also has to find a solution to the macroeconomic dilemma of high tax rates versus high growth. On the related note, more than debt relief, important is the creation of a **market for local debt**. India needs to improve its capital markets. India also needs to raise the abilities of local bodies to borrow, thanks to decentralization.

Paul Quintos and Tony Tujan (IBON) on Tax Reforms in the Philippines: After the fall of the Marcos dictatorship in 1986, the governments unified tax schedules for professionals and corporations, resulting in an increase in revenues. However, the neoliberal restructuring in 1992 brought a decline in import duties, and subsequently tax collection went down. The restructuring also encouraged FDI and

export manufacturing, using measures such as tax holidays, VAT exemptions and corporate tax rate reductions. Moreover, in 1997, the effective tax rate on important products for tax collection (e.g. tobacco and petroleum) was lowered. As a result, the tax base was seriously eroded. 2004-2005 saw reforms to reverse the fall in tax revenues. These included higher excise duties and VAT rates, tax coverage of petroleum products and penalty system for tax administrations, among others. In recent years, **tax collection improved but the efficiency of tax collection actually deteriorated**, for example due to tax leakages. In 2008, the government increased the amount of personal exemptions for income tax payers in order to compensate for the effects of the financial crisis. The budgetary situation is worsening as revenues fall and expenditures rise.

The IMF "suggested" that, in order to rein the budget deficit, the government should increase its tax collection efforts (for instance through the creation of a "sin tax"), broaden its tax base, and step up fiscal incentives. Rather than resorting to new regressive tax measures or more cutbacks in spending during already depressed conditions, **IBON advocates that the government deals with huge leakages from the national budget**. Debt servicing, left by the Marcos dictatorship, is equivalent to as much as 60% of the government's annual tax collection. Tax evasion (around one-third of the potential take from individual, corporate and VAT taxes), smuggling (2% of GDP per year in lost tax revenue) and redundant fiscal incentives (worth approximately 1% of GDP) also represent major financial leakages. IBON argues that tax reforms must be part of a broad public sector reform, including a comprehensive audit of the country's debt to identify illegitimate debt, the scrapping of redundant fiscal incentives, cutting down on smuggling, and increasing tariffs for sensitive and strategic products and industries. The tax administration should be improved, and a financial transaction tax could be implemented to curb financial speculation. At the international level, IBON favours the creation of an independent debt arbitration mechanism and international cooperation against capital flight.

Discussion: A specificity of the Philippines is the importance of **remittances**, which have been growing in recent years, meaning that people are finding jobs overseas. In times of financial crisis, these remittances are declining and cannot be relied upon as a source of revenue. This makes it even more urgent for the country to lock the leakages mentioned. The Philippines should also control inflationary trends to limit the cost of debt servicing.

The analysis of DRM should include the consideration given to **foreign debt versus domestic debt**. Many developing countries have benefited from multilateral debt reductions, hence external debt has come down to an extent, but domestic debt tends to remain very high, crowding out private borrowing and investment. Government's borrowing domestically to invest in infrastructure can have positive effects, but it should be integrated into the calculus.

Debapriya Bhattacharya and Mustafizur Rahman (CPD) on the Financial Crisis Experience in Bangladesh: Tax/GDP ratio in Bangladesh has remained low (11.2 % of GDP in 2008-09), but it has not declined further in spite of trade liberalisation experienced by the country in the 1990s and resulting in the loss of import duties. Taxes, and especially indirect taxes (domestic and import-related), have traditionally been the major source of government revenue. Reliance on those, narrow tax base, the existence of a large informal economy and the lack of administrative capacity are the weakest links which have constrained Bangladesh's revenue mobilisation efforts. Only about 10 % of potential tax payers pay income taxes in Bangladesh.

Bangladesh's revenue is **highly dependent on import duties**, accounting for 34 % of total domestic revenue. As a result, in times of crisis, the fall in global commodity prices has meant lower import duty and VAT collection. Moreover, slowdown in economic activities - particularly in export-oriented industries - has meant **lower scope for direct tax collection**. Finally, the thrust for higher public expenditure in terms of enhanced financial stimulus and public investment has also stressed the need for higher revenue collection to maintain fiscal balance. The impressive performance of the tax authority in collecting income tax, to compensate for lower revenue collection from imports, led to higher than targeted growth of income tax revenues. The net result was that overall revenue earnings for the fiscal year fell short of target only by about 4 per cent.

In April 2009, the **first stimulus package** worth around USD 495 million was announced. It included a cash subsidy programme for the crisis-affected export sector, the stepping up of safety nets, and help to agriculture. In order to stimulate domestic investment, the central bank decided to cap the commercial lending rate at 13%. However, no major revenue mobilisation policy initiatives were visible until the FY2009-10 budget announced in June 2009. The **second stimulus package** was large and concentrated on safety nets, job creation and training. Thereafter, the government will need to put more emphasis on direct sources of additional revenue. It has opted for greater administrative effort to enhance the tax base and has reorganized the duty structure.

The crisis has not only forced the government to widen and deepen the domestic tax base, but also reemphasized the need of **institutional strengthening** for the purpose of more effective revenue collection. Research shows that domestic revenue of Bangladesh is non-substitutable with foreign aid. Therefore, institutional strengthening of revenue mobilisation efforts needs to be supplemented by a structural change in the economy.

Discussion: Domestic resource mobilisation requires adapting to **time-lines**. Some countries, like Bangladesh, entered the financial crisis with a 3-6 months lag. That should be taken into account during the fiscal consolidation. There is also a need for a **global budgetary effort**: low-income countries, which do not have enough resources to launch stimulus packages, have been adversely impacted by the stimuli given to domestic sectors in other developing countries.

SESSION III: LATIN AMERICA

Christian von Haldenwang (DIE) on SATs: Semi-autonomous tax agencies can play a significant role in strengthening the effectiveness, efficiency and legitimacy of decentralized tax systems. The ***Servicios de Administración Tributaria (SAT)*** currently operate in nine Peruvian cities. Findings indicate that the SAT collects local taxes and non-tax revenues more effectively than conventional tax administrations. Also, although the SAT-model *per se* does not generate strong incentives for the promotion of efficiency, there is some evidence that efficiency may become more important once the SAT are consolidated. Finally, there are hints that the Peruvian SAT contribute to the legitimacy of the tax system thanks to higher levels of transparency and client orientation.

SATs are public sector decentralized agencies, and not fully privatized entities. Their revenue comes from the commission on collected taxes. They fall under the oversight of the Ministry of Finance, the Controller General and the Municipal Council. SATs have autonomy to pay their staff attractive salaries and to set their internal structure. 1996 was the beginning - 3 SATs were funded under Fujimori's administration and their number has grown steadily ever since. It emerges that cities with SATs have fared better than others on revenue raising front (**better effectiveness**). Moreover, the variation of tax revenue was lower (12.9%) in those cities, compared to (18.5%) elsewhere. The emergence of SATs has led to lower compliance costs (**better efficiency** - shorter waiting time, simplification of procedures, and provision of forms free of charge and such like improvements that make tax payment easier) and higher customer satisfaction. Of course, although SATs seem to have a positive effect on revenue collection, they should not be taken as miracle solution to DRM, as there still remain the problems of legitimacy with respect to non-effective revenue spending by SATs.

Discussion: An interesting **alternative model exists in India**, among other Asian countries, whereby tax administrations make use of businesses to perform parts of the tax administrative process. Indian case arises on the grounds of India's distinguished IT know-how. Numerous administrative processes are privatized – for example the e-payment of taxes or refunds via private sector banks. Moreover, with a large identification system of citizens, expanding now in India thanks to its IT potential, tax administrations can be more effective in their operations. Already large and small towns, and increasingly villages too, are wired up into the system. This debate falls within the question of new public management, or private component being introduced into public management. The nature of SATs is a bit different. SATs mimic private enterprises but they are not private enterprises, and their autonomy is contingent on political will to keep the autonomous. On occasions there arise political tendencies to undermine SATs autonomy. Moreover, in India the authorities make use of simulations to assess the potential performance of a process if privatized. In Peru there is a problem of data, and the ability to simulate depends on the quality of data the administration has. The data must often be generated by the administrations themselves, rather than coming from civil registries. This is a good place where one could reform by introducing a private sector management tool.

A few questions remain. Firstly, some countries might lack **resources**, technical and human, to operate tax administrations as those described above. For example in Brazil, the states have big tax potential, but they have also big problems of capacity. Secondly, what about the **design**? Are commission rates linked to tax revenue objectives? How do they change? What is the minimum size of a region to make viable the presence of an agency? The latter can possibly be calculated, within the limit of error. SATs have budgets and part of them must be covered by commission. Excessive commission rates are politically problematic, but SATs can calculate what region size is required so that they are able to cover a specific part of their budget. Clearly, the region needs some tax potential for SAT's presence to be worthwhile. Regarding the linkage between the commission and target revenue, it is very difficult to set targets at the inception phase as fiscal potential is not obvious. Moreover, investment needs in the required SAT infrastructure and capacity building are heavy at the beginning, while it is crucial to preserve the incentives for SATs to set up. Nevertheless, some linkages exist. National administration gets smaller commission on revenue collected than local SATs. If an above-target amount is collected, it must be transferred to the MoF.

Finally, when a mix of taxes and licenses is considered, these fees are more closely linked to certain services at the **local** rather than at national level. It is easier for taxpayers to assess the quality of service paid for and provided close to them. Hence, local governments have an incentive to improve the provision of public goods to encourage compliance. In such an environment, introduction of an SAT makes sense, as one cannot expect good performance of an agency if local policy is not citizen oriented. There is also a reverse causality, whereby tax-complying citizens lobby for improvements in the quality of provided services. In Peru, this works well. But similar reforms could also be introduced by conventional tax administrations, by investing in ICT, customer orientation and liability assessments.

María Angélica Arbeláez (Fedesarrollo) on Fiscal Policy in Colombia: Colombia's fiscal performance has substantially deteriorated in the last decade. The reforms carried out over the last fifteen years have either been limited or have been designed to respond to short-term needs, rather than to generate permanent and structural changes. On the spending side, the only reform that helped to control expenditures was **decentralisation** which limited regional transfers. On the tax side, several "quick fixes" were implemented, and they were not enough to finance growing expenditures, to provide room for further redistribution or to undertake short-term stabilisation. Regarding the so-called "**social contract**", even though social expenditures have increased, their effectiveness has been partial. A good example is the rate of coverage in education, which has increased more slowly than the pace of expenditures on education. Moreover, public investment in public works and transportation has been low, and even decreasing over the last fifteen years.

In addition, fiscal policy has served as a weak economic stabilizer due to its **pro-cyclical behaviour** and the lack of savings in good times. In crisis, the growth of expenditures to compensate for the fall in demand has been financed through new debt. Unfavorable dynamics of revenues, combined with the ensuing low capacity for indebtedness, limit the Government's scope to raise budget expenditures. Colombia does not have institutional arrangements or budget rules based on structural balance, by which the Government could annually estimate the fiscal revenues and schedule spending in accordance with these structural revenues (as occurs in Chile). Moreover, in order to improve the counter-cyclical capacity, fiscal authorities should improve the automatic stabilizers through, for example, the adoption of social support programmes with clearly defined entry and exit clauses (unemployment insurance instead of programmes such as *Familias en Acción*).

In 2003 Colombia adopted a **Fiscal Responsibility Law**, which requires the use of medium expenditure frameworks, though it does not include enforcement instruments as do other FRL's (Brazil, Chile). In Chile, for example, when the annual output gap is positive, it is mandatory to generate a structural surplus of 1% of GDP. In addition, this surplus must be accumulated in two sovereign funds, in order to cover future pension obligations and deficits when the output gap is negative. In terms of tax policy in Colombia, there is the need to reduce tax exemptions, make the income tax more progressive, increase the taxable base (by reducing the rate for corporations), increase the range of goods subject to the VAT, reduce the number of tax rates, eliminate distortionary taxes that were transitory and have become permanent (Transaction Tax, Wealth Tax), and to improve the tax administration.

Discussion: Conclusions for Colombia show similarities to the Bangladeshi case, although Colombia is a MIC, while Bangladesh has the status of a LIC. How can one compare the potential effects of fiscal policies in such two different countries? Countries which have a larger part of their economies devoted to agriculture require a different stabilisation policy. The ability of tax policy to stabilise the economy might be higher in more developed economies, while expenditures might work better in less developed ones. To what extent does this potential depend on the **structure of the economy** or the source of tax revenue? This remains more of a question than an answer.

Next, it is possible that the use of tax measures (e.g. reducing rates) is more socially costly than approaching the fiscal problems through public expenditure. In post-crisis context, most commonly the **adjustment** seems to be taking place more on the expenditure side. Is it because of the structure of tax systems? Or because the reaction time of adjustment is faster with expenditure as stimulus than if taxation rebates are used? Tax reforms require time lags before they are translated into investment increases.

Whether tax reductions or **expenditures** are used depends also on the political process. In Colombia, it is difficult to introduce real structural reforms as the changes must be approved by the Congress in a costly bargaining process. Consequently, spending is a faster way of providing a stimulus. Moreover, there is a belief that spending is a better redistributive tool. Hence, preference is given to subsidies and exemptions. When temporary measures are considered, it is easy to introduce them but politically difficult to reverse them later. Similarly, the efficiency of fiscal reforms is low in broader sense – small reforms take place, but not comprehensive ones. As a corollary, the instability of reforms makes fiscal policy less credible.

The debate about taxation versus expenditures must take place bearing in mind the **political economy** setting. In OECD countries this debate is present. On the expenditure side, policy can be effective if targeted at the poor and in countries where social safety nets are low. However, in numerous cases, authorities lack information on who the poor actually are. Countries which have no social safety nets are especially touched by this problem, e.g. Paraguay. Moreover, there must exist political will to take back the stimulus once crisis recedes. Finally, some countries find it difficult to actually spend the money. For example in Peru, a large fiscal stimulus was allocated to infrastructure, but only a small part was spent due to unavailability of channels for investment.

Gabriel Oddone (MercoNet) on Pro-cyclical Tax Policies: Developing countries, especially those with small-scale internal markets, tend to face deep macroeconomic fluctuations. In general, such countries have weak institutions with somewhat inefficient macroeconomic regimes and incomplete (in some cases non-existing) markets, which are not capable to efficiently manage, absorb and particularly time-distribute the effects of external shocks on the domestic economy. On the contrary, the systems themselves sometimes contribute to and magnify them.

One specific case of an institutional weakness is the pro-cyclical tax policy, which generally derives from pro-cyclical taxing structures. The pro-cyclical nature of tax collection in developing countries is related to two closely connected aspects. First, **consumption tax** tends to have a significant bearing on tax collection. Second, due to **incomplete financial markets**, consumption is more volatile than income. As a consequence, tax policies can hardly act in a counter-cyclical way to help distribute the impact of external shocks over time, and therefore to soften the cyclical contraction.

Thus, as opposed to what is usually suggested by the literature on tax policies and growth, in small and open economies the stylized facts show that a tax structure levying consumption excessively may end up promoting growth volatility, and hence affecting the long-term growth itself. In fact, sharp macroeconomic fluctuations are likely to generate uncertainty which leads myopic investors to demand extraordinary high profits from their activities. This type of environment does not foster long-term structural and R&D investment needed to achieve productivity improvements and long-term growth. Based on the above, in order to contribute to the smoothing of cyclical fluctuations, we posit that these economies should rebalance tax collection by relying less on consumption tax and more on income tax.

Discussion: There are **historical reasons** why especially Latin American economies are intensive in consumption taxes. In Latin America there has been a long history of intense taxation in external sectors. The most important reforms in 70s attempted to shift the tax burden to internal sectors. This has been paired with the institutional (in)ability of agencies to collect taxes in general. When direct tax collection potential is weak, indirect taxes become a fallback. Finally, the liberal 90s provided ideological reasons for the existence of indirect taxation, as being more efficient and less distortive.

However, **countries at different levels of development merit different tax policy design.** In developed countries, indirect taxes are recommended as they create lesser distortions to labour supply, investment and risk taking than direct taxes. However this is not the case in the developing world. An interesting example concerns property taxation. In the OECD, housing tends to be under-taxed, inducing overinvestment in housing taking and away resources from other productive uses. But it is to the contrary in India, where incentives are needed so that more investment in housing takes place.

To be able to do countercyclical policy, e.g. in a recession, necessitates pecuniary resources, if the authorities have access to them. But one does not envisage raising revenues from taxes during a downturn. It is more an issue of **sustainability in the long-run**. While the political cycle is very much a fact, fiscal policy should be used to smooth – not exacerbate – the business cycle (which is hardly corre-

lated with the political cycle). For example in Uruguay, moving to a structure more intense in income taxes allows to diversify the sources of tax collection and possibly leads to better a spending potential during the times of crisis.

It is true that the most important stimulus tool in recession is through expenditures, but becomes problematic if the coffers are empty. There is little room to respond to external shocks using domestic means. The problem is therefore two-fold: tax structure, plus the denomination of **debt in foreign currency**. In times of crisis, when domestic currency depreciates, the weight of debt increases as a fraction of GDP. It is necessary to progressively shift the debt from foreign to local, denominated in local currency. But needed also are less pro-cyclical tax structures. Meantime, in times of crisis aid is required from international institutions.

Regarding alternative policies, while tax base volatility might not necessarily be bad if institutional arrangements are in place (allowing to save the surpluses accumulated during a boom, e.g. in Chile via the copper fund), this mechanism requires some conditions. One is a relative economic stability over a period of time. Second is the endowment of a principal object of revenue (as in Chile or Norway). Last but not least, there is potential to lower the volatility of consumption by encouraging **precautionary saving**. Consumption tends to be more volatile in developing countries predominantly due to financial friction and the absence of good saving vehicles. Functional **financial markets** can help reduce the volatility of consumption, so their development would be a way of dealing with the roots of the volatility problem. Other than that, erratic policies encouraging **erratic spending** (e.g. on housing, cars, appliances) should be minimized. These two, combined with better, more counter-cyclical, tax structure and tacking the build-up of debt, could be seen as a set of policy recommendations.

SECTION IV: AFRICA

François Yatta (LEDNA) on Fiscal Decentralisation in Africa: Decentralisation is the major institutional innovation faced by African countries since their independence. Fiscal decentralisation, being part of it, refers to the public allocation of resources and the organisation of fiscal relationships between several tiers of government in a country. However, the capacity of local governments to provide local public services and to foster local economic development is constrained by the narrowness of local finances.

The principal obstacle is the fact that the central government cannot decentralise financial resources it does not have. Africa is the region of the world with the **lowest level of pooling of resources** for public action (public levy rate on average 15%, whereas 20 to 25% in Latin America). The preponderance of **informal sector** in African economies is one of the reasons for this. These scarce local public resources are also explained by the **unbalanced taxation**: 10% of taxpayers are at the origin of 80% of the revenues from taxes.

The second obstacle is the pre-eminence of import-export duties and **indirect taxation**. In the majority of African countries, customs duties often represent 50%, and sometimes more, of the whole public revenue. They are typically the receipts of Central governments, making rather difficult the dialogue with local governments regarding their sharing. On the other hand, due to regional integration and globalisation, customs duties are expected to decline. Consequently, central governments hesitate to share the declining resources, which to date have no guarantee to be replaced by substitute taxation with the equivalent easiness of collection. This context of fiscal transition of African countries is not in favour of fiscal decentralisation.

Funding decentralization through local taxes in Africa still remains a problem for several reasons. **Fiscal incivism** (individuals and businesses not paying taxes) is the first. Social and political crises question the legitimacy of public governance. Local governments suffer because the structure of their levy is based on direct taxation, while central governments allocate to themselves the most productive taxes. Finally, one observes a proliferation of local taxes with poor yields, instead of a setting-up of manageable taxes that could yield a sufficient level of revenues.

Institutional constraints also hamper local taxation. Local tax rates are generally determined by the parliament, reducing the direct relation between the choice of the level of local service and the level of local tax. Moreover, central administrations tend to have control over local taxes, which they can amend or cancel without consulting local authorities and without compensation. In most African countries, the fiscal chain is entirely controlled by central administrations; hence the identification of taxpayers, the issuance of tax assessments and tax collection are generally carried out by central governments, which are too remote from local realities.

Local taxation cannot be independent from national taxation. Reforms directed towards domestic indirect taxation have double impact. First, the field of direct taxation is not invested into by central governments, while the cost of enhancing local direct taxation is too high for local bodies. A step to be considered should be the generalisation of **shared taxation** between central and local governments – from VAT to direct taxes.

Discussion: The main objective of fiscal decentralisation at the local level is to promote the effective allocation of resources (**allocative efficiency**), the provision of public goods and services (**productive efficiency**) and the efficiency of fiscal policies through greater involvement of citizens in the fiscal chain (**fiscal efficiency**). To these aims, there should be increased local taxation and less transfers from central governments. The main objective at the national level is to reach macroeconomic **stability, redistribution and economic continuity**. To meet these goals, less local taxation and more transfers from central to local governments are needed.

Morocco, Nigeria and South Africa enjoy very different ways of fiscal decentralisation. In Morocco, very large (and balanced) flows of tax and transfers take place directly between the central government and citizens. Local bodies play very little role by comparison. In Nigeria, the majority of taxes is collected by the federal government, but transfers are executed very much in equal measures by the federal government and the states. This set-up requires that transfer system exists between the federal government and the states to start with. In South Africa, tax revenue feeds the central government,

which in turn makes a transfer to provincial governments who in turn manage the expenditures at the regional level. In the three countries, local bodies play quite a substantial role in direct local transfers, but only in South Africa local governments are fed directly by revenues from citizens.

Lessons can be learnt from decentralisation stories in Asia, and vice versa, e.g. in India.

Roy Culpeper (NSI) on DRM in Sub-Saharan Africa: Enhancing domestic resource mobilisation (DRM) in sub-Saharan Africa makes sense on a number of levels. Elevating domestic savings and investment is fundamental to higher sustained growth and poverty reduction. Moreover, enhanced DRM can reduce aid dependence, and increase ownership and policy space. In the longer term it can strengthen governance and democratic accountability. The current global financial and economic crisis, which will depress external inflows and export earnings, reinforces these arguments, as African Finance Ministers and Central Bank Governors have recently acknowledged. Country strategies to enhance DRM should be based on the constraints and opportunities each country faces. Donors need to integrate enhanced DRM into their policy frameworks by planning aid exit strategies and working with partner countries toward building sustainable capacity for development in the public and private sectors.

DRM has been of interest to African policy makers for a while, but the crisis makes DRM even more so urgent. As a **holistic approach to DRM** is needed, it is vital to look both at public and private revenue mobilisation. Consensus exists that there is no scope for higher development path not backed up by higher domestic saving. This lesson has been learnt very much from the experience of South East Asian economies. In theory – in neoclassical models – saving and investment do not matter for growth. However new models, especially endogenous growth models, propel the impact of saving and investment on growth. Moreover, research shows that foreign saving tends to be an imperfect substitute for domestic saving. Also, if MDGs are considered to be a worthy long-term objective, they should become sustainable, which is possible only if African governments can support them from domestic resources. Finally, there exists a political economy argument for enhanced DRM – there is no taxation without representation, and vice versa!

This study looks at 5 countries – Burundi, Cameroon, Ethiopia, Tanzania, and Uganda – which are by no means homogenous. All are very poor, except Cameroon which is a MIC. Burundi is heavily aid dependent, while others are so as well but to a lesser extent. The objective is to identify key constraints and opportunities for DRM in public, private formal (banks and non-bank intermediaries) and private informal (micro finance) sectors.

Key constraints emerge. In the public sector these are, among others, narrow tax base, high tax rates which include fraud and evasion, loopholes, complex legislation, inefficient and unmotivated administration, easily available foreign aid, and corruption last but not least. In the private formal sector, fundamental limitations include the state using bank financing, which leads to high interest rates faced by SMEs, limited competition in banking, the absence of capital markets, restrictive monetary policy, easy foreign aid and costly mobilisation of rural saving. Private informal sector is constrained by the non-monetised income of its clients, and under-equipment in technology and skills.

On the other hand, there are plenty **opportunities** for DRM enhancement. In the public sector there is a scope to reform taxes and customs, widen tax base, eliminate loopholes, simplify legislation, eliminate discretionary powers and combat corruption. Private formal sector would benefit from macro-economic stability, increased competition, the strengthening of supervision in the banking sector, a deeper and wider pension system and the use of technology to lower implementation costs. Opportunities for improvements in the private informal sector could come from deeper regulation and stronger confidence in microfinance, guarantee mechanisms for SMEs and farms, support in training, credit lines made available, audit services and the availability of guarantees.

In such context, what can **donors** do? First step is to acknowledge that DRM is a goal in its own right and that chronic aid dependence is detrimental to DRM. Donors should work actively towards the aim that the necessary resources are there flowing from aid to programmes which will help developing countries go beyond aid dependence in the future. They should ensure that trade and investment liberalisation is consistent with DRM efforts. Another important action to be taken is to facilitate the transfer of remittances towards the continent, e.g. by reducing the costs of transfers, agreements between banks and alike. Last but not least, donor countries should put efforts into identifying and repatriating illicit

flight capital. Summarising, actions to be undertaken should include (i) at sectoral level - improvements to tax administrations and legislation, hence public revenue mobilisation; (ii) the deepening of financial sector to improve its efficiency, soundness, regulation and competitiveness; (iii) help to MFIs increase borrowing and saving services for the poor especially in rural areas.

Discussion: First, holistic approach to DRM is needed, because public sector is not able to do the full job without the involvement of private sector. In particular, **rural DRM** is crucial, especially in Africa and Asia, where the absence of saving collecting institutions is endemic.

Second, what are fiscal responses in the presence of **ODA flows**? Is it true that tax efforts are relaxed if aid is present? Perhaps this might not necessarily be the case in Africa. Would giving loans be a better solution than donating aid?

Third, it is crucial to think of alternative sources of tax revenues, e.g. from tax on **natural resources**. Should these revenues be consumed or saved? In Bangladesh, in the case of gas, tax holidays are present, but how the pricing of the product should take place, especially if it is a non-renewable fuel? Should it remain underpriced in order to give a competitive edge to the economy? What about the corporate income tax in such a setting?

Last but not least, a marked issue in a **small open economy** is that external saving is growing fast, and the global income is untaxed. However, there is a multiplier effect, as such resources add to foreign reserves. Unfortunately, little gets translated into investment.

Overall, very few institutions study in detail taxation, while expenditures are studied much more. More studies are needed.

FINAL CONCLUSIONS

Regis Avanthay (DEV): A number of issues were mentioned as being of particular importance, starting with capacity building and the strengthening of tax and customs administrations both at central and at decentralised level. It has been insisted that donors can play a productive role in enhancing capacity, both on the expenditure and revenue sides of DRM. Emphasis was put on the replacement of excise duties by VAT and the resulting distributional effects, often unfavourable to the poor. Moreover, it was noted that the design of taxation of natural resources must depend on whether the resource is renewable or non-renewable, with non-renewables deserving far stronger scrutiny. Various ways to broaden the tax base were discussed, among others the inclusion of the informal sector into the mainstream. On this note, it emerged that the informal sector is very often the mainstream, hence its formalisation might be very difficult to achieve. This must be accounted for in the design of inclusion strategies. Especially, the informal sector is very dynamic, as well as very diverse - for example in terms of geography (rural versus urban) and character (services versus production). The focal question emerged on whether taxation is at all a good entry point for tackling the informal sector problem, or whether other means of incorporating the informal into formal should be envisaged. This remained more of a question than an answer. Finally, we asked if tax compact were of interest as a way to enhance taxation efforts. Undoubtedly, it is very much so and is especially desired by the developing countries themselves. Finally, it must not be forgotten that DRM is a very broad topic. We discussed only the revenue part of the public component of DRM. In the future we need to discuss the private DRM. In this respect, the questions of saving, investment and capital markets are imperative.

Bert Brys (CTPA): Four strategies are emerging as how to increase public revenues. Firstly, it is common to propose increasing the rates and broadening the base. But perversely, decreasing the rates might very well lead to an increase in overall revenues, in the spirit of Laffer curve, when the base expands as a result and/or the business activity is stimulated. Secondly, there is a link between taxation and growth, as growth leads to a larger tax base. Of course it remains to be answered how this growth should be best achieved, whether by domestic or foreign investment (and its crowding-in effect). The recommended tax mixes are in general different for the developed and developing economies. While a shift from direct to indirect taxation is recommended for the OECD (so as not to distort leisure and investment decisions), rather the opposite holds for non-OECD economies, as progressive direct taxes are more redistributive. However, high direct taxes create distortions to labour supply and investment, and too high levels might be unfavourable to growth. There is also a question of cyclical policy, since indirect taxation tends to exacerbate the cycles. Thirdly, regarding the capital flows and capital flight, the Tax Compact is desirable in order to diminish international tax competition. Finally, to get as many tax payers as possible into the reach of tax systems, an improved tax administration, reductions in compliance costs for firms and individuals, and potentially a fiscal federalism could be recommended.

The crucial overall conclusion is that taxpayers must get the value for their money. In this way, tax systems may gain legitimacy and fiscal compliance can be encouraged. Moreover, there is a need for reliable tax indicators. Before policies are designed, we need to measure the actual tax burden, e.g. on the formal versus informal sectors; as it looks now, the burden on the informal sector might be already very high. Finally, needed is a long-run strategy to increase domestic resources. Can we come up with a set of guidelines or steps on how to increase domestic resources? Should the strategies be designed differently for different countries, depending on where the countries are in their development process? These are questions for future consideration.

Christian Daude (DEV): Fundamental for the effectiveness of public revenue mobilisation is the quality of "goods and services" delivered in return for taxes collected. This connects to the issue of state's fiscal legitimacy, and remains a problem for Latin America – whether in the context of transparency or the quality of spending. Regarding transparency and institutional design – the question is how to decentralise and what incentives should there be for tax authorities, both on the spending revenue sides. Lessons learnt in Asia could be guidance for Latin America. In long-term, as countries are heterogeneous, it is a challenge to make an explicit recommendation on how to raise more revenues so that the quality of pub-

lic services can increase. There is a reverse causality between those. In some countries, revenue is a problem, e.g. in Guatemala. In others, it is the expenditure side which is pressing, e.g. in Brazil. Finally, there comes the question of cyclicity, and the means of dealing with the crisis and external shocks. Fiscal policy tends to be pro-cyclical, not just because of tax systems' design, but also because in times of crisis expenditures are cut very fast - buffer resources are low.

David Batt (APF): Undoubtedly, DRM is a challenging endeavour, especially in Africa. Firstly, within the domain of DRM, next to its public revenue component, the private one is crucial as well, since development cannot succeed without the mobilisation of saving and productive investment. Secondly, fiscal decentralisation must be taken forward. There are varied lessons being learnt about the process conducted so far both in Africa and Asia. In view of the multiplicity of circumstances, there is no single set of solutions - each country's policy must be a function of its own specificity. Thirdly, it remains crucial to study the link between aid transfers and domestic tax efforts. Clearly, donors can play a role in enhancing developing countries' capacity to generate their own revenues. Finally, we look forward to seeing how multinational cooperation can help the globalising world escape the perils of tax avoidance, tax evasion and capital flight.

The OECD Development Centre

Who we are

The **OECD** Development Centre helps policy makers in OECD and developing countries find innovative solutions to the global challenges of development, poverty alleviation and the curbing of inequality. It is a unique institution within the OECD and the international community, where the governments of Member and developing countries, enterprises and civil society organisations discuss questions of common interest informally. Its Governing Board comprises OECD countries but also emerging and developing economies. See www.oecd.org/dev.

Working with us

The activities of the Development Centre are funded by the member countries of the Development Centre's Governing Board and other partners including foundations and corporations. To develop innovative activities, the Centre invites more public and private partners to join them. Financial contributions from OECD governments are eligible for classification as Official Development Assistance.

Contact

Régis Avanthay
Head of Partnerships and Networks
OECD Development Centre
regis.avanthay@oecd.org
Tel. +33 (0) 1 45 24 84 84

Anna Batyra
Partnerships and Networks
OECD Development Centre
anna.batyra@oecd.org
Tel. +33 (0) 1 45 24 82 98