

OECD Development Centre Development Finance Network (DeFiNe) Meeting

Domestic Resource Mobilisation for Development Policy Solutions in Times of Crisis

Programme

24th September 2009

20.00 Dinner

Le Bistro de Breteuil
3, Place de Breteuil
75007 Paris
Tel. 0145670727

25th September 2009

IEA Building, Room IEA 1
9, rue de la Fédération, 75015 Paris

8.30-9.00 Arrival/Registration

9.00-9.15 Welcome (Guillaume Grosso - DEV, Stephen Groff - DCD, Richard Gallacher - CTP)

9.15-10.45 SESSION I: GENERAL (Régis Avanthay - DEV)

1. "Revenue Mobilisation as an important dimension of the overall Domestic Resource Mobilisation process: Issues, Challenges and Some Reflections" (15 min)
George Mavrotas (GDN)
2. "Informal Sector and Domestic Resource Mobilisation" (15 min)
Imed Drine (UNU-Wider)
3. "International Tax Compact" (15 min)
Peter Wolff (DIE)
4. Floor Discussion and Preliminary Conclusions (45 min)

10.45-11.15 Break

11.15-12.45 SESSION II: ASIA (Richard Gallacher - CTP)

1. "Tax Rules in Stimulus – Developing Country Perspective - India" (15min)
Yoginder K. Alagh (IRMA)
 2. "Taxation and Development in the Philippines" (15 min)
Paul Quintos and Tony Tujan (IBON)
 3. "Implications of the Global Financial Crisis for Domestic Resource Mobilisation - The Bangladesh Experience" (15 min)
Debapriya Bhattacharya and Mustafizur Rahman (CPD)
 4. Floor Discussion and Preliminary Conclusions (45 min)
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12.45-14.00 LUNCH

14.00-15.30 SESSION III: LATIN AMERICA (Christian Daude - DEV)

1. "Taxation, Fiscal Decentralisation and Legitimacy – The Role of Semi-autonomous Tax Agencies in Peru" (15 min)
Christian von Haldenwang (DIE)
2. "The Colombian fiscal policy: a limited tool for long-term development and short-term recovery" (15 min)
María Angélica Arbeláez (Fedesarrollo)
3. "Pro-cyclical Tax Policies and Macroeconomic Fluctuations" (15 min)
Gabriel Oddone (MercoNet)
4. Floor Discussion (45 min)

15.30-15.45 Break

15.45-17.00 SESSION IV: AFRICA (David Batt - APF)

1. "Local Public Resource Mobilisation in a Context of Fiscal Decentralisation and Intergovernmental Fiscal Relations in Africa" (15 min)
François Yatta (LEDNA)
2. "Enhancing Domestic Resource Mobilisation in sub-Saharan Africa" (15 min)
Roy Culpeper (NSI)
3. Floor Discussion and Preliminary Conclusions (45 min)

17.00-17.40 CONCLUSIONS

Régis Avanthay	10 min
Bert Brys	10 min
Christian Daude	10 min
David Batt	10 min

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(Institutions in alphabetical order)

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Abstracts

"Revenue Mobilization as an important dimension of the overall Domestic Resource Mobilization process: Issues, Challenges and Some Reflections"

George Mavrotas (GDN)

We live in turbulent times. The current deep financial and economic crisis and its implications for the developing world are currently dominating the research and policy agenda. Two years ago it looked more likely the next shock to the global economy would come from the South: specifically a rapid slowdown in China's growth or some big blow up in emerging markets. As it turned out, the shock has come from the North, first. And this demonstrates an iron law of the globalization process, i.e. expect the unexpected. Though the origins of this crisis have been traced to the North, the repercussions, unequal and varied in their scope and impact, are being felt widely across regions and countries. Some of the impacts that are universal include slowdown in exports, fall in asset markets, reduced credit for consumption and investment and the resulting increase in unemployment, poverty and increased difficulty in making further progress with the Millennium Development Goals (MDGs). Responses from regions are varied and based on the unique set of challenges faced by these regions, but a longer-term strategy of intergovernmental cooperation might be in order to prevent future shocks.

In this context, it is not surprising that the global financial 'architecture' is currently (again) under scrutiny and the whole development finance 'system' is being re-examined. Indeed, recent work in the broad area of development finance but also in the area of international aid flows has stressed the growing complexity of the multilateral development finance system and more importantly that the current multilateral development finance 'system' is rather a *non-system*, in the sense that unlike some of its elements (such as the Bretton Woods sister organizations) it has not been planned, and it is not the result of coherent design.

The UN Doha Conference on the other hand clearly stressed that the international context of aid has changed profoundly since Monterrey. In particular the Doha Declaration on Financing for Development emphasized that the international community is now challenged by the severe impact on development of multiple, interrelated global crises and challenges which include food insecurity, volatile energy and commodity prices, climate change, and above all, the global financial crisis. Indeed, the financial crisis changes the aid landscape in view of the implications that a global financial meltdown may have for aid budgets. Furthermore, during these difficult times for aid budgets, honoring aid commitments remains a big challenge. Recent work has shown that what will most certainly happen as a result of the global financial crisis is a notable shift in the composition of resource flows towards multilateral contributions (as more funds are channeled through the International Monetary Fund (IMF) and the World Bank); and in this context, there is a danger that much of the new resources will bypass the poorer and more vulnerable countries, and instead be destined almost exclusively for the emerging markets and middle income countries, to reduce systemic risks. A relevant issue is the *volatility* of the capital flows (both aid and portfolio flows) which makes recipient countries dependent on them particularly vulnerable during macroeconomic and financial crises.

Crises, however, provide also us with opportunities to look at other sources of development finance beyond aid flows, FDI and portfolio flows. And this takes us to the central issue of Domestic Resource Mobilization, which has two dimensions, both important to make further progress with the MDGs, particularly during a crisis period. The first is building the *domestic financial system* (the banking and in-

insurance sector as well as the market for equities and public and private debt). The second is increasing government *revenue mobilization*.

Building the domestic financial system has been rather neglected as a potential source of development financing in connection with the MDGs in recent work. However, there is substantial potential there which if realized can help accelerate progress with the MDGs. The above important route has the additional advantage of engaging directly local communities in the overall development financing process. Furthermore, financial sector development can enhance savings mobilization and domestic investment for pro-poor growth. The issue is becoming of crucial importance in view of the overall low savings rates of many low-income economies in recent years (most of them in Africa) and the fact that a substantial number of developing countries have undertaken a series of financial reforms recently to improve economic performance. Indeed, many developing countries often lack an appropriate financial sector, which provides incentives for individuals to save and acts as an efficient intermediary to convert these savings into credit for borrowers. The financial liberalization experience of many low-income countries in recent years, although towards the right direction in certain cases, seems to suggest that transforming the financial structure of an economy is a complicated process which assumes a deep understanding of the entire set of interactions between financial sector reforms and the economy. At the same time, the current crisis (but also the experience of the Asian financial crisis) clearly suggest that whilst financial liberalization may be desirable, the process must be correctly regulated, which requires building institutional capacity – a costly process.

Revenue Mobilization is an important dimension of the overall Domestic Resource Mobilization 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 mobilize more domestic revenues, and there are opportunities in even the poorest countries to do so. This, however, requires governments to undertake considerable institutional investment to improve often archaic tax administrations.

The introduction of VAT in a number of developing countries has been successful in raising more revenue. But 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. Excise duties have received less attention in the reform agenda compared to other instruments, but they can raise substantial revenue and at the same time be distributional friendly. However, one needs to have realistic rates to avoid avoidance and corruption and they should be seen as long-term opportunity for raising revenue as the economy develops and the consumption of luxury commodities rises.

A central challenge is **broadening the tax base**. According to the empirical evidence broadening the VAT base cannot be achieved without increasing the tax burden of the poor. Accordingly, broadening the VAT base should be a low priority and should be implemented only in those countries where the net fiscal incidence (ie the net impact of taxation and public spending taken together) is favorable to the poor. Priority should instead be given to the wide 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). Improving the collection of direct taxes is also important, and the emphasis should be on reducing tax evasion. In order to protect poorer households it is important to set the income tax threshold at a suitably high level (as has been done in Kenya for example).

Last but certainly not least, **building institutional capacity** remains a crucial component in the reform agenda. A number of challenges are relevant on that front: First, governments should provide a governance framework within which revenue authorities can perform effectively without continual compromise. Second, governments need to respect the independence of the revenue authority and address the need to maintain incentives for staff within such service. Third, governments also have to recognize that weaknesses in budgetary and expenditure management systems will undermine the potential economic and political returns on investment in the revenue services. And finally, institutional components have been biased towards organization, IT-related procedures and manpower upgrading, with insufficient attention to accountability and anti-corruption institution building and cost-effectiveness of administration.

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"Informal Sector and Domestic Resource Mobilisation"

Imed Drine (UNU-Wider)

In the majority of developing countries, external financing represents the main source for public finance. Their strong dependence on external financial resources has made them relatively vulnerable, given the volatility of these flows. The current financial crisis has created financial difficulties for many developing countries, given the lack of liquidity on the international market, putting into question the robustness of their development process.

In this regard the informal sector, which constitutes a major portion of the economy in developing countries generally, seems to be a potential source for funding and enlarging the tax base. Collecting taxes from the informal sector is obviously a difficult exercise, but the potential gains justify thinking about incentive mechanisms that improve commitment to pay tax. In the final analysis, long-term policies to bring the informal sector into the formal sector are indispensable and should be pursued. Meanwhile, a more flexible and adaptive tax system, the integration of informal sector into the development process, and a better supply of public goods could encourage the informal sector to help fund productive public services.

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**“International Tax Compact
Initiative to strengthen international cooperation with developing countries to fight tax
evasion and tax avoidance”
Peter Wolff (DIE)**

Tax evasion and tax avoidance are a serious drain on domestic resources, probably higher than aggregate inflows from ODA.

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.

Activities pursued by the OECD and by the United Nations are making valuable contributions in this regard. However, developing and transition countries’ interests are often underrepresented in the existing international initiatives. Furthermore, there is a serious analytical gap with regard to the scale, channels and methods for tax evasion and avoidance.

Therefore, 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:

- **Activities at the domestic level:** Reinforce activities in support of tax reform (i.e. tax system development and enhancement) in partner countries.
- **Activities at the international level:** Support developing and transition countries in building the requisite capacity to participate, as equal partners, in international tax cooperation processes.
- **Analytical Work and Studies:** Closing the analytical gap that still exists with respect to tax evasion and avoidance.
- **Networking and dialogue:** Facilitate 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.) and between all participants of the initiative so that best practice experiences may be gathered and refined for the implementation in national policies.

Networking and dialogue activities have started in 2009. A joint study with the OECD Centre for Tax Policy and Administration (CTPA) on revenue losses resulting from inappropriate tax practices with focus on key African countries has been commissioned.

“Tax Rules in Stimulus – Developing Country Perspective - India”

Yoginder K. Alagh (IRMA)

1. Importance of Domestic Resource Mobilisation; Free play for coordinating alternate sources including FDI, aid and technology imports; Difficulties and solutions?
2. Presumptive taxation for widening tax base in services, informal sector links of organized sector and agriculture; First step for better records and accounting.
3. Tariff policies and harmonization with reform; Negative protection; Agriculture in the WTO regime.
4. Providing quality services by reengineering business processes in the tax departments through process reform and technology; E-filing of returns, E-payment of taxes, refunds with ECS, computer aided selection of scrutiny, a centralised processing centre and taxpayer information system.
5. Simplification, optimal-rate structures and widening of base; Income taxes; VAT and GST.
6. Transparency for tax structures for foreigners; Fast-track dispute-settling procedures.
7. Examples of progress and problems will be from India.

Introduction

This paper addresses the problem of domestic resource mobilization as a part of policy to stimulate the economy of developing countries to the 'normal growth path' as they recover from the economic crisis since mid 2008. While the problem can be examined in a larger framework of financing as a part of a strategy of public private partnerships in investment and economic revival, the paper has been mandated to concentrate on taxation strategies. The larger context it works within is the framework of economies integrating with the global economy in an economic and fiscal reform mode. Tax policies are detailed in this context, including better business and technologically efficient models of tax administration. Therefore the well known ongoing efforts at simplifying and widening the tax base are the background.

There are two amplifications, which give an interesting flavour to this discussion. The first set of issues arises from the institutional nature of developing economies. The preponderance of informal sector economic organizations in the developing world has been known from the work of the ILO, UNIDO as well as the Development Centre of the OECD. There is evidence to suggest that this sector is in fact expanding. It is largely seen as a sector which needs support and not as a source of fiscal revenue. This is particularly so since this is a sector with 'thin employment', including below poverty level wages. However it is now also documented that informal sector enterprises may be of different kinds and some are both technologically and in a financial sense, resourceful and expanding. Taxes are never liked like mothers in law and have adverse incentive effects, but since they are needed, the 'viable' part of the informal sector may be a source of revenue. The difficulty here is assessing the tax base since by nature accounts, at least as per accepted accounting standards, are not kept in the informal sector. We suggest 'presumptive assessment' for this purpose as a transitory method, particularly since its imposition may in fact also help better accounting practices being adopted if assessments based on 'pre-

sumptive characteristics' are contested by the tax payer. In these cases since the assessed would have to submit accounts that would be a desirable outcome in itself.

A corollary of this set of issues is the need to examine if there are resources raising possibilities at the local context in large federal developing economies. Here the orthodoxy is that such possibilities are not there in substantive measure given the rudimentary nature of local self government institutions in developing countries. We re-examine this context using Indian experience. For if such possibilities exist they release the resource constraint in areas critical for widespread agricultural and rural growth. These resources in a sense are doubly blessed. They add to the resource pool and also give more manoeuvrability to local authorities, which is an important added gain.

A second amplification is that the downturn itself could lead to domestic policies of a suboptimal kind from the perspective of trade reform. Such policies may be dictated by pressing needs to minimize large employment or output losses, which may need distorting protection. Such protection would need to be kept at minimum and should in any case be of a transitory nature. Alternately the need for such policies may arise in the distortionary nature of some global markets. An example is global agricultural markets in the emerging context of the WTO discussions. If there are welfare distorting economic policies, it would be legitimate to use tax policies to reap welfare losses as a social dividend rather than allowing them as unearned or rentier private gains. We give the example of negative protection and tariff policies as a case. These would also be justified in the case of environmental or social 'bads'.

The Need

The importance of domestic resource mobilization particularly by the State, even if stimulus policies are funded by external resources emerges from the need of priority to non tradable infrastructure in any investment programme. This is the so called third gap in addition to domestic savings and external resources. In the stimulus packages in India for example, even though the country had plentiful external reserves and a high savings rate, the details of government expenditure programmes discussed in the study required resources with the Government at regional and local levels for investment in infrastructure and agricultural and rural development programmes. An FAO study showed that some 'free resources' were necessary to implement high priority agricultural and rural development programmes, with local institutions even when such expenditures were largely funded from higher levels of government within the country or external aid.

The Indian Eleventh Plan recognizes that, rule based free devolution of resources or resource mobilization at the local level becomes a constraint for speedy integration of projects in a local plan even when the local bodies have plentiful cash resources from tied aid or devolution from higher levels of government.

Taxing the Informal Sector

An Indian study for the ILO by the present author has conclusively demonstrated both the expansion of the informal sector, the low wage component in this expansion, but also the very dynamic and prosperous sub sectors. For example the Indian diamond polishing industry largely in the informal sector has a remarkable expansion record including very substantial purchase of retail outlets in the US. There are other examples. The Indian tax reform in 2009/2010 includes a policy initiative for "Introducing a new package of presumptive taxation to encourage voluntary compliance by small businesses."

In the agricultural, first stage agro processing sector and plantations for example, the characteristics of land and water availability can be used to structure a tax design. Land revenue surveys use a system of a 'hundred cents' for defining a 'standard' piece of land in a particular soil and irrigation class as a standard according to which a particular tenant is assessed for potential income or production assessment. A better method is for the tax authorities to access the data base for estimating agricultural yield statistics, which in India are based on crop cutting experiments. These would yield directly output estimates. In the case of non agricultural products, electricity consumption or use of purchased inputs could provide the basis.

The assessed would always have the right to contest the presumptive assessment by providing standard accounts which would have other benefits for the economy in terms of transparency and policy making exercises. The Central Board of Excise and Customs in India introduced in 2009 a production based levy for pan masala and guthka sectors which are hazardous stimulants in much demand in India and according to their Chairman this 'was a huge success' (Personal interview, August 25).

Local Resource Raising Capabilities

The standard orthodoxy is that local governments in rural or urban areas are not in a position to raise resources since they are close to the taxpayer and therefore susceptible to political pressures. Indian experience showed this to be an empirically erroneous proposition.

It was found that the notion that local bodies do not raise resources is incorrect. There is wide variation in performance. Resource-raising local bodies are more than just 'Best Practice Cases'. At the aggregate level the good news was that in about a quarter of the best cases as the local economy grew, econometric studies showed that resources raised by the local bodies grow at one and a half times the economies' growth rate. The elasticity of own resource raising by local bodies was 0.6 as a whole. However we requested the authors of this work to rerun the equations for the better financially run bodies and for them the elasticity was estimated at 1.4.

These results were corroborated by many field examples. In the state of Tamil Nadu 22% of Village Panchayat (local bodies) resources in 1996/97 came from tax and non tax resources and another 6.5% from miscellaneous receipts. In the same year the average expenditure of a Village Panchayat was Rs. 1.06 lakhs (lakh=1,000,000: 1Euro=Rs.69 approximately). The story was not dissimilar in the beginning of this century. The average expenditure went up to Rs.3.64lakhs, incrementally financed from grants and deficits. The modal own income group moved from ten thousand to fifty thousand and then from fifty thousand to one lakh Rs. Around a quarter of gram panchayats had income between one to two and a half lakhs and forty six above one crore (ten million). While the expenditure was above three lakhs around a quarter of the Village Panchayats had own resources between one to two and a half lakhs of Rupees. These kinds of facts suggest the need of detailed exercises for fiscal consolidation. The better units have to become models for the average local bodies. State Finance Commissions can use them as examples for prudence and rule based policies.

Investment finance for rural infrastructure is essential. It is essential that non-revenue sources have to be seriously rationalized and properly tapped. Efforts to help create healthy balance sheet for the local institutions will put them in a position to present a rating and a borrowing-risk that is viable if not attractive to the Financial Institutions that can then be approached for underwriting or taking exposure.

The moral of the story is that:

- If achievements are made models for incentives, local bodies would soon meet current expenditures and be in a position to productively borrow if the Treasury does the reform to permit it.
- This is slow. For example a policy for urban borrowing is still under preparation. It is easier to buy the bond of a foreign local body rather than an Indian one.
- Since this is a global problem inter country experience sharing would be useful

President Obama has a constituency of farmers, small businesses and small industry. Financial restructuring needs institutions which build instruments, collateral, facilitation for communities and the small producers on whom the real and not the derivative economy rests. This market is very robust in India today as the experience of groups like Basix and IFMR shows. These kinds of arguments are central to global reform in the financial sector. There are synergies between releasing the constraint in local level spending and the current rate of development getting out of crisis.

The current problem of releasing the fiscal constraint at the spending levels is not largely a resources problem, but a restructuring and devolution problem. For State and local bodies to spend along desirable lines, rather than digging and filling up ditches or spending mechanically on centralized schemes, either the best practices have to be replicated in resource raising and/or free resources made available on a formula basis. Newer financial structures and institutions at regional and local levels need organizational and financial market reformat higher levels like experience sharing, markets for local securities, community collateral and so on. This reform has a national and global edge.

Taxation Opportunities in a Stimulus

A case in point of the kind of opportunities discussed above is taxation policies to avoid negative protection. India has some experience of this. It is now recognized in the growth debate that India was growing reasonably fast in the Eighties, when it designed an extensive programme of reform emphasizing internal competition initially. In the mid eighties around two thirds of organized Indian industry was removed from price and quantitative controls to tax and tariff rate interventions. From firm level controls the economy moved to industry level interventions with strong schemes of incentives and disincentives. These would discriminate between industries, but not between firms. The policy framework was seen as a transitional regime, leading later to more general opening up of the economy. A group that was set up under my supervision to work out a strategy of phasing out import substituting industries discovered that around half of Indian industry was globally efficient in the sense that at international prices of outputs and inputs, firms would make profits ($DRC's < I$), but at market prices they suffered losses. In a partially reforming economy, if the input supplier has not been subjected to competition, even- if a firm is efficient, it will make losses, because the global competitor gets components and equipment at cheaper prices or his interest rate is lower. Clusters of industries would need to be reformed together and tariff policies would need to be determined in an optimal manner taking these configurations into account. The Indians were seen in some of the literature as following this path, sequencing and phasing reform. According to the World Bank in 1992, "Policies that reward cost reduction and technical change and place pressures on domestic manufacturing to bring about such change would have to be implemented. Protected markets make enterprises soft and encourage obsolete technologies. Y. K. Alagh refers to a study of the Indian tire industry for the 1981-84 period where price increases were higher than increases in material costs, and the top four companies consistently maintained their share of production, while the technology used was obsolete." The Indian example was seen as a counterfactual. Lance Taylor in a fairly widely quoted paper described an MPS (Multifaceted Price System) as a "transition from an administered towards a market regime" and argued that the

Indians had switched industry successfully from firm level controls to an industry level efficiency policy, linked with economy level strategic objectives. By 1992, India moved away from this policy stance to that of a uniform tariff rate and reducing that rate.

In a distorting trade epoch which to an extent all depressions will be, it is possible to bring in policies of inverted tax structures in a measured and phased manner. India's budget papers, for the 2009/10 stimulus budget describe this policy as indirect tax rates compensating for 'deeper cuts on finished goods as compared to their raw materials'. Peak tariff rates, set by reform of the tax system are not changed, but tariff rates reduced on specified inputs, components and capital goods.

For the agricultural sector expert bodies like the Commission on Agricultural Costs and Prices, the Finance Ministry's Economic Adviser and a Committee I chaired on economic policies for a WTO trade dominated regime argue for variable tariff rates calibrated to protect the efficient Indian agricultural producer and a number of quantitatively worked out counterfactuals are available in the Indian policy literature. Such a policy would obviously raise revenues. The World Bank has advocated this policy for India as 'working a level playing field'. The Government of India however keeps its options open, both for giving it elbow room in the ongoing WTO negotiations and of keeping domestic food prices in control.

These are seen as purely temporary and transitional measures and as part of the reform of the tax system it is projected that an attempt will be made to;

'Review custom duty exemptions and move to a uniform duty structure to eliminated inverted duties.'

Business Processes and Tax Administration

The Indian tax system has been implementing since 2002 extensive information and administration systems advances using information technology solutions and reengineering of business processes in its working. In this process it has been aided considerably by the country's software system skills. This period has also been one in which non government consultancy skills have been used extensively for designing new solutions to tax administration. This has fostered a less intrusive tax system and encouraged voluntary compliance, such that effective tax rates have gone up in a dramatic manner.

While the details are available in the Finance Ministry's Economic Survey and web sites of the Central Board of Direct Taxes and the Central Board of Excise and Customs, the main initiatives have been filing of E returns, E payment of taxes, the establishment of a state of the art Centralized Processing Centre, Issue of Refunds through ECS, Refund Bankers, including private sector banks, Computer Aided System of selection of cases for scrutiny based on transparent criteria and an effective Taxpayer Information System with increasing interactive procedures.

In addition to being a part of a massive exercise of evolving an electronic system of personal identification of each member of India's 1.2 billion population, being developed by the Chairman of its largest Software Systems Company, the globally known Infosys, who has been appointed in the Government with the rank of a Cabinet Minister, Tax administration is introducing this year a unique computer based Document Identification Number(DIN) to assist correspondence. The larger system is called UID (Unique Identification Number). The Authority has been set up with a time bound task of a unique identification of each citizen. Another business process initiative underway is the development of communication systems in the tax administration using IT tools for interaction with the tax payer.

While India's metros and smaller towns are well wired up, in a major OECD Development Centre meeting on technology for poverty removal in 2002, the survey had shown hardly any general IT service providers in rural areas in the developing world, unlike bio technology products which were diffusing. The situation has now changed and a pilot project I had reported of the wiring of fifty five villages has this year been given a State level award for application of IT for rural development. It is one of many initiatives and it is likely that smaller settlements will increasingly use E support for tax administration and compliance. South-South collaboration should be actively promoted in this area.

Simplifying the Tax System

This is a complex area in taxation practice and yet is very important. Regarding indirect taxes over the past several years, significant progress has been made to improve the tax structure, broaden the base and rationalize the rates

Notable among the improvements made are:

- Replacement of the single point state sales taxes by the VAT in all of the States
- Reduction in the Central Sales Tax rate to 2 per cent, from 4 per cent, as a part of a complete phase out
- Introduction of service tax by the Centre, and a substantial expansion of its base over the years.
- Rationalization of the CENVAT rates by reducing their multiplicity and replacing many of the specific rates by ad-valorem rates based on the maximum retail price (MRP) of the products.

In defining options for further reform, the starting point is the basic structure of the tax. The Empowered Committee of State Finance Ministers (EC) in November 2007 had recommended a "dual" GST, to be levied concurrently by both the Central and State Governments. The dual GST option permits both levels of government to apply the tax to a comprehensive base of goods and services and eliminates tax cascading.

GST would facilitate greater vertical equity in fiscal federalism, reduce cascading nature of commodity taxes and through shift to value addition as the basis for assessment unify the market for goods and services. The target is to commence GST from the financial year 2010/11. The EC (which was instrumental in the implementation of the state level VAT) in consultation with the Central Government constituted a Joint Working Group (JWG), consisting of officers of the Centre and State Governments to examine the various models and options for GST. The JWG presented its report to the EC on November 19, 2007. The EC has sent its recommendations to the Government of India in the form of "A Model and Road Maps for Goods and Services Tax in India" in April 2008, which included an outline of the GST design proposed.

Foresighted changes have also been contemplated for direct taxes. The Finance Ministry has introduced a Direct Tax Code for discussion. This rationalizes the structure of direct taxes and suggests simplifications of exemptions.

The corporate tax regime in India has a higher base rate, set off with sector specific tax incentives (exemptions/deductions). This complicated the effective tax computation as also resulted in protracted litigation. The Code seeks to rationalize corporate taxation in a big way. The corporate tax rate has been proposed at a lower 25% and tax incentive provisions have been largely eliminated. The code

proposes to replace the current business profits with specified adjustments basis of computing income from business to an income expense model, as prevalent in certain developed and other Asian countries.

The code proposes to introduce the Exempt-Exempt-Tax (EET) method of taxation for savings. Contributions and interest accumulation/accretions will be exempt; however, all withdrawals will be subject to tax in the year of withdrawal.

The code materially seeks to re-alter the provisions relating to capital gains taxation. First, the code seeks to bifurcate capital assets as investment assets and business assets. Income arising upon transfer of an investment asset would only be taxable as capital gains. Second, the code would eliminate the distinction between short-term and long-term assets, by providing for taxation of gains arising on transfer of any investment asset.

India therefore has a road map for indirect tax reform with 2010 as a target and a Direct Taxes Code draft to encourage discussion. It should be possible to make progress on the former during the stimulus revival, while giving a deadline for the latter is problematic, although the process has begun. The indirect tax structure should be stimulus friendly and lead both to a wider tax net and a payer friendly system

Conclusion

There exist possibilities of tax revenue mobilization in a reform compatible manner. All of them need thinking out of the box and would lead to resistance. However it should be possible to build core support since the structures would soften the impact of the melt down. In particular detailed proposals available with a practical road map of implementation during the revival period would stand better chances of acceptance.

"Taxation and Development in the Philippines"

Paul Quintos and Tony Tujan (IBON)

This paper provides a brief overview of tax reforms in the Philippines over the last two decades. It shows that tax reforms initiated by the government after the Martial Law years resulted in an improvement in tax effort. But neoliberal restructuring in the 1990s eventually undermined these gains by dramatically lowering tax collection from import tariffs and customs duties, and providing overly generous fiscal incentives to foreign investors and other rent-seeking groups within the local business community.

Recent reforms introduced to avert another fiscal crisis has resulted in a slight improvement in tax effort but has worsened the regressivity of the tax burden. These gains are also proving to be unsustainable due to a decline in collection efficiency, reduction in corporate income tax rates and higher personal exemptions.

The paper argues against the introduction of new regressive tax measures in response to another looming fiscal crisis. Rather, the paper draws attention to major leakages in the public treasury that need to be plugged urgently:

- a. Debt servicing which is equivalent to as much as 60 percent of the national government's annual tax collection;
- b. Tax evasion which is around one-third of the potential tax take from individual, corporate and Value-Added Tax;
- c. Smuggling which costs the government upwards of 2% of GDP per year in lost tax revenue; and
- d. Redundant fiscal incentives worth approximately 1% of GDP or close to half of the financing gap for the attainment of the Millennium Development Goals (MDG)

The paper also argues that tax reforms in the Philippines cannot work unless they form part of a more comprehensive public sector reform program. Fiscal policy must move away from prioritizing debt servicing and competing for foreign direct investment to active state promotion of the people's well-being above all. The paper concludes with policy recommendations for enhancing domestic resource mobilization for development in the Philippines.

**“Implications of the Global Financial Crisis for Domestic Resource Mobilisation
The Bangladesh Experience”
Debapriya Bhattacharya and Mustafizur Rahman (CPD)**

Introduction

In view of the growing demand for generating adequate resources to confront the manifold developmental tasks facing developing countries, domestic resource mobilisation continues to remain a daunting challenge for the low income countries (LICs) such as Bangladesh. As such countries started to graduate from predominantly aid-receiving status to trading nations, the task of generating resources from domestic sources became ever more difficult. Mobilising tax and non-tax revenues, through prudent fiscal policies that balances the purposes of growth, equity and self-reliance was not easy. These tensions and challenges have all the more exacerbated because of the current global financial crisis (GFC) with concomitant implications for domestic resource mobilisation in LICs like Bangladesh.

Salient Features of Revenue Structure of Bangladesh

Revenue-GDP (or tax-GDP) ratio in Bangladesh has remained low (11.2 per cent of GDP in 2008-09), although slow improvement over the past years is being observed. The ratio did not slide back in spite of the heightened pace of trade liberalisation experienced by the country in the 1990s resulting in loss of import duties. Tax revenue has traditionally been the major source of government revenue in Bangladesh. Like many LICs, high dependence on indirect taxes (from both domestic and import related sources) is one of the major features of revenue structure in Bangladesh. Narrow tax base and lack of administrative capacity are the other two weakest links which have constrained Bangladesh's revenue mobilisation efforts. Although contribution from direct tax has increased in the recent past at present only about 10 per cent of potential tax payers pay income taxes in Bangladesh. Existence of a large informal economy also limits the opportunity to accelerate revenue effort. Various reform measures were introduced from time to time to strengthen revenue mobilisation effort, viz. launching of value added tax (VAT) in FY1991-92¹ and creation of Large Tax-Payer's Unit (LTU) in FY2002-03.

Revenue impact of the GFC

The budget for FY2008-09 presented in June 2008 was relatively large, prepared in the backdrop of record-high inflation and prompted by the rise in global commodity prices resulting in higher import payments and rising subsidy burden for the government. A deficit projection of 5.0 per cent of GDP (15 per cent higher than the previous year) was the highest in recent years. The projected higher expenditure was envisaged to be met by higher domestic revenue generation and foreign financing, along with increased government borrowing from domestic sources.

The GFC, impacted on domestic resource mobilisation in Bangladesh in a number of ways². *Firstly*, Bangladesh's revenue is highly dependent on import duties accounting for 34 per cent of total domestic revenue. As a result, the fall in global commodity prices meant lower duty collection and VAT collection at import stage. *Secondly*, slowdown in economic activities particularly in export-oriented industries meant lower scope for direct tax collection. *Thirdly*, apprehension regarding slow down of foreign resource flow created pressure on need for generating additional domestic resources to finance developmental budget. *Finally*, the thrust for higher public expenditure in terms of enhanced financial stimulus

¹ July to June period is considered as the fiscal year (FY) in Bangladesh.

² For details see Rahman, M., Bhattacharya, D., Iqbal, M. I., Khan, T. I. & Paul, T.K. (2009). *Global Financial Crisis Discussion Series. Paper 1: Bangladesh*. London: Overseas Development Institute.

and public investment also stressed the need for higher revenue collection to maintain fiscal balance. Thus, the GFC made implementation of the budget for FY2008-09 even more challenging.

Trade taxes. With the onslaught of the financial crisis and the consequent decline in global demand, global commodity prices experienced significant fall. Combined with depressed investment situation and lower import demand at the local level, imports of the country was significantly lower in FY2008-09 compared to its recent trend (posting only 4 per cent growth compared to 26 per cent growth in the previous year). Negative export growth posted by many of the export sectors despite overall moderately high export growth (thanks to resilient performance of the clothing sector) also indicated slowdown of import demand. This was also reflected through significantly higher foreign exchange reserves of the country. Owing to this fall in imports, both in value terms and in many instances in volume terms, the government faced formidable challenges in mobilising domestic resources. Large shortfall was likely since revenue earnings at the import stage (due to slowdown in imports) faced severe shortages; growth in import duty collection was negative (-) 2.8 per cent in FY2008-09.

Direct taxes. However, impressive performance of the tax authority in collecting income tax, to compensate for lower revenue collection from imports led to achieving higher than targeted growth of income tax. This resulted in lower shortfall in revenue mobilisation. The net result was that overall revenue earnings for the fiscal year fell short of target by about 4 per cent.

Depressed global economy led to lower investments at the local stage, eventually leading to lower than projected GDP growth in FY2008-09. Against the targeted growth of 6.5 per cent, a 5.9 per cent growth was achieved. Recently conducted empirical study³ has showed that domestic revenue mobilisation in Bangladesh is dependent on changes in the level of per capita income at a significant level. Thus the adverse impact in terms of potential income growth, in turn affected domestic resource mobilisation negatively.

Budgetary adjustment. Adverse affect of the GFC in terms of the shortfalls in revenue collection experienced in FY2008-09 was mitigated to some extent thanks to significantly lower than projected government expenditure in terms of import payments and subsidies. Poor implementation of public investment programmes, a perennial problem in Bangladesh, actually led to lower than targeted deficit at the end of the fiscal year. While such lower deficit might have eased the immediate pressure, medium to long term impact of such phenomenon could negatively affect the economy through low investment-low growth-low revenue vicious cycle⁴.

Government's Action

The government's immediate reaction was cautious because export sector was able to sustain higher growth rate in spite of the GFC. Eventually in April 2009 the first stimulus package worth around USD 495 million was announced with some increase in cash subsidy programme for affected export oriented sector and putting thrust on safety net and agri-oriented sectors. In order to stimulate domestic investment, the central bank decided to cap the commercial lending rate at 13 per cent. But no major revenue mobilisation related policy initiatives were visible until the budget for FY2009-10 announced in June 2009.

³ Bhattacharya, D; Iqbal, M. A. & Khan, T.I. (2009). Delivering on Budget FY2009-10: A Set of Implementation Issues. Dhaka: Centre for Policy Dialogue (CPD). Presented at the CPD Dialogue on Implementation Challenges of the Budget FY2009-10 held on 12 August, 2009

⁴ *Ibid.*

A larger expenditure has been planned comprising significantly higher public investment and safety net programmes. The government was forced to consider new safety net measures in view of the GFC such as enhancing employment generation programme, programme for returning workers from abroad and training of new labour. A larger second stimulus package worth about USD 720 million was announced. Such high expenditure has not only relied on a larger projected deficit but also require significant effort to mobilise government revenue. *Secondly*, the government will need to put more emphasis on direct sources for the additional revenue planned for FY2009-10. *Thirdly*, for a change within the indirect sources domestic instruments are expected to bear the burden of incremental revenue. *Fourthly*, following the third point, the government has opted for greater administrative effort to enhance the tax base and has also reorganised the duty structure.

Lessons Learned

Import-dependent Bangladesh economy did face the adverse impact of GFC through lower revenue off take. The GFC once again reinforced the need for greater emphasis on direct taxes as a source for domestic revenue mobilisation. The GFC has exposed the long standing structural weaknesses of revenue mobilisation in Bangladesh. It has not only forced the government to widen and deepen the domestic tax base, but also reemphasised the need for institutional strengthening towards higher and more effective revenue effort. Inadequate flow of foreign aid reinforced the need for more extensively tapping domestic need.

Reduction of vulnerabilities to shocks will call for a greater reliance on domestic sources of revenue. The necessity such a shift is further heightened by the fact that domestic revenue of Bangladesh is non-substitutable with foreign aid, as a recent empirical study conducted by the CPD has shown⁵. The study indicated that domestic revenue mobilisation in Bangladesh is significantly influenced by the level of per capita GDP. It is also found that share of modern sector in the GDP affects revenue mobilisation, along with public investment and imports. Consequently, institutional strengthening to reinforce revenue mobilisation efforts also needs to be supplemented and reinforced by a structural change in the economy.

⁵ Bhattacharya, D., Khan, T. I. & Rahman, M. T. (2009). Challenges of Resource Mobilisation and Tax System in Bangladesh. Dhaka: Centre for Policy Dialogue. [Forthcoming]

“Taxation, Fiscal Decentralisation and Legitimacy – The Role of Semi-autonomous Tax Agencies in Peru”

Christian von Haldenwang (DIE)

This paper shows that semi-autonomous tax agencies can play a significant role in strengthening the effectiveness, efficiency and legitimacy of decentralized tax systems. It does so by analyzing the *Servicios de Administración Tributaria* (SAT), which 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 SATs 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.

Until recently, the issue of local revenue generation has not been a particularly prominent sub-field of developmental studies. Research on domestic revenues and tax reform in developing countries has focused almost exclusively on the national level, accounting for the fact that the percentage of public revenues generated at sub-national levels is typically rather insignificant (Fjeldstad and Moore, 2008; Aizenman and Jinjarak, 2009). Decentralization has been a major topic in development policy and research, but given the high dependency of local governments on central state transfers, scholars have paid more attention to central-local fiscal relations, and less to local revenue generation as such (Bird, 2000; Oates, 2006; Hankla, 2008; Shah and Shah, 2006; Weingast, 2009). Donors have been increasingly interested in “good financial governance”, but their main focus has been on budgetary issues, trying to make sure that their taxpayers’ monies would be well spent (Leiderer and Wolff, 2007).

These days, however, local revenue generation is beginning to receive more attention by development researchers and practitioners. This has something to do with three major challenges developing countries face world-wide:

- First, as an outcome of urbanization and decentralization, local governments all over the world assume new functions as providers of public services (UCLG, 2008).⁶ In this context, financing local government and public infrastructure is a crucial and frequently quite conflictive issue. The decentralization of tasks and competencies is not always accompanied by an adequate decentralization of funding (Bird and Slack, 2008).
- Second, many developing countries fall short of realizing their potential of internal revenue generation. For instance, most Latin American countries share a long history of low tax pressure (Perry et al., 2006: 92-97; ECLAC, 2007: 134). In previous years, structural revenue gaps could often be compensated through increased revenues from other sources, such as remittances, royalties, credits, etc. Today, however, the financial crisis is affecting public finance world-wide, making it necessary to mobilize resources in a much more active way. Tax administration reform and the fight against tax evasion and fiscal fraud will become a priority for many governments in the near future. This includes untapping the potential of local revenue generation.
- Third, issues such as fiscal accountability and legitimacy acquire additional relevance in development financing, as donors and international finance organizations introduce new development assis-

⁶ With the term “public services” I mean to refer to the whole range of goods and services provided by public entities, including basic social services, security and legal protection, public infrastructure, etc.

tance modalities. The beneficial effects of tax administration reform, it is argued, go well beyond a mere increase in revenues. Raising the effectiveness, transparency and rule-obedience of tax systems contributes to a higher credibility of public administration in general, encouraging taxpayers to hold authorities accountable for their spending decisions and to push for additional public sector reform (Moore, 2008; Ross, 2004; Timmons, 2005). Local tax systems are particularly well-suited to promote good financial governance, since they collect revenues from a broad group of taxpayers. Also, the link between taxes and public services is assumed to be closer at the local level.

Starting in the 1980s, some developing countries have founded so-called semi-autonomous tax agencies as a reaction to problems of revenue generation. These agencies are autonomous in their budget decisions, internal organizational structure and human resources management. Their main source of finance is a commission on the taxes and non-tax revenues they collect. Currently, they exist in a total of ca. 30 countries.⁷ There are only few cases, however, where semi-autonomous tax agencies have been established at the local level.

Financing tax administration through a commission entails strong incentives to raise tax collection. At the same time, transferring tax authority to entities outside the core public administration involves certain political risks – especially, if a more robust tax collection does not go hand in hand with tangible improvements in public service delivery. Against this background, the main question to be discussed in this paper is whether semi-autonomous tax agencies are in fact an adequate response to problems of fiscal decentralization, revenue mobilization and good financial governance.

The paper presents the findings of an empirical study carried out in Peru in 2008/09. At present, Peru is the only country where the model has been applied on a broader scale at both, the national and the local level. So far, nine Peruvian cities have founded so-called *Servicios de Administración Tributaria* (SAT), with two other agencies to be inaugurated soon. The study combines a quantitative analysis of data on municipal revenues, provided by the Peruvian Ministry of Economy and Finance (*Ministerio de Economía y Finanzas*, MEF) with a qualitative research approach based on 66 semi-structured interviews in five Peruvian cities (Lima, Trujillo, Piura, Arequipa and Tacna).

The findings presented in the following sections indicate that semi-autonomous tax agencies can play a significant role in strengthening tax systems, even though they are certainly no panacea for every fiscal problem that may arise in the development process. (1) Peruvian SAT collect local taxes and non-tax revenues more effectively than conventional tax administrations. (2) The SAT-model *per se* does not generate strong incentives for the promotion of efficiency, but there is some evidence that efficiency may become more important once the SATs are consolidated. (3) Finally, although no conclusive evidence was found concerning the relationship of semi-autonomous tax administration and legitimacy, there are hints that the Peruvian SAT contribute to the legitimacy of the tax system thanks to higher levels of transparency and client orientation.

The following chapter provides a conceptual framework for the assessment of local tax systems (*section 2*). The paper then introduces the semi-autonomous agency model as applied in Peru since the 1990s (*section 3*), before presenting the findings of the field work with respect to effectiveness, efficiency and legitimacy (*section 4*). Based on these findings, the concluding chapter summarizes the strengths and weaknesses of the SAT model (*section 5*).

⁷ See Mann (2004); Taliero (2004) and von Soest (2008) for comparative analyses of semi-autonomous tax agencies in developing countries, and Fjeldstad and Moore (2008: 249-255) for a comprehensive summary of the debate.

“Colombian fiscal policy: a limited tool for long-term development and short-term Recovery”

María Angélica Arbeláez (Fedesarrollo)

After a long period of fiscal discipline during the eighties and since the mid-nineties (even during the crisis of the eighties), Colombia's fiscal performance has substantially deteriorated. This has strongly limited the role of public finance in promoting effective long-term development, and has prevented fiscal policy from being a useful tool for short-term economic stabilization. The lack of fiscal discipline, which was mostly driven by the Constitution of 1991 and by structural reforms undertaken in the first quarter of the nineties, has not been offset by the adoption of deep reforms from the mid-nineties onward. Rather, 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 type of reforms that helped to control expenditures and the growing deficit were decentralization reforms that limited regional transfer increases. Other budget reforms have been insufficient in their scope and implementation. On the tax side, several “quick fixes” or “piece meal” reforms were implemented, and they were not enough either to finance the increasing trend of expenditures or to provide room for a more redistributive role for fiscal policy or for undertaking short-term stabilization measures. Tax reforms have given priority to short-term revenue needs (e.g., the imposition of discriminatory taxes) over long-term criteria of *efficiency* and *equity*.

Regarding the so-called “social contract” in the long run, 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 in education. Some social indicators have improved slightly and poverty has shrunk, but to a degree that is less than proportional to social spending efforts. This result is mostly explained by inefficiencies in expenditures and increasing corruption. In addition, income distribution inequality remains practically unaltered.

Public policy has not been growth-enhancing in key areas, such as infrastructure. Public investment in public works and transportation is low, and, even worse, it has been decreasing over the last fifteen years. In fact, fiscal adjustments have been made at the expense of such investment. Some indicators show that the quality of infrastructure in Colombia is still very poor.

In addition, fiscal policy has served as a weak economic stabilizer. One of the reasons is pro-cyclical behavior and the lack of savings in good times. A good example is the recent boom of 2004-2007 (GDP grew 7.5% in 2007), in which increase in expenditures was maintained. As a result, in the current economic downturn the role of the fiscal policy in propelling economic recovery and serving as a stimulus has been restricted.

Despite the pro-cyclical behavior during the past recent economic boom, the Colombian government was aware of the need to use fiscal policy in a more counter-cyclical way in 2008-2009. This has been made possible thanks to previous adjustments that lowered the debt combined with better access to international markets (e.g., compared to 1999-2000). In fact, although one of the channels available for expanding expenditures during the recent downturn has been to decumulate assets (e.g., through stabilization funds), this approach has not been adopted. Rather, the growth of expenditures to compensate for the fall in demand has been financed through new debt. However, it is worth noting that although access to external finance has given the government room to partially offset the economic downturn, the level of debt, which is still high and needs to remain on a sustainable path, does not al-

low for maintaining the increased pace of expenditures. In fact, in 2010 the deficit of the Central Government will increase again and revenues are projected to be lower. Therefore, the dynamics of revenues combined with the low capacity for indebtedness limits the Government's field of action for raising budget expenditures.

This makes evident the need for the Government to design institutional mechanisms to improve its capacity to implement counter-cyclical fiscal policies. It requires rules that guarantee that spending will evolve in line with long-term fiscal revenues, encouraging fiscal savings when revenues increase beyond their long-term trend, and de-saving when they grow below their long-term path. Colombia does not have any kind of institutional arrangement or budget rules based on structural balance, by which the Government could annually estimate the fiscal revenues that would be generated if the economy were to reach its potential level, and schedule spending in accordance with these structural revenues (as occurs in Chile).

In order to improve the counter-cyclical capacity, fiscal authorities should improve the automatic stabilizers through, for example, the adoption of social support programs with clearly defined entry and exit clauses (unemployment insurance instead of programs such as *Familias en Acción*), and the definition of budget expenditures based on permanent, not transitory, revenues. In addition, the government should stabilize mining and energy income (by strengthening the existing funds such as the FAEP). Projections of long-term growth and oil prices, for example, should be made by experts who are independent from the government.

In 2003 Colombia adopted a Fiscal Responsibility Law, which requires the use of medium expenditure frameworks, though it does not include enforcement instruments or quantitative targets, as do other FRL's (Brazil, Chile). Therefore, it is difficult to assess its actual effects on expenditure growth. 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, different studies (the most influential being *Fiscal Reform in Colombia: Problems and Prospects*, 2005), have made several recommendations regarding the need to adopt structural tax reforms aimed at, principally, reducing tax exemptions and carefully reviewing their impact and the source of financing, making the income tax more progressive and increasing the taxable base (reducing the rate for corporations), increasing the scope in terms of goods subject to the VAT and reducing the number of rates, eliminating distortionary taxes that were transitory and have become permanent (Transaction Tax, Wealth Tax), and improving the tax administration.

Finally, the Colombian authorities need to improve the institutional framework and institutional arrangements in order to improve fiscal discipline and the consistency of spending and revenue policies with macroeconomic stability, budget allocations according to policy priorities (by sector, regions), and efficiency and evaluation of expenditures (see, Olivera, 2008). In addition, great efforts must be made to increase budget transparency, and therefore fiscal legitimacy.

“Pro-cyclical Tax Policies and Macroeconomic Fluctuations”

Gabriel Oddone (MercoNet)

Developing countries, especially those with small-scaled internal markets, usually face deep macroeconomic fluctuations. These usually derive from exogenous crashes associated with sharp alterations to exchange terms, sudden stops and significant increases in international interest rates. In general, these 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 these external crashes on the domestic economy, even to the extent of contributing and magnifying them some times. One specific case of these aforementioned institutional weaknesses is the presence of pro-cyclical tax policies, which generally derive from pro-cyclical taxing structures.

The pro-cyclical nature of tax collection in developing countries is mainly related to two closely connected aspects. First, consumption tax usually has a significant bearing on tax collection. Second, due to incomplete financial markets, consumption is usually more volatile than income. As a consequence of both aspects, tax policies can hardly act in a counter-cyclical way, which would aid to distribute the impact of external crashes over time, and therefore, soften cyclical contraction.

Thus, as opposed to that suggested by literature on the relation between tax policies and growth, in small and open economies, stylized facts show that a tax structure levying consumption excessively may end up promoting growth volatility and hence affecting long term growth. In fact, sharp macroeconomic fluctuations are likely to generate uncertainty, which leads myopic investors to demand extraordinary high profits from their businesses. This type of environment does not foster long term structural investment and R&D investment, especially in developing economies, in order to achieve productivity improvement and long term growth.

Based on the above, in order to contribute to the smoothing of cyclical fluctuations that are usually suffered by small and open developing economies, we posit that these economies should rebalance tax collection, relying less on consumption tax and more on income tax.

**“Local Public Resource Mobilisation in a Context of Fiscal Decentralisation and Intergovernmental Fiscal Relations in Africa
François Yatta (LEDNA)**

Decentralization is the major institutional innovation faced by African countries since their independence. If it is irreversible, the capacity of local governments to provide local public services and to foster local economic development is constrained by the narrowness of local finances. Fiscal decentralization, which emerges in practice, attracts today the attention of African decision makers, African populations, as well as development partners. It is, more than ever, a necessary condition to the success of the processes of decentralization.

Fiscal decentralization refers to the public allocation of resources and the organization of intergovernmental fiscal relationships between several tiers of government in a country. This concept requires the definition of a local government's own resource field, the identification of the field of shared resources between the Central and local governments, and the definition of the transfer mechanism from the Central to local governments. Fiscal decentralization faces two major obstacles in African countries.

The principal obstacle is the fact that the Central government cannot decentralize financial resources it does not have. The acute financial crisis faced by Central governments puts them indeed in the practical impossibility to transfer to local governments the financial resources that they themselves have a great difficulty to collect, due to the degree of poverty of the population. Thus Africa is the region of the world where the level of pooling of resources for public action is the lowest. The public levy rate is around, on average, 15% in the majority of African countries, whereas their level reaches 20 to 25% in Latin America, and 40 to 50% in OECD countries. The preponderance of informal sector in African economies is undoubtedly one of the reasons for this situation. But 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. This does not promote good tax citizenship, whereas these countries still remain largely under-taxed.

The second obstacle is the pre-eminence of customs duties in public resources. The structure of budget revenues of African countries reflects one of the main characteristics of developing countries: a strong preponderance of import-export duties and indirect taxation such as the value-added tax (VAT), compared to the taxation based on the domestic economic activity and assets. In the majority of African countries, the customs duties (from import and export) often represent 50%, and sometimes more, of the whole public revenue. The fact that the customs receipts are typically the receipts of Central governments makes rather difficult the dialogue on their sharing with local governments. But on the other hand, because of the dynamics of regional integration and the process of globalization (see World Trade Organization, WTO and the Doha accord), the customs duties are expected to decline. In such conditions, the Central governments hesitate to share the declining resources, which to date have no guarantee to be replaced by a substitute taxation with the equivalent easiness of collection and similar result as the customs receipts. In short- and medium-term, we are running towards a situation of even more significant tension within public finance. This context of fiscal transition of African countries is not in favour of a real fiscal decentralization in African countries.

Therefore, the funding of decentralization through local taxes in Africa still remains a problem for several reasons. Fiscal incivism is the first. Most of African countries underwent or still undergo major social and political crises, which questions the legitimacy of public governance. Local governments still suffer from this situation because the structure of their levy is based on direct taxation of domestic

economic activity, contrary to Central governments whose resources come predominantly from indirect taxation, particularly import-export taxes and VAT. Doing that, Central governments allocate to themselves the most productive taxes and leave to local authorities the ones which are least productive and most difficult to collect. Furthermore, very often, the Central administration does cancel certain local taxes, such as the most of poll taxes, without consulting local authorities and, at times, without compensation. The fiscal system is another problem of local taxation. It is generally very complex, with a large number of taxes, which - translated into reality – puts an increased weight of the tax system on a small number of taxpayers. Consequently, one observes a proliferation of local taxes with often very poor yields instead of a setting-up of manageable taxes that could yield a sufficient level of revenues.

Two institutional constraints also hamper local taxation. The determination mode of local taxes is the most important one. In most African countries, local authorities are not responsible for the calculation of local tax rates. The local tax rates are generally determined by the parliament. By reducing the direct relation between the local choice of the level of service and the level of local tax, this “local” application of national norms is not naturally conducive to raising the awareness of local authorities in terms of accountability. The instrumentation of local taxes remains a constraint in Africa. In most African countries, the fiscal chain is utterly controlled by Central government administrations. In fact, because the legal regime of local finance generally falls under the regime of public finance, and is accompanied by the generally-established poor institutional capacity of local governments, the identification of taxpayers, the issuance of tax assessments and the tax collection are generally carried out by departments of the Central government, which are too remote from local realities.

The prospects of local taxation cannot be independent of those of national taxation. Reforms introduced within the framework of fiscal transition are directed towards the domestic indirect taxation. This situation will have a double impact on tax decentralization; on one hand, the hopes of a better instrumentation of local taxation undoubtedly will still remain dark, taking into account the fact that the field of direct taxation will not be finally invested into by Central governments; in consequence, the marginal cost of enhancing local direct taxation will still be too high for local governments; in addition, the reinforcement of local governments’ financial autonomy passes by the generalization of shared taxation between central and local governments. The national taxes concerned could be the value-added tax (VAT) and the few direct taxes, such as personal income taxes and business income taxes. The methods of this shared taxation are to be invented in each country taking into account social, cultural, economic and political specificities.

Lastly, fiscal decentralization will have to take into account three principal objectives in order to maximize the contribution of local governments to the achievement of the millennium development goals (MDG’s). The first is to limit the harmfulness of local taxation, which should make it possible to avoid undesirable implications for the achievement of national macroeconomic objectives, the promotion of economic activities and the reduction of internal disparities. The second is to ensure the effectiveness of the local public expenditure, in particular while helping to attenuate spatial disparities, by supporting an optimal and efficient implementation of local public expenditure. The third objective is to ensure the optimality of resources at each level of government by making its level proportional to the importance of the competences transferred to local governments.

**“Enhancing Domestic Resource Mobilization in sub-Saharan Africa”
Roy Culpeper (NSI)**

Enhancing domestic resource mobilization (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.

The OECD Development Centre

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