Fiscal Policy for Inclusive Sustainable Development

Anis (Anisuzzaman) Chowdhury
Adjunct Professor
Western Sydney University & University of New South Wales
Australia

Former Director
Macroeconomic Policy Development Division (MPDD)
United Nations Economic and Social Commission for Asia and the Pacific (UN-ESCAP), Bangkok

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In a development context, fiscal policy serves both as an instrument of macroeconomic stabilization and as an instrument to achieve growth and poverty reduction objectives. (Development Committee, World Bank-IMF, 2006, p. i)

I. Introduction

The above is a significant observation about the role of fiscal policy for inclusive and sustainable development by the Development Committee.\(^1\) It took almost half a century for the Bank and the Fund to realise what Ursula Hicks (1965, p. 61) said about fiscal policy in developing countries: “Fiscal policy may be taken to embrace all government transactions which have as their objective the support of general economic policy . . . [which] is geared to promote growth with stability and to increase welfare through a more equal distribution of available (spendable) incomes.”

Ironically, the fiscal policy stance, advised by the World Bank (Bank) and the International Monetary Fund (IMF) over the past four decades has emphasised solely its stabilisation role. It was assumed that once the macroeconomy was stabilised, growth would follow. That is, macroeconomic stability was seen as both necessary and sufficient conditions for growth and development. The role of fiscal policy in macroeconomic stability is summarised in an IMF publication\(^2\) as follows: “From a macroeconomic perspective, one of the central insights from past research on developing countries is that prudent fiscal policy — that is, low budget deficits and low levels of public debt — is a key ingredient for economic growth, which in turn is essential for reducing poverty and improving social outcomes.” (Clements, Gupta and Inchauste, 2004, p. 1)

Thus, fiscal deficit became a policy target under the Bank/IMF programmes. During the structural adjustment programme (SAP) period, government expenditure in developing countries declined from around 19 per cent of GDP in 1980 to 16 per cent in 1998 (Fan and Rao, 2003).\(^3\) Countries, often met fiscal deficit targets to stabilise economies by significantly cutting public investment, social services and environmental programmes, despite their potential negative impact on growth, inequality and poverty as well environmental sustainability. For example, African governments’ share of expenditures on transportation and telecommunication in total government expenditure declined from 5.9 per cent in 1980 to 3.9 per cent in 1998 (Fan and Rao, 2003).

As noted in the World Bank’s Growth Commission Report, “International financial institutions, the IMF in particular, have tended to see public investment as a short-term stabilization issue, and failed to grasp its long-term growth consequences” (World Bank, 2008, p. 36). That is, fiscal balance was achieved

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1Joint Ministerial Committee of the Boards of Governors of the World Bank and the International Monetary Fund on the Transfer of Real Resources to Developing Countries.
2Gupta, Sanjeev, Benedict Clements, Gabriela Inchauste (eds.) Helping Countries Develop: The Role of Fiscal Policy, Washington DC: IMF
3The sample included 43 countries – 17 from Africa, 11 from Asia and 15 from Latin America.
without any regard for efficiency and composition of public expenditure. In a “one-size-fits-all” approach, the differential needs of countries at different stages of development were also ignored. As a consequence, development objectives seriously suffered as documented by the World Bank’s Lessons from the 1990s.\(^4\)

It was further assumed that potential negative impacts of public expenditure cuts, especially in the area of infrastructure and social services (or, education and health), would be more than offset by increases in private investment. This was premised on the incentives such as corporate tax cuts and risk-sharing arrangements such as public-private partnerships (PPPs) that were implemented on the advice of the IMF and the World Bank. However, evidence suggests otherwise.

For example, a survey of the 1980s’ experiences, reported in The World Bank Research Observer, found, “In many countries, macroeconomic adjustment has not improved the response of private investment. Even when substantial progress has been made in correcting imbalances and restoring profitability—often through drastic cuts in real wages—the effect on private investment has been weak and slow to appear” (Serven and Solimano, 1992, p. 96). This experience remained more or less the same even in the later decades. The IMF’s Fiscal Affairs Department (2004, p. 3) noted that, “The share of public investment in GDP, and especially the share of infrastructure investment, has declined during the last three decades in a number of countries, particularly in Latin America. Since the private sector has not increased infrastructure investment as hoped for, significant infrastructure gaps have emerged in several countries. These gaps may adversely affect the growth potential of the affected countries and limit targeted improvements in social indicators.”

As private investment failed to respond, corporate tax-cuts put significant pressure on fiscal balance. The situation was made worse by the rise in government’s contingent liabilities due to inadequate risk-sharing in PPPs. The Growth Commission Report observed, “In too many cases, the division of labor has put profits in private hands, and risks in the public lap…there have been … numerous failures” (World Bank, 2008, p. 36). These developments seriously affected fiscal space for both counter-cyclical and distributional transfer measures (e.g. subsidised public social programmes).

Cuts in corporate and top marginal tax rates had to be matched by widening the indirect taxation net, especially value added tax (VAT) in an attempt to neutralise their impacts on tax revenue. But this added to the cost of living burden of the low-income households, especially in the face of deep cuts in public social programmes such as primary healthcare and basic education.

In sum, there has been not only the neglect of fiscal policy’s growth role, but also steady declines in fiscal policy’s redistributive function.\(^5\) After advocating tax

\(^4\) Unfortunately, the one-size-fits-all policy prescription of the IMF and the World Bank failed to produce the expected long-term gain of higher growth, despite harsh pains of adjustment. William Easterly, former World Bank economist, described the experiences of the 1980s and 1990s as “lost decades” for Latin America and Africa (Easterly, 2001). In sombre words, the former President of the World Bank, James Wolfensohn acknowledged the failure of the Washington consensus before his retirement, “... if we take a closer look, we see something else – something alarming. In developing countries, excluding China, at least 100 million more people are living in poverty today than a decade ago. And the gap between rich and poor yawns wider.” (Foreword to Thomas et al, 2000).

\(^5\) See UNCTAD (2012) for the trends in the redistributive role of fiscal policy.
cuts and widening of indirect tax net, including the introduction of VAT for over three decades, the IMF finally recognised that those measures contributed to inequality (IMF, 2017). As a result, growth and poverty reduction suffered while inequality of income and wealth rose rapidly in many developing countries.

Ironically, fiscal policy’s stabilisation role did not improve, even when its developmental and distributional roles were undermined. In majority of developing countries, fiscal policy displayed pro-cyclical tendencies – expenditure rising during good times and falling during bad times – especially during the decades prior to the 2008-2009 global financial crisis (Ilzetzki and Vegh, 2008; Kraay and Serven, 2013). Thus, fiscal policy tended to reinforce the business cycle (the ‘when-it-rains-it-pours’ syndrome).

In light of the above this paper aims to provide a framework for fiscal policy in stimulating economic growth, diversifying economies and reducing poverty and inequality. The paper is organised as follows. Section II is a brief discussion of how sceptical views about the effectiveness or applicability of Keynesian type fiscal policy in developing countries that persisted from the start evolved into almost an ‘anti-fiscal policy’ stance under the influence of the IMF and the World Bank advice which became the orthodoxy. Section III then overviews the impacts of these developments on fiscal policy instruments (e.g., taxes), nature of fiscal policy (e.g. pro- or counter-cyclical) and the fiscal space, in particular, the impacts of privatisation and PPPs. Section IV provides a critical assessment of the orthodox views on fiscal policy’s ineffectiveness. This includes identifying flaws in the orthodox analytical frameworks as well as pointing out the lack of robustness of empirical evidence. Section V then discusses what can be done to reverse the trend and revitalize fiscal policy’s distributive role. Section VI focuses on ways to enhance fiscal space which is essential for consistent counter-cyclical fiscal policy for stabilisation and implementing a comprehensive universal social protection system as well as undertaking public investment to achieve inclusive and sustainable development in developing countries. Section VII contains concluding remarks.

The paper notes the challenging circumstances that developing face in the post-2008-2009 global finance crisis (GFC) era, and emphasises the dangers of one-size-fits-all approach to policy making. Cross-country evidence is merely a guide; country specific circumstance must determine the ultimate policy details. The key messages the paper intends to convey are: countries must (a) balance stabilisation and development goals of fiscal policy; (b) examine the growth and distributional impacts of the size and composition of public expenditure and revenue raising mechanisms; (c) build-up their fiscal space to be able to consistently pursue counter-cyclical fiscal policy; (d) driven essentially by a pro-growth agenda in their search for “fiscal space”; (e) strengthen automatic stabilisers through tax progressivity and a well-designed social protection system. The paper also highlights the importance of institutions that enhance democratic accountability, rather than technocratic independence or rules, for the effectiveness of fiscal policy.
II. Fiscal policy in developing countries: from persistent scepticism to fiscal rules

When modern macroeconomics of the 1940s vintage was constructed by the intellectual heirs of John Maynard Keynes, they assigned a major role to the government for fighting recessions in particular – and business cycles in general – through the twin instruments of monetary and fiscal policy. A ‘dual mandate’ was typically espoused by developed country policy-makers – the simultaneous attainment of both full employment and price stability.

Despite major achievements in industrialised countries, little attempt was made to ‘export’ the Keynesian macroeconomic framework to developing countries. This is evident from two pioneering United Nations expert reports, *National and International Measures for Full Employment* (published in 1949) and *Measures for the Economic Development of Underdeveloped Countries* (published in 1951). While the 1949 report used the Keynesian macroeconomic framework to examine the problem of stabilisation in developed countries, the 1951 report was preoccupied with attaining rapid growth to reduce poverty in developing countries. It was concerned primarily with how capital accumulation could drive growth and structural transformation, especially under conditions of surplus labour. There was no substantive discourse on how macroeconomic policies could be used to pursue development goals. Macroeconomic policies were deemed relevant only to the extent they influenced savings and investment, fundamental for accelerating growth as in the Harrod-Domar growth model.

In fact, there was a view that Keynesian macroeconomics was not applicable in developing countries. For example, in the debate within the Indian Planning Commission during the early 1950s, two leading economists, V.K.R.V. Rao and A.K. Dasgupta believed (for different reasons) that Keynesian fiscal activism would not work in developing countries like India. Instead of raising output, such activism would generate inflation. For Rao, inflation would accelerate due to structural rigidity limiting supply, and for Dasgupta, it would occur as nominal wages must be raised to maintain subsistence real wage which was already too low and could not be lowered any further. Thus, supply-side policies were preferred that emphasise the need to raise savings, including public sector surplus.

The extent of deep scepticism about the effectiveness of fiscal policy can be seen from the following observation of Rao (1952, pp. 217-18):

“...I would prefer to say that the economic policy of deficit financing and disregard for thrift advocated by Keynes ... does not apply in the case of an underdeveloped economy... [The] blind application of the Keynesian formulae to the problems of economic development has inflicted considerable injury on the economies of underdeveloped countries and added to the forces of inflation that are currently afflicting the whole world. The old-fashioned prescription of ‘work harder and save more’ still seems to hold good as the

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6 For an extended discussion of the evolution of macroeconomics in the context of developing countries, see Chowdhury and Islam (2018).
7 This is very much in the spirit of ‘classical’ economics where supply creates its own demand, or savings determine investment.
medicine for economic progress, at any rate as far as the underdeveloped countries are concerned."

II.1 Michal Kalecki’s contrarian view
However, there were dissenting views. Michał Kalecki, for example, in his “The Problem of Financing Economic Development”, first published in Mexico in 1953, highlighted the importance of public investment and showed how inflationary deficit financing could meet the investment needs for accelerating growth through forced savings. In the Keynesian spirit, Kalecki believed that demand determines supply, or investment drives savings which is very much contrary to the classical Say’s law which stipulates that supply (or savings) determines demand (or investment). Kalecki’s 1953 exposition attracted great interest and possibly gave rise to a new school of thought – ‘Structuralism’ – in development economics. But the structuralist school remained confined predominantly in the domain of causes of inflation, and devoted its energy in debating the monetarist school, instead of offering coherent analytical macro models for development goals.

II.2 Neo-classical counter revolution
Meanwhile the Keynesian macroeconomic policy framework came under attack from its conservative critics, led initially by Milton Friedman and subsequently by Robert Lucas and like-minded intellectual luminaries. As rich countries struggled to cope with the aftermath of the oil shocks in the mid-1970s, developing countries faced serious debt crisis in the 1980s following sharp rises in interest rates in the US and UK which decisively veered towards the monetarist position on fighting inflation. Debt-stressed developing countries were forced to seek assistance from the IMF marking the start of the era of ‘structural adjustment programme’ (SAP) that lasted officially until 1998. The sustained policy experiment under the rubric of SAP, led by the IMF and the World Bank – the two Washington-based institutions – imbued the core ideas of the anti-Keynesian intellectual atmosphere that prevailed in the Organisation for Economic Cooperation and Development (OECD). The paradigm shift was termed as “neo-classical counter-revolution” in development economics.

In short, deficit-debt-inflation were all seen as inimical to growth and poverty reduction. This view became entrenched, especially in the 1980s. It was claimed that active expansionary fiscal policies pursued in the 1970s (in particular fiscal deficit) were responsible for poor economic performance leading to the debt crisis in the 1980s, and hence calls for fiscal retrenchment by the Fund and the Bank.

II.3 SAP and Washington consensus
The primary ambition behind ‘structural adjustment lending’ was that developing countries would be offered financial support – through a combination of loans and

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8 See Kalecki (1955)
9 See Seers (1964)
10 More than 950 ‘structural adjustment lending’ under the auspices of the IMF and World Bank were executed between 1980 and 1998. See Easterly (2001).
11 Toye (1993)
grants – on condition that they implement wide-ranging reforms cutting across macro- and microeconomic policies. The expectation was that such reforms would spur growth and reduce poverty in low and middle-income countries.

‘Prudent macroeconomic policies’, manifested in the application of ‘fiscal discipline’, was central to SAP. Indeed, Williamson who summarised core elements of SAP into ‘ten commandments’ under the infamous epithet, ‘Washington consensus’, proposed a specific fiscal target (operational budget deficit of 1 to 2 per cent of GDP). Failure to meet this target was tantamount to “prima facie evidence of policy failure”. The ‘Washington Consensus’ was quickly co-opted as part of the global discourse on development.

However, the emphasis on fiscal prudence around a debt-GDP or fiscal deficit target has actually been formalised in Europe through the architecture of the European Monetary Union (EMU) effected by the Maastricht Treaty of 1992. Such a Treaty is among the first in the developed world to formalise the notion of fiscal prudence through fiscal rules that embodied precise numerical targets. It is this target-driven approach to fiscal policy that has cast a great deal of influence on the rest of the world and eventually found their way to the developing world.

Although the so-called Washington consensus came under heavy criticisms, especially in the wake of the 1997-98 Asian financial crisis, and the SAP was officially abandoned in 1998, macroeconomic orthodoxy did not really wither away. The constant refrain about the critical importance of macroeconomic stability and the need for using numerical fiscal targets in guiding fiscal policy remained intact. In sum, the persistent influence of macroeconomic conservatism in the developing world cannot be ignored. Hence, a continuing debate on its desirability and efficacy remains as relevant today as it did in the past.\(^\text{12}\)

II.4 Fiscal rules
By the late 1980s, political economy explanations (e.g. pressure to legitimise the regime or to buy votes) became the dominant explanation for deficit-debt-inflation, although there were also some discussions of structural reasons (e.g. low tax base) to explain why developing country governments resort to deficit financing.\(^\text{13}\) A pejorative title, ‘macroeconomic populism’ was used to discredit Keynesian fiscal-monetary activism.\(^\text{14}\)

\(^{12}\) It is worth mentioning the Brookings Institution’s 1979 conference to critically analyse whether orthodox stabilisation policies – fiscal and monetary restraint and devaluation – were harmful to national economies, especially to the poor. The experts attending the conference discussed how developing countries special circumstances could be taken into account in designing macroeconomic stabilisation policies in order to avoid prolonged loss of output, and undue hardship on the poor. See Cline and Weintraub (eds.) (1981).

\(^{13}\) See, for example, Thorp (1971) and Tanzi (1982) for discussion of structural factors. Aghevli and Khan (1978) developed a model using the idea of inflation-induced fiscal deficits which arise when government revenues rise slower than government outlays with inflation because of structural constraints in the fiscal system (such as low/narrow tax base and revenue collection delays) Inflation-induced fiscal deficits may then become the dynamic force to sustain inflation. That is, although inflationary finance may start with an objective of achieving growth, it could generate hyperinflation to cause growth retardation in the end.

\(^{14}\) Dornbusch and Edwards (1989), who invented the term ‘macroeconomic populism’, defined it as an approach to economics that emphasises growth and income distribution and deemphasises the risks
It is argued that re-election minded incumbents have an incentive to use policy instruments (fiscal and/or monetary policy) in such a way that during election years, public spending and/or money aggregate increase to satisfy the median voter despite potential adverse effects on fiscal sustainability and aggregate macroeconomic stability. Thus, the IMF is of the view that fiscal rules can serve as a useful depoliticised policy framework. Over time fiscal rules contribute to macroeconomic stability and growth by reducing time-inconsistency in fiscal policy, or strengthening government’s commitment credibility for fiscal sustainability.\(^{15}\)

A fiscal rule represents legislated and long-term numerical limits on budgetary aggregates pertaining to debts, deficits, expenditures and revenues. In an IMF working paper, Schaechter et al (2012) have reported on a database of fiscal rules in use around the world. It shows an increasing number of countries adopting some kind of fiscal rules since the early 1990s. In 1990, only five countries — Germany, Indonesia, Japan, Luxembourg, and the United States — had fiscal rules that covered at least the central government level. That number surged to 45 by March 2012. If both central and regional/provincial governments are considered, then 81 countries were found to have some kind of fiscal rules.\(^{16}\)

Providing a credible medium-term anchor to fiscal policy seems to be the obvious motive for adopting or strengthening fiscal rules after the 2008-2009 financial crisis. An additional reason is the need to support currency unions, especially the Euro zone which is threatened by serious debt crises in a number of member countries.

Fiscal rules, and in particular cyclically-adjusted or structural balance rules, have become increasingly popular in developing economies (Figure 1), especially of inflation and deficit finance, external constraints and the reaction of economic agents to aggressive non-market policies. They believed, “(short-term) expansionary policies can succeed provided they stay far clear of foreign exchange constraints, emphasize reactivation only for a brief initial period, and then shift to growth policies. Most important for success, expansionary policies need to be aware of capacity constraints and for their financing must rely on an extremely orthodox fiscal policy and rigorous tax administration” Dornbusch and Edwards (1991, p. 13). While macroeconomic populism can occur under a populist government which gives priority to distributive objectives, a non-democratic regime behaves in an opportunistic manner to legitimise its rule by buying allegiance of political elites. Healy and Page (1993, p. 284) hold that the degree of political instability in developing countries has a systematic influence on budget deficits and monetising them: “The more uncertain are rulers’ expectations of the duration of their power, the higher the degree of fiscal and monetary irresponsibility.” MacIntyre (2000), linked fiscal policy to rent-seeking behaviour. According to him, fiscal policy -- particularly the expenditure side of the ledger -- is one important but largely overlooked site for rent-seeking. Government spending is all about handing out money and is thus a natural venue for rent-seeking. To the extent that government spending provides subsidies, it is in effect creating a rent for the recipient of the subsidy. Political leaders sometimes find the official state budget to be an awkward vehicle for the transfer of such rents because it may be exposed to the glare of scrutiny, and hence they engage in opaque off-budget activities. According to MacIntyre, it was not a coincidence that one of the stringent conditions that the IMF demanded of Indonesia as part of its ‘rescue packages’ in 1997 and 1998 was that all off-budget sources of revenue be brought into the open and included in normal budgetary calculations.

\(^{15}\)See, for example, Kopits and Symansky (1998) and Kopits (2001) for early expositions of the issue at the IMF

\(^{16}\)However, five countries (Argentina, Canada, Iceland, India, and Russia) no longer had a fiscal rule in effect at end-March 2012. So, the number of countries with a fiscal rule stands at 76. Schaechter et al (2012) summarised pros and cons of different kinds of fiscal rules and find that new generation of fiscal rules with escape clauses are complex.
since the GFC. Balanced budget rules have become common in Africa and Eastern Europe, often adopted alongside debt rules (Huidrom, Kose and Ohsorge, 2016). At the same time, many countries have adopted flexible fiscal rules, with escape clauses to deal with exceptional circumstances, such as large natural disasters, unexpected, and massive terms of trade shocks.

Figure 1: Fiscal rules: trends and distribution

A. Trends, 1952–2013

B. Distribution across developing economies, 2013

Source: Huidrom, Kose and Ohsorge (2016)
Notes: The database includes 87 economies. AFR: Sub-Saharan Africa; EAP: East Asia and Pacific; ECA: Europe and Central Asia; LAC: Latin America and Caribbean; SAR: South Asia. There is no reported fiscal rule for the Middle East and North Africa.

Related to fiscal rules is a suggestion for an ‘independent fiscal agency or board’, an institutional framework akin to an independent central bank, to safeguard the implementation of fiscal rules from political interference. Such agency or board should have legal guarantees for independence, highly qualified professional staff, and assured financing (Debrun and Schaechter 2014). ‘Prudential limits’ on public debt-to-GDP ratios play a crucial role in the discussion of fiscal rules. Such benchmarks typically emanate from technical work undertaken by IMF staff.

The IMF and the World Bank are also in favour of sovereign wealth or stabilisation funds, especially in resource-rich developing countries.17 Funds saved during good times are released to cushion potential revenue shortfalls and to mitigate negative shocks to government expenditure. Figure 2 shows the trends and distribution of stabilisation funds. Many stabilisation funds are integrated with the budget, with clear rules to guide the accumulation and withdrawal of fund resources (Bagnall and Truman, 2013). The IMF also suggests fixed and simple rules – based on a modified permanent income hypothesis – for the use of resource revenues. It is claimed that such rules would prevent over-spending during resource booms and ensure fiscal sustainability during down-turns. Additionally, rule-based public spending is supposed to prevent exchange rate over-valuation and hence so-called ‘Dutch disease’. Since stabilisation funds separate government expenditure from

17 Stabilisation funds were first set up in Kuwait in 1953, and were adopted widely in the 2000s, when high international oil prices—along with the discovery of oil in a number of economies—facilitated their establishment.
fluctuations in the availability of revenues, theoretically speaking, they can be important institutional mechanisms for improving fiscal space, while mitigating fiscal pro-cyclicality.

III. Trends in fiscal policy

This section discusses (a) declines of tax progressivity, (b) pro-cyclical biases of fiscal policy and (c) fiscal risks due to privatisation and public-private partnerships (PPPs) in developing countries. It also highlights how SAP and the advice from the Bank and the Fund influenced observed developments in these areas.

III.1 Tax cuts and VAT reduced redistributive power

Globally there have been declines in tax rates since the early 1980s with the rise of neoliberal economic thinking which sees tax as a distortion and disincentive for both capital and labour. Thus, top marginal tax rates for both personal income tax (PIT) and corporate income tax (CIT) were cut along with the reductions in tax-brackets. As can be seen from Figure 3a, the top statutory PIT rates declined sharply in all countries regardless of their income levels. But the sharpest declines occurred in developing countries. This decline was especially pronounced for the GDP-weighted trend which is more representative of the world economy.18

18 The values are weighted by GDP measured in 1990 U.S. dollars.
As expected, the decline in the statutory tax rates coincided with a fall in effective average tax rates in every region. Estimates by Peter, Buttrick and Duncan (2009) reveal that the greatest downturn in the tax rates took place during the mid to late eighties. Peter, Buttrick and Duncan also found that while both high-income rates and low-income rates trended downward throughout the sample period, the high-income rates (for the income corresponding to quadruple of a country’s GDP per capita) fell at a much faster rate.

As noted by Abbas et al (2012), Africa witnessed a major reduction of marginal tax rates, as a result of the combination of narrower tax bases and lower rates. A race to the bottom is evident among special regimes, most notably in the case of Africa, creating effectively a parallel tax system where rates have fallen to almost zero. Overall, the trend is declining gradually in emerging and developing economies, similar to advanced economies, where comparable effective average marginal tax rates declined by about 10 percentage points over 1982-2001 and by 5 percentage points during 1990-2001 (Devereux and Griffith, 2003).

Reductions in top marginal PIT rates happened when the number of income brackets also declined. Thus, the overall progressivity of PIT declined significantly. This means declines in the redistributive power of the tax system which is generally low in developing countries due to a smaller share of personal income tax in total revenues (UNCTAD, 2012).

Developing countries also joined the race to the bottom by cutting CIT rates in a bid to attract mobile foreign direct investment (FDI). This was influenced particularly by the World Bank’s Doing Business Report which gives favourable rankings to countries with lower tax rates. Figure 3b shows that the average CIT rate dropped from about 45 per cent in 1990 to 28 per cent in 2015 in low-income economies. In the case of the emerging market economies, the average CIT rate dropped from around 40 per cent to around 22 per cent during the same period. The pattern holds for each region as well when using median CIT rates.
Despite the cuts in tax rates (both PIT and CIT), total tax revenues generally rose in almost all regions – developed and developing – as measured by median tax-GDP ratio. This is because, the emphasis shifted from direct to indirect taxes, such as value added tax (VAT) or goods & services tax (GST). For example, as noted by Kasalovská (2014), in 2012, more than 150 countries worldwide had some kind of VAT. In the sub-Saharan region, for instance, around 80 per cent of the countries implemented VAT. A review by ILO (2014) of IMF policy discussions found that 94 governments in 63 developing and 31 high income countries were considering raising VAT or sales taxes.

During 1985-2009, the share of VAT or GST on global tax revenues rose from 11 per cent to 19 per cent, making this tax on average the third most important source of tax revenue. As can be seen from Figure 4, the median GST revenue, increased in all developing regions while it remained stable in developed countries. The steepest increased occurred in SIDS and LDCs.

In sum, cuts in marginal tax rates for PIT and CIT together with widening of VAT/GST net have made the tax system less progressive, thus diminishing its redistributive power. The redistributive capacity of fiscal policy in emerging and low-income economies has historically been limited because of lower levels of direct taxes and transfers, compounded by weak taxation systems and a narrow tax base. Yet, they witnessed a decline in the redistributive capacity of fiscal policy.

The advice from the World Bank and the IMF has been particularly responsible for this development. As part of SAP developing countries implemented an array of major economic reforms during the 1980s and the 1990s; and tax reforms formed an integral part of these reforms. As Islam (2001) observed, the IMF exerted a strong influence on the design of tax reforms in developing countries. About 50 per cent of all adjustment loans provided by the IMF and the World Bank between 1979 and 1989 included conditions relating to fiscal reforms, and more than 50 per cent included conditions relating to both trade reforms and the rationalisation of government finances which had tax reform elements (Webb and Shariff, 1992).
However, an “ideal” tax system for a developing country, as prescribed by the IMF, entails a narrower view of the role of tax. Its predominant focus is to raise revenue in a manner which is less distortionary and administratively feasible. It typically emphasises broad-based indirect taxes such as VAT and relegates distributional role of taxation to footnotes. As far as direct taxes are concerned, it favours an administratively simple form of personal income tax, with a moderate top marginal rate and corporate income tax, with a moderate-to-low rate.19

Thus, Emran and Stiglitz (2005, pp. 599-600) noted, “Over the last few decades, … VAT has been …implemented in a large number of developing countries under the structural adjustment and stabilisation policy conditionalities of the IMF and the World Bank.” Based on an analysis of official IMF policy documents for 18 sub-Saharan African economies, Marshall found that IMF country reports strongly supported the introduction or expansion of sales taxes (VAT in particular), and recommendations for reducing corporate income tax rates were common. IMF’s recommendations to cut CIT were backed by influential IMF research papers.20

III.2 Pro-cyclical biases undermined stabilisation role
During recessions the government should be able to lower taxes and raise public expenditures to ‘spend’ its way out of the recession whereas during good times, taxes can be raised and public expenditures reduced to reduce chances of overheating of the economy. However, a large number of researchers have found positive correlation between the cyclical component of government consumption

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19 See Stotsky (1995). The essence of policy advice from the Fund and the Bank was summarised by UNCTAD (2012, p. 120) in the following words, “The emphasis of the reforms of the 1980s and 1990s was primarily on two of the three classic functions of fiscal policy …: ensuring macroeconomic stability and efficient resource allocation. The third function, that of influencing income distribution, was considered to be of minor importance.”

20 For example, Tanzi and Zee (2001) argued, “small countries should not levy source-based taxes on capital income.” This is based on the argument that capital is highly mobile compared to labour (thus, more difficult to tax). Following the same line of argument, Klemm (2009) held, “The complete abolition of corporate income tax would be the most direct application of the theoretical result that small open economies should not tax capital income (…) In the extreme case of perfectly mobile capital and immobile labour, this is clearly optimal.”
and GDP, and the pro-cyclicality of fiscal policy in developing countries has become part of the conventional wisdom. After conducting highly rigorous econometric exercises, Ilzetzki and Vegh (2008) found overwhelming support for the existence of a causal relation from output to government consumption in developing countries. They, thus, concluded that their analysis, “leaves no doubt that fiscal policy is indeed pro-cyclical in developing countries” (p. 26).

Figure 5 presents some evidence of pro-cyclicality of fiscal policy. The majority of developing economies (in blue), including upper middle-income ones, are in the upper and lower right quadrants. They display pro-cyclical tendencies. However, a number of developing countries are also in upper and lower left quadrants, implying that their fiscal policy does not suffer from pro-cyclical biases. In fact, a number of developing and emerging economies did pursue counter-cyclical fiscal policies in the wake of the 2008-2009 GFC, made possible by build-up of fiscal space during the global expansion and commodity price boom of the early 2000s. This development has generated so-called ‘graduation’ literature that claims that fiscal policy in developing economies has become less pro-cyclical or counter-cyclical (see Frankel, Végh, and Vuletin 2013).

Figure 5: Fiscal cyclicality in booms and downturns (1990-2011)

Source: Carneiro and Leonardo Garrido (2015)
Notes:
- Plots the value of the fiscal stance proxy in periods of expansion (when the cyclical component of real GDP are positive) versus that registered in downturns.
- Includes 156 countries after dropping countries with less than 5 observations available when the cyclical component of real GDP is >0 or less than 5 observations available when the cyclical component of real GDP is <0.
- Upper right quadrant – pro-cyclical in both booms and downturns; Upper left quadrant – counter-cyclical in boom and pro-cyclical in downturns; Lower left quadrant – counter-cyclical in both booms and downturns; Lower right quadrant – pro-cyclical in booms and counter-cyclical in downturns.
A number of different explanations can be found in the literature for the pro-cyclical biases of fiscal policy in developing countries. But they can be grouped into two categories – structural and political. Among the structural factors are their narrow tax base and inelastic public expenditure. Therefore, tax revenues and expenditures rise during expansionary phases of the business cycle whereas revenues and expenditures both decline during recessions for similar reasons. Developing countries also do not have well-designed social protection measures, making automatic stabilisers weak. Others also point to credit constraints faced by developing countries, preventing them from raising money in international capital markets in bad times and forcing them to adopt a contractionary fiscal policy in downturns. On the other hand, political economy considerations encourage fiscal profligacy during good times.\(^{21}\)

However, SAP and the World Bank-IMF advice also contributed to the pro-cyclical biases of fiscal policy. SAP’s emphasis on cuts in subsidised public social programmes and the World Bank-IMF’s policy advice to replace any universal social programme with targeted safety-net measures and to cut top marginal tax rates further weakened automatic stabilisers. The Bank’s and the Fund’s advocacy in favour of fiscal rules to impose discipline, and thus to prevent political pressures to spend during booms constrain fiscal policy in responding in bad times, and hence reinforce asymmetrical pro-cyclical bias. Even the rules with escape clauses to deal with bad times, have an adverse effect, by making fiscal policy even more pro-cyclical when public debt is high (Combes, Minea and Sow, 2017).

\textbf{III.4 Privatisation and Public-Private Partnerships worsened fiscal position}

The Bank-Fund reform agenda under SAP also included sales of public assets for improving fiscal position. The argument relies on the view that the proceeds from the sale of public assets exceed the net present value of proceeds that would have produced through annual dividends to the government.

But it was not the case in most instances as the privatisation programme resulted in shifting of profitable state-owned enterprises and public assets because the private sector is generally not interested in loss-making entities. Thus, the sales of public assets had only temporary or short-run impact on public debt; but impaired governments’ long-term revenue capacity as they lost their profitable assets. Governments have forgone future revenue to get money now, but in the long run they became worse off, especially when they were left with the unprofitable ones, or when the new private owners used various loopholes to avoid and evade taxes.\(^{22}\)

\(^{21}\) World Bank (2013b) offers explanations of the pro-cyclical bias of fiscal policy in developing countries. Developing countries have generally pro-cyclical access to capital markets, and governments must therefore make spending cuts during downturns, when they are less able or unable to borrow. During upswings, governments are often under political pressure to spend the higher revenues.

\(^{22}\) For example, Australia’s the busiest international airport, Sydney Airport, paid no tax in the 10 years since it was privatised. The last time Sydney Airport paid tax was before its sale to Macquarie Bank in 2002. Not only has the company that controls the airport continued to structure its affairs so that it has no tax liability, it has also won a tax benefit of almost $400 million! [https://www.smh.com.au/business/airports-pot-of-gold-20130822-2segw.html](https://www.smh.com.au/business/airports-pot-of-gold-20130822-2segw.html)
Studies found that in many cases, the revenues from privatisation were too little and too late to provide a solution to many fiscal crises.\textsuperscript{23} An analysis of 29 transition countries over 20 years found a robust negative relationship between privatisation and the budget balance. A heavy loss of revenue appears to be associated with the privatisation process (Crivelli, 2013). Sunderland (2011) found that an increase in privatisation revenues was correlated with a worsening of the fiscal budget balance in 47 developing countries, lending support to the hypothesis that revenues from the sales of state owned enterprises were used to finance a larger deficit.

Public-Private Partnerships (PPPs) have also gained prominence as a means to resolve governments’ fiscal burden, especially for infrastructure. PPPs are also used in some social sector, such as health. But studies have found that PPPs are not necessarily a panacea; instead they restrict access and have dubious impacts on poverty reduction (Jomo, et al 2016). The historical experience of several countries in the developed and developing world shows that PPPs can pose significant financial risks to the public sector due to inadequate risk-sharing with private partners.

Contrary to the claims, PPPs are often riskier for governments than for the private companies involved; typically, the government is expected, if not contractually required to step in to assume costs if things go wrong. That is, PPPs usually socialise costs and risks while guaranteeing profits for the private partner. Some longer term fiscal implications of PPP-related ‘contingent liabilities’ have been acknowledged by the IMF, another advocate of PPPs (Queyranne, 2014).\textsuperscript{24}

IV. Critical evaluation of the orthodoxy

The common orthodox objections to fiscal policy include inflationary impacts and external imbalances causing macroeconomic instability and hence growth retardation ending with unsustainable debt. These chain causations are premised upon little or no output impacts of public spending due to offsetting declines in private spending either due to adverse impacts of higher interest rates (referred to as ‘crowding out’) and/or increased private sector savings in anticipation of higher future taxes to pay for higher public debt (referred to as ‘Ricardian equivalence’).

It is generally believed that the inflationary consequences of public fiscal deficits in developing countries arise from the lack of sufficiently developed domestic capital markets to absorb newly issued government debt. As a result, central banks are obliged to buy government bonds, regarded as monetisation, leading to classic demand-pull inflation. The orthodox position on the fiscal deficits-money-inflation relationship is aptly captured by the World Bank (1988, p. 57), “Inflation… is often a fiscal phenomenon: it is caused by governments with no

\textsuperscript{23}See, for example, Pinheiro and Schneider (1994). The paper develops a model, incorporating time preferences and longer term fiscal impacts, which shows that major fiscal benefits can be expected only under rare circumstances.

alternative source of deficit finance resorting to money creation at a higher rate than the growth in money demand.”

Both Keynesians and monetarists also believe that fiscal activism spills over to balance of payments crisis, although the transmission mechanism differs, depending on flexible or fixed exchange rates. Nevertheless, both Keynesians and monetarists assign an active role to budget deficits, and as mentioned earlier, fiscal deficit target is a central element in the programmes of the Fund and the Bank.

According to the mainstream Keynesians, the positive causal relationship between fiscal and external deficits happens directly through goods markets – excess demand has to be filled by imports. It is shown in equation (1), derived from the national income identity:

\[(X - IM) = (S_p - I_p) + (S_g - I_g)\]  

(1)

Where \(X\) = exports; \(IM\) = imports; \(S_p\) = private savings; \(I_p\) = private investment; \(S_g\) = government savings (tax revenue – public outlays) and \(I_g\) = government investment.

Assuming that private sector saving is equal to private sector investment (or the private sector saving-investment gap is stable), then equation (1) implies a direct link between trade deficit and fiscal deficit, often referred to as twin deficits.

On the other hand, the causal link between fiscal and external deficits, in the monetarist framework, works through adjustments in the domestic and foreign demand for stocks of national assets, leading to loss of international reserves.

The monetarist fiscal deficit-inflation relationship can be derived from the following equations. Equation (2) shows how budget deficits (left hand side) financed by selling bonds changes the balance sheets of the central bank, domestic residents and foreigners (right hand side). It, thus, explicitly links government budget constraint to the balance sheet of the central bank.

\[(G + r_tB_{t-1} + I_g - T) = (C_t - C_{t-1}) + (BF_t - BF_{t-1}) + e(BF_t^* - BF_{t-1}^*)\]  

(2)

Where the subscript \(t\) indexes time
\(G\) = government consumption
\(r_tB_{t-1}\) = interest payments on government debt (bond)
\(I_g\) = government investment
\(T\) = tax revenue
\(C_t\) = stock of government debt held by the central bank (end of period \(t\))
\(BF_t\) = stock of government bonds held by domestic residents (end of period \(t\))
\(BF_t^*\) = domestic bonds held by foreigners (end of period \(t\))
\(e\) = nominal exchange rate.

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25 This is also echoed in Fischer and Easterly (1990, pp. 138-39): “Milton Friedman’s famous statement that inflation is always and everywhere a monetary phenomenon is correct. However, governments do not print money at a rapid rate out of a clear blue sky. They generally print money to cover their budget deficit. Rapid money growth is conceivable without an underlying fiscal imbalance, but it is unlikely. Thus, rapid inflation is almost always a fiscal phenomenon.”

26 See, for example, Johnson (1975) and Mundell (1962, 1963). See Vera (2009) for a simple exposition of different aspects of the Keynesian and monetarist frameworks for the causal relationship between the two deficits.
Equation (3) is the balance sheet of the central bank and shows that change in money supply (left hand side = liabilities) is linked to the change in balance sheet of the central bank (right hand side = assets).

\[(M_t - M_{t-1}) = (C_t - C_{t-1}) + e(R_t^* - R_{t-1}^*)\]  
(3)

Where \(M_t\) = monetary base (end of period t)
\(R_t^*\) = foreign currency value of international reserves (end of period t)

Combining (2) and (3), and assuming that budget deficit has to be financed only by money creation (i.e., the 2\textsuperscript{nd} and 3\textsuperscript{rd} terms on the right hand side of equation (2) are zero), we get

\[(G + r_t B_{t-1} + I_g - T) = (M_t - M_{t-1}) - e(R_t^* - R_{t-1}^*)\]  
(4)

Applying the quantity theory of money (i.e., the equation of exchange), the law of one price, the interest-parity theorem, and the equilibrium condition in the money market, all of which are linked to the assumption of full-employment and free capital flows, we get \(M_t = M_{t-1}\) and expression (4) reduces to

\[(G + r_t B_{t-1} + I_g - T) = -e(R_t^* - R_{t-1}^*)\]  
(5)

Equation (5) captures the monetarist position linking fiscal deficits to external balance through adjustment in the asset market. Given an independent and stable money demand function, fiscal expansion financed by an expansion of money supply induces economic agents to adjust their money holdings to restore their desired level. In the process they buy foreign assets causing an increase in the balance-of-payments deficit. That is, fiscal deficits, financed by borrowing from the central bank leads to a fall in the central bank’s holding of international reserves without any final change in the stock of money.

However, a careful analysis shows that the orthodoxy is based on assumptions which cannot be taken seriously in the context of developing countries. Thus, the empirical evidence supporting the fiscal deficits-inflation-external imbalance relationships is also not robust.

IV.1 Deficit and inflation: Not a certainty

The inflationary finance story requires that strict quantity theory of money holds with its constant velocity of circulation (or a stable money demand function) and full-employment assumption. It does not allow for any variation in output, for example, due to productivity growth.

These are very restrictive assumptions in the context of developing countries. It is true that in the absence of a well-developed capital market, the option for most developing countries is borrowing from the central bank, commonly referred to as printing money. But most developing countries are characterised with surplus
labour and wide-spread under-employment. They also suffer from excess capacity due to under-consumption or inadequate effective demand, exacerbated by high inequality and lack of easy access to international markets. The velocity of money may not be stable in the short run, especially when households face liquidity constraint and money plays a larger role in precautionary holdings in the absence of social protection. Therefore, a larger budget deficit, which translates into a larger money stock, may not lead to inflation if demand for precautionary holdings also rise.

Furthermore, when fiscal deficit is incurred for productive investments in infrastructure, education and healthcare (i.e. in physical and human capital formation), and if expansionary fiscal policy achieves its intended purpose of boosting output and structural transformation, increased money supply should match the increased demand for money needed for a higher level of transactions. Hence there should not be excessive inflationary pressure. Nonetheless, some inflationary pressure due to expansionary fiscal policy is inevitable; but that does not depend on the mode of financing the deficit. Instead, price rises are unavoidable in an expanding economy undergoing structural change. There is no evidence of runaway inflation just because some prices rise. Policy makers should ensure the expansion of sectors desirable for long-term development.

As a matter of fact, endogenous growth models do suggest that increasing budget deficits may be expected to increase long-run growth rates (see Gemmell, 2001). Fazzari (1994) and Arestis and Sawyer (2004) have argued that the aggregate demand impact of fiscal policy may also influence the supply-side potential of the economy (through the impact on the size of the capital stock). These channels of debt-financed public expenditure are also recognised in the IMF’s World Economic Outlook 2012 and 2014. The possible impacts of fiscal policy on economic growth are discussed further in subsequent sub-sections.

Thus, it is not surprising that an in-depth study at the World Bank concluded, “Inflation does not show any simple correlation with fiscal deficits across countries” (Easterly and Schmidt-Hebbel 1991, Executive Summary). This is also evident from Figure 6 which plots year-on-year inflation rates against fiscal deficit/GDP ratios in 113 countries covering the period 2000-2016. Interestingly, Easterly and Schmidt-Hebbel (1991) also found that the causality runs from inflation to budget deficits through various channels, such as effects on nominal interest payments on existing debts and collection of tax revenues lagging behind increases in public outlays.

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27 Open unemployment is low as poor people cannot afford to remain unemployed in the absence of a comprehensive social protection system. This situation is described as ‘disguised unemployment’ by Joan Robinson. “In a society in which there is no regular system of unemployment benefit, and in which poor relief is either non-existent or ‘less eligible’ than almost any alternative short of suicide, a man who is thrown out of work must scratch up a living somehow or other by means of his own efforts. And under any system in which complete idleness is not a statutory condition for drawing the dole, a man who cannot find a regular job will naturally employ his time as usefully as he may….. and it is natural to describe the adoption of inferior occupations by dismissed workers as disguised unemployment.” (Robinson, 1936, pp. 225-26; emphasis original).

28 In 1982, the government of Brazil argued with the IMF that measuring the deficit in nominal terms was seriously misleading in a high-inflation country, where most of the nominal interest payments on government debt were really accelerated amortisations of principal. The IMF accepted this argument, if initially with some reluctance, and hence it sometimes now pays attention to the ‘operational
Figure 6: Fiscal deficits and inflation
(102 developing countries, 2000-2016)

Source: World Development Indicators

IV.2 Deficit and external imbalance: A complex matter

The formal relationship between fiscal deficit and external imbalances represented by equations (1) and (5) in the Keynesian and monetarist frameworks, respectively. But equation (1) is mere an accounting identity which must hold *ex post*, and does not prove anything about the direction of causality. Yet, the orthodox view falsely presented it as a causal relation running from the saving variable on the right-hand side of identities (1) to the trade account balance on the left, ignoring numerous other possibilities.

To begin with, the assumption that private sector savings-investment gap is stable is not based on facts on the ground. With easy access to foreign capital, when private sector investment is not constrained by domestic private savings, external borrowings by the private sector (resulting in capital account surplus) can lead to exchange rate appreciation and hence deficits in the current account even when there is no increase in fiscal deficit. This is what exactly happened in Southeast Asian countries leading to 1997-98 financial crisis despite their ‘prudent’ fiscal position.29

Structuralist economists have long argued that developments in external sector affect fiscal deficits.30 For instance, a strong link between the foreign and the fiscal sector is caused by heavy reliance of corporate income taxes on exports of mineral products.31 Moreover, as recent experiences revealed, unexpected changes in deficit’, which includes in expenditure only the real component of interest paid on government debt. See Olivera (1967), Tanzi (1982), Aghevli and Khan (1978) for the inflation-induced fiscal deficits.

29 Of course fiscal deficits and public debt ballooned after the crisis as the governments were forced to respond to the crisis and took over private sector debts

30 For example, Taylor, a leading structural macroeconomists held, “Causality runs from the external to the internal deficit (Taylor, 1991, pp. 203).

31 Tanzi (1986) points out that about 50 per cent of the tax revenues of developing countries may be directly related to the foreign sector.
such factors as export earnings, major import prices, the cost of foreign borrowing, and the availability of foreign credit may affect not just the incomes of countries but also their fiscal variables. Leading structuralist economists argued that foreign-determined variations in net financial flows, specifically in total interest paid on the foreign debt, were a main factor behind the increase in fiscal deficits in several Latin American countries since the early 1980s; but net interest payments component of the external account is ignored in the orthodox analysis. During the 1998 Russian and Brazilian crises, the average interest rate of public debt rose from 5.8 per cent in 1996 to 9.4 per cent in 2001, driving the interest payments/tax collection ratio from 12.2 in 1998 to 23.4 in 2001 (Damill, et al., 2005).

The monetarist framework (equation 5) is equally fraught with problems. Asset market adjustments leading to the fiscal deficit-external account relationship (equation 5) depend on the law of one price, interest rate-parity theorem and incorporate the assumptions of full-employment and free capital mobility. There is a good deal of scepticism about the applicability of these assumptions or theorems in developing countries. Without full-employment and perfect substitution of financial assets (and hence absence of the interest rate-parity theorem), demand for money is no more stable. Therefore, the pure determinism from the budget deficit to changes in international reserves as in equation (5) is questionable.

As can be seen from Figure 7, there is no obviously discernible relationship between fiscal deficits and external imbalances, especially when fiscal deficits are less than 10 per cent of GDP. However, there is a clear negative relationship when fiscal deficits exceeds this limit. That is, fiscal deficits in excess of 10 per cent of GDP is associated with higher current account surplus (upper left quadrant of Figure 7). More in-depth studies are needed to explain this seemingly perverse association.

Figure 7: Fiscal deficits and current account of balance of payments (113 developing countries, 2000-2016)

Source: World Development Indicators

For example, see Arida and Lara Resende (1985), Bacha (1992), Bresser-Pereira (1990) and Damill et al. (2005)
IV.3 Deficits-growth: No evidence of crowding out and Ricardian equivalence

A lingering concern about fiscal deficit is its impact of interest rates when governments borrow domestically, raising the spectre of ‘crowding-out’; i.e. government borrowings driving up interest rates and adversely affecting private investment. This ignores the fact that government action is necessitated in the first place due to inadequate private investment in social and environmental sectors where private rate of return is perceived to be low. Moreover, the immediate financial implication of expansionary fiscal policy action when the central bank uses interest rates – in a world of ‘endogenous money’ – is to add to the cash reserves of private sector banks in which government checks are deposited. This, in turn, increases (net) liquidity if the central bank does not implement offsetting money market operations. Hence, the actual central bank discount rate should decrease, exerting downward pressures on retail interest rates. This should, therefore, encourage, rather than crowd-out private investment.

Chowdhury (2004) examined the crowding out phenomenon along with its related effects of fiscal actions in five South Asian economies (Bangladesh, India, Nepal, Pakistan and Sri Lanka) using a VAR model. He found that budgetary action did not have any perceptible influence on the domestic interest rate of the sample countries. Chakraborty (2012) explored the evidence of fiscal deficit determining the interest rate in India by using an asymmetric vector autoregressive model and high-frequency macro data of a financially deregulated regime, but controlling for capital flows. Contrary to the debates in policy circles, it was found that an increase in the fiscal deficit did not cause a rise in interest rates during the period 2006-2011. However, a reverse causality was detected, from interest rates to deficits.

Reviewing the empirical literature on both developed and developing countries, one IMF study (Hemming, Kell and Mahfouz 2002) concluded that fiscal multipliers are overwhelmingly positive. A more recent IMF study (Ilzetki, Mendoza and Végh, 2011) has found that the long-run multiplier was 1.6 for developing countries – i.e., for every extra dollar of public investment, the net benefit to the economy was $1.6. In other words, developing countries significantly benefit from government investment. This has also been vindicated during the 2008-2009 global financial crisis and when a number of large developing and emerging economies responded with fiscal stimulus; but their interest rates did not immediately increase.

Thus, we can expect a positive relationship between fiscal deficits and growth. That is, higher fiscal deficits should correlate with higher growth. As can be seen from upper left quadrant of Figure 8, higher fiscal deficits are associated with higher per capita GDP growth, and the association is stronger for fiscal

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33 The recent experiences suggest that causality may run from interest rate to fiscal deficit. For example, a negative external shock – such as a reversal in the terms of trade or sudden stop in capital inflows – may generate monetary policy reactions. The Central Bank may tend to maintain high interest rates to avoid capital flight and protect the economy from devaluation. If part of the public debt is indexed to the short-term interest rate, monetary policy translates into high debt service and higher budget deficits. See Camara and Vernengo (2004) for the Latin American experience.

Chakraborty (2002) examined the causality issue within the context of liberalisation of interest rates in India and found that causality runs from real interest rate to fiscal deficit.
deficit/surplus are less than -10 and +10 per cent of GDP. This indicates that both too high fiscal deficits and fiscal surplus may have growth retarding effects.

Figure 8: Fiscal deficits and per capita GDP growth (113 developing countries, 2000-2016)

Source: World Development Indicators

IV.4 Debts-macro instability: Influenced by outliers

If the fiscal deficits-inflation-external balance relations are not as straight-forward as the orthodoxy believes, then one cannot make any confident assertions about the link between debts and macroeconomic instability. A careful scrutiny of the data indeed shows that the relationship between debt-to-GDP ratio and macroeconomic instability is weak. Figure 9, reproduced here from of the IMF Fiscal Monitor (May 2010, p. 67)) confirms this. Virtually, there is no relationship between initial gross debt and macroeconomic stability. The apparent slight positive relationship is due to outlying values – debt in excess of around 120% of GDP.

The claim that high public debt causes lower growth is also not grounded in robust empirical evidence as can be seen from Figure 10 (reproduced from the same IMF source). Here, too, the weak relationship is driven by a few extreme values or outliers. There seems to be no strong relationship for a large number of cases shown in the circle. This evidence is also consistent with the absence of any significant crowding out and/or so-called Ricardian equivalence effects.
A July 2010 IMF study of 38 developed and developing economies for the 1970-2007 period found that the elasticity of growth with respect to debt is only -0.02. The same study found that the elasticity of growth with respect to other variables (such as initial years of schooling which contributes positively to growth) is much higher (the size of the elasticity coefficient on schooling is well in excess of 2.0). Hence, the growth-inhibiting effects of a given percentage increase in debt-to-GDP ratio can be easily overwhelmed by a given percentage increase in growth-promoting variables achieved through public spending on education. The same can

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34 Kumar and Woo (2010)
be true of public spending on health and similar areas that contribute to human and social development. For example, for a sample of 28 developing countries, Minh (2012) per capita GDP growth is dependent upon the growth of per capita public health expenditure in the GDP, growth of per capita public spending on education in the GDP, population growth, growth of the share of total health expenditure in the GDP and the share of gross capital formation in the GDP.

The above findings raise question about public debt as a policy target and the wisdom behind fiscal rules.

IV.5 Optimal debt: Is there one?35
There is a widespread perception that after a certain level, debt has a negative impact on a debtor country’s economic performance. This view has appeared in the literature under different titles: “debt overhang” (Krugman, 1988), “debt intolerance” (Rogoff, Reinhart and Savastano, 2003), “debt sustainability” (Hamilton and Flavin, 1986) and “threshold” (Reinhart and Rogoff, 2009, 2010). Thus, ‘prudential limits’ on public debt-to-GDP ratios play a crucial role in the discussion of fiscal policy. How robust are the proposed prudential limits on public debt-to-GDP ratios? Should they be treated as optimal in designing fiscal policy? These are the issues that are explored in this sub-section.

A debt-to-GDP ratio of 60 per cent is quite often noted as a prudential limit for developed countries. For developing and emerging economies, 40 per cent is the suggested debt-to-GDP ratio that should not be breached on a long-term basis. Based on these benchmarks, an April 2010 report by the Fiscal Affairs Department of the IMF offered illustrative ‘fiscal adjustments’ that would be required for developed countries and developing and emerging economies to reach suggested public debt-to-GDP ratios by 2030.36 Thus, there is a tendency to treat these benchmarks for debt-to-GDP ratios as “optimal” in the specific sense that crossing these thresholds poses threats to debt sustainability. This is consistent with the IMF’s global macroeconomic model which assigns a dual role to fiscal policy: (1) smoothing out business cycles in the short run; (2) meeting targets for debt sustainability in the long run.37

Are these benchmarks really optimal? The 60 per cent figure was one of a handful of targets European governments set at the start of the 1990s to prepare for economic and monetary union and the eventual formation of the euro zone. There was no hint of optimality; it was the median debt-to-GDP ratio at the time of the Maaschrit treaty.

The IMF study that recommends an external debt limit of 40 per cent of GDP for developing countries does not provide any reason to believe that it is optimal, stating that “…an external debt ratio of about 40 percent provides a useful benchmark” (IMF, 2002, p. 25). In interpreting this benchmark, the authors of the report issue an important caveat: “… it bears emphasising that a debt ratio above 40 percent of GDP by no means necessarily implies a crisis – indeed … there is an 80

35 Draws on Chowdhury and Islam (2010)
37 Laxton, et al., p. 45. The authors of GIMF arrive at ‘calibrated debt-to-GDP ratios’ that range from 50 to 60 per cent (Table 7), noting that they are ‘roughly in line with the data’ (p. 52).
percent probability of not having a crisis (even when the debt ratio exceeds 40 percent of GDP)” (IMF, 2002, p. 25).

The authors of a September 2010 IMF study on fiscal space emphasises that the debt limit found in their research “is not an absolute and immutable barrier ... Nor should the limit be interpreted as being the optimal level of public debt” (Ostry, et al., 2010, p. 3). According to this study of 23 advanced countries, the estimated debt limits, using the historical interest rate–growth rate differential, range from about 150 to 260 per cent of GDP, with a median of 192 per cent. The study assumes that interest rate–growth rate differentials are generally projected to be less favourable than the historical experience, and finds the corresponding median long-run debt ratio to be 63 per cent of GDP and the median maximum debt ratio to be 183 per cent of GDP.

Yet, they conclude, “prudence dictates that countries target a debt level well below the limit” on the ground that “the limit delineates the point at which fiscal solvency is called into question.” Two key factors affecting solvency are the response of primary balance (i.e., the budget balance net of interest payments on the debt) to increases in debts and the possibility of adverse shocks. It is assumed that when debt gets very large, it may be difficult to generate a primary balance that is sufficient to ensure sustainability, and that shocks can push countries beyond their debt limit. So, the advice is to remain well below the limit for the sake of prudence. This advice is not derived from the analysis of liquidity/rollover risk. Liquidity is not an issue for domestic debt as it can always be paid off by printing money, a sovereign right which households or firms do not have.

In 1988, Belgium had the highest public debt; that position is now filled by Japan, whose debt rose from below 60 per cent in 1988 to around 236 per cent of GDP in 2017. Italy’s debt also shot to 131.5 per cent of GDP in 2017.38 Interestingly, Singapore – generally regarded as a beacon of macroeconomic stability and fiscal prudence – had public debt-GDP ratio of 111 per cent in 2017. None of these countries experienced spiralling inflation or very high interest rates as is commonly feared when government fiscal deficits rise. Japan is facing just the opposite – deflationary pressure and a zero interest rate. The higher debt-to-GDP ratio in Japan is partly due to very low inflation. A higher, but still moderate, inflation rate will raise nominal GDP and lower the public debt-to-GDP ratio unless there is an actual increase in the government’s gross liabilities.

It must be noted here that the discussion of debt limit or debt threshold is influenced by the existence of a negative correlation between public indebtedness and economic growth. However, as is well known, correlation does not imply causality. Indeed, a survey of literature by Panizza and Presbitero (2013) did not find strong evidence around the existence of a causal relationship that stems from public indebtedness to economic performance. It is quite possible that higher debt is driven by poor economic performance, which could be due to a number of factors, such as adverse terms of trade shocks or inability to access capital market at times of crisis. For example, Irons and Bivens (2010) found evidence of causality occurring from

38 General government gross debt; IMF public debt data base, [https://www.imf.org/external/datamapper/GGXWDG_NGDP@WEO/OEMDC/ADVEC/WEOWORLD/JPN/AFG/UKR](https://www.imf.org/external/datamapper/GGXWDG_NGDP@WEO/OEMDC/ADVEC/WEOWORLD/JPN/AFG/UKR)
economic growth to debt, and concluded, “overreaching claims of debt threshold suffer from theoretical and empirical flaws”. Research by Easterly (2001a), shows that growth slowdowns led to rising debt ratios among all developing countries during 1975-94, and debt crises often result in part from major growth slowdowns through their repercussions on the future public revenues.39

As highlighted earlier, when there is spare capacity in the economy or unemployment, higher fiscal deficits add to purchasing power and do not exert any upward pressure on interest rates or inflation, nor do they cause large current account deficits. However, it is often claimed that higher public debt today has to be paid by higher tax tomorrow. This is not necessarily true. As long as the interest on the debt is less than the annual increase in nominal GDP, the debt need not be repaid because it will be a shrinking fraction of GDP. This was pointed out more than half a century ago by Evsey Domar (1944, p. 822), “the problem of the burden of debt is essentially a problem of achieving a growing national income”. Evsey Domar (1993, p. 478) again emphasised after 50 years, “the proper solution of the debt problem lies not in tying ourselves into a financial straight-jacket, but in achieving faster growth of the GNP…”.

Yet, the debate on debt continues. The current preoccupation with identifying prudential limits on public debt-to-GDP ratios have had the consequence of distracting attention from the crucial role that fiscal policy plays in promoting growth and development. This point is made forcefully in an insightful ‘interim report’ that informed the deliberations of the Development Committee of the IMF and World Bank in April 2006. The authors of the report note that debts and deficits are useful indicators for “…controlling the growth of government liabilities, but (they) offer little indication of longer term effects on government assets or on economic growth. Conceptually, the long-term impact is better captured by examining the impact of fiscal policy on government net worth”. The report argues that “…there is clearly a need for fiscal policy to incorporate, as best as possible, the likely impact of the level and composition of expenditure and taxation on long-term growth….” (p. i).

This recognition of the Development Committee is very much in line with Abba Lerner when he emphasised ‘functional’ finance over ‘sound’ finance. According to Lerner (1943, pp. 39), “The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound.” Therefore, debt is sustainable if government expenditure is both growth- and productivity-enhancing. The notion that government deficits will need to be ‘financed’ through higher taxes in the future is spurious as revenues will rise in an expanding economy.

The issue, however, is different when it comes to the accumulation of external liabilities. The question is then not only of being able to repay, but also whether other countries would be willing to continue to lend. Paradoxically, in crisis-hit

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39 The recent European evidence following the GFC also confirms this. The debt-GDP ratio in most of the crisis countries rose despite significant fiscal consolidation through expenditure cuts which failed to generate robust growth.

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countries with access to private capital markets, fiscal prudence does not offer any safeguard against the pitfalls and perils of private sector-led accumulation of external liabilities because they eventually become the liabilities of the government. This is a lesson that Bulgaria and other countries have painfully discovered in the wake of the Great Recession of 2008-2009 as Indonesia and Thailand discovered during the 1997 Asian financial crisis.

IV.6 Fiscal Rules: Help or hindrance?40
The proponents of fiscal rules base their arguments on fiscal or debt sustainability and credibility of fiscal policy. By restraining expenditure or overall deficits, it is argued that fiscal rules keep public debt within a sustainable level and hence improve the credibility of the fiscal authority in the eyes of financial markets from where a sovereign authority has to borrow. The IMF’s Fiscal Affairs Department paper notes, “The credibility of the needed fiscal adjustment will be essential to anchor longer-run expectations about government solvency.” (IMF (2009, p. 4).

While the argument is very appealing, especially when a good number of countries are currently facing debt crises and forced to borrow at high interest rates, the experience is not very convincing. As noted in a World Bank publication, “this newly acquired fiscal technology, by itself, will generate neither discipline nor anticyclicality” (Giugale, 20100, p. 184). Thus, it is not surprising that the adoption of rules, per se, has had mixed success in limiting pro-cyclicality (Huidrom, Kose and Ohlsorge, 2016). According to Bova, Carcenac, and Guerguil (2014), balanced budget rules that target headline fiscal balances can lead not only to more volatile business cycles, but also they tend to be associated with more pro-cyclical fiscal stances. On the other hand, budget balance rules that target structural balances tend to be more closely associated with counter-cyclical fiscal stances. 41 Challenges such as off-budget government guarantee (e.g., related to PPPs) is one of the possible factors for the limited success of balanced budget rules to reduce pro-cyclicality.42

Others, for example Snudden (2013), believe that insufficient flexibility contributes to fiscal rules limited success. Critics of first generation fiscal rules often point out the danger of rigidity; i.e. fiscal rules constrain governments from responding to extra-ordinary circumstances such as natural disasters or external shocks or financial sector crises. Thus, the new generation fiscal rules, especially those designed in the wake of the recent financial crisis, do include escape clauses. The problem here, though, is that fiscal rules with escape clauses, especially when

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40 Draws on Chowdhury and Islam (2012)
41 Research by Guerguil, Mandon and Tapsoba (2017) finds that not all fiscal rules have the same impact. The introduction of escape clauses in fiscal rules does not seem to affect the cyclical stance of public spending. The results are mixed for cyclically-adjusted budget balance rules: enacting the latter is associated with counter-cyclical movements in overall spending, but with pro-cyclical changes in investment spending. Structural factors, such as past debt, the level of development, the volatility of terms of trade, natural resources endowment, government stability, and the legal enforcement and monitoring arrangements backing the rule also influence the link between fiscal rules and counter-cyclicity. The results are robust to a wide set of alternative specifications.
42 Asian countries which are generally seen as ‘fiscally prudent’, following some sort of balance budget rules, engage in wide-spread off-budget activities thus, making their fiscal situation vulnerable (see World Bank, 2014).
the “extra-ordinary” situations are not well defined or try to cover all conceivable future events, they become complex and hence loses their credibility defeating the very purpose of them. Hence the IMF seems to prefer a simple rule, “…so that it can be readily operationalized, communicated to the public, and monitored” (IMF, 2009, p. 4). Similarly, according to Frankel (2011), rules are best when simply defined and supported by surveillance arrangements, respected by the government, yet operated by a nongovernment agency. The World Bank (2015) believes that Chile’s use of an independent technical fiscal council and a fiscal rule that targets a fixed structural balance is a good example of a well-designed, credible, and successfully operated fiscal rule.

However, such fiscal rules, devised and implemented by an independent fiscal agency, can pose risks to democracy and development. The underlying philosophical rationale for fiscal rules lies in the distrust of politicians or governments as can be found in an earlier IMF working paper by Koptis (2001). The author interprets fiscal rules as potential instruments to depoliticise the policy framework. Schaechter et al (2012) also observe that fiscal rules are important for “correcting distorted incentives and containing pressures to overspend, in particular in good times, so as to ensure fiscal responsibility and debt sustainability”. Fiscal rules, as in the case of independent central banks operating within an inflation targeting framework, are seen by its advocates as necessary to enhance the credibility of macroeconomic policies by removing discretionary intervention of politicians.43

If the intention is to remove discretion from politicians, then how can they implement their election manifestos? The national budget is an important instrument for fulfilling promises made by political parties. By removing this instrument, fiscal rules can potentially undermine accountable governance, especially in new democracies. Therefore, one may ask, ‘credibility for whom’ – electorates or financial markets? Thus, by trying to enhance the credibility of governments in the eyes of financial markets, fiscal rules can undermine the credibility of a democratic polity.

Fiscal rules can also distort political discourse, as elections are fought on the agenda of debts and deficits. As parties or presidential candidates try to out-bid each other on their credibility with regard to ‘sound’ finance, the political debate becomes narrowly focused. Electorates are presented with a choice to elect a party or candidate based on who can convince them in being more committed to cutting

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43 While fiscal rules in countries such as Germany or Indonesia were motivated by their experience of hyperinflation caused by excessive government expenditure financed by printing money, the empirical rationale for recent enthusiasm perhaps can be traced to Dornbusch and Edwards (1990), which attributed the Latin American debt crisis in the 1980s to profligate governments driven by populist policies, although the crisis was due to much more complex reasons. To begin with, oil shocks of the 1970s forced the Latin American governments, like others, to borrow. They also found commercial banks in the US, flushed with money deposited by oil exporting countries, too eager to lend at cheap rates. The debt crisis was triggered by sudden and steep rise of interest rates in the US and the UK due to fight inflation first policies of President Reagan and Prime Minister Thatcher. The theoretical rationale for rule-based policy came from the work of institutional economists, such as Douglas North.
expenditure, instead of who has a better social or economic programme for the country.

Fiscal rules are likely to reflect the visions or manifestos of the party in power at the time these rules are legislated and would disadvantage the party that may form a government at a later date. In theory, this bias can be circumvented if rules are based on some international norms, but this would vitiate the principle of designing fiscal rules in line with country-specific circumstances.

As noted, the main aim of fiscal rules reviewed in Schaechter et al (2012) is solvency and sustainability. The guidelines for the fiscal rules developed by the IMF’s Fiscal Affairs Department (2009) are aimed at developing credible strategies to strengthen public finances. They basically relate to budgetary aggregates and follow accounting rules of balancing government revenue and expenditure over a medium term in a double-entry book-keeping framework without due consideration for the composition of government expenditure. Thus, this ignores fiscal policies’ developmental role. It is assumed that fiscal solvency and sustainability is both a necessary and sufficient condition for growth and poverty reduction.

This view implicitly presupposes that fiscal policy is ineffective in influencing aggregate output and employment due to crowding out and/or Ricardian equivalence. But none of these propositions have any robust empirical basis, especially in developing countries as highlighted earlier.

However, the solvency and stabilisation view still dominates policy discourse. As the ECB notes, “Upholding trust in the soundness of public finances enhances confidence among all economic agents and thereby contributes to sustainable growth in consumption and investment”.44 This raises a fundamental question, whether the policy-making process should become hostage to the ‘confidence game’ in which evidence-based policy-making is replaced by a band of amateur psychologists seeking to read the collective mood of financial markets. When this happens, fundamental macroeconomic policy errors are likely to be committed with serious consequences for poverty and development, as the mishandling of the 1997 Asian financial crisis by international financial institutions has shown.45

Macroeconomic stability is necessary for growth, but it is not sufficient. As highlighted earlier, the Development Committee of the IMF and the World Bank in its 2006 report drew attention to the forgotten fact that in a development context, fiscal policy is not only an instrument of macroeconomic stabilisation, but also an instrument to achieve growth and poverty reduction objectives. Therefore, “the design of fiscal policy needs to identify and also incorporate the transmission channels through which fiscal policy influences long-term growth. This requires that attention be focused on the likely growth effects of the level, composition and efficiency of public spending and taxation. Fiscal policy that neglects these effects runs the risk of achieving stability while potentially undermining long-term growth and poverty reduction…. The fiscal deficit is a useful indicator for purposes of stabilization and for controlling the growth of government liabilities, but it offers little indication of longer term effects on government assets or on economic growth” (Development Committee, 2006, p. i). Had the European governments worried about

44 ECB Bulletin, November, 2003, p. 6
45 See Krugman (2002)
deficits and debts, they could not rebuild Europe from the ruins of war, nor could they build welfare states that blunted the appeal of socialism and helped consolidate democracy.

Furthermore, empirical evidence on the effectiveness of stabilisation funds in improving fiscal discipline is mixed. Cross-country evidence suggests that the establishment of a stabilisation fund itself does not by itself guarantee its success in shielding the domestic economy from commodity price volatility (Gill et al, 2014). Critics have also questioned the robustness of the ‘permanent income rule’ to establish benchmarks for fiscal sustainability. This rule ‘…limits each year’s spending to the real return’ on financial assets a resource-rich government builds up through the vehicle of a sovereign wealth fund. The aim is to construct a ‘…financial asset of equal value to the reserves that have been depleted and, from a theoretical perspective, achieves inter-generational equity’ (Heuty and Aristy, 2010:7). The permanent income approach might well be valid for capital-rich high income countries, but less valid for capital-poor developing and emerging economies. The social returns to investment in education, health and infrastructure in resource-rich developing economies may well be higher than the returns on financial assets sterilised abroad. Spending the oil wealth upfront on activities with high ex-ante social returns is likely to be a better way of transferring wealth across generations than the one implied by the permanent income rule.

As a concluding observation, it is worth reiterating that the literature on fiscal rules completely ignores the financial imperatives of meeting core development goals. These goals might be national adaptations of the Sustainable Development Goals (SDGs) and/or the social protection floor initiative adopted by the UN system in 2009. The available empirical evidence suggests that without a determined resource mobilisation strategy, there will be significantly unmet financing needs in developing countries.46 It also appears that fiscal policy loses its capacity to combat inequality if it is de-linked from a developmentally-oriented strategy of raising revenues on a sustainable basis and in improving the benefit incidence of tax and spending instruments.47

In sum, fundamental to addressing growing inequality and achieving sustainable development goals is the ability of the government to consistently pursue counter-cyclical fiscal policy and to provide public services along with universal social protection measures for vulnerable individuals. This, in turn, requires determined efforts to enhance fiscal space.

V. Revitalising fiscal policy for addressing inequality

Within the SAP’s constrained circumstance, much of the focus of so-called pro-poor fiscal analysis, promoted by the IMF and the World Bank under the ‘poverty reduction strategy papers, (PRSP) has been on expenditure switching policies, altering the pattern of government spending in favour of pro-poor public goods (Roy and Weeks, 2004). However, such budgetary re-allocations achieved very little, when the taxation system became less progressive and could not adequately perform

46 See ILO (2009); Markandya, et al. (2010).
47 See Bastagli, Coady, and Gupta (2012)
its redistributive role. Furthermore, the ceiling on public expenditure constrained expansion of public services that benefits the low-income households, such as low-cost public housing, subsidised healthcare or education. This section discusses how fiscal policy can be re-geared to address growing inequality. It begins with presenting some stylised facts.

V.1 Stylised facts – fiscal policy and inequality

There is a widespread belief that trends and changes in income inequality can be at least partly caused by changes in the level and composition of government revenue and spending. This follows from the well-studied Kuznets’ hypothesis that inequality first rises with the level of income and then declines. Therefore, to the extent government’s taxation and spending policies affect the level of GDP, they will also have implications for inequality.

Figures 11 and 12 broadly confirm this stylised fact in a cross-section of over 100 countries – developed and developing. Figure 11 uses alternative measures of inequality – Gini coefficient and income share of top 10 per cent of the population. Both show that there is a negative association between tax/GDP ratio and inequality. That is, higher the tax-GDP ratio, the lower is the level of inequality. This negative association between tax-GDP ratio and inequality is more robust in developed countries where generally tax-GDP ratio is high and inequality is low compared to developing countries.48

Figure 11: Government revenue and inequality

![Graph showing the relationship between Gini coefficient and tax/GDP ratio.](image)

Source: World Development Indicators (various issues)

Higher tax/GDP ratio means greater ability of the government to spend on sectors that help reduce inequality. For example, higher public expenditure on health and education supports accumulation of human capital and hence contributes to

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48 For example, Islam, Madsen and Doucouliagos (2018) find a strong negative association between tax-GDP ratio and alternative measures of inequality in 21 OECD countries over a long time period spanning 1870 to 2011.
enhancing equality of opportunities. This stylised fact is confirmed by Figure 12 which plots public education expenditures (as % of GDP) and alternative measures of inequality.

Figure 12: Public expenditure and inequality

As in the case of tax-GDP ratio, the negative association between public expenditure and inequality is stronger in developed countries, which generally have greater tax power and hence spend higher proportions of GDP than developing countries. That is, tax power matters.

However, there is more than the above broad stylised facts. For example, types of taxations (e.g., direct and indirect taxes, income and wealth taxes etc.) as well as progressivity of tax structure can have significantly different impacts on both tax power (tax-GDP) ratio and inequality. As highlighted in Section III, over the past three decades countries have become more dependent on indirect taxations which are generally more regressive. At the same time, they have also cut top marginal tax rates. Thus, the tax structure has become less progressive reducing its effectiveness as a redistributive tool.

Additionally, it is argued that the effects of taxation on income distribution needs to be seen in the context of the trade-offs between growth and equity, and this means looking at the overall effects of any reform on the fiscal regime as a whole, and not just at whether individual taxes are progressive or regressive. The proponents of tax cuts used the theory of optimal taxation to argue that a tax rate beyond a threshold level negatively affects entrepreneurial spirit and hence growth.49 But Figure 13 casts serious doubts about this claim. It shows a very week

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49 The theory of optimal taxation had a profound impact on tax theory and dominated academic discourse concerning the design on a tax system. At the centre of the optimal taxation theory is the assumption that tax payers respond to a tax system, either treating it as a burden or encouragement. Thus, efficient taxation minimises the efficiency losses incurred through the excess burden of taxation when collecting a specified amount of tax revenue. Frank Ramsey (1927) showed that authorities intending to raise a given amount of tax revenues should impose a tax in inverse proportion to the elasticity of demand for the good, so that commodities which experience inelastic demand are taxed.
statistically insignificant negative relationship (correlation coefficient -0.084) between tax-GDP ratios and growth rates in about 150 countries involving both developed and developing economies.

Finally, although the tax-GDP ratio has generally increased, in most cases, it has not been commensurate with the increase in demand for public expenditure. Thus, most countries have experienced rising debt levels which forced them to either cut or restrain public spending. This means, public spending, including transfers, have not been sufficient enough to offset the adverse impact of falling tax progressivity on inequality during the past decades. In sum, income distribution worsened due to falling progressivity of taxation and inadequate public social spending, including transfers since the early 1980s.

more heavily. This would imply a regressive tax structure – higher tax rates for essential goods and services, and lower rates for luxuries.

A second line of influential optimal taxation theory is that of James Mirrlees (1971), which formalised the classic trade-off between equality and efficiency. It posited that governments’ attempt to tax high ability individuals to give transfers to those of low ability would discourage high ability individuals from exerting as much effort, thus adversely affecting growth. Therefore, the tax system has to be incentive compatible to make sure that high ability taxpayers keep producing at the high levels corresponding to their ability.

The work of both Ramsey and Mirrlees has been influential in diminishing the role of progressive taxation over the past three decades. They have been used to justify tax cuts at the top on the ground that a wealthier person has more flexibility when making labour supply decisions. The same argument has been applied to corporate tax cuts as capital is more mobile than labour. This argument has got an added impetus during the 1990s at the height of globalisation and countries engaged in competitive corporate tax cuts.

However, practitioners find the theory of optimal taxation problematic despite enormous intellectual resources that have gone into it. For example, Vito Tanzi, former Director of IMF’s Fiscal Affairs Department noted, “optimal taxation, a branch of public finance that had conquered the academic world…[But] in terms of concrete results, optimal taxation theory must be considered a highly unproductive activity. Its recommendations often conflict with what governments want to do or what taxpayers expect them to do.” Quoted in Boadway (2012).
Ironically, tax cuts are often justified on the ground that they would unleash entrepreneurial spirit and hence higher investment and growth. The stylised fact revealed in Figure 13 raises doubts about the robustness of this argument in favour of tax cuts. Recent research has found that past studies showing positive growth impacts of tax cuts were either methodologically flawed or deliberately misleading. Research at the US Congressional Research Service has found that “slower growth periods have generally been associated with lower, not higher, tax rates” (Gravelle, and Marples, 2014).

In a recent article, The Economist (2017), which generally has a pro-business stance, found that the relationship between tax rates and growth or investment is not very strong. It concludes, “the decision to invest in a country depends on a lot more than tax”. Research has shown that these may include good infrastructure, high quality education, and social cohesion. Recent World Bank findings from its enterprise survey show that tax incentives are not high on the list of critical factors affecting inflows of foreign direct investment (FDI).

As highlighted in Section III, developing countries made tax bases narrower and provided substantial targeted tax incentives to attract mobile foreign direct investment (FDI). But studies have shown that such tax incentives generally failed to bring in enough FDI to compensate for loss tax revenues. Additionally, the use of tax incentives may in practice cause more harm than good because targeting mobile activities is difficult, administratively risky, and prone to rent-seeking and corruption, particularly for countries with weak administrative capacity.

V.2 Recreating distributive fiscal policy

This sub-section argues for recreating distributive fiscal policy to address the challenge of rising inequality. Following Lusting and Higgins (2012), the discussion distinguishes between stock of income-generating assets (private and public) and receiving income flows (private and public) in order to identify distributive fiscal policy instruments.

Recent decades have witnessed tremendous concentration of wealth in the hands of few. There is no disagreement that asymmetric wealth distribution generates asymmetric labour and especially capital income flows, resulting in market or pre-tax income inequality. For example, Oxfam’s Reward Work, Not Wealth report reveals that the world’s wealthiest 1 per cent got 82 per cent of the wealth generated in 2017, while the bottom 50 per cent saw no increase at all.

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50 See, for example, Alinagh and Reed (2016), and Huang and Frentz (2014).
51 OECD (2008) noted: “while tax is recognized as being an important factor in decisions on where to invest, it is not the main determinant. FDI is attracted to countries offering: access to markets and profit opportunities; a predictable and non-discriminatory legal and regulatory framework; macroeconomic stability; skilled and responsive labour markets; and well-developed infrastructure. All of these factors will influence the long-term profitability of a project.”
52 World Bank (2017)
53 A 2008 IMF research paper compared the cost of concessions in terms of revenue foregone with the benefits which were marginal at best in Caribbean countries. Foregone tax revenues ranged between 9.5 per cent and 16 per cent of GDP per year, whereas total foreign direct investment did not appear to depend on concessions. See Chai and Goyal (2008).
54 See Abramovsky and Phillips (2014)
55 This section draws on Kohler (2015)
Therefore, tackling rising wealth inequality and wealth concentration is key to preventing rising income inequality. Governments need political will to implement policies of direct wealth transfers, through such measures as land reform and nationalisation of financial institutions. These have to be supplemented with ongoing wealth distributive tax measures, such as wealth or inheritance tax, property tax, etc. in order to prevent reoccurrence of wealth concentration.

An important policy message is that governments have to carefully assess their privatisation and PPP programmes that have contributed to skewed wealth concentration and governments’ fiscal risks.

Figure 14 is a flow chart showing how various taxes and transfers can redistribute private income-generating assets and the flows of income from them. Private income-generating assets include properties (e.g. land or real estate) as well as industrial and financial capital. They also include human capital embodied in people, such as education and skills.

Progressive direct taxes and direct transfers are two main instruments to reduce market income inequality and stabilise disposable income to protect vulnerable individuals against shocks. The IMF’s analysis did not find any robust justification
for the decline in tax progressivity from the perspective of optimal taxation theory. Nor did it find any strong evidence that lower tax progressivity significantly stimulates growth. On the other hand, as documented in the previous Section, the decline in tax progressivity has worsened income inequality considerably. Thus, the IMF concludes, “there would appear to be scope for increasing the progressivity of income taxation without significantly hurting growth for countries wishing to enhance income redistribution”.

However, given the increased dependence on regressive indirect taxation, countries need to strengthen their progressive transfer measures, such as social protection, cash transfer or universal basic income. Improving access to quality healthcare and education is crucial for achieving equity of opportunities or addressing inequality in human capital. This would require expanded public provisioning of such basic services and increased public social expenditure.

An important policy message is that governments have to carefully assess their austerity-based fiscal consolidations that had serious adverse impacts on human capital accumulation, and exacerbated poverty and inequality.

Obviously, redistributive policy instruments for income-generating private assets and income flows have implications for public assets and public income-expenditure flows. Hence, they should shape public policies as shown in Figure 15 which distinguishes between ‘asset-based’ and ‘income-based’ public policies.

Figure 15: Fiscal policy instruments for public income-generating assets and the public revenue-expenditure flows

![Figure 15](source: Kohler (2015))

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56 IMF (2017), *Fiscal Monitor*, October
57 Ibid, p. 13
For example, taxes (including corporate taxes) raise public revenues and transfers generate public expenditure. As highlighted earlier, governments’ privatisation programmes shifted massive amount of public income-generating assets to the private sector since the early 1980s. This weakened the capacity of governments to conduct asset-based public policies. As a result, governments are increasingly relying on income-based public policies to fund their current and capital expenditures.

Therefore, strengthening their tax system and improving its progressivity become critically important. However, re-nationalisation of some of the assets which are vital for equity should be considered. For example, the successful re-municipalisation of Paris water supply in 2009 has become an inspiring model for many other cities both in France and abroad.\(^{58}\) Several South American countries also adopted re-nationalisation programmes in the early 2000s. However, re-nationalisation programmes should be carefully designed and not driven by just populist back-lash.

VI. Mobilising resources for an enhanced fiscal space\(^ {59}\)

The term ‘mobilising’ suggests that resources are available, but that they somehow are either (a) not collected fully, or (2) not being used for development, due to specific obstacles or a lack of incentives. The report of the Inter-Governmental Committee of Experts on Sustainable Development Financing (IGCESDF), set up in June 2013 by the General Assembly of the United Nations, estimated that several trillion dollars per year would be needed annually for climate-compatible and sustainable development, with US$5-7 trillion additional financing for infrastructure. It also estimated that the available global savings were around US$22 trillion a year which should be sufficient to meet these needs, if they are allocated correctly.

Therefore, according to the IGCESDF, “the challenge for policymakers lies in facilitating greater investment of disperse financing flows into areas of global need, and in improving the quality of present policies, approaches and instruments,

\(^{58}\) https://in.reuters.com/article/water-utilities-paris/pariss-return-to-public-water-supplies-makes-waves-beyond-france-idINL6N0PE57220140708

\(^{59}\) The term fiscal space was first introduced by Heller (2005) in an IMF paper as the “availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government’s financial position.” Thus, the notion of fiscal space is closely linked to the concept of fiscal sustainability, which in turn is related to the capacity of a government to finance its operations, to service its debt obligations, and to ensure its solvency. Some critics have pointed out its narrow scope for developmental goals. Pick (2017), in an OECD paper, believes that the IMF definition is more applicable for developed countries. According to him, fiscal space methodologies centred on long-term debt levels are inappropriate for most low- and lower-middle-income countries. Since these countries typically do not have the same access to markets as OECD countries, are more vulnerable to macroeconomic shocks and rely on a greater range of financing sources, including official development assistance. Moreover, for these countries, the issue of fiscal space arises in the immediate term – the pressing need for expenditure today – and the challenge is how to find the resources for their financing. This, in turn, means that the sums involved are different: the shorter time horizon imposes a constraint on how much money can be generated through IMF’s fiscal space analysis. This limits its usefulness when countries are trying to raise significant additional resources to achieve the SDGs. See Cheng and Pitterle (2018) for discussions on various measures of fiscal space.
addressing inefficient and harmful subsidies, corruption, tax evasion, illicit financial outflows...”. The IGCESDF Report proposed a basket of over 115 policy options, including for tax revenues; and suggested areas for advancement of the global partnership in the areas of trade, taxation, financial market stability, debt and development cooperation, among others.

According to Pick (2017), the potential for identifying significant additional resources in developing countries on the expenditure side is limited, and the best means of creating fiscal space lies on the revenue side, where average tax revenues are around 15 per cent of GDP, less than half the level in OECD countries, where tax revenues averaged 34.2 per cent of GDP in 2014. Developing countries, in general, made significant progress in raising tax revenues. The United Nations Inter-Agency Task Force (IATF) 2018 report shows that the median tax-GDP ratios in all developing regions increased, despite some drops in middle income countries and Small Island Developing States (SIDS) after the GFC (Figure 16). However, the developing regions still lag behind the developed countries where the median tax-GDP ratio is slightly over 25 per cent. As the IATF 2018 report noted, “Large gaps remain between LDCs, middle-income countries and countries in developed regions, with the 2016 gaps rising to levels not seen since 2008” (p. 41). More importantly, the median tax-GDP ratio in least developed countries (LDCs) seems to have plateaued and declined in 2016 to 13.3 per cent of GDP.

![Figure 16: Median tax/GDP ratio (%) by income grouping, 2000-2016](source: United Nations, Inter-Agency Task Force (IATF) Report, 2018)

In light of the above observation, this section will focus on the challenges that developing countries face in raising tax revenues and suggest possible alternative sources of domestic resources.

**VI.1 Limitations of tax revenues**

The two most critical constraints to direct taxation in developing countries are (1) low income level and (2) economic structure.

**VI.1.1 Low income**

Low income means, low tax base – there are simply not enough people earning significantly above the income threshold liable for tax (Besley and Persson, 2014).
Thus, even raising the top rate is unlikely to yield substantially large revenues, whereas it may encourage tax avoidance and evasion. This stylised fact is presented in Figure 17, which shows that tax shares in GDP are positively correlated with income. That is, low-income countries have low tax-GDP ratio because their income level is low. The tax-GDP ratios of today’s developed countries were very similar a century ago to what they are now for poorer countries. In other words, countries tax capacity grows with income levels. Thus, asking developing countries to further strengthen their tax capacity may be an onerous demand on them. Creating capacity and institutions for an efficient tax system requires resources (money); poor countries simply do not have them by definition.

Figure 17: Country-level taxes and income

Source: Besley and Persson (2014)
Note: The outliers, in the lower right corner, 2 are the three oil states of Bahrain, Kuwait, and Oman.

VI.1.2 Large agriculture sector
The low income constrain is compounded by the presence of a large agriculture sector. The tax-GDP ratio is likely to be low if the share of agriculture is high. Research has shown that higher shares of agriculture and service sectors in GDP are negatively correlated with tax-GDP ratios in developing countries. This can be due several factors. First, small holder peasant agriculture, characterised by family workers, production for self-consumption and low market transactions. When outside workers are employed, wages are low and paid in cash and not properly recorded. Second, where large farmers dominate in a feudal setting, they possess significant political force against taxing agricultural income or land. Third, agriculture primarily produces food and basic raw materials, which are often either exempt from tax or subject to relatively low rates. Finally, agricultural incomes are

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60 See World Bank (2012)
fluctuates more than other sources of income due to their dependence on climate. Thus, agricultural incomes are not a stable source of tax revenue.

VI.1.3 Informality
A further complication is the incidence of informality. The large informal sectors in poor economies are inherently hard to tax. The incomes of small-scale informal firms, such as street vendors or village shops, and their owners are hard to measure for tax purposes, especially in the absence of formal record keeping. Across countries, the size of the informal sector is strongly negatively related to income taxation, as revealed in Figure 18 for about 75 countries from around the year 2000.

![Figure 18: Share of income taxes in tax revenue vs. size of informal economy](source: Besley and Persson (2014))

As Besley and Persson (2014, p. 110) noted, “Having a large informal sector makes broad-based taxation of income next to impossible. It may also mean that the elasticity of taxable income with regard to the level of taxes is much higher than otherwise—that is, when the government of a country with a large informal sector tries to raise taxes, the taxable income reported to the government may drop substantially.”

VI.1.4 Indirect tax - VAT
As noted in Section III, the median goods and services tax (GST) revenue, increased in all developing regions while it remained stable in developed countries (see Figure 4). The steepest increased occurred in SIDS and LDCs. Raising GST or value added tax (VAT) has become a common approach for many countries.

However, the factors, such as informality, that affect direct taxation, also limit the scope for expanding GST or VAT base, as acknowledged in an IMF study which concluded that scope to raise revenue “by simply raising standard VAT or GST rates is becoming limited” IMF (2011, p). Moreover, GST/VAT is a regressive tax with its incidence falling disproportionately on low-income households, even after

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61 See La Porta and Shleifer (2014)
exempting goods and services that are dominant in the consumption basket of the poor. Therefore, raising VAT or GST can only be a prudent policy if targeted to the products that the better-off consume disproportionately more. For example, it is possible to exempt necessary basic goods that many low-income families depend on while setting higher rates for luxury goods that are principally consumed by wealthier families (e.g., luxury cars). This will also raise legitimacy of the tax system. However, taxing elites and high-income/wealth individuals requires “political will as much as technical capacity” (IMF, 2011).

VI.2 Compounding factors
A number of compounding factors – mostly policy induced – also play a role in limiting developing countries tax intakes as narrated below.

VI.2.1 Tax avoidance and evasion
As highlighted in the IATF 2018 Report, a barrier to greater domestic resource mobilisation (DRM) is a high and persistent level of tax evasion and avoidance. Table 1 presents some estimates of lost revenues due to corporate tax avoidance, which can be as high as US$500 billion annually. Tax avoidance happens due to loopholes in the tax regulations and can be quite legitimate from a legal point of view. Tax evasion, on the other hand, is outright illegal.

Table 1: Select international corporate tax avoidance estimates

<table>
<thead>
<tr>
<th>Estimates by</th>
<th>Estimated volume of tax loss</th>
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</thead>
<tbody>
<tr>
<td>WIDER Working Paper, 2017</td>
<td>US$500 billion annually</td>
</tr>
<tr>
<td>ECLAC Survey 2016</td>
<td>US$340 billion in 2015</td>
</tr>
</tbody>
</table>

Source: IATF 2018

VI.2.2 Globalisation and tax losses
Historically, developing countries depended more on trade taxes because of administrative ease. However, they generally are losing revenues due to the pressure of globalisation. There are four main reasons for revenue losses: first, trade liberalisation and associated tariff cuts. Developing countries have steadily reduced tariff rates since the 1990s, lowering their capacity to generate revenue from trade. The financial implications of this trend are likely greater for low-income countries, which sliced tariffs by more than half, from 36 to 12 per cent between 1996 and 2010, on average, compared to a 7 per cent average cut in middle-income countries (Figure 19). Many developing countries could not compensate the loss from trade-related taxes with the more regressive indirect taxes such as GST or VAT. An IMF study found that middle-income countries could recover only up to 60 cents of each dollar of tariff revenue lost, and low-income countries recovered no more than 30 cents (Baunsgaard and Keen, 2005).
Second, capital movements increase opportunities for tax evasion because of the limited capacity of tax authorities to check the overseas incomes of its residents; evasion is easier as some governments and financial institutions, especially in tax havens, systematically conceal relevant information. The IATF 2018 report acknowledges the difficulties in tracking and estimating the extent of ‘illicit financial flows’ (IFFs) due to the very non-transparent nature of these transactions. A December 2015 report from Global Financial Integrity, ‘found that developing and emerging market economies lost US$7.8 trillion in IFFs from 2004 through 2013, with illicit outflows increasing at an average of 6.5 per cent per year—nearly twice as fast as global GDP.

Third, avoidance (not evasion) may increase, given international differences in tax rules and rates, because of the choice of tax regime that international-tax-treatment of enterprise income commonly offers. This is more likely for taxation of profits from corporations’ international operations. Transfer pricing for goods, services and resources – moving among branches or subsidiaries of a company – provides opportunities for shifting income to minimise tax liability.

Fourth, as highlighted in Section III, international competition for inward FDI has led governments to reduce tax rates and to otherwise increase tax concessions to corporations (see Figure 3b). However, it is well known that direct tax concessions have little effect in diverting international investment, let alone in attracting such flows. Therefore, such competitive tax concessions or beggar-thy-neighbour policies have led to unnecessary loss of revenue for many developing countries.

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62 See footnote 51, OECD (2008). The IMF notes, “The effectiveness of tax incentives — in the absence of other necessary fundamentals — is highly questionable. A tax system that is riddled with such incentives will inevitably provide fertile grounds for rent-seeking activities. ... Developing countries would be well advised to refrain from reliance on poorly targeted tax incentives as the main vehicle for investment promotion.” (Tanzi and Zee, 2001)

Recent World Bank (2017) findings from its enterprise survey show that tax incentives are not high on the list of critical factors affecting inflows of foreign direct investment (FDI). The Economist (2017) found that the relationship between tax rates and growth or investment is not very strong.

63 See Chai and Goyal (2008)
VI.3 Actions for enhancing tax revenues
There is no reason to be overly pessimistic about direct taxation, as tax reform has significantly improved the contribution of direct taxes to overall revenue in many countries. A number of developing countries have reduced income tax rates on the wealthiest groups. In terms of individual income taxes, 34 of the 149 countries with data (or 22 per cent of the sample) had lowered the tax rates for the highest income earners in 2014, compared to the 2010-13 period (Ortiz, Cummins, Karunanethy, 2015). Thus, it is certainly possible to raise the share of direct taxation of the wealthy in developing countries and thereby enhance both legitimacy of the tax system and tax revenue through more progressive income taxes.

VI.3.2 Environmental taxes
There is also increasing recognition of the need to take action to limit emissions of greenhouse gases and further reduce emissions of local air pollutants. Using traditional command-and-control environmental regulation to accomplish those goals would be costly. Environmental taxes, such as carbon tax, environmental taxes or pollution charges (e.g., motor fuel tax), have the potential to address both of those issues, providing a source of new tax revenue and a cost-effective way to reduce pollution emissions. One of the most cited examples in developing countries is China’s sulphur tax, introduced in 2006. Vietnam’s environmental tax law came into effect in January 2012. Some developing countries, such as Colombia, also have effluent taxes. China’s existing complex Pollution Levy System addresses water- and air-borne pollutants. While these taxes are aimed primarily to address environmental issues, they also raise substantial revenues which can be targeted for developmental use. A UNU-WIDER discussion paper shows that a global carbon tax alone has the potential to raise sufficient revenue to finance the United Nations’ Millennium Development Goals (Sandmo, 2003).

VI.3.3 Resource rents
Natural resource taxes can be part of the environmental taxation package. Since non-renewable resources do not require inputs to create them, companies can earn supernormal profits or economic rents. Governments in resource-rich countries can capture these rents either by directly extracting natural resources through a state-owned enterprise, joint-ventures or other forms of co-extraction, or by selling off the exploitation rights and taxing the profits. A number of countries have effectively managed their natural resources through public companies, including Botswana (diamonds), Brazil (oil), Indonesia (oil and gas) and Malaysia (tin, oil and gas). Revenue raised through resource rents can be invested in other forms of physical capital (such as infrastructure) to offset the depletion of natural capital through natural resource extraction in order to preserve the same level of total capital.

Long-term concessions are the most common form of arrangement for renewable natural resources such as forests. Many countries also apply tax to exports of forest resources. However, non-compliance and corruption are major issues. For example, a 2007 study estimated Tanzania was losing up to 96 per cent of potential forestry tax revenues, or $58 million per year. On the other hand, some

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64 There are of course significant extraction costs; so this is not akin to plucking fruit from a tree.
countries have been able to improve compliance. In Cameroon, for instance, revenues grew from $3 million to $30 million between 1995 and 2001 (Spratt, 2013).

Fisheries is another area with revenue potential. Many African countries, for example, have signed fishing agreements with the European Union, allowing EU trawlers to fish in their waters. Similarly, Pacific Island countries have signed fishing access agreements with other countries. Revenues from such access agreements can be significant. The EU’s agreement with Mauritania, for example, generates $80 million annually, or 25 per cent of total government revenues (Spratt, 2013).

However, these arrangements are historically criticised for over-exploitation. Therefore, they should not be driven solely for revenue generation and must be consistent with the objective of sustainability. Revenues raised from these arrangements should be used to sustainable natural resource management and development of natural resource based industries.65

VI.3.4 Financial institutions taxes
Many countries are considering financial institutions taxes on their profits and remuneration. For instance, Turkey taxes all receipts of banks and insurance companies, and, in the United Kingdom and France, all bonus payments in excess of €25,000 are taxed by 50 per cent. Another example is a bank debit tax in Brazil, which charged 0.38 per cent on online bill payments and major cash withdrawals; before its discontinuation in 2008, it raised an estimated US$20 billion per year and financed healthcare, poverty alleviation and social assistance programmes.

At the international level, it has been estimated that applying a 0.005 per cent single-currency transaction tax on all four major currencies could yield up to US$33 billion per year for developing country assistance. And if applied more broadly to cover all financial transactions globally, a 0.01 per cent tax could raise over US$1.0 trillion annually (Leading Group on Innovating Financing for Development 2010).

Like environmental taxes, financial institutions taxes also achieve other desirable goals. These taxes are considered to curb excesses of finance such as speculative activities, not linked to the economic fundamentals, which were responsible for the GFC. Therefore, such levies and taxes contribute to financial sector stability.

VI.3.5 Excise taxes
These are another important source of revenue in developing countries as they have a buoyant base and can be administered at low cost. Many countries, however, either abolished or reduced exercise taxes with the introduction of GST or VAT. But from a revenue perspective, excise duties are more convenient, involving few producers, large sales volumes, relatively inelastic demand and easy observability. Excises may be levied on quantities leaving the factory or arriving at ports, thus simplifying measurement and collection, ensuring coverage, limiting evasion and improving monitoring. Excise taxes currently amount to less than 2 per cent of GDP in low-income countries, compared to about 3 per cent in high-income countries.

65 Spratt (2013) has provided a framework for environmental and natural resources taxes in developing countries.
VI.3.6 Miscellaneous taxes
There are a miscellaneous set of other taxes that can also be considered. They include property and inheritance taxes; airline and hotel taxes, tourism taxes; international transportation taxes; levies of taxes for social programmes; “sin” taxes (e.g., on cigarettes, alcohol or even sugary products that contribute to obesity), etc.

VI.3.7 Compliance
There should also be a greater effort to ensure better compliance with, and higher collection of existing taxes. Limiting the discretionary authority of tax officials could also help improve compliance and reduce evasion. Computerisation of tax administration can help limit corruption, as it makes it harder to tamper with records. Improved tax administration can increase the share of personal income taxes in total tax revenue. Expansion of the scope for tax deduction at source has been very effective in taxing those otherwise hard to reach. Every individual who is a house owner, vehicle owner, club member, credit card holder, passport, driving licence or identity card holder and telephone subscriber can be required to file a tax return.

VI.3.8 International tax cooperation
Finally, finance ministries and tax authorities in developing countries need to cooperate amongst themselves and with their counterparts in the OECD economies to learn from one another and to close existing loopholes in their mutual interest. With the huge and growing size of public debt as well as the real and imagined fiscal constraints to sustained global economic recovery, such cooperation is more urgent than ever. Here it would be pertinent to draw attention to ESCAP’s proposal to set up a regional tax forum to share best practices, avoid tax competition and stem illicit transfer of funds (see ESCAP 2014).

However, even after all these actions, we cannot expect the tax-GDP ratio to raise rapidly. The historical evidence reveals that increases in the tax-GDP ratio occur only slowly over time; dramatic increases from one year to the next are rare. More importantly, as highlighted earlier (Figure 17), countries tax capacity grows with income levels. As Ahmad and Stern (1989, p. 1014) highlighted, “A major option is taxation where the tools adopted and the revenue obtained will be a function of the pattern and organisation of production activities and the administrative capabilities of the tax authorities as well as the bases defined for taxation and the selected rates… scarcity of simple ways of collecting revenue, or ‘tax handles’, characterise early stages of development…” Cross-country comparisons suggest that the sorts of taxes that are possible change in the course of time.

Therefore, developing countries must examine alternative sources of non-tax revenues for sustainable development. The balance between tax and non-tax revenue is a central policy choice that faces most governments.

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66 As far back as in 1960, ESCAP, in its annual flagship publication, recommended to its member States to set up special tax courts to expeditiously deal with tax fraud cases.
VI.4 Alternative sources of revenue
As the IGCESDF report noted, there are adequate funds available. The overall saving rates in most developing countries have increased substantially from an average of around 18 per cent in the late 1960s to about 32 per cent in 2009 of their incomes, as reported in the World Bank’s Global Development Horizon. It also expects saving rates in developing countries to rise with higher income growth rate and redistribution of income from asset holders, who tend to be older and thus have lower saving rates, to workers who tend to be younger and thus have higher saving rates.

Figure 20 presents trends in private savings as a percentage of gross private disposable income (GPDI). The trends in the three sets of developing countries – high growth Asian, oil-exporting and low-income – reveal that income is a single most important determinant of private savings. The high growth Asian economies experienced a rapid rise in private saving rates as with their income. Private saving rates in oil-exporters have been volatile as their export income. The low-income developing countries, despite doing reasonably well, seem to have hit the limit of their low income levels. Thus, as tax revenues, private savings are constrained by income level (and growth).

Figure 20: Average private saving rates (GPDI) across country groups

Note: GPDI - gross private disposable income. Year averages are calculated on the unbalanced panel of 165 countries.

The fact that across countries higher saving rates tend to go hand in hand with higher income growth implies the existence of both ‘virtuous cycles’ of saving and prosperity and ‘poverty traps’ of insufficient saving and stagnation. As Loayza, Schmidt-Hebbel and Servén (2000, pp. 393-394) observed, “If virtuous cycles can be jumpstarted by a hike in aggregate saving, then the social value of saving would

exceed its private value in many developing countries, particularly poorer countries."

Policies to ease access to financial institutions (and instruments) and financial sector stability as well as monetisation of the economy do enhance private savings. Some countries employed government bonds or certificates as saving instruments in the absence of a well-developed financial sector. Others, for example Singapore and Malaysia, have mobilised significant amount of private savings during their early phase of development by using administrative methods, such as compulsory contributions to provident or retirement (pension) fund. Empirical evidence compiled by the World Bank’s research team shows that countries that increase the funding of their mandatory retirement programmes tend to achieve higher private saving rates (Loayza, Schmidt-Hebbel and Servén, 2000).

However, contrary to the conventional belief, the World Bank research team found that the effectiveness of tax incentives granted to private savers—typically on specific financial instruments—in raising national saving is mixed and, overall, not promising. Similarly, it casted doubts on the effectiveness of financial liberalisation—"Deeper analysis of …episodes of financial liberalisation fails to find a systematic direct effect on saving rates: it is clearly negative in some cases… positive in others … and negligible in the rest" (Loayza, Schmidt-Hebbel and Servén, 2000, p. 405).

Thus, designing right policies is critical.

Further challenge lies in finding ways to channel these private savings to sustainable development investment. As highlighted in Section III, one of the options—PPPs—preferred by the IMF and the World Bank as well as the donor community, had adverse impacts on fiscal space due to inadequate risk-sharing. Here we elaborate on PPPs’ contingent fiscal liabilities and their effectiveness in achieving SDGs. Then we consider the pros and cons of public borrowing from domestic sources—(i) the non-bank private sector and (ii) the central bank (also known as ‘printing money’), as an alternative avenue for fiscal space.

VI.4.1 Public-Private Partnerships (PPPs) not very promising
Public-Private Partnerships (PPPs) is one of the ways recommended by the IGCESDF report, endorsed in the Addis Ababa Action Agenda (AAAA). However, PPPs suffer from some serious problems both in terms of fiscal and sustainable development outcomes.

Inadequate risk sharing and contingent fiscal liabilities: PPPs are ideally risk-sharing arrangements between the government and the private investors who are generally thought to be better than the government bureaucrats at evaluating and managing risk. However, as noted by the IMF, government guarantees are “used fairly widely to shield the private sector from risk and are a common feature of PPPs”. The IMF (2004) also finds that the risk assumed by the private partner is under-priced and governments are forced to extend a guarantee to cover the price differential. This means considerable contingent fiscal risk as governments can be left bearing an unduly large share of the risk involved in a PPP and facing potentially large fiscal costs over the medium term. The problem is compounded as governments usually

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68 IMF Staff Team Led by Richard Hemming (2006)
treat PPPs as off-budget activities and hence their fiscal position does not adequately reflect the potential fiscal cost.

*More expensive than publicly funded projects:* Generally PPPs are found to be more expensive. For example, a European Investment Bank report, which compares the cost of 227 new road sections across 15 European countries, “estimate that the ex-ante cost of a PPP road to be, on average, 24 per cent more expensive than a traditionally procured road” (Blanc-Brude, et al, 2006, p. 2). The OECD (2008a) cautions that governments may have ‘cherry picked’ their best projects for delivery through PPPs; had these projects been delivered through public procurement, their performance may have been just as good.

*Doubtful development outcomes:* Researchers have also cast doubt about PPPs contribution to poverty reduction and inclusive development. One World Bank study finds that the private sector operators reaped the gains in savings in the form of higher profits without passing on benefits to the consumer. In its most recent evaluation of the World Bank’s involvement in PPPs, the Independent Evaluation Group (IEG 2014, p. ix) highlights the need “to shed more light on important aspects of public service delivery - for instance, access, pro-poor aspects, and quality of service delivery.” It notes that there is “not a single project with data available for all of the above-mentioned dimensions” and those on and pro-poor and fiscal effects are particularly sparse. Consequently, governments cannot assess how far PPPs benefited the poor. Based on a comprehensive survey, for instance, Joseph (2014, p. 6) concludes that PPPs in the health sector, are “a double-edged sword. Although they are able to provide large amounts of money, they do not allow for a holistic view of the healthcare concerns faced by a country”.

*Distort development priorities:* PPPs select a small number of the most profitable projects, and persuade governments to prioritise spending on these projects, even if this distorts the development of public services. In Africa, for example, they finance high-tech hospitals in a few urban centres where there are enough wealthy people to support private medicine, but not the universal networks of clinics or the salaries of staff needed to provide healthcare for the poor. Similarly, in the case of urban infrastructure, a World Bank research paper concluded that PPP is “inherently limited in scope for financing urban infrastructure for the wide array of non-commercial infrastructure services cities need… Local governments need good sources of public finance to fund those services, and some form of government borrowing is needed for major investments in these areas to avoid inter-generational inequities” (Annez, 2006).

After a systematic review of a large body of literature on PPPs in developing countries, the Evaluation Department of the Government of the Netherlands, (2013), concluded that (i) the evidence base on PPP evaluations is still scarce and hardly relies on sound and robust empirical counterfactual analysis; (ii) reported effects of PPPs are rather positive at output level, but also weak, mixed and negative effects

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69 IEG (World Bank) 2014
70 See Hall (2015)
are registered in several occasions; and (iii) the evidence of some development outcomes and effectiveness is rather weak.

Thus, it is unsurprising that PPPs have yet to become a major catalyst of investment in key sectors for sustainable development. Even in countries which make most use of PPPs, such as UK and Australia, they only account for about 15 per cent of all infrastructure investments; for most OECD countries the proportion is less than 5 per cent and, within Europe, PPPs represent little more than 5 per cent of all infrastructure investment.\(^7^1\)

However, it has to be noted that in light of the above limitations, the World Bank in association with the IMF has developed some PPP guidelines at the request of the G20. The EC and OECD have also worked on the subject as well as the UN Regional Commissions, such as ECE and ESCAP. All of them recommended more transparent accounting and reporting practices for PPPs.\(^7^2\)

### VI.4.2 Public borrowings remain viable

As Ahmad and Stern (1989, p. 1013) noted public domestic borrowing has to remain as one of the options for DRM since “the level of government expenditure and particularly of public investment in key areas of the economy has often been … a necessary ingredient of the development process.” However, there has been aversion to government borrowing, especially since the debt crisis of the 1980s.

**Borrowings from the non-bank private sector:** It is argued that government borrowings from the non-bank private sector do not positively add to savings and growth, ultimately risking debt sustainability. As mentioned in sub-section IV.6, two main channels are suggested through which this can happen – (a) crowding out and (b) increase in private savings to offset negative public saving (borrowing), called ‘Ricardian equivalence’.

As stated in Section IV, extensive research, even within the IMF, could not find convincing evidence to support the crowding-out claim. This is not surprising as the crowding-out view ignores the adverse effects that a depressed economy may have on investment through low demand, low profitability and financial crunches. Moreover, interest rate is only one factor to influence private investment; there are other factors, such as availability of quality infrastructure and human capital, which are more important for the private sector’s investment decision. So, if the government borrows for such productivity raising investment, there should be crowding-in of private investment.

It should also be noted that government borrowings contribute to the development of domestic bond market. For example, the US was a small underdeveloped country two centuries ago with serious financial problems as current least developed countries. Alexander Hamilton, the first Treasury Secretary,

\(^7^1\) See Hall (2015)

\(^7^2\) The Addis Ababa Action Agenda (AAAA, paragraph 48) commitment to hold “inclusive, open and transparent discussion when developing and adopting guidelines and documentation for the use of PPPs, and to build a knowledge base and share lessons learned through regional and global forums” is an important step to bring these various strands of work together and develop a more systematic approach towards the development of guidelines for PPPs.
established public credit and securities markets in the early 1790s which became a foundation of the US economic infrastructure and a bulwark for long-term growth. The US governments – federal and state – borrowed large sums during the 1820s and 1830s to build roads, canals and other transport infrastructures, including railways.

Surveys of empirical literature by the IMF and World Bank research teams also could not find robust empirical support for the so-called Ricardian equivalence hypothesis. As a matter of fact, Ricardo himself rejected this hypothesis as unrealistic.\(^73\) If Ricardian equivalence does not apply, especially when there are underemployed resources “a fiscal expansion through debt creation (rather than taxation) may lead to greater effective demand and higher incomes in the short run. In less-developed countries debt finance could be a mechanism for activating unproductively used funds in that government borrowing may lead to better developed capital markets (e.g. by introducing new ‘instruments’ for savings) so that there might also be some beneficial long-term effects” (Ahmad and Stern, 1989, p. 1025).

Thus, it is unsurprising that the negative relationship between government debt and growth is driven by outliers (debt-GDP ratio exceeding 100 per cent) as emphasised in Section IV (see Figures 8, 9 & 10). The IMF’s 2012 World Economic Outlook (October, p. 109) also noted that “there is no single threshold for debt ratios that can delineate the ‘bad’ from the ‘good’”. In its October 2014 World Economic Outlook, the IMF observed that “debt-financed projects could have large output effects without increasing the debt-to-GDP ratio, if clearly identified infrastructure needs are met through efficient investment”. The IMF’s October 2015 World Economic Outlook asserted that debt-financed public investment in infrastructure, education, health and social protection would boost aggregate demand and productivity.

These recent IMF findings corroborate with Ahmad and Stern (1989, p. 1024), that “… ‘tapping’ the resources of the ‘household’ sector through domestic borrowing may be seen as a ‘supplement’ or an alternative to tax revenues. Given that tax revenue involves collection costs and generates consumer resistance, which may be substantial in developing countries, and that the purchase of government securities is more or less voluntary, governments may well be tempted to make more use of the latter if financial markets and institutions permit.”

**Borrowings from the banking sector:** Public borrowings from the banking sector lead to increase in money supply. Borrowings from the central bank, effectively monetise public debts, and directly increase money supply and hence is also referred to as ‘printing money’. Government borrowings from commercial banks also have the effect of money creation if the commercial banks are not fully ‘loaned up’ and have excess reserves. If loans to commercial banks’ customers are not affected, there is a net addition to money stock.

If government spending through money creation leads to inflation, holders of money face a reduction in their purchasing power. Therefore, they may be forced to

\(^{73}\) Ahmad and Stern (1989) op cit. quoted Ricardo (1987, p. 247), “loan finance is a system which tends to make us less thrifty- to blind us to our real situation”. Thus, on the Ricardian view loan and tax finance differ with respect to their impact on capital formation; saving and capital formation being reduced by a switch towards domestic borrowing.
hold a larger volume of money to maintain their real balance, thus involuntarily transferring resources to the government through seigniorage - profit made by a government from additional currencies due to the difference between the face value of notes and coins and their production costs.\textsuperscript{74} It means, borrowing money from banks or inflationary financing is a form of forced savings. Inflation also increases tax revenues through bracket-creeping. This happens when tax-payers are pushed to higher income brackets as their nominal income rises with inflation.

However, inflationary financing is generally opposed on the ground that inflation retards growth and adversely affects the poor. But it ignores the fact that expansionary fiscal policy through public borrowings from the banking sector may cause output expansion and hence may not be inflationary. This would depend on a number of factors such as the structure of the labour market, the extent of underutilised capacity and resources, the foreign exchange regime, the demand for money and so on. Therefore, as in the case of debt-growth relationship, the negative inflation-growth relationship is driven by outliers (Figure 21), inflation rates above 25-40 per cent, according to Dornbusch and Fischer (1993), Fischer \textit{et al} (2002) and Bruno and Easterly (1998).\textsuperscript{75}

\begin{figure}[h]
\includegraphics[width=\textwidth]{figure21}
\caption{Inflation-growth relationship (1960-2010)}
\end{figure}

In sum, given the limitations in raising tax revenues and accessing the capital market, and dubious experiences with PPPs in either improving fiscal space or positive developmental impacts, the developing countries cannot avoid deficit financing, especially for much needed public physical and social investment. Such actions are unlikely to have adverse impacts either on private investment or on inflation. Instead, likely to enhance countries’ productive capacity.

\textsuperscript{74} It is also referred to as inflation tax - the penalty for holding cash at a time of high inflation

\textsuperscript{75} Stanley Fischer served as First Deputy Managing Director of the IMF from September 1994 to August 2001 and as Special Adviser to the Managing Director from September 1, 2001 until January 31, 2002. Michael Bruno was Vice-President and Chief Economist of the World Bank.
VI. Concluding remarks

The onus on fiscal policy remains substantial in developing countries for accelerating economic growth and structural transformation as well as for addressing worsening inequality. This role has become more daunting and complex after decades of neglect under the influence of the neo-liberal orthodoxy promoted through the IMF/World Bank’s aid conditionalities. Developing countries have to reverse more than four decades of trends in tax structures and expenditure patterns to favour growth, structural transformation and redistribution while improving fiscal policy’s stabilisation role.

Fortunately, a growing consensus has emerged in light of the experiences of neo-liberal experiments that there is no trade-off between growth and redistribution. Growing inequality is now seen as a threat to social and political stability which can undermine growth. In addition, growing inequality depresses effective demand which can only be maintained through unsustainable increases in household debts. Thus, there is also growing recognition of the need to address rising inequality and balance fiscal policy’s development and stabilisation roles.

While selective, this paper has discussed some of the ways how fiscal policy can be re-oriented for growth, redistribution and stabilisation. Growth promoting and access enhancing public investment – physical and social – has to play a central role in this regard. Such public investments do not threaten macroeconomic stability; instead, expand fiscal space through their growth effects, and a larger fiscal space means greater ability to consistently pursue counter-cyclical fiscal policy. While a progressive tax structure along with a well-designed transfer system is an essential element of distributive fiscal policy, also supports counter-cyclical fiscal policy through stronger automatic stabilisers.

This paper has discussed, for example, how the tax system can be reformed to expand fiscal space and at the same time address inequality as well as achieve environmental sustainability and financial sector stability goals. However, there is no denying that the task is challenging and there is no ‘one-size-fits all solution’. Designing detailed policies has to take into account country specific circumstances; this paper has only highlighted some of the major challenges that developing countries face in some key areas of fiscal policy: their tax structure, and fiscal space.

The task is enormously daunting for low- and lower-middle-income developing countries which have limited scope for expanding their fiscal space through tax revenues, while their public investment needs for the SDGs are huge. Illustrative simulations at the IMF (Baum, et al, 2017) reveal that the fiscal space available in low income countries will be insufficient to undertake the spending needed to achieve the SDGs, even under benign conditions. Traditional approaches, such as improving public investment efficiency and domestic revenue mobilisation can somewhat narrow the gap, but will still fall far short of what is required. They cannot avoid resorting to deficit financing through borrowing from the banking sector.

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76 For example, according to UN estimates, low-income countries will have to increase their annual public spending by up to 30 per cent of GDP to achieve the SDG. See (Baum, et al, 2017).
But recent commodity price drops have accelerated the rising indebtedness of low-income countries. According to the IMF (2018), 24 out of 60 (40 per cent) are now either already facing debt crises or are highly vulnerable—twice as many as five years ago, with a few already seeking IMF bail-outs. Rising interest rates due to monetary policy normalisation in the US and other major countries can lead to a full blown debt crisis, similar to the one in the 1980s. Meanwhile, growing trade and currency conflicts are worsening the woes of those already worse-off.

Therefore, urgent actions are warranted on the part of the international community to devise debt forgiveness mechanisms similar to the Highly Indebted Poor Country Initiative (HIPC) of the 1990s, which significantly improved fiscal space and social public spending in low-income indebted countries. The problem is compounded this time by declining concessional aid from OECD countries. Also, more creditors are not part of the Paris Club, obliged to deal with sovereign debt on less onerous terms.

Middle-income and emerging economies, which were able to pursue counter-cyclical fiscal policy in response to the 2008-2009 GFC, also face challenging circumstances as inequality has risen in a number of them and their growth remains much below the pre-crisis level. According to a World Bank study (Kose, et al. 2017), fiscal space has shrunk in many emerging market and developing economies since the crisis. They, therefore, too may have to consider deficit financing to promote growth and distribution.

However, extreme care is needed when it comes to borrowing externally, and regardless of sources of borrowing, the aim must be productivity enhancing public expenditure. That is, the emphasis should shift from ‘prudent finance’ that judges fiscal policy from the perspective of pre-determined (presumably ‘optimal’) nominal values of debt and deficits to ‘functional finance’ to carefully assess the growth and distributional impacts of public expenditure and taxation. Functional finance advocates matching expenditures with long term benefits they generate.

Finally, while the paper advocates a pro-active fiscal policy framework with public investment at the centre, it does recognise that it may fall prey to wide-spread corruption or profligacy. However, the paper takes the view that technocratic insulation of fiscal policy though such institutional fetters as ‘fiscal rules’ and ‘independent fiscal authority’ in order to depoliticise fiscal policy and supposedly prevent corruption and ‘pork-barrelling’ are unlikely to ensure fiscal policy’s effectiveness and fiscal sustainability. On the other hand, they undermine democratic governance.

Institutional frameworks, such as ‘performance-based budgeting’ and ‘participatory budgeting’, which augment democratic accountability, are likely to have a better chance of succeeding. In this context, instead of an independent fiscal authority to devise and implement some kind of ‘depoliticised’ fiscal rule, an independent authority similar to the US Congressional Budget Office can be considered. Its job would be merely evaluate costs and benefits – financial, social and environmental – of proposed fiscal programmes of the government and opposition.

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77 Approximately 30 member countries of the Organisation for Economic Co-operation and Development (OECD) have established such institutions. Most have been established since the 2008 global financial crisis.
parties. It helps level the playing field for all political parties in their access to policy costings and budget analyses. It also enhances the transparency and public understanding of the budget and fiscal policy settings so that the voters can make informed judgements.

It may also be useful to follow some kind of “golden rule” (Roy and Weeks, 2004) that requires balancing the current budget (recurrent expenditure) and limiting the deficit in capital account to a sustainable level in accordance with the long-term returns generated by capital expenditures. The separation between recurrent and capital budget can allow for greater transparency in the budget process, with the overall objective of ensuring control over profligate consumption expenditure, especially in the government’s wage bill.

References


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78 Of course, a neat separation between current and capital budgets is not possible as capital projects cannot be implemented without also paying wage bills.


ESCAP (2014), Economic and Social Survey of Asia and the Pacific 2014, Bangkok


Fiscal policy – Anis Chowdhury


