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REPORT OF THE EXPERT GROUP MEETING ON FISCAL POLICY REFORMS IN THE LEAST DEVELOPED COUNTRIES

Geneva, 16-17 March 1995

Preparatory process for the
High-level Intergovernmental Meeting

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INTRODUCTION

1. The Secretary-General of UNCTAD convened the Expert Group Meeting on Fiscal Policy Reforms in the Least Developed Countries from 16 to 17 March 1995 in Geneva as part of the preparatory process for the High-level Intergovernmental Meeting on the Mid-Term Global Review on the Implementation of the Programme of Action for the Least Developed Countries for the 1990s, scheduled to be held in New York from 25 September to 6 October 1995. Fiscal policy experts from 8 least developed countries (Bangladesh, Cape Verde, The Gambia, Malawi, Mali, Nepal, Uganda, Zambia), representatives of the World Bank, the African Development Bank, the International Monetary Fund, the Economic and Social Commission from Asia (ESCAP), and academicians participated in the meeting. The former Minister of Finance of Tunisia also participated. The list of participants is given in annex I of this report. Annex II contains a list of documents prepared for the Meeting.

2. In his **opening statement,** Mr H.A. Diallo, Director-in-Charge of the Division for Least Developed, Land-locked and Island Developing Countries, drew attention to the effects of persistent fiscal deficits in many LDCs on their economic performance. The conjuncture in the 1980s of adverse commodity and capital markets and changing perceptions on the role of government and the increasing demand for private participation in economic development had driven reforms in the tax system in ways which would be more responsive to economic growth.

3. Tax systems then in place in many LDCs had displayed a number of remarkably similar characteristics which adversely affected resource mobilization and allocative efficiency. Heavy reliance on taxes on international trade coupled with an unrationalized and distortionary basis of rate differentiations, exemptions, and preferences, had resulted in a tax system which was inequitable in operation, difficult to administer and harmful to economic growth. Moreover, changing perceptions on the role of government and, in their wake, the increasing demand for private participation in economic development had lent urgency to reforms in the tax system in ways which would be more responsive to economic growth and emerging needs.

4. While there were significant inter-country variations in the design of reforms and treatment of specific issues, fiscal reforms in LDCs were similar in their broad orientations. In most countries, their initial objectives had been targeted on expenditure compression to restore macro-economic stability. On the revenue side, the main orientations were: expansion and diversification of the tax base away from international trade taxes in favour of more broadly based consumption or a modified version of the value added tax; elimination of the disincentive effects arising from onerous levels of taxation; reduction of the distortionary effects of differential taxation of different assets goods and sectors of the economy with the aim of encouraging domestic competition and improving incentives for private-sector activity and protection of vulnerable groups through non-regressive taxes. More recent reforms had concerned improvements in

administrative efficiency in revenue collection and the management and control of public expenditures.

5. Finally, he pointed to the differential needs and scope for tax reforms at the country level, taking into account specific country circumstances and initial conditions, implementation capacity, and socio-economic policies and priorities. Experts were invited to deliberate on a tax agenda for LDCs for the rest of the 1990s on such issues as options for broadening and deepening the tax base and, in particular, widening the application of the VAT; reducing the inequitable aspects of the fiscal systems; rationalizing customs and import tariff structures; strengthening implementation and enforcement capacity; and the adoption of poverty-sensitive approaches in restructuring expenditures.

I. SUMMARY OF DISCUSSIONS

6. The experts addressed wide-ranging fiscal issues on the basis of oral presentations and various papers, for example, "Tax structures in LDCs and the objectives of tax reforms", "Commodity taxation and the value added tax", "Raising public revenues in low-income countries; options and issues", "Budgetary crisis and revenue support for transitional developing economies: the case for Cambodia", "Public expenditure analysis", "Improving expenditure management and controls in low-income countries", "Poverty alleviation in a financing programming framework", and the "Sequencing of fiscal policy reforms with other macro-economic policy reforms" (ct; annex II). Several LDC participants provided information on their own country’s experiences in carrying out different aspects of fiscal policy reforms.

A. General Issues in tax reforms

7. Some of the key areas for reforms in LDCs’ tax systems highlighted by the experts were: the need to raise tax ratios; to broaden the tax base including diversification of the range of tax instruments away from trade taxes towards, *inter alia,* the value added tax (VAT) and other direct taxes such as income taxes; to improve stability in tax revenues while encouraging compliance. The latter includes such aspects as political commitment, reducing exemptions, improving the transparency of fiscal processes and strengthening of tax administration.

8. While, in theory, the design of tax systems should satisfy the criteria of elasticity, simplicity, equity and efficiency, fulfilment of all four criteria was a complex task and may be well beyond the design and implementation capacity of LDCs. At their present stage of economic development, priorities should perhaps be focused on achieving the objectives of elasticity and administrative simplicity. With regard to former, it was desirable for the tax system to aim at achieving dynamic elasticity; this approach would lead to the exploitation of new tax handles and growing sources of tax bases which would emerge with economic growth.

9. Concentration on the objectives of simplicity and elasticity in the design of tax systems does not necessarily interfere with the

ability to take into account equity considerations. This objective could be built into the tax system by the institution of progressive forms of taxation and priority expenditure allocations in sectors beneficial to vulnerable groups. Periodic assessments of revenue responses of various tax sources to changes in the economy would be helpful in assessing elasticity and in developing revenue forecasts.

B. Revenue reforms

10. Regarding the experiences of Asian LDCs in broadening the tax base, it was noted that the reforms had been more extensive with respect to indirect taxes than for indirect taxes, logically because of their disproportionately large contribution to total tax revenues in LDCs. Efforts to broaden the base of direct taxes in these countries had encompassed such measures as the reduction of exemptions, extension of the income tax net to a wider number of entities (eg. all wage earners), introduction of presumptive taxes on "hard-to-tax" groups (e.g. doctors, lawyers, small business establishments), reduction in the highest marginal tax rates, as well as the number of rate slabs.

11. Efforts to broaden the base of indirect taxes usually involved the introduction of VAT, extension of existing sales or turn-over tax to include additional goods and services, and imposition of new taxes along with reductions in the overall tax rates, especially in the case of import duties where rate reductions were accompanied by reductions in the dispersion of rates applicable to different import categories.

12. The strengthening of tax administration and enforcement through such measures as the withholding of tax at source, centralization and computerization of the tax collection system, and improving institutional capacity through staff training had also contributed to the broadening of the tax base in Asian LDCs.

13. The above measures had positive effects on tax buoyancy. Thus, five out of a sample of seven LDCs in the Asia-Pacific region (Bangladesh, Bhutan, Lao PDR, Maldives, Myanmar, Nepal and Solomon Islands) managed to increase the average revenue (excluding foreign grants) to GDP ratio during the period 1990-1993 as compared to 1985-1989.

14. Political commitment, the integrity of governments, their authority in preventing the abuse of power and their ability to resist pressure groups were important considerations in the success of efforts to broaden the tax net and to raise revenues. Rationalization of rate structures and categories and reduction of exemptions were also singled out as relatively effective measures in raising revenues.

15. Questions were raised on how best to bring the rural/agricultural and informal sector into the tax net. The potential for capturing revenues from the rural sector was illustrated by the case of Mali where tax revenues from the sector contributed to only 2 per cent of GDP, which was negligible in comparison to the size of the sector's share in GDP of about 50 per cent. Similarly, it was acknowledged that

the informal sector represented considerable potential for raising revenues since incomes generated often exceeded those in the formal sector. To capture revenues from the latter source, LDCs such as Mali, for example, had begun to implement a series of taxes on imports of products used by the informal sector, as well as on sales of factories to retail outlets. These measures had facilitated the identification of potential taxpayers in the informal sector with commercial links to the State or its enterprises.

16. On the issue of taxing exports, it was acknowledged that many LDCs practised implicit taxation of exports through overvalued exchange rates. This implicit form of taxation was often more dominant than direct taxation of exports. While in general the rationale for export taxes was weak, there was a case for direct export taxes if there was a risk of natural resource depletion and if production was dominated by large concerns or multinationals which would otherwise escape taxes because of inadequate domestic income or corporate taxation systems. But whether such taxes were an effective means for taxing corporations would ultimately depend on the ability of the exporter to shift the incidence of tax. Increased globalization and competition, however, cautioned host governments to be pragmatic in the design of their tax and regulatory framework if they were to compete effectively for foreign investment.

17. Broadening the tax base had important implications for absorptive capacity in LDCs. Hence administrative and institutional reforms are necessary pre-conditions for underpinning tax reforms. Several participants expressed the view that, in situations of severe institutional constraints, it was preferable for the tax effort to concentrate on a relatively smaller range of taxes with good revenue potential rather than disperse collection efforts over a wider range of taxes which were beyond the authorities’ capacity to administer and enforce effectively.

18. On the issue of privatizing tax collection, the general view was that many pragmatic difficulties stood in the way of effective privatization. Firstly, the benefit of potential rents extractable by private tax collectors would, in most cases, far outweigh any compensation package intended to deter them from corruption. Secondly, there was the risk that privatization into the hands of a private monopoly would perhaps pose greater risks to efficiency gains than those generated by public monopolies. Third, legal impediments stood in the way of privatization in some countries, such as Zambia whose constitution explicitly vests authority for tax collection in the Ministry of Finance. Privatization of pre-shipment inspection, for example through the Swiss Sociéte Générale de Surveillance (SGS) system, was thought by some experts to be quite helpful in preventing tax evasion and under-invoicing, but the costs were said to be quite prohibitive. In this connection, the proper motivation and adequate compensation of tax collectors/customs officials through bonuses and other incentive schemes were thought to be important in effective tax administration. But authorities had to be vigilant in determining when such schemes had outlived their usefulness and should be withdrawn.

C. Expenditure reforms

19. On the issue of expenditure reforms, the considerable efforts of several LDCs in containing expenditure through reform of public enterprises - including privatization, retrenchment of the civil service, reduction of fringe benefits and more rigorous screening of capital expenditure - was widely acknowledged. Citing the experiences of seven Asian LDCs, one speaker noted that the average annual growth of current expenditure during the period 1990-1993 was below the level attained in the 1985-1989 period in six out of the seven cases, the only exception being Maldives. With regard to capital expenditure, the average growth rate in the period 1990-1993 in four (Bangladesh, Lao PDR, Maldives and Nepal) out of seven countries was lower than the average annual growth rate in current expenditure; for another three (Bhutan, Myanmar and Solomon Islands) the opposite held. Hence, the generalization that LDCs' success in containing public expenditure largely emanated from curtailment of capital expenditures, while it may be true for African LDCs, is not necessarily true for their counterparts in the Asia-Pacific region.

20. The structure of government expenditure had important medium and long-term implications for economic performance and national solvency and creditworthiness. A key issue is whether expenditure patterns were directed towards the strengthening of the productive base; this in turn had potential implications for the sustainability of tax revenues, government solvency and political stability. Changes in the structure of expenditures which reduced non-productive outlays in favour of increased productive investment in socio-economic infrastructure would have profound implications for medium and long-term national solvency, even though their short-term impact on the budget may be neutral. On the other hand, short-term budgetary improvements achieved through compression of productive expenditures or postponement of such vital investments as human capital formation would have negative implications for growth and national solvency, with potentially undermining effects on political stability. In this connection, it was acknowledged that the fragility of political and social systems in Sub-Saharan Africa, justified a minimum level of defence expenditures.

21. The need for greater rationalization of government expenditure allocations was emphasized. Privatization and other reforms aimed at improving the performance of parastatals and reducing their burden on State budgets were some alternatives for rationalizing State budgets. But such measures were hampered by the lack of a viable private sector in many LDCs and by the underdeveloped capital markets. Given the LDCs' low level of development and their vast needs for investment resources, the vital role of external assistance in underpinning reforms was underlined. However, global investment norms suggest that countries should aim at an investment ratio of 25 per cent of GDP for long-term economic viability. Prospects for attaining this level of investment would, however, hinge critically on stepping up domestic resource mobilization, since country experiences suggest that over the long term the contribution of external capital flows to investment programmes would, for most countries, not exceed 2-3 per cent of GDP.

22. Rationalizing the structure of expenditures, moreover, required a clear specification of objectives sector by sector and an assessment of what should constitute a reasonable cost for delivering essential services. Devising performance indicators was thought to be useful in providing warning signals to policy- makers on the need for fiscal intervention as, for example, when military expenditures exceed combined expenditures on health and education.

D. Some pre-conditions for the success of reforms

23. Reform success was predicated on such factors as initial conditions, political stability, the credibility of reforms influenced by such factors as their breadth and scope, policy compatibility and consistency, and the degree of internalization of policy measures. The timing and sequencing of policy changes was also thought to figure importantly in reform success. For example, premature moves to liberalize the capital account before full implementation of trade reforms had resulted in capital flight in some countries.

24. Strong political commitment, although essential, was not sufficient in itself to ensure the success of reforms in the fiscal system. Given weak implementation capacities in LDCs, institutional reforms must underpin reforms in the tax system.

25. Reforms would also need to take into account the absorptive capacity and specific circumstances of each country. For example, it would be unrealistic to attempt to impose property taxes in countries without the prior establishment of a detailed registry of properties. Similarly, for VAT to function effectively, it was necessary to lay the institutional groundwork in terms of sound accounting and invoicing systems. The quality in the design of each tax would also figure among the success factors in reform programmes. In this connection, the importance of monitoring reforms with a view to identifying and rectifying implementation problems was emphasized. In Cambodia, for example, a tax on the value of construction was found to be detrimental to investment and had had to be subsequently withdrawn.

26. A no less important factor in reform success was the quality of tax administration. In this connection, tax administration and enforcement should be concentrated on large tax payers and revenue sources. To the extent that reforms produced winners and losers, experts acknowledged the importance of public information and education in mobilizing support for reforms.

27. The role of external financing in hedging against policy reversals in the face of external shocks was also recognised as fundamental to reform success and durability.

II. CONCLUSIONS AND POLICY IMPLICATIONS

28. The following are the main conclusions and policy implications to emerge from the Expert Group Meeting:

A. General issues

(1) The Expert Group Meeting in the context of wide consensus on the desirability of market-oriented systems, examined the issue of fiscal policy reforms to promote economic growth and balance-of-payments adjustment in an acceptable manner. In recent years, several LDCs have made considerable efforts in implementing major tax revenue and expenditure reforms. The experts took into account the mixed results of such policy efforts, individual country circumstances and their differential needs for continuing tax reforms.

(2) It is not possible to lay down uniform prescriptions for reforms that will fit all countries in all circumstances. Components, timing and sequencing details will vary from country to country, depending upon the circumstances prevailing when the reforms are initiated, the preparations made and the implementation capability.

(3) It is, however, possible to discern some general principles which can help guide the reform process in general, and fiscal reforms in particular. But the success of these efforts is predicated on full political commitment and accountability of governments and transparency of fiscal processes.

(4) It is important to recognize at the outset that fiscal reforms are generally a component of a broader reform package. Typically this includes, *inter alia,* trade, exchange rates and other macro-economic and sectoral policy reforms. It is vital to recognize the links between different components of a reform programme to ensure policy consistency and compatibility.

(5) Fiscal adjustment involves both short-run and long-run objectives. Short-run objectives are essentially targeted at reduction of the budget deficit, containing inflation and attaining balance in the external accounts, to provide a stable foundation for longer-term reforms, as well as to gain credibility for the entire process.

B. Revenue tax

(6) In pursuing reforms aimed at revenue enhancement, the emphasis should be on sustainable reforms. Such reforms should in turn emphasize revenue productivity. A high elasticity of revenues is most desirable. The aim should be to develop dynamic elasticity where a simple and well administered tax system results in emerging or rapidly growing bases so as to raise the revenue ratio over time. Rather than rely on progressive tax systems to generate high elasticity, simple, flat rate (or less differentiated) tax systems including those which rely on dynamic growth in VAT bases and well motivated increases in administrative and collection efficiency may be preferable.

(7) In the short run, efforts should focus on improving administrative efficiency and exploiting more fully the existing tax base, for example by reducing exemptions and improving compliance (e.g. by improvements in the rate structure) while containing the growth of public expenditure.

(8) Experience has shown that short-run stabilization of the budget, and initial reforms to the tariff structure can be achieved without revenue depletion.

(9) Medium-term and long-term objectives of tax reform should be targeted at broadening the coverage of taxation and developing new tax handles, including the mobilization and well managed utilization of non-tax revenue sources such as those emanating from exploitation of natural resources. This will enhance stability by reducing dependence on trade taxes and increasing reliance on direct taxes and broader expenditure-based taxes. Experience has shown not only that these are more efficient instruments, but that they are essential to enhancing the elasticity of tax systems and less harmful to international competitiveness.

(10) Several criteria can be used in evaluating alternative tax handles, in particular elasticity, efficiency, equity and administrative simplicity. It is possible to use these criteria to inform choices between alternatives.

C. Expenditure/Outlays

(11) Medium and long-term objectives of expenditure reform should focus on the composition of government expenditures, not only in terms of the balance between current and development expenditure, but also among components of current expenditures, taking into account the objectives they are intended to serve. Experience has shown that development expenditure is usually more vulnerable than current expenditure to expenditure restraint.

D. Implementation and capacity building

(12) To be successful, reforms in general and tax reforms in particular must be appropriately underpinned by training and administrative support. With more complicated taxes such as VAT, this means making adequate provision for training and appropriate information prior to the tax reform. It also means that, as the tax is broadened in its coverage, training needs are realistically assessed and dealt with. The multilateral agencies have a key role to play in providing technical assistance. Additional external financial assistance would also be required to offset, particularly, the adverse effects of reforms on vulnerable groups in order to sustain political commitment to reforms. To assess the success of particular actions, countries need to devise selected performance indicators that reflect the effectiveness and efficiency of measures taken, the degree of compliance, and the impact on society.

(13) The Meeting emphasized the need for capacity-building and improving conditions of service so as to create efficient local

institutions for promoting and sustaining reforms.

E. Issues for research

(14) More research is needed on (a) macroeconomic framework of analysis which would provide better guidance on fiscal targets; (b) examination of optimal allocations of government expenditures; (c) development of dynamic revenue bases; (d) developing modalities of effective restructuring and motivation of administrations; (e) providing modalities for greater private sector participation; (f) desirable rules of thumbs or norms for guiding behaviour, especially of policy-makers.

III. ORGANIZATIONAL MATTERS

A. Elections of officers

29. At its opening meeting on 16 March 1995, the Expert Group Meeting elected the following officers: Chairman: Mr James Mtonga, Permanent Secretary, Ministry of Finance (Zambia); Vice-Chairman-cum Rapporteur: Professor David Greenaway (University of Nottingham, United Kingdom).

B. Adoption of the agenda

30. The agenda was adopted at the opening meeting, as follows:

1. Opening of the Meeting, adoption of the agenda and organization of the work of the Meeting
2. Main issues on fiscal policy reforms in LDCs
3. Presentation of country studies and experiences
4. Conclusions.

C. Conclusions, recommendations and report of the Meeting

31. A group was set up to prepare the conclusions and recommendations of the Meeting. At its closing meeting, on 17 March 1995, the Expert Group Meeting adopted its conclusions for inclusion in the report on its session. (For the conclusions, see section II, para. 28 above).

Annex I

LIST OF PARTICIPANTS

1. Mr. Moncef BEL HAJ AMOR
Former Minister
Tunisia

2. Mr. Sheetal CHAND
Division Chief
International Monetary Fund

3. Mr. Ian DANSON
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5. Mr. Marcos EVANGELISTA
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African Development Bank
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8. Prof. David GREENAWAY
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9. Mr. Azizul ISLAM
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10. Mr. Saiful Islam KHAN
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11. Mr. F. Desmond MCCARTHY
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12. Mr. James MTONGA
Permanent Secretary
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13. Mr. Mambury NJIE
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14. Mr. Patrick SINYINZA
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15. Mr. Govinda BAHADUR THAPA
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16. Mr. Marcel VAN DER KOLK
First Secretary
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17. Mr. Michael WARD
Principal Economist
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l8. UNCTAD secretariat
- Mr. R. Lawrence
- Mr. H.A. Diallo
- Mr. C.K. Patel
- Ms. S. Toh

Annex II

LIST OF DOCUMENTS

- Fiscal Policy Reform in the Least Developed Countries
  A secretariat Background Note (UNCTAD/LDC/GE.2/5)

- Poverty Alleviation in a Financing Programming Framework: An Integrated Approach (UNCTAD/LDC/GE.2/2)
  by **S.K. Chand and P. Shome**, Fiscal Affairs Department, International Monetary Fund

- Commodity Taxation Including Value Added Tax: The Case of Bangladesh (UNCTAD/LDC/GE.2/3)
  by **Saiful Islam Khan**, Member National Board of Revenue (VAT), Bangladesh

- Budgetary Crisis and Revenue Support for Transitional Developing Economies: The Case of Cambodia (UNCTAD/LDC/GE.2/4)
  by **Michael Ward**, Principal Economist with the International Economics Department, World Bank

- The Fiscal Balance Act: the Conventional Perspective
  by **Michael Ward**

- Notes on Improving Expenditure Management and Controls in Low-Income Countries (UNCTAD/LDC/GE.2/6)
  by **James Kahoza**, Auditor General of Uganda

- A Note on Fiscal Policy Reforms in Asia-Pacific LDCs
  by **Azizul Islam**, Director, Development Research and Policy Analysis Division, ESCAP, Bangkok

- The Gambia's Experience with Tax Reform
  by **M.B. Njie**, Principal Economist and Head of Macroeconomic and Financial Analysis Unit, The Gambia

- Fiscal Stabilization and Economic Growth in LDCs
  by **Oladunjoye Fajana**, Economist with African Development Bank, Côte d'Ivoire

- Le développement des récettes publiques dans les pays à faible revenue
  A partir du cas du Cambodge
  by **Moncef Bel Haj Amor**, (Former Minister, Tunisia) Consultant, Banque Mondiale-PNUD-MDP

- Raisons historiques et principes généraux de la réforme fiscale au Cap-Vert
  by **Marcos Evangelista**, Directeur-Général des Impots du Gouvernement du Cap-Vert