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Policy Brief

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Overview

Growth, poverty reduction, and social peace are all undermined when public expenditure management and taxation are weak and when the fiscal deficit and public debt are not managed successfully. And large-scale aid and debt relief cannot work without a good fiscal system. The macroeconomic frameworks of many poor countries are improving, but fiscal policy's full potential will not be realized until good and accountable expenditure and taxation systems are built. Good fiscal policy can raise economic growth through well-chosen public investments provided that the spending is large enough. Growth itself increases the tax base generating the potential for higher public spending on poverty reduction. Fiscal reform can be a tool for peace when an unfair distribution of spending and taxation generates grievances that turn violent. Overall, fiscal policy reveals more about the political priorities underpinning a country's development strategy than any other area of policymaking.

Policy Brief written by Tony Addison, Alan Roe and Matthew Smith

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Fiscal Policy for Poverty Reduction, Reconstruction, and Growth

AN EFFECTIVE STATE IS ABLE TO MOBILIZE REVENUE AND SPEND it on infrastructure, services, and public goods that both enhance human capital and the well-being of communities (especially the poor), as well as stimulating investment and employment creation by the private sector. An effective state also manages public finance to ensure that macroeconomic balance is maintained—with policy neither too restrictive to discourage private investment and growth, nor too accommodative to create high inflation and crowd out private investment. Fiscal issues are therefore at the heart of the state's role in the development process and failure in this policy area—whether it is in taxation, public expenditures, or in managing the fiscal deficit and public debt—can quickly undermine growth and poverty reduction. Fiscal weakness can also be fatal to social peace when one or more ethnic, religious, or regional groups are taxed unfairly—or receives too little in the allocation of public spending.

These and other crucial issues are addressed in *Fiscal Policy for Development: Poverty, Reconstruction and Growth*, edited by Tony Addison and Alan Roe, and now published in paperback by Palgrave Macmillan for UNU-WIDER. The book reviews all of the major areas of fiscal policy, setting out and assessing how thinking around public spending, taxation, and the macroeconomics of fiscal reform have evolved, particularly towards reducing poverty, accelerating growth, and preventing conflict.

Aid Can Not Be Effective Without a Good Fiscal System

Fiscal policy is central to the continuing debate over aid effectiveness. The pioneers of development economics in the 1950s and 1960s assumed that the basic structures of public expenditure management and taxation that we take for granted in rich countries would not take too long to establish themselves in post-independence Africa and Asia. However, they were sorely disappointed in many of the new African states (and in some of the Asian ones as well). In the 1970s poverty reduction was, for the first time, placed at the forefront of development; aid was intended to help governments meet basic needs, but the assumption was again made that the associated pro-poor public spending would not be too difficult to organize. Pessimism set in with the 1980s and aid flows became organized around highly

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controversial programmes of structural adjustment, including fiscal reforms that often included crude mechanisms to curb public spending and bring fiscal deficits down (frequently resulting in unnecessary cuts in already low levels of pro-poor spending). By the 1990s aid lending had created a fiscal burden of debt-service that took resources away from development and poverty spending, and the Heavily Indebted Poor Counties (HIPC) Initiative together with the Multilateral Debt Relief Initiative (MDRI) are as a result freeing up 'fiscal space' (see the companion volume *Debt Relief for Poor Countries*, edited by Tony Addison, Henrik Hansen, and Finn Tarp, also published by Palgrave Macmillan for WIDER). Towards the end of the decade a start was made in shifting away from project aid and towards budgetary support, as country 'ownership' came into vogue. This trend continues today, although it periodically stumbles over the governance dimensions of fiscal policy—not least in countries reconstructing from conflict and those in unstable regions such as the Horn of Africa and Africa's Great Lakes region.

Inevitably much of the aid debate, while certainly well-meaning, has been broad-brush, sometimes simplifying the issues in order to gather public support for mobilizing more money. Amidst the earnest pleas for more aid and debt relief, there are dissenting voices, arguing that the poorest countries will find it difficult to absorb and effectively use the additional monetary resources. Certainly for those working on fiscal issues at the country-level, how best to use aid (and domestic revenues) has always been a priority issue, and one that poses tough choices for public finances, which cannot be glossed over. At the heart of the issue of aid effectiveness (as well as the related impact of debt relief) is state capacity in poor countries. This includes the quality and honesty of the public administration, and its ability to channel resources to their best uses.

Good Fiscal Management is a Difficult Business in Poor Countries

Development does not proceed very far without a supporting macroeconomic framework, consisting of monetary, exchange-rate, and fiscal policies. Macroeconomic policy has to be flexible to deal with large-scale shocks—a change in the fortunes of a major export earner, for example—but also credible; entrepreneurs, both large and micro, will be reluctant to invest if they believe the government to be only weakly committed to its chosen policies. Constructing an effective macroeconomic framework is therefore a delicate art, and many governments tend to veer from one extreme to the other, sometimes spending like there is no tomorrow (blowing the revenues from a temporary commodity price boom is always a political temptation) and sometimes being so restrictive that development and poverty spending are

Taxing and spending decisions are inherently political and therefore conflictual (some violently so). But weak institutions may fail to implement plans effectively, and macroeconomic shocks can overturn the best-crafted of spending programmes.

cut to the bone. Hence, there is a fine line to be walked in keeping an economy growing to generate more and better livelihoods, and keeping it stable so that inflation does not reach levels at which it undermines growth—'not too hot, not too cold', is the prescription.

By the mid-1990s a measure of fiscal stability had been achieved in most poor countries as a result of the stabilization programmes, often draconian, begun in the 1980s (with, however, some spectacular exceptions, notably Angola and the Democratic Republic of the Congo). The WIDER study finds that that low income economies have mainly emerged from this period of tight fiscal discipline with an average budget deficit of 3% of GDP, low inflation, and a marked recovery in GDP growth—albeit growth from the pit of a deep recession. But the debt picture is bleak; the WIDER study also finds that many low-income countries have levels of domestic debt that are unsustainable. For some this acts as a drag on growth since they need to keep interest rates high in order to attract capital (which, in itself, adds to the interest burden of debt and, in the worst cases, the debt-service burden can get out of hand, growing explosively and resulting in an unsustainable fiscal position). Donors provide much-needed concessionary finance but they can also create problems as well; failure and delay in disbursements exacerbate government problems in running tight budgets. And aid in aggregate is easier to obtain in good times when the economy and public finances are doing well, rather than in bad times when governments most need it (aid is therefore too often *pro-cyclical* rather than *counter-cyclical*).

In summary, the macroeconomic framework has improved in many countries but effective macroeconomic policy must be underpinned by reforming and building effective fiscal institutions on both the expenditure and revenue sides.

There is also a balance to be struck in mobilizing more revenue and doing so in ways that do not discourage innovation, and growth through punitive tax rates

Better Management of Public Finances is Imperative but Often Slow to Implement

Most public expenditure reform has begun by examining the budget planning process, that is, with *allocation* issues. Improvements in expenditure management functions, such as treasury management, budget execution, accounting, and auditing, that is, departments concerned with *operational* issues, have often lagged well behind. But the two must be done together—otherwise resources may not be delivered correctly, even if they have been planned correctly. Given the existence of vested interests (and sometimes outright corruption) successful public expenditure management reform cannot therefore be dissociated from more fundamental institutional reforms within government, and this is the focus of the 'New Public Management Model' which has underpinned recent reform with its increased emphasis on governance and accountability.

Re-orientating public spending to development and poverty priorities is

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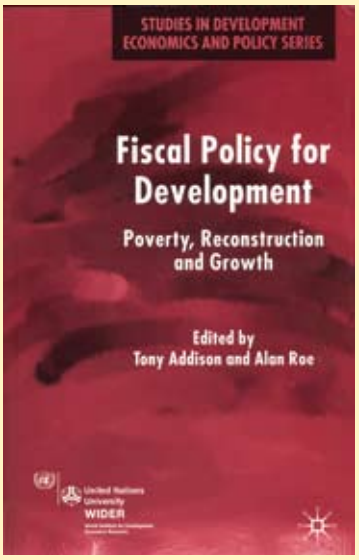

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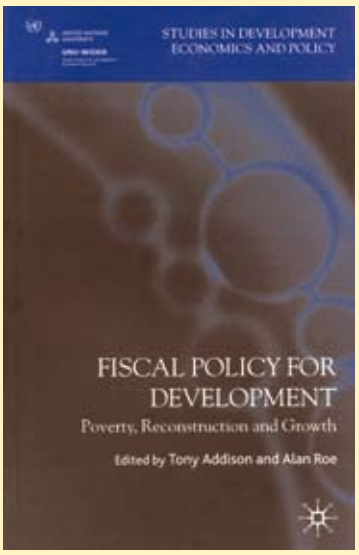

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essential but not as straightforward as it first appears. Raising social spending is imperative but, to take the example of health, healthcare spending will not necessarily be beneficial at the margin: the poverty impact will be small if increased spending on drugs simply leads to increased illegal selling of these drugs by corrupt employees. Budgetary cuts often focus on 'general administration' but this can thwart efforts to improve monitoring, as audit and legal institutions both fall under this expenditure category. And while military spending might seem an easy target for cutting, this is not always so; insecurity is often central to poor people's perceptions of poverty—as shown by participatory studies in rural Uganda, for instance. So, care needs to be taken in assuming it is easy to spot which lines of a budget plan will be guaranteed to help the poorest people.

Fiscal policy is more than just a question of good economics; it is also fundamental to the politics of development

Taxation is now at the forefront of the fiscal policy debate; more attention having been previously given to the expenditure side of public finances. Many countries in sub-Saharan Africa, but also some in South Asia, taxed agriculture heavily until reform began in the mid-1980s. This taxation was 'implicit' (in the structure of policy) rather than 'explicit' (since agricultural income is difficult to tax, for example). The reform agenda has therefore consisted of: reducing the implicit taxation of agriculture through sector and macroeconomic reforms; reforming customs and excise services—so that the revenue actually reaches the government—but also reducing dependence on trade taxes by reforming sales taxes (and introducing the more efficient Value Added Tax (VAT)); reforming income and capital gains taxes, including taxes collected by local government; and generally broadening the tax base and making the administration of tax institutions more efficient (and honest). As the 1990s progressed, these reforms took on a strong governance dimension, given the widespread alarm at the weakening of states (in part due to over-zealous donor conditionality to downsize the public sector in the 1980s) and the recognition that effective state-building requires effective revenue mobilization. But this can only occur with the consent of the governed in a democracy.

Most developing countries hope to raise tax revenues of 15-20% of GDP. But the WIDER study finds that in practice very similar tax structures and tax rates appear to generate very different revenues across different countries. This is usually due to the varying level of taxpayer compliance and efficiency of tax collection, and also to variations in the sizeable exemptions that are often offered. Tanzania and Uganda have both struggled to raise revenues despite successful stabilization programmes, for example. There is also a balance to be struck in mobilizing more revenue and doing so in ways that do not discourage innovation, investment, and growth through punitive tax rates. Therefore while countries take action to broaden the existing narrow tax base, aid inflows must continue at high levels and, indeed, donors need to step up aid if governments are to meet the ambitious Millennium Development Goals (MDGs).

If a measure of peace can be achieved then any political settlement must have a fiscal dimension

Good Fiscal Policy Should Raise the Growth Rate

The debate over the growth impact of public spending, taxation, and the overall fiscal position has become too ideological—varying between the zealous denial that public spending can do any good at all and that all taxes are pernicious to the equally extreme position that 'macroeconomics doesn't really matter' and public spending can be expanded almost without limit. The WIDER study attempts to bring the debate back down to earth, pointing out, for example, some of the methodological pitfalls in this area and therefore the care that must be taken in deriving policy conclusions. Issues of causality must be treated very carefully in empirical research: fiscal variables both affect, and are affected by, growth.

Previous research tells us that there is mostly a positive relationship between public investment and private investment—the so-called 'crowding-in' effect. However, there is a limit; eventually public investment starts to crowd out private investment from domestic financial markets, thereby undermining economic growth, and for this reason most of the empirical evidence finds that increases in the fiscal deficit eventually have a negative growth effect. Consequently a careful balance must be struck. The WIDER project emphasizes *threshold effects* as being of crucial importance to understanding the growth impact of public spending and to making good policy. For example, investment in infrastructure may become effective only after a certain infrastructure level has been reached (that is, building a road between two towns is useless if the road stops half way). And the state needs a certain number of civil servants to effectively run public services, but once that point is reached the efficiency of service-provision starts to fall as bureaucrats get in each others way; and as the public's transaction costs in dealing with an ever-larger bureaucracy rise.

The main findings of this research are that capital expenditures start to have a positive impact on private investment only after a minimum level of expenditure on these categories has been reached. Reducing the capital budget is therefore very harmful for investment and growth when the threshold value for capital expenditures has not been reached—the case in some early stabilization programmes. Likewise, public investment will not yield higher growth when there is no adequate provision for the accompanying recurrent expenditure, and misallocations in the capital/recurrent mix of public spending have at times been harmful for growth.

The MDGs Will Not be Achieved Without a Good Fiscal System

Our ability to get anywhere near meeting the MDGs depends to a large extent on improving the quality of fiscal policy in poor countries. This is especially the case in resource-rich countries where resource extraction is often an enclave activity (oil and natural gas in West Africa, for example) so that growth does not directly generate much in the way of increased employment; in these countries the main way that growth can reduce poverty is through the transmission of the resource revenues into higher pro-poor public spending. For the most part this is not

Endorsements of WIDER Fiscal Policy study

'Researchers and policy analysts will find this book to be an excellent basis for thinking about a number of difficult fiscal, tax, and budgetary issues facing developing economies. The readings are of high quality and relevant to current policy analysis. The papers contained in this book scream out to policy makers as to why better budgetary practices as outlined in this book are not commonly adopted throughout the world.'

- Jack Mintz, President and CEO, C.D. Howe Institute, Toronto, Canada.

'This book stands out in two ways. First, this is cutting edge research. The list of authors reads as a Who's Who? in the field of fiscal policy analysis in developing countries and the quality of the contributions is very high. Second, the volume moves well beyond the traditional topics. Novel issues include the design of new tax systems when the state is very weak, the fiscal implications of war, assessing the impact of fiscal policy on poverty, and the effect of tax choices on economic growth.'

- Jan Willem Gunning, Professor, Free University, Amsterdam, The Netherlands.

'Sustainable development in low-income countries cannot occur without a prior improvement of their fiscal institutions. This important book analyses thoroughly the various facets of this problem, and makes some definite contributions that will help the development community redirect its analytical efforts in the right direction.'

- Jean-Paul Azam, Professor, Université de Sciences Sociales, Toulouse, France

happening, and the poor are missing out on the revenue boom provided by higher commodity prices (especially oil) with revenues instead flowing into spending for elites (or directly into their pockets). Similarly, in societies characterized by high levels of inequality in access to land and other productive assets, the best means for redistribution may not lie in redistributing these assets themselves but by incorporating redistribution into the fiscal system—through progressive taxation (of capital gains from land sales, for example) to finance public spending that creates better livelihoods and human capital for the poor. In summary, growth can contribute to poverty reduction even in societies with very high levels of asset inequality, but only if fiscal institutions are built and focused on the poor.

When examining the effect of fiscal policy on poverty, it is tempting to look solely at the expenditure side. But the WIDER study emphasizes the importance of viewing fiscal policy in its totality. Ideally we need to consider the effect of public expenditure, while also considering how the resources to fund this expenditure are raised. The impact that public spending has on the poor will be affected by whether they are financed from higher taxation or from deficit financing and inflation. If higher taxation is used, then who will bear the burden? If through deficit financing, who will bear the consequences of the increased inflation or interest rates? This is methodologically challenging and remains a substantial research issue.

One attempt to analyse which expenditure categories will have most impact on poverty and inequality is to undertake a line-by-line examination of a government budget allocation. But this partitioning of expenditure categories along 'poverty beneficial' and 'poverty non-beneficial lines' does not address the real problem—since public spending data is often a poor reflection of actual service delivery. For example, there is less of a relationship between public expenditure on health and health improvement measures than would be predicted; whilst income is always an important determinant of life expectancy and child mortality, public spending on health as a share of GDP is not. So we need better tools to understand spending's impact which include monitoring people's perceptions of whether beneficial change is occurring in their daily experience of the state and its spending and taxing decisions. The WIDER study reviews progress to date in deploying both quantitative and qualitative methods, as well as the new generation of tools such as public expenditure tracking surveys (PETS). These innovative tools need to be applied to many more countries and on a much more regular basis.

Fiscal Reform as a Tool for Peace

A link to social peace is not the first thought that springs to mind when thinking about medium-term expenditure strategies, VAT, and all the other arcane terminology of fiscal policy. But who gets what (through public spending) and who pays for it (via taxes) can certainly play a role in the descent into violent conflict—particularly in societies where an absence of democracy blocks the peaceful expression and resolution of grievances over the use of public money. This is especially true in economies with abundant natural resources, such as oil and natural gas, where the use of the resulting revenues is often opaque and unfair; the grievances that have built up and turned violent in the Niger Delta over the misappropriation of Nigeria's oil revenues are a case in point. Accordingly, the WIDER study aims to raise awareness of fiscal policy and its relationship to conflict.

Fiscal problems worsen when conflict takes hold, revenues from indirect taxes fall as economic activity shrinks, the effectiveness of tax collection declines, and taxpayers become less willing to comply as the crisis of governance deepens. Governments then become even more dependent upon trade taxes which in turn tend to contract as conflict undermines a country's formal trade with the rest of the world (much of its international trade becoming increasingly informal and untaxed by the state). For example, per capita income in Rwanda declined by 40% and tax revenue by 75% from 1993 to 1994 during the country's turmoil. The result is a fall in the government's ability to fund expenditures with a rising fiscal deficit contributing to macroeconomic instability. High military expenditure also damages partnerships with donors who become reluctant to commit money to budgets given the 'fungibility' of aid and who therefore largely confine themselves to small-scale project support (and conflict is a big constraint on scaling-up aid more generally).

If a measure of peace can be achieved then any political settlement must have a fiscal dimension. The different contending ethnic, religious, or regional groups will expect redress, often implying a radically different pattern of public expenditures including increased spending on services and infrastructure in the previously neglected (often remote) regions which are frequently the centres of rebellion and secession. None of this is easy, even with the necessary political will. Rebuilding states, putting into place effective public expenditure management and taxation systems are all expensive in themselves. Nevertheless, if it can be achieved then a tangible rise in the level and quality of basic service provision can build support for political settlements and new post-war states. And since conflict undermines revenue mobilization and pro-development spending, international efforts at peace-building must have a fiscal pay-off in addition to their humanitarian benefits.

Fiscal Policy for Development: Poverty, Reconstruction and Growth

Edited by Tony Addison and Alan Roe

1. Introduction: *Tony Addison and Alan Roe*
2. The Macroeconomics of Fiscal Policy in Developing Countries: *Raghbendra Jha*
3. Fiscal Policy Design in Low-Income Countries: *Christopher S. Adam and David L. Bevan*
4. Fiscal Effects of Aid: *Mark McGillivray and Oliver Morrissey*
5. Changing Approaches to Public Expenditure Management in Low-Income Aid Dependent Countries: *Adrian Fozzard and Mick Foster*
6. Taxation Policy in Low-Income Countries: *Christopher Heady*
7. Fiscal Policy in a Growth Framework: *Norman Gemmell*
8. Fiscal Policy and Private Investment in Less Developed Countries: *Niels Hermes and Robert Lensink*
9. Assessing the Impact of Fiscal Policy on Poverty: *Andrew McKay*
10. Efficiency of Public Spending: New Microeconomic Tools to Assess Service Delivery: *Ritva Reinikka and Jakob Svensson*
11. Welfare Implications of Fiscal Reform: The Case of Food Subsidies in India: *Sonia Bhalotra*
12. The Fiscal Dimensions of Conflict and Reconstruction: *Tony Addison, Abdur R. Chowdhury, and S. Mansoob Murshed*
13. Fiscal Policy, Conflict, and Reconstruction in Burundi and Rwanda: *Léonce Ndikumana*

Conclusion: Fiscal Policy Reveals a Society's Priorities

Making a link between fiscal policy and growth is still one of the most methodologically challenging issues in development economics, and the poverty effects of fiscal policy have turned out to be less straightforward than simply observing changes in public spending on basic services and infrastructure. To really understand the latter we need to employ the full panoply of quantitative and qualitative techniques, especially in understanding why so many of the chronically poor are largely excluded from public provision. And there must be much more recognition of the role played by unfair patterns of expenditure and taxation in inflaming the grievances that lead to civil war.

Improving our technical understanding of how fiscal policy works for development is certainly vital, but fiscal policy is more than just a question of good economics; it is also fundamental to the politics of development. Who gets what from the state, how public spending is financed, and who pays for it, say much about how a society is governed and whether policy choices do—or do not—give priority to the poor. In this sense, fiscal policy reveals more about a country's development strategy than probably any other area of policymaking.

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INSIDE:

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