

DEVTECH Sphere

DEVTECH SYSTEMS, INC.
Summer 2003

TRADE AND FISCAL REFORM: TWO PARTNERS FOR DEVELOPMENT

This issue of *Sphere* examines the relationships between two important engines of economic growth and development:

- **Free and open international trade regimes** that send clear price signals to producers and consumers about domestic and global market opportunities for efficient investment and expenditure decisions.
- **Strong and effective public revenue and expenditure systems** at the national and subnational levels that fund critical public health, education, and other social services.

There is a strong consensus in the development literature about the positive contributions to economic development that come from open trade regimes supported by effective internal fiscal systems. There is less understanding, however, about the important and mutually reinforcing relationships between the two.

BUILDING TRADE CAPACITY AMONG DEVELOPING AND TRANSITION ECONOMIES

In May 2003, the U.S. Agency for International Development (USAID) launched its Trade Capacity Building (TCB) strategy, providing a road map for the trade and development policies outlined in the U.S. National Security Strategy released the previous year. The TCB strategy is aimed at helping developing and transition economies participate fully in the World Trade Organization (WTO) rules-based global trading system. Active participation in ongoing trade negotiations and effective implementation of trade agreements are two important components of the U.S. TCB strategy for developing countries. Improving their economic responsiveness to opportunities from trade is another component.

In preparation for the Doha "Development Round" of WTO trade negotiations in November 2001, DevTech directed a USAID-sponsored survey of U.S. federal government support for trade capacity building in developing and transition economies. The survey found that U.S. assistance has progressively grown over recent years, from US\$327 million in 1999 to US\$476 million in 2002. These totals represent significant amounts of development assistance. Their allocation across the range of TCB

The DevTech Sphere is a quarterly newsletter that focuses on issues of relevance to the international development community. In this Summer 2003 issue, Dr. Phillip Church and Dr. Arthur Mann, two of DevTech's senior economists, examine the importance of fostering strong decentralized fiscal systems as a critical component in building the capacity of developing and transition economies to participate in the emerging World Trade Organization rules-based global trading system and in special regional trade agreements such as the Central American Free Trade Area and the Free Trade Area of the Americas.

implementation activities will determine how effectively TCB goals are achieved.

The U.S. government's trade capacity building initiatives have taken on increased importance in the context of recent regional trade agreements. In 2000, western hemispheric leaders agreed to the formation of a Canada to Chile Free Trade Area of the Americas (FTAA). Moreover, the United States is supporting countries of the Central American isthmus to reach agreement on a Central American Free Trade Area (CAFTA) by the end of 2003 that can represent these countries as a group in future WTO and FTAA

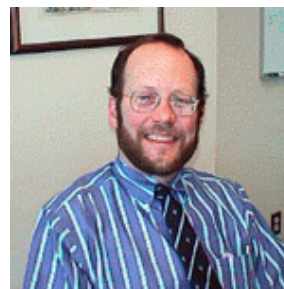
negotiations. The United States is also exploring support for similar regional trade agreements (RTAs) in Asia, the Middle East, and Africa. USAID is mobilizing technical and financial support for each of these RTA initiatives.

WHY TRADE LIBERALIZATION AND FISCAL REFORM MUST GO HAND-IN-HAND

Historically, countries have depended on import tariffs or "border levies" both to protect domestic industry and to generate public revenues. Developing countries continue to depend on import tariffs for

a significant share of government revenues, while developed and more open market economies have shifted to internal revenue sources such as broad-based income and consumption taxes. Since import tariffs are one of the easiest taxation systems to administer, entire institutional and political structures have evolved for this purpose, and developing countries have been reluctant to abandon them. As recently as 2000, import tariffs accounted for more than 20 percent of total tax revenues in developing countries, compared to 2 percent in developed (OECD) countries.

DevTech's role in providing economic and database expertise to the Development Information Services (DIS) project at USAID has enabled the U.S. government and other donors to meet an urgent information need on their trade capacity building efforts. Several years ago, USAID realized the need to report on its development assistance activities that supported building the trade capacity of developing countries. Although donors had supported TCB work for decades, it had never been measured as such.



DIS trade staff Kimberly Schneider and Michael Shea.

Working with senior management at USAID and other U.S. government agencies, DevTech analysts designed the concepts and definitions that are used to measure TCB funding. Next, they designed survey instruments to collect the information from nearly 100 operating units with the U.S. government. DevTech's database expertise was used to generate an innovative and popular online searchable database. As the information needs of USAID have grown, DevTech analysts have expanded and refined the data and text reports available on TCB. When the WTO and the Organization for Economic Co-Operation and Development (OECD) Development Assistance Committee decided to emulate the U.S. approach in collecting data on TCB activities, a DevTech analyst attended the planning meetings held in Geneva, serving as the technical expert in the U.S. delegation. DevTech analysts created a TCB data reporting system that generates key reports for the U.S. government with speed and comprehensiveness and serves as a model for the donor community.

Border levies take the form of import duties, export licensing fees, and dual exchange rates. In other cases, government agencies have been assigned exclusive monopoly control over the import or export and pricing of commodities of critical importance. Typical examples are government coffee and grains marketing boards in Africa and public petroleum product import monopolies in Latin America. Some developing country governments have sought to impose special internal fees and taxes on foreign investors seeking to set up manufacturing or natural resource extraction operations within their borders, or taxing their revenues at rates higher than their domestic competitors.

While border levies and foreign investment levies are important sources of revenue for developing country governments, they are also trade-distorting handicaps that lead to economic inefficiencies that reduce the benefits from participating in global trade.

Participation in the benefits of a WTO rule-based trading system requires that all such border levies on trade and discriminatory taxes on foreign investment be abolished. Import quotas and parastatal pricing schemes also are to be eliminated through a process called “tariffication,” the conversion of quotas and controlled border prices to their trade-distorting tariff equivalents and then the gradual reduction and elimination of those tariffs over an agreed period of time.

For developing countries, the trade liberalization that comes with greater involvement in a rules-based global trading system means short-run revenue losses from lower import tariffs, export licensing fees, and special levies on foreign investments. At the same time,

In **Mexico**, DevTech is currently working with the National Fiscal Coordination System to strengthen the legal and fiscal decentralization framework that presently governs the relationship between the federal and state and local governments. Among other issues, this project involves estimating state-level tax capacities and expenditure needs in order to generate a more efficient flow of transfers from the federal level. In **El Salvador, Guatemala, and Montenegro**, DevTech has provided assistance to municipal governments to develop and draft municipal tax codes and property tax laws as well as to prepare comprehensive proposals for the implementation of property tax reforms.

governments are being pressured to do more, to expand health and education and other social services, all within already tightly constrained fiscal budgets.

To achieve macroeconomic stability and sustain funding for social services (e.g., health, education, internal law enforcement, judicial systems), developing countries need to tap alternative sources of fiscal revenue. Trade negotiators cannot expect developing countries to comply with their WTO agreements unless higher levels of domestically based fiscal revenues can be generated and the institutional mechanisms for their collection are strengthened.

Consequently, a key element in the trade liberalization process combines phasing out these trade-constraining levies and replacing them with the introduction and/or strengthening of internal taxes that impact equally both imports and domestically produced goods and services. At the national level this implies more reliance on income and value-added taxes (VAT) and the reduction of tax expenditures, while at the subnational levels it should lead to the enhanced use of property taxation and different forms of tax-sharing arrangements (excises, value-added, and perhaps income) with the national government.

Also important are good tax administrative systems. The design and implementation of an entire array of efficient and revenue-buoying systems that underlie tax collection and enforcement are critical. Such systems run the gamut from taxpayer registration to arrears collection, and involve such varied aspects as the detection of stop-filers, improved auditing procedures, and taxpayer services.

STRENGTHENING NATIONAL AND SUBNATIONAL FISCAL SYSTEMS

DevTech is helping countries implement national and subnational fiscal reforms that pave the way for reducing their tariff and nontariff barriers to trade. With those reforms in place, developing countries will be in much stronger positions to participate in the benefits of expanding global trade. They also will provide much more hospitable environments for foreign investors to bring the capital and technology critical to sustained expansion of output and employment. In turn, with economic growth come new opportunities for generating the additional public revenues needed to improve the quantity and quality of social services.

While the term “fiscal policy” is often taken to mean only tax policy, it really

In 2002, DevTech conducted a study that quantified tax expenditures in **Guatemala**. Tax expenditures are legally generated by preferences that reduce the amount of revenues governments can collect. They appear in various forms, and include tax incentives and subsidies. The study concluded that, while at first glance tax expenditures amounted to over 7 percent of gross domestic product (GDP), by taking into account price elasticities of demand and supply, the net amount of forgone tax revenues came to just over 3 percent of GDP. In the context of Guatemala's tax ratio of only 10 percent, this is an appreciable amount. Consequently, a comprehensive proposal for reducing tax expenditures was made.

deals with both sides of the public sector's budget: revenues (tax and non-tax) and expenditures. Any discussion of fiscal performance and strengthening must include the design and reform of both tax and expenditure systems.

The basic principles underlying all DevTech work on taxation at both national and provincial/state and municipal levels are:

- **Neutrality.** In market-oriented economies, resource allocation is sensitive to changes in relative prices, and reform-induced tax changes should be efficient; i.e., for a given revenue target, they should interfere as little as possible with the private sector's investment, saving, production, and consumption decisions, with the caveat that taxation can be used to reduce negative externalities, e.g., pollution. This implies the use of broad-based income and consumption taxes with few exemptions and deductions, coupled with a limited set of excise taxes to address the externality issue. In the developing world, by far the most popular broad-based consumption levy is the VAT, which should be imposed at one rate with limited exemptions and zero rat-

ing of exports. The use of tax incentives (e.g., subsidies or exemptions given to specific sectors or industries) should also be limited; they distort private-sector decision-making and require higher tax rates to meet public revenue requirements.

- **Equity.** The distribution of the tax burden should be fair and equitable across households and firms. This implies designing a tax structure that respects the concepts of vertical equity—those with a greater ability to pay based on income and wealth should bear a higher proportional tax burden—and horizontal equity—

those with similar abilities to pay should bear equal burdens. The taxes usually equated with equity are those on income and wealth, while conventional wisdom concludes that broad-based consumption taxation (e.g., a VAT with few exemptions) is inequitable. In developing countries such “verities” are not necessarily valid. A poorly administered income tax (personal and corporate) can lead to a large amount of tax evasion at high income levels, and ends up burdening the salaried middle class. A VAT that does not exempt basic necessities may not be regressive across a fairly wide spectrum of household income groups, given that the consumption patterns of lower- and middle-income classes exclude taxed goods and services. Although any tax system design cannot dismiss equity considerations, efforts to redistribute national income via the tax system are misplaced. Distributional concerns are far better met using the expenditure side of the public budget.

In **Bosnia-Herzegovina (BiH)**, DevTech is involved in a multi-year tax modernization project to improve efficiency of tax administration, reduce corruption, and enhance transparency. DevTech is assisting the country's three tax administrations (the Federation of Bosnia-Herzegovina, the Republic of Srpska, and the District of Brcko) in developing a comprehensive design for tax administration reform and for moving toward the creation of a “single economic space” within all of BiH. As part of the design, software and hardware specifications to automate overall tax administration were developed. At this time, DevTech is assisting in the modernization of the three tax administrations in accord with the comprehensive designs developed in the past year. Among other project aspects, this modernization is paving the way for replacing the sales tax with a VAT, supporting the reduction in corruption and fraud, and simplifying overall administrative practices.

- **Administrative Efficiency.** A tax is only as good as the government's ability to collect it. This leads to a multitude of issues. Both administrative and taxpayer compliance costs should be minimized, and this is accomplished via **simplicity** (a limited number of taxes, rates, and exemptions), **clarity** (tax regulations and laws are easy to comply with and understand), **predictability** (taxpayers should know in advance the tax implications of their decisions), **certainty** (no scope for discretionary tax code or liability changes), and **transparency** (a well-drafted and defined tax code and regulations). Although more easily said than done, efficiency implies putting in place and maintaining all the required systems to identify and register taxpayers and to collect all due tax liabilities. One example of this is the use of withholding under the income tax.

The other side of the revenue/taxation coin is the integral relationship with public expenditures; without the first, the latter cannot exist. And, since nobody enjoys paying taxes, it is clearly important to design expenditure structures that are efficient and that rationally reflect a nation's social and economic needs. This leads into the multifaceted world of expenditure policy and of public expenditure management (PEM). The former deals with "what" should be done, while the latter relates to "how" to do it.

DevTech has provided technical assistance on both sides of these interrelated issues. As part and parcel of most of its projects, the initial analysis of problems is followed by policy recommendations and, often, building civil

In **Ukraine**, DevTech is working with the national and municipal governments to support budget reform. At the national level it assisted the Ministry of Finance in establishing policies, procedures, and programs via the design and implementation of performance-program budgeting (PPB) and strategic planning. It is presently working with local governments to generate budget resources to deliver more effective services to the community and to be more accountable for results to both the central government and their own residents. These activities include: technical assistance and training for PPB implementation; improvement of revenue and expenditure estimates and multi-year capital and investment planning; introduction of medium-term expenditure frameworks; and outreach efforts to enhance citizen participation, liaisons with stakeholders, and overall transparency. It continues, too, its work with Parliament advice and analysis, and technical advice to the Ministry of Finance.

society support for the recommended reforms. PEM includes a veritable gamut of goals: budgeting, project and program management, transparency, accountability, and political approval. Some of the principal aspects of DevTech's work within PEM have involved:

- **Budgeting.** While the first step in the budget process is lining up expenditures with revenues, efficiently allocating these revenues among competing ministries, multiple functional expenditure categories, and myriad programs and activities is no mean task. One of the principal ways of strengthening budget management systems is via the design and implementation of performance-based budgeting, which, at a minimum, provides the tools to better judge the efficiency of public spending.
- **Budget Management.** After putting a budget system in place, daily management aspects come into play. These involve such tasks as cash management techniques, day-to-day tracking systems, cost standards and

costing systems, and accrual-based accounting.

- **Transparency and Accountability.** Performance-based budget systems based on the ready availability of documentation, coupled with value-for-money audits and annual evaluations, lead to more transparent and accountable public spending. Needless to say, these represent very important aspects of corruption-reducing measures.
- **Political Approval.** The ultimate goal of all parts of an effective PEM system is to achieve legislative, citizen, and market (domestic and international) approval. Such approval not only aids in reducing one excuse for tax evasion, but also decreases public debt emission costs (interest rates) and enhances donor willingness to fund economic development projects.

— Dr. Phillip Church &
Dr. Arthur Mann
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Senior Economists

Established in 1984 by economist Jorge A. Sanguinetti, Ph.D., DevTech Systems, Inc. is a consulting firm that offers technical assistance in the following practice areas:

- Economics and social development
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- Gender integration
- Human capacity development
- Performance monitoring and evaluation

WE INVITE OUR READERS TO SEND THEIR LETTERS AND COMMENTS ON THE MATERIAL IN THIS ISSUE OF THE *SPHERE* TO DEVTECH SYSTEMS' ARLINGTON OFFICE.

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