Preparatory Process for the
Third International Conference on Financing for Development
Substantive informal session: "Domestic Public Finance"

11 November 2014, Trusteeship Council Chamber, United Nations, New York

Domestic public finance is essential to providing public goods and services, increasing equity, and helping manage macroeconomic stability. The Monterrey Consensus emphasized that "an effective, efficient, transparent and accountable system for mobilizing public resources and managing their use by Governments is essential." Domestic resource mobilization is at the crux of financing for development; it reinforces a country's ownership of public policy and allows countries to move toward financial autonomy. Governments may also use taxation policy to prioritize real income gains at the bottom of the income distribution through progressive tax policies, such as "earned-income tax credits", and VAT exemptions on basic goods and services. However, current domestic resource mobilization remains insufficient to meet sustainable development needs, and gaps persist between developed and developing countries' capacity to raise public revenues. In terms of uses of resources, there are many elements of incorporating sustainable development criteria into fiscal policies, including spending allocation, procurement policies and removing harmful subsidies.

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Programme

Substantive informal session: "Domestic Public Finance"
11 November 2014, Trusteeship Council Chamber, United Nations, New York

Co-Chairs: H.E. Mr. George Wilfred Talbot (Guyana)
H.E. Mr. Geir O. Pedersen (Norway)

Session 1:
10 a.m. to 1 p.m.: Raising domestic resources for sustainable development

Setting the Scene:
- Prof. Atul Kohli, Princeton University

Followed immediately by Q&A

Round table on country experiences with taxation
- Benedict Clements, Division Chief, Fiscal Affairs Department, IMF
- Luis Maria Capellano, Undersecretary for Public Revenue, Ministry of Economy and Finance, Argentina
- Pekka Ruuhonen, Director-General of Tax Administration, Finland

Discussant
- Alvin Mosioma, Director, Tax Justice Network Africa

Session 2:
3 pm to 6 pm –Mainstreaming sustainable development criteria and effective use of public finance

Moderator: Mansur Muhtar, Ministry of Finance, Nigeria

Panel
- Benedict Clements, Division Chief, Fiscal Affairs Department, IMF
- Yoganath Sharma Poudel, Undersecretary, Ministry of Finance, Nepal
- Vinicius Pinheiro, Deputy Director, ILO (former State secretary of social protection, Brazil)
- Rainer Kattel, Professor of Innovation Policy, Tallinn University of Technology
- Claire Schouten, International Budget Partnership
- William Dorotinsky, Acting Director, Governance and Public Sector Management Practice, World Bank

Substantive informal session: "Domestic Public Finance"
Briefing Note

<u>*Raising domestic resources*</u>

- *Trends and policies*

Domestic finance has grown rapidly in recent years, representing by far the greatest share of financing sources for most countries. Since 2002, public domestic finance in developing countries more than doubled, increasing from US$ 838 billion to US$ 1.86 trillion.[1] Some countries have achieved sustained revenue increases of 4-5 per cent of GDP over just a few years. In absolute terms, this growth mainly reflects developments in middle-income countries. Domestic public finance also doubled in low-income countries, though it remains insufficient to meet sustainable development needs. Tax revenues account for about 10 – 14 per cent of GDP in low income countries, which is about one third less than in middle income countries, and significantly less than in high income countries, which achieve tax to GDP ratios of 20 - 30 per cent.[2] There is also a significant difference between low-income and middle-income countries. In 2009, tax revenue accounted for 13.6 per cent of GDP in the former, as compared to 19.3 per cent in the latter.[3]

Domestic resource mobilization depends on many factors, such as size of tax base, a country's capacity to collect and administer taxes, tax elasticity, the volatility of sectors being taxed, and commodity prices. While optimal tax policy design is necessarily reflective of a country's economic and social situation, there are some generally accepted principles of sound public finance management, e.g. tax systems should be fair, efficient and transparent. In general, the tax base should be as wide as possible, while maintaining equity and efficiency. Key indicators of success in tax reform include high level political commitment, administrative and policy reform and strong leadership in the revenue administration.[4]

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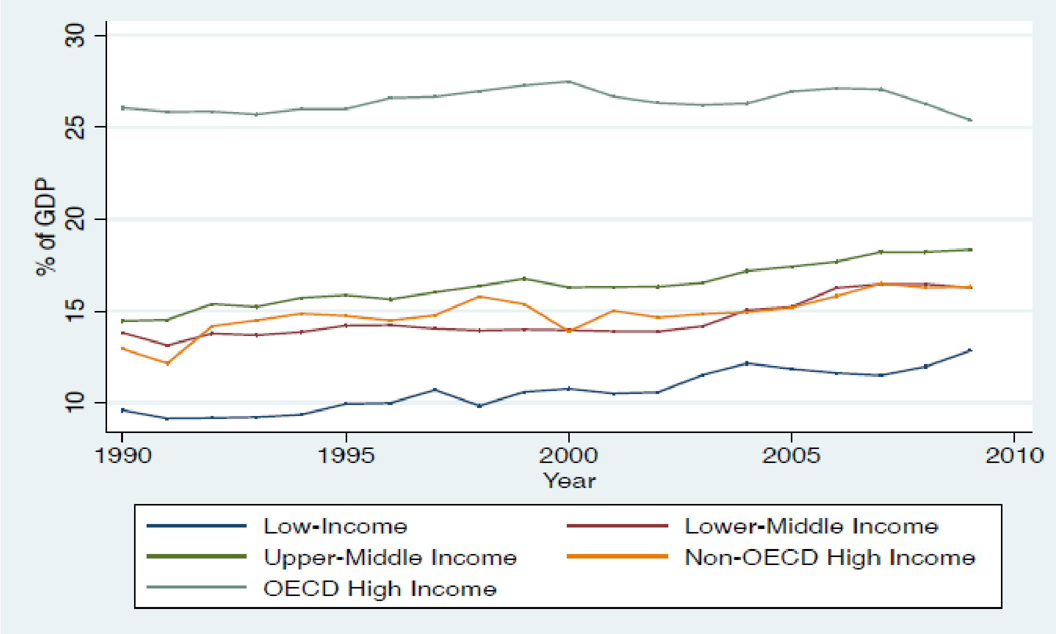
[1] http://capacity4dev.ec.europa.eu/ffd/document/data-2000-2012-delinked

[2] World Bank, 2013, *Financing for Development post-2015*.

[3] Source: World Bank, World Development Indicators 2013.

[4] Report to the G20 Development Working Group by the IMF, the OECD, UN and World Bank: Supporting the Development of More Effective Tax Systems. http://www.imf.org/external/np/g20/pdf/110311.pdf

Figure: Average tax to GDP ratios by country income level



Notes: OECD High income includes all OECD countries excluding Mexico, Poland and Israel. Non-OECD high income includes Uruguay, Qatar, Aruba, Croatia, Lithuania, Brunei Darussalam, Malta, Trinidad and Tobago, Antigua and Barbuda, Barbados, Singapore, Cyprus, Kuwait, Equatorial Guinea, Hong Kong, St Kitts and Nevis, San Marino, the Bahamas and Bahrain.

Source: Prichard, Cobham, and Goodall, 2014, based on ICTD Government Revenue Dataset

Countries have variable experiences with fiscal reform, and while some experiences are idiosyncratic others can help inform a deeper understanding of the potential for policy reform in other countries. Widening the tax base has been instrumental in recent advances in tax collection in many developing countries, including LDCs and SIDS. Recent improvements in tax collection also reflect increased revenue from value added taxes (VAT), robust receipts from corporate income taxes, and, to a lesser extent, personal income taxes, but also declining trade tax revenues.[5] Value added taxes have spread rapidly in developing countries, often in conjunction with lowering trade taxes; around 150 countries now have a VAT, which typically accounts for around one quarter of all tax revenue. The switch from trade taxes to a VAT has, however, sometimes led to a reduction in total revenues. Concerns have been raised about the distributional impact of value added taxes, as a proportional tax on all consumption is regressive relative to annual income, although the evidence is inconclusive.[6]

Many developing countries have significantly improved their tax administration within the last 2 decades. The average time to prepare, file and pay (or withhold) taxes decreased by almost 20 per cent from 2005 to 2013 in developing countries. Countries that have succeeded in raising revenues have also often used innovative mechanisms and experiments, including the use of lotteries, transparency initiatives, and new technology.

Nonetheless, in many countries, the capacity of tax collection and enforcement remains a concern. In particular, revenue administrations remain affected by under-resourcing,

[5] See UNTT Working Group on Sustainable Development Financing, 2013, The variety of national, regional and international public sources for development finance.

[6] Overall, studies of the incidence of government taxation and spending programmes are characterized by significant uncertainties, particularly in developing countries.

misallocation, and weak mid-level skills. To date, technical assistance to the revenue and customs sector has attracted a minimal share of ODA. In 2012 it is estimated that only $120 million of ODA from OECD DAC donors is targeted at tax-related activities, less than 0.07% of the total.[7] More focus could be placed in responding to national requests for strengthening fiscal management capacity and capacity building for domestic resource mobilization. In addition, examples of successful reforms can inspire policy design elsewhere.

Corporate income tax revenue is under pressure due to globalization. The revenue challenges that such downward pressures pose are a greater concern for developing than advanced economies: the corporate income tax raises about 17 per cent of total tax in the former, compared to 10 percent (pre-crisis) in the OECD. This may in some cases reflect its use to extract resource rents, absent better targeted instruments. Statutory rates have fallen globally, yet so far revenues raised from this source have been reasonably robust in low-income countries, and have gained in importance in middle-income countries in recent years.

Incomes from personal income taxes are generally low and stagnant in developing countries. They are overwhelmingly raised from wage withholding in large enterprises and from public sector employees, and raise between 1 and 3 per cent of GDP. In this regard, tax evasion and avoidance by the very rich could be addressed more forcefully. Not only is the revenue loss substantial but failure of the wealthy to pay their fair share also undermines broader trust in the tax system.

- *Domestic resource mobilization in resource rich countries*

In resource-rich countries, the management of natural resources is particularly critical. Revenue related to resources often accounts for more than half of total revenue in petroleum-rich countries and over 20 percent in mining countries. However, fiscal regime design for extractive industries is complex. Investments are often characterized by large sunk costs, long time horizons and significant uncertainty over resource prices, rendering the credibility of the investment regime critical to investors. The prominent presence of multinational enterprises in the sector also heightens concerns over tax planning and avoidance in the host country. In addition, the exhaustibility of the resource itself raises issues concerning the time profile of development and extraction.

Fiscal rules governing the extractive industries should ensure that the public interest is appropriately compensated. Governments can design policies to ensure that a share of resource earnings are saved and invested for the benefit of future generations, as in sovereign wealth funds (SWFs). When tax revenues from resource extraction are volatile, governments can accumulate surplus earnings in years of high prices and smooth government expenditures in years of low prices through commodity stabilization funds. International cooperation is needed to tackle the illicit trafficking of natural resources, including from countries in situations of conflict.

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[7] OECD (2014), *Development Co-operation Report 2014: Mobilising Resources for Sustainable Development*, OECD Publishing. DOI: 10.1787/dcr-2014-en.

- *International cooperation*

However, it is important to recognize that there are limits on what individual governments can accomplish on their own in the globalized economy. Illicit financial flows (IFFs) are particulalry problematic. The term IFF is characterized by a lack of terminological clarity, but it is generally used to convey three different sources: the proceeds of commercial tax evasion, revenues from criminal activities, and public corruption. IFFs have become a matter of major concern because of the scale and systematic adverse impact of such flows on the development and governance agenda. While improved domestic policies in tax administration are vital to increasing revenue collection for sustainable development investment, there is a limit to what they can achieve based on the existing international policy environment within which IFFs, as well as tax avoidance, have blossomed. International cooperation on tax matters, which will be discussed in more detail in a follow-up informal substantive session in December, is of particular importance to tackling these problems.

Guiding questions

1. *What policies and country experiences have been most effective at taxation at the practical level? How can the best balance be found between legitimate calls for greater certainty for taxpayers, and equally legitimate calls from governments and the citizenry for greater certainty that the right amounts of tax on profits will be paid in the right places.*
2. *What guiding principles and mechanisms are best adapted to meeting these challenges? What roles can be played by different types of taxation?*
3. *How should capacity building in this area be strengthened?*

<u>*Effective use of public finance*</u>

The Monterrey Consensus agreed that "Investments in basic economic and social infrastructure, social services and social protection, including education, health, nutrition, shelter and social security programmes, which take special care of children and older persons and are gender sensitive and fully inclusive of the rural sector and all disadvantaged communities, are vital for enabling people, especially people living in poverty, to better adapt to and benefit from changing economic conditions and opportunities." There are many elements of improving efficiency and incorporating sustainable development criteria into fiscal policies, including in spending allocation, procurement policies and removing harmful subsidies. Some key questions include how to phase out harmful subsidies while protecting vulnerable populations; how to incorporate gender into fiscal policy; how to finance social protection; and how to tackle corruption. Combating corruption also plays an important part in complementing efforts to improve domestic revenue mobilization.

- *Data and trends*

Overall, data on fiscal policies are hard to compare across borders because of the different political and social constructs in which fiscal policy must operate. However there is data in some areas. For example, the IMF has estimated that 2011 pre-tax energy subsidies amounted to $480 billion, primarily in developing countries, and post-tax energy subsidies amounted to

$1.9 trillion, primarily in developed countries.[8] Similarly, in agriculture, producer support subsidies among OECD members total $259 billion in 2012.[9]

On the policy front, some Member States have introduced more sustainable procurement policies, based on minimum environmental and social standards for public sector suppliers. A small number of countries have reduced or completely removed harmful and inefficient subsidies, such as fossil fuel subsidies. Only 27 per cent of the global population enjoys access to comprehensive social security systems, whereas 73 per cent are covered partially or not at all. Of particular significance are the divergent trends in richer and poorer countries: while many high-income countries are contracting their social security systems, many developing countries are expanding them.[10] To date 172 Member States are party to the United Nations Convention against Corruption.

- *Issues*

A central element of good financial governance is proper planning and execution of the budget. Generally accepted principles of good budgeting address the stages of formulation, approval, execution and audit. These principles should ensure that public spending is consistent with national sustainable development strategies, inclusive of environmental, social, economic, gender, and other goals. The Intergovernmental Committee of Experts on Sustainable Development Finance argued that “Governments should use fiscal policies (both tax and spending) to address inequalities, fight poverty, improve water and sanitation, and support other social services, in particular to benefit low income, vulnerable and marginalized groups. A frequent call is to give priority to public investment projects that are ‘pro-poor’ and gender sensitive.”

It is common in normative budget policy discussions to ask if specific subsidies continue to be warranted. Countries should review the efficacy of all subsidies as a matter of sound fiscal management. The Open Working Group concluded that countries should “rationalize inefficient fossil fuel subsidies that encourage wasteful consumption by removing market distortions, in accordance with national circumstances, including by restructuring taxation and phasing out those harmful subsidies, where they exist, to reflect their environmental impacts.” It further argued that in doing so member States should fully take into account “the specific needs and conditions of developing countries and minimize possible adverse impacts on their development in a manner that protects the poor and affected communities.”[11]

Structural vulnerabilities, which affect the poor and other socially excluded groups, women, persons with disabilities, indigenous peoples, migrants, minorities, children, older persons, youth and other marginalized groups, can be reduced by aiming for universal provision of

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[8]The IMF defines consumer subsidies to include two components: a pre-tax subsidy (if the price paid by firms and households is below supply and distribution costs) and a tax subsidy (if taxes are below their efficient level).IMF, 2013, *Energy subsidy reform – lessons and implications*, Washington, D.C.

[9] OECD, 2013, *Agricultural Policy Monitoring and Evaluation*, Paris

[10] For more details please see ILO 2014, World Social Protection Report 2014/15: Building economic recovery, inclusive development and social justice.

[11]The Open Working Group agreement is based on the outcome of the Rio+20 conference. Reservations were expressed by several Member States to paragraph 225 of the Rio+20 outcome document, A/CONF.216/16, chapter I, resolution 1, paragraph 225 (see General Assembly 123rd plenary meeting, 2012, A/66/PV.123).

basic social services. Additionally, policies to strengthen “social protection floors” can help. The International Labor Organization has found that social protection floors are affordable in most countries out of domestic revenues, but may require international assistance for the poorest countries. In addition to offering protection against risks, social protection can contribute to equitable growth by reducing poverty and inequality, raising labour productivity, and enhancing social stability.

Gender-responsive budgeting (GRB) is government planning, programming and budgeting that contributes to the advancement of gender equality and the fulfillment of women's rights. It entails identifying and reflecting needed interventions to address gender gaps in sector and local government policies, plans and budgets. GRB also aims to analyze the gender-differentiated impact of revenue-raising policies and the allocation of domestic resources. Effective gender-responsive budgeting should be institutionalized and linked up with other ongoing public finance reforms. Data availability is important to understand the impacts of gender-responsive budgeting.

As part of budget execution, authorities may wish to align their procurement policies with national sustainable development strategies, which may imply defining minimum environmental and social standards for public sector suppliers, though this needs to take into account different domestic situations. Sustainable procurement can have the added benefit of promoting sustainable technologies, which could then be adopted by the private sector as they become more cost competitive. Public procurement systems can also promote the development of sustainable local businesses.

Planning and execution of budgets should be based on transparency, legitimacy, accountability and participation of citizens, consistent with country capabilities and circumstances. Furthermore, fiscal decentralization can strengthen local governance and create local ownership for the disposition of funds. Some countries have experimented with participatory budgeting, which allows citizen commissions to determine the direction of some elements of public spending. This has been particularly popular at the municipal level.

Good governance and combatting corruption are of course important complements to budget processes. Corruption can have adverse effects on businesses, individuals and public financial management. High scores on corruption indicators are also strongly associated with low public revenue. In this regard, internal and external audit and control mechanisms can contribute.

Guiding Questions

1. *There are many elements of incorporating sustainable development criteria into fiscal policies and increasing effectiveness, including procurement policies, removing harmful subsidies, debt management and reducing corruption. How can these different areas be balanced?*
2. *What strategies have worked to change fiscal priorities while protecting vulnerable populations?*
3. *Which reforms have the greatest long-term sustainable development impact, and how can multiple reforms work in synergy? How can reforms that mainstream sustainable development become institutionalised?*