V.
What Institutions Can Help Fiscal Adjustment?

> *The more a people feel taxation, and the more jealously they watch over public expenditure, the better it is for them and for their rulers.*
>
> *—Francis Wayland (1796–1865)*

Fiscal adjustment does not happen in a vacuum. It is not enough for a finance minister simply to decide to adjust; the decision must be put into effect and supported by public institutions. Without well-functioning fiscal institutions, even the best-designed policy measures risk failure. Key fiscal institutions for achieving and sustaining fiscal adjustment include those that implement revenue administration (tax and customs), budget (public financial) management, and intergovernmental relations.

Modernizing Revenue Administration

Raising revenue and implementing revenue policies depends critically on the quality of revenue administration (Silvani and Baer, 1997). Customs departments face additional challenges, for example, from trade liberalization, the requirements of World Trade Organization membership, and the heightened need to protect national borders (Keen, 2003). Strong and modern revenue administrations will be better able to implement new revenue measures effectively, generating a rapid revenue response. Weak and outdated administrations typically need reforming if they are to deliver durable revenue improvements.

Modernizing revenue administrations means moving to a principle of voluntary compliance, where taxpayers and traders are expected to comply with their obligations with little intervention from revenue officials. This recognizes that no revenue administration can determine the correct liability and control the compliance of every taxpayer. Voluntary compliance is achieved through self-assessment, where taxpayers and traders—with access to information and assistance from the tax and customs departments—calculate their own liabilities, file returns and declarations, and pay the tax and duties that they themselves assess. If they fail to make accurate assessments and pay the correct amounts, they risk being audited and paying penalties. The roles for tax and customs departments are, first, to help taxpayers and traders understand and meet their obligations, and, second, to take action against noncompliers, particularly those with greatest impact on the revenue performance.

Beyond these general principles, modern revenue administrations require the following:

- *Clear and simple laws*. Laws and regulations that are easy to understand and apply facilitate efficient revenue administration and minimize taxpayer/trader effort and compliance costs.
- *Efficient collection systems and procedures*. Simple forms and straightforward assessment, filing, and payment arrangements facilitate administration and compliance. Administrations need to strike a balance between the controls necessary to protect revenue and the costs and inconvenience imposed on businesses in meeting their obligations.
- *Service orientation*. Tax and customs departments face increasing demands to improve their service to the business sector. This is particularly so for customs administrations, where improvements in service directly reduce the costs and enhance the competitiveness of exporters and importers.
- *Verification programs based on risk analysis*. Modern administrations optimize tax collection by focusing on taxpayers and traders posing the greatest risk to revenue. Tax and customs administrations should embrace risk-management approaches and develop analytical capabilities to better understand the make-up and compliance behaviors of the taxpayer and trader base.
- *Function-based organizational structures*. Experience strongly suggests that tax departments organized according to key functions (such as audit and enforcement) operate more efficiently than those structured by type of tax. Function-based administrations facilitate specialization. They also eliminate duplication and inefficiencies characteristic of tax-type-based structures.
- *High level of automation.* Because a large part of revenue collection involves high-volume transaction processing, modern revenue administrations rely heavily on information technology. Computerized systems are also essential for supporting the information needs and analysis associated with risk-management approaches.

Box 9. Features of a Dedicated Large Taxpayer Office

Taxpayers covered. Depending on the selection criteria used, the taxes to be covered, and the resources to be committed, large taxpayer offices typically cover 60–80 percent of the domestic tax revenue base but usually only 500–1,000 taxpayers (typically 1–2 percent of the total).

Taxes covered. Most large taxpayer offices and large taxpayer audit units in developing countries focus on collection, enforcement, and audit of (1) corporate and other income taxes; (2) VAT or sales tax; (3) excises; and (4) taxes withheld from the salaries and wages of their employees.

Criteria used to identify large taxpayer offices. Annual turnover is the most effective and objective way to identify large taxpayers. Other criteria sometimes used—but not preferred—include (1) amount of tax arrears; (2) level of imports; and (3) specific economic sectors (e.g., banks and insurance companies).

Large taxpayer office *organization and functions.* Function-based organizational structures work best. Key functions include registration, all information processing tasks, taxpayer assistance, collection monitoring and enforcement, and taxpayer audit.

Service strategy. Large taxpayer offices provide a single point of access for large taxpayer inquiries, requests for rulings on important technical issues, and so on.

Audit strategy. Because of the large amounts of revenue involved, and the complexity of many transactions and their taxation treatment, large taxpayers often require close audit attention. It is not uncommon, therefore, for 50 percent or more of large taxpayer office resources to be devoted to audit-related activities.

- *Differentiated treatment of taxpayers by their revenue potential*. A growing trend among tax administrations has been to give special attention to the largest taxpayers. As a first step, this often involves establishing a large taxpayer office for the most significant taxpayers (Box 9). A number of tax administrations have further segmented their taxpayer population and developed enforcement and service programs tailored to the needs and risk profiles of medium-sized enterprises and small businesses.
- *Effective management*. Modern revenue administrations increasingly recognize the importance of a strong and professional management team to formulate the revenue administration's strategy; communicate

the organization's direction and objectives to its staff and external stakeholders; ensure that the organization focuses on sustained and fundamental improvements in performance, not just short-term revenue targets; and ensure that resources match the required outputs.

All of this takes considerable time: a full-blown modernization program can take three to five years to carry out. Benefits are likely to flow during that time as new systems and processes come on stream. But the lag effect, as taxpayers begin to change their underlying behavior in response to a more effective tax administration, can take longer. In the short term, generating revenue quickly from administration reform alone is difficult and efforts should focus on specific areas of noncompliance:

- Better controlling large taxpayers. A large taxpayer office can usually be set up for administration of the biggest taxpayers within 12 months and it should be staffed with the best personnel from the tax administration.
- Ensuring that state-owned enterprises are compliant. This sends a strong signal to the private sector that the government is serious about compliance.
- Implementing compliance-enforcement programs to target the largest and newest arrears using task forces of specially trained staff.
- Establishing audit teams trained to deal with problematic sectors, and conducting a program of short and sharp routine VAT audits to generate a credible presence in the taxpayer community.
- Setting up registration task forces to bring in significant taxpayers that have opted out of the tax system can be productive, provided that they target medium-sized taxpayers and not a large number of nonproductive small taxpayers.
- If the VAT threshold is set too low, raising it can free up resources from administering a large number of nonproductive taxpayers and refocus these resources on the more significant medium-taxpayer group. Reducing filing frequency from monthly to quarterly for medium taxpayers can also substantially reduce administration and allow resources to be refocused.

Effective Public Financial Management

Implementing fiscal adjustment requires an effective public financial management (PFM) system (Potter and Diamond, 1999). Such a system provides a framework for policymakers to determine the appropriate amount of adjustment and the tools to deliver it. A PFM system is a multifaceted technical process that starts with budget preparation and extends to budget execution, accounting, and reporting. But even strong preparation and execution systems can be undermined by weak governance and a poor institutional setup. Ultimately, budgets and PFM systems must be supported by senior officials and politicians. Ministries of finance need to be able to enforce fiscal discipline over spending units that are unprotected by political patronage. In addition, different units in the PFM process need to be well coordinated and the legal framework needs to be supportive of, and supported by, a strong-willed executive.

The primary objective for the PFM system in fiscal adjustment is to enforce aggregate control: it must deliver expenditure outcomes consistent with macro-fiscal policy. This fundamental tenet of sound budget management requires *getting the basics right*. The budget needs to fully reflect expected liabilities. Timely and robust information on spending should be available so that meaningful expenditure control, which responds to changing macroeconomic conditions, can be exerted. Without these basic functions fulfilled, even the best policymaking can fail, with deficit targets missed, persistent payment arrears accrued, and expenditure priorities undermined.

Moving beyond these basic stabilization goals requires the public financial management system to focus on *enhancing expenditure efficiency.* It should provide policymakers information and mechanisms that enable them to pursue productive efficiency (ensuring outputs are delivered for the least cost) and allocative efficiency (ensuring that the optimum mix of outputs is provided). The costs of managing public funds should also be minimized.

Budget Preparation

Budget preparation will differ from one country to another, depending on budgetary systems and capacity. But there are common principles.

Getting the basics right entails ensuring that the budget covers all relevant expenditures in a way that enables policymakers to make the difficult decisions needed to secure an appropriate fiscal position. For many countries, this means swiftly extending budget coverage, improving the realism of annual budget projections, and consolidating recurrent and development budgets. The two key principles are:

- *Consistency with macroeconomic constraints*. This is best achieved by having the finance ministry set an overall spending ceiling (a "top-down" approach). Under a "bottom-up" approach, where the budget spending envelope is determined more by spending ministry requests than by macroeconomic considerations, the credibility of the budget could be undermined and macroeconomic stability threatened.

- *Unifying the budget.* Revenue and expenditure should be considered together to determine annual budget targets. The budget should cover all entities operated on a nonmarket basis, owned or controlled by the government, and predominantly funded by the budget. Budget fragmentation—involving, for example, separate development and recurrent budgets and extrabudgetary funds—complicates the development of a consolidated picture of government finances, hampers assessment of the recurrent costs of investment plans, and fosters duplication.

Enhancing expenditure efficiency requires a preparation system that can identify and prioritize growth-enhancing and poverty-reducing activities. For many countries, this means improving budget classifications, moving to multiyear frameworks, and gradually inserting measures of output and performance into the budget preparation system. The key principles are:

- *Universality.* All resources should be directed to a common pool to be allocated to government priorities. Rigidities in spending priorities—such as earmarked funds—are often introduced for political economy reasons and can make resource allocations inefficient and difficult to change. Rigid spending priorities can also complicate fiscal adjustment as they are not subject to a review and do not compete for funds with other programs.
- *Multiyear planning.* Expenditure efficiency requires regular medium-term planning frameworks by function, ministry, and (ideally) program. Budgets often focus only on the current year, or are incremental, failing to consider future circumstances. Thus, they cannot be sustained. The multiyear plan should be based on existing policies and should facilitate the evaluation of new policies. It should also be coordinated with debt management operations.
- *Prioritization.* Prioritizing expenditures is critical for meeting deficit or spending targets and helps spending ministries limit their requests. If priorities are not communicated early in the budget preparation process, overspending or arrears are likely.
- *Adequate nomenclature.* Budget classification systems should permit budgets to be adequately designed, implemented, and checked. Without adequate budget classification, it is not possible to understand how expenditures are allocated among different items or programs, and thus how and what to adjust. Spending items should be classified by implementing institution (administrative), purpose of spending (functional),

Box 10. Tracking Poverty-Reducing Spending

Public spending can, and should, play a major role in tackling poverty. But this requires that governments know how much they are spending on poverty reduction and on what items. A basic principle is that all poverty-reducing spending should be tracked. If only parts are tracked, there can be no assurance that poverty-reducing spending is increasing overall. Well-developed budget classification systems can rely on existing systems to identify and track such spending. For others, setting up a "virtual" poverty fund can be a short-term solution. Such a fund is a limited classification designed to provide financial information specifically about poverty-reducing spending. Budget items considered (by the country) to contribute to poverty reduction are "tagged," and these together form the virtual fund. All tagged items are monitored by the ministry of finance as part of overall budget execution.

Separate, institutional, poverty funds, where revenues are set aside in a separate account, with expenditures occurring outside the normal public financial management system, are problematic for the following reasons:

- They do not necessarily capture additional poverty-reducing spending. Resources are fungible, and a country can offset spending by the fund by lowering its own spending in the same area.
- They undermine the comprehensiveness of the budget. Diverting limited technical skills to create and manage these funds aggravates problems of transparency, duplication, and governance in the budget as a whole. Such funds make the budget less flexible without ensuring additional funds for reducing poverty.

Even when poverty-reducing spending is identified, tracking requires effective government accounting, reporting, and audit systems. These systems in many poor countries have serious weaknesses and may not provide adequate oversight. In particular, donor-financed spending may not be covered, and reports on public spending may not be timely or accurate. Devolution of poverty-reducing programs to local governments can also make tracking more difficult.

use of expenditure (economic), and—especially for more advanced public financial management systems—program (e.g., to facilitate the tracking of poverty-reducing spending) (Box 10).

Budget Execution and Reporting

Budgets, once passed, must be implemented to carry out the intended adjustment and to adjust to any within-year shocks. This requires effective budget execution procedures.

Getting the basics right means addressing the problems that result in budget overruns and payment arrears. These include the proliferation of exceptional procedures that bypass expenditure control, and difficulty in reconciling bank statements with budget accounts, partly because of the lack of reliable and timely data on cash expenditure. These problems can be addressed by:

- *Controlling spending during the year.* Controls should encompass all the stages of budget execution (typically, authorization, commitment, verification, payment authorization/order, payment, and accounting). Many cash-based systems do not provide useful information on commitments, and weak expenditure control fosters arrears.
- *Cash planning that ensures the budget is executed as smoothly as possible.* A cash plan should project payments coming due and the availability of cash to meet them. When a shortfall is projected over the next few months, and cash rationing cannot be avoided, authorizations can be reduced accordingly. Unless commitments by ministries are also reduced, however, arrears may result.
- *Reporting and reconciliation.* Timely in-year budget execution reports, systematic data reconciliations, and clarity on the accounting basis is fundamental to ensure that fiscal adjustment is implemented as planned.

Enhancing expenditure efficiency in the execution and reporting process can be achieved mainly by reducing the costs of managing public funds—for example, by establishing a single Treasury account and installing an integrated financial management system. Also important is enhancing the quality of reporting to improve transparency and accountability—for example, by moving toward accrual accounting and improving the management of, and accounting for, aid flows. These problems can be effectively addressed by:

- *Implementing an appropriate institutional framework*. Line ministries and spending agencies should be responsible for budget execution through delivery of services. And the ministry of finance should be responsible for regulatory controls and for cash planning and debt management. To perform these functions, an increasing number of developing countries are strengthening the (typically preexisting) treasury function within the finance ministry.
- *Consolidating all government financial resources in a single account system*. There is a clear, and welcome, international trend toward consolidating all government banking arrangements in a single treasury

account (TSA), controlled by the ministry of finance. The TSA provides complete information for government funds, strengthens control over cash flows (and reconciliation), reduces the cost of borrowing, minimizes idle cash balances, and enhances the efficiency and transparency of budget execution.

- *Integrating the various stages of budget execution into an integrated financial management information system.* This helps manage public monies better, allowing greater financial control, better monitoring of the government cash position and better cash planning, and better fiscal reporting. It also provides better data for budget formulation. Computerization of such integrated treasury systems can further improve efficiency, but it is costly and complex.
- *Internal audits and controls and independent (external) audit*. These can be helpful when the staff is well qualified and compliance with audit recommendations is strong. But it may foster corruption if governance weaknesses are not addressed.

The list of what a public financial management system should ideally do is long, and the resources available in many countries to strengthen such systems are limited. Moreover, what is appropriate in an advanced economy may not be in a developing country. This means that the design and sequencing of PFM reforms should be country specific, depending on needs, the starting point, and on what is practically possible. The guiding principle for many developing countries should be to get the basics right before tackling more sophisticated reforms. Not doing so can result in much financial waste and can even undermine critical parts of the existing PFM system. These issues of sequencing and capacity-appropriate design are particularly important in post-conflict countries (Box 11).

Effective Intergovernmental Relationships

If fiscal adjustment is to work for a country as a whole, subnational finances must be controlled. In particular, experience shows that market discipline by itself does not prevent unsustainable debt accumulation and typically needs to be complemented by other forms of borrowing control (Ter-Minassian, 1997).

Borrowing controls can take the form of rules at lower levels of government or direct controls over subnational borrowing. Under a rules-based approach, debt limits for individual subnational jurisdictions can be set based

Box 11. Rebuilding Fiscal Institutions in Post-Conflict Countries

Weak, or nonexistent, institutions make implementing fiscal adjustment in post-conflict countries particularly challenging. The strategy for rebuilding these institutions must be tailored to the country's capacity, focusing on the basics, yet flexible and consistent with the long-term goal of moving to a modern fiscal system (IMF, 2004b). This strategy entails a three-step process:

- *Creating a legal/regulatory framework for fiscal management.* This means reviewing existing legislation with a view to simplifying tax laws and procedures, or establishing new ones if existing laws are inadequate.
- *Establishing/strengthening the central fiscal authority.* Such an authority usually comprises four departments: a budget department, a treasury department, and separate departments for tax and customs administrations. Some countries have also established an explicit mechanism for coordinating donor assistance. The decentralization that is often needed to secure the peace should not endanger economic reforms and fiscal control.
- *Designing appropriate revenue and expenditure policies while simultaneously strengthening revenue administration and public financial management.* For tax policy, this means, for example, being more open to suboptimal policies—such as export taxes—that generate urgently needed revenue. For revenue administration, it means focusing on basic procedures, such as systems for filing and paying taxes that are easy to comply with. And for public financial management, it means implementing simplified systems, such as budget classifications under broad categories of outlays, to be refined later.

on criteria that mimic market discipline, such as current and projected levels of debt service relative to revenues. Direct controls can also be used. These include annual limits on the overall debt of individual subnational jurisdictions, central government review and authorization of individual borrowing operations, and/or the centralization of all government borrowing.

In countries with autonomous subnational governments, the center may not be able to legislate debt limits, or other requirements. The main leverage in such cases is transfers from the center, in combination with a no-bailout commitment of subnational governments by the central government.

While most countries have some form of revenue sharing (where the central government collects revenue but transfers part of it to subnational levels), excessive reliance on this method of funding subnational governments can hamper fiscal consolidation. For example, the central government may need to raise national revenues by more than the targeted reduction in the overall deficit to accommodate extra spending by subnational governments of shared or earmarked revenue.

Design Issues and the Right Incentives

In theory, assigning expenditure to local levels can raise the efficiency of service delivery, because the provision of public goods is better targeted to community needs and governance can be improved. But the potential efficiency gains can be significantly undermined in practice by the lack of clear and costed spending responsibilities and institutional constraints. In addition, devolution of expenditure responsibility to lower levels of government in countries with regional income disparities will, as a rule, have to be accompanied by income equalization transfers, which may not be politically feasible (Ahmad and Craig, 1997). In such circumstances, decentralization will lead to increased regional disparities in the level and quality of services and thus hurt the poor.

On the revenue side, the main objectives are accountability on the use of public funds while leaving the central government with sufficient instruments for stabilization and redistribution. These point to a system of assignment of own sources of revenue to each level of government—combined with various types of intergovernmental transfers to bridge any resulting gap between revenue and expenditure assignments.

Central government should be assigned taxes levied on the more mobile tax bases (e.g., profit taxes) to avoid tax competition among lower levels of government; taxes that are more sensitive to changes in income (or those that can best be used for stabilization purposes); and taxes that are levied on bases that are distributed unevenly across regions (e.g., taxes on natural resources), for distributional reasons (Norregaard, 1997). Multistage sales taxes, such as the VAT, which are difficult to coordinate and administer at the subnational level, are also best collected centrally. By contrast, single-stage sales and excise taxes are generally good candidates for assigning to regional governments. Property taxes, business license taxes, and various types of user fees for local services are ideal candidates for local taxation, since their base is relatively immobile. The personal income tax is also suitable for partial assignment—through "piggy-backing"—to the subnational level.

Most tax assignments are likely to cause large vertical imbalances—that is, fiscal imbalances between the subnational government level and the national level—as well as horizontal imbalances across jurisdictions, because the capacity to raise own revenues and spending needs differs across jurisdictions. These imbalances should be addressed through intergovernmental transfers. This is crucial not only to promote a more equitable distribution of resources, but also to ensure that effective limits can be set on the borrowing of subnational governments.

Intergovernmental transfers can be broadly grouped into two main categories: revenue-sharing arrangements and direct transfers (grants). Transfers can be grouped into general-purpose (unconditional) grants and specific-purpose (conditional) grants. The latter may be open-ended or subject to a cap. Both revenue-sharing arrangements and grants can be tailored to distributional purposes. In general, transfers based on objective criteria, such as population and per capita income, maintain incentives for efficient use of resources and tax effort. Gap-filling transfers, on the other hand, generate perverse incentives that can lead to budget overshooting and cost overruns.

Key Institutions

Achieving the potential benefits of devolution of spending responsibilities requires strong institutions and a high degree of transparency at all levels of government. In most developing and emerging market economies, this requires the administrative capacity of subnational governments to be upgraded substantially. To coordinate overall fiscal policy, it is also necessary to have timely and complete reporting and control systems at all levels.

Poor oversight of subnational governments and soft budget constraints have led to weak governance and to lack of accountability in many countries. In such cases, decentralization has had disappointing results in improving the efficiency and equity of public spending, while weakening the overall fiscal position. In this context, several countries have been improving their budget processes and developing fiscal responsibility legislation and internal stability pacts, which include fiscal targets or limits on subnational governments. These changes, to be effective, must be accompanied by credible sanctions and enforcement mechanisms when subnational governments breach the rules or do not meet reporting requirements.