The Fiscal Problems of Less Developed Countries

Among the most difficult problems faced by developing countries is that of balancing a budget which is swollen by the cost of development. This problem is enhanced both by the slowness with which revenues grow, and by technical difficulties in controlling expenditures. The Fund is alive to the importance of the problem and is now able to offer help to its members in this field.

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WHILE EACH of the less developed countries has its own unique historical antecedents and institutional and social structure, many of them share common problems that prevent them from developing as rapidly as they otherwise might. Two of the most persistent of these problems are inflation and balance of payments deficits. Often budget deficits of the central government and, at times, deficits of the over-all public sector, have been an important cause of the inflation and balance of payments deficits. Although some developing countries have made significant efforts to improve their tax and budget systems, almost all that have received Fund support for stabilization programs through drawings or stand-by arrangements were experiencing serious fiscal difficulties at the time the support was granted.

In the course of its activities, the Fund has built up close contacts with its member countries, including the less developed countries. Through annual consultations with each member country, the Fund is able to review the member's policies and problems, especially in the financial field. Such reviews also take place when the Fund provides financial assistance to member countries. The Fund thus has had an opportunity to view at close range the financial problems of a very large number of the less developed countries, both comparatively as they occur from country to country and dynamically as each country progresses in its own development process.

Growth of the Public Sector

In these reviews the Fund has watched how the less developed countries in their desire to accelerate their rate of economic growth are taking steps which tend to increase the size of the public sector—i.e., central government, local governments, and state enterprises—relative to gross national product (GNP). Since there is little or no spontaneous development, the only way toward more significant growth

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appears to be for public authorities to take the initiative. While the share of the public sector in GNP in the developed countries generally exceeds 20 per cent, it is below that level in most less developed countries, and in many is even less than 10 per cent. Expenditures for irrigation, power, transportation, etc.—i.e., *infrastructure investment*—and increased expenditures in health, education, and other programs for the development of human resources entail considerable growth in the size of the public sector.

To some extent these increased expenditures may be financed through borrowing, and external financing may be an important component of any country's development resources. The magnitude of the desired increase in expenditures is such, however, that heavy reliance on foreign borrowing is not possible if future balance of payments difficulties are to be prevented. At the same time, only limited borrowing in the domestic capital markets is possible. Thus, the greatest share of the increased public sector expenditure must be generated internally through the revenue system, as the main procedure to reallocate the resources that the development effort requires.

Revenue Problems

In almost all the less developed countries, the revenue systems are still weak and structurally ill-suited to provide the resources necessary to accelerate economic growth. Typically, their revenues under any given set of existing rates, rules, and regulations grow less rapidly than the over-all economy. Appeals have to be made to the legislature for changes in rates merely to keep the size of the public sector constant. Basically, this reflects failure to tap adequately the more dynamic sectors of the economy. A major factor contributing to the inelasticity of these revenue systems is the very heavy dependence upon customs duties rendered comparatively stagnant by balance of payment limitations on import growth, by the fixed character of specific duties, and by the shift in import composition to lower duty, or even exempt, capital goods and raw materials. In addition, the prevalence of often specific indirect taxes and land taxes based on long outdated assessments inhibits revenue growth. The yield from a typical revenue system does not generally keep pace with increases in prices; thus under inflation the financial position of the government worsens.

The situation is often further complicated when public enterprises of a commercial nature charge inadequate prices for services that they provide in electric power, railway transportation, water, etc., and require financial support from the central government's tax revenues. However, an increasing number of countries has adopted pricing policies for some public agencies so that they earn enough money to cover the domestic currency components of the agencies' investment programs, in addition to covering current operating costs. These countries find that, given steady and assured financing, the business type public agencies can borrow money abroad more easily to fulfill the foreign currency requirements of their investment programs and can meet their over-all investment targets.

The inelasticity of revenue systems also leads to other problems. In the quest for more and more revenues, many governments of the less developed countries have adopted ad hoc tax measures that have piled tax upon tax and made the revenue systems exceedingly complex. Such ad hoc measures pay little attention to the

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consequent discouragement of production and investment. Too often the resulting revenue systems penalize efficient production while providing incentives to speculative, unproductive investment. The growing complexity of the revenue systems also adds to the problems of administering them. In very few of the less developed countries is there an abundance of skilled, experienced tax administrators. Complex revenue systems are frequently beyond the capacity of the existing staff to administer efficiently, so that widespread tax evasion and an inequitable enforcement of the tax system results. As the public becomes aware that evasion is occurring, voluntary compliance diminishes, and the tax system becomes more difficult to administer. This may generate a vicious circle. If a further shortfall in revenue requires additional ad hoc measures, the cycle of complexity and weak administration becomes more intense and the quest for additional revenue is frustrated.

Importance of Budgeting

On the expenditure side, too, the fiscal systems of most less developed countries are weak. Budgeting in its true sense involves the distribution of resources according to carefully established priorities. It also involves control of the growth of total public expenditure and keeping these expenditures within the limit that can be financed by government revenues and noninflationary borrowing. Frequently, however, there is a tendency in the less developed countries to compartmentalize expenditures without looking at public expenditure as a whole. The investment budget is often separated from the ordinary expenditure budget. Too often the budget involves no true budgeting but merely a compilation of the requests for public funds by the various ministries, departments, or agencies. Control over public expenditures is also weakened by widespread earmarking of particular revenues for specified expenditures and by the practice of allocating to certain specified programs or institutions fixed percentages of total budget expenditures. Such earmarking may continue long after the period when there was a clear rationale for the expenditure involved.

In most less developed countries steps have now been taken to plan public expenditure for fixed capital assets over a period of years. These plans, however, are sometimes not well integrated with the plans for other public expenditures or with plans for the alignment of total public expenditure with available resources. Because of the compartmentalization of expenditure, and often because of a preoccupation with expenditure on fixed capital assets, there has been insufficient attention to a forward look at public expenditure as a whole. This has led in a number of instances to "stop and go" programing of expenditure which damages the economy and further weakens control of public expenditure.

Of course, not all the fiscal difficulties of the less developed countries can be traced to weak fiscal systems. Many of the less developed countries rely heavily on the export of raw materials and are particularly sensitive to shifts in world supply and demand of a few basic commodities. Any fall in prices is soon reflected in falling government receipts from customs duties and internal taxes. Such countries' financial problems may at times be intensified by disasters such as floods, prolonged droughts, or earthquakes. In any event, ideal solutions to the fiscal problems are not always available.

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Countries faced with the problem of curbing serious inflation and bringing balance of payments under control are often forced to adopt emergency fiscal measures which may be helpful in the short run but would be undesirable if long continued. These measures include such actions as the deferment of capital outlays and the imposition of surcharges on imports or foreign payments. A weak fiscal system, however, can make a country's problems more difficult than they need be, whereas a strengthening of such systems may facilitate solutions.

The Fund for some time has been increasingly concerned with fiscal problems, particularly in member countries where deficits in the public sector have been a substantial destabilizing force in the economy. In its *Annual Reports* and other publications and statements, the Fund has described the erosive effects of inflation on the development process and has shown the need for monetary and financial stability as a prerequisite for economic growth. The Fund is very interested in aiding its members to achieve their development aspirations and believes it can help to create the conditions in which their development efforts may prosper and bear fruit.

Need for Expertise

Taxation and government expenditures are especially sensitive and complex subjects. They are politically sensitive because of their well-recognized implication for the distribution of income and wealth. Traditionally, legislatures have exercised more control over taxes and government expenditures than over monetary policy, exchange controls, and/or exchange rates—other areas of concern to the Fund. There is a need, however, for expert advice in the fiscal field because the multiplicity and complexity of taxes and expenditure programs pose many technical problems of economic analysis, legal drafting, and administration.

To help to meet this need, the Fund has expanded its work in the fiscal field by broadening its coverage of fiscal matters in its periodic consultations with members, by responding to requests for technical assistance, and by carrying on more research in public finance. In May 1964, the Fund established a Fiscal Affairs Department to carry forward these activities in a more systematic way, and to further its technical assistance in the fiscal field.

The Fund is concerned particularly with the over-all economic activity in the country and its impact on the country's balance of payments. The relation of government finance to the over-all economic activity and to a country's payments position is well recognized. The primary purpose of the Fund is to engage in short-term foreign exchange operations designed to help countries to overcome temporary balance of payments problems. Thus, the Fund can combine, if need be, financial support with technical advice and assistance to help a country overcome its difficulties. Furthermore, the Fund maintains a continuing relationship with national authorities in fiscal matters just as it does in monetary matters. This continuity should make both the formation and the application of policy more effective than sporadic efforts can do.

The Role of the Fund

Taking fullest advantage of these features of Fund operations, the Fund's activities in the fiscal field are intended to complement the advice and assistance being given the less developed countries by other international or-

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ganizations and some national governments. The Fiscal Affairs Department maintains close liaison with these other agencies.

In providing technical assistance to member countries, the Fund recognizes that taxation and government expenditures are more than purely technical matters. Historical antecedents and the social and institutional background have to be taken into consideration. Any measures taken will also depend in large measure upon political acceptability. The Fund provides technical assistance only after a member country explicitly requests it.

By operating chiefly through a continuing and full-time staff the Fund hopes to build up over the years a unique pool of expertise and information in the fiscal field. In addition, files of information on fiscal practices and experience are being accumulated. Eventually the collection may become a world center of fiscal information.

The Fiscal Affairs Department is divided into three:

1. *Tax Policy Division*—deals with the applicability of different taxes to particular situations and with the relation of taxation to monetary and other economic measures. This Division provides advice on tax structure and helps members to draft tax laws and regulations.

2. *Tax Administration Division*—handles problems in organization and methods of efficient administration of tax instruments under conditions prevailing in the less developed countries; techniques of collection; the estimation of tax yields; and methods of dealing with tax avoidance, evasion, etc.

3. *Budget Division*—provides expertise in budget structure, budget classification, analysis, and forecasting of expenditure and income. It concentrates on governmental accounting practices, expenditure controls, and financial reporting techniques to ensure centralized knowledge and control of expenditures in the public sector, including the special problems of state enterprises. It also seeks to coordinate planning for the annual budget with that of the longer-range development or investment budgets, and to develop the use of cash budget techniques as a means of integrating fiscal analyses with the financial analysis of price, monetary, and balance of payments developments as examined in detail by regular Fund missions.

The staff of the Fiscal Affairs Department includes 22 professional members from 13 countries. Thus, the Department is able to call upon fiscal expertise from widely varying backgrounds. Drawing upon the training and experience of its staff and the cumulative past work of the Fund, both within and outside the Fiscal Affairs Department, the Fund is now ready to provide its members with short-term and long-term technical assistance over the whole of the fiscal field.

Panel of Experts

The Fund has recognized that a number of particular problems giving rise to requests for technical assistance may be of such a highly specialized nature that they cannot be dealt with effectively by the regular staff. Such requests, particularly in connection with fiscal administration, i.e., tax administration, accounting, and budget and expenditure planning and control, may require the services of experts with closer, more specialized experience in the areas needed. To meet these needs, the Fund has established an international panel of ex-

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perts. These experts are either (1) so specialized in their qualifications that it would be difficult to fit them into an inevitably small permanent staff, or (2) hold such responsible official positions that their governments would be reluctant to release them for more than a short time. The expertise desired from this group is found, for example, in a senior budget official with experience in expenditure policy or budgetary controls, or in the field of tax administration, e.g., assessment and collection of land taxes, sales and excise taxes, customs duty procedures and collections, income tax administration, etc. In addition the panel includes a few outstanding persons from universities and research organizations.

Several governments have indicated their willingness to assist the Fund by providing lists of experts who could be made available for technical assistance assignments. Inclusion in the panel commits neither the expert's government to release him at a particular time nor the individual to accept a particular assignment. The purpose of the panel is to provide the Fund with a list of qualified persons and a knowledge of their backgrounds so that the Fund will know where to look for the required expertise and so that it may be able to fill any request for technical assistance relatively promptly. A knowledge of the language of the country of assignment is essential. The field assignments of experts drawn from the panel are for periods varying from a few weeks to one year. After a short Fund orientation and briefing in Washington, the experts are sent to member countries and brought back to headquarters for debriefing upon completing an assignment.

Requests for technical assistance in the fiscal field have been received from member countries in Africa, Asia, the Middle East, and Latin America. The Fund has been able to comply with several of the requests by providing the services of regular staff members or experts drawn from the panel.

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