



# It's Mostly Fiscal: A Public Finance Perspective on Economic Development

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# Fiscal Pressures in Poorer Countries

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- Competing fiscal pressures
  - High need for spending on education, health, and infrastructure
  - But narrow tax base and low revenue
- Result inevitably is low growth
  - Low tax rates generate too little revenue to finance needed investments
  - But high tax rates undercut tax base



## Why such a narrow tax base?

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- Monitoring of taxable activity difficult
  - In developed economies, monitoring largely based on the paper trail available from the financial sector
  - In poorer countries, firms can more easily operate in the cash economy instead, in whole or in part
  - Other indicators, such as visible capital, provides less useful information



## Tensions in setting tax rates

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- With a narrow base, need a higher tax rate in order to collect as much revenue
- But a higher tax rate induces firms to shift to the cash economy
- In practice, tax rates comparable to those in developed countries, but many firms shift to cash economy



## Resulting tax base

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- Tax base commonly confined to large capital-intensive firms, largely in heavy industry and natural resources
- But poor countries often do not have a comparative advantage in these sectors, particularly when these firms face high tax rates



# Possible policy responses to expand tax base

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- Impose higher taxes on firms that can less easily be informal
  - Excise taxes, with rates varying by sector
  - Corporate taxes, since capital-intensive firms more easily monitored
- Protect tax base from competition
  - Tariffs on imports competing with taxed firms
  - Subsidize loans to taxed firms
  - Restrict entry of multinationals in heavily taxed sectors
- Discourage cash economy: “license Raj”, entry barriers, inflation



## Responses can improve efficiency

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- Without such policies, taxes on a narrow base can generate high efficiency costs by shifting activity into the informal economy
- Policies lessen these tax induced reallocation
- Under optimal policies, taxed sector may even be “too” large



# Responses have mixed effects on growth

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- Entry barriers, restrictions on credit, and tariffs all reduce growth
- But extra funds for education and infrastructure increase growth
- But funding still low, creating a type of poverty trap due to difficulties in raising revenue



# What about Market-Oriented Reforms?

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- Conventional market reforms
  - Reduce tariffs heavily
  - Reduce tax rates and “broaden” tax base
  - Reduce inflation rate
  - Market allocation of credit
  - Scale back restrictions on entry
- Expect rapid entry, since existing firms handicapped by high tax rates



# Implications of market reforms for tax revenue

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- New firms often informal and hard to tax
- New entrants take customers and factors away from easily taxed firms
- Imports also undercut easily taxed firms
- Threats force a cut in tax rates, further reducing revenue



## Size of these effects in China

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- During the first decade and a half of the Chinese economic reforms,
  - GDP grew by 300%
  - Tax revenue fell from 26% to 10% of GDP
  - Corporate tax rate fell from 55% to 33%
  - Excise taxes largely replaced by a VAT with a much lower tax rate



# Available responses to fall in tax revenue

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- Cut government spending, e.g. on education and infrastructure
- Shift to user fees or private provision of services
- Run a deficit



## Problems if cut spending

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- Poor education and infrastructure undermines growth, perhaps for decades
- Since cuts particularly hurt poor, risk of political pressure to end market reforms
- Pressure then to protect services, in order to maintain support for reforms



## What about maintaining spending through user fees or private provision?

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- Poor still lose on net, creating political opposition to reforms
- Private providers also face risk of expropriation if political balance shifts
- Can succeed if the reforming government has sufficient political control, e.g. China, Korea, Taiwan, Chile



## What about use of debt finance?

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- Unless future budgets less tight, simply generates worse fiscal problems in the future
- If future budgets potentially less tight, still face risk of a financial crisis if investors lose confidence that future revenues will materialize



## Growth does expand tax base

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GDP per capita	Tax Revenue/GDP
\$0 - \$2,500	17.7%
\$2,500 - \$5,000	18.9%
\$5,000 - \$10,000	23.4%
\$10,000 - \$17,500	30.4%
\$17,500 +	37.7%



## Why the growth in revenue/GDP?

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- Improvement in quality of financial sector, making it harder for firms to survive in the cash economy
- Increasing need by firms to use financial sector as they improve in productivity and need more capital, and trade at a greater distance



# Can governments borrow to maintain services?

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- Figures suggest that has a chance to work if initial GDP above about \$5,000, though face risk of a financial crisis
- Very unlikely to work in poorer countries, so that reforms force a cut back in services, risking a political crisis



# Political economy problem in agreeing to market reforms

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- Government officials lose access to revenue now in exchange for more revenue in the (distant) future
- Attractive to officials only if they have a sufficiently long time horizon
- In China, restoration of initial revenue/GDP took 25 years



# Political Economy Problems in Maintaining Market Reforms

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- Until the tax base includes most activity, the government gains revenue by favoring those sectors paying tax
- Spending on education and infrastructure also implies short run fiscal costs but fiscal benefits only after many years
- Governments with a short-time horizon then gain from undercutting reforms
- Reforms at risk until per capita GDP rises above roughly \$10,000



# What about partial reforms that preserve government revenue?

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- For example, allow entry of new firms, but
  - Continue to restrict domestic entry in sectors generating most tax revenue
  - Maintain tariff protection for heavily taxed sectors
  - Maintain some controls over allocation of credit



# Benefits and Costs of Partial Reform

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- Helps to maintain government revenue, so support from officials and from poor
- Slows shift of resources out of the easily taxed sectors
- This slowing does not necessarily have efficiency costs, given the differential tax rates



## Summary

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- For countries with GDP per capita above about \$5,000, market-oriented reforms may well succeed, but this still requires low debt and a strong stable government
- Otherwise, only partial reform likely to work