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Role and problems of fiscal policy in financing economic development in African developing countries

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## Methods of finance

Financial policy makers in African developing countries are continuously grappling with the problem of making adequate provision for existing services and facilities and also trying at the same time to channelize as far as possible increasing amounts of resources for capital formation through the public sector. This is by no means an easy task and the measure of success achieved is not impressive in all cases.

The methods of finance that could generally be tapped by these countries are:

(i) tax revenues;
(ii) borrowing both internal and external;
(iii) gifts and grants;
(iv) receipts of public enterprises;
(v) departmental receipts for services rendered and;
(vi) deficit financing in exceptional circumstances.

Development expenditures in most cases are met with by foreign loans and grants. Apart from this however, several African countries are still dependent on foreign budgetary support for meeting a portion of their recurrent expenditures. The number of countries so dependent was still as large as 18 in 1970. This dependence on foreign budgetary support for meeting recurring expenditures is however, diminishing gradually. It was less than 10 per cent of total revenue receipts in 1970 for 10 of the countries concerned. But this aid is still quite substantial in the case of countries such as Liberia, Ethiopia, Swaziland and Malawi and some countries belonging to former French West Africa.

## Need for more domestic resources

The adequate availability of domestic resources both physical and financial is of crucial importance for meeting not only local costs of development but also for meeting the growing recurring liabilities of debt servicing. Moreover under the impact of rising prices and implementation of plan schemes in the social and economic sectors the developing countries are faced with the problem of rapidly rising administrative expenditures which have to be provided for before any public sector savings become available for development. It is a fact however, that in the existing circumstances most African countries have little to spare once they have met their recurrent expenditures. The United Nations Survey of Economic Conditions for 1971 has brought out that out of the 23 African developing countries for which comparative data was available the share of current expenditure in total Government expenditure in 1970 was above 70 per cent in seven cases; between 70-80 per cent in 6 cases between 60-70 per cent in 8 cases and less than 60 per cent in 2 cases 1/.

1/ For details see table A-73 of Appendix to "Survey of Economic Conditions 1971 part I United Nations Publication Sales No.E.71.II k.9."

## Growth of the Public Sector in the Region

During the first decade after achieving their independence most of the African developing countries witnessed a markedly rapid expansion in the scope of the public sector. Although this distinctly rapid expansion has now been halted the level of public sector activities in most countries has acquired a pattern of steady growth which probably would continue into the future under normal circumstances. In most countries the percentages of GDP represented by central Government expenditures were in the range of 15 to 19 per cent in 1970. Only in three countries viz. Algeria, Tunisia and Zambia these percentages were above 40 per cent while in six other countries these percentages were below 15 per cent 1/.

## Role of fiscal policy in Economic Development

With the growth of the public sector, there is a growing awareness in most of the countries of the region of the need for the development of adequate fiscal and financial policies and tax reform planning as part of the process for preparation of national plans for economic development. The development plans of most of the countries postulated substantial fiscal effort with a view to accelerating capital formation for the implementation of development projects. However, the effort contemplated was not made in most cases, or if made it fell short of expectations. This resulted in poor plan performance.

The acceleration of economic development in order to raise the living standards of the people is a major goal of all countries in the region. To achieve this goal increased availability of goods and services is required for which one must continuously aim at increased production by planning for a sustained increase in investment. It is only when national income increases faster than population growth that living standards can be raised. It is only when more is produced that there will be more to go round. It is not only important that development should take place but it is even more important that it should take place in accordance with a planned programme which should engulf not only the sources and methods of mobilizing resources but their proper allocation in accordance with a system of national priorities. The major problem being to increase productive investment measures have to be devised: (a) to mobilize existing potential surplus of production over consumption and (b) to channellize this surplus into productive investment. Without productive investment the mobilization of surplus will not initiate growth.

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1/ For details see Table 14.3 page 191 Survey of Economic Conditions in Africa 1971.

## Assessment of financial resources

In the process of development planning it is also an essential exercise to estimate as realistically as possible how large a programme can be implemented within the means of the country during the periods covered by the medium-term plan or annual plan. The realistic assessment of financial resources required for development and the adoption of proper policy measures to raise these is therefore a task of great importance.

"Finance" has often been described as the Cinderella of Planners. The failure of many countries to realize the growth targets set in the plan has often been related to the failure to raise adequate resources matched with the availability of real resources in the economy viz. materials, equipment and labour etc. The mere provision of financial resources however, is not enough. Indeed, if these are provided beyond the limits set by the availability of real resources, price inflation is the unavoidable consequence with eventual disruptive effect on the economy and consequently on the development effort. The function of finance under a programme of planned development should therefore be to provide money for development in amounts corresponding to the real resources which can be mobilized. Looked at in this way, the proper role of finance should be positive and supportive rather than merely negative and restrictive.

The modern states especially those of the developing countries have to perform wide and varied tasks. They have to assume responsibility not only for their traditional functions of maintenance of law and order but they have also to accept responsibility for maintaining the equilibrium and the economic prosperity of the nation.

Public finance is no longer designed simply to meet a few basic collective needs but now involves state intervention in the economic and social fields. It aims at steering the national economies by modifying the distribution of goods and services and incomes among the private individuals in order to replace unproductive private expenditures by productive government expenditures.

The increase of domestic savings is one of the essential problems facing economic development in Africa. The ultimate aim of economic development being to accelerate the rate of increase of income per head, the rate of capital accumulation and consequently the rate of domestic savings are of crucial significance.

## Importance of the modern budget

The modern budget is not merely an estimate of revenue and expenditure, it is an instrument for implementation of the economic and social policy of the Governments and also a weapon for achieving an overall economic equilibrium by incorporating measures which intervene in the nations economic life in order to correct unfavourable economic conditions. This is possible because of the considerable proportion of the national income which the Government budget represents.

No Government in the modern world, whether of developed or developing countries can afford to be indifferent or oblivious of its financial policies particularly those concerning income, employment and prices. Government financial policies generally lie in the fields of taxation, expenditures and debt management. The extent and quantum of Government taxes and expenditures are bound to exercise strong pressures on the way or purposes for which taxes are imposed or expenditures incurred. Government debt or borrowing policies whether affecting internal or external borrowing have a profound effect on resource mobilization and availability of credit etc.,

There is no doubt that any Government worth the name in the conditions existing today tries to base its financial policy decisions on some sort of economic analysis of the issues involved. Such analysis and issues are often presented in the medium and long-term plans for economic growth adopted by the Governments. Inspite of this however, the changing social, economic and political conditions exercise a profound effect and largely determine the adoption of specific policy measures. In many cases the framework for economic analysis in decision-making may be and often is thrown overboard. Taxation in particular is a delicate financial instrument in view of its repercussions upon prices, profits and direction of investment and economic activity in general. However, it may be stated without contradiction that if any government fails to relate its financial policies for a long time to the state of the economy, and popular demands for basic services and guarantees of minimal security and opportunities will eventually cause popular resentment. "Political forces no doubt basically determine the practicability of many suggested financial policies. In addition, the choice between alternative courses of action might also be determined primarily by the effects of these measures or courses of action on the political framework"1/.

## Basis of fiscal policy

Among the various means available to a government for furthering its development objectives, fiscal policy is potentially the most important because it comprises the powerful tools of taxation and budgetary allocations. The budgetary mechanism permits the channelling of resources into uses of high developmental priorities. Budgetary operations can act upon resource allocations both directly and indirectly through the provisions of incentives for better resource use.

A tax system suited to the needs of developing countries in Africa must discourage the use of resources in activities of low developmental priorities and reward and favour their use in areas of high priority.

1/ Fiscal policy and politics - Paul J. Strayer - Harper & Bros New York 1958.

In other words, taxation must bring about a shift of resources from consumption to investment and from investment contributing less to a country's economic and social objectives to investment contributing more to those objectives.

The basic national income concept expressed by the equation

$$Y = C + I + G$$

(i.e. income equals consumption plus investment spending plus Government spending)

lays down the basis and the need for fiscal policy e.g. if there is a deficiency in spending in the private sector of the economy, resulting in a decline in effective demand below that sufficient to clear the market or if there is an excess of spending in the private sector resulting in excess of demand leading to inflation Government has to step in to restore the necessary equilibrium. This it can do in various ways e.g. it may vary its rate of spending - creating either a deficit or a surplus, or it may directly encourage or discourage spending on private account by budgeting outlays at constant levels and lowering or raising taxes or it may adopt a combination of these techniques. Further it may resort to grant of subsidies or levying of penalities to restore the equilibrium.

Taxation can aid economic development by influencing investment choices by the private sector by providing proper tax incentives, such as accelerated depreciation, tax holidays and others, which would raise their direct yield to the investor sufficiently to influence his investment decision in their favour.

A tax system may also be designed to encourage a more effective use of resources which are idle or partly idle. Most developing countries possess unemployed or under-employed labour and under-utilized or unutilized lands. The potential stimulus to proper land utilization which could ensue through fiscal measures is considerable. Where land ownership for instance is such that proper economic use of land is not being achieved, fiscal measures could be used to improve land utilization, In cases where land was being used extensively with low output per unit, taxation might stimulate its more intensive use by the owner, or encourage the sale of land to others who would cultivate it more intensively. In appropriate cases, tax incentives could also be employed to encourage more labour intensive methods of production and thus to increase employment opportunities.

Foreign exchange is often one of the scarcest resources of developing countries. Taxation - particularly customs duties - may be employed to conserve these resources and to direct them to priority uses.

Taxation can also favour export transactions and thus help to increase the availability of foreign exchange. Exports may be stimulated through a reduction in the rate of export taxes or the imposition of taxes on the domestic consumption of export products which would increase the supply available for export.

Fiscal policy can also be used to achieve a more equitable distribution of income and of the costs of financing the activities of the government. The distribution of income in many developing countries was very unequal. Economic development often tended to increase such inequality. Moreover the income groups which benefited most from the governments development efforts often did not pay a commensurate proportion of the governments costs. Where such conditions existed the effective use of a progressive taxation system with respect to income and wealth could be effectively used to reduce distortions in income distribution.

As increasing savings and investment are necessary pre-conditions for economic growth this factor must be taken into account in formulation of tax policy. However, it must be stated that to the extent taxation transfers to the Government resources which would have been saved and invested by the private sector it would enhance development only in so far as the use made of those resources by the Government was more effective than which the private sector would have made of them.

## Economic analysis of tax policy

The formulation of an adequate tax policy would require analysis of both the specific effects of individual taxes and of the aggregative effects of the tax system as a whole.

The economic analysis of tax policy revolves round the problem of incidence of taxation but in view of the general lack of precision in this respect it is of limited use in the measurement of true burden of taxation. Tax incidence views and theories regarding forward and backward shifting are still inadequate. The critical issues of progression, regression or proportion in the tax burden distribution for example call for a knowledge of the rate at which the utility of income declines as a result of taxation 1/. No tax burden distribution assumptions may be completely satisfactory. In the last resort political and social judgements even more than economic analysis will determine policy.

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1/ For a more detailed review of this subject see Walter J. Blum and H. Kalen Jr. "The Uneasy Case for Progressive Taxation". The University of Chicago Law Review XIX (1952) 417-520.

Inspite of this however certain basic oft repeated postulates of taxation must be kept in view as far as possible. These are:

(i) persons in equal circumstances should be treated equally;
(ii) tax revenues should vary countercyclically;
(iii) taxes should be imposed upon those with low incomes at a lower rate than those with high incomes;
(iv) taxes should be lighter on a larger family than a small one and;
(v) taxes should be used not only as a means of balancing the budget, but also as a means of directing the character and quantum of investments;
(vi) administrative and political realities must be weighed fully alongwith economic analysis. A theoretically perfect tax may have adverse effects unless it is properly administered.

Simplicity in tax laws

Proper attention should be paid to make the tax laws as simple as possible. There is always a cost attached to the operation of any tax system both for Government in administering the taxes and for the taxpayer in complying with requirements. Efforts made by a Government to enforce and collect taxes, especially where tax laws were complicated required highly trained personnel who could perhaps be more effectively used elsewhere. At the same time the tax payers would have to employ qualified accountants or other personnel to manage their tax affairs. Simplicity, no doubt, is an essential requirement of any tax structure designed for the promotion of economic development. Complexity encouraged efforts to evade the tax. It was also necessary to provide tax payers with adequate information and to reduce formalities to a minimum.

Education and publicity

Efforts should also be made to demonstrate that the tax system was equitable and that Government was resolute in collecting any taxes due under its laws. A tax system could not be successful unless it was acceptable to the people. Education and publicity were therefore, necessary.

Elasticity of tax revenues

Because of the slowness of legislative procedures relating to tax changes it was desirable for the tax structure to have a high revenue elasticity so that tax receipts would rise faster than national income. This would enable the government to meet the growing demand for services and public investment.

Taxation of consumption vs savings

It may also be mentioned that the impact of a tax structure which would further economic development would have to be primarily on consumption. If savings were taxed in the same way as consumption, the tax structure would discourage savings and retard growth.

Income tax in African countries.

In most developing countries in Africa income taxes were still not contributing a high proportion of Government revenues. There is no doubt a strong case for their effective administration so as to accustom the population to them. In the case of small business and persons engaged in professions income taxes were difficult to enforce because of the frequent absence of records of transactions. There is need in such cases for introduction of operational presumptive techniques to facilitate assessment and collection. In the case of wages and salaries incomes the "pay as you earn" system of withholding taxes at source has been successfully introduced in many African countries. It needs in many cases however, to be fully extended and procedures and forms etc. streamlined.

Excise duties

As revenues from import duties decline increasing use should be made from levy of excise duties. Experience in many African countries has been that the tax systems are not adjusted quickly by levying excise duties to account for losses on account of import duties with the setting up of import-substitution industries.

Sales tax

There are many merits also in a widely based sales tax. Sales tax on goods other than bare necessities like foodstuffs could be a large source of revenue and could reduce over-dependence on income taxes or the over-extension of excise duties. However, the difficulty of determining the appropriate point for the collection of a sales tax was often a deterrent to its use. A single stage and fairly general sales tax would be preferable in the existing conditions in many African countries.

Profits of public enterprises

Many African countries have established public enterprises and other parastatal bodies to manage the production and sale of goods and services in the public sector. However, in most of the cases these ventures run at a loss or their rate of return is not even commensurate with the going rate of interest on borrowings for their investments.

There is no doubt an urgent need for improving the operation of such bodies to make them more efficient and economical so that their profits could become an important source of revenue for financing economic development.

Relationship with monetary policy

In consideration of the various fiscal measures their proper relationship with monetary operations must be understood and established. If fiscal measures are designed as primary instrument for stimulation of total spending a generally easy or non-restrictive money policy would be required. If on the other hand the goal is to restrain spending then a tight money and credit policy would be more appropriate. If expansion of money supply through credit expansion is permitted it should not offset the beneficial effects of a cash surplus in the budget. The difficulty, however, lies in the fact that the extent of the action required to bring about the results desired is difficult to estimate accurately at any point of time. As such any corrective action has to be tentative in amount and direction and should be constantly reviewed in order to affect the changes indicated or to take other policy measures needed to correct the situation.

Limits of taxable capacity

This is a highly debatable issue especially in the context of the subsistence conditions prevailing in most of the African developing countries. Some experts have tried to express tax limits in terms of a percentage of the national income or in terms of tax rates.1/ A more realistic approach, however, would be to say that the limit to be applied is determined by political and social forces. "They include such factors as past experience, quality of administration and balance in the tax system, including such items as the severity of specific rates, the purpose for which revenues are required and extent to which the economic system has in it elements which prevent taxes from becoming effective"2/.

"The standard text book treatment of the issue of long-range tax policy usually bypasses the difficult task of translating the glittering generalities of equity, administrative convenience, certainty and ability which go back to the days of Adam Smith into specific guides for policy. Each of us can give these principles content, but few will agree on a total programme or the relative priority assigned to items of which there can be general agreement. One of the most widely accepted

1/ See Colin Clark "Public Finance and Changes in the Value of Money" in Economic Journal LV 1945 371-389.

2/ Paul J. Strayer "Fiscal Policy & Politics" Harper & Bros New York 1958.

principles is that taxes should not be arbitrary or capricious in their effect upon individuals or groups, but those who favour the use of tax power to provide an incentive for certain types of activity have always been willing consciously to use taxes in a selective manner to achieve their end. The principle of convenience and certainty is often in conflict with the laudable desire to make full allowance for special cases or circumstances so that a more refined adjustment of tax to ability can be achieved. Even the principle that those in equal circumstances should be treated equally defies exact expression due to the difficulty of defining equal circumstances. It is not difficult for interest groups to find ways of claiming special treatment in the name of national interest, but it is difficult to prove the adverse effects of exceptions without resort to a level of generalizations and abstractions that removes the argument from the popular level".1/ One can go to the extent of saying that at the present time there are no rules or guides that can serve as a rigid framework for the analysis of tax policy in different countries. Perhaps one has to be devised for each on the basis of political and economic factors prevalent. This leads to the conclusion that a continuous review of fiscal policy to make the desirable and feasible changes is always necessary.

Some problem areas in tax policy

As already mentioned above we still do not have any precise answer to the question of the real burden imposed by any tax. The tax incidence theory in so far as our present knowledge goes is still very general. This raises problems as the prime question facing the tax policy makers is that of the proper distribution of the tax burden among all members of the community.

Inspite of the difficulties with incidence theory however, the widespread use of progressive income tax and death duties is advocated on grounds of equity. However, the practice of imposing high rates under a steeply progressive schedule and then making such rates ineffective by extending the loopholes in the law, induces tax payers to find means of realizing income in a form subject to preferential rates. This has the effect of redirecting capital and forcing management and individuals to make decisions solely for tax purposes.

Another source of discrimination may be found in the provisions for exemptions and deductions from taxable income and their administration. The flagrant abuses in connection with the allowances for expenses are well known.

Another troublesome area of tax policy is that of the proper co-ordination of the Corporation Income Tax and the Individual Income Tax.

1/ Ibid page 212.

Starting with the premise that the corporation is a legal entity and that the stockholders' interest in the profits of the corporation may be thought of as similar to that of partners the conclusion is reached that taxation of both corporate income and dividend income is discriminatory and unfair. This has led to attempts to eliminate this abuse in tax laws.

Taxation is often avoided by retention of earnings in the form of undistributed profits. In such cases the use of a withholding tax on undistributed profits and the granting of a tax credit or allowance for sums withheld has to be carefully worked out.

The broadening of the tax base of the individual income tax to include most low income families and individuals is often thought to be a desirable reform measure. This has however, to be seen in relation to administrative capabilities. This may be easier where collection at the source on a "pay as you earn" basis can be possible. In cases of high exemptions much greater reliance on indirect taxes becomes inevitable with all its regressive effects. A progressive income tax in such circumstances is in fact tantamount to a progressive super-structure added to a regressive base. In the conditions prevailing in most of the developing countries in Africa the exemption of a minimum of subsistence from all taxation has to be given serious attention, although in the last analysis, actual tax policy has to be determined by revenue requirements, administrative capacity and political considerations.

Administrative limitations have also resulted in many countries in another serious problem. This is the discrimination between the wage-earner subject to deduction of tax at source and the difficulty of adequate coverage of self-employed professionals and small traders etc.,

The distribution of the tax burden on the basis of benefit or "user charges" also deserves proper consideration. Gasoline tax and licence fees levied are such examples. The growth of toll roads and bridges for instance could be a major instrument of highway development in many African developing countries.

The generally severe burdens imposed upon the lower income groups are the result of the heavy weight of the indirect excises, sales taxes and property taxes, many of which result in a regressive distribution of the tax burden among various income categories. The exemptions and progressive rates of the individual income tax may therefore be very important, in such cases, not only for producing a generally progressive distribution of the tax burden but also to offset the tendency for the tax burden on the great majority of the tax payers to be regressive.

These problems would be gone into detail in this course and I hope that the distinguished participants would throw light during the course of discussions on their own views and experiences about the same.

The common notion, especially in this region, that the poor at the subsistence level are not in a position to contribute in the form of tax revenues has however, to be seen in relation with the fact that this group stands to benefit more from government expenditures especially in the social and beneficient spheres and transfer payments and subsidies. Exemption of income groups at the bottom from all taxes would be wrong and not in line with the policy to promote economic growth. In the last analysis, the harm done by regressive indirect taxes may be much less than the harm that would result from the failure of the African Governments to mobilize increasing amounts of domestic resources for promoting economic growth. This is especially important at the present juncture when the countries in the region are tackling the task of putting their economies on the path of self-sustaining economic growth as soon as possible. The role of fiscal policy in harnessing resources for economic development can hardly be over-emphasized. This is the most important instrument and method for increasing public savings and their channelizing in productive investment in a climate of economic and financial stability.