Fiscal space for stability and development

Drawn from TDR 2014

Delivered by:

Diana Barrowclough, Senior Economist, and Nicolas Maystre Economist,

Division on Globalization and Development Strategies.

Diana.Barrowclough@unctad.org

Key points

- Domestic resource mobilization is essential for national development. External sources of finance complements, not replaces, it.
- Enhanced fiscal space is both a cause and an effect of economic growth and structural change -- it goes hand-in-hand with higher levels of income, modern economy, and better public services.
- Diminished fiscal space is often part of a vicious circle of under-development.
- Globalization brings new threats to fiscal space, alongside opportunities.
- Greater policy ambition (including post 2015 agenda) needs greater and more sustainable public resources - need to address lost revenues, fiscal composition, fiscal base, capacities.

Fiscal space and developmental states

- The ability to mobilise and allocate resources is part of the definition of the State. "tax history" = "national history"

- Characteristics of successful developmental states - includes shared vision of development and broad social consent, supported by institutional arrangements for continuous dialogue and co-ordination between key stakeholders. (fiscal covenant)

- Public finance is a key component in legitimizing the role of the State and establishing spheres of government responsibility.

- Fiscal space -- "the ability of governments to use fiscal instruments to pursue various economic, development and social policy objectives."

Fiscal space continued…

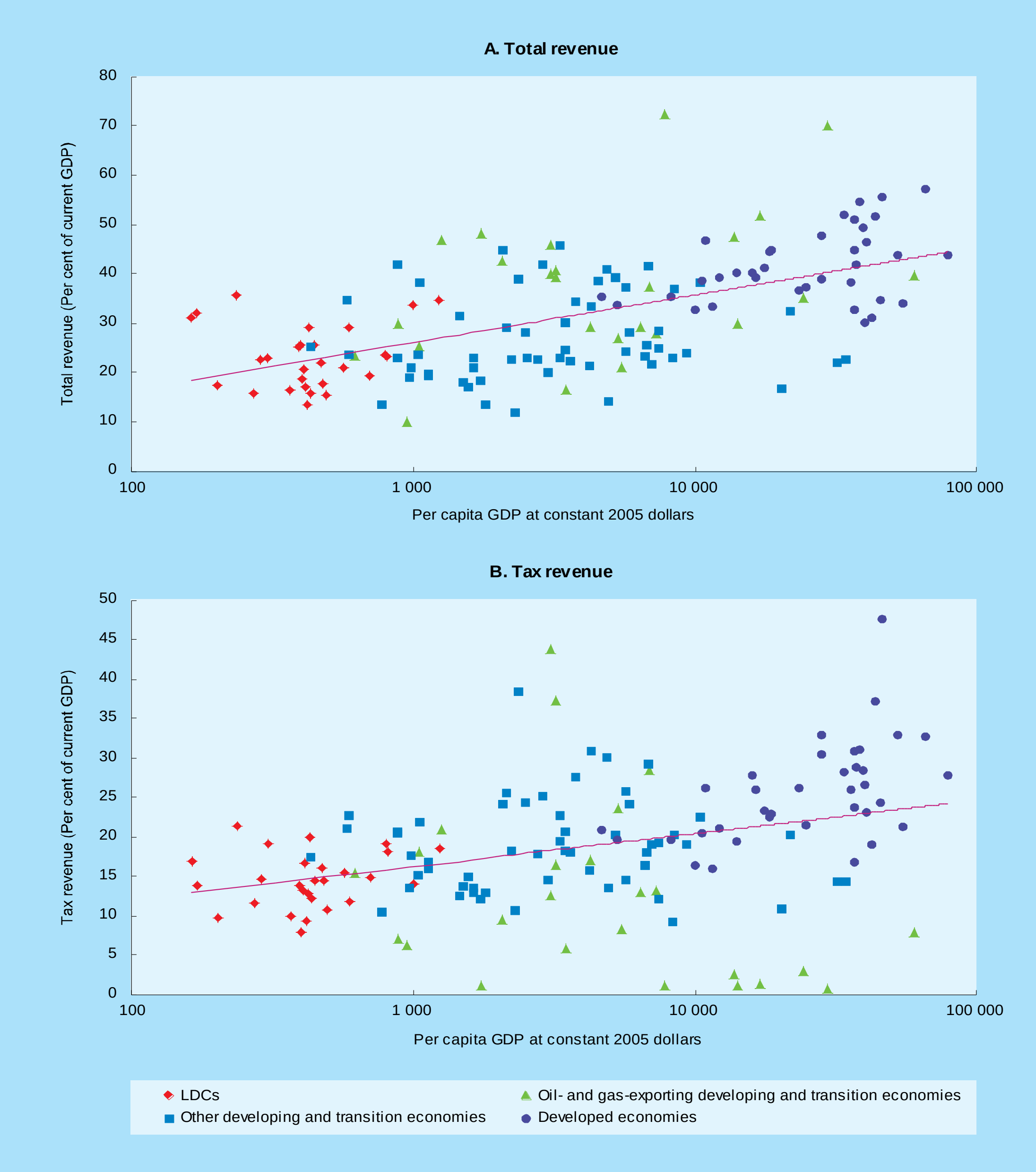
- Fiscal space has quantitative dimension - budgetary (rough approx is share of public revenue in GDP).
- And a qualitative dimension - related to level and composition of public revenues and expenditures. Decision making can be constrained *de-jure* by international agreements, external conditionalities and legal rules.
- And constrained *de facto*, by perceived demands of investors, power of interest groups.
- It is dynamic - because changes in public spending impact on the economy - both in long and short-term.
- Creating fiscal space is a long-term historical process: UK, USA examples.
- Enlargement of tax base reflects not only growth of formal economy, but also investment in legislation, tax administration and enforcement.
- No single benchmark but broad themes clear.
- Significant differences in ratio of public revenues to GDP across countries at similar levels of p.c. income
- How to increase revenues? How to ensure composition can best promote inclusive growth, structural transformation.

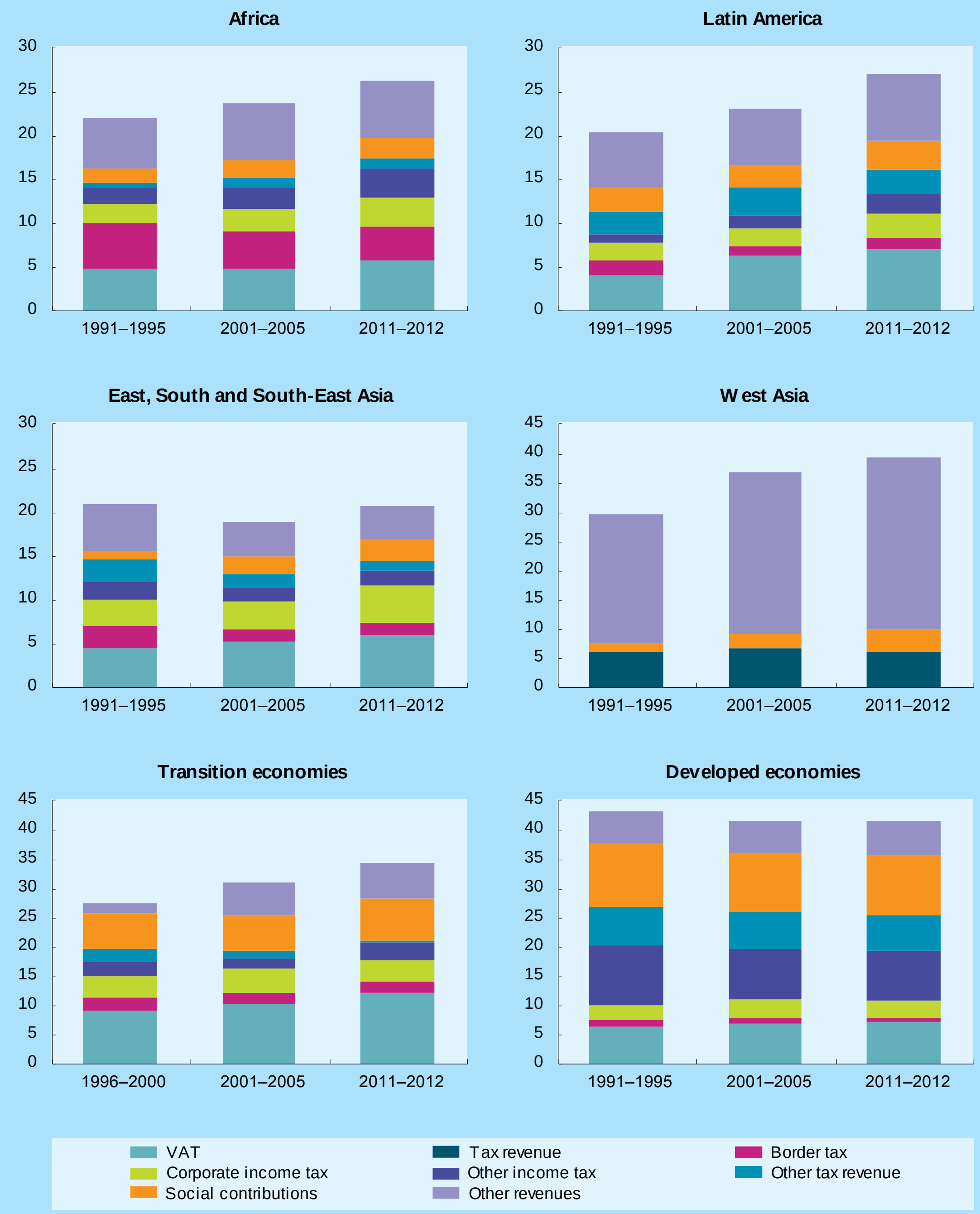
Fiscal space and long-term trends…

- Creating fiscal space is a long-term historical process, that does not occur automatically: UK, USA examples.
- Enlargement of tax base reflects not only growth of formal economy, but also investment in legislation, tax administration and enforcement.
- No single benchmark but broad themes clear.
- Significant differences in ratio of public revenues to GDP across countries at similar levels of p.c. income
- How to increase revenues? How to ensure composition can best promote inclusive growth, structural transformation.

Relationship between public revenues and per capita GDP, 2012

Fiscal space and economic development have, subject to local factors, traditionally evolved hand in hand





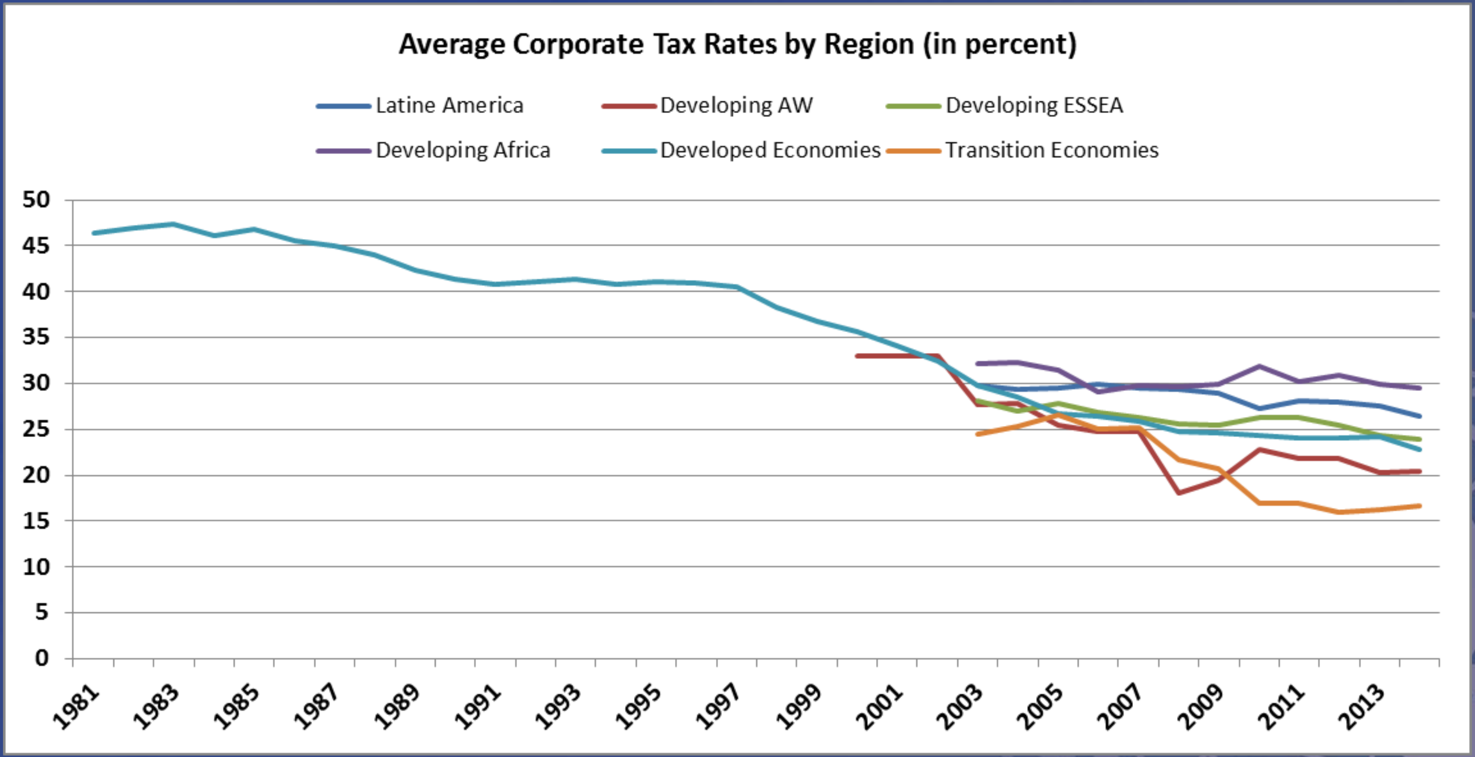
Africa
Latin America
East, South and South-East Asia
West Asia
Transition economies
Developed economies
0
5
10
15
20
25
30
35
40
45
1991–1995
2001–2005
2011–2012
1996–2000
VAT
Corporate income tax
Social contributions
Tax revenue
Other income tax
Other revenues
Border tax
Other tax revenue

Why this matters -- greater fiscal space is needed

- Greater fiscal space in which to finance a more ambitious policy agenda -- financing and delivering structural transformation, and less inequality.

- Addressing structural weaknesses and ensuring inclusive growth, in a less favourable external economic environment
- Industrial policies – supported by macroeconomic policies – to stimulate productive investment, develop local markets and diversify.
- Rebalancing growth strategies with less emphasis on exports to developed countries, greater role for domestic and regional demand
- Public investment in infrastructure and human capital, social investment
- Need for stable and long-term domestic as well as foreign sources of capital
- Threats to fiscal space include - tax competition, tax optimisation

Corporate tax rates cascade downwards….



Stemming fiscal haemorrhaging from tax competition, tax avoidance practices and unfair distribution of natural resource rent

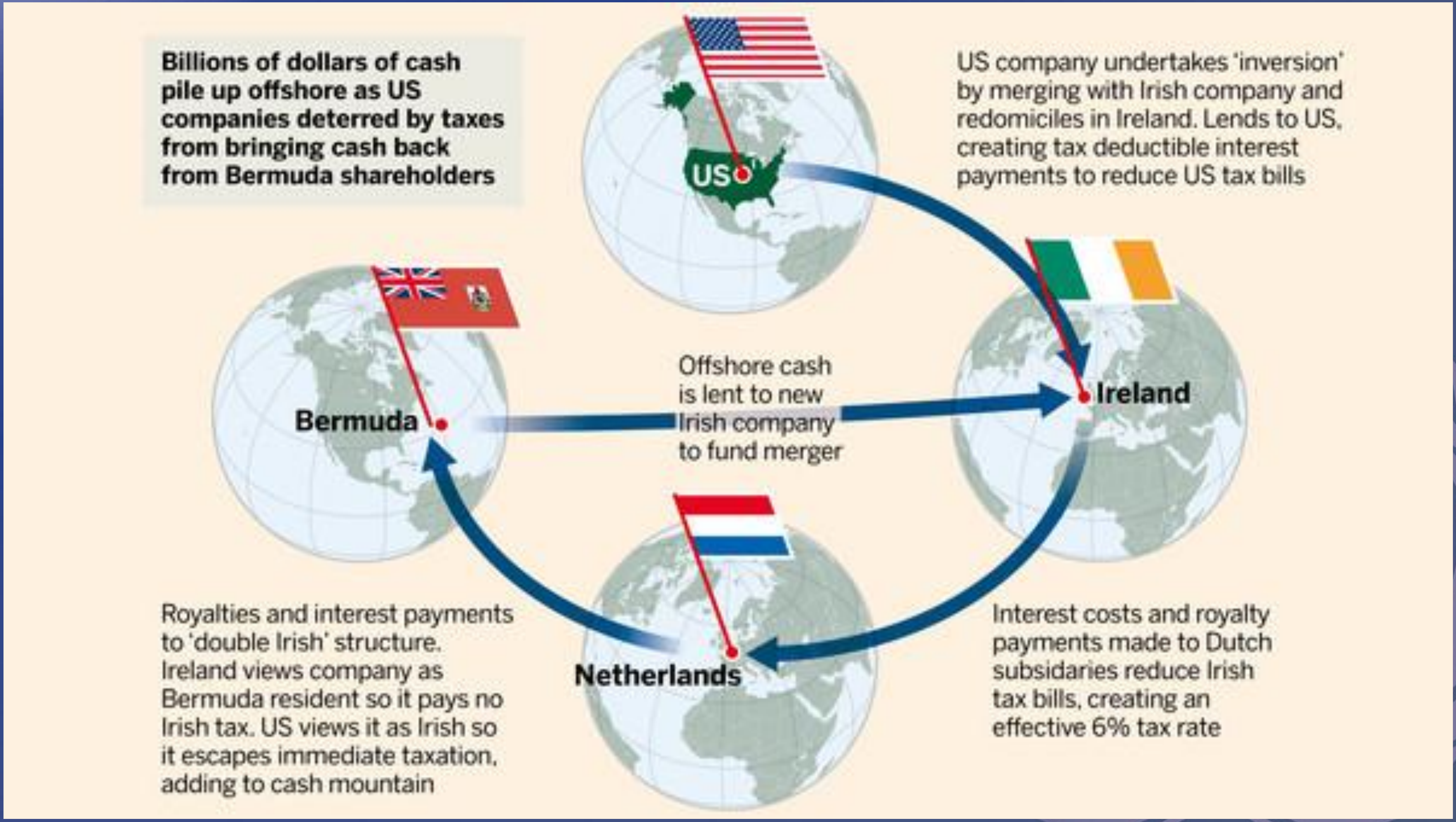
The current structure of the global economy is making it difficult for countries to expand government revenues and to choose their tax structure

A large proportion of illicit financial flows goes through offshore financial centres, based in "secrecy jurisdictions". Approximately 8–15 per cent of the net financial wealth of households is held in tax havens, mostly unrecorded, resulting in a loss of public revenue amounting to \$190–\$290 billion per year (\$66–\$84 billion in developing countries)

As for corporates, their main vehicle for tax avoidance or evasion and capital flight from developing countries is the misuse of "transfer pricing". By this means, developing countries may be losing over \$160 billion annually, well in excess of the combined aid budgets of developed countries.

In a sample of resource-rich developing countries, UNCTAD's calculations show that between 2004 and 2012, Governments captured only about 17–34 per cent of the rents generated in extractive industries dominated by private firms.

Illustration of one tax avoidance scheme: The Irish inversion (FT)



Country responses in extractive industries

- Measures aimed at expanding production or local transformation
- Measures aimed at improving distribution of rents:
  - Revising or renegotiating licences and contracts
  - Revising royalties and rents
  - New taxes
  - Increased state equity

Public revenues from extractive industries depend on changing taxation rules and ownership of firms

Share of Government revenues in rents from the extractive industries, 2004–12, in %

	2004-05	2011-12	2004-12
Oil			
Angola	60.0	93.5	83.3
Colombia	30.7	46.1	41.1
Ecuador	69.6	93.3	76.3
Venezuela	56.7	70.6	64.1
Copper			
Chile	52.2	52.8	51.9
10 major private firms	*24.2*	*39.4*	*32.0*
CODELCO	*92.0*	*77.9*	*86.9*
Peru	30.5	40.4	32.7
Zambia	1.4	30.5	17.5
Gold			
Ghana	41.0	32.0	27.7
Mali	19.7	28.3	33.6
Peru	24.2	29.0	27.7
Tanzania	27.4	21.2	17.9

Responses to tackle international tax leakages - national and international levels

- Global Forum on Transparency and Exchange of Information for Tax Purposes
  - Country classification and peer review process
  - Declaration on Automatic Exchange of Information in Tax Matters
  - Initiatives on base erosion and profit shifting
- G20 and related initiatives
- UN Committee of Experts on International Cooperation on Tax Matters
- Other regional, bilateral and national initiatives with spillover effects (see eg. Brazil, UK, US)

Brazil's unilateral attempt to fight trade mispricing in commodities

- The "arm's length principle" is the usual methodology for handling trade mispricing. It consists in comparing the applied transfer price to a "comparable uncontrolled price", i.e. the price applied to a similar transaction between unrelated trading parties. However, finding such a “free market” comparable transaction may be complex (or virtually impossible), and requires strong administrative capabilities and costly procedures.
- Brazil introduced a simplified comparable uncontrolled price (CUP) method in 2012.
- This aims to provide a reference price for commodities that Brazilian exporters and importers should use to avoid trade mispricing in their valuation of international trade.
- In particular, the Law (no. 12715/2012) authorizes the Brazilian tax authorities to determine what should be considered as commodities, and which commodity exchange should be recognized for applying the newly introduced methods.
- The law allows for price adjustments such as market premium and transportations costs, and, where there are no internationally recognized spot or futures quotations, the price of imported and exported goods could be compared with the prices obtained from independent data sources provided by internationally recognized research institutions.

Towards a multilateral tool for addressing transfer mispricing?

- *It is often in practice extremely difficult, especially in some developing countries, to obtain adequate information to apply the arm's length principle* (United Nations Practical Pricing Manual for Developing Countries (2013).

- It would therefore be important to generate a set of reference prices, at least for the primary commodities that contribute for most of many developing countries' exports.

- This has led to the so-called "sixth method", which provides for the mandatory use of publicly quoted commodity prices for certain transactions involving commodity products".

- Given its expertise, UNCTAD could establish such a set of reference prices.

Developing countries can aim at the widest possible policy space

- Skilful use of policy space that remains under existing trade and investment agreements to pursue proactive policies with a view to fostering structural transformation and rebalancing growth strategy
  - Refocus on multilateral agreements which recognize the legitimate concerns of developing countries
  - Eliminate pro-investor-biased mechanisms embedded in International Investment Agreements that reduce policy space
  - Carefully consider loss of policy space when engaging in bilateral and regional trade and investment agreements
  - Joining global value chains should not mean aligning policies simply to interests of lead firms, follow development interests also