Issue Paper: Linking revenue to expenditure

Introduction

Mobilising domestic resources through taxation is crucial in helping developing countries to finance their development, relieve poverty, reduce inequality, deliver public services and build infrastructure for inclusive growth. Taxation is not solely about raising revenues: it can also act as a catalyst for governmental responsiveness and accountability by providing incentives for taxpayers and governments to enter into a "tax bargain" or "fiscal contract". Evidence gathered by the Task Force on Tax and Development (see working paper "What drives tax morale?") suggests that people's willingness to pay taxes depends in part on their satisfaction with public services and their perception of how well governments spend tax revenues.

In many developing countries this link between tax collection and public service delivery remains weak, and there is a tendency to treat the revenue and expenditure sides of the public finance equation as two separate silos. Strengthening the links between revenue and expenditure is one strategy developing countries can use to foster a virtuous cycle of increasing accountability, trust, tax morale and, ultimately, tax revenues. The Task Force has promoted this idea with work on Taxpayer Education strategies (See the OECD publication "Building Tax Culture, Compliance and Citizenship: A Global Source Book on Taxpayer Education").

While the need for spotlighting the tax-expenditure links is widely recognised in theory, there is no consensus on what further practical efforts can be made. This informal Task Force on Tax and Development paper attempts to stimulate discussion of the issue by highlighting five examples of what, in practice, may better connect revenue to expenditure.

Earmarking or hypothecation

Earmarking means dedicating the revenue from a specific tax to a particular expenditure. This enhances the transparency of the use of tax revenue and helps to monitor expenditure, build trust and encourage public engagement and taxpayers' participation in deciding how tax revenues are spent.

Earmarking may therefore formalise important tax bargains between governments and taxpayers as well as increasing political acceptance of taxation and reducing resistance to new or higher taxes. It may also guarantee minimum levels of financing for public services that the government considers important, with greater funding stability and continuity potentially leading to greater efficiency.

Earmarking can also be used to dedicate revenues from so-called "sin taxes" to specific public services (e.g. using taxes on tobacco to fund health spending). Sin taxes are levied on products or services that are seen as vices, such as alcohol, tobacco and gambling, and are used to discourage their use without making them illegal. A more indirect form of earmarking are consumption tax exemptions on goods needed by the poor, VAT exemptions on food staples such as cooking oil, for example. Disadvantages of earmarking include reduced fiscal flexibility in the long-term as certain revenues and expenditures are already determined prior to the process of allocating resources; earmarking can lead to a misallocation of resources, with too much being given to earmarked activities, leaving fewer revenues for other activities. A common problem results from the fact that revenues are highly fungible, and newly hypothecated funds can be offset by shifting existing funding to other areas, leaving the overall pattern of expenditure unchanged. This may hamper effective budgetary control and interfere with the powers and discretion of the legislative and executive branches of government. Finally, earmarked taxes may serve a political purpose with little impact on spending patterns.

Current examples of earmarking, such as India's tax for education and Ghana's tax for health, provide no conclusive evidence for or against earmarking, but suggest that the practice is likely to be successful when it is (i) substantive and specific, guaranteeing actual increases in spending in the designated area; (ii) transparent and easy to monitor; (iii) only a moderate share of the total budget, in order to protect fiscal flexibility. Further evidence also suggests that earmarking works better at local government level, where the correspondence between beneficiaries and taxpayers is closer and users can more easily express their preferences by voting. The role of an active civil society to oversee the long-term implementation of an earmarking arrangement is also crucial.

Local taxation

Local taxes offer many advantages in comparison to central taxation in terms of strengthening the links to specific local public expenditure. Local taxes are more broad-based and affect a larger number of people than central taxes, as most people experience taxation most directly at the local level (e.g. through poll taxes, market fees, business fees or user fees). A property tax can strengthen the "fiscal contract" as its characteristics of being specific to a location and highly visible facilitate tax bargaining and stimulate the public engagement of taxpayers. Local authorities are, moreover, better able to match their policies to their taxpayers' preferences, and competition between jurisdictions in the provision of public goods may lead to efficiency gains.

A major drawback of local taxation is its potential to undermine accountability and state-citizen relationships by opening the door to corruption and abusive behaviour, as most local tax systems in developing countries feature high levels of arbitrariness and coercion, which makes them unpopular and inefficient. Their high visibility makes them more prone to political resistance. In addition, local authorities often lack the administrative capacities and means to administer local taxes efficiently, as they are often assigned expenditure functions that exceed their fiscal revenues, leading to poor service delivery, which is detrimental to tax compliance. Local tax revenue remains relatively low, commonly comprising less than 5% of total government revenues.

Sierra Leone offers a successful example of local taxation and property tax reform which highlights the critical success factors of building up public support and civil society engagement through a combination of outreach, transparency, equity and highly visible service provision.

Natural resource management

Natural resource endowments may weaken the link between taxes and greater demands for representation, and quality of public goods and services. In addition to macroeconomic and budgetary challenges such as price volatility, the “Dutch disease” and finiteness, resource revenues can have negative impacts on democracy and governance (“resource curse”), leading in extreme cases to a rentier state that is not accountable to its citizens or ”spoils-based” politics where elected officials direct resource wealth unequally to those groups who supported their election. Pressure may also build up on politicians to spend money fast to maintain public support, and institutions are more likely to be of low quality.

Two specific instruments can be used to counter these risks and improve the link between the revenue and expenditure sides of natural resource wealth, in order to enhance transparency and accountability: special fiscal institutions and direct distribution mechanisms.

Special fiscal institutions are designed to counter the risk of discretionary and volatile spending that a sudden surge of natural resource revenues might encourage. They can be used to help policy makers maintain fiscal discipline. Special fiscal institutions for managing natural resource revenues take two main forms: special fiscal rules for natural resources, such as medium-term fiscal frameworks that connect spending levels to overall macroeconomic conditions, and resource funds, such as stabilisation funds, saving funds and development funds. Resource funds can promote a sense of ownership of the fund’s resources among the population and allow for the consolidation of the institutional mechanism to increase transparency and accountability and decreasing rent-seeking behaviour. In particular, development funds may be important when linking revenues and expenditure in order to strengthen accountability. These funds are dedicated to a particular type of expenditure, e.g. delivering specific national infrastructure projects. A specific savings purpose can assist in building support for prioritisation and limit the extent of structural spending initiatives that may not be affordable if prices fall. The rationale behind those funds is not to try to restrict expenditure in terms of controlling total levels of spending, but to ensure that natural resources revenues are spent on specific items that are politically valued. A limited ability to spend in a cost-effective or timely way can, however, frustrate citizens who know that resource wealth is being accumulated but cannot see the benefits first-hand.

The direct distribution of resource revenues to citizens in the form of unconditional cash transfers offer an alternative, more innovative, tool using natural resource revenue. People can feel more connected to the extraction of their resources and may have greater incentives to monitor resource incomes, their management and distribution, as their own income is at stake. As the state is deprived of revenue resources, direct cash transfers create an incentive for better revenue mobilisation through taxation in order to cover the costs of public services. By taxing back parts of the cash transfers, the fiscal contract would be strengthened as people would be more likely to monitor public spending and service delivery. Direct cash transfers are likely to be more equitable and pro-poor compared to current spending patterns in developing countries and they might have immediate and significant economic benefits for poor households.

Downsides to direct distribution mechanisms include the risk of taking public expenditure below a desirable level, given the economy's need for infrastructure and public goods. Moreover, recovering resources through taxation can have logistical costs as well as risks due to the relatively poor quality of tax administrations in resource-rich countries. The key constraint for direct distribution mechanisms in many developing countries is the ability to physically distribute the payments and control misappropriation. On the revenue side, low capacity in the tax administration may prevent the state taxing back distributed revenues in the short term. Finally, there is no guarantee that such a redistribution mechanism would not be affected by rent-seeking and abusive behaviour.

Civil society

Civil society organisations (CSOs) play a crucial role in raising taxpayers' awareness about the taxes they pay and the operation of budgetary processes. They also organise taxpayers so as to secure effective tax bargains with the government. They can therefore play an essential role in explaining the link between tax revenues and public service delivery. CSOs may also encourage the government to be more transparent about tax collection and public spending, and promote public debate about taxation.

The taxpaying public is not homogenous, and social groups are differently affected by tax policies and types of taxes. Different stakeholders engaged in tax bargaining through civil society organisations may therefore represent specific interests of groups of taxpayers.

Tax issues are far less prominent on the public agenda in developing countries than in most high-income countries. Most tax revenues in developing countries are collected from a small number of large companies. Moreover, in many developing countries, public debate on taxation is to a large extent limited to international tax issues such as the taxation of multinational companies. Even though these are important topics, broader engagement about tax and public spending is still lacking, especially at national and local level.

The most vocal and effective civil society organisations that shape policy debate on tax and development (e.g. Action Aid, Christian Aid, Global Financial Integrity, Oxfam and Tax Justice Network) tend to focus mainly on international tax issues. Membership activities in Latin America and Sub-Saharan Africa are relatively small. Those national and local members would be particularly important in strengthening the link between tax spending and public goods. National taxpayer associations could become important by combining oversight of taxation and the transparent and efficient use of taxpayer's money with broader taxpayer education programmes.

There are opportunities for international co-operation to strengthen the role and work of CSOs in tax bargaining and taxpayer education through education that explicitly focuses on linking revenue and expenditure issues. On the other hand, civil society representatives at national and local level have to be supported in their work of capacity-building which is particularly crucial for establishing a fiscal contract within a country. Cooperation with international CSOs and their regional networks would be helpful in mobilising and engaging local and national CSOs.

A Coalition for Sustainably Resourced Public Service Delivery

The Global Partnership for Effective Development Cooperation discussed the idea of a "Coalition for Sustainably Resourced Public Service Delivery" at its meeting in Mexico in April 2014. The aim was to ensure that developing countries were able to cover the public-sector costs of health, education, social protection, and other programs that will be needed to achieve their post-2015 development goals.

Specifically, once formed the Coalition will help interested developing countries to perform assessments of their expenditure needs and of the related requirements for tax revenue and other domestic resources required by their post-2015 development agenda. These assessments will help both donors and partner countries to identify disparities between the costs of achieving post-2015 outcomes at country level and the apparent capacity to self-finance those costs.
Where gaps are identified, leaders in developing countries need to commit to closing them. For example, when chairing a September 2014 UN event on Domestic Financing for Health, Kenya's President Uhuru Kenyatta committed his government to mobilising more domestic resources to raise health funding to 15% of the total budget[1], a target that most African leaders have adopted, but few have achieved, to support the current MDGs.

Questions for discussion:
- Do these examples stimulate interest in investigating revenue-expenditure links further?
- Which other issues offer potential benefits in promoting these links?

[1] This goal would represent a near doubling of the 7.6% of Kenya's budget devoted to health in FY2010/11.