

Mexico's debt default in 1982 sparked off a macroeconomic crisis, that national policymakers in developing countries interpreted to be a systematic breakdown of existing model of economic development (the author calls it a mistaken notion). This was taken as an opportunity by developing countries to embark on extensive liberalization along with stabilization measures.

The article tries to answer the following question. What are the fiscal implications of the attempts to manage an economic reform that combines stabilization and liberalization? The article analyzes it through three policy issues

1. Problem of maintaining consistency between appropriate methods of reducing the fiscal deficit and the pursuit of liberalization goals that have fiscal consequences.
2. How to provide the basic public services that can both reduce poverty and stimulate economic growth, given the context of liberalization and stabilization policies; wherein there is pressure to reduce public expenditure and to shrink the role of the state in the economy.
3. The problem of finding adequate funding to maintain basic public services. Is increased taxation the only means of public finance that satisfies the criterion of long-term sustainability?

1. Fiscal Consistency of stabilization and liberalization: Problem of timing, or Optimal sequencing.

Two schools of thought:

BIG BANG approach: Comprehensive stabilization and liberalization approach should be started immediately at the start of the reform process. Not to give political opponents the time to organize an opposition.

GRADUALISM approach: Stretch the reform over a longer period of time to ease the pain of adjustment and allow time to build a political consensus.

Neither looks at the optimal sequencing of reform measures, which may differ for different economies.

The author draws an analogy of the CRITICAL PATH ANALYSIS (CPA): A tool used in Operations Research to figure the optimal sequence of myriad interrelated activities. This process depends on discovering three things – procedure ordering of its activities, uncertainty about the duration of its activities and alternative designs and their resource costs.

Economic theory of the second best shows that if the asset and income distribution is optimal, an economy without any impediments to general equilibrium must be preferable, in terms of welfare, to an economy where such impediments ('economic distortions') exist. Eliminating one distortion while leaving others in place may reduce welfare rather than improving it. The effect of one distortion may be counterbalancing the effect of another distortion. In this case the economy may become more distorted than less distorted.

Liberalization is at most times in direct contradiction to stabilization policies.

eg1. Liberalization of the financial system causes rise in the rates of interest on government debt, (all else being constant) this will increase government expenditure on debt interest, and thus widen fiscal deficit.

eg2. Liberalization of foreign trade involves the lowering or removal of tariff barriers to imports, which will reduce customs revenue for imports and (all else being constant) will increase the size of fiscal deficit. In developing countries taxation on foreign trade comprises a major source of revenue.

Examples of liberalization aiding stabilization policies

eg1. Imposition of hard budget constraints on public enterprises.

If one were to establish rules of precedence for policy changes,

Rule 1: would be "Macroeconomic stabilization must be started first, if there is serious macro instability."

Rule 1 (a): Until stabilization measures have reached the target values for the fiscal and balance of payments deficit, liberalization measures should be pursued to the extent that are consistent with these stabilization targets.

Rule 1 (b): Advance in the sequence of liberalization measures those that reinforce stabilization goals, and hold back those that make stabilization more difficult.

Rule 2: Stabilization measures should have an appropriate sequencing in themselves. Monetary policies need to be complemented by fiscal and exchange rate policies.

2. Maintaining Basic Public Services: Does reduction in public expenditure have an adverse effect on the provision of basic public services (health and education)?

Public expenditure can grow as the deficit is reduced, IF REVENUES ARE MADE TO GROW FASTER. Governments have two policy options regarding deficit reduction – expenditure reduction or revenue raising. Subsidies can also lead to bloated public expenditure; which generally goes to the politically powerful domestic groups.

Policy conditionality that accompanies loan from the international financial institution is rather weak. IMF used to focus on net ceilings of expenditures rather than detailed prescriptions (such as quality and quantity of budgetary cuts), because of their policy not to meddle with a country's domestic expenditure priorities.

Functions vulnerable to cuts during expenditure declines include Infrastructure, Productive enterprises. Governments have a tendency to cut capital expenditure rather than current expenditure. Hence jobs are protected, but supplies/machineries are not. So we have a situation of medical / teaching staff being employed but deprived of essential equipment.

Research shows that health and education expenditures show no significant relation with expenditure declines or growth. Social expenditures are being somewhat protected when total expenditure declines.

3. Raising more taxes: Faced with unsustainable fiscal deficit and a public expenditure that cannot be further reduced, governments turn to other forms of public finance. Relying on foreign aid as a source of government revenue has the disadvantage that aid disbursements are highly volatile.

The credit worthiness of a government depends on how much tax revenue it is believed to be capable of raising, in relation to the amount of internal debt it is willing to contract.

Side constraints that need to be respected in the process of achieving revenue objective

- a) Legitimacy of government should be enhanced. Attention to equity is one way of achieving this.
- b) Achieve economic efficiency. A system of taxation that distorts economic behavior will reduce welfare.
- c) Ease of administration, Minimizing financial costs of tax collection, the compliance cost to the taxpayer and the opportunities for leakage of revenue through corruption.

Historically, developed nations have established institutions necessary for direct taxation, thus are able to raise 17.36% of their GDP as personal taxes (income and social security taxes). Developing countries are able to raise 3.38% of their GDP as personal taxes. The absence of direct personal taxation on the revenue side of the budget is matched by the absence, on the expenditure side of much spending on social security, education and health services.

Some of the East Asian countries (NICs – Newly industrialized countries) have been able to shift the balance of their government taxation sources away from consumption taxes and towards income taxes. Perhaps this is related to the government's ability to engineer rapid, sustained and well-distributed growth of private incomes.

VAT – Value Added Tax : a recent tax technology.

Advantages of VAT

- Because of its broad base – VAT has a high revenue-income elasticity. Its revenue-income buoyancy can exceed 1. It is positively correlated with expansion in government revenue.
- Taxation of savings is avoided.
- VAT is neutral in its impact on foreign trade flows. Exports are generally not taxed and imports are taxed at the same rate as domestically produced goods.
- Given the high reliance of developing countries on taxes on foreign trade, the raising of additional revenue from a VAT will have the good effect of reducing the responsiveness of total tax revenue to trade fluctuations.
- Switch to domestic consumption taxes (in the shape of VAT), will also reduce the fiscal cost of trade liberalization.
- VAT has a lower political profile. – the tax can be incorporated into the overall price of the good or the service.
- It is paid by customers in small amounts, as and when purchases can be afforded.
- Low visibility and broad base of the tax makes it less vulnerable to tax evasion by customers.
- The broad base of the tax makes it less vulnerable to the political opposition of particular lobby groups.

Disadvantages of VAT

- It is not a progressive tax and scores low on the equity criterion. A comprehensive, single rate VAT is a proportional tax on consumption, neither progressive nor regressive. It is less equitable than an income tax with a threshold and rising marginal rates, and no exemptions. (However VAT can be levied at two (even four - India) rates. Zero rates can be levied on basic needs goods such as food and clothing.
 - It is thought of administratively unworkable, except in advanced nations. (requires an ability to maintain records).
 - May kill the informal sector because the informal sector works because the existing tax machinery has not found a way to bring into the tax net. The incentives of rebates on inputs may tempt this sector to join in.
 - Difficulties arise in countries where there is a division of tax powers between the federal and the state governments is constitutionally entrenched, and no provision has been made for the VAT. In order to minimize distortions the VAT should be levied by the center, but states are unwilling to support the constitutional amendment that would give the center this new fiscal power.
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QUESTIONS

Question 1: Toye argues that "both economic and political reasons require that domestic taxation is the primary and principal instrument used to generate government income." However a look at Table 1 & 4 shows that developing countries are able to generate only 6.81% of GDP in personal taxation (as compared to 19.86% of GDP in developed countries - which is more than half of the "total taxable income per GDP"). Further the author admits that apart from some East Asian countries (NICs) most other regions of the developing world have not been able to "shift the balance of its taxation sources from consumption taxes towards income taxes." Is it possible for developing nations to create a similar shift in the main source of taxation? How have the few East Asian countries managed it?

[NIC = Newly Industrialized Countries]

Question 2: The US, with a federal structure like India, presents an interesting case of not implementing VAT despite several attempts in the last 30 years. One of the reasons appears to be the fear of the Federal Government usurping the States' power of sales taxation. On June 1, 2003; 15 states in India will introduce the VAT (Value Added Taxation). However, there has been widespread opposition to the VAT in India. Looking at India and US as cases in point do you think VAT is feasible in such nations in the context Federal-state relations.

Refer:

http://www.themavericks.net/archives/new/vat_india03.htm ----->> FAQs on VAT

<http://www.thehindubusinessline.com/bline/2003/03/11/stories/2003031101811700.htm> --->> Why some states in INDIA oppose VAT (Note: 1crore = 10 million and 48 Indian Rupees = 1 US Dollar approx.)

http://www.themavericks.net/archives/new/vat_overated03.htm ----->> arguments against VAT

<http://www.rediff.com/money/2001/feb/14vat.htm> (CII - Confederation of Indian Industries) ---->> Argument FOR VAT.

More on VAT in India : <http://www.blonnet.com/2003/03/27/stories/2003032700060800.htm> --->> States vs Federal

Question 3: The author refers to the Critical Path Analysis (used in Operations research) as an example of a useful tool that can be used to evolve appropriate sequencing of economic reforms, while dealing with the often divergent policies of stabilization and liberalization. Comment on the significance of such methods given that "many of the great economic theorists have struggled to add a time dimension into fundamental economic theory." Why is it inherently difficult to sequence economic policies or predefine a time frame?
