# Linkages between public sector revenues and expenditures in developing countries

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Abstract

Contemporary interest by the international development community in the connections between revenue and expenditure derives from three preoccupations: first, boosting the level of domestic revenue in low- and middle-income countries so that they can scale up their public expenditure whilst becoming less dependent on external finance; second, increasing the developmental orientation of public expenditure and more generally improving its efficiency and effectiveness; and third, strengthening the quality of fiscal governance through greater government accountability to citizens for the use of public resources.

This paper explores whether a better understanding of the conceptual linkages between revenue and expenditure may offer useful insights for governments and external actors targeting the above objectives. It discusses three sets of technical instruments that are used regularly by governments in support of their policy objectives: fiscal rules, revenue hypothecation and tax expenditures. The paper considers the possible role for external development cooperation in this arena of domestic public finance and concludes with some reflections on the significance of this agenda.

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# Abbreviations

| | |
|---|---|
| GDP | Gross Domestic Product |
| GFS | Government Finance Statistics |
| HIPC | Highly Indebted Poor Countries (Initiative) |
| IDS | Institute of Development Studies |
| IMF | International Monetary Fund |
| ODI | Overseas Development Institute |
| OECD | Organisation for Economic Cooperation and Development |
| PIH | Permanent Income Hypothesis |
| SFI | Special Fiscal Institution |

# 1 Introduction

## 1.1 Purpose and starting points

In exploring the relationship between the revenue and expenditure sides of public finance, this paper addresses three questions.

- What are the conceptual linkages between public revenues and public expenditures, and how are those linkages relevant and important for policy purposes?
- Which are the main technical instruments used by domestic policy-makers to connect revenues and expenditures to achieve specific policy objectives?
- What is the role of international cooperation in supporting this agenda on linking revenues and expenditures?

Interest in the linkages between the two sides of public finance isn't new. Standard approaches to public finance consider revenue and expenditure jointly at the aggregate level for fiscal policy purposes. Governments target a particular fiscal stance and seek to balance planned spending with equivalent revenues and financing. Alongside fiscal policy, there is a connection in terms of how the efficiency and effectiveness of public expenditure relates to the willingness of citizens to provide revenue through domestic taxation. Through this fiscal contract, the state establishes a mandate to extract revenue in return for providing benefits to taxpaying citizens through public expenditure.

At a conceptual level, the connection between revenue and expenditure is necessary and obvious. The budget itself and the government balance sheet more broadly are both reckonings of that equation. Despite this basic symbiosis, it shouldn't simply be assumed that conceptual linkages will translate into specific practical measures for policy purposes. In the absence of a particular policy objective, the potential technical instruments will have no inherent purpose or benefit. The starting point will be a specific objective within a domain such as domestic resource mobilisation, strategic resource allocation or good financial governance. The range of possible instruments may then be considered with reference to that goal.

We don't deal directly with instruments or measures that focus only on the revenue *or* expenditure sides of public finance. The potential policy options selected here are those whose impact comes from their relationship to both revenue *and* expenditure. There are numerous options that exist to use either tax policy *or* expenditure policy to achieve government objectives. General taxation policy and revenue administration are dealt with extensively in the policy and research literatures. The same applies to public expenditure policy and management. The attempt here is to be more particular and to ask a less standard question in order to test for potential new areas of domestic policy action and international engagement. We concentrate on those measures that target revenue-expenditure linkages. This isn't an exhaustive list of areas where revenue and expenditure policy intersect. This paper covers the three measures discussed most frequently and most extensively in the literature, and for which there are the most examples of practical implementation. The focus remains on the theoretical and conceptual linkages between revenue and expenditure in these areas, rather than on providing extensive real-world case study examples or lessons learned.

International cooperation can take very different forms and approaches. There is an important distinction between the technical modes of engagement focused on designing and implementing measures to connect revenues and expenditure, and the more political agenda of attempting to influence the level and incidence of either revenue or expenditure. Increasing the level of domestic revenues and the effectiveness of public expenditure are priorities for international development agencies, but these are principally domestic and inherently political prerogatives.

## 1.1 Structure of the paper

Following this introduction, the paper is organised by four sections.

- First, we define conceptually the revenue-expenditure relationship and explain the emphasis we select for the paper. That framing covers the intuitively obvious fact that revenue provides the financing for public expenditure. It also addresses the more complex issue of the fiscal contract through which revenue and expenditure affect the relationship between the state and its citizens. The notion of a fiscal contract is the main precept of our argument in this paper. We briefly discuss general fiscal policy and intergovernmental fiscal relations as two other central conceptual issues.

- Second, we explain and illustrate some of the prominent measures used by governments to link revenue and expenditure in pursuit of wider policy objectives. Specifically, these are fiscal institutions (such as fiscal rules and special funds), hypothecation and earmarking of revenues, and the use of tax expenditures or incentives. We discuss the standard arguments for and against these measures, and provide illustrative country examples. These aren't the only institutional and policy measures available to governments wanting to influence or exploit the revenue-expenditure relationship. For example, the coordinated use of revenue and expenditure instruments will affect the overall distributional incidence of fiscal policy (IMF, 2014a; Lustig et al., 2014), and the design of intergovernmental fiscal relations will determine the vertical connections between revenue and expenditure (Ter-Minassian, 1997). However, the three sets of measures provide a good entry-point for analysis.

- Third, we consider the potential role for external actors, especially development agencies and multilateral organisations. That includes the direct provision of budgetary funding, the deployment of technical assistance and advice, the contribution of global knowledge sharing and cross-country lesson learning, and the role of international norm-setting and regulation on cross-border tax issues. Although the scope for external action may appear limited, we propose some ideas for more effective engagement.

- Finally, we conclude with a set of reflections on the potential significance of the revenue-expenditure linkages identified. We also set out ideas for future research and policy engagement in this area.

# 2 Conceptual linkages between revenue and expenditure

Public sector revenues and expenditures are of course linked by definition. States cannot spend money they don't have, at least not over the long run. Concerns over how different levels and kinds of revenues can be used to fund different levels and kinds of spending are among the oldest problems in public finance. Obvious as the connection may be, it is not a trivial question either for policy-makers or academics, and different communities of researchers approach the issue in very different ways. At its most elemental, the revenue-expenditure nexus is founded on the relationship between the state and its funders – specifically, the 'fiscal contract'. It is complicated by several intervening elements, most importantly the precise source of funding and the horizontal relationship between revenues and spending. We discuss these in turn.

## 2.1 General fiscal policy

The most obvious and immediate way in which revenue and expenditure connect, regardless of any special attempt to draw the two closer together, is through general fiscal policy. The literature on fiscal policy is large and concerns how governments could or should balance income, expenditure, debt and deficits to achieve sustainable public finances. Within this framework, overall expenditures and overall taxes are usually considered separately. The only links between expenditures and revenue are at an aggregate level, where marginal adjustments are made between the two to accommodate an overall balance. Rather than try to cover this literature in depth, in this paper we focus on specific policies that governments could consider taking *within* their fiscal policy specifically to link the two sides of the fiscal equation.

## 2.2 The fiscal contract

Public finance economics assumes that the state is a black box, capable of autonomous decision-making and implementation (Stiglitz, 2000). According to the optimal tax literature, the state's utility function is the maximisation of social welfare (Boadway, 2012). In public choice economics, states are run by self-interested actors who maximise their own budgets without particular regard for aggregate welfare (Niskanen, 1974). In both cases, the assumption is that states are self-contained, with no relationship between revenues and expenditures other than abstractly at their aggregate level. Thus, states are at leisure to tax as they please and the relationship between state and citizens does not matter for public spending (Timmons, 2005).

The fiscal contract literature, by contrast, is based on the principle that governments sell citizens services for revenue and respond rationally to the preferences of their customers by providing them with what they want (Timmons, 2005; Bird and Zolt, 2013). Revenue collection is inherently costly because of the logistical and technical transaction costs, but also due to the political costs inherent in extracting resources from individuals and groups in society who would rather not relinquish those resources. In countries where the political system is based on narrow elite controls, or 'limited-access orders' (North, Wallis et al., 2007), trying to extract revenues from the government's own elite base is risky business.

Tax collection is a question of legitimacy. Acceptance of the state's authority to tax is a central element of accepting a state's authority in general, which is the essential definition of legitimacy (Weber, 1980

[1921]). Citizens are assumed to pay more for public spending if it is seen as beneficial by a majority of those who pay. Every state also relies on enforcement, or the threat thereof, by building up a capable tax collection bureaucracy that is able to punish non-compliance. With the exception of the most medieval tax collection, where government agents literally serve as 'stationary bandits' working entirely by force (Tilly, 1992), states inevitably rely on the legitimacy of their tax collection efforts, whether they fund war-making, visible infrastructure or social welfare.

### 2.2.1 Sources of revenue and the fiscal contract

This line of thinking goes back to the well-established foundations of fiscal sociology, which posit that the composition of revenues is a strong determinant of the character of the state and the way it spends its money (Schumpeter, 1918; Moore, 2003). States applying broad-based taxation of their citizens will, over time, spend these revenues on what those citizens demand; whereas governments that are insulated from their citizens by the ability to access other revenue sources, such as domain revenues, natural resource rents, or rents from aid, may not be as responsive. This co-evolution of taxation, spending and state capacity is at the crux of the evolution of European states (Tilly, 1992). Particular revenue sources typically correlate with specific patterns in the level and allocation of public expenditure. Other functional pressures could motivate different patterns (Krause, 2013). Nonetheless, the findings of fiscal sociology have laid the foundations for much of the contemporary thinking on the relationship between taxation, state-building and public spending in developing countries today, especially in the context of fragile states.

There is evidence that governments which aren't forced to rely on taxation for their public spending tend to spend less for the benefit of their (less-taxed) citizens and are less democratic (Mauro, 1998; Cockx and Francken, 2014). Where the source of such rents relies on natural resources, blessing can quickly turn to curse as groups jockey to capture the lucrative revenue sources, as well as the state itself (Collier and Hoeffler, 2005). Recent research by the International Monetary Fund (IMF) has found that resource-wealthy governments do indeed follow the reduced incentive to incur the political cost of domestic taxation, so that there is a negative relationship between resource wealth and tax effort (Gupta and Crivelli, 2014). Similar points have been made with reference to the rents from external aid, tax effort and government, with the available evidence suggesting a negative relationship (Easterly, 2014; Crivelli, Gupta et al., 2012).

Contemporary development policy focuses more directly on the idea that taxation is critical to developing good governance, widely defined, in the sense of building state institutions that are responsive, accountable and competent. Expressions of this idea vary, but a common theme is that taxation can actively foster state-building by providing a focal point for bargaining between the state and citizenry and through the development of high quality institutions for tax collection (Bräutigam et al., 2008). There are different views of the practical implications for current development policy. The Organisation for Economic Cooperation and Development (OECD) argues that the orthodox agenda associated with the IMF and others 'broadly serves state building as well as economic policy objectives' (OECD, 2008: 22). Bräutigam (2008: 33) contends that '[a] reform agenda focused on issues of state building in the poorer countries would look substantially different'.

How taxation might strengthen governments and lead to more pro-developmental spending is a contested issue in development policy and there is no settled agenda. The main question is whether an increase in tax revenues can lead to the expansion of responsiveness and accountability by providing incentives for citizens and government to enter into a fiscal contract in which citizens accept and comply with taxes in exchange for government provision of effective services, the rule of law and accountability (Moore, 2007, 2008).

### 2.2.2 Intergovernmental fiscal relations

The challenges of fiscal contracts are further complicated by intergovernmental fiscal relations. Ultimately, all public services are delivered locally somewhere. In unitary states, service delivery, as well as tax collection, takes place via de-concentrated units of the central government, although local governments are hardly ever without any own revenues at all. In federal states, the assignment of expenditure responsibilities and the authority to collect taxes to fund them (or indeed vice-versa) can become quite complicated. The motivation for decentralising government functions often rests on the argument that decisions are better taken closer to the groups directly affected by them.

The literature on intergovernmental fiscal relations has developed a sophisticated set of criteria for the optimum combination of scale, efficiency and effectiveness of both collection and expenditure (Oates, 1999; Boex and Kelly, 2013). There is also an important dimension of fiscal contractualism underlying intergovernmental fiscal relations in the sense that locally (or provincially) elected governments can rely on a higher degree of legitimacy if they are able to provide locally (or provincially) tailored services that taxpayers care about with fewer spillovers or externalities. This could, among other benefits, improve tax morale and in turn increase revenues for providing more and better services. However, there is still little systematic evidence on this point.

The idea of a fiscal contract is most prominent in the context of international support for state-building in fragile states and the provision of financial aid to low-income countries (World Bank, 2011; International Development Committee, 2013). The notion is more abstract and less explicit in middle-income countries and the OECD. Nonetheless, trust in government and the willingness of citizens to pay the taxes required for public spending remain live political issues even in very high-income countries, such as the United States. This fundamental relationship explains in part why governments worldwide deploy specific policy measures to try and link revenues more closely to public spending, as discussed in more detail in the next section.

## 2.3 Conclusions from the literature

No consistent policy canon emerges from the theory and evidence on fiscal contracts. On the other hand, it provides a valuable foundation to the discussion of revenue-expenditure linkages. Three insights from the literature are particularly relevant for this paper.

- There is an accountability relationship between taxpayers and the state, such that governments which fund themselves through citizen taxation are more likely to spend public funds on priorities favoured by taxpayers.
- States don’t necessarily have to survive on domestic taxes alone. They may have other sources of funding, notably resource rents, domain revenues and external aid. To the extent that they can rely on other sources, they are less likely to incur the transaction cost of taxation and less likely to spend in the interest of citizens.
- A growing body of both historical and contemporary cross-country evidence reinforces these observations.

# 3 Using linkages for wider policy objectives: selected measures

In the previous section we discussed the conceptual linkages between expenditure and taxation, with particular reference to how the two sides of a government's fiscal actions can help deliver – or hinder – a 'fiscal contract' between state and citizen. This section reviews how the linkages between expenditure and revenue can be actively managed by government to achieve wider policy objectives. We consider three broad groups of tax and expenditure mechanisms: special fiscal institutions; hypothecation and earmarked revenue; and tax expenditures.

## 3.1 Fiscal institutions

Many governments aim to structure more clearly the relationship between revenue and expenditure within fiscal policy through the operation of particular fiscal rules. These arrangements are frequently introduced in response to the specific challenges and opportunities presented by natural resource revenue. However, many fiscal institutions are relevant to all countries, regardless of their resource wealth. We consider first the general sets of rules and then the specific institutions designed for managing natural resource revenues.

### 3.1.1 Fiscal rules that aim to balance revenue and expenditure

Fiscal rules refer to a system that aims to guide fiscal management above and beyond regular annual budgeting. There are different types of fiscal rules and supporting policy frameworks, but all are intended as a strong (often permanent) constraint on fiscal policy – with the aim of providing clear performance indicators on government debt, borrowing, deficit or spending (Kopits and Symansky, 1998). Fiscal rules feature across developed, emerging and advanced countries, with a documented surge in their use in recent years (IMF, 2009). They have different legal and administrative forms, from explicit constitutional limits on total government deficit and borrowing (so-called 'balanced budget' amendments) to less binding political commitments to operate fiscal policy in a certain manner, often under the external scrutiny of officially-mandated 'fiscal councils' (IMF, 2013). Fiscal rules fall into four broad categories (IMF, 2013).

- **Debt rules.** These typically set an explicit maximum for public debt, providing one easily observable and clear constraint to government fiscal policy. Such rules provide little guidance as to what fiscal policy should be when public debt is below the maximum. As an example, countries participating in the West African Economic and Monetary Union system are required to limit their public debt to below 70% of GDP.

- **Budget balance rules affecting the annual deficit.** The focus of the deficit rule can be annual deficits, cyclically-adjusted deficits or an estimation of structural deficits. Over time, such rules will constrain the increase in debt-to-GDP ratios. Chile has operated a version of structural balance rule that requires government to generate a surplus or balance based on an estimation of structural revenue.

- **Expenditure rules related to overall spending.** These typically set a finite limit on total spending, or specific sub-sets of spending (such as non-investment recurrent spending) in terms of their absolute value, their growth rates, or in terms of spending as a percent of GDP. Botswana, for example, instituted a rule to limit expenditure to 40% of GDP in 2003.

- **Revenue rules.** These can outline minimums or maximums for tax collection aimed at increasing revenue mobilisation or restricting an excessive tax burden. In 2005, Timor-Leste introduced a law to put a ceiling on the use of oil revenues in the national budget.

Fiscal rules are often controversial for both theoretical and practical reasons. They can limit the ability of policy-makers to respond flexibly to a changing macro-fiscal context. During exceptional and unforeseen fiscal events, strict limits on taxation and spending may simply be inappropriate, and even damaging. Rigid fiscal rules may introduce a pro-cyclical bias in public spending, causing fiscal expansion during periods of economic growth, and contraction during slowdown – although this criticism may be more related to the flawed design and/or application of a fiscal rule rather than the existence of a rule itself. Fiscal rules may also suffer fundamental credibility challenges – any rule that is implemented when certain circumstances support it can equally be jettisoned when those circumstances change. For example, fiscal rules have been instituted in Argentina, but have been repeatedly breached by the government, without significant penalty. Where the broader political equilibrium in a country isn't aligned with the requirements of a fiscal rule, the fiscal rule probably won't, in practice, change behaviour (Scartascini, 2013). Countries without a constitutional or legal basis to their fiscal rule may find it easy simply to amend or change rules that no longer serve a positive purpose. Conversely, many countries have operated a successful and responsible fiscal policy in the absence of a clear fiscal rule, suggesting that such a rule isn't necessary or sufficient for a responsible fiscal policy (Kopits, 2001).

The major argument in favour of fiscal rules is precisely the inverse of the constraint objection raised above. Fiscal rules are positively welcomed as a restraint on the ability of policy-makers to exercise their full discretion. Well-designed fiscal rules provide a constraint on irresponsible tax and expenditure policies, and therefore increase the likelihood that effective policies will be followed over the long term. In turn, this can help to reduce macroeconomic imbalances, encourage faster economic growth and reduce the incidence of fiscal crises. The existence of a fiscal rule – apart from its actual impact on fiscal policy outcomes – can also signal to the market and citizens that the government takes overall fiscal responsibility seriously, potentially generating additional benefits in state-society relationships and in market expectations of the risk of doing business with government.

The literature suggests that the mere existence of a fiscal rule is not enough to generate beneficial outcomes. While cross-country evidence suggests that countries which have instituted fiscal rules have experienced improvements in fiscal performance, often explicit rules are instituted *after* an initial period of fiscal consolidation, rather than at the very beginning (IMF, 2009). Importantly, the absence of a fiscal rule doesn't mean that responsible fiscal policy is impossible to achieve. Effective fiscal rules need to be supported by an amenable political and institutional environment (IMF, 2013). A poorly designed rule can cause more harm than good (Corbacho and Swartz, 2007).

### 3.1.2 Special fiscal institutions for natural resource wealth management

Natural resources such as hydrocarbons and minerals have the potential to transform a resource-rich developing country by supporting significantly higher public expenditure, especially for productive public investment. However, special characteristics of natural resource wealth make it harder to translate into beneficial expenditure than regular revenue. From a macroeconomic perspective, sudden natural resource revenues can lead to harmful imbalances in exchange rates ('Dutch disease'). From an expenditure point of view, swings in commodity prices can lead to more volatile and uncertain revenues from year to year; and in terms of public financial management, volatility in the budget from one year to the next can lead to inefficient and unpredictable spending decisions.

From a long-term political perspective, natural resource revenues are by their nature finite and therefore they present complex issues of inter-generational equity and long-term fiscal sustainability. From a short-term political economy perspective, significant resource revenues can have negative impacts on governance – often referred to as the 'resource curse'. Natural resource revenues can lead to the

development of a ‘rentier’ state that has a weakened fiscal compact with its citizens. Natural resource revenues can intensify short-term political decision-making as politicians come under pressure to rapidly satisfy higher citizen expectations. In countries with weak institutions, natural resource revenue may reinforce dysfunctional political behaviour and be used to ‘paper over the cracks’ of deep-rooted social and economic problems rather than encourage actions to address them.

Given these particular features of natural resource revenue, increasing attention is focused on how special fiscal institutions (SFIs) that bridge the revenue and expenditure sides of natural resource wealth can be used to constrain policy-maker behaviour (Sharma and Strauss, 2013). Such mechanisms aim to weaken the potential link between high and volatile natural resource revenue on the one hand, and higher and more volatile expenditure on the other. This approach is usually modelled on the principles of the permanent income hypothesis (See Box 1).

### Box 1: Permanent Income Hypothesis (PIH)

Resource-rich countries have typically relied on the PIH for guiding their fiscal policy frameworks and establishing fiscal benchmarks. The PIH implies that, for a country with only resource revenues, the inter-temporal budget constraint is satisfied when the yearly spending (i.e. the non-resource primary deficit) is limited to the eternal value of resource wealth (i.e. the present value of all future resource revenue) (Baunsgaard et al., 2012).

In the extreme case – the so-called ‘Bird-in-Hand’ approach – the additional expenditure to be financed by the resource revenues is equal to value of the accumulating financial asset (i.e. the interest earned on the financial assets generated from the resources that have been extracted). Norway has successfully implemented this approach, which tends to lead to a back-loading of the spending path.

The PIH approach has been criticised for setting benchmarks that are too tight for capital-constrained resource-rich developing economies. Poor countries may need to raise the level of spending on infrastructure, health and education more rapidly to promote growth and improve service delivery during the early stages of resource extraction. A modified PIH with a sustainable fiscal policy allows for additional upfront spending. That permits for a drawdown of government wealth accumulated from the natural resources on the basis that public spending can be stabilised at a higher level because of front-loaded and growth-enhancing domestic public investment

*Source: Adapted from Sharma and Strauss, 2013*

SFIs for natural resource revenues take two main forms: fiscal rules and resource funds.

- **Fiscal rules specifically for natural resources.** These are often a variation on the more general fiscal rules discussed above. They aim to reduce the cyclicality of natural resource revenue funded spending by promoting a framework that constrains the scope of action by policy-makers by raising the cost of immediately spending the revenues from natural resources. As with general fiscal rules, frameworks that focus on managing natural resource revenue can be formulated in a number of ways: requiring a non-resource primary fiscal balance; a non-resource current fiscal balance; or only allowing resource revenue to be spent depending on the state of the structural budget balance (Ossowski, 2013). Countries such as Chad, Ecuador, Mongolia and Peru have expenditure growth rules relating to natural resource revenue (Sharma and Strauss, 2013).

- **Resource funds.** Many natural resource rich countries have established a resource fund as a way of managing resources that aren’t intended for immediate consumption through the national budget. These funds provide a way of smoothing the expenditure of natural resource revenues by saving funds from one year for use in a future period. For many countries, this type of resource fund is also a sovereign wealth fund designed to generate an investment return as well as simply hold revenue. Resource funds can be divided into different types

according to their main objectives (Ossowski, 2013), although many countries have funds that combine two or more of these features:

- **Stabilisation funds**. These support the distancing of changes in expenditure from changes in revenue and reduce the impact of natural resource revenue volatility on public expenditure. Such funds often operate with rules about when money must be deposited in the fund (for example when the revenue from natural resources is particularly high) and when money can be withdrawn (when revenue drops below a certain point and funds are used to support a pre-determined level of expenditure). Countries such as Chile and Timor-Leste have set up stabilisation funds.
- **Savings funds.** These generate a store of wealth for future generations, and go some way to resolving the issue of inter-generational equity in natural resource wealth. They provide a means by which wealth earned in the present day can be more fairly shared out between future citizens. Funds like this have been established in Libya and Russia.
- **Development funds**. Such funds are often created to finance a particular type of expenditure, for example a fund might be created that focuses on delivering specific national infrastructure projects. These funds do not try to discipline expenditure in terms of controlling total levels of spending; rather they try to discipline expenditure by ensuring that natural resource revenues are spent on specific items that are politically valued. Chad, the United Arab Emirates and Kazakhstan have established versions of a development fund.

### Box 2: The Timor-Leste Petroleum Fund

The Timor-Leste Petroleum Fund is considered to be a good example of a sovereign wealth fund to manage petroleum resources in a fragile or post-conflict setting. Drawing extensively on the experience of Norway in particular, the fund was set up and its governance codified by law in 2005. The income from oil is received by the central bank and managed with the help of professional investment managers. The law codifies a formula to calculate the sustainable income that can be withdrawn and transferred to the government budget each year, although the legislature can vote to release more than the sustainable amount. Timor Leste is a signatory to the Extractive Industries Transparency Initiative, and overall the fund's structure and governance has been reviewed well by international agencies. The sharing of responsibilities between central bank, executive and legislature puts the fund on a more sustainable footing, less susceptible to interference in the short run. However, the withdrawals in recent years have been significantly in excess of the sustainable income formula, raising doubts about absorptive capacity and fiscal institutions. The experience of the Petroleum Fund shows that careful institutional design in combination with an active political process can build fiscal institutions that sustainably link revenues to expenditures. It also underscores the limits of institutional design: the institutions of today are always subject to the political will of tomorrow's governments.

*Source: McKechnie (2013)*

There is a wide literature on the successes and failures of SFIs in the context of natural resource revenue that cannot be fully reviewed here. Some evidence suggests that the experience of such funds has been mixed or that the contribution to sound fiscal policies has been negligible (David et al., 2003). Other recent studies suggest that the existence of stabilisation funds does in fact smooth expenditure compared to situations without them (IMF, 2014b). Other analysis has concluded that success has depended more on the underlying commitment of government to fiscal discipline and sound macroeconomic management than the strength of the technical design (Fasano, 2000).

## 3.2 Hypothecation and earmarking

Citizens in many countries perceive only a weak relationship between paying taxes and receiving services, leading to a weak fiscal contract. One solution to this problem is to explicitly strengthen revenue and expenditure linkages by requiring that revenue earned from one source be solely dedicated to specific expenditures. Where expenditure and revenue move beyond aggregate balance and are specifically linked for certain purposes, the standard mechanism is hypothecation or earmarking.

Earmarking of revenues to fund specific expenditures is widely practiced throughout the world. Common examples include national pension systems, where contributions to the scheme are used to pay out to beneficiaries. In addition, some public sector enterprises could be said to operate on a hypothecated expenditure basis, since revenues from the enterprise's operations remain entirely within the entity to be used to finance further expenditure in the same area. Other examples include revenue from controversial activities (e.g. gambling in national lotteries) being earmarked for certain 'positive' expenditures (e.g. community arts projects).

There are many forms of earmarking and they have differing rationales. The literature identifies three main variables in the approach to hypothecation. First is the degree of *specificity* of expenditures involved (i.e. whether the revenue is supporting one clear activity or several). Second is the *strength of the linkage* between revenues and expenditures (i.e. whether the source of revenue relates closely to the purpose of the expenditure). Third is the question of whether there is an *identifiable benefit rationale* for the linkage. This can lead to different types of hypothecation (See Table 1).

### Table 1: Possible varieties of hypothecation

| Examples | Are the expenditures funded by the revenue clearly specified? | Is there a clear link between earmarked revenue and expenditure? | Is there a clear rationale for the earmarking? |
|---|---|---|---|
| Self-financing public company (e.g. water utility) | Yes (water services are a specific category of expenditure) | Yes (water charges go to fund water services) | Yes (charges for water use relate directly to the delivery of water services) |
| Fuel tax for road maintenance and construction | Yes (road maintenance and construction is a specific category of expenditure) | Partly (fuel tax might be the main source of finance for road construction but general government revenue might also be used to fund expenditure if fuel revenues are too low) | Yes (fuel tax provides revenue based on a charge for 'consumption' of road services through fuel use) |
| Tobacco taxes to fund health expenditure | Partly (health expenditure is a wide field) | No (tobacco taxes are likely to account for a small minority of public expenditure on health care) | Yes (tobacco use damages health, often resulting in a public burden) |
| Lottery revenues to fund health programmes | Partly (health expenditure is a wide field) | No (revenue from the lottery is likely to account for a small minority of public expenditure on health care) | No (there is no strong link between playing the lottery and negative health impacts) |

*Source: Adapted from Fjeldstad and Heggstad (2012)*

Earmarking can be justified on a number of grounds. In cases where the source of hypothecated revenue is closely linked to the nature of the expenditure, it can apply the 'benefit principle' of taxation (i.e. that broadly consumers should pay, in a tax, for the services they benefit from). In the water utility example above, greater consumption of water services (and the greater expenditure needed to deliver them) will result in a commensurately higher charge for water services in the form of water bills (and therefore greater revenue to cover those expenditures). Where the hypothecation relationship on the revenue and expenditure side is very close – as in the case of utility bills – it can function like a price

mechanism and provide appropriate signals for the efficient allocation of resources for service providers.

Hypothecation can also support a stronger political acceptance of taxation in certain circumstances. Linking taxation with certain expenditures can reduce resistance to new or higher taxes and encourage compliance through higher tax morale (See Box 3). For example, the controversial negative impacts that gambling might bring can be politically neutralised by agreeing that some or all of the revenue from this 'bad' activity will be redirected to a 'good' activity. However, without a direct link between the source of the revenue and the focus of the expenditure, such a link will remain political, and not immediate as in the case of a water utility noted above. Earmarking can also ensure minimum levels of funding for certain expenditures. In situations where budget allocations are uncertain or subject to erratic bureaucratic decisions, direct hypothecation for certain expenditures might be able to by-pass the internal discussions that go into resource allocation.

### Box 3: Earmarking in Ghana

Recent experience in Ghana provides explicit evidence of the possibilities regarding tax earmarking, as tax earmarking has become a prominent revenue strategy at the national level. In 2000 the Government of Ghana sought to increase the VAT rate from 10% to 12.5%, but faced heavy public opposition. In order to secure public acceptance, the Government earmarked 100 % of the new revenues to a new Ghana Education Trust Fund, designed to fund scholarships and educational infrastructure, primarily at the tertiary level. In 2003 the newly elected Government sought to increase the VAT rate to 15%, but again faced stiff public opposition. In response, the tax increase was renamed the National Health Insurance Levy and allocated to the creation of a National Health Insurance Fund.

*Source: Adapted from Prichard (2010).*

Despite these advantages, there are many reasons why hypothecation might create more problems than it claims to solve.

- It reduces budgetary flexibility since certain revenues and expenditures are already determined before the allocation of resources begins. A budget with a great deal of notional hypothecation – where hypothecated revenue sources don't carry an intrinsic link to expenditure they will fund – could become excessively rigid and unable to respond to changes in political priorities (Bird and Jun, 2005).

- It can often be essentially presentational – the fungibility of revenues and expenditure means that new hypothecated funds can simply be offset by shifting funding to other areas, leaving the overall pattern of expenditure unchanged.

- There can also be risks to accountability in using hypothecation. Since a certain amount of expenditure and revenue is effectively pre-determined, it can reduce the role of democratic legislatures in amending and approving the overall budget.

- It might also encourage rent-seeking behaviour from special interests in order to entrench a particular advantage through the revenue and expenditure system.

- It may also inadvertently weaken the fiscal contract in aggregate. Certain expenditures may be insulated from negative political reaction through hypothecation, but that may simply open the question about the remainder of all expenditure, which does not have a particular 'justification' through hypothecation.

- Although hypothecation that takes the form of user charges for certain services may have an advantage in terms of aligning costs and benefits through the benefit principle (as noted above), there can be distributional impacts. Hypothecated user charges may be regressive, and weigh most heavily on the poor in society.

There is no simple answer as to whether and when hypothecation might yield a beneficial result in linking revenue to expenditure that is worth taking the significant risks outlined above. The literature suggests that positive outcomes are likely to be achieved when: hypothecation is substantive and specific, with a clear and immediate link between the revenue stream and expenditure activity in question; it is transparent and easy to monitor; and when such arrangements take up only a moderate share of the total budget so as not to undermine flexibility (Prichard, 2010).

## 3.3 Tax expenditures

Revenue and expenditure relationships can be used to deliver two common objectives of public policy – correcting market failures and solving equity challenges. However, it is important to distinguish between areas where revenue and expenditure policy operate independently of each other to achieve policy outcomes, and areas where revenue and expenditure policy operate together. Tax expenditures are an example of policy operating on both the revenue and expenditure side.

Tax expenditures are often referred to as 'revenue foregone' as they involve giving a tax concession or preference to a particular activity over and above the regular tax rate that applies in the relevant circumstance. It is the difference between what would have been paid under the normal tax rules compared to what is actually paid after the tax expenditure. Tax expenditures are used indirectly to deliver subsidies to certain activities to increase their frequency and prevalence by reducing their cost. Modes of delivering tax expenditures can vary, but often include tax exemptions, allowances, credits or offsets, rate relief and deferral of payment and/or generous timing rules.

Given that tax expenditures seek to offer a subsidy through the tax system, it could be asked why governments don't simply provide subsidies through the more usual route of expenditure policy. They are thought to offer advantages over more regular expenditure subsidies for a number of reasons. Tax expenditures can be more cost effective. If the government wishes to offer a broad subsidy to a large number of people without separately assessing each applicant, a tax concession may offer the lowest-cost path to deliver this. The tax system provides an existing infrastructure through which to deliver the benefit, and this will be cheaper than setting up an entirely new administrative bureaucracy. Tax expenditures can also improve take-up and coverage of the subsidy. The tax system offers a chance to advertise the existence of the available subsidy to all taxpayers – a potentially large group of people. By making assessment for tax expenditure eligibility something all taxpayers must do as part of completing their tax administration, government can ensure its subsidy gains wide exposure and uptake.

There are also disadvantages to using tax expenditures as a method of delivering subsidies. Tax expenditures may have negative impacts on the political economy of tax and spending. They often face less scrutiny than direct spending in budgetary approval. The usual practice is for legislatures to review, scrutinise and approve expenditures, whereas tax expenditures don't involve direct appropriations and aren't always routinely considered as part of budget scrutiny. They may create vested interests to defend and perpetuate them, particularly if they are heavily targeted, and they may be harder to eliminate than wasteful direct expenditure since there is seemingly no immediate cost to the government. Tax expenditures may also have negative distributional affects. The poorest in society may not pay any taxes at all, and therefore be unable to claim any tax expenditures. It also may only be the relatively wealthy who can afford the kind of tax advice that would allow for exploitation of these tax expenditures. In many tax systems, claiming tax exemptions essentially involves a self-declaration of eligibility and a decision by the taxpayer to reduce their tax payment accordingly. The cost of supervising this system

may be greater than for a system based on direct expenditure where applicants must prove their eligibility to government, which then decides if they are eligible to receive the benefit and subsequently pays it.

For many countries, tax expenditures represent significant shares of public expenditure, and even of GDP. In Bangladesh, they are estimated at about 31% of revenue and 2.5% of GDP (Mortaza et al., 2006). Other estimates, using different measurement concepts, suggest even higher tax expenditures as a share of GDP in Turkey (5%) and China (over 10%) (Fuest and Riedel, 2009). Work to identify, quantify and publicise tax expenditures is widely recognised as a key part of fiscal transparency. To make a system of tax expenditures fair and equitable, the publication of a full list of the tax expenditures will allow for a better debate between government, civil society and citizens with regard to what tax exemptions are beneficial, and help to identify those that are simply providing rewards for a minority without compensatory social benefits to other groups (IMF et al., 2011).

## 3.4 Concluding reflections on policy measures

This section has provided an overview of three sets of measures that could be enacted to take advantage of the links between expenditure and revenue. The three categories are very different, with varying sets of benefits and risks associated. Governments will need to consider the risks of fiscal institutions, hypothecation and tax expenditures carefully before deciding whether to adopt them. It is important to note that, in OECD countries, hypothecation and tax expenditures in particular are regarded more as politically expedient fixes than solutions to public finance challenges. For fiscal rules and other fiscal institutions, the debate is more about the preconditions for their successful introduction. Governments need to weigh transaction costs and success probability against the potential long-run benefits.

In each case, an important lesson is that simply adopting policies based on areas of revenue and expenditure linkage will not necessarily lead to improvement in outcomes. Fiscal sustainability and prudent use of natural resource revenue can be achieved without explicit binding fiscal rules. When done effectively, taxes can be raised from specific sources and spent on others without necessarily using hypothecation to justify each instance. Tax expenditures are only one way of incentivising the behaviour of economic agents, and there may be other ways (e.g. basic tax rates, expenditure policy, and regulation) to achieve the desired outcomes. Governments must choose carefully when implementing policies and not assume that explicitly establishing these linkages is necessary or sufficient to achieve wider policy objectives.

The relationship between the underlying concern over the fiscal contract and the specific policy measures discussed here is theoretically complex and empirically challenging. It could be argued in principle that a more visible and direct link between revenue sources and spending objectives through hypothecation is liable to increase taxpayers' faith in the state. However, the underlying argument of state-formation through the fiscal contract also assumes a continually strengthening central fiscal authority that is able to respond to political needs with fiscal means, an ability that is directly constrained by hypothecating revenues. For an example of how an accumulation of such constraints can cripple a government's room for manoeuvre – and eventually coincide with, if not cause, a sustained straining of the fiscal contract – one need look no further than contemporary US states (e.g. Conti-Brown, 2012).

Many of the details that could link specific policy measures to a strengthened fiscal contract remain unexplored and require further investigation for a proper assessment of costs and benefits. Giving legislatures or organised civil society a stronger role in the design and maintenance of fiscal institutions may strengthen their legitimacy and build the fabric of the fiscal contract. But if the relationship between them and the executive is antagonistic, or legislatures and civil society are weak, would the effect be the same? Historically, these rights were won by domestic forces, not granted by the executive in order to strengthen the fiscal contract (e.g. Schick, 2002; Tilly, 1992; Krause, 2013). As a result, if external actors alone insisted on greater participation, and the executive acceded to satisfy international demands

without domestic incentives being aligned, would it still work? How would we know if it did, and are increased tax collections a sufficient proxy for a fiscal contract? Much empirical work remains to be done to develop a better sense of whether fiscal contracts are more of a historical metaphor or rather a meaningful guide for policy.

# 4 Possible roles for international cooperation

The discussion above has concentrated on the conceptual links between the revenue and expenditure sides of the fiscal relationship, and the technical instruments that governments use to develop and exploit specific linkages in pursuit of policy objectives. In this section we discuss the possible roles for international cooperation and external action. We distinguish three areas of possible involvement by external actors: they can undertake actions to provide funding to boost government revenue or fiscal space and in doing so influence expenditure patterns; they can provide policy advice and technical assistance directly to governments for the design and implementation of policy instruments; and they can be influential in 'changing the rules of the game' at an international or regional level when it comes to domestic revenue and expenditure policies.

We should be clear that over the long term there is unlikely to be a strong direct role for external actors to affect policy or institutional outcomes in this particular domain of public finance. While the actions of international actors such as the IMF, other donors and regional institutions such as the EU may change the short- and medium-term incentives facing governments regarding revenue and expenditure policy, the above discussion has noted that the development of a durable fiscal contract and/or other state-society revenue and expenditure settlement is a long-term and domestically driven process. As a result, the overall long-term direction of policy regarding policy linkages between revenue and expenditure will typically lie with national governments themselves. External actors may find opportunities to provide different forms of supporting action, whilst recognising that they cannot directly decide or implement these measures. In that sense, the possible roles for development cooperation in this arena are no different to those for many other aspects of public finance.

## 4.1 Direct provision of revenue and financing

Development agencies may provide finance to governments in the (formal or informal) expectation that certain patterns of expenditure will be implemented as a result. In this relationship, external actors are involved on the revenue side through providing funding, and on the expenditure side through trying to influence expenditure allocation. This type of relationship is associated with instruments such as general budget support or sector budget support.[1] For example, a development agency might provide general budget support on the condition that spending on broad budget areas identified as 'pro-poor' does not fall below an agreed threshold (Simson, 2012). In sector budget support, the revenue-expenditure linkage may be particularly precise: funds are often made available to a government in exchange for commitments to spend a certain percentage of the overall budget on a particular sector, alongside a list of sector policy reforms. The funds may be tightly earmarked to particular categories of expenditure, or even to certain budget lines in some cases. Depending on the context, this revenue-expenditure relationship need not be one of coercive conditionality. It may be the case that funders and governments genuinely share the same goals so that the higher revenue financed by external actors, and the sector expenditure conditions attached, reflect actions that the government supports and would have pursued independently.

[1] See Tavakoli and Smith (2011) for a survey article on recent budget support evidence.

Revenue support in return for expenditure policy changes can be supplied indirectly through other forms of financing that aim to boost or influence government fiscal space. For example, under the Highly Indebted Poor Country (HIPC) initiative, eligible countries received write-offs for their external debt if they fulfilled certain criteria related to economic management and pro-poor expenditure. While debt write-off does not generate revenue directly, it still expands the fiscal space available for governments to undertake expenditure in the areas that the HIPC process determines to be most important. Finally, many development agencies and international financial institutions provide finance in the form of loans, loan guarantees or other forms of concessional credit in return for certain expenditure and policy reforms.

The expectation of expenditure policy reform in return for the provision of additional revenue through foreign aid has inherent challenges. The general literature on conditionality emphasises the limits of external policy influence and the potentially perverse effects of such conditions (e.g. Cordella and Dell'Aricca, 2002; Morrissey, 2004). The issues are especially pronounced in fragile states and external funding agencies are strongly impelled to design their engagement with governments in a more precautionary way by following a principle of 'do no harm' (OECD, 2007). Four concerns about the direct provision of revenue and financing emerge from the relevant literature.

- **Fungibility and additionality.** Money is fungible and additional funds intended to increase spending allocations in a particular sector may simply be off-set by reductions in the government's own contribution to that sector, leaving no net increase. This 'additionality' problem is often tackled through a conditionality and monitoring system requiring government to spend a percentage of its own funds in the nominated sector in exchange for external support. However, the government's real spending intentions in the absence of foreign aid can't be known with any certainty by external funders.

- **Macroeconomic management.** Provision of large amounts of aid revenue, regardless of the government's enthusiasm for receiving it under whatever terms, also carries wider macroeconomic risks. Significant inflows of foreign currency to small economies can artificially inflate the exchange rate (a form of 'Dutch disease') and therefore harm export competitiveness if aid cannot spur offsetting improvements in productivity (Adam and Bevan, 2006). Thus the domestic authorities may not wish to convert large-scale foreign aid immediately into increased government expenditure.

- **Domestic accountability.** Receipt of large amounts of revenue not from domestic taxpayers may have negative governance impacts. It risks undermining the emergence of a domestic fiscal contract and can shift government accountability towards external actors rather than the domestic public.

- **Unintended consequences.** Large amounts of aid may be considered akin to windfall natural resource revenue and may create similar 'resource curse' risks. Some literature finds a relationship between high aid receipts and increases in military expenditure (Collier and Hoeffler, 2007). Others argue that provision of large amounts of external aid to dysfunctional governments can entrench that dysfunction in certain contexts (Chabal and Daloz, 2010).

Development agencies that intervene directly to finance a fiscal expansion or to influence the composition of public expenditure must pay close attention to the effects of their action on the domestic fiscal contract in particular. There is a risk that the intended benefits of increases in aggregate or sector-specific expenditure will be offset by a weakening of the domestic accountability and thus potentially the level of tax morale on the revenue side. This outcome isn't inevitable, but the discussion in Section 2 suggests the risk isn't trivial either.

## 4.2 Technical advice and technical cooperation

External actors may choose to focus on providing technical advice to governments, as well as or instead of providing finance directly. Technical advice is a wide field – for example, the definition used by the OECD relates to any activity that augments knowledge and skills or builds know-how and productive aptitudes of people in developing countries (OECD, 2011). Commonly-used forms of technical assistance and advice relevant to the revenue and expenditure fields cover the following categories.

- **Capacity support.** Following Welham et al. (2013) we categorise capacity support into three types, none of which are novel or particular to public finance issues but all of which apply to the role of external actors engaging at the interface between government revenues and expenditures.

  - *Capacity building.* This is the process through which individuals and organisations obtain, strengthen and maintain the capabilities to set and achieve their own development objectives over time (UNDP, 2008). Relevant examples would include external experts providing training to finance ministry officials on the operation of a fiscal rule, or on how to hypothecate revenues within the public finance system.

  - *Capacity supplementation.* This refers to interventions to fill substantive advisory functions, using personnel outside the usual civil service structure. An example would be advice from external specialists on the merits of different types of fiscal rule, whilst leaving decision-making and implementation to the domestic authorities.

  - *Capacity substitution.* This covers the use of external personnel or specialists filling line positions – not advisory roles – within the regular civil service. Such a position would not necessarily come with the expectation that skills and capabilities would be transferred during the period of the assistance.

- **Global knowledge sharing and brokering.** International agencies and regional membership bodies can provide access to comparative global knowledge and analysis. There are a growing number of examples in the area of public finance. The OECD Centre for Tax Policy and Administration provides statistics, databases and lesson-learning documents that could be used by developing country policy-makers to inform their activities, including specific information on comparative experiences with tax expenditures (OECD, 2010). The IMF regularly publishes research and analysis on the design and impact of fiscal institutions (e.g. IMF, 2013; IMF, 2009).

- **Peer-to-peer learning.** Governments engage in peer-to-peer learning and awareness-raising exercises to review their activities and compare their own performance against another similar country and use this to self-diagnose areas for improvement. The process is often facilitated by external agencies (OECD, 2014). Such bodies also exist at a regional level, for example the African Tax Administration Form provides a mechanism for sharing experience and learning on common issues for African tax authorities; the Collaborative African Budget Reform Initiative provides the equivalent function for senior budget officials. This model has now spread to regional groupings in Asia (the Public Expenditure Management Network in Asia) and in Europe and Central Asia (Public Expenditure Management Peer-Assisted Learning).

Despite the generic nature of these options, technical assistance in the public finance and public sector fields is at the forefront of latest international debate on how to provide more effective technical advisory support to low- and middle-income countries. More process-driven, flexible and problem-oriented approaches have now started to become part of the mainstream discourse (Andrews et al., 2012; Andrews, 2013). A central tenet of this renewed philosophy underpinning technical assistance is that

specific policy objectives or development 'problems' should form the starting point. Accordingly, external advice should facilitate or support the process of domestic actors specifying those problems or objectives and thereafter developing the possible options in response. The implication for technical assistance on revenue and expenditure linkages is that external actors would avoid the starting point of assuming any particular instrument will be relevant or appropriate (for example fiscal rules, hypothecation or tax expenditures). Rather they would focus on consultation and shared diagnosis as the way to identify more bespoke 'solutions' that fit both the context and the real underlying need.

## 4.3 Changing the international rules of the game

External actors can influence developing country tax and expenditure policies by affecting the way international activity in these areas is regulated. As the international regulations, norms and common standards in revenue and expenditure policy change at a global or regional level, developing countries wishing to broaden their engagement with the rest of the world or relevant region will increasingly be expected to abide by them. By providing incentives for developing countries to amend their policies in line with international or regional norms, international regulation can be seen as a route through which external actors can have an influence over domestic policy.

There are numerous examples. At a global level, the OECD coordinates a process to develop and maintain a Model Tax Treaty, to encourage harmonisation of treaties along similar lines, and provides the coordinating forum for agreements on other areas of common interest for a number of states, for example the Action Plan on Base Erosion and Profit Shifting.[2] At a regional level, the EU accession process requires candidate countries to adopt certain standards of public administration, including those relating to expenditure and revenue policies. While many of these will be voluntary rather than compulsory for developing countries, the fact that other countries adopt them can make such systems de facto obligatory for participation in certain types of international activities.[3]

On both the revenue and expenditure sides, there are already clear international standards and categorisations of revenue and expenditure through systems such as the IMF Government Finance Statistics (GFS) and the UN Classification of Functions of Government that guide how revenues and expenditures are recorded and reported. The impact of these classification systems on domestic public finance management will vary according to the level of integration by the country into the international system and thus the degree of conformity. The GFS system in particular is relevant to the present paper because it covers both revenue and expenditure, thus permitting stronger analytical connections between the two sides and at a disaggregated level.

The emergence of a set of multilateral networks and alliances may also prove influential in setting the future agenda and framing the nature of international cooperation on public finance issues such as domestic resource mobilisation and good financial governance – especially for low- and middle-income countries. The Global Partnership for Effective Development Cooperation, the Effective Institutions Platform and the OECD Task Force on Tax and Development are notable examples of the proto-institutions which are concentrating effort on taxation issues. They provide horizontal mechanisms for peer exchange, agenda development and the formation of coalitions on specific issues. The mixed composition of governments, international organisations and civil society organisations differentiates

[2] See the OECD Centre for Tax Policy and Administration website: www.oecd.org/ctp.

[3] Changing the international rules of the game for taxation may also create opportunities from which developing countries can benefit. The motivations of international organisations for this kind of global standard-setting may be partially oriented to the concerns of low-income countries aspiring to increase their mobilisation of tax revenues, from multinational corporations for example. Recent attention by the G8, G20 and OECD on international taxation issues could prove beneficial for developing countries, provided they are able to develop sufficient organisational capacity to take advantage of the changing norms and rules. These measures don't relate to revenue-expenditure linkages per se but they illustrate the potential for international action.

these groupings from other international bodies and arguably gives them some additional influence to mobilise a wide support base and to influence international norms, especially in the development sector.

## 4.4 Concluding reflections on external action

The above discussion lays out three ways in which external actors might influence the design and operation of policies designed to exploit linkages between revenue and expenditure. Taken together, some tentative lessons emerge. The most direct way for external actors to influence a government expenditure and revenue policies is through provision of funds in exchange for commitments to certain allocations of revenue. This is a common approach used by development agencies. Such an approach brings a clear risk of undermining the domestic fiscal contract, may create a form of 'resource curse' and often requires a costly architecture of oversight and monitoring to manage problems of fungibility and additionality. Where development agencies don't wish to engage in the direct provision of funding, they may provide technical advice and knowledge transfer or aim for indirect influence through international standard setting. However, given the limits of external influence on national governments' domestic fiscal affairs, the most important determinant of policies that link revenue and expenditure is likely to remain the national government itself.

# 5 Conclusions and policy agenda

## 5.1 Summary of findings

This paper has considered the conceptual linkages between public revenues and public expenditures and the reasons why such linkages may be important or useful for policy-makers. Building on that analysis, it has described the main technical instruments used by governments to connect revenues and expenditures in pursuit of particular policy objectives – noting the incidence of those measures in selected countries. Finally, it has discussed the potential roles of international cooperation in this area of public finance.

At the conceptual level, we conclude that there are two important dimensions to the relationship between revenue and expenditure: general fiscal policy, and the fiscal contract between a state and its citizens. Fiscal policy is by definition concerned with determining the balance between aggregate revenue and aggregate expenditure. It also covers the distributional incidence of revenue and expenditure policies, both separately and in conjunction. Instruments will be used by a government to influence the overall fiscal stance and the detailed fiscal incidence of the public finances. The nature of these links may further be affected by the main sources of revenue used by the state to fund public expenditures as well as the nature of intergovernmental fiscal relations, especially in federal states.

Governments routinely exploit specific connections between the two sides of the public finance equation through policy instruments such as fiscal rules, earmarked revenues and tax expenditures. These measures exist as part of an array of instruments used to achieve wider policy objectives. The utility of such linkages is therefore instrumental not intrinsic. We haven't attempted to evaluate the use of the three sets of measures, but it isn't evident that these measures are always necessary or effective mechanisms to achieve their underlying policy objectives. Context is all important, as are political incentives. The international development community has started to take increased interest in this agenda, but the inherently domestic and political nature of the issues poses obvious limitations to external action deployed through financing and advisory means.

## 5.1 Limitations and caveats

The revenue-expenditure nexus, specifically concerning domestic taxation, is a special case from the point of view of development cooperation. The literature on institutions and development in general, and work on taxation and fiscal contracts in particular, suggest that governments follow specific incentives, and are constrained by their political environment, when deciding from whom to extract revenues. The same calculations about incentives and context apply to their spending decisions. It is easy to think of governments that don't prioritise health or education to the same extent that the development community does. In those cases, governments may decide not to fund health expenditures extensively, but still accept external grant funding for the sector. The potential scope for external funding action to scale up aggregate and sector-specific expenditure may therefore be relatively high.[4]

The level and composition of revenues is at the heart of state capacity and the state's relationship with the elites that sustain it. Governments will rarely threaten the foundation of their existence by trying to

[4] However, there are also practical macroeconomic constraints that may cause central finance agencies and sector spending ministries to take different stances on the issue of increasing public expenditure through external aid. See Killick and Foster (2007) on the macroeconomic effects of scaling up aid and Williamson et al. (forthcoming) on the debate about 'additional' sector spending in Uganda.

challenge the elites that keep them in office (CABRI et al., 2011). The UK Parliament International Development Committee published a report in 2013 strongly urging the British government to make future aid conditional on more efforts to increase domestic tax collection (International Development Committee, 2013). The findings from the literature suggests, however, that there are limits to the ability of aid and other kind of development finance to lever sustainable policy change at country level where this is not desired by the national government. In many countries, governments fail to raise their tax take not because they object in principle, nor because they lack the technical understanding or bureaucratic capacity to do so, but because they lack the political strength and mandate domestically. That calls for an astute rather than coercive approach to external development cooperation, rooted in an understanding of how the domestic fiscal contract and the sources of domestic revenue affect the role and instincts of the state vis-à-vis its citizens.

## 5.2 Potential significance of this agenda

Further enquiry will be valuable in exploring each of the three main dimensions covered by this paper: conceptual linkages, specific policy instruments and the scope for external action. That might include more detailed examination and comparison of particular country examples, and a more exhaustive review of the bodies of relevant literature. Revenue-expenditure linkages may provide a means for governments to achieve wider objectives, but they will have benefits and costs like any other kind of policy reform. It is important to analyse them with reference to a specific policy objective and in a particular country context, not simply in isolation.

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