Tax Competition, Globalization and Declining Social Protection

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Abstract

The decline, or stagnation, in broad-based social expenditure, so crucial to the well being of mother and child, occurs because of various reasons. First, the government may derive less utility from this category of expenditure, compared to spending on its political support group, the military or other prestige projects. Second, the authorities may find that they have less revenue in the era of globalization because of international tax competition, falling domestic tax bases and capital flight. Third, in the interests of macroeconomic stability the government may have to balance its books. This usually means expenditure reduction rather than revenue expansion. In a setting of overall spending cuts, the burden borne by the social sector is often greater than in other areas such as defence. This paper is concerned with aspects of both the revenue and expenditure side in the provision of social services. It demonstrates that small and vulnerable developing can be seriously disadvantaged by international tax competition in mobile factors. This is most applicable to North-South tax competition, as well as competition between larger and smaller nations in the South. The very existence of mobile capital, and the danger of its exit, may induce developing countries in general to lower corporate tax rates below the OECD average. On the expenditure side, policy coherence amongst bilateral and multilateral donors is necessary in the context of the HIPC initiative, which aims to divert debt-servicing to social sector expenditure. It is important that donors move towards greater complementarity in designing aid-conditionality.

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1 Introduction

Globalization, or the increased openness, since 1980 has led to the marginalization of many developing countries, as far as the fruits and benefits of globalization are concerned (Murshed 2000). Yet, opting out of the present-day globalized economic system is not a seriously viable alternative for any country. It is important to emphasize the newer vulnerabilities engendered by the rapid pace of globalization during the past two decades. Among them is the fact that a more open economy will be subject to greater fluctuations in economic activity. A fifth of humanity (about 1.2 billion individuals) live in abject poverty with incomes below a dollar a day. The actual number of people living in poverty is greater than this, once we take into account those individuals whose lot is euphemistically described as being that of the 'near' poor. This, broader, poverty figure for the world is actually rising. The 'lost decade' of the 1980s for Latin America and Africa still persists in much of sub-Saharan Africa. Over 40 countries in 1998 were still saddled with real per-capita incomes they had achieved two or three decades earlier. Accompanying this growth failure are the inevitable entitlement losses such as those associated with malnutrition, infant mortality and increased susceptibility to infectious disease.

Globalization presents a challenge for social policy. Openness raises vulnerability, a problem that is even more acute for nations that have failed to grow. It is increasingly accepted that globalization raises income inequality (Milanovic 2002). This is true, even for countries that are on average prospering from globalization, leave alone the growth failures of the world. Indeed, globalization may add to the sources of income risk for the poor in the sense described by Holzmann and Jorgensen (2000). This raises the need for social protection. Social spending on health and education is part of this insurance against the risks raised by globalization. Social expenditure is also consistent with a development trajectory that leads to sustainable human development. But there is another, *efficiency*, argument for social expenditure in the health and education sectors. This states that public expenditure in these fields augments human capital, raising productivity and growth rates.

Given all of these reasons we are left with the question as to why broad-based spending on the social sector by governments in developing countries is declining in many cases. This is a result of the paucity of both will and means. Governments in developing countries face declining revenues. Many are highly indebted and have to divert a considerable portion of government revenues to debt servicing. In addition the advent of globalization has meant trade liberalization, sometimes under the guise of structural adjustment programmes. Traditionally, trade taxes or import duties, now lowered, had been an important source of government revenue in low-income countries. Moreover, low-income countries have a very small income-tax base by virtue of being poor. Another source of revenue is the tax levied on the profits of multinational companies. But here it should be remembered that foreign direct investment (FDI) to developing countries is highly skewed, with about ten countries accounting for two-thirds or more of FDI inflows from the OECD. Most low-income developing countries attract very little FDI, and therefore cannot obtain much tax revenue from this source. If that is the case, then the tax competition (or lowering of taxes) to attract mobile international capital should be more applicable in the aggregate North-South arena, or developed-developing country interaction. Corporate tax rates are on an average lower in the South

relative to the North. On the whole, tax competition on mobile international capital, has reduced corporate tax rates levied on multinationals globally. They are often granted major financial concessions.[1] Finally, globalization is said to have increased the size and scope of avoidance and evasion on the tax obligations of the rich in developing countries. Opportunities for capital flight have increased, and offshore financial centres have mushroomed, including 'offshore' and shadowy activities in major G-7 nations.[2]

But the shortfall in revenues, or means, is only one side of the coin. Governments must have the will or desire to engage in broad-based social spending. But they are not always benevolent. Even when the means exist they do not always expend resources on broad-based social spending. Many observers regard government, particularly central government, as the 'Leviathan', with an insatiable appetite for vainglorious expenditure (Eichenberger and Frey 1996). In a developing country context this means expenditure on the military, prestige projects, as well as spending on a discriminatory/sectarian basis or on supporters. More importantly when total government expenditure has to be cut, it is these prestige projects and military expenditure that are most resilient. This means that social expenditure declines more than proportionately when there is an overall decline in spending.

In summary, it means that faced with falling revenues, structural adjustment programmes requiring movement to a balanced budget, lower import taxes, tax competition in mobile factors, supply shocks and the political imperative to spend on the military, elites and supporters there is a fall in broad-based social sector expenditure. To that we have to add the realization that the state anywhere is less than benevolent.

This paper will address some of the issues outlined in the previous paragraph. I will be concerned with aspects of both the revenue and expenditure side in the provision of social services. Section 2 deals with the revenue dimension, mainly tax competition. It demonstrates analytically that small and vulnerable developing can be seriously disadvantaged by international tax competition in mobile factors. There may be a race to or towards the bottom, as far as tax rates are concerned, especially for weaker countries in the South. This analysis is applicable to North-South tax competition, as well as competition between larger and smaller nations in the South. Section 3 deals with the expenditure side, including government preferences about different types of spending, and is also concerned with the current HIPC initiative to divert debt servicing towards social spending. Section 4 deals with some stylized facts on social expenditure and government revenues. Finally, section 5 concludes with some policy recommendations.

2   Revenue side

This section will be concerned about mechanisms via which tax revenues to governments in developing countries might potentially decline due to globalization. Globalization implies integration, internationalization and international mobility. There are two sources of difficulty that increased globalization might bring to the revenue

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[1] There is a global trend for taxes to be levied more on immobile relative to mobile factor incomes.

[2] For example, the involvement of British banks in money laundering by the Abacha regime in Nigeria, and the role of a US bank in Russian financial irregularities.

raising capacity of these nations. The first is a diminished ability to tax international capital inflows, and the second is to do with a reduced capacity to tax rich citizens whose savings are increasingly mobile in an outward direction from the domestic tax jurisdiction. The bulk of the analysis in this section will be concerned with the first issue. One estimate of the revenue loss from 'tax competition' in taxing profits on FDI by multinationals is about US$35 billion (OXFAM 2000). This refers to the lower tax rates on company profits, which averages at 20 percent for developing countries compared to the 35 percent OECD average. The calculation is based on a FDI capital stock of US$1220 billion attracting a 20 percent profit, taxed at 35 percent not 20 percent. Additionally, there will be a further loss of revenues due to the tax avoiding behaviour of multinationals, transfer pricing. OXFAM (2000) estimates the loss of revenue from the inability to tax rich domestic residents in developing countries at US$15 billion. This is based on an estimate of capital flight, equivalent to US$700 billion being taxed at 22 percent. The grand total from these two effects amounts to US$50 billion. This is approximately equivalent to the total amount of official development assistance (ODA) to developing countries.

To deal with international tax competition first, mobile international capital inflows are said to lead to the phenomenon of tax competition. This, it is said, has led to a reduction in corporate tax rates. Moreover there is meant to be a 'race to the bottom'; as countries compete on tax rates they drive these tax rates down towards zero. I will demonstrate that this type of competition might disadvantage smaller and poorer less developed countries. Larger and/or richer nations, particularly in the North, might be able to attract, or continue attracting, mobile capital even when they charge higher taxes than their relatively less profitable, poorer and smaller counterparts. This might occur even with perfectly mobile international capital. Furthermore, I will show that there is not always a tendency towards a race to the bottom, rather than the zero tax rates, associated with rock bottom.

For analytical simplicity let there only be two countries (indexed $i = 1, 2$).[3] Let Y denote output derived from mobile international capital or foreign direct investment (FDI). Note that Y, does not denote total GDP. In country, i:

$$Y^i = F(K^i), F_1 > 0, F_{11} < 0 \tag{1}$$

K denotes the capital-labour ratio into country i. Note that *total* corporate tax revenues are related to capital stocks, while tax competition concerns capital inflows. The remainder of this section deals with capital inflows. Let the total amount of capital flows into the two countries, during the period in question, be fixed:

$$K^1 + K^2 = K \tag{2}$$

The after-tax profit rate on capital (r) in country i, is given by:

$$r^i = (1 - t^i)F_i(K^i) \tag{3}$$

Where F_i is the marginal product of K in country i, and t stands for a proportional tax on

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[3] In what follows, superscripts refer to countries (1 and 2), subscripts to partial derivatives.

Y. For analytical simplicity the tax is levied on *Y*, and not the fraction of *Y* that represents profits.

The revenue to the government in country *i*, from this source (R^F) is given by:

$$R^{Fi} = t^i F(K^i) \tag{4}$$

The above holds true when there is no international capital mobility between the two countries in response to tax rate differentials. If, however, in every period capital could choose where to locate in response to ex-ante tax rate differentials, then its location decisions would lead to the equalization of *post-tax earning rates* on capital in both countries.[4] Utilizing equation (3) we would have:

$$(1 - t^1) F_1(K^1) = (1 - t^2) F_2(K^2) \tag{5}$$

This is the result of the no arbitrage condition whereby post-tax rates are equalized in the two countries. Note that if the marginal product of capital is greater in one country it can set a higher tax rate than in the other country. In our example it is country 1. This could occur if country 1 has a larger and more productive capital stock. Other reasons could include a larger market in country 1, or a better risk perception.

We could define a government revenue function in general form as:

$$R^{Fi}(t^i) = t^i F^i(K^i(t^1, t^2)) \tag{6}$$

In this function, each country's revenues depend on the capital stock locating in that country. But unlike in (4) the capital stock, in turn, is also a function of the tax rates in both countries due to international tax competition.

What would occur if country 1 raised its taxes? Differentiating (6) with respect to *t* for country 1 yields:

$$\frac{\partial R^1}{\partial t^1} = F(\bullet) + t^1 F_1 K_1^1 \tag{7}$$

Note that there are two terms on the right hand side of (7). The first term is the direct tax or revenue effect. The second term is the indirect or tax-base effect of a marginal change in taxes. Note that it is negative, as $K_1 < 0$ because as the tax rate is raised in the home country less capital locates there. [But if the other country raises its taxes, more capital flows into the home country, $K_2 > 0$.] This effect is only present in an open economy, and in the presence of tax competition. Otherwise the second term on the right hand side of (7) would vanish. The important point is that the presence or emergence of tax competition lowers each country's ability to obtain tax revenues.

Each government will maximize revenue by setting (7) equal to zero. In effect, the two countries are playing a non-cooperative game, or a Cournot-Nash game. This game is

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[4] Governments move first by announcing tax rates. This is followed by investment location decisions.

what we refer to as tax competition. The reaction functions for both countries can be obtained from (7).[5] For country 1:

$$\frac{dt^2}{dt^1} = \frac{2F_1K_1^1 + t^1F_1K_{11}^1}{-(F_1K_2^1 + t^1F_1K_{12}^1)} > 0, K_{11} < 0, K_{12} > 0 \tag{8}$$

A similar expression can be obtained for country 2. The two reaction functions in Figure 1 are upward sloping, as an increase in one country's tax rate results in the other country following suit. Their intersection defines the equilibrium of the tax competition game. Notice that two reaction functions are in place for country 2. The upper reaction function refers to country 2 when it is equal to country 1; the bottom reaction function applies when it is weaker.

Figure 1
Tax competition
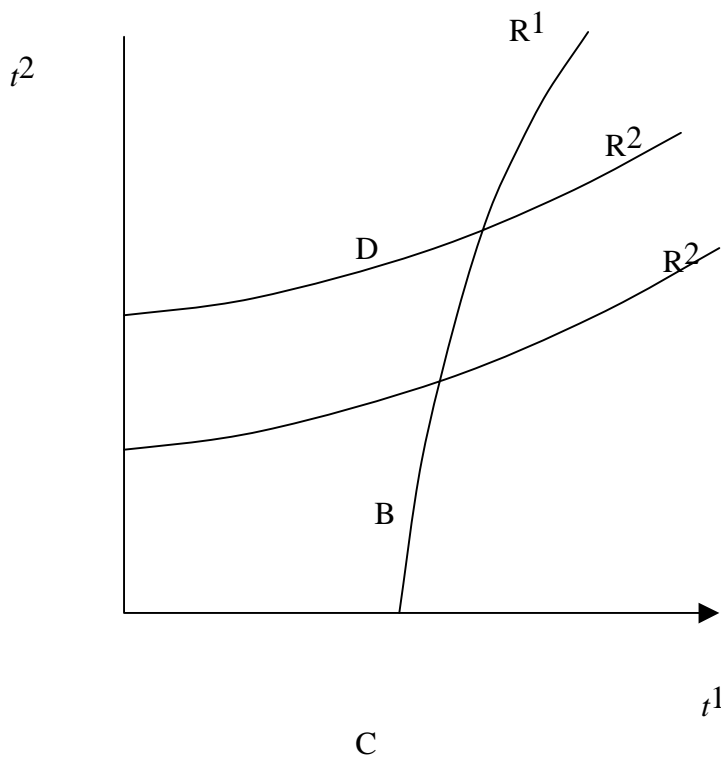
Note:

(i)   In the present example, country 1 has an advantage over country 2. This is to illustrate that tax competition could disadvantage small nations, compared to large neighbouring countries. This result is unlike in much of the literature, for example in Kanbur and Keen (1993).[6] In fact, country 1 may be viewed as a country in the North, and country 2 as a small nation in the South. At point B in Figure 1, country 1 is able to set a higher tax rate and capture more revenues than country 2. This is because capital is more productive in country 1 ($F_1 > F_2$), and marginal tax increases discourage capital inflows to a lesser degree in country 1 ($K_{12} > K_{21}$). Beggar my neighbour tax policies could actually favour larger countries, especially in the North over the South. This is a point that is not normally dealt with in the literature. Note that country 1's reaction function is steeper than country 2's showing that it adjusts its tax rate by a smaller amount in response to its rival. If the two countries were symmetric then the equilibrium will be at point D. Both countries could, however, obtain more revenues in the absence of tax competition and mobile capital.

(ii)   Generally, there is a race towards the bottom, rather than a race to the bottom as a result of tax competition (see also Dehejia and Genschel 1997). This is because FDI involves fixed or sunk costs unlike equities or savings. Even if tax rates are greater in one country not all the FDI stock can instantly relocate. Of course, the FDI stock can exit in the longer run.

(iii)   There is a possibility, however, of a race *to* the bottom for country 2. If the productivity of FDI capital is very low in country 2, then the equilibrium could be at point C in Figure 1, a corner solution. It might set its tax rates equal to zero and still attract little FDI. The reaction function of country 2 would be subject to a sharp discontinuity at point B, corresponding to the vertical axis in Figure 1 between the origin and point C. This captures the reality of FDI for most low-income developing countries; some ten (mainly large) countries account for at least two-thirds of all developing country FDI inflows. The outcome at point C may also be viewed as the fate of a small vulnerable low-income country in the South, following North-South tax competition.

(iv)   A cooperative outcome might generate better results for both governments. But cooperation in terms of tax rates is fraught with difficulties, dangers of defection, as well as a variety of other coordination failures. The distribution of gains from coordination (who gets what) is unclear, and there could be many free rider problems. Such a coalition can only be stable if most countries, including the G-7 nations, are credibly committed to it.

(v)   If one country were to be a Stackelberg leader, it is not necessarily better off compared to the follower. For country 1 Stackelberg equilibrium might be to the left of B, C or D in Figure 1.

The analysis above is applicable to corporate taxation of foreign direct investment. Moving on to the second point raised at the beginning of this section, it has been

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[6]   They show, in the context of commodity taxation, that small countries can always attract more sales.

strongly argued that globalization reduces the capacity to tax the income or savings of wealthy individuals (OXFAM 2000, for example). This is because globalization might improve the technology of tax avoidance and evasion via increased international offshore overseas opportunities to invest savings. If that is the case, the revenues of government from this source (R^S) will be attenuated.

$$R^S = atY^N \qquad\qquad (9)$$

where Y^N is a measure of national income, $a < 1$, and represents increased opportunities for 'capital flight'. This serves to lower total revenues in the context of an already low tax base caused by low per-capita incomes.

3   Expenditure side

So far we have been concerned with the revenue side. But on the expenditure side too, there might be difficulties in directing spending towards the social sector. This could occur for two reasons: (i) the government itself is relatively unconcerned with social expenditure compared to other forms of government consumption; or (ii) policies of structural adjustment and budgetary balance have led to overall government expenditure reduction. In reality, both these factors coincide and are inter-connected.

Consider a general form of the government budget constraint:

$$G - iD = R + A + H \qquad\qquad (10)$$

Here G represents expenditures and the right-hand side we have income sources composed of tax revenues (R) from all sources including excise and import duties; aid (A); and the inflation tax or seignorage revenue (H). Current government borrowing is omitted, as in low-income countries it takes the form of soft loans from aid donors. Debt servicing is indicated by iD, where D denoting the stock of debt and i is the interest rate applicable to debt. Debt servicing results in the diminution of available revenues for government expenditure.

Turning to the composition of government expenditures, we could decompose these into two generic types of spending for our purposes:

$$G - iD = M + S \qquad\qquad (11)$$

where M indicates military expenditure, spending on prestige projects and social sector expenditure that is either elitist or sectarian[7] and S stands for broad-based social expenditure.

The government will not have a neutral attitude towards the various types of state spending. Its preferences regarding expenditure will be related to some utility function. In a democracy with voting, this will coincide with median voter preferences. Government spending may be swayed by its political supporters and contributors to its

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[7] This involves favouring certain groups over others. So by social spending (S), I mean broad-based spending on the entire population.

coffers to the cost of others. Alternatively, it could combine the interests of supporters with a degree of altruism, or even fear, of the rest of the population. On the endogenous formation of government policy functions in respect of trade and domestic taxes, see Helpman (1997) and Murshed (2001). Let us say that the government's utility function (*U*) takes the following specific form:

$$U(M,S) = (M - f)^g \, S^{1-g} \tag{12}$$

The expression, *f* represents a fixed expenditure on *M* without which the government cannot cling on to power. It also captures an indivisibility in the total expenditure on *M*. It can easily be shown that the expenditure share of *M* increases as the total income available to the government declines.[8] Additionally, an authoritarian, or even a benevolent government, may derive greater utility from military expenditure and other unproductive spending, *M* compared to *S*. The political imperative of looking after one's own often dictates this. *M* is spent on the political support group, who may be much fewer in number than the general mass of people, but are better at organizing themselves (Olsen 1965).

Structural adjustment policies have meant that many developing countries have had to balance the budget. In terms of (10) above this implies bringing income into line with expenditure. This can be done either by raising more revenue via taxes or reducing government expenditure. Seignorage taxes are ruled out by anti-inflationary policies, and the real level of aid is stagnant if not declining. Moreover, the reduction of trade taxes may actually lower total revenues. The tax base may also decline due to poor growth rates and supply shocks. Many governments in low-income countries have responded to the fiscal conditionality associated with structural adjustment by lowering expenditure, as low incomes rule out an expansion of the tax base. Overall revenues could decline (*dR* < 0) due to falling import tax revenues and supply shocks. So given a government utility function of the type in (12), falling revenues mean a fall in the share of social sector expenditure.

We then come to the highly indebted poor country (HIPC) initiative, as well as the emphasis now being put on poverty reduction. Under the HIPC schemes, donors would like to see increased spending in the social sector in return for debt forgiveness, as this is pro-poor. This will occur if the utility function is of the type in (12) above. If, however, at higher incomes the utility function alters such that *f* = 0 in (12) then an increase in government revenues due to debt forgiveness will not cause a more than proportionate increase in *S* expenditure. In those circumstances, we are likely to be confronted with the familiar fungibility problem associated with resource transfers, whereby part of the transfer can be diverted to purposes other than what it is intended for. Success in overcoming the fungibility problem requires a greater degree of policy coherence amongst various donors in designing conditionality. This is notoriously difficult to achieve with many donors or principals dealing with the same recipient who has multiple set of conditionality to meet, many of which contradict each other. See, Murshed (2001), as well as Murshed and Sen (1995) on some of these issues at a conceptual level. Designing conditionality, which takes the form of high powered

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8 The expenditure share of M (S^M) = $[g(Y^G - P^M f) + P^M f]/Y^G$, where $Y^G = G - iD$ and P^M is the unit price of M.

incentives, becomes more difficult the more conflicting are the various tasks associated with the many conditionalities. For example, one donor say an international financial institution (the IMF) may want budgetary balance. Another donor, say a Nordic country, might wish greater social sector expenditure. The recipient cannot exert effort to meet one set of conditions without lowering effort in another direction of conditionality. This would not be a problem if the different types of conditionality were complementary, in terms of the implied tasks and efforts. It is, therefore, imperative that donors move towards greater policy coherence, which means increased complementarity in aid-conditionality design.

Some might think it necessary to influence the process of government expenditure policy formation in developing countries. This refers to the government utility function in (12), and this process is even more difficult than designing aid or debt relief conditionality. It involves the domestic political process, and even if that were possible it would raise thorny issues concerning ownership of policy and interference in state sovereignty.

4   Stylized facts on revenues and expenditures

In this section I will focus my attention mainly on the highly indebted low-income countries in Africa for whom data on revenues and expenditure are available.[9] This is because these countries are central to the HIPC initiatives, as well as the stated donor aims regarding poverty eradication.

Chart 1 displays information on total tax revenues as a proportion of GDP for several highly indebted countries in Africa. There are sharp fluctuations in revenue, but the average (median) is displaying a steady decline since 1980. Table 1 reflects the annual percentage change in general government consumption (not expenditure which includes transfers) from 1980 to 1995 for a broader range of low and lower-middle income highly indebted countries. Government spending on health, education, but also the military, fall into government consumption. Expenditure on debt servicing, does not however, fall into this category. There is a marked volatility in government consumption after 1985 to the early 1990s. This also reflects trends in GDP growth, as well as the need to divert expenditures towards debt servicing, which will lower government consumption on services such as health and education.

Chart 2 examines three broad headings of average (median) tax revenues for the countries included in Chart 1. What is clear is that the share of trade taxes as a proportion of total revenue shows a marked tendency to decline between 1980 and 1990. This is a consequence of trade liberalization, part and parcel of the structural adjustment policies of the 1980s and beyond. There is a much greater reliance on indirect taxes on goods and services, whose share in total revenue is rising. Income,

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9   The data in this section are drawn from the IMF (2000) and the World Bank (1999).

profit and corporate tax rate shares are steadier although they decline after the mid 1980s reflecting the difficulties of taxing potentially mobile factors of production.[10]

Chart 3 reflects the growth in aid dependency. The share of aid in central government expenditure shows a tendency to climb steeply. The indebtedness position of central government as a proportion of GDP also shows a remarkable upward tendency. All of these are not surprising given that the countries in question are severe growth failures, starting from a low-income base. In contrast the overall budget deficit does not show an upward trend, staying steady. One would have expected the deficit to rise, given the difficulties in the economy, but it displays resilience, reflecting cuts in categories of expenditure, other than debt servicing whose GNP share is also fairly constant. This implies some cuts in social-sector spending, or at least no increase, at a time when it is most needed.

In Chart 4 we have three broad headings of government expenditure. Spending on education declines during the 1980s. Military expenditure is lower than on public sector education, but greater than on public health spending for the years we have data. Combined health and education spending is in excess of official military expenditure, but this in the context of very low-income countries who do not face any major external military threat. Furthermore, military expenditure does show an upward trend. It also has to be borne in mind that given growth failure and the rise in poverty, the *need* for social spending, including health and education will also have been rising considerably during this period.

5 Conclusions

(i)   The decline, or stagnation, in broad-based social expenditure, so crucial to the well being of mother and child, occurs because of the confluence of three factors. First, the government may derive less utility from this category of expenditure, compared to the necessity of spending on its political support group, the military or other prestige projects. Second, the authorities may find that they have less revenue in the present era of globalization because of international tax competition, falling domestic tax bases and capital flight. Third, in the interests of macroeconomic stability, the government may have to balance its books. This usually means expenditure reduction rather than revenue expansion. In a setting of overall spending cuts, the burden borne by the social sector is often greater than in areas such as defence.

(ii) Tax competition on internationally mobile capital can lead to a race to the bottom in tax rates for small vulnerable economies. The stylized facts on FDI to developing countries suggest that size does matter. By contrast larger developing countries and OECD nations may be able to tax multinationals substantially, and still attract FDI. Tax competition to attract FDI inflows is more applicable in the North-South arena, resulting in the South as a whole having below OECD average corporation tax rates. Intra-Northern FDI accounts for most of the world's FDI stock as well as

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[10] For most countries data on revenues from taxes on profits is not separated by source, domestic or foreign.

flows. Most developing countries are marginalized when it comes to FDI inflows from the North. China, Brazil and Mexico receive about 50 percent of all developing country FDI inflows originating in the OECD. Other low-income countries do not receive much FDI, except in the mining and energy sectors, despite having a panoply of incentives for attracting FDI. In some instances, even a zero tax regime would not attract any FDI because of negative perceptions regarding the potential host nation. But the very existence of mobile capital, and the danger of its exit, may induce developing countries in general to lower corporate tax rates below the OECD average.

(iii) OXFAM (2000) has calculated that with a tax rate on multinationals equal to the OECD average, and a moderate tax on the savings of individuals which have leaked abroad would yield revenues of about US$50 billion to developing countries. They assume that this could automatically be directed to social expenditure and poverty alleviation. The implication is that sovereign states will spend it in the social sector rather than on other wasteful forms of expenditure. Also, the benefits from the 'release' of these revenues may not accrue to the countries with the greatest need.

(iv) Then there is the question of the offshore financial centres (OFCs) that have mushroomed in recent years. They often thrive on the proceeds of the nexus between corruption, crime and conflict (see Addison et al. 2001). Globalization raises OFC numbers, and the total amount of finance channelled through them. Even G-7 countries are not immune from offshore activities. OECD led initiatives are picking on small tax havens outside the OECD, but doing little to halt their own domestic offshore and illegal activities. Flight capital is arguably a more important source of lost revenue for low-income developing countries than tax competition (Abacha in Nigeria and Mobutu in the DRC).

(v) For some (middle-income) developing countries there could be a loss of revenues due to the volatility of short-tem speculative capital inflows, and financial contagion spilling over from afflicted neighbours. Although a very limited number of developing countries receive this form of financial flows, many more risk contagion effects from neighbours. Exchange rate volatility, banking crises and balance of payments problems arise from these types of speculative financial flows that are themselves subject to herding behaviour. Banking crises, in particular, mean huge taxpayer financed rescue packages, and these do cut deeply into the social sector budget.

On the policy recommendation side, three points spring to mind:

(i) Governments and donors still need more convincing about the efficiency arguments in favour of social expenditure. Not only does it promote sustainable human development, but also high quality human capital is a necessary pre-condition for a growth take-off. Furthermore, the absence of broad-based spending in the social sector can lead to tensions and conflict, particularly when public expenditure is discriminatory along ethno-linguistic lines, see Stewart (2000).

(ii) There is a greater need for policy coherence amongst donors interested in pro-poor growth. This need emerges from the tricky business of designing aid conditionality (see Murshed 2001, Murshed and Sen 1995). Policy coherence amongst bilateral

and multilateral donors is all the more crucial in the context of the HIPC initiative, which aims to divert debt-servicing to social sector expenditure.

(iii) There have been calls for a world tax authority (WTA) by OXFAM (2000) and others such as Tanzi (1999). Such an organization could be a useful instrument for information sharing, both in regard to criminal-fraudulent dealings, as well as helping to ascertain the global income or profits of multinationals.

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CHART 1: REVENUE AS A % OF GDP FOR SELECTED AFRICAN HIPC COUNTRIES
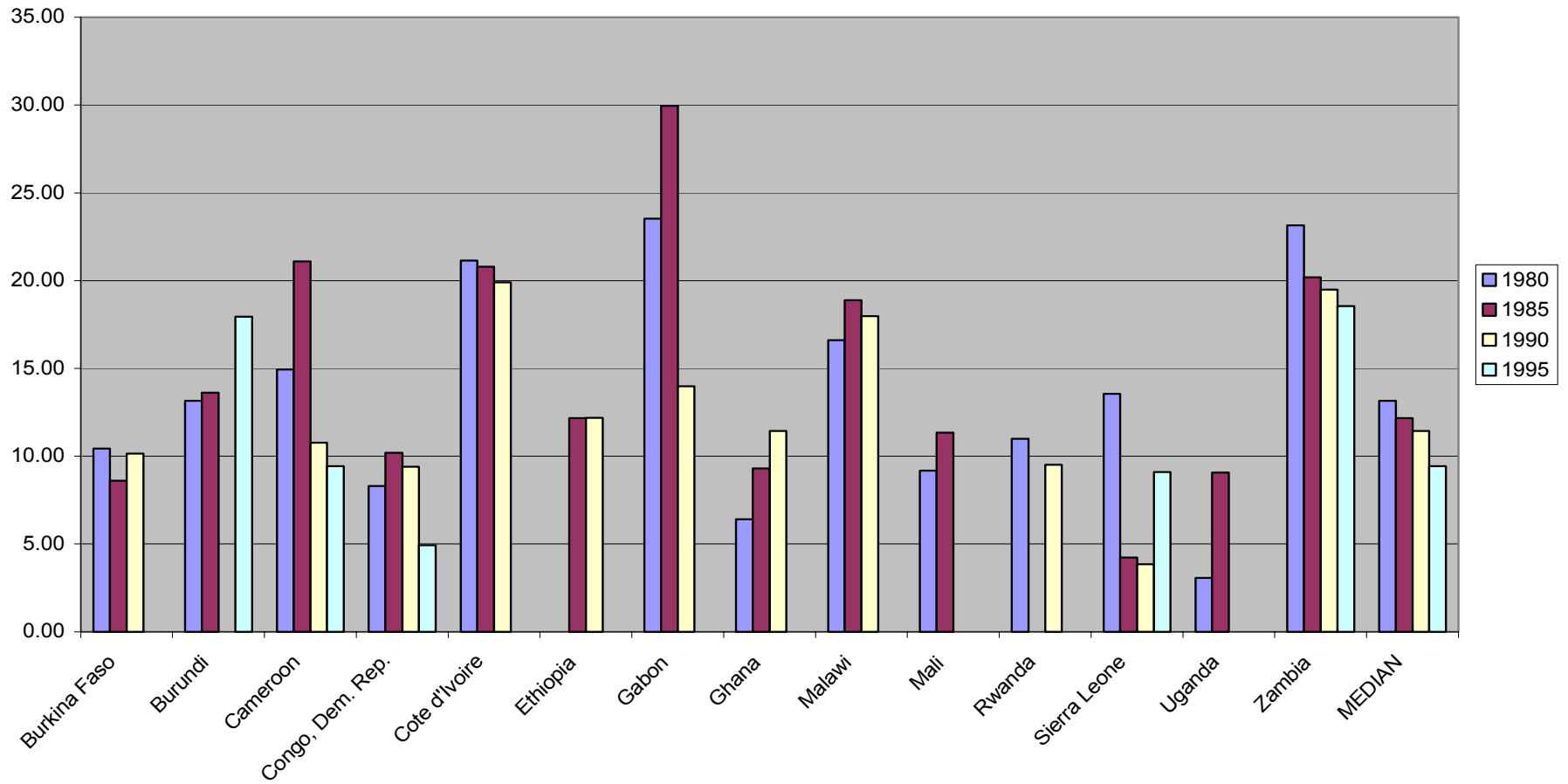
CHART 2: REVENUE SOURCES FOR SELECTED AFRICAN HIPC COUNTRIES

1980, 1985, 1990, 1995

- Taxes on goods and services
- Taxes on income, profits and capital gains
- Taxes on international trade
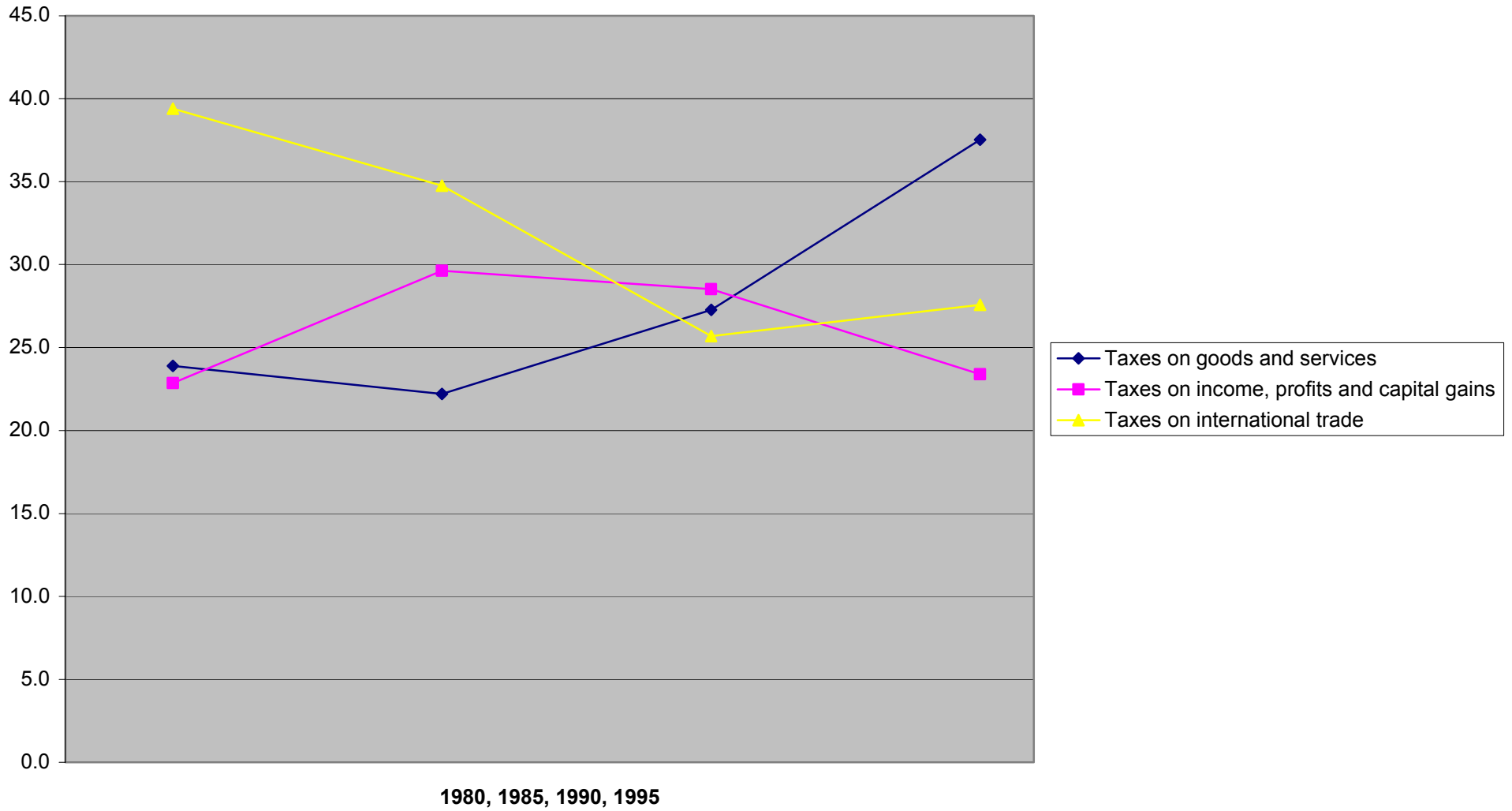
CHART 3: AID, DEBT & DEFICITS FOR SELECTED AFRICAN HIPC COUNTRIES

Legend:
- Aid (% of central government expenditures)
- Central government debt, total (% of GDP)
- Total debt service (% of GNP)
- Overall budget deficit, including grants (% of GDP)
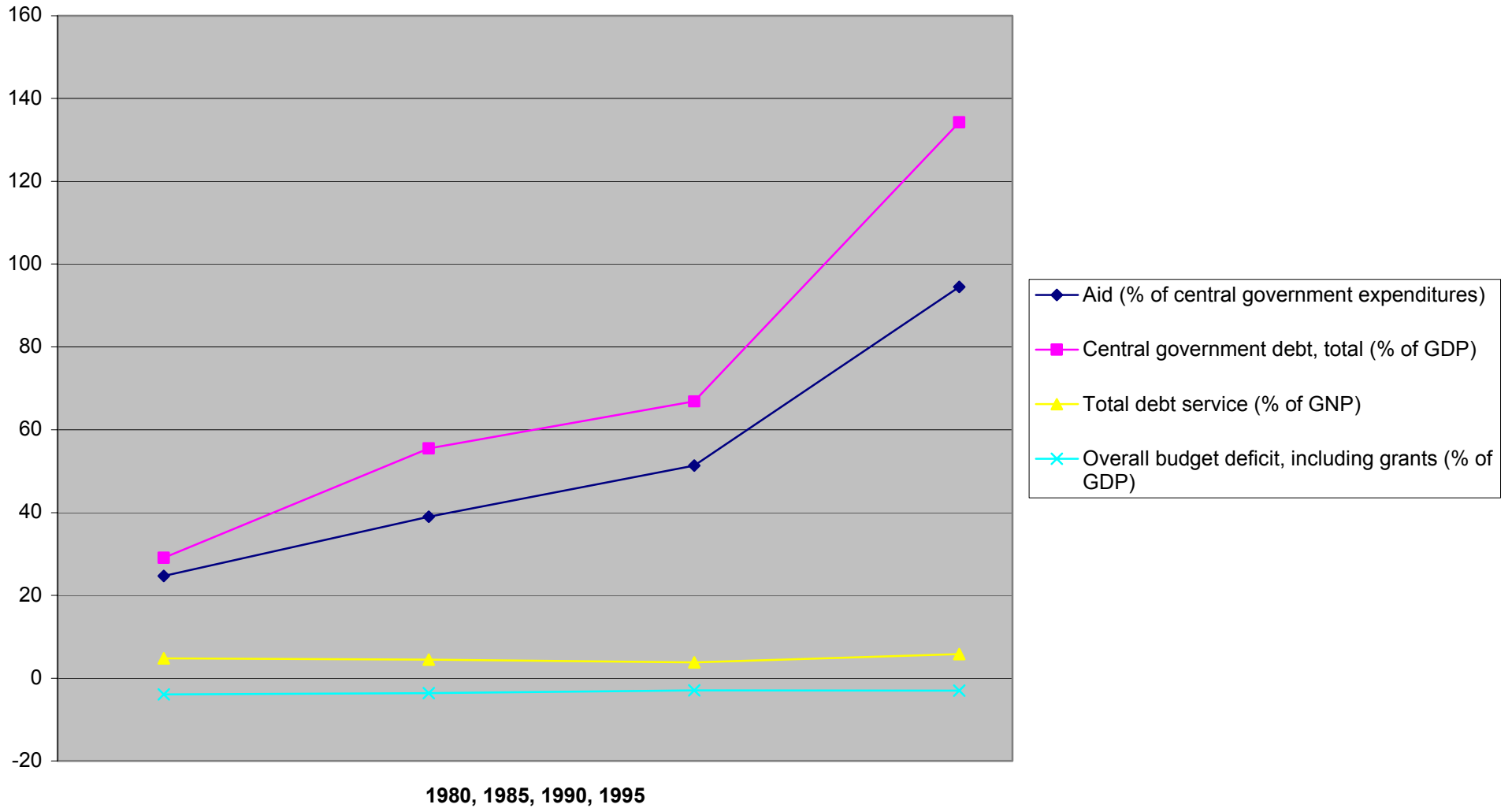
1980, 1985, 1990, 1995

CHART 4: EXPENDITURE CATEGORIES IN SELECTED AFRICAN HIPC COUNTRIES

Legend:
- Health expenditure, public (% of GDP)
- Public spending on education, total (% of GNP)
- Military expenditure (% of GNP)

TABLE 1
ANNUAL PERCENTAGE CHANGE IN GOVERNMENT CONSUMPTION FOR SELECTED HIGHLY INDEBTED COUNTRIES

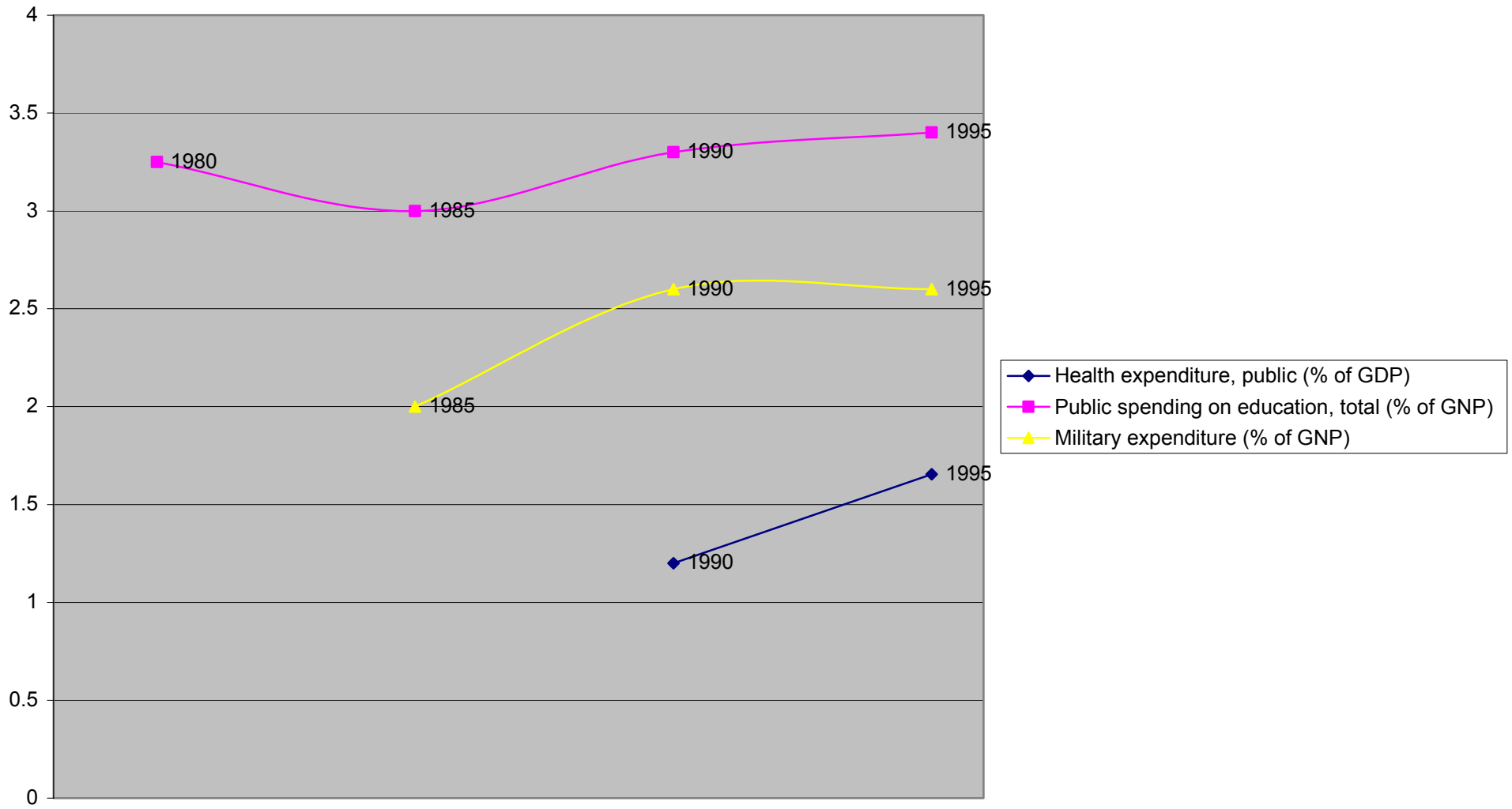|	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Bolivia	..	8	-3	-12	4	-7.4	-14.1	-3.8	3.8	0.9	-0.1	3.3	3.7	2.5	3.1	6.6
Burkina Faso	-11	10	53	-4	3	2.7	15.0	5.8	-3.9	-7.8	6.2	2.3	1.6	4.3	4.3	-2.6
Burundi	-31	-8	16	-20	-3	13.3	21.7	-7.1	16.2	-0.9	5.3	-1.3	-0.4	21.5	-6.6	-13.4
Cameroon	6	7	8	13	8	7.3	27.7	-3.4	-18.3	-2.9	13.0	9.5	-16.6	-10.6	4.3	0.9
Central African Republic	-6	-3	-11	-15	5	4.4	1.0	0.8	-1.1	-0.2	-0.8	1.3	-3.3	-10.7	22.1	-47.1
Congo, Dem. Republic	9	9	-5	-10	-6	0.6	0.8	9.1	25.7	-16.7	-6.9	-34.1	135.5	-31.1	-68.2	10.0
Congo, Republic	13	5	25	16	12	6.8	-2.1	-13.7	-3.3	4.6	-0.9	9.4	3.7	-5.5	-26.9	-38.1
Côte d'Ivoire	-24	7	-4	0	-8	0.0	6.9	1.4	4.2	5.6	-18.1	-12.9	8.0	-3.6	-7.3	16.0
Ecuador	9	2	0	-6	-4	-4.2	-0.8	1.6	1.5	-2.7	2.1	-2.2	-3.2	-1.2	0.0	1.9
Ethiopia	..	..	8	21	-13	-12.5	19.2	9.0	12.5	3.5	0.1	-23.5	-42.8	21.6	10.6	2.7
Gabon	32	19	5	21	9	-2.2	-5.4	-19.5	-1.3	-9.8	-2.9	3.1	5.7	-2.0	0.8	21.8
Ghana	28	16	-11	-2	-13	14.9	14.9	3.5	0.5	4.5	0.5	5.3	18.7	18.7	-1.1	3.7
Guinea	..	..	..	..	..	..	..	11.2	4.3	16.0	10.9	2.1	3.4	-0.9	-2.4	1.8
Guinea-Bissau	2	5	20	2	15	-5.6	-4.7	5.5	39.0	-4.0	16.9	-9.0	-21.8	16.8	-1.3	10.4
Honduras	12	1	-3	-2	4	5.3	9.3	6.0	9.0	2.8	-13.5	-10.2	12.9	1.7	-2.7	-10.8
Jamaica	-4	2	4	-1	-7	32.1	-19.2	45.2	10.5	-3.5	6.9	-16.8	-16.4	-17.1	8.0	21.0
Madagascar	5	0	-3	0	-2	2.5	-0.6	7.1	-4.2	5.7	-2.7	-6.9	-1.6	-1.5	-5.0	2.7
Malawi	4	-4	2	0	8	11.8	24.4	3.7	-1.5	3.6	1.3	1.9	0.7	-3.4	19.4	-30.1
Mali	-3	-9	-4	5	0	27.2	19.3	8.6	-6.8	16.2	1.3	7.2	-0.3	-6.1	-4.0	-3.0
Mauritania	-12	-11	-19	7	-10	-2.6	-23.1	-3.8	-0.2	-4.2	8.6	1.3	-2.8	80.2	-13.0	-0.1
Mozambique	..	11	3	-1	-13	-18.5	1.0	2.0	4.5	12.0	1.0	-10.2	40.3	-34.7	-2.1	-35.1
Nicaragua	14	13	111	-21	13	11.8	0.0	26.3	-50.0	-16.7	30.0	-30.8	-11.1	-12.5	0.0	0.0
Niger	-24	-6	6	1	-22	8.6	9.8	8.3	39.0	4.6	-5.2	-3.9	12.7	-5.9	3.0	-14.3
Nigeria	11	10	13	-4	-12	-19.9	-1.5	-25.6	24.8	-9.5	70.0	-21.8	33.7	8.7	-22.6	-10.6
Rwanda	0	71	-10	-7	-8	18.5	4.0	10.5	3.6	7.8	7.2	18.2	17.3	-13.9	-70.4	62.8
Sierra Leone	..	0	23	0	-9	20.0	4.3	-20.8	-13.7	8.0	9.5	-3.4	-5.8	5.8	8.1	9.4
Syrian Arab Republic	1	5	6	5	9	-7.5	-10.1	-22.6	-17.6	24.8	2.1	-9.3	6.3	-2.7	3.5	12.0
Uganda	..	..	..	5	5	-1.8	-4.0	17.6	-5.3	-7.7	17.8	2.2	6.3	7.1	8.3	9.2
Zambia	12	15	-11	-16	6	-4.9	0.9	-18.7	-12.3	25.5	18.4	35.2	-9.9	-61.2	-9.0	-2.1

Source: World Bank (1999).