

## IGC, London October 21, 2011

### Workshop on Fiscal Policy in Developing Countries

#### Questions

Poor-country governments need to pay for wages and salaries of government employees as well as for infrastructure projects, transfers to the neediest, etc. While the appropriate level and composition of government spending is itself an important research question, this workshop will focus on the revenue side of the government budget. In the short run revenues to pay for public spending must come from some combination of: (i) taxes, that may be highly distortionary, particularly in economies with low fiscal capacity; (ii) debt, which may be very expensive, particularly if the country has had a history of default; (iii) foreign aid, which may be associated with Dutch disease, increased corruption and rent seeking. Any poor-country government must therefore answer the following questions, among others:

- (i) Which is the (second) best combination of tax, (domestic and foreign) debt, and foreign aid to finance the flow budget constraint at a given point in time?
- (ii) Within the tax component, and given the sectoral structure of the economy (subsistence agriculture, cash-crop agriculture, and urban sector) and its break down into formal and informal, and under realistic assumption on the fiscal capacity of the government, which tax bases should be targeted and what is the best tax structure? Is there a special role for taxing corporations?
- (iii) How do economists' recommendation vis-à-vis the use of fiscal instruments to dampen business cycle fluctuations change in the context of poor and very poor countries?
- (iv) Are there commitment mechanisms that poor-countries can put in place to lower their temptation to default/exposure to shocks that lead to default in such a way of abating interest costs?
- (v) Is there an optimal positive amount of foreign aid/share of foreign aid in the budget or are the corruption/rent seeking problems associated with aid so severe that it is best to do entirely without?
- (vi) How do the answers to these questions change for countries rich in oil and other natural resources?
- (vii) Fiscal capacity is a constraint on fiscal policy but there may be channels in which current fiscal policy affects future fiscal capacity. If so, what and how important are they?

## **Workshop Structure**

We propose a workshop to discuss these and other related issues, and identify gaps in knowledge/promising research questions. In particular, the workshop will be conceptually organized in three parts.

Part 1. Overview of current fiscal practices in developing countries. What do developing countries actually do? E.g. what is the “typical” breakdown of revenues between taxes, new debt, and aid? What kind of borrowing costs do they face? Et cetera.

Part 2. Overview of existing academic theoretical and empirical work on these questions. Comparison with current practice as per Part 1. How close is current practice to what research suggests should be done (in a second-best world)?

Part 3. Discussion of questions arising from Part 1 and Part 2. If current practice deviates from (theoretically) optimal is it just a matter of changing practice or is theory missing some crucial friction? What are the unanswered questions? What are the puzzles good research should explain?

## **Participants**

We think of three sets of participants, each to be the most active during the three parts, or phases, of the workshop. The first group would be experts of fiscal policy as it happens on the ground. Among these we would pick maybe one or two to give an overview of current practices (Part 1). These participants could be identified from international organizations (IMF or World Bank) or from government officials in some partner countries. Also IGC country experts could fulfil this role.

The second group would be formed by academics who have actively contributed to high-quality theoretical or empirical research on the questions of the workshop. From this group we would seek to recruit two or three to give an overview of existing research (Part 2).

The third group is made up of academics who have not necessarily written much on these topics, but which we would like to get excited about doing so. In some sense these are the target audience for the workshop. We would hope these would be the ones to respond in Part 3 to the material presented in Parts 1 and 2 and to help through their questions to define the research agenda going forward and, hopefully, to be among those to pursue this agenda. The ultimate goal of the workshop is to widen the set of people who want to work on fiscal policy in developing countries.