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Ehtisham Ahmad Visiting Senior Fellow, India Observatory, LSE

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For further information, please contact:

India Observatory
London School of Economics & Political Science
Houghton Street
London
WC2A 2AE
United Kingdom

E-mail: india.observatory@lse.ac.uk
Web: sticerd.lse.ac.uk/india
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Ehtisham Ahmad
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London School of Economics and Zhejiang University

1. Introduction--differing governance models and the SDGs

Achieving the targets specified in the SDGs will require a significant expansion in the quality and magnitude of public services as well as appropriate investment in sustainable infrastructure in most emerging market economies, under conditions of relatively constrained public resources especially at lower levels of government. Consequently, there is an increasing premium on good governance to ensure that domestic resources are raised as efficiently as possible, without adversely affecting the business climate, or bearing disproportionately on the poor and the disadvantaged. Good governance equally requires that public monies are spent in an accountable manner, and that leakages and rent-seeking are minimized. Accountability also implies that there is no unwarranted buildup of liabilities for higher levels of government or future generations.

But how does good governance prevent cheating and corruption? This involves institutions, including behavioral norms and organizational structures, as well as incentives facing different groups in the economy—principally politicians and officials, but also firms and households under different circumstances. There is an additional level of “game play” between different levels of government. But differences in institutions across types of countries ensures that the good governance criteria may look quite different under models of electoral competition or if officials are appointed.

in advanced western societies, there is reliance on the electoral process to ensure discipline, or “yardstick competition”. The electoral discipline comes into play as voters evaluate performance of their officials relative to those in other jurisdictions at regular periods (Salmon, 1958, Besley and Case 1993). The precise mechanisms however vary from the US to Mexico or China, India or Indonesia. The organizational structures, and tax and social policies designed to stop the
cheating will differ in each case (Ahmad 2015). The US relies heavily on electoral and market discipline, but this mechanism was not sufficient in preventing the Eurocrisis. South-South learning regarding causes of governance failures in Mexico and Pakistan provide some insights to the necessary conditions to make the yardstick competition model work in the ASIAN region. It is generally not sufficient to set a fiscal rule and expect that the market will take care of implementation, particularly in the context of incomplete information.

At the other extreme is an “administrative progression” model, in which high officials are recruited by competitive examination, paid well and then rewarded by a promotion system and arms-length evaluation of performance. This model was also used as the British colonial system of governance (top British officials are still called “Mandarins”). However, the mechanisms to ensure that appointed officials do not cheat or engage in corrupt practices are quite different from those under the electoral competition model. Much depends on the examination system to choose officials of the highest caliber, training in various roles, and progression on the basis of performance, and the willingness of the leadership to hold lower-level officials to account. Information on sources and uses of public funds is critical for an oversight mechanism to work in such models. Many countries in Asia, especially China and Vietnam, operate the administrative progression model.

In many post-colonial countries in Asia, for example, “hybrid options” are evolving, with a continuation of powerful appointed officials, or the military, together with elected parties that often compete for resources to fund the electoral process. The governance outcomes in these models also depends crucially on the information flows regarding sources and uses of public funds, and the balance of power between often relatively weak political parties and the officials.

The governance challenge in electoral competition models is that parties often vie for funding, as much as performance and message. While there are limits on campaign contributions in some countries, in others there are few constraints. And, in emerging market countries, there is often a quid pro quo for contributions and other support in lieu of licenses, tax-breaks and preferences. With weak information flows, the lines of responsibility are blurred sufficiently to make the electoral competition somewhat moot. In hybrid models, there may be competition between officials with the politicians for a share of the rents, and accountability is even more diffuse. As politicians gain power at the expense of the officials, the latter are often co-opted, and the

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2 See Ehtisham Ahmad, Massimo Bordignon and Giorgio Brosio, 2016, *Multilevel Finance and the Eurocrisis*, Edward Elgar,
instruments of accountability, especially monitoring and audit of flows of funds could suffer. The result is often special deals and tax breaks for the backers and financiers of the parties in power.

The channels of accountability in multilevel countries are even more complex, as interest groups representing states or provinces can block sensible reforms that most parties may agree on, should there be a negative overall impact of resource flows in specific cases, even if there is broad agreement among parties that the changes are needed as with spending or revenue assignments in Germany and India. This makes it difficult to carry out the VAT reforms in India that have been expressly part of the manifestos of both the main parties over at least a decade. The generation of sub-national liabilities permits considerable “game play” between the lower levels of administration and the center that can jeopardize good governance as well as the operation of “fiscal responsibility” laws or regulations.

Regional or local gainers and losers are also relevant in administrative progression models, as was seen in China in 1993/4. A complex system of revised tax assignments and transfers was needed to persuade provinces to cede powers to the State Administration of Taxation at the Center to administer the VAT, for example. However, with weak information flows on sources and uses of funds and the generation of liabilities, there are significantly greater possibilities for diversion of resources and rent-seeking. This has been one of the main reasons for the strengthening and modernization of treasury and budget management systems in China, together with the tightening of information flows as part of the on-going campaign against corruption in China.

Despite differences in institutional structure across regions, South-South learning has proved to be remarkably effective, and the focus on gainers and losers because of structural reforms has been critical in both administrative models in unitary states, such as China, as well as in federal countries with inter-jurisdictional competition, such as China. The Chinese experience was taken into account in the more successful reform attempts in Mexico in 2007 and then again in 2013. Some of the Mexican refinements from the 2013 reforms are relevant for unitary countries in Asia, such as China (the completion of the VAT reforms in May 2016) and the ongoing reform efforts in Indonesia. ³ There is greater similarity in the South-South reform context than copying US-centric models in the ASIAN region, or even comparisons between the US and EC countries, for example (see Ahmad and Brosio, 2006). ⁴

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³ See papers from the LSE/University of Indonesia program on “Tax and Social Policy under Informality—lessons from Mexico and Indonesia” (volume under preparation).
While the general lesson across emerging market countries is that both taxes and spending (particularly transfers) matter in offsetting gainers and losers of any set of reform options, the specific institutional and informational requirements may differ. Although there is convergence in terms of modern tax instruments given global competition as well as the standards (UN System of National Accounts (SNA) and associated UN/IMF Government Financial Statistics\(^5\) and accounting standards) and instruments of government financial management (e.g., Treasury Single Accounts (TSA) and Financial Information Management Systems (FMISs), the informational requirements for good governance vary across types of countries. Thus, extreme caution is needed to interpret the requirements of good governance across countries, including in the ASIAN region itself.

Section 2 of this paper focuses on the role of accountable tax policy and administration as the basis for financing the SDGs. Section 3 looks at incentives and information flows in improving governance and stopping rent-seeking or cheating. Section 4 focuses on special issues that arise with respect to both revenue and budget systems given in meeting the requirements of sustainable growth, given multilevel governments in both unitary and federal states. Section 5 concludes, with a plea for more South-South collaboration and exchange of relevant experiences.

2. Tax policy and administration: financing the SDGs

In all systems, taxes not only provide revenues, they affect incentives, distribution of income and competitive positions. Thus, taxes are drivers for structural change and a cornerstone of good governance. Special preferences for powerful interest groups are at the heart of governance failures, as we discuss below.

2.1 Method

Sustainable investments and basic public services require financing. A rule of thumb with respect to the Millennium Development Goals (MDGs) was a target of taxes of around 18% of GDP to be able to finance the basic services needed to achieve the MDGs. The SDGs, however, recognize the importance of sustainable infrastructure investments, as well as the fact that public budgets are not likely to be able to meet the full extent of the “infrastructure gaps.” Consequently, more than 18% of GDP is likely to be required for general government revenues. Concomitantly,

\(^5\) The IMF/OECD Government Financial Statistics Manual (GFSM), incorporates the UN Functional Classification (COFOG) and is revised periodically to ensure consistency with the UN System of National Accounts. The last major update was in 2001, and additional minor adjustments were introduced in 2014 (GFSM2014) following the most recent amendments to the SNA.
appropriately designed own-source revenues at each level of government are needed to ensure “responsible” access to credit, and provision of basic public services. The increased role of accountability and good governance applies to all aspects of the public finances, including financing, and the prudent and sustainable management of spending, including public investments and liabilities.

a. Gainers and losers—political economy of fiscal reforms

The theory of reform (see Ahmad and Stern 1991) shows that, relative to the status quo, there may be several welfare-improving directions for raising an additional dollar of revenues. This will involve balancing the effects of the tax changes on firms and producers, as well as on households under different circumstances. In effect, there are efficiency and equity tradeoffs facing policymakers. As we explore further below, the choices are constrained by different administrative considerations and the interests of different levels of government.

Welfare improving directions of tax reform vary according to the preferences of the government and the weight placed, for example, on the effects on the poor of the tax/price changes or adjustments in public supplies. Thus, given that basic cereals (wheat, corn or rice) are often in inelastic demand in most emerging market economies, it is often tempting to tax this class of commodity if the government as a low level of inequality aversion (at the limit, an Atkinson index of zero, with a dollar to the poorest valued as much as a dollar to the richest). However, with even a modest weight given to a dollar or rupee to the poor relative to a similar transfer to the rich, basic cereals become a less attractive commodity to tax than other items, such as automobiles, that might be consumed mainly by the rich. But as luxury goods tend to be more elastic demand, the changes in nominal tax rates must be higher than on basic foods to raise an equivalent amount of revenues. Table 1 illustrates the tradeoffs in relation raising a “rupee” from various classes of goods estimated for Pakistan (from Ahmad and Stern 1991). An interesting pattern emerges relating to the switching of rankings between commodities. For instance, wheat is an attractive item to tax at low levels of inequality aversion, and much more attractive than fuel and light. But the rankings change, even with moderate levels of inequality aversion. Fuel and light becomes one of the most desirable items to tax (values of $\varepsilon > 1$), given the high expenditures on such items by the upper income groups.

6 International agencies are often accused of a single-minded pursuit of the revenue objective, but that has begun to change—see e.g., comments by Mrs. Lagarde (the Managing Director of the IMF) on the importance of income distribution.

The tradeoff between equity and efficiency is clearly seen with the choice of instruments to raise revenues. Production efficiency requires that the tax instruments chosen should not add to the cost of doing business. Many OECD countries moved from the prevailing turnover taxes, and final point sales taxes, to the VAT from the 1970s. A similar pattern emerged in emerging-market countries involving a shift from trade taxes to the “full” VAT to enhance competitive positions. Note, that for a VAT to work efficiently there should be no breaks in the inter-industry chain, so that when goods are exported, the full cumulative amount of tax can be refunded. With breaks in the VAT chain, e.g., with exemptions and high-threshold effects, the tax begins to cascade like a turnover tax or production excise. It then adds to the cost of doing business, and because of a break in the information chain, cannot be easily refunded on export.

In Pakistan, for example, the breaks in the chain have led to problems with “flying invoices” and unverifiable and often fraudulent refund claims. The split tax bases for the VAT in Brazil generate
the same effect (popularly called “invoice sight-seeing”) and more importantly add to the cost of doing business while creating productive avenues for rent-seeking.

Very simply, both import duties and turnover taxes add to the cost of doing business and cannot be refunded easily on exports, making the economy less competitive. The principle of equal treatment of imports and domestic production has been incorporated in free trade agreements around the world. This has led to the increasing emphasis and reliance on the VAT. However, in evaluating the tradeoffs between equity and efficiency, it is important to keep the full gamut of taxes, transfers and social policies in mind. It is typically a mistake to expect a single instrument, such as the VAT, to achieve both revenue generating and equity objectives. It is useful to keep in mind the famous Tanzi dictum: “keep it simple.”8 We argue that this applies particularly with respect to prevention of rent-seeking. However, the principle is not simple to implement, as the institutional context matters. In many cases, e.g., several Latin American and Asian countries, and it turns out also in Southern Europe, attempting to “simplify” the administration by focusing on large taxpayers generates discontinuities in information flows, and as seen below, could increase the incentive and ability to cheat.

Another argument for greater reliance on taxes that do not add to the cost of doing business comes from the experience of formal social security programs in Latin American countries, as well as European economies affected by the economic crisis, particularly since 2010. In the Latin American case, universal social benefits financed by payroll taxes that fall on formal sector firms and workers, tend to be evaded by both, generating incentives for evasion and informality (Levy 2008). These incentives interact with and compound other policies that encourage tax arbitrage. The solution proposed by Levy (2008) was to reduce the distorting taxes such as the payroll tax and replace them by the VAT. However, prior to the 2013 reforms, the Mexican VAT was full of “holes” and incapable of preforming the required adjustments. In the Eurozone case, adverse demographic profiles also put upward pressures on payroll taxes, and other policies added to the cost of doing business. For countries, such as Portugal, that did not have exchange rate flexibility, the only option was to shift from distorting payroll taxes to the VAT to reduce the cost of exports and make domestic production more competitive.9 Again, the holes in the VAT had to be fixed before relying on it to compensate for the reduction in distortive taxes on labour and capital.

8 See Vito Tanzi (2010), Keynote speech to the Annual Meeting of the Pakistan Society of Development Economics, Islamabad.
9 This has come to be known as “fiscal devaluation” (see de Mooij and Keen(2012), “Fiscal Devaluation” and Fiscal Consolidation: the VAT in troubled times, Fiscal Affairs Department, IMF, Working Paper 12/85.).
b. Revenue targets and political economy constraints

The MDG criteria implied an envelope of around 18% of GDP in tax revenues to meet the simple basic needs that were involved. Many countries in the region have achieved this target, including India (see Figure 1 below), and as discussed below, China in a more spectacular manner. However, the target was met using very inefficient mechanisms, including a VAT that did not meet all the criteria for efficiency, such as refunds of taxes on capital purchases or a base split between goods (subject to VAT) and services subject to a business tax managed by local governments. This led to cascading and added to the cost of doing business in China, until the integration of taxation of goods and services under the centrally managed VAT in May 2016.

Figure 1

![Graph showing General Government Revenue and GDP per Capita, 2012](image)

Source: IMF 2013, India Staff Report.

The Chinese case is of special interest. Because of the Responsibility System introduced by Deng Xiaoping in the late 1970s, both the total revenues generated, as well as the proportion shared
upwards with the central government fell precipitously. While there was a positive impact on producers, the declining overall revenue generation had a negative impact on public finances— with the total tax/GDP ratio falling from 25% at the start of the reforms to around 10% by 1992/3 (see Figure 2). China did not have a central tax administration and relied on upwards revenue-sharing. Consequently, in the absence of modern fiscal institutions and instruments, the structural changes generated a fiscal crisis.

Figure 2 PR China, Evolution of tax/GDP ratios and central-local shares

The fall in total revenue collection affected the incentives of local governments to share revenue upwards. Consequently, the central government’s share of total revenues also fell precipitously, despite various attempts to incentivize local officials (Gao Qiang, 1995)\(^\text{10}\). The central share, which had been around 55% of total revenues at the start of the Responsibility Reform, fell to well under 30% by 1993 (see Figure 2), as local governments sought to protect local interests in the face of falling revenue collections.

\(^{10}\) See Ehtisham Ahmad, Gao Qiang and Vito Tanzi, 1995, *Reforming China’s Public Finances*, IMF.
Thus, by 1992/3, the plummeting tax/GDP ratio, as well as the decline in the share going to the center, meant that the central government’s ability to maintain macroeconomic stability, ensure redistribution, or meet the fundamental responsibilities of a nation state were seriously compromised. By 1993/4 a major tax reform was needed to consolidate the structural reforms made because of the Responsibility System, and strengthen the ability of the Central government to maintain macroeconomic stability and public investment (see Ahmad, Gao Qiang, Tanzi, 1995\textsuperscript{11}; Ahmad 2008\textsuperscript{12} and Ahmad, Rydge and Stern, 2013\textsuperscript{13}).

The establishment of the State Administration of Taxation on the most modern lines, and central revenue-raising powers, facilitated the introduction of an “investment-type VAT”. However, a “package” of tax administration and policy reforms was designed to minimize losses and share benefits across rich and poor provinces alike. The key elements of the “package” included the following:

- Prevention of losses among local governments by a “hold harmless” clause—this guaranteed all provinces 1993 levels of revenues in absolute terms in perpetuity;
- Providing a share of the (increasing) revenues from the VAT with the provinces that generated the value added—these were mainly the richer ones;
- Introducing a modern “equalization framework”—this enabled all provinces to provide similar levels of services at similar levels of effort. The version adopted in China was based on the Australian model, but with simpler factors,\textsuperscript{i} and provided a “buy-in” from the poorer provinces; and
- The most innovative measure in the “package” provided for a revenue-returned policy to provide additional funds to the better-connected provinces, but on a gradually decreasing basis. This measure was critical in providing for a concentration of resources in existing “production hubs”, largely along the coast, making use of the existing connectivity in the short run to generate investment, exports and employment opportunities.

The VAT initially implemented was applied only to manufacturing, largely because of administrative constraints, and because of the need to leave at least some tax handles in the

\textsuperscript{11} Ehtisham Ahmad, Gao Qiang and Vito Tanzi, 1995, \textit{op cit}.
\textsuperscript{13} Ehtisham Ahmad, James Rydge and Nicholas Stern, 2013, “Structural change leads to tax reforms leads to structural change,” \textit{China Development Research Forum}, Beijing.
hands of provinces (this was the local business tax mainly on services). Further, the VAT was of “investment type”—i.e., that VAT on capital purchases could not be offset against VAT on sales. This again was to meet the revenue targets of the government and was simpler to administer with the nascent SAT. Almost 15 years later, in the aftermath of the 2008 global economic crisis, there was pressure to reduce the cost of doing business and protect Chinese competitiveness. The investment-type VAT was converted to a consumption type VAT, with VAT on capital purchases permitted to be offset against VAT on sales. China carried out a further reform to its VAT in May 2016, to integrate the goods and services component. Even though this led to a loss in revenues, especially for provinces and lower levels of government, the reform was driven by a need to generate greater efficiency and reduce costs of doing business.

India has also begun a Constitutional amendment to integrate the VAT on goods and services assigned to different levels of government. Again, the objective is to maintain market share relative to China and other countries, that are carrying out tax reforms to generate efficiency. As in China, compensations to “losing states” are proposed, but these are lump-sum and time-bound and do not reflect the need to permanently realign the transfer mechanisms as was done in the Chinese case, e.g., with the introduction of an equalization system for current transfers. The multilevel aspects of the Chinese reforms are discussed below.

A corollary of the integrated VAT reforms is that it generates information that can be used to stop the cheating and base shifting in the income taxes. This is examined further below in the context of fiscal reforms that draws on the Mexican 2013 reforms that provide an example of reforms designed to block cheating and informality.

While the targets in the MDGs were reflected in overall requirements for revenues for general government, many of the basic services are delivered at the sub-national level. Of the 17 SDGs, at least 8 require actions at the local and regional levels—including # (3) health care; (4) education; (6) water and sanitation; (9) industry and infrastructure; (11) sustainable cities and communities; (13) climate action; (15) ecosystems, forests and desertification; and (16) reducing corruption. Apart from the direct delivery of the services, there is a need for investment in the supporting infrastructure. This typically requires a credible foundation of own-source revenues that can be used to repay debt.

The implication is that more than the 18% of GDP identified under the MDG targets is likely to be needed over time, and that many of the additional revenues and tax bases must be concentrated at the sub-national levels to ensure that subnational borrowing decisions are soundly based. Unfortunately, this is where the institutional and governance pre-conditions are the weakest in emerging market economies, including in the ASIAN area. This suggests the need for coordinated
work to develop relevant policy and organizational alternatives suited to the appropriate context in specific countries.

c. Multilevel aspects of structural reforms

Multilevel governments pose significant constraints to reform options, even in middle-sized countries in the Asian region and emerging markets elsewhere. What is striking is that similar issues arise in unitary and federal countries alike, and that South-South lessons are more important than learning from countries with very different institutions.

Perhaps the most significant fiscal adjustment in any emerging market economy in recent memory was the Chinese 1993/4 reforms described above. Despite advice from foreign experts who recommended the normative, or US-based, approach to multilevel finance: “fix the spending assignments, including the SOEs, and then the financing arrangements to follow”, the Chinese authorities adopted what has become known a decade later as the “positive approach” to multilevel finance. This involves offsetting gainers and losers of reforms, and the strengthening of fiscal institutions. Thus, the hold-harmless clause, revenue-sharing and equalization systems ensured that no province would lose and that rich and poor provinces would have a share in the downward revenue-sharing/equalization system. This reversed over a thousand years of upward revenue sharing (the Center did not have a tax administration until the State Administration of Taxation (SAT) was established in the early 1990s). And the VAT was the centerpiece of the reform effort that almost doubled the tax/GDP ratio in a decade, ensuring that the center had the ability to conduct macroeconomic policies, redistribution and above all investment for growth.

The final component in the 1993/4 Chinese reforms was the “revenue-returned” that shared additional funds back to the provinces that generated them for investment purposes. Several foreign “experts” objected to this element on the grounds that money should be given to the poorer provinces and to compensate people affected by the radical tax increases. However, the position of the authorities was that providing the additional investment funds to the poorer interior provinces would have been counterproductive, given the lack of connectivity and markets. The focus was to develop the coastal hubs and concentrate on export led-growth. Freeing up the labour markets led to over 150 million people migrating to the coastal metropolitan area. Over 700 million people were lifted out of poverty in a sustained double-digit growth spurt over two decades. Of course, given problems of success, there is a need for rebalancing now to shift to producing for domestic consumption by focusing on internal hubs. In 1993/4, tax reforms were needed to consolidate structural reforms initiated by Deng Xiao Ping, but now a second stage of tax reforms is needed to stimulate structural change to reduce
congestion, pollution and inequalities and generate sustainable growth (see Ahmad, Rydge and Stern, 2013).

While China showed the effectiveness of balancing “gainers and losers” among sub-national entities in the context of a unitary administration with appointed officials, the approach is even more relevant in federal states with multiparty elections. The lessons from China were first internalized in a country outside the ESCP region—Mexico, in 2007. It is interesting that the Chinese experience was relevant, as Mexico is a federal state, with multi-party system in which opposition parties had the power to block legislation in the upper house, as in India or Pakistan. In India, the Constitutional Amendment to fix the multilevel VAT also envisages compensatory transfers to states for a limited period. However, without the “permanent” use of an equalization system, or assignment of a new tax handle that the states can operate for own-revenue purposes, the Indian proposals do not quite reflect the multi-level tax-transfer system in totality to implement national tax reforms for efficiency, own-source revenues for accountability, and equalization transfers for equity that are the hall-marks of a “sustainable package” of reforms.

Mexico is a laboratory for fiscal reforms. A VAT was introduced in the early 1980s, involving the suppression of dozens of state level taxes, and represented a model for tax reforms in emerging market countries (see Gil Diaz, 1986, Newbery and Stern 1986). The reforms were made possible because the same party was in power in the Federal Government and in most of the State Governments, and the states were compensated through an intricate system of compensatory transfers. However, over time special exemptions and reduced rates for distributional and investment purposes were introduced, and the Federal taxes displayed signs of “good intentions bad outcomes.”. This reduced the non-oil tax/GDP ratio to just over 10% of GDP by the late 1990s. The States were left with few own-source revenues (over which they had control, either over rates or the base). The non-oil revenue situation was precarious, like that in China in the early 1990s or Pakistan around 2010, given that petroleum production is projected to fall in the medium-term. Attempts to fix the holes in the VAT or the corporate income tax (CIT) affected states in differential ways, and were blocked by “losers” among the states, as political parties proliferated and the monopoly of the PRI at both federal and state level eroded. Indeed, given the complex and opaque system of transfers, states could get additional resources from the Federal government towards the end of the financial year—removing any incentive to impose

15 In 2000, the PRI ceded power at the center, after 70 years, to successive PAN administrations (Fox and Calderon), until 2012, when the Peña Nieto administration regained power for the PRI at the Federal level. However, a truly multi-party system has evolved in Mexico.
own-source taxes. Most states refused to apply a piggy-back on the personal income tax that was open to them, and blocked efforts by the center to reform the VAT.

Finally, in 2007, the Federal Government introduced a new minimum tax that operated on value-added principles (the IETU) but was credited towards the CIT, replacing a minimum gross asset tax (GAT) that is used widely in Latin America to plug holes and preferences in the CIT. However, it was largely ineffective in Mexico. The IETU was expected to be less distortive than the GAT, and was introduced by utilizing the Chinese stop-loss provisions across states, and partially rationalizing the complex intergovernmental revenue-sharing/transfer system. This ensured that no state would lose because of the reforms. This showed that the “positive” approach used in a unitary state in Asia, could apply in Federal country like Mexico in Latin America, in relation to the possible constraints imposed by the interests of state governments. The IETU and subsequent reforms are discussed in greater detail in the next section.

It is notable that an attempt in Mexico to fix the holes in the VAT in 2010, by promising to link compensation to the conditional cash transfers (CCT) received by poor individuals under the 1990s Oportunidades program was rejected. At the same time, a package of reforms in Pakistan aimed at fixing the holes in the VAT and adjusting energy prices, and raising the tax/GDP ratio from under 10% of GDP towards 14%, formed the core of an adjustment program supported by the IMF and the World Bank. It also envisaged a CCT program, the Benazir Income Support Program (BISP) modeled on the Mexican Oportunidades, as compensation for possible negative price effects on the poorest groups. While the BISP is reportedly an effective mechanism to provide support to the poorest elements in society, especially in rural areas, most of the groups that might be affected by the tax changes were largely urban traders and salaried middle income households. While the envisaged tax reform was not introduced, the BISP was implemented, as it bought political support for the ruling party with funds provided by donors.

d. Governance and institutions

Tax and social policies need to align incentives facing different levels of government, firms and households, and should remove possibilities of arbitrage or incentives to cheat. The policies, however, need to be supported by an administration that generates information, probability of detection and effective sanctions to block the ability to cheat. Modern tax administrations are typically organized on a functional basis that focuses on reducing the compliance costs for taxpayers, minimizing direct contacts between tax officials and taxpayers (except in the taxpayer services and facilitation department), and relying on information generation and audit to identify anomalies and stop cheating. Rather than the outdated model of rewarding officials who bring
in more revenues, arms’ length institutions prevent direct contact between tax officials and taxpayers to ensure that revenues are collected efficiently, and cash flows tracked to prevent rent-seeking and leakages.

A typical approach to subnational governance in many emerging market economies, from Mexico to South Asia, has been to establish separate tax administrations for split bases for the VAT and income taxes. This leads to an increase in the complexity facing businesses. With the VAT, there are possibilities of arbitrage and “cheating” as the integrated flow of information becomes harder to achieve. The overall quality of the administration, especially for the wide-area taxes such as the VAT and income tax, then is as good as the weakest link. The essence of local accountability, however, lies in the incentives that are generated by a control at the margin over rates and a specified base. If a subnational government cannot control the marginal rate of a subnational tax, even with its own administration, the tax is no longer an own-source revenue but must be considered as a shared-revenue or transfer with relatively high collection costs (Ahmad 2015), as we see below.

The typology of modern tax administration builds on a functional approach (see Figure 3) to administration that ensures arms-length operations, by ensuring that no single administrator can influence a tax payment, and that there are checks and balances based on the generation of information, risk assessment and audit. The enforcement function is particularly important as it reflects the collection of information from various taxes into a common data base (e.g., the VAT, CIT and excises) that can be juxtaposed against real sector variables and third party information (e.g., asset holdings, and consumption patterns) that provide a basis to signal risk-based audit. The outmoded approach to “incentivize” tax collectors by assigning bonuses in relation to taxes generated, was needed in older systems of production-based excises (common in South Asia, for example) where the tax collector sat in a firm to monitor turnover. However, this was the source of great corruption and potential to “make deals” that are just not possible with the modern functional tax administration approach. Indeed, a 1986 assessment is noteworthy, in that this has been consistently ignored. In his cover note to the Finance Minister, the Chairman of the 1985 Tax Reform Commission (Mr. Qamar-ul Islam) described the Pakistan tax system:

16 See Ambrisanio, F and M. Bordignon (2015), in Ehtisham Ahmad and Giorgio Brosio, eds., 2015, Handbook of Multilevel Finance, Edward Elgar. There can be no hard budget constraints for subnational governments, if they do not at the margin have control over the rates of a tax instrument, that can be increased if the jurisdiction runs into difficulties in meeting its debt repayment obligations.

17 Ahmad, E., “Governance and Institutions,” in Ahmad and Brosio (2015), op cit.
“as stated in our letter dated May 15, 1986 transmitting our interim report, the three basic maladies from which Pakistan is suffering at present are tax evasion, smuggling and corruption. These are inter-related and one feeds on the other.”18

Subsequently, the 2001 Shahid Husain Committee Report recommended a modern functional approach to tax administration in Pakistan, but this has never been properly implemented, given the lack of enthusiasm on the part of tax administrators and politicians, despite a $130m tax administration reform programme financed by the World Bank, and then another $300m package in 2013 after the first package was deemed to be a failure.19

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18 Letter from Chairman Qamar ul-Islam to the Finance Minister, December 31, 1986.
19 Government of Pakistan, Report of the Task Force on the Reform of Tax Administration, Islamabad April 14, 2001 (Shahid Husain task force). See also Government of Pakistan, 1985,
There is a continuum between policies and administration that ensures accountability. As seen in Figure 3, shared-revenues do not ensure accountability, as they do not represent control over tax rates at the margin. Hence, a shared tax cannot be used as an instrument to raise additional funds, should the need arise (e.g., as collateral for borrowing). Thus, in incentive terms, shared revenues are like transfers (Figure 3, columns 1a and 1b). The fact that there is sub-national administration does not affect this assessment. For instance, even if all elements of tax administration were carried out at the state/provincial level, but the rates at the margin are determined in common with all jurisdictions as is being proposed in India (variant of 1b), the subnational jurisdictions cannot claim the revenues as own-source. In some cases, the state/provincial government could use the tax administration to influence the tax base, but that generates distortions and a possible “race to the bottom”.\footnote{20}

The control over rate structures is much more effective in generating accountability, even if all or some elements of tax administration are managed at a different level of administration. Indeed, face-to-face negotiations between taxpayers and the tax administrator is a severe problem in the case of the property tax e.g., in South Asia as well as Mexico, reflecting the problems in many emerging market economies. The issue of the property tax is discussed further below.

By structuring the administration along functional lines, it becomes possible to concentrate on the key elements that make for an efficient tax structure. The flow and management of information is critical, both within a tax and across taxes. The registration function ensures that there is a common tax identifier number for all taxes and levels of government—and facilitates the flow of information and linkages between different types of taxes, particularly the VAT, the income taxes and payroll tax. The enforcement function depends on a central database and flow of information across different criteria, particularly for the VAT and income taxes. This triggers flags for anomalies that need to be audited, with effective sanctions, as may be stipulated in the legislation. If the VAT and income tax bases are split, there is a danger that neither tax will perform effectively to raise revenues, while minimizing distortions and burdens on the taxpayers. With limited scope for local rate adjustments, there is even less justification to maintain or create multiple tax administrations, even though this tends to occur for political reasons, as in Pakistan following the 18th Amendment.

\footnote{Report of the Tax Reforms Commission, (Qamar ul-Islam Commission) in which the tax administration was labelled as the most corrupt of the Pakistani institutions.}
\footnote{In Mexico, the race to the bottom occurred with the vehicle tax assigned to the states in 2010, because of cross border competition as well as the possibility of accessing “gap-filling” central transfers for meet deficits at the end of the budget year (Piñeda, 2014).}
A local surcharge, generating the same amount of revenue as the revenue-share, even with central administration, becomes an own-source of revenue if the subnational jurisdiction has the right to raise or lower the marginal rate that it has been assigned. The surcharge or piggy-back is typically not recommended in the case of the VAT, but could work well with an integrated base for the personal income tax. Note that the income tax base is also split in India and Pakistan, with multiple administrations, creating significant loopholes and rent-seeking opportunities. The surcharge on the full income tax could facilitate the integrate the tax administration, without loss of own-source revenue raising powers, and be a way to block the cheating for one of the fastest growing revenue bases in emerging markets such as India. And because the full tax base is used, the cheating in the income taxes can be blocked with an appropriate use of information from the income tax—increasing the “total pie” available for the surcharge. Thus, higher revenues could be generated without a need to raise tax rates and further increase incentives to evade.

The surcharge approach is important in the context of a potential carbon tax that could form the basis for initiating structural changes, with the production and consumption patterns. Thus, the more congested and polluted metropolitan areas may require a higher than standard carbon tax rates, without running the risk that the tax might fall to zero as result of a race to the bottom. Again the national tax administration capabilities, would prevent the race to the bottom while providing rate setting options for provinces/states and potentially also municipal governments.

2.2 Overall effects and governance in selected Asian countries

Singapore is a small unitary country with a population of 4 million, with an extremely efficient tax and spending system, and a great deal of transparency. Pakistan, on the other hand, has a federal structure and a population of almost 200 million. It has had great difficulty in shifting from the protection of infant industries under high protective barriers to a more efficient investment climate. The system of administrative controls has spawned a culture of rent-seeking.

Pakistan has had trouble in establishing a modern tax administration. The Chairman of the Government Taxation Reforms Commission in 1985 call the Central Board of Revenue, the most

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corrupt of Pakistan institutions\textsuperscript{22} and had endorsed a gradual move towards a VAT, based on background work by Ahmad and Stern,\textsuperscript{23} as a mechanism to avoid the discretion in granting licenses and exemptions to high tax rates that spawned the rent-seeking culture. The strategy of economic reform in Pakistan since the early 1990s, supported by successive adjustment and stabilization programs of the IMF and the World Bank, was predicated on reducing tariffs and shifting to a more efficient financing mechanism of the VAT/GST on both goods and services, to generate more efficient outcomes for growth, exports and structural reforms. While a GST on goods was established in 1990,\textsuperscript{24} it was under pressure from the IFIs and operated very much like the system of excise taxes it replaced. It was implemented like a production excise that led to “backward shifting”, and maintained the cascading of the previous system. This led to continued pressures for exemptions, and reduced efficiency, as well as increasing costs faced by firms. It also made it very difficult to accurately identify export refunds. Consequently, as tariffs were reduced after 2000, the tax/GDP ratio fell to around 10\%, where it has fluctuated for the past decade. This has exacerbated the inadequate financing of public services, particularly public education, and investment. Moreover, the practice of granting exemptions has provided ample opportunities for politicians to “make friends and influence people,” and for rent-seeking opportunities on the part of officials.

In Singapore, the issue of a VAT was raised at Independence in the late 1970s, but was not formalized until 1986, at around the same time as the discussion in the Pakistan Taxation Reforms Commission. The Singapore Economic Reforms Committee was explicitly concerned about the negative impact of high direct taxes on Singapore’s competitive position and job creation prospects, and recommended a shift from direct taxes to the GST.\textsuperscript{25} After considerable consultation, a VAT was introduced in 1994 at a low rate of 3\% with no exemptions, including for food, except for some financial services, and zero-rating of exports. This was accompanied by a reduction in the CIT and top PIT rate from 40\%, removal of cascading excises, as well as reductions in the property tax. Compensation was provided for pensioners and spending on education was increased. The CIT was reduced gradually to 17\%—which is the lowest in the ASEAN region, and the simple but efficient VAT raised to 7\%, where it currently stands today. By 2010, the taxation of goods and services generated 4.7\% of GDP in Singapore (with a VAT rate of 7\%), whereas in

\textsuperscript{22} See Qamar ul-Islam (1985), \textit{The Report of the Taxation Reforms Commission}. The idea of a VAT for Pakistan was first raised by an IMF technical assistance mission in 1977 let by Vito Tanzi.

\textsuperscript{23} See the discussion in Ahmad and Stern (1991), \textit{Theory and practice of tax reforms in developing countries}, Cambridge University Press.

\textsuperscript{24} Under the Pakistan 1973 Constitution (which maintained the split tax bases from the Colonial Government of India Act 1935), taxes on goods were assigned to the Central level and on services to the provincial level, which reversed the Colonial practice that is maintained in India.

\textsuperscript{25} Republic of Singapore (1986), \textit{Report of the Economic Committee—new directions}.
Pakistan, a 17% GST rate generated less than 3% of GDP around the same time. Clearly, the extensive exemptions and preferences in the Pakistan GST explain some of the differences in performance. More importantly, the absence of exemptions in the Singapore VAT supports the strong trading and export-oriented production structure.

The overall tax/GDP ratio in Singapore is around 14%--or considerably lower than the indicative MDG level. However, the proportional spending on education at 22% of all outlays (general government) is among the highest in the world (Thailand is 20%, Korea at 15%, Chile at 16%, China at 14% and USA at 15%).\(^\text{26}\) The latest PISA ranking, places Singapore as the best performing country in the world with respect to educational outcomes.\(^\text{27}\) It is interesting that the current world ranking in education is heavily dominated by the ASIAN region: (1) Singapore, (2) Japan, (4) Chinese Taipei, (6) China-Macau, (7) Viet Nam, (8) China-Hong Kong and (9) China (B-S-J-G). Estonia at #3 and Finland at #5 are the highest ranking European countries in the top ten. The US is way behind in the middle of the PISA scores. The excellence in education has undoubtedly played a major role in the structural reforms and growth in the region over the past couple of decades.

Both the policy framework and administration structure are relevant in the context of governance to prevent tax avoidance, base erosion or outright cheating. Singapore has the advantage of a strong taxpaying culture, buttressed by a simple tax system—with a CIT of 17% and a single rate VAT of 7% with minimal exemptions. It has one of the most efficient tax administrations with amongst the lowest collection costs in the ASIAN region, and better than in most OECD countries (see Table 2). The simplicity in the tax policy framework, following the Tanzi dictum, is a principal requisite for an efficient administration.

Modern tax administrations rely on effective management of big data. And the VAT plays a major role in ensuring that the revenues raised do not adversely affect Singapore’s preeminent position as a trading nation, with the effective removal of all taxes from exports facilitated, by the clean VAT value chain with minimal exemptions. The efficiency is carried through to the spending side as well, and Singapore has achieved the top ranking in the world vis a vis education even though its tax/GDP ratio is below the indicative MDG level. The impact on structural reforms in nicely encapsulated in the Harvard-MIT complexity assessment, that shows how the economy has


China is now represented by Beijing-Shanghai-Jiangsu-Guangdong (B-S-J-G).
diversified over time. A positive index (1.64 for Singapore) shows high complexity and diversity in the production and export performance of the economy (Figures 4a and 4b).

By contrast, the Pakistan example illustrates a negative index (-0.4), illustrating low complexity linked to the poor public services, particularly education, and inadequate infrastructure investments, largely due to the failure to address the domestic resource mobilization challenges. The increasing dependency on traditional exports and raw materials makes the economy more vulnerable to competition from countries, including from more efficient countries the ASIAN region, such as Viet Nam and Cambodia, where wages, exchange rates and the tax system enhance their competitive advantage.

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29 Cambodia, for instance, expects to benefit from the shifts in the value-chain in China, together with the improved connectivity, leading to new opportunities in agriculture, garments, and construction sectors. Chea Chanto (National Bank of Cambodia), in May Kunmakara, December 2016.
<table>
<thead>
<tr>
<th>Country</th>
<th>Administrative costs for tax administration/ GDP (at market prices) %</th>
<th>Variation 2013-08</th>
<th>Significant factors affecting comparability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>0.284 0.185 0.198 0.147 0.139 0.152 0.188</td>
<td>0.002</td>
<td>Some major costs not included</td>
</tr>
<tr>
<td>Japan</td>
<td>0.137 0.141 0.149 0.143 0.142 0.152 0.148</td>
<td>0.007</td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>0.104 0.112 0.113 0.106 0.103 0.098 0.099</td>
<td>-0.014</td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>n.a. n.a. n.a. n.a. n.a. 0.130 0.121 n.a.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>n.a. 0.042 0.043 0.034 0.029 0.029 0.028</td>
<td>-0.014</td>
<td>Direct taxes only</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.135 0.111 0.153 0.078 0.081 0.102 0.122</td>
<td>0.011</td>
<td>Costs exclude indirect taxes</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.070 0.082 0.086 0.083 0.088 0.083 0.088</td>
<td>0.006</td>
<td></td>
</tr>
</tbody>
</table>

Figure 4a Economic Complexity Map 2008
Figure 4b: Singapore--Changing export tree map 1968-2008
Figure 5b: Pakistan: Changing export tree map 1968-2008
With improved connectivity, given the increasing emphasis on intra-regional trade corridors, the weaknesses in the business climate and unnecessary additional costs due to inefficiencies in the tax and spending system will likely become unsustainable, even if in a superficial sense ad hoc criteria of debt sustainability are met. On the other hand, countries with efficient tax and spending systems, that can harness credit for public investment to create sustainable “hubs” should be able to exceed the limits inherent in the typical criteria on the stock and flows of debt and make full use of the opportunities that the new corridors create.

3. Improving governance: incentives and information flows to stop cheating

Many, but not all elements, of the Singapore fiscal reform package are applicable to other emerging market economies, including in the Asian region. Singapore is a small unitary state, with relatively good information on both the sources and uses of funds. And Singapore is not constrained by the need to balance the interests of sub-national governments, avoiding the problems with tax/transfer reforms that occur in unitary multilevel countries, such as China and Indonesia, as well as in federal states, such as India and Pakistan. Yet, as the Singapore tax reforms in 1994 showed, there is a need to think about the gainers and losers of any reforms. Any set of tax reforms must involve an assessment of the effects on private producers and the country’s competitive position, as well as the need to avoid or mitigate a negative impact on the poorest groups that are unable to participate in the labour market.

A key feature of the Singapore reforms is the role of a properly designed VAT in reducing the cost of doing business as well as improving competitive positions. A similar consideration has led China to integrate the VAT on goods (administered by the central State Administration of Taxation (SAT)) and the taxation of services (which were administered by province), through the integrated VAT administered by the SAT. The reform was completed in one-go in May 2016. And India is following with the proposed Constitutional Amendment to consolidate the base of the Central and State-level VATs. In countries, such as Portugal, a shift to the VAT from taxes on payroll or capital constituted a “fiscal devaluation”, as it led to a reduction in export costs with the fixed exchange rate within the Eurozone (de Mooij and Keen, 2012).30

30 De Mooij and M. Keen, (2012), op cit.
An example with relevance for the broader Asian region, is the experience of the far-reaching tax reforms in Mexico in 2013. Santiago Levy (2008) argued that inappropriately designed social protection systems can raise the cost of doing business and increase the incentives for firms to “hide” outlays on labour, and for workers to accept temporary and informal contracts. Both these incentives lead to inefficient outcomes and reduce potential growth—constituting “good intentions but bad outcomes.” The recommendation was a shift from the high payroll tax on firms, that add to the cost of doing business, to the VAT that should be neutral to production and exports. But the Mexican VAT was not capable of performing this function, and the “good intentions, bad outcomes” story applies to the Mexican tax system, particularly the VAT, as much as to the social security system.

Since the VAT was introduced in the early 1980s, successive governments provided additional incentives for investment and production by reducing rates in sensitive or “border regions”, along with exemptions and domestic zero-rating for both investment and distributional objectives. And the base for the major taxes (including both VAT and income taxes) was split, with the allocation of the small taxpayer regime (REPECOS) to the state level. With access to “gap-filling” transfers from the federal government to meet state deficits, there was no incentive for the latter to pursue the “hard to tax” groups under the REPECOS. The Mexican Tax Administration (SAT) estimated that there was 95% evasion with respect to the REPECOS. The “gap-filling” transfers also had a negative impact on incentives to implement own-source revenues, such as the “piggy back” on the income tax that has been an option, or the vehicle tax after it was fully devolved to the States in 2010, The net result was that the non-oil tax/GDP ratio for general government was around 10%. The C-efficiency of the Mexican VAT was not dissimilar to that in Pakistan, and at around 25% was among the lowest in the world. Consequently, an “inefficient” VAT could not be a replacement for the distorting payroll tax.

The Mexican Income Tax (ISR) also suffered from growing base-erosion. Many of the beneficiaries were large firms with important political connections. Once given, the special provisions and tax breaks become virtually impossible to remove—something that resonates also in other emerging country contexts (and in developed countries for that matter). Initially the Mexican government tried to follow the widespread attempt at a implementing “minimum tax”, following the Latin American practice of implementing a gross asset tax —called the minimum asset tax (IMPAC) in Mexico. As with the ISR, the incidence was on the largest taxpayers, who could maintain their preferences. To “plug” the seeping holes in the tax, the Government in 2007 turned to a variant

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of a VAT as a minimum tax. Of course, the Mexican government knew that a turnover tax would add to the cost of doing business and would adversely affect the competitive position of Mexico vis-à-vis its trading partners.

Removing preferences and deductions involves confronting powerful vested interests head-on, and this becomes complicated if some parties can use State-level interests to block measures in the Senate. In 2007, the Government was not able overcome the opposition in the Senate to address the holes either in the Income Tax, Impuesto sobre renatas (ISR), or the VAT. As mentioned above, an indirect mechanism was chosen with a minimum tax in VAT-mode, creditable against the ISR through the Impuesto Empresarial a Tasa Única (IETU). This was facilitated by a Chinese-style “stop-loss provision” and a rationalization of intergovernmental transfers. This ensured that no State lost revenues because of the reforms. Thus, the “reform package” was approved by Congress although individual reforms to specific taxes were not successful, presaging the reform efforts to follow.

While the IETU had some disincentive effects, the underlying value-added design did not disadvantage investments as much as a turnover tax would have. However, the IETU added further to the complexity and burden of tax compliance. Not surprisingly, its base began to display additional breaks at the behest of powerful interests that plagued the ISR in the first place. While an additional 0.4% of GDP per annum was generated since 2007, this was not equivalent to the envisaged “plugging of holes.” Moreover, IETU did not significantly expand the base of non-filers. Further consolidation of the income tax base was required to build upon gains and generate information. A simple and full base VAT was still needed to identify non-filers, and reduce incentives to cheat, together with a credible audit threat. But if this were feasible in the first place, the IETU would not have been needed.

It is noteworthy that an attempt failed in 2010 to close the holes in VAT by providing additional benefits to households through the Oportunidades scheme (the famous conditional cash transfer, CCT, on which many other schemes including in the Asian region, are modelled). Firstly, many of the “losers” from a VAT reform are urban households and the CCT provides benefits mainly to poor rural households, making it an inappropriate compensation mechanism for many energy price and tax reforms. Secondly, the main losers in a VAT reform tend to be firms with vested interests, and possibly some states, given the revenue-sharing system. The interactions between the “holes” in the VAT and the special provisions in the ISR present a formidable incentive to cheat and engage in informal activities, but which cannot be addressed by the CCTs, as was seen in Mexico in 2010. Of course, there are other problems with CCTs that have become apparent in México that are relevant for countries in the ASIAN region, including Indonesia, that are considering both tax reforms and energy price adjustments.
There are two mechanisms for evading or avoiding taxes. The first involves firms avoiding coming into the VAT/ISR net by remaining below the annual turnover threshold, or splitting into different firms to avoid paying tax. This is the typical case discussed in the literature and formalized in Keen and Mintz (2013). The revenue losses from this reconstitution by “avoiders” at lower levels of turnover are likely to be small, and this provides the logic for the strong support from the international agencies to raise the registration threshold to “reduce the burdens on the tax administration” (see e.g., the report by the IMF and World Bank to the G20). Small traders and SMEs exercise enormous political power in countries such as Pakistan, and are a stumbling block to meaningful reforms—unless it can be simultaneously illustrated that the losses might be offset by a rationalization of the income taxes, as in Singapore. But this also requires the establishment of an arms’ length tax administration that does not impose additional costs of doing business, especially on small firms.

While there is some evidence for the Keen-Mintz hypothesis in Mexico, by far the more important element in the informality story of Levy is outright evasion by larger firms, which also have much greater political clout than the smaller traders in a more advanced country like Mexico (Ahmad, Pöschl and Zanola, 2017).

The principle channels for rent-seeking are two-fold:

1. *Generate incentives to cheat,* through pricing discontinuities and arbitrage including multiple VAT rates for the same good with special regimes for border regions and the *maquiladoras* (Special Economic Zones, SEZs); together with holes in the direct taxes; and high marginal rates that add to the cost of doing business. Rents are generated due to multiple pricing regimes; SEZs, exemptions, tax preferences, and domestic zero-rating.

2. *Absence of information on transactions or components of value-added;* these generate silos of tax information within tax groups, and across tax instruments. Breaks in the value-added chain, and presumptive mechanisms to estimate VAT liability used extensively e.g., in the Pakistan case, prevent the self-policing aspects of the VAT from operating. This is exacerbated by the weak or ineffective tax administrations for components of the tax system—in the Mexican case, this was the small taxpayer regime that opened the flood-gates of informality.

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33 IMF and World Bank, G20 recommendations.
The overall incentives to cheat in Mexico are summarized in Figure 6. Larger firms are higher up in the picture and are represented by larger rectangles. Similarly, more compliant firms are on the right of the picture and the degree of compliance is depicted by a greater extent of shading of the rectangle.

Figure 6. Incentives to Cheat in Mexico

Source: Ahmad (2014 and 2017).

Several cases can be identified:
• **REPECOS and adjusters:** Firms with turnover below MEX $2 million could join the REPECOS regime for small businesses (the white boxes to the bottom left of the chart). Very few of these pay any tax in Mexico. Although there is no legal registration threshold for the VAT, this became the de facto threshold. This group of smaller taxpayers is effectively written-off by IFIs, but includes the “adjusters”, who legally reduce turnover to stay under the REPECOS threshold.

• **Enanos or Ghosts:** In Mexico, there are many so-called “enanos”, too large to be eligible for REPECOS, but pretend to be eligible regardless. Furthermore, since the enforcement of REPECOS is generally very weak, businesses know that if they pay something, they will keep the state government happy and keep SAT off their backs. These are the “ghosts” identified by Kanbur and Keen (2015).

• **Larger firms:** As argued by Levy (2008), there is a great deal of cheating by middle and large size firms that hide transactions, turnover, employment and profits by trading with enanos, truly REPECOS firms, ghosts and other cheaters. These firms reduce payroll and profits taxes as well as avoiding the VAT chain.

• **Honest firms:** Some firms may not be able to cheat—it is often assumed by international agencies—either because they are run by multinationals, or are too large to do so in an undetected manner. On the other hand, the large firms are often reflective of the best-connected “vested interests.” And multinationals are better able to avoid taxation than most of the large domestic firms, e.g., by moving corporate headquarters to low tax jurisdictions—e.g., Ireland or Luxemburg, if not Panama or the Bahamas. However, we maintain the “honest” firm categorization in Figure 6 for completeness’ sake.

All the possible forms of VAT fraud are greatly facilitated by the existence of the maquiladora regime and particularly by the lack of transparency in the regime, which allows firms to hide and/or disguise activities and the ever-widening definition of a maquiladora, which allows more and more firms to enter the regime.

The revenue sink-holes created by the interaction between the maquiladoras regime and the VAT are summarized in Figure 7. The orange, dotted arrows depict a standard carousel fraud. Businesses that import inputs can pass on the input credits to another Mexican firm, which can then export and claim the input credits. This kind of fraud is greatly facilitated by the ability of maquiladoras to operate as part of a larger group of firms both within Mexico and abroad and with very few reporting requirements to the Mexican authorities.

The green, dashed arrows depict a more straightforward export fraud in which a pair of related firms, one maquiladora and one outside the regime, collude to claim an input credit for a
transaction that never occurred. Finally, the red, solid arrows show the most pernicious fraud. Under the maquiladora regime, bonded imports are permitted without incurring a VAT liability provided the transformed outputs are re-exported. These inputs or their resulting transformed outputs are then passed onto another Mexican company which then sells them in the domestic market without having paid ever having paid the VAT on the imported inputs. Customs data shows that only an estimated 50-60% of the inputs imported under this scheme ever actually leave the country again properly.

Figure 7. The maquiladora sink holes

A comparison of the profit distributions declared to the tax administration versus that implied by the Economic Census data (which may itself be an underestimate) provides clues to the extent of possible under-declarations and their components. The details are highlighted in Ahmad, Pöschl and Zanola (2017), and provide support for the Levy hypothesis, but show that there are both
the incentives and ability to cheat in firms of all sizes. The smaller and middle-sized firms do not appear to have a monopoly on cheating the tax administration.

Under the circumstances, there are unlikely to be many firms that would be immune to taking advantage of the opportunities of maximizing profits. And to expect that raising the VAT registration threshold per se would raise revenues would be wishful thinking indeed.

The package of tax reforms at the end of 2013 is instructive, and was designed to “block the holes in the tax system”. The principal components were to integrate the small taxpayers’ regime with the regular tax system, replacing REPECOS by RIF—the integrated small taxpayer system. This required the small taxpayers below the Mex $ 2m threshold to use a simple cash-flow electronic accounting package, and issue electronic invoices. All taxpayers were accordingly brought under SAT registration, compliance and audit. The VAT itself was reformed, with the anomalies removed, retaining the standard rate and eliminating the special rates for the border regions. The idea was simply to bring the whole value-chain in the economy under SAT supervision. The ISR was rationalized, but rate structure maintained. With the full VAT in operation, and electronic invoices including for the small taxpayers, the room for large firms to engage in “hidden transactions” was effectively blocked. Consequently, there was little need to maintain the minimum tax, IETU, and it was abolished, reducing the administrative burdens on taxpayers. The only additional tax was the introduction of a carbon tax or petroleum excise, above an adjustment of petroleum prices towards world prices.

The political economy of the reform was important. It was supported by all parties, because the “package” would enhance the basis for long-term growth, minimize the impact on the poor by excluding taxes on non-processed food, and creating a basic minimum pension that did not create labour market disincentives or a poverty trap. This ensured that the most vulnerable, especially in the urban areas, would not be affected by relative price changes. Since unprocessed food does not enter the middle of the production chain, the information flows that the reform focused on were maintained. The only compensatory measure was the basic pension for those above 65 who did not have alternative occupational pensions. The typical IFI-supported recommendation to resort to the CCT, or Oportunidades, was not utilized to facilitate the adjustment in energy prices.

Indeed, Oportunidades had a negative impact on incentives to participate in the labor market, generated no reduction in poverty in the poorest state, and had been open to diversion of funds in key states—seen during 2012. It was replaced in 2014, by Prospera, that focused on training, and supporting small business, designed to encourage participation in the labour market.
3.2 Outcomes and lessons for Asian countries

Despite the period of low growth affecting much of Latin America, largely due to the depressed prices for natural resources, particularly that of petroleum in the case of Mexico, the 2013 tax reform largely offset the fall in petroleum revenues, raising an additional 3.5% of GDP with no increase in the rates of the major tax instruments. The exception was in the case of the carbon tax that raised an additional 1.4% of GDP in 2015 relative to the excise in 2013. Although, during the period of depressed activity, the VAT increased by around 0.5% of GDP in 2014 relative to 2013 to around 4% of GDP, the biggest gains were with respect to the income tax (ISR), that increased to 6.8% of GDP in 2015 relative to 5.1% in 2012. These improvements helped maintain the level of public expenditures at pre-crisis levels (see Figure 8).

Figure 8  Mexico: 2013 tax reforms


Some broader lessons from the Mexican reforms for Asian countries follow:

1. Perhaps the most important lesson is to establish a complete VAT (with no major breaks in the value-added chain) to reduce the cost of doing business, even if this may result in an overall loss of revenues. Indeed, the efficiency aspect of the VAT led China to complete in May 2016 the integration of the business tax on services, administered by provinces,
with the VAT on goods administered by SAT. This, is also the objective of the Indian Constitutional Amendment that is presently being taken through the different stages of approval before implementation.

In the Chinese case, the compensation for provinces is through an increased share of the VAT revenues, as well as “ad hoc” transfers to ensure that no province loses because of the reform, building on the experience of China’s own 1993/4 reform (and adapted for the 2007 Mexican reforms). But neither the revenue-share, nor ad hoc transfers provides own-source revenue. Consequently, neither induces accountability at the sub-national level—potentially increasing governance problems. We take up the issue of necessary improvements in sub-national governance in Section IV, which is a work in progress in China, as well as Mexico and many ASIAN countries.

2. A second important lesson from the 2013 Mexican reforms is that the tighter flow of information from the VAT also makes it harder for firms to cheat on their income taxes (the value added at each stage is the additional wages and profits generated). Thus, although the VAT revenue enhancement was positive in Mexico, the biggest benefit was in terms of the improvement in the income tax collections. In order to achieve the tax-on-tax synergies, it is necessary to both achieve the full value-added chain (including a better integration with the small taxpayer regime that may use a simple cash-based accounting package, as provided by SAT in Mexico), but also the strengthening of functional capabilities of the tax administration to be able to match the information generated from different sources, together with a robust risk-based audit capability that would operate in common across many tax heads. While a special focus om large taxpayers may still be warranted, the integration of information from small taxpayers is critical to close loopholes, and has implications for the legal and de facto thresholds for the VAT.

3. **A third lesson is that the tighter flow of information from the VAT can also help address the base-shifting problem associated with large MNCs.** The VAT, for instance, helps EC governments to evaluate the extent of profits generated by corporations such as Google or Apple in the major European countries, and the extent of CIT avoided. For instance, the reductions in the CIT in the UK (to 20% currently, and scheduled to go down to 17%) has not prevented Apple from paying virtually no tax in the UK, and after penalties and negotiation a 3% CIT rate for Google over the past decade. There is clearly scope for tightening the legal framework determining the CIT base to prevent such egregious avoidance, even in countries with efficient tax administrations.
4. By extension, the possibilities of leakage from SEZs is particularly high, particularly in countries with relatively weak tax and budgetary management systems. The main objective of creating a special zone or “hub” is to provide synergies between public investment and services to ensure that there is uninterrupted supply of electricity, water supply, sewage, as well as education and health facilities to “attract” private investment (both foreign and domestic) to benefit from agglomeration effects, locational advantages as well as skilled labour. Tightening of corporate tax rules because of the “base shifting” phenomena is an advantage, as this will ensure that production actually takes place in these “hubs”, and that they are more than vehicles for firms to “show profits” as in Ireland or Panama. The VAT is then critical as an informational and control mechanism in SEZs, and will not be expected to raise revenues, as much of the output from SEZs would be exported and subject to zero-rating for VAT purposes. This consideration would again modify the traditional approach to the VAT in SEZs, which exempts all activities in SEZs. Indeed, the completion of the VAT chain makes the whole country a SEZ. For instance, the new international airport in Querétaro has led to a major influx of investment (Aerospace, Nissan, BMW HQ)—illustrates that infrastructure development (new airport to complement the existing motorway links to Mexico City and the US) together with a clean city environment and absence of congestion, university with skilled workers are the critical ingredients to make new “hubs” functional and well integrated with the rest of the economy.

5. The control mechanism associated with the information generated by the VAT is also an important tool to monitor investment and production in natural resource sector, including petroleum. Again, this requires a modification of the typical recommendation made by the IFIs in relation to the VAT, which permits VAT on capital goods to be refunded more or less immediately. Unfortunately, this loses the lever to extract information. The leakages from the Nigerian petroleum sector, documented by the Ribadu Commission Report\textsuperscript{36}, could be plugged by utilizing all possible sources of information, of which the VAT is an important component. The more appropriate formulation, especially in countries with informality, may well be what is practiced in China—to permit the VAT on capital and other inputs to be offset against VAT liability on outputs, or zero-rated when exports are verified. Of course, as correctly recommended by Professor Ribadu, it is also important to track the flow of funds, including the interface between the management systems of the Petroleum Company and the Government’s Financial Information Management System (IFMIS) as well as that with the Treasury Single Account (TSA).

6. A sixth lesson is that while the overall distributional effects will depend on combinations of taxes, and taxes and social policies, a careful design of the VAT itself will minimize the need for compensatory measures. For instance, excluding non-processed basic staples (wheat, rice, maize) in different countries would go a long way towards “protecting the poor” (as argued by Ahmad and Stern 1991 in the context of India and Pakistan). This was also the approach taken in the Mexican 2013 reforms. Empirical work in Timor Leste, suggests that if the authorities were to implement a VAT which exempts non-processed (rice, corn and cassava) a single rate VAT would still be quite progressive (see Figure 9, Ahmad and Breton, 2016\textsuperscript{37}).

Figure 9 Timor-Leste: Impact of a VAT (% of total household expenditure)

Source Ahmad and Breton 2015.

\textsuperscript{37} Ahmad, E and M. Breton (2015), A VAT for Timor Leste, Some policy and design considerations, ADB and Timor-Leste Fiscal Reforms Commission.
a) The Mexican experience shows also that it is not always appropriate to utilize CCTs, such as the former Oportunidades program, to accompany tax reforms, such as the VAT, or energy price reforms including with the introduction of a carbon tax. While CCTs may be justified as stand-alone programs to support the poorest groups in society, usually in rural areas as in Pakistan\(^{38}\) or Mexico, whereas the major impact of concern is typically poor and fixed income workers in urban areas.

b) Further, the Mexican example shows that the opposition to tax reforms in multilevel countries comes from powerful interest groups as well as lower level governments that might be affected by changes in assignments or transfer and revenue-sharing arrangements. Thus, the proposed adjustment in Oportunidades in 2010 to facilitate the VAT reform was rejected. And in 2013, the VAT was reformed, and a carbon tax was also introduced at the same time, and the CCT was not utilized.

c) The only compensation together with the package of tax reforms in 2013 was the minimum basic pension, that does not create labour market distortions, or generate a “poverty trap.” Indeed, the energy price adjustments in Indonesia are likely to create the fiscal space for efficiency and equity enhancing health care coverage.\(^{39}\)

7. **A seventh lesson is that the carbon tax and excises more generally need to eliminate “implicit subsidies” and prevent a “race to the bottom”**. There are two components in the Mexican or Indonesian context. The implicit subsidy argument suggests that the carbon tax should be imposed above a reference price such as the world price for, say, petroleum products. This ensures that there is no implicit subsidy, as well as generating positive revenues, and generating incentives for firms and households to adjust the choice of techniques and consumption away from environmentally damaging products. The piggy back on a carbon tax provides local flexibility to implement a higher than national rate if needed, and also makes the tax an own-source of revenue that could be leveraged to access credit. Thus, there is a case for a higher tax in the more congested areas metropolitan areas, such as Mexico City or Jakarta, than in remote cities. However, assigning own-source taxes to states, such as the vehicle tax, tenencia, given the system of “gap-filling” transfers has not had a very successful track record as discussed above.

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\(^{38}\) The Benazir Income Support Program in Pakistan was modelled on the defunct Oportunidades program from Mexico, and largely targets poor rural households. It was implemented in 2010 with the support of the World Bank and bilateral donors such as US AID and DFID, to support a VAT reform, which has been effectively abandoned.


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Consequently, a “piggy-back” on a central base and administration would be indicated to prevent a “race to the bottom.” This also provides an own-source of revenue for sustainable access to credit and financing of infrastructure. Similar issues apply with respect to “excises” meant to counteract health hazards, particularly with respect to the traditional “bads” such as tobacco and alcohol. However, in Mexico, there has been a sharp increase in obesity and diabetes, leading to an increase in health expenditures. While national taxes on sodas and confectionary are appropriate, and were introduced in the 2013 reforms, there may also be a case for higher taxes in the metropolitan areas where the consumption of such “bads” is greater. This brings us to the multilevel issues relating to governance that are critical whether the focus is on federal countries like Mexico or India and Pakistan, or unitary states such as China and Indonesia. In East Asia in particular, the ageing of populations is putting pressures on health budgets and the interactions between taxes and spending at different levels of government is very sharply focused.

4. Multilevel governance for sustainable development

Why should multilevel governance matter? This is because most of the SDG targets are implemented at the lower levels of government, in both federal countries and unitary states. This applies particularly to basic education and even critical elements of health care. And, even wide-area or cross-jurisdictional infrastructure, financed by the central government, needs local connectivity and public services to make it function efficiently.

Institutions and the policy framework at the sub-national level matter as they do at the national level that is so often the focus of international agencies. And as we saw above in the discussion of national taxes such as the VAT and the CIT, the incentives to cheat that arise from split bases can lead to a failure of overall policy design, even if these were supported by decades of technical assistance, as was the case in Pakistan.\(^{40}\) Quite often the technical support has resulted in IT solutions with inadequate attention to the context in which “expensive” systems are being developed or purchased, and this applies both to the revenue generation as well as the budget-related organizations. Consequently, in many cases, there is a semblance of progress, but the actual institutions continue to atrophy as the previous manual checks and balances cease to be

\(^{40}\) For a review of technical assistance to Pakistan in the fiscal area, particularly with respect to tax policy since the late 1980s, see Ehtisham Ahmad and Azizali Mohammed, 2017, “Pakistan, the US and the Bretton Woods Institutions—a continuing Great Game,” in the Routledge Handbook of the Pakistan Economy.
relevant in a more complex society, with a negative impact on governance especially at the lower levels of administration.

4.1 Who does what, and what are the outcomes?

The issue of spending assignments among different levels of government represents a complex set of issues that are beyond the scope of this paper except to the extent to which they influence the outcomes relating to the SDG process. The “normative” approach to spending assignments is greatly influenced by the US model, and this is largely reflected in the EC’s subsidiarity rules. The latter requires that spending be sent down to the lowest level that can effectively manage the function. Thus, the expectation is that basic education will be provided at the local or municipal level. The effects of this “normative” approach are profound, as countries as diverse as Indonesia and Pakistan have sought to assign the function entirely to lower levels of government. In Indonesia, the decentralization reforms in 1999/2000 pushed the function down to the district/municipal level (third tier). In Pakistan, the 2010 18th Amendment to the Constitution gave exclusive jurisdiction over education to the provinces (second tier). Unfortunately, the failure to address the overall revenue envelope has turned the reassignment into an unfunded mandate.

An alternative “positive” or political economy approach (see e.g., Ahmad and Brosio 2015 and Lockwood 2015)\textsuperscript{41} would ask whether the spending assignments, however chosen and often through politically driven considerations, generate the necessary incentives to be effectively operative. This involves full information on the costs of provision and the associated liabilities. A critical element in the functioning of the assignment is the availability of local own-sources of revenue at the margin (above transfers that close vertical and horizontal gaps). Many governance failures in competitive models in recent years, e.g., in the crisis in Europe (Ahmad, Bordignon and Brosio, 2016). Even in administrative progression models, that are relying increasingly on measuring performance for assigned functions (e.g., experimentation in the Chinese province of Zhejiang), just focusing on outcomes without full focus on costs, including recourse to credit or debt by the relevant jurisdiction, sets up inaccurate assessments and incentives to rely increasingly on debt for future progression.

In this section, we focus on the incentive structures that lead to good governance. This includes the incentives accountability and to use funds efficiently, and information on where the money goes and how it is spent.

4.2 Own-source revenues as drivers of structural change

Own-source revenues are needed to establish hard-budget constraints at the subnational level, as argued by Ambrosanio and Bordignon (2015).\textsuperscript{42} This is mainly because limits and sanctions

associated with borrowing rules are not credible without the marginal cost of borrowing falling on the jurisdiction that incurs the liability. If another jurisdiction bears the cost of liabilities incurred, then the incentive is to spend without consideration of efficiency and also minimize the tax burden on local residents. The interjurisdictional (yardstick) competition model breaks down, and the potential “padding of costs” at the expense of the central government opens the doors to rent-seeking. This applies in unitary and federal states alike. The proviso also applies in models where the local administrator is appointed by the central government, such as in China (see Ahmad 2017; and Ahmad, Niu and Xiao, 201843)—only that the penalties would have to accompany the official along his career path, even if no longer posted in the jurisdiction concerned. Notice that in both cases, the own-source revenues are necessary conditions for better governance, but are far from sufficient.

As seen in Mexico, there is a resistance on the part of the state-level governments to accepting own-source revenues, e.g., with respect to the PIT-piggy back that has been an option, as well as to the more surprising failure of the vehicle tax in 2010. Clearly, gap-filling transfers are preferred to own-source revenues, as there is no political cost to generating the additional funds. Even shared revenues are preferred to own-source revenues, as the political costs are effectively borne by the central government. But there is a cost in the effective outcomes in relation to public services, and this is clear in the case of education. Much of the funding for education came from central government earmarked transfers, but implementation at the state and local levels. Consequently, the center did not even know the number of teachers that it was financing and whether or not they knew how to teach. Given the central role of education, the Federal requirement that teachers take a proficiency test in 2014 was strongly resisted, and had to be enforced with an effective centralization of the function.

It is important to stress that shared revenues and transfers do not constitute own-source revenues needed for responsible access to credit for investment. Even taxes nominally under the control of subnational jurisdictions, e.g., with the co-occupancy of the VAT base proposed in India with subnational administration, will not strictly qualify as own-source if the states cannot control the rate structure. State control over rates would create a nightmare for firms, and would be antithetical to the creation of a common market.

Gap-filling transfers negate the positive incentives that are generated by own-source revenues, and remove any scope for increases, e.g., to repay local debt, if a higher-level jurisdiction at either national or supranational level can be tapped to meet additional spending needs as the political

costs of the additional spending are not incurred by the local jurisdiction. Equalization transfers are not gap-filling if standardized factors of need and revenue bases are used, as these are not under the control of the recipient jurisdiction. However, if actual sub-national spending and revenues are used, the “equalization” system becomes another form of “gap filling,” as the local jurisdiction can begin to manipulate it—either by ramping up spending or reducing taxes that bear on their populations.

**Own-taxes for sustainable and clean cities**

Property taxes have long been regarded as the main source of financing local revenues, particularly given the experience of the United States. High property taxes are also synonymous with good public service delivery. The taxes track property values due, in particular, to the quality of public education in any given jurisdiction. Mobility plays a major role in this story, as taxpayers vote with their feet and move to jurisdictions that provide better education, in particular, even if the resulting property tax rates are higher as a result. This is a key feature of the political competition models. However, for the system to work, there must be a clear delineation of property titles, as well as a real-time adjustment in relation to changing property values, as well as the costs of service delivery. Unfortunately, these preconditions do not exist in many parts of the world, and the property tax is moribund in many parts of Africa, Latin America as well as Asia. Experiments in China, in Shanghai and Chongqing, to introduce versions of the US-style property tax have not been very successful, given the difficulty in establishing who owns what and how the property values are changing.

The Indian property tax is of long-standing use, but has not generated much revenue either. However, local public finances need significant restructuring if they are to be able to provide for a modicum of basic services and sustainable access to financing for local investment for clean cities and sustainable growth. This applies equally to spending, revenues and transfers, although the focus here is primarily on the property tax arrangements.

The Indian property tax is based on the standard “ownership and valuation model” common in Western countries. The valuation is based on an estimate of the annual rental or capital value of the property (Valuation (Metropolis) Act of 1869). However, as pointed out in Rao (2012), the information base on the property tax in India is severely deficient and unreliable. This is partly because the cadaster is woefully out of date, and the valuation system has not kept pace with market price changes.

An alternative is to move to a presumptive basis for taxing properties based on location and size to try to approximate true values. This reform was initiated in Patna in 1992/3 but failed to yield
additional revenues. A similar outcome occurred in Delhi. But in Bangalore, the application of presumptive estimates led to a virtual doubling of the property tax revenues between 2007/8 and 2008/9. However, the typical problems with arbitrary adjustments to presumptive measures have appeared recently. A 40% increase in valuations due to the new airport led to inequities within Bangalore, and had to be rescinded—and increases were capped at 25%. Fine-tuning the valuations to specific neighborhoods might yield more accurate changes but open the system to possible collusion and rent-seeking.

A true self-assessment system, as implemented in Bogotá in 1994 by Mayor Mockus, also generated a substantial and sustained increase in property tax revenues—the cadaster and valuation basis was retained as a minimum. However, the system relies on relatively good information on local property transactions to operate the sanction of forcible purchase of the property at 1.5 times the declared value. There is no need for a heavy-handed use of the sanction, and one or two examples suffice. However, there is the danger that the sanctions might be misused for “political” purposes, although the Bogotá system is still in operation despite changes in city administrations.

A final alternative is to side-step the valuation system altogether, and link the property tax to size, location and the cost of public services delivered. This is the Marshallian “benefit tax” proposal that overcomes political resistance and links the taxes paid to services provided (see Ahmad, Brosio and Pöschl 2015)44. The ownership issue can also be finessed (this is relevant for China, but also India) as the tax falls on the occupant, rather than the owner, unless the property is vacant. This is also the current UK system—the traditional property tax was abandoned by Margaret Thatcher because of the difficulty of keeping up with valuation changes.45 It is important to note that the valuation requirements are no longer binding in a system that links property use to the cost of local services. However, there needs to be an accurate map of properties. The Indian Geographic Information System can be used to map the actual properties. Again, ownership is not critical as the tax-benefit system is paid for by users, and not owners (unless the property is vacant, as in the UK).

Satellite imagery can prove to be a very useful tool, and is now highly developed and readily available in most parts of the world. This also cannot be easily evaded and can sidestep the corruption that takes place in measuring and recording property areas as well as structures. This

45 It is interesting that the UK raises more in the property tax (4% of GDP) than the US with the traditional property tax (around 3.5% of GDP). See IMF GFS Yearbook, recent years.
also has useful applications with respect to monitoring forestry and natural resources as well as illegal logging and mining.

**There remains, however, a very close link between own-source taxes, transfers and expenditures.** This is partly related to the overall resource envelope, but also the incentives that face local officials. Own-source revenue handles are needed for accountability for local spending that comes with hard budget constraints. But transfer design also matters. In India, while spending assignments vary by state, the revenue assignments also differ. For example, many states have prohibited the use of octroi or taxes on domestic trade that formed a significant part of local revenues, at least since the enactment of the Government of India Act in 1935. But in most cases, there were no additional sources of revenues to assign to the local governments in lieu of octroi, and the result has been unfunded mandates, and greater transfer dependency. This, of course, generates perverse incentives, as local governments are loath to improve revenue collections for fear of losing “reliable” transfers that carry no local political costs. This perpetuates the culture of “fiscal dentistry” or transfers to fill deficits that used to be pervasive in India at all levels (Govinda Rao, 2002).

While the GST reform being introduced in India through a Constitutional Amendment is designed to reduce the cost of doing business in India and remove barriers to internal trade, it effectively removes the most important own-source tax handle in the hand of the states as they would no longer be able to change rates if needed. Alternative own-source revenue handles for states, that will also have implications for the mega-metropolises (above 10 million inhabitants), could include consolidating the split base for the personal income tax (PIT) in the same spirit of consolidating the sales tax base for the GST, and creating a state/metropolitan “piggy-back.” Note that mega-metropolises need to be treated differently from smaller cities—because of the wide area functions that are needed—as for example in Beijing, Shanghai and Guangzhou. The “piggy-backed” arrangements could be extended also to the city level with the creating of bands within which a city may be able to set its own marginal tax rates. No local administration is needed, and as in the US the main administrative functions could be handled by the IRS. The use of local third-party information would help to expand the coverage of the PIT, to better capture the fastest–growing income base in the country. As mentioned above, a similar approach could be adopted vis à vis a carbon tax designed to stimulate structural change, with a state/local “piggy-back” on a nationally determined base with IRS administration (Ahmad and Stern 2011). However, the incentive system inherent in the intergovernmental transfer system is critical in

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ensuring that own-source revenues are used if the handles are provided to lower level jurisdictions.

Both the “piggy-backed” tax options would provide significantly greater revenues to local governments than the meagre 0.4-0.5% of GDP generated in terms of local resources (own-taxes) and 0.27% of GDP in transfers (see Bird and Rao 2011). But these new instruments would also provide more revenues to the richer areas. Consequently, there would be a need to establish a state-level “equalization framework” to enable cities to provide similar levels of public services at similar levels of tax effort.” This would replace the ad hoc system of state transfers that is so damaging to local tax collection incentives.

In conclusion, a proper system of local own-source revenues is needed before cities are able to borrow for investment purposes in a sustainable manner. This linkage is important to align incentives for a clean environment. It is also important to recognize that PPPs represent local liabilities, and the repayment schedule needs to be linked to own-source revenue generation. Otherwise, there is a clear and present danger that there will be a buildup of liabilities that might go unnoticed until there is a crisis, as was the case in Europe during the recent crisis (Ahmad, Bordignon and Brosio 2016).

4.3 Budget institutions and governance— who spends what and where does the money go?

A key component of good governance at the sub-national level concerns full information on financial transactions and build-up of liabilities in a standard and timely manner. Without full information on such transactions, there is considerable scope for unproductive spending as well as corruption. Measures to monitor spending and outcomes at different levels of government are needed both for the implementation of fiscal rules as well as providing the basis to evaluate the costs of spending and outcomes. Without this information, it is unlikely that leakages and inefficiencies in spending can be addressed.


48 Ahmad, Ehtisham, Massimo Bordignon and Giorgio Brosio (2016), Multilevel Finance and the Eurocrisis, Edward Elgar.
The EU practice of relying on the market to discipline local governments broke down during the post-2008 economic crisis (see Ahmad, Bordignon and Brosio, 2016). Local governments could hide liabilities, including by passing regular payments channels and dealing with local banks, and parking liabilities in PPPs. The additional and largely hidden liabilities added to the magnitude of the crisis, but there was also plenty of evidence that funds were misappropriated in several cases. The presumption that markets would discipline local governments, without the need for standardized reporting of transactions and arrears, such as with the OECD/IMF Government Financial Statistics standards, is generally not a viable option without the full information on current and future payment streams.

As with the tax side, it is common for countries to purchase expensive Financial Information Management Systems (FMISs) without thinking through how it might affect the processes and procedures across government entities, and the architecture of connecting with line agencies and sub-national governments. It is also common for line agencies or local governments to move ahead of the Ministry of Finance or Treasury and purchase their own systems, often with incompatible charts of accounts that make it virtually impossible to generate data on general government operations—either the economic classification that would also cover the buildup of liabilities, or the functional or program classifications that make it possible to report on the key SDG deliverables, such as spending and outcomes on education or health care, for instance. Thus, many countries such as Pakistan, are only able to report on budgetary central government operations and not functional spending or outcomes necessary for the SDGs. This data has to be generated manually, and cannot be easily verified. And the absence of Treasury Single Accounts means that the usual cross checks in terms of being able to follow the flow of funds is missing—thus also opening the door to the possible game-play between levels of government, or rent seeking behavior.

In a rare admission, the Internal Evaluation Group of the World Bank admits that despite having spent $3.5 billion in 75 countries, “having a fully functional FMIS in place is not a sufficient condition as a good budget management tool” (World Bank, 2016, p.23). Unfortunately, many of the systems do not track the full GFSM-classified budget, with the economic, functional, program and project classifications in the chart of accounts, to be able to generate accurate and timely information, including on liabilities. And some countries that might score highly on the individual rankings (see Table 3), might miss out key elements that affect the ability and incentives for officials to “cheat”, as is becoming clear with the Panama cases as well as the investigations in Brazil and other countries.

Some countries perform well with respect to the TSA, but it is not evident that this applies to all levels of government. Another lacuna is that some agencies that should be included at a particular level of government are left out.

After two decades of being in the forefront in the establishment of a Treasury Single Account, as well as Government Financial Management Information Systems (SIAFI), Brazil has realized that incomplete or inconsistent information allows agencies and sub-national governments to play games. The States are now required to move to the full GFSM2014 in their chart of accounts, to be able to track the buildup of liabilities at the General Government level (all levels of government).

Many FMISs in emerging market economies, put in at great expense, require mapping tables to generate GFSM-consistent data for inclusion in the GFS yearbook. Table 5 that in many multilevel countries in the ASIAN region, only data on central government budgetary transactions were included in the GFS Yearbook—not even the functional classification, and no information at all on provincial and local transactions. In the context of increasingly decentralized delivery of the SDG goals, this poses a significant challenge that needs to be addressed in a coherent manner.

Following the 1993/4 fiscal reforms, China also sought to place its budget framework on a modern basis, and established Treasury Single Accounts at the Central and Provincial levels, and began the implementation of the GFSM2001 (and now GFSM2014) standards after 2002. However, these developments were on a cash basis and at the higher levels of government. In this regard, China has made better progress than the other BRIC countries, except for Russia (see Table 4—also Table 5 for other ASIAN countries), in that there is a clear goal, and uniform standards are being developed, but are not complete. This applies to the treatment of liabilities and the budget process. China prohibited direct borrowing by local governments in the 1990s, but permitted companies owned by local governments to borrow. The expectation was that this borrowing would be largely for investment—a modified golden rule. However, in the absence of full information, it was very hard to identify what the companies were borrowing for, and the boundary between local government functions and the activities of the companies was very blurred indeed.

Despite the heavy expenditures on TSAs and integrated financial information management systems (IFMISs), the performance in ASIAN countries, especially at the sub-national level, leaves much room for improvement.
Table 3 World Bank, IEG Evaluation of Budget Management Systems

<table>
<thead>
<tr>
<th>Country</th>
<th>TSA Status</th>
<th>FMIS Coverage</th>
<th>Core Functionality</th>
<th>Ancillary Features</th>
<th>Technical Aspects</th>
<th>Total System Strength</th>
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Source, World Bank 2016. A traffic light system is used to reflect the IEG’s evaluation of effective standards—with green as passable, red as unsatisfactory, and yellow as representing room for improvement.
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Source: GFS Detailed Tables

Note: N/A means that the table is missing in the database
Table 5  Other Asian Countries

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While China has made a consistent and determined effort to revamp the systems over the past 15 years, significant gaps remain regarding the recording and management of sub-national liabilities. However, China has done much better than most other Asian countries in establishing the key elements of budget infrastructure.

The Chinese budget law was revised in 2014 to permit the issuance of local government bonds for qualifies provinces and there is now a requirement to move to accruals according to the full GFSM2014 standard. While local governments were required to prepare balance-sheets, this is at an early stage. A recent examination of the balance sheet produced by one of the most advanced counties in China showed that there are large gaps in the information available. This could prove problematic in a systematic management and resolution of outstanding liabilities that have built up over time (Ahmad and Zhang, 2017)\textsuperscript{50}. There are clearly adequate resources at the central level to meet the current levels of local government debt, but there is an incentive problem involved. Without own-source revenues at the local level, it is not credible for the central government to insist that the liabilities will not be covered by the central budget, and there remains a risk that these must be financed by the center.

Changing the budget law in China to permit US-type local bond issuance also faces the credibility test. Without own-source revenues, as in the US, for the process to function effectively, it may not be possible to ensure hard budget constraints (Ter-Minassian 2015)\textsuperscript{51}. The risk remains that either the central government will be forced to intervene directly if local liabilities cannot be serviced threatening the delivery of basic services, or indirectly if there are risks associate with an accumulation of bad loans on bank balance sheets. The latter occurred during the recent crisis in Spain and Ireland, even though there were no central guarantees. Of course, there were plenty of examples of leakages and rent-seeking behavior facilitated with the weak oversight over the transactions.

Attempts by the Chinese government to impose performance evaluation standards on local officials represent a move in the right direction. However, without a tight control over liabilities and effective management of local balance sheets, it is perfectly possible for local officials to meet performance targets or exceed them, by incurring unseen liabilities, and being promoted to other jurisdictions before these come to light. Thus, in an administrative progression system, such as China, or hybrid arrangements as in South Asia, more information is required rather than less than in countries in which electoral competition works efficiently.

\textsuperscript{50} Ahmad, Ehtisham and Xiaorong Zhang, 2017, in Ahmad, Niu and Xiao (2017) \textit{op cit.}

The issue of accurate measurement and reporting of liabilities is increasingly important given the emphasis on Public Private Partnerships (PPPs) in meeting SDG goals (see Ahmad, Bhattacharya, Vinella and Xiao, 2015). This is also an issue now in China, that is basing its rebalancing partly on PPP contracts. Many ASIAN countries are far less advanced than China in setting up modern public financial management (PFM) systems. The liabilities do not go away, and as in the EC countries, treating PPPs as a mechanism of “kicking the fiscal bucket down the road” is tantamount to storing up problems for the future.

5. Conclusions

Good governance is critical in meeting the requirements for sustainable development. Yet how this is to be achieved will vary, given differences in institutional arrangements. The most prominent distinctions are between countries that rely on electoral (or yardstick) competition to achieve better governance, or those that operate on a system of appointed officials and administrative progression. Yet, there is more in common between Federal Mexico and Unitary China, than might be the case between Mexico and its northern neighbor, the US. Yet the governance literature is heavily dominated by the US experience and traditions, including a reliance on the market to take care of governance problems. In many cases, including as seen in the post-2008 European context, US-type reliance on the market involved passing the “buck” to future generations or just kicking the can down the road to other jurisdictions, including higher levels of government.

As we have seen in this paper, the relevant organizational structures and policies needed in most emerging market economies with incentives to “cheat” may vary substantially from one type of institutional arrangement to the next. Yet, the South-South comparison yields strong results in the importance of full information on a standard basis—and here the UN COFOG/ and OECD-IMF GFSM2014 standards are critical. Indeed, the administrative progression countries are no different from the others, and need the same, if not more, accurate and timely information required for yardstick competition.

And incentives matter, including in the unitary administrative progression countries. The greater relevance of local provision and infrastructure for sustainable growth places increasing importance on own-source revenues for accountable governance as well as responsible access

to credit. This is an area that requires considerable additional work on most Asian countries, as well as Emerging Market countries in other regions.