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Development finance – what role do public finances of partner countries play?

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The debate on the SDGs reveals that the world community will have new ambitious targets upon the expiry of the MDGs. However, substantial financial resources have to be provided to achieve them: the financing of the necessary infrastructure alone by 2020 will cost USD 1.2 to 1.3 trillion annually, according to estimates by the World Bank. In addition to the private sector, the public finances of developing and emerging countries will thus be called upon to provide additional funds.

If you only look at the figures, there seems to be considerable leeway. In industrialised countries for instance, public revenue on average accounts for 20-30% of GDP, compared with only 16-20% in emerging markets. Developing countries on the other hand have a ratio of only 10-14% of GDP. In principle, an increase in disposable state resources is possible by

(i) increasing the tax rate or the tax and contribution ratio, and/or

(ii) taking out loans.

It is often overlooked that

(iii) efficient use of public funds can release significant resources too.

Increasing the tax ratio

Except in some countries that are rich in commodities, income and sales taxes as well as customs duties are the most important means of generating public revenue. Approaches to increasing the tax ratio include

- increasing the tax rate,
- expanding the tax base and
- improving tax efficiency.

Increasing tax rates in countries with widespread poverty often has limited potential and is usually only productive in the context of progressive tax rates in higher income brackets. The same applies for expanding the tax base by introducing new taxable events.

Improving collection efficiency is therefore of particular importance, and not just in terms of fairness (formalisation of the informal sector, closing of legal loopholes and combating tax fraud and capital flight). In many cases, however, the tax authorities lack adequate procedures and capacities. They often only have small budgets, a lack of expertise and inadequate IT equipment (which plays a crucial role in tax administration).

In the long term, promoting economic growth is the most productive way to increase government revenues, because large parts of the population or companies will then be in a position to make a larger contribution.

Public debt and a sense of proportion

Raising funds on the financial market (in the country and abroad) is a legitimate means of public-sector financing, and given the low interest rates at present it has also become more important for low-income countries again. This is why numerous African countries have issued government bonds recently. To prevent the risk of excessive debts however (especially at rising interest rates), there should be a professional debt management service. This also means that debt servicing must be secured in the long term by sufficient state revenues, e.g. using commodity revenues or generating stable economic growth, or that the funds be invested in productive, revenue-generating purposes from which the debt can be financed.

Releasing resources through efficiency improvements in spending

As countries are not exposed to any competitive cost pressure, they have the tendency to finance additional tasks by raising tax rather than by introducing politically sensitive cuts or increases in efficiency on the expenditure side. Yet there is considerable potential here too: Transparency International has estimated, for example, that public procurement costs are 20-25% higher than necessary due to corruption alone. Improvements with regard to transparent and fair tendering procedures, audits to verify the effectiveness of the procedures or budget management controls, by Courts of Auditors for example, may lead to considerable budgetary savings.

Subsidies that may put a heavy strain on public finances often have a potential to save public funds, too. Commodities (e.g. energy) are subsidised in many countries, with the argument being to make them affordable for the poor. Yet it is predominantly the middle and upper classes which benefit. To give the poor access to important products or services, targeted cash transfers would be the more efficient way in many cases.

Under certain conditions, efficiency improvements in the public sector can also be achieved through Private-Public Partnerships.

Conclusion: still room for improvement

Discussions about financing the Sustainable Development Goals frequently centre on increasing official development assistance (ODA) and mobilising private-sector resources. It is sometimes overlooked that there is also considerable potential in the area of public finances of partner countries. Development cooperation can help partner countries to make better use of this potential, whether directly by promoting reforms in the area of Public Financial Management for example (courts of auditors, IT for tax administrations, etc.) or indirectly by promoting long-term economic growth generating taxes. ■