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# Financial Policy in Developing Countries

by Dr Heider Dawar, Bonn \*

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**The present financial policies of the developing countries are hardly likely to create favourable conditions for economic growth. A change can only be brought about if the financing of development projects and the imports of consumer goods can be successfully integrated in an overall plan for economic growth and the generation of new sources of revenue for the state.**

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Even developing countries are not entirely at the mercy of their economic problems, provided they shape their economic policies in the light of the knowledge of our time and apply the experiences of yesterday in plotting their course for tomorrow. To achieve their main objective — steady economic growth — a financial policy drawn up with the above in mind might quite possibly help them in no small measure, and yet frequently no such attempt is made. On the contrary, in many countries it is the insufficiently thought-out financial policy which represents one of the major obstacles to economic development.

## **Inappropriate Financial Policies**

One of the main problems facing many developing countries stems from their exclusive reliance on agriculture. For these countries agricultural exports are the main source of foreign exchange income with which to finance the imports they need to further their development. Sales of farm products from developing countries are however on the decline. This decline is steadily becoming more pronounced on account of the slight income elasticities in industrial countries and the relatively inelastic demand for farm products from developing countries whatever their price. This downward trend of exports, together with increasing imports — especially of consumer goods — has led to the chronic deficits on trade accounts from which many developing countries are suffering. The situation, which makes it increasingly difficult for these countries to pay for the import of capital goods, is frequently aggravated by an inappropriate financial policy.

As far as revenue policy is concerned, developing countries usually tend to look at it from the point of view of a private enterprise rather than that of a national economy, laying the main emphasis on financial profitability and administrative simplicity. There is hardly ever an attempt made to direct the national economy by fiscal means as is the practice in industrial countries. Up to the present im-

portant preconditions for such a global policy simply do not exist. Developing countries rely for instance for their incomes mainly on indirect taxation. Direct taxes, such as income tax, affect only a thin layer of the population where assessment and collection are relatively easy. It is frequently overlooked that under such a system fiscal profitability flourishes at the expense of long-term economic development and the lucrativeness of other taxes.

Thus what characterizes the tariff structures of many developing countries is that export duties and similar taxes and imposts are relatively high while duties on imports are, by comparison, low. Now, duties levied on exports weaken the competitiveness of the developing countries in the world market, whereas low tariffs on imports tend to increase the native population's propensity to consume rather than save or invest. As the demand for consumer goods, and especially for luxuries, can be met in overwhelming measure only by imports, the country in question needs more and more foreign exchange while the revenue derived from exports frequently diminishes. As a result, the modest foreign currency reserves are largely used not for the acquisition of badly needed production goods, but for consumer wares, which from the point of view of a growth-oriented policy is less desirable.

A purposive financial policy can counteract this trend by imposing heavy duties on imported consumer goods while furthering export-oriented local production. The most important task in this context will be to establish a tariff designed to stimulate the type of growth which is in keeping with the economic and social requirements; in other words the tariff should be used, not primarily for fiscal purposes, but as an instrument for the achievement of economic and development-political aims. Haberler calls attention to the difficulties that arise in this context, saying that it is hardly possible to achieve the two objectives at the same

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time, i. e. to exploit to the maximum a rich source of revenue while affording maximum protection to national producers. For maximum protection can only take the form of a prohibitive duty which by definition brings in no revenue. On the other hand, from a fiscal point of view, a tariff is the more productive the faster imports increase and the less the tariff contributes to the development of local production, which means in the case of developing countries the less the tariff fulfills its function as an aid to development.

A system of taxation which is essentially geared to covering the financial requirements of the state is bound, in the long run, to impair not only total government revenue, but also the rate at which private and public capital accumulates. It is nowadays widely recognised that the financial authorities are competent to play a part in the regulation of the economic development as a whole. In the case of developing countries this presupposes, of course, that the composition of their taxation system is so altered as to give it a social character, and this can be achieved particularly by shifting the emphasis from "indirect" to "direct" levies.

#### **Wrong Use of Foreign Aid**

A cause for serious concern is the constantly growing foreign indebtedness of many developing countries which results from an increasing recourse to foreign capital aid while revenues from exports are stagnating. This ominous situation is further aggravated by the fact that frequently non-urgent projects are selected, which means that the true purpose of economic aid – to stimulate output – is missed.

Concrete examples abound in excessively grandiose schemes and unsuccessful capital aid programmes. One has only to think of the numerous capitals in Latin America, Africa and Asia, with their modern airports, hotels, their broad tree-lined avenues, their water supply and sewage systems, while the other towns have remained hundreds of years behind the times. The Report of the Pearson Commission contains a warning against the constantly growing foreign indebtedness which it attributes to bad economic management but above all to structural factors. The Report points out that the purpose of the aid, which is to stimulate the debtor countries' export capacity to enable them to redeem their debts is scarcely helped by protectionist measures on the part of creditor countries. According to Pearson, a large part of bilateral development aid is in fact used to gain short-term political or strategic advantages or to stimulate the export business of the donor-countries.

What procedure may then be recommended, particularly in regard to the financing of development projects? The possibility of financing development schemes from internal funds without recourse to external capital aid will have to be considered if the foreign aid is offered in a tied form and on unfavourable terms. Developing countries finding themselves in this position must then re-examine their current expenditures as well as expenditures for development in the light of the new conditions and, if necessary, curtail them so that the funds thus saved may be used for priority projects. This procedure undoubtedly demands great sacrifices of the entire population – particularly when the country concerned is one of the so-called "least developed countries" in which the current revenue scarcely exceeds normal expenditure – a state of affairs that can only be called stagnation. Yet the recommended method would seem to be sounder in the long run than recourse to foreign aid which is either tied to an unproductive use of the funds borrowed and/or carries relatively high interest rates. As example for the latter kind of credits may be cited the relatively high interest rates of the multilateral credit institutions such as the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC) whose loans are granted on almost commercial terms.

A second possibility would be to accept the foreign aid with a view to shifting the emphasis in the direction of immediately productive projects which promise a quick return, save foreign currency and are more labour intensive. Such a procedure can make the economy less vulnerable and at the same time place the country concerned in a stronger position to meet its foreign debt liabilities.

The above description shows that the financial policies as at present conceived and carried out by the so-called developing countries are hardly likely to create favourable conditions for economic growth. On the contrary, this policy constitutes one of the greatest obstacles to the economic development of these countries. A change can be brought about only if the financing of the great development projects as well as the imports of consumer goods, which constitute such a heavy burden on the balance of payments, can be successfully integrated in an overall plan for the growth of the domestic economy; in this context new sources of government revenue could be generated by, say, diversifying exports and stimulating domestic production. Every less developed country should, therefore, set in motion a long-term planning operation in order to reduce its dependence on foreign countries and to make its economy more crisis-proof.