

Introduction to Tax Policy Design and Development

Richard M. Bird and Eric M. Zolt
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I. Introduction

Taxes matter. People talk about them, complain about them, and try to dodge them when they can. Businesses also react to taxes, both in how they organize their activities and, perhaps, in where they carry them out. How people and businesses react in turn affects the level and structure of taxation. The question we consider in this introductory module is how developing countries may best design and develop tax policies to achieve whatever their policy objectives might be, given the complex economic and political environments they face.

As the title of this course suggests, its focus is primarily on “practical” issues of tax policy in developing countries. As John Maynard Keynes (1936, pp. 383-84) famously said, however, “practical men, who believe themselves to be quite free from any intellectual influences, are usually the slaves of some defunct economist. . . . soon or late, it is ideas, not vested interests, which are dangerous for good or evil.” Practical tax policy is certainly not immune to the influence of either ideas or vested interests. Several recent studies demonstrate the influence of both these factors, as well as the specific political institutions that in turn reflect these factors, in shaping tax policy in countries such as the United States and Sweden (e.g, Steinmo, 1993).

Developing countries are no different: ideas, interests, and institutions play a central role in shaping tax policy. To set the stage for subsequent modules of this course, which address many important, but narrower, aspects of tax policy, this introductory module therefore considers in rather broad terms both some important theoretical and philosophical developments related to tax policy and also some equally important ways in which circumstances in different developing countries may call for different tax policy designs.

We proceed as follows. In Part II, we provide a short overview of what tax systems look like around the world. There are some important similarities in the level and structure of taxation in different countries, but also some differences reflecting both regional and economic factors, such as the level of per capita income. Although there continues to be wide variations in the tax structures among countries, countries, regardless of their income level, have generally adopted taxes that are similar in character, such as personal and corporate income taxes, value-added taxes, and excises taxes. We conclude this discussion by raising a question (to which we return at the end of the module) about the implications of the phenomenon of “globalization” for tax policy in developing countries: does still more harmonization, at least in the formal structure of tax systems, lie in the future?

Against this background, we then discuss in Part III the principal policy objectives that different countries may attempt to achieve through budgetary and especially tax policy -- such as the need to raise revenue (usually for more than one level of government); the desire to raise such revenue equitably or fairly; the desirability of minimizing the costs of raising taxes; the desire to encourage economic growth and such related questions as the desire to encourage (or discourage) particular types of activity or to help (or penalize) particular groups or regions; and the wish to encourage and facilitate honest and responsive government.

Finally, in Part IV, we sketch briefly the broad political economy context within which tax policy design and development issues must be considered by practical reformers. We do not provide definitive answers to most of the questions raised in this introduction, many of which are considered in more depth in later modules, and some of which cannot be definitively answered. Our aim is rather simply to set out some of the basic issues facing tax policy designers in developing countries and to suggest at least some of the key elements that must be considered in designing the best feasible tax structure for a particular country at a particular time.

II. An Overview of the World of Taxes

No single tax structure can possibly meet the requirements of every country. The best system for any country should be determined taking into account its economic structure, its capacity to administer taxes, its public service needs, and many other factors. Nonetheless, one way to get an idea of what matters in tax policy is to look at what taxes exist around the world. The level and structure of taxes, and the way in which taxing patterns have changed in recent years are reviewed here on the basis of data collected for some recent years for 168 countries, representing every region of the world.¹

¹ There are many problems in assembling such data. For example, although we shall focus here largely on national taxes, it should be noted that the data coverage in this sample varies. For 55 countries in the sample, only central government is included, while for 69 countries, general government, including regional and local government, is covered. For 17 countries, the sources do not make it clear which governments are included. Data are analyzed for the most recent year for which they are available for each country -- usually 1998. The length of the time series used to investigate the changes in this pattern also varies by country, based on data availability. The data were collected for a period averaging about six years, usually in the mid-1990's. The data reported in this section are based on work done by William Fox for a background report for the United Nations. (Some later sections of this module also draw on this report, as yet unreleased, which was prepared by R. Bird, W. Fox, and M. McIntyre.) GDP data were obtained from the IMF World Economic Outlook Database at www.imf.org/external/pubs/ft/weo/2002/ol/data/index.htm. Revenue data were obtained from IMF Country Reports at www.imf.org/external/country/index.htm and OECD Revenue Statistics CD Rom, 1965-2000, dated 2001.

1. Tax levels

On average, the tax ratio -- taxes as a share of GDP -- was a bit less than one-fifth of GDP (18.8 percent) for the 168 countries in the sample.² This is a simple average, treating each country as a single observation, so that a small island such as St. Lucia receives the same weight as the United States or China. In fact, tax ratios in the sample range from well under 10 percent in a few countries, most of which are small and all of which are low income -- for example, Myanmar, Chad, Guatemala, and Central African Republic -- to well over 40 percent in a few high-income countries in western Europe such as France and Sweden. Surprisingly, however, some lower-income countries, particularly transitional countries, also had high ratios, such as Belarus, Ukraine, Algeria, and Sudan. Similarly, some higher-income countries, such as the United States, had considerably lower tax ratios than others, with Hong Kong being the extreme case in this respect.

Both opportunity and choice appear to affect tax levels. Countries with access to rich natural resource revenues, such as Venezuela and Azerbaijan, tend to have higher tax ratios than otherwise comparable countries, though such revenues may also be highly volatile, reflecting commodity price changes. Tax ratios in higher income countries appear to reflect more choice than chance. Some, such as Sweden and the Netherlands, have large and centralized governments and others, such as the United States and Switzerland, have smaller and more decentralized governments.

Broadly, however, tax ratios do vary by income levels. The countries in the sample for which GDP data were available were divided into three groups based on per capita GDP. Eighty-nine countries in which per capita GDP was less than USD1,000 in 1999 were classified as low-income, 51 countries where per capita GDP was between USD1,000 and USD17,000 were classified as medium-income, and the 24 countries with per capita GDP greater than USD17,000 were classified as high-income. As earlier studies (Tanzi, 1987) have shown, in general, taxes tend to rise as per capita incomes rise. The tax ratio rises from about 17 percent in the low-income group, to 22 percent in the medium-income group, and 27 percent in the high-income group.

Several factors could explain this relationship. The demand for public services may rise faster than income (the income elasticity for services is greater than one), particularly in lower-income countries. For instance, urbanization tends to rise with income, and the demand for public services is generally higher in urban areas. At the same time, however, it is usually easier to collect taxes in urbanized areas. More generally, the capacity of countries to collect taxes appears to rise as income levels increase.

² If social insurance contributions are included, the average tax ratio rises to 21.7 percent. We shall not discuss social insurance payments, however, in part because it is not always clear whether they are included in the tax data for some countries.

More detailed analysis confirms the broad conclusion that, on average, tax ratios rise with per capita income levels; however, the relationship between rising income levels and higher taxes is significant only for the poorer countries.³ As incomes rise in poor countries, the size of the public sector almost invariably becomes relatively larger. After some point, however, this “income determinism” of the tax level declines and the relationship between income and tax levels largely disappears. As already mentioned, the rich countries have more choices, and some rich countries have chosen to levy much lower taxes than others. Perhaps the most important conclusion that can be derived from these data, however, is that there is, at best, a weak relationship between economic development and the level of taxation. Even the poorest countries, while obviously more constrained than rich countries, appear to have considerable discretion as to how much they raise in taxation.

2. Tax structure

The manner in which countries raise taxes differs as widely as do the amounts they raise. The pattern of taxes found in any country depends upon many factors such as its economic structure, its history, and the tax structures found in neighboring countries. Choice also plays a part, as different countries may also attach different importance to such commonly accepted characteristics of a good tax system as fairness, economic effects and collection costs. Nonetheless, it is again useful to consider briefly average patterns as one approach to tax policy in any one country.

For the sample as a whole, consumption taxes accounted for almost 40 percent of the total, and income taxes (including special taxes levied on extractive industries) were almost equally important. Within the consumption tax category, value-added taxes (VATs) account for about 40 percent of the total, with excises being almost equally important. Personal income taxes are a bit more important than corporate taxes (including the extraction taxes) within the income tax category. Most of the remaining tax revenues come from taxes on imports and exports.

A country’s revenue structure appears to depend to some extent upon its location and economic structure. In small island countries such as Barbados, for instance, international trade taxes may play an unusually important role. More generally, and not surprisingly, trade taxes tend on the whole to be more important in the lower-income group, where they account for 24 percent of tax revenues, compared to only 1 percent in the higher-income group. Trade taxes (mainly customs duties) appear to decline steadily

³ A simple regression of per capita taxes on per capita GDP has an elasticity of only 0.61, indicating that taxes grow more slowly than income, but a more appropriate quadratic regression on income shows that taxes tend to rise with income, but more slowly as income rises. Indeed, after per capita income reaches about USD35,000, the tax ratio actually declines. Linear regressions estimated separately for each income group yielded a significant coefficient on per capita GDP only for the low-income countries.

as countries become more developed.⁴ An interesting exception are the transitional countries which -- although many of them fall within the low-income group as defined here -- have traditionally relied little on trade taxes (Martinez-Vazquez and McNab, 2000). In general, however, trade taxes clearly decline in importance as income rises.

The higher the level of per capita income, the more a country relies on direct taxes, especially those on personal income. Similarly, although they rise more slowly, consumption taxes too become relatively more important in more developed countries.⁵ These differences in tax structure appear to reflect certain basic differences between low and high-income countries. Low-income countries tend to raise more revenues at the border, where relatively few collection points need to be controlled. For the same reason, they are more likely to rely more heavily on excise taxes on tobacco, alcohol and so on. In contrast, direct taxes (and VAT) tend to require both a more effective tax administration and taxpayers who are more sophisticated, conditions more likely to exist in developed countries.

3. Recent trends

Over the short time period covered in the data (only five or six years for most countries in the sample), tax burdens have increased only slightly on average, from 18.0 to 18.8 percent of GDP. Indeed, taxes actually went down a bit in Asia in this period. Taking a longer perspective, Tanzi (1987) reported for the late 1970s an average tax ratio of 17.8 percent of GDP for the 86 developing countries in his sample. The comparable ratio for the 75 countries for which overlapping data are available was 18.6 percent, again suggesting a slight increase over time in tax ratios.

One way to summarize revenue growth over time is in terms of “tax buoyancy,” that is, the percent change in tax revenue divided by the percent change in GDP.⁶ Since, as noted above, on average revenues have grown more quickly than GDP, the overall average buoyancy was 1.04. Moreover, buoyancies were roughly the same in all three income categories, although they tended to be lower in Africa, and especially Asia, than elsewhere.

The relative importance of different taxes has changed in recent years. The most striking feature has been the increase in the share of revenues generated by consumption taxes. One reason has been the continued move to the adoption of broad-based VATs, which rose from 34 to 40 percent of all consumption taxes even in the short period considered in our sample. About 70 percent of the world’s population lives in the 123 or more countries that now levy a VAT (Ebrill et al., 2001). On the other hand, there has also been some increase in the share of revenues raised from direct taxes, especially personal income taxes. In contrast, although the change is small, corporate taxes are

⁴ The coefficient in a regression of per capita GDP on international trade taxes as a share of GDP is negative and statistically significant.

⁵ The income elasticity of direct taxes is 0.80, for consumption taxes 0.61, and for trade taxes 0.09.

⁶ On the relation between “buoyancy” and “elasticity”, see the discussion at note 8 below.

relatively less important. Taxes on international trade have dropped dramatically, decreasing by 4.3 percent of total collections in this short period -- a decline approximately offset by the 4.1 percent rise in consumption taxes. The use of trade taxes has dropped even more over the longer term. In 1981, for example, trade taxes accounted for 30.6 percent of developing country revenues (Tanzi, 1987), compared to only 24.3 percent for the same countries in 1998.

4. Conclusion

This course focuses on developing countries, covering a wide variety of countries, with very different tax levels and structures. Some countries may lack effective governance structures. Such countries need to develop and implement effective and efficient tax systems if they are to be able to provide for the needs of their people and to participate effectively in the world economy. Another group of countries may have made substantial progress in meeting development goals. These countries may still face significant problems in tax policy due to globalization and other factors. Although even the less-developed countries may face fiscal challenges due to heavy dependence on trade taxes, those countries with a developing economy must also cope with potentially troublesome and important problems in the income tax area. While globalization and other factors may lead to further convergence of tax systems, the evidence to date suggests that the size and structure of taxation in most countries will continue to be dominated largely by domestic rather than global factors.

III. What Can Taxation Do?

This Part examines the role of taxes as well as some criteria that may be useful in designing tax regimes. The main purpose of taxation is to generate sufficient revenue to finance public sector activities in a non-inflationary way. In Part II, we showed that countries raise revenue in different ways. A country's choice on how to structure its tax system depends upon many factors, such as the level of development, the need and desire for increased public services, and the capacity to levy taxes effectively. Tax policy choices also depend on a country's preference as to such public policy goals as attaining a desired distribution of income and wealth and increasing the rate of national (and perhaps regional) economic growth.

No one likes taxes. People do not like to pay them. Governments do not like to impose them. But taxes are necessary both to finance desired public spending in a non-inflationary way and also to ensure that the burden of paying for such spending is fairly distributed. While necessary, taxes impose real costs on society. Good tax policy seeks to minimize those costs.

Tax policy is not just about economics. Tax policy also reflects political factors, including concerns about fairness. In many countries, increased economic growth has increased the disparity between the rich and the poor. Taxes influence the before-tax

distribution of income by changing economic incentives. They also influence the after-tax distribution of income through, for example, progressive income taxation.

Finally, regardless of what a particular country may *want* to do with its tax system, or what it *should* do with respect to taxation from one perspective or another, it is always constrained by what it *can* do. Tax policy choices are influenced by a country's economic structure and its administrative capacity. These factors reduce the tax policy options available to developing countries.

Efficiency, equity and administrative feasibility are key criteria in designing and evaluating tax systems. This Part provides an overview of the role of taxes in part by focusing on these criteria. The first section examines some considerations in using taxes to raise revenue to fund government operations. The second section reviews issues of economic efficiency and different costs of taxation. Next, fairness concerns are addressed. The fourth section reviews the interaction of tax administration and tax policy. The fifth section considers taxation and growth, and the sixth section touches on such issues related to decentralization. The final section examines the use of taxes for non-tax purposes.

1. Raise revenue

Tax systems exist primarily to raise revenue to fund government operations. Lack of sufficient revenue often results in large budget deficits. Except when short-term fiscal stimulus may be considered appropriate for macroeconomic reasons, deficits generally have undesirable macroeconomic consequences such as crowding out private investment and increasing inflation. Preventing deficits requires good control over both the expenditure and revenue sides of government. The legislated budget must be structured each year to operate strictly within estimates of likely revenue receipts. While this may seem obvious, even these initial conditions for good tax and budgetary policy are not satisfied in a number of countries.

Tax reforms should as a rule be undertaken to achieve long-term rather than short-term objectives.⁷ Tax systems should not normally be altered on a temporary basis to meet anticipated current year shortfalls. Frequent tax changes increase enforcement and compliance costs and may increase efficiency costs, especially where businesses make production and location decisions on the basis of a particular tax structure.

Unless tax revenues grow sufficiently quickly to finance desired services over the long term, governments must reduce expenditures, raise tax rates, or alter other structural characteristics of the system. Thus, a good tax system must generate sufficient revenue to fund projected government expenditures. Although countries differ in the projected

⁷ The immediate revenue effects of a tax policy change need not reflect its long-term effects, owing both to transitional aspects of the new structure and to the fact that taxpayers often change their behavior temporarily to take advantage of higher or lower tax burdens in the years before or after the changes.

rate of revenue growth primarily due to differences in projected demand for public services, usually revenue growth rate should be roughly equal to the overall economic growth rate, unless the country wants to increase (or reduce) the size of its government.

The rate at which revenues increase over time differs depending on the tax structure, the quality of tax administration, and the pace and nature of economic growth. The “income elasticity” of a tax system measures how fast revenues grow relative to the economy.⁸ Tax elasticity is defined as the percentage change in tax revenues divided by the percentage change in GDP (or potential tax base, such as personal income). Elasticity equal to one, for example, means that tax revenues will remain a constant share of GDP. Elasticity greater than one indicates that tax revenues grow more rapidly than income. In principle, revenues should grow at the same rate as desired expenditures (that is, the income-elasticity for revenues and expenditures should be the same). In practice, however, many developing and transitional countries have had great difficulty in achieving this target. This leads to frequent tax “reforms” aimed primarily at closing short-term revenue gaps. Tax policies enacted in such economically and politically difficult circumstances often fail to resolve the underlying basic problem of inadequate revenue elasticity.

The overall elasticity of any tax system is simply the average of the elasticity of individual taxes, weighted by the percentage of total taxes raised by the tax. The elasticity of a tax depends on the specific characteristics of its structure. The elasticity of personal income taxes generally reflects the progressivity of their rate structure and, most importantly, the level of the personal exemptions (or zero bracket) relative to average income levels. Consumption taxes are more elastic if they cover more rapidly growing goods and services rather than just more slowly growing traditional goods and if they are levied as a percentage of the price (like a VAT) rather than on the specific number of units purchased (as with many excises). Property tax revenue increases more rapidly when reappraisals occur on a regular basis and when property is fully valued.

Revenue growth generally slows during recessions and accelerates during expansions. Revenue elasticity also tends to rise in expansions and fall in recessions, thus exacerbating the volatility of revenue flows. The elasticity of the corporate income tax is particularly volatile because in a recession corporate profits fall much more precipitously than overall economic growth. Countries that depend heavily on taxation of natural resources such as oil or minerals are especially vulnerable to cyclical swings, with wide swings in commodity prices changing the level of tax revenues. Generally, a country that relies on a balanced set of tax instruments rather than a single revenue source will have lower tax revenue volatility, just as an individual investor can reduce the volatility of her investment portfolio by adopting a diversified investment strategy.

⁸ Tax “elasticity” refers to revenue growth in the absence of any tax policy changes, while tax “buoyancy” refers to growth including the effects of such changes. In principle, elasticity is a better measure of the growth potential of the tax structure. In practice, however, as in Part II, data limitations often force analysts to rely on buoyancy data.

2. Economic efficiency

Some may contend that economists overemphasize the costs of taxation and the importance of efficient resource allocation. Taxes do, however, impose real economic costs, and all countries should seek to minimize such “deadweight losses,” which reduce the resources available to achieve socially desired objectives. Countries with scarce resources need to adopt tax policies to help ensure that those resources are used as efficiently as possible.

Some confusion may exist as to what is meant by the “costs” of taxation. Some people may think of such costs solely in terms of the taxes collected. However, taxes are simply a means of transferring resources from private to public use and are not themselves a cost in economic terms. Economic costs are incurred only when the amount of resources available for society’s use, whether for public or private purposes, is reduced by taxes. There are several ways taxes can reduce the amount of economic resources.

The costs of taxation

First, taxes cost something to collect. Depending on the types of tax, the actual cost of collecting taxes in developed countries is roughly 1 percent of tax revenues. In developing countries, the costs of tax collection may be substantially higher.⁹

Another economic cost is the “compliance costs” that taxpayers incur in meeting their tax obligations, over and above the actual payment of tax. Tax administration and tax compliance interact in many ways. Often, administration costs are reduced when compliance costs are increased, e.g., when taxpayers are required to provide more information thus increasing compliance costs, but making tax administration easier and less costly. A tradeoff between administration and compliance costs does not always exist, however. Both compliance costs and administration costs may increase when, for instance, a more sophisticated tax administration requires more information from taxpayers, undertakes more audits, and so forth.

Third parties also incur compliance costs. For example, employers may withhold income taxes from employees, and banks may provide taxing authorities information or may collect and remit taxes to government. Compliance costs include the financial and time costs of complying with the tax law, such as acquiring the knowledge and information needed to do so, setting up required accounting systems, obtaining and transmitting the required data, and payments to professional advisors. Although the measurement of such costs is still in its infancy, there are a few studies that estimate compliance costs in developed countries (Sandford, 1995). These studies conclude that compliance costs are perhaps four to five times larger than the direct administrative costs incurred by governments. A recent careful study of compliance costs with respect to the personal income tax in India (Chattopay and Das Gupta, 2002) suggests that compliance

⁹ A recent study in Guatemala, for example, estimated them at 2.5 percent of collections (Mann, 2002).

costs may be as much or more than ten times higher than in developed countries. Compliance costs are generally quite regressively distributed, and are typically much higher with respect to taxes collected from smaller firms.

Finally, taxes may give rise to what economists call “deadweight” or “distortion” costs. Almost every tax may alter decisions made by businesses and individuals as the relative prices they confront are changed.¹⁰ The resulting changes in behavior likely reduce the efficiency with which resources are used and hence lower the output and potential well being of the country. No matter how well the government uses the resources acquired through taxation, governments need to limit the negative consequences of tax-induced changes in behavior.

Taxes on wages (personal income taxes, wage taxes, social security taxes, and so forth) reduce incentives to work. For example, the higher the tax rate on wages in the formal sector, the less attractive working in the formal sector becomes relative to working in the untaxed informal sector. Consumption taxes also discourage work. Taxes on spending increase the amount of time one must work to pay for goods and services through the marketplace. As taxes are not imposed on leisure, at the margin, taxes likely discourage (taxed) work.

Taxes not only alter relative prices (in this case, the net (after-tax) wage), but also income. As taxes reduce individuals’ after-tax wages, they may choose to work more to compensate for lost income. The net effect on work of any tax change reflects both this income effect and the effect of the change in relative prices (the substitution effect). Many studies have examined the impact of taxes on work, with results varying from country to country depending upon the structure of taxes, the nature of the workforce, and the nature of the economy.¹¹ In the present context, it is important to note that the substitution effect (the change in relative prices) will cause individuals to change their work decisions and, if those decisions had been economically efficient before the tax, to reduce the potential output of the nation.

¹⁰ There are a few exceptions. Lump-sum taxes, where the tax burden is the same regardless of any behavioral responses by taxpayers, are one example, much favored by theorists. More importantly in practice, to the extent that taxes fall on economic “rents” – payments to factors above those needed to induce them into the activity concerned -- they too may not affect economic activity. Well-designed taxes on natural resources and land, for example, may thus to some extent produce revenue without economic distortion. Finally, in certain instances, taxes – again, if properly designed – may not only create distortions in economic behavior but may even induce desirable behavior. Certain environmental levies, for example, or even crude proxies such as taxes on fuel, may to some extent have such effects. Such instances of “good” taxes – those with no bad economic effects – should of course be exploited as fully as possible, just as well-designed charges should to the extent possible, given public policy objectives, be used to finance certain public sector activities that specifically benefit identifiable individuals. In the end, however, most of the taxes needed to finance government will have to come from other sources and will hence give rise to the efficiency costs discussed in the text.

¹¹ For one such recent study, of Colombia, for example, see Alm and López-Castaño (2002).

Almost all taxes affect resource decisions. Consumption taxes, such as the value-added tax, may discourage the consumption of taxed as opposed to untaxed goods (e.g. housing in some countries). Taxes on gasoline, alcohol, and cigarettes can reduce the consumption of these items.¹² Income taxes, because they tax the return to savings, may alter the amount of savings or the form in which savings are held. For example, failure to tax capital gains until they are realized (when the asset is sold) encourages the holding of assets (a lock-in effect). Taxes may also affect investment, and such effects may be especially important when economies are more open to trade and investment. Foreign investors may choose to locate their activities in a particular country for many reasons, such as the relative costs of production, access to markets, and sound infrastructure. Taxes may also influence their choice of location. To the extent taxes lower the after-tax return on investments in a country or a region, the level of investment and hence growth may be lower than it would otherwise be. Corporate income taxes may also influence the composition of a firm's capital structure (use of debt or equity financing) or dividend policy. For example, retained earnings are encouraged when dividends are subject to tax at the shareholder level and debt is preferred over equity where interest on debt capital is deductible and dividends paid from equity capital are not.

Exactly how important such tax effects are is a matter of considerable debate among analysts,¹³ but the consensus is that they are much more important than was thought thirty or forty years ago. The efficiency costs of taxation are some multiple of the administrative and compliance costs mentioned above. The lowest estimates of the efficiency costs of taxes for developed countries are at least 20-30 percent of revenues collected, and much higher estimates are common in the literature. If these efficiency costs are the consequence of rational policy decisions (for example, to redistribute income through the fiscal system), they may be acceptable. Still, it is important to design taxes to minimize such possible adverse consequences, especially in poor countries. Although the efficiency losses are real, they are not directly visible. The efficiency cost of taxation arises because something does not happen: some activity did not occur or occurred in some other form. Output that is not produced, however, is still output, and potential welfare, lost.

A suggested approach

Good tax policy requires minimizing unnecessary costs of taxation. To minimize costs, experience suggests three general rules: First, tax bases should be as broad as possible. A broad-based consumption tax, for example, will still discourage work effort, but such a tax will minimize distortions in the consumption of goods if all or most goods and services are subject to tax.¹⁴ A few items, such as gasoline, tobacco products and

¹² As noted earlier, not all such effects need be bad: for instance, if tobacco consumption falls, people may live longer, healthier and more productive lives.

¹³ For a recent survey of the effects of taxes on saving, for example, see Bernheim (2002).

¹⁴ In theory, in order to minimize efficiency losses different tax rates should be imposed on each commodity, with higher rates imposed on those goods and services where the changes in behavior are the smallest. To do so, however, requires much more information about how taxes

alcohol, may be taxed at a relatively higher rate, either because of regulatory reasons or because the demand for these products is relatively unresponsive to taxation.¹⁵ The tax base for income tax should also be as broad as possible, treating all incomes, no matter from what source, as uniformly as possible.

Second, tax rates should be set as low as possible, given revenue needs to finance government operations. The reason is simply because the efficiency cost of taxes arises from their effect on relative prices, and the size of this effect is directly related to the tax rate. The distortionary effect of taxes generally increases proportionally to the square of the tax rate, so that doubling the rate of a tax implies a fourfold increase in its efficiency costs. From an efficiency perspective, it is better to raise revenue by imposing a single rate on a broad base rather than dividing that base into segments and imposing differential rates on each segment. In practice, the cost of differential treatment must be balanced against the equity argument for imposing graduated rate schedules.

Third, from an efficiency perspective, it is especially important that careful attention be given to taxes on production. Taxes on production affect the location of businesses, alter the ways in which production takes place, change the forms in which business is conducted, and so forth. Developing and transitional countries generally need to impose taxes on production for several reasons. First, countries with limited administrative capacity find it easier and less expensive to collect excise and sales taxes at the point of manufacture. Second, to the extent that taxes represent the costs of public services provided to businesses, the businesses should bear the cost, via taxation, for those services. Finally, countries need to tax corporate income to prevent tax avoidance by individuals who would avoid shareholder level taxes by retaining earnings within a corporation and to collect taxes from foreign-owned firms.

3. Fairness concerns

Fairness or equity is a key issue in designing a tax regime. From one perspective, taxes exist primarily to secure equity. National governments do not need taxes to secure funds because they can simply print the money required to fund operations. The tax system can be viewed as a mechanism to take money away from the private sector in as efficient, equitable, and administratively inexpensive way as possible.

What is fair?

What is considered equitable or fair by one person may differ from the conceptions held by others. Traditionally, tax scholars have defined fairness in terms of horizontal and vertical equity. Horizontal equity requires those in similar circumstances

alter behavior than is available in most countries. Moreover, this approach does not take administrative and equity concerns into account. For these reasons, in practice it seems generally advisable to impose a uniform tax rate to the extent possible.

¹⁵ Unfortunately, in many instances this implies that such taxes will be highly regressive with respect to income.

to pay the same amount of taxes. For apportioning tax liability, horizontal equity often embraces some notion of ability or capacity to pay. Vertical equity requires “appropriate” differences among taxpayers in different economic circumstances.

On the surface, both concepts have great intuitive appeal. Those who have the same ability to pay should bear the same tax liability. Similarly, it makes good sense for there to be appropriate differences for taxpayers in different situations. Unfortunately, both concepts may have limited usefulness in tax policy debates.

The concept of horizontal equity has been challenged as being incomplete, not helpful, and derivative. For example, an income tax can completely satisfy horizontal equity requirements only if we assume individuals have identical tastes and a single type of ability or income. Once we allow preferences to vary and provide for different types of ability or income, then only a tax based on an individual’s ability to earn income, rather than actual earnings, can effectively provide for equal taxation for those in equal positions. In addition, the concept of horizontal equity may be incomplete to the extent it focuses only on a short time period, such as one year, or fails to consider the impact of all taxes or ignores the provision of government services or other benefits. The concept of horizontal equity also may not be useful unless we can determine which differences are important and why these differences justify different tax treatment.

Similarly, much disagreement exists about the usefulness of the concept of vertical equity and about what constitutes appropriate differences in treatment. Consider several possible conceptions of fairness. To some, fairness could require that all individuals pay the same amount of tax. Thus, one could design a tax system that imposes a head tax on each individual over the age of 18 years old. Fairness could also require all taxpayers to pay the same rate of tax on their income. In some countries, the “flat tax” or “single rate tax” rhetoric enjoys great popularity. While most flat rate proposals provide for a high threshold (zero rate bracket) before the imposition of the flat rate, the notion of one tax rate that fits all strikes many as an equitable manner of determining tax liability. To others, however, fairness requires those taxpayers with higher income to pay a higher percentage of their income in tax. Although the progressive rate structure may rest on a shaky theoretical foundation, it has been the most common income tax rate structure. Many find a basic attraction to assessing tax on the basis of “ability to pay” with the result that the rich are better able to contribute to the financing the government operations.

Questions may also be raised about the relative fairness of consumption taxes versus income taxes. Consumption tax proponents question whether any income tax system can be fair. There are several, somewhat related, strands to their positions. One approach takes a societal view. Income is what individuals contribute to society; consumption is what they take away from the pot. Therefore, if we want a society that will continue to grow and prosper, we are better off taxing consumption rather than income. A second approach considers consumption as a better measure of a household’s ability to pay. Because of the greater variations in income over a person’s or household’s lifetime, it may be better to use consumption as the base for taxation rather than income.

Finally, income taxes impose higher taxes on households with higher savings. As such, the income tax system penalizes savers over those who consume currently.

Proponents of income tax claim that a person's net increase in economic wealth is a better measurement of ability to pay than the use of their income. That is, an income tax proponent would say the person who earns \$1 million and spends \$10 has a greater ability to pay than the person who earns \$10 and spends \$10. Under a consumption tax, both would bear the same tax burden while under an income tax, the first person would bear a much greater tax burden. Some consumption tax advocates concede the consumption tax alone would not be appropriate if it failed to tax a person's savings as well as consumption. It is argued, however, that the income tax is not an appropriate tool to tax savings. One alternative would be to use a consumption tax to tax spending and a wealth tax to tax savings.

As these brief comments suggest, discussions of fairness in general, or of horizontal and vertical equity in particular, are, by themselves, of limited usefulness. Simply saying we should accord equal treatment to equals adds little to tax policy discussions. We need to choose an ethical framework before making any comparisons—whether comparing equals or making “appropriate” comparisons among unequals. Without such a fundamental framework one cannot evaluate the relative fairness of different proposals or different tax regimes. Perhaps the best we can do normatively is to determine the consequences of a proposal or regime, and then evaluate them in the context of different ethical structures. In the end, only through its political institutions can any country really define and implement its view of what is an acceptably fair tax system.

A possible approach

Fairness may be approached in various ways. As discussed above, one may consider the relative tax burdens imposed on taxpayers who are in the same or in different economic circumstances. Alternatively, one may consider the overall effects of taxation on income and level of well-being. The policy implications of these two approaches may be quite different. The first approach focuses on the distributional consequences of a particular reform proposal to change a particular provision or series of provisions. Unfortunately, although proposals to reform taxes based on such analysis may indeed improve particular measures of horizontal and vertical equity within the limited group actually subject to the full legal burden of the tax in question, they may also have implications for others that may in some instance make the system as a whole less fair.

From the perspective of social and economic inequality, what matters in the end is the overall impact of the budgetary system on the distribution of wealth and income. Both expenditures and taxes should therefore be taken into account in considering how government policy affects the distribution of income, as well as the overall equity implications of any tax change.

Taxes affect equity in many and complex ways. They may treat people who are in essentially the same economic position differently (horizontal equity). Taxes may fall more heavily on those who consume alcohol than on those who consume housing, or on those who get their income in the form of wages rather than from farms or dividends. Taxes may also differ in their effects on income distribution (vertical equity). They may tax the rich relatively more (progressivity) or less (regressivity) than the poor.

Some countries may wish to favor cities, other countries may favor rural areas. Some may choose to favor rich savers in the name of growth, others the poor, in the name of redistribution. Like most policy instruments, tax policy can play many tunes. What is critical from an equity perspective is, first, to be aware of the equity implications of tax reforms for different groups, and, second, to ensure that the actual outcome of such reforms is consistent with the intended outcome.

Consider, for example, the case of a transitional country like the Russian Federation, in which the big “untaxed” sector is not traditional agriculture (as in many low-income countries) but rather the relatively large “shadow” economy. The existence of such a sector may have important implications for the effects of particular tax policy. For example, to the extent the VAT functions properly, it will to some extent serve essentially the same function as a presumptive tax on the informal sector (since credits are only available for firms that are registered as taxpayers and those earning income in the shadow sector are taxed when they purchase commodities through the formal sector). On the other hand, if many high-income recipients operate through the shadow economy, the effects on equity of increasing the progressivity of the personal income tax are not always obvious. Government employees and employees of large, formal market firms may be the primary personal income taxpayers and hence bear the brunt of such changes.

In such circumstances, it is not inconceivable that indirect taxes such as a VAT and especially certain excises in “higher-income” consumption goods such as motor vehicles may be more progressive than a personal income tax that in reality falls largely on a limited group of wage earners.¹⁶ In short, it is important in thinking about taxation and equity to focus not on preconceived notions about labels -- for example, that anything called a personal income tax is, by definition, progressive, while anything called a VAT is, by definition, regressive – but rather on the reality of how taxes work in practice.

Such arguments do not mean that corporate and personal income taxes do not serve an important role in developing and transitional countries. Such taxes are often the largest tax source for high-income countries, and the same may become true in other countries as their economies develop, more businesses and individuals become part of the

¹⁶ A tax is considered progressive when the tax burden as a percent of income is greater for higher income households than for lower income households, proportional if the percentage of income paid in taxes stays constant as income rises, and regressive if the percentage paid in taxes falls as income rises. A higher income taxpayer will normally bear a larger absolute tax liability than a lower income taxpayer, regardless of whether the tax is progressive, proportional or regressive, so the difference between the three concepts is how rapidly taxes rise with income, not whether taxes rise with income.

formal economy, and information and tax administration improves. Currently, however, particularly in the least developed countries, revenue systems rely heavily on consumption taxes and are likely to continue to do so for some years to come.

Taxes may not make the poor richer, but they can certainly make them poorer.¹⁷ Fiscal attempts at poverty alleviation in developing countries must therefore be undertaken primarily on the expenditure side of the budget. Nonetheless, the poor should not be made even poorer through taxes. It may therefore be desirable to exempt certain “basic needs” items from even the broadest-based consumption tax. Certainly, heavy taxes on items that constitute major consumption expenditures for poor people should generally be avoided.

Taxation is one of the few ways in which the wealthy may be made less wealthy, short of outright confiscation. But taxes have likely had only moderate success in reducing income inequality in developed countries and appear to have had even less success in reducing income inequality in developing countries. The major tax instruments for achieving progressivity are the individual income tax and various wealth taxes (such as taxes on real property, taxes on personal assets, and inheritance taxes). None of these taxes has been particularly effective in developing countries in reducing income inequality.

Although attempts to redistribute income through taxation have generally not been effective in most developing and transitional countries (Chu, Davoodi, and Gupta, 2000), it may often be politically necessary and desirable to tax those who gain the most from economic development, bearing in mind the need at the same time to minimize the efficiency costs of unduly high tax rates. Sustainable tax policy needs to be accepted as fair by those affected. Even in the poorest countries, automobiles and other luxury products are more visible than income, so that it should be feasible to collect progressive taxes on these items.¹⁸

Tax incidence

To determine the fairness of a tax regime, one must consider the economic incidence of taxation. It is important to distinguish between those who have the liability to pay a particular tax and those who suffer the economic incidence or burden of the tax. Tax burdens fall on individuals in their roles as consumers, producers and factor

¹⁷ Some developed countries, such as Canada and the United States, use their income tax systems to provide income support to certain low-income people. Using the tax system to make such transfers requires both that the tax administration is efficient and that most people file tax returns. Neither condition is satisfied in most developing countries.

¹⁸As Hughes (1987) notes, taxing fuel correctly can be especially difficult in countries like Indonesia in which petroleum products (in this case, kerosene) are an essential consumption item for the poorest people. Bosnia seeks to impose differential rates on fuel for home heating versus for other purposes (such as transportation), but this has proven to be very difficult to enforce and is subject to significant evasion.

suppliers, not on corporations or other institutions. For example, although the VAT law may require firms to pay VAT to the government, it is likely that the real economic incidence of the VAT falls on the ultimate consumer. Similarly, although motor fuel taxes are almost always collected high in the distribution chain (for example, at import or from major distributors), the cost of the tax is likely borne by consumers. In other instances, it is unclear who actually bears the economic costs of taxation. For example, the economic incidence of property taxes may be borne either by the owners of land and capital (who also bear the legal incidence) or by the users or renters of the property, depending upon market conditions.

Determining tax incidence requires a good understanding of how various markets operate in an economy, particularly the ability of different types of taxpayers to shift the cost of the tax to other economic actors. Who actually bears taxes depends on the relative supply and demand elasticities of consumers and suppliers and other factors. While economists have made important advances in estimating tax incidence, much work remains, particularly in determining tax incidence in developing countries.

For example, it is still not clear who bears the cost of the corporate income tax. As corporations are just legal constructs, the tax cost must fall on individuals. As a result of the corporate tax, shareholders (or all owners of capital) could receive lower returns, consumers could pay higher prices, or workers could receive lower wages, or some combination thereof. In addition, the tax consequences in the short-run could differ from long-run consequences. The incidence of a corporate income tax thus depends on such factors as the openness of the overall economy in terms of the inflows and outflows of capital investment, as well as on the extent to which capital moves between the corporate and unincorporated sectors, the relative capital-intensity of corporations, and the elasticity of demand for goods produced by corporations and other businesses. These factors are not easy to measure. As economic conditions vary among different countries, taxes that have the same legal incidence may have different economic incidence in different countries (Shah and Whalley, 1990).

Consider also the payroll tax. Economists generally assume the payroll tax is actually borne by workers in the long run, regardless of the actual division between employers and workers on the obligation to pay the tax. Again, the incidence depends on the elasticities of supply and demand. Because the supply of labor is relatively inelastic, most or the entire tax burden falls on workers. In some instances, the imposition of a payroll tax may have additional effects. The change in the after-tax wage will have both income and substitution effects on workers. It is possible that the labor supply curve could curve backwards such that the wage rate could fall by more than the amount of the tax. In this case, because of the additional supply response, the employers could actually benefit from the imposition of a tax on labor.

Chu, Davoodi, and Gupta (2000) find that for 36 studies of overall tax systems in 19 different developing countries, 13 studies found the tax system progressive, 7 studies found the tax system proportional, 7 studies found the tax system regressive, and the remainder of the studies had mixed findings or insignificant effects. For income tax

systems, 12 of the 14 studies were progressive, one study was regressive, and one had a mixed finding.

Two other considerations add to the difficulty of trying to determine the tax burden of both individuals and groups of individuals in different income classes. The first factor is the necessity to consider the tax incidence of a group of taxes. The more different types of taxes, the harder it is to untangle the tax incidence of a particular tax and the cumulative and interactive effects of the total group of taxes.

Second, a complete analysis of incidence requires consideration of all parts of government activities. In examining both some specific taxes and tax systems as a whole it is important to consider both taxes and benefits from government expenditure programs. For example, a complete analysis of the incidence of a social security tax requires estimates of the incidence of the tax and the retirement benefits provided under the retirement system. Similarly, it is useful to compare the tax incidence on individuals in different income classes with the benefits provided under such government expenditure programs as education, health and housing assistance.

In all countries, the tax system can effectively be split into two parts. One part of the tax system has relatively high tax compliance rates. A substantial portion of labor income may be subject to final or provisional withholding, many forms of income from capital may be subject to withholding or information reporting requirements, and many, but not all, medium and large corporations are subject to public reporting requirements and keep relatively accurate books and records. Taxpayers operate in the “formal” economy and the difference between estimated tax liability and actual tax payments is relatively small.

In contrast, the second part of the tax system has relatively low compliance rates. This part of the economy is comprised of many small enterprises operating, at least in part, in the “informal” economy. Here, tax evasion is quite high and efforts to bring this sector into compliance are difficult and expensive. The tax administration lacks the information and resources to tax effectively a large informal sector of the economy.

When governments require additional tax revenue, the common approach is to raise tax rates on the part of the tax system where compliance rates are high. This contributes to the actual and perceived unfairness of the tax system as reforms increase the tax burdens on taxpayers with high compliance rates.

The role of income taxes

Several reasons exist why developing countries are less capable of using the tax system to redistribute income. First, income and wealth taxes play a relatively small role in the tax structure of developing countries as compared to developed countries. In those Latin American countries for which data are available, for example, personal income taxes collect much less than 1 percent of GDP.

Second, the individual income tax in developing countries is often merely a wage withholding tax. In many countries, taxes on labor in the formal sector comprise over 90 percent of the total individual income tax revenue. In some countries, the tax law does not reach some forms of income from capital, such as capital gains. In other countries, the limitations of tax administrations may effectively exempt certain types of income from tax (for example, income from passive assets held outside the country). The limited ability of the individual income tax to tax effectively income from most forms of capital means that it is unlikely that the very rich bear significant tax liability.

Third, it may of course be politically difficult to impose effective income tax and wealth taxes in many countries. It may be acceptable to pass tax legislation that is in theory progressive but in practice does not impose significant tax liability on the upper classes. The appearance of progressivity may be necessary for the tax system to be politically acceptable even if the reality of effective progressivity is not, in the end, acceptable.

Taking all these factors into account, what can be said about the role of income taxes in developing and transitional countries? First, even if a country's sole objective is economic growth, a clear case exists for taxing corporate income, if only to collect a fair share of the revenue that multinational and large domestic businesses derive from economic activities in that country. It is of course true that by taxing corporations differently, and usually more heavily than other forms of business, governments tend to discourage, at least in principle, the operation of businesses in corporate form. Still, the fact that most major businesses all over the world operate in corporate form despite the prevalence of corporate income taxes suggests that the corporation remains in general the best available vehicle for mobilizing large amounts of capital for business purposes. Since corporations are the engine of development in all modern societies, a tax on corporations is in effect a tax on the modern, growing sector of the economy.¹⁹ Countries need to tax that sector both to secure the revenue they need to meet expanding expenditure demands and also to ensure that those who benefit most from development pay their fair share. But they must also ensure that corporate taxes are not so high as to discourage growth. In general, the best approach for developing or transitional countries is thus to impose a moderate, stable tax on all corporations.

Personal income taxes (as distinguished from general wage levies such as those imposed in many countries for social security purposes) serve to mitigate, at least to a moderate degree, the inequalities in income and wealth that almost invariably accompany growth. Care must, however, be taken not to complicate such taxes unduly, thus raising their costs to too high a level. Even if a country could change its individual income taxes and wealth taxes to make them more effective, it is not clear the benefits of increased

¹⁹ In many developing countries, the corporate sector may be quite small to begin with. Nonetheless, corporate taxes may have an importance beyond the revenue they yield. To the extent a corporate tax falls on foreign-based corporations, for example, it may both yield revenues that are paid in effect by foreigners and also provide a useful window to the way business is conducted in developed countries.

progressivity would be worth the economic costs. As discussed elsewhere, it is difficult to determine the effects of taxes on economic behavior. It is also likely that the consequences are quite different in developed versus developing countries. For example, taxes may play a lesser role in influencing decisions about work vs. leisure in developing countries, but a greater role in influencing decisions regarding operating in the formal vs. grey or black economy, or in saving at home vs. portfolio investment outside the country.

In principle, it is also desirable to expand the base of consumption tax to encompass more services in part to reduce regressivity. Unfortunately, it has often proved exceedingly difficult to include many services, especially those that may be consumed disproportionately by the rich, in the base of taxes such as the VAT, so that even the best-designed consumption taxes are unlikely to be very progressive, at least within the market sector of the economy.²⁰ Progressivity in the personal income tax may thus provide a useful offset to the likely regressive impact of the consumption taxes on which the revenue systems in most lower and middle-income countries depend. In such countries, for the most part personal income taxation should likely have a “threshold” – the level of income at which the tax begins to apply – well above average income levels. Moreover, to check tax avoidance, it would likely also be wise to keep the top marginal rate of the personal income tax fairly close to the rate of the corporate income tax.

Both corporate and personal income taxes may thus play an important role in developing and transitional countries. However, given the current economic context in many countries, the most important part of the tax regime in such countries is likely to be a broad-based value-added tax, probably supplemented by a few high-rate excise taxes on selected items.

In the end, the most effective way to reduce inequality in many countries seems likely to be through spending programs targeted at the poor. For example, expenditures aimed at improving primary education or primary health services may prove more effective at reducing inequality than trying to change the tax system to tax the rich. Under this approach, it may be better to use the tax system to raise as much revenue as possible without regard to distributional concerns and use expenditure programs to transfer resources.

4. Tax administration

The best tax policy in the world is worth little if it cannot be implemented effectively. Tax policy design must take into account the administrative dimension of taxation. What *can* be done may to a considerable extent determine what is done in any country.

²⁰ See the example cited in note 25 below. To the extent the poorest sectors of society remain largely outside the market economy, a VAT may, of course, nonetheless be broadly progressive in its incidence.

Tax design in developing countries is strongly influenced by economic structure.²¹ Many developing countries have a large traditional agricultural sector that is not easily taxed. Many transitional and developing countries have a significant informal (shadow) economy that also is largely outside the formal tax structure. The potentially reachable tax base thus constitutes a smaller portion of total economic activity than in developed countries. The size of the untaxed economy is in part a function of tax policy. For example, the high social insurance tax rates levied in transition countries such as Croatia create an incentive for a large informal economy by discouraging employers from treating many service providers as employees or encouraging the under-reporting of wage levels.²² The resulting lower tax revenues often lead governments to raise tax rates, further exacerbating incentives to evade taxes. Improving tax administration is thus central to the choice of tax structures and to improving taxation in developing and transitional countries.

The resources used in administering and complying with taxes (or, for that matter, evading them) are real economic costs, in terms of the ability of the economy to provide goods and services. Good tax policy requires keeping such costs as low as possible while also achieving revenue, growth, and distributional goals as effectively as possible. This is no small task. Three ingredients seem essential to effective tax administration: the political will to administer the tax system effectively, a clear strategy for achieving this goal and adequate resources for the task. It helps, of course, if the tax system is well designed, appropriate for the country in question, and relatively simple, but even the best designed tax system will not be properly implemented unless these three conditions are fulfilled. Most attention is often paid to the resource problem -- the need to have sufficient trained officials, adequate information technology and so on. However, without a sound implementation strategy, even adequate resources will not ensure success. And without sufficient political support, even the best strategy cannot be effectively implemented.

Unfortunately, but unsurprisingly, few countries at any income level have senior government officials who are eager to incur the economic and political costs of major tax policy and tax administrative reforms. Frequently, international agencies require such tax reforms as a condition for loans. Countries, desperate for revenues, launch frantic efforts to raise revenue without hurting politically powerful interests or without providing the time, resources and consistent long-term political support needed for effective tax administration. This reluctance to collect taxes efficiently and effectively without fear or favor is understandable in those countries with a fragile political foundation. But no magic way exists to obtain a viable long-term tax system without major changes in tax administration and often in tax policy also.

²¹ A century ago, for example, the now developed countries also relied heavily on excises and trade taxes, in part reflecting the nature of their economies at that time.

²² A number of agencies in addition to the tax administration, such as social security administration and the customs administration and in some countries the financial police (for example, in the countries of the former Yugoslavia), are often involved in revenue administration..

If the political will exists, the blueprint for effective tax administration is relatively straightforward. The tax administration must be given an appropriate institutional form, which may mean a separate revenue authority. It must be adequately staffed with trained officials. It should be properly organized, which generally means an organizational structure based on a function rather than on a tax-by-tax basis.²³ Computerization and appropriate use of modern information technology is important, but technology alone is not sufficient and these improvements must be carefully integrated into the tax administration. New computer systems have often developed parallel to the existing structure (in the Philippines, for example), but little can be gained from a system that does not recognize the skills and needs of tax officials.

Effective tax administration requires qualified tax officials. Tax authorities must provide for training and retraining staff as needed. The tax authorities need to collect the information needed for effective administration from taxpayers, relevant third parties, and other government agencies. The information must be stored in an accessible and useful fashion; and, most importantly, it must then be used to ensure that those who should be on the tax rolls, are, that those who should file returns, do, that those who should pay on time, do, and that those who do not comply are identified, prosecuted and punished as appropriate. All this is easy to say and hard to do -- but it is not an impossible task. Countries such as Singapore are models of what can and should be done, and such models should be studied closely and, once adapted as necessary, implemented.

The first task of any tax administration is to facilitate compliance. This requires making sure that those who should be in the system are in the system and that they comply with the rules.

First, taxpayers must be found. If taxpayers are required to register, the registration process should be as easy as possible. Systems must be in place to identify those who do not register voluntarily. Tax authorities should adopt an appropriate unique taxpayer identification system to facilitate compliance and enforcement.

Second, tax authorities need a process for determining tax liabilities. This may be done administratively (as with most property taxes) or by some self-assessment procedure (as with most income taxes and VATs).²⁴

²³ Alternatively, organization by client groups may sometimes be sensible. But what is never sensible is to assign specific taxpayers to specific officials for prolonged periods of time, a practice still common in some countries.

²⁴ Globalization confronts tax administrations with some special problems. For example, tax administrations must ensure that revenues and expenses are properly calculated in determining taxable profits for the corporate income tax, and that export credits and refunds are properly handled under the VAT. A number of countries (e.g. Ukraine) have failed to provide the timely rebates provided by the VAT legislation for exported goods. Taxpayers cannot be expected to respect tax laws when the government does not.

Third, the taxes due must be collected. In many countries, this is best done through the banking system. It is seldom appropriate for tax administration officials to handle money directly.

Finally, tax authorities should provide adequate taxpayer service in the form of information, pamphlets, forms, advice agencies, payment facilities, telephone and electronic filing, and so on, to make taxpayer compliance with the system as easy as possible.

This approach rests on treating the taxpayer as a client (albeit not a willing one) to be served and not a thief to be caught. Unfortunately, the latter attitude seems to prevail in many developing countries.

Of course, some taxpayers are not honest, so the second important task of any tax administration is to reduce tax evasion. Tax authorities require estimates of the extent and nature of the potential tax base, for example, by estimating what is sometimes called the “tax gap.” Some estimate of the number and type of individuals and firms not registered with tax authorities is needed to devise strategies to bring them into the tax system. In some countries the major tax problem may be that many taxpayers who are in the system are substantially under-reporting their tax base. Without some knowledge of the unreported base, and its determinants, no administration can properly allocate its resources to improve tax collection and to ensure all parts of society bear their fair share of the tax burden.

In addition to exploring the nature of the tax gap and undertaking the often difficult tasks involved in extending the reach of the tax system into the informal economy to the extent feasible, close attention must also be paid to the simple task of ensuring that those who are in the system file on time and pay the amounts due. Immediate follow-up of non-filers and those whose payments do not match their liabilities is a too often neglected aspect of good tax administration. Adequate interest charges must be imposed on late payments to ensure that non-payment of taxes does not become a cheap source of finance. Similarly, an adequate penalty structure is needed to ensure that those who should register do so, that those who should file do so, and that those who under-report their tax bases are sufficiently penalized to increase the costs of evading tax.

Enforcing a tax system is neither an easy nor a static task in any country. It is especially difficult in the changing conditions of developing countries. Unless this task is tackled with seriousness and consistency, however, even the best designed tax system will fail to produce good results.

A third major task is keeping the tax administration honest. No government can expect taxpayers to comply willingly if taxpayers believe the tax structure is unfair or that the revenue collected is not effectively used. But even a sound tax structure and sound expenditure policy can be vitiated by a capricious and corrupt tax administration. Developed countries took centuries to develop and implement sound tax administration practices aimed at preventing dishonest tax officials from succumbing to obvious

temptations (and even then, not without regular embarrassing lapses). Unfortunately, most developing countries are trying to maintain large government operations on a precarious fiscal foundation without substantial time to solve the corruption problem.

Tax officials must be adequately compensated, so that they do not need to steal to live. They should be professionally trained, promoted on the basis of merit, and judged by their adherence to the strictest standards of legality and morality. Tax officials should have relatively little direct contact with taxpayers and even less discretion in deciding how to treat them.

The failure to develop good tax administration and good tax policy together has been a particular problem in some transitional countries. In Russia, for example, serious problems existed with both the structure of the VAT and the lack of administrative experience and capacity. A simple example is that under the initial VAT legislation, no tax liability was due when loans were made from one business to another. Thus, a buyer would claim to have made a loan that was never repaid (and was in fact payment for goods) to a supplier and no tax was due. The result was a significant loss of revenue. A more capable administration would have foiled this simple evasion technique, but better legislation was also needed.

Even if policies are good, the way in which they are administered can yield very different outcomes than those intended. Administration that is seen as unfair and capricious may bring the tax system as a whole into disrepute. The initial failure of transitional countries to develop their tax administrations when introducing new tax structures resulted in very uneven tax imposition, lower than anticipated revenue, and widespread tax evasion. Similarly, in some developing countries, corporate tax liabilities are often negotiated rather than calculated as set out in the law. Bribery is sometimes so common that it is considered a regular part of the compensation of tax officials. Such corruption undermines confidence in the tax system, negatively affects willingness to pay taxes, and reduces a country's capacity to finance government expenditures.

Finally, some have argued that improved tax administration alone can generate the revenues required to balance the budget or to finance tax policy changes that will narrow the tax base through concessions or lower tax rates. Although better tax administration will generally enhance tax collection, increased revenue may not be the only goal of improved administration, which is needed also to improve fairness, for example. Moreover, since improving administration takes time, any additional revenues may only accrue over a number of years. Cutting tax rates or granting additional concessions in the hope that improved administration will quickly make up any revenue losses is never a good idea.

5. Taxation and growth

Much has been written about the effects of taxation on growth and equity. However, even in developed countries with stable, long-established tax systems and

excellent data, there is still much we do not understand about this complex subject. Our understanding of the relationship of tax on growth in developing countries is even less complete. Consider, for example, the trade-off between growth and equity. Most societies want to be richer. Most also want the increased wealth to be distributed fairly. Are these objectives compatible? Despite much theoretical and empirical inquiry as well as political and policy controversy, no simple answer exists.

Some contend that because growth never occurs across economic sectors evenly, it is inevitable that increased inequality will result. Others contend that societies in which resources are distributed more equally will do better in the long term. Still others suggest that, whatever the answer may be, countries can devise policy measures that are fully compatible with achieving both more growth *and* more equity. While the answer likely depends on a country's specific circumstances, the current situation in many developing countries offers -- at least in principle -- so many opportunities for improvement that some countries may be able to have their fiscal cake (growth) and eat it too (redistribution).

Over the past 50 years, there have been many policy prescriptions for economic growth (Easterly 2002). Policy advisors have, in rough chronological order, called in turn for increased capital investment, improvements in education, population control, reduction of government controls on market activities, and loan forgiveness programs as "silver bullets" that would result in improved economic performance in developing countries. Unfortunately, none of these cures worked as advertised.

Similarly, there is no magic tax strategy to encourage economic growth. Some countries with high tax burdens have high growth rates and some countries with low tax burdens have low growth rates. Looking at the relationship between growth rates and tax rates in the United States over the last 50 years reveals that the U.S. has had its greatest periods of economic growth during those years where the tax rates were the highest (Slemrod and Bakija 1996). Of course, this does not mean that high tax rates are the key to economic growth. It may be that growth rates in the U.S. might have been even higher in those years with high tax rates if the rates had been lower. The point is that the relationship between taxes and growth is complex. Just looking at the nominal tax rates provides little information as to the real effective tax rates on different individuals and different activities, the level of government infrastructure and services that are "purchased" with those tax dollars, and other government policies that may help or hinder economic activity.

Tax incentives

Many countries have sought to improve their economy by introducing a variety of tax incentives for investment, for savings, for exports, for employment, for regional development, and so on (Shah, 1995). Often, such incentives are redundant and ineffective, giving up revenue and complicating the fiscal system without achieving their stated objectives. Even to the extent that incentives may be effective in inducing investors to behave differently than they would have done in response to market signals,

the result is often distorting and inefficient, diverting scarce resources into less than optimal uses. Essentially, tax incentives improve economic performance only if government officials are better able to decide the best types and means of production than are private investors. Tax incentives also result in very uneven tax burdens, with domestic companies often subject to full taxation (at least in theory), while other firms, often foreign investors, benefit from tax incentives that reduce their effective tax rates.

Despite such strictures, many developing and transitional countries continue to introduce and extend a variety of special tax incentives, partly in competition with one another for increased foreign direct investment. Experience suggests, however, that non-tax factors, such as a sound macroeconomic policy, good infrastructure and a stable governance system are more important factors in locational decision than tax benefits. Although a limited role for certain simple incentives may exist as part of a growth-oriented fiscal policy, as some East Asian experience suggests, tax incentives cannot compensate for the absence of such critical factors. Should a country decide to introduce a few limited incentives, these tax incentives should be well-designed, properly implemented, and periodically evaluated if they are to do more good than harm.

It is important to understand how particular tax instruments work in particular environments. Some taxes that appear to be anti-growth and pro-redistribution (such as personal income taxes with highly progressive nominal rate structures) may, at times, have neither of these characteristics, while other taxes, such as the VAT, may seem regressive compared to other tax alternatives, but actually may be mildly progressive (at least between lower and middle income groups). As noted earlier, however, one cannot judge the effects of a tax by its name, but only by close examination of the details of its design, implementation and economic consequences.

A “pro-growth” (and nothing else!) tax system

Consider a country that was concerned *only* with economic growth and therefore wishes to design a “pro-growth” tax system. What might such a system look like? Several characteristics come to mind.

First, there would be little or no taxation of profits, to avoid discouraging entrepreneurship and risk-taking. Taxing profits reduces the return from entrepreneurship and risk-taking. Consequently, under a pro-growth tax system, no good case exists for taxing normal profits.²⁵ Most countries, however, do tax profits, and properly so – for example, to prevent people from placing assets in a corporation to avoid personal income taxes and to obtain a share for the host country of profits earned by foreign investors. Nonetheless, high taxes on profits are unlikely to form part of a growth-oriented tax strategy. Instead, at most a reasonably low and stable broad-based profits tax seems called for.

²⁵ On the other hand, there is an excellent case for taxing so-called supra-normal profits (economic rent) as heavily as possible. Unfortunately, it is not easy in practice to tell “normal” from an “excess” profit.

A purely growth-oriented tax strategy would also likely tax consumption more than income. The difference between consumption and income is saving, and from a strict growth perspective, more saving is better than less. So if domestic savings are essential to financing domestic investment, there is a “growth” argument for taxing income from savings more lightly.

Even in the most growth-oriented tax system, however, taxes should be kept as low as possible on the poorest people simply because they must consume to be productive. Just as some so-called “investment” (for example, in luxury homes or elaborate office buildings) may not be conducive to productivity, so some “consumption” is productive. If people lack food to eat or lack basic clothing and shelter, or if they are not healthy and sufficiently educated to engage in meaningful work, they are unlikely to be economically productive. Equity (in the sense of not taxing the poor) and growth (in the sense of enhancing the productivity of the labor force) are thus quite compatible objectives. A “good” VAT in such a system, for example, might exempt certain specific items that constituted a significant fraction of the consumption of poor people.²⁶

Finally, a growth-oriented tax system in developing countries may seek to increase the cost of operating in the non-monetized traditional sector (through tax or other measures) to encourage movement into the monetary (modern) sector. Imposing higher taxes on traditional agriculture may be difficult politically and administratively, and it may not necessarily be equitable, but it is likely conducive to growth by shifting resources away from the traditional agriculture sector. Taxation of the modern sector through levies such as VAT and income taxes thus often needs to be supplemented by taxes on agricultural land and (especially with respect to the “informal” or “shadow” sector of the economy) presumptive taxes.²⁷

²⁶ In the case of Jamaica, for example, one study found that exempting only five narrowly-defined items would cut the VAT burden on the lowest 40 percent of the income distribution in half (Bird and Miller, 1989). Of course, since all such exemptions both complicate administration and are almost inevitably poorly targeted (in the sense that much of the benefit goes to the non-poor) they should be kept to a minimum.

²⁷ Presumptive taxes are taxes that “presume” a certain taxable capacity based on objective (measurable, visible) indicators of production or consumption such as land, electricity used, employees, machines, vehicles, and so on. Such taxes, in many different forms, have a long history in many countries. They seldom produce much revenue and often suffer from many defects of design and administration. Nonetheless, despite such problems, presumptive taxes may in principle play two vitally important roles in developing countries. First, such taxes are often the only levies effectively imposed on the often large non-modern (or at least “non-official”) sector of the economy. Secondly, presumptive taxes can sometimes serve as a backstop for “normal” taxes in the formal sector. For example, Mexico imposes a minimum tax on the gross assets of a business: if the profits reported for tax purposes exceed a certain minimum rate of return on the assets, the profits tax is applied as usual, but if the reported rate of profits is below the minimal return, the business is instead subject to a tax based on assets.

In short, a purely growth-oriented tax system would seem to be one that has a relatively low and stable tax on profits and some taxation of the traditional agricultural and informal sectors, but with major fiscal reliance being placed on a broad-based consumption tax that makes some allowance for exemptions of necessary consumption. What is conspicuously missing in this picture, of course, is any explicit mention of a personal income tax or any concern for fairness in taxation. As noted in section 3 above, and reiterated in Part IV, however, one simply cannot leave this issue out of account in designing and implementing a tax system.

6. Taxation and Decentralization

Reforming tax structures is generally difficult in any country. Reforming tax administrations is often even more difficult, and certainly takes longer. Even countries that succeed in reforming tax structures and administrations may still fail to reap the expected benefits unless they pay close attention to the often troubling problems arising from the finance of state and local governments. Such problems are by no means restricted to the relatively few (though important) federal countries such as Brazil, India, and Nigeria. Rather, they are arising with increasing frequency around the world in countries as diverse as China, Colombia, and Uganda.

One reason for the increased importance of intergovernmental fiscal relations is simply because decentralization is increasingly important in many countries, not least in fiscal terms (Litvack, Ahmad, and Bird, 1998). Decentralization is occurring in many countries around the world, with the expected benefits varying to some extent. Some countries anticipate that better service delivery will result because the diverse demands and needs of the population can be served more effectively by local officials who have better information on what people want. Local officials often can be held more accountable than national officials, and particularly by the local population who have better access to the mayor than to members of parliament. This allows improved local voice in deciding the level and quality of services and in demanding improvements where they are needed. Decentralization may be seen as a means of accommodating the varying interests of different ethnic groups by reducing the potential number of points of friction. This has the potential to allow nation building. There may also be diseconomies of delivering some services at the national or even regional level, which means that local service delivery can be less expensive. The capacity to generate sufficient revenues is often a disadvantage of decentralization. The difficulties of taxing economic activity that can flee or be easily hidden is one of the reasons for problems in collecting tax revenues at the local level. While there are (as usual) considerable variations from country to country, in many developing and transitional countries, it is becoming increasingly important to ensure that local and regional governments, like national governments, have an adequate resource base. Unfortunately, this again is an area in which practice falls far short of what is needed, particularly when countries are really attempting to devolve significant public sector responsibilities to sub-national levels of government.

There is no single definition of decentralization of tax revenues. The extent of decentralization can be summarized in terms of the degree of local (or regional) control

over four factors: ownership of tax revenue, choice of tax base, choice of tax rate, and tax administration. Revenue ownership is required if tax revenues are to be seen as decentralized, but ownership is normally not sufficient to view taxes as decentralized. The revenues are best seen as a grant if local governments only have revenue ownership, since the rate, base and administration are at the national level. In this case local governments cannot control the amount of revenues raised or the means through which the revenues are raised. Many of the local revenues in Middle Eastern countries like Egypt are best thought of as part of a grant system rather than as local taxes. Transfers from higher-level governments may in many instances be sensible both to close the gap between what reasonable tax rates can raise from a region's tax base and to further national interests in the provision of services with interjurisdictional spillovers. But grants should normally provide only part of local revenue because governments are normally more accountable for revenues that they raise directly and because taxpayers are better able to link the receipt of public services and the payment of the taxes if both are housed within a single government.

From the perspective of economic and political accountability, the most essential element of fiscal decentralization is that local or regional governments are allowed to determine the rates of taxes for which they are politically responsible, and that these taxes are sufficiently important in terms of the revenues generated to ensure that the setting of rates can affect expenditures in some noticeable ways. Control over the tax rate gives local officials the ability to influence the level of services provided (which is necessary if governments are to be devolved) and makes them more accountable to local citizens who are better able to see the extent of revenues going to the local governments. Thus, it is important that some taxes, and hopefully representing a significant amount of revenue, be decentralized to every devolved local government. But, decentralization of taxes does not necessarily require that local governments must finance all their expenditures, and a large role for grants and intergovernmental transfers will exist in most developing and transition countries.

Local control over tax bases is inappropriate in many cases because administration and compliance costs can often be reduced if the same tax bases exist across the country. A constant base means that businesses operating across the country are not subjected to multiple tax structures. There are also lower administration costs if the taxes are administered at the national level. However, the political incentive exists for higher-level governments to give away the tax base of a lower government (for which the higher government gets no revenue), as has occurred in Bosnia and Herzegovina, because the higher government receives all of the political benefits from the tax incentives without confronting the lost revenues. The perverse incentives are a disadvantage of local officials not having control over their base. An in-between ground can be found by having national control over tax bases, but with significant local input (even to the point of requiring local agreement for any changes), as exists to varying degrees in Canada, Australia, and Papua New Guinea.

Local control over the tax administration is often not necessary because in many instances national collection of local and regional taxes may be more efficient than

establishing numerous small and likely inefficient local collection agencies. There can be economies of scale in a single administration. Companies operating across the country are better controlled by a national administration. Also, a national tax administration allows for the ability to move revenue agents from time to time in order to limit the likelihood of fraud. Again, the potential problem is that national tax administrations may do a poor job of collecting local taxes. The national tax administration does not have the same incentives to collect local taxes and to respond to local officials as it does to the Parliament and the Prime Minister. The result can be that the administration puts very little effort into ensuring that local taxes are collected well. Good incentives for effective collection of local taxes must be established if the national administration is to collect local taxes. A regional tax administration may be able to collect some local taxes as well, given the same caveats.

While the design of a good sub-national tax system is even more country-specific than the design of a good tax administration, like the latter this task lends itself to some generalizations. First, at the local level, in almost all countries more use can and should be made both of user charges and especially of a simple property tax. User fees should be imposed wherever possible to finance services. They can normally be effectively imposed when the recipients of services are easily identifiable and receipt of the service can be separately identified for individuals or households. Obvious examples include utility services, which should be fully priced, and any subsidies desired for equity reasons made explicit as public expenditures. Services such as utilities should be considered for privatization as well. Local property taxes should also provide a significant revenue source. Central or regional governments may play an important role in setting up a standard tax law and in undertaking the technical tasks of valuing property and training staff, but collection and enforcement of property taxes should likely be at the local level making this an example of a tax that is best administered at the local level. In all cases, the determination of the tax rate should definitely be at the local level, albeit within some specified range that could be established by either the national or regional government. Maximum rates are particularly important for non-residential property, to curb “tax exporting” and similar ways of breaking the essential connection between those who make the policy decision with respect to rates and those who benefit from the expenditure of the revenues collected. The property tax, like user fees, can often be a good benefit tax, but only if local incentives to impose taxes on some captive industries are limited. Minimum rates may also be useful to limit the degree of tax competition that can arise between local or regional governments. Few developing or transitional countries currently give local governments sufficient discretion – or responsibility – with respect to property taxes.

Secondly, if regional governments are expected to play an important role in providing nationally critical services such as education and health, they will usually need access to some more important tax base such as a payroll tax or a personal income tax (which in practice in most countries is little more than a payroll tax). The most efficient way to impose such regional taxes is usually as a “surcharge” on existing national taxes, with the regional taxes being collected together with the national tax – but being clearly shown to taxpayers as separate – and remitted to the appropriate regional government.

Such a system superficially may appear similar to the widespread system of “revenue-sharing” or “tax sharing” found in almost all transitional countries (such as Hungary and Croatia) and in a number of developing countries as well, but it is conceptually and practically totally different. The usual “tax sharing” system is no more than a disguised intergovernmental transfer with the recipient governments bearing no responsibility at all for the tax rate or the amount they receive. Tax sharing is often the antithesis of sound decentralization policy and is conducive to irresponsible spending by sub-national governments (Bird and Smart, 2002).

7. Using the tax system for non-tax objectives.

The tax system can be used to encourage or discourage certain activities. For example, taxes can be used to correct market failures, such as positive or negative externalities. Externalities exist when market prices fail to reflect all the benefits or costs associated with an activity. The classic negative externality is pollution. Firms that pollute affect the welfare of others, often in a way that is outside the market mechanism.

The presence of externalities could prompt different types of government action. The government could regulate the activity by providing rules of conduct and penalties for failure to comply. It could establish clear property rights, such that all affected parties would be brought together and bargain in a manner that could result in the parties accounting for the costs and benefits of their activities. Another alternative would be to use the tax system as a tool to correct for externalities. A tax on pollution may correct for market failure by requiring polluting firms to bear the cost of pollution. In addition, excise taxes on tobacco, alcohol, and gasoline for motor vehicles may seek to reduce the use of these products by imposing additional costs that reflect some or all of the negative externalities generated by these products.

Even apart from market failures, policymakers could use the tax system to encourage or discourage certain activities. Countries use tax provisions to encourage larger families, retirement savings, capital investment, home ownership, and a host of other activities that may or may not have elements of market failures.

Policymakers can often choose between subsidizing the activity directly through grants and other programs or indirectly through the tax system. Many countries use a “tax expenditure” budget to account for the costs of tax provisions that are used to promote non-tax objectives. Requiring estimates of the costs in terms of foregone revenue helps improve the accountability of legislatures from granting tax benefits.

IV. Conclusion -- The Political Economy of Taxation

This module has covered a very wide range of issues, for the most part at a rather general level of discussion. A truly “practical” examination of how to design and implement any specific tax change in any particular developing country would of course

require a much more detailed and specific examination of many complex issues.²⁸ Such was not possible in the brief time available. Instead, we have attempted to survey a broad range of relevant issues related to tax policy design in developing countries in general. Subsequent modules will develop many of the points raised in more detail.

In the economic and administrative perspectives emphasized in this module, developing countries face a very difficult task in designing and implementing suitable tax systems. Many such countries have large traditional agriculture sectors. Other significant components of the potential tax base are often in other equally “hard-to-tax” sectors such as small business and the informal or shadow economy. Such countries in practice have often relied heavily on taxes on international trade, but this tax base too is becoming increasingly hard to tax in the face of pressures for trade liberalization. As countries develop, the mass modern production and consumption activities on which the tax systems of developed countries rest -- taxes on wages and personal income, on corporate profits, on value-added -- expand and need to be brought into the tax base without overstraining administrative capacity or unduly discouraging the expansion of such activities. Economic growth is often encouraged by, and results in, closer involvement with the international economy, but such “globalization” simultaneously may cause fiscal problems. The “leading edge” of growth may become the “bleeding edge” of the fiscal system as it becomes difficult to levy taxes effectively on capital income, thus potentially exacerbating internal inequalities. Life is not easy for tax people in developing countries, and is not becoming any easier.

All these problems are potentially greatly exacerbated by the political economy context within which taxation must be designed and implemented. While detailed exploration of this subject is not only beyond the scope of this course but, as yet, not very well understood, it may be useful to conclude this introductory overview of the issues by simply noting some salient considerations that emerge from exploration of taxation as not just an economic but very much a political phenomenon. Tax policy decisions are not made in a vacuum. Nor are they made, as is often assumed in economic discussion, by a “benevolent” government. Rather, they reflect a set of complex social and political interactions between different groups in society in a context established by history and state administrative capacity.

Taxation is not simply a means of financing government but one of the most visible parts of the social contract underlying the state. Why do citizens comply with tax laws, at least to some extent? One key reason is because they accept the state as legitimate and credible and are thus both, to some extent, willing to support it and, to some extent, afraid of what will happen to them if they don’t. Unless states are accepted as legitimate in this sense, they will not be capable of securing sufficient resources to govern or to develop. In this context, the success of tax reform clearly depends upon the way in which different political groups perceive the reform and how they react to their

²⁸ To get the flavor of such an exercise, consider two recent (useful) tools prepared for the World Bank -- the “diagnostic” for tax administration reform (available at worldbank.org/publicsector/tax/Toolkit.doc) and the “design tool” for tobacco taxes (available at worldbank.org/tobacco/pd/4%20tobaccoTaxes%20.doc).

perception. To an important extent, then, tax reform is “an exercise in political legitimation” (Lledo, Schneider, and Moore, 2003). Those who will have to pay more must be convinced that they will, so to speak, get something worthwhile for their money. Those who will not pay more must also get behind a reform if it is to succeed. The bureaucracy, those who will have to implement the reform, must also support it, or at least not actively oppose it.

Some see the inevitable political processes underlying reform as “statist” in the sense that the state can be viewed as an institution in its own right that seeks to maintain and increase its capacity, including its capacity to collect taxes. Others see acceptance of increased tax burdens as inextricably entwined with the expansion of a more democratic polity and a more inclusive society. For citizens to pay more, they must get more of what they want and the public finances must be both transparent and accountable. Earmarking revenues to favored objectives, for example, a practice usually disliked by budgetary and public finance experts, may prove an essential ingredient of a successful tax reform from this perspective.

Whether one views tax policy from the traditional public economics, macro, and administrative perspectives discussed in Part III or the more explicitly political perspectives touched on here, however, one conclusion is inescapable: taxation is from any perspective complex and difficult, but it is important to get it as right as we can. Finally, as if this were not hard enough, tax life is getting even more complicated owing to “globalization.”

Taxation and globalization

Countries no longer have the luxury to design their tax systems in isolation. Commentators use the term “globalization” to mean anything from an increase in mobility of business inputs, primarily capital, across regions, to changes in consumption and production patterns so that national borders have reduced significance. The result is a loss of tax sovereignty by individual countries.

With the dramatic reduction in trade barriers over the last decade, taxes have become a more important factor in location decisions. There is increased tax competition for portfolio investment, qualified labor, financial services, business headquarters, and, most importantly for developed countries, foreign direct investment. This means that taxes do matter, and a country with a tax system that differs substantially from other countries, particularly its neighboring countries, may suffer (benefit). In addition, with increased financial innovation, labels are losing their meanings. Lawyers and investment bankers can with relative ease convert equity to debt, business profits to royalties, leases to sales, and ordinary income to capital gains -- or the other way around.

Much of the traditional tax regime for taxing cross-border transactions rests on a stylized set of facts: (i) small flows of cross border investments; (ii) relatively small numbers of companies engaged in international operations; (iii) heavy reliance on fixed assets for production; (iv) relatively small amounts of cross-border portfolio investments

by individuals; and (v) minor concerns with international mobility of tax bases and international tax evasions. But all this has changed in recent years.

What do these changes mean for tax systems of developing countries? First, there is increased pressure to reduce trade taxes. WTO membership requires significant reductions in import and export taxes. This has different consequences in different parts of the world. Trade taxes in OECD countries account for about 2-3% of total tax revenue. In contrast, trade taxes in African countries often account for 25-30% of tax revenue. In addition, African countries have less capacity to make up lost revenue by increasing other taxes.

Second, there will be increased pressure on corporate income tax revenues -- again with different consequences in different regions. Corporate tax revenues are a larger portion of tax revenues for developing countries as compared to developed countries. In the last 10 years there has been a major change in business operations with the disaggregation of production resulting in different operations in different countries. There has also been an increase in value-added due to services and intangibles which makes it harder to locate the source of corporate income and thus harder for countries to tax corporate income. Also, increased intra-company trade makes it easier to avoid or evade taxes.

Third, there will be increased pressure on individual tax revenues. Increased mobility of capital makes it harder to tax income, especially as it becomes easier for individuals to earn income outside of their country of residence. It may also be harder to tax labor income, as labor becomes more mobile, as traditional employer-employee relationships evolve into independent contractor status, and as owner-managers convert labor income into capital income.

Finally, there will also be pressure on VAT revenues. Much has been written about the challenges posed by electronic commerce on both the income tax and VAT base. Improvements in technology allow increased sales without the seller having a physical presence in a country, as well as increased use of digitized products that make collecting taxes on such products more difficult.

In these and other ways, the eternal problems of designing and implementing a good tax system continue to be complicated by the changing world within which such decisions must be made.

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