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Taxation and Development

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For more than half a century, scholars and international agencies have been making recommendations about taxation in developing countries. The advice economists have offered to developing countries has changed over time, particularly regarding income and consumption taxes. Why? What do we know now about taxes and developing countries that we did not know 50 years ago? What do we still not know that we really should know? What should scholars and international agencies do if they wish to make tax policy recommendations that are economically sensible and likely to prove feasible, acceptable, and helpful in practice? This brief note offers some tentative answers to these complex questions.

The Changing Consensus

What did we say in the 1960s and 1970s? The advice was usually to tax more and tax better, with "better" often being defined as coming closer to a *comprehensive income tax*.[1] Taxes on trade and on domestic consumption were seen simply as necessary evils to generate the needed revenues. In most cases, neither international nor subnational issues were taken into account when determining appropriate tax policy.

In contrast, although the basic message currently is often the same as it was in those earlier years—more and better—both "more" and "better" now usually mean the value added tax (VAT). Comprehensive income taxation is no longer an ideal. To a considerable extent, both substantial tax progressivity and, in particular, income taxes on capital are considered (1) undesirable on economic grounds (such as efficiency and competitiveness) and (2) usually unattainable in practice (for example, because of political and administrative constraints). Capital taxation is particularly out of favor as a result of such international concerns as competition for direct foreign investment. Moreover, as discussed in *PREM Note* 157, subnational tax issues also are of concern in many countries.

One reason that the policy advice changed is the optimal taxation approach developed in the 1970s.[2] Around the same time, new empirical evidence began to emerge about the sensitivity of savings and, especially, capital inflows to taxation. The combination of new theory and better empirical work led most tax experts to retreat from the previous emphasis on imposing high marginal-rate income taxes and to embrace taxing capital income at the same rates as labor income. Experience with the serious administrative (and political) constraints that have persistently hampered attempts in most countries to tax income—for example, in the form of capital gains—has generally pointed in the same direction.

It is fortunate from a revenue perspective that VAT came along to save the day. In most countries, however, VAT largely replaced excises and taxes on trade, with the latter particularly declining as trade became more liberalized. Although income taxes generally continue to be significant in revenue

terms, both personal and corporate income tax rates have declined around the world, not least because of the growing influence of international factors.

Tax policy recommendations and, to some extent, tax policy realities thus have changed over the last 20 years. Nonetheless, what might be called the fiscal component of the "Washington consensus" has proved to be surprisingly resilient in that the tax policies recommended to developing countries still largely follow the "broad-based, low-rate" (BBLR) approach[3]—although now generally in the form of a broad-based, uniform VAT and a flatter and more uniform income tax (especially on capital income).

Why so many countries adopted this approach is a puzzle in some ways. It is possible, but not likely, that they were persuaded to do so by the arguments of economists. Because there is little evidence that anyone (other than economists) involved in tax policy cares much about efficiency, a more likely reason may be that this type of system fits better with such policy objectives as growth and trade expansion than did the previous expert consensus view favoring comprehensive income taxes. Or perhaps the explanation is simply that politically powerful interest groups now are more likely to support—or at least to contest less vigorously—such policies than they did comprehensive income taxation.

Do Taxes Come with Growth?

Although it is not clear that a better tax system will increase economic growth, it does seem clear that a bad tax system may stifle it. For example, a summary of a report exploring Latin America's less-than-outstanding growth performance in recent decades concludes that "Latin American tax regimes encourage the survival of unproductive firms, obstruct the growth of small and large enterprises alike, and foster a deeply unequal and segmented business universe" (IDB 2010, p. 5). Indeed, if bad taxes discourage growth, perhaps one inference from the fact that the average tax ratio for central governments in less-developed countries had increased by about 24 percent (from 11.3 percent of GDP in 1953–55 to 13.8 percent of GDP in 1966–68) might be that their tax systems have improved over this period (Chelliah 1971, p. 263).

However, a more plausible inference is that richer countries tend to have higher taxes. At the beginning of this century, for example, average tax levels were twice as high in developed countries (35 percent of GDP) than in developing countries (17 percent of GDP). Moreover, although the level of income in developing countries as a whole has continued to rise in recent decades, tax levels in such countries have not increased similarly. For example, whereas the average tax level in Organisation for Economic Co-operation and Development countries rose from 30.1 percent to 35.5 percent between 1970 and 2000, the similar ratio hardly altered for developing countries, creeping up from 16.2 percent in the 1970s to only 17.0 percent by 2000 (Bahl and Bird 2008, p. 280). Moreover, despite the marked rise of the VAT during this period, the balance between income and consumption taxes in developing countries has hardly changed in recent decades as both excise and import tax revenues have declined sharply.[4]

Many studies have attempted to explain the marked differences in tax levels between rich and poor countries. Probably the most obvious explanation is the marked difference in the capacity to tax among countries at different levels of economic development. As countries become richer, their increasing wealth generally is accompanied both by extensive development of the financial structure and by increased dependence on large, formal organizations as sources of employment and income for an increasingly large fraction of the population.[5] These developments make it easier for governments to track, measure, and tax growing income and wealth. In contrast, a much greater fraction of economic activity in developing countries takes place in small-scale activities that often are in the so-called informal sector—hence, outside the organized financial sector and inherently difficult to tax.

The main lesson suggested by this line of analysis is that in order to tax more, a country must be more developed. Such news is unlikely to be very helpful to developing countries—not least because they often are simultaneously told that if they impose higher taxes at the margin on growing sectors of their economies, they will discourage growth. Taxes may come with growth, but even the best tax policy is unlikely to yield much revenue in the absence of growth. Of course, if foreign donors step in (or natural-resource bonanzas occur), countries may be able to grow without taxing themselves—and politicians sensitive to their own political futures usually will be happy to follow such easier paths to an expanded public sector.

Some writers have suggested that this dilemma is more apparent than real—that if they choose to do so, even the poorest countries can tax more than they now do simply by improving administration and by getting the "politics of taxation" right.[6] This advice surely is correct in some ways. However, it is unlikely to be either easy or simple to implement. It is not helpful to tell countries wishing to have bigger (and, one hopes, better) tax systems that they first must be better countries. A related (though perhaps a bit more encouraging) approach in the literature emphasizes not so much the *capacity to tax* (that is, the level or structure of GDP) or the *ability to tax* (that is, the level of financial development) as the *willingness to tax* (what might be called the demand side of the fiscal equation). If people want more public services and trust that their government will try to deliver such services as effectively and efficiently as possible, they are more likely to support efforts to raise taxes than

they are when experience has taught them to expect little in the way of benefits from increased government activity (as has happened in too many countries).[7] This view implies that taxes imposed without adequately representing the interests of the people being taxed are unlikely to be collected easily (and will not be productively spent). Again, the inference is that better governments can collect more—and, again one hopes, better—taxes. Although this seems plausible, and some evidence suggests that it may even be right, once again it is all too clear that there is no simple road to better (or bigger) taxation in developing countries.

However one interprets either the empirical story of the last 50 years or the ideas sketched above, it is clear that the links between taxation and economic efficiency—like those between economic efficiency and economic growth—are difficult to tease out and to understand either in general or for any particular country. Thus, it seldom is easy to draw clear policy implications from the literature for any particular country at any particular time. To illustrate, it is rare that much policy discussion of taxation adequately considers the distributional or stabilization dimensions of the fiscal problem; instead, discussion focuses mainly on efficiency concerns, even though policy makers almost invariably operate in environments in which distributional, stabilization, and political considerations dominate.

Even leaving such considerations aside, perhaps the strongest and most relevant policy conclusion one can draw from an examination of the extensive empirical and theoretical literature on the links between taxation and economic development is simply that we do not yet understand much about this issue in general.[8] Nonetheless, the literature does support a number of specific policy suggestions (discussed below) that many developing countries would do well to take into account in designing and implementing their tax systems.

Lessons for Developing Countries

Optimal tax theory is a useful and clarifying approach in many ways; but, for a number of reasons, it seldom offers clear lessons for tax policy makers. As an example, it is often true that only a small subset of available taxes is considered, and such important real-world phenomena as market failures and regulatory policy are left out of account. Moreover, the revenue requirement usually is taken as given (ignoring what it is to be spent on), administrative constraints and transaction costs typically are left out of account, and most potentially relevant nonrevenue objectives and the effects of differences between the public interest and the private interests of those charged with carrying out public policy are ignored.

Perhaps the main practical policy implication of optimal tax theory is that production efficiency matters: in particular, it is bad to tax intermediate goods used in production because it distorts resource allocation—one reason most economists generally have favored value added taxation. It is unfortunate that this important point has proved hard to market to citizens and to politicians focused much more on the immediate distributional impact of policy changes than on their long-run implications for efficiency, investment, and growth.

In practice, policy advisers probably rely less on theory than on rules of thumb closer to Adam Smith's famous canons of taxation—certainty, simplicity and convenience, and economy. For example,

- The BBLR approach mentioned earlier is such a rule of thumb: *taxes should have broad bases and low rates* to minimize negative economic effects on prices and to reduce the potential for administrative corruption and tax evasion.
- An important corollary of the BBLR proposition is to *minimize tax concessions*—although this advice often seems to be more honored in the breach than in the observance (perhaps because of the enduring political attractiveness of tax favoritism).
- Another common prescription intended largely to discourage corruption and evasion is for *fewer rates of tax* to reduce the problems arising with differentiated tax rates.
- Yet another prescription intended to *improve the convenience and simplicity of the taxes* facing unsophisticated or poorly educated taxpayers is the use of simple and often "presumptive" (estimated) taxes—although this approach needs to be handled with great care to avoid doing harm.
- *Taxes on international trade should be reduced* because they distort allocation of resources in line with comparative advantage. A possible exception to this rule might apply for some least-developed countries where ease of collecting taxes at the border may dominate.
- *Revenues from income taxes are buoyant;* indeed, two reasons that countries traditionally were advised to rely more on income tax with economic development were that taxes would more closely reflect citizens' ability to pay and that revenue would be more income elastic. Even those people who think that distribution is primarily the task of the expenditure rather than the revenue side of the budget would do well to keep in mind the elastic nature of the income tax. Indeed, governments presumably should be interested in both the elastic and the progressive characteristics of the income tax—the first to finance expanding expenditures and the second to increase the degree of perceived fairness and trust in government.

No doubt many other useful lessons may be derived in principle from the substantial literature on tax theory and

tax economics. In practice, however, surprisingly few such lessons have been tested in the context of developing countries, partly because most critical issues depend on elasticities about which we usually know far less than we need to design good tax policy. Consider some common tax policy design issues that come up again and again in developing countries:

- Should income taxes be progressive, flat, dual (or schedular), or nonexistent?
- Should foreign source income be taxed—and if so, how?
- Should indirect taxes be imposed at uniform or at differentiated rates?
- If differentiated, how should externalities (and regulatory policies) be taken into account?
- Should small businesses be taxed differently from large businesses—and if so, how?
- What taxes should be assigned to different levels of government?
- Should taxes be lighter or heavier on "growing" sectors of the economy?
- How should (and can) the "informal" sector be taxed more effectively?

No simple or general applicable answers to any of these questions are available-or, in some cases, even conceivable. Nonetheless, as implied by the earlier list of rules of thumb, experience and the literature do suggest a number of ways in which these and other policy issues can be (and have been) explored in detail in the circumstances of particular countries.

Keys to Successful Tax Reform

The economic literature on taxation and development focuses on taxation as a policy instrument. However, it seldom does so in the context of the policy process. In practice, the process may largely determine the product in two important senses[9]:

1. Tax administration matters—a lot! The best tax policy ineffectively administered amounts to nothing (see *PREM Note* 156). Conversely, the revenue administration will, in effect, produce its own "policy product," even if there is no coherent or "designed" policy, In short, policy outcomes depend very much on how policies are administered. Thus, critical aspects of tax administration need more research and must be integrated more closely with tax policy work, Among the questions to be studied are these: How much should be spent on administration? How should tax administration be organized and run? How can countries deal with the "hard-to-tax" populations (both rich and poor)?
2. More important, taxation is about politics, just as politics is partly about taxation—especially its perceived distributional effect. In addition to considering in more detail how tax policy and administration may affect the building of social capital (for good or ill), more attention needs to be paid to other "political" aspects of tax policy in developing countries—for example, how to sell taxes to an always-unwilling public. Good marketing is at least as important for successful tax reform as is good policy design. For example, one way to market policy changes may be to use fiscal illusion to fool people about what really is being done. An opposite tack may be to stress the increased visibility and accountability of policy actions. (As discussed in *PREM Note* 157, this may be one reason to support a degree of taxation decentralization in some countries.) Another possible marketing approach may be to explore or exploit to an extent the "sales potential" of earmarking—that is, the real or symbolic establishment of links between taxes and expenditures. Again, decentralization may provide an example in some circumstances.

To mention such approaches is certainly not to recommend them. Nonetheless, such ideas call for more attention in the literature on "taxing for development" than they have received. Similarly, politicians matter, as does the immediate political environment. There is not, probably cannot, and perhaps should not be anything like a "politician-proof policy." Tax policy reform requires a viable and politically relevant champion who owns the reform and can sell it. Packaging also matters. Selling reform depends not only on the contents of the policy package, but also on how it is presented. This is true because perception is reality to a considerable extent in the world of politics. Without visible benefits to offset the visible costs of taxation, new tax policies are unlikely to be accepted (even if they are technically better than the policies they replace). Finally, details matter. The fate of a policy may turn on how some particular group perceives its interests to be affected or on the precise sequencing and scope of reform.

Conclusion

From the perspective of international institutions concerned with improving tax outcomes in developing countries, this note suggests two general conclusions:

1. One must know the context well to be sure that one is recommending the right product and that one understands the right way to get to "there" from "here." Doing so requires a clear analytical model, and demands that the issues in each country be approached in light of a thorough understanding of the path-dependent and context-specific conditions within which policy initiatives are introduced and implemented. It also requires one to pay close attention to relevant local con-

ditions and evidence—microdata, heterogeneity, perceived norms, and so forth; and to be able and willing to produce fact- and logic-based analysis in a form that can enter the relevant political-bureaucratic discussion. In many instances, what this suggests is that international institutions should support both official and (perhaps especially) nonofficial local research and dissemination efforts rather than attempting to do the work themselves.

2. Always be mindful of the no-one-size-fits-all principle. There is no magic blueprint—no tax system, structure, or particular policy that makes sense for all countries at all times. Realizing that, from the government's perspective, taxes are only one of a set of "governing instruments," it is critical in designing and evaluating tax policy to take carefully into account the design, administration, and consequences of such other government activities as those related to nontax revenues, expenditures, and regulations.

Designing and implementing a viable and sustainable tax strategy for development in a developing country is a difficult and time-consuming task. But it can be done—and has been done, as countries from Chile to Singapore have shown—when countries really want to do so; take the lead themselves; and obtain the technical, institutional, and perhaps even financial support that may be required.

Notes

1. A comprehensive income tax is levied on net income from all sources according to the same rate schedule.

2. For a review of both the basic theory of optimal taxation and the earlier empirical evidence mentioned, see Auerbach and Feldstein (1985).

3. For example, policies recommended in World Bank (1991).

4. For a detailed examination of the effects of VAT on revenue, see Keen and Lockwood (2010).

5. Gordon and Li (2009) provide a useful exploration of this issue.

6. As an example, the UN Millennium Project (2005) notes that, on average, developing countries needed to mobilize "only" an additional 4 percent of GDP in tax revenue to obtain the revenues needed to achieve the Millennium Development Goals. It appears to assume that any developing country worth its salt reasonably could be expected to increase its current tax take by the required 22 percent—or almost three times more than such countries had managed over the previous three decades.

7. A useful and concise statement of this argument is provided by Moore (2007). Its empirical basis is explored to some extent in Bird, Martinez-Vazquez, and Torgler (2008).

8. For extensive reviews of the empirical and theoretical underpinnings of this statement (in developed countries), see Johansson et al. (2008) and Myles (2009).

9. A stimulating discussion of this issue in the context of Latin America may be found in IDB (2006).

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