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**Tax Policy in Developing Countries: Looking Back and
Forward**

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Abstract

We review the changing nature of tax policy in developing countries over the last 30 years and consider what factors determining the level and structure of tax revenues in such countries may have changed recently and how such changes may affect future developments.

A century ago any list of the developing countries of the world would almost certainly have included three "regions of recent settlement" -- Canada, Australia, and Argentina. Today, only Argentina would be included in such a list. Did different tax choices have any influence on this outcome? Arguably, they may have done so. Argentina's heavy reliance on export taxes and its failure to develop an adequate internal tax system undoubtedly played some role first in derailing its impressive economic progress in the early years of the last century and then in explaining its inability to get firmly back on the growth track in the latter half of the century.

Whether this argument is right or not, this brief story introduces two of the most important lessons that have been learned about taxation and development over the last hundred years. The more obvious lesson is simply that one must be careful not to kill the goose that lays the golden eggs -- in Argentina's case, agricultural exports. A less obvious but equally important lesson is that a good internal tax system provides not only revenue but an essential element in developing a capable state. Argentina is clearly still working at this task. In contrast, Canada and Australia -- responding in part to wartime exigencies -- essentially managed to create such systems in the first half of the last century.¹

Are there lessons for contemporary developing countries to be learned from such broad assertions as these? There may be, although there is far too much that is not yet understood about the historical role of tax policy and tax administration in the development of countries to explore this topic further here.²

In the present paper we focus less ambitiously on the last few decades where the data are better and where the subject has been more extensively worked. The main question considered is whether the setting for tax policy in developing countries is any different now than in the past, and whether or not such differences show up in how countries tax. In the next section, we begin by looking at how the level and structure of taxes has changed over time. In recent decades both technical knowledge and the degree of training have improved markedly in low and middle income countries around the world. If these developments have resulted in better tax

¹ For detailed study of the Australian and Canadian cases, see Smith (2003) and Gillespie (1991).

² Those interested in such questions should probe more deeply into the burgeoning sub-discipline of fiscal history: see, for example, Brownlee (1996), Daunton (2001, 2002), Lindert (2003), and Webber and Wildavsky (1986).

decisions and those decisions have made a difference, the data should show it. We then turn to the central question discussed in this paper: are the factors now driving tax policy in the developing world different than in the past? We conclude by speculating about some factors likely to shape tax policy in low income countries in the next decade or so and draw a few general conclusions.

Tax Levels and Tax Structure

How developing countries tax themselves changes continuously. But are either tax levels or tax structures very different now than they were 30 years ago?

The Level of Taxation

Table 1 depicts the average level of the ratio of taxes (including social security taxes) to GDP for three groups of countries: industrialized, developing and transition.³ In industrialized countries the average tax share increased from 30 to about 35 percent over this 30 year period. In developing countries, however, the tax share of output increased only slightly: indeed, since the 1980s their tax shares have been almost constant. This represents a remarkable slowdown. In an earlier study (of a more limited sample that excluded social security taxes) Chelliah (1971) found that the average tax ratio for central governments in less developed countries had increased by about 24 percent over the previous two decades (from 11.3 percent in 1953-55 to 13.8 percent in 1966-68). This general result held true for nearly every country in his sample. "Convergence" in tax levels across countries appeared to be well on its way. In reality, however, by the end of the 20th century, the tax ratio in industrialized countries was about twice that in developing countries -- a much greater difference than in the 1970s. Indeed, as Table 1 shows, the tax share in the transition countries actually *declined* in the last decade of the century, reflecting the continuing realignment of public-private expenditure responsibilities in those countries.⁴

³ For detailed sources and further discussion, see Bahl (2006)

⁴ The term "transitional" is often used to refer to the former Soviet bloc countries as well as China and Vietnam which are seen as being in transition from centrally planned to more market dominated systems.

Table 1
Tax Levels: Tax Revenues as a Percent of GDP^a

Country Groups	1970s	1980s	1990s	2000s^b
Industrialized	30.1	33.7	35.5	33.4
Developing	16.2	17.3	17.0	17.0
Transition	n.a.	47.7	29.6	29.1
Total	19.8	21.6	22.6	21.8

Source: Calculated from data in IMF (2003), as reported in Bahl (2006).

Notes: n.a. = not available

(a) Decade averages.

(b) Only limited data are available.

Almost half a century ago, Nicholas Kaldor (1963), fresh from his recent exposure to India's tax system, argued that for a country to become 'developed' it needed to collect in taxes 25-30 percent of GDP. More recently, perhaps having noted that most developing countries (like India) remain well short of Kaldor's target, the UN Millennium Project (2005) was somewhat less ambitious in advising developing countries that on average they needed to mobilize only an additional 4 percent of GDP in tax revenue beyond their current average level of about 18 percent.⁵ However, the news is not good for those who think that a larger tax state is an essential aspect of development, for example because of the need for public investment in infrastructure: the tax to GDP ratio hardly changed in developing countries in recent decades. The average developing economy seems to have been content with (or constrained to) a level of taxes roughly equivalent to 17 percent of GDP.⁶

These countries are not discussed in detail in this paper: for such a discussion, see Martinez-Vazquez and McNab (2000).

⁵ For a recent summary of tax levels and structures in countries grouped by income level, see Fox and Gurley (2005). Of course, 'revenue' is not identical to (or limited to) tax revenue but such niceties are neglected here. Bird, Martinez-Vazquez and Torgler (2006) analyze both revenue and tax ratios in developing countries and find no great differences in most instances.

⁶ Even 50 years ago 17 percent of GDP seemed like a minimal target for taxation in developing countries to early writers in the field such as Martin and Lewis (1956).

Most developing countries have consistently failed to meet the targets cheerfully established for them by outsiders. A few fast-growing Asian countries such as India managed to reach and even exceed the UN-prescribed 4 percent of GDP increase in tax ratio in the early years of this century but it is by no means clear that these new higher levels will be sustainable.⁷ As Table 1 shows, in most developing countries the tax ratio has changed surprisingly little in recent decades. The belief that some seem to hold that developing countries can increase their tax take simply through more vigorous collection efforts is particularly naïve.⁸ There is more to improving tax effort than simply exhorting countries to try harder.

Of course, there is considerable variation across developing countries. While this is not the place to go into details, a recent analysis of the determinants of this variation in the tax ratio suggests that (a) developing countries that increased taxes did so largely in response to an increase in *per capita* GDP; (b) increased reliance on indirect taxes did not seem to drive the increases; (c) emphasis on social service spending tended to dampen it while spending more for economic services did not seem to matter; and (d) there is some support for the argument that corruption and taxation are substitutes (Bahl 2006).⁹

The Structure of Taxation¹⁰

In contrast to the stasis of the tax level in developing countries, as Table 2 shows, in recent decades there have been pronounced shifts in their tax structures. Unlike the 1950s and 1960s, when tax revenues from import duties were increasing at a faster rate than GDP (Chelliah 1971),

⁷ As Poirson (2006) shows, general government revenues as a share of GDP have been surprisingly constant over time in India: much of the recent increase appears attributable to always volatile corporate tax revenues.

⁸ One of the best documented cases in which better administration increased revenues markedly in a short time was Argentina's rapid expansion (from 13 to 23 percent of GDP) over the the 1989-92 period. Morrisset and Izquierdo (1993) estimated that about two-thirds of this increase was attributable to improved administrative effort. As in other cases, however, subsequent experience in Argentina demonstrated how difficult it is to sustain such increases over time (Bergman 2003). When improved technology or increased administrative effort expands revenues, in many instances it appears that political pressures soon dampen or even fully offset any resulting net increase in tax ratios (Martinez-Vazquez 2001).

⁹ The last point also receives some support from the analysis of Bird, Martinez-Vazquez, and Torgler (2008). Of course, one must always view cross-country regression-based interpretations with some skepticism.

¹⁰ Various authors have tracked and explained changes in the structure of taxes over time, with mostly similar results, e.g. Chelliah (1971), Tanzi (1987), Burgess and Stern (1992), Bird and Zolt (2005), and Bahl (2006).

in more recent years international trade taxes declined from about 32 percent to about 25 percent of total taxes -- a shift precisely offset by an increase in the share of domestic indirect taxes from about 25 percent to about 35 percent by the end of the 1990s.¹¹ Trade liberalization towards the end of the 20th century was obviously a driving force in tax reform in developing countries as was the widespread adoption of the value added tax and the continuing improvement in its administration.¹² As Bird and Zolt (2005) stress, in contrast to the experience in most developed countries depicted in Table 2, the personal income tax has continued to play at most a very

Table 2
Tax Structures: Tax Categories as Percent of Total Taxes^a

Income Tax	1970	1980	1990	2000^b
Industrialized	35.5	37.8	38.6	53.8
Developing	29.6	28.6	27.6	28.3
Transition	12.3	16.5	26.7	23.3
Total	30.7	30.2	29.7	28.5
Indirect Taxes				
Industrialized	27.2	29.4	30.5	19.8
Developing	25.2	29.3	34.9	40.1
Transition	10.5	21.8	37.9	42.1
Total	25.3	28.9	34.2	39.0
Taxes on International Trade				
Industrialized	4.6	2.8	1.0	1.0
Developing	32.4	30.7	25.6	19.0
Transition	7.7	5.2	7.6	5.4
Total	25.2	23.8	18.2	14.1

Source: IMF (2003), as reported in Bahl (2006).

Notes: As for Table 1

¹¹ The minor importance of trade taxes in transitional countries is one reason it is useful to separate this group of countries out in the tables.

¹² See Baunsgaard and Keen (2005) on the substitution of VAT for trade taxes, and Bird and Gendron (2007) for a detailed discussion of the VAT in developing and transitional countries in recent years.

limited role in developing countries. Developing countries have been hesitant to go too far in taxing labor in the formal sector, and labor in the informal sector has remained out of reach. Only limited data are available. In addition, in many countries recently there has been some decline in reliance on the company income tax (Keen and Simone, 2004) owing to rate reductions, base narrowing due to incentive policies, and declines in reported profitability. The long-term story with respect to income taxes has been the continued inability of the tax administration in less developed countries to administer such taxes effectively. Much the same is true with respect to property taxes.

What Do these Trends Tell Us?

Has the failure to mobilize resources through taxation at the margin been growth-enhancing or growth-retarding? There is no agreement on this subject. Some argue that the failure to mobilize more resources has constrained governments from extending the quantity and improving the quality of public services delivered or unburdening themselves from heavy debt.¹³ More specific to the question of economic development, lower taxes may constrain infrastructure investments to suboptimal levels and retard industrial development. Lower taxes in some cases have led to lower primary surpluses than are optimal, especially when combined with high debt burdens, a matter of much concern to organizations like the IMF (2006).¹⁴ Others argue that lower taxes keep money in private hands where it is more likely to find its way into investment and job creation. This camp also holds that government expenditures in the developing countries are biased toward consumption and likely to crowd out private investment and hence hamper growth.

Empirical work on the impact of tax *levels* on growth in developing countries has come to no firm conclusions. Even endogenous growth models that allow for the effects of tax policy on growth do not give a consensus answer about whether higher taxes crowd out faster rates of economic growth (Tanzi and Zee, 1997; Mintz, 2003). It is difficult to separate the effect of the level of taxes from the level of expenditures and the budget balance. Not surprisingly, different model specifications produce different results.

¹³ This is the view taken in such documents as UN Millennium (2005). For a skeptical view of the case for such state-driven "big pushes" for development see Easterly (2006).

¹⁴ The primary budget surplus is the surplus excluding interest payments on debt.

The effect of tax *structure* on economic growth is an equally unresolved issue. In theory distortions in the tax structure can impose a drag on the economy. Using computable general equilibrium models, the welfare cost of some taxes in some developing countries have been estimated to be more than 100 percent of the amount of tax raised.¹⁵ Others point to the stimulus effects of tax rate reductions. The evidence here is also not clear. Ivanova, Keen and Klemm (2005), for example, find no evidence of a supply side effect from Russia's rate reduction and adoption of a flat rate income tax, but Martinez-Vazquez, Rider and Wallace (forthcoming) do find evidence of a labor supply effect.¹⁶ As Lindert (2003) shows in historical context, the effects of taxes in particular country settings often depend on very detailed characteristics of tax design and implementation that are not easily captured in econometric models.

Determinants of Tax Policy Choices

Looking back to the 1970s, the prescriptions for good tax policy dispensed to developing countries by consultants and donors, when they did not amount simply to saying "copy my country," did not stray far from Adam Smith's maxims for a good tax (Goode 1993). The recipients of such advice quickly adopted the rhetoric. Politicians almost everywhere swore that their proposed reform would be easier to understand and administer and would distribute any increase in tax burdens in an equitable way. Only the neutrality maxim failed to make much headway in reform rhetoric. Most policy makers (and not just those in developing countries) wanted to hold open the option to use tax policy for social, economic and political engineering. Significant gaps are observable between the policies recommended by experts (whether international or local), the rhetoric of local politicians, and what was actually implemented. In practice, tax policy is usually heavily shaped by past decisions and frequently overtaken by current events. Economic, administrative, political, and social realities have always shaped tax policy decisions and constrained what could be done. We note here three such factors that were important in the 1970s.

Deficits

¹⁵ For a good country study, see Rutherford, Light and Barrera (2005).

¹⁶ For a recent review of the Eastern European experience with flat taxes, see Gray et al. (2007)

A critical constraint on tax reform in most developing countries has long been their precarious macroeconomic condition (World Bank 1988). Slow economic growth was accompanied by pressures to upgrade deficient public service levels and to invest in infrastructure that would enhance growth. But revenue growth was slow because of slow economic growth, a tax base that was hard to reach, and a weak tax administration. Often, it was easier to raise revenues from foreign grants, borrowing or financial measures like seigniorage and inflation than from taxes. The result was a cycle of low revenue growth, deficits, and ever increasing debt service and repayment claims on available revenues.

When countries are in this situation, structural reform inevitably takes a backseat to revenue enhancement and tax changes that generate quick revenue flows such as increases in excise taxes or taxes on financial transactions¹⁷ are favored over the conventional policy advice for broader based taxes, rate structures that would improve the built-in elasticity of the tax system, and improved tax administration. In particular, countries have often proved all too willing to fall back on the “perennial” excises (petroleum, tobacco, liquor, and beer) where administration is easy and revenue more or less certain. It has been much more difficult for countries to adopt prudent economic and fiscal policies (e.g., eliminate protectionist measures, devalue, privatize, reduce public employment rolls, and enforce the tax system) than to adopt short term fixes. The reason for this reluctance to do "the right thing" is clear: in developing as in developed countries, fundamental reforms are almost always painful to at least some groups, and politicians generally have short political lives (and hence high discount rates).

Tax Administration

In most developing countries, tax administration was in a poor state in the 1970s (Radian 1980). Tax bases were grossly under-assessed, collection rates were low, and penalties existed more in law than in fact. In some countries, tax evasion was seen to be more a badge of honor than a crime. Low tax morale (Frey 2002) combined with inadequate and unwilling enforcement to produce an adverse "tax culture" (Edling and Nguyen-Thanh 2006). Staff was underpaid and under-skilled, recordkeeping was manual, modern procedures for assessment and collections were not in place, and tax systems were often so complex that they made a bad situation worse.

¹⁷ For example, the bank debit taxes in Latin America (Arbelaez , Burman, and Zuluaga 2005).

Faced with such realities, some countries (and advisors) opted to concentrate on improving tax administration, others attempted to devise tax systems that could work with bad tax administration, and still others continued to ignore the interdependence of tax policy and tax administration.¹⁸

Foreign Advisors

To some extent tax policy in some countries in the latter part of the 20th century was influenced by foreign advisors. The role of such advisors was presumably never to substitute for government decision makers or politicians but simply to bring the best thinking about tax policy to bear -- for example, in Indonesia in the early 1980s (Gillis 1985). In some instances, advisors also paid considerable attention to the details needed to help make the case for those who would have to sell the reform (Bahl 1991). In other cases, their contributions shifted and often lifted the level of the debate even if their specific proposals rarely made it into law (Shoup 1989; Musgrave and Gillis 1971). Sometimes outside advisors may have served a useful role in bringing unpopular messages that government officials did not want to embrace in public but were not unwilling to have “forced” upon them (e.g., raise the gasoline tax rate, eliminate certain exemptions from the VAT, or reduce protective tariffs) -- or at least this is a common rationalization put forth by those who (like us) have at times carried the banner of the IMF into fiscal battles around the world.

Where the contribution of such advisors was positive, it was usually more from the cumulative effects of exposing policymakers to elements of what had to be done to get good tax policy than from the success of any particular set of specific tax structure proposals. In the best cases, good tax policy eventually got into the ring with good tax politics. What seemed at first to be radical and unthinkable in the context of a particular country came over time to be seen as within the feasible choice set. An example was the introduction of a flat rate broad-based individual income tax into policy discussion in Jamaica in 1984. At first viewed with shock owing to its clear departure from the existing progressive system of statutory rates (applied to a base riddled with exemptions), over time the proposal gained acceptance and was adopted in 1986 (Bahl 1991).

¹⁸ For our own (partly contrasting) early views on these issues, see Bahl and Martinez Vazquez (1992) and Bird (1989). For a recent overview of the administrative dimension of tax reform in developing countries, see Bird (2004).

Two groups of external advisors tilled these fields. One group consisted of scholars who studied the tax system in question, usually doing much of their work in the field while drawing on their analytical knowledge and accumulated experience. They developed and substantiated a tax reform program, usually complete with revenue estimates, burden projections, and estimates of the potential economic effects. The path breaking missions led by Carl Shoup to Japan in 1949-50 and Venezuela in 1958-59 and by Richard Musgrave to Colombia in 1968 and Bolivia in 1976 created models on which future tax studies would build.¹⁹ The strength, and the weakness, of this approach to tax reform is that the advisor could fly home after the assignment was over. Unencumbered by considerations such as “selling” the reform to interest groups, politicians, or the general public, advisors were insulated from the political consequences of tax policy changes, but could also be objective. On the other hand, they were not always constrained to be realistic. In the long run, undoubtedly the most valuable contribution of scholars such as Shoup and Musgrave as well as such other important early contributors as Arnold Harberger (1989) was that by publishing their policy studies they helped to train a generation of students, from both developed and developing countries, who influenced tax policy discussions and design for years to come.

In contrast to this first group of advisors, whose work was largely financed directly or indirectly by the countries in question, a second group of advisors came from such bilateral donors as USAID and such international agencies as the IMF, the World Bank, and the regional development banks. Advice from these sources was usually delivered by staff or consultants -- sometimes members of the first group mentioned -- who had considerable expertise and experience. In contrast to the purely scholarly work, however, such advisors were sometimes driven to a much greater extent by such goals as reducing the fiscal deficit or promoting the private sector, in part at least in response to the political imperatives under which they operated. Although some (e.g. Emran and Stiglitz 2005) have recently argued that the connections between the tax policies advocated by international agencies and positive developmental outcomes are by no means clear, at the time most advisors undoubtedly believed that such policies would help countries achieve a more sustainable growth path.

¹⁹ On the various Shoup missions, see papers by Shoup, Gillis, McLure, and Nakazato in Eden (1991). Although Musgrave's missions have not as yet received a similar retrospective view, see McLure and Zodrow (1997) with respect to Colombia. For examples of missions based in part on these early formative experiences, see Bahl (1991) and Bahl and Wallace (2007) on Jamaica, Gillis (1989) on Indonesia, and McLure et al. (1990) on Colombia.

Fiscal policy became such an important and distinct component of economic development policy that a fiscal affairs department (FAD) was established in the IMF in the mid-1960s largely to provide technical assistance in both tax policy and tax administration. Many of those later prominent in giving tax advice around the world served part of their apprenticeship at FAD. FAD's work as a whole played an important role in shaping tax structure and tax administration practices in many developing countries. For example, it is highly unlikely that either VATs or LTUs (Large Taxpayer Units) would have been so widely and quickly adopted around the world without the aid and influence of FAD. Although long-time FAD Director Vito Tanzi (1994) once noted, quite correctly, that in the end what any country chose to do with respect to tax policy was its decision, this argument is a bit ingenuous with respect to the many small countries in which not only was the fiscal reform agenda at times largely set by IMF concern with the fiscal balance but the major intellectual input into the reform program also emanated from the same source.

Have Things Changed?

Some of the factors just mentioned seem less relevant today. For example, perhaps in part because the lessons have been so well learned, tax reform in most developing countries is less driven by fiscal crises now than in the past. Budgets are more under control in most developing countries than was the rule 30 years ago.²⁰ On the other hand, as we discuss below, trade mobilization and capital mobility have created new revenue problems for many developing countries, and new challenges for tax policy.

Concern with vertical equity and progressivity also plays a smaller role with respect to tax reform than in earlier years (Bird and Zolt 2005). Tax administrations in most developing countries are not up to the task of implementing taxes intended to redistribute income away from the rich and upper middle class, such as capital gains taxes, a comprehensive progressive income tax, or a property tax assessed at full market values. Even if a nominally progressive system is implemented, its impacts may sometimes be regressive, as when higher corporate tax rates result in up capital flight and job losses. Across much of the political spectrum, many experts and an increasing number of policymakers now accept that for the most part distributional concerns are

²⁰ Not all: for example, Central America is still plagued by chronic fiscal deficits, increases in public debt and generally low rates of revenues mobilization (Agosin et al. 2006); see Instituto (2007) for a recent detailed study of this region.

better addressed on the expenditure side of the budget, where benefits may be better targeted to low income people,²¹ With respect to the revenue side of the budget, perhaps the main consensus view now when it comes to distribution is that taxes should not unduly burden the very poor.²²

On the other hand, although tax administration has come a long way in many developing countries over the last three decades (Bird and Zolt 2007), there is still much to be done. For example, most developing countries have adopted a modern value added tax (VAT). However, there are many ways in which VATs can and should be improved in most developing and transitional countries, in part by ensuring that VAT design is more in tune with the real capabilities of VAT administration and in part by providing a better defence against the common tendency to narrow the VAT tax base by expanding exemptions and zero-rating as the years go by (Edmiston and Bird 2006). Nonetheless, there is no question that the VAT is now properly considered central to a good tax system in most countries. Similarly, while the assessment of taxable income in developing countries continues to move closer to the OECD practice (OECD 2006a) in some respects, for example, with respect to the taxation of capital income, some variant of "dual income taxation" may fit better with the economic and administrative realities of many developing countries than either the "classical" or "comprehensive" traditional models of income taxation (Boadway 2005).²³

Despite the improvements, there remain areas where good tax policy continues to surrender to tax administration constraints. Sometimes the battle never even starts. One example is the failure to tax capital gains, which still is a major loophole in the tax systems in most developing countries.²⁴ A second is the failure to establish a property tax that generates a respectable level of revenue. The combination of the need for judgmental assessments in the absence of good information on property values and popular opposition to a tax on unrealized income is hard to overcome. Be Finally, there is the continued inability of income tax administrations to sweep the informal sector into the tax net.

The Wicksellian Connection

²¹ Compare, for example, the recent surveys by Heady (2004), Moore (2004) and Toyé (2000).

²² See, for example, the recent study of taxation in Latin America by CEPAL (2006).

²³ A particularly interesting experiment along these lines was launched in Uruguay in 2007, with the introduction of a 'dual rate' dual income tax: see Barreix and Roca (2007).

²⁴ As indeed it is also in many developed countries: see OECD (2008).

A long-standing question in public finance concerns the linkage between revenues and expenditures and particularly the direction of causation. Many would like to believe in a classic theory of the state in which government expenditures are determined based on citizen preferences and a budget constraint and the efficient level of taxation emerges from this calculus.²⁵ This model is far too simple to explain reality in any country, but an increasing number of analysts are exploring the many complex ways in which demands for expenditures and acceptance of taxes are linked with each other and with the rate of economic growth. While much of this work has focused on more developed countries (e.g. Lindert 2003), some attention is beginning to be paid to developing countries (Lieberman 2003; Brautigam, Fjeldstad, and Moore 2007). In particular, scholars are increasingly paying close attention to the manifold ways in which tax structure and tax administration constitute one of the primary interfaces between the state and its citizens.²⁶ The level and structure of taxation in any country at a particular point in time invariably reflects in part a sort of "fiscal equilibrium" attained between conflicting interests. However, the specific taxes utilized and how they are implemented may over time alter that equilibrium, and hence in turn influence future tax levels and structures. Tax policy not only emerges from the political arena but to some extent may influence the way in which policy decisions are made within that arena.

There is a more cynical view: the process of budget determination at the margin is driven primarily by revenue determination. The level of taxes in low income countries is held down by a political system that seems to favor lower taxes over higher public service levels, by administrative failings, and by perceived and real constraints from international competition. Note from Table 1 that the tax ratio meter has for nearly a quarter of a century been stuck at about 33 percent for industrial countries and about 17 percent for developing countries.

None of this is to say that the process of budget determination will not change. Although Wicksellian concepts about linking expenditures and revenues (Breton 1996) have had little effect on tax policy in developing countries to date, the increasing attention being paid to public expenditure management may eventually change public attitudes about willingness to tax. This shift in interest is indicated by recent work on tax expenditures in developing countries (Swift 2006), by attempts by agencies such as the World Bank to take public expenditure determination

²⁵ For a review of competing theories of the growth of government, see Mueller (2003).

²⁶ For three very different examples, see Sokoloff and Zolt (2005), Hoffman and Gibson (2005), and Bird and Ebel (2006).

more seriously, by more attention to the potential benefits (as well as problems) of earmarking (Bird and Jun 2005) -- and most importantly, perhaps, the continuing worldwide discussion of decentralization issues. In the future, Wicksell may perhaps come to play a larger role in our thinking about tax policy in developing countries (Bird 2007). At present, however, for the most part tax policy is largely considered in almost complete isolation from the expenditure side of the budget in most developing (as in most developed) countries.

The New Setting for Tax Reform

Good tax policy influences economic development, but economic development also influences the way we think about tax policy. As economies have developed and as the world economy has changed over the past three decades, tax policy choices and tax policy decisions have also changed. This does not mean that the need for revenue is a less important driver of tax reforms than in the past. In many developing countries, tax levels are still clearly too low to support the delivery of an adequate package of public services. In some cases, present debt levels are unsustainable at current levels of tax effort. The old problems persist, but the setting has changed. We outline next several components of the new setting and discuss their implications for tax policy.

Who Does the Thinking?

Developing countries are now properly much less reliant on foreign advisors than was the case in an earlier day. Not only are their own policy staffs better trained and more experienced, but they are also less dependent on the IMF and other creditors and hence less likely to want or heed advice from donors and international advisors. Who is thinking about what constitutes a good tax strategy for a developing country and what they think has changed. External advisors may sometimes remain important in doing background analysis and bringing world experience to bear on the problems, but their involvement in final decisions is much diminished by comparison with earlier times.

This tilt toward the developing country knowledge base has important implications for tax policy matters. One would expect a tendency toward more sensitivity to politics in deciding what reform proposals will actually get to the table for discussion, and less interest in more risky

comprehensive reforms than in piecemeal adjustments. Foreign advisors, who are insulated from local politics, always tend to be more courageous than elected officials both in their tax structure recommendations and in their willingness to propose tax increases. Whether this tilt will be good or bad for tax policy in developing countries is an interesting question, although not one anyone can yet attempt to answer.

International Factors

The new global economy and capital mobility are pushing tax structures away from reliance on the corporation income tax as capital moves more freely across countries in response to relatively small changes in interest rates and tax rates. Indeed, though reflecting more the competitive international environment of recent decades than the persuasiveness of economists, income tax rates on both persons and corporations have been sharply reduced around the world. In Latin America, for example, the average tax rate on corporations fell from 41 percent in 1985 to 29 percent in 2003 and the top rate on personal income from 51 to 28 percent. Over this period, collections from direct taxes in Latin America increased by only 5 percent, from 4.0 to 4.2 percent of GDP (Lora and Cardenas 2006).

In contrast to 30 years ago, most developing countries now seek to attract foreign direct investment (FDI) to stimulate technological progress and economic growth. The literature suggests that host country tax rates matter, and that tax rate elasticities of FDI are roughly about -0.6 (Echavarria and Zodrow 2005). On the other hand, it appears that home country tax rates (the Treasury transfer effect) are not very important (Slemrod, 1990).²⁷ An obvious implication is that an investment-attracting strategy might be to provide preferential tax treatment for foreign vs. domestic corporations, as China has done for many years. Of course, such policies are open to both criticism and abuse: for instance, it is not difficult for domestic firms to look "foreign" when it is fiscally advantageous to do so. For such reasons, China is scheduled to eliminate its current preferential treatment in 2008.

Trade liberalization and compliance with WTO rules and trade agreements are another new limiting factor on tax reform. As Table 2 shows, the reliance on international trade taxes is coming down as tariffs fall, so most developing countries are faced with the prospect of offsetting

²⁷ For a recent review of the evidence in developed countries, see OECD (2008a).

a revenue loss at least in the short run. The most obvious way to do so is to raise general consumption tax rates, but in low income countries Baunsgaard and Keen (2005) find that no more than 30 percent of the reductions in trade tax revenues has been recovered through increases in domestic taxes. Policy makers in many countries have also been reluctant to cut income tax rates and to put more emphasis on domestic consumption taxes such as VAT in part perhaps because they see such suggestions as little more than code for “increase taxes on the poor.” Even those developing countries (e.g. in Latin America) that did follow this model for the most part have seldom offset the potential revenue losses of income tax rate reductions by base expansions.²⁸

There are other routes to revenue recapture. Over time, one might expect the revenue enhancing effects of depreciation of the exchange rate (which may accompany trade liberalization) and the revenue enhancing response of import consumption to the lower tariffs to offset much of the direct revenue loss (Ebrill et al. 1999). Freer trade has clearly brought great rewards in much of the world. But increased rewards are usually accompanied by increased fiscal risk. The long run may prove to be too long for countries near the fiscal edge like some in sub-Saharan Africa. Building sustainable revenue systems in fragile low-income countries continues to be a major policy concern, as does ensuring the continued provision of essential public services in poor countries that remain highly vulnerable to the vagaries of the international economy.

Tax Bases and Tax Rates

The traditional argument is that broader bases are less distorting because they can raise any given amount of revenue at lower rates. Similarly, the standard argument has long been that even where there is a premium on attracting foreign direct investment a level playing field with the lowest possible tax rate is to be preferred to specific tax incentives. There is good economic intuition behind this argument. An incentive to (international) investors in area A discriminates against (domestic) investors in area B to the extent the incentive increases the after-tax rate of return. Targeted incentives are generally the handiwork of bureaucrats, politicians, and lobbyists who individually and collectively seldom have a good track record in picking winners.

²⁸ In contrast, developed countries that cut corporate rates usually did expand the tax base in compensation (Norregaard and Khan 2007).

Moreover, targeted incentives may channel new investments into low productivity sectors and dampen the growth in value added.²⁹

The new setting for tax reform casts some doubt on these arguments. Tax bases are not simply ‘given’ to governments: they can be ‘grown’ – or destroyed – through the manner in which a given tax burden is collected. For example, taxes may discourage, or encourage, the ‘formalization’ of the economy, or they may foster or discourage the growth of such ‘tax handles’ as imports, or they may be used to shape and direct economic growth into particular channels in a variety of ways and for a variety of purposes (Bird 2007).

A particular concern in this respect in many developing countries today is the appropriate treatment of the small and medium enterprises (SME) sector. Since to some extent this sector overlaps the informal sector, balancing the desire to facilitate the growth of such enterprises with the need to collect revenues has led many countries to institute relatively favorable presumptive (or simplified) tax systems. Unfortunately, most such systems have been designed more on the basis of faith than evidence. In at least some instances countries may run the risk of bringing into play a sort of Gresham's Law under which a bad tax system will erode the basis of the normal tax system. Much work remains to be done to understand these issues.³⁰

More generally, out there in the real world most governments in developing countries continue to offer expansive tax incentive programs, for good reasons or bad. Railing against such programs has not proved much use: a more sensible policy route in many countries is likely to urge better management of incentive programs -- for example, imposing a sunset on each program with a provision for evaluation as a condition for continuation as well as requiring annual estimation and reporting of the tax expenditures implied.³¹ That no developing country seems to do these things speaks volumes for the dominance of politics in tax policy decisions -- a reality that is of course equally evident in many developed countries.

Corruption

Corruption and taxation have always been associated in history (Webber and Wildavsky

²⁹ See Bahl and Wallace (2007) for a discussion of the Jamaica case.

³⁰ For a good introduction, see Alm, Martinez Vazquez and Wallace (2004) as well as the papers and presentations available at <http://www.itdweb.org/SMEconference/>.

³¹ For an good review of the bad incentives to be found round the world, see McLure (1999); for some suggestions on how to live more happily even with bad incentives, see Bird (2000).

1986). Until recently, however, the connection between the two was seldom discussed in public by policy advisers. Things have changed. One hypothesis is that there is some political limit to how much tax people will bear in a developing country. If part of that “allocation” is eaten up by corruption, the level of formal taxation will be lower. Tanzi and Davoodi (2000), Martinez-Vazquez et al. (2007), and Bahl (2006) report some empirical evidence of a substitution effect between taxation and corruption. Corruption impacts on taxation in many ways. Corruption in the form of bribes paid to tax collectors erodes confidence in the tax system and encourages evasion. Moreover, the presence of corrupt government officials can dampen enthusiasm for upgrading the quality of the tax administration through increased compensation and training.

Corruption has become a significant part of the discussion about tax structure choices. Certain policy actions flow from the concern about the potentially negative effects of corruption. Such measures as the following come to mind:

- First, make the structure of each tax as transparent as possible. Taxpayers are harder to cheat when they fully understand their taxpaying responsibilities. Nothing good can come of a situation in which tax administrators and tax payers negotiate over how large the tax liability should be. One problem in the practice of income taxation in developing countries is that, apart from withheld taxes, tax liabilities are in fact often negotiated.
- Second, minimize the degree of contact between taxpayers and tax administrators, and move toward self-assessment. VAT and payroll taxes score relatively high in this respect.
- Third, reduce compliance costs. This lowers the amount of bribe a (rational) taxpayer might be willing to pay to avoid the declaration and payment process. Since on average compliance costs are 4 to 5 times higher in developing than in developed countries (Evans 2003) they usually offer a more bribery-friendly environment.
- Increase the probability of detection. To the extent corruption follows an economic calculus the expected value of the outcome of taking a bribe may be heavily influenced by the chances of getting caught and being heavily penalized.

Tax Administration, Yet Again

Of course recommendations like these take us right back to the question of tax

administration. Problems in this area remain an important limiting factor in making tax policy choices in developing countries. If anything, the new setting (or at least the new advice) complicates matters. Consider the case of the individual income tax. In the 1960s, the needed reforms seemed clear: make more use of third party information to draw the informal sector into the tax net, simplify the tax structure to reduce contact between taxpayers and tax officials, and raise rates to generate more revenue from the formal sector. In the new setting, the large informal sector is still seen as the major constraint. However, if governments increase taxes on wages, the result may be a further impediment to the growth in the formal sector of the economy (Rutkowski 2007). Revenue mobilization through increasing effective rates is significantly tempered in the new advice.

The tax treatment of small firms also remains a problem. The presumptive tax approach to assessing tax liability can bring small enterprises into the tax net but may have a low revenue benefit-administrative cost ratio (Engelschalk 2004). As applied in practice, moreover, often the result is to keep too many firms with taxpaying capacity outside the normal tax net (Bird and Wallace 2004). Effective taxation of both urban and rural real property, whether through capital gains taxes or property taxes, also remains beyond the ability of most developing country tax administrations.³²

In many countries, even when policy makers want to do the fiscally right thing the skill level of the tax administration staff remains a problem in part because, particularly in countries with growing private sectors, the civil service cannot retain qualified staff. Some countries have recently attempted to circumvent such problems by creating autonomous revenue boards that are outside the normal civil service salary/hiring/promotion standards. Unfortunately, experience with such boards to date does not suggest that this is always or necessarily the best route to a higher quality and more honest tax administration (Bird 2007).

Natural Resources

When it comes to natural resources, the revenue issue has always been clear. In the 1960s the level of taxation in developing countries was significantly related to the share of GDP earned in the extractive sector (Bahl 1971). Similarly, energy imports have long been heavily

³² Two reviews of this issue, with country case studies, are Bird and Slack (2004) and Bahl, Martinez-Vazquez and Youngman (2008).

taxed almost everywhere. In the new setting, however, natural resource issues take on more significance, in three ways.

First, resource-rich countries are faced with finding a way to tax the natural resource sector so as to generate “adequate” revenues without discouraging the necessary inflow of foreign direct investment (FDI) to develop the resources. This is not easy and forces some hard choices. In earlier days, politicians would simply negotiate an incentive package to attract the FDI inflow. Because an announcement of new FDI was a political positive, because the politicians making the deal had short political lives and high discount rates, and because of the risk a foreign company would face in such an undertaking, the resulting incentive packages were often viewed as too favorable to the companies – particularly, of course, when the outturn was very favorable. In recent years, as natural resource prices have increased significantly (e.g., oil and gold) countries are increasingly focused on renegotiating the original contracts for a larger share of higher profits. The contentious question on the table now is what is a “fair share” for each party, and how this can be estimated in the context of the set of complicated business arrangements that characterize almost all major resource activities. The negotiated tax treatment of natural resource undertakings has again become a big issue in many developing countries, but the countries are in a much stronger position than in earlier eras.

Second, the growing price of natural resources, largely but not exclusively oil, shows no sign of abating reflecting both political issues in some major producing regions and continued heavy demand from newly emerging industrial countries, notably China. If countries tax energy consumption and petroleum imports at ad valorem rates, tax bases and revenues will expand. However, if countries are locked into specific rates or subsidize the price of motor fuels and the industrial use of petroleum, they face unpopular but necessary tax decisions. The need for a more rational energy tax policy to cope with these developments (as well as environmental issues) poses a substantial challenge for many, perhaps most, developing countries.

Third, natural resource considerations are also important on the expenditure side of the budget. Rising natural resource prices will continue to force up the prices of industrial, agricultural and government inputs, as well as consumer goods. The entry of China onto the international economic stage will continue to put pressure on the price of minerals and oil, requiring many countries to increase taxes to maintain the real level of public services. On the

other hand, the increased cost of private production and consumer goods, especially food, will certainly increase resistance to tax increases.

Fiscal Decentralization and Property Taxation

Another important component of the new setting for tax policy is fiscal decentralization. Many developing countries have identified strengthening subnational governments as one item on their development policy agenda. Thus far, interest has centered mostly on decentralizing expenditure delivery. In some cases the process has gone quite far, e.g., China now makes 70 percent of all government expenditures through its provincial and local government budgets. The average for all developing countries is a much more modest 13 percent, but there is a great deal of inter-country variation. Empirical analysis has shown that the expenditure decentralization ratio rises with the level of economic development and urbanization, and tends to be higher in larger countries with more diverse populations (Bahl and Wallace 2005). Many countries seem to see a growing role for subnational governments in their future, whether they view the prospect with pleasure or otherwise.

The decentralization of taxes has lagged in this process. Significant tax assignment to subnational governments is not uncommon in developed countries (OECD 2006). At one extreme, U.S. state governments and Canadian provinces have almost complete autonomy in choosing any tax base, so long as there is no interference with interstate commerce. In Denmark and Sweden, local taxes account for nearly one-half of local government spending. Revenues from subnational government taxes in Switzerland are greater in amount than revenues received from grants. Japan has lagged other industrialized countries in the assignment of taxes to local governments but is now introducing a new intergovernmental reform that shifts taxing power significantly to local governments.

In most developing countries, however, central governments have been reluctant to release taxing powers to subnational governments. The subnational government share in total taxes in developing countries is only about 10 percent by comparison to 20 percent in

industrialized countries. These figures have changed little in the last 30 years.³³ Most subnational government expenditures in developing countries are financed through transfers. In contrast, in a few developing countries, like the Philippines, Brazil, and Colombia, a third or more of subnational government expenditure is financed from own source revenues. In these cases regional and/or local governments usually have access to some form of taxation on business transactions in addition to a property tax (Bird 2003). The transitional countries are a special case. They have always pass significant responsibility to subnational governments but usually devolved very little revenue raising power. China is perhaps the extreme example, with subnational governments having almost 70% of expenditure responsibility but essentially no independent taxing power.

In the new setting, developing and middle income countries may be more receptive to moving toward local government taxation, and particularly to the property tax. With heightened international competition, there may continue to be limits to what can be raised from traditional central taxes, and involving subnational governments more directly in taxation can result in a greater overall rate of revenue mobilization. Typically, central governments rely on a combination of company income tax, individual income tax, value added tax, excises and customs duties. In most developing countries, however, these taxes have a high entry threshold.³⁴ Small firms, most individuals, and owners of immovable property are under-represented in the tax base as the result of both this administrative feature and evasion. The revenue mobilization hypothesis is essentially that subnational governments have the potential to reach below-threshold payroll, consumption and real property wealth in ways that the central government cannot.

If this hypothesis is correct, increases in subnational government tax revenues will not be offset by equal amount reductions in central government tax revenues. Moreover, increased subnational revenue mobilization could reduce the need for intergovernmental transfers from central revenues. In many countries, local governments to some extent do seem to have broadened the tax base with a variety of tax instruments and administrative measures such as

³³ Calculated from IMF, *Government Finance Statistics Yearbook*, various years, and from country studies (see Bahl and Wallace 2005).

³⁴ See Keen and Mintz (2004) for discussion of the appropriate threshold with respect to value-added taxes: these authors conclude, as do others such as Bird and Gendron (2007), that the VAT threshold is too high in most developing countries -- a fact recently recognized in South Africa's 2008 budget when the VAT threshold was substantially increased.

levies on the sales of assets of firms, licenses to operate, betterment charges and various forms of property taxation. Subnational governments have a comparative advantage when it comes to some kinds of taxes. Often, for instance, local governments oversee a variety of licensing and regulatory activities and track property ownership and land-based transactions for a variety of reasons. They thus have ample opportunity to identify businesses in the community and to gain some knowledge about their assets and scale of operation. Moreover, because the potential revenue is much more important for them in relative terms, local governments have more incentive to carry out such activities than do national governments.

Arguably, the most appropriate local government revenue source is the property tax. Yet this tax has been underused significantly in developing countries, accounting for only about 0.6 percent of GDP on average, compared to more than 2 percent in industrialized countries (Bahl and Martinez-Vazquez 2008). One constraint has been administration. To ratchet up the revenues from the property tax would require significant investment in surveys, valuation methods, and recordkeeping, as well as aggressive enforcement. Most developing countries have not been willing to undertake this kind of investment for the prospect of gaining only a meager amount of revenue. Another constraint has been the absence of an incentive for local governments to invest in upgrading the property tax, owing to heavy inflows of central transfers to finance local expenditures. The next decade could see significantly more interest in property taxation in developing countries, if fiscal decentralization proceeds and if central governments insist on increased local revenue mobilization. Property tax revenues often suffer owing to their fragmented structure, i.e., a proliferation of taxes on essentially the same base but administered separately under different laws. In some circumstances the new setting may result in rationalization of the system (annual property tax, transaction taxes and duties, betterment levies, capital gains taxes, etc.), with ensuing administrative efficiencies and revenue gains. Finally, there is the issue of political resistance to a tax that is highly visible, judgmentally administered and levied against accrued gains. Local governments might be willing to take on this resistance, if the revenue return is great enough and if the incentives are correctly set. In theory, the property tax might be replaced by other productive forms of local taxation; in most developing countries, however, while sales and income taxes may sometimes be appropriate for larger regional governments, perhaps including metropolitan cities, there is not much besides the property tax for small local governments.

Conclusions

Over the last 50 years, as "developing" became increasingly a synonym for low and middle income countries, and as economists and others became increasingly engaged in the exercise of attempting to design and implement improved taxation systems in developing countries, both the scope of the problems encountered and, to a lesser extent, our understanding of the lessons to be learned have changed. What have we learned about taxation and development from the extensive experience of the last half-century?

First, something that is obvious, but can always bear repeating, is that there appears to be no necessary relationship between tax levels and either income levels or growth rates. Both "big governments" and "small governments" may succeed; or they may fail.

Secondly, the last 30 years seem to show fairly conclusively that for sustained development it is not only desirable but, over time, essential to keep tax and expenditure levels close together. In this sense most developing countries are now "fiscally conservative" -- and experience suggests strongly that on the whole this is a good thing for their people.

Thirdly, if we look a little more deeply, it seems evident that it is in all likelihood more important for both economic growth and development (in the broader sense of incorporating an increasing proportion of the population in the growing prosperity) that countries spend well than that they tax well. Of course, this is subject to the caveat we mentioned in the introduction that one does not kill the golden goose by overtaxation -- whether the "goose" be trade, investment, work effort, development of sound public and private institutions, or any of the other factors whose interplay determines economic outcomes.

Fourthly, turning more specifically to taxes, from a structural perspective, it appears that the best way to ensure that the goose thrives is for developing countries to have a tax "portfolio" that incorporates broad-based taxes on both consumption and income while keeping effective rates on sensitive economic margins as low as possible. In recent decades, the VAT has come to play an increasing role in many developing countries, and on the whole this has been a positive development. However, income taxes (Bird and Zolt 2005; Barreix and Roca 2007), excise taxes (Cnossen 2005, 2006), and property taxes (Bahl and Martinez Vazquez 2008) all have continuing

important roles to play in taxation for development. There is still much work for tax policy specialists in developing countries.

Finally, there is even more work for tax administration specialists -- at least for the perhaps rare specimens of this embattled breed who lift up their heads from the technical minutiae of their daily concerns to consider carefully the society in which the administrative system has to function. No tax is better than its administration, so tax administration matters -- a lot. This observation returns us to the first lesson mentioned in the introduction. Since few if any tax administrations can long out-perform government administration in general, those concerned with development must consider carefully not only how different tax designs and different styles of tax administration affect revenue but also the extent to which they facilitate and encourage better government. There is no silver bullet for tax policy problems in developing countries. But there may be different paradigms that might help. Perhaps because we are (in the terms introduced by Easterly (2006)) "Searchers" who observe how things work on the ground -- as opposed to "Planners" who stand above the fray and consider how things "should" work -- we think that decentralization (development from below³⁵) may provide a useful approach in many developing countries. But that is a topic for another day.

³⁵ This is the title of a pioneering book on local government finance in developing countries by Ursula Hicks (1961).

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