Tax Policy in Developing Countries

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State of Existing Tax Literature

• All too few papers focus on tax policy in developing countries
  – Frustrating experience as editor of *Journal of Public Economics*
  – *Notable exceptions* (Newberry-Stern, Tanzi)

• Academic work almost entirely focuses on experience in the U.S., and more recently in Western Europe
Differing Issues in Developing Countries

• Informal Economy a much larger fraction of GDP
• Corruption a major problem – too much discretion available to tax inspectors given lack of alternative sources of information?
• Capital flight – weak domestic financial institutions make capital flight easy
Many other Puzzles regarding Tax Policy in Developing Countries

• Very low revenue as fraction of GDP
• Little use of personal income taxes
• High fraction of revenue comes from a small number of large firms
• Substantial use of nontraditional sources of revenue: seignorage, tariffs, fees
Existing Explanations

• Political economy
  – Yet same types of policies seen in U.S. in 19th century
  – “Optimal” tax base shouldn’t depend on distributional objectives
  – Outcomes do not seem to be sensitive to type of regime
Perverse Outcomes from Sensible Policies

• Experience in Mexico
• Effects, e.g., of shifts from tariffs to sales and income taxes – Brazil, Pakistan
Poor Tax Administration

• To what degree do feasible changes help?
  – Do countries with newly computerized systems shift to more “traditional” tax systems?

• Cash economy remains hard to tax. What affects its size?

• Given poor state of tax administration, what tax structures work best?
Areas where we know too little?

• How is the
  – size of the informal economy
  – extent of corruption
  – amount of capital flight
  affected by the choice of tax structure?

• How do non-tax policies (financial regulation, inflation, bureaucratic red-tape) affect these activities?
  --Direct measurement infeasible, so what can be done?
Approach Taken in Recent Tax Literature

- Measuring all the different forms of behavioral response hopeless

- Feldstein approach: What is the impact of behavioral responses on tax revenue?
  - If private markets otherwise efficient, then this measures the efficiency effects of policy change, “regardless” of the type of behavioral response.
  - Need to consider interactions among tax bases, though
How Robust is this Approach?

- In principle, captures changes in size of informal economy, or in capital flight, appropriately
- If policies affect ease of corruption, hard to capture effects of policy change on tax burden, holding private behavior fixed
- Ignores implications of market failures, e.g. credit constraints
- Effects on economic growth, e.g. by encouraging entry of new firms, leading to more rapid learning
Problems with Implementation

• Key issue is to measure what revenue would have been *without* any behavioral responses
  – Capture mechanical effects of a change in tax rate or tax administration
  – If tax rate changes, expect proportional increase in revenue from that tax
  – Need to control for other factors that cause tax revenue to change over time, e.g. business cycle
Data Needs

• Tax revenue, to begin with!
• Tax base whose rate has changed, to forecast mechanical effects
• Business cycle controls
Other Evidence

• Why does tax revenue change as it does?
  – Shifts in industry composition?
  – Increase in size of formal sector?
  – Drop in corruption, as seen perhaps through drop in number of officials or increase in their required legal pay?
Policy Changes to Focus on

• Policies that countries now considering adopting or abandoning

• Knowledge of the economic effects of such decisions, when taken elsewhere, can greatly assist policy debate
Examples of Possible Studies

• Changes in a VAT
  – Shift to a more uniform rate – To what degree do firms now facing a higher tax rate shift into the informal economy?
  – Shift to a consumption rather than production base
  – Shift from turnover taxes to a VAT
Other Examples

• Cut in tariff rates
  – What are the revenue effects of the resulting change in composition of domestic production?
  – What happens to the size of the informal economy?
• Changes in inflation rate – To what degree does this drive activity into the formal sector, by raising the costs of using cash?
• Financial sector reforms – To what degree does this pull firms into the formal sector?
• Financial transactions tax – Extent of financial disintermediation. Drop in size of cash economy, since cash more expensive?
• Reforms in tax administration
  – Mechanical effect on tax revenue harder to judge – look at impact on private activity, compared with changes in tax rates?

• Following such reforms, to what degree do increases in tax rates cause a smaller loss in tax revenue than before?

• Fiscal decentralization: Can local governments monitor economic activity better or worse than the national government?
• Use of presumptive taxes
  – Expect fall in corruption
  – Firms shift further underground, or into the fully formal economy
Distributional Effects of Policy Changes

• What happens to net-of-tax wages, interest rates, consumer prices, agricultural prices due to policy changes?