



## **Initiative for Policy Dialogue**

### **IPD Tax Task Force**

#### **Summary from 30 March 2005 Task Policy Meeting**

Composed by Indira Rajaraman

#### **On the Types of Studies That Can Most Fruitfully Be Pursued**

- Data availability problems in the developing world mean that, in general, an issue-based approach goes much further than a purely technique-driven approach.
- The most data-feasible area of study of the effects of tax policy changes on economic behaviour, along the lines of the excellent studies for the developed world by Eissa and Saez, will be corporate income taxation. For some if not all countries, it may be possible to obtain data for a difference-in-differences approach.
- The most important issue in the Indian context is the revenue impact of trade reform. In the eighties, the replacement of import quotas by tariff equivalents led to a marked rise in the tax-GDP ratio, to an all-time high, aggregating across all levels of government, of 16 percent in FY90. In the nineties, the reduction in tariff rates led to a fall in customs revenue by two percentage points of GDP, which has been compensated from other sources so far only to the extent of one percentage point (Rajaraman, 2005). Since tariff revenues are always lost at the level of national government, there is the further issue in fiscal federations of tariff revenue losses leading to a possible alteration in the balance of power within the federation (Rajaraman, 2004). There are equity consequences of the loss in revenue share of national-level government, since it is only at that level that cross-regional inequalities can potentially be corrected. The predatory fiscal behaviour by national government in federal Brazil, spoken of by de Oliveira, is the kind of outcome that could predictably result from the attempt of national government to restore the loss in its relative revenue resulting from trade tariff reductions. A comparative study of relative shares of different levels of government, and the timing and level of introduction of replacement levies during a process of tariff reductions, for the subset of fiscal federations in the developing world (Brazil, Argentina, India, Pakistan), could yield a useful understanding of the political economy forces driving tax policy. I have an unpublished paper (Rajaraman, 2003) with a preliminary study along these lines based on GFS data from the IMF.
- In India, even though the largest share of tax revenues is from indirect taxes, direct taxes have yielded the largest increment in replacement revenue for lost trade tax

revenue, and are therefore worth studying. This is also supported by the potentially greater data availability on corporate taxation.

- Tax policy changes in the developing world are typically very messy, and are not once-over changes of the kind in the US in 1986. There are decisive years when policy changes are introduced (1991 in India), but what follows is a gradual process which is multi-dimensional. The overall direction of change across all the dimensions may be consistent from year to year, but need not always be. This has implications for the kind of econometrics attempted.
- On the corruption issue, while tax policy can indeed be more or less corruption-enabling, it may be worthwhile trying a cross-country regression to test for whether corruption, as measured through standard indices like Transparency International, is statistically significantly related to the ratio between civil servant salary and per capita GDP.

Rajaraman, Indira (2005) "Fiscal Developments and Outlook in India", invited paper at IMF-NIPFP conference on **Fiscal Policy in India**, New Delhi, January 2004 (NIPFP Working Paper 15, 2004). Forthcoming in Peter Heller and M. G. Rao, ed. (Oxford University Press).

Rajaraman, Indira (2004) "Fiscal Restructuring in the Context of Trade Reform", in G.C.Srivastava, ed. **The Dynamics of Fiscal Federalism: Challenges Before the Twelfth Finance Commission** (Taxmann); 201-230; downloadable from NIPFP website as Working Paper 7, 2004. Abbreviate version in **Economic and Political Weekly** XXXIX: 26 (June); 2787-2794.

Rajaraman, Indira (2003) "Fiscal Constraints to Trade Reform" unpublished.