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 19^{th} 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?