1. Sustainable development requires a good tax system

Jorge Martinez-Vazquez and Richard M. Bird

Budgets are where the dreams of development planners and reformers come to be born or to die. The hopes and aspirations of any society as well as its capability to realize them are revealed more clearly by how governments spend and tax than by the declarations of politicians or the advocacy of interest groups, whether domestic or international. How a country finances its public sector is not simply about money but about such broader issues as the relation between state and society, how political institutions function in articulating and implementing social objectives, and the extent to which states succeed in achieving them. Spending and regulatory policy are of course also important but since even the best-intentioned government cannot spend revenues it does not have a critical element of development policy always and everywhere is taxation.

How much a country taxes, what it taxes, how it determines its tax policy, the extent to which the level and structure of taxation are related to spending policy, how taxes are administered, and how well both policy and administration adjust to the ever-changing environment all countries now face in this globalizing world – such matters are not simply esoteric issues best left to public finance specialists. On the contrary, as historians are increasingly recognizing, they are the “sinews of power” in the important sense of being critical links between what a country may wish to achieve through its political institutions and what is actually achievable and achieved.1

In the last few years the development community at large has at last begun to take seriously some of the problems arising from the weakness in many countries of the critical link between taxation and development. In addition to the simple need for additional revenue emphasized by the UN Millennium Project (2005), the centrality of taxation for development has recently been stressed by both the European Commission (2010) and

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the OECD Development Advisory Committee (OECD 2012). Moreover, increased attention is also being paid both to the role of taxation in affecting the distribution of income and wealth (International Tax Dialogue 2011) and in improving governance (OECD 2010). Some aid agencies have also moved tax and development to the top of their “to-do” lists, with particular attention being paid to improving tax policy and especially tax administration as well as to reducing fiscal barriers to bringing micro and small business into the formal sector and strengthening domestic and international efforts to reduce capital flight and international tax evasion. In a recent useful survey of the aid literature, Fjeldstad (2013) identifies some of the critical issues many developing countries face with respect to strengthening the link between tax and development that have been highlighted in the recent development literature:

1. The need to increase revenues to finance major social and infrastructure needs;
2. The need to design taxes to favor efficiency, growth and equity;
3. The need to reduce tax exemptions to increase the tax base and reduce corruption and evasion;
4. The need to reduce taxes on the poorest and to increase taxes on the richest;
5. The need to deal more adequately with profit-shifting by multinational companies;
6. The need to design and implement taxes with careful attention to the implications for improving the quality of governance.

All of these questions are, to varying extents, discussed in the present book. Of course, some of them – especially the first three listed – have long been the focus of the relatively few tax scholars who have dedicated much of their careers to the study and improvement of tax systems in developing countries. Roy Bahl stands out among the small group of development tax experts not simply because of his important work on subjects that are now, once more, at the forefront of development discussion but also because of the extent to which he has long been actively engaged not only in thinking about such matters but in doing what needs to be done to improve outcomes both by training tax and public finance specialists in developing countries and by carrying out extensive field work in a variety of countries around the world. Since Roy’s experience and work on taxation in developing countries is unique in the extent to which he has paid close attention to subnational issues it is not surprising that, as more and more countries began to turn in recent
decades to some form of decentralization as a possible way to deal with some of their problems, he has again played a critical role in shaping much of the recent expansion of work on issues of regional and local finance in developing countries.2

The essays in this volume by friends, colleagues, and students of Roy Bahl all relate to some aspect of the critical linkages between taxation and development. The three essays in Part I, for example, focus mainly on the key question of how much and in what way countries can, should, and do tax: what factors determine the level and growth of taxes in different environments, how the effects of alternative possible changes in taxation may be modeled and evaluated, and how views as to what changes are advisable have altered over time. In contrast, the four essays in Part II consider from different perspectives aspects of some difficult and important issues in tax design: how to deal with multinational enterprises, how to deal with small and informal enterprises, the connection between tax policy and income inequality, and the appropriate way to deal with a particular form of “tax expenditure” or, in the particular case considered, outright subsidy.

Looking still more deeply into fiscal reality, the three essays in Part III similarly consider from different perspectives three aspects of fiscal decentralization: why theory and practice seem always to differ, how to reform the property tax, and the unduly neglected subject of local user or beneficiary charges. Finally, to round off the volume, Roy Bahl in the final essay stands back from the critical but often context-specific and complex details raised in many of the preceding chapters and discusses in more general terms the fundamental question of just how, when, and to what extent tax systems in developing countries can be strengthened.

Several common themes emerge to varying degrees in the course of the superficially diverse topics covered in this volume. One such theme is the importance of better understanding the ways in which taxes and expenditures are linked. At the macro level, this point is made explicitly in Chapter 2. It is also central to the discussion of the economics and politics of taxation and inequality in Chapter 7, and comes up again with respect to particular aspects of tax policy in Chapters 4 (on the evolution of ideas about tax policy) and Chapter 6 (on taxing small and medium enterprises), as well as in all three of the chapters dealing with fiscal decentralization and subnational revenues. The importance of understanding the intergovernmental context in designing tax policy at any level of government is itself another cross-cutting theme that is discussed not only in the chapters on decentralization but also in the context of the issues considered in Chapters 4 and 6. Both of these themes might perhaps be subsumed under a third theme that echoes throughout the
book as a whole, namely, the critical importance of considering tax issues within the specific context of each country taking into account not only the level and structure of its economic development but also its history, its regional location, and its political institutions. As Acemoglu and Robinson (2012), Besley and Persson (2011), and Alesina and Reich (2013) have recently emphasized in different ways, since the economic and political development of every country is both path-dependent and context-specific it is inextricably linked not only to such non-economic factors as those just mentioned but also to other critical factors such as social norms and culture that are even harder to measure, analyze and understand (Inglehart and Welzel 2010).

Many years ago, when one of us was just beginning the study of public finance, he was both impressed and somewhat terrified to be told that to understand the subject one really needed deep knowledge of not only economics but also political science, public administration, sociology, management, and accounting. Subsequently, as his own experience with the field expanded, he began to add to this list of ideal requirements for the well-rounded student of public finance knowledge of mathematics, history, law, and psychology. Obviously any one person can be at best a dilettante with respect to many of these fields, so most who work in the field of tax and development have understandably tended to hew fairly closely to their own disciplinary base, which for most has been economics. Of course, as is discussed further in Chapter 4, the nature of the economics discipline has itself altered considerably over the last 50 years. One consequence is that economists have substantially increased their analytical understanding of the economic effects of taxation: indeed, much of what was once called “public finance” is now more commonly called “public economics” – at least by economists. This development had many beneficial effects in sharpening the economic analysis of tax policy in developing countries and in particular in facilitating the development of new tools that have in recent years led to much more and much better empirical analysis (as discussed in Chapters 2 and 3).

Over the same period, however, a subset of economists concerned with public sector issues moved in a different direction towards what is often called the “public choice” approach, which in effect returned to the older political economy tradition of Colm (1955) although in a considerably more analytically and empirically rigorous way. However, although some have applied this approach fruitfully to explore some issues of taxation and development both empirically (Kenny and Winer 2010) and conceptually (Brautigam, Fjeldstad and Moore 2007), there seems still to be a considerable distance to go before this approach really moves into the mainstream (Keen 2012). Nonetheless, as many of the chapters in the
present book confirm, to understand how taxes work in developing
countries more progress is needed in the direction of broadening rather
than narrowing our approach to the subject although there is still, of
course, much to be done with respect to developing and applying new
modeling techniques to developing country data. The chapters in this
book thus consider the past (what we have learned), the present (what
problems we currently face), and the future (how can we better approach
those problems) of tax and development. We have learned much about
this subject over the last half century. As is almost always the case with
complex social phenomena, however, there is still much more to be
learned.

OUTLINE OF THE BOOK

The next three chapters in the volume provide a general overview of the
changes that have taken place in analyzing tax performance and in tax
thinking more generally in recent decades. Success in terms of the usual
criteria is evident in some countries and their experience suggests lessons
that may be useful to those facing similar problems in other countries.
However, even in such success stories progress has usually been slow and
many challenges still lie ahead. Taxation may be the weakest link in
development policy for several reasons. Central to the economic
approach, for example, is the concern that taxes may be inefficiently
distorting the allocation of resources, thus retarding growth. A politically
more salient argument in many countries may simply be that the existing
tax systems may not raise sufficient revenue to permit the level of public
expenditure on infrastructure and social services needed to promote
growth and development. How much and how tax revenues are raised in
any country largely reflects collective political choices, although such
choices may, or may not, adequately reflect the underlying concerns of
the people. From both a political and an economic perspective, however,
since adequate tax effort is critical to satisfying growing needs for health,
education, public infrastructure and other basic services it is always an
essential component of development policy.

Chapter 2, by Musharraf Rasool Cyan, Jorge Martinez-Vazquez and
Violeta Vulovic, reexamines the question of what determines the level of
tax effort exercised by different countries. The earlier literature on this
question largely focused on the comparison across countries of the
availability of “tax handles” and the comparison of actual collection
performance against a measure of potential collections. In effect, the
extent to which each country utilized its tax bases was compared with the
average utilization rates found in countries with comparable levels and structures of economic development. More recent studies along this line have expanded this approach by taking into account not only such “supply” factors as the size of potential tax bases (imports, mining, etc.) but also factors influencing “demand” such as the extent to which political institutions give people “voice” and legal institutions establish a favorable “climate” for private saving and investment. This chapter breaks new ground by relating the definition of tax effort not so much to what other countries are doing as to the developmental needs and budgetary goals that set the parameters of potential tax reform. The authors argue that it is important to link the adequacy of tax effort explicitly to the specific expenditure objectives of government and the associated gains in national welfare.

Chapter 2 also examines the extent to which it matters if the traditional regression model (which, as noted above, essentially “benchmarks” countries against the average of other countries) or the newer stochastic frontier modeling approach (which instead benchmarks against the “best” performance) is used to estimate tax effort. While the authors find that the differences in the two approaches are not that great, they argue that the capacity measures yielded by both approaches do not really provide a politically appealing revenue target specifically applicable to a country. They suggest that more meaningful ways to measure tax effort might be to take either the gap between current revenues and the existing level of public expenditures – the result of a country’s political choices – or the gap between existing revenues and those required to reach such presumably desired targets as the Millennium Development Goals (UN Millennium Project 2005). Although the latter of these approaches has been explored to some extent in such recent official documents as IMF (2011), the present chapter appears to be the first to compare the results of measuring tax effort in terms of the existing fiscal gap with the results of the more conventional regression and stochastic modeling approaches. While the estimates reported here are only preliminary, this approach to assessing tax effort appears worthy of further exploration since experience suggests that governments are more likely to move to strengthen revenues to meet clearly defined and understandable goals than to meet objectives suggested by inherently complex and difficult to understand econometric analyses.

Not all that long ago such essential components of policy analysis as revenue impact estimates, the distribution of tax burdens, and the efficiency effects of tax reform proposals consisted at best of some sort of spreadsheet analysis involving aggregate figures combined with lots of guess work. At worst, it was little more than a set of back of the envelope
calculations illustrating some of the expected outcomes of different policy packages. Matters are now very different as a result of the evolution and introduction of two sets of analytical tools that have become integral components in the preparation and analysis of serious tax reform packages in countries around the world. Some decades ago, tax administrations in a few developed countries began to construct micro datasets from structured samples of individual taxpayers, particularly with respect to personal and business income taxes, in order to be able to calculate how the tax liabilities of different taxpayers would be affected by changes in the structural design of the tax system. Such micro-simulation models (MSM) are now widely available in many countries around the world and have become considerably more sophisticated by allowing behavioral responses of taxpayers to the different tax design scenarios. This approach has proved particularly useful in analyzing the distributional impact of tax changes. Around the same time as MSM models began to be constructed, largely on the basis of administrative data, academic economists began using computable general equilibrium (CGE) models, initially to understand the interrelated determination of relative prices in many sectors of the economy. Soon, however, applied CGE models began to be used to study the impact of different tax structures, and such models have subsequently proved to be a useful way to analyze the likely impact on efficiency of tax changes.

In Chapter 3 Andrew Feltenstein, Luciana Lopes, Janet Porras-Mendoza and Sally Wallace examine the impact of these two new tools — micro-simulation and computable general equilibrium modeling — on tax reform and tax advice in developing countries. The authors both identify the strengths and weaknesses of both techniques and present a useful review of how they have been used in analyzing tax policy reforms in developing countries. Since, as noted above, the two approaches are essentially complementary in what they can do, with MSM focusing on distributional effects and CGE on allocative efficiency, it is not surprising that many attempts have been made to use both approaches in a combined fashion. Two main approaches have been followed in integrating these approaches. The “top-down” approach, which is the most commonly used, feeds the aggregate results obtained from the computable general equilibrium model into the micro-simulation model. In contrast, in what Chapter 3 calls the “bottom-up” approach, the micro-simulation model is first used to generate parameters that are then employed in designing and running the computable general equilibrium model. The authors conclude that either approach can be useful in yielding more accurate estimates of the impact of tax reform on revenues, allocation of resources and after-tax income distributions and illustrate,
with an application to the case of Pakistan, the relative usefulness of each of these modeling techniques.

The conventional wisdom on development taxation has changed substantially over time, with three distinct stages being discernible. In the first few decades after World War II, the dominant “model” was essentially the same as the “comprehensive income tax” ideal long advocated as the appropriate objective for developed countries. Understandably, most early studies in developing countries essentially followed the same lines and advocated tax reform policies not all that different from those that their authors advocated in their own countries. This approach to development taxation did not turn out to be very successful. Such policies were seldom accepted in full and even when they were accepted in part they were not very successful in achieving the objective of establishing an equitable and efficient revenue system. These poor results were one reason why a second, quite different approach to development taxation began to emerge in the 1980s. More importantly, however, the new “model” adopted by most advisors reflected the important post-1970 developments in public economics mentioned earlier, with the result that the new model implicitly underlying most advice on tax matters remained essentially a “one size fits all” normative approach, although the ideal to which developing countries were now urged to aspire, which took the form of a “broad base low rate” model centered more on the VAT than the income tax, was also reinforced by an increasing body of empirical evidence.

Chapter 4 by Richard M. Bird suggests that over the last two decades another “model” for tax reform in developing countries has begun to emerge that differs substantially from its predecessors in several important respects. This approach does not present a single model suitable for all countries but rather a list of factors that need to be taken into account in developing an appropriate model of reform given the specific circumstances and objectives of the particular country in which it is to be applied. This approach explicitly recognizes that taxation plays many roles, both positive and negative, with respect to different policy goals and that careful attention needs to be given to how each of the many dimensions of the design, implementation, and effects of the tax system may affect these goals. In addition, it emphasizes the need to bring more explicitly into the analysis of national tax reform such often-neglected factors as macroeconomic conditions, international economic developments, the political institutions within which reforms are developed, become law, and are implemented, intergovernmental relations, social security systems and other relevant aspects of expenditure policy, as well as relevant regulatory policies. Experience tells us that what happens to
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tax systems always and everywhere reflects where the change is taking place, why it is taking place, who is for and against it, and what is going on elsewhere in both the domestic and international policy world. Obviously, no one, anywhere, can really factor all these potentially relevant characteristics into either a simple analytical or a computable empirical model, so as with all model-building, formal or informal, the most important decision is often what can and should be left out of account while still producing meaningful results. In part because such critical decisions cannot really be made – and, the author suggests, should not be made – by those not directly responsible for and affected by them, the chapter concludes that the most useful role for foreign advisers concerned with taxation in developing countries is to train, support, and assist domestic analysts and policymakers to make the best decisions they can over the long haul rather than simply to fly in, dispense advice, and leave.

One of the most conspicuous features of economic globalization is the high and continuously increasing mobility of capital across national borders. This capital mobility has become an important factor shaping policy around the world. Competition for mobile capital has led countries to redefine their tax systems by, for example, lowering corporate income tax rates (Devereux, Lockwood, and Redoano 2008), adopting “dual” income taxes with different rates on labor and capital income (Bird and Zolt 2011), and introducing a panoply of tax incentives intended to attract more direct foreign investment (Klemm and van Parys 2012). The increased competition for investment capital has forced developing countries to become more competitive not only in terms of tax policy but also with respect to public investment in infrastructure and such aspects of governance institutions affecting foreign direct investment flows as the simplicity and certainty of business licensing. Regardless of what any developing country may do to improve the attractiveness of its own “environment” for foreign investors, however, the extent to which countries can successfully tax foreign companies is not fully within their control. Instead, it inevitably depends critically on what is going on in the world in general. Much attention has recently been paid to one important aspect of this international context – the extent to which a country’s tax base may be eroded by profit shifting and especially the use of tax havens (OECD 2013). Another important factor, however, is how the home country tax system of foreign investors (largely developed countries) treats earnings generated in host countries (significantly, emerging and developing countries).

Chapter 5 by Thornton Matheson, Victoria Perry and Chandara Veung considers how some important recent changes in the treatment of
cross-border investment income in major developed countries may affect the extent to which developing countries can effectively generate tax revenues from the profits generated by foreign direct investment. A number of major capital exporting (home) countries have shifted recently (or are contemplating doing so shortly) from what is called worldwide corporate taxation – under which investors are taxed on all income regardless of where it is generated but are generally allowed a credit for taxes paid in the host country – toward the so-called “territorial” system, under which home countries tax only those profits originating in the home country – that is, exempt income earned abroad. The authors find that this regime change has significant implications for the volume, distribution and financing of foreign direct investment in developing countries. The conclusion that the move to a territorial system makes businesses more sensitive to host-country statutory tax rates, especially for the case of foreign direct investment financed from new equity, is reinforced by an analysis of bilateral outbound foreign direct investment data for the UK for 2002–2010, a period during which the UK changed from a worldwide to a territorial system. Every country has long had difficulty in designing its tax system to deal appropriately with foreign firms as well as in implementing whatever policy it decides to follow in the face of the complexity of the structure and operations of such firms, and the fact that so much of their activity is beyond the reach or knowledge of any country. This task has of course been particularly difficult for developing countries which, almost by definition, have far less expertise in such matters than developed countries, let alone the firms in question. Changes such as those discussed in this chapter that are made by developed countries for what presumably seem to them to be good reasons do not necessarily make life any easier for tax policymakers and tax administrators in developing countries. Indeed, all too often, they may make life more difficult. This is one area in which more external support along the lines sketched in the preceding chapter might perhaps be most helpful.

Tax enforcement around the world for the last few decades has largely focused on large taxpayers, domestic as well as foreign. This approach makes sense because the always scarce resources available to tax administrations are usually most productive in revenue terms if focused on large taxpayers, who constitute only a small percentage of all taxpayers but often account for two-thirds or more of tax revenues collected. Recently, however, there has also been increasing interest in many countries in how best to tax the smaller taxpayers (ITD 2007; IFC 2007). Some smaller taxpayers may fall within the category of the “hard-to-tax”, a label applied to those who fail to register voluntarily or
file returns and are unlikely to keep appropriate records (Alm, Martinez-Vazquez and Wallace 2004). Because such taxpayers represent a sizable share of the economy in some developing countries, this new interest in dealing with them may sometimes be linked to revenue issues. It may also sometimes be seen as a way to make it possible and desirable for smaller taxpayers, who are often initially included in special simplified regimes, to eventually graduate into full civic responsibility as ordinary taxpayers. But more than revenue may also be involved. For example, improving the extent to which smaller taxpayers are included within the tax system may be perceived as a way to increase tax morale and horizontal equity across the board and hence to increase the extent to which taxation may play a positive role in building up trust in the state.7

William F. Fox and Matthew N. Murray explore the largely unsettled issues of how best to foster tax compliance among small enterprises in Chapter 6. Decisions have to be made on what businesses are to be considered “small” and what, if any, special rules should be applied to such taxpayers as well as about the design of enforcement regimes and administrative policies and procedures. Such decisions must take into account not only the conventional concerns about revenue and equity but also such complex factors as the incentives for firms to remain small, the presumably desirable effects of inducing more firms to move into the “formal” sector of the economy, and the possible strengthening of tax enforcement in general as a result of expanding the scope for cross verification. There is also an important issue of credibility. If the decision is made to tax small enterprises, but there is neither strong political willingness to do so nor a relatively efficient and non-corrupt tax administration, the attempt to extend the reach of the tax system to encompass small enterprises may backfire and compromise overall tax compliance. The authors examine a number of ways in which unique regimes for small enterprises have been implemented such as the use of minimum thresholds and the introduction of presumptive tax regimes. Much of their discussion is centered on the VAT, which is by far the most important source of revenue in developing countries. On the whole, they offer little support for such alternatives as special presumptive regimes both for administrative reasons and because such systems tend to discourage rather than prepare taxpayers to graduate into the regular system of taxation. The authors conclude that it is better to integrate small firms directly into the general tax system although in a simplified fashion.

The ultimate purpose of taxation is to secure the funds needed to provide public services in as fair (in the sense of being politically
acceptable and sustainable) and economically sound a fashion as possible. Understandably, the major thrust of much of the economic literature on taxation in developing countries has been on the revenue and economic rather than the political aspect of these objectives. Much attention has been paid to the essentially macroeconomic issue of the appropriate level of taxation, an emphasis that has been highlighted in recent years in many countries by cyclical problems. Especially since the evolution of public finance into public economics in the 1970s even more attention has been paid to a wide variety of microeconomic issues related to the effects of taxation on growth and development. These issues are obviously important. But anyone who actually works on tax issues in any country soon learns that most critical factors that shape what is actually done often arise in terms of the supposed distributional effects on different regions, different groups (workers, capitalists, homeowners, voters) and, of course, different income levels (rich, poor). Until recently, however, the dominant literature on tax and development paid surprisingly little attention to how taxation may affect the distribution of income and wealth. One reason for this relative neglect may simply have been because it is much more difficult to determine the distributional effects of taxation with any confidence than most people (and most politicians) think. Even with all the advances made in analyzing and modeling tax reforms, the major tool available for such work continues to be simply to simulate in quantitative terms the impact of particular assumptions about the incidence of taxes, few of which have as yet been empirically validated in any convincing way. Nonetheless, in recent years the increasing wealth of the few at the top has once again, after decades of neglect, moved concern with taxation and inequality back to the top of the tax policy agenda in many countries.

In Chapter 7, Richard M. Bird and Eric M. Zolt compare and contrast the role taxation and more broadly fiscal policy has played with respect to income distribution in several countries in North and South America. They begin by noting that in some ways the world seems to have turned “upside down” in recent years as incomes have become more unequal in North America, especially in the United States, and less unequal in Latin America. The picture is much the same whether one considers trends in Gini coefficients, in poverty reduction, or in social mobility: while still strikingly unequal in many respects, all these indicators have clearly improved (in the sense of moving towards greater equality) in major Latin American countries in recent years, while they have worsened in the United States. Moreover, the authors find that, although the United States continues to rely most heavily on the (presumably essentially progressive) personal income tax and the Latin American countries most...
heavily on the VAT (which is often considered to be basically regressive), on the whole the public sector’s impact on distributional outcomes has become more progressive in Latin America and less so in the United States. While only a relatively small part of this impact is attributable to taxation, and the personal income tax in the US undoubtedly remains considerably more progressive than those in the other countries studied (Mexico, Colombia, Brazil, Peru, and Argentina), the authors nonetheless suggest that the changes noted may suggest an underlying shift in the “fiscal contract” existing in Latin America. The chapter develops the notion of the fiscal contract – a concept mentioned in passing earlier in Chapter 6 – as the fiscal manifestation of the underlying changes in the “social contract” that over time shapes the policy decisions emerging from political institutions. In effect, the authors suggest, drawing on experience in other countries, that since the tax system sustainable in any country must be one that is supported by the interests of a critical set of politically significant groups, the recent changes in Latin America may be read as evidence of a change in the political balance that has probably been driven in large part by the recent substantial increase in the size and importance of the middle class in the region. From this perspective, they conclude that, perhaps surprisingly, it may turn out to be more difficult to restore “fiscal balance” in political and social terms in the United States than it will be to sustain at least for some time the relative turn toward equality evident in recent Latin American experience.

The desirability of broadening the base of taxes such as income and consumption taxes has long been argued by tax policy experts. The other side of this argument is that few tax advisers support any of the many tax incentives, tax concessions, tax exemptions, tax holidays, tax expenditures, or whatever other label may be attached to policies that imply narrowing rather than broadening the tax base. Three basic arguments may be made against such measures. The first is simply that because they narrow the tax base, higher tax rates (which are more inherently distorting) must be imposed on the remaining base in order to raise any given amount of revenue. The second is that because such concessions almost always increase both the complexity and the administrative costs of the tax system, they introduce still further efficiency as well as (in most cases) equity costs. And the third is simply that the social benefits received from such concessions can almost never be shown to exceed the costs to which they give rise. Of course tax concessions are simply one manifestation of what seems to be the inexorable drive of political systems to subsidize a seemingly endless variety of “good things” – or at least things or activities that some can plausibly argue to be “good”. Subsidies spend revenue rather than collect them. But like taxes subsidies
impact on the efficiency of resource allocation and the distribution of income. Subsidies come in many forms and shapes in addition to tax concessions such as transfers to persons or businesses, either directly or through price control policies. Such policies in some countries demonstrably weaken the fiscal position of governments but are seldom subjected to the same rigorous scrutiny and political debate as proposed tax reforms. This is unfortunate since it is even more important for developing countries to spend wisely than to tax more or in a better way. Because the pressure to tax more usually arises from the need to finance expenditures it is critical to ensure that inefficient and inequitable expenditures are eliminated before seeking to increase taxes.

Unfortunately, such wasteful expenditures remain all too common in many countries. As Charles E. McLure, Jr. shows in Chapter 8, there are many reasons why the extensive fuel subsidies found in some developing countries need reform. Because subsidies to fossil fuel consumption result in serious distortions in such key sectors of the economy as transportation, energy and the environment, they are particularly inappropriate for many reasons besides the simple waste of fiscal resources. In his characteristically careful, detailed and restrained analysis of this important and complex subject, McLure shows that subsidies to fossil fuel consumption exacerbate such problems as traffic congestion and air pollution, increase energy insecurity, waste foreign exchange, and increase unproductive public bureaucracy. He then rigorously reviews such key definitional issues as the shortcomings of the price-gap methodology commonly used in the quantification of the subsidies, estimates fossil fuel consumption subsidies for 37 countries based on International Energy Agency data, and outlines the budgetary and other positive implications of eliminating subsidies. Chapter 8 concludes with a careful discussion of two arguments often used to defend such subsidies: to encourage consumers to switch from traditional fuels, which in many ways can be even more problematic, to modern fuels and their allegedly desirable distributional effects. Fuel subsidies are sometimes said to protect the interests of the poor. In reality, however, as the chapter argues, the incidence of most fuel subsidies is regressive, with most benefits flowing to the middle and upper income classes. In summary, fossil fuel subsidies are precisely the sort of wasteful and inefficient expenditure that developing countries should not be in the business of raising taxes to finance.

It is now widely accepted that good fiscal decentralization requires subnational governments to have a significant degree of revenue autonomy. Such autonomy not only encourages such governments to raise revenues but also increases both political accountability and fiscal
responsibility by creating, in effect, a hard budget constraint at the margin.\textsuperscript{9} Greater tax autonomy and its twin sister, lower transfer dependency, are also arguably associated with a long list of other virtuous outcomes such as better budgetary and macroeconomic stability. Moreover, although by no means all issues are settled there appears to be considerable consensus in the literature about how to provide more tax autonomy to subnational governments. Examples of best practice with economically attractive tax sources for subnational governments are abundant. Providing adequate revenue autonomy is not complex, requiring only the devolution of power to subnational governments to set tax rates for tax sources they select from a closed list. Nonetheless, many countries, developed as well as developing, have failed to adopt such “best practices” and continue struggling to find adequate financing for the increasingly large expenditure needs of subnational governments. Why do revenue assignments in practice tend to deviate significantly from those suggested by generally accepted normative criteria and why are potentially good subnational taxes often badly designed? Paul Smoke in Chapter 9 examines in depth why theory and practice differ so much in the implementation of subnational revenue systems. Smoke asks whether the problem arises because subnational taxation principles are inappropriate or whether they are just poorly applied. Although, as is all too often the case, the evidence is limited, conflicting and difficult to interpret, he concludes that the answer is that both factors seem to be at play. Although the conventionally suggested taxation sources are logical, they are often difficult to implement in practice and encounter certain critical constraints in terms of important contextual factors such as political will or administrative capacity. Although historical factors such as colonial roots may play some role in explaining the lack of effective change, political economy considerations remain the most obvious and important reason why inappropriate tax assignments and bad design have proved so difficult to reform over the years in so many countries. In the face of such powerful constraints, policy designers need to focus much more on pragmatic implementation strategies, inductively seeking out what really works, and giving full consideration to key political and administrative realities. Chapter 9 lays out the need for much fuller exploration of such key elements of the political economy setting within which decisions about subnational revenues are made as the durability of the “political will” underlying the original push for decentralization, the nature of the national bureaucratic environment that typically defines the all-important (and often devilish) “details” of decentralization, the distribution of local political powers and the incentives faced by both national and local politicians, the specific nature of
electoral processes, non-electoral governance mechanisms, the level of tax morale and compliance attitudes with respect to local revenues, the importance of deconcentrated systems competing with decentralized units, and local capacity and whether there are in place political incentives to use it.

In contrast, the two chapters that follow consider some lessons experience suggests with respect to the two most important sources of local “own revenue” now found in most countries: property taxes and user charges. Tax experts agree that property taxes have the potential to be a significant source of revenues at the subnational level in both developing and developed countries. The property tax is particularly attractive because those revenues can be raised both with relatively low efficiency costs and in a fairly equitable way. Despite its promise, however, few countries have come close to realizing the potential of the property tax. Moreover, attempts to reform and strengthen the performance of property taxes have seldom achieved much success in practice. As Chapter 9 emphasized, the principal reasons appear to lie in the always somewhat nebulous realm of political economy. Despite its long history and some past successes,10 most experience in recent decades suggests that the property tax is often one of the most unpopular of taxes. The reasons for its unpopularity include both its generally high visibility and the fact that it is based not on a measurable flow (such as income or expenditures) but usually on the value of an asset which may or not be related to income. Although people hold very different conceptions (many of which are demonstrably misperceptions) about the horizontal fairness of the tax, on the whole they know they do not like it, and politicians who are responsive to their constituents generally go along with such opposition. In addition to this fundamental political barrier, the property tax is also often difficult and relatively costly to administer, particularly in the form of a market value-based tax which is both conceptually preferable and generally recommended. Such a tax requires a good property registration system and frequent property valuations, neither of which is either cheap or in existence in most developing countries. Moreover, even when solid tax base information is available, it is often costly and difficult to collect and enforce the tax since there is seldom any good way to base the system on the sort of declarations or withholding through business intermediaries used for sales and income taxes. In many countries, the subnational governments charged with administering the tax lack either the means or the authority to demand payment. Unsurprisingly, poor tax administration reinforces the perceptions of arbitrariness and unfairness among taxpayers and results in still
greater reluctance on the part of politicians, local or national, to make effective use of the property tax as a source of local finance.

Despite such problems, Roy Kelly argues in Chapter 10 that it is still possible to succeed with property tax reform by carefully designing country-specific reforms to take adequately into account both the need to “sell” them to the public and to cope with administrative capacity problems, by preparing carefully and methodically to implement the reform, and by persisting with the effort to the point where the property tax can indeed become a meaningful source of subnational revenues. In line with some of the arguments made in earlier chapters, he suggests that such reforms to local government finance can be seen as a critical component of a broader public sector reform to become “demand-driven”. His argument is based not on academic naiveté about the real world but rather on his extensive and intensive experience for decades with property taxation reform efforts in a number of developing countries. In addition to doing the technical work well, which is not a quick process, the chapter suggests that successful reform of the property tax requires many of the elements present in any other successful tax reform such as political leadership and the right incentives to mobilize administrative and popular support. On the technical side, the chapter outlines in detail the key policy and administrative components required to make the property tax work: determining the appropriate coverage of the tax base and the structure of tax rates and establishing sound and adequate systems for valuation and collection. Because the weakest point of property tax reform is the quality of tax administration, once the political side is on board, the real problem is to get right all the details of adopting simplified data capture, data management and tax mapping procedures, appropriate valuation methodologies, transparent assessment procedures, accountable collection mechanisms, effective enforcement systems, and targeted taxpayer service. None of it is difficult in principle but pulling it all together in practice has proved to be a time-consuming and tricky task.

Most experts would agree that perhaps an even more appropriate source of revenue for local governments than the property tax is user charges and fees, as developed extensively some years ago in the seminal study by Bahl and Linn (1992). Charges and fees fill the bill so well because they embody what is often called the “benefit principle” of charging those who get services from the public sector for what they get. They thus allow local governments not only to provide the right amount of public services demanded by local residents but at the same time to finance those public services efficiently – two conditions that are rarely satisfied within the public sector. When the services provided (and
charged for) are determined by the local community itself, all sides of the ideal local government triangle – who decides, who benefits, and who pays – are equal, and people presumably get both what they pay for and what they want. What more can be asked of any funding mechanism? Many services provided by local governments are amenable to being financed with user charges and fees, including water and sewerage, electricity, parking, garbage collection and disposal, urban transportation and road use, pre-school care, residential care for the elderly, museums, parks, and sport facilities. Other services, such as health and education, can be partially financed with user fees. In addition, user fees can be charged to cover the public costs of registration and monitoring for a wide range of activities including business licensing, real estate titling and registration, and driving permits. Betterment levies (varieties of which are known under names such as plusvalía and development charges in different countries) may also be imposed and paid up front by developers and owners for such local infrastructure improvements as sidewalks, lighting, additional road construction, and water and sewerage access. From a political economy perspective, local user charges and fees also offer the advantage of not directly competing for any tax base with central governments. Perhaps for this reason, central governments are often much more generous in granting autonomy to subnational governments to set charges and fees than to set taxes. Despite all the positive attributes of local user charge financing, however, in reality user charges and fees are severely underutilized by local governments, especially in developing countries.

As Yeti Nisha Madhoo and Shyam Nath say in the title of Chapter 11, such charges are thus indeed the “Cinderella of subnational finance” – the ideal belle of the local fiscal ball but instead relegated to minor household chores. After setting out the principles and practices of user fees and charges and their revenue potential, the authors consider some reasons why beneficiary charges have been so little and so badly used in practice. They identify a variety of factors including such general structural features as the strong centralization of revenues and the heavy reliance on intergovernmental fiscal transfers to finance local activities found in many countries. Even where intergovernmental reforms have stressed the need to emphasize subnational budgetary autonomy more, in general the solutions sought have focused far more on such ideas as revenue sharing and piggybacking subnational taxes on central levies than on increasing and improving local beneficiary charges. The chapter also examines in some detail the case of local water services, considering both the trade-offs between public versus private provision of water services and the implications of water utility policies for full and partial
cost recovery. This discussion is supported by an empirical analysis using the results of a contingent valuation survey in Mauritius to quantify the welfare effects of charging for water services taking into account both user willingness to pay and the cost of providing water services. While this case is perhaps relatively unusual in the sense that charging turns out to be desirable in terms of its effects on both efficiency and distribution, the authors suggest that it may perhaps only be through the orderly privatization of public services such as water that are subject to crowding and exclusion that fees and charges as a form of financing such services may attain their proper role in the developing world.

Chapter 12 concludes the volume with an essay by Roy Bahl, who draws on over four decades of intensive work in the trenches of tax reform efforts in numerous developing countries as well as his extensive body of academic work to take a panoramic view of the progress and lack thereof in tax system reform and explore the question of whether the “weakest link” will ever be strengthened. Recognizing the limitations of many developing countries in terms of both the accessibility of tax bases and their administrative capacity to collect what are often complex taxes, Bahl argues that not only have the economies and tax bases of most countries grown over time but that how to implement good tax policy and modernize tax administration has also been well learned and documented. The hard question remains: why have we not observed more progress in the tax systems of so many developing countries?

To answer this question, Bahl first takes a close look at the evolution over the long run of tax revenue trends in developing countries and the main explanations generally put forward to explain the lackluster performance of the tax to GDP ratio in many countries. He argues that some of the answer lies in the choices made in the design of tax structures – not so much the types of taxes that are emphasized but rather the narrowness of the initial tax bases chosen. The main problem, however, in his view has been the exceptionally slow pace that most countries have taken with respect to modernizing tax administration, a pace that reflects both their fundamental lack of commitment to effective enforcement and the resulting inadequate investment of resources in the task of administrative modernization. Nonetheless, Bahl is optimistic about the future of tax reform in developing countries, suggesting that the staggering need for increased expenditure on infrastructure and social services may in the end force new ground to be broken when it comes to reforming both tax policy and tax administration. Recent marked improvements in taxation in Latin America, a region of the world that for many decades had been a proverbial underperformer, may, he suggests, perhaps herald further good news in the future on this front from other
regions. The argument in this final chapter that the critical fiscal link may perhaps be forged more strongly in the near future under the combined pressure of the economic need to expand public expenditures and the political need to finance that expansion more sustainably in a way that meets the needs and wishes of the expanding politically relevant population, provides an optimistic and welcome coda to this volume.

NOTES

1. The phrase “sinews of power” comes from Brewer (1990). An equally critical developmental role is assigned to state finances by Ferguson (2001). Although both these authors focus on issues of war finance, a broader developmental approach has been taken in recent years by numerous other recent works exploring the critical role of public finance in shaping state development, following the lead of Tilly (1975); see, for example, Martin, Malhotra, and Prasad (2009) and Cardoso and Lains (2010).

2. Roy’s expertise in this area grew initially from his extensive work on state and local finance in the US – work that continued – e.g., New York (Bahl and Duncombe 1991) and Ohio (Bahl 1995) – but was soon strengthened by his key role in a number of major country studies in e.g., the Philippines (Bahl and Miller 1983), Korea (Bahl, Kyo and Park 1986), Jamaica (Bahl 1991, Bahl and Wallace 2007), Guatemala (Bahl, Martinez-Vazquez and Wallace 1996), China (Bahl 1999) and South Africa (Bahl and Smoke 2003).

3. The professor who said this had obviously been influenced by an interesting essay by Colm (1955, 20–21) on public finance as “a borderline science … that tries to strike a balance between politics and economics.”

4. See Newbery and Stern (1987) for an early overview of the implications of the new (optimal tax) approach initially launched by Mirrlees (1971) for tax and development as well as Ahmad and Stern (1991) for an excellent first attempt at a country study using this approach combined with then state of the art empirical techniques. Boadway (2012) provides a useful recent overview of the current state of the art, and examples of the range and nature of recent analytical and empirical work along these lines may be found in many recent studies from such institutions as the IMF and the World Bank as well as in many of the studies reported in such books as Bird, Poterba and Slemrod (2005), Alm and Martinez-Vazquez (2006), Gordon (2010), and Zodrow and Fuest (2013) as well as in numerous recent journal articles and theses.

5. The modern “fathers” of this approach were of course Buchanan and Tullock (1965), whose followers have sometimes been characterized as the “Virginia school” although other important strands of the modern revival of the new political economy in economics have come from the work of Gary Becker and the so-called “Chicago school” as well as from other sources. Useful summaries and overviews of the many contributions of economists to this literature from different perspectives may be found in Persson and Tabellini (2000, 2003) and Mueller (2003). However, much of the push for the recent interest in applying the new political economy perspective to taxation in developing countries has come from such political scientists as Bates (2008), Lieberman (2003), Mahon (2004, 2011), and Moore (2007).

6. Such models have also been expanded in some countries, including some developing countries, to include not only income but also other forms of taxation (VAT, excises, import duties, property taxes, payroll taxes). They have even, in some instances,
linked to some aspects of transfer policy (e.g., social security), tax expenditures (exemptions, incentives) and even direct expenditures, although few if any developing countries seem as yet to have done much along these lines.

7. Although Chapter 6 does not emphasize the political aspects of small business taxation, Moore (2013) identifies the failure to pay sufficient attention to the need to improve local revenue raising – the level of government with which most people engage most directly – as perhaps the biggest failure in tax reform in sub-Saharan Africa from a political perspective.

8. Indeed, there is an extensive literature (e.g., Newbery 2005, Smith 2006, and Guevara 2007) that argues that rather than subsidize fuel consumption an excellent case can be made in many countries for imposing heavier taxes on the consumption of fossil fuels than on other commodities.

9. See Rodden, Eskeland and Litvack (2003) for a number of useful explorations of this concept. Other interesting recent studies may be found in, for example, Brosio and Jimenez (2012) and Martinez-Vazquez and Vaillancourt (2011).

10. Sokoloff and Zolt (2005), for example, draw an interesting contrast between the property-tax based growth of local government in North America and the general failure of effective local government in Latin America.

REFERENCES


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