

# **Tax Policy in Emerging Countries**

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**Richard M. Bird and Eric M. Zolt**  
**University of Toronto and UCLA**

International Tax Program  
Institute for International Business  
Joseph L. Rotman School of Management  
University of Toronto  
Toronto, Ontario  
Canada M5S 3E6

Tel: 416 978-2451  
Fax: 416 978-0002  
Email: [iib@rotman.utoronto.ca](mailto:iib@rotman.utoronto.ca)  
Website: <http://www.rotman.utoronto.ca/iib/>

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### **Abstract**

We consider in this paper how emerging countries may in practice best design and develop tax policies, given the complex economic and political environments they face. After an overview of what tax systems look like around the world, we discuss the principal objectives that countries may attempt to achieve through tax policy. We conclude by considering the broad political economy context within which tax policy and development issues must be designed and implemented. Our aim is to set out some of the basic issues facing tax policy in emerging countries and to outline some key elements that should be considered in designing the best feasible tax structure for any particular country at a particular time.

JEL: O23, H20

## **Tax Policy in Emerging Countries**

**Richard M. Bird and Eric M. Zolt<sup>1</sup>**

Taxes matter. People talk about them, complain about them, and try to dodge them when they can. Businesses also react to taxes, both in how they organize their activities and in where they carry them out. How people and businesses react in turn affects the level and structure of taxation. The question we consider in this paper is how emerging countries may best design and develop tax policies to achieve whatever their policy objectives might be, given the complex economic and political environments they face.

We focus less on theoretical than on practical issues of tax policy in developing countries. As Keynes (1936, pp. 383-84) famously said, however, “practical men, who believe themselves to be quite free from any intellectual influences, are usually the slaves of some defunct economist. ....soon or late, it is ideas, not vested interests, which are dangerous for good or evil.” Practical tax policy is not immune to the influence of either ideas or vested interests in any country. Ideas, interests, and institutions play a central role in shaping tax policy in emerging countries. We therefore consider briefly both some important ideas related to tax policy and some important ways in which circumstances in different countries may call for different tax policy designs.

We first provide a short overview of what tax systems look like around the world. Against this background, we then discuss the principal objectives that different countries may attempt to achieve through tax policy. Finally, we look briefly at the broad political economy context within which tax policy and development issues must be designed and implemented. We do not provide definitive answers to most of the questions we raise, not least because some of them cannot be definitively answered. Our aim is simply to set out

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<sup>1</sup> Professor of Economics Emeritus, University of Toronto and Professor of Law, UCLA. This paper draws from our presentation to a course on Practical Issues in Tax Policy in Developing Countries at the World Bank in 2003.

some of the basic issues facing tax policy in emerging countries and to outline some key elements to be considered in designing the best feasible tax structure for a particular country at a particular time.

## **The World of Taxes**

One way to get an idea of what matters in tax policy is to look at tax regimes around the world. On average, the tax ratio -- taxes as a share of GDP -- was a bit less than one-fifth of GDP (18.8 percent) for 168 countries included in a recent study (Fox and Gurley 2005).<sup>2</sup> This is a simple average, treating each country as a single observation, so that a small island such as St. Lucia receives the same weight as the United States or China. Tax ratios range from under 10 percent in a few small low-income countries (e.g., Myanmar, Chad, and Guatemala) to well over 40 percent in a few high-income countries (e.g., France and Sweden). However, some low-income countries also had high ratios (e.g. Ukraine and Algeria) and some higher-income countries, such as the United States and Hong Kong, had considerably lower tax ratios than others. Both opportunity and choice affect tax levels.

Tax ratios vary roughly by income levels. Studies of relative tax burdens generally divide countries into three groups based on per capita GDP.<sup>3</sup> As earlier studies (Tanzi 1987) also found, taxes tend to increase as per capita incomes increase. The tax ratio increases from about 17 percent in the low-income group to 22 percent in the medium-income group and 27 percent in the high-income group.

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<sup>2</sup> If social insurance contributions are included, the average tax ratio rises to 21.7 percent. We shall not discuss social insurance payments, however, in part because it is not always clear whether they are included in the tax data for some countries.

<sup>3</sup> Eighty-nine countries in which per capita GDP was less than USD1,000 in 1999 were classified as low-income, 51 countries where per capita GDP was between USD1,000 and USD17,000 were classified as medium-income, and the 24 countries with per capita GDP greater than USD17,000 were classified as high-income.

Several factors could explain this relationship. The demand for public services may rise faster than income (the income elasticity for services is greater than one), particularly in lower-income countries. For instance, urbanization and the demand for public services tend to increase with income. In addition, the capacity of countries to collect taxes increases as income levels increase. However, the relationship between rising income levels and higher taxes is significant only for poor countries.<sup>4</sup> As incomes rise in poor countries, the public sector grows. After some point, however, this “income determinism” of the tax level declines and the relationship between income and tax levels largely disappears. Rich countries have more choices, and some rich countries have chosen to levy much lower taxes than others. However, even the poorest countries have considerable discretion as to how much they raise in taxation. As recent studies show, what matters is not just the income base but also the institutional base, specifically the extent to which taxpayers trust their governments (Bird, Martínez- Vazquez and Torgler 2006).

The pattern of taxes in different countries varies, reflecting such factors as economic structure, history, and the tax structures found in neighboring countries. Choice again plays a part: countries may attach different importance to such commonly accepted characteristics of a good tax system as fairness, economic effects and collection costs. On average, consumption taxes account for almost 40 percent of all taxes followed closely by income taxes (including special taxes levied on extractive industries). Within the consumption tax category, value-added taxes (VATs) account for about 40 percent, with excises being almost equally important. Personal income taxes are slightly more important than corporate taxes (including the extraction taxes) within the income tax category. Most remaining tax revenues come from taxes on imports.

A country’s revenue structure depends to some extent upon its location and economic structure. In small island countries such as Barbados, for instance, international

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<sup>4</sup> A quadratic regression of per capita taxes on per capita GDP on income shows that taxes tend to rise with income, but more slowly as income rises. Indeed, after per capita income reaches about USD35,000 the tax ratio actually declines. Linear regressions estimated separately for each income group yielded a significant coefficient on per capita GDP only for the low-income countries.

trade taxes may play an unusually important role. Trade taxes are most important in the lower-income group, where they account for 24 percent of tax revenues, compared to only 1 percent in the higher-income group.<sup>5</sup> Trade taxes clearly decline in importance as per capita income rises.

The higher the level of per capita income, the more countries rely on direct taxes, especially those on personal income. Consumption taxes too are relatively more important in more developed countries.<sup>6</sup> Low-income countries raise more revenues at the border, where relatively few collection points need to be controlled. For the same reason, they are more likely to rely more heavily on excise taxes on tobacco, alcohol and fuel. Direct taxes (and VAT) require both a more effective tax administration and more sophisticated taxpayers, conditions more likely to exist in developed countries.

The picture just sketched has not changed much over time. Tanzi (1987) reported for the late 1970s an average tax ratio of 17.8 percent of GDP for the 86 developing countries in his sample. The comparable ratio for the 75 countries for which overlapping data are available decades later was only 18.6 percent. The "tax state" has not made much progress in recent decades.

The relative importance of different taxes, however, *has* changed in recent years, most strikingly in the increase in the share of revenues generated by consumption taxes. One reason has been the widespread adoption of broad-based VATs, which rose from 34 to 40 percent of all consumption taxes even in the short period (about six years) considered by Fox and Gurley (2005). The VAT has generally replaced trade taxes rather than direct taxes, as the share of revenues raised from direct taxes has also increased, especially personal income taxes. Although globalization may lead to further convergence of tax systems, the evidence suggests that the size and structure of taxation in most countries continues to be dominated largely by domestic rather than global factors.

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<sup>5</sup> An interesting exception are the transitional countries which -- although many of them fall within the low-income group -- have traditionally relied little on trade taxes (Martinez-Vazquez and McNab 2000).

<sup>6</sup> The income elasticity of direct taxes is 0.80, for consumption taxes 0.61, and for trade taxes 0.09.

## **Taxing Choices**

The main purpose of taxation is to generate sufficient revenue to finance public sector activities in a non-inflationary way. Taxing choices depend upon such factors as the level of development, the need and desire for increased public services, and the capacity to levy taxes effectively. The choices made also depend upon the availability of less politically painful sources of revenue (e.g. natural resource revenue and foreign aid) as well as preferences about such public policy goals as attaining a desired distribution of income and wealth and increasing the rate of national (and perhaps regional) economic growth.

Tax policy is not just about economics. It also reflects such political factors as concerns about fairness and the desire of governments to stay in power. In addition, regardless of what a particular country may *want* to do with its tax system, or what it *should* do with respect to taxation from one perspective or another, it is always constrained by what it *can* do. Tax policy choices are shaped by both economic structure and administrative capacity -- factors that constrain the options available.

### **Raising revenue**

A good tax system must generate sufficient revenue to fund projected government expenditures. Unless tax revenues grow sufficiently quickly to finance desired services over the long term, governments must reduce expenditures, raise tax rates, or alter other structural characteristics of the system. As a working rule, revenue growth should be roughly equal to the overall economic growth rate, unless a country wants to increase (or reduce) the size of its government.

The rate at which revenues increase over time differs depending on the tax structure, the quality of tax administration, and the pace and nature of economic growth. The income elasticity of a tax system measures how fast revenues grow relative to the

economy. Elasticity is defined as the percentage change in tax revenues divided by the percentage change in GDP (or potential tax base, such as personal income). Elasticity equal to one, for example, means that tax revenues will remain a constant share of GDP. Elasticity greater than one indicates that tax revenues grow more rapidly than income. In principle, revenues should grow at the same rate as desired expenditures (that is, the income-elasticity for revenues and expenditures should be the same). In practice, however, many emerging countries have had great difficulty in achieving this target. This leads to frequent tax “reforms” aimed primarily at closing short-term revenue gaps. Tax policies enacted in such economically and politically difficult circumstances often fail to resolve the underlying basic problem of inadequate revenue elasticity.

The overall elasticity of any tax system is the average of the elasticity of different taxes, weighted by the percentage of total taxes raised by the tax. The elasticity of a tax depends on the specific characteristics of its structure. The most elastic tax is usually the personal income reflecting both its progressive rate structure and the level of personal exemptions relative to average income levels. The elasticity of the corporate income tax is volatile because in a recession corporate profits fall more precipitously than overall economic growth. Countries that depend heavily on taxation of natural resources such as oil or minerals are especially vulnerable to cyclical swings. Consumption taxes are more elastic if they cover more rapidly growing goods and services rather than just traditional goods and if they are levied as a percentage of the price (like a VAT) rather than on the specific number of units purchased (as with many excises). A balanced set of tax instruments rather than a single revenue source will lower tax revenue volatility, just as an individual investor can reduce the volatility of her investment portfolio by adopting a diversified investment strategy.

### **Economic efficiency**

Even the best designed taxes impose real costs on society. Good tax policy seeks to minimize those costs. Taxes impose real economic costs that reduce the resources available to achieve socially desired objectives. Taxes are not themselves a cost in

economic terms because they simply transfer resources from private to public use. Costs are incurred only when the amount of resources available for society's use, whether for public or private purposes, is reduced by taxes. This occurs in several ways.

First, taxes cost something to collect. On average, the cost of collecting taxes in developed countries is roughly one percent of tax revenues. In emerging countries, the costs may be substantially higher.<sup>7</sup> In addition, taxpayers incur compliance costs in meeting their tax obligations, in addition to the actual payment of tax. Administration costs may be reduced when compliance costs are increased, e.g., when taxpayers are required to provide more information, thus increasing compliance costs but making tax administration easier and less costly. This tradeoff between administration and compliance costs does not always exist. Both compliance costs and administration costs may increase when, for instance, a more sophisticated tax administration requires more information from taxpayers, undertakes more audits, and so forth. Tax systems also impose compliance costs on third parties. For example, employers may withhold income taxes from employees, and banks may provide taxing authorities information or may collect and remit taxes to government.

Compliance costs include the financial and time costs of complying with the tax law, such as acquiring the necessary knowledge and information, setting up required accounting systems, obtaining and transmitting the required data, and payments to professional advisors. Although the measurement of such costs is still in its infancy, estimates for developed countries (Evans 2003) suggest that compliance costs are perhaps four to five times larger than the direct administrative costs incurred by governments. A recent study of compliance costs for the personal income tax in India (Chattopadhyay and Das Gupta, 2002) suggests that compliance costs may be as much as ten times higher than in developed countries. Compliance costs are typically much higher with respect to taxes collected from smaller firms.

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<sup>7</sup> A recent study in Guatemala, for example, estimated them at 2.5 percent of collections (Mann, 2002).

Finally, taxes usually give rise to what economists call “deadweight” or “distortion” costs. Most taxes change relative prices and hence alter decisions made by businesses and individuals. The resulting changes in behavior often reduce the efficiency with which resources are used and hence lower the output and potential well being of the country. For example, taxes on wages (personal income taxes, wage taxes, social security taxes, and so forth) reduce incentives to work. The higher the tax rate on wages in the formal sector, the less attractive working in the formal sector becomes relative to working in the untaxed (or better, not directly taxed) informal sector.<sup>8</sup> Consumption taxes also discourage work. Taxes on spending increase the amount of time one must work to pay for goods and services through the marketplace. As taxes are not imposed on leisure, at the margin, all taxes discourage (taxed) work. No matter how well the government uses the resources acquired through taxation, governments need to limit the negative consequences of tax-induced changes in behavior.

Taxes alter not only relative prices (in this case, the net (after-tax) wage) but also income. As taxes reduce individuals’ after-tax wages, they may choose to work more to compensate for lost income. The net effect on work of any tax change reflects both this income effect and the effect of the change in relative prices (the substitution effect). While the results vary from country to country depending upon the structure of taxes, the nature of the workforce, and the nature of the economy, most empirical studies suggest taxes discourage work in the formal sector of the economy (Rutkowski 2007).

Almost all taxes affect resource decisions. The resulting efficiency losses are real, but they are not directly visible. The efficiency cost of taxation arises because something does not happen: some activity did not occur or occurred in some other form. Output that is not produced, however, is still output (and potential welfare) lost. Consumption taxes may discourage the consumption of taxed as opposed to untaxed goods (e.g. housing in some countries). Income taxes, because they tax the return to savings, may alter the amount of savings or the form in which savings are held. For example, failure to tax capital gains until they are realized (when the asset is sold) encourages the holding of

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<sup>8</sup> As the supply of labor increases in the informal sector, the wages of the informal sector will fall relative to the wages in the formal sector, thus indirectly taxing those working in the informal sector.

assets (a lock-in effect). Taxes may also affect investment, and such effects may be especially important when economies are more open to trade and investment.

Exactly how important such tax effects are is a matter of considerable debate, but the consensus is that they are much more important than was thought thirty or forty years ago. The efficiency costs of taxation are some multiple of the administrative and compliance costs mentioned above. The lowest estimates of the efficiency costs of taxes for developed countries are at least 20-30 percent of revenues collected, and much higher estimates are common in the literature.<sup>9</sup>

Good tax policy requires minimizing unnecessary costs of taxation. To do so, experience suggests three general rules: First, tax bases should be as broad as possible. A broad-based consumption tax, for example, will still discourage work effort, but such a tax will minimize distortions in the consumption of goods if all or most goods and services are subject to tax.<sup>10</sup> A few items, such as gasoline, tobacco products and alcohol, may be taxed at a relatively higher rate, either because of regulatory reasons or because the demand for these products is relatively unresponsive to taxation.<sup>11</sup> The tax base for income tax should also be as broad as possible trading all income from similar sources as uniformly as possible.<sup>12</sup>

Second, tax rates should be set as low as possible, given revenue needs. The efficiency cost of taxes arises from their effect on relative prices and generally increases

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<sup>9</sup> To the extent that some efficiency costs result from rational policy decisions (for example, to redistribute income through the fiscal system), they may of course be considered to be acceptable.

<sup>10</sup> In theory, in order to minimize efficiency losses different tax rates should be imposed on each commodity, with higher rates imposed on those goods and services where the changes in behavior are the smallest. To do so, however, requires much more information about how taxes alter behavior than is available in most countries. Moreover, this approach does not take administrative and equity concerns into account. For these reasons, in practice it seems generally advisable to impose a uniform tax rate to the extent possible.

<sup>11</sup> Unfortunately, in many instances this implies that such taxes will be highly regressive with respect to incomes, although this is not necessarily the case in developing countries: see e.g. the discussion of alcohol excises in sub-Saharan Africa in Bird and Wallace (2006).

<sup>12</sup> Until recently, the usual expert advice was to tax income from *all* sources informally. Increasing empirical evidence and experience suggests, however, that while it is critical to taxable capital income uniformly and desirable to tax all labor income uniformly it is not always best practice to tax labor and capital income in exactly the same way (Boadway 2005).

proportionally to the square of the tax rate, so that doubling the rate of a tax implies a fourfold increase in its efficiency costs. From an efficiency perspective, it is better to raise revenue by imposing a single rate on a broad base rather than dividing that base into segments and imposing differential rates on each segment. This cost of differential treatment must be balanced against the equity argument for imposing graduated rate schedules.

Third, from an efficiency perspective, taxes on production such as corporate income taxes and sales taxes, other than VAT should be limited. Such taxes are especially distorting, because they may affect the location of businesses, alter the ways in which production takes place, and change the forms in which business is conducted.

### **Fairness concerns**

Fairness is a key issue in designing a tax regime. From one perspective, taxes exist primarily to secure equity. National governments do not need taxes to secure funds because they can simply print the money they need. The tax system can be viewed as a mechanism to prevent inflation by taking money away from the private sector in as efficient, equitable, and administratively inexpensive way as possible.

Conceptions of fairness likely differ among members of a society. Traditionally, tax scholars have defined fairness in terms of horizontal and vertical equity. Horizontal equity requires those in similar circumstances to pay the same amount of taxes. Horizontal equity often embraces some notion of ability or capacity to pay. Vertical equity requires “appropriate” differences among taxpayers in different economic circumstances.

On the surface, both concepts have intuitive appeal. Those who have the same ability to pay should bear the same tax liability and taxpayers in different situations should be treated appropriately differently. In practice, however, neither concept is particularly helpful in determining appropriate tax policy. The concept of horizontal

equity, for example, is as a guide to policy incomplete, not helpful, and derivative. For example, an income tax meets horizontal equity requirements only if we assume individuals have identical tastes and a single type of ability or income. Once we allow preferences to vary and different types of ability or income, only a tax based on an individual's ability to earn income, rather than actual earnings, provides equal taxation for those in equal positions. Horizontal equity is also incomplete to the extent it focuses only on a short time period (such as a year) or fails to consider the impact of all taxes or ignores the provision of government services or other benefits. Horizontal equity is not a useful practical guide unless all concerned agree precisely which differences are important and why these differences justify different tax treatment.

Equal disagreement exists about the usefulness of the concept of vertical equity. To some, fairness could require that all individuals pay the same amount of tax. Thus, one could design a tax system that imposes a head tax on each individual over the age of 18 years old. Fairness could also require all taxpayers to pay the same rate of tax on their income. Several countries have recently adopted "flat tax" regimes. While most flat rate systems provide for a high threshold (zero rate bracket) before the imposition of the flat rate, the notion of one tax rate strikes many as an equitable manner of determining tax liability. To others, however, fairness requires taxpayers with higher incomes to pay a higher percentage of their income in tax. Progressive rates may rest on a shaky theoretical foundation, but in practice the most common income tax rate structure is a progressive one. Many find it attractive to assess a basic tax on the basis of "ability to pay" as measured by income.

As these brief comments suggest, discussions of fairness are, by themselves, of limited usefulness in tax design. Simply saying we should accord equal treatment to equals is useless. A detailed (and widely shared) ethical framework is needed to make comparisons—whether comparing equals or making "appropriate" comparisons among unequals. Without such a fundamental framework one cannot evaluate the relative fairness of different proposals or different tax regimes. In the end, only through its

political institutions can a country, rich or poor, define and implement its view of what is an acceptably fair tax system.

For example, some countries may wish to favor cities, others rural areas. Some may choose to favor rich savers in the name of growth, others the poor in the name of redistribution. Like most policy instruments, tax policy can play many tunes. What is critical from an equity perspective is, first, to be aware of the equity implications of tax reforms for different groups and, second, to ensure that the actual outcome of such reforms is consistent with the intended outcome.

It is especially important in thinking about taxation and equity in emerging countries to focus not on preconceived notions about the progressivity or regressivity of specific taxes (for example, that anything called a personal income tax is, by definition, progressive, while anything called a VAT is, by definition, regressive) but rather on the reality of how taxes work in practice. In some circumstances, for instance, indirect taxes such as VAT (and excises on some items such as motor vehicles) may be more progressive than a personal income tax that falls largely on a limited group of wage earners (World Bank 2003).

Taxes may not make the poor richer, but they can certainly make them poorer.<sup>13</sup> Fiscal attempts at poverty alleviation in developing countries must be undertaken primarily on the expenditure side of the budget. Nonetheless, the poor should not be made even poorer through taxes. It may therefore be desirable to exempt certain “basic needs” items from even the broadest-based consumption tax. Heavy taxes on items that constitute major consumption expenditures for poor people should generally be avoided.

Although attempts to redistribute income through taxation have generally not been effective in most developing and transitional countries (Chu, Davoodi, and Gupta, 2000), it may often be politically necessary and desirable to tax those who gain the most from

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<sup>13</sup> Some developed countries use their income tax systems to provide income support to certain low-income people. Using the tax system to make such transfers requires both that the tax administration is efficient and that most people file tax returns. Neither condition is satisfied in most emerging countries.

economic development, bearing in mind the need at the same time to minimize the efficiency costs of unduly high tax rates. Sustainable tax policy needs to be accepted as fair by those affected. Even in the poorest countries, automobiles and other luxury products are more visible than income, and it is often feasible to collect progressive taxes on such items.

To determine the fairness of a tax regime one must consider the economic incidence of taxation. It is important to distinguish between those who have the liability to pay a particular tax and those who suffer the economic incidence or burden of the tax. Tax burdens fall on individuals in their roles as consumers, producers and factor suppliers, not on corporations or other institutions. For example, although the VAT law may require firms to pay VAT to the government, it is likely that the real economic incidence of VAT falls on the ultimate consumer.

It is often unclear who actually bears the economic costs of taxation. For example, it is not clear who bears the cost of the corporate income tax. As corporations are simply legal constructs, the tax cost must fall on individuals. As a result of the corporate tax, shareholders (or all owners of capital) could receive lower returns, consumers could pay higher prices, or workers could receive lower wages, or some combination thereof. In addition, the tax consequences in the short-run could differ from long-run consequences. The incidence of a corporate income tax depends on such factors as the openness of the overall economy in terms of the inflows and outflows of capital investment, the extent to which capital moves between the corporate and unincorporated sectors, the relative capital-intensity of corporations, and the elasticity of demand for goods produced by corporations and other businesses. None of these is easy to measure. As economic conditions vary among different countries, taxes that have the same legal incidence may have different economic incidence in different countries (Shah and Whalley 1990).

In many emerging countries the tax regime can be thought of as two systems. One system has relatively high tax compliance rates. A substantial portion of labor income may be subject to final or provisional withholding, many forms of income from capital

may be subject to withholding or information reporting requirements, and many medium and large corporations are subject to public reporting requirements and keep relatively accurate books and records. For taxpayers who operate entirely in the “formal” economy, the difference between estimated tax liability and actual tax payments is relatively small.

In contrast, the other part of the economy is comprised of many small enterprises operating at least in part in the “informal” economy and has relatively low compliance rates. Here, tax evasion is high and efforts to bring this sector into compliance are difficult and expensive. The tax administration lacks the information and resources to tax the large informal sector effectively. In this situation, when governments require additional tax revenue, the common approach is to raise tax rates on the part of the tax system where compliance rates are high thus exacerbating the perceived unfairness of the tax system. The evidence suggests that it is difficult for countries with large informal sectors to reach the "tipping point" at which the low-compliance sector begins to shrink and the high compliance sector to dominate.

### **The Tax Mix**

Emerging countries are generally less capable of using the tax system to redistribute income (Bird and Zolt 2005). Income and wealth taxes play a relatively small role in the tax structure of such countries as compared to developed countries. In Latin America, for example, personal income taxes collect less than one percent of GDP. The personal income tax is often merely a wage withholding tax. In many countries taxes on labor in the formal sector comprise over 90 percent of personal income tax revenue. The very rich often pay relatively little in income taxes. The appearance of progressivity may be necessary for the tax system to be politically acceptable; but in practice no significant tax liability is imposed on higher incomes.

Nonetheless, income taxes have an important role in emerging countries. Even if a country’s sole objective is economic growth, a clear case exists for taxing corporate income, if only to collect a fair share of the revenue that multinational and large domestic

businesses derive from economic activities in that country. Since corporations are the engine of development in all modern societies, a tax on corporations is in effect a tax on the modern, growing sector of the economy. Countries need to tax that sector to secure the revenue they need to meet expanding expenditure demands and to ensure that those who benefit most from development pay their fair share. But they must also ensure that corporate taxes are not so high as to discourage growth. In general, the best approach for emerging countries is thus to impose a moderate, stable tax on all corporations, probably at the same rate as a flat income tax imposed on other forms of capital income received by persons.<sup>14</sup>

In principle, consumption taxes should cover more services in part to reduce regressivity. Unfortunately, it has proved difficult to include many services in the consumption tax base, especially those that may be consumed disproportionately by the rich. Thus, even the best-designed consumption taxes are unlikely to be very progressive, at least within the market sector of the economy.<sup>15</sup> A modest degree of progressivity in the personal income tax on wages and salaries may thus provide a useful offset to the possible regressive impact of the consumption taxes.

Both corporate and personal income taxes may thus play an important role in developing and transitional countries. However, given the current economic context in many countries, the most important part of the tax regime in such countries is likely to be a broad-based VAT, probably supplemented by a few high-rate excise taxes on selected items.

In sum the most effective way to reduce inequality is not through taxation but rather through spending programs targeted at the poor. Expenditures aimed at improving primary education or primary health services are likely to prove more effective at reducing inequality than trying to change the tax system to tax the rich. The role of the

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<sup>14</sup> This argument is developed more fully in Bird and Zolt (forthcoming).

<sup>15</sup> To the extent the poorest sectors of society remain largely outside the market economy, a VAT may, of course, nonetheless be broadly progressive. For further discussion, see Bird and Gendron (2007).

tax system in emerging countries is essentially to raise the revenue for such expenditure programs rather than to play a substantial redistributive role in its own right.

### **Tax administration**

The best tax policy in the world is worth little if it cannot be implemented effectively. Tax policy design must take into account the administrative dimension of taxation (Bird 2004). Tax design in developing countries is also strongly influenced by economic structure.<sup>16</sup> Many emerging countries have a large traditional agricultural sector that is not easily taxed. Many also have a significant informal (shadow) economy that is largely outside the formal tax structure. The potentially reachable tax base thus constitutes a smaller portion of total economic activity than in developed countries. The size of the untaxed economy is in part a function of tax policy. The resulting lower tax revenues often lead governments to raise tax rates, further exacerbating incentives to evade taxes. Improving tax administration is thus central to the choice of tax structures and to improving taxation in emerging countries.

Three ingredients seem essential to effective tax administration: the political will to administer the tax system effectively, a clear strategy for achieving this goal and adequate resources for the task. It helps, of course, if the tax system is well designed, appropriate for the country in question, and relatively simple, but even the best designed tax system will not be properly implemented unless these three conditions are fulfilled. Most attention is often paid to the resource problem -- the need to have sufficient trained officials, adequate information technology and so on. However, without a sound implementation strategy, even adequate resources will not ensure success. And without sufficient political support, even the best strategy cannot be effectively implemented.

Unfortunately, but unsurprisingly, few politicians in countries at any income level are eager to incur the economic and political costs of major tax policy and tax

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<sup>16</sup> A century ago, for example, the now developed countries also relied heavily on excises and trade taxes, in part reflecting the nature of their economies at that time.

administrative reforms. Frequently, international agencies require such tax reforms as a condition for loans. Countries, desperate for revenues, launch frantic efforts to raise revenue without hurting politically powerful interests or without providing the time, resources and consistent long-term political support needed for effective tax administration. Reluctance to collect taxes efficiently and effectively without fear or favor is understandable in those countries with a fragile political foundation. But no magic way exists to obtain a viable long-term tax system without substantial political support.

If the political will exists, the blueprint for effective tax administration is relatively straightforward. The tax administration must be given an appropriate institutional form, which may (or may not) mean a separate revenue authority (Taliervo 2004). It must be adequately staffed with trained officials. It should be properly organized, which generally means an organizational structure based on a function rather than on a tax-by-tax basis.<sup>17</sup> Computerization and appropriate use of modern information technology is important, but technology alone is not sufficient and improvements must be carefully integrated into the tax administration.<sup>18</sup>

Effective tax administration requires qualified tax officials. Tax authorities need to collect the information needed for effective administration from taxpayers, relevant third parties, and other government agencies. The information must be stored in an accessible and useful fashion and used to ensure that those who should be on the tax rolls, are, that those who should file returns, do, that those who should pay on time, do, and that those who do not comply are identified, prosecuted and punished as appropriate. All this is easy to say and hard to do -- but it is not impossible. Countries such as Singapore and Chile provide models of what can and should be done.

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<sup>17</sup> Alternatively, organization by client groups may sometimes be sensible. But what is never sensible is to assign specific taxpayers to specific officials for prolonged periods of time, a practice still common in some countries.

<sup>18</sup> For further discussion of the role of technology in improving taxation in emerging countries, see Bird and Zolt (2007).

The modern approach to tax administration rests on treating the taxpayer as a client (albeit not a willing one) to be served and not a thief to be caught. Unfortunately, the latter attitude seems to prevail in many emerging countries. Of course, some taxpayers are not honest, so a second important task of any tax administration (after facilitating compliance) is to reduce tax evasion. In addition to undertaking the difficult tasks involved in extending the reach of the tax system into the informal economy to the extent feasible, close attention must also be paid to such simple but often neglected tasks as ensuring that those who are in the system file on time and pay the amounts due. Adequate interest charges must be imposed on late payments to ensure that non-payment of taxes does not become a cheap source of finance. Similarly, an adequate penalty structure is needed to ensure that those who should register do so, that those who should file do so, and that those who under-report their tax bases are sufficiently penalized to increase the costs of evading tax.

All this may sound obvious and easy but experience around the world suggests that it is neither of these things in many emerging countries. Enforcing a tax system is neither a simple nor a static task in any country and it is especially difficult in the changing conditions of emerging countries. Unless this task is tackled with seriousness and consistency, however, even the best designed tax system will fail to produce good results.

A third major task is keeping the tax administration honest. No government can expect taxpayers to comply willingly if taxpayers believe the tax structure is unfair or the revenue collected is not effectively used.<sup>19</sup> But even a sound tax structure (and a sound expenditure policy) can be vitiated by a capricious and corrupt tax administration. Developed countries took centuries to develop and implement sound tax administration practices aimed at preventing dishonest tax officials result succumbing to obvious temptations (Webber and Wildavsky 1986). Unfortunately, many emerging countries are trying to maintain large government operations on a precarious fiscal foundation without having resolved the corruption problem. Corruption undermines confidence in the tax

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<sup>19</sup> Some empirical evidence supporting this assertion is reviewed in Bird, Martinez-Vazquez and Torgler (2007)

system, negatively affects willingness to pay taxes, and reduces a country's capacity to finance government expenditures.

## **Taxation and growth**

Even in developed countries with stable, long-established tax systems and excellent data, there is still much we do not understand about taxation, growth and equity. Our understanding in emerging countries is even less complete. Consider, for example, the trade-off between growth and equity. Most societies want to be richer. Most also want the increased wealth to be distributed fairly. Are these objectives compatible? Despite much theoretical and empirical inquiry as well as political and policy controversy no simple answer exists.

Some contend that because growth never occurs across economic sectors evenly, it is inevitable that increased inequality will result. Others contend that societies in which resources are distributed more equally will do better in the long term. Still others suggest that, whatever the answer may be, countries can devise policy measures that are fully compatible with achieving both more growth *and* more equity. While the answer likely depends on a country's specific circumstances, the current situation in many emerging countries offers so many opportunities for improvement that some countries may be able to have their fiscal cake (growth) and eat it too (redistribution).

Over the past 50 years, there have been many policy prescriptions for economic growth (Easterly 2002). Policy advisors have, in rough chronological order, called in turn for increased capital investment, improvements in education, population control, reduction of government controls on market activities, and loan forgiveness programs as "silver bullets" that would result in improved economic performance in developing countries. Unfortunately, none of these policies has worked as advertised.

Similarly, there is no magic tax strategy to encourage economic growth. Some countries with high tax burdens have high growth rates and some countries with low tax

burdens have low growth rates. Looking at the relationship between growth rates and tax rates in the United States over the last 50 years reveals that the U.S. had its greatest periods of economic growth during those years where the tax rates were the highest (Slemrod and Bakija 1996). Of course, this does not mean that high tax rates are the key to economic growth: growth rates in the U.S. might have been even higher in those years with high tax rates if the rates had been lower. The point is simply that the relationship between taxes and growth is complex.

Many emerging countries have sought to improve their economy by introducing a variety of tax incentives for investment, for savings, for exports, for employment, for regional development, and so on (Shah 1995). Such incentives are often redundant and ineffective, giving up revenue and complicating the fiscal system without achieving their stated objectives. Even to the extent that incentives may be effective in inducing investors to behave differently than they would have done in response to market signals, the result is often distorting and inefficient, diverting scarce resources into less than optimal uses (McLure 1999). Tax incentives also result in very uneven tax burdens, with domestic companies often subject to full taxation (at least in theory), while other firms, often foreign investors, benefit from tax incentives that reduce their effective tax rates. A limited role may exist for certain simple incentives as part of a growth-oriented fiscal policy, as some East Asian experience suggests (Bird and Chen 1998). But tax incentives can not compensate for the absence of such critical factors as a sound macroeconomic policy, good infrastructure and a stable governance system.

### **The Political Economy of Taxation**

This discussion above has been at a very general level. A truly “practical” examination of how to design and implement any specific tax change in any particular developing country would require a much more detailed and specific examination of many complex issues. Nonetheless, the basic conclusion is clear: emerging countries face a very difficult task in designing and implementing suitable tax systems.

Many such countries have large traditional agriculture sectors. Other significant components of the potential tax base are often in other equally “hard-to-tax” sectors such as small business and the informal or shadow economy (Bird and Wallace 2004). Such countries have often relied heavily on taxes on international trade, but this tax base too is becoming increasingly hard to tax in the face of pressures for trade liberalization. Economic growth is often encouraged by, and results in, closer involvement with the international economy, but globalization may also lead to fiscal problems. The leading edge of growth may become the bleeding edge of the fiscal system as it becomes difficult to levy taxes effectively on capital income, thus potentially exacerbating internal inequalities. As countries develop, the mass modern production and consumption activities on which the tax systems of developed countries rest -- taxes on wages and personal income, on corporate profits, on value-added -- expand and need to be brought into the tax base without overstraining administrative capacity or unduly discouraging the expansion of such activities. Life is not easy for those concerned with taxation in emerging countries, and it is not becoming any easier.

The problems are usually exacerbated by the political economy context within which taxation must be designed and implemented. Tax policy decisions are not made in a vacuum. Nor are they made by a disinterested benevolent government. Policy reflects a set of complex social and political interactions between different groups in society in a context established by history and state administrative capacity. Taxation is not simply a means of financing government but one of the most visible parts of the social contract underlying the state.

Why do citizens comply with tax laws, at least to some extent? One key reason is because they accept the state as legitimate and credible and are thus both, to some extent, willing to support it and, to some extent, afraid of what will happen to them if they don't. Unless states are accepted as legitimate in this sense, they cannot secure sufficient resources to govern or to develop. The success of any tax reform thus largely depends upon the way in which different political groups perceive the reform and how they react

to their perception. To an important extent, then, tax reform is “an exercise in political legitimation.” (Lledo, Schneider, and Moore 2003). Those who will have to pay more must be convinced that they will, so to speak, get something worthwhile for their money. Those who will not pay more must also get behind reform if it is to succeed. Earmarking revenues to favored objectives, for example, a practice usually disliked by budgetary and public finance experts, may prove an essential ingredient of a successful tax reform from this perspective (Bird and Jun 2007). The bureaucracy, those who will have to implement the reform, must also support it, or at least not actively oppose it.

Some see the inevitable political processes underlying reform as “statist” in the sense that the state can be viewed as an institution in its own right that seeks to maintain and increase its capacity, including its capacity to collect taxes. Others see acceptance of increased tax burdens as inextricably entwined with the expansion of a more democratic polity and a more inclusive society. Whether one views tax policy from the traditional public economics and administrative perspectives set out earlier or the more explicitly political perspectives just mentioned, one conclusion is inescapable. Getting taxes right in emerging countries is a complex and difficult question. But given its impact on the well-being of billions of people, it is important that countries try to get it as right as they can.

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