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Countries**

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Foreign Advice and Tax Policy in Developing Countries¹

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¹ I am grateful to Sijbren Cnossen, Jorge Martinez-Vazquez, and others at the conference for helpful comments on an earlier draft of this paper but I am of course solely responsible for its contents. Given the scope of the material surveyed here and the need for brevity, not only are many issues touched on only in footnotes but a rather long list of references -- including no doubt too many self-references -- is included.

‘Go west, young man’ is one of the many popular quotations that appears never to have been said by (any of) its purported authors.² Nonetheless, these words capture in essence the advice given to many an ambitious American in the late 19th century – the period of the opening up of the west in the United States. Equally, aspiring tax policy experts in the post-World War Two period who were too young to have played any role in the war and immediate postwar reforms in their own countries might have been well advised to ‘go South’ if what they wanted to do was to play an active role in developing and implementing tax reforms. How else could someone fresh out of graduate school have a chance not only to design major new taxes and to analyze a variety of complex policy questions but also to have the analysis taken seriously by decision-makers?

Following in the footsteps of such pioneers as Carl Shoup and Richard Musgrave, over the last half century many economists from developed countries have dispensed advice on tax reform to developing countries – often, whether they had asked for such advice or not. The life of such peripatetic tax advisers has not always been one of wine and roses. Quite apart from any hazards associated with field work, those who wished to storm the heights of academia were not always well-advised to spend too much time on this path at a time when increasing emphasis was being placed on contributions to theoretical and econometric matters that were for the most part far removed from those that had to be used in a field in which the tool needed was more often a sturdy machete to clear away the underbrush than the latest finely tuned analytical tool to analyze data that did not exist.³ Nonetheless, those with strong policy interests who were open to new experiences and willing not only to travel but also to spend the time and effort required to understand the institutional settings in which they worked undoubtedly did much fruitful work over the last half century or so both by bringing new ideas and analysis to fiscal vineyards around the world and by calling attention to the many important facets of reality that were not easily encompassed by prevailing wisdom.

Those engaged in such tasks inevitably learned much about the real world and about how to “do” tax policy. Two stars of the academic world, Peter Diamond and Emanuel Saez (2011), recently said that “...a

² See <http://www.llrx.com/features/quotedetective.htm>.

³ The dilemma facing such advisers was clearly stated in Krugman (1993), which basically argues that most work done on development economics before about 1990 was essentially useless and irrelevant because it was not based on the kind of formal, testable models that had over the preceding two decades become the ‘gold standard’ in academic economics. While there is much truth in this view, even the best such model often leaves one a long way from devising a workable solution to a real problem in the real world. Economic theory and economic policy are and should be closely related: but they are not the same and, as noted later, the relevant knowledge does not flow only in one direction.

result from basic research is relevant for policy only if (a) it is based on economic mechanisms that are empirically relevant and first order to the problem, (b) it is reasonably robust to changes in the modeling assumptions, (c) the policy prescription is implementable (i.e. is socially acceptable and is not too complex).” This is precisely the approach followed for many years by good policy analysts like Roy Bahl. However, although the middle ground between grand theory and case studies – the space within which policy-relevant approaches to good development tax policy presumably lurk – remains largely undeveloped, the heyday of foreign ‘fiscal doctors’ is perhaps now past. Before reaching this conclusion, however, it is useful first to review what the standard approach to tax policy in developing countries has been over the past half-century.

An important characteristic of much foreign tax advice in the initial decades after World War Two was that no one asked for it. Instead, advice and advisors, short-term and long-term, initially arrived on foreign shores largely at the initiative of the victorious powers such as Britain, France and the United States. In all too many instances, the tax policies suggested reflected those currently in place in the advisor’s home country.⁴ In other cases, ideas currently under discussion, though not implemented, in the home country were suggested for implementation abroad.⁵ Finally, in a few instances, ideas were developed at home specifically for export.⁶ Of course, even among the earliest foreign tax studies some – though usually incorporating elements of each of these models – transcended them to some extent

⁴ For a beautiful example of how the sales taxes initially imposed in francophone Africa mirror almost perfectly the version of the tax prevailing in France a few years earlier, see Hill (1977). France was of course not the only source of such ideas, and Africa by no means the only recipient: every advisor carries with him knowledge of his own system and is usually eager to share it with others. A particularly important instance of the wholesale imposition of a foreign tax policy model is the ‘soviet-type’ (command economy) tax system, originally developed in the USSR as part of its planning system and subsequently adopted in substantial part throughout the so-called Sino-Soviet Bloc in the decade after World War Two (Wanless 1985). The story of how this system was replaced in what became called the ‘transitional countries’ towards the end of the 20th century is nicely summarized in Martinez-Vazquez and McNab (2000) but not further discussed here.

⁵ For a classic account of how a theoretical fiscal concept (land revenue) that was never accepted as a policy instrument at home came to be firmly implanted in India in the late 18th century, see Stokes (1989). Little had changed in this respect in the late 20th century: for two examples, see (Goode 1961) on the (brief) adoption of a personal expenditure tax in India and what was then Ceylon and some aspects of the more recent history of income tax reform (Bird and Zolt 2005).

⁶ The income taxes initially imposed in much of anglophone Africa as well as other British territories around the world – and still found in e.g. Iraq as late as the beginning of the present century – were largely derived from a ‘model’ income tax devised by an interdepartmental committee in London in 1922 (Thuronyi 2003). Although such later efforts as the ‘Basic World Tax Code’ (Hussey and Lubick 1992) never had such success, the tendency to devise an all-purpose model to serve different ‘clients’ remains strong in the tax advisory business.

and had an important and lasting impact on subsequent tax policy development in the countries concerned.⁷

The bilateral aid programs that began to flourish in the 1960s were based both in the countries just mentioned (often focused mainly on their former colonies) and to a lesser extent in other developed countries. As time went on, however, the array of regional and multinational agencies established in the post-Bretton Woods world – the UN, the World Bank, and above all the IMF, particularly after the establishment of its Fiscal Affairs Department (FAD) in 1964 -- became the major players in the fiscal advice arena. Even when not formally initiated or financed by the developed countries in one guise or another the modus operandi of most fiscal missions continued to be very much along what may perhaps be labeled, with no disrespect to either side intended, the ‘teacher-student’ path.⁸

Foreign fiscal advice to developing countries has always been driven as much by the training, experience and interests of those giving the advice as by any specific need for advice perceived by the recipient countries. As discussed in the next section, the advice given changed over time both because our understanding of theoretical and empirical public economics changed and because more and more advisers were increasingly exposed to reality in a variety of developing countries. Time also changed how advice was received, owing both to increasing technical capacity in recipient countries and to changes in the political and economic realities they confronted. The resulting changes in both the ‘supply’ and the ‘demand’ curves for foreign tax advice suggest, or so this paper argues, that increasing substitution of domestic for foreign suppliers is both inevitable and on the whole a good thing although there may remain an important – but very different – role for both foreign aid and to a lesser extent foreign experts in helping to improve fiscal outcomes in developing countries.

Fifty Years of Fiscal Advice⁹

The three decades between the end of World War II and the first oil crisis of the mid-1970s were on the whole years of growth and prosperity in most developed countries. Experience first with successful government-led success in war and then with rapid and generally equalizing market-led growth

⁷ Perhaps the classic example is the famous Shoup (1949) report in Japan – a report that to this day remains the benchmark for tax discussion in Japan -- although few of its many recommendations remained in force for long (Brownlee, Ide and Fukagai, forthcoming).

⁸ It should be noted, however, that some early major studies e.g. in Venezuela (Shoup 1959) and Indonesia (Gillis 1985) were largely organized and funded by the countries themselves.

⁹ Much of the material in this section draws heavily on earlier discussions in Bird (2011, 2012).

inevitably shaped the ideas of the few people – mainly economists – who were beginning in the 1950s and 1960s to think about tax issues in the very heterogeneous group of developing countries, many of which were then in the process of emerging from colonial status.

Over the past fifty years both academic researchers and international institutions -- sometimes following ideas suggested by research, sometimes responding to populist fads or pressures from the politically powerful -- have issued many policy prescriptions with respect to how to improve economic growth and development in poor countries: increase capital investment; improve education; control population; liberalize trade and capital markets; reduce government controls on market activities; and so on, and on (Easterly 2002). Each of these policies has at times been marketed as a universal “silver bullet” that will result in improved economic performance wherever applied. Unfortunately, none has worked as advertised.

The standard approach to tax and development has similarly undergone a number of major model changes over the years, with various stages in between and the extent of ‘beta testing’ or ‘piloting’ varying sharply from model to model. Much has been learned about taxation and development over the last half-century. However, we still have much to learn. Even the best research answers to particular questions have usually turned out to be extremely difficult to apply in practice. Moreover, since even the best research is only one of many inputs into policy-making, the task is not only to improve research on tax and development but also to improve how knowledge is marketed to those who can, if they wish, put the knowledge to use. Whatever approach is taken, despite the understandable desire of many to find a relatively simple model with which to understand and manipulate complex reality, there is no magical fiscal medicine, the swallowing of which will always and everywhere be beneficial. What this complex and changing world needs is less such a non-existent ‘universal fix’ than a fiscal medicine kit containing a variety of remedies and treatments directed at the variety of fiscal problems and needs which arise at different times and often in different ways in different developing countries. Of course, the core contents of the ‘tax kit’ are still likely to be similar in most countries but what is considered to be the ‘core’ has changed markedly over time.

Development Tax Model 1.0

In the beginning (c.1960), the accepted academic view of good tax policy was, more or less, that the ideal tax was a broad-based personal income tax with progressive rates that included capital gains in the tax base and was integrated with the corporate income tax in order to make both the decision to

incorporate and the choice between debt and equity finance more neutral (Auerbach 2010). This concise summary tells the story: it was all about the income tax, especially in English-speaking countries. The report of the Canadian Royal Commission on Taxation (1966) was called ‘a landmark in the annals of taxation’ by Harberger (1968) precisely because it was the most detailed attempt to turn these ideas into practical policy recommendations.¹⁰

It is thus not surprising that what might be called version 1.0 of the (implicit) Development Tax Model (Figure 1) essentially set out a progressive comprehensive personal income tax as the ideal tax for developing (as for developed) countries. Indirect consumption taxes were considered to be at best as a necessary evil, and both the international and sub-national aspects of taxation were generally neglected. Moreover, in line with the prevailing post-war Keynesian view of ‘government as leader’ most expert advisers urged not just better (more progressive) but more taxes as necessary to development (Kaldor 1963). For twenty years or more such eminent foreign advisers as Kaldor, Shoup, Musgrave and their followers generally recommended packages based on variants of this model to all comers.¹¹

Figure 1 - Development Tax Model 1.0

Unfortunately, the outcome of this advice was not all that impressive. In contrast to the earlier post-war years (Chelliah 1971) during the 1970s and 1980s relatively few developing countries significantly increased their tax-GDP ratios (Bahl and Bird 2008). Structurally, however, two important changes did occur in most countries: the introduction of the VAT and the general lowering and flattening of statutory income tax rates. Each of these changes might perhaps be interpreted as illustrating the success of good tax advice. The downward shift of personal and corporate income tax rates was supported both by

¹⁰ As previously noted with respect to the Shoup report in Japan, however, few of the more fundamental recommendations of the Royal Commission report were fully accepted in Canada (Bird and Bucovetsky 1972)

¹¹ I was no exception: see Bird (1970). The selected readings included in successive editions of Bird and Oldman (1964, 1967, 1975, 1990) provide a useful sampling of the changing literature in the field over time.

developments in economic theory and by research results demonstrating the potentially large efficiency costs of high marginal tax rates. Similarly, to some extent at least the widespread adoption of VAT can perhaps be attributed to the more favorable views of consumption taxes emerging in the literature in these decades as well as to the argument that this way of taxing consumption is less economically distorting than most other forms of indirect taxation. Whether for these reasons or others, it was clear by the end of the 1980s that a new standard model of development taxation had emerged.

Development Tax Model 2.0

One way to think of this new model, as set out, for instance, World Bank (1991) and sketched in Figure 2 might perhaps be as the fiscal component of the so-called ‘Washington consensus’ that ruled the policy roost after the early 1980s.¹²

Figure 2 – Development Tax Model 2.0

Value added tax as the main revenue pillar
Substantial reductions in import tariffs
Income taxes – broader bases but lower rates
Few or no tax incentives
Excises for revenue (and externality pricing)
Sub-national taxation essentially property tax

The main pillar of development tax policy in this model was no longer the personal income tax but the VAT (value-added tax), preferably imposed at a single rate and on a broad base (Ebrill et al. 2001). One reason for placing VAT at the fiscal center in many countries was the increasing emphasis – first through GATT and then the WTO -- on the need for signatory countries to impose lower and more uniform import tariffs. Income taxes, both personal and corporate, remained important sources of revenue in many countries but preferably with lower rates and broader bases – and less use of tax incentives. Although growing interest in decentralization issues led to more attention being paid to local governments, for the most part they were simply told to make better use of the traditional property tax. Interestingly, although some attention was paid to the continuing importance of traditional excises, almost never were payroll taxes or non-tax revenues, important though such revenues are in some

¹² Elsewhere, it has been labelled the BBLR (broad base low rate) model (Bird 2011a).

countries, taken into account in tax discussions. Finally, although more nuanced, as with Model 1.0 the underlying message to most developing countries with respect to tax levels continued to be that ‘more is better.’

Since VAT did become more important in many countries (Bird and Gendron 2007) and income tax rates declined almost everywhere (Peter, Duncan and Buttrick 2011), at first glance those selling Model 2.0 seems to have been much more successful than their predecessors were with Model 1.0. However countries seldom do things because economists produced persuasive theories or evidence that it would be good to do them. Indeed, often tax researchers have not so much led the reform elephant as mopped up behind it. VAT, for example, was developed in France and then adopted in Europe as a better way to administer a general consumption tax, particularly with regard to cross-border trade. Countries lowered and flattened income taxes at least in part because more people rose into tax brackets formerly occupied, if at all, by a few rich people and in part because of perceived international competition for capital (Leibech and Hochgatterer 2012). To some extent, the role of tax economists was simply to rationalize developments that had already occurred in the real world.

Moreover, neither the level nor the structure of taxation in most developing countries has actually changed much. The UN Millennium Project (2005), much like Kaldor (1963), informed developing countries that on average they needed to mobilize another 4 percent of GDP in tax revenue to achieve the minimal Millennium Development Goals – that is, to increase from their current average tax ratio of 17-18 percent to something closer to 22 percent. More recently, the IMF (2011) was a bit more cautious, suggesting only that a 2 to 4 percent increase in the ratio was both desirable and feasible in most developing countries – though noting that most could likely get up to 2 percent more from VAT alone with no great effort. Despite such optimism, in reality the tax-GDP ratio has, on average, hardly increased in developing countries over the last 30 years. Indeed, taxes went up relatively much more in developed countries during this period (Bahl and Bird 2008). Of course, a few fast-growing countries from time to time have managed to achieve and even exceed the UN-prescribed rate of increase but it is not yet clear that the new levels reached will be sustainable.

Fiscal inertia seems to be more common than fiscal growth, with many countries remaining for relatively long periods at more or less the same tax-GDP level. Kaldor (1963) noted long ago that the main reason taxes have not gone up in most countries is because it is seldom in the interest of those who dominate the political institutions to increase taxes. Economists – on the whole not a group keen to man the revolutionary barricades – have found it difficult to suggest an alternative explanation. They often end

up advocating little more than the always unwelcome medicine of fiscal puritanism – a hard-to-swallow mix of fiscal abstinence (stop wasting money) and fiscal rectitude (collect the taxes you impose).

There is some evidence of similar ‘inertia’ even in tax structures. Although there is considerable variation within the diverse group of developing countries, often less has been going on than is apparent to eyes dazzled by the seemingly endless changes of tax rates and tax legislation. For example, although how consumption taxes are collected has changed to some extent as countries have adopted VATs, the relative importance of such taxes on average has hardly changed at all as increased VAT collections (often on the same import base) have been offset by decreases in customs revenues (Martinez-Vazquez and Bird 2011).¹³ Despite the fiscal challenges they face and the many tax changes they have made, when it comes to tax reality in many countries, “business as usual” is often a better description than “tax reform”.

Although poorer countries are more constrained than richer countries, they too have considerable discretion as to how much they raise and how they raise it (as well as how they spend it). Both opportunity and choice affect tax levels and tax structures. Originally, most studies of tax determinants stressed opportunity – that taxes mainly reflected economic structure. Per capita GDP and the non-agricultural share of GDP continue to be important explanatory factors. However, more recent studies using such ‘demand-side’ variables as quality of governance, inequality, size of informal sector, and tax morale (e.g. Bird, Martinez-Vazquez, and Torgler 2008) suggest that to a significant extent tax levels in different countries reflect people’s perception of the quality and responsiveness of the state. Kaldor (1963) was thus right in the important sense that countries that wish to tax more need governing institutions that facilitate rather than obstruct the achievement of this goal. Enhancing the rule of law, reducing corruption and the shadow economy, and improving tax morale are neither simple nor easy. But advising countries to work on such matters may nonetheless be more sensible than suggesting they wait around until someone finds oil on their territory. Indeed, since oil money all too often has exacerbated governance problems (Collier and Hoeffler 2005) many urge that such countries usually need to improve governance – even though, with easy money from oil, experience suggests that most are less likely to do so.

¹³ Moreover, in some countries the change in consumption taxes has been more in form than in reality as the ‘new’ VAT continues to be interpreted and administered in more or less the same way as the ‘old’ excises or turnover taxes that were presumably replaced.

How countries structure their tax systems depends upon the need and desire for increased public services, the capacity to levy taxes effectively, and preferences for such public policy goals as attaining a desired distribution of income and wealth and increasing the rate of growth. In a study based on observations for 100 countries over the 1975-92 period Kenny and Winer (2006) show that countries tend to utilize *all* tax bases more as tax levels rise. For example, if one compares OECD countries to Latin American countries, the latter collect less as a share of GDP from every tax source (Barreix and Roca 2006). Unsurprisingly, how heavily countries rely on different tax bases over time increases more on bases that become relatively more important. For example, as oil production and prices increase, oil countries get more revenue from this source.¹⁴ Further, much as argued in the traditional ‘tax handles’ approach (Musgrave 1969) taxes on particular bases tend to increase when the administrative costs of imposing those taxes decline. For example, rising education levels lower the cost of imposing personal income taxes and are hence associated with more reliance on such taxes.¹⁵ Kenny and Winer (2006) suggest that an additional critical factor influencing tax structure choices is the extent to which reliance on particular tax sources can be translated into effective political opposition. For example, as Prichard (2009) shows for Ghana, fuel taxes may be derailed by strong opposition from well-organized taxi and truck operators.

Only when the basic underlying political, economic, and administrative realities that underlie tax policy change is a country likely to alter its tax mix substantially. Even a good tax reform – one that raises (more) revenue in a more efficient and equitable fashion – is perhaps unlikely to be more effective than, say, a good seat belt law. That is, if everything else stayed the same, many lives would be saved. However, things do not stay the same because some people appear to drive more recklessly when they feel safer, so overall highway death rates may decline less than expected. Similarly, if countries tend to achieve equilibrium with respect to the size and nature of their fiscal systems that reflects the balance of political and other factors, they tend to stay there until “shocked” to a new equilibrium.¹⁶ One implication is that ‘reform’ in one aspect of tax policy may often be offset by changes elsewhere that

¹⁴ On the other hand, expanding trade has in recent years not been associated with increasing dependence on trade taxes (Baunsgaard and Keen 2005).

¹⁵ As Gordon and Li (2009) emphasize, financial development and the expansion of the corporate sector also increase the importance of income taxes.

¹⁶ Along similar lines, Peacock and Wiseman (1961) called the discrete jump in tax effort and public expenditure in post-war Britain a “displacement effect”: general perceptions about what is a tolerable level of taxation tend to be stable until shocked by a social upheaval so that levels of taxation that would have been previously intolerable become acceptable and remain at the new higher level after the social perturbations have disappeared. The jump in tax levels in Nicaragua after the Sandinista revolution – and the maintenance of the new, higher level – under subsequent conservative governments provides another example.

tend to return to the pre-reform situation. For instance, one of the most striking features of the various major tax reforms that had took place in Mexico in earlier decades (Gil-Diaz and Thirsk, 1997) was how little effect they had on Mexico's tax ratio. As Martinez-Vazquez (2001) discusses, most of these reforms appear, either intentionally or by coincidence, to have been undermined by unrelated ad hoc measures or offset by administrative deterioration.

On the whole, we still have relatively little understanding of the likely effect of tax changes on either political or -- despite the extensive literature asserting the contrary -- economic outcomes. For example, only a few small mice of agreement have yet emerged from the mountain of empirical studies on the impact of taxes on growth (OECD 2008) although, as Martinez-Vazquez, Vulovic and Liu 2011) show, the evidence that heavier reliance on 'direct' taxes adversely affects growth continues to mount. Of course, much of the evidence is derived from cross-country studies that are inherently able to cast at best limited light on the impact of a particular tax change in the setting of a particular country.¹⁷ Still, as countries develop and become more open, all are faced to some extent by the task of capturing in the tax base expanding production and consumption activities without either overstraining administrative capacity or unduly discouraging the expansion of such activities. Unfortunately, the leading edge of growth in many countries -- outward-oriented development -- may all too easily become the bleeding edge of the fiscal system as it becomes more and more difficult to levy taxes effectively on capital income, thus potentially exacerbating internal inequalities and political pressures on the tax system.

Moreover, even the best tax laws yield revenue only when they can be effectively implemented. In many developing countries, there is a large traditional agricultural sector that is not easily taxed. Often there is also a significant informal (shadow) economy that is largely outside the formal tax structure -- an economy that may itself to some extent be a function of how taxes are designed and implemented (Alm, Martinez-Vazquez and Wallace 2004). Such problems are more difficult when their scale is great and available administrative capacity limited. *How* revenue is raised -- the effect of revenue-generation effort on equity, on the political fortunes of the government, and on the level of economic welfare -- may be equally (or more) important as *how much* revenue is raised. The best tax administration is not simply that which collects the most revenues; facilitating tax compliance is not simply a matter of adequately penalizing noncompliance; tax administration depends as much or more on private as on

¹⁷ Salmon (2012) presents a nice critique of the limited usefulness of cross-country empirical studies as a basis for political economy analysis, while Lindert (2003) emphasizes the extent to which detailed characteristics of tax design and implementation and market structure that are not easily captured in econometric models determine the impact of specific policies in different countries.

public actions (and reactions); and there is a complex interaction between various environmental factors, the specifics of substantive and procedural tax law, and the outcome of administrative effort. All this makes tax administration complex and assessing the relation between administrative effort and revenue outcomes a difficult task. Work on such issues has barely begun even in developed countries, and we know far less than we should about many aspects of the critical administrative dimension of taxation in developing countries.¹⁸

Much the same can be said of an even more fundamental determinant of tax system change – the political economy of taxation. Those who design and implement tax systems, like those who try to escape them, probably consider themselves to be eminently ‘practical’ people responding to the world around them as they see it. Keynes (1936, 384-85) once said that “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.” This dictum may both unduly flatter economists and give too little weight to the fact that tax policy is shaped not only by ideas but also by vested interests, changing economic conditions, administrative constraints and technological possibilities, and, especially, by the nature and functioning of the political institutions within which these factors affect policy decisions. But it is fundamentally correct: ideas matter.

So, however, do interests and institutions. The best tax system for any country is presumably one that fits its economic structure, its capacity to administer taxes, its public service needs, and its access to such other sources of revenue as aid or oil. It must also take into account such nebulous but important factors as ‘tax morale’, ‘tax culture’, and, perhaps above all, the level of ‘trust’ existing between people and their government. Tax policy decisions are not made in a vacuum. Nor are tax systems implemented in one. The taxes that are adopted in a country and how they are administered are always and everywhere both path-dependent and context-specific. They reflect the outcome of complex social and political interactions between different groups in society in a specific institutional context established by history and state administrative capacity. In turn taxes may themselves to some extent influence the showing the context, nature and outcomes of such interactions (Moore 2007). Like tax administration, tax politics deserves close attention by those interested in improving tax policy although

¹⁸ For more detailed discussions of tax administration in developing countries, see Bird (1989, 2004).

as yet it is far from clear how, if at all, closer consideration of the political economy aspect is likely to affect the substance of tax policy advice.¹⁹

Until recently, however, little research has focused on either the administrative or the political dimensions of taxation. Economists understandably have approached the tax-development nexus from their own disciplinary perspective, as illustrated by the prolonged theoretical discussion among tax economists about new forms of progressive direct consumption taxes (McLure and Zodrow 2007). This discussion may have led many economists to change their view of the relative virtues of taxing consumption versus income. In the policy world, however, its main consequence may have been to foster a better -- but still not very (if at all) progressive -- indirect consumption tax in the form of VAT.²⁰ Of course, VAT has swept the board in the developing world for reasons that have little, if anything, to do with the internalization of lessons from research -- in part owing to the reputed administrative advantages of VAT compared to other forms of sales taxes, in part reflecting the desire of the IMF and other external advisers (as well as governments) to increase the income-elasticity of consumption taxes, and perhaps especially by the need to replace the revenue from customs duties affected by trade liberalization.

Similarly, much economic research suggests that high marginal tax rates (MTRs) can induce a variety of changes in the behaviour of taxpayers, with resulting economic costs. Tax-induced changes may include changes in hours worked and in labor force participation, the substitution of non-taxable for taxable consumption, changes in the timing of income realization, changes in the form of compensation (including incorporation), use of deferred compensation and other tax shelters, and increased evasion. A high MTR is most costly when applied to a tax base that is more responsive to tax rates — when, for example, affected taxpayers may easily substitute from paid work to unpaid family care, or from conventional employment to activities in the less-taxed informal sector, or they may even move to another country. Such behavioral responses to taxation can be usefully summarized in the “elasticity of

¹⁹ For an interesting overview of the rapidly growing literature on PEA (political economy analysis) – though without specific reference to tax policy – see Copestake and Williams (2012). Some aspects of PEA with respect to taxation are considered in the Latin American context in IDB (2006) and more generally in Brautigam, Fjeldstad and Moore (2007). Economists too have good work on the political economy of taxation, as summarized a few years ago by Persson and Tabellini (2000, 2003). For the most part, however, this work understandably plays to our disciplinary expertise in model-building and econometrics. As Frey and Steiner (2012) emphasize, despite such interesting recent works as Acemoglu and Robinson (2011) and Engerman and Sokoloff (2011), all too many economists still seem to assume that governments want and are able actually to maximize social welfare.

²⁰ The progressivity (or otherwise) of VAT is discussed in Bird and Gendron (2007), as well as Jenkins, Jenkins and Kuo (2006).

taxable income” (Feldstein 1995) — the average percentage decrease in a taxpayer’s taxable income due to all behavioral responses when the taxpayer’s marginal share (one minus the marginal tax rate) is decreased by 1 per cent. Examining the effects of the 1986 U.S. tax reform on a sample of taxpayers, Feldstein (1995) estimated the elasticity of taxable income to be quite large, with preferred estimates ranging from 1.0 to 1.5. To put these estimates in perspective, note that even unitary elasticity implies that government revenues would reach their maximum level at a tax rate of 50 per cent; further tax increases would actually decrease revenues. Although this approach to determining the revenue-maximizing tax rate is an understandable approach to making old arguments about efficiency more meaningful and palatable to policymakers (Bird and Wallace 2005), such arguments appear to have had little direct influence on tax policy. Income tax rates may have come down around the world, but there is little evidence that the structure of MTRs accords with what analysis suggests.²¹

A recent review of optimal taxation notes that “where large gaps between theory and policy remain, the ...question is whether policymakers need to learn more from theorists, or the other way round” (Mankiw, Weinzierl and Yagan 2009). With respect to taxation in developing countries, the answer seems clear: tax researchers need to understand the constraints and objectives facing policymakers before offering them pre-cut solutions to what researchers think are their problems. In fact, both the theory and the evidence on the size and distribution of any gains from such policies are at best ambiguous (Diamond and Saez 2011). To paraphrase Shakespeare, there are more things in heaven and earth than are dreamt of in optimal tax theory. Not only is the world within which tax policy decisions are made complex; so are the motivations of those who make, and react to, such decisions.

The reduced marginal tax rates on high income recipients and corporations found around the world seems less likely to reflect absorption of the lessons of optimal taxation than the globalization of international capital markets and the accompanying regional and international competition for capital. Although tax research has not yet produced convincing guidance to what a good system of international taxation might look like, solutions to the problems arising from the imposition of international constraints on domestic tax policy are perhaps more likely to emerge from the sort of ‘soft governance’ embodied in the endless meetings and discussions of agencies like the OECD rather than from either the dictates of economic theory or the rather drastic solution of creating a de facto international tax

²¹ See Auerbach (2010); Mankiw, Weinzierl and Yagin (2009).

authority.²² Experience shows that “...there are many problems that people are unable to solve in the abstract, but are able to solve when placed in a real-world context” (Babcock and Loewenstein 1997, 122). International taxation is likely to continue to be one such problem.

Looking back at Model 2.0 with all this in mind, at best the glass seems half full from a policy perspective. The core ideas of Model 2.0 -- the BBLR approach to income taxes and the VAT as a superior form of sales tax and the best way to replace trade taxes -- were extensively marketed to the developing world by fiscal missionaries from the IMF and elsewhere. The audience was surprisingly receptive to the message, although the relative success of these ideas may lie at least to some extent in the fact that, arguably, they coincide with elite interests. Since elites pay (or think they pay) most of the income taxes in developing countries they benefit directly from reduced and flatter income taxes. Elites do not pay most VAT, but they do control the companies that act as collection agents for this tax and it is generally in their interests to extend the tax base as far as possible in order to draw into the tax net as much of their ‘informal sector’ competition as possible. Whatever the reasons, the generally sensible core advice of Model 2.0 was widely accepted. On the other hand, not only was inadequate attention paid to both the administrative and political economy aspects of taxation but a number of substantive fiscal issues important in many countries – for example, subnational taxation²³ and payroll taxes and non-tax revenues more generally²⁴ -- have been unduly neglected. More importantly, despite much expert work by the IMF and others on tax administration in recent years, as yet little has been done to relate this work adequately to policy, let alone to take adequate account of the country-specific political economy considerations that in end seem to be the primary determinants of both policy uptake and policy success. At best, what may emerge from the experience recounted to this point is what perhaps might be labeled Development Tax Model 3.0.

Towards Development Tax Model 3.0

What might such a new standard ‘model’ look like? Before attempting to answer this question, it may be helpful to consider the sorts of objectives and instruments that need to be taken more carefully into

²² Musgrave (2002) remains perhaps the most interesting attempt to derive policy rules from theory; for different views on international tax policy see e.g. Tanzi (1995) and Bird and Mintz (2003).

²³ See Bahl and Bird (2008a) and Bird (2011b).

²⁴ On the importance of non-tax revenues, see Bird and Das-Gupta (2012); Alm and Lopez-Castaño (2006) and Bird and Smart (2012) discuss some aspects of payroll taxation. Another unduly neglected issue, natural resource taxation, has recently received much more attention (Daniel, Keen and McPherson 2010).

account by tax advisers. One useful starting point is to think about the different roles taxes play – for example, stabilization (revenue sufficient to finance public expenditure in a sustainable way), redistribution (altering the market-generated distribution of income and wealth), and regulation (affecting private sector allocative decisions) – and to consider how different taxes may be linked to the achievement of these goals.²⁵ From this perspective, the main role of a broad-based single rate VAT (like a similar payroll tax or a flat-rate income tax) is simply to raise revenue, while progressive personal income taxes and wealth taxes are presumably intended mainly as redistributive instruments, and excises as well as the corporate income tax (in addition to backing up the personal income tax) play primarily a regulatory role (Avi-Yonath 2009).

The Distributional Objective

Consider first the issue of progressivity. Model 1.0 assumed (roughly) the more progressive the tax system the better, while Model 2.0 in effect assumed tax progressivity was not an important issue. Neither assumption provides either a correct or a useful starting point. On one hand, progressivity is not costless. On the other, in the policy context of most countries tax advice that assumes distributional considerations are either unimportant or can easily be achieved by (usually unspecified) adjustments somewhere else in the tax-transfer system is of little use. Distributional issues often dominate in the minds of those who shape policy and the general inability of politicians to understand tax incidence and of tax economists to say much that policymakers consider relevant about distributional issues has often relegated the economics of taxation to the sidelines in policy discussion. Although distributional studies are often both conceptually and empirically difficult and model, let alone to convey to decision-makers, the reality is that equity concerns lie at the heart of many public policy questions. Unless tax economists deal explicitly and satisfactorily with this issue their advice is unlikely to be influential.

Policy-makers often talk about poverty-alleviation and more egalitarian income distribution. In practice, however, their real distributional concerns about policy outcomes are often driven less by the desire to maximize social welfare than by more narrowly focused political economy considerations: How will this region or locality be affected relative to that one? Will home-owners be disadvantaged or benefited? How will the old be affected? What will be the effects on farmers and the rural sector? Will this or that industry be better or worse off? Although such questions are seldom considered in mainline tax research they are frequently critical in shaping policy decisions. To resonate in policy circles, research

²⁵ For an extended discussion of tax policy objectives in the context of a developed country, see Bird and Wilkie (2012).

needs to speak to such questions. If experts want their research to be taken seriously, they need to be able to tell good stories that relate to the concerns that people have – regardless of whether those concerns are seen as central, or even acceptable, within the accepted disciplinary research model.²⁶

Tax policy is not just about economics but about politics. To provide useful advice on tax issues in any country one must understand the political as well as the economic factors that shape policy decisions and policy outcomes. As noted earlier, the level and structure of taxation reflect deep-seated institutional factors that, in the absence of severe shocks, do not change quickly. Tax policy decisions reflect the outcome of complex social and political interactions between different groups in society in an institutional context established by history and state administrative capacity. Taxation is not just a means of financing government; it is also a very visible component of the social contract underlying the state. Citizens are more likely to comply with tax laws if they accept the state as legitimate and credible and are thus to some extent both willing to support it and afraid of what will happen to them if they don't. Tax policy changes thus depend largely on how different political groups perceive proposed changes and how they react to these perceptions: as Lledo, Schneider, and Moore (2003) put it, any major tax reform is thus always and everywhere “an exercise in political legitimation.”

Those who have to pay more must be convinced that they will get something worthwhile for their money. Those who do not want to pay more must not be able to block reform and, in the end, must be willing to go along without taking to the hills in revolt or fleeing the country.²⁷ Those within government and in the private sector who implement the reform must support it or at least not actively sabotage it. And of course politicians must see sufficient support to warrant putting reform not only on the agenda but on the ground in practice as well as law.

To illustrate how little research usually has to do with policy consider, for instance, property taxes in the United States. Although research on this tax has long been a major industry it is hard to detect much, if any, effect on actual tax policy as a result.²⁸ For example, the literature demonstrates clearly that taxes on property are decidedly superior to taxes on property transfers; yet the latter are invariably much

²⁶ As US experience with death taxes illustrates (Graetz and Shapiro 2005), one well-told story, even if not true, may outweigh 100 well-done econometric studies.

²⁷ Or, at the extreme, perhaps creating their own country: Rabushka (2008, 868) concludes his recent exhaustive recent review of taxation in colonial America with the unequivocal (though controversial) statement that “The American Revolution....was a tax revolt, first and foremost.”

²⁸ Witness the major survey papers by Zodrow (2001) and Fischel (2001): the rate of production has not slowed down, as Augustine et al. (2009) demonstrates.

more politically popular and, in most developing countries, often more important in revenue terms. Property tax research and property tax policy appear to be activities carried out by different people in different rooms who do not communicate well with each other.

Excises are another ancient tax that still generates significant revenues in many countries. Countless studies have considered the efficiency effects of taxes on alcoholic beverages and tobacco. Again, however, such studies have had little perceptible effect on either the level or structure of these taxes.²⁹ Much the same is true with respect to taxes on vehicles and fuel, despite the substantial economic literature suggesting alternative designs of these levies on efficiency grounds. Perceptions about the effects on changes on equity and politics almost always trump efficiency analysis even if – unusually -- the latter is presented to policymakers in both language and a context to which they can relate.

In one way or another, perceived fairness is thus always a key issue in designing any tax regime. Indeed, from one perspective, taxes exist primarily to secure equity. National governments do not need taxes to secure funds: they can simply print the money required to fund operations. The tax system is in effect a mechanism designed to take money away from the private sector in as efficient, equitable, and administratively inexpensive way as possible. Of course, what is considered equitable or fair by one person may differ from the conceptions held by others. Some may stress horizontal over vertical equity, for example, as OECD (2006) argues is increasingly true in developed countries and as Bergman (2003) suggests is also the case in Latin America. Others may tilt the balance the other way, as did the ‘progressive’ thinking underlying Model 1.0. One way or another, however, equity also matters in tax policy discussions.

Does this means tax progressivity matters? Harberger (2006) argues it does not matter much: insofar as government policy affects the distribution of income and wealth, spending – such as providing education (even when financed from regressive taxes) -- is much more important than taxing the rich. Even in a relatively advanced country like Chile with an unusually well-developed and effective tax administration the progressivity of the income tax simply cannot have any significant influence on distributional outcomes (Engel, Galetovic and Raddatz 1999). One may argue that such taxes share the burden of government more fairly and may even be essential to building social trust, but one cannot

²⁹ Cook (2007) provides a recent review of both research and policy on alcohol in the U.S. For a more general overview of excise tax research and policy, see Cnossen (2005). The important interaction between tax and regulatory policy is one aspect that clearly needs more attention: for some initial thoughts in one small area, see Bird and Wallace (2006).

argue persuasively in the context of most developing countries that they are likely to be effective redistributive tools. As Lindert (2003) shows, it was not by taxing the rich but by taxing the growing middle class that developed countries 'grew' large states. Similarly, in notoriously unequal Latin America income tax only began to be relatively efficient and effective revenue raiser to any extent when it began recently in (some) countries to bite into the middle class, essentially by combining reduced top rates with lowering the level at which those reduced rates come into play (Lora and Cardenas 2006).

How to Sell Tax Reform

Process issues are often more important than substantive issues like efficiency or equity when it comes to selling tax reform. Marketing matters. Those who want serious tax reform need to understand not only tax theory and practice but also the dark art of political salesmanship. This warning needs to be taken particularly seriously by those who are concerned not only with how tax revenues may build up a more sustainable state but also with how the revenues are collected may contribute to, or detract from, the long-term development of state legitimacy. Consider for example the question of 'fiscal illusion.' Which is more important: what taxes do or what people think they do? Economists have always focused on the objective reality of outcomes and assumed that citizen-voters will eventually if not immediately see through the veil of perception and make policy decisions on the basis of reality. But is this right? Even if in the long run budget constraints will force people to face up to fiscal reality, history demonstrates everywhere that policy decisions have usually been shaped mainly by governed more by perceptions than by reality.³⁰

As an example, consider earmarking and what Breton (1996) calls the 'Wicksellian connection' between the two sides of the budget. Establishing such a linkage in the minds of people is critical to the whole issue of state legitimation. This argument is, for example, one of the key elements in explaining the popularity (and mixed results) of fiscal decentralization around the world (Bahl and Bird 2008a). Earmarking – linking specific revenue sources to specific expenditures -- has existed since the earliest recorded fiscal practices (Webber and Wildavsky 1986). Both politicians and taxpayers often find earmarking an attractive and feasible way to finance social security, road works, education, environmental programs, and other good things. Politicians like earmarking as a means of reducing

³⁰ Recently economists have begun to take this issue more seriously, as evidenced by the growing literature on behavioral economics (Congdon, Kling and Mullainathan 2011) and especially on "tax saliency" (Feldman and Ruffle 2012) although to date the emphasis on the latter has been more on the effects on private allocative decisions than on governmental decisions about how to impose taxes.

taxpayer resistance to higher taxes. Officials like to have secure revenue sources dedicated to fund their activities. Taxpayers like the greater accountability they perceive with respect to how their tax dollars are spent. Economists, however, have come only lately to the table when it comes to understanding and analyzing this common fiscal practice.³¹

Budgeting experts, for instance, have almost unanimously condemned earmarking as a bad idea, arguing that no rational budgetary process is conceivable unless the practice is essentially banned. Although the implicit (and implausible) assumption in this argument is that budgetary decisions are (or should be) made by a government with the sole objective of maximizing social welfare, the condemnation of earmarking for distorting expenditure allocation is supported by the fact that rampant earmarking has certainly at times had this effect in some countries. This approach remained essentially unchallenged in the public finance world until Buchanan (1963) revived an important efficiency argument (made earlier by Wicksell) in favor of establishing as tight a linkage as possible between taxing and spending decisions.³² In this approach, earmarking is seen not simply as a way to secure political consent for a tax increase but rather – under certain specific conditions – perhaps the *best* way to deal with the fundamental normative problem of public economics -- how to provide people with the public services they really want -- where ‘want’ is interpreted in the only economically relevant sense of what they (collectively, as determined through their political institutions) are willing to pay for.³³

The economic case for earmarking is strongest when there is a close benefit link between taxes and spending. Benefit-related earmarking (like user charges) if properly designed and implemented reveals taxpayer preferences for public services and sends a clear demand signal to the public sector about how much of a service should be supplied. Since revenues received (and only such revenues) are spent on the service in question, supply automatically adjusts to demand and economic efficiency is achieved. Such earmarking may also be considered equitable in the sense that no one receives a service without paying for it or pays without receiving service. Provided that the public service thus financed is similar to

³¹ This discussion draws on a more detailed treatment in Bird and Jun (2007).

³² Whether earmarking increases public trust in government or reduces it depends very much upon the context. For example, earmarking (hypothecation) was widespread in Britain at the turn of the 19th century but was then rejected and replaced in mid-century by the ‘Gladstonian’ approach to public finance, an important feature of which was a consolidated budget with no earmarking (Daunton 2001). Interestingly, the stated reason for the turn away from earmarking was to *restrict* the growth the state in order to restore public trust in the neutrality of the public finances in the face of the then-common perception that hypothecated revenues were being (mis)used by the political elite to expand the ‘fiscal-military’ state in their own interests.

³³ As Sijbren Cnossen, quoting Richard Goode, noted in a comment on an earlier draft of this paper: “if you want the ends you must also want the means.”

a privately supplied service in the sense that both an individual's consumption of the service and the marginal cost of providing the service can be satisfactorily measured, most people would probably consider such levies fair on the whole.³⁴ Since informed and rational taxpayers – 'economic men' as it were -- are aware that when payments are extracted from them the funds will be used to pay for certain expenditures, they will presumably support the taxes or charges if and only if they support the expansion in the supply of government services for which the earmarked revenues are targeted. In these circumstances, both tax and expenditure decisions will be made more rationally than under general fund financing.

Unsurprisingly, such perfection seems seldom to be observed in practice. Many factors may explain the relatively disappointing performance of earmarking in the real world: the cost and difficulty of controlling many separate funds (Fullerton 1996), the inappropriateness of many of the linkages that have been established for political reasons between particular revenues and expenditures (McCleary 1991), and the understandable resistance of citizens to attempts to charge for services that initially were provided 'free' or at highly subsidized prices (Bird and Tsiopoulos 1997). Most earmarking seen in most countries makes little economic sense. Often, not only is there no logical link between the tax imposed and the spending for which it is designated but there is also no solid budgetary link. How much is collected from the designated source and how much is spent on the designated activity are essentially separate decisions, decided independently. What is the rationale for such non-logical non-linkages, and do they matter at all? These are not trivial questions. Many countries have many earmarked revenues, and new ones are created or at least suggested every day, not least in the environmental field.

One important rationale for imposing taxes designated to be spent on this or that popular activity is simply revenue enhancement. Politicians hope to justify the imposition of a new tax by capitalizing on the presumed 'halo effect' of something popular like education, health or 'greenness.' Earmarking may also sometimes be motivated in some instances by rent-seeking behavior. As an example, an increase in tobacco taxes with the proceeds earmarked for increased health spending may receive support from non-smokers, who would not pay the tax but want more spending on health; from smokers, who feel guilty about smoking and are worried about the health consequences of smoking; and from people in the health business who (presumably) not only believe that higher taxes on tobacco and more spending on health are good but also realize that they would be clear gainers if health spending increases as a

³⁴ Partial earmarking may be appropriate even if consumption of a particular public service generates external benefits for other households. In the limiting case in which the service is a pure public good and the marginal cost of extending service to another household is zero there is clearly no role for either user pricing or earmarking.

result (which may not be the case). Some studies (Cnossen and Smart 2005) suggest that the result may be that tobacco taxes (which are highly regressive) may already be higher in some countries than can be rationalized on externality grounds. But can politicians be expected to resist such a win-win combination?³⁵

If earmarking makes sense, by definition, it is economically sensible. When there is not a clear benefit rationale, it is hard for an economist to defend any form of non-benefit earmarking that actually affects expenditures (in the sense that the level of expenditure on any particular activity is determined at the margin by the amount of revenue collected from any particular tax or charge). But if calling a new tax a 'health tax' makes it more marketable, provided the tax is better than the alternatives and spending is not affected, should economists be perturbed by mislabeling?³⁶ Such concerns, like those with respect to various perspectives on tax equity, need careful consideration by tax advisers.

Setting the Target

The implicit policy target set in both Models 1.0 and Model 2.0 was, to oversimplify, an 'ideal' system derived from economic theory. The most popular alternative target is probably what is usually called 'best practice' – that is, developing countries are in effect advised to adopt the pattern found in some 'model' country – perhaps some statistical average of better (best) performing countries, as defined in terms of growth rates or some other 'output' measure or simply chosen on a best-judgment basis. Benchmarking as a way of establishing standards for evaluating the performance of tax systems has become increasingly popular in recent years (Gallagher 2005).³⁷ Benchmarking can be thought of as a systematic process for identifying and measuring 'performance gaps' between one's own outputs and processes and those of others, usually those recognized as leaders in the field or between actual performance and some hypothetical 'ideal' performance. The underlying motivation is presumably that by identifying such gaps one can perhaps begin to understand why they exist and how they might be closed in the country being studied.

³⁵ Earmarking tobacco taxes to health programs can be rationalized to some extent on 'benefit' grounds but is unlikely to have much effect on health spending. Earmarking such taxes to e.g. 'anti-tobacco' advertising campaigns may significantly increase the flow of funds to such activities (Jha and Chaloupka 2000) but this does not mean it is the best use of such funds.

³⁶ For an argument that they should indeed lose sleep over fostering political deception, see Bird (2010), although this appears to be a minority opinion among those concerned with policy.

³⁷ The following argument is developed at more length with respect to tax administration in Vazquez-Caro and Bird (2011).

The basic logic of benchmarking is sound and should in principle be both attractive and useful even to those being benchmarked: if others can deliver similar results more effectively and efficiently than you do, why not learn from them? However, if the intended objective is to provide useful guidelines for restructuring a particular tax system – to lay the basis for successful tax reform -- most benchmarking exercises fall far short. Benchmarking may sometimes help to identify areas of possible weakness, that is, deviations from some ‘norm’ that may perhaps be symptoms of problems that might usefully be examined more closely. However, although such exercises may lead to the collection and analysis of useful data, in themselves they neither supply clear explanations of the underlying problems nor insights that are likely to prove helpful in resolving those problems: problems are not solutions and possibilities are not certainties. Good benchmarking from the perspective of any country cannot be simply a matter of blindly adopting the practices of others, even those considered by experts to be ‘best in class.’

The real motivation for benchmarking is not so much to provide solutions as to help pick out areas in which there may be opportunities for change and improvement. In the case of revenue systems, as emphasized earlier, very often such opportunities are likely to be ‘soft’ (qualitative) in nature and difficult to identify very precisely, let alone resolve. Benchmarking exercises like those increasingly popular with aid agencies that focus primarily on ‘hard’ (quantifiable) data are all too likely to provide seriously incomplete information and may lead to changes (such as new technology) being implemented in an unsustainable manner. It is always tempting to look at what ‘might be’ and to set it up as a target; but it almost always a mistake when it comes to institutional reform to attempt to run before one can walk. As Schick (2012) has recently emphasized with respect to budgetary practices, it is usually more critical to get the basics right than to strive for any sort of perfection. A country without control over cash budgeting is not well advised to attempt to implement accrual accounting. Similarly, a country without a good taxpayer identification system and good telecommunications infrastructure (not to mention a reliable electricity supply) is usually not well advised to move immediately to a web-based tax system. This does not mean that countries cannot and should not in some instances try to move, as it were, from the 19th to the 21st century rather than painfully repeating the learning experiences more developed countries underwent in the intervening century. Nor does it mean that it is may not sometimes be useful to hold out immediately unattainable targets as inspirational and possibly motivating goals. But it does mean that when it comes to implementing tax reform close attention needs to be paid to such critical ‘soft’ elements of organizational ‘culture’ as the philosophy, behavior and style of management, as well as its strategy and the degree of participation, communication,

recognition, empowerment, and ‘ownership’ in the environment in which tax policy is formulated, designed and implemented (Gill 2001).

Of course, no one wants to hear that it may take decades before they are in a position to undertake this or that particular reform successfully, whether in tax structure or tax administration. No one wants to have to rethink their whole way of doing business (and politics) simply in order to make this or that tax incentive potentially useful (rather than, as usual, wasteful) or to get any real benefits from some attractive ‘free’ information technology being offered by an aid agency. What people want to hear is rather that they can simply bolt on this or that new feature to their existing system without making any more basic changes, and still get good, quick, and preferably quantifiable results. Similarly, many overweight people want to believe that there is a simple ‘magic bullet’ -- a pill, a potion, a machine -- that will make the problem go away. They do not want to hear that what they really need to do is to change their diet and exercise regime for life. It always seems much easier to buy a new IT approach off the shelf or to hire additional or better qualified (and paid) staff than to change how one makes policy or manages its implementation. It seems easier; but it is also seems much less likely to produce ‘good’ or ‘better’ results, let alone the ‘best’ results that are presumably the desired end goal.

Few countries that are currently considered ‘developed’ (US, Germany, Japan) or ‘successful’ (China, Korea) followed anything like ‘best practice’ benchmarking as a guide to policy change. Instead, one way or another – and the way was very different in each of the countries mentioned – they gradually altered their tax structures and administrations over time in response to (almost never in advance of) changes in the underlying political, economic, and social environment that requires (and is needed to support and sustain) such improvements. It is far from clear why more can or should be expected of other countries.

The Need for a Long-Term Perspective

Viewed in long-term perspective, many developing countries have not yet completed even the earlier parts of the long cycle that produced the (more or less) redistributive and (more or less) growth-facilitating fiscal states now found in most developed countries—the long preparatory period during

which the idea of the desirability and even necessity of a larger state and at least a mildly progressive fiscal system became established to different degrees in different countries.³⁸

In many Latin American countries, for example, inequality is a big problem (de Ferranti et al. 2004; Gomez Sabaini 2006). A key, and related, governance problem in most of the same countries is lack of accountability. A better tax system is critical to the solution of both problems. Reforms that link taxes and benefits more tightly such as decentralization and more reliance on user charges may (like earmarking) sometimes help accountability -- though not necessarily reduce inequality.³⁹ On the other hand, reforms that replace highly regressive and inelastic excises by a relatively non-distortionary general consumption tax like a VAT may actually reduce inequality—especially of course if the increased revenues are invested in growth-facilitating activities such as education and infrastructure.

Many governments in developing countries -- not just those in Latin America -- are in dire straits. Even countries that have reached relatively safe harbors politically, achieving a certain degree of legitimacy and stability, are often in an economically precarious situation. The budget is politically and economically constrained. Life is difficult. Nothing can be done. All this may be true to some extent, but it is also both too much a counsel of despair and too easy a way out. Even in the most hopeless situations something usually can be done to improve matters. No doubt there will continue to be considerable dispute over what should be done to improve tax systems. Indeed, in most countries it would be better if there was more informed public dispute about such matters because unless and until an adequate degree of political consensus on what should be done is achieved, no significant tax changes are likely to be made. In short, to a considerable extent the main tax challenge facing many developing countries is simply that there is as yet no implicit "... social contract between governments and the general population of the kind that is embedded in taxation and fiscal principles and practices in politically more stable parts of the world" (Lledo, Schneider, and Moore 2004, 39).

Such principles do not become embedded either painlessly or quickly. The specific substantive suggestions that Lledo, Schneider, and Moore (2004) make to improve matters -- such as better VAT administration on a broader base --are already the stuff of countless existing reports and most countries

³⁸ Compare the different, but parallel, stories told by Lindert (2003) and Alesina and Angeletos (2003) about how different developed countries have reached quite different fiscal equilibria. Why should uniform outcomes be expected in the much more heterogeneous developing world?

³⁹ Instead of improving matters, wrongly handled each of these approaches may end up worsening them if the reformed institutions are captured by particular interests as happens all too easily even in developed and democratic countries (Berry 2009). There is no such thing as a free lunch when it comes to institutional change.

probably should in their own interests do many of the good things that experts advise. But the question is why so many have done so little. Lledo, Schneider, and Moore (2004, 40) suggest, perhaps rather wistfully, that if Latin American countries wish to improve their tax systems they should “...improve political institutions in ways that broaden and deepen social contracts. For example, create more responsive and less clientelistic political parties, more cohesive and less polarised party systems, and improved capacity of civil society to monitor government and participate in tax debates.” In other words, since there cannot be good taxation (as they understand it) in the absence of good representation countries must get their politics right before they hope to get their tax systems right. This may be correct, but how useful is it to advise countries they should be something other than what they are?

Much thought and practice around the world suggests that there are three basic principles of good taxation or, indeed, public finance more generally.⁴⁰ First, using resources to finance public services should not result in a sacrifice of private value higher than the value of the public service produced. In other words, the last unit of resources transferred to the public sector -- the Marginal Cost of Funds (MCF) for public services (in terms of the private goods forgone) -- should just equal the marginal social benefit from expenditure on public services (Dahlby 2008). The main macro lesson related to this principle is embodied in the practical budgetary principle of maintaining aggregate fiscal discipline to ensure that government spending does not exceed the resources that citizens (who presumably benefit from the expenditures) are willing to allocate to it through the political process.⁴¹ If fiscal discipline is not maintained, countries may run large and persistent budget deficits – deficits that both reflect serious underlying problems and make those problems worse the longer necessary corrective action is delayed. One of the most important changes in recent decades is that an increasing number of countries that have undergone such experiences have tried to reduce the likelihood of future indiscipline by establishing such fiscal institutions as more comprehensive and transparent budgets as well as specific fiscal rules like fiscal responsibility laws (Liu and Webb 2011) that may at least in some circumstances restrain the level and nature of government borrowing. In this respect, expert advice, as conveyed in the literature and in the practice of international institutions seems on the whole to be both correct and

⁴⁰ The following paragraphs draw on Bird and Das-Gupta (2012); for the basic theory, see Slemrod and Yitzhaki (2001) and for the practitioner's perspective, see Diamond (2006) and Schiavo-Campo and Tommasi (1999).

⁴¹ Intergenerational considerations may complicate the attainment of fiscal sustainability in this sense just as they complicate the attainment of environmental sustainability, but this point is not further discussed here.

widely accepted, although of course arguments about the extent to which fiscal discipline can or should be relaxed always occur in times like the recent (and on-going) ‘workout’ from the financial crisis.

The second and third principles are essential if people are to perceive (and hopefully receive) sufficient “value for money” to be willing to sustain stronger tax systems. The second principle is simply that, to maximize national economic welfare, the benefits received from the last dollar spent on each public service should be equal. While it is impossible to allocate budgetary resources strictly in this fashion because we cannot really measure well-being precisely and because it is not clear how meaningfully can one compare the benefits from the last dollar spent on the army to those from the last dollar spent on health, the idea is both clear and correct. In some circumstances, as noted earlier, its budgetary embodiment may take such forms as earmarking or decentralization, even though unless carefully designed and implemented both approaches may sometimes create more problems than they resolve. More generally, however, the point is simply that since resources are scarce in developing countries, wasting those resources by spending them on something worth less than the opportunities forgone when taxes are imposed is a dead loss. In practice, the best way we know to improve the allocation of public resources is to measure and assess both public sector performance and the economic cost of public services as well and as transparently as possible. Like adequate representative governance, institutions that promote transparency and accountability are essential to ensuring that people on the whole get what they want when they pay their taxes. Few countries do what they can or should along either of these lines, but progress on both the political and administrative fronts are essential to ensuring that reforms intended to increase and improve tax systems are sustainable.

Much the same can be said with respect to the third principle mentioned, namely, that the services provided should promote the intended social outcomes (effectiveness) with as little leakage or waste as possible (efficiency). Although international agencies have devoted considerable effort to providing technical assistance in developing such institutions in some countries, not all that much success is yet evident. Summing up, the main message here is simply that since spending better is, if not always a necessary precondition, at least a necessary accompaniment to better taxation, good tax advice requires much closer attention to what is to be done with the revenue than is usually recognized.

At Last, The ‘Model’

After all these preliminaries, any simple presentation of a ‘standard’ model may seem impossible. Despite its label, Figure 3 therefore suggests more an approach than a model. More important than the

precise configuration of the ‘product’ – the reform package -- is the process through which it is conceived, ordered, assembled, delivered, and implemented satisfies the real needs and capacities of the country in question.

The basic components of the tax system as set out in items 3 and 4 in Figure 3 already exist in most countries, although seldom in ideal form. From a revenue perspective there are almost always have two basic ‘tax pillars’ – VAT and income tax, with the latter being some appropriate combination of personal, corporate, dual and/or flat taxes -- which will play a central role in any analysis of taxation. Such common recommendations as a broad-based flat VAT (Bird and Gendron 2007) or even more recent arguments for dual income taxes (Bird and Zolt 2011), may provide useful starting points but considerable finesse is invariably needed to move very far in such directions from wherever the country in question is now.

Figure 3: Development Tax Model 3.0

1. Custom-built rather than Off-the-Shelf
2. Time frame – short, medium, long
3. Core revenue pillars: VAT, income tax
4. Other taxes: Import duties, Excises (including environmental levies),
Property tax (and other subnational taxes), Payroll taxes
(including social contributions)
5. Non-fiscal aspects of tax policy, notably tax incentives
6. Critical features to be taken into account in tax analysis:
 - a. Non-tax revenues
 - b. Administrative aspects
 - c. Linked spending (social security, earmarking, decentralization)
 - d. Transfers
 - e. Regulations
 - f. Macroeconomic environment
 - g. International aspects
 - h. Decentralization policy

The other main revenue sources commonly found are those listed in the next row: again, there is nothing new about this, except perhaps bringing both property taxes (and other local taxes) and payroll taxes (including social contributions) into the spotlight as necessary components of tax analysis – whether the central focus is on revenue, efficiency, equity, or administration, or any combination of these or other objectives -- rather than relegating them to the sidelines.

What is more novel in this approach is the emphasis placed on the other items listed in Figure 3. First, as item 1 indicates, the best approach to tax policy reform varies in every country. Reforms need to be ‘custom-built’ like a Dell computer as the customer requires rather than following the Henry Ford assembly-line approach (the customer can have color he wants as long as it is black) to which both Models 1.0 and 2.0 seem to have lent themselves in all but the most skilled hands. However, it seems both possible and desirable to develop several basic platforms for different categories of countries.

One approach might be to develop separate basic ‘policy packages’ for countries with substantial natural resource revenues or those emerging from crisis or those which are significantly decentralized in a meaningful way, to mention three areas to which considerable attention has been paid in recent years. A more general approach might be to work within a framework along the lines of that recently set out by von Haldenwang and Ivanyna (2012), who classify countries as high, average or low tax performers depending on whether they are above (high), below (low) or within (average) the 95 percent confidence interval of the trend line relating tax ratio and log GDP per capita, and then further analyze the 46 low-performing countries in terms of the estimated quality and effectiveness of governance, the importance of non-tax revenue and aid, and region on the one hand. They conclude that the (mainly oil-producing) countries with high non-tax revenue (including aid) and low governance (such as Libya and Nigeria) have no incentive and little possibility of improving tax performance,⁴² that some (mainly higher-income) countries seem simply to have chosen the low-tax path (Hong Kong, Malaysia) and that a diverse set of factors ranging from lack of capacity to ‘crowding out’ of tax effort by aid may explain what is going on in a third, larger group of low performing countries .

⁴² Although they include Colombia in this group, it is clearly different from any of the other countries included and appears to fall within this category – as von Haldenwang and Ivanyna (2012, 26) themselves note – owing to a combination of special circumstances in the period considered – a sharp rise in non-tax revenue, a (somewhat questionable) borderline rating on the ‘voice and accountability’ measure used (p.25), a more justified poor score with respect to corruption (p. 26), and the problems arising from substantial armed conflict. (For a recent detailed discussion of the Colombian experience in this period from a different perspective, see Bird 2012a.)

As von Heldenwang and Ivanyina (2012) themselves conclude, much more work needs to be done – e.g. in improving data on tax administration and subnational revenues as well as taking into account such more nebulous but important factors as the differing influence in different countries at different times of historical, regional and explicitly redistributionist or elitist political agendas – before sufficiently meaningful ‘benchmarks’ for tax performance can be established to guide those assessing or shaping tax policy in particular countries. Nonetheless, exercises like that in their paper may provide a useful starting point for such analysis. To put much the same point another way, close consideration of the factors listed in item 6 of Figure 3 that prevail in a particular country is likely to point to some commonalities shaping policy recommendations for particular subsets of countries. To repeat the key point made here, however, one should not simply assume that such commonalities exist, as was too often the case when models 1.0 and 2.0 guided past policy recommendations.

Secondly, as item 2 in Figure 3 indicates, the time perspective taken in analysis matters. If the need is for immediate revenue, the appropriate policies are unlikely to be the same as if the aim is to facilitate the long-term attainment of a more rapidly growing or more just society. Cycles matter as well as trends. Is the country in a deep recession, coming to the end of a long boom, or simply in the doldrums? The acceptability, feasibility, incidence and effects of different policy recommendations are much more sensitive to the macroeconomic environment (row 6e) than seems to be recognized in much tax advice. If, as may often be the case, the idea is to make recommendations that will both respond to some current pressing problems and also move the system to a more sustainable and desirable position over the longer term, then ‘one size’ is even less likely to fit all and much more attention than usual needs to be paid to how to get ‘there’ from ‘here’ over what is likely to be a bumpy and winding road. Phase-ins, ‘grandfathering’, and all the usual compromises found in real-world policy processes need to be carefully considered and where necessary included as part of the initial policy proposal if it is not to go seriously astray. This is one, among many reasons, why much more attention needs to be paid to building up robust domestic policy ‘think tanks’, as noted in the concluding section.

Thirdly, analysis of tax policy reform in developing countries must take tax incentives more seriously (item 5). No matter how strongly or how often fiscal experts underline and demonstrate not only that most tax incentives yield little or nothing in the form of net gains from a societal perspective but they are also likely to mess up the tax system more generally, the political process will continue to churn out endless incentive proposals. Perhaps the time has come to accept this reality and focus efforts not on fruitless efforts to get rid of incentives but rather on developing a process for limiting the damage they

do and perhaps, over time, reducing their number and scope. Tax economists are basically correct in urging countries following the incentive path to keep it simple – that is, to aim at an investment-friendly environment by lowering taxes on investment in general rather than through detailed and complex systems attempting to direct investment into predetermined activities. However, since no one seems to be listening perhaps more attention should be paid not to stopping countries doing what they seem to want to do but rather to ensuring that they do it in as open and transparent a way as possible in order to try to reduce the harm and possibly even increase the efficacy of fiscal incentives.⁴³ In any case, the persistence and importance of such non-fiscal concerns in shaping tax policy deserves more careful and explicit attention than it has sometimes received.

Finally, as mentioned earlier, item 6 lists a number of critical factors that need to be explicitly considered in considering tax policy reform. Several of the factors listed have already been discussed earlier to varying extents – macroeconomics, non-tax revenues, administrative aspects, decentralization, earmarking, and the international dimension. However, transfers and regulation may need a few words. The earlier discussion of the distributional aspect of taxation is sufficient reason to pay close attention to transfers. In fact, with respect to both interregional and interpersonal concerns, transfers and taxes have to be considered together not only for distributional but also for efficiency reasons (Bahl and Bird 2008a). As for regulation, it is impossible to understand or analyze either the effects of many taxes without explicitly taking into account relevant features of the regulatory environment. For example, the old question of how excise taxes on alcohol affect consumption may depend to a substantial extent on how (and how effectively) beverage production and distribution is regulated (Bird and Wallace 2006). Similarly, the new question of the effects of taxes on financial transactions also depends substantially on how such transactions are regulated (Bierbauer 2012).

All this may seem to complicate the work of tax advisers. In reality, however, what Figure 3 attempts to do is not to set out a set of precise guidelines as to how to achieve success but a synthesis of what those who wish to improve fiscal outcomes need to understand if they wish their proposals to be not only accepted but to have positive outcomes. To paraphrase Tolstoy, every country's tax system is imperfect in its own ways and faces its own set of costs and benefits with respect to prospective policy changes. Designing good taxes for imperfect places is not easy, implementing them is likely to be even more difficult, and getting the powers-that-be to accept them may be impossible. But this is the world we live

⁴³ For suggestions along these lines – e.g. give incentives only in the form of explicit credits against taxes otherwise due in order to have a fully transparent system and establish a regular formal 'sunset' evaluation of incentives so that they are periodically reviewed and cancelled if found to be ineffective -- see, for example, Bird (2000).

in. After fifty years of flying tax advisers, perhaps it is time to realize that the best way to realize the impossible dream of tax reform may be not to continue tilting quixotically against imagined windmills but rather to examine the ground much more closely in order to determine how a better tax system may perhaps be constructed modularly and incrementally in hostile terrain.

Play the Right Game

For foreign tax advisers to become any more successful in “speaking truth to power” (Wildavsky 1979) or even in being heard by domestic decision-makers, they must play the right game. The tax policy world is very different in many respects now than it was 50 or even 20 years ago. Both the economic and the intellectual environments have changed. In many countries, the debate is really less about taxes than about what kind of society the people who matter want -- and how it is determined which people matter. Ideas on the relevant balance between taxes and society forged over the first half of the 20th century have changed in recent years, as evidenced both by the death of death taxes in developed countries and by the limited success of developing countries in achieving the high levels of income taxation to which many of them aspired in the post-colonial period. In most countries, it seems, the key question of how best to make the connection between the two sides of the budget sustainably operational is not simply unanswered by tax research as yet: it has not really been asked.

History suggests that the need to secure an adequate degree of consensus from the taxed is one of the principal ways in which, over the centuries, democratic institutions have spread (Sokoloff and Zolt 2005). No non-dictatorial government in this age of information and mobility can long stay in power without securing a certain degree of consent from the populace, not least in the area of taxation. State legitimacy thus rests to a considerable extent on the ‘quasi-voluntary compliance’ of citizens with respect to taxation (Levi 1988). To secure such compliance in a sustainable way tax systems must, over time, represent in some real sense the basic values of at least a minimum supporting coalition of the population. Until an adequate degree of political consensus on what should be done is achieved, no significant tax reforms are likely to be made or, if made, to be sustainable. “Consensus” does not require everyone to agree. But it does mean everyone has to agree (a) that the process was explicit and fair; (b) that they were treated well and their views were heard; and (c) that they are able not only to live with but to commit to the outcomes in some meaningful sense.

Countries have sometimes tried to finesse some of these problems by appointing some kind of special tax reform commission, whether foreign, domestic, or mixed. The track record of such efforts is not good. Appointing an outside group is often simply a way to postpone dealing with a problem. However good the final output of such efforts may be, the results are seldom ‘owned’ by those who must sell them and then make them work. Ownership matters. So does leadership. So does a coherent strategy, and of course so do adequate resources. Good tax policy planning involves economists, lawyers, administrators, and – importantly – adequate discussion with taxpayers and “third party” tax collectors like banks and companies. Successful tax reform involves all this plus solid and continuing political support and adequate administrative follow-up. It is not easy anywhere. But it can be done – if it is done right domestically.

Good domestic planning and policy formulation focuses on what matters and what can be done and pays close attention to detail and implementation. Building up adequate institutional capacity in the tax field, both inside *and* outside government, is critical to being able to adapt policies to changing circumstances and needs, thus ensuring some degree of robustness and resiliency. The role of outsiders such as academics and aid agencies in this process is more to be supportive when countries want to reform their systems than to tell them when and how to do it.⁴⁴ In the end, if a country needs or wants better tax policy or administration, it can have it: the answer largely lies in its own hands. Even those who want to do the right thing, however, can often use help in finding out just what is right and how it can best be done.

It is always easy for those not in the game to give advice to those who are trying to play it. It often seems appealing and immediately productive to establish performance benchmarks for success, to support this particular organizational change reform here (revenue authority) and that new technology (web-based technology) there, in the apparent belief that such simple ‘one-size-fits-all’ approaches can provide quick (but sustainable!) answers to the many complex problems inherent in policy reform in difficult environments. Such approaches seem appealing. But so far at least the evidence suggests that most have not been very productive.

⁴⁴ Of course, as Sen (1999) stresses, there is always a role for outside critics and ‘goal-setters.’ However, although it may be not only more pleasant but sometimes even useful to stand outside and above the messy world of policy, the emphasis here is on how foreign advisers may help those down in the tax reform trenches to win the game once it begins. To do so, they must be close enough to the field of battle to understand the terrain in which it is fought.

Fifty years of experience tells us that the right game for tax researchers and outside agencies interested in fostering better sustainable tax systems in developing countries researchers is not the short-term political game in which policy decisions are made. The right game for them is instead the long-term one of building up the institutional capacity both within and outside governments to articulate relevant ideas for change, to collect and analyze relevant data, and of course to assess and criticize the effects of such changes as are made. Tax researchers in developing countries can and should play an active role in all these activities. To do so, however, they often need considerably more and more sustained support from academic institutions abroad as well as from international agencies than is now available. Such long-term 'institution-building' activities are seldom immediately rewarding. They appear at present to be out of fashion with international agencies concerned with development, where most efforts at present seem to focus on designing and implementing ever more rigorous 'benchmarking' schemes. Nonetheless, the long-term institution-building approach seems still to provide the most useful way in which foreigners may perhaps be able to assist in the formidable and on-going task of achieving more efficient, equitable, effective, and sustainable tax systems in developing countries.

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