



Tax policy and reform

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Tax policy in the developing world

- In recent years policy debate on enhancing and reforming tax systems in developing countries has become prominent
- Several reasons, including:
 - Increasing financial needs
 - Effects of trade liberalisation
 - Increased focus on long run fiscal sustainability
 - Much focus on potential benefits for state-building (accountability)
 - Widely articulated desire/need to become more independent of foreign aid

Many goals and dilemmas in taxation

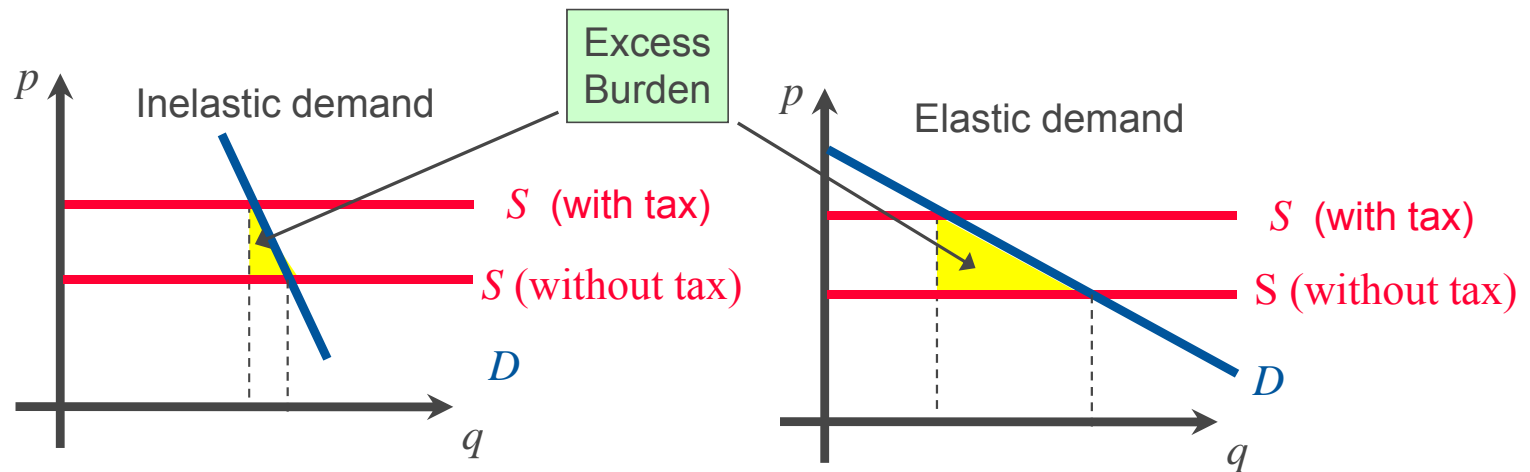
Goals

- Raise revenue for government expenses (social goods)
- Redistribute income
- Influence behaviour, for example environmental taxes
- Macroeconomic stabilization

Dilemmas

- Simplicity versus specificity
- Revenue generation versus distributional goals (incidence) – they do not always go hand in hand
- A technical illustration (next slide)

What is optimal in the tax system?



Who pays? Tax incidence

- In economics, tax incidence or tax burden is the analysis of the effect of a particular tax on the distribution of economic welfare
- Tax incidence is said to "fall" upon the group that ultimately bears the burden of, or ultimately has to pay, the tax
- The key concept is that the tax incidence or tax burden does not depend on where the revenue is collected, but on the price elasticity of demand and price elasticity of supply
- We need proper economic analysis!

Tax burden

- A country's tax burden is the ratio of tax collection against the national gross domestic product (GDP)
- This is one way of illustrating how high and broad the tax base is in any particular place
- Some countries, like Finland, have a high tax-to-GDP ratio – other countries, like India, have a low ratio (in SSA about 16%)

What types of taxes are important?

- OECD countries derive more revenue from **income taxes** than in developing countries
- **Trade taxes** are a significant source of income in developing countries compared to industrialized countries
- Developing countries are more prone to tax **exemptions**

Some of these differences can be explained in terms of **administrative convenience** – trade taxes are easier to enforce than payroll taxes in countries with large informal economies – but complex issue (FDI)

Conditions for effective taxation

- Monetised economy
- Ability to read and write
- Accounting skills
- Public accept
- Political issues
- Tax administration quality

Put differently: what are challenges in increasing tax collection/compliance in developing countries

- **Large informal economies:** Most workers typically employed in agriculture or in small, informal enterprises; firms may prefer to stay informal to avoid dealings with corrupt officials (unless benefits of being formal are larger); tax code may be complex
 - All in all: broad-based income or company taxation may be hard to implement
- **Skilled staff for tax administration scarce:** lack of a well-educated and well-trained staff has two impacts:
 - In general difficult to collect revenue and monitor progress properly
 - Statistical and tax offices have difficulty in generating reliable statistics to help policymakers assess behavioral impacts of tax reform.

- **Complicated tax rules and bureaucracy in the tax administration:** With many tax exemptions and bureaucracy hard to comply with the tax rules even if one does not want to evade taxes at the outset
- **Corruption:** Tax administrations may lack credibility in the eyes of the people because of corruption; there may be strong resistance for tackling corruption from those who benefit from the system

- **Political constraints.** Political power is often concentrated among the wealthiest or associated with specific ethnic groups; there may also be few check and balances on the political power of government, leading to:
 - Insufficient redistribution
 - Benefits for the few
 - Misallocation of government resources
 - All of the above can lead to little general support for taxation and public spending

Guidelines for reforms in developing countries

- Main challenge is to find a workable balance between reducing tax evasion without creating an overaggressive tax administration that can suffocate economic activity and drive agents into the informal sector
 - Companies should be encouraged to go formal with enhanced protection of property rights and other legal benefits
 - Administrative burden of paying taxes should be eased for example by simplifying the tax code and increasing transparency in fiscal governance
 - Optimal tax system design is dependent on country characteristics
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Examples of tax reforms

- 1. Lower tax rates:** In some cases lowering the tax rate can lure companies and individuals back to the formal economy and increase overall tax revenue
- 2. Create incentives for tax officials:** make sure their objective is to enforce the law rather than simply collect revenue -> more surveillance; predatory tax authority can create more incentives for tax evasion

3. Simplify tax rules, procedures and reduce tax exemptions: Russia introduced a 13% lower personal income tax for all and as a result the tax revenue increased despite a relatively low rate

4. Discourage cash and in-kind payments to drive individuals and firms to the formal economy and encourage consumers to ask for receipts: For example, Argentina gives instant reimbursement on VAT payments if debit/credit card is used

5. Targeted compliance programmes for the wealthiest: Measures (both sticks and carrots) have been successful in advanced countries but also for example in India; increased compliance of the wealthiest can also increase the perception of fairness of the tax system.

And above all

- A considerable amount of pragmatism and country case knowledge is required
- In addition to concrete analysis and understanding of how different types of tax measures are likely to work – or not work
- Much more country based tax analysis is required



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