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# REDISTRIBUTION VIA TAXATION: THE LIMITED ROLE OF THE PERSONAL INCOME TAX IN DEVELOPING COUNTRIES

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AND
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# REDISTRIBUTION VIA TAXATION: THE LIMITED ROLE OF THE PERSONAL INCOME TAX IN DEVELOPING COUNTRIES

Richard M. Bird* and Eric M. Zolt**

*Inequality has increased in recent years in both developed and developing countries. Tax experts, like others, have focused on how taxes may reduce this growing inequality of income and wealth. In developed countries, the income tax, and especially the personal income tax, has long been viewed as the primary instrument for redistributing income. This Article examines whether it makes sense for developing countries to rely on personal income taxes to redistribute income. We think not, for three reasons. First, the personal income tax has done little, if anything, to reduce inequality in many developing countries. Second, it is not costless to pretend to have a progressive personal income tax system. Third, opportunity costs also exist from relying on taxes for redistributive purposes. If countries want to use the fiscal system to reduce poverty or inequality, therefore, they need to look elsewhere.*

*This Article begins with some initial reflections on the redistributive role of the tax system. It then considers the relative success of developed and developing countries in using tax systems to redistribute income. Finally, the Article examines some alternatives in reforming the personal income tax, as well as options available to developing countries in designing and implementing more progressive fiscal systems.*

INTRODUCTION ..... 2
I. THE DISTRIBUTIVE ROLE OF THE TAX SYSTEM ..... 4
II. HOW SUCCESSFUL HAVE TAX SYSTEMS BEEN IN REDISTRIBUTING INCOME? ..... 11
A. Who Really Pays? The Question of Fiscal Incidence ..... 12
1. Problems With Incidence Studies ..... 14
2. The Shadow Economy Further Considered ..... 19
3. Revolution or Evolution? ..... 23
B. What Is Progressivity and to What Extent Has It Been Achieved? ..... 25
C. Differences in Tax Systems Between Developed and Developing Countries ..... 28

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1. Comparing the Tax Systems of Developed and Developing Countries ....28
2. Difficulties Facing Countries With High Inequality in Designing and Implementing a Progressive Tax System ....35
III. IMPLICATIONS FOR DEVELOPING COUNTRIES ....40
A. Costs of Taxation ....41
1. Administrative Costs ....41
2. Compliance Costs ....42
3. Efficiency Costs ....43
4. Political Costs ....45
B. The Importance of Spending Well ....46
IV. MODEST PROPOSALS FOR INCREASING PROGRESSIVITY ....49
A. Linking Spending and Taxes ....50
1. Decentralization ....50
2. Benefit Taxation ....52
B. Untax the Poor ....55
C. Tax Income More Effectively ....58
1. Retaining a Comprehensive Income Tax Approach ....59
2. The Presumptive Tax Approach ....61
3. De-Linking the Taxation of Income From Capital and Income From Labor ....65
CONCLUSION ....69

## INTRODUCTION

Many developing countries have extremely unequal distributions of income and wealth. At the end of the last century, the Gini coefficient, a common measure of income inequality, was 0.522 in Latin America compared to 0.412 in Asia, and only 0.342 in the developed, Organization for Economic Cooperation and Development (OECD) countries.[1] In Latin America, measured income inequality increased steadily over the last three decades, rising from 0.484 in the 1970s to 0.508 in the 1980s and then again to 0.522 in the 1990s. Even in Asia, the least unequal developing region, income inequality rose slightly in the 1990s after holding steady in

1. The data in this paragraph come from DAVID DE FERRANTI ET AL., WORLD BANK GROUP, INEQUALITY IN LATIN AMERICA AND THE CARIBBEAN: BREAKING WITH HISTORY? 2-29, 2-31 (2004), *available at* http://www.worldbank.org/lac. The Gini coefficient is zero when income is equally distributed and rises towards one as income is more unequally distributed. It is derived from the Lorenz curve, which plots the cumulative percent of the population (ranked from lowest to highest income) against the cumulative share of income. *See generally* Donald W. Kiefer, *Measures of Progressivity*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 285 (Joseph J. Cordes et al. eds., 1999).

the 1980s.[2] Other measures of inequality tell the same story. The poor are relatively much poorer and the rich are relatively richer in developing countries than in developed countries. In 1992, for example, almost half (48 percent) of income in Latin America accrued to the richest decile of households with only 1.6 percent going to the poorest decile: that is, on average, those at the top of the income heap commanded thirty times as many resources as those at the bottom. In Asia, the comparable ratio was only fourteen times, while in the developed countries it was twelve times. Given the apparently high concentration of income and wealth even within the top decile of the income distribution, the contrasts between rich and poor in much of the developing world are in all likelihood considerably starker than even the Latin American numbers suggest.[3]

Tax experts, like others, have long been concerned with the role that taxation might play in alleviating the marked inequality in income and wealth evident in so many developing countries. In developed countries, the income tax, especially the personal income tax, has long been viewed as the primary instrument for redistributing income and wealth. This Article examines whether it makes sense for developing countries to rely on the income tax for redistributive purposes.

Here, we put forth three propositions. First, the personal income tax has done little to reduce inequality in many developing countries. This failure is not surprising given that in many countries personal income taxes are neither comprehensive nor very progressive—they often amount to little more than withholding taxes on labor income in the formal sector. The personal income tax plays such a small role in the tax systems of developing countries (measured either by personal income tax revenues as a percentage of total tax revenues or by personal income tax revenues as a percentage of GDP) that it would be unrealistic to believe that this tax could have a meaningful impact on distribution.

Second, it is not costless to pretend to have a progressive personal income tax system. Tax systems generate real administrative, compliance, economic efficiency, and political costs. The costs associated with badly

2. Income inequality has also increased in many developed countries. *See, e.g.*, Lynn A. Karoly, *Trends in Income Inequality: The Impact of, and Implications for, Tax Policy*, *in* TAX PROGRESSIVITY AND INCOME INEQUALITY 95 (Joel Slemrod ed., 1994).

3. One caveat to this bleak picture is that the distribution of consumption is, even in the worst cases, considerably less unequal than income. *See* DE FERRANTI ET AL., *supra* note 1, at 2-14. Studies of "lifetime" income distribution (or tax incidence) find less inequality than the annual figures cited here, because individuals generally follow the common lifecycle pattern of consuming more than income when they are young or old, while being net savers (consumption less than income) during prime working years.

designed and badly administered personal income tax systems likely exceed the costs associated with other taxes. Furthermore, there are opportunity costs. The personal income tax adopted in many developing countries was largely copied from developed countries and has, to some extent, displaced other methods of taxing income that may be more effective on both revenue and fairness grounds.

Third, given the ineffectiveness of the personal income tax, if countries want to use the fiscal system to reduce poverty or reduce inequality, there are alternative approaches that merit consideration. Countries need to make better use of their expenditure programs in targeting resources to the poor. Given the dominance of taxes on consumption (trade taxes, excise taxes, and general consumption taxes) in the tax structure of developing countries, the distributional consequences of consumption taxes are of far greater importance than those of the personal income tax. Countries can also make greater use of benefit taxation, that is, charging for goods and services provided by the government—often to nonpoor groups. Greater fiscal decentralization (moving tax and expenditure authority to lower levels of governments) may allow for better matching of those who benefit and those who pay for government activity. Finally, countries can consider alternatives to taxing income other than the current comprehensive income approach.

We proceed as follows. Part I sets forth some initial reflections on the redistributive role of the tax system. Part II examines the relative success of developed and developing countries in using tax systems to redistribute income. Part III examines some implications for developing countries, focusing on both the costs of having progressive tax systems and the importance of expenditure programs to address distributional concerns. Part IV sets forth some modest proposals for increasing progressivity in developing countries.

## I. THE DISTRIBUTIVE ROLE OF THE TAX SYSTEM

Countries use taxes for many purposes. Taxes are used to raise revenue to fund government services, to encourage or discourage certain types of behavior, and to correct market imperfections. Countries also use taxes (and expenditures) to change the distribution of income or wealth. From some perspectives, the main reason for a tax system is to allocate the cost of government in some fair way. Achieving a politically acceptable degree of fairness in taxation, which allows governments to extract funds from the private sector without adding to inflationary pressure, is an essential

ingredient in achieving the quasi-constitutional equilibrium necessary to maintain a sustainable political structure.[4] A country's tax system is thus both an important and a highly visible symbol of its fundamental political and philosophical choices.

There are, of course, many different nonexclusive views of the possible redistributive role of the tax system. First, the tax system may be used to redistribute income to reduce the level of inequality (as measured, for example, by the Gini coefficients cited earlier). Second, the tax burden may simply be allocated in whatever manner is politically acceptable as fair, with its distributive impact following from that allocation rather than being its rationale.[5] Third, the tax system may attempt to allocate tax burden in accordance with one of the many other concepts of fairness or justice found in the literature.[6] Fourth, a quite different approach might see the task of the tax system as simply to raise the maximum amount of revenue (given various economic and political constraints) to fund redistributive expenditure policies. Finally, a more limited approach might focus less on reducing inequality as such and more on alleviating poverty through pro-poor tax policies that seek to free the poor from some of their tax burdens. Differences in one's view of the appropriate redistributive role of taxes will lead to different tax system designs. Of course, regardless of one's intention, what actually happens when tax regimes are adopted and administered may be, and often is, something very different than what was intended.

Ideas about the appropriate distributive role of taxation not only differ sharply but also have changed over time. In the 1950s and 1960s for instance, tax policy discussion (and to a lesser extent tax reform) in many developed and developing countries reflected postwar optimism about the possibility of constructive state action to remedy perceived ills. In Latin

4. This argument is developed further in RICHARD M. BIRD, TAXATION IN LATIN AMERICA: REFLECTIONS ON SUSTAINABILITY AND THE BALANCE BETWEEN EQUITY AND EFFICIENCY (Joseph L. Rotman Sch. of Mgmt., Univ. of Toronto, Int'l Tax Program Paper No. 0306, 2003), *available at* http://www.rotman.utoronto.ca/iib/ITP0306.pdf, some sections of which we have drawn on in preparing this paper.

5. As we discuss below, we agree with Arnold C. Harberger that it makes more sense in developing countries to focus on how the costs of government are shared among different income groups than to pretend that governments in such countries can use the tax system to redistribute income. Arnold C. Harberger, Taxation and Income Distribution: Myths and Realities (Aug. 2004) (unpublished manuscript, on file with authors).

6. It is difficult to disentangle the results of using the tax system to achieve one's sense of what is fair from using the tax system deliberately to alter market-generated distributional outcomes. As Louis Kaplow and Steven Shavell argue in detail, fairness and justice are complicated and differentiated concepts that provide no clear guidance to policy designers. LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 52–62 (2002).

America, for example, dirigiste views about the developmental and distributional roles of taxation were common both in the work of the United Nations Commission for Latin America (CEPAL), which was influenced mainly by postwar European experience, and in the reformist approach of the largely U.S.-trained advisers and consultants unleashed on the continent by the Alliance for Progress and the U.S. Agency for International Development.[7]

Most analysts in the 1950s and 1960s seem to have taken for granted that a highly progressive personal income tax (sometimes with marginal rates ranging up to 60 or 70 percent), buttressed by a substantial corporate income tax (often levied at rates on the order of 50 percent), constituted the core of an ideal tax system. Consumption taxes, then mainly excises, customs duties, and cascading manufacturers' sales taxes, were grudgingly accepted as necessary for revenue purposes, but the sooner such levies could be replaced by decent income taxes the better. Little attention was directed at local taxes, because all the action was at the central government level. Similarly, no one worried much about the international context: Tax policy was considered a purely domestic affair.

The two main aims of taxation were generally seen to be, first, to raise substantial revenue to finance the state as the engine of development and, second, to redistribute income and wealth. Not only did the need for redressing inequality through fiscal means seem obvious, but the ability of taxes to do the job was largely unquestioned. Indeed, many optimists thought that both goals, revenue and redistribution, could be achieved simply by imposing high effective tax rates on income. The costs of doing so received little attention because the depressing effects of taxes on investment, saving, and growth were considered to be small. High tax rates made it easier for governments to use tax incentives to induce private investors to invest in those projects or sectors most needed for developmental purposes. In short, the conventional wisdom was that developing countries could solve their fiscal problems by "learning to tax," an expression which usually meant to tax in a properly progressive fashion with heavy reliance on personal income taxes.[8]

7. For a review of this early period, see Richard M. Bird & Oliver Oldman, *Tax Research and Tax Reform in Latin America—A Survey and Commentary*, 3 LATIN AM. RES. REV. 5 (1968).

8. Nicholas Kaldor provides the quintessential summary of this approach in Nicholas Kaldor, *Will Underdeveloped Countries Learn to Tax?*, 41 FOREIGN AFF. 410 (1963). It should be noted, however, that Kaldor favored a personal tax on expenditure rather than on income. NICHOLAS KALDOR, AN EXPENDITURE TAX 46–53 (1955). Taxing expenditures would encourage saving—but would also serve an explicitly redistributive aim of ensuring that "dissaving" (spending out of previously accumulated wealth) is taxed.

In the not too distant past, most tax policy advisors thus saw the personal income tax as the center of the tax universe. The main challenges in developing countries were considered to be, first, to adopt a good comprehensive progressive income tax and, second, to put into place a sufficiently effective tax administration to spread the cost of government among members of society in accordance with some appropriate concept of ability to pay. Income—especially the comprehensive Haig-Simons concept—was, by general agreement, the best proxy for ability to pay.[9] As a result, most early tax missions to developing countries advised policymakers to replace taxes on consumption (tariffs, export taxes, excise taxes, and general sales taxes) with taxes on income. They also recommended a comprehensive progressive personal income tax both to redistribute income and to ensure that tax revenues would increase with sufficient speed to allow government expenditures to expand at a rate higher than the growth rate.[10]

Progressive taxation did not begin with the personal income tax. Throughout history, even in ancient times,[11] countries often have collected proportionally greater taxes from the rich than from the poor through the use of inheritance taxes, property and other forms of wealth taxes, businesses taxes, and faculty taxes. Some analysts trace the evolution of the income tax through the more or less logical developments of some of these precursors.[12] Interesting as further exploration of this historical theme may be, however, none of these earlier efforts approached the modern income tax in either scale or scope, and none approach the current (limited) importance of the personal income tax in most developing countries.

The rise of the personal income tax is a relatively recent phenomenon, even in developed countries. Although progressive income taxes were first adopted around the early and mid-1800s, it was not until World War II that

9. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

10. Most analysts, including Kaldor, assumed that countries moving from developing to developed status needed to collect tax revenues, preferably in as progressive a manner as possible, at a level of 25–30 percent of GDP rather than the 10–15 percent common to developing countries. Nicholas Kaldor, *Taxation for Economic Development*, 1 J. MOD. AFRICAN STUDS. 7, 9–21 (1963); *see also* Alison Martin & W. Arthur Lewis, *Patterns of Public Revenue and Expenditure*, 24 MANCHESTER SCH. OF ECON. & SOC. STUD., 203 (1956), *reprinted in* READINGS ON TAXATION IN DEVELOPING COUNTRIES 91 (Richard M. Bird & Oliver Oldman eds., rev. ed. 1967)

11. *See* Maureen B. Cavanaugh, *Democracy, Equality, and Taxes*, 54 ALA. L. REV. 415, 442–81 (2003) (examining the tax regime in Athens).

12. See the classic account in EDWIN R.A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD (2d ed. 1914).

they became a major source of tax revenue in most developed countries.[13] Personal income taxes started small. Few were taxed, and tax rates were low. Wartime revenue needs, however, coupled with the critical administrative innovation of wage withholding, turned the class tax into a mass tax. Both the need for revenue and the desire to curb war profiteering played a critical role in the imposition of highly progressive income tax rate structures. After the war, central governments in North America, Western Europe, and other more developed regions continued to expand on the basis of high and growing revenues from the progressive income tax, buttressed in many cases by the adoption and expansion of social security (payroll) taxes. These social security taxes not only extended the income tax's coverage of labor income but probably also improved compliance.

As the world economy slowed in the 1970s, concern for growth began to trump equity, and attitudes toward the appropriate role and structure of taxation began to change. By the end of the century, most analysts and policymakers had come to believe that high tax rates not only discouraged and distorted economic activity but also were largely ineffective in redistributing income and wealth. Moreover, the decline of taxes on international trade associated with economic liberalization and widespread adherence to the World Trade Organization (WTO), together with increased competition for foreign investment, caused both developed and developing countries to focus on the international consequences of their tax systems. Growth-oriented (supply-side) economic policies became popular, and views on the appropriate role for government moved from dirigiste to laissez faire, that emphasized reducing the size of the state through privatization and other means. One outcome of all these factors was that income tax rates on both individuals and corporations were cut sharply and are now almost universally in the 20–30 percent range.[14] At the same time, a new form of general consumption tax, the value-added tax (VAT), became the mainstay of the revenue system in most developing countries, as well as a prominent feature in almost every developed country but the United States.[15]

13. Britain adopted the first progressive income tax in 1799 to help finance the war against Napoleon. *See* SVEN STEINMO, TAXATION & DEMOCRACY: SWEDISH, BRITISH AND AMERICAN APPROACHES TO FINANCING THE MODERN STATE 53–54 (1993).

14. For detailed analysis of trends in Latin America over this period, see PARTHASARATHI SHOME, TAXATION IN LATIN AMERICA: STRUCTURAL TRENDS AND IMPACT OF ADMINISTRATION (Int'l Monetary Fund, Working Paper No. 99/19, 1999), *available at* http://www.imf.org/external/pubs/ft/wp/1999/wp9919.pdf.

15. On the VAT, see the recent survey in LIAM EBRILL ET AL., THE MODERN VAT (2001).

Nonetheless, most discussion about tax burdens in developed and developing countries alike continues to focus on the personal income tax. This focus is understandable given the high visibility of this tax. For several reasons, however, it is too narrow, particularly in the context of developing countries. First, what matters for income distribution are the distributional consequences of all taxes, not just income taxes. In many developing countries, personal income taxes constitute less than 5–10 percent of tax revenue and less than 2 percent of GDP.[16] The effects of even the most progressive income tax on distributional outcomes are likely to be small compared to the effects of more important taxes on consumption, such as the VAT. Second, particularly in developing countries, the distributional effects of the myriad implicit taxes imposed through inflation, financial regulation, trade regulation, and in a wide variety of other ways are often more important than those of the formal tax system.[17] Third, expenditures are an important tool in redistribution. What matters is the final distributional outcome, not the incidence of any particular piece of the fiscal puzzle.

Redistribution is about balancing efficiency losses against equity gains. Moral philosophers, economists, and law professors long have wrestled with the question of calculating equity gains. It is difficult to discuss the benefits of redistribution without some notion of the appropriate role of government and the success of government in fulfilling that role. In examining the redistributive role of taxes, it is equally difficult (and often not very useful) to disentangle the following issues: the amount of resources available to the government, the tax regime that provides those resources, and the effectiveness with which the government uses the resources.

Let's start small. One view of the proper role of government is simply to provide the basics for defense and security, plus the framework for the operation of a market economy.[18] How should this level of government services be paid for? Here one can imagine a range of tax options that could rest on notions of benefits received, ability to pay, or some per capita or flat-rate assessment on income, wealth, or other tax base. If it were possible

16. *See infra* Part II.C.1.

17. For discussion of some of the more important implicit taxes, see SEQUOIA INST., MORE TAXING THAN TAXES?: THE TAXLIKE EFFECTS OF NONTAX POLICIES IN LDCS (Richard M. Bird ed., 1991). We shall not discuss this issue in detail in the present paper, however. While such implicit taxes may often be imposed for purposes similar to those of formal taxes (for example, inflation, like seigniorage, is one way of raising revenue for government purposes), they do not leave clear budgetary tracks. Moreover, their distributional effects are even more difficult to analyze than those of normal taxes.

18. *See* ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 26–27 (1974).

to allocate the benefits of this limited government to the individuals in society, then the resulting redistribution would simply reflect the differences between the amount paid under the tax system and the benefits received by individuals. Either the often postulated (but never policy-relevant) outside "ethical observer" or—preferably—the society itself could then assess whether any mismatch of taxes and benefits is desirable, acceptable, or objectionable.

To make such a determination, one may use any of the various welfare frameworks found in the literature. These frameworks include utilitarian approaches that recognize the diminishing marginal utility of goods and services and liberal, egalitarian approaches that combine equality of opportunity with a priority to improve the condition of the worse off.[19] Even if one thinks bigger governments are good for redistribution, it remains unclear how to estimate gains from redistribution through progressive taxation.[20] Social welfare functions attempt to show the relationship of the welfare of individual members to the welfare of society as a whole. A simple utilitarian approach sums the welfare of individuals to determine the aggregate welfare of a society. Weighted utilitarian approaches generally assign greater weight to the utility of poorer members of society. Other approaches focus on the welfare of the least-well-off individual.[21]

In the end, however, such approaches may fail the test of political viability.[22] For some that will not end the debate, but only shift it to an argument about political institutions, moving the welfare debate to the constitutional level[23] or even beyond to some hypothetical world of social consensus.[24] Circularity is thus complete. We can either accept that what a country does is right in terms of its institutions, or we can reject those institutions and either postulate some other world or call for major changes—presumably accepting whatever ensues from such changes as right, although it is not clear on what grounds we do so.

19. *See* JOHN RAWLS, A THEORY OF JUSTICE 17–45 (1971); *see also* LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 40–75 (2002). For an excellent introduction to these and other approaches, see RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 76–85 (5th ed. 1989).

20. As Edgar K. Browning shows, in some cases redistribution may involve equity losses. Edgar K. Browning, *Inequality and Poverty*, 55 S. ECON. J. 819, 824–25 (1989).

21. *See* RAWLS, *supra* note 19, at 34–45.

22. For emphasis on the critical importance of this test, see JOHN G. HEAD, PUBLIC GOODS AND PUBLIC WELFARE 3–68 (1974).

23. *See* JAMES M. BUCHANAN, THE LIMITS OF LIBERTY: BETWEEN ANARCHY AND LEVIATHAN 68–73 (1975).

24. *See* RAWLS, *supra* note 19, at 40–45.

A similar conundrum arises concerning the appropriate fiscal institutions for countries in which government plays a role well beyond the minimal state. Many developmental economists, for example, see a vital role for governments in developing countries to provide greater opportunity to all citizens through improved access to education, health care, and employment opportunities. This might be accomplished by providing a minimum package of goods and services in the form of in-kind benefits (for example, free primary and secondary education) to all individuals. Alternatively, the government could provide free or subsidized services, perhaps based on some means-tested formula. However, such an approach is exceedingly difficult to administer and, in many developing countries, may not gain the essential political support of the middle class.[25] Others have stressed possible externalities from more equal distribution, such as reduction in crime and greater political stability.[26]

All these arguments presuppose not only that governments wish to reduce inequality and to deliver more services to the less advantaged, but also that they can do so. Both assumptions are questionable for many developing countries. Yet if they do not hold, then bigger government means both greater potential for mismatch between taxes paid and benefits received and greater potential for the government to hurt, not help, distributional inequality. If both taxing and spending policies are regressive, then the poor may have more to gain from smaller rather than larger governments. Facts matter. Unfortunately, as we discuss below,[27] we simply do not know many of the critical facts in developing countries.

## II. HOW SUCCESSFUL HAVE TAX SYSTEMS BEEN IN REDISTRIBUTING INCOME?

In this part, we examine how successful taxes have been in redistributing income in developing countries. We start by distinguishing between who pays a tax and who actually bears the economic burden of that tax. This question turns out to be surprisingly complex. Second, we examine how one measures the progressivity of a tax system. This, too, is

25. Harberger, *supra* note 5, stresses the need for middle-class support of redistribution to the poor. This argument applies even more strongly to cash transfer programs. Such programs might nonetheless have a critical role to play in alleviating poverty in at least some more advanced developing countries. *See* DE FERRANTI ET AL., *supra* note 1, at 9-34 to 9-35.

26. Lester C. Thurow, *The Income Distribution as a Pure Public Good*, 85 Q.J. ECON. 327, 327 (1971).

27. *See infra* Part II.A.

no simple matter. Third, we review briefly some key differences in tax systems between developed and developing countries.

## A. Who Really Pays? The Question of Fiscal Incidence

The most recent, thorough review of fiscal incidence in developing countries is a study prepared by an International Monetary Fund (IMF) team in 2000,[28] based on income distribution data from the World Bank and the United Nations University's World International Development Economic Research Institute.[29] Perhaps surprisingly, before the effects of redistributive tax and transfer programs are taken into account, income inequality is actually lower on average in developing countries than in developed countries. Less surprisingly, however, the IMF study found that, although developed countries were successful in using tax and transfer programs to reduce income inequality, comparable equalizing effects through fiscal action were absent in developing countries.[30]

The various quantitative studies of tax incidence surveyed by the IMF team show that the redistributive effects of taxes are minor in developing countries for two main reasons. First, the tax structure in most such countries is dominated by taxes on consumption that are generally assumed to have a regressive incidence. Second, corruption and poor governance limit the effectiveness not only of tax policy but also of transfers and other redistributive policies.[31] A third reason (not discussed in the IMF study) that most developing countries achieve little fiscal redistribution is because little is attempted, essentially for political reasons.[32]

The IMF study found that income taxes appear to have a progressive incidence in most of the nineteen developing countries for which data were available.[33] The study therefore concludes, in traditional fashion, that if

28. KE-YOUNG CHU ET AL., INCOME DISTRIBUTION AND TAX, AND GOVERNMENT SOCIAL SPENDING POLICIES IN DEVELOPING COUNTRIES (United Nations Univ., World Inst. for Dev. Econ. Research, Working Paper No. 214, 2000), *available at* http://www.wider.unu.edu/publications/wp214.pdf.

29. At the time this Article went to press, the most current version of this database was WIID2beta.xls, *available at* http://wider.unu.edu/wiid/wiid/htm.

30. CHU ET AL., *supra* note 28, at 30–33.

31. *Id.* at 31–32.

32. For a persuasive argument to this effect, see JAMES A. ROBINSON, POLITICIAN-PROOF POLICY? (World Bank Group, Working Paper No. 26945, 2003), *available at* http://www-wds.worldbank.org.

33. CHU ET AL., *supra* note 28, at 5–8. The only exception they cite is Jamaica, but a more recent study found the Jamaican income tax to be progressive, too. *See* James Alm & Sally Wallace, *Can Developing Countries Impose an Individual Income Tax?* (unpublished paper presented at "The Challenges of Tax Reform in a Global Economy," Conference, Andrew Young School of

developing countries want to redistribute more through the fiscal system they can do so by relying more heavily on income taxes. An important caveat is noted, however, in that the magnitude of the redistribution that can be achieved through such means would be small in most developing countries, given the distribution of income and the nature of the income tax.[34] The same conclusion emerges even more clearly from a well-done incidence analysis of Chile, which has the best-run tax system in Latin America.[35]

A recent South African study also highlights the potentially important distributional role of income taxation.[36] This study finds that without a progressive income tax, the reliance on the VAT and other consumption taxes would have made the entire tax system regressive. The study's key point is not that the progressivity of the income tax affects income distribution significantly. Rather, because taxes on consumption are regressive, without the income tax offset the tax system as a whole would be undesirably regressive.

While the IMF study reaches the same conclusion, it also notes that more recent studies of the incidence of taxes on consumption suggest that they are significantly less regressive than those analyzed in earlier studies.[37] The change from import taxes to sales taxes motivated largely by trade liberalization has, it seems, made tax incidence a little more progressive in most poor countries.[38] Although the regressivity of the VAT continues to be a common theme in the literature, recently supported by Nobel prizewinner Joseph Stiglitz,[39] the evidence nonetheless is that the VAT is likely on the whole to be less regressive than the trade and excise taxes it

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Policy Studies, Georgia State Univ. May 24–25, 2004) *available at* http://www.aysps.gsu.edu/publications/2004/alm/indiv_incometax/pdf.

34. CHU ET AL., *supra* note 28, at 30–32.

35. *See* Eduardo M.R.A. Engel et al., *Taxes and Income Distribution in Chile: Some Unpleasant Redistributive Arithmetic*, 59 J. DEV. ECON. 155, 156–58 (1999).

36. Marlene Botes, *Regressivity of VAT—The First Decade's Experience in South Africa*, 12 INT'L VAT MONITOR 237 (2001).

37. CHU ET AL., *supra* note 28, at 12. See, for example, an earlier IMF survey of incidence studies by Richard M. Bird & Luc Henry De Wulf, *Taxation and Income Distribution in Latin America: A Critical Review of Empirical Studies*, 20 INT'L MONETARY FUND STAFF PAPERS 639, 639–46 (1973).

38. A recent survey reinforces this conclusion. NORMAN GEMMELL & OLIVER MORRISSEY, TAX STRUCTURE AND THE INCIDENCE ON THE POOR IN DEVELOPING COUNTRIES 25–29 (Ctr. for Research in Econ. Dev. and Int'l Trade, Research Paper No. 03/18, 2003), *available at* http://www.nottingham.ac.uk/economics/credit/research/papers/CP.03.18.pdf.

39. M. Shahe Emran & Joseph E. Stiglitz, *On Selective Indirect Tax Reform in Developing Countries*, 89 J. PUB. ECON. 599 (2005).

has replaced. Furthermore, in at least some developing countries, the VAT may be about as progressive as the income tax.[40]

1. Problems With Incidence Studies

It is not clear, however, how seriously to take any of these incidence studies. One can have at best limited confidence in conclusions about the economic incidence of particular taxes, whether in general or in country-specific circumstances. Despite all the effort that has been devoted to this subject, we actually know surprisingly little about either the incidence of particular taxes or, with even more force, the overall incidence of government taxing and spending programs. This is especially true with respect to developing countries.

Serious conceptual issues exist in all exercises that attempt to put quantitative flesh on the skeleton of conventional incidence theory. It is conceptually challenging to measure the incidence of an entire tax system because doing so effectively assumes that all relative prices, technology, and output levels would have remained unchanged if the government were financed by other means.[41] Even if one accepts the validity of this bold assumption—for example, because the distribution of factor incomes generated by alternative output patterns is assumed to be unchanged, an assumption that seems particularly implausible in developing countries—the way in which such studies estimate the incidence of taxes on consumption and taxes on income and wealth is inherently contradictory.[42] The incidence of consumption taxes rests on the assumption that all demands are perfectly inelastic (or supplies perfectly elastic), while the incidence of income and wealth taxation often makes exactly the opposite

40. For two recent detailed studies of the incidence of indirect taxes, see KELLY D. EDMISTON & RICHARD M. BIRD, TAXING CONSUMPTION IN JAMAICA: THE GCT AND THE SCT (Andrew Young School of Policy Studies, Georgia State Univ., Working Paper No. 04-32, 2004), *available at* http://isp-aysps.gsu.edu/papers/ispwp0432.pdf; SÒNIA MUÑOZ & STANLEY SANG-WOOK CHO, SOCIAL IMPACT OF A TAX REFORM: THE CASE OF ETHIOPIA (Int'l Monetary Fund, Working Paper No. 03/232, 2003), *available at* http://www.imf.org/external/pubs/ft/wp/2003/wp03232.pdf. Studies of the effect of substituting domestic consumption taxes for trade taxes fail to consider that replacing import taxes with domestic consumption taxes also removes an (unbudgeted) "tax" previously imposed on consumers who paid higher prices to protected domestic producers. Harberger, *supra* note 5.

41. Jacob Meerman, *Do Empirical Studies of Budget Incidence Make Sense?*, 33 PUB. FIN. 295, 296–97 (1978). Economists generally use as a standard for comparison in these exercises that financing of the government sector was through a proportional comprehensive income tax. This assumption is particularly heroic in the developing country context.

42. *See* Alan R. Prest, *The Budget and Interpersonal Distribution*, 23 PUB. FIN. 80, 82–83 (1968).

assumption: that supplies are perfectly inelastic (or demands perfectly elastic). One cannot have it both ways. Nevertheless, the usual simple summing of the numbers obtained on the basis of contradictory assumptions in effect does this.

Quite apart from such fundamental conceptual limitations on aggregate incidence studies, few studies made in developing countries have addressed the many serious questions raised by Anwar Shah and John Whalley with respect to the applicability of conventional incidence assumptions in the fragmented and incomplete markets found in many such countries.[43] Here are some examples. First, consider the incidence of the taxes on the labor income that constitutes most of the base of the personal income tax and the payroll tax.[44] The common assumption is that taxes on such income are borne by labor, and economists looking at the relative elasticities for the supply and demand for labor usually have found this assumption plausible in developed countries.[45] In countries with large informal sectors, however, the incidence of a tax on labor in the formal sector may be borne to some extent by workers in both formal and informal sectors.[46] If taxes on labor result in a decrease in the after-tax income of labor in the formal sector, for instance, fewer workers will enter that sector from the agricultural and informal sectors. The wage rate in the informal sector will then decline, or perhaps, if that rate is already at a subsistence level, over time the pretax wages of those remaining in the formal sector will adjust until labor market equilibrium is restored.[47] We return to this issue below.

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43. Anwar Shah & John Whalley, *Tax Incidence Analysis of Developing Countries: An Alternative View*, 5 WORLD BANK ECON. REV. 535, 540 (1991).

44. In estimating the incidence of payroll taxes, an additional issue is how to treat benefits linked to the payroll taxes. There is no simple answer. Very different tax-benefit relationships may characterize each of the many varieties of payroll taxes found in many developing countries. *See* James Alm & Hugo López-Castaño, *Payroll Taxes in Colombia*, *in* FISCAL REFORM IN COLOMBIA: PROBLEMS AND PROSPECTS (Richard Bird et al. eds., forthcoming 2005).

45. *But see* Jeffrey D. Kubik, *The Incidence of Personal Income Taxation: Evidence From the Tax Reform Act of 1986*, 88 J. PUB. ECON. 1567, 1567–68 (2004). Kubik shows that tax changes that have disparate affects on different types of labor income will also affect pretax wages so as to offset some of the apparent direct effects of taxes on after-tax incomes.

46. For a careful analysis along these lines in the case of Colombia, see Alm & López-Castaño, *supra* note 44.

47. The mechanism is the same as that discussed in Kubik, *supra* note 45. As Alessandro Balestrino and Umberto Galmarini argue, increased taxes on one sector will also affect occupational choice and hence, over a longer time, the relative growth of labor supplied to the two sectors. ALESSANDRO BALESTRINO & UMBERTO GALMARINI, ON THE REDISTRIBUTIVE PROPERTIES OF PRESUMPTIVE TAXATION 1–3 (CESifo, Working Paper No. 1381, 2005), *available at* http://www.cesifo.de/~DocCIDL/cesifo1_wp1381/pdf.

Second, economists have long struggled with the incidence of corporate income taxes. The conventional wisdom was originally that corporate taxes were borne by some combination of owners of corporate capital, employees, and consumers of products and services produced by the corporate sector; such splits still are commonly used in empirical incidence studies. As Arnold Harberger showed, however, given reasonable assumptions and a closed economy, the incidence of corporate income tax falls on all owners of capital, whether in the form of personal residences or company shares.[48] Subsequent analysis demonstrated that in open economies, the primary incidence of the corporate tax may be on labor income.[49] In a small open economy, the tax even might be regressive. In other cases, the outcome may depend to some extent on the distributive effects of taxes on state-owned enterprises, economic rents paid to foreign owners, and more generally on the home country treatment of foreign source income earned by investors. Because no one knows the true incidence of the corporate tax, many studies simply present alternative scenarios, with no weighting as to which is more likely to hold in reality. The same problems arise with respect to all capital income taxes, including the personal income tax to the extent that it reaches capital as well as labor income.

Third, the incidence of a more ancient tax on capital, the tax on land and improvements on property, is again subject to very different interpretations. The traditional view is that a land tax is borne by landowners (at the time the tax is imposed) with the tax on structures being borne by tenants (if any). Given the concentration of land ownership in many developing countries, this suggests that the incidence of such taxes is likely progressive. In contrast, the so-called "new view" treats the property tax like the corporate tax and argues that it generally lowers the return on capital, with the added twist that additional distortion costs may arise to the extent that there are differential rates on different types of capital.[50]

48. Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215, 227–30 (1962).

49. *See, e.g.*, Arnold C. Harberger, *The ABCs of Corporation Tax Incidence: Insights Into the Open-Economy Case, in* TAX POLICY AND ECONOMIC GROWTH 51 (1995). Again, as mentioned *supra* note 40 with respect to tariff changes, there may be a similar extra burden that gets reallocated among income classes. As Michael Braulke, Giacomo Corneo, and others have noted, there also may be both a reduction and redistribution of income among countries. Michael Braulke & Giacomo Corneo, *Capital Taxation May Survive in Open Economies*, 5 ANNALS ECON. & FIN. 237, 239–43 (2004), *available at* http://www.aeconf.org/Articles/Nov2004/aef050203.pdf.

50. George R. Zodrow, *The Property Tax as a Capital Tax: A Room with Three Views*, 54 NAT'L TAX J. 139, 141–42 (2001).

Finally, to the extent that the local property tax may be regarded as a payment for services received by property owners, it really does not have any burden and may in fact lead to a better, more desired bundle of local services being provided.[51] These views are not mutually exclusive, and all may hold to some extent in any one country.[52] This is particularly true given the extreme complexity of land and property taxes in most countries.[53]

Fourth, the incidence of consumption taxes (export and import taxes, excise taxes, and general consumption taxes such as VAT) is also not straightforward. To the extent consumption taxes are partial—covering some consumption and not other consumption—their incidence depends on prevailing market conditions, which are likely to vary considerably from product to product. VATs in developed countries reach only about two-thirds of all consumption; in developing countries, VATs generally apply to less than half of consumption spending.[54] Given the importance of consumption taxes in developing countries, it is likely more important from a distributive perspective to reduce regressive elements of consumption taxes than to raise the top marginal rate of the personal income tax.

Summing up this enormous range of possible outcomes, as Shah and Whalley argue:

> It seems to be equally defensible to suggest that the value added tax is a progressive, rather than a regressive, tax; . . . and that reductions in personal taxes can have substantially progressive incidence effects because of reductions in evasion and improved administration, ultimately reducing transfers to high-income groups through bribery and corruption.[55]

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51. William A. Fischel, *Homevoters, Municipal Corporate Governance, and the Benefit View of the Property Tax*, 54 NAT'L TAX J. 157, 158 (2001).

52. For a detailed recent discussion of land and property taxes around the world, see RICHARD M. BIRD & ENID SLACK, INTERNATIONAL HANDBOOK OF LAND AND PROPERTY TAXATION (2004).

53. *See id*.

54. For example, Mark Gallagher estimates that in some developing countries (for example, Haiti) as little as 11 percent of the potential VAT base is actually taxed. MARK GALLAGHER, ASSESSING TAX SYSTEMS USING A BENCHMARKING METHODOLOGY 10 (U.S. Agency for Int'l Dev., Research Paper for the Fiscal Reform in Support of Trade Liberalization Project, 2004). In a few such countries (for example, Chile), the ratio is comparable to those achieved in countries such as France and Germany (which tax about two-thirds of consumption). *Id*. On the whole, however, a much smaller proportion of consumption is taxed in developing than in developed countries. *Id*.

55. Shah & Whalley, *supra* note 43, at 549.

These conclusions are, of course, also arguable. Nonetheless, it seems fair to say that the available quantitative evidence on tax incidence in developing countries is neither conclusive nor persuasive.

The analytical and quantitative complexities associated with incidence are even more difficult when it comes to the expenditure side of the budget.[56] The IMF survey mentioned above reviewed fifty-five studies that attempted to estimate the incidence of spending programs in twenty-five developing countries.[57] These studies suggest that spending on both primary and secondary education was generally progressively distributed in both Latin America and Asia,[58] although less so in sub-Saharan Africa and the Middle East.[59] Health expenditure generally was also relatively progressive, with the poorest quintiles in Asia and Latin America receiving, respectively, one and a half and three times as much as the richest quintiles.[60] In contrast, public expenditure on tertiary education benefited the richest quintile in all regions.[61] Some other spending programs, especially targeted ones such as food stamps in Jamaica or deliberately pro-poor investment in Colombia in the early 1970s, also have been shown to be progressive.[62] Not surprisingly, given the importance of informal labor markets noted earlier, the sometimes substantial cash transfers in some Latin American countries through pension and social security benefits were distributed much less progressively than similar programs in developed countries.[63]

Estimates of expenditure incidence, like those of tax incidence, are suspect in many ways. Still, the general conclusion that increasing spending on programs used more frequently by lower-income persons is progressive in incidence seems fairly robust.[64] Governments that provide substantial funding for such services as primary education and basic health

56. *See* JORGE MARTINEZ-VAZQUEZ, THE IMPACT OF BUDGETS ON THE POOR: TAX AND BENEFIT INCIDENCE 30–42 (Georgia State Univ., Int'l Studies Program, Working Paper No. 01-10, 2001), *available at* http://isp-aysps.gsu.edu/papers/ispwp0110.pdf.

57. CHU ET AL., *supra* note 28, at 4–6.

58. For example, the poorest quintile in Latin America received over four times more than the richest quintile.

59. CHU ET AL., *supra* note 28, at 9–11.

60. *Id.* at 10–11.

61. *Id.* at 10.

62. In Chile, for instance, the share of cash transfers received by the poorest quintile increased from 33 percent in 1992 to 40 percent in 1996 and compensated to some extent for the deterioration in the distribution of income during this period. Eduardo Aninat et al., *Addressing Equity Issues in Policymaking: Lessons from the Chilean Experience*, *in* ECONOMIC POLICY & EQUITY 109, 130 (Vito Tanzi et al. eds., 1999).

63. *See* DE FERRANTI ET AL., *supra* note 1, at 9-29 to 9-33.

64. *See* MARTINEZ-VAZQUEZ, *supra* note 56, at 40–42.

care are likely, on the whole, to have a moderately progressive net budget incidence even if the tax regime considered alone is proportional or even mildly regressive. Moreover, expenditures can in principle be more "targeted" than taxes without unduly distorting incentives, at least to the extent that the targeted groups have lower than average behavioral responses to price changes.[65] Therefore, governments that are concerned with poverty reduction or that simply wish to ensure that public services are provided with relative equity to all citizens (a goal that, given the much greater relative gain to low-income people from equal services, itself alleviates poverty) seem better advised to attempt achieving such goals through expenditure rather than tax policy.

### 2. The Shadow Economy Further Considered

Much recent discussion of developing countries has focused on the so-called "shadow" (underground, informal) economy. The shadow economy has important implications for taxation and distribution in most developing countries. Estimates of the size of the shadow economy in developing countries often range from between 30 percent and 60 percent of total GDP.[66] The shadow economy can be divided into two categories: (1) illegal activity, such as drugs, prostitution, and smuggling; and (2) legal activity,

65. Generally, such responses should be related to income and wealth. For example, greater command over assets makes it much easier for the rich to rearrange their affairs to avoid taxes.

66. These estimates do not mean that the measured GDP is understated by such percentages.

> GDP is a value-added measure, and the usual hidden economy measure is a measure of total activity and hence not directly comparable. Such double counting would have to be eliminated from the estimate to be comparable to GDP. For this reason, the ratio clearly overestimates the relative importance of the informal sector in GDP. In addition, some illegal activities (for example, drug smuggling) included in the informal sector are generally not included in GDP. The result of such factors is that an estimated underground economy of, say, forty percent may imply an understatement in measured GDP of only twenty percent or less, depending upon the nature of the informal sector (for example, the importance of illegal activities), the extent of double counting in the estimate of that sector, and the extent to which the activities measured are included in the measure of GDP. As these factors may vary over time, demonstrably do vary over the business cycle, unquestionably differ from country to country, and may also have very different implications with respect to tax evasion in different circumstances, even good estimates of the size of the informal sector do not provide a very useful guide to tax policy.

EDMISTON & BIRD, *supra* note 40, at 63–64.

consisting primarily of unreported income from self-employment, wages through informal work arrangements, and bartering transactions.[67]

Recent studies of shadow economies in developing (and transitional) countries reveal two interesting, and perhaps surprising, findings. First, in some countries the size of the shadow economy is increasing rather than decreasing.[68] Until recently, the perception has been that as economies matured, the importance of the informal sector gradually would decline as successful firms moved into the formal sector. It now seems, however, not only that some degree of informality will persist—as indeed it has in all countries—but also that the informal sector may in at least some circumstances become even more important. Second, and perhaps less unexpected, the evidence is that all income groups are engaged to varying extents in the informal sector.[69] Neither informal work arrangements nor businesses operating outside the formal economy are limited to low-income individuals. Moreover, many businesses and individuals operate in both the formal and informal sectors at the same time.[70]

Many nontax factors contribute to the growth and persistence of the shadow economy.[71] Government regulations, for instance, may substantially increase labor costs and reduce flexibility in hiring and firing employees, hence deterring the expansion of the formal sector. Regulation of property transfers, capital flows, financial institutions, and so on may all add to the "implicit tax" burden of operating in the formal sector, without adding to the budgetary resources available to the government. It thus may

67. *See* FRIEDRICH SCHNEIDER & DOMINIK H. ENSTE, SHADOW ECONOMIES AROUND THE WORLD: SIZE, CAUSES, AND CONSEQUENCES 4–5 (Int'l Monetary Fund, Working Paper No. 00/26, 2000); *see also* FRIEDRICH SCHNEIDER & DOMINIK H. ENSTE, THE SHADOW ECONOMY: AN INTERNATIONAL SURVEY 6–14 (2002) [hereinafter SCHNEIDER & ENSTE, THE SHADOW ECONOMY].

68. MARTHA CHEN, INFORMALITY AT WORK: RECONCEPTUALIZING THE EMPLOYMENT CHALLENGE (unpublished paper presented at the "Reviewing the First Decade of Development and Democracy in South Africa," Conference Univ. of Kwazulu-Natal, Sch. of Dev. Stud., Oct. 21–22, 2004).

69. *See, e.g.*, DE FERRANTI ET AL., *supra* note 1, at 410–11 (examining distribution of informal workers by deciles in Argentina and Brazil).

70. Richard M. Bird and Sally Wallace refer to such enterprises as "icebergs" in the sense that the formally visible part may constitute only a small portion of the whole. Richard M. Bird & Sally Wallace, *Is It Really So Hard To Tax the Hard-To-Tax? The Context and Role of Presumptive Taxes*, *in* TAXING THE HARD TO TAX: LESSONS FROM THEORY AND PRACTICE 121, 126–27 (James Alm et al. eds., 2004) [hereinafter TAXING THE HARD TO TAX].

71. As Simeon Djankov and others show, regulatory and other burdens on formal private sector activity are almost invariably much higher in poor than in rich countries. SIMEON D. DJANKOV ET AL., THE REGULATION OF ENTRY 16 (World Bank Pol'y Research, Working Paper No. 2661, 2001), *available at* http://ssrn.com/abstract=242738.

be cheaper to bribe officials and to avoid the rules than to comply with them.

Tax factors may work in exactly the same way.[72] Income taxes on wages and social security charges are quite substantial in many developing countries.[73] The larger the spread between labor costs and the after-tax earnings received by workers, the greater the incentives are to adopt informal work arrangements. Like other forms of tax avoidance or evasion, the desirability of informal work arrangements is also affected by the probability of government detection and the amount and nature of penalties. Theoretically, governments can reduce the supply of labor in the shadow economy through aggressive enforcement and imposition of substantial penalties for informal work arrangement on both workers and employers. In practice, this almost never happens, and in some countries, the main outcome of attempts to reduce informal activity likely has been to increase the scope for officials to extort and harass even legitimate businesses.[74]

Businesses choosing whether to operate in the shadow or the formal economy (or in some mixture of the two) face a similar cost-benefit calculation. The costs of operating in the formal economy include both taxes and the costs of complying with various government regulations. Firms in the formal sector will incur greater labor costs because they will be required to withhold taxes on wages and any social security obligations. They will also be subject to tax on profits, either under a corporate income tax or under the personal income tax system. Firms operating in the informal sector gain because they can expand without suffering the burdens of government regulation and taxes. At the same time, however, these firms may lose access to financial markets for both debt and equity. The

72. Indeed, as Emmanuelle Auriol and Michael Warlters argue, one rationale for increasing both tax and nontax barriers to entering the formal sector may be to raise tax revenues by increasing returns (and rents) in the formal sector. Tax authorities, even the weak tax administrations found in many developing countries, are much more successful in taxing the formal sector than the informal sector. Emmanuelle Auriol & Michael Warlters, Taxation Base in Developing Countries 2–20 (Aug. 22, 2003) (unpublished manuscript), *available at* http://web.hhs.se/site/research/conferences/workshop12_13dec/Auriol%20taxation_base.pdf.

73. Even if we ignore the impact of personal income taxes, additional payroll taxes imposed for social security and other purposes range from 15 percent to 45 percent of wages in Latin America. In addition, in many countries there are various kinds of compulsory labor levies (for example, to finance apprenticeship schemes or child welfare programs) that have to be added to these rates. In Colombia, for example, where the formal payroll taxes are 36.5 percent of wages, the "real" taxes (again excluding the income tax) are 41.5 percent of payrolls. *See* Alm & López-Castaño, *supra* note 44, at 42 tbl.1.

74. *See e.g.*, Michael Engelschalk, *Creating a Favorable Environment for Small Business Development in Transition Countries*, *in* TAXING THE HARD TO TAX, *supra* note 70, at 275.

effect of a VAT on the shadow economy is more complicated. While firms operating in the shadow economy may escape VAT liability on their sales, they also will not be able to reclaim credit for any VAT paid on inputs. For this reason, it has often been suggested that one way to impose an appropriate tax burden on those in the informal sector is through consumption taxes.[75]

The existence of a large sector of the economy not subject to income taxation is important in assessing the equity effects of different fiscal instruments. For instance, a well-designed general consumption tax might be more progressive than a personal income tax if the latter in practice really only burdens a limited group of wage earners. In such circumstances, increasing the role of consumption taxes may make the tax system less distorting in its allocations and reduce the pressure on market-based activities to move into the informal sector. A VAT may level the competitive playing field by granting some relief from taxes on business inputs to those taxpayers who actually pay taxes on their sales, while imposing tax on those businesses that operate informally.[76] From this broader perspective, a VAT may be less regressive than conventional incidence analysis suggests.

To sum up, the level and structure of taxation, and the size and nature of the shadow economy, are closely interrelated. Although there is still much that we do not understand about these relationships, at least two conclusions appear fairly robust. First, taxes on wages (including payroll and social security taxes) retard the expansion of the formal sector and

75. There are several versions of this story. To the extent trade is carried out by large firms in the formal sector, a VAT imposed on such firms can tax an important part of the informal sector (for example, nonreporting plumbers and other home repair enterprises that buy supplies at a business registered for VAT). Those who operate entirely in the cash economy may escape having to deal directly with tax authorities, but they will end up paying VAT to the extent that they purchase either consumer goods and services or inputs for their productive activities from the formal sector. In addition, consumption taxes may reach the informal sector via shifting of the taxes into wages, returns to capital, or consumer prices. Small manufacturers operating in the informal sector may be taxed effectively via indirect taxes if the tax is capitalized in some way that affects the return to capital or labor. To the extent that such arguments hold in any country, even illegal and criminal activities—a not inconsiderable part of the informal sector—will be subject to at least some taxes. While increased reliance on indirect taxes will not bring tax-dodging businesses into the formal sector, it will increase the tax burden on the informal sector and contribute to both increased equity of the relative tax treatment of the formal and informal sector, and the efficiency of resource allocation. *See* EDMISTON & BIRD, *supra* note 40, at 62–63.

76. See, for example, Silvio Fedeli, *The Effects of Interaction Between Direct and Indirect Tax Evasion: The Cases of VAT and RST*, 53 PUB. FIN. 385 (1998), which shows that a VAT both offers more opportunity for administrative actions (like more effective penalties) to reduce evasion and is on the whole less conducive to the growth of the informal economy in the first place than other forms of consumption taxation.

hence increase the supply of labor to the shadow economy. If the alternative to formal employment is primarily subsistence agriculture,[77] the result is to reduce the rate of economic growth in general by preventing migration from low-productivity to high-productivity activities. If the alternative is informal, small scale manufacturing and service activities,[78] the result may or may not be to reduce growth rates. Second, failure to tax the shadow economy will likely reduce the level of tax revenue available to fund government programs. Thus, government will be less likely to undertake growth-facilitating programs (such as infrastructure improvements and health and education programs) on the scale needed to support increased private sector growth.

3. Revolution or Evolution?

In the end, what really matters from the perspective of distributional equity in developing countries is not who pays, and how much, given the existing tax system. This question is one that, as we have argued, no one can answer with much confidence.[79] Rather, the critical inquiry is who will pay more or less if certain specified tax changes are made. The usual and apparently innocuous tax incidence study implicitly compares present reality with an alternative that could come into existence only with a revolutionary change in political regime. In real life, however, the tax changes associated with regime change are by no means obvious.[80] In political terms, when a sharp regime change (such as dictatorship to democracy) occurs, even the poorest country faces new opportunities for fiscal change. In principle, such countries are freed from many past restraints on political action and can choose among different alternatives. What a country may choose, however, is inevitably constrained by the economic realities that it faces—its fiscal requirements, its economic situation, the international environment, and so on.

77. *See* W. ARTHUR LEWIS, THE THEORY OF ECONOMIC GROWTH 330–40 (1955).

78. *See* John R. Harris & Michael P. Todaro, *Migration, Unemployment, and Development: A Two-Sector Analysis*, 60 AM. ECON. REV. 126, 127–28 (1970). Both this model and that mentioned in the previous footnote postulate a perfectly elastic supply of labor to the formal sector. For a much more nuanced approach, see, for example, William F. Maloney, *Does Informality Imply Segmentation in Urban Labor Markets? Evidence From Sectoral Transitions in Mexico*, 13 WORLD BANK ECON. REV. 275 (1999).

79. In addition to the limitations of tax incidence studies discussed in the text, other considerations complicate the analysis, such as the differences between annual versus lifetime perspectives of tax incidence.

80. *See* José Antonio Cheibub, *Political Regimes and the Extractive Capacity of Governments: Taxation in Democracies and Dictatorships*, 50 WORLD POL. 349, 373–74 (1998).

To illustrate, when leftist governments took over from dictatorships in Greece, Spain, and Portugal in the 1970s, tax levels in those countries soared in a manner reflecting political preferences, the then-prevailing economic orthodoxy about the relatively mild economic consequences of increasing taxes, and the generally booming economy.[81] Much the same happened when an extreme leftist government came into power in Nicaragua at the end of the decade. When other, less radical, leftist governments took over in several Latin American countries in the 1990s, their political preferences may have been similar to the new regimes in the 1970s. However, both the world and the view of the economic consequences of highly progressive tax rates had changed, and one result was that tax rates were not increased.

More generally, as Carolyn Webber and Aaron Wildavsky emphasize in their monumental history of taxation and expenditure, "fiscal inertia" is a force to be reckoned with.[82] Where a country ends up in terms of both tax levels and tax structure depends in large part on where it begins. To put it another way, how fiscal systems develop depends significantly on how they were started.[83] Similarly, countries react more to tax changes in neighboring countries than to changes in countries on the other side of the world, although almost all countries take notice of tax changes in the United States and the European Union and react by emulation or in some counterbalancing fashion.[84] No country is a tax island that stands alone outside either its own history or its current context. Fiscal change, like other policy change, is thus more evolutionary than revolutionary.

From an analytical perspective, at least, this is fortunate, because questions about incremental as opposed to revolutionary change can, in principle, more often be answered with some degree of certainty. In practice, however, outcomes at the margin often depend on such hard-to-determine factors as the size and nature of the shadow economy, the size and nature of tax evasion, and the effectiveness of tax enforcement. Hence, they cannot easily be estimated.

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81. Ken Messere, *Half a Century of Changes in Taxation*, 53 BULL. FOR INT'L FISCAL DOCUMENTATION 340, 343–44 (1999).

82. CAROLYN WEBBER & AARON WILDAVSKY, A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD 560–614 (1986).

83. Tax laws around the world, for example, can be categorized into several "families" reflecting national and imperial histories. *See* VICTOR THURONYI, COMPARATIVE TAX LAW 60–203 (2003).

84. *See* THE BROOKINGS INST., WORLD TAX REFORM: A PROGRESS REPORT 1–8 (Joseph A. Pechman ed., 1988); WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES (Michael J. Boskin & Charles E. McLure, Jr. eds., 1990).

B. What Is Progressivity and to What Extent Has It Been Achieved?

What do we mean by progressive taxes? The personal income tax in most countries is progressive in the sense that tax rates increase as taxable income increases. Assuming that income taxes are generally borne by the individuals who pay them, as taxable income rises, tax liability will also increase. Whether the tax system is actually progressive, however, depends on many factors, such as how well the statutory definition of income corresponds with broader economic definitions of income.[85] But many problems exist in interpreting what the figures derived from such exercises mean. For example, the rate of increase in progressivity may differ sharply and unevenly across different ranges of income distribution, differential (and largely unknown) degrees of tax evasion may alter assessments of relative progressivity, and as mentioned earlier, consideration of the untaxed shadow economy may change one's view of progressivity.[86]

Several studies in developed countries have found that nominally progressive tax systems have surprisingly weak redistributive effects. The (estimated) progressivity of progressive statutory personal income tax rates is more than offset by the (estimated) regressivity of consumption and other taxes. For example, Joseph Pechman and Benjamin Okner found that the U.S. tax system in 1966 was not significantly progressive over a range of assumptions about the incidence of particular taxes, and it did not exert any major influence on the distribution of income.[87] A follow-up study by Pechman found that for the 1966–1985 period, despite significant changes in tax rates, the U.S. tax system remained essentially proportional overall with little effect on income inequality.[88]

Other studies have found that the income tax has had a somewhat greater effect in reducing inequality in other developed countries.[89] Still, even under the most progressive assumptions as to the incidence of different

85. For the classic discussion of the various (and not always consistent) methods of measuring progressivity (marginal rate progressivity, average rate progressivity, and so on), see R.A. Musgrave & Tun Thin, *Income Tax Progression, 1929–48*, 56 J. POL. ECON. 498 (1948).

86. Implicit taxation through regulation and other means of course may also alter effective burdens substantially (not least because one person's implicit tax is often another's implicit subsidy, thus altering pretax distribution). As mentioned earlier, however, this factor is left out of account here, as it is in virtually all incidence studies, essentially because such "taxes" provide no revenue for government budgets. *See* discussion *supra* note 17.

87. JOSEPH A. PECHMAN & BENJAMIN A. OKNER, WHO BEARS THE TAX BURDEN? 1–10 (1974).

88. JOSEPH A. PECHMAN, WHO PAID THE TAXES, 1966–85?, at 1–10 (1985).

89. For example, in Canada. Andrew Sharpe, *Linkages Between Economic Growth and Inequality: Introduction and Overview*, 29 CAN. PUB. POL'Y S1 (supp. 2003).

taxes, taxes generally are not very effective in reducing inequality. One reason is simply that inequality arises from many nontax related factors. In Latin America, for instance, inequality arises from a complex set of interconnected causes acting through markets, household formation, and state policy, all of which reflect the unequal sociopolitical distribution of power in most Latin American countries.[90] For example, although returns to education are relatively high in Latin America, access to those returns is restricted by the continuing inequality of access to education, even in countries where spending on education may be relatively high. Countries where a relatively high share of public spending on education is on a postsecondary sector to which few poor people have access because they cannot obtain good secondary education are not reducing poverty, expanding the middle class, or reducing income inequality through such spending. Instead, in distributive terms, they are more likely to be maintaining the unequal status quo.

As many recent studies have argued, the state's best chance to affect income inequality may be through its expenditure programs. But in most developing countries, spending programs have been poorly targeted from the perspective of either relieving poverty or reducing inequality.[91] This is no accident; within broad limits, politicians implement the policies they need to survive and thrive in the society in which they operate.[92] In most developing countries, politics are essentially clientistic, and it should come as no surprise that the fiscal systems put into place are not very pro-poor when, as usually is the case, the pro-powerful party is in power. Until the political environment, the nature of political competition and the political equilibrium reflected in fiscal outcomes changes, the distributional status quo ante seems likely to persist.

This does not mean, however, that nothing can be done if those who run a country want to do it.[93] Some contend that fiscal redistribution, even in developed countries, does not work well for two reasons. First, simply transferring income does not solve the long-term problem of poverty.

90. For details, see DE FERRANTI ET AL., *supra* note 1, at 6-1 to 6-32.

91. *See* SYED M. AHSAN & JAIDEEP OBEROI, INEQUALITY, WELL-BEING AND INSTITUTIONS IN LATIN AMERICA AND THE CARIBBEAN 1–9 (CESifo Working Paper No. 846, 2003), *available at* http://www.cesifo.de/~DocCIDL/cesifo_wp846.pdf; *see also* VICTOR LLEDO ET AL., PRO-POOR TAX REFORM IN LATIN AMERICA: A CRITICAL SURVEY AND POLICY RECOMMENDATIONS (IDS Report commissioned by the Department for International Development, London, England, Mar. 2003).

92. *See* ROBINSON, *supra* note 32, at 5–15.

93. Of course, as the Aprista government showed in Peru some years ago, and as is now also evident with the Chavez government in Venezuela, pro-poor clientelism is still clientelism.

Nevertheless, this argument may carry little weight if reducing short-term suffering from poverty is sufficiently desirable. To the extent that such short-term relief leads to improved human capital development, redistribution may even contribute to long-term poverty alleviation. The lesson for developing countries is not to eschew redistribution policies but to redistribute in the most economically beneficial way possible. The second argument against fiscal redistribution is that it gives rise to relatively high effective marginal tax rates and hence substantial efficiency losses. Again, the lesson for developing countries is not that nothing can be done through the fiscal system to deal with inequality, but rather that effective marginal tax rates should be kept as low as possible by increasing the tax base. This is why the usual broad-base, low-rate recipe for tax reform makes sense from both an efficiency and a distributional perspective.[94]

In most countries, a properly designed tax regime can generate sufficient revenue to finance needed social and public services in a mildly progressive (or at worst proportional) way. Arguably, everyone benefits in terms of both improved economic well-being and a more sustainable political system if such a tax policy is coupled with an expenditure policy for health, education, and infrastructure improvements that focuses on developing a country's human capital, which contributes to higher productivity and growth.

Even so, it is far from clear whether those in power in many developing countries are willing to change tax and expenditure policies in these directions. They may instead prefer to continue living in the belief that "après moi, le déluge."[95] One reason why inequality is more marked in Latin America than in other parts of the world may be, paradoxically, the vent afforded by the proximity and relative ease of access to the United States. The powerful rich can easily hide their capital in the United States, safe even from U.S. taxes if they hide it right,[96] and simultaneously set up a comfortable alternative refuge for themselves and their families. The aspiring middle class, at least once they have acquired sufficient educational credentials, can often exit to more lucrative U.S. opportunities, thus removing the voice for change that they might otherwise have exercised in their own countries. Even at the bottom of the distributional pyramid, millions of the unskilled poor in some countries can move across the border

94. *See, e.g.*, WORLD BANK, LESSONS FROM TAX REFORM (1991).

95. These immortal words ("after me, the deluge") are often attributed, perhaps a bit too appropriately, to Louis XV of France.

96. Charles E. McLure, Jr., *U.S. Tax Laws and Capital Flight From Latin America*, 20 U. MIAMI INTER-AM. L. REV. 321, 322–23 (1989).

and find low-skilled, but relatively better paying, jobs in the United States. If to some extent at least all sides of a potential conflict continue to have relatively attractive and accessible exit options, incentives to change the low-level distributional equilibrium present in many Latin American countries are clearly weakened.

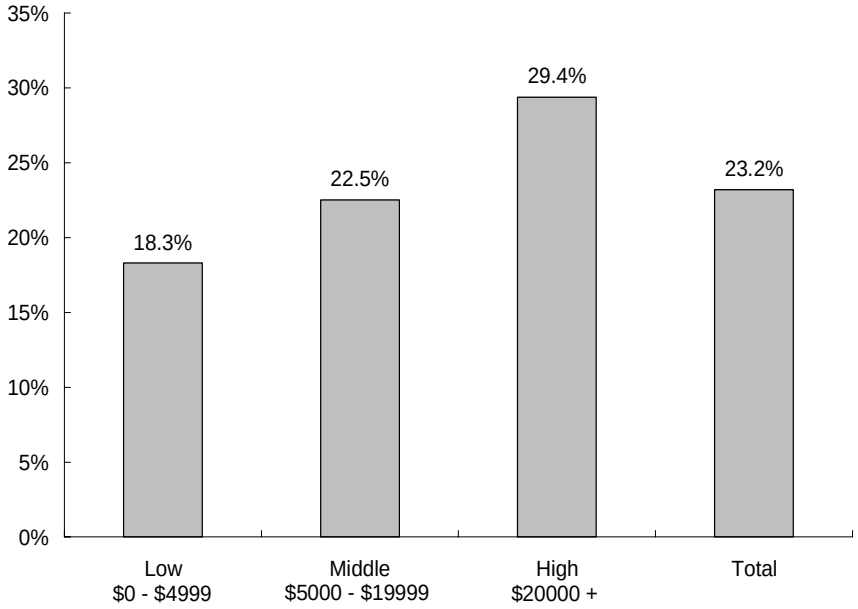
### C. Differences in Tax Systems Between Developed and Developing Countries

In this part we compare the tax systems of developed and developing countries to understand the relative use of different tax instruments and to determine the potential for using the tax system for redistributive purposes. We then examine some of the difficulties that countries with high inequality may face in designing and implementing progressive tax systems.

#### 1. Comparing the Tax Systems of Developed and Developing Countries

In examining the differences between the tax systems of different countries, we first consider the aggregate tax burden (measured as a percentage of tax to GDP) for a group of developed and developing countries. This is well-covered ground. As set forth in Figure 1 below, the average tax-to-GDP ratio for low-income countries (per capita GDP less than $5000) is 18.3 percent, 22.5 percent for medium-income countries (per capita GDP between $5000 and less than $20,000), and 29.4 percent for high-income countries (per capita GDP greater than $20,000). We simply note that the larger the share of tax burden, the greater potential the tax system may have to redistribute income (either regressively or progressively).

**Figure 1.** Tax Revenue as a Percentage of GDP by GDP/Capita Category.




*Sources*: WORLD BANK GROUP WORLD DEVELOPMENT INDICATORS (2004), *available at* http://www.worldbank.org/data/wdi2004/; Government Finance Statistics (July 2004); BRAZ. MINISTRY OF FIN., BULLETIN OF FISCAL STATISTICS (2002) (Social Security Tax = COFINS), *available at* http://www.tazenda.gov.br/portuguese/releases/2002/Boletim%20de%20Estatístiu%20Fiscais%20%para%20Divulgação%20Inglês.PDF; IR. OFFICE OF THE REVENUE COMM'RS, STATISTICAL REPORT 2001, *available at* www.revenue.ie/df/strpt01.pdf; Hong Kong, Department of the Treasury, http://www.try.gov.hk/internet/ ehpublications.html; Japan, Ministry of Finance, *at* http://www.mof.go.jp/english/; Malaysia, Ministry of Finance, *at* http://www.trasury.gov.my/ englishversion/mru/indexes.htm; New Zealand, Department of Treasury, *at* http://www.treasury.govt/nz/; Philippines, Bureau of Internal Revenue, *at* http://www.bir.gov.ph/home.htm; KARIM NASHASHIBI, FISCAL REVENUES IN SOUTH MEDITERRANEAN ARAB COUNTRIES: VULNERABILITIES AND GROWTH POTENTIAL, Int'l Monetary Fund, Working Paper No. 02/67 (2002).

*Time Period*: 1999 data used for Azerbaijan, Burundi, Egypt, Morocco, Nepal, Norway, and Turkey; 2001 data used for Indonesia; 2000 data used for all other countries.

Next, we examine the relative use of different tax instruments by countries in different regions. In Figure 2 we present information for years 1975 through 2002 to focus on the contribution of income tax revenues to total tax revenues.

**Figure 2.** Tax Structure by Region, Percentage of Total Tax Revenue, 1975–2002.

| | Income Tax | | | Domestic Goods and Services | | | |
|---|---|---|---|---|---|---|---|
| | Total | Individual | Corporate | Total | General Consumption | Excises | International Trade |
| **North America** | | | | | | | |
| 1975-1980 | 61% | 44% | 16% | 12% | 6% | 5% | 5% |
| 1986-1992 | 57% | 46% | 10% | 12% | 7% | 5% | 3% |
| 1996-2002 | 82% | 66% | 16% | 15% | 9% | 5% | 2% |
| **Latin America** | | | | | | | |
| 1975-1980 | 28% | 10% | 18% | 33% | 16% | 14% | 23% |
| 1986-1992 | 28% | 10% | 18% | 36% | 17% | 13% | 21% |
| 1996-2002 | 27% | 7% | 19% | 52% | 36% | 14% | 14% |
| **Western Europe** | | | | | | | |
| 1975-1980 | 28% | 22% | 6% | 33% | 19% | 10% | 4% |
| 1986-1992 | 28% | 21% | 6% | 34% | 22% | 10% | 2% |
| 1996-2002 | 44% | 32% | 12% | 49% | 30% | 14% | 0% |
| **Asia** | | | | | | | |
| 1975-1980 | 42% | 22% | 19% | 35% | 10% | 21% | 22% |
| 1986-1992 | 40% | 21% | 19% | 37% | 18% | 16% | 20% |
| 1996-2002 | 44% | 23% | 20% | 39% | 19% | 15% | 13% |
| **Africa** | | | | | | | |
| 1975-1980 | 29% | 13% | 15% | 27% | 12% | 12% | 34% |
| 1986-1992 | 25% | 13% | 10% | 29% | 16% | 11% | 37% |
| 1996-2002 | 30% | 17% | 11% | 35% | 21% | 11% | 32% |

*Sources*: IMF Government Finance Statistics (July 2004); IMF, TAX POLICY HANDBOOK tbls. 1–30 (Parthasarathi Shome ed., 1995); Japan, Ministry of Finance, *at* http://www.mof.gov.jp/english; Mexico, Ministry of Finance and Public Credit, *at* http://www.shcp.gob.mx/english/.

*Notes*: In determining the percentage of total tax revenue for different types of taxes, we excluded social security taxes. For some regions, the taxes included in Figure 2 do not sum to 100% because of the existence of other miscellaneous taxes. To maintain consistency of measurement and to allow cross-country comparisons between tax structures, the table reflects consolidated central government revenue for most countries. However, if these data were unavailable, we used national or state budgets, or some combination of national, state, and local revenues. To even out annual fluctuations, the figures are averaged over 1975–1980,

1986–1992, and 1996–2002. For 1975–1980, Brazil, Malaysia, Myanmar, Nepal, Nicaragua, Panama, Portugal, and Singapore are omitted from calculations because of large, unidentifiable amounts in residual (that is, nonindividual, noncorporate) categories. For 1986–1992, Brazil, Chile, Nepal, Nicaragua, Panama, Peru, Philippines, and Singapore are omitted for the same reason. For 1996–2002, Brazil, Chile, Mexico, Nicaragua, Norway, Panama, and Singapore are omitted for the same reason.

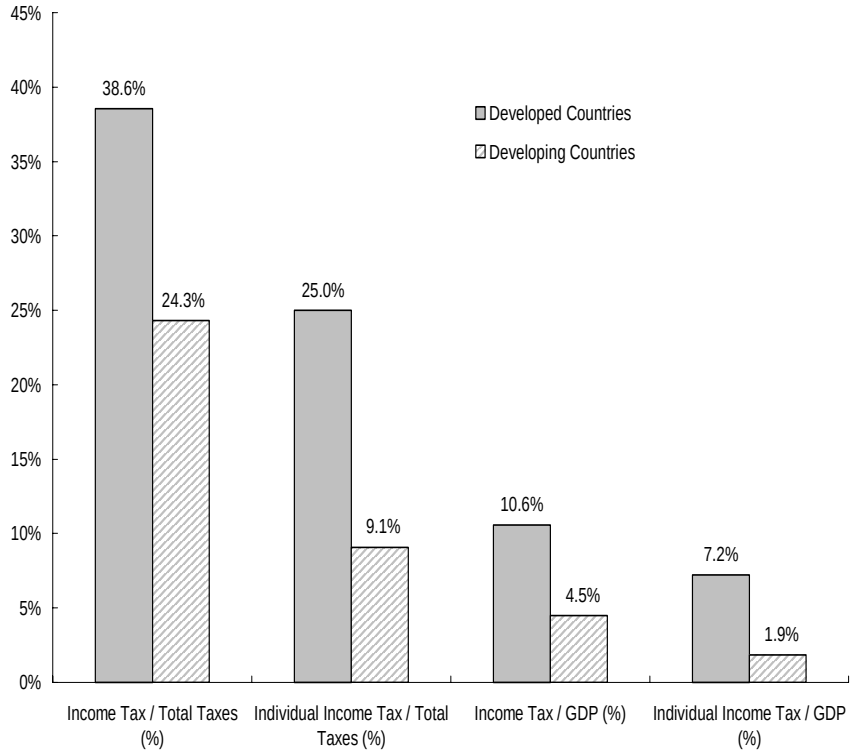
1. The aggregate for North America includes Canada and the United States.
2. The aggregate for Latin America includes Brazil, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Mexico, Nicaragua, Panama, Peru, Uruguay, and Venezuela.
3. The aggregate for Western Europe includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.
4. The aggregate for Asia includes Australia, India, Indonesia, Japan, Korea, Malaysia, Myanmar, Nepal, New Zealand, Pakistan, the Philippines, Singapore, Sri Lanka, and Thailand.
5. The aggregate for Africa includes Burundi, Cote d'Ivoire, Lesotho, Madagascar, Mauritius, Morocco, South Africa, Tunisia, and Zimbabwe.

We then examine the relative role of income taxes in developed and developing countries. Here we find that income taxes play a much smaller role in total tax revenue in developing countries than in developed countries.[97] Developed countries raise about 38.6 percent of total tax revenue from income taxes as compared to 24.3 percent of total tax revenue for developing countries. As others have noted, while individual income tax revenues are often three to four times corporate tax revenues in developed countries, in developing countries corporate tax revenues often exceed personal income tax revenues, sometimes by substantial amounts.[98] Whereas tax revenues from personal income taxes average about 25 percent of total tax revenues for high-income countries, tax revenues from personal income taxes for developing countries are about 9.1 percent of total tax revenues. As a percentage of GDP, personal income tax revenues in developed countries average about 7.2 percent of GDP as compared to only about 1.9 percent of GDP for developing countries.

**Figure 3.** Composition of Tax Revenues for Developed and Developing Countries, 1999–2001.

97. *See* Figure 3.

98. VITO TANZI & HOWELL H. ZEE, TAX POLICY FOR EMERGING MARKETS: DEVELOPING COUNTRIES 12–15 (Int'l Monetary Fund, Working Paper No. 00/35, 2000), *available at* http://www.imf.org/external/pubs/ft/wp/2000/wp0035.pdf.




*Sources*: as for Figure 1.

Perhaps the most disappointing finding for those who view the personal income tax as the primary instrument for redistribution is how little the share of total tax revenue or GDP has changed over the last thirty years. In Figure 4, we examine the role of the personal income tax in different regions from 1975 through 1992. While it is difficult to compare data from different sources, the pattern is clear.[99] If learning to tax means increasing the role of income taxes, particularly personal income taxes, many developing countries have yet to learn this lesson.

99. More recent data do not appear to change the pattern. In Latin America, for example, the share of income taxes declined even more in the late 1990s. BIRD, *supra* note 4, at 6 tbl.1.

**Figure 4.** Personal Income Tax Revenues by Region, 1975–1992.

| | 1975-1980 | | 1981-1985 | | 1985-1992 | |
|---|---|---|---|---|---|---|
| | Individual Income Tax / Total Taxes (%) | Individual Income Tax / GDP (%) | Individual Income Tax / Total Taxes (%) | Individual Income Tax / GDP (%) | Individual Income Tax / Total Taxes (%) | Individual Income Tax / GDP (%) |
| OECD | 28.0% | 7.4% | 28.1% | 7.8% | 27.6% | 8.0% |
| Non-OECD | | | | | | |
| Western Hemisphere | 8.5% | 1.5% | 6.4% | 1.2% | 6.4% | 1.2% |
| Asia | 15.4% | 2.2% | 14.1% | 2.2% | 14.7% | 2.3% |
| Africa | 10.2% | 1.8% | 11.0% | 2.1% | 11.4% | 2.2% |

*Sources*: IMF, TAX POLICY HANDBOOK tbls. 1–30 (Parthasarathi Shome ed., 1995).

It is difficult to find information on the composition of income under different personal income tax systems. One source is Modi, Richupan, and Wu, whose data are now twenty-five years old.[100] Nevertheless, based on our experience in a variety of countries, the picture they display of major differences in personal income tax systems in developed and developing countries still appears to hold. First, there is a substantial difference in the proportion of individual income taxpayers to the total population. In developed countries this proportion ranges between about 25 percent and 78 percent of the total population, with an average of about 46 percent. In contrast, the comparable range in developing countries is between 0.14 percent and about 12 percent, with an average of less than 5 percent.[101] Second, as a percentage of GDP, the proportion of income subject to the personal income tax is also much lower in developing countries. The range for developed countries is from 40 percent to 80 percent, with an average of about 57 percent; in developing countries, the range is from 3 percent to 28 percent, with an average of only about 14 percent.[102] Third, in many developed countries, the proportion of income tax collected from wage and

100. Jitendra R. Modi et al., *Statistical Tables in* VED P. GANDHI, SUPPLY-SIDE TAX POLICY: ITS RELEVANCE TO DEVELOPING COUNTRIES (1987).
101. *Id.* at 360.
102. *Id.* at 361.

salary income is slightly over 80 percent.[103] In developing countries, on the other hand, those with effective withholding systems (even though only on the formal sector), often collect more—up to 95 percent—from withholding on wages while the percentage of tax revenue collected from wage and salary income in countries with less effective withholding schemes is much lower.[104]

The effective scope of personal income taxes in developing countries is thus much narrower than in developed countries. First, much income from capital escapes taxation in most countries.[105] Some countries provide specific exclusions for certain types of capital income, such as interest on government bonds and capital gains. Some countries also exempt income earned outside the country. Even if countries do nominally tax residents on their income earned offshore, they invariably have little success in taxing assets held outside the country. And that sucking sound, tax-wise, is the large amount of portfolio investment in U.S. bonds and securities that likely bears little, if any, tax in the country of residence.[106] Second, as discussed in Part II.A.2, income from the shadow or informal sector is not taxed. Again the size and composition of the informal sector varies greatly between and among developed and developing countries. The greater average size of the shadow economy in the latter, however, highlights the challenge of using the income tax regime to tax income in a comprehensive manner.

To sum up, while the income tax laws of different countries are remarkably similar in many ways, the ability of the personal income tax to influence the redistribution of income varies greatly from country to country, and on the whole its role in developing countries is substantially smaller than in developed countries. The personal income tax is hardly the comprehensive progressive income tax regime long urged by most tax policy advisors. The personal income tax is much less prominent in the tax picture (measured either as a percentage of GDP or as a percentage of

103. *Id.* at 362.

104. *Id.*

105. For example, in most developing countries, capital gains are essentially untaxed. Roger H. Gordon & Joel Slemrod argued that even in the United States, if one took into account the deductibility of interest in most countries there was likely no net tax on capital income. Roger H. Gordon & Joel Slemrod, *Do We Collect Any Revenue From Taxing Capital Income?*, *in* 2 TAX POLICY AND THE ECONOMY 89, 90–91 (Lawrence H. Summers ed., 1988). Although more recent work suggests that some net taxes on capital income are now imposed in the U.S., it seems unlikely that similar results would be found in most developing countries. Roger Gordon et al., *Do We Now Collect Any Revenue From Taxing Capital Income?*, 88 J. PUB. ECON. 981, 1000–01 (2004).

106. *See* McLure, *supra* note 96, at 322–23.

income tax/total tax revenue) in developing countries. In developed countries, personal income tax revenues are about 8–10 percent of GDP. In developing countries, personal income tax revenues are often less than 1–2 percent of GDP.[107] In some regions, and especially regions with high inequality like Latin America, the difference is even more dramatic.

### 2. Difficulties Facing Countries With High Inequality in Designing and Implementing a Progressive Tax System

Quite apart from the limited potential for direct redistributive policy through personal income taxation in most developing countries, inequality itself may affect the aggregate level of taxes (thus influencing the scope of redistributive expenditures). Inequality also may affect the relative use of different tax instruments and the division of taxing and spending authority between levels of governments. As with all tax design issues, policy possibilities and outcomes vary by country and over time, and different circumstances in different countries call for different tax policies. Nonetheless, it is generally true that there are severe limitations on using the tax system to redistribute income, especially in developing countries and in countries with high inequality.

There are several reasons why inequality may lead to challenges for both tax design and tax evasion.[108] Countries with extreme inequality find it difficult to raise adequate revenue in a relatively fair and efficient manner. Stated differently, countries with a substantial middle class have a wider array of tax policy alternatives than do countries without one. Sustained excessive inequality in a country, whether generated by the market or from governmental policy, may not be sustainable over time. Aristotle stated that "it is manifest that the best political community is formed by citizens of the middle class, and that those states are likely to be well-administered in which the middle class is large . . . for when there is no middle class troubles arise, and the state soon comes to an end."[109] In

107. In the few developing countries where personal income taxes play a significant role, the explanation often lies in the dominance of public sector (government and state enterprise) employees in the taxpayer population, or even that of foreign workers. *See, e.g.*, Richard M. Bird, *Taxation in Papua New Guinea: Backwards to the Future?*, 17 WORLD DEV. 1145, 1148–55 (1989).

108. Kenneth L. Sokoloff & Eric M. Zolt, *Inequality and Taxation: Evidence From the Americas on How Inequality May Influence Tax Institutions*, 58 TAX L. REV. (forthcoming 2005).

109. ARISTOTLE, POLITICS, *quoted in* Kim M. Bloomquist, *Tax Evasion, Income Inequality and Opportunity Costs of Compliance*, *in* NATIONAL TAX ASS'N, PROCEEDINGS: 96TH ANNUAL CONFERENCE ON TAXATION 100 (2004).

contrast, Adam Smith noted that there may be "a lot of ruin in a nation."[110] As Latin America demonstrates, states may persist, if not always thrive, for decades and even centuries without developing either a solid middle class or a good administration. Nevertheless, in the end Aristotle is probably right.

Sustainable government in the long run requires a judicious balance of equity and efficiency, and an adequate system of income taxation may constitute an important element in that balance. In this sense, taxes are "the bread and butter of politics."[111] As in all politics, however, an essential ingredient of most sustainable solutions is to trade at the margin some virtues (such as distributive justice or fairness in allocating the costs of government) against others (such as economic growth or administrability). "[T]ax policy is about trade-offs, not truths."[112]

The sheer magnitude of inequality in Latin America, for example, suggests that there is more than enough room at the top to relieve the extreme poverty at the bottom, if controlling political powers really wanted to do so.[113] The real problem in most countries is that there is little evidence that anyone in authority gives high priority to this policy objective. As was said some years ago, when it comes to redistributive taxation in Latin America the "rich . . . appear to consider themselves to be middle class, the middle class to be poor, and the poor to be virtually nonexistent."[114] Some have questioned whether many developing countries have yet experienced the earlier parts of the cycle that produced the (more or less) redistributive fiscal state now found in developed countries—the long preparatory period when the idea of the desirability, and even necessity, of a more effectively progressive tax system becomes so established that, when the time is ripe, such taxes are in fact implemented.[115] Instead, bypassing this egalitarian period, many developing countries seem to have moved directly from the feudal inequality based on land to the modern era of inequality based on capital (including human capital). One might perhaps speculate that, as Engerman and Sokoloff

110. This quotation comes from a letter sent by Smith to a friend after the Battle of Saratoga. *See* Herb Stein, *Herb Stein's Unfamiliar Quotations*, SLATE (May 16, 1997), *at* http://slate.msn.com/id/2561.

111. MURPHY & NAGEL, *supra* note 19, at 4.

112. Messere, *supra* note 81, at 342.

113. In Mexico, for instance, if only 10 percent of the income of the top decile were distributed to the bottom two deciles, their income would more than double. *See* DE FERRANTI ET AL., *supra* note 1, at 400 tbl.A.2. Of course such calculations are just arithmetic, not policy recommendations: They ignore both behavioural reactions and feasibility considerations.

114. Bird & De Wulf, *supra* note 37, at 677.

115. 1 PETER H. LINDERT, GROWING PUBLIC: SOCIAL SPENDING AND ECONOMIC GROWTH SINCE THE EIGHTEENTH CENTURY (2004).

almost (but not quite) say with respect to Latin America, that most people in the region may not really know what moderate or justifiable inequality might mean because they have never seen it.[116]

The smaller the number of truly rich in a country, the higher the income tax rates that have to be imposed on high income groups relative to low income groups to raise a given amount of revenue. The required marginal income tax rates would probably be infeasible in many countries, because even in the unlikely event that the weight of high income groups' political voice proves insufficient to block such legislation, or at least its effective implementation, capital and high-value labor could simply exit. Increasing progressivity in tax rates changes the supply of labor by individuals and the level and nature of capital investments. The extensive literature on optimal taxation in developed countries provides some limited insights on how to design an appropriate rate structure to balance increased equality from higher individual income tax rates against the resulting economic distortions on labor supply.[117] The critical factors are the sensitivity of the labor supply to the after-tax wage rate and the distribution of endowments in a society. On the whole, optimal tax theory suggests that greater inequality should permit greater tax progressivity because the equity gain from redistribution should increasingly outweigh efficiency losses as income distribution becomes more polarized.

There are three ways in which a progressive personal income tax system may influence behavior more markedly in a developing economy than in a developed one. First, high personal income tax rates seem more likely to influence the choice between formal and informal employment arrangements.[118] In many developing countries, it is not unusual for informal workers to comprise between 40 and 60 percent of the labor force.[119] As noted earlier, taxes on labor income may lead many employers and employees to negotiate informal arrangements to reduce tax liability.[120]

Second, high individual income tax rates may also influence the decision to operate in the formal or informal economy. The greater the

116. *See* Stanley L. Engerman & Kenneth L. Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 3 ECONOMIA 41 (2002). Doreen Warriner once said, despairingly, that Latin Americans did not seem to know what good farming means—probably because they had never seen any. DOREEN WARRINER, LAND REFORM IN PRINCIPLE AND PRACTICE 219 (1969).

117. *See generally* Karoly, *supra* note 2; Joel Slemrod, *Optimal Taxation and Optimal Tax Systems*, 4 J. ECON. PERSP. 157 (1990).

118. The discussion in this section relies heavily on Sokoloff & Zolt, *supra* note 108.

119. SCHNEIDER & ENSTE, THE SHADOW ECONOMY, *supra* note 67, at 44–51 tbl.5.1.

120. *See* discussion *supra* Part II.A.2.

benefits from operating in the formal economy, the more likely firms are to choose to operate there. The lower the benefits of being in the formal sector, and the higher the costs through taxes and regulations, the more likely firms are to operate in the informal sector. Currently, the activity in the informal economy in developing countries is in the order of 40 percent of GDP, well over twice the level in most developed countries.[121]

Third, high personal income tax rates may influence decisions of where to locate capital investment. Reductions in capital controls and improvements in financial technology have made it easier than ever before for individuals and firms to invest funds outside their home countries. Changes in tax laws, particularly the change in U.S. tax law providing for no U.S. taxation of portfolio interest earned by nonresidents, have also made it more attractive for the wealthy in developing countries to invest in U.S. government and corporate securities.[122]

In the United States, only about 40–45 percent of the income of the wealthiest individuals comes from wage income, compared to over 75 percent of income for taxpayers as a whole.[123] High-income individuals also have greater flexibility in structuring their form of wage income to minimize taxes. Comparable data are not readily available for developing countries, but, subject to the importance of informal (and untaxed) labor earnings at lower income ranges, the dominance of nonwage income at the top of the income distribution is likely to be even more marked in developing countries. Given the apparently growing ability of high-income individuals in some countries to hide capital abroad (in untaxed U.S. deposits or other fiscal havens, for example), it has become increasingly difficult to have an effective progressive tax system in developing countries without subjecting income from these investments to some level of taxation and, as all countries know, doing so is far from easy.

An aspect of income inequality that has been little explored is its possible relation to the quality of tax administration. A recent U.S. study

121. *See id*. Recall, however, that significant limitations exist in using the relationship of the size of the informal economy to GDP as a major factor in tax policy decisions. *See supra* note 66.

122. For example, estimates of investments by Latin Americans in U.S. and other non–Latin American securities are staggering. U.S. Treasury estimates of investments in U.S. and foreign securities by residents of developing countries through U.S. financial intermediaries show a dramatic increase over the last twenty years. Department of the Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System, Report on Foreign Portfolio Holdings of U.S. Securities (June 2005) and data provided in the Treasury International Capital reporting system, *at* http://www.ustreas.gov/tic.

123. Joel Slemrod, *On the High-Income Laffer Curve*, *in* TAX PROGRESSIVITY AND INCOME INEQUALITY 177, 181 tbl.2 (Joel Slemrod ed., 1994).

argues that inequality and tax evasion are positively related for at least two reasons.[124] First, because an increasing fraction of higher incomes normally accrues in forms that are less observable than wages, there is more opportunity for the rich to evade and remain undetected. "Richer means harder to tax,"[125] both because it is difficult to tax capital income effectively and because those who receive high labor incomes can often control the timing and form of their compensation.[126] Second, because the rich normally perceive a growing gap between what they pay in taxes and what they get in benefits from the public sector, the opportunity cost of compliance also rises with income.[127] Such problems are even greater in developing countries than they are in developed ones.

The tax level in any country depends not simply on the ability of its tax administration to collect taxes from the available tax handles but on a much wider array of considerations. If, for example, potential taxpayers perceive that their preferences are properly represented in political institutions and consider government to be helpful rather than wasteful, they may be more willing to vote for higher levels of taxation and to comply with their tax obligations. Both supply factors (tax handles) and demand factors (such as societal institutions like governance and corruption, and framing institutions such as the size of the shadow economy, inequalities in the distribution of income, and tax morale) affect the level of taxation and hence the size of the public sector. Preliminary examination of how this calculation works out in countries around the world suggests that it will not be easy to increase the role of taxation substantially in most developing countries.[128]

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124. *See* Bloomquist, *supra* note 109, at 19.

125. This is the title of an article on the United States by Henry Aaron, *Richer Means Harder to Tax*, *in* TAX POLICY IN THE TWENTY-FIRST CENTURY 232 (Herbert Stein ed., 1988).

126. *See id*. at 240–45.

127. Preliminary results by Torgler and Uslaner suggest that the association noted by Bloomquist between inequality and noncompliance in U.S. data is consistent with the robust negative correlation found in cross-country data between inequality and tax "morale"—defined as the intrinsic motivation by citizens to pay taxes, which, it has been argued, depends on their attitude toward the state. E-mail from Benno Torgler to Richard M. Bird & Eric M. Zolt (July 12, 2004) (on file with authors); *see also* BRUNO S. FREY, NOT JUST FOR THE MONEY: AN ECONOMIC THEORY OF PERSONAL MOTIVATION (1997).

128. *See* RICHARD M. BIRD ET AL., SOCIETAL INSTITUTIONS AND TAX EFFORT IN DEVELOPING COUNTRIES 6–18 (Joseph L. Rotman Sch. of Mgmt., Univ. of Toronto, Int'l Tax Program Paper No. 04011, 2004). Latin America stands out as a region in which the combination of the dominant policy *ideas* (about equity and fairness, efficiency, and growth) and the dominant economic and social *interests* (capital, labor, regional, ethnic, rich, poor) combine with the key political and economic *institutions* (democracy, decentralization, budgetary; and free trade,

## III. IMPLICATIONS FOR DEVELOPING COUNTRIES

Where does all this take us? For many developing countries, the personal income tax has few, if any, progressive elements. Even where some progressivity exists, it often exists only for certain types of income (such as labor income subject to withholding regimes) and for certain ranges of income within the limited group of the population subject to income taxation.

It may be that many developing countries will eventually catch up with developed countries in taxing income more comprehensively. Improvements in tax administration will broaden the income tax base. Economic development, particularly the increase in the number of medium and large enterprises, and the shift from subsistence agriculture to a formal service and manufacturing sector, will make it easier to tax income other than the wages of employees in the formal sector. But this has been a common refrain for the past fifty years, and it still has not happened in most developing countries.[129]

In at least some developing countries, the attempt to implement a progressive, comprehensive global income tax was probably not the best strategy in the first place. Substantial enforcement, compliance, and efficiency costs arise from progressive income taxes—and it may be that such costs are greater when the level of inequality is higher. When, as in many developing countries, progressive income tax systems are accompanied by high levels of tax evasion and (often well-justified) low levels of satisfaction with governments' use of tax revenues, the net distributional benefits are unlikely to be great. Such countries thus have the worst of both worlds—the costs of a progressive income tax system with few, if any, of the benefits.

If the conventional prescription of a comprehensive personal income tax to achieve redistribution has not been effective, what are the alternatives? In this part, we examine some of the fiscal choices for distributive policy facing developing countries. Our basic point is simply that the question of the progressivity and indeed the role of the personal income tax is not the keystone of distributive policy. It is just one—and

protectionism, macroeconomic policy, market structure)—to produce a generally low tax level and an uneven tax structure. *See id.* at 18–39.

129. *See supra* Part II.C.1, Figure 5, illustrating the lack of progress in developing countries on improving revenues from personal income taxes over the last thirty years.

not at all the most important—element of redistributive policy for countries concerned with poverty in particular and inequality more generally.[130]

We begin by examining some factors that influence the choice of alternatives, particularly the economic, administrative, and political costs of taxes. Against this background, we then consider the choice between spending and taxation as the core of redistributive policy, arguing that good spending policy matters much more than good tax policy.

## A. Costs of Taxation

Many factors affect the choice of tax policies. One is the costs and benefits of alternative tax and expenditure packages in a particular country. Another is political: What is the appetite for change, and what is the willingness to devote resources to reducing poverty or inequality? Such factors may vary greatly among developing countries, so, not surprisingly, no one policy prescription fits all. In this part we examine the costs that may result from taxes and, in particular, from a progressive income tax system. Taxes impose real costs, and poor countries especially need to minimize such deadweight losses, which reduce the resources available to achieve socially desired objectives.

### 1. Administrative Costs

Taxes cost something to collect. All taxes impose costs on governments, taxpayers, and often third parties. History suggests that governments that collect taxes at low administrative costs prosper, and those with high administrative costs struggle.[131] At present, developed countries devote, on average, roughly 1 percent of tax revenues to cover the budgetary costs of tax collection. The costs of tax administration are generally higher in developing countries.[132] In most developing countries, income taxes are much more costly to collect than taxes on consumption.

130. Of course, as discussed in Part I, governments in developing countries have at best a limited ability to affect income distribution through fiscal policy.

131. See 1 LINDERT, *supra* note 115, at 302–05, on the victory of the British over the French. *See also* NIALL FERGUSON, THE CASH NEXUS: MONEY AND POWER IN THE MODERN WORLD, 1700–2000 (2001).

132. A recent study in Guatemala, for example, estimated tax collection costs at 2.5 percent of collections. *See* ARTHUR J. MANN, ESTIMATING THE ADMINISTRATIVE COSTS OF TAXATION: A METHODOLOGY WITH APPLICATION TO THE CASE OF GUATEMALA 4 (2002), *available at* http://devtechsys.com/CASE024.pdf. See also GALLAGHER, *supra* note 54, at 9, for a summary of a number of such studies.

It is also likely that the marginal return in revenue terms from investing administrative resources in consumption tax systems (customs, excises, and VAT) is substantially greater than investments in improving collection of personal income taxes, particularly the nonwage withholding portion.

2. Compliance Costs

In addition to imposing costs of enforcement and collection, tax regimes impose compliance costs on taxpayers, over and above the costs of actually paying taxes.[133] Compliance costs are incurred by people who have reporting or withholding obligations—for example, employers withholding income taxes from employees and banks that collect and remit taxes to the government. Costs include the financial and time costs of complying with the tax law, such as acquiring the knowledge and information needed to do so, setting up required accounting systems, obtaining and transmitting the required data, paying professional advisors, and so on. Attempts to measure such costs are still in their infancy, but studies in developed countries find that, on average, compliance costs in these countries are perhaps two to six times larger than the direct administrative costs incurred by governments.[134] One study, which focused on India, suggests that compliance costs may be considerably higher in developing than in developed countries.[135] Compliance costs are generally regressively distributed, and are typically

133. Tax administration and tax compliance may interact in many ways. Often, administration costs are reduced when compliance costs are increased; for example, requiring taxpayers to provide more information increases compliance costs but makes tax administration easier and less costly. However, there need not always be a tradeoff between administration and compliance costs. Compliance costs may increase along with administration costs when, for instance, a more sophisticated tax administration requires more information from taxpayers or undertakes more audits.

134. *See* Chris Evans, *Studying the Studies: An Overview of Recent Research Into Taxation Operating Costs*, 1 EJOURNAL OF TAX RES. 64 (2003), *at* http://www.atax.unsw.edu.au/ejtr/content/previous_issues.htm.

135. *See* SAUMEN CHATTOPADHYAY & ARINDAM DAS-GUPTA, THE COMPLIANCE COST OF THE PERSONAL INCOME TAX AND ITS DETERMINANTS (2002). The authors estimated compliance cost in India for wage income as a percentage of collections to be up to ten times higher than in developed countries. *See id.* at v–vi. They characterize their findings as "preliminary and subject to error," because of sampling issues. *Id.* at v. Notwithstanding this caveat, the study provides highly credible evidence of serious problems with India's income tax. These results do not mean that compliance costs are always likely to be so high for the personal income tax in developing countries. But they do suggest that a tax like India's income tax is an inappropriate model for other developing countries to follow. As reported in the study, India's personal income tax is exceptionally complex, is shot full of exemptions and concessions, has a highly progressive nominal rate schedule, and is administered in an apparently capricious and dishonest fashion. *See id.* at 66–70. In brief, the tax is badly designed for the circumstances in which it must operate and cries out for major reform.

much higher for taxes collected from smaller firms. Moreover, like administrative costs, compliance costs vary with different types of income, and those associated with nonwage income can be especially high.[136]

3. Efficiency Costs

Almost all taxes have the potential to alter decisions made by businesses and individuals.[137] The resulting changes in behavior likely reduce the efficiency with which resources are used and potentially lower the output and well-being of a country as a whole. No matter how well governments use the resources transferred through taxation, it is necessary to limit the negative consequences of such changes in behavior as much as possible.

Taxes on wages influence decisions regarding where and how much to work. The higher the tax rate on wages in the formal sector, the more attractive it is to enter the untaxed informal sector. Consumption taxes may also discourage work, because they increase the amount of time that one must work to pay for goods and services through the marketplace. Of course, taxes not only alter relative prices—in this case, the net wage—but also income. Because people who work will have less net income after a wage tax is imposed, they may choose to work more to offset the income loss. In many cases, they may have to work more simply to keep themselves and their families alive. The net effect on work of any tax change reflects both this income effect and the effect of the change in relative prices (the substitution effect). Voluminous studies of the impact of taxes on work exist for many countries, with results varying by country, depending on the tax structure and the nature of the economy.[138]

136. The same study showed that the costs associated with nonwage income were actually higher than the tax revenue collected. *Id.* at v–vi.

137. There are a few exceptions such as certain lump sum taxes for which the tax burden is the same regardless of any behavioral responses by taxpayers. More importantly in practice, to the extent that taxes fall on economic rents—payments to factors above those needed to induce participation in the activity concerned—they too may not affect economic activity. Well-designed taxes on natural resources and land, for example, may thus to some extent produce revenue without economic distortion. Finally, in certain instances, taxes—again, if properly designed—may not create distortions in economic behavior but may even induce desirable behavior. Certain environmental levies and benefit levies (even crude proxies such as taxes on fuel) may to some extent have such effects. Such instances of good taxes—those with no bad economic effects—should of course be exploited as fully as possible. In the end, however, most of the taxes needed to finance government will have to come from other sources and hence will give rise to the efficiency costs discussed in the text.

138. For one such recent study of Colombia, for example, see Alm & López-Castaño, *supra* note 44.

The important point in the present context is that, regardless of the income effect, the substitution effect of taxation leads people to alter their work decisions. If those decisions would have been economically efficient without the tax, imposing taxes reduces the country's potential output. Such substitution effects are the source of efficiency losses from taxation. They may be counterbalanced to greater or lesser degrees by nonfiscal factors, or by putting the tax revenues to good use, but the efficiency losses nonetheless exist. An important concern in designing a good tax system is thus to minimize the efficiency costs of taxation to the extent consistent with other policy objectives.

Taxes have other effects on resource decisions. Consumption taxes such as the VAT may discourage, for example, the consumption of taxed goods and services as opposed to untaxed items (such as housing in some countries). Taxes on gasoline, alcohol, and cigarettes can reduce the consumption of these items.[139] Income taxes, because they tax the return to savings, may alter the amount of savings or the form in which savings are held. For example, failure to tax capital gains until they are realized (sold or otherwise disposed) encourages the holding of assets. Taxes may also affect investment, and such effects may be especially important when economies are more open to trade and investment.[140]

Exactly how important such tax effects are is a matter of considerable debate among analysts even in developed countries.[141] But the consensus is

139. Of course, not all such effects need be bad: If tobacco consumption falls, for instance, people may live longer, healthier, and more productive lives.

140. Firms may choose to locate their activities in any of a number of countries for many reasons—the relative costs of production, access to markets, and so on—but taxes, too, may affect their choice of location. To the extent that taxes lower the after-tax return on investments in a country or a region, the level of investment and hence growth may be lower than it would otherwise be. Corporate income taxes may also affect how corporations structure their finances. For example, retained earnings are encouraged when interest on debt capital is deductible and dividends paid from equity capital are not.

141. For a recent survey of the effects of taxes on saving, for example, see B. Douglas Bernheim, *Taxation and Saving*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1173 (Alan J. Auerbach & Martin Feldstein eds., 2002). A consideration of importance in many developing countries is that to the extent that higher marginal rates impinge on economic rents, they give rise to no distortionary effects. In countries where wealth and income may reflect whom you know as much or more than what you do, so that high incomes arise to a significant extent through government policies (for example, awarding monopolies or imposing trade taxes or quotas that allow for excess profits for local producers), this point should not be forgotten and suggests that higher rates on higher incomes may not have such bad effects after all. On the other hand, to the extent that such higher incomes reflect effort, then, as the optimal tax literature shows, increasing marginal tax rates at the top of the rate schedule has greater efficiency costs than increasing rates on the middle class. This is true both because the higher the tax rate the greater the distortion, and because increasing rates in the middle of the rate schedule operates as a lump sum tax (and hence as an incentive and not a deterrent) with respect to those higher up the rate schedule.

that the effects are much more important than they were thought to be thirty or forty years ago. The efficiency costs of taxation are probably a high multiple of the administrative and compliance costs mentioned above. The lowest estimates for developed countries are perhaps 20–30 percent of revenues collected, and much higher figures are not uncommon in the literature.[142] To the extent that such costs are an inevitable consequence of rational policy decisions (for example, to redistribute income through the fiscal system), they may be considered acceptable. Still, it is critical to design taxes to minimize such possible adverse consequences in poor countries. This point is worth emphasizing because such effects mentioned above are real, but not directly visible. The efficiency cost of taxation arises because something does not happen; an activity does not occur or occurs in some other form. Output that is not produced, however, is still output (and potential welfare) lost.

Progressive tax systems may increase equity, but they inevitably impose efficiency costs.[143] Collecting a given amount of revenue via a structure with higher marginal tax rates imposes higher costs than an equal-yield proportional tax. The general rule is that the distortionary effect of taxes increases in proportion to the square of the tax rate, so that doubling the rate of a tax implies a fourfold increase in its efficiency costs. From an efficiency perspective, it is thus always better to raise revenue by imposing a single rate on a broad base rather than dividing that base into segments and imposing differential rates on each segment. In practice, of course, this consideration needs to be balanced against the equity argument for imposing graduated rate schedules.

### 4. Political Costs

Finally, it is costly for governments to enact laws that are not or cannot be effectively enforced. The costs are likely as great with tax laws as in any other area of government regulation. To the extent that tax laws rely on voluntary compliance, respect for the tax system is a key factor in establishing an environment in which paying taxes is an accepted obligation. Behavioral economists have long noted that perception of

142. *See* Charles L. Ballard & Don Fullerton, *Distortionary Taxes and the Provision of Public Goods*, 6 J. ECON. PERSP. 117 (1992).

143. While such costs may be necessary to achieve distributional objectives, their political invisibility may cause them to be consistently underestimated. *See* Louis Kaplow, *On the (Ir)Relevance of Distribution and Labor Supply Distortion to Government Policy*, 18 J. ECON. PERSP. 159 (2004).

fairness plays a large role in tax evasion behavior.[144] Recent studies of tax morale suggest that a sustainable tax system rests on widely held perceptions of both a fair tax system and a government that effectively and responsively provides goods and services. Measures of tax morale and the shadow economy also tend to be highly correlated. Indeed, some studies suggest that low tax morale might be responsible for the rise of the shadow economy.[145]

Inequality in the distribution of wealth and income is also closely related to public perception of to how well the fiscal system addresses social objectives with respect to fairness, social justice, and redistribution. If a perceived unfair distribution of tax burdens is thought to be one cause of income inequality, the result may be to lower the level of trust in institutions and to increase tax avoidance and evasion. Latin American countries, in which incomes are more unequally distributed than elsewhere, clearly do less well in this respect than other countries at equal levels of development. Highly unequal distributions of income may also lead to low levels of solidarity. The prevailing low levels of taxation are often interpreted as the result of the unwillingness of the richest to pay taxes to provide public services for the masses because the elite can generally provide their own public services privately, ranging from public safety to education and even to roads. Tax levels appear to depend significantly on widespread perceptions that government institutions are honest and responsive and that there is a fair and predictable public sector environment for all.[146]

## B. The Importance of Spending Well

After reviewing the past fifty years of fiscal futility in achieving distributional goals through income tax progressivity, many development specialists have argued that developing countries concerned with equity and growth are better off to collect as much revenue as they can through as nondistorting a tax system as possible and then seek to reduce inequality or

144. *See, e.g.*, F. A. Cowell, *Tax Evasion and Inequity*, 13 J. ECON. PSYCHOL. 521 (1992); Josef Falkinger, *Tax Evasion, Consumption of Public Goods and Fairness*, 16 J. ECON. PSYCHOL. 63 (1995); Michael W. Spicer & Lee A. Becker, *Fiscal Inequity and Tax Evasion: An Experimental Approach*, 33 NAT'L TAX J. 171 (1980).

145. *See, e.g.*, JAMES ALM & BENNO TORGLER, CULTURE DIFFERENCES AND TAX MORALE IN THE UNITED STATES AND EUROPE 14–17 (Andrew Young School of Policy Studies, Georgia State Univ., Working Paper, 2004), *available at* http://aysps.gsu.edu/Publications/2004/040501taxmorale.htm.

146. BIRD ET AL., *supra* note 128, at 29.

poverty through expenditure policy. Given the tax mix dominant in most developing countries, this approach in part calls for devoting resources to improve compliance under consumption taxes rather than trying to improve the coverage and compliance for the personal income tax. More importantly, it also calls for good spending.

Just as the end of production is consumption, so the end of taxation is expenditures. Governments whose constituents think are effective in providing goods and services are more likely to enjoy public acceptance of the need for taxation than are governments in countries where people believe nothing good comes from government. When the public believes much government expenditure is at best misguided and at worst almost a complete waste from both a distributive and a developmental perspective, support for taxation is likely to be minimal. Almost every country could use expenditure reform to accompany, support, and perhaps replace tax reform.

Political scientists sometimes define the key functions of government to be delivering services and managing conflict. No government can stay in power unless it can muster sufficient support. Some may support the government because they agree with its intentions; others do so because they dislike its opponents even more. The evidence in all countries, however, is that some critically needed support usually comes from groups to whom, so to speak, government delivers the goods. This often occurs in terms of public expenditures that favor their interests—whether it be subsidies to urban workers, irrigation projects in a particular region, or subsidizing inefficient but employment-generating public enterprises. Of course, because in many developing countries the poor have little if any direct influence in the budgetary process, their interests may not receive very high priority in expenditure policy. Increased tax revenues are thus unlikely to result automatically in increased redistributive expenditures. On the contrary, the politically powerful groups will likely gain at the expense of the poor.

It is far from clear that increased taxes will lead to increased spending on, for example, education for the poor. If more education for the poor is a policy goal, more taxes may produce this result. However, the increased spending could also mainly provide more and better-paid jobs for teachers and those who staff the educational bureaucracy, without any increase in the availability or quality of education for low-income groups. It is more important in many developing countries to spend more wisely than to spend more. The existing structure of expenditure in any country in many ways

reflects its economic and political structure. Drastic changes in expenditure patterns cannot be expected in the absence of similarly drastic changes in these underlying factors, changes often driven by exogenous events that alter the relevant political costs at the margin of spending in one way or another.[147] It may therefore seem quixotic to call for a serious attempt to reform public expenditures in developing countries to get more distributional and developmental impact for each tax dollar.

Such a conclusion is too pessimistic. Several countries have succeeded in reforming their expenditure programs.[148] Such changes may, over time, not only produce results that help both distribution and development but also reduce the need for more taxes to accomplish desired policy ends. And perhaps, if the expenditure programs are perceived as successful (for example, by increasing accountability to citizens as to how the money is spent), they may perhaps lessen resistance to necessary tax increases.

All countries can improve the effectiveness of expenditure programs.[149] If the goal is to reduce poverty in developing countries, for example, programs need to be structured and implemented so as to maximize their impact on the poor. Countries face difficult choices in allocating funds to different types of education, health, and infrastructure programs. They may decide to give priority to primary education or university education, to regional clinics or world-class hospitals, to market roads or superhighways. Such choices influence how the benefits of such spending programs are distributed within the population.

It is difficult in any country to get political support for social expenditure programs if there is little overlap between those who pay taxes to fund the programs and those who receive the benefits of the programs. Arnold Harberger has nicely framed this challenge facing developing

147. *See* WALTER HETTICH & STANLEY L. WINER, DEMOCRATIC CHOICE AND TAXATION (1999).

148. A particularly striking recent example that demonstrates if the will is really there, the way can often be found, comes from the state of Madhya Pradesh in India, the state government succeeded in only a few years in establishing 31,000 new schools and enrolling two million additional children, many from the poorest groups in society, while at the same time reportedly reducing the unit cost and improving the quality of the education provided. *See* William McCarten & Vinod Vyasulu, *Democratic Decentralisation and Poverty Reduction in Madhya Pradesh: Searching for an Institutional Equilibrium*, 14 DEV. IN PRAC. 733, 736 (2004).

149. In many developing countries, the evidence to date with respect to the effects of government social spending programs on poverty alleviation is much less encouraging than the case mentioned in the preceding note. *See, e.g.*, Florencia Castro-Leal et al., *Public Social Spending in Africa: Do the Poor Benefit?*, *in* 14 WORLD BANK RES. OBSERVER 49 (1999), *available at* http://www.worldbank.org/research/journals/wbro/obsfeb99/pdf/article3/pdf; Peter Lanjouw & Martin Ravallion, *Benefit Incidence, Public Spending Reforms, and the Timing of Program Capture*, 13 WORLD BANK ECON. REV. 257 (1999).

countries.[150] In designing education and health programs, for example, governments need to choose between limiting the programs to the poor or providing the programs on a large scale. If policymakers choose to extend benefits to the middle class, then the costs may become too high to provide quality services. If policymakers choose to limit services to the poor, then it is often difficult to get political support for the programs. Governments must thus sometimes choose between too little for too many (at the cost of a larger government, higher taxes, and distortionary costs), and even less for fewer.

Whichever path is chosen, it is still necessary to collect taxes as efficiently and effectively as possible. Any country seriously interested in redistribution, even if only in terms of "leveling up" rather than "leveling down," must pay close attention to tax system design and implementation. Expenditure policy is more important in reducing inequality from the bottom up, but tax policy also has an important role to play.[151]

## IV. MODEST PROPOSALS FOR INCREASING PROGRESSIVITY

In this part, we examine some approaches that may improve the progressivity of fiscal systems in developing countries. We begin by reviewing decentralization and benefit taxation as a means of improving the link between taxation and spending. We focus on the significant advantages of the "benefit approach," broadly conceived, as a partial solution to the serious financing problems facing developing countries. We speculate on why this approach mostly has been neglected. Turning then to the design of the tax system, we first examine the need to address the distributive aspect of designing and implementing consumption taxes in developing countries. Finally, we review the limited role of the personal income tax in developing countries, arguing both that the rate structure should not be excessively progressive and that, more importantly, developing countries may do well to abandon the form and pretense of comprehensive income taxation and return to some form of explicit schedular taxation. We conclude by reviewing the emerging experience with dual income taxes, and we note its implications for income taxes in developing countries.

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150. *See* Arnold C. Harberger, Reflections on Distributional Considerations and the Public Finances 12 (unpublished paper prepared for the World Bank Course on Practical Issues of Tax Policy in Developing Countries) (2003), *available at* http://isp-aysps.gsu.edu/academics/conferences/conf2004/Harberger.pdf.

151. We discuss this perspective further in Part IV.B *infra*.

## A. Linking Spending and Taxes

Tax policy depends on the way in which different political groups perceive fiscal change and how they react to that perception. Tax reform is thus always "an exercise in political legitimation."[152] Those who will have to pay more must be convinced that they will get something worthwhile for their money. But even those who will not have to pay more must support reform if it is to succeed.

### 1. Decentralization

One important way to establish the political linkage between expenditures and revenues needed for sustainability may be decentralization. Decentralization is not a panacea: Indeed, it sometimes may create new problems (or at least make existing problems more obvious), and, if inappropriately implemented, it may sometimes make matters worse for the poor if they lack a local political voice. Decentralization also has many virtues, such as allowing people to take more control over their own lives, better satisfying local preferences, and often lowering the costs of service provision. Careful and continuous efforts both to involve locals in the process and make them face the opportunity costs of their decisions are essential to success, but achievements along these lines are unlikely to come quickly or easily. Effective decentralization policy is not easy to design, and it is even harder to implement. It can be done, though, and it is worth doing.[153]

Experience in a variety of settings suggests that two conditions are particularly important for successful decentralization.[154] First, local decisions must be democratic in the sense that the costs and benefits of

152. LLEDO ET AL., *supra* note 91.

153. Two examples may make the point. First, in the Madhya Pradesh case mentioned *supra* note 148, at 735–37, it seems that one key to success was the devolution of the responsibility both for recruiting and paying teachers to the local level, thus reducing the scope for corruption and strengthening local monitoring of teacher performance and the relationship between teachers and the communities they serve. Second, a recent study of Colombia's experience with decentralizing education found that with a decentralized system, there was some possibility of more positive outcomes—more creative and productive innovations—occurring at least in some areas, and perhaps also the further possibility of generating a demonstration effect that may, over time, lead to the multiplication of such experiences. ALAN ANGELL ET AL., DECENTRALIZING DEVELOPMENT: THE POLITICAL ECONOMY OF INSTITUTIONAL CHANGE IN COLOMBIA AND CHILE 161–89 (2001). If the center cannot or will not lead, at least its ability to block the development of more effective educational systems from below may perhaps be reduced. *Id.*

154. For further discussion of this point, see JENNIE LITVACK ET AL., RETHINKING DECENTRALIZATION IN DEVELOPING COUNTRIES (1998).

decisions are transparent and that those affected have an opportunity to influence the decisions. Second, the costs of local decisions must be borne fully by those who make the decisions. That is, there should be no significant tax exporting (shifting the tax burden to those outside the jurisdiction) and no funding at the margin from transfers from other levels of government. When local governments face a hard budget constraint, and those who make the decisions both receive most of the benefits and pay most of the costs, a strong linkage exists between local expenditures and local revenues. Local governments, depending on their political institutions, are then able to make decisions as to the type and nature of taxes for which they will be accountable to local residents.[155]

Accountability is a complex concept with many dimensions. Political accountability requires political leaders at all levels to be responsive and responsible to their constituents. It also requires constituents to be fully informed about the consequences of their (and their representatives') decisions. Administrative accountability requires a clear legal framework for who is responsible for what, what financial reports are to be made in what form, to whom, and when, and so on. And finally, as just emphasized, economic accountability requires that local residents be responsible for paying for local services, which in turn requires that local authorities be able to set at least some tax rates. Although few developing countries currently allow much local fiscal autonomy, there seems to be some trend in this direction. The redistributive welfare state in developed countries was, by and large, the creation of powerful central governments financed by revenues flowing (largely through the vehicle of a progressive personal income tax) from postwar expansion and driven by the desire to avoid economic crises similar to those experienced in the 1930s. Many developing countries originally set out to emulate this model. In the very different current circumstances, however, developing countries may be more successful in redistribution arising from locally driven decisions that respond to locally perceived needs rather than by accepting the largesse of hard-pressed central government budgets. As yet, however, the evidence is inconclusive as to the relative success of these two different models.[156]

155. As the Madhya Pradesh case suggests, the rule stated in the text is by no means definitive. McCarten & Vyasulu, *supra* note 148, at 735–37. There, local governments administered state funds more effectively than the state, without the requirement of any local revenue. *Id*. On the whole, however, experience suggests that people are more likely to be careful in spending their own money than they are other people's money.

156. But see the pro-decentralization evidence, *supra* note 153, and the assertion, unsupported, but redolent of much field experience, *supra* note 155.

2. Benefit Taxation

The benefit approach to taxation also merits more consideration than it usually receives in developing countries.[157] In equity terms, the benefit principle mirrors the commercial principle that it is fair to pay for what you get. When a consumer buys a loaf of bread, she receives the loaf and the baker the money. Similarly, when a citizen receives a direct and measurable benefit from a government activity, it seems only fair that she pays for what she receives. The benefit could be in the form of services, such as education and health programs, or in the form of infrastructure improvements, such as irrigation projects or airports. The case for the benefit approach is even stronger on efficiency grounds. If each taxpayer pays an amount just equal to his evaluation of the marginal benefits received for each public service consumed, then the total taxes collected from all individuals provide a measure of the worth of the public services. Given this information, governments can then provide services to the point at which the marginal evaluation of the service by individuals, as measured by what they are willing to pay for it, just equals the marginal cost of providing the service. Individuals will pay a marginal tax for collective goods and services equal to the marginal benefits they receive, and the government will provide just enough of each good or service to make the total incremental benefits (and taxes) equal to the marginal cost of supplying the service. This ideal benefit tax system determines both the level and structure of public expenditure and the level and distribution of taxation.

There are important limitations in applying the benefit principle to certain types of government services, though. First, benefit taxation is unsuitable as a means of financing government activity for public goods, or those services that by their very nature cannot be sold to individuals. Once such services are made available to one individual, they are automatically available to all. Second, it makes little sense to subject to benefit taxation services that are part of the redistributive activities of government. In developing countries, however, a surprisingly large share of government activity consists of providing what are essentially private goods (such as education) to readily identifiable persons.[158] Further, in most developing

157. Portions of the following argument draw heavily on RICHARD M. BIRD, TAX POLICY AND ECONOMIC DEVELOPMENT (1992).

158. *See, e.g.*, ALAN A. TAIT & PETER S. HELLER, INTERNATIONAL COMPARISONS OF GOVERNMENT EXPENDITURE 2, 28–29, 30–31 (Int'l Monetary Fund, Occasional Paper No. 10,

countries, only a few explicitly redistributive expenditure policies exist, and even those are often in effective.

The principal barrier to effective use of benefit taxation in most developing countries, however, lies in public attitudes rather than inherent limitations. The relative neglect of the benefit tax approach in developing countries may simply be that the virtues of the competing ability-to-pay approach to taxation seem so obvious in the context of countries with extreme inequality. This is one reason that a progressive income tax structure has seemed to many to be the best tax approach in such countries. In practice though, as we discussed earlier, the progressive taxes that have been applied have proved arbitrary and not particularly progressive in their impact. This outcome is not surprising because redistribution can be achieved through taxation only by taking from those who have income and wealth—and the rich generally have, among other things, the power to block the effective implementation of such policies.

In this context, a benefit tax approach may have more merit than previously thought, especially in developing countries where many free and subsidized public services go in large measure to the nonpoor.[159] Many developing countries have, over the years, either on their own initiative or following well-meaning foreign advice, adopted some common postwar expenditure policies of developed countries without the benefit of the tax base available in those countries. These countries now face difficult choices as to which programs to continue to subsidize.

The principal beneficiaries of such policies may be those who can most afford to pay. This occurs in part because of the choice of the services provided, such as heart transplants instead of primary health care. Probably more important, however, is the demonstrated importance of access to public services as the key to who benefits.[160] There will always be high demand for free public services. If budget limitations restrict the expansion of such services, and the rich have greater access than the poor, the

1982). More recent data available in the Government Finance Statistics series published by the International Monetary Fund provide no reason to alter this conclusion.

159. *See, e.g.*, David E. Sahn & Stephen D. Younger, *Expenditure Incidence in Africa: Microeconomic Evidence*, 21 FISCAL STUD. 329 (2000) (finding that (1) social expenditure in eight sub-Saharan African countries is poorly targeted, (2) expenditures on primary education and primary health care are the most progressively distributed; and (3) expenditures on postsecondary education are the most regressively distributed). Similar results may be found in many earlier studies. *See, e.g.*, MARCELO SELOWSKY, WHO BENEFITS FROM GOVERNMENT EXPENDITURE?: A CASE STUDY OF COLOMBIA 3–36 (1979).

160. *See, e.g.*, JACOB MEERMAN, WORLD BANK PUBLIC EXPENDITURE IN MALAYSIA: WHO BENEFITS AND WHY (1979).

redistributive results of providing free public services are regressive, not progressive.

Nonetheless, once the public perceives that most public services should be provided free and that charging for such services is regressive, it is difficult to change either the perception or the policy. This is true even if it may be administratively feasible, economically desirable, and distributionally beneficial to charge for some services. For example, consider the provision of free university education in developing countries to those few and relatively affluent students who manage to get through the often grossly underfunded primary and secondary school systems. Such students (and their generally well-connected parents) fight fiercely against any infringement of their entitlement to free (or heavily subsidized) education. Not surprisingly, it is politically unpopular to restructure a tax system in the direction of the benefit principle.[161]

In developing countries, significant potential gains nevertheless exist from introducing more rationality into both taxing and spending through good charging policy and sensible uses of benefit taxes (such as financing roads mainly through taxes on motor vehicles and fuel). A larger benefit element is especially needed with respect to the construction of urban infrastructure and the provision of urban public services that would be better paid directly by the direct beneficiaries: the more affluent inhabitants of larger urban areas. Too often, poor rural peasants bear a substantial part of this cost.[162] Similar things happen in rural areas, of course, with respect to irrigation schemes and the like.[163]

Those concerned with promoting development in a fair and efficient way need to pay more attention to how expenditures are financed. One key to meaningful tax reform may be precisely to link expenditures and revenues more explicitly than usually has been done either in practice or

161. Benefit taxes also suffer from bad press partly because there have often been clear misuses of the principle of linking taxes and expenditures, and partly because of the implicit comparison with some hypothetical benevolent monarch who could determine the optimal size and structure of public sector activities. *See, e.g.*, Richard M. Bird & Thomas Tsiopoulos, *User Charges for Public Services: Potential and Problems*, 45 Canadian Tax. J. 25 (1997). This last objection is misguided. A good case can be made that expenditure programs can be improved by linking the provision of goods and services to a demonstrated willingness to pay for them.

162. *See* MICHAEL LIPTON, WHY POOR PEOPLE STAY POOR: A STUDY OF URBAN BIAS IN ECONOMIC DEVELOPMENT (1976) (stressing that urban expansion is too often financed in many developing countries at the expense of the rural poor).

163. *See, e.g.*, Mona Sur & Dina Umali-Deininger, The Equity Consequences of Public Irrigation Investments: The Case of Surface Irrigation Subsidies in India (presented at the 25th International Conference of Agricultural Economics, Aug. 16–22, 2003), *available at* http://www.iaae-agecon.org/conf/durban_papers/papers/020.pdf.

advocated in the literature. In the end, of course, the distributive effects of benefit financing in any particular context will depend on the details of the particular expenditures and financing methods used.

B. Untax the Poor

If countries wish to lessen the tax burden on the poor, many alternatives exist.[164] In many developing countries, for instance, the personal income tax already provides for high thresholds that remove the poor from the tax rolls. In some developing countries, however, the thresholds are sufficiently low to impose high effective tax rates on relatively low-income people. Even in countries where there is a high threshold under the income tax, low-income individuals are often not provided similar relief under social security taxes.

Consumption taxes are frequently considered to be highly regressive.[165] While taxes on consumption may be less regressive on a lifetime rather than an annual perspective, given the relatively short life expectancies and the level of poverty in many developing countries, such refinements may carry little weight. About thirty years ago, a study found that taxes (mainly taxes on consumption) on average took around 10 percent of the incomes of the urban poor, and a bit less of the incomes of the rural poor in a number of developing countries.[166] There is little reason to think that matters have changed much in recent years, although the outcome in any particular country may differ depending on such factors as the complicated interplay of the distributional effects of different consumption taxes, with some (for example, gasoline taxes) rising with income, some (for example, tobacco taxes) falling with income, and some remaining essentially flat. Because traditional excise taxes are one of the largest sources of revenue in the tax systems of developing countries, the precise incidence attributed to these taxes is an important determinant of the overall impact of the fiscal system on the poor. The incidence of such taxes, however, varies sharply

164. *See generally* ERIC M. ZOLT, ROLE OF TAXES IN POVERTY REDUCTION STRATEGIES (World Bank Inst., 2001).

165. In a recent study in the United Kingdom, for example, while transfers were estimated to reduce the Gini coefficient sharply from 0.53 to 0.38, and direct (income) taxes to reduce it further to 0.35, indirect (consumption) taxes were found to be so regressive that they actually increased the Gini coefficient back to 0.40. *See* Nicholas Stern, *Public Policy for Growth and Poverty Reduction*, 49 CESIFO ECON. STUD. 5, 16 n.4 (2003).

166. Charles E. McLure, Jr., *Taxation and the Urban Poor in Developing Countries*, 5 WORLD DEV. 169, 175–76 (1977).

from country to country, depending on the specifics of local consumption patterns and tax structures.

Policymakers in developing countries need to consider the distributive (and other) effects of excise taxes, most importantly, taxes on tobacco, alcohol, motor fuel, and vehicles. Such taxes produce substantial revenues, especially if one includes VAT and import tariffs that are also imposed on these same products. Taxing such goods raises complex externality issues. Although poverty does not entitle one to an unlimited license to create negative externalities, equity has led some to take a strong position against sumptuary taxes in developing countries.[167] For some, the primary argument for excise taxes on alcoholic beverages and tobacco products is their revenue productivity.[168] However, the failure in most developing countries to maintain the real level of sumptuary taxes in the face of inflation casts doubt on the view that these levies are just a simple way to tax the poor. Those who advocate higher taxes on alcohol on social grounds in developing countries may have a valid point, especially in those circumstances where higher alcohol taxes may not be regressive.[169]

Many policy advisors also have focused on consumption taxes as a way not just of reducing regressivity but also of increasing progressivity. This is often difficult to achieve. While income inequality continues to grow in some countries, the poor today in most countries are economically better off than in previous times. In many developing countries, for instance, items such as cosmetics and electrical goods that were previously considered luxuries are no longer limited to the wealthy but have spread to the growing lower-middle and middle-income groups. While taxes on such items may still be broadly progressive in their impact, there is unlikely to be much gain in imposing differential luxury rates under a general consumption tax like the VAT, given the efficiency and administrative costs to which such differentiation gives rise.[170] Well-designed excise taxes, especially on motor vehicles, fuel, hotel rooms, airline tickets, high-value liquor, and tobacco,

167. *See, e.g.*, Charles E. McLure, Jr., & Wayne R. Thirsk, *The Inequity of Taxing Iniquity: A Plea for Reduced Sumptuary Taxes in Developing Countries*, 26 ECON. DEV. & CULTURAL CHANGE 487 (1978).

168. JOHN F. DUE, INDIRECT TAXATION IN DEVELOPING COUNTRIES 63 (1970).

169. *See* RICHARD M. BIRD & SALLY WALLACE, TAXING ALCOHOL IN AFRICA: REFLECTIONS FROM INTERNATIONAL EXPERIENCE (Joseph L. Rotman Sch. of Mgmt., Univ. of Toronto, Int'l Tax Program Paper No. 0304, 2003), *available at* http://www.rotman.utoronto.ca/iib/ITP0304.pdf.

170. *See, e.g.*, Sijbren Cnossen, *VAT in South Africa: What Kind of Rate Structure?*, 15 INT'L VAT MONITOR 19, 19–24 (2004). The costs of rate differentiation are discussed more analytically in Ali Agha & Jonathan Haughton, *Designing VAT Systems: Some Efficiency Considerations*, 78 REV. ECON. & STAT. 303 (1996).

also have an important distributive (and allocative) role to play in developing countries. Indeed, they may constitute one of the most progressive elements in the tax systems of such countries.[171] Another way to make consumption taxes more progressive is to expand the base to include more services, which tend to be consumed disproportionately by the better-off. Although not usually considered under the heading of consumption taxation, yet another approach would be to implement more effectively taxes on the consumption of wealth held in such forms as luxury homes (notably, the property tax).

There may thus be some substantial differences in consumption patterns between income groups in developing countries that can be differentially taxed through excise and sales taxes. In such countries, one cannot assume that whatever small degree of progressivity may be achieved by, say, a differentiated sales tax rate structure could be attained more easily and fairly through small changes in the income tax. With respect to the poor, who are effectively outside the scope of the income tax in developing countries, this argument is not valid; and with respect to the rich, it makes the equally suspect assumption that the income tax is an effective instrument of redistribution. Nonetheless, on the whole, trying to reach the rich more effectively through luxury taxes is unlikely to achieve much.

On the other hand, in many developing countries, imposing a uniform VAT would increase the price of many goods essential even to the poor. For example, a study in India estimated that such a tax would reduce the expenditures of the poorest rural households by almost 7 percent and those of the poorest urban groups by about 5 percent.[172] Such results suggest strongly that there is a good distributional case for exempting certain basic food products. A study of the Jamaican tax system found that exempting only a few major food items would substantially lower taxes on low-income families and make the VAT slightly progressive.[173] Although the poor may consume a relatively small amount of these basic food products, so that much of the exemptions' benefit goes to the nonpoor, such exemptions nonetheless still may be warranted in developing countries.

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171. For further discussion, see EDMISTON & BIRD, *supra* note 40, at 56–60.

172. Ehtisham Ahmad & Nicholas Stern, *Alternative Sources of Government Revenue: Illustrations From India, 1979–80*, *in* THE THEORY OF TAXATION FOR DEVELOPING COUNTRIES 281, 318 (David Newbery & Nicholas Stern eds., 1987).

173. *See* Richard M. Bird & Barbara Diane Miller, *The Incidence of Indirect Taxation on Low-Income Households in Jamaica*, 37 ECON. DEV. & CULTURAL CHANGE 393 (1989). As EDMISTON & BIRD, *supra* note 40, at 48–55, found, it appears the VAT in Jamaica is still slightly progressive.

To sum up, while taxes on consumption in most developing countries do not appear to be as regressive as often thought,[174] they do impinge on the lives of many poor people in limited, but important, ways. Because an important distributive objective of tax policy is presumably to make the poor less poor, the proper design of consumption taxes is thus an important question in development taxation. Like many such questions, this one is not easy to resolve. The challenges in designing pro-poor consumption taxes arise both because of the complex and subtle distributional effects of such taxes and their detailed structure and administration. Still, policymakers in developing countries concerned with distributive issues can and should pay close attention even to apparently minor features of consumption tax design and implementation, because such details may have more important distributive effects than the income taxes in such countries.

### C. Tax Income More Effectively

Developing countries face different challenges in improving the taxation of income. We start by putting forward our position. Our own preference is to retain personal income tax regimes. While we recognize the limitations of using the personal income tax to redistribute income, we believe such taxes can contribute both by generating revenues and by building a more politically cohesive and stable state.[175]

Although taxes cannot level up distributional inequities, proper fiscal design can avoid increasing inequality. The main direct distributive role of taxes, however, is to level down.[176] Despite the many qualifications we have noted, the income tax, and particularly the personal income tax, is probably

174. *See* GEMMELL & MORRISSEY, *supra* note 38.

175. We do not discuss corporate income taxes in this paper, but we assume that any viable personal income tax that attempts to tax capital income needs to be backed up by a corporate income tax. *See* Richard M. Bird, *Why Tax Corporations?* 56 BULL. FOR INT'L FISCAL DOCUMENTATION 194 (2002).

176. Maureen Cavanaugh goes so far as to say that "taxes are the most important means by which the political system implements its version of distributive justice." Cavanaugh, *supra* note 11, at 417. She argues that, in particular, there is a strong association between political equality and taxes on the wealthy, and that this leveling down role of taxation is a necessary ingredient of any democratic system. *See id*. at 460–81. Both parts of this argument seem true to some extent: Taxes can, in principle, level down at least to some degree, and it may be that some visible effort (if not necessarily much impact) in this direction may be politically essential in a democracy. On these grounds, for example, Webber and Wildavsky label the income tax "a mirror of democracy," in the sense of being a symbol of the strength of egalitarianism and commitment to social justice in a society. WEBBER & WILDAVSKY, *supra* note 82, at 526.

the only significantly progressive element found in most tax systems.[177] Relying on a progressive personal income tax to accomplish any desired redistribution in developing countries may often amount to little more than "dipping deeply . . . with a sieve."[178] However, both the dip (progressive rates) and the sieve (loopholes) may to some extent prove to be necessary ingredients of fiscal equilibrium in a capitalist democracy. A progressive income tax, whatever its defects in practice, may be an important and sometimes critical symbol of concern with the distributive outcomes of the market system. Symbols matter.

If policymakers decide to strengthen the personal income tax, the key question is whether to retain a comprehensive income tax approach, to revert to some updated version of the older presumptive tax approach, or to consider proposals that de-link the taxation of income from labor and capital. We think the last of these alternatives merits serious consideration given the circumstances of many developing countries.

1. Retaining a Comprehensive Income Tax Approach

What would it take for a developing country to have a viable comprehensive personal income tax system? This has been the subject of countless reports that seek to improve the tax systems in developing countries. The usual starting point is to expand the tax base. Depending on the country, this might include taxing interest on government bonds, taxing noncash compensation to employees, taxing residents on portfolio income earned outside the country, taxing capital gains, and eliminating the use of tax holidays.

Countries could also seek to reduce the portion of the economy operating outside the tax system. This approach would require devoting greater administrative resources to taxpayer registration and compliance, devising simplified rules for taxing small businesses, professionals, and agriculture, and increasing the costs of operating in the informal economy while increasing the benefits of operating in the formal economy. Tax authorities could try to increase the number and types of individuals subject to withholding regimes on labor income, for example, by expanding the

177. The possibly progressive incidence and potential redistributive role of taxes on land and other property are not further discussed here, despite the attractiveness of such taxes from both efficiency and equity perspectives, in part because of the small role such taxes play in all countries and in part because of the many complex administrative and other obstacles to making much heavier use of such taxes. *See* BIRD & SLACK, *supra* note 53.

178. SIMONS, *supra* note 9, at 219.

definition of employee for tax purposes beyond the requirements of employment law. Another alternative would be to not allow businesses to deduct payments without either withholding or information reporting. Countries could also examine the possibility of improving and expanding information reporting and withholding regimes to cover nonwage income. In this age of relatively easy cross-border portfolio investment activity, local tax authorities could seek to obtain information from the tax authorities of other countries regarding the investments and the activities of their residents through exchange of information agreements.

All of these approaches have been tried at various times in different places. In some circumstances, they have worked fairly well. In others they have not, and the question is always whether the game is worth the candle. Suppose, for example, that one could realistically estimate the enforcement and compliance costs of a progressive, comprehensive income tax, as well as the behavioral effects of higher effective tax rates on formal employment arrangements, operation in the formal economy, and mobile investment either coming into or leaving the country. The question would then be whether the incremental gain in terms of additional tax revenue and progressivity justifies the political, administrative, and economic costs. Those who have attempted this task for any developing country almost invariably end up recommending something far short of the traditional textbook view of a comprehensive progressive personal income tax as the mainstay of the tax system.[179] The costs and risks of following this strategy are, in most developing countries, simply too high relative to its chance of success, whether considered in revenue, growth, or distributive terms. While countries that want to do more along these lines can generally do so, the recommended path is usually to lower (not raise) marginal rates, coupled with broader bases with respect to income from labor (informal sector, fringe benefits) and capital (tax incentives, interest, perhaps real estate gains), heavier reliance on withholding (for example, by banks) and third-party information, and, especially, better tax administration (using taxpayer identification numbers, outsourcing routine data processing, adopting case-tracking systems, and improving and expanding audit systems). In the end, in many developing countries, it is questionable that the additional revenue and other benefits of moving toward a

179. A good recent example is ROY BAHL & SALLY WALLACE, COMPREHENSIVE TAX REFORM: FINAL REPORT (Jamaica Tax Reform Project, Andrew Young School of Policy Studies, Georgia State Univ., Dec. 2004).

comprehensive personal tax would justify the additional administrative and political costs.

2. The Presumptive Tax Approach

Good tax administration is challenging in all countries, especially developing countries. It takes time, skill, and resources, all of which are in short supply in many countries. One common approach to tax income more effectively is to impose taxes on bases that tax authorities, rather than the taxpayer, determine. This administrative assessment approach is particularly effective when the self-assessment approach (of sales or income, for example) is not reliable or available.

The use of such administrative assessments, or presumptive taxes, is surprisingly widespread in taxation around the world, though under many names.[180] Some presumptive tax systems calculate taxable income based on key factors that are presumably associated with income generation, such as sales, turnover, number of employees, size of firm, and assets of the taxpayer. The estimated tax base is typically calculated based on coefficients for different factors applied to specific taxpayers, specific types of taxpayers (such as certain sized enterprises in particular industries), or in some cases on more aggregate indicators, such as industry and region, or external indicators of income. The basic idea is to take advantage of data that are easier for officials to obtain than the information required to determine actual taxable income under the regular income tax rules.[181]

180. Some taxes, such as the property tax, are usually assessed entirely in this way. To a much more limited extent, export taxes have sometimes been applied on presumed values, and the same approach has been used for certain import and excise duties. An alternative approach is to impose such taxes not on a value basis but on such characteristics as size, weight, chemical composition, and the like. Official assessments of VAT in some countries have on occasion been based on presumed sales/purchase ratios for particular industry sectors. An equally presumptive approach exists when VAT is "withheld in advance"—that is, sellers are required to remit VAT for which their customers are presumed liable, in the expectation that those customers will not in fact ever pay that liability themselves. Income taxes are also sometimes assessed on individual taxpayers or groups of taxpayers based on presumed profit margins on assets or sales. Alternatively, tax may be imputed from external indicators or calculated on the basis of estimated changes in net worth. Even at the upper end of the evasion scale, questionable cross-border transactions (transfer prices and the like) are often estimated based on presumed "comparables." Presumption in many guises is thus both a common and an extremely varied tool of tax administrations around the world. *See* Bird & Wallace, *supra* note 70, at 123–24, 132–55.

181. In Colombia, for example, which has had a separate tax on net worth since the 1930s, two forms of presumptive income tax were introduced in 1974: a tax on the income presumed to be generated by net wealth (initially at a rate of 8 percent) and a similar levy based on 2 percent of gross receipts. CHARLES E. MCLURE, JR. ET AL., THE TAXATION OF INCOME FROM BUSINESS AND CAPITAL IN COLOMBIA 139–47 (1990). In both cases, these taxes were applied when the

Such taxes are intended to capture at least some minimum level of tax from entities regardless of either their reported or their true net income, in some instances (as in Colombia) by taxing assets or gross receipts instead. Although sometimes introduced in the name of simplification, in practice minimum presumptive taxes are often not simple because they require two separate calculations of tax liability—one in accordance with the regular tax law and one in accordance with the presumptive tax regime. Moreover, such levies, even if introduced to cope with some passing crisis, often become a permanent fixture in tax systems.[182]

Most presumptive tax systems have two thresholds. There is a minimum threshold below which activities are not subject to tax (though sometimes they are subject to local license fees based on type of activity). There is also a maximum threshold above which taxpayers no longer qualify for the presumptive tax regime and are subject to tax under the regular tax system.[183] These critical thresholds may be stated in terms of assets, receipts, or employees. Too high an exit threshold undermines the regular tax system and invites too many participants into the special regime. An

reported income for tax purposes fell below that presumed on the stated basis. These taxes were subsequently abolished, but similar levies, though generally based on gross rather than net assets, became popular in other Latin American countries in the 1980s. *See* Peter D. Byrne, *The Business Assets Tax in Latin America—The End of the Beginning or the Beginning of the End?*, 15 TAX NOTES INT'L 941 (1997). Such levies may be imposed either as presumptive taxes (in lieu of normal taxes) or as minimum taxes.

182. In the United States, for example, the lack of indexing for inflation, as well as other factors, created a situation in which many tax filers needed to calculate their alternative minimum tax (AMT) in addition to their regular tax. Such alternative tax systems make life more complicated, not simpler, although they may sometimes produce more revenue than under the regular tax system. ROBERT REBELEIN & JERRY TEMPALSKI, WHO PAYS THE INDIVIDUAL AMT (U.S. Treasury Dep't, Office of Tax Analysis, Paper No. 87, 2000), *available at* http://www.treasury.gov/ota/ota87.pdf. Rebelein and Tempalski note that between 2000 and 2010, the number of AMT taxpayers under the U.S. income tax system will grow at an annual rate of 30 percent. Gilles Larin and Marie Jacques argue that although the AMT in Canada produces complication, it fails to generate additional tax revenue. Gilles Larin & Marie Jacques, *Is the Alternative Minimum Tax a Paper Tiger?*, 42 CAN. TAX J. 804 (1994).

183. A major flaw of such regimes in many countries is that they do not include explicit plans for graduating taxpayers out of the special system and into the normal system of taxation. This serious design flaw increases the potential unintended impacts of special regimes and hinders their success in achieving stated goals. A few countries place limits as to the number of years that a taxpayer can be taxed under the alternative presumptive scheme. But very few countries set the tax levels or rates of the imputed system high enough to encourage taxpayers to move on to the regular tax system. On the contrary, the political economy of presumptive systems almost guarantees that the tax burdens enjoyed by those in such regimes are sufficiently favorable to make them an attractive place to stay and to provide no incentive to ever graduate.

entry threshold that is too low may discourage small business activity and may impose tax liability on persons who should not be in the tax system.[184]

Graduation might be facilitated by some version of the Japanese and Korean systems of awarding certain fiscal privileges, such as depreciation of assets and access to tax incentives, only to those who enter the regular tax system.[185] The same effect can be achieved by the popular device of tax clearance certificates, required in many countries to obtain things such as passports and liquor licenses. Only those filing regular tax returns can qualify for these certificates.[186]

Existing presumptive tax regimes have seldom been examined carefully. Most, however, do not seem to have been very successful from any perspective. The firms subject to presumptive tax regimes may prefer such regimes because it shelters them from some of the complexity of the tax system and the rapacity of some tax officials.[187] The tax administration may also prefer presumptive regimes because they no longer have to deal with troublesome small taxpayers and can concentrate on the big taxpayers, where the tax revenue is. Politicians may also prefer presumptive tax regimes, because the small taxpayer community is large and vociferous and because they think it costs them little or nothing in terms of revenues—or perhaps may even generate revenue.

However, those concerned with the equity, the efficiency, and the long-term development of sound tax systems should be less sanguine about presumptive tax regimes. Presumptive tax regimes intended in part to reduce the compliance and administrative costs of taxation may increase, rather than decrease, efficiency costs because these regimes are generally

184. The argument is simple. Any line drawn in the tax sand creates Type I and Type II errors. Specifically, in setting up a presumptive system some will be included who should not be (Type I) and some will be excluded who should be included (Type II). If the tax presumed is below the "real" tax—that which would be due under the normal tax system—those who are really small taxpayers and are excluded will clamor to be included; the others will be silent. But if the presumed tax is above the real tax, everyone in the system will scream in protest. Lowering the rate of presumption will silence such protests, but at the expense of increasing the overinclusion error, which has no similarly self-corrective feature. Combining unduly low presumptive rates with the usual failure to apply normal tax administration procedures (such as audit) to simplified taxpayers simply aggravates the problem, making it even more attractive for people and enterprises to migrate into the safe harbor of the simplified system.

185. *See generally* Noburu Tanabe, *Blue Return System in Japan*, *in* READINGS ON INCOME TAX ADMINISTRATION 221 (Patrick L. Kelley & Oliver Oldman eds., 1973).

186. Of course, this approach may be considered too discriminatory against those who operate small businesses to be acceptable, or it may give too much scope for officials to harass taxpayers.

187. For example, Engelschalk, *supra* note 74, stresses this motivation for simplified regimes in transition countries.

not well designed and almost never well integrated with the regular tax system.[188] Presumptive tax regimes that define eligibility very narrowly may also undermine the fairness of the overall tax system. For example, minimum tax systems may have this result. If the minimum tax calculation is based on a presumed average relationship between assets and net income, for instance, some firms will be treated more harshly than others because of differences in the ability to use assets to generate net income.[189] If the goal of the minimum tax is simply to insure some tax payment, that goal might be reached in the short term. In the long run, however, unintended advantages may be given to certain firms and not to others.

Another concern regarding the impact of presumptive tax regimes is their implications for tax compliance. A traditional tax system relies on both enforced compliance and voluntary compliance. One goal of presumptive tax regimes is to bring hard-to-tax sectors into the tax net and to encourage participation in the regular tax system, thus increasing voluntary compliance. But a presumptive tax regime that does not graduate its taxpayers may undermine the tax system as a whole. Instead of expanding the regular tax system, such a system may create a new generation of taxpayers who rely on presumptive tax regimes for their existence.[190] Moreover, some so-called simplified systems are actually complicated. Although in theory more complication may or may not reduce compliance, in practice, experience tends to support the latter outcome.[191]

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188. We do not discuss here the efficiency benefits potentially arising from lump sum taxes (which is what presumptive systems often amount to) because we are primarily interested in the dynamics of relating such systems to regular tax systems.

189. Studies of retail traders in Sierra Leone and businesses in Cameroon provide examples of the wide variance found in reality with respect to the sorts of ratios used in presumptive systems. *See* Barry L. Isaac, *Price, Competition, and Profits Among Hawkers and Shopkeepers in Pendembu, Sierra Leone: An Inventory Approach*, 29 ECON. DEV. & CULTURAL CHANGE 353 (1981); *see also* Bernard Gauthier & Mark Gersovitz, *Revenue Erosion Through Exemption and Evasion in Cameroon*, 64 J. PUB. ECON. 407, 407–24 (1997).

190. The political economy incentives in developing such regimes are to impose taxes that are—bar exceptional cases—*lower* than those that would be imposed by the regular system. The net result is likely both to reduce tax revenues and to maintain resources in activities that are more tax efficient than economically efficient. Even well-designed special regimes, which graduate their taxpayers to the regular system, may reduce tax compliance of those in the regular system if the special regime is seen as too favorable.

191. Mexico's simplified system is a good example of the possible adverse implications of special regimes for the hard-to-tax sector. Before the 2002 tax reform, small enterprises and sectors such as agriculture and transport in Mexico were subject to a simplified system of presumptive and cash-flow taxation. These businesses could use a cash-flow accounting system so that tax was not paid on retained earnings, but simply on money taken out of the firm. This system both increased possibilities for tax evasion and complicated the structure of the entire tax

Despite such problems, presumptive tax approaches may nonetheless play a useful, perhaps even a necessary, supporting role in establishing and enforcing some form of taxation on business income in many developing countries. They may, for example, aid in bringing the shadow economy into the tax system, and if such regimes are well-designed, even contribute to improving the respect for tax laws. But they probably have little to contribute to achieving distributive goals except perhaps to the extent that the imposition of presumptive levies may discourage some from entering lines of activity to which normal tax systems cannot easily be applied.[192]

### 3. De-Linking the Taxation of Income From Capital and Income From Labor

One promising approach to taxing personal income more effectively in developing countries is to establish separate regimes for the taxation of labor and capital. Some relatively recent European tax reforms may provide some guidance for reforming developing countries' income tax systems in this manner. These reforms have moved away from the modern global comprehensive income tax systems towards the schedular tax approaches that characterized many early income tax systems.

The Nordic countries have made the most significant move away from a comprehensive income tax model to an explicitly schedular tax system.[193] The Nordic approach taxes income from capital separately from income from labor. The tax base for income from capital includes, in principle, income from all assets, including interest, dividends, and capital gains from financial assets, imputed rent on housing, accrued returns on pension savings, and profits from personal businesses.[194] A uniform tax rate is then

system as certain industries were allowed the cash-flow taxation and others were not. Stephen B. Webb, *Challenges and Prospects for Tax Reform*, *in* MEXICO: A COMPREHENSIVE DEVELOPMENT AGENDA FOR THE NEW ERA 179, 186 (Marcelo M. Giugale et al. eds., 2001). Transfer pricing schemes also permitted significant tax avoidance under this scheme. *Id.*

192. For models showing possible distributive gains from imposing supplementary presumptive tax systems, see BALESTRINO & GALMARINI, *supra* note 47, at 3–13, and ALESSANDRO BALESTRINO & UMBERTO GALMARINI, PRESUMPTIVE TAXATION, MARKETS, AND REDISTRIBUTION (Ctr. for Household, Income, Lab. & Demographic Econ., Working Paper No. 10/2002, 2002).

193. Peter Birch Sorensen, *From the Global Income Tax to the Dual Income Tax: Recent Tax Reforms in the Nordic Countries*, INT'L TAX & PUB. FINANCE 57 (1994); Sijbren Cnossen, *Taxing Capital Income in the Nordic Countries: A Model for the European Union?*, *in* TAXING CAPITAL INCOME IN THE EUROPEAN UNION: ISSUES AND OPTIONS FOR REFORM 127 (Sijbren Cnossen ed., 2000).

194. Robin Boadway, *The Dual Income Tax System—An Overview*, CESIFO DICE REPORT, Mar. 2004, at 3, 7. Boadway notes that this tax base is broader than most existing income tax

applied to the total of capital income. The labor (or noncapital) income category could include all income from labor, including income from pensions, as well as government transfers. This income is taxed at a progressive tax rate and could incorporate personal deductions or credits to account for taxpayer-specific characteristics.

Treating income from capital differently from labor income has its own difficulties. One problem is how to allocate income attributable to closely held businesses, in which the labor of the owner-employees is a significant part of value created. In many developing countries, family held businesses account for a significant part of economic activity. If labor income is taxed at much higher rates than capital income, taxpayers will have an incentive to treat as much of the income as possible as capital income. The Nordic countries have adopted different approaches to allocate profits between capital and labor income.[195] However, if the spread between the tax rates for labor income and capital income is relatively small, then problems of characterization of the income will be less important.

The Nordic countries have de-linked the taxation of capital and labor for two reasons. First, the high marginal income tax rates of the prior system created great incentives to shift investment capital out of the countries through both legal and illegal means. Second, the revenue needed to support the level of government expenditures in those countries did not allow for a significant reduction in the tax revenue generated by labor income.

Developing countries may have different concerns. In developing countries, the two major advantages of a dual income tax system would be rationalization of the taxation of capital income and improved enforcement and compliance, because adopting a single flat tax rate on capital income may allow for an opportunity to expand the tax base to include types of income that were previously exempt from taxation, such as interest on government and publicly traded corporate bonds. A single flat tax rate should also improve enforcement and compliance, because a uniform rate

systems, which generally provide for some tax relief for certain types of capital income. *Id.* It is unlikely that developing countries could or would adopt as broad a tax base for income from capital as the Nordic system.

195. One approach provides for an imputed rate of return on the business assets and then treats any residual income as labor income. *See* Vidar Christiansen, *Norwegian Income Tax Reforms*, CESIFO DICE REPORT, Mar. 2004, at 9, 9–10. For a review of the similar challenges facing the United States in trying to separate returns to capital and labor in the context of the maximum tax on earned income, see Michael Asimow, *Section 1348: The Death of Mickey Mouse?*, 58 CAL. L. REV. 801 (1970).

should allow for greater effectiveness in withholding tax (under a final withholding regime) for many different types of income.[196]

In 2001, the Netherlands adopted a slightly different approach to schedular taxation than the Nordic model.[197] This approach provides for three separate boxes of income: (1) taxable income from work and home ownership; (2) taxable income from a substantial business interest; and (3) taxable income from savings and investment. Each box is subject to its own tax rate and method of computing income. The law also provides for the quarantine of losses so that losses from each box may not offset income from any other box. The Netherlands tax law provides for progressive income tax rates for income in box 1 (primarily income from labor), a flat income tax rate for box 2 income (primarily income from business activity), and a presumptive tax rate for box 3 income (portfolio investments). Net assets in this last box are assumed to yield a return of 4 percent, and are subject to an income tax rate of 30 percent. This is the equivalent of a wealth tax of 1.2 percent.[198] This is a new approach to the taxation of investment assets: Whether taxpayers in the Netherlands earn a 1 percent or 10 percent return on their portfolio assets does not matter for income tax purposes—it is assumed the return is 4 percent. This approach was common in many nineteenth century tax systems,[199] allowing taxing authorities to assess tax based on the estimated value of the asset without needing to trace and confirm the actual income generated by the asset.

It is not clear whether this presumptive tax approach for portfolio assets would be desirable for developing countries. The Netherlands approach arose in the context of the challenges to its tax system in the taxation of portfolio income. Taxpayers were structuring financial investments to generate return in the form of capital gains (which were exempt from tax) rather than as current income. In the Netherlands, the level of voluntary compliance is quite high and the ability of tax administration to monitor the investment assets of taxpayers is sufficiently

196. Of course, like any income tax approach, the dual income approach can work effectively only if tax authorities can monitor the portfolio investments held by their residents outside the country. Because this requires an improbable degree of cooperation among developing countries and developed countries to facilitate exchanges of information to improve compliance, it is not likely to happen soon.

197. *See* Gerard T.K. Meussen, *Netherlands Income Tax Act 2001*, 40 EUR. TAX'N 490, 490–98 (2000).

198. *Id.* at 492–96.

199. *See* Peter A. Harris, Origins of the Income Tax in the United Kingdom and Its Former Colonies to 1820 (2005) (unpublished manuscript, on file with authors).

robust to allow for this type of wealth tax. These conditions do not hold in most developing countries.

What is common to both the Nordic and Dutch tax reforms is the lower effective tax rates for most taxpayers for income from capital than income from labor. To some, it may seem unfair for capital income to be generally subject to lower tax rates than income from labor. Some may contend that separate tax regimes for labor income and capital income violate the traditional tax norm concept of horizontal equity.

The issue of fairness in separate taxation of labor and capital income is more complicated than appears at first examination. First, it is not clear how useful the concept of horizontal equity is in examining the differential treatment of labor and capital income. It may be more useful to look at the total allocation of tax burden (or after-tax income) than comparing the tax treatment of specific items. Second, it may be that the tax differences are arbitraged away through changes in rates of return. Third, even where labor and capital income are subject to the same nominal tax rate, capital and labor income are not, under current rules, subject to uniform treatment. Different tax rules apply to labor and capital income to determine when and how much is taxable. Finally, applying horizontal equity concepts without considering the role of tax avoidance or evasion is missing a large part of the picture.[200]

Separate tax regimes for taxing labor income and capital income may in some circumstances make everyone better off even if horizontal equity is violated. Assume that under a hypothetical tax system the tax rate for all income is 30 percent and total tax revenue is $100 million, of which $20 million is from taxes on capital and $80 million is from taxes on labor. We now adopt a schedular tax on capital income (at, say, 20 percent) that is more effective at taxing capital than the current system—so that tax revenues from capital income increase to $30 million. Assuming that aggregate tax revenue requirements remain at $100 million, the tax revenue needed from labor income is reduced to $70 million—which could allow for a rate reduction to perhaps 27 percent. It likely makes little sense for

200. *See* Francesco Forte, *Comment on Schedular and Global Income Taxes*, *in* READINGS ON TAXATION IN DEVELOPING COUNTRIES 185 (Richard Bird & Oliver Oldman eds., 1964); Fernando Rezende, *Income Taxation and Fiscal Equity*, 2 BRAZ. ECON. STUD. 105 (1976); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 86–108 (1996).

policymakers to forego a rate reduction for everyone merely because some concept of horizontal equity is violated.[201]

## CONCLUSION

Despite the costs of progressive personal income taxation, discussed earlier, the mere fact that such tradeoffs exist is not necessarily a deterrent to some leveling down. Rich countries are more fortunate than poor ones. They can choose, within broad limits, the size of their governments. Both large governments, with big tax bills, and small governments, with small tax bills, are sustainable in countries that have well-functioning markets and governments.[202] The road chosen largely depends on the importance attached to the redistributive role of government. Those developed countries (like Sweden) that redistribute relatively more have large governments, while those counties (like the United States) that redistribute relatively less have smaller governments. A critical point here, however, is that the big-government countries that redistribute more have, in general, less redistributive tax systems than the lower-taxing, less redistributive countries.[203] Those who wish to redistribute through budgetary policy do so mostly on the spending and not the taxing side of the budget. Such countries are careful not to kill the golden goose by overtaxing those who receive relatively higher returns from the market. They not only rely more heavily on consumption taxes and less heavily on taxes on capital than small-government rich countries, but they are also particularly careful in structuring their income tax systems not to penalize those who work more or entrepreneurs who are more successful than others.[204]

What lessons can poor countries learn from this experience? Because markets do not function well in such countries, their choices are obviously more restricted. Absent the good fortune of exploitable, highly valued natural resources (exploited for the benefit of the country and not, as is too often the case, for the benefit of a few) or recourse to an antimarket

201. See Daniel N. Shaviro, *Commentary: Uneasiness and Capital Gains*, 48 TAX L. REV. 393, 404–411 (1993), for a similar argument with respect to the preferential tax treatment of capital gains.

202. 1 LINDERT, *supra* note 115.

203. *Id.*

204. *Id.* Even in countries with relatively progressive tax systems, most effective redistribution takes place through expenditure policy. In Canada, for example, the Gini coefficient of income was estimated to be 0.424 before taxes and transfers, but only 0.316 after taxes and transfers. Two-thirds of the reduction was due to transfers and only one-third to taxes. *See* Sharpe, *supra* note 89, at S6.

command economy, most developing countries do not have the choice of having a big government. These countries have less leeway for redistribution through general expenditure programs based on the Scandinavian model. As governments also do not function well in many developing countries, they are unlikely to achieve similar results through highly targeted (that is, less expensive) spending policies. Moreover, it is difficult to secure the needed political support for programs (such as education and health) for the poor without extending such programs to the middle class and even the wealthy, thus increasing program costs dramatically with few discernible effects on distributional outcomes.[205]

These problems do not mean, however, that developing countries have to rely more on taxes for redistribution. Although the evidence is mixed as to whether taxes have more or less distorting effects on market outcomes in poor countries than they do in rich countries, the evidence is clear as to the relative ability to implement redistributive policies through the tax system. Developing countries thus are on the horns of an unpleasant dilemma. Either they go for big government, with the risk of spoiling both the market and (through corruption) perhaps government itself, while achieving little in the way of real redistribution, or they stay small, focus on market-supporting activities, and depend largely on development-oriented policies that facilitate improvements in human capital to achieve redistribution. The conclusion for most countries seems clear: Follow the second path.

Taxes, particularly the personal income tax, have done little if anything to reduce inequality in developing countries. Yet, tax systems simply cannot be too progressive in many developing countries. The costs are too high and the gains too low. Instead, given the limited instruments available to such countries and the widespread market failures characterizing them, perhaps the best policy is to introduce a broad-based VAT to finance necessary government expenditure (including, of course, redistributive provision of social services, especially for human capital formation).[206] To this, one can add the increasingly strong case in many countries for greater local control over fiscal decisions. Such local decisions will not always be better. But wrong decisions at the local level will do less damage, and better decisions from the perspective of local people (for more

205. *See, e.g.*, Harberger, *supra* note 150, at 11–13.

206. Similar conclusions emerge clearly from most recent analyses of this question. *See, e.g.*, Christopher Heady, *Taxation Policy in Low-Income Countries*, *in* FISCAL POLICY FOR DEVELOPMENT: POVERTY, RECONSTRUCTION AND GROWTH 130 (Tony Addison & Alan Roe eds., 2004).

primary and less tertiary education support, for example) are more likely to emerge.

As it has operated in most developing countries, the global progressive personal income tax long advocated by tax experts is in fact neither global nor progressive, nor personal, nor often even on income (but rather on some presumptive basis). A more schedular approach to income taxation in such countries may be not only inevitable in practice, but not all bad in principle. A comprehensive income tax in developing countries may still have greater appeal to many tax analysts from an equity perspective, but it is considerably less desirable from economic and, especially, administrative perspectives.[207] Similarly, while a consumption tax may be best from the latter two perspectives, it is likely to be less acceptable politically and perhaps less desirable from an equity perspective. A dual income tax therefore may prove an acceptable compromise.

In developing countries in which administrative constraints are tighter, the need for economic efficiency greater, and policymakers care about equity considerations, this conclusion seems even stronger. A modestly progressive tax on wage income and a comprehensive low-rate tax on capital income (at both corporate and individual levels) is likely the most one can or should aim for in such countries. Along these lines, one approach for a personal income tax for developing countries would be one with a roughly equal constant marginal rate imposed on a broad schedular base.[208] Such a tax (coupled with a corporate income tax at the same rate), together with a broad-based VAT, appropriate excise taxes, more use of local and benefit financing, and above all, improved expenditure policy, seems likely to provide many developing countries with much firmer footing for redistributive policies than the fifty-year-old model of the one-size-fits-all highly progressive personal income tax imposed on a comprehensive base.

207. *See* Boadway, *supra* note 194, at 3–4.
208. For an example, see Alm & Wallace, *supra* note 33.