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Recent Tax Policy Trends and Techniques – A Review

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Abstract.

This paper considers on recent tax policy and trends and techniques. Tax policy trends have been decisively influenced by tax research. In both the OECD countries in India and developing countries, the two most important changes in tax systems in recent decades have been the introduction of the VAT and the general lowering and flattening of statutory income tax rates. The downward pressure on personal and corporate income tax rates has certainly been supported, if not initiated, by the increasing research measuring the distortions caused by high marginal tax rates. Equally, the widespread adoption of VAT is probably due at least in part to acceptance of the economic argument that this form of sales tax is less economically distorting. For the most part, however, countries have not done these things because economists produced persuasive theories or empirical evidence that it would be good to do them but for their own reasons. After reviewing a number of aspects of how tax policy decisions are made in practice, the paper concludes that if tax scholars are interested in improving policy, they should focus not on the short-term political game within which policy decisions are inevitably made in all countries but rather on the long-term game of building up institutional capacity, both within and outside governments, to articulate relevant ideas for change, to collect and analyze relevant data, and to assess and criticize the effects of such changes as are made. Economic research may provide valuable inputs into policy decisions, both because it is the only approach focusing on efficiency concerns and because it can (but often fails to) say some useful things about the distributional outcomes that impact more immediately on policy decisions in most countries. But it is not and cannot be a substitute for the development of the political institutions that need to exist if 'good' tax policy is to be developed and implemented.

Keywords: Tax Policy; Tax Research; Developing Countries.

Introduction:

It is no surprise that the subsequent three decades that are the focus of this paper have also produced mixed results, not least in the fiscal sphere. Of course what one sees always depends not only on where one sits but also on precisely where (and when) one looks-as well as on what one is looking for. What I am looking for in this paper is essentially evidence that recent tax policy has been influenced by tax research. Or, to put it another way,

what evidence is there that tax researchers have been focusing on the problems that really shape tax policy? Most tax research is carried out in the OECD countries in India that are the principal focus of this volume, and the issues discussed here are of course relevant to those countries. For the most part, however, I focus in this paper on developing (non-OECD) countries. I do so for three reasons. First, since in the era of globalization we are all in a real sense in the same boat, it may be useful even for those whose primary concerns are for a particular developed country to reflect in more general terms on how tax issues arise and are dealt with around the world. Second, since both the fiscal problems and the concerns about the relevance of much economic research on taxation are greater in developing countries, the question raised above comes out most sharply in this context. Finally, the dominance of "first-world" economists both in shaping tax research and in giving advice on tax policy to developing countries, suggests that experience in the non-OECD world may provide a particularly clear test of whether that advice makes sense. Have we been giving good advice? Has anyone been listening? Are there important issues to which we should pay more attention if we want tax research to contribute more to tax system improvement? How may tax researchers in any country, OECD or developing, be more successful than experience suggests they have been to date not only in "speaking truth to power"
(Wildavsky 1979) – But also in being heard?

As Easterly (2009) has recently reminded us, there has never been a shortage of outside experts urging developing countries to make a 'big push' to break out of the low-income trap. This observation is certainly true with respect to taxation. In the early 1960s, for example, Nicholas Kaldor (1963), fresh from recent exposure to India's tax system, argued that for a country to become 'developed' it needed to collect in taxes something of the order of 25-30 percent of GDP. Even the more modest recent targets mentioned above seem unduly ambitious in terms of the historical record. A few fast growing Asian countries such as India managed to reach and even exceed the UN prescribed 4 percent of GDP increase in tax ratio in the early years of this century but it is by no means clear that such levels are sustainable. On the whole, fiscal inertia rather than fiscal growth appears to prevail, with many countries remaining for relatively long periods at more or less the same tax-GDP level. Of course, there is considerable variation within the diverse group of developing countries. While this is not the place to go into details, a recent analysis of the determinants of tax ratios suggests, among other things, that (a) developing countries that increased taxes did so largely in response to an increase in per capita GDP and (b) that there is at least some support for the argument that corruption and taxation are substitutes (Bahl 2006). While there are some striking exceptions-such as the case of Nicaragua mentioned later in this paper-when it comes to tax levels in developing countries, on the whole less has been going on that may be apparent to eyes dazzled by the seemingly endless changes of tax rates and tax legislation in many countries. To paraphrase a remark Galbraith (1964) once made, few of the irreversible transformative changes so often predicted as a result of this or that tax reform seem to have occurred. "Business as usual" is a better description than "tax reform" when it comes to tax reality in many countries.

Tax Structures:

The manner in which countries raise taxes differs as widely as the amounts they raise. The pattern of taxes in any country depends upon economic structure, history, the tax structures found in neighboring countries, administrative capacity, and political institutions. To illustrate, tax design is, for instance, strongly influenced by economic structure. Many developing countries have a large traditional agricultural sector that is not easily taxed. Many also have a significant informal economy that is largely outside the formal tax structure. As a result, the potentially reachable tax base usually constitutes a smaller portion of total economic activity than in developed countries.

As Table 2 shows, consumption taxes are much more important in developing countries. On the other hand, income taxes are much more important in developed countries. For the whole sample studied by Fox and Gurley (2005), personal income taxes were a bit more important than corporate taxes (including extractive taxes) and VATs accounted for about 40 percent of consumption taxes, with excises being almost as important. In developing countries, however, the personal income tax plays a very limited role (Bird and Zolt 2005). Such countries have been hesitant to go too far in taxing labor in the formal sector, and labor in the informal sector is largely beyond the taxman's reach. The result is that, although personal income tax revenues are frequently 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 (Tanzi and Zee 2020). Even company income taxes have shown little growth in many developing countries as a result in part of continued and even increasing An obvious reason why most developing countries reap little from either income or property taxes is their continued inability to administer such taxes effectively.

The differences in the relative use of income taxes are even more pronounced when examined on a regional basis. For instance, personal income taxes account for only about 1 percent of GDP in Latin America compared to (almost) 3 percent in Africa (Fox and Gurley 2005). Variations between countries within regions are even greater. In small island countries such as Barbados, for instance, international trade taxes may play an unusually important role. Trade taxes tend on the whole to be more important in poor countries, where they account for 24 percent of tax revenues compared to only 1 percent in rich countries. Trade taxes (mainly customs duties) decline steadily as countries become more developed. It is the poorest countries that have faced the greatest challenge in replacing such revenues in recent years as a result of trade liberalization. As Baunsgaard and Keen (2005) demonstrate, many of these countries have not been able to rise to this challenge.

Tax Systems:

Of course, many important aspects of tax systems are not directly visible in the recorded revenue figures. Tax laws emerge from a political process and produce revenue only when implemented. What can be done to a considerable extent determines what is done in any country. In many developing countries, as already mentioned, there is a large traditional agricultural sector that is not easily taxed. Often there is also a significant informal (shadow) economy that is largely outside the formal tax structure (Alm, Martinez-Vazquez and Wallace 2004). To some extent the size of the 'untaxed' economy may itself be a function of the design and implementation of the tax system. For example, the high social insurance tax rates levied in some countries may discourage employers from reporting the extent of employment, encourage the under-reporting of wage levels, and foster the development of the informal economy. If the resulting lower tax revenues lead governments to raise tax rates still further, incentives to evade taxes will be exacerbated. Such problems are more difficult to cope with when a country's administrative capacity is limited, as it is in most low-income countries. The importance of good administration has long been as obvious to those concerned with tax policy in developing countries as has its absence in practice. The real tax system people and businesses face reflects not just tax law but also how that law is actually implemented in practice. How a tax system is administered affects its yield, its incidence, and its efficiency (Tanzi 1991). Tax administration is too important to policy outcomes to be neglected by tax policy reformers. Unfortunately, tax administration is a difficult task even at the best of time and in the best of places, and conditions in few developing countries match these specifications. Moreover, administration is inherently country-specific and surprisingly hard to quantify in terms of both outputs and inputs. The best tax administration is not simply that which collects the most revenues; facilitating tax compliance is not simply a matter of adequately penalizing noncompliance; tax administration depends as much or more on private as on public actions (and reactions); and there is a complex interaction between various environmental factors, the specifics of substantive and procedural tax law, and the outcome of a given administrative effort. All this makes tax administration a complex matter.

Trends in Tax Research:

Until recently, however, few economists devoted much thought to either the administrative or the political dimensions of taxation. Understandably, they instead approached research on taxation almost entirely from the disciplinary base of mainstream economics. What lessons has this impressive body of research suggested in recent decades for those concerned with improving tax policy in any country.

Income vs. Consumption:

As Auerbach (2009) notes, the accepted academic view of good tax policy, circa 2010, was approximately as follows:

- The ideal tax was a broad-based income tax with progressive rates.
- Capital gains were properly taxed under such a tax. (Practically, however, gains could only be taxed on a realization basis, with the resulting lock-in effects often being mitigated by a reduced tax rate.)
- Integrating corporate and personal income taxes was seen as a way of making both the decision to incorporate and the debt-equity choice more neutral. (Usefully, dividend relief would also dampen the distortion from lower capital gains tax rates.)

- The dominant approach to taxing cross-border income flows was capital export neutrality although a limited case could also be made for capital import neutrality.

Conclusion:

Tax researchers can and should play an active role in all these activities. Such long-term 'institution-building' activities are seldom immediately rewarding. They appear to be out of fashion with international agencies concerned with development. It seems much more appealing and immediately productive to establish performance benchmarks for success, to support this particular organizational change reform here (revenue authority) and that new technology (computerization) there, in the apparent belief that such simple 'one-size-fits-all' approaches can provide quick (but sustainable!) answers to the many complex problems inherent in policy reform in difficult environments. It may be appealing. But it is wrong. This concise summary seems to me to tell the story of the 1960s: it was all about the income tax, at least in English-speaking countries. Indeed, the report of the Canadian Royal Commission (1966) at the time was called 'a landmark in the annals of taxation' by Harberger (1968) precisely because it was considered to be the most detailed attempt to turn these ideas into practical policy recommendations.

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