

## focus 5 on *taxation*

### Raising revenues for equitable policies

The publicly-provided, equity-enhancing programs outlined in this report, from early childhood development interventions to water supply, have to be financed. The resources to fund them must generally be raised through taxation. In fact, a key ingredient for a well-functioning public sector is a societal understanding that the quality of public services depends on everyone paying their share of the tax burden. Where this perception fails, the social compact breaks down, and tax avoidance and evasion become widespread. This leads to a vicious circle of free-riding and tax rate increases, with adverse consequences for the public finances, the quality of service delivery, and social cohesion.

It follows that the same institutions that influence the quality and breadth of service delivery also affect the overall tax effort. Revenues, like spending, increase with a country's level of income, but the quality of institutions—notably voice and accountability—also matters, even when controlling for income<sup>1</sup> (see figure S5.1). Voice and accountability can strengthen the tax effort, as the services provided become a reflection of the desires of the broader electorate rather than of a privileged few. Lindert (2004) argues that the expansion of voice in twentieth-century Europe was the driving force behind fashioning the social compact that delivered high and equitable growth alongside extensive public provi-

sion of services during 1950–80. In Chile and the Republic of Korea, too, the emergence of representative institutions (and higher incomes and administrative capacity) led to higher taxation and spending.

For similar reasons, high inequality in the distribution of political power and wealth may be prejudicial to the tax effort. The low tax revenues in most of Central America may reflect the low solidarity of the elite with middle- and lower-income groups: the small, wealthiest segment of the population is unwilling to pay more in taxes to provide public services, because the elite can procure many private substitutes for publicly-provided services, ranging from public safety to education and roads.<sup>2</sup>

Resource rents can relieve the fiscal constraint on spending and in principle provide resources for equitable provision, though they raise a host of governance challenges. The ability of resource-rich states to rely on “unearned” revenues can undermine the accountability embedded in the social compact underpinning sound public finance.<sup>3</sup> If not properly addressed, the result may be wasted natural resources, corrupt state institutions, and poorer prospects for long-run growth and equity. A few recent efforts to harness resource rents for broad-based development in countries with poor institutions aim to introduce greater transparency and accountability (see box on next page).

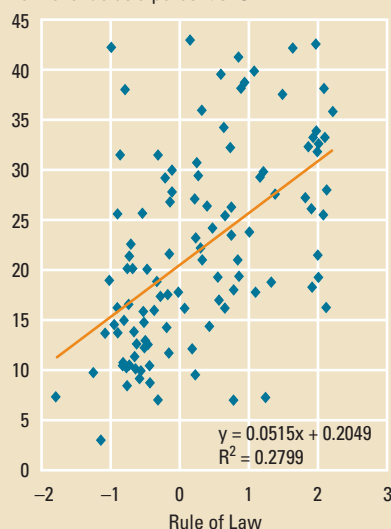
Foreign aid can also weaken the social

compact, in much the same way as resource revenues, by making governments less beholden to civic interests.<sup>4</sup> Some evidence suggests that higher levels of aid are associated with lower revenue collection, especially among poorly governed countries.<sup>5</sup> Donors should thus consider ways of supporting accountable institutions in recipient countries—both for spending and taxation (see chapter 10 for discussion of aid).

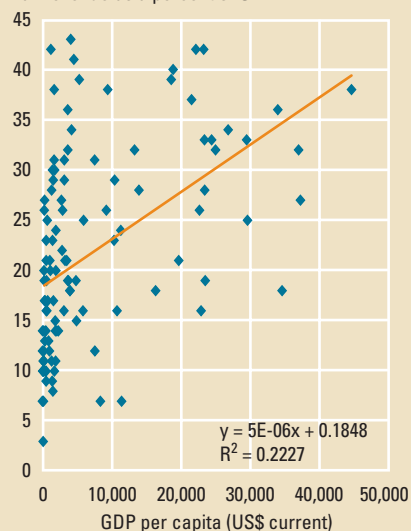
While institutional transparency and accountability and linking good public services to the taxes that fund them are probably the first-order determinants of successful revenue-raising, technical aspects of public finance are important to reduce efficiency costs. Lindert (2004) argues that among industrial countries, high social benefit/high tax societies—most notably Scandinavia—have paid particular attention to tax design to reduce adverse incentive effects for labor effort and capital investment to sustain growth. Tax design is an immense area. From the perspective of equity, the primary contribution of taxation is in providing the resources to fund equity-enhancing spending. For this, the principal criteria are minimizing efficiency costs, administrative feasibility, and political supportability. For specific tax instruments, there can also be potential for positive direct effects on equity. Here we suggest seven basic principles for mobilizing tax revenues in ways that minimize efficiency costs, while not undermining equity.<sup>6</sup>

#### Fiscal effort increases with income and the quality of institutions

Tax revenue as a percent of GDP



Tax revenue as a percent of GDP



Source: Authors' calculations based on Kaufmann, Kraay, and Mastruzzi (2005).

1. *Tax bases should be as broad as possible.* A broad-based consumption tax, for example, will still discourage labor supply on the margin, but choices between tradable and nontradable goods and services will not be distorted, if all are taxed at the same rate. A few items (such as gasoline, tobacco products, and alcohol) may be chosen for higher tax rates, because of their negative spillover effects or because the demand for these products is relatively unresponsive to taxation. As a result, at any given tax rate, efficiency costs will be relatively low and revenues relatively high. Income tax bases should also be broad, treating all incomes, from every source, as uniformly as possible.
2. *Tax rates should be as low as possible* (as long as they raise sufficient revenue to finance the appropriate expenditures of government). Of course, the broader the

base, the lower the rate needed to generate a given revenue level. Lower rates lower the efficiency costs. The general rule is that the distorting effect of taxes increases proportionally to the square of the tax rate, so halving the tax rate implies a fourfold increase in efficiency. From an efficiency perspective, it is better to impose a single rate on a broad base of taxpayers, rather than dividing that base into segments and imposing different rates on each one. This needs to be balanced against the distributional argument for graduated rate schedules.

3. *Keep indirect taxes from being regressive.* With a few key exemptions, value-added taxes (VAT) can be made less regressive. Bird and Miller (1989) show in Jamaica that exempting just five specific items from VAT halves the burden on the poorest 40 percent of the population. Reducing regressive excise taxes (as well as import duties), on food or kerosene is also desirable. To make up for lost revenue from any of these measures, there are often good reasons for higher taxes on private transport. Export taxes are generally best avoided, both on efficiency and on equity grounds.
4. *Raise personal income tax collections.* Collection from personal income taxes is

low in developing countries. But in the light of the second point, higher revenues should be sought first by closing loopholes and enforcing greater compliance, and only later through higher marginal rates. Income taxes need to apply to persons and to corporations. To keep tax avoidance in check, the top marginal rate of the personal income tax should be fairly close to the rate of the corporate income tax, which means that the rate is not likely to be all that high.

5. *Use property taxes more.* Property taxes account for only a small share of taxes in developing countries. Their coverage is typically not comprehensive, and assessments and collection rates are low. Although nominal rates are also low, governments usually find rate increases in this very visible tax difficult to sell politically. Simply raising the tax rate usually would burden only the few actually paying taxes. Higher nominal rates are likely to be acceptable only with better tax administration, such as more comprehensive coverage, better and more frequently evaluated assessments, and enforced penalties for late payment.<sup>7</sup>
6. *Consider inheritance taxes.* Because heirs have not earned the wealth, taxing gifts,

estates, and inheritances are consistent with this report's notion that predetermined circumstances should not affect a person's life chances.<sup>8</sup> The efficiency arguments and the evidence are mixed: parents may work more or less to avoid inheritance taxes, and so may save more or less. Although inheritance taxes may be difficult to collect and are likely to represent only a modest reduction in wealth concentration, they may help prevent "extreme concentrations of wealth from being passed from generation to generation."<sup>9</sup> In addition, a design that restricts transfers of control rights on corporations can be good for both equity and efficiency.<sup>10</sup>

7. *Avoid implicit taxes.* In many instances, the most important taxes affecting the poor are not formal ones levied through the tax code, but implicit taxes, including bribes<sup>11</sup> and inflation. Other implicit taxes to be avoided include many instances of "regulation as taxation" such as quasi-taxes imposed through controls on trade, prices, credit, foreign exchange, or capital markets.<sup>12</sup>

### Managing resource rents transparently and equitably

High overall standards of transparency and accountability are essential if the revenues from extractive industries are to be used well. However, as a second best solution in weak institutions of accountability, many countries, developed and developing, do not pool the revenues from extractive industries with other resources in a unified planning and budget process. Instead, they are channeled to a dedicated fund, with special arrangements to earmark the revenues for specific purposes; define reporting and disclosure requirements; and establish oversight bodies to ensure that the arrangements are properly implemented.

One common objective of such revenue management arrangements is to save part of the revenue stream. The savings may be used for short-term budgetary stabilization, so that expenditures are protected from fluctuations in prices and output. They may also be used to build up financial assets, which can generate revenues over an extended period, in some cases constituting a perpetual fund, so that future generations can benefit from the revenues generated from the depletion of resources. Azerbaijan, Chad, and Kazakhstan

have legislated savings to deflect pressures to spend revenues quickly and unproductively.

Revenue management arrangements can also serve distributional objectives. In Chad, the Oil Revenue Management Law assigns a share of revenues to a "future generation fund" and specifies allocations for poverty reduction. Such earmarked allocations may be anathema to financial managers, but they communicate and underline the government's commitment to prudent and redistributive spending. Nigeria's experience in the Niger Delta during the 1980s and 1990s highlights the resentment and political instability that can result when local communities see no demonstrable benefits from the extractive industries in their midst. The democratic government has responded by creating a Niger Delta Development Commission to fund local development, with statutory contributions from the federal government and the oil companies.

High standards of transparency and accountability are essential if the revenues from extractive industries are to be used for development purposes. To reduce the risk of diversion of revenues, the Extractive Industries Transparency Initiative (EITI), championed by the United Kingdom, calls on governments and extractive indus-

tries to report and reconcile payments and revenues. Some companies have taken the initiative of publishing payments to government in some of the countries in which they operate—for example, Shell in Nigeria and British Petroleum in Azerbaijan. The "Publish What You Pay" coalition advocates more systematic disclosure of companies' annual reports and for home-country legislation to make such declarations mandatory. Equally important are improvements in government reporting arrangements to ensure transparency in the application of revenues generated by large projects, such as the Chad-Cameroon pipeline and the Nam Theun 2 hydropower project in the Lao People's Democratic Republic.

Revenue management arrangements are likely to be more successful when they are the product of a broad consultative process and the rationale is widely understood. Timor-Leste has facilitated broad civil society involvement in the design of the revenue management arrangements for its offshore oil and gas industry. Draft legislation on the industry's commercial and tax regime and legislation on a proposed petroleum fund, have been published and subjected to numerous public consultations.