Tax Performance in Developing Countries

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ISSUES

•Tax performance (tax/GDP) is determined by inherently structural factors (variables capturing the tax base, to which tax rates are applied)

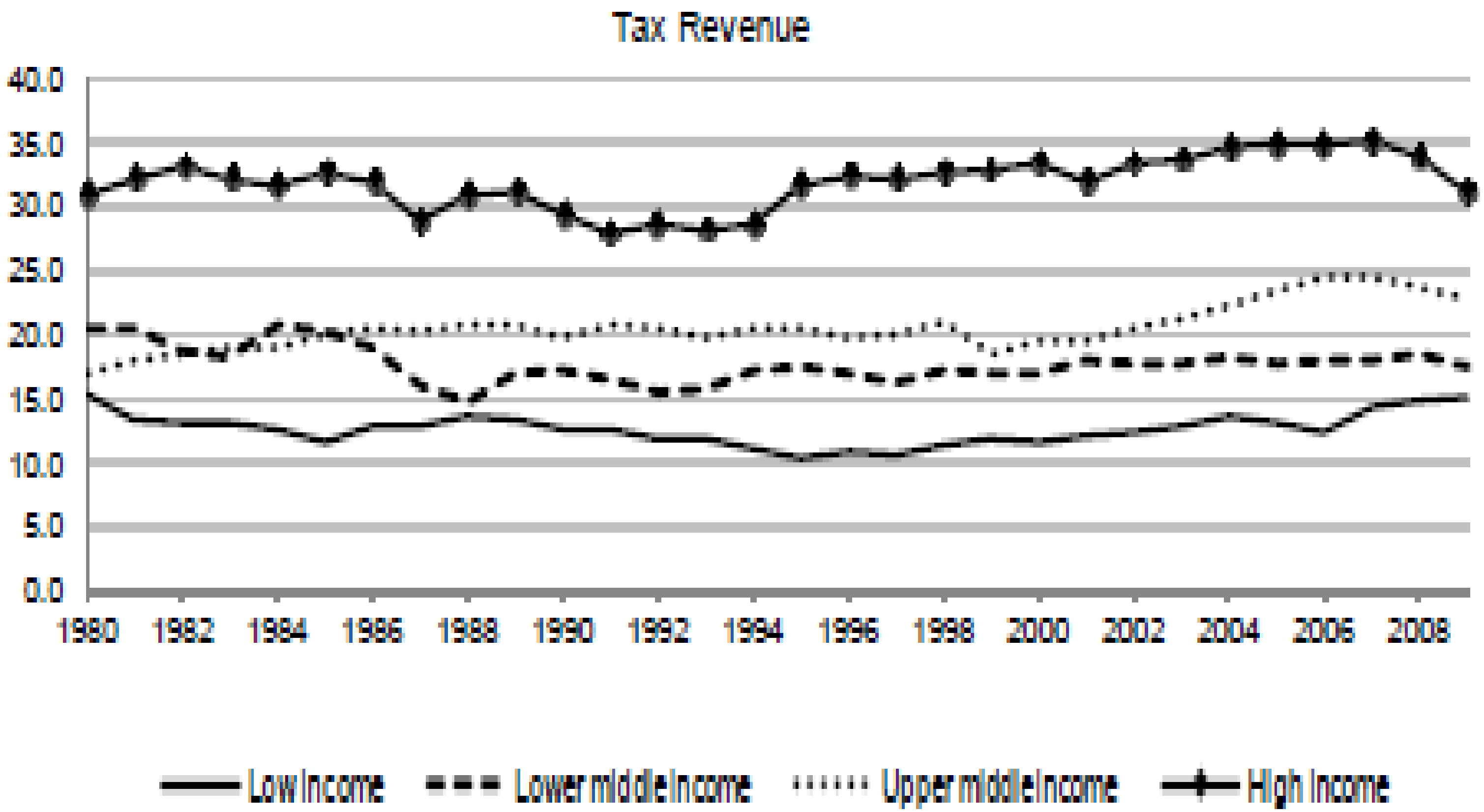
•Tax policy (reform) primarily concerned with tax rates and measures to improve administration and collection efficiency

•Changes in the tax base are largely determined by economic performance and some bases are easier to tax (trade, spending) than others (corporations, MNEs, resource sector)

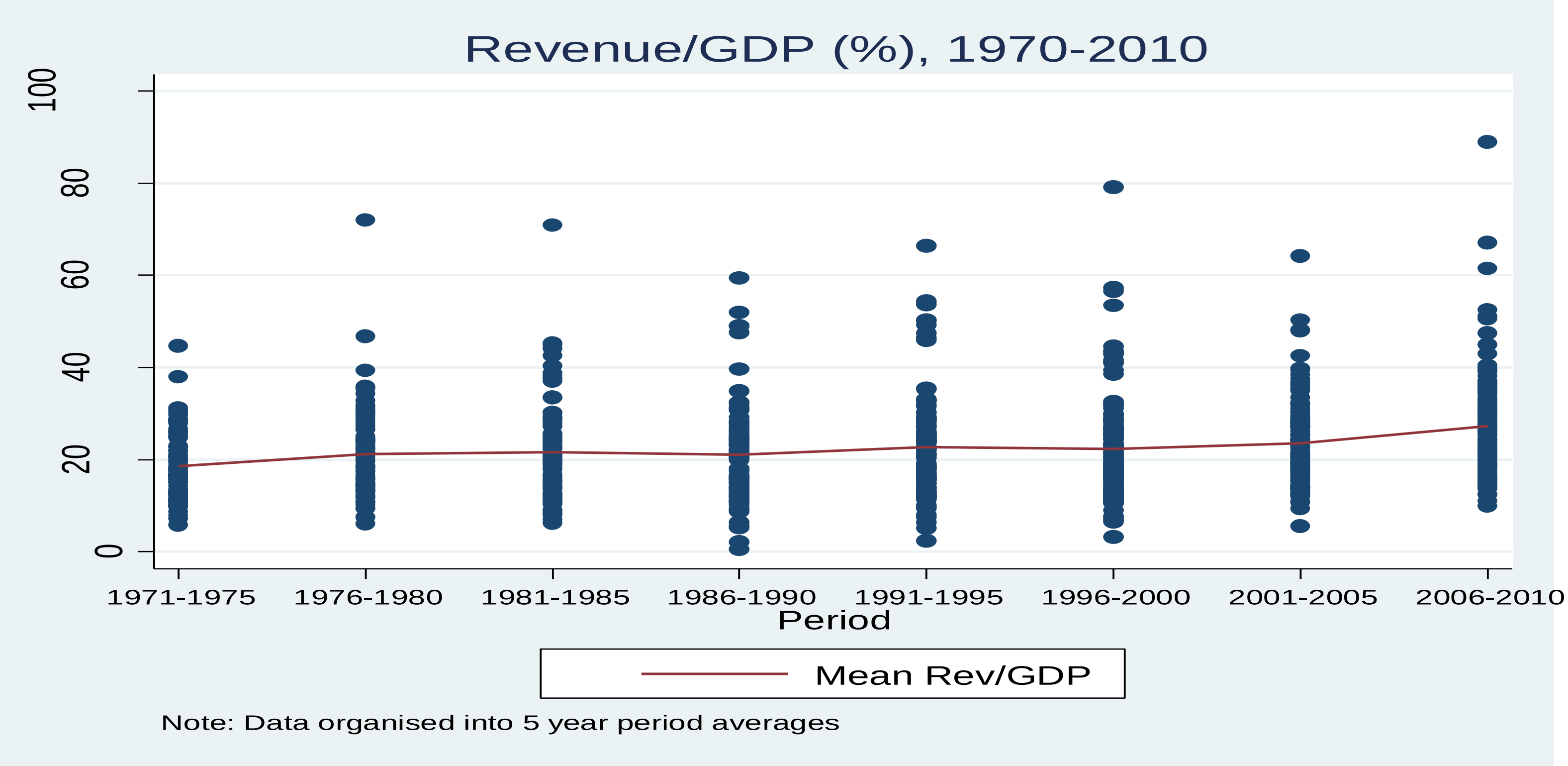
Trends

- Overall tax/GDP ratios have not changed noticeably on average since the early 1980s, especially for LICs/SSA
- VAT and CIT shares of revenue have increased
- PIT shares have remained rather flat
- Trade tax shares have declined
- Measured relative to GDP, the decline in trade tax revenue has not been offset by increases in revenues from other taxes in LICs
- In general, as income levels rise the increase in other revenues is more likely to compensate for declines in trade taxes

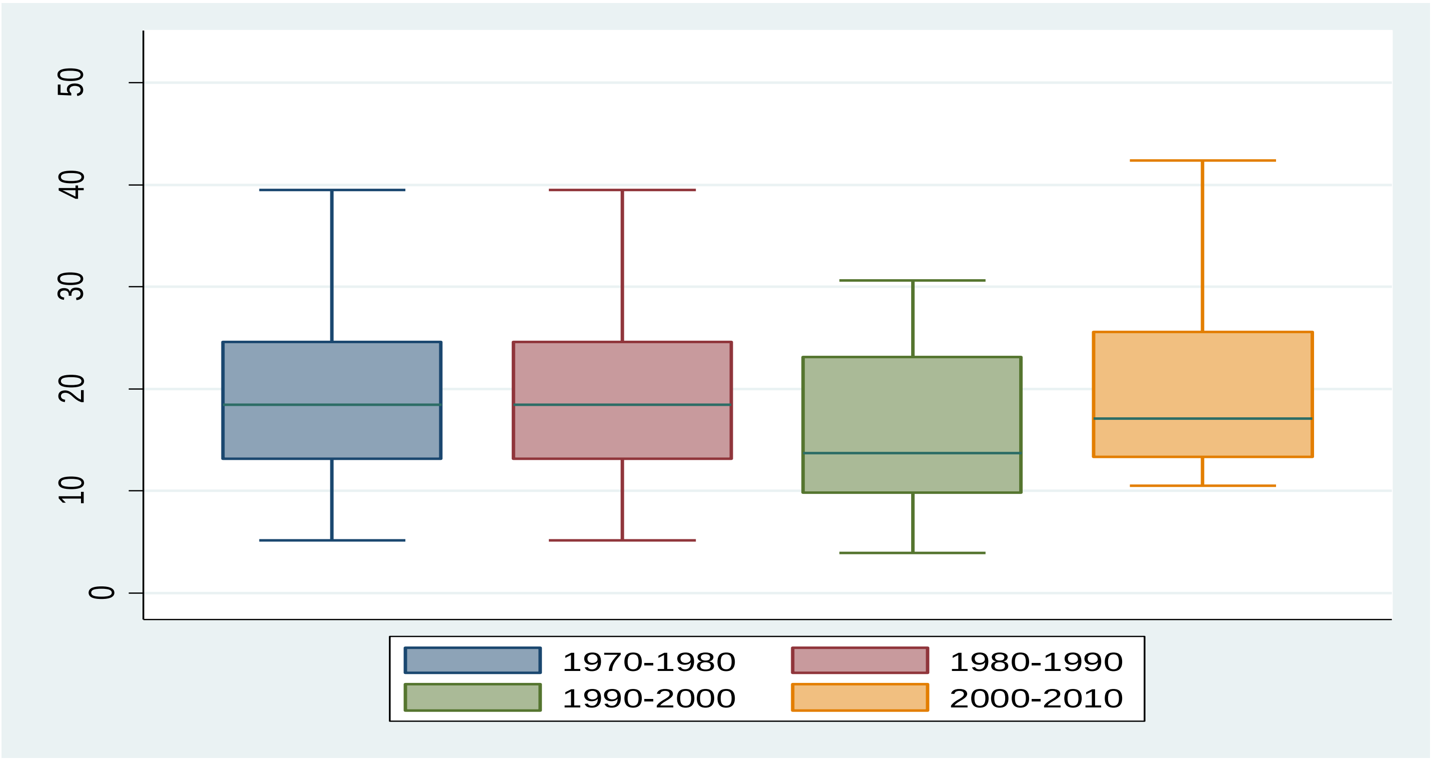
Tax/GDP Trends, IMF, 2011 (Figure 2, p. 13)



Tax Performance

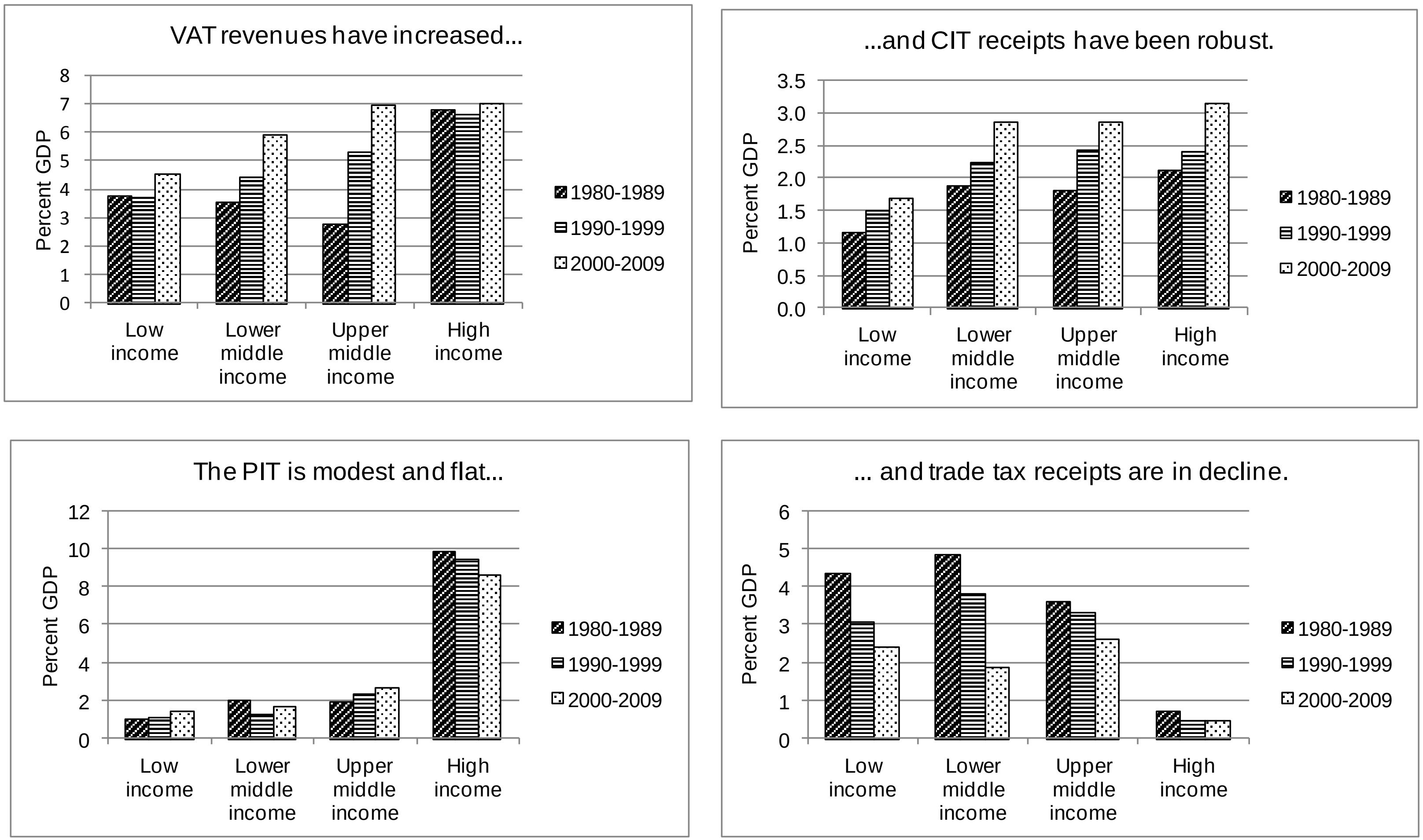


SSA Revenue/GDP Trends



The box plot: whiskers indicate the maximum and minimum values, the line in the box is the median and the size of the box indicates the distribution between the 25th and 75th percentile.

IMF, 2011 (Figure 7, p. 16)



Tax performance typically modelled as determined by:

- Income– revenue expected to increase with GDP pc as collection efficiency improves with development
- Share of agriculture– (% GDP) consistently associated with lower revenue
- Share of industry– (% GDP) expected to increase revenue but evidence is very mixed
- Trade– imports and exports have traditionally been the principal source of tax revenue in LICs
- Aid– ambiguous effect and mixed evidence
- Resources– difficult to tax (transparently)
- Better governance associated with higher revenue

Tax Performance

- Resource tax revenues (often less transparent and more volatile) are important for many SSA countries

- Absence of growth in tax base even with increasing GDP

- Increasing difficulties in taxing the bases that are growing (resource extraction, MNEs and very wealthy individuals)

- Formal sector employment and earnings (the income tax base) and private sector spending (the indirect tax base) are not growing at the same rate as GDP it will be difficult to increase the ratio of tax to GDP

Trade Taxes

Why have trade taxes (especially tariffs) been so important in LICs?

- Revenue needs – the border is often the easiest point to levy taxes (imports and exports recorded), and taxing exports may be easier than taxing the income of producers

- Infant industry arguments promoted protection until trade reforms from the 1980s

- Political (economy) – influential groups lobby for help from the government and tariffs are a politically cheap way of doing this

Tariff Reform (Africa)

- Significant tariff reductions since mid 1980s when average tariffs were over 35% (on average) so that by the early 2000s the average was below 15%

- Reductions strongly influenced by donors, especially World Bank, promoting trade liberalisation (but not consistently linked to other tax reforms)

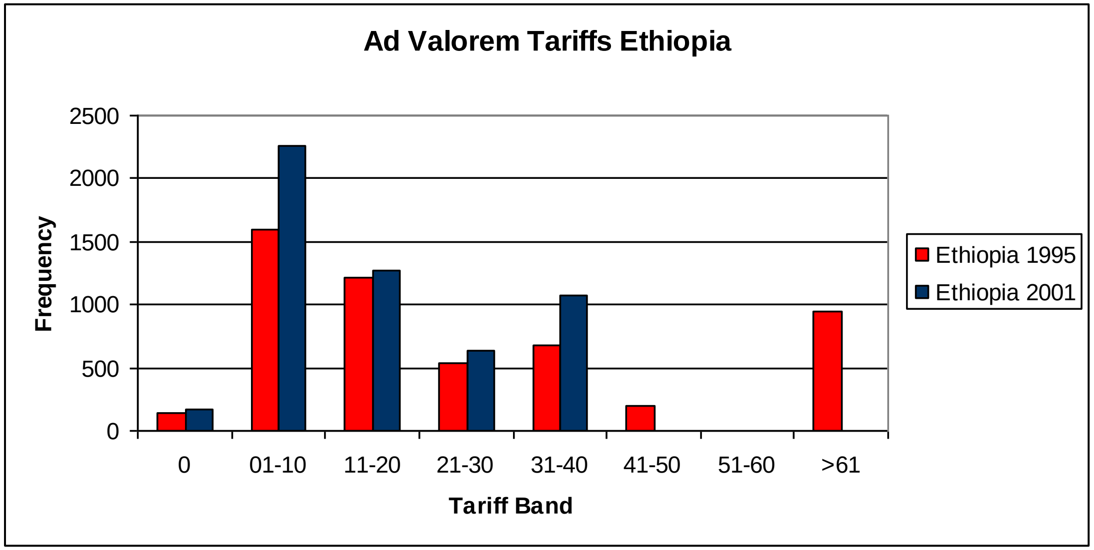
- Pattern of tariff reductions was essentially technocratic in nature (preserves relative protection)

- Larger sectors (measured by the number of employees or establishments) appear to have higher protection

- While political economy factors may have influenced the initial pattern of protection, reforms since the early 1990s have diluted the extent of average and relative protection

Tariff Pattern Changes

Figure 1 Tariff Structure in Ethiopia 1995 and 2001

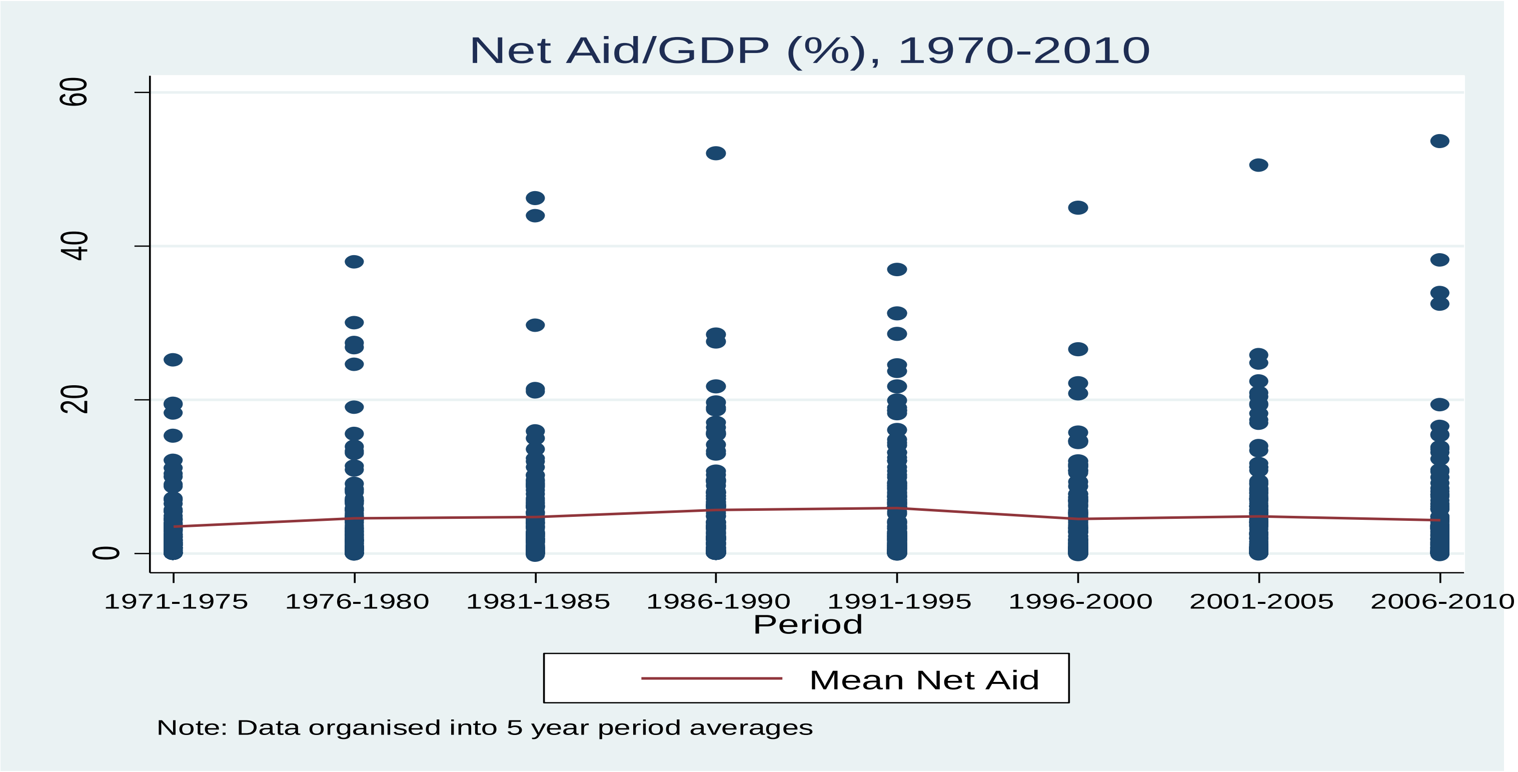


Notes: The tariff (t) bands are: 0%, $0 < t \leq 10\%$; $10 < t \leq 20\%$; $20 < t \leq 30\%$; $30 < t \leq 40\%$; $40 < t \leq 50\%$; $50 < t \leq 60\%$; $t > 60\%$.

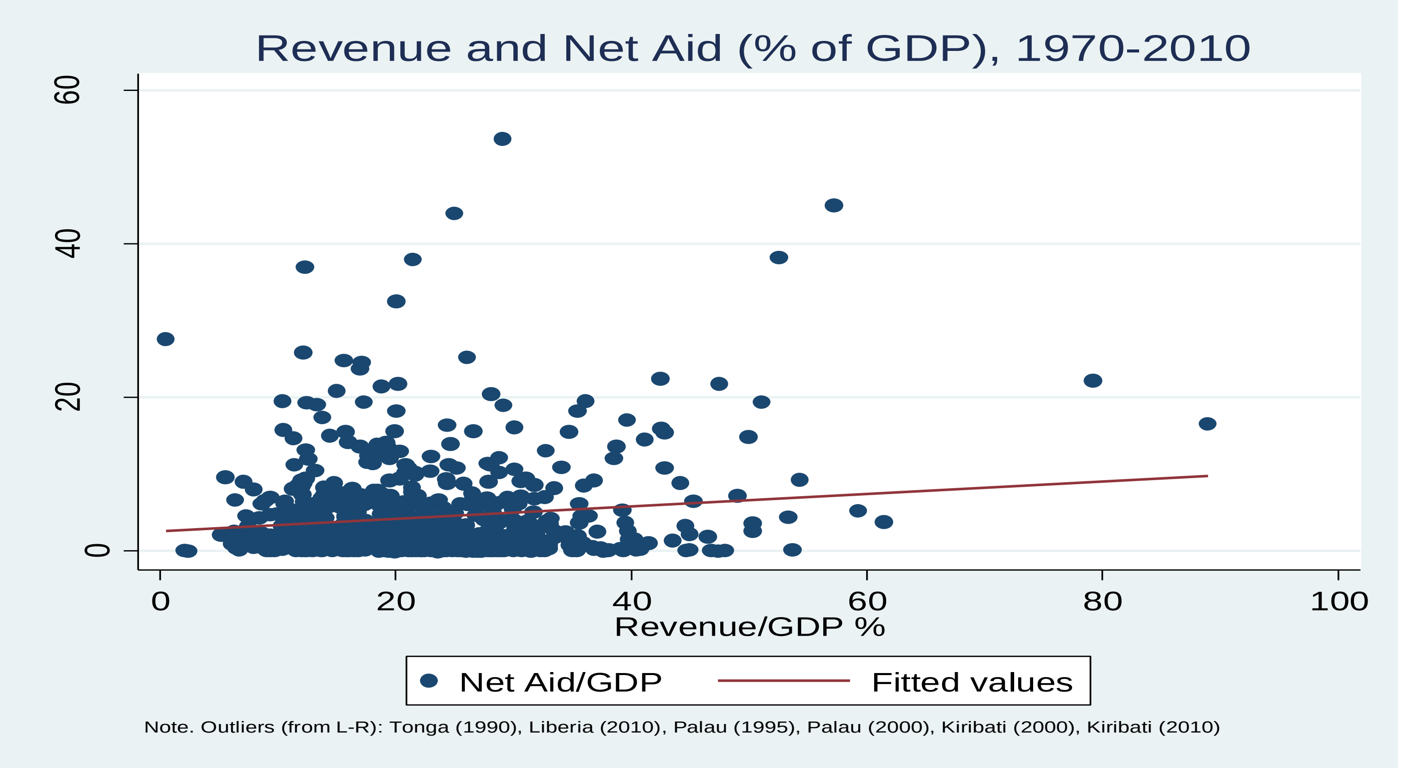
Aid and Taxation

- Aid, and more generally donors, can influence tax performance in a number of ways
- Advocating reforms that reduce tax rates (e.g. tariffs)
- Supporting reforms to improve the tax system (e.g. VAT, SARAs, administration)
- Reliance on aid may reduce incentives to mobilise domestic revenue (but cedes influence to donors)
- Effective aid and economic reforms increases the tax base

Slight Rise in Aid on Average



Weak Correlation With Revenue



Aid and Taxation

- ‘IMF view’ that loans increase tax effort whereas grants reduce tax effort
- Others show that results are not robust and can even be reversed [most likely since 1990s]
- Major issue is that country characteristics may ‘co-determine’ high grant share and low tax/GDP ratio
- Appropriate donor support can improve tax systems and increase revenues
- Tax base growth can also be influenced by donor support

Some References

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- Benedek, D., E. Crivelli, S. Gupta and P. Muthoora (2012), Foreign Aid and Revenue: Still a Crowding Out Effect? Washington DC: *IMF Working Paper WP/12/86*