

Fiscal Affairs Department

OVERCOMING THE CONSTRAINTS TO GROWTH: THE ROLE OF TAX AND SPENDING REFORMS



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“Fiscal Policy, Equity, and Long-Term Growth
in Developing Countries”

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Outline

- (Only) details matter
- Linking taxing and spending
- Dealing with informality

(ONLY) DETAILS MATTER

OECD empirical work points to a growth hierarchy:

1. Property taxes
2. Consumption taxes
3. Personal income tax
4. Corporate income tax

Recent IMF work extends—and modifies—these results for a wider set of countries

But how to move to practical guidance?

- **Other instruments**—e.g. resource taxes; carbon pricing
- **Where do the differences** (e.g., PIT and VAT) **come from**, given equivalencies (e.g., VAT and wage tax)?
- **And details matter**: Not all VATs/PITs/CITs are the same. Two examples.....

Corporation tax:

Priority not to cut, but to reform:

- More effective taxation of rents
- Reduce bias to debt finance

...by for instance, an 'Allowance for Corporate Equity'
(as Belgium, Italy...)

- Strengthen international tax regime

Value Added Tax

Share in total revenue may be positively associated with growth...

Dependent Variable in (growth)	
VAT share	0.263**

Note: Fixed effects; 74 countries 2001-08.

...but decomposing changes in VAT revenue into changes in standard rate, breadth of base ('C-efficiency') and consumption share:

Dependent Variable in (growth)	
VAT share	0.263**
Standard rate	0.442
C-efficiency	0.398***
Consumption share	-0.303

Note: Fixed effects; 74 countries 2001-08.

Where are the gains in C-efficiency to come from?

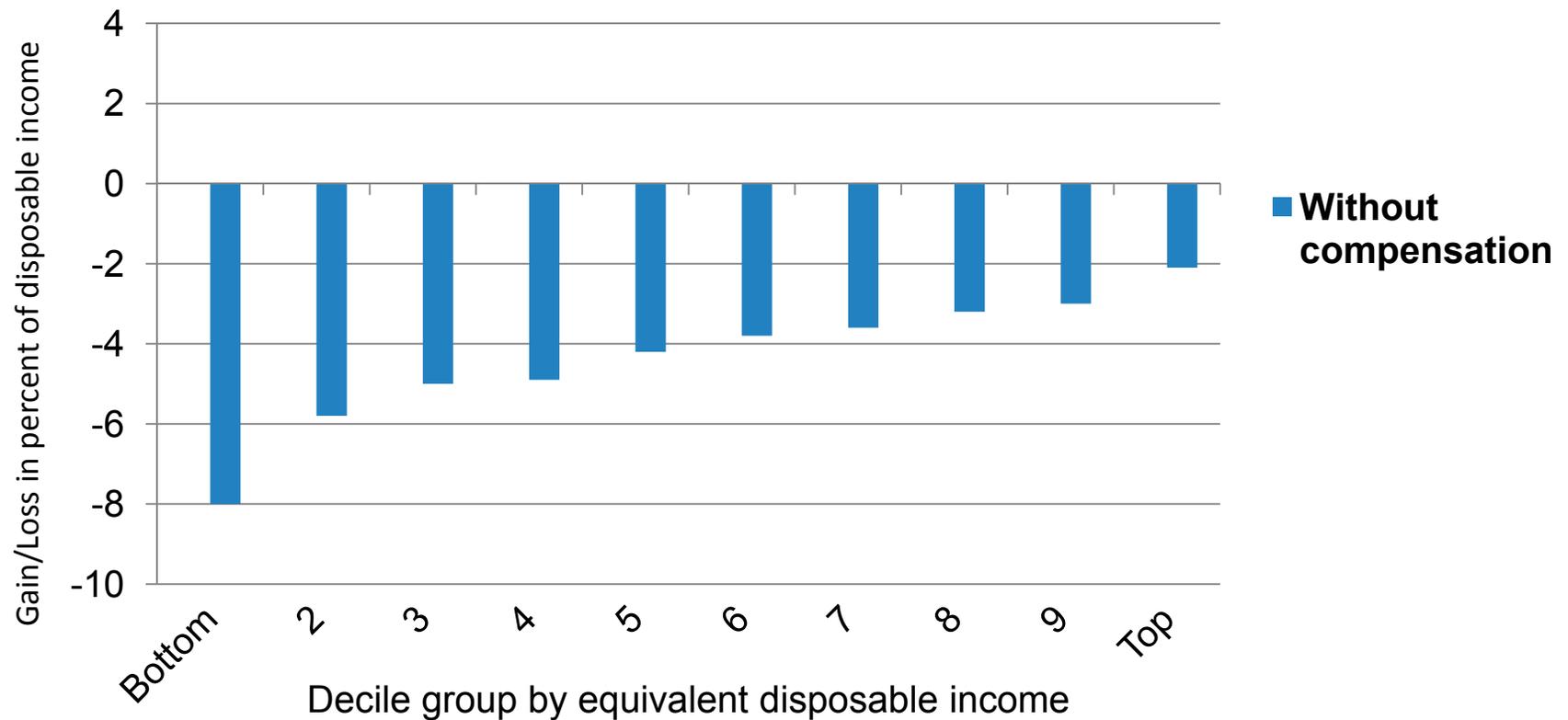
	C-efficiency	Policy gap	Compliance gap
Belgium	52	42	11
France	51	45	7
Greece	47	33	30
U.K.	48	42	17
Colombia	45	16	46
Guatemala	47	19	42
Peru	55	14	36
Uruguay	56	17	33

Sources: Keen (2013), Barreix et al (2012).

LINKING TAX AND SPENDING

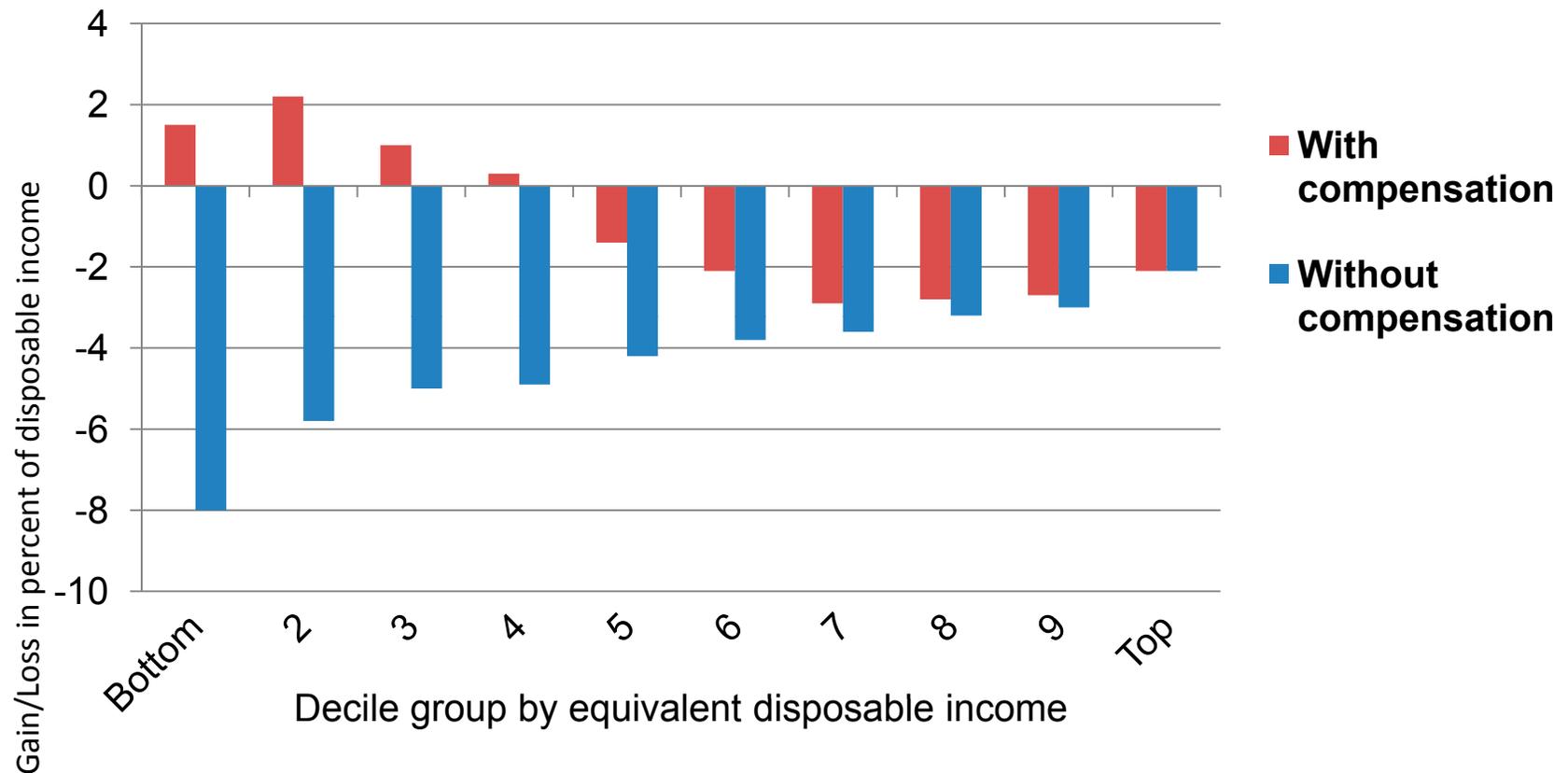
One aspect: Coordinating reforms for
efficiency and equity

In the UK, for instance, eliminating zero-rating (increasing C-efficiency) has a regressive impact...



Source: Crawford, Keen, and Smith (2011).

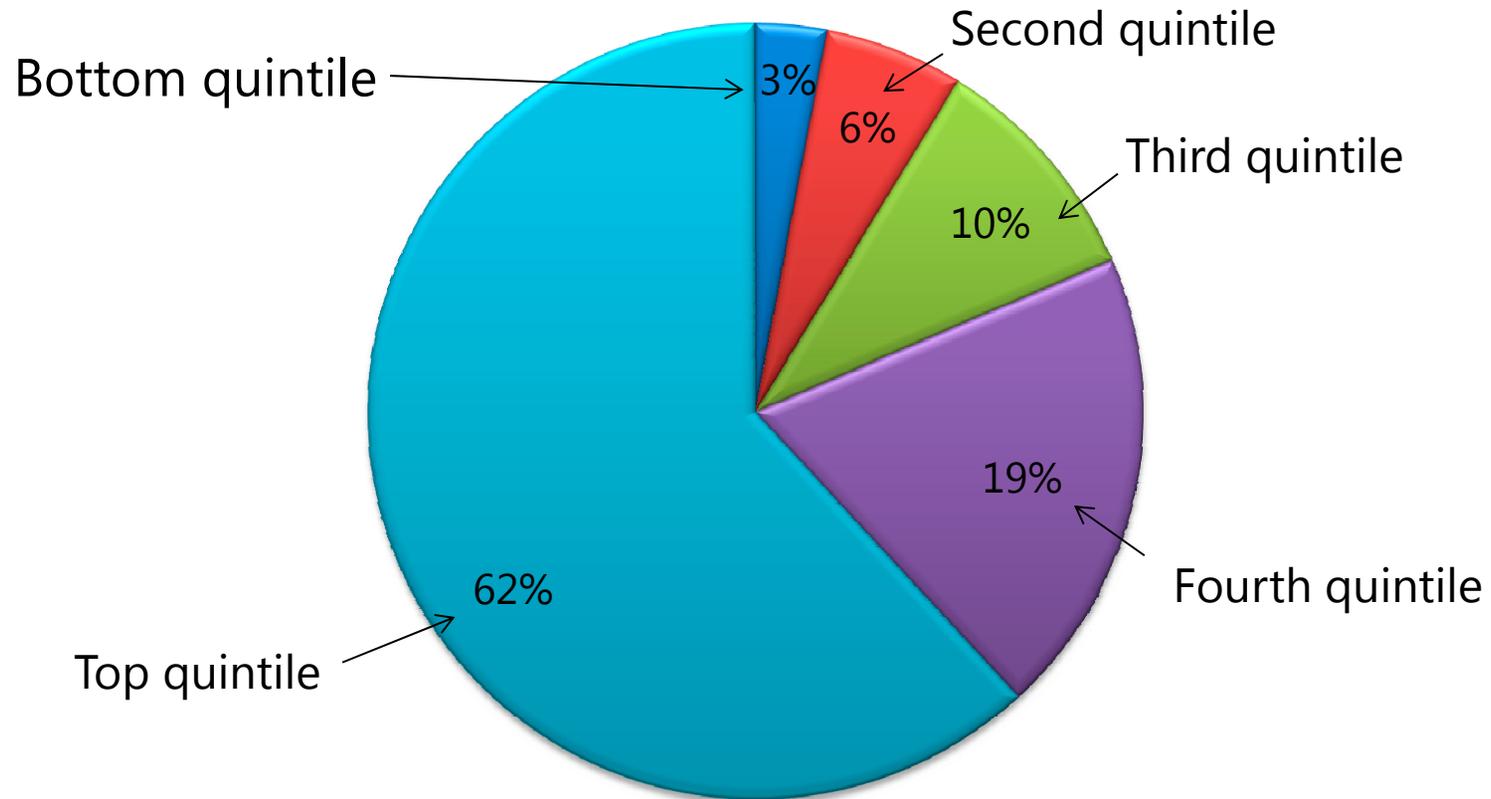
...which can be offset by uprating benefits...



Source: Crawford, Keen, and Smith (2011).

...using up only about half of the revenue gain

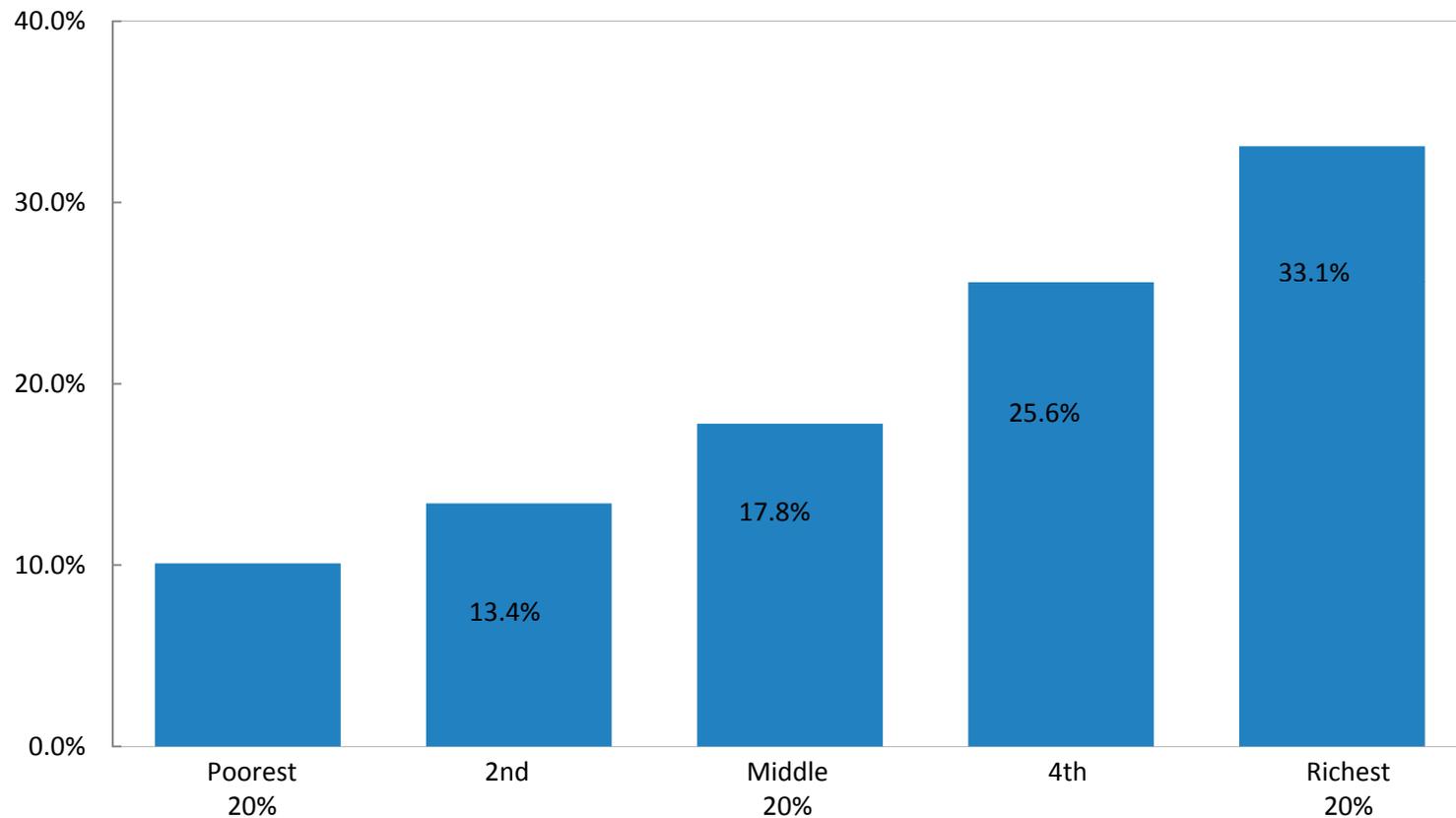
Spending does not need to be very finely targeted to beat price subsidies, e.g., for gasoline subsidies:



Source: Arze del Granado et al (2013).

Can \$1 be spent so that the poorest gain by 4 cents?

Benefit incidence studies suggest answer often “yes”:



For curative medical care in India. Source: Mahar et al (2007).

So why don't these reforms happen?

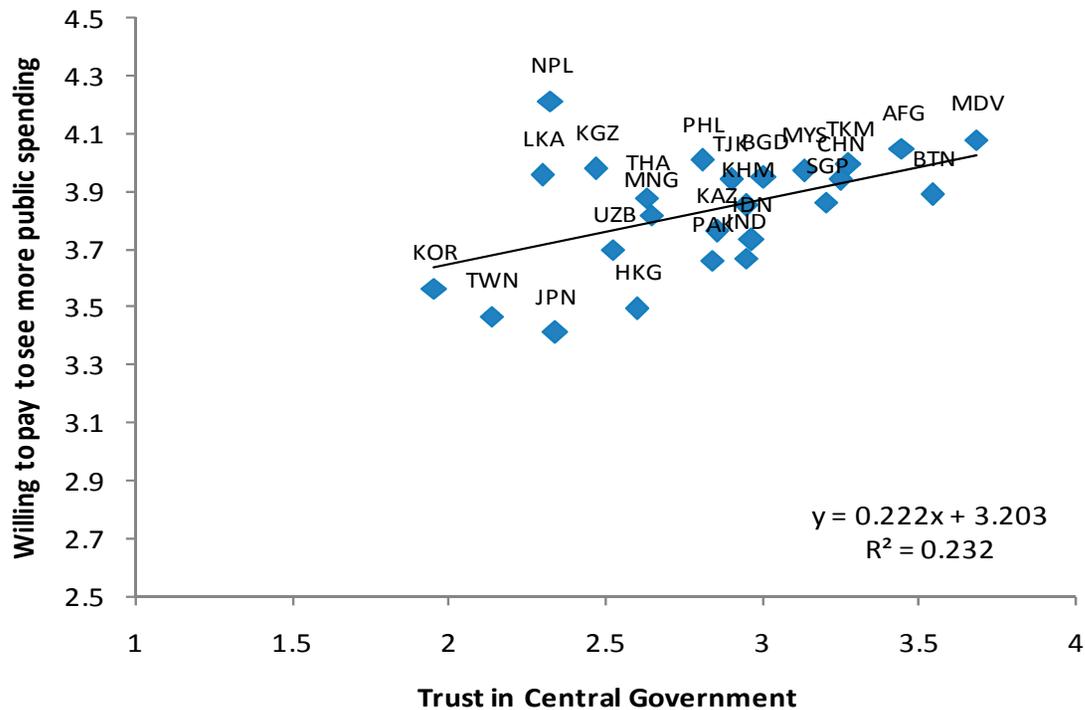
- They increase marginal effective tax rates over some range
 - But rarely cited as a reason
- Powerful are the main beneficiaries from what might look like a pro-poor policy
- Compensation may not be credible

Ways ahead?

- Earmarking?
 - Implies either inflexibility or intransparency
- Lessons from recent work on subsidy reform:
 - Comprehensive, detailed reform plan
 - Far-reaching communications strategy
 - Consider sequencing reform, to build up trust

Second (related aspect): Willingness to
comply ('tax morale')

In Asia, for instance:



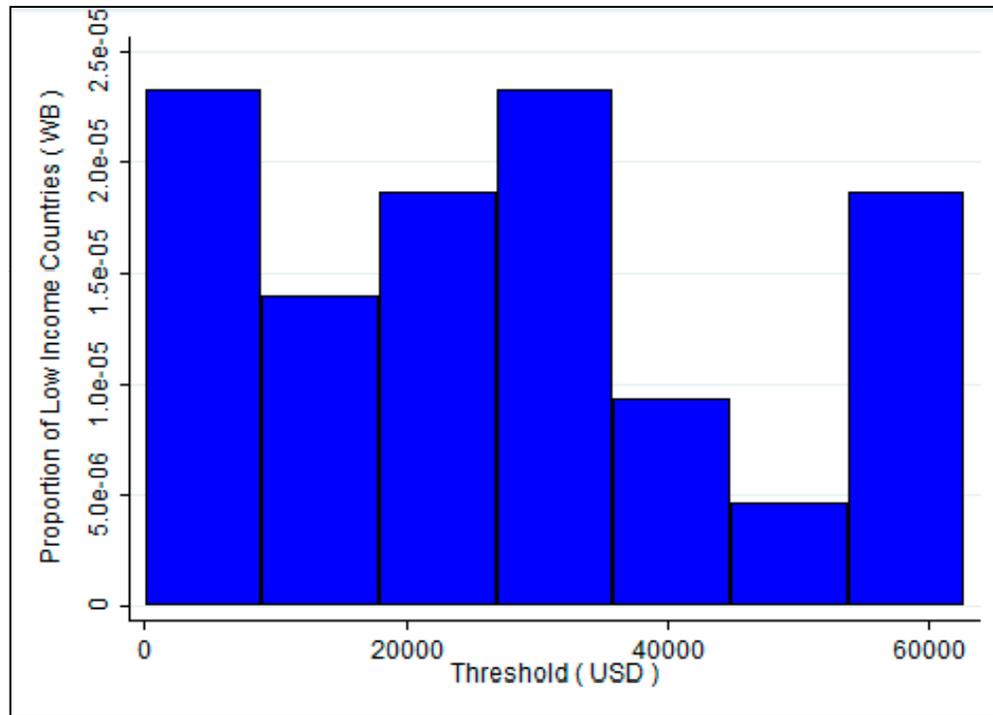
Links between advice on tax reform, PFM and transparency may be closer than often supposed

DEALING WITH 'INFORMALITY'

‘Informality’ often cited as a major obstacle to growth, revenue mobilization and social support

- But little attention in practice—which has focused on larger taxpayers
- Term reasonably well-defined in context labor regulation—but not for fiscal policy
- What are the real issues from fiscal perspective?

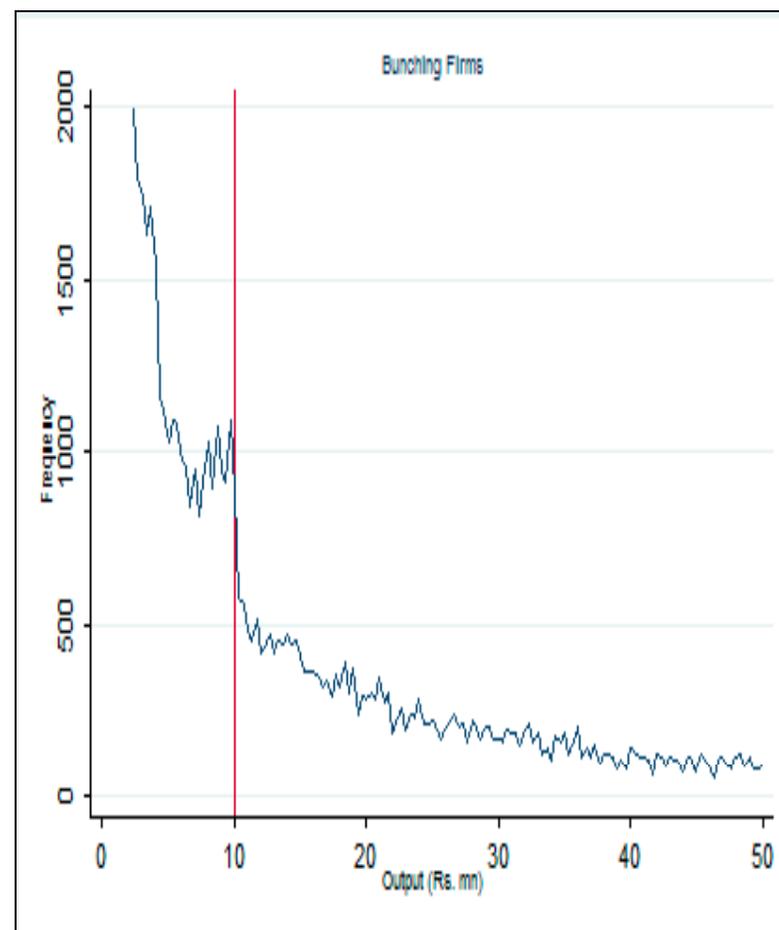
Take choice of VAT threshold—an important (but often neglected) choice



Because of compliance and administration costs, best threshold not zero—but what should it be?

Four types of firms:

- **Unaffected**, and pay no **VAT**—may well be ‘informal’, but fully compliant
- **Contract**—reduce sales to just below threshold
- **Cheat**—non-compliant, but often ‘formal’ in any normal sense (e.g. professionals)
- **Comply**



Source: Chatterjee and Wingender (2011).

Implications:

- Issue isn't informality—it's non-compliance and distortions
- Cheating can generally be reduced by raising the threshold
- But likely wise to set threshold lower than would otherwise be the case
 - E.g. to limit revenue loss from contraction

Wider issue of how to deal with cheaters

- Primarily administrative, but e.g.
 - Use threshold to ensure ‘manageable’ no. of cheaters
- Use of withholding taxes
 - Widespread, but how effective?
- Taxing inputs
 - Not just VAT, but e.g. carbon pricing
- Decoupling social contributions from employment relations?

What of those below the threshold (naturally or after contraction)?

- Narrow cost-benefit above suggests ignore
- But a case for some form of tax (even if it raises less than it costs to administer)?
 - To alleviate competitive distortions
 - As a measure of ‘statebuilding’: to encourage citizens to hold policy makers accountable
 - To develop book-keeping and other skills

CONCLUDING

- We shouldn't over-state what we know
 - Even about taxes' real incidence
- ...and have much to learn
 - E.g. on smaller taxpayers
- Progress can be hard...
 - e.g. C-efficiency increases with political stability
- ...and take time
 - 'big-bang' reforms don't necessarily deliver
- No simple recipe—but we have some ingredients