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**Taxation and Development:  
What Have We Learned from  
Fifty Years of Research?**

Richard M. Bird  
July 2013



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# Taxation and Development: What Have We Learned from Fifty Years of Research?

Richard M. Bird<sup>1</sup>

## Summary

This paper considers how economic thinking about taxation in developing countries has changed over the last half century. It suggests that three different 'models' of development taxation may be discerned over this period. The key element in the first model, which was derived from the dominant public finance literature in the 1950s and 1960s, was the introduction of a comprehensive progressive personal income tax. Experience proved that this approach was not very useful. Fortunately, increased knowledge of the reality of conditions in developing countries, combined with post-1970 theoretical and empirical studies of taxation, soon led to the emergence of a second model for development taxation, centered on a broad-based VAT and much lower rate income taxes, both personal and corporate. While there is still much to be said for this model, more recent investigations of the political and administrative as well as economic dimensions of tax systems in developing countries have led to the gradual emergence of a third 'model' – or, perhaps better, framework – for development taxation. Unlike the earlier approaches, this approach focuses on the need to 'custom build' the different components of the tax system as well as the system as a whole and emphasizes the extent to which sustainable reforms must be developed 'in house' by countries themselves.

**Keywords:** Taxation in developing countries; tax research and tax policy; economics, politics and administration of taxation

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<sup>1</sup> This paper is a revised version of a lecture delivered at the inaugural conference of the International Centre for Tax and Development at the Institute for Development Studies on 21 June 2011.

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# Introduction

From one perspective, the answer to the question posed in the title of this paper is simple: of course we have learned a great deal about taxation and development over the last half-century. However, it is equally obvious that we still have a lot more to learn. Many of the policy suggestions emerging from research often direct our attention to important matters that we do not as yet understand as well as we should. Moreover, even the best research answers to particular questions have usually turned out to be extremely difficult to apply in practice. As two prominent economists recently noted about tax research, ‘...a result from basic research is relevant for policy only if (a) it is based on economic mechanisms that are empirically relevant and first order to the problem, (b) it is reasonably robust to changes in the modelling assumptions, (c) the policy prescription is implementable (i.e. is socially acceptable and is not too complex)’ (Diamond and Saez 2011, abstract). Few propositions even in the most recent research literature on taxation in developing countries – see, for example, Stiglitz 2010 – as yet come close to passing these tests.

The middle ground between grand theory and case studies – the space within which policy-relevant approaches to the tax-development nexus presumably lurk – remains largely undeveloped. Indeed, a major rationale underlying the research to be undertaken under the auspices of the new International Centre for Tax and Development is, as I understand it, precisely to clear out some of the underbrush obscuring the critical political-economic linkages that dominate this middle ground so that we may begin to understand better how to improve tax policy and administration in the very heterogeneous settings found in different developing countries.

It is important to emphasise that this is not and cannot be a search for some new, simplistic ‘one size fits all’ solution. Over the past fifty years both academic researchers and international institutions – sometimes following ideas suggested by research, sometimes responding to populist fads or pressures from the politically powerful – have issued many policy prescriptions with respect to how to improve economic growth and development in poor countries: increase capital investment; improve education; control population; liberalise trade and capital markets; reduce government controls on market activities; and so on, and on (Easterly 2002). Each of these policies has at times been marketed as a universal ‘silver bullet’ that will result in improved economic performance wherever applied. Unfortunately, none has worked as advertised.

What might be called the standard approach to tax and development has similarly undergone a number of major model changes over the years, with various stages in between and the extent of ‘beta testing’ or ‘piloting’ varying sharply from model to model. Despite the understandable desire of many to find a relatively simple model with which to understand and manipulate complex reality, it seems most unlikely that we shall ever be able to develop some magical fiscal medicine, the swallowing of which will always and everywhere lead to ‘the improvement of mankind’ (as an historian of thought (Robson 1968) once labelled the fundamental aim of John Stuart Mill’s life and work). What this complex and changing world needs is not some non-existent ‘universal fix’ but rather a sort of fiscal medicine kit containing a variety of remedies and treatments that may help us cope with the wide variety of fiscal problems and needs that arise at different times and often in different ways in different developing countries.

My aim in this brief paper is thus both ambitious and modest. It is ambitious in that I attempt not only to provide a perspective on a half century of work by many people and institutions on many taxation issues in many developing countries but also to point out some questions that seem to call for more research. However, its conclusion is modest in the sense that I emphasise that even the best research is only one of many inputs in shaping public policy.

Indeed, I argue that to some extent the problem is perhaps not so much to improve research on tax and development as it is to improve how we market what we learn to those who can, if they wish, put the knowledge to use.

Consider, for example, the two most important changes in tax structures around the world in the last fifty years: the introduction of the VAT and the general lowering and flattening of statutory income tax rates. Depending on one's political perspective and on how one interprets the economic analysis, each of these changes might be considered in any particular country – or perhaps more generally – to be either a fine example of how good tax research can influence tax policy or a horrible instance of how the rich and powerful can and do employ research selectively to support their personal interests.

The worldwide move downward of personal and corporate income tax rates, for example, has been supported both by developments in economic theory and by research results showing the large efficiency costs of high marginal tax rates. Similarly, to some extent at least the widespread adoption of VAT probably reflects the research results suggesting that this way of taxing consumption is less economically distorting than most other forms of indirect taxation.<sup>2</sup>

On the other hand, economic research has seldom if ever been either the main or the only story with respect to either of the changes just mentioned (or, for that matter, of any significant tax change). Economic research may of course provide valuable inputs into policy decisions, both because it is the only approach that focuses tightly on the important question of how efficiently we are using the resources we have to obtain the things we want and because it can – though often economists do not – say some useful things about the distributional outcomes that impact more immediately on policy decisions in most countries. However, as history shows, even the best economic research on taxation in itself never provides either a necessary or sufficient basis on which to develop and implement 'good' fiscal institutions.

# 1 Fifty Years of Fiscal History

The three decades between the end of World War II and the first oil crisis of the mid-1970s were on the whole years of growth and prosperity in most developed countries. This experience first with successful government-led success in war and then with rapid and generally equalising market-led growth inevitably shaped the ideas of the few people – mainly economists – who were beginning in the 1950s and 1960s to think about tax issues in the very heterogeneous group of developing countries, many of which were then in the process of emerging from colonial status.

Most experts, perhaps inevitably, tended to suggest to developing countries looking for (or, at least, receiving) advice on tax matters not just what they thought had worked in their own countries but also what they considered to be even better – one might even say 'optimal' – systems suggested by new theoretical research. At the time, the accepted academic view of good tax policy was, more or less, that the ideal tax was a broad-based personal income tax with progressive rates that included capital gains in the tax base and was integrated with the corporate income tax in order to make both the decision to incorporate and the choice between debt and equity finance more neutral (Auerbach 2010). This concise summary tells the story: it was all about the income tax, at least in English-speaking countries. Indeed, at the time the report of the Canadian Royal Commission on Taxation (1966) was called 'a

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<sup>2</sup> For further discussion of these two examples, see Bird (2011).

landmark in the annals of taxation' by Harberger (1968) precisely because it was the most detailed attempt to turn these ideas into practical policy recommendations.

Given this background, it is not surprising that what might be called *Development Tax Model 1.0* basically set out a progressive comprehensive personal income tax as the ideal tax for developing, as for developed countries. Indirect consumption taxes were considered at best as a necessary evil, and both the international and sub-national aspects of taxation were generally neglected. Moreover, in line with the prevailing view of 'government as leader' most experts urged not just better (more progressive) but more taxes as necessary to development (Kaldor 1963). For twenty years or more such eminent foreign advisers as Kaldor, Shoup, and Musgrave and their followers recommended packages based on this model to, more or less, all comers.<sup>3</sup>

The outcome of all this advice is not impressive. During the 1970s and 1980s, not only did relatively few developing countries increase their tax-GDP ratios but income taxes became relatively less important in most countries as broad-based consumption taxes (usually in the form of VATs) became more important in the tax mix. Interestingly, over this same period, new developments in both theoretical and empirical public finance generally reinforced the lesser emphasis on income taxes and heavier reliance on consumption taxes that had emerged in practice. The result of the parallel developments in both practice and research was the gradual emergence of what might be called *Development Tax Model 2.0* as, more or less, the fiscal component of the so-called Washington consensus that ruled the policy roost after the early 1980s.

The main pillar of development tax policy in this model – which I have elsewhere called the BBLR (broad base low rate) model (Bird 2011a) – was no longer the personal income tax but the VAT (value-added tax), preferably (according to Model 2.0) imposed at a single rate and on a broad base. One reason for placing VAT at the fiscal centre in many countries was the increasing emphasis on lower and more uniform import tariffs. Income taxes, both personal and corporate, were still seen as important but with definitely lower rates, broader bases and fewer incentives. More attention was paid to local governments but for the most part they were told simply to make better use of the traditional property tax. Interestingly, although some attention was paid to the continuing importance of traditional excises, almost never were payroll taxes, although important in some countries, taken into account at all in tax discussions. Finally, as with Model 1.0, the message to most developing countries with respect to tax levels continued to be that 'more is better' – tax levels should be increased.

As noted earlier, VAT did become more important in many countries and income tax rates definitely declined almost everywhere, so at first glance it may seem that Model 2.0 was much more successful than Model 1.0. If one probes more deeply, however, it can be argued that in broad terms neither the level nor the structure of taxation in most developing countries is all that different in 2011 than it was when I first began to think about these issues in Mexico fifty years ago.

Consider first tax levels. The UN Millennium Project (2005), much like Kaldor (1963), informed developing countries that on average they needed to mobilise another 4 per cent of GDP in tax revenue to achieve the minimal Millennium Development Goals – that is, to increase from their current average tax ratio of 17-18 per cent to something closer to 22 per cent. More recently, the International Monetary Fund (IMF 2011) was, as one might expect, a bit more cautious, suggesting only that a 2 to 4 per cent increase in the ratio was both desirable and feasible in most developing countries – and noting that most could likely get up to 2 per cent more from VAT alone with no great effort. In reality, however, the tax-GDP ratio has, on average, hardly increased in developing countries over the last 30 years. Indeed,

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<sup>3</sup> For my own early effort along these lines, see Bird (1970).

taxes went up relatively much more in the developed countries during this period (Bahl and Bird 2008). Of course, a few fast-growing countries from time to time have managed to achieve and even exceed the UN-prescribed rate of increase though in most cases it is not clear that the new, higher levels reached are necessarily sustainable.

On the whole, fiscal inertia seems more common than fiscal growth, with many countries remaining for relatively long periods at more or less the same tax-GDP level. Kaldor (1963) would likely say now, as he said then, that the main reason taxes have not gone up in most countries is not because circumstances make it difficult but because it is seldom in the interest of those who dominate the political institutions to increase taxes. Economists more generally – not a group keen to jump on the revolutionary barricades – find it difficult to suggest an alternative explanation and often end up doing little more than recommending the always unwelcome medicine of fiscal Puritanism – a combination of fiscal abstinence (stop wasting money) and fiscal rectitude (collect the taxes you impose).

Perhaps more surprisingly, there is some evidence of similar ‘inertia’ even in tax structures. Although there is considerable variation within the diverse group of developing countries, in most countries less has been going on than may be apparent to eyes dazzled by the seemingly endless changes of tax rates and tax legislation in many countries. For example, although how consumption taxes are collected has changed as countries have adopted VATs, the relative importance of such taxes on average has hardly changed at all as increased VAT collections (often on the same import base) have been offset by decreases in customs revenues (Martinez-Vazquez and Bird 2011). ‘Business as usual’ is thus a better description than ‘tax reform’ when it comes to tax reality in many countries – despite the fiscal challenges they face and the many tax changes they often make.

Of course, even the poorest countries, although obviously more constrained than richer countries, have considerable discretion as to how much they raise and how they raise it (as well as how they spend it). Both opportunity and choice affect tax levels and tax structures. Originally, most studies stressed opportunity – that country taxes mainly reflected their economic structure. Per capita GDP and the non-agricultural share of GDP continue to be important explanatory factors. However, more recent studies using such ‘demand-side’ variables as quality of governance, inequality, size of informal sector, and tax morale (e.g. Bird, Martinez-Vazquez, and Torgler 2008) suggest that to a significant extent tax levels in different countries reflect people’s perception of the quality and responsiveness of the state. Kaldor (1963) was thus right in the important sense that countries that wish to tax more need governing institutions that facilitate the achievement of this goal. Doing so by enhancing the rule of law, reducing corruption and the shadow economy, and improving tax morale, is obviously neither simple nor easy. But at least some countries may find it easier to do such things than to find oil – and they may well be better off by doing so since oil wealth may solve the revenue problem only at the cost of exacerbating substantially the governance problem.

Despite the emergence in recent years of a mountain of empirical studies on the impact of taxes on growth (OECD 2008), only a few small mice of agreement have yet emerged from the mountain, largely because the effects of taxes in particular country settings often depend both on very detailed characteristics of tax design and implementation and market structure that are not easily captured in econometric models.<sup>4</sup> Still, as countries develop and become more open, the expanding mass modern production and consumption activities on which the tax systems of developed countries rest (Gordon and Li 2009) need to be captured in the tax base without either overstraining administrative capacity or unduly discouraging the expansion of such activities. This can be a fine line to draw and one that may be beyond the reach of some countries, not least because what is often the leading edge of growth – outward-oriented development – may all too easily become the bleeding edge of the fiscal

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<sup>4</sup> For a nice historical analysis underlining this point, see Lindert (2003).



system as it becomes more and more difficult to levy taxes effectively on capital income, thus potentially exacerbating internal inequalities and political pressures on the tax system.

Moreover, even the best tax laws yield revenue only when they can be effectively implemented. In many developing countries, 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 – an economy that may itself to some extent be a function of how taxes are designed and implemented (Alm, Martinez-Vazquez and Wallace 2004). Such problems are more difficult to cope with when the scale of the problem depth is great and the available administrative capacity limited.

In a very real sense, 'tax administration *is* tax policy' (Casanegra de Jantscher 1990, 179). *How* revenue is raised – the effect of revenue-generation effort on equity, the political fortunes of the government, and the level of economic welfare – may be equally (or more) important as *how much* revenue is raised. The best tax administration is not simply the one that reflects the most revenues; facilitating tax compliance is not simply a matter of adequately penalising 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 administrative effort. All this makes tax administration complex and assessing the relation between administrative effort and revenue outcomes a difficult task. Work on this subject has barely begun even in developed countries (OECD 2009), and we know far less than we should about many aspects of this critical dimension of taxation in developing countries (Bird 2004).

The same can be said of an even more fundamental determinant of tax system change – the political economy of taxation. Those who design and implement tax systems, like those who try to escape them, probably consider themselves to be eminently 'practical' people responding to the world around them as they see it. Keynes (1936, 384-85) once said that 'practical men, who believe themselves to be quite free from any intellectual influences, are usually the slaves of some defunct economist. ....soon or late, it is ideas, not vested interests, which are dangerous for good or evil.' This dictum both unduly flatters economists and gives too little weight to the fact that tax policy is shaped not only by ideas but also by vested interests, changing economic conditions, administrative constraints and technological possibilities, and, especially, by the nature and functioning of the political institutions within which these factors affect policy decisions.

Developing countries are no different than others: ideas, interests, and institutions determine tax policy. The best tax system for any country is presumably one that reflects its economic structure, its capacity to administer taxes, its public service needs, and its access to such other sources of revenue as aid or oil. In addition, however, it must also take into account such nebulous but important factors as 'tax morale', 'tax culture', and, perhaps above all, the level of 'trust' existing between people and their government. Tax policy decisions are not made in a vacuum. Nor are tax systems implemented in one. The taxes that are adopted in a country and how they are administered are always and everywhere both path-dependent and context-specific. They reflect the outcome of complex social and political interactions between different groups in society in a specific institutional context established by history and state administrative capacity. In turn taxes may themselves to some extent influence the showing the context, nature and outcomes of such interactions (Moore 2007). Like tax administration, tax politics deserves close attention by those interested in improving tax policy.

## 2 Where Are We Now?

Until recently, however, little research focused on either the administrative or the political dimensions of taxation. Economists, for example, approached the tax-development nexus strictly from their own disciplinary perspective. To illustrate, one curious result of the prolonged theoretical discussion among tax economists about new forms of progressive direct consumption taxes may, by leading most economists to change their view of the relative virtues of taxing consumption versus income, have been to foster a better – but still not very (if at all) progressive – indirect consumption tax in the form of VAT. Of course, VAT has swept the board for a number of reasons that have little, if anything, to do with the internalisation of lessons from research. In the European Union, for example, the rationale for adopting the VAT was primarily to deal with troublesome cross-border trade issues. In most of the rest of the world, the rationale was in part the reputed administrative advantages of VAT compared to other forms of sales taxes, in part the desire of the IMF and other external advisers to increase the income-elasticity of consumption taxes, and most recently the need to accommodate WTO-linked trade liberalisation while replacing the revenue from customs duties.

Similarly, much economic research suggests that high marginal tax rates (MTRs) can induce a variety of changes in the behaviour of taxpayers, with resulting economic costs. Tax-induced changes may include changes in hours worked and in labour force participation, the substitution of non-taxable for taxable consumption, changes in the timing of income realisation, changes in the form of compensation (including incorporation), use of deferred compensation and other tax shelters, and increased evasion. Statements like these are uncontroversial to economists and may appear to support arguments lowering higher marginal rates and imposing less progressive taxes. In fact, however, both the theory and the evidence on the size and distribution of any gains from such policies are at best ambiguous (Diamond and Saez 2011). To paraphrase Shakespeare, ‘there are more things in heaven and earth, Horatio, than are dreamt of in optimal tax theory.’

Nonetheless, many countries around the world, both developed and developing, have lowered marginal tax rates on high income recipients and corporations. In part, this decline in income tax rates is likely attributable to increasing recognition of the fact that, countries can no longer treat the international dimension of tax policy as a kind of ‘add-on’ to domestic tax policy. The globalisation of international capital markets and the accompanying regional and international competition for capital clearly influenced corporate tax policy in a number of countries prior to the recent financial crisis. In the more open international capital markets of recent decades all countries are to some extent in competition for capital and must factor this reality into their income tax systems.

Tax research has not yet produced any simple norms to tell us what a good system of international taxation would look like. I suspect, however, that answers to the intractable problems facing international tax designers are unlikely to be found either in the traditional source or residence principles (Bird and Wilkie 2000) or in such new ‘principles’ as ‘capital ownership neutrality’ (Desai and Hines 2003). Some have suggested that what the world may need to grapple with the tax problems of globalisation is a formal ‘International Tax Organisation’ with at least some enforcement powers (Tanzi 1995). However, this seems to be several giant steps closer to world government than anyone is likely to go in the near future – or perhaps should go at all. Those looking for solutions to the international tax dilemma should perhaps pay more attention to the ‘soft governance’ institutional setting of the OECD since reasonable (that is, acceptable) solutions may eventually emerge from this milieu (Bird and Mintz 2003). As experience shows, ‘...there are many problems that people are unable to solve in the abstract, but are able to solve when placed in a real-world context’ (Babcock and Loewenstein 1997, 122). International taxation may be one such problem.

A recent review of optimal taxation notes that ‘where large gaps between theory and policy remain, the ...question is whether policymakers need to learn more from theorists, or the other way round (Mankiw, Weinzierl and Yagan 2009, 2).’ With respect to the tax-development nexus the choice seems clear: tax researchers need to understand the real constraints and objectives facing policymakers before offering them pre-cut solutions to what researchers think are their problems. Not only is the world within which tax policy decisions are made complex; so are the motivations of those who make, and react to, such decisions.

As mentioned earlier, for example, economic research undoubtedly contributed to the two most important changes in tax systems in recent decades – the introduction of the VAT and the general lowering and flattening of statutory income tax rates. But countries did not do these things because economists produced persuasive theories or empirical evidence that it would be good to do them. On the contrary, often tax researchers have not so much led the reform elephant as mopped up behind it. VAT, for example, was developed in France and then adopted in Europe as a better way to administer a general consumption tax, particularly with regard to cross-border trade. Countries lowered and flattened income taxes because more people rose into tax brackets formerly occupied, if at all, by a few rich people and because of perceived international competition for capital and to some extent even for highly-skilled workers. To some extent, economists then came along to rationalise in terms of accepted theory developments that had already occurred in the real world.

Even when policy-makers do buy economic arguments and evidence, they often do so for their own reasons, not simply because the economic doctor tells them it would be good for them. Indeed, to those who have been involved in the process, it sometimes seems that tax research and tax policy are activities carried on by different people in different rooms who do not communicate very well with each other. Economists in particular often feel this way when they see the extent to which perceptions, often unfounded, about the effects of changes on equity or politics trump efficiency analysis, even if the latter – unusually – has been presented to policy makers in a language and context to which they can relate. One good anecdote, even if untrue, often trumps 100 sound econometric studies in the world of tax politics.

This rather negative appraisal of the effects of tax research on tax policy does not, of course, imply that tax economists should give up. It is essential, to paraphrase Harberger (1971), that economists continue to carry the flag of efficiency proudly into battle because if they do not, no one else is likely to do so, and the efficient use of scarce resources is especially important in poor countries. Moreover, the research glass is at least half full from a policy perspective. Both the BBLR approach to income taxes and the VAT as a superior form of sales tax and the best way to replace trade taxes were extensively marketed to the developing world by fiscal missionaries from the IMF and elsewhere. The relative success of these ideas may lie at least to some extent in the fact that, arguably, they coincide with elite interests. Elites likely pay most of the income taxes in developing countries so they benefit directly from reduced and flatter income taxes. Although elites do not pay most VAT, they control the companies that act as collection agents for this tax, and it is generally in their interests to extend the tax base as far as possible in order to draw into the tax net as much of their ‘informal sector’ competition as possible. But none of this means that these changes were not sensible in most countries: they were.<sup>5</sup>

Researchers who wish to influence public policy must pay more attention to the issues that appear to motivate elite policymakers – both officials and politicians – as well as people more generally, even if this means that they may pay somewhat less attention to producing publishable academic papers. This is in no sense a plea for ‘dumbing down’ policy analysis.

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<sup>5</sup> See the discussion in Bird (2011a) and Bird and Gendron (2007).

On the contrary, in many ways – certainly from the perspective of improving tax policy outcomes – it is a plea to smarten it up.

To illustrate, analysis that assumes distributional considerations are either unimportant or can easily be accommodated by (usually unspecified) adjustments somewhere else in the tax-transfer system simply does not resonate in the policy context of most countries. Distributional issues matter in tax policy. Indeed, they often dominate in the minds of those who shape that policy. However, it is unlikely that the principal concern is the sort of broad poverty-alleviation goal beloved by many academic writers on development. Policy-makers may talk about poverty-alleviation and more egalitarian income distribution. In reality, however, at least in my experience, their concerns about policy outcomes are usually much more narrowly focused: How will this region or locality be affected relative to that one? Will home-owners be disadvantaged or benefited? How will the old be affected? What will be the effects on farmers and the rural sector? Will this or that industry be better or worse off?

Such questions are seldom considered in mainline academic research, but they are frequently the meat and bones of actual policy decisions. To resonate in policy circles, research thus needs to speak to such questions, whether or not they fit easily or at all within the accepted disciplinary research model. If academics want their research to be taken seriously, they need to be able to tell good stories that relate to the concerns that people have – regardless of whether those concerns are seen as central, or even acceptable, in some circles.

For example, although fairness is always a key issue in designing any tax regime what is considered equitable or fair by one person may differ from the conceptions held by others, including academic researchers. The general failure of tax economists to say anything that policymakers consider useful about distributional issues has often relegated them, and their evidence, to the sidelines in policy discussion. Distributional studies are both conceptually and empirically difficult and very model-specific. But equity issues lie at the heart of many public policy questions and unless and until economists can deal more explicitly and satisfactorily with this issue both in the practical terms mentioned earlier and in more philosophical terms<sup>6</sup>, their success record in influencing tax policy seems unlikely to improve much.

In addition, if one wishes to affect policy, one must be able to explain it in a way, and in forums, that will come to the notice of policymakers. Although a few prominent academic economists have not hesitated to engage in public discussion of key policy issues, attempting to convince wider audiences of the cogency and importance of the economic analysis of taxation, such direct involvement in policy discussion is usually off limits for those who aspire to tenure in an academic economics department. Nonetheless, those concerned with the persistence of bad policies unsupported by either coherent reasoning or cogent empirical evidence must be willing both to communicate with policymakers and to engage with the (small) informed public with which policymakers interact.

Tax policy is not just about economics but about politics. To understand how the economic analysis of tax issues is perceived in any country and to affect policy outcomes one must understand as best one can the political as well as the economic factors that shape policy decisions and policy outcomes in that country. The level and structure of taxation reflect deep-seated institutional factors that, in the absence of severe shocks, do not change quickly. Tax policy decisions are not made in a vacuum. Nor are they made by a benevolent government. They reflect the outcome of complex social and political interactions between

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<sup>6</sup> For example, although surprisingly few tax policy economists seem even to be familiar with Rawls (1971), they would do well to think more deeply about some of the important, and difficult, issues raised in Sen (2009)'s recent impressive reconsideration of the idea of 'justice'.

different groups in society in an institutional context established by history and state administrative capacity. Taxation is not just a means of financing government; it is also a very visible component of the social contract underlying the state. Citizens are more likely to comply with tax laws if they accept the state as legitimate and credible and are thus to some extent both willing to support it and afraid of what will happen to them if they don't. Tax policy changes depend largely on how different political groups perceive proposed changes and how they react to these perceptions.

As Lledo, Schneider, and Moore (2003) put it, any major tax reform is thus always and everywhere 'an exercise in political legitimation.' Those who will have to pay more must be convinced that they will get something worthwhile for their money. Those who do not want to pay more must not be able to block reform and, in the end, must be willing to go along without taking to the hills in revolt or fleeing the country.<sup>7</sup> Those within government and in the private sector who have to implement reform must support it or at least not actively sabotage it. And of course politicians have to see sufficient support to warrant putting reform not only on the agenda but on the ground.

### 3 Play the Right Game

If tax research is to affect tax policy, researchers must therefore play the right game. Major changes in taxation generally require major changes either in the political reality of a country or in its economic circumstances. In normal times a 'good' tax reform – one intended to raise more revenue in a more efficient and equitable fashion – may be like a 'good' seat belt law: if everything else stays the same, lives will be saved (the tax ratio will increase). But things do not stay the same: some people drive faster when they are belted in (administrative efforts slack off, concessions to favoured groups multiply) with the result that death rates (tax ratios) show little change. Countries appear to achieve a sort of equilibrium position with respect to the size and nature of their fiscal systems that reflects the balance of political forces and institutions and then to stay there, fluctuating around some relatively stable ratio, until 'shocked' into a new equilibrium (Bird 2003).

The tax policy world is very different in many respects now than it was 50 or even 20 years ago. Both the economic and the intellectual environments have changed. Ideas matter; so do institutions and interests. To understand the tax policy game in any country, all these aspects need to be considered. An historical example may help make the point. In the United States over the 1860 to 1920 period 'economic crises and wars helped create a consensus for an income tax that falls most heavily on the wealthiest taxpayers (Weisman 2002, 366).' The lengthy debate about taxes that took place over this period was not really about taxes at all but rather about what kind of society Americans wanted. The debate going on today in the United States about taxes is similarly largely about more fundamental questions, although the outcome is as yet very unclear.

Ideas on the relevant balance between taxes and society forged over the first half of the 20<sup>th</sup> century have changed in recent years, as evidenced for instance by both the death of death taxes in developed countries and the limited success of developing countries in achieving the high levels of income taxation to which many of them aspired in the post-colonial period (Bird and Zolt 2005). As noted earlier, both tax levels and the distribution of tax burdens have probably changed less than have ideas about the nature of a good tax system. However, in most countries the basic underlying question of how best to make the 'Wicksellian

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<sup>7</sup> Or perhaps creating their own country: for example, Rabushka (2008, 868) concludes his exhaustive recent review of taxation in colonial America with the unequivocal (though controversial) statement that 'The American Revolution...was a tax revolt, first and foremost.'

connection' (Breton 1996) between the two sides of the budget sustainably operational is not simply unanswered by tax research as yet: it has not really been asked.

Taxation is always and everywhere a contested concept. Some pay and some do not. Some pay more than others. Some receive compensating services, some do not. Such matters are in democratic states resolved only through political channels. Indeed, history suggests that the need to secure an adequate degree of consensus from the taxed is one of the principal ways in which, over the centuries, democratic institutions have spread (Sokoloff and Zolt 2005). No non-dictatorial government in this age of information and mobility can long stay in power without securing a certain degree of consent from the populace, not least in the area of taxation. State legitimacy thus rests to a considerable extent on the 'quasi-voluntary compliance' of citizens with respect to taxation (Levi 1988). To secure such compliance in a sustainable way tax systems must, over time, represent in some real sense the basic values of at least a minimum supporting coalition of the population.

What countries actually do is always and inevitably determined in the first instance by political and not economic calculations. Countries vary enormously in the effectiveness and nature of their political systems. Some may be close to 'failed states' in which institutions are so ineffective that it does not matter much what they attempt to do: it will not work. Others may be 'developmentalist' and wish to use their fiscal systems as part of a relatively dirigiste interventionist policy. Still others may be of a more *laissez-faire* disposition. Some may be more populist, some more elitist, some more predatory.

Many governments of all types in developing countries are in dire straits. Even countries that have reached relatively safe harbours politically, achieving a certain degree of legitimacy and stability, almost always feel – often correctly – that they are in an economically precarious situation. The budget is politically and economically constrained. Life is difficult. Nothing can be done. All this may be true to some extent, but it is also both too much a counsel of despair and too easy a way out. Even in the most hopeless situations something usually can be done to improve matters. But unless and until an adequate degree of political consensus on what should be done is achieved, no significant tax changes are likely to be made. History tells us that such changes are unlikely to occur either painlessly or quickly. One possible guide to how to improve tax policy outcomes may perhaps be to adopt some version of what may be called *Development Tax Model 3.0*.

Unlike the earlier versions, a Model 3.0 tax reform is one that is essentially built-to-order in accordance with the customer's needs and specifications: it is, so to speak, ordered from Dell in 2011 rather than from Ford in 1921. As with a computer, each component of the system – the key pillars (VAT, income taxes) as well as the ancillary components and connections (e.g. VAT links to trade and excise taxes, and the linkages between personal and corporate income taxes and payroll taxes) – can then be specifically designed for the particular policy context, drawing of course on prior experience and, to the extent desired and feasible, factoring in such critical matters as the relationship between taxes, transfers, and regulations, between central and sub-central governments, and between the domestic and the international economy. In this approach, however, what is much more important than the precise configuration of the 'product' – the reform package – is to ensure that the process through which it is conceived, ordered, assembled, delivered, and implemented satisfies the real needs and capacities of the country in question.

Reforming taxes in any country is always a one-off operation in the sense that it occurs in the unique circumstances of that place at that time.<sup>8</sup> Most studies of tax reform focus on the

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<sup>8</sup> Much of what follows relates only to 'major' tax reforms (Bird 2004a). Many countries constantly 'reform' their tax systems by altering rates, redefining bases, and adding and clarifying interpretations to existing law. It is not always a simple matter to tell when such 'technical changes' constitute a major reform but this issue is not discussed further here.

*substance* of what should be considered. As just suggested, however, the more fundamental question is not so much *what* should be taken into account in developing a tax reform proposal but rather *how* the issues, whatever they are, should be approached (IDB 2006). To be successful, for instance, reforms must be both comprehensible and fit with existing institutions. Even the best system for studying and developing reform proposals will never suffice to bring about good policy changes in the absence of a coherent strategy, continuing support from above, and an acceptable level of administration.<sup>9</sup> Good policy formulation is never enough; but it is always better than its opposite (or absence).

Some countries have tried to finesse some of these problems by appointing some kind of special tax reform commission, whether foreign, domestic, or mixed. The track record of such efforts is not good. Appointing an outside group is often simply a way to postpone dealing with a problem. However good the final output of such efforts may be, the results are seldom 'owned' by those who must first sell them and then make them work. Ownership matters. So does leadership. So does a coherent strategy, and of course so do adequate resources. Good tax policy planning involves economists, lawyers, administrators, and – importantly – adequate discussion with taxpayers and 'third party' tax collectors like banks and companies. Successful tax reform involves all this plus solid and continuing political support and adequate administrative follow-up. It is not easy anywhere. But it can be done.

Good planning and policy formulation focuses on what matters and what can be done and pays close attention to detail and implementation (Gillis 1989; Thirsk 1997). In particular, building up adequate institutional capacity in the tax field, both inside *and* outside government, is critical to being able to adapt policies to changing circumstances and needs, thus ensuring some degree of robustness and resiliency (IDB 2006). The role of outsiders such as academics and aid agencies in this process is more to be supportive when countries want to reform their systems than to tell them when and how to do it.

## 4 Conclusion

To conclude, looking back over the last 50 years, it seems to me that the most important long-term contribution outsiders have made to improving tax policy through research in many countries has been by encouraging, and even funding, informed non-government 'think tanks' and university studies in relevant fields (including foreign training) as well as by fostering data gathering and analysis both within and outside government. Such activities are not glamorous and seldom produce clear short-run pay-offs. Nonetheless, they are critical to establishing institutions that may, over time, be able to provide ideas and studies that may inform (and perhaps even make more articulate) the interests that shape tax systems.

In the end, if a country needs or wants better tax policy or administration, it can have it: the answer largely lies in its own hands. Even those who want to do the right thing, however, can often use help in finding out just what is right and how it can best be done. It is always easy for those not in the game to give advice to those who are trying to play it. It often seems appealing and immediately productive to establish performance benchmarks for success, to support this particular organisational change reform here (revenue authority) and that new technology (computerisation) 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. Such approaches seem appealing. But so far at least the evidence suggests that most have not been very productive.

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<sup>9</sup> For example, as Yoingco (1976) shows, for many years the Philippines had by far the best developed and institutionalised tax planning process in Asia and in some respects perhaps in the developing world. The results in terms of good policy, however, are not very evident.

Fifty years of experience tells us that the right game for tax researchers is not the short-term political game in which policy decisions are made. Academic researchers and outside agencies interested in fostering better sustainable tax systems in developing countries will employ their efforts and resources most usefully if they play in the right game. That game is the long-term one of building up the institutional capacity both within and outside governments to articulate relevant ideas for change, to collect and analyse relevant data, and of course to assess and criticise the effects of such changes as are made. Tax researchers, especially in developing countries themselves, can and should play an active role in all these activities. To do so in most countries, however, they are likely to need considerably more and more sustained (and disinterested) support from academic institutions abroad as well as from international agencies than is now available. Such long-term 'institution-building' activities are seldom immediately rewarding. They appear to be out of fashion with international agencies concerned with development. But they are, I think, more likely to provide the most useful paths in the long run to achieving more efficient, equitable, effective, and sustainable tax systems in most developing countries.



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