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The tax consensus has failed!

Recommendation to policymakers and donors, researchers and civil society

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Structures of taxation should provide four clear outcomes, but the tax consensus has failed to deliver for developing countries on each and every one of them. In low-income countries and sub-Saharan Africa above all, these failures have critically undermined broader development hopes.

The tax consensus must be consigned to history - to allow countries to re-establish policy space and put a range of options back on the table - and researchers and advocates like the Tax Justice Network for Africa can play a significant role in this process.

This paper briefly sets out the nature of the tax consensus, summarises its failings and then explains why these were inevitable. The first quote below reflects the nature and perva-

MAIN POINTS

The tax consensus has failed. Revenue losses exceed aid flows, and poorer countries - especially in sub-Saharan Africa - have seen redistribution prevented and political representation weakened. The tax consensus must be consigned to history, and international steps taken to begin undoing the damage done. Advocacy is vital.

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siveness of the tax consensus; the second is from a damning internal World Bank review of the resulting policies.

'During recent decades, a powerful consensus has developed… [which] has included not only the structure of taxes, but also the level of tax rates. This conventional wisdom is probably pretty soundly based, and so to refuse to subscribe to it would be imprudent as well as incurring disapproval from IFIs.' - Adam & Bevan (2004), p.60.

'The major limitation of [World] Bank operations in the area of tax and customs administration pertains to the inadequate institutional framework for knowledge accumulation... Unlike several other areas of operation, theoretical underpinnings for efficient and effective tax and customs administration are still rudimentary.' - Barbone, Das-Gupta, de Wulf and Hansson (1999), p.31.

We begin by considering the main demands on a tax system.

GOALS OF TAXATION - THE FOUR Rs

Taxation systems can be thought of as facilitating four main objectives. Most obviously, taxes raise the revenue with which governments can drive human development by providing systems of health, education and social security as well as the basis for a successful economy through regulation, administration and investments in infrastructure.

A second goal is redistribution, to reduce poverty and inequality and ensure that the benefits of development are felt by all. Gemmell & Morrissey (2005) summarise two decades of tax studies as follows: income taxes are progressive (although evasion is generally ignored); corporate taxes are regressive at low incomes and then become progressive; property taxes (more or less absent from the consensus, and often generating only small revenues, but important in a number of low-income countries, e.g. Namibia) are progressive; indirect taxes are generally regressive; and the overall picture is mixed, although structures are often regressive at low incomes.

A third key goal is that of 're-pricing' - that is, of using taxes and subsidies as appropriate to ensure that all social costs and benefits of production or consumption of a particular good are reflected in the market price. Most obviously, this may include taxing tobacco to limit damage to health , or petrol to limit environmental costs. Finally, and perhaps most importantly - although often underappreciated - is the goal of strengthening and protecting channels of political representation. Ross (2004) uses a panel of data on countries at all levels of income to show that these channels are systematically strengthened when the share of tax revenue in government expenditure is higher - that is, when governments rely most on tax. Mahon (2005) shows that the strongest relationship exists for *direct* tax revenues: where citizens contribute most to expenditures through taxation of personal income and corporate profits.

FLAWED AND FAILED

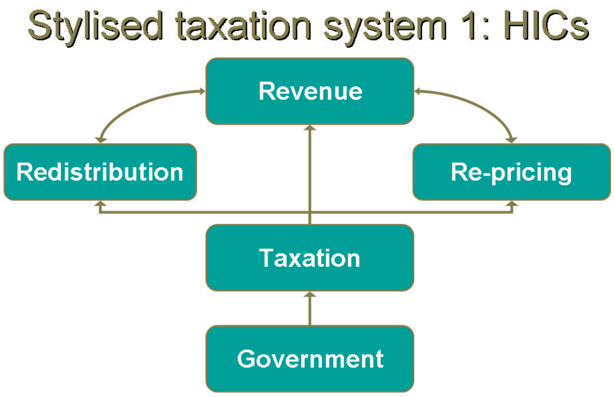
The key components of the consensus that has become dominant are these: first, to aim for neutrality of the tax system; second, to pursue redistributive goals (if any) via expenditure not taxation; and third, to achieve revenues of the order of 15-20% of GDP (although revenues in the EU-15 average in excess of 30%).

Tax neutrality, that the tax system should not distort production or consumption decisions, leads in practice to lower pressure on direct taxation, to trade liberalisation in the interests of efficiency, and to much greater emphasis on sales taxes to provide revenues.

This feature of the consensus relies on the assumption that an economy without taxes will deliver an efficient outcome, and hence taxes should create as few distortions as possible. Such an assumption however is inappropriate for poor countries - and indeed for rich. The implication of relaxing it is that (distortionary) taxation may be efficiency-enhancing, and hence the main policy recommendations in this regard cannot be supported.

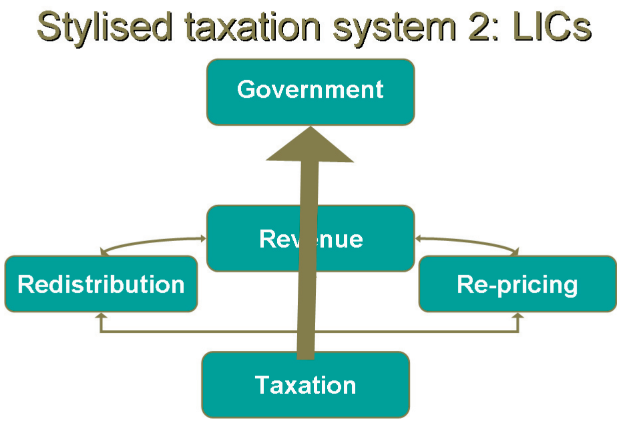
The decision not to use tax for redistribution relies on the assumption that governments have at their disposal a full range of instruments, including critically the option to make direct cash transfers to households. Non-progressive taxation can be combined with this to generate the equivalent effects of a progressive (e.g. income) tax If governments do not have the capacity to make such transfers however - as in all low-income countries, including notably much of sub-Saharan Africa - then following the tax consensus involves giving up most of their power to reduce inequality.

Heady (2004) provides a more lengthy critique of these assumptions. Perhaps the most unfortunate assumption contained in the consensus is a more hidden one. In effect, the consensus is predicated on the view that government is the basis for the solution to an optimale taxation problem, where the outcomes concern revenues, redistribution, re-pricing and the range of economic and broader human development outcomes discussed. This situation is illustrated for a stylised high-income country (HIC) in the figure below.



This stylisation is not appropriate to (at least the majority of) low-income countries. In the absence of a long history of sustained, legitimate and representative government, the system of government is itself in part an *outcome* of taxation. That is, that as detailed above, the channels of representation emerge from the process of taxation which leads citizens to hold government to account.

The tax consensus is oblivious to this, and as such is simply not suited to application to low-income countries. One cannot lay the blame for poor development outcomes entirely at the door of the tax consensus; but nor can it escape blame for failures in revenue collection, in redistribution and above all in the development of strong political systems through which governemnts are effectively held to account. Bad governance is directly linked to bad tax structures - and the consensus generates these in abundance.



LOST REVENUES

Poorer countries, and sub-Saharan Africa especially, are not only less able to raise revenue in absolute terms, but in fact they also appear less able proportionally.

'Tax effort' is a static measure of a country's utilisation of its tax capacity, and 'tax buoyancy' a dynamic measure capturing the elasticity of tax revenue with response to policy changes and growth.

Table 1 shows the percentage of countries in various groupings with scores for each index that are below average. It is clear again that on the whole poorer countries are exploiting their tax capacity least, and have revenues which are least sensitive to both policy changes and growth (the exception is the performance of upper-middle income groups, which score uniformly below average on tax buoyancy).

Table 1:

Countries with below average tax scores

Countries	Tax effort	Buoyancy
LICs	55%	53%
LMICs	43%	25%
UMICs	42%	100%
HI OECD	22%	22%
Sub-Saharan Africa	54%	57%

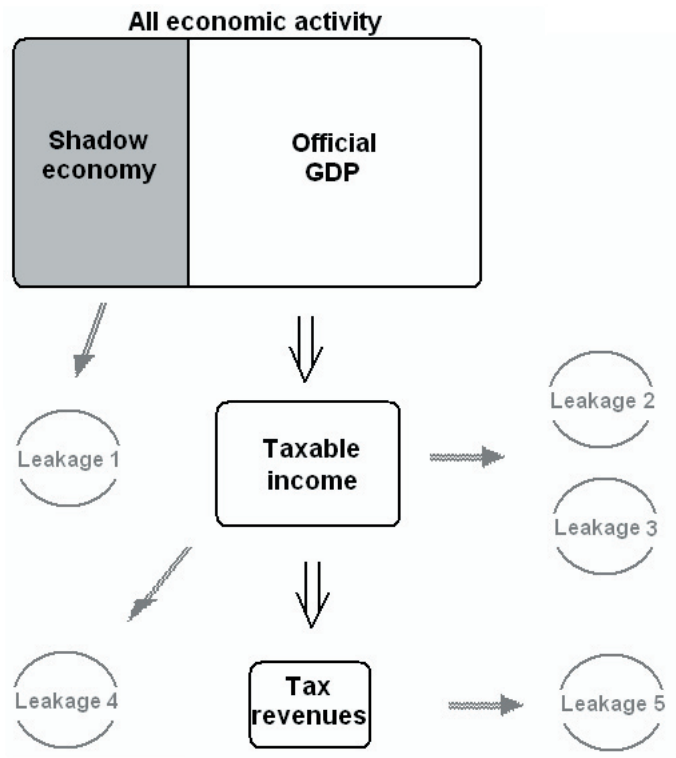
Source: Teera (2002).

Note: LMICs and UMICs refer to lower- and upper-middle income countries respectively, HI to high income OECD countries.

These data, after two decades or more of tax consensus policies, show its bleak failure on even this most basic measure. Adam and Bevan (2004) also comment on the failure of consensus policies to produce desired revenue outcomes: 'Remarkably enough, however, very similar tax structures and tax rates seem to generate very different revenues in different countries. The reason presumably lies in different levels of taxpayer compliance and of the efficiency of tax administration, and this is where a government's discretion to increase revenue lies' (p.60).

We return to compliance in the following section, but it should be noted that governments' discretion is powerfully undermined by international structures relating to flows of finance and goods.

A simple model of a taxed economy can be used to demonstrate the key leakages (figure 3, taken from Cobham, 2005).



The five tax leakages are these:

1. Tax due on the shadow economy (economic activity which is not captured in official statistics).

2. Tax due on income earned from assets which are held offshore: that is, by individuals using tax havens..
3. Tax due on income earned by multinationals and then moved offshore without paying appropriate (through e.g. transfer pricing).
4. Tax that would have been received had not rates been diminished by tax competition between jurisdictions seeking to attract foreign investment (although note that efficiency of such incentives is at best unproven).
5.Tax due but not paid; a potentially large leakage where enforcement mechanisms and administration are underfunded, and/or penalties for non-payment are small.

Cobham (2005) uses recognised international data sources to attribute values to leakages 1-3; comparable values for leakages 4 and 5 are not currently available. Research from the Tax Justice Network (2005) puts the total annual tax loss due to individuals' use of tax havens at US$255 billion, which scales for developing countries to approximately US$50 billion. Oxfam (2000) estimate the cost to developing countries of multinational profit-shifting (leakage 3) to be US$50 billion also. Cobham (1999) discusses ways in which international financial liberalisation has contributed predictably to both these leakages.

Finally, using data on the size of shadow economies (from Schneider, 2005) and the average tax take on economic activity in individual countries, leakage 1 is valued at approximately US$285 billion. A number of remarks are required about this last value. While it represents the leakage, it is *not* equivalent to potential revenue for several reasons:

First, every economy has a shadow and elimination therefore seems likely to be impossible under reasonable conditions. A feasible long-term goal might be to halve the difference between developing countries' shadow economies and those of the richest economies. For example, the average shadow size for low-income countries in 2002/3 is 32.7% of official GDP; that for members of European Economic and Monetary Union is 18.5%, so a reasonable (very) long-term target for the former might be 25.6%. Similar calculations give a feasible total for all developing countries of approximately US$58 billion.

Second, much - though not all - of the economic activity in the shadow economy involves a population at or close to the survival level, so clearly no progressive or pro-poor tax system could seek to raise large sums of revenue from these activities. Nevertheless, the human development benefits of bringing the workers here into the formal sector, with the possibilities of greater rights protection and possible direct assistance (negative taxes, i.e. transfers).

The third reason concerns the actual reasons for non-compliance with tax, and is explored below. Here we have established a value for potentially retrievable tax losses to developing countries (due to three of the five leakages only) in excess of US$150 billion a year - compared to an OECD aid budget of around US$100 billion.

TAX AS A SOCIAL ACT

Studies of tax behaviour are fraught with difficulties. Questionnaire respondents may be unreliable due to either political incentives to misrepresent hardship due to taxation or to personal reasons to present a more compliant appearance. Studies by tax authorities can be limited by a need to preserve anonymity and by the same lack of knowledge that results in evasion.

Economic modelling suggests that observed levels of compliance are in fact significantly in excess of that predicted for maximising, rational agents, for existing levels of fines and (expected) probabilities of assessment by tax authorities.

A promising response has emerged from the experimental economics literature, however. The main findings relevant here are these: that compliance depends positively on (i) the perceived or expected level of redistribution, and (ii) individuals' expectation of others' compliance levels (Bosco & Mittone, 1997; Mittone, 2006).

The implication is that paying tax is a social act (Frey & Torgler, 2006) - reflecting a desire to participate in a group, rather than economic maximisation. This then is the final flaw in the tax consensus. Redistribution has no clear place under the consensus, and is excluded from taxation; while levels of real and perceived compliance are dramatically weakened by the absence of international measures to tackle evasion through tax havens and by multinational firms.

As a result, it can come as no surprise that the consensus has also failed in addressing the problem of non-compliance. Non-compliance is self-reinforcing in the presence of obvious evasion by rich individuals and large companies, and a lack of redistribution exacerbates these effects.

Torgler & Schneider (2007a, b) show that the size of the shadow economy depends directly on the level of 'tax morale' - that is, the 'belief in contributing to society by paying taxes' (2007b, p.8). The estimated US$385bn of tax revenues lost annually by developing countries are seen to be primarily driven by the international tax evasion of corporates and rich individuals that also undermines this tax morale, enlarging the shadow economy.

POLICY IMPLICATIONS

Given these estimates of tax leakages, and our analysis of tax as a social act, some policy priorities emerge clearly.

To address the issue of lost annual revenues in excess of the aid budget, developing a culture of compliance is key. From this it follows that the high-profile evasion by multinationals and individuals through tax havens must be tackled first, and as an immediate priority.

Re-focusing on redistribution will not only directly address inequality and poverty but is likely in addition to increase compliance rates and hence available revenues (which may of course be returned to citizens through lower taxes for all, rather than spent - governments will have discretion to reflect voter preferences if evasion is reduced).

The tax consensus has failed; but we should perhaps not attempt to replace it with another equally unflexible set of policy recommendations. Instead multilateral and bilateral donors should concentrate on funding research to establish best practice in real economies (not stylised high-income countries), while advocates and policymakers should seek to open up policy space once again.

It seems likely that greater reliance on direct taxes, designed so as to be more progressive, may improve tax systems in many countries - and outputs including the system of government itself. Bird & Zolt (2005) make the case for dropping income tax as inefficient and relying instead on more careful targeting of indirect taxation. Such measures may have short-term advantages where administrative capacity is limited, and - in the absence of coordinated international measures to plug the leakages identified - the short term may in fact be long.

Two possibilities for further research are suggested. In the issue of tax evasion by corporates and high net worth individuals, there are typically one or more professional firms involved in the activity. Christensen (2007) cites a recent example in the US where four schems sold by KPMG (earning them US$180 million) were found to have cost the US Treasury US$85 billion. Apart from suggesting near-criminal underpricing by KPMG, the case revealed that firm staff had discussed that it was worth doing even if they were caught, since the fines would be low.

Now, as noted by Frey & Torgler, humans do not typically act with this cold rationality in tax affairs. If, however, such firms do, then minimally they should face the same punishment schedule as individual taxpayers. If KPMG were to have faced a potential fine of, say, 200% of the tax evaded, their calculation would have been dramatically different.

A second suggestion relates to the need to build compliance. It may be possible to exploit the self-reinforcing properties noted by providing disincentives to evade. If at each level of government (local, state and regional), increases in tax revenues were matched (in some proportion) by the higher level of govenrment, then the local social cost of an individual's evasion would outweigh the private benefit and change the terms of the decision.

At the national level, an element of aid might be devoted to a similar strategy. Here, the dangers that Ross identifies (of non-tax-funded government expenditures weakening political representation) may also be alleviated by ensuring that such funds will flow to any elected government, to spend as directed, rather than being allocated at the whim of donors.

CONCLUSIONS

The tax consensus has failed. When this is recognised and accepted, and measures are taken to cut the developing country revenue leakages that exceeed aid flows, then policy space will once again open up for tax systems that raise revenue, redistribute and strengthen channels of political representation for genuinely sustainable development. Until then, tax evasion and those who commit and facilitate it will continue to undermine the human development opportunities of of the world's poor.

The responsibility to press for change lies now with bodies such as the Tax Justice Network and the newly-launched TJN Africa, and for the many involved NGOs, researchers and advocates - and those not yet involved.

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