



OCGG Economy Section

Advice Program  
World Economy

Governance Area  
Development and Governance

Project  
Development and Fiscal Policy

# Taxation policy and development

by Alex Cobham

## MAIN POINTS

Taxation has been neglected in development discussions, allowing mistakes such as the failure to ensure revenue stability during trade liberalisation. Countries exhibit different priorities among revenue creation, redistribution and representation, seriously undermining the value of the limited consensus view.

## ABOUT THE AUTHOR

Alex Cobham is the Director of the OCGG Economy Section and a Supernumerary Fellow in economics at St Anne's College in Oxford. He can be contacted at [alex.cobham@oxfordgovernance.org](mailto:alex.cobham@oxfordgovernance.org)

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## Executive Summary

This OCGG Economy Analysis paper sets out the broad facts of taxation in different regions and countries of the world, and assesses how they have developed over time. Over the last thirty years, rich countries have generally maintained or extended their overall tax take (as a share of gross domestic product), through increasing both direct (e.g. income tax) and indirect (e.g. VAT) tax revenues. Trade taxes and the associated revenues have all but vanished.

Every poorer region has sought to increase revenues, starting from their much lower base. There has been little positive contribution from direct tax, and the pressure for trade liberalisation has meant this important source of indirect tax has generally fallen. This has led to a general trend of increasing reliance on tax on the sales of goods and services.

Systems of taxation can contribute to societies in three main areas: those of revenue, redistribution and (political) representation. Different countries exhibit differing relative urgency of needs in terms of these factors, and so it is of paramount importance to distinguish the primary goal when considering tax policy:

- Low-income countries, notably in sub-Saharan Africa and south Asia, face overwhelming difficulties in regard to both the level and the stability of revenues. As such, their requirement is for viable and long-term new sources of funds. The implications of this are not only the well-known need to stabilise and lengthen the term of aid delivery, but also extend to richer countries' approach to future WTO talks. Specifically, if further trade liberalisation is to be pursued, the poorest countries must be offered guaranteed long-term alternative revenue support (*over and above* existing aid levels) in order to prevent further collapse of state structures and their ability to support human development.
- Human poverty in middle-income countries, above all those in Latin America and the Caribbean, is more clearly the result of levels of income inequality than absolutely low income *per se*. This implies priority for redistributive tax measures over an absolute need for revenues, although the latter remains pressing. As such, the goal of medium- and long-term thinking on tax policy must be to address the question of distribution. This mitigates against increasing reliance on indirect taxation, at least on sales; but systems of direct (income, profit and capital gains) tax have not yielded the hoped-for gains, despite extensive efforts to remodel them after (the moving target of) rich country systems. Most redistribution in rich countries is seen to arise typically from cash transfers, a feature almost completely absent in middle-income countries. Reconsideration of this channel offers a path to addressing the great inequalities (though putting the emphasis back on levels of revenue).
- Finally, countries rich in sources of non-tax revenue – primarily oil and diamonds – face a less binding revenue constraint, but at the expense of avoiding a typically important channel of pressure for political representation – which has implications not only for inclusion but also for inequality. The observed pattern of diminishing revenues from each major tax source in the Middle East and north Africa are unlikely not to be associated with existing problems of representation. One response is to seek to maintain levels of income tax, as a more direct channel to political involvement, even if trade and sales taxes are allowed to fall further.

## Introduction

Tax is a central but neglected element of development policy. The structure and administration of taxation are frequently omitted from discussion and research agenda. Questions of a primarily redistributive nature may be deemed political, and so unsuitable for neutral economic analysis, and moreover as questions to be resolved by the democratic process in individual countries. On the other hand, many questions are posed in terms of system reform and these may instead be considered as purely 'technical' – matters of economic and bureaucratic efficiency to be settled by experts.

As a result, tax generates neither the sort of attention given by independent empirical academic research to e.g. questions of optimal exchange rate arrangements, nor the level of NGO advocacy focus devoted to e.g. multinational investment behaviour.<sup>1</sup> This twin neglect may explain how an element of such importance for human development has such a low profile – and possibly why its contribution may have been damaging.

This neglect, it is argued, has led to two main developments. First, the treatment of tax as a specialist area, with a resultant focus on 'efficiency' rather than theoretical analysis or practical research, has contributed to a lack of knowledge of potentially important peculiarities of individual countries. This in turn has contributed to treatment of poor countries' systems as simply underdeveloped versions of rich country equivalents. Technical assistance has then focused on helping the former to reach 'our level', rather than a more careful and constructive engagement.

Problems of this nature are increasingly widely recognised. The World Bank's study of its own performance in this area during the 1990s is damning:

'The major limitation of 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

Such recognition has brought with it efforts to improve assessment, including a recent USAID project (see Gallagher, 2004) which attempts to construct a series of international benchmarks by which to compare tax systems internationally.

One issue stemming from the previous neglect, and which may not necessarily be addressed in this approach, is that – as in other areas, but perhaps with less resistance and attention – a pattern can be traced of poor countries playing an impossible (and underfunded) game of catch-up with a moving target of rich countries' tax structures.

This movement in structure is detailed below. Examining changing world patterns of taxation revenues and particular country experiences (section 1), and then considering the distributional implications (section 2) allows us to see both overall

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<sup>1</sup> The Tax Justice Network, which grew out of interactions at the World and European Social Fora, is an honourable exception, and does unite NGO actors with interests in this field. Mainstream NGOs however are often only focused on two areas: the possibility for international taxes to raise funds for development (see e.g. Attac's proposals for a Tobin tax on financial transactions), and the damage done by tax competition between countries (see Oxfam's important 2000 paper on tax havens).

trends and specific impacts of these trends on countries at different levels of wealth and with different pre-existing structures.

The observed trends and their implications are considered with reference to new theoretical work, and with attention to the broad features of different regions' tax systems (section 3). Particular conclusions are drawn with regard to Latin America and the Caribbean and to south Asia and sub-Saharan Africa especially, concerning the costs and benefits of particular changes in systems, and the resulting impact on systems' ability to deliver.

To develop the analysis, it is first necessary to set out the goals of taxation. Different taxes have different implications in terms of each of these, so that general tax trends have important effects on the ability of tax systems to deliver the wider development goals that we have in mind.

### Goals of taxation

Four main purposes of taxation can be distinguished, each one of potentially great significance in the attempt to improve the welfare of citizens living in poverty.

**Revenue** is the most obvious and direct role of taxation. Three separate calls on the public purse can be identified, each of which must ultimately be met by tax revenues:

- i. The short-term need to address immediate problems of human development – the imperative that stems from a basic needs conception of poverty, including the provision of food, clothing and emergency medical treatment;
- ii. The (immediate) need for investment to address less pressing but equally important human development issues – those stemming from a more complex (development as freedom) approach to poverty, including education and preventative medicine (e.g. against HIV/AIDS) – and to simultaneously improve economic potential; and
- iii. The creation and/or long-term maintenance of the institutions and governance structures needed as guarantors of (the long-term stability of) quality of life, and prospects for its further improvement – what Román-Zozaya (2005) refers to elsewhere in this project as the institutions of the 'capitalism-capable society'.

That this demands must one day be met from domestically-generated (non-aid) revenues is the only alternative to postulating permanent dependence. Torrance and Lochery (2005) examine the expenditure advice given to low and middle-income countries by the international financial institutions.

**Redistribution** is the second (though not necessarily secondary) role of a tax system. It is of course not valuable for its own sake but specifically, rather, to the extent that it can allow a given society to achieve human development gains by lifting its poorest members out of (broadly defined) poverty. Where a society has wealth sufficient to meet the first demand on revenues above, inequality may form the obstacle to widespread human development. Immediate gains from direct quality of life enhancement are complemented by longer-term benefits through the effective increase in the society's (economic) development potential.

**Representation** is the final potential advantage generated by a well-functioning tax system. On the one hand, this relates directly to the claim ‘no taxation without representation’. The sentiment stretches back to the US revolution against colonial British power, and further still to the Magna Carta in 1215, which could be described as a limited franchise for the wealthy individuals who footed the bill for the British monarchy’s bellicosity.

The connection between representation and taxation goes further however. Citizens may feel they have a lower stake in governance and policy outcomes when they are excluded from (the sensation of) government as the community purchase of a public good. That is, low tax burdens in resource-rich countries can not only lead to less disciplined government, but also (i) the undermining of the likelihood of good policy outcomes – even when policies are good, and (ii) widespread exclusion. This latter has costs in relation to feelings of self-respect, so that it should concern development policymakers not only through a lens of ‘poverty as social exclusion’ but also in terms of broader conceptions – for example, the philosopher Honderich’s seven ‘great goods’ include self-respect.

**Re-pricing economic alternatives** is the fourth purpose of taxation policy. Specifically, taxation can be governments’ main tool by which to influence the behaviour of their individual and corporate citizens. Addressing externalities by e.g. increasing the costs of polluting behaviour, or the incentives to save, can deliver substantial benefits.

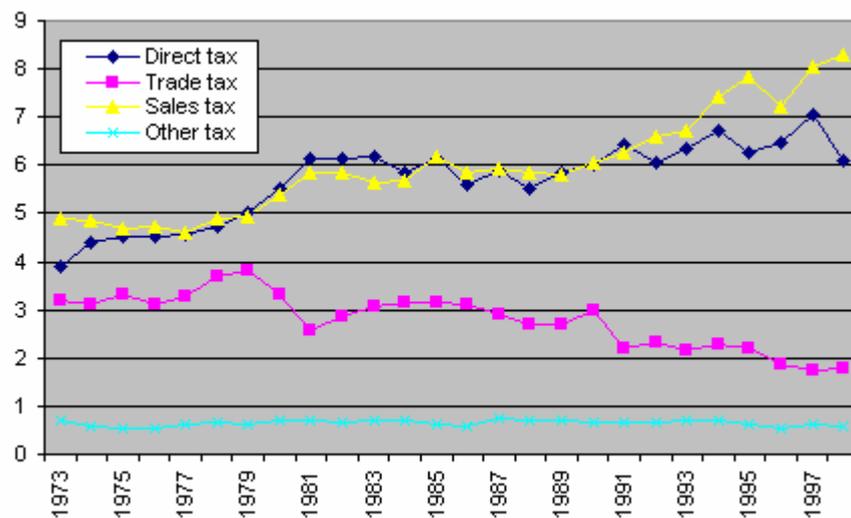
Of these four aims, this OCGG Economy Analysis will focus primarily on the first two. As well as having the most straightforward macroeconomic interpretation, these are the most clearly linked to human development. Something will be said on the importance of political representation, but little on the process of re-pricing economic alternatives. This last provides less generalisable results, and is also – generally – more concerned with marginal improvement than great structural change. Societies that have dealt successfully with the previous issues are in a position to assess maximising behaviour in this regard, and this will tend to be specific to particular country circumstances.

## II. World trends in taxation revenues

Despite considerable variation in the availability and quality of government revenue statistics, aggregate data can still show the general trends over thirty years. Figure 1 uses the 'World' series of values provided in World Development Indicators, for the following variables: direct tax (tax on income, profits and capital gains, plus social security contributions); sales tax (tax on the sale of goods and services – both general and specific); trade tax (tax on imports and tax on exports); and other taxes.

There is a relatively similar level of reliance (values around 3-5% of GDP) on the first three forms of tax in the 1970s, while other tax revenues are small. By the 1990s however, trade taxes have dwindled to account for less than 2% of GDP, while direct and sales taxes have grown to 6% and 8% respectively.<sup>2</sup>

Figure 1: Components of 'World' taxation, 1973-98 (% of GDP)



To see the main patterns underlying these world data, figures 2 and 3 set out decade averages for various rich countries and poorer regions respectively.<sup>3</sup> Figure 2 shows that the richer country pattern is consistent with the 'World' pattern observed. Direct taxation increases consistently, except in the UK and New Zealand where it retreats marginally after reaching 20% of GDP. Sales taxes increase significantly, with the exception of the US – but note that this is due to the US levying its main sales taxes at state level, while the data refer only to central government budgets. Trade taxes fall to, or are maintained at, very low levels.

Figure 3 shows the patterns by region, excluding the countries in figure 2. The regions are as follows: Central and Eastern Europe and Western Asia (CEEWA), South Asia, East Asia, Middle East and North Africa (MENA), sub-Saharan Africa (SSA), Latin America and the Caribbean (LAC) and Oceania. The differences from figure 2 are striking. While the trends in direct and sales taxes are similar, with consistent increases (MENA aside), the share of GDP that each accounts for is only towards half that of the rich countries. Trade taxes meanwhile have generally diminished in importance, as in figure 2, but from a much higher base.

<sup>2</sup> All data in this paper is drawn from WDI and GFS unless otherwise specified.

<sup>3</sup> Note that this project refers throughout to 'poorer' and 'richer' countries, rather than any other categorisation, to indicate differences in specifically *economic* development only.

Figure 2: Components of taxation, decade averages (% of GDP) – richer countries

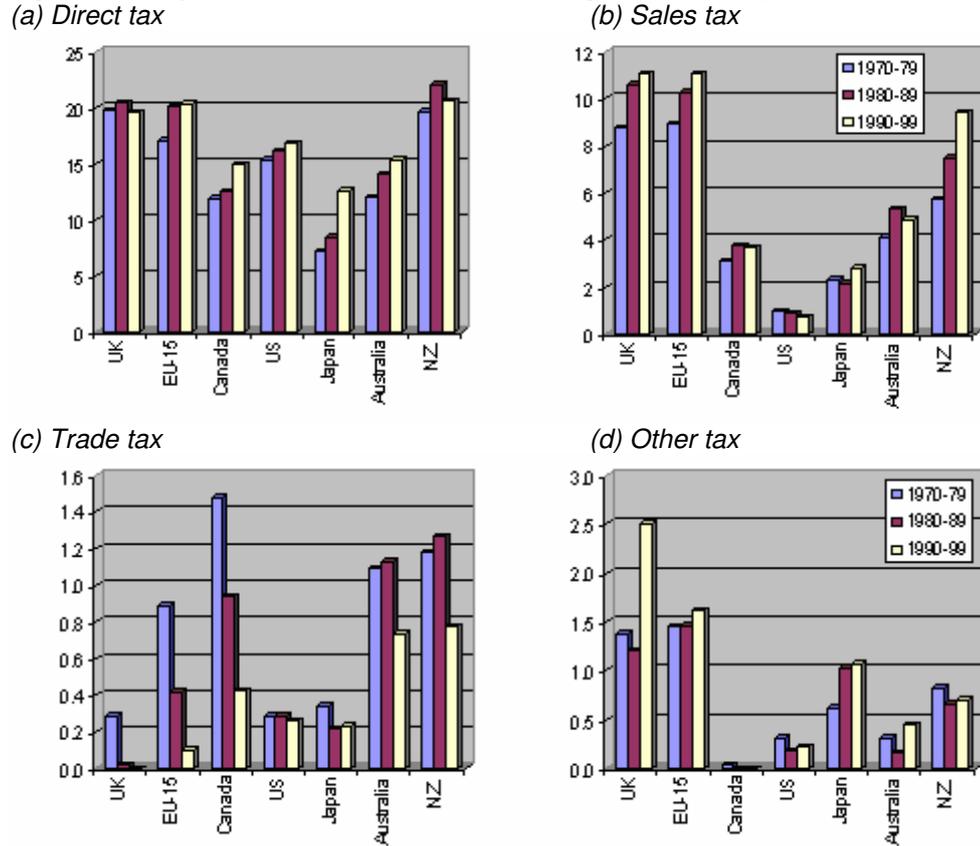
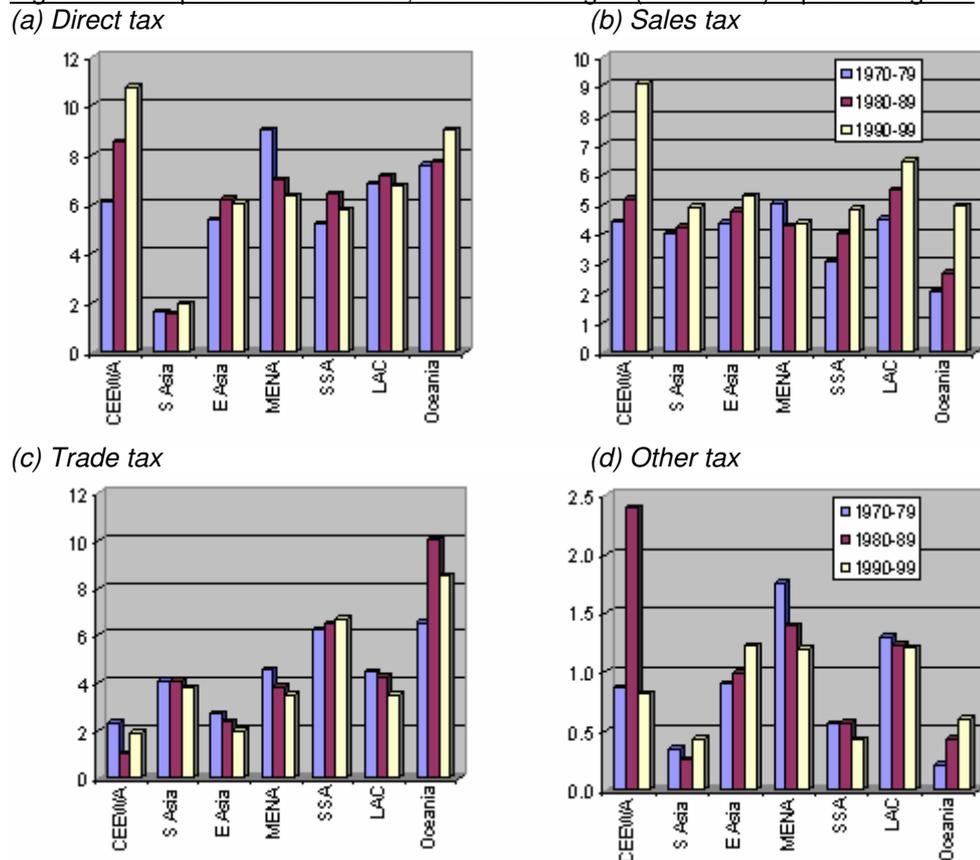


Figure 3: Components of taxation, decade averages (% of GDP) – poorer regions



To demonstrate the differences more clearly, figure 4 shows the contributions of each component to total tax revenues, again as a share of GDP. Panels (a)-(d) of figure 4 show the development of tax in the UK, EU-15, US and Japan. All show increases in total tax revenues. The European countries (including the UK) are characterised by total central government revenues of around one-third of GDP. While the EU increased its direct tax take from the 1970s to 1980s, the remaining growth for the group and the UK are the result of sales tax revenue increases.

In contrast, due to a lower total propensity to tax and the decentralisation of sales taxes, the US exhibits a lower overall take and continuing growth in direct taxation only. Japan shows some sales tax growth, but overwhelmingly it is an increase in direct tax revenues that occurred concurrently with the country's massive economic development during the period.

Panels (e)-(k) of figure 4 show the development of tax in the poorer regions. Of these, three of the relatively rich regions exhibit important parallels with panels (a)-(d). The pattern of East Asia is close to that of Japan, showing a dramatic increase in total revenue driven by direct tax only and occurring concurrently with the tigers' successful economic development. Latin America and the Caribbean saw fairly stable direct tax revenues, falling trade tax (with trade liberalisation taking hold) and increasing reliance on sales tax. Aggregates for the broad CEEWA region show increases driven by a convergence of direct tax revenues towards a more western European level, and great increases in the 1990s in sales tax.

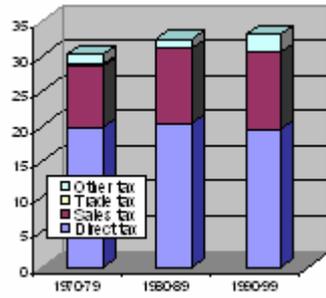
Middle East/North Africa (and to a lesser extent Oceania) shows a significant and sustained reduction in each tax component, most notably in direct tax. In the case of the former at least, this reflects the vast resource wealth of the region. Finally, panels (f) and (i) show the development in the two poorest regions of the world. South Asia exhibits by far the lowest contribution from direct taxation of any region, and by far the lowest total tax revenue. Despite managing notable increases in sales taxes during the period, the overall growth has been constrained by a fall in the (originally dominant) share of trade tax. Sub-Saharan Africa also increased sales tax revenues, but a fall in already low direct tax revenue from the 1980s to 1990s has restricted the overall growth here. In both poor regions, trade taxes are responsible for more than a third of total tax revenue.

In terms of the goals of taxation set out in section I, a number of points emerge clearly. With regard to revenues raised, the differences between rich and poor countries are large. There has however been considerable progress in most regions in increasing the overall tax take during the last thirty years. The key revenue concern must be that the poorer countries of south Asia and sub-Saharan Africa continue to be heavily reliant on trade taxes, when these are increasingly under pressure from trade liberalisation processes.

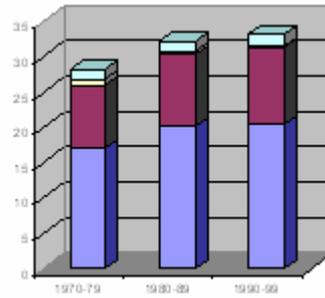
The countries of Latin America and the Caribbean are considerably further ahead in this on average, and as a result have been unable to grow their revenue take – despite relatively intense efforts to 'modernise' systems. Mexico in particular has seen reforms in the late 1980s and early 1990s deliver 'a tax structure that is in many ways comparable, if not superior, to that in many OECD countries' (Martinez-Vazques, 2000, p.2). Indeed, the author argues that the authorities have not sought to further expand the total take, instead concentrating on shifting the burden. As such, the big change has been the replacement of trade tax revenues (and to a lesser extent those of direct tax) with sales tax revenue.

Figure 4: Total tax revenues by component (% of GDP)

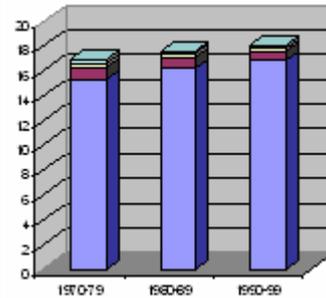
(a) UK



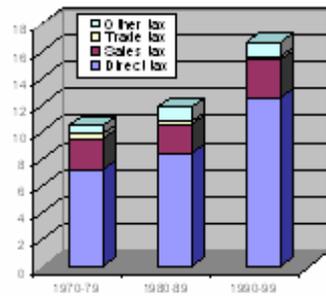
(b) EU-15



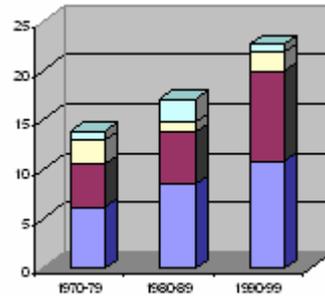
(c) US



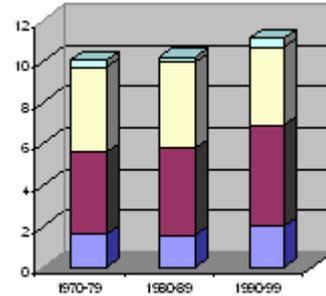
(d) Japan



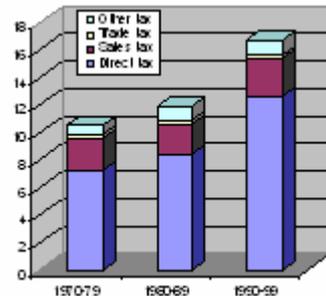
(e) CEEWA



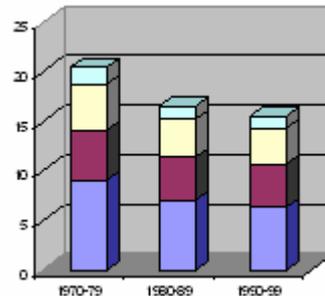
(f) S Asia



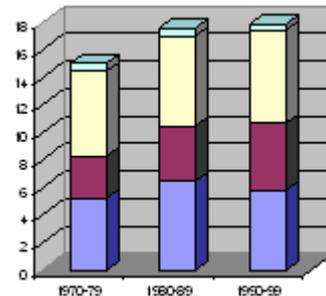
(g) E Asia



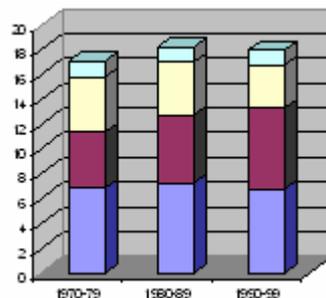
(h) MENA



(i) SSA



(j) LAC



(k) Oceania

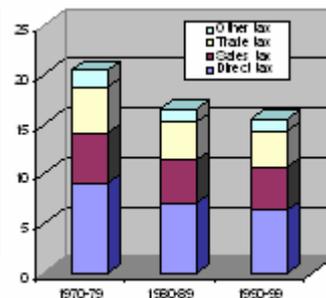


Figure 5 shows the development of tax revenues in seven poorer countries from different regions, which allows a more nuanced picture to emerge. In Latin America, both the relatively wealthy Mexico and the relatively poor Bolivia exhibit similar pattern of high dependence on indirect sales tax. The main difference is that Mexico has been able to complement this with significantly increased direct taxation (doubling income, profits and capital gains tax from around 15% of expenditures in the 1980s, to over 30%); Bolivia has struggled to raise this value above 5%.

In East Asia, the relatively wealthy Thailand shows a typical pattern, once the aid inflows relating to the 1997-8 capital account crisis are accounted for. Taxes on goods and services dominate, but – as Mexico – it has been possible to rely on income, profits and capital gains taxes to a fair extent. In common with the poorer South Asian Sri Lanka, trade taxes have been significantly reduced. In the latter however, increased goods and services taxes have directly compensated this loss, but direct taxation revenues have not been significantly grown at all.

Finally, three different African examples tell three different stories. The relatively rich Morocco has grown direct and trade revenues gradually, while increasing sales taxes more sharply. Kenya has grown direct and sales taxes together, seeking to address persistent revenue shortfalls as Cheeseman and Griffiths (2005) detail, and to this end have also managed during the 1990s to reverse the slide in trade tax revenues (albeit not to the levels of the 1980s and 1970s). The chart for Cote d'Ivoire shows a country much nearer the beginning of the process outlined. Trade taxes are still the dominant source of revenue, even despite reductions during the 1990s and increases due to each other major type of tax.

It is of concern that poorer countries are not only less able to raise revenue in absolute terms, but moreover that they appear less able *proportionally* also. Teera (2002) has calculated, following Goode (1984), measures of 'tax effort' – a static measure of a country's utilisation of its tax capacity, and of '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).

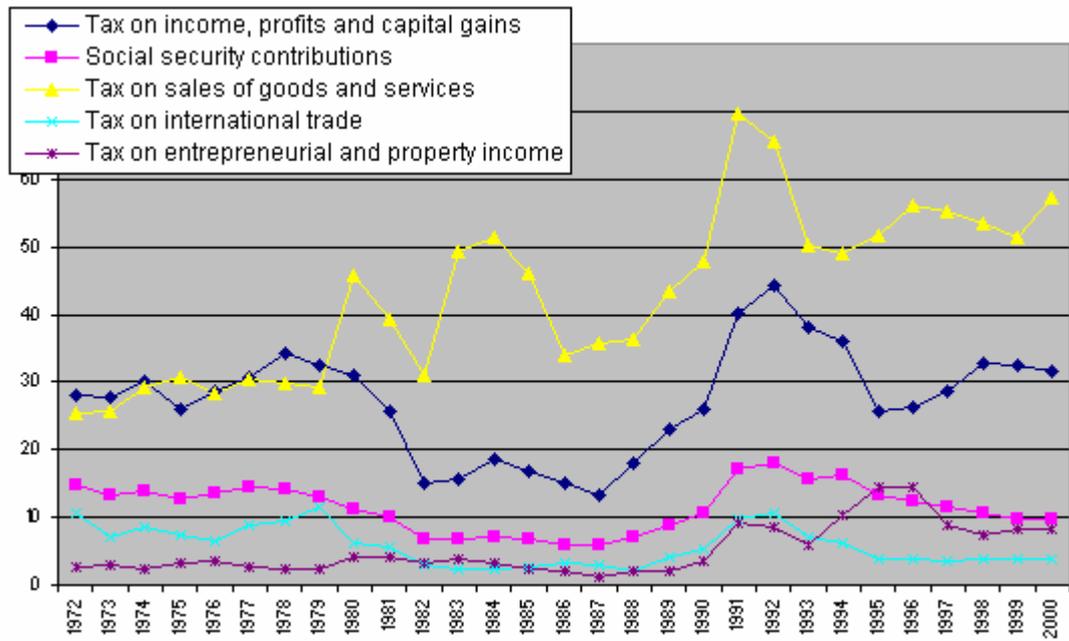
Table 1: Countries with below average tax scores

<u>Country Groups</u>	<u>Tax effort</u>	<u>Tax Buoyancy</u>
Sub-Saharan Africa	54%	57%
Low-Income	55%	53%
Lower Middle-Income	43%	25%
Upper Middle-Income	42%	100%
High-Income OECD	22%	22%

Source: Teera (2002).

Figure 5: Tax revenue sources (% of total expenditure)

(a) Mexico



(b) Bolivia

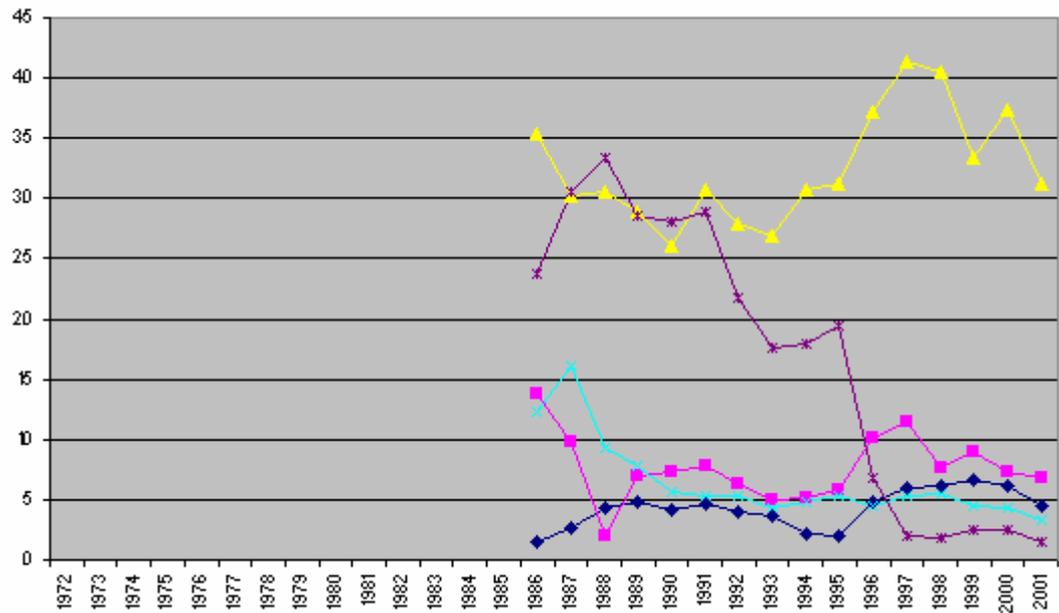
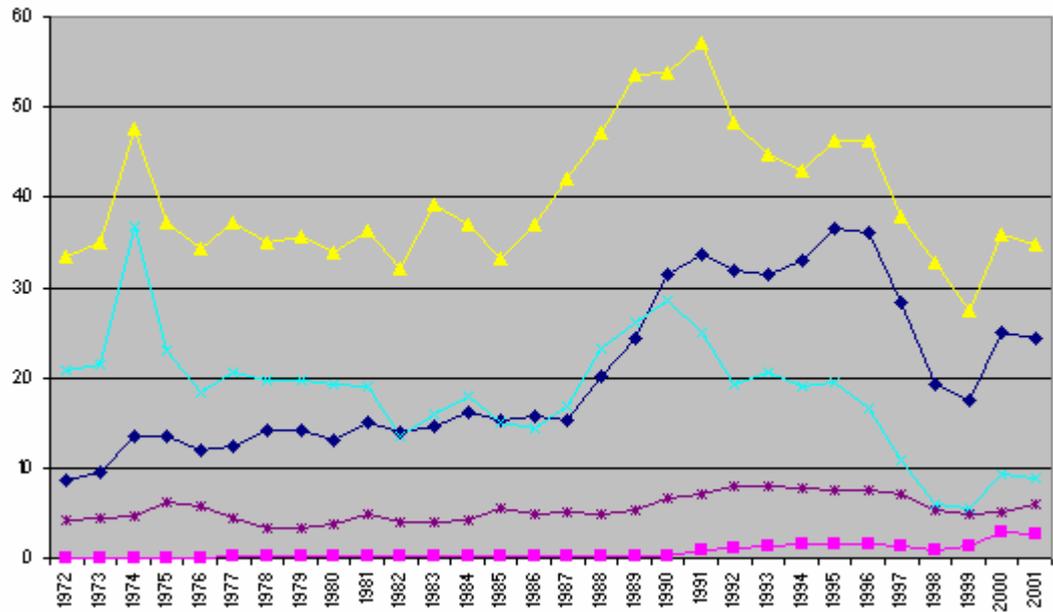


Figure 5: Tax revenue sources (% of total expenditure), continued

(c) Thailand



(d) Sri Lanka

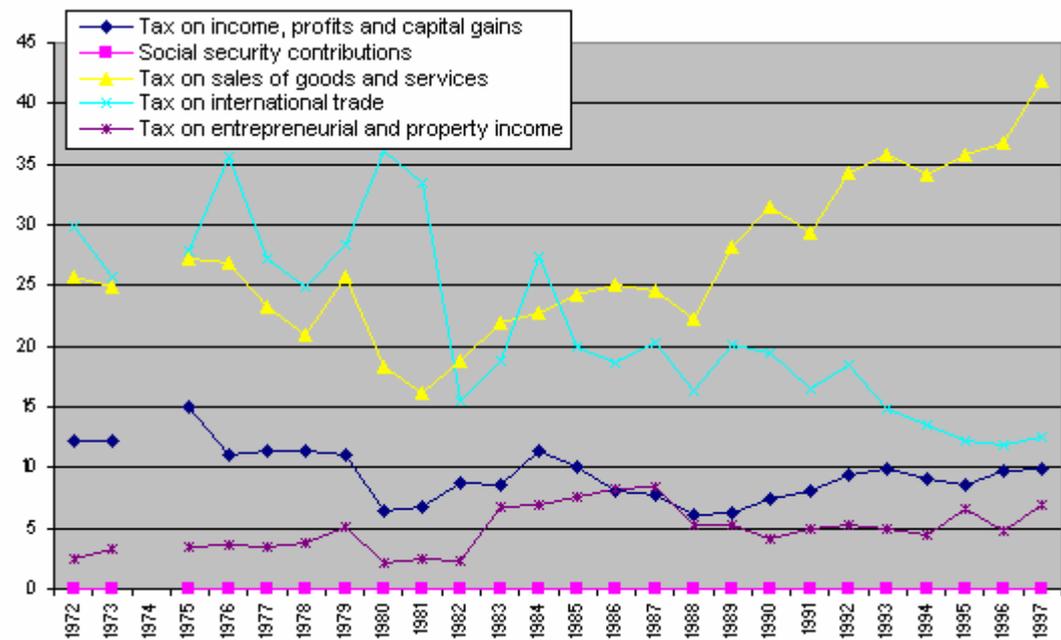
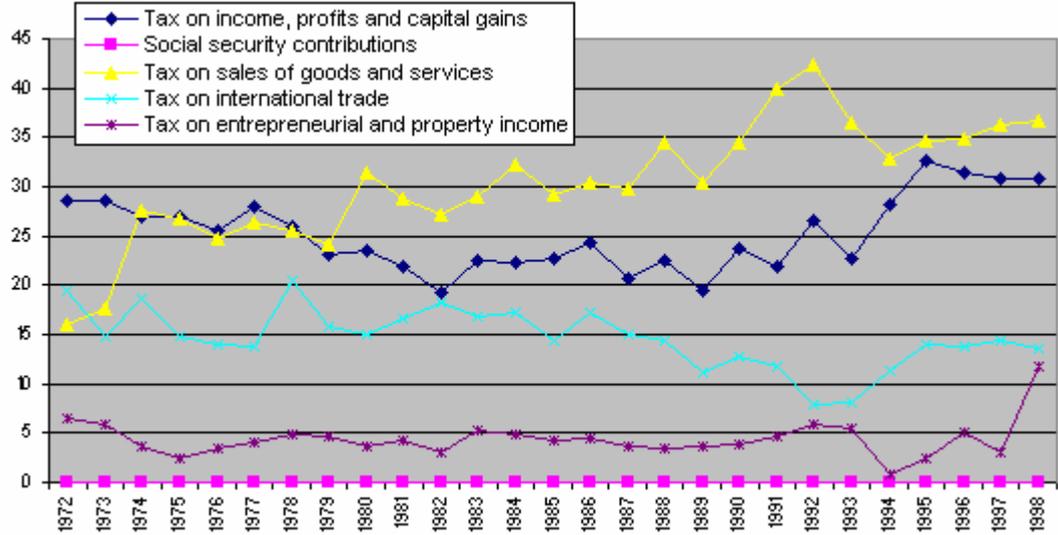
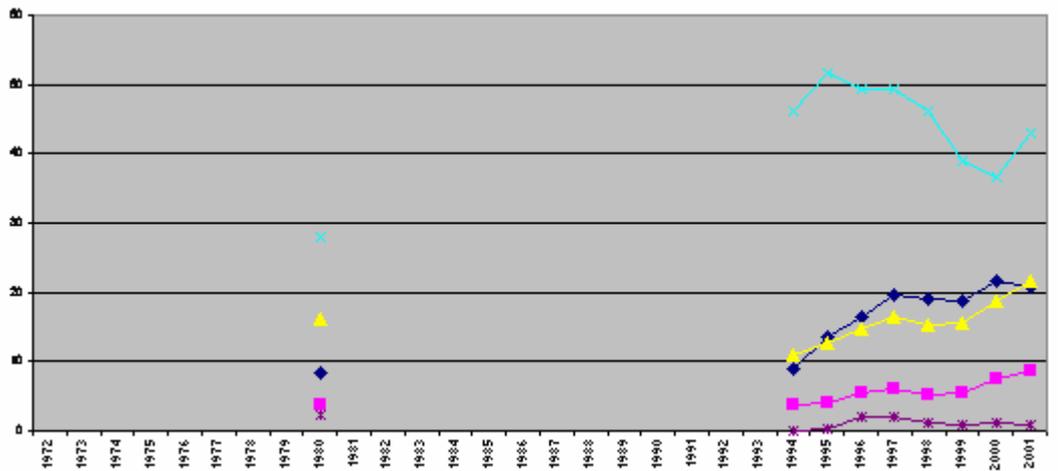


Figure 5: Tax revenue sources (% of total expenditure), continued

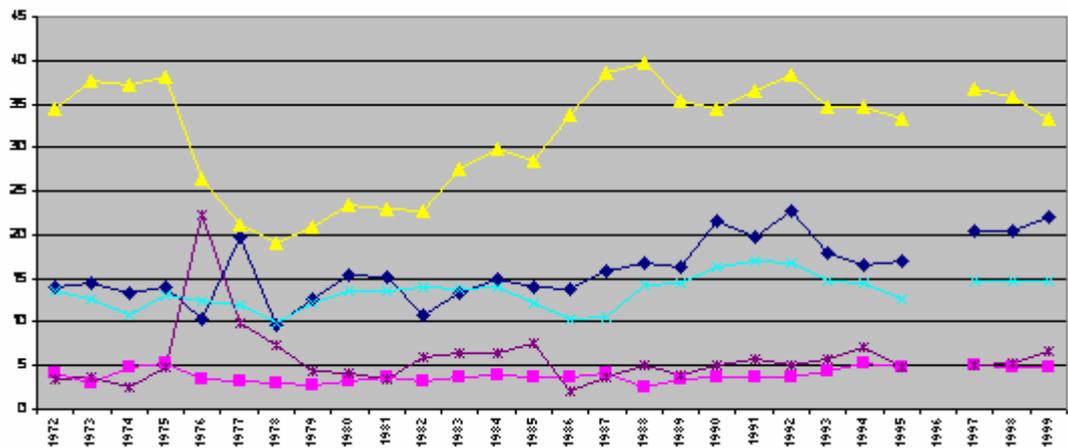
(e) Kenya



(f) Cote d'Ivoire



(g) Morocco



As a sign of growing concern over the issue of taxation, the first high-quality panel data study of the development of tax revenues has been carried out by IMF staff. Baunsgaard and Keen (2004) use an unbalanced panel of 125 countries for the period 1975-2000 to examine the extent to which countries have been able to replace lost trade tax revenues from other sources. They obtain three main results. First, for the full sample, they show using different estimation techniques that each dollar of lost trade tax revenue is replaced by only 28¢-49¢. That is, governments lose in total revenue roughly between 50% and 70% of the loss of trade taxes due to liberalisation.

The second result emerges from repeating the analysis for countries at different income levels. While high-income countries have been able to replace lost revenues more than fully, middle-income countries see a drop in total revenues equivalent to 45-65% of the drop in trade tax revenues. Most worryingly, low-income countries have replaced almost none of the lost revenues. Finally, the third result obtained by Baunsgaard and Keen is that the replacement levels are broadly unaffected by whether or not the country in question had a VAT system.

The paper is still in draft form, and there is undoubtedly further work to be done. The high-income countries result, for example, presumably reflects not so much any efforts to replace the (minimal) lost revenue to trade liberalisation, but simply an (also small) average expansion of tax revenues over the period. Given the massive swings (and general downward trend) in the prices of many commodities on which many poorer economies have relied, but also the common increase in trade after liberalisation, it may be of value to decompose loss of trade revenues into three: direct and indirect results of policy, and externally driven changes. Finally, the authors themselves note that a more complex treatment of VAT might yield clearer insights in regard to the third result.

The results are certainly in line with the growing weight of evidence against the old consensus however, and the overall revenue picture is bleak – especially for the poorest countries. The view that liberalisation has been pushed without sufficient concern for government revenues – and in those countries where the need for stable and higher revenue streams is critical – now seems to have overwhelming support.

In terms of the contribution to not only revenue but also to redistribution, the implications of the pervasive shift to reliance on goods and services taxes – at the expense of trade taxes above all – needs close attention. First however the broader trends in inequality and redistribution are set out in the following section.

### III. Taxation structures and redistribution

The experience of specific countries can usefully inform the general analysis above. While good quality data is relatively scarce for poorer countries, it is possible for at least some of the richer countries especially to pinpoint the contribution to redistribution of different parts of the tax system.<sup>4</sup> It is useful first to consider some data on the (after-tax and transfer) inequality in a number of rich and poorer countries. Table 2 sets this out.

Table 2: Gini coefficients, 2000

Country	Gini	Income shares <sup>1</sup>	
		Poorest	Richest
<b>Poorer countries</b>			
Algeria	35.3	2.8	26.8
Bangladesh	33.6	3.9	28.6
Brazil	60.0	0.9	47.6
Central African Rep.	61.3	0.7	47.7
Egypt	28.9	4.4	25.0
Estonia	35.4	2.2	26.2
Ghana	32.7	3.6	26.1
Indonesia	36.5	3.6	30.3
Lao PDR	30.4	4.2	26.4
Mexico	59.7	1.4	42.8
Mozambique	39.6	2.5	31.7
Pakistan	31.2	4.1	27.6
Russian Federation	48.7	1.7	38.7
Slovenia	26.8	3.2	20.7
South Africa	59.3	1.1	45.9
<b>Richer countries</b>			
Belgium	25.0	3.7	20.2
Canada	31.5	2.8	23.8
Denmark	24.7	3.6	20.5
France	32.7	2.8	25.1
Germany	30.0	3.3	23.7
Italy	27.3	3.5	21.8
Japan	24.9	4.8	21.7
Portugal	35.6	3.1	28.4
UK	36.1	2.6	27.3
US	40.8	1.8	30.5

Source: WDI.

Note: 1. Shares of the richest and poorest 10%.

Figure 6 shows, for rich countries only, comparative levels of final income inequality, and redistribution, in terms of Gini coefficients. The importance of policy stance is underlined by the difference between a ranking of the least equal societies after taxes and transfers and the same ranking on simple market (factor) income.

An important related result is the difference between what are typically conceived of as similar relatively equal Scandinavian structures. Finland and Denmark (a) exhibit relatively low pre- and post-taxes and transfers income inequality. Sweden, in contrast, is as unequal as the United States in market income, but carries out the largest redistribution to remove more than half of the initial inequality.

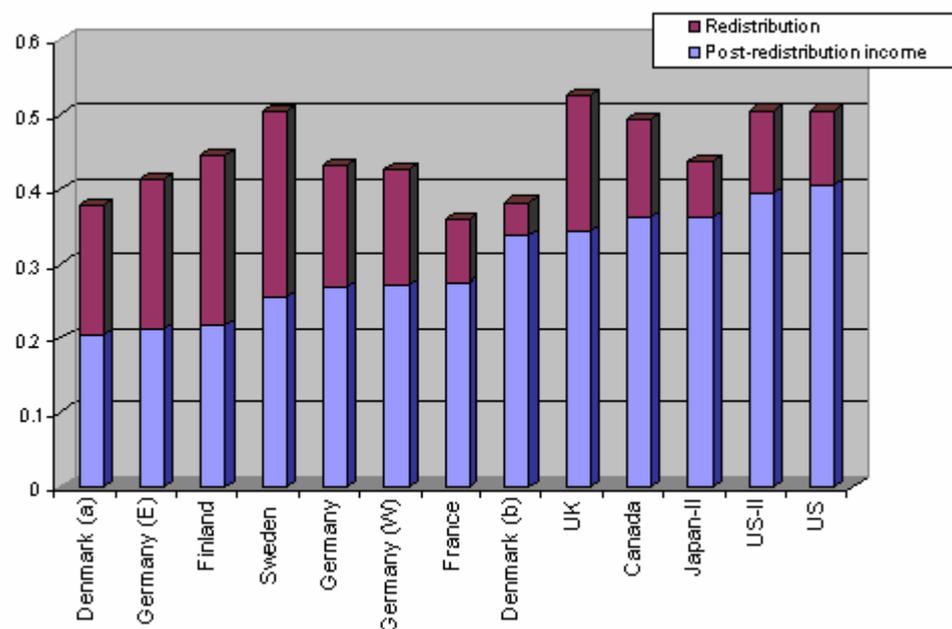
Perhaps surprising also is the similarity in structure between France, Japan and the US. Although the absolute levels of inequality are rather higher in the latter, the

<sup>4</sup> I am indebted to Kerstin Gerling for collation of the rich country data presented in this section. A more detailed study of this data is forthcoming.

relative willingness to redistribute (as a proportion of initial inequality) is similarly low in each. The UK in contrast shows a similar (proportional) willingness to intervene to the relatively equal Germany.

In terms of poorer countries, data on pre- and post-taxes and transfers inequality is severely limited. De Mello and Tiongson (2003) survey the existing empirical work on the extent of inequality, and the primary conclusion is that data quality is insufficient. The most common finding was that the relationship between inequality and redistribution is statistically insignificant, and capable of returning both positive and negative coefficients. De Mello and Tiongson themselves provide the most comprehensive effort to test whether higher inequality is associated with higher government redistribution, and find that in fact the reverse is true. They report that ‘In general, the countries where redistributive public spending is more needed – countries with low per capita incomes and high inequality – were found less likely to redistribute income through public policies’ (p.20).

Figure 6: Gini coefficients of final income inequality and redistribution, 1990s



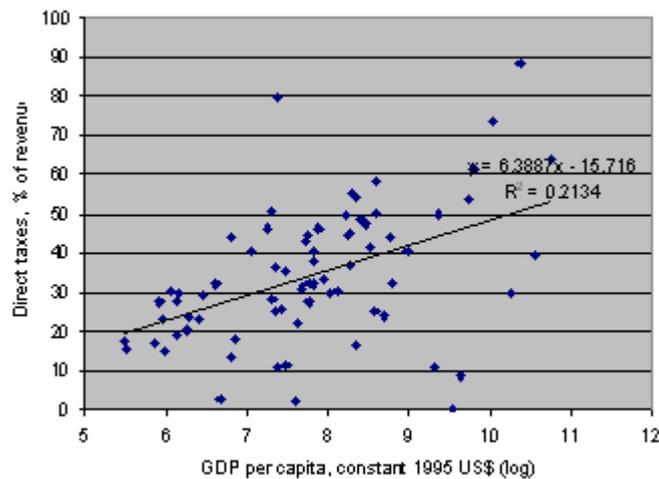
Source: author’s calculations; underlying data from central banks, statistical offices and census bureaux – see footnote 4.

While these authors may be more rigorous and with better access to data than some of the previous literature however, the general finding of insignificance remains appealing, due to the differences in political system and climate which the empirical work necessarily abstracts from. But if a relationship does exist in the direction stated, it is clearly of concern. Chu, Davoodi and Gupta (2000) also survey incidence studies and consider income inequalities before and after redistribution, but with a somewhat different focus. They assess the extent of redistribution and inequality in poorer as opposed to rich countries, and conclude that while the former exhibit market inequalities equivalent to the latter, the much smaller extent of redistribution in poorer countries is the main basis for their higher final income inequality levels. FitzGerald (2003) confirms this for Latin America.

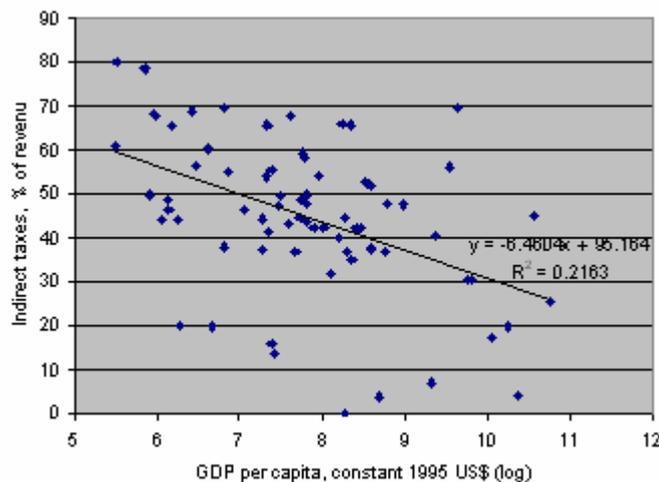
A number of reasons for this can be identified:

- first, tax systems tend to be weak in terms of administration, hence allowing significant unpaid tax through both evasion and corruption;
- second, the extent of direct tax is low – as Martinez-Vazques (2001) shows from another survey of incidence studies, this is both the most progressive form of tax and the relatively underutilised form in poorer countries. Figure 7 below confirms this latter point graphically; and
- third, differences in the system of transfers are also important. While a companion paper deals with these in depth, it is useful to point out here a central difference between rich and poor country structures. Specifically, as Chu et al. (2000) and many others have noted, redistribution in rich countries is often dominated by cash transfers – a feature lacking in most poor country systems.

Figure 7: Shares of taxes in total revenue, by country GDP per capita  
 (a) Direct tax share



(b) Indirect tax share



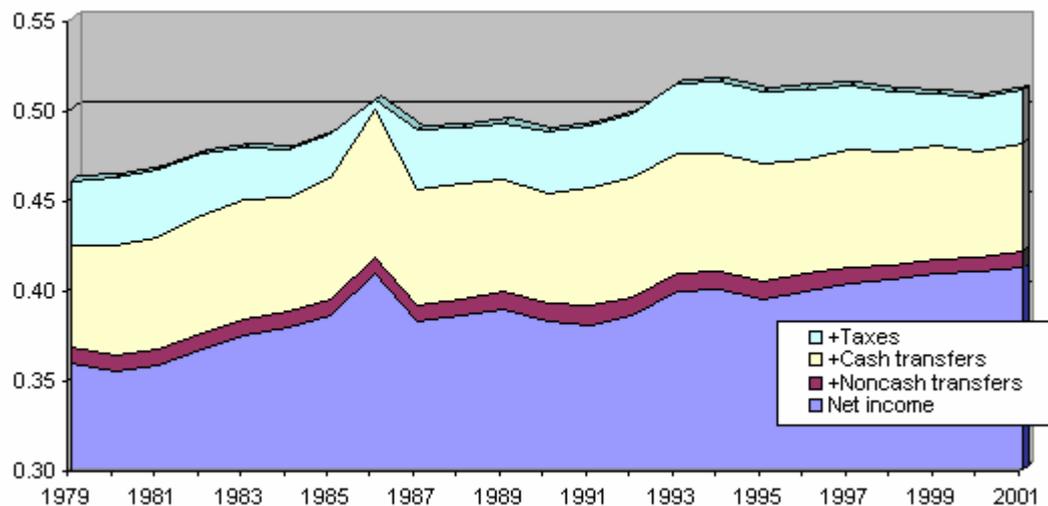
Note: both associations are significant at the 1% level.

Detailed US data confirms this point by showing the contribution to redistribution of each element of the tax and transfer system. As Figure 8 makes clear, cash transfers are by far the most important vehicle of inequality reduction in the US. Other rich countries have generally higher progressivity in income taxes however, and much greater redistribution through noncash benefits, so this is an extreme case – but the point is valid nonetheless.

If revenue and administrative capacity constraints make cash transfers impractical, the need to find redistribution elsewhere in the tax and transfer system is evident. Either poorer countries must adopt this aspect of rich country systems too, or the imposed shift towards more regressive methods of taxation must be questioned – and before permanent inequality effects (such as the political link found by Crowe, 2005) take place.

Both targeting and progressivity of transfers relating to health and education have improved in poorer countries over the 1990s, and this is reason for optimism. There remains much to be done in specific areas, not least in targeting women – see e.g. Laframboise and Trumbic, 2003. At a general level, Davoodi, Tiongson and Asawanuchit (2003) consider benefit incidence studies in 56 countries between 1960 and 2000, show that despite improvements a disproportionate amount of the benefits of in-kind education and health provision is expropriated by the middle class, and notably in HIPC and sub-Saharan African countries. The question remains of where redistribution can be found.

Figure 8: Redistribution in the US tax and transfer system (Gini coefficients)



Source: author's calculations, US Census Bureau.

#### IV. Policy implications and conclusions

Raising sufficient revenue continues to be problematic, above all for the poorest countries but also for those where a lack of redistribution is the main factor underlying final inequality levels well in excess of those in rich countries. It has been seen here how the issue of raising revenue, especially in terms of replacing that lost directly to trade liberalisation, has been increasingly addressed through expansion of tax on the domestic sale of goods and services.

The model of Emran and Stiglitz (2002) suggests that we should be deeply concerned about the distributional impact of this shift. While acknowledging that the current consensus is for exactly this shift of indirect tax incidence, they question the reliance of the underlying analysis on unrealistic assumptions of markets' performance. In particular, they demonstrate that when the existence of an informal sector is accounted for given the relatively pervasive presence of informational constraints, this result can be reversed: 'Once the incomplete coverage of VAT due to an informal economy is acknowledged [...] the standard revenue-neutral selective reform of trade taxes and VAT reduces welfare under plausible conditions. Moreover, a VAT base broadening with a revenue-neutral reduction in trade taxes may also reduce welfare' (p.i).

This raises a larger question about the nature of this common reform pattern. The literature on the development impact of trade liberalisation is broadly supportive of the existence of long-term economic growth benefits. What remain open to question are the distributive implications and the shorter-term growth effects. A mainstream but positive take on this comes from DFID's *Handbook on Trade Liberalisation* – McCulloch, Winters and Circera, 2001: 'while [liberalisation] will generally affect income distribution, it does not appear to do so in a systematically adverse way. Nevertheless, it is important to recognise that most trade reforms will hurt someone, possibly pushing them into, or deeper into, poverty, and that some reforms may increase overall poverty even while they boost incomes in total' (p.xxiii).

The same authors note that trade liberalisation need not always cut revenues, especially when non-tariff barriers and tariff exemptions are tackled too – as appears to be in the case of Kenya, for example (see figure 5, panel e). But as is clear from the data presented here, this is certainly often the case. They also argue that alternative sources of revenue need not target the poor – but the danger is that they do, as Emran and Stiglitz suggest.

Finally, McCulloch et al. point out that 'good macroeconomic management is far more important for maintaining social spending than trade taxation' (p.xxiv). While this seems evidently true, it is not clear that it justifies fighting problems of revenue-related poverty and inequality with effectively one hand tied behind the government's back. The results of Baunsgaard and Keen (2004) - that in general middle income countries have replaced only around half of lost revenues after trade liberalisation, and low income countries almost none – underline the critical damage that liberalisation has actually done to revenues, regardless of good intentions.

Ultimately then, this paper calls for trade liberalisation to be reconsidered for poorer countries (notably in sub-Saharan Africa and South Asia) in much the same way as

capital account liberalisation has finally been.<sup>5</sup> The burden of proof – that growth benefits will outweigh the total damage caused in inequality and poverty terms, including but not limited to those that occur through fiscal policy – must be shouldered by those who would encourage poorer countries to liberalise. It seems unlikely that for the poorest this case is likely to be convincing.

Where there can be shown to be benefits from participation in trade talks and resultant agreements, poorer countries should be provided with guarantees of long-term replacement revenues, to short-circuit problems with the differing time horizon of costs and benefits and to ensure that the former do not dominate the latter with immediate human development costs through fiscal policy restrictions. The recently released report of the UK's Commission on Africa (2005) gives welcome support to ending liberalisation pressure on the poorest sub-Saharan countries: 'liberalisation must not be forced on Africa through trade or aid conditions and must be done in a way that reduces reciprocal demands to a minimum' (p.290).

For those countries where revenues are less immediate a problem than redistribution, in particular much of Latin America and the Caribbean, the response must focus on the direction of development of tax and transfer structures. Cash transfers may be unlikely for revenue reasons to become a significant part of systems, at least in the medium-term future. While improvements have been made in the administration of in-kind benefits, these remain nonetheless unsuitable to bear the burden of major redistribution (whether in the UK or Kenya).

The need is for more redistribution to be carried out through the tax system. The difficulty is that more progressive taxes are more difficult to use to raise sufficient revenues. Indeed, the extreme response is the recent adoption by Georgia of a completely flat income tax structure. If such a move could increase revenues sufficiently to fund real redistribution through transfers, it would offer a possible solution. The danger is that it may remove the last opportunity for poorer countries to carry out redistribution and offer nothing in its place. This leaves the unsatisfactory situation of a longer-term focus on cash transfers, with both the need for increased revenues and the required improvement in administration capacity as obstacles.

The less discussed representational goal of the tax system is likely to be an immediate priority only for some oil-rich countries (primarily but not exclusively of the Middle East and North Africa). To minimise the exclusion and undermining of political representation that a relaxation of government's financial dependence on the electorate can bring, a goal should be pursued of maintaining direct taxation even as lower revenue pressures allow others taxes to be reduced.

Finally, this discussion should be seen in the context of recognising the considerable costs of continuing tax reform, which may in many cases – given that resources of skilled government engagement are limited – represent only a shift towards the structural pattern of the rich countries, without a clear rationale nor yet obvious benefits in terms of the most pressing tax goals in a particular country.

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<sup>5</sup> Compare e.g. Oxfam/Bretton Woods Project (2001) and Cobham (2002) with Prasad, Rogoff, Wei and Kose (2003).

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This OCGG Economy Analysis is part of a series of publications stemming from the OCGG Economy Section's Development and Fiscal Policy project, by early career-stage researchers currently studying and working at leading universities around the world. The central theme is the reassessment of fiscal policy priorities in development.

The project seeks to assess the prospects for poorer countries moving towards stable and sustainable long-term paths on which governments are able to pursue poverty reduction and broader human development goals through the exercise of fiscal policy. Advice for bilateral and multilateral donors will focus on the nature of development assistance provided and on the policy priorities pursued.

The project combines different approaches, leading to research that:

- assesses the experience of specific countries (from Mexican social policy to Kenyan tax administration, from Argentinean inequality to Zambia's use of aid revenues);
- considers the drivers of policy change at national and international level, including a careful case-study assessment of IFI recommendations for fiscal policy made to countries at different levels of income;
- offers new theoretical perspectives (e.g. on political inequality and inflation as a tax, and the decomposition of poverty changes into their growth and inequality components); and
- carries out analysis on newly assembled data (e.g. on the components and nature of redistribution in rich countries).

All work, both advice and underlying research, is made available via our website, at

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Registered Address:  
141 Rampart Rd  
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