THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Zentrum für Entwicklungsforschung
Center for Development Research
University of Bonn

Political economy of tax reforms: meeting the SDGS

Ehtisham Ahmad

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Fiscal objectives for SDGs….

- What revenue envelope is needed for sustainable growth?
  - Minimize the costs of doing business in increasingly difficult trading environment, while
  - Financing minimum public services and addressing inequalities
  - But vested interests, often with ostensibly good intentions, prevent reforms: regional/provincial and classes or groups of individuals
- Success stories, amid lots of failures: on offsetting gainers and losers
  - Singapore
  - Lessons from China’s 1993/4 reforms in dealing with regional interests
  - Mexico, 2007 and 2013 in addressing
- Agenda for multilevel finance—importance of tax-benefit links to align incentives
  - Challenges for efficient energy-use, clean cities and health care

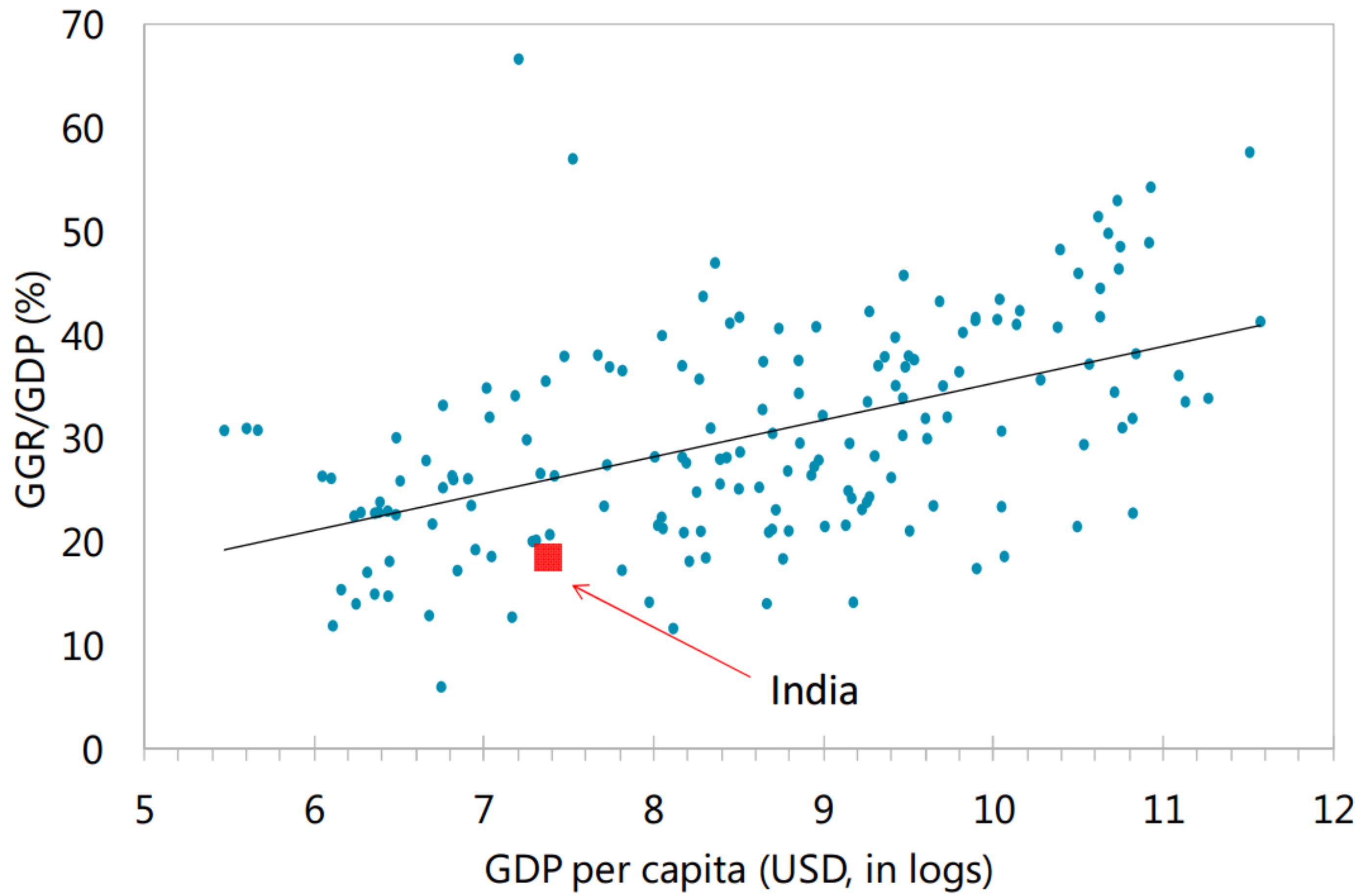
Raising revenues, addressing incentives and managing gainers and losers

Overall tax revenue envelope needed…

- The MDGs implicit requirement of around 18% tax/GDP ratio
- SDGs, in addition include a component for sustainable investment
  - As significant unmet needs in all parts of the world, including G24 countries,
  - There also has to be access to private financing, in a fiscally sustainable manner, especially at the sub-national levels
  - Avoid generating or aggravating economic crises, such as in post-2007 Europe (see Ahmad Bordignon and Brosio 2016)
- Multilevel tax handles are critical
  - Public investment with significant access to credit at sub-national levels, including borrowing and PPPs, has to be linked to own-source revenue generation over time
    - i.e., over which a subnational jurisdiction has control at the margin
  - Poorly developed handles in most emerging market economies

Is 18% tax/GDP enough?

General Government Revenue and GDP per Capita, 2012
(excluding oil exporters and microstates)



Source: IMF (2013), *India 2013 Article IV* Consultation, based on World Economic Outlook

But politically hard for countries stuck at 10-12% tax/GDP ratio to get to 18-20%...

- This is often due to split revenue bases between levels of government due to a colonial heritage
  - Case of the Government of India Act 1935 affecting both India and Pakistan
  - Very hard to change given gainers and losers as a result
- India has implemented a subnational VAT, to get to 18% tax/GDP, but the split base adds to the cost of doing business, and increased complexity for taxpayers
- Mexico, started with efficient VAT in 1980s, but gradually introduced exemptions, preferences and multiple rates
  - To meet distributional concerns and also to “encourage investment”
  - In fact, opened up incentives for rent seeking, and the ability to take advantage of the opportunities
  - Became difficult to plug the holes, despite repeated attempts from 1999-2010
- Most interesting sequencing is that of China
  - Initial focus on efficiency, plus employment generation
  - Income distributional issues and “rebalancing” at the second stage

Inefficient taxes and rent-seeking: why some countries seem to be stuck in quick sand?

- Similarities between Pakistan and Mexico (before 2013)
- Split bases (goods and services) problematic
  - Tax breaks for distributional objectives, or encouraging sectors, generates rent-seeking behaviour that becomes entrenched over time
  - Harms competitiveness (e.g., vis a vis competitor countries)
  - Insufficient financing for basic services
- ***Incomplete information on value added chain*** leads to incentives to cheat and **informality, compounding…**
- ***High effective corporate tax rates*** a major disadvantage
- But first some success stories in Asia (Singapore and China)

Asian experiences with financing SDGs--education

- Asia has some of the best performing countries/regions in the world
  - PISA (OECD, December 2016), 7 Asian countries in the top 10 global rankings
    - (1) Singapore; (2) Japan; (4) China Taipei; (6) China Macau; (7) Viet Nam; (8) China_Hong Kong; (9) China_Beijing-Shanghai-Jiangsu-Guangdong
    - China_Shanghai was top of the previous PISA rankings
  - Only 2 European countries in top 10: (3) Estonia and (5) Finland;
- But also some laggards
  - Pakistan, continues to struggle with literacy, basic services
    - spending on education has declined over the past decade despite a vigorous attempt to eliminate overlapping responsibilities (18^{th} Amendment to the Constitution, 2011)
    - Additional share given to provinces in December 2010 National Finance Commission Award
    - Largely linked to failure in the domestic resource mobilization agenda

Asian experiences….revenue envelopes

- China and India have done well to raise overall tax/GDP ratio for general government to around 18% (China from 10% in 1992/3)
  - But not enough as spending and investment needs are great,
  - Split VAT base causes distortions and adds to cost of doing business
    - China completed integration of VAT on goods and services in May 2015
    - India: Constitutional Amendment for integration of the VAT base
- Pakistan lagging (around 10%) provisions and gaps/exemptions and split bases in virtually all major taxes
  - National Finance Commission Award (December 30, 2009) expected tax/GDP ratio to go to 15% by December 2015 from 9.3%
  - Major tax reforms did not happen, ***instead VAT base was split between goods and services*** (latter assigned to provinces revenues)
  - Major revenue effort at provincial level, largely focussed on transaction and nuisance taxes that did not stem revenue haemorrhage
  - Three national tax amnesties in this period
  - Tax/GDP ratio stood at 9.5% in December 2016 ((NFC report to Parliament)
  - ***Turned the spending assignments into unfunded mandates***

Pakistan: Ineffective Tax-benefit linkages?

- For IMF SBA in 2008, the authorities promised to revamp the VAT and eliminate loopholes, along with energy price reforms to close the revenue-gaps
- Conditional Cash Transfer (CCT) the Benazir Income Support Program, modelled on Mexican *Oportunidades* to be introduced (with WB and bilateral financing)
  - To compensate "losers" and gain political acceptability
- However:
  - CCT correctly went to poorest rural households, while most of the "losers" were fixed and low income people in urban areas
  - CCT was implemented, but the tax reform was not
- Tax/GDP ratio remains below 10%, despite new WB loan of $300m for new tax administrations
- Repeated amnesties without credible sanctions or improved plugging of hole ineffective in raising revenues
  - Create incentives to wait until the next amnesty

Singapore—less than 18% tax/GDP for top PISA ranking

PISA leader, with low, but efficient and effective tax/spending system

Singapore: tax on tax reforms to encourage investment and trade

- VAT introduced in 1994, as a mechanism to reduce taxes that added to the cost of doing business
  - the Corporate Income Tax of 40%, as well as
  - taxes on assets VAT design
- Uncomplicated VAT in keeping with Tanzi principle: “keep it simple” (Quaid-e-Azam Lecture 2010)
  - No exemptions
  - No compensation, idea is to create investment and full employment
- Over time, CIT reduced to 17%, while VAT raised to 7%
- Relatively low tax/GDP ratio (less than 15%)
  - But most efficient tax administration, and well-prioritized public spending (education 22% of the budget)

Costs of tax administration

Country	Administrative costs for tax administration/ GDP (at market prices) %							Variation	Significant factors affecting comparability
	2007	2008	2009	2010	2011	2012	2013	2013-08	
Italy	0.284	0.185	0.198	0.147	0.139	0.152	0.188	0.002	Some major costs not included
Japan	0.137	0.141	0.149	0.143	0.142	0.152	0.148	0.007	
Korea	0.104	0.112	0.113	0.106	0.103	0.098	0.099	-0.014	
China	n.a.	n.a.	n.a.	n.a.	n.a.	0.130	0.121	n.a.	
India	n.a.	0.042	0.043	0.034	0.029	0.029	0.028	-0.014	Direct taxes only
Malaysia	0.135	0.111	0.153	0.078	0.081	0.102	0.122	0.011	Costs exclude indirect taxes
Singapore	0.070	0.082	0.086	0.083	0.088	0.083	0.088	0.006	

Source: Survey responses, OECD Statistical Database, Eurostat and World Bank Statistics.

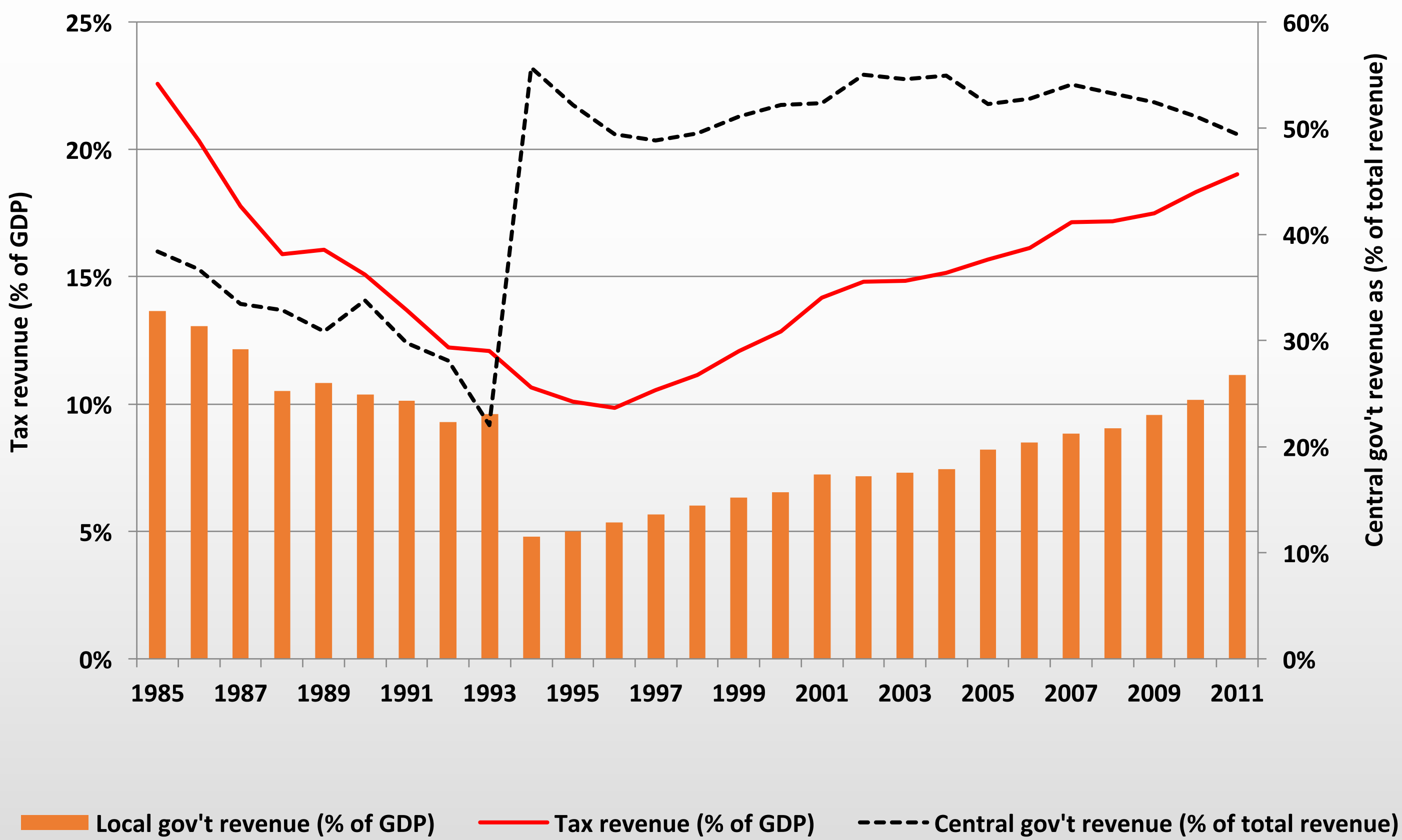
China: 1993/4 reforms: balancing gainers and losers, while generating rapid growth with full employment

From 1993/4 to 2016

China: Political economy of sustained growth with 1993/4 reforms

- Fiscal responsibility system entailed reducing the tax on SOEs
  - Tax/GDP ratio dropped sharply from 25% to 10% by 1992
  - And central share from 50% to 25%, as local governments prioritized their own spending before sharing revenues upward
  - By 1992/3 central government ability to conduct macroeconomic policy, redistribution or investment severely curtailed
- 1993/4 reforms: based on creating a central tax function (SAT) from scratch and a new tax VAT—tax-transfer linkage important in getting provincial buyin
- VAT on goods to be shared with local governments
  - Lump sum guaranteed transfer to ensure no province lost (stop-loss provision, used in Mexico's 2007 reform)
  - Revenue-share from VAT and income taxes benefitted rich provinces
  - Equalization system, provided an inducement for the poor provinces
  - Revenue returned: created space for investment for coastal "hubs", critical for sustained growth over the next two decades
- Effects:
  - No individual compensation—but maintenance of full employment
  - Major reduction in poverty (over 700m; as 150m migrated to coastal hubs)

China: The success of the 1993/4 reforms



Source: Ahmad, Rydge and Stern, 2013, *China Development Forum*

China: Need for additional taxes for sustainable “rebalancing”

- Integration of the VAT on goods and services—replacing local business tax (on services) completed in May 2016
  - Reduce cost of doing business
  - But removes last tax handle in the hands of local governments
- Sub-national tax agenda to address problems of success:
  - Increasing inequalities
    - Need to expand personal income tax beyond withholding on wages; e.g., piggy back on central base, with local information (e.g., from third parties, including on assets)
    - Address failure of property tax—needed for accountability
      - Ownership/valuation model not easy to implement
  - Climate change/carbon tax—local “piggy-back” with flexibility for LGs with greater pollution/congestion to charge higher rates, while avoiding race to the bottom
- Own-source revenues at local level as basis for access to credit
  - Rationalization of local government borrowing and
  - Lay basis for new internal hubs:
    - to supplement national investments in cross-border connectivity (One Belt One Road), links with SE Asia (Indonesia), Central and South Asia, Europe

The Mexican reforms in 2007 and 2010—partial success and some lessons

Mixed success and political economy lessons from failure

Creeping erosion of tax bases in Mexico…

- As in Pakistan, a non-competitive trading regime in Mexico was the cause for preferences and exemptions both for the income taxes and the VAT
- And prior to NAFTA, there was considerable emphasis on the creation of SEZs (the maquiladoras in the border zone with the US)
  - Designed to attract US investment and provide cheap labour
  - And for the US firms to make higher profits, and keep Mexican workers in Mexico
  - Firms exempt from income tax and VAT
- Lower VAT rates in the border regions adjacent to the maquiladora
- Subsequent to NAFTA, Mexico lifted trade restrictions, and the exchange rate was market-determined
- But the preferences remained—very hard to remove once bestowed
- Successive Finance Ministers (since the late 1990s) tried to initiate reforms to fix the income tax, or others to fix the VAT
  - Because of strong vested interests, none of the reform attempts worked
  - The non-oil tax/GDP ratio stagnated at around 10%, VAT efficiency of 25%,
  - Close parallels with Pakistan

2007—IETU to "partially" close loopholes in the CIT

- Carstens, as Finance Minister, in 2007, did not have the political support to fix the VAT
  - **But tried to close the holes in the CIT using the IETU (VAT-like minimum tax)**
    - A Gross Assets Tax (GAT, popularized in Latin America by the IMF) was distortive and had also not worked, was replaced by:
  - A unique enterprise based minimum VAT-like tax, IETU credited towards the CIT, that was less distortive than the GAT
- **The introduction of the IETU was based on principles used in the 1993/4 Chinese reforms**
  - Rationalization of the transfer system, with greater clarity in the untied revenue-sharing arrangements, and also in the special purpose transfers
  - A stop-loss provision so that no state would lose as a result of the reform
- **But revenue impact was small**, half percent of GDP, and began to erode as political pressure was applied

Lessons from failed reform attempt in 2010

- In 2010 there was **an attempt to fix the VAT** by adding additional amounts paid to recipients of the CCT (Oportunidades), as in Pakistan
  - CCT had been introduced, successfully, in Mexico in the late 1990s to phase out the generalized tortilla subsidy, and had caught the imagination of the IFIs
  - As in Pakistan, the VAT reform failed—the CCT did not address the main losers from the VAT reform
- At the same time, the **vehicle tax, *tenencía,* was fully devolved** to the States
  - They stopped collecting it—ostensibly because of competition across states, but mainly because
  - States had access to MOF transfers at the end of the year, in case of deficits
  - So the entire transfer system had become “gap-filling”
  - And states had no incentives to raise own-source revenues or even manage their spending efficiently
- States also **refused to avail of a piggy-back on the PIT** that was available to them
- The main source of **financing for states remained the *nomina*, or payroll tax**,
  - Federal Government carried the political burden, as it also covered social benefits at the national level

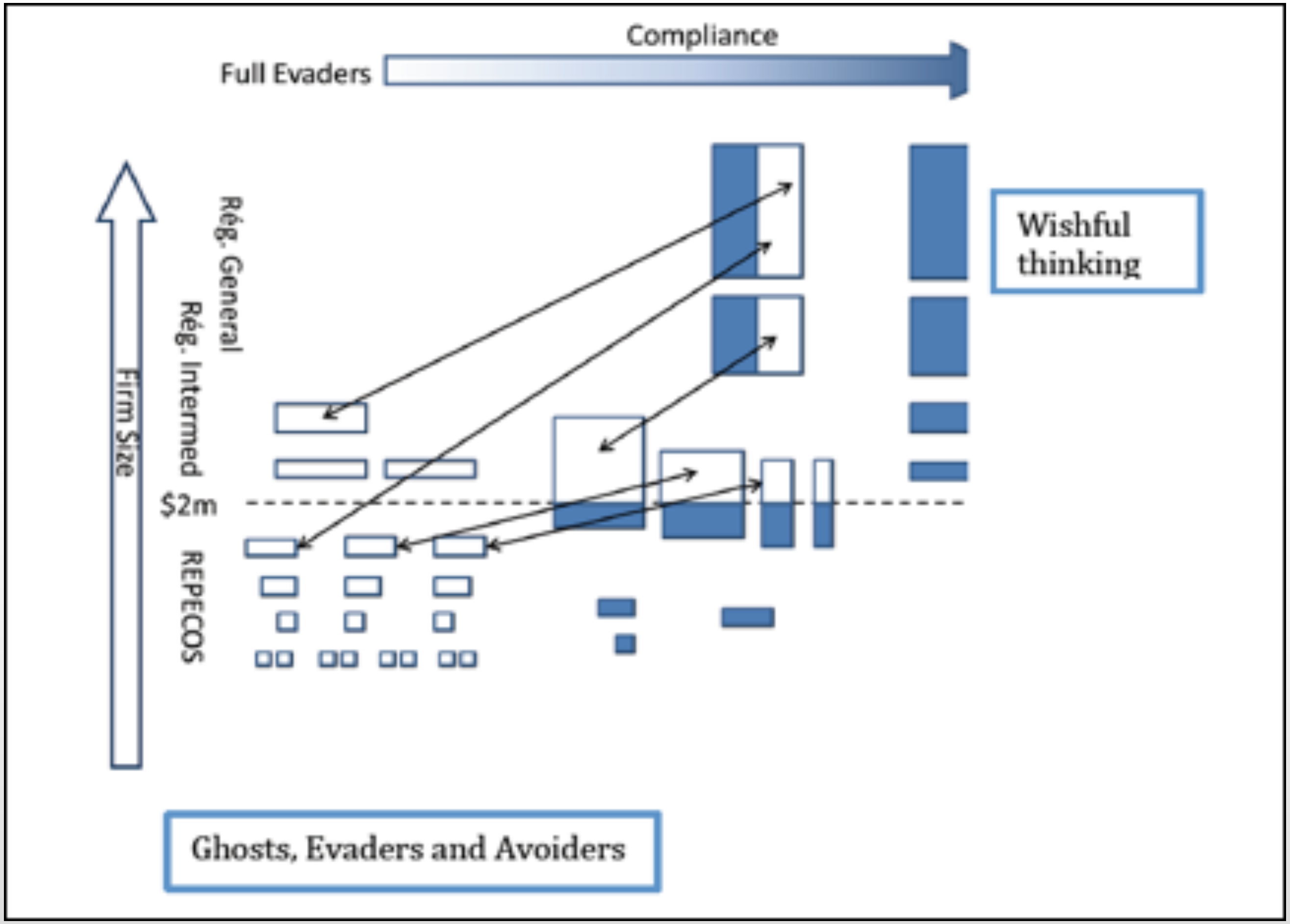
Good intentions, bad outcomes (Levy, 2008)

- **Universal benefits financed by "payroll taxes on formal sector**" Santiago Levy (2008) argued:
  - Add to the cost of doing business leading to informality, but
  - Not all informality is bad or illegal (Kanbur and Keen), e.g., in rural areas
- **"Informality" as evading the payment or taxes or social contributions**
  - Applies to firms of all sizes, as they hide output (inputs), employment, and profits; and workers hide wages by accepting short-term contracts and avoid paying contributions
  - leads to less efficient use of resources, and lower growth potential
- *Levy's Recommendation*: **reduce high social contributions and shift to VAT that does not add to the cost of doing business**
  - Same issue arises in S. Europe, post crisis, where exchange rate adjustments are not possible—shift from high social contribution to VAT is "fiscal devaluation"
- But not possible to rely on "Swiss cheese" VAT or CIT in Mexico

Incentives to cheat, plus ability to get away with it

- **Split bases for VAT and Income taxes**
- *REPECOS* (small taxpayers regime (below ~US$ 250k administered by states) provided a convenient shelter from SAT audit
  - No incentive for states to chase taxpayers, given transfer design (year end gap-filling exercise);
    - Evidence: bunching at lower end—minimum required to keep SAT at bay
    - 90% + evasion (SAT assessment)
  - convenient mechanism even for larger firms to "hide" production
- *Made worse by Maquiladoras* (Special economic zones); and lower border rates
- Progressive deductions and exemptions continue to nibble away at the "Swiss cheese" of tax base:
  1. ***Temptation effect*** (generates incentives to cheat)
  2. ***Information gaps*** (limits possibilities of offsetting cheating?)

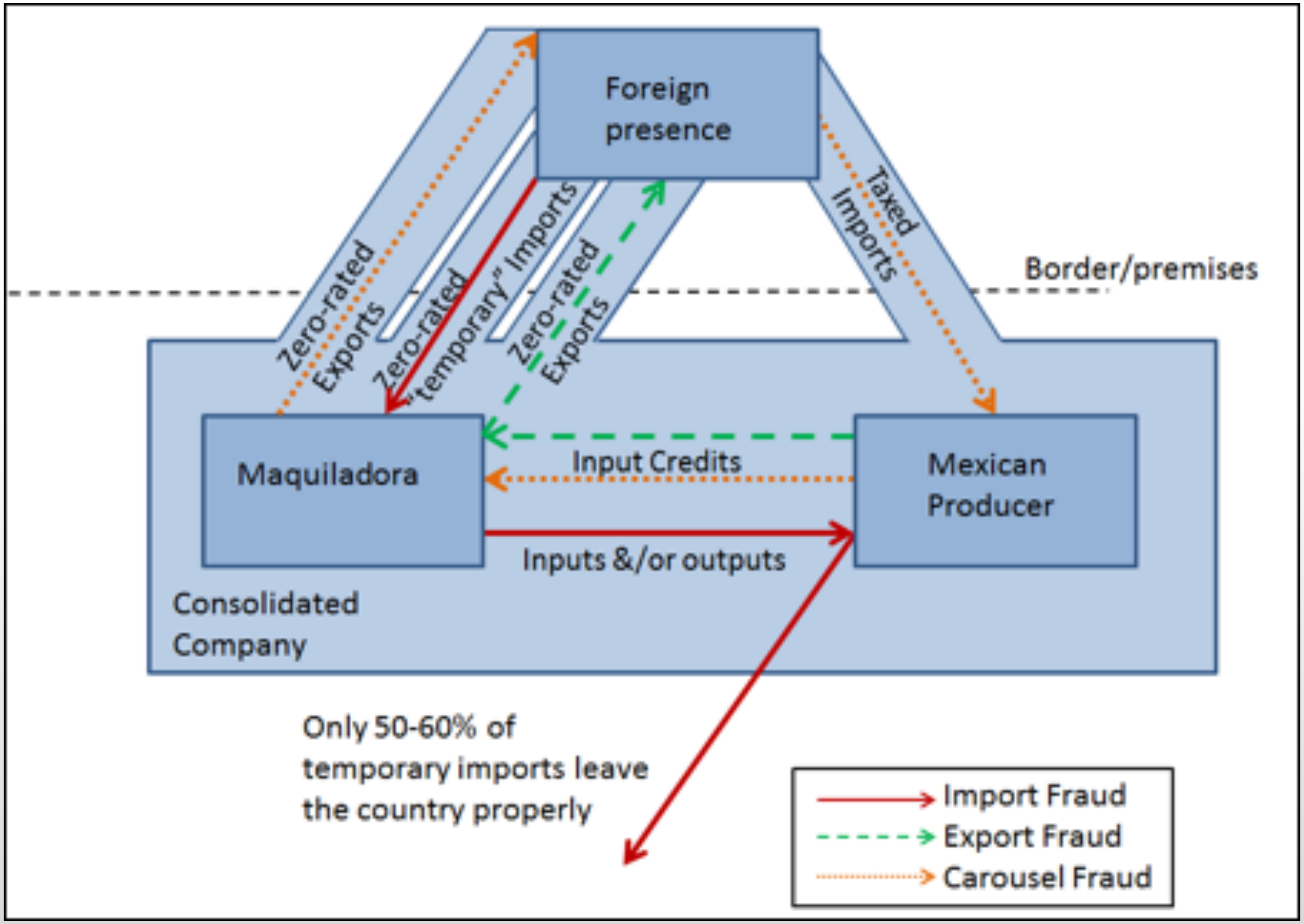
Mechanisms to cheat…



Special Economic Zones add to cheating---Maquiladora sink-hole

- Firms shifted income tax liability to maquiladora subsidiary
- Carousel fraud
- Import fraud
  - VAT free goods smuggled into Mexico creating problems for domestic manufacturers
- Only lost revenues and create distortions

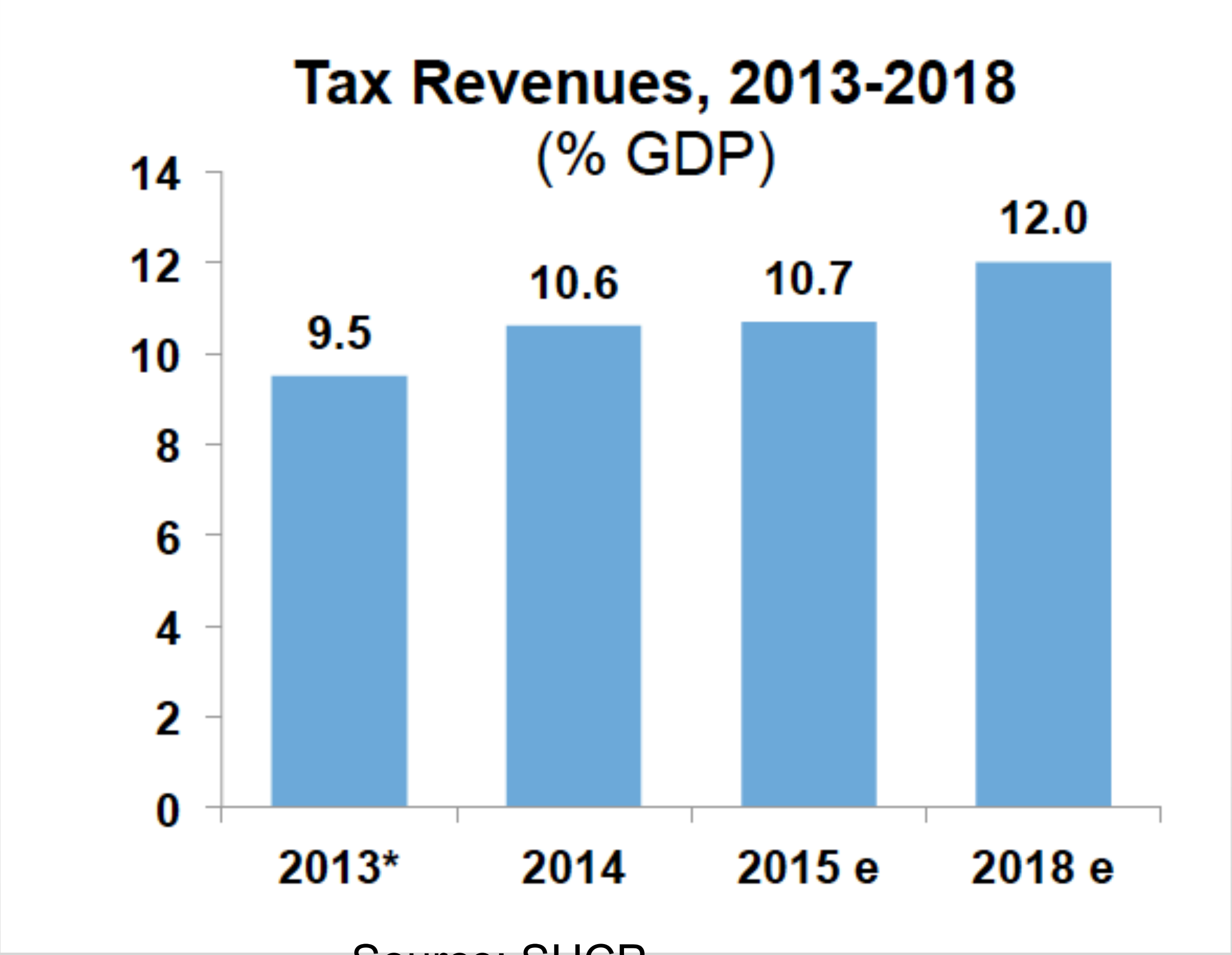
SEZ’s (Maquiladoras) play a role in this



The 2013 "package" of reforms: meant to affect structural change, not revenues

- **Tax policy**, all the main taxes that were impossible to touch previously
  - Eliminated the special provisions in the VAT
  - Rationalized the CIT
  - Minimum asset tax (IETU) abolished
  - Carbon tax, above a petroleum price set at world prices
  - Excises on "bads"
- **Administration:** Blocked the ability to cheat by integration the small taxpayer regime (RIF)
  - Simple cash-based accounting packages issued by SAT to taxpayers
  - Must issue electronic invoices
  - Reverses the segmentation of the tax base, all firms subject to SAT audit
- **Compensation as part of "packge":**
  - Reliance only on basic (social) pension (*65 y mas*) for those without occupational pension
  - CCT: *Oportunidad* not used, replaced in 2014 by *Prospera*, a program to encourage small businesses and encourage employment

Initial projections of the expected revenues (2014)



Source: SHCP

Excises and carbon tax: initial benefits during 2014 (0.3% of GDP)

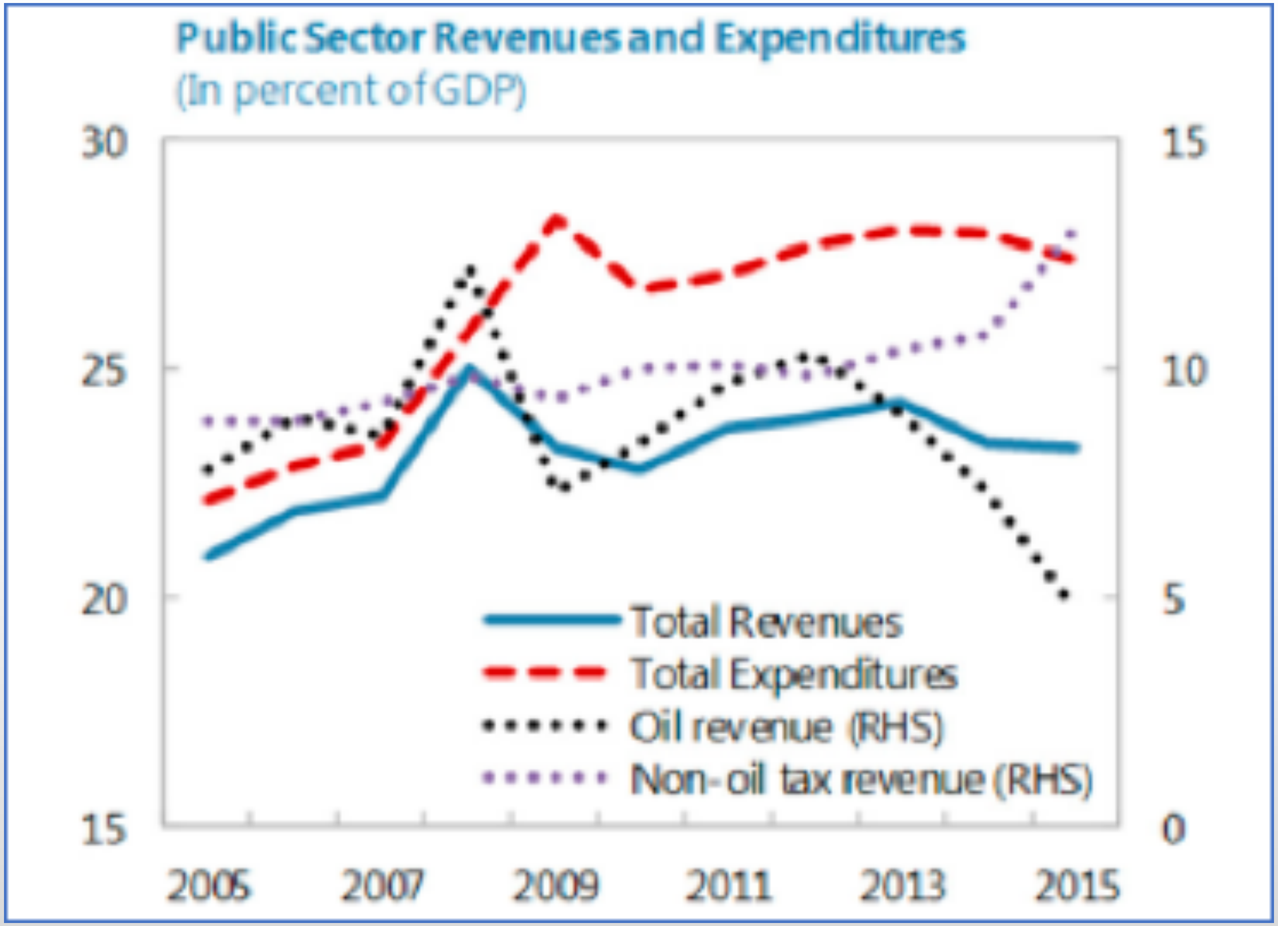
Excises on Sodas	• 10% reduction in consumption of sodas • 13% increase in purified water • Revenue generated 0.1% of GDP
Excises on confectionery	• Reduction of 1.1% in sale of chocolate products • Reduction of 0.5% in sale of sweets and confectionery • Revenue generated 0.1% of GDP
Carbon Tax	• Reduction in carbon emissions of 22.2 million tons • Reduction of 432,000 tons of carbon monoxide • Reduction of 99,000 tons of particulates • Revenue generated 0.1% of GDP

Source: Mexican Ministry of Finance.

But the reforms quickly began to raise revenues…

- Additional revenues pushed non-oil tax/GDP ratio to around 14% in 2015 (+3.5% of GDP above 2012 level)
- Although VAT revenue increase was small initially (+ 0.5% of GDP to a total VAT of 4% of GDP in 2014)
- Main impact was on the Income Tax: +1.7% of GDP in 2015 relative to 2012
- Carbon tax: + 1.4% of GDP,
  - although political pressure to further increases could be diffused by
    - adopting the piggy-back approach, together with
  - an equalization framework

Actual revenue performance far exceeds projections…



IMF, December 2016, Mexico Article IV staff report

Turning the whole of Mexico into a Free Trade Zone....although Ford cancelled the Cruze plant in January 2017 under US pressure....

Creation of new clean “hubs” for sustainable development

- Public investment by Federal Government: new Capital airport at Querétaro
  - Small university town, attractive environment
  - Attracted Aerospace ($1.5 bn) and BMW ($1.3 bn)
  - Good local infrastructure
- The national tax reforms leave Mexico much better prepared to take on the challenges in international trade that it is facing
- But additional urban hubs require state and local investment in services and smaller investments to link to national grids
- State and local incentives remain a problem

Sub-national tax agenda

More than revenues—accountability, incentives and distributional effects

Sub-national issues

- Own-source revenues at subnational level may be small relative to nation-wide tax instruments
- But: affect incentives and accountability
  - At the provincial/state level: but often focus on “maximizing share of national pie”
  - Municipal level—even more relevant for service delivery, investment and SDGs
- Shared revenues (often on asymmetric basis, e.g., Acheh in Indonesia)
  - Important for political economy perspective, but
  - do not represent “own-source” revenues
- Tax administration does not have to be sub-national—setting “rates at margin” does

Typology for local taxation and policy

		1a	1b	2a	2b	3a	3b
Key Factors	Central Tax	Shared taxes Central Admin	Joint-Admin	Own-revenue/ Surcharge Joint-	Central	Local Tax Joint-Admin	Local Admin
Rate/ base	CG	CG	CG	LG	LG	LG	LG
Revenue	CG	CG / LG	CG / LG	LG	LG	LG	LG
Administration							
Registration	CG	CG	CG	CG	CG	LG	LG
Valuation	CG	CG	CG	CG	CG	LG	LG
Assessment	CG	CG	CG	CG	CG	LG	LG
Bill Delivery	CG	CG	CG/LG	CG/LG	CG	LG	LG
Collection	CG	CG	CG	CG	CG	LG	LG
Enforcement	CG	CG	CG	CG	CG	LG	LG
Services	CG	CG	CG/LG	CG/LG	CG	LG	LG

Central Control

Local Autonomy

Note: enforcement would include both (1) the maintenance of a common data base on transactions and assets, using tax and third party information, and (2) audit.

Revenue-sharing is not subnational own-source revenue

- **Very hard to agree on “sharing proportions”**
  - Political economy considerations often lead to asymmetric solutions, including in Indonesia
  - The asymmetric solutions in Spain have intensified inequality and separatist tendencies (e.g.., for Catalunya), rather than reducing them
- **Exclusive reliance on revenue-sharing,** thus
  - **Enhances fight** over resources
  - **Asymmetric solutions may be needed** (e.g., Indonesia), but opens up pressures elsewhere as the poorer regions fall behind
  - **Enhances local resistance to change:** shifting out of petroleum/coal (the latter is important in China)

Own-source revenues and transfer design

- **Often local revenue bases are unevenly distributed, and own-source revenues can enhance inequalities**
  - Need to be complemented by equalization transfers to create level playing field and
  - Permit local governments to provide similar levels of service at similar levels of tax effort
- But, **badly designed equalization is tantamount to "gap filling" for deficits**:
  - completely negates incentives to use own-source revenues

How to “equalize” can be tricky

- **Standardized factors for equalization** (as in Australia and originally in Indonesia) are consistent with hard-budget constraints and efficient use of resources
  - Unfortunately, very few countries use standardized factors—none in Latin America
- **Dilemma that natural resource sharing is hard to equalize:**
  - if “favored” region left out of equalization, **intensifies the resulting inequalities,** and possibly increases pressures to secede (Ahmad and Brosio, 2016, Lisbon Law School)
  - **If included in the “equalization” with the use of actual revenues and deficits** (to offset the revenue-sharing inequality) <u>**converts the equalization transfer into distortive ‘gap filling"**</u>
    - Negative consequences for incentives for all sub-national entities

Piggy-back on Personal Income Taxes

- Much of the progressivity comes from the exemption limit, (Ahmad and Stern, 1991) and
  - the welfare systems needs to be integrated to avoid a "poverty trap"
- But, with split bases, PIT largely applied to formal sector wages—becomes an additional burden with the payroll tax
  - inequality enhancing measure, if non-wage incomes largely excluded
  - Could generate further informality and base erosion
- But, information on assets (e.g., property registers, cars) from sub-national administrations could be used to verify non wage income flows

Carbon tax—with a provincial/municipal piggy back

- National carbon tax with a local piggy-back (Ahmad and Stern, 2012)
  - to permit a higher marginal rate in more polluted/congested area, but
  - with a national minimum to prevent a race to the bottom
- Issue of gainers and losers becomes important
  - How to compensate is an empirical issue—most of the people affected are likely to be urban middle and upper income groups
  - Fixed and lower income urban workers
  - Can the creation of jobs be sufficient?
- Also “gap-filling” transfers, or use of “actual” factors in equalizing systems, is likely to override the incentives to use local tax handles, even if one existed

Containing health expenditures through local taxation

- Many of the key basic functions are at the local level, including inter alia
  - Sanitation
  - Public health and education, including nutritional advice-–this may have to be supplemented by specific excises, which could be at central or local levels
  - Mother and infant/child clinics for preventive care, nutrition and vaccinations
- Given the importance of the preventive functions, it is often in national interest, and “Special purpose transfers” may be in use
- But with imperfect information on spending and budgets,
  - no certainty that the funds will be used effectively and not diverted (as with Oportunidades in some Mexican states)
  - Key role of own-source local taxes to align incentives

Property taxes to anchor local access to credit, new clean cities and "hubs"

- **Typical failures with property taxes in emerging market countries**, Latin America including Mexico, many Asian countries
  - US-type model based on ownership and valuation hard to implement—abandoned in the UK
  - Self assessment option: Bogotá, may be subject to abuse
  - Presumptive approach, did not work in Delhi or Pune, and is proving problematic in Bangalore
- **Linkage with service delivery** (Marshallian principles) Ahmad, Brosio, Pöschl (2015) and (2017 on Mexico) to overcome resistance
  - Focuses also on service delivery, enhances accountability
  - Maximum and minimum "bands" legislated in unitary countries,
  - Local rate setting for accountability but avoid race to the bottom
- **Scope for electronic property registers and satellite imagery** (arms' length administration to reduce scope for corruption)

General lessons for emerging market economies

Political economy and institutions critical

- Non-standard recommendations may be needed in the presence of informality
  - Lower effective threshold may be needed, by integrating small taxpayers, while keeping focus on the largest
  - Full value-added chain essential to generate information, stop cheating and base shifting
- Chinese approach to administration: match all invoices (Golden Tax Project) to block cheating and also facilitate efficient and accurate VAT refunds for exporters
- Reduced cost of business, enhanced competitive position
- Political economy of offsetting opposition to each main tax by putting them together, minimum compensation needed
- But significant work on sub-national taxes and transfers remains in many Emerging Market Economies

Key lessons

1. Raise revenues efficiently for sustainable growth and job creation
   - Taxes that do not add to the cost of doing business
   - Basis for addressing inequalities and financing clean cities or sustainable “hubs”
2. Appropriately design multilevel tax and social policies that generate sustainable growth
   - Avoid distorting benefits that create a “poverty trap”
   - Address the issues of gainers and losers in a sustainable manner
3. Attention to institutions and incentives to cheat at each level of administration