Public Finance and Development

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Discussion

Many puzzling aspects of tax policy in poorer countries

- In poorer compared to developed countries,
  - (Taxes/GDP) about half as large
  - (Trade taxes/total taxes) much higher
  - (Person income taxes/total taxes) a third as large
  - But income tax rates roughly the same
- Patterns as true in the time series data and the cross-section data

Many puzzling aspects of tax policy in poorer countries

- Added observation: Role of wars
  - Wars lead to a permanent jump in tax revenue
  - Wars also lead to permanent changes in composition of tax revenue
- This observation forms the basis for the model used in this paper:
  - Intuitively, states invest in monitoring technology during wars that remains useful after wars are over

Economic trade-offs when investing in fiscal capacity

- Evasion, *e*, chosen to minimize

$$t(Y-e)+c(e,\tau)$$

- Implications:
  - Evasion independent of *Y*
  - Tax distortions to *Y* independent of *e*
  - Optimal *t* low when *e* high
    - While counter-factual, heterogeneity in evasion costs can help explain data

Economic trade-offs when investing in fiscal capacity

- Costs: $F(\Delta\tau)$, independent of *Y*
- Implications
  - Higher *Y* implies higher *t*, and therefore more enforcement
- Functions *F* and *c* differ by tax, so degree of enforcement differs by tax at each level of income

Provides rationale for low revenue in poor countries

- Forecast lower revenue even at same enforcement, but also lower enforcement in poor countries
- Assumed cost differences by tax:
  - Flexible enough to rationalize any pattern of tax differences in poor countries
  - But few testable forecasts

Political considerations when investing in fiscal capacity

- Value of future tax revenue varies depending on political context
  - High during a war
  - High if officials remain in power longer
  - Lower if successor governments have different preferences on use of funds

Political explanations for low revenue in poor countries

- Political differences with richer countries?
  - Governments shorter lived?
  - Society more polarized?
  - Fought fewer wars in the past?

Political explanations for low revenue in poor countries

- But no evidence presented for systematic political differences in poor countries
- Casual evidence suggests skepticism
  - Past U.S. tax structure mirrors that in developing countries
  - Developed countries without recent wars, e.g. Denmark or Sweden also have high revenue. (see Figure 12)
  - Policies in China?

Empirical evidence key to differentiating among theories

- Authors should be commended for the diverse body of evidence they produced.
- Evidence consists of correlations between two variables.
- Better to at least control for per capita income
- Doing so would provide a test of the degree to which political factors vs. income per se explains puzzling tax policy in poorer countries

With economic factors alone,

- Model simply forecasts
  - Lower tax revenue and lower tax rates in poor countries
  - Policies can vary arbitrarily by tax

But enforcement of taxes highly interdependent

- For example, the corporate tax collects a much higher fraction of revenue in poorer countries
- If the government observes (*Revenue – payroll – materials – depreciation*),

  then it has enough information to support each of the standard taxes

Alternative assumptions about sources of information

- Consistent with this, most of literature focuses on enforcement differences by firm
  - Dharmapala et al: Fixed costs of monitoring a firm, but covers all taxes
  - Kleven et al: Larger firms cannot hide information, again affecting all taxes
  - Gordon-Li: Firms differ in gains from use of financial sector
  - Another possibility is that information mainly from state-owned firms

These alternative models have many testable forecasts

- With full information on some firms and none on other firms, standard optimal tax structure ***if*** no mobility of tax base from taxed to untaxed firms
- Mobility adds new consideration to choice of tax structure

Example from Gordon-Li

- If labor-intensive firms relatively mobile, then optimal taxes on labor income will be low.
- If tax burden/sales differs by industry, then tariffs needed to neutralize the resulting trade distortions
- Incentives to intervene in capital market so as to favor taxed firms

Broader implications

- Basic intuition: If "x" makes revenue collection harder, then policies that discourage "x" become attractive
  - If observe activity only of large firms, then discourage production in small firms
  - If observe only activity using the financial sector, then discourage firms that don't value use of banks, e.g. inflation

What if quality of information varies by firm?

- Observe *I* easily, yet costs *c* to hire accounting firm to document *B*
  - Presumptive tax on *I* if don't observe *B*
  - Tax $E(B \mid I)$?
- Should firms can be given choice between presumptive and ordinary taxes? What should incentives be to report *B* ?

Resulting role of fiscal capacity

- Role of fiscal capacity is then to monitor the accounting firms
- If monitoring poor, then tax base in practice is I, regardless of the law.

Summary

- Striking observation that wars generate permanent increases in tax revenue
- Paper surveys a body of work that builds off of this observation
- But does this observation help us understand why tax policies differ so dramatically in poorer countries, or where policy reform should focus?