UN ESCAP

Meeting of Expert Group on Tax Policy and Public Expenditure Management for Sustainable Development (2018)

Fiscal Contracting and Revenue Mobilization

Eric M. Zolt

UCLA School of Law

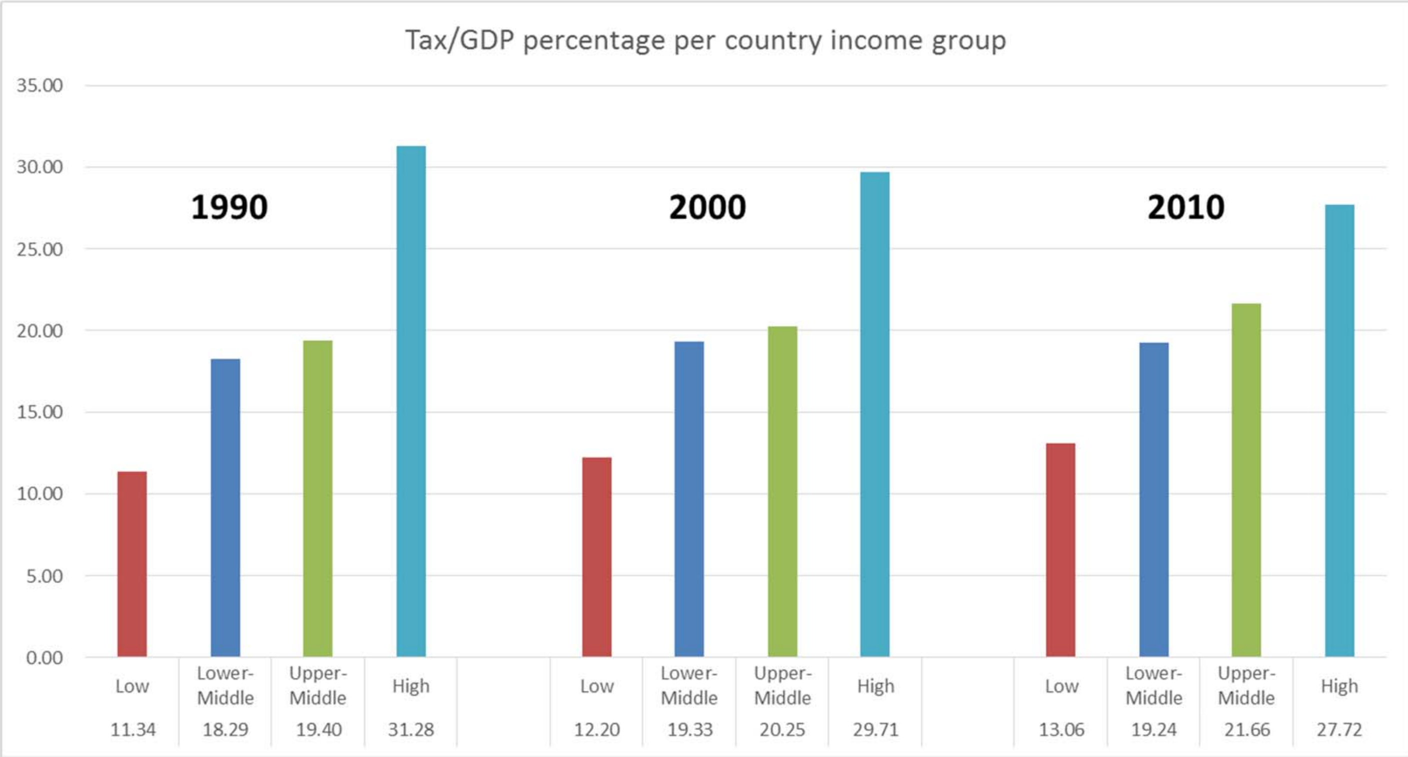
Overview of Presentation

- How tax systems differ
- Why tax systems differ
- Tax effort and tax capacity
- Fiscal contract and fiscal contracting
- Inequality and taxation
- Increasing size of the middle class and changing tax and spending patterns

How taxes differ

- Types of taxes
  - Taxes on consumption
    - Turnover, VAT, excise, import duties and export taxes
  - Taxes on labor income
    - Wage taxes and social security taxes
  - Taxes on business and investment income
  - Wealth and inheritance taxes
  - Property and land taxes
- Tax levels (overall tax burden)
- Tax structure (relative revenue contribution of different taxes)

Aggregate level of taxes



Aggregate level of taxes: Southeast Asian Countries

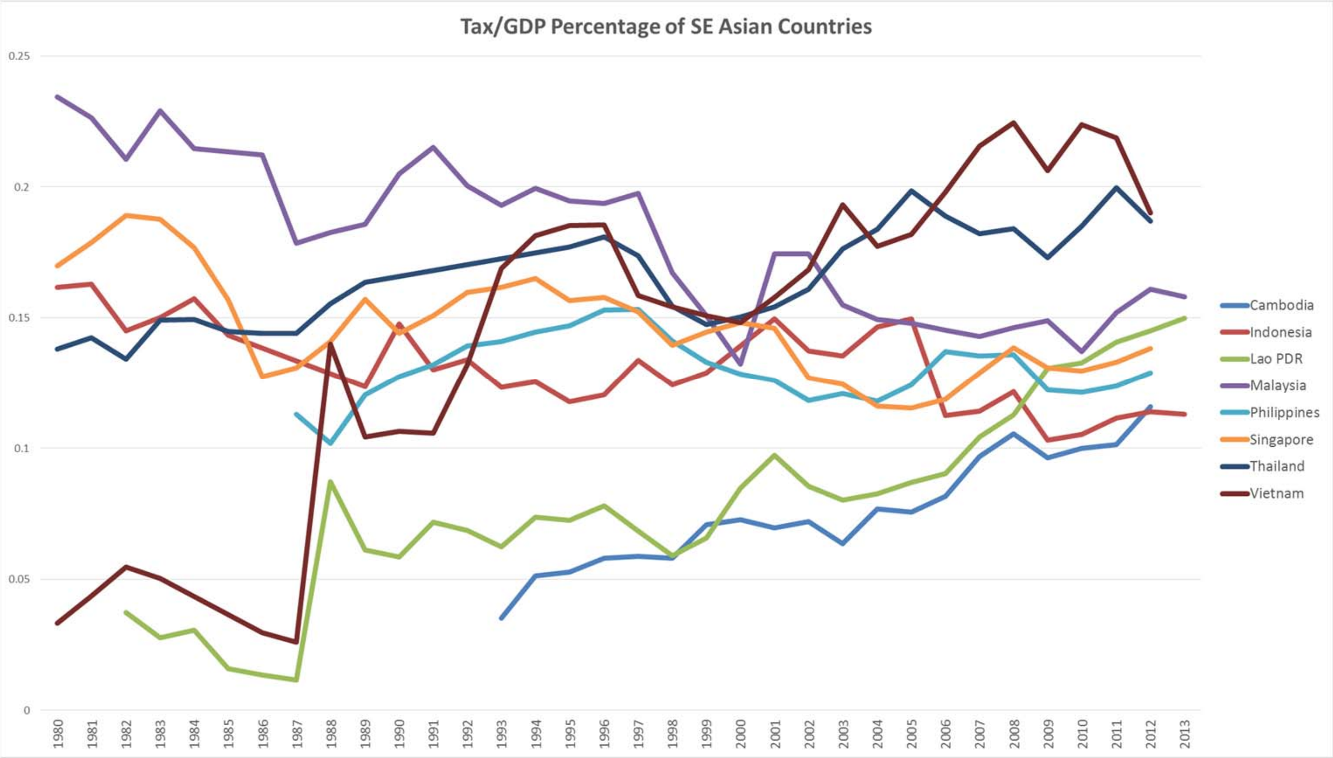
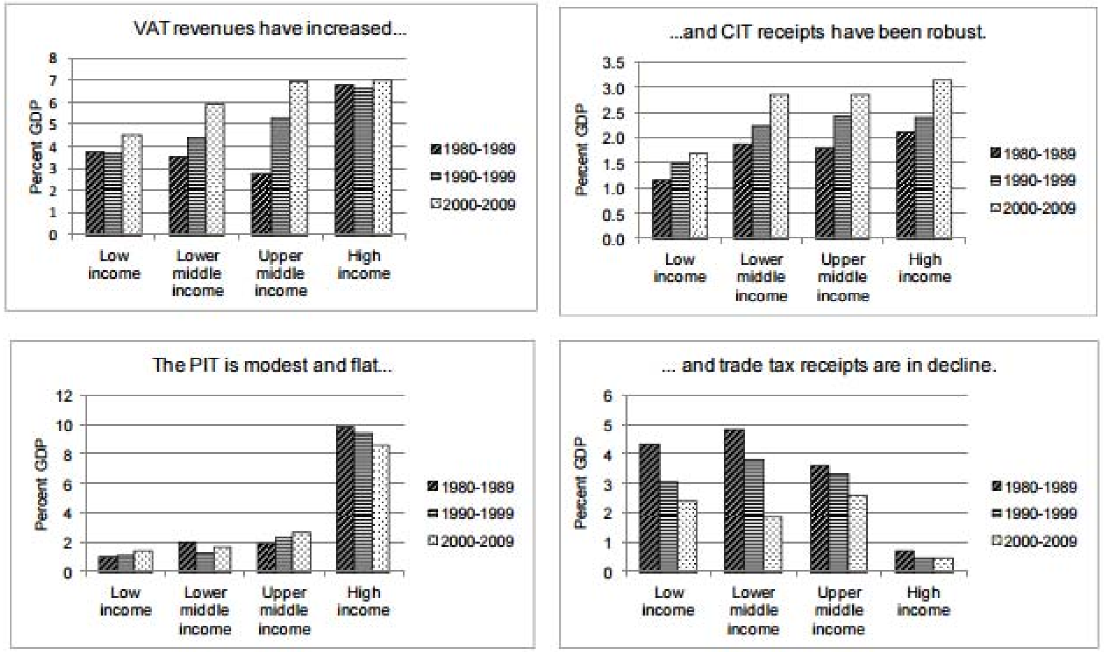


Figure 7. Trends in the Composition of Revenues, 1980–2009
(In percent of GDP)



Source: IMF staff calculations.
Note: Group medians and dynamic income groups.

Why taxes differ – economic, administrative, and historical factors

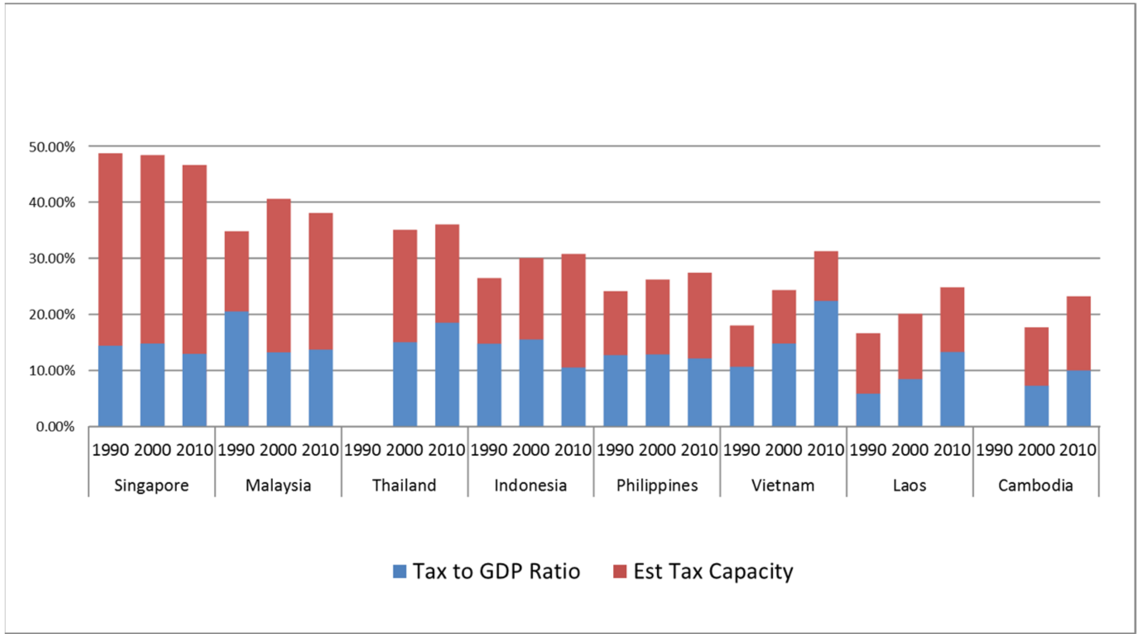
- Different economic environment to collect taxes
  - Level of economic development
  - Size of informal sector
  - Role of financial sector
  - Availability of non-tax revenue (primarily from natural resources)
- Different abilities to impose and collect taxes
  - Culture of compliance or non-compliance
  - Investments in tax capacity
- Different history – particularly for many developing countries that were formerly under colonial rule
- Different geography

Why taxes differ – political factors and policy preferences

- Different political environment
  - distribution of political power among interest group varies by countries
- Different political institutions
  - Presidential vs. parliamentary systems
  - Majority elections vs. proportional representation
  - Veto-gates and legislative malapportionment
- Different values
  - Different views of role of government (different demands and tastes for public goods and services)
  - Different preferences for redistribution

Tax effort and tax capacity

- Tax effort: level of taxation (tax-to-GDP ratio)
- Tax capacity: look at different factors that reflect the ability of governments to impose and collect taxes
- Beginning in 1960s, IMF worked to identify those explanatory factors that were useful in determining differences between countries
- Later efforts added more explanatory variable and different techniques (stochastic frontier models)


50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
1990 2000 2010 1990 2000 2010 1990 2000 2010 1990 2000 2010 1990 2000 2010 1990 2000 2010 1990 2000 2010 1990 2000 2010
Singapore
Malaysia
Thailand
Indonesia
Philippines
Vietnam
Laos
Cambodia
Tax to GDP Ratio
Est Tax Capacity

Thought Experiment: Indonesia Taxation 1990 vs. 2010

1990

GDP Per Capita (2011 $)	$4,500
Trade (% GDP)	49%
Agriculture VA (% GDP)	19%
GINI	29
Education (% GDP)	1%

Tax/GDP: 14.8%

Est. Tax Capacity: 26.5%

Est. Tax Efficiency: 55.8%

2010

GDP Per Capita (2011 $)	$8,500
Trade (% GDP)	47%
Agriculture VA (% GDP)	14%
GINI	36
Education (% GDP)	3%

Predicted Tax/GDP: 17.2%

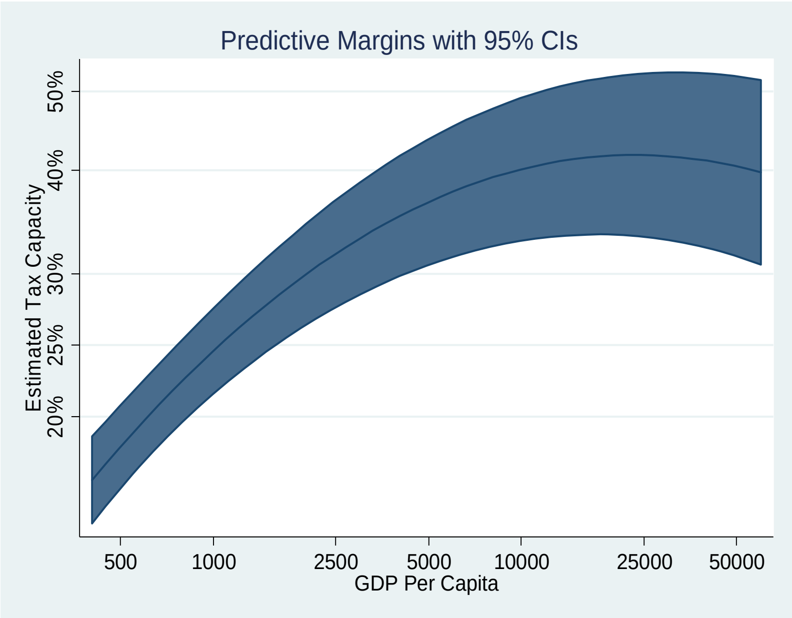
Actual Tax/GDP: 10.5%

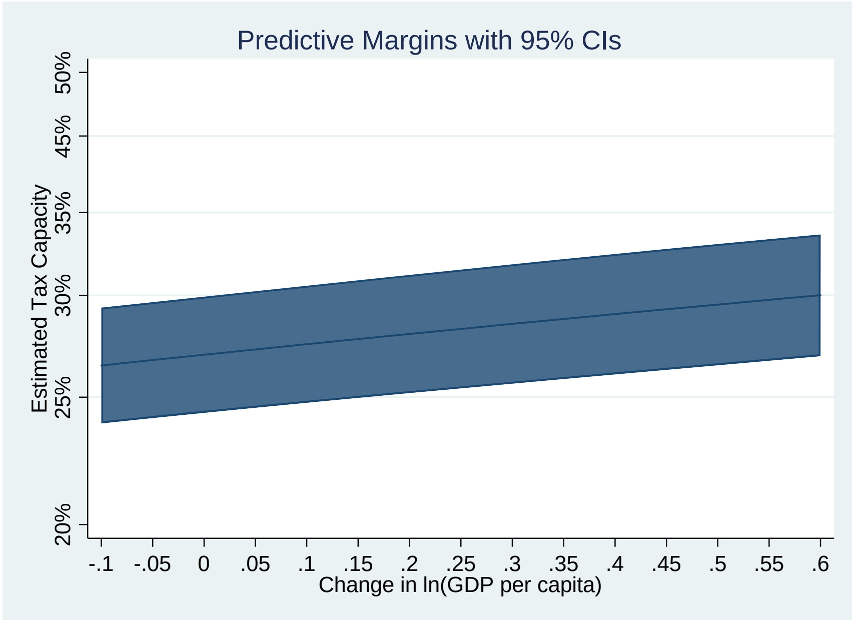
Est. Tax Capacity: 30.8%

Est. Tax Efficiency: 34.9%

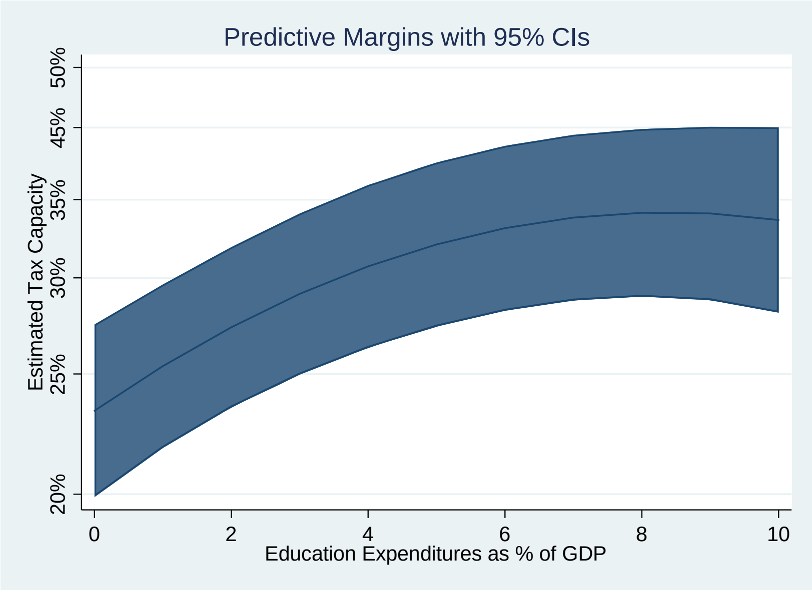
Estimates based on statistical models from Fenochietto & Pessino IMF WP 13/244

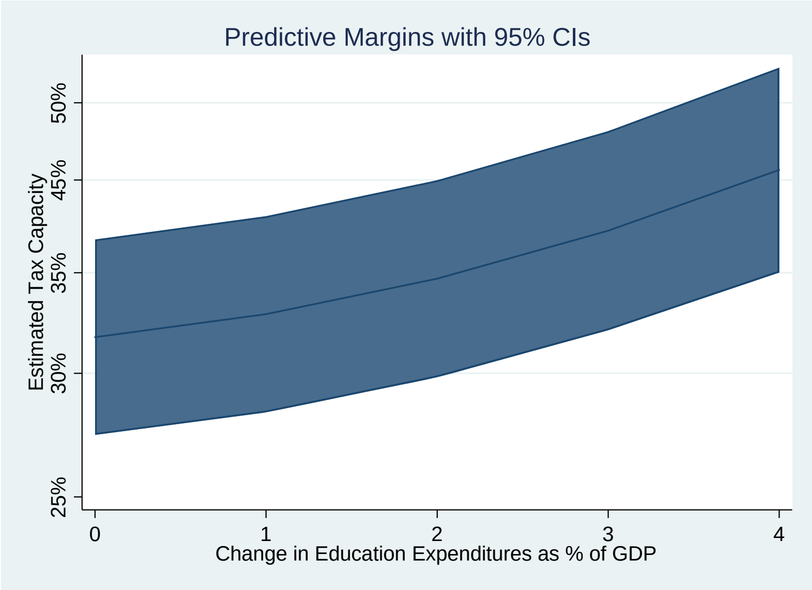
GDP Per Capita & Tax Capacity: Between vs. Within





Education Spending & Tax Capacity: Between vs. Within





Taxation and the State

- Two broad approaches (Hettich & Winer 1999)
  - Taxation as an exchange between citizens and government with taxes the price of public goods and services
  - Taxation as a coercive taking of resources with little connection between government expenditures and taxes paid

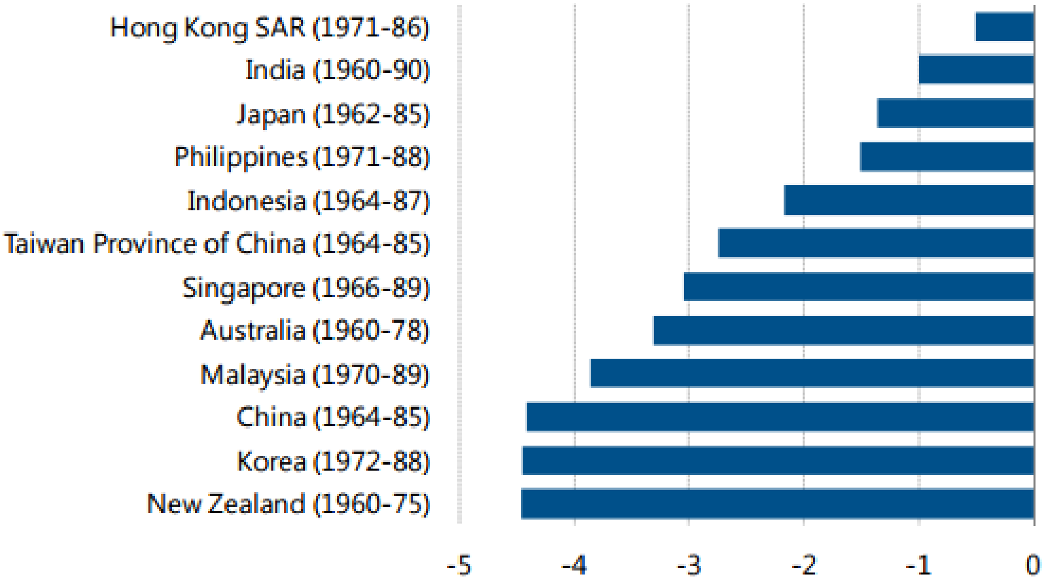
Social contract v. Autonomous state

- Social contract
  - Governments rest on implicit agreement that states can exercise power over citizens in exchange for protecting certain rights and providing certain services
  - Fiscal policy is a key component of social contract
- Autonomous state
  - Much public finance literature effectively assumes that the government has sufficient coercive powers to design and enforce tax systems (avoiding the messiness of politics)
  - People pay taxes because they must without any relationship between the source of revenue and the nature of expenditures

Fiscal contract v. Fiscal contracting

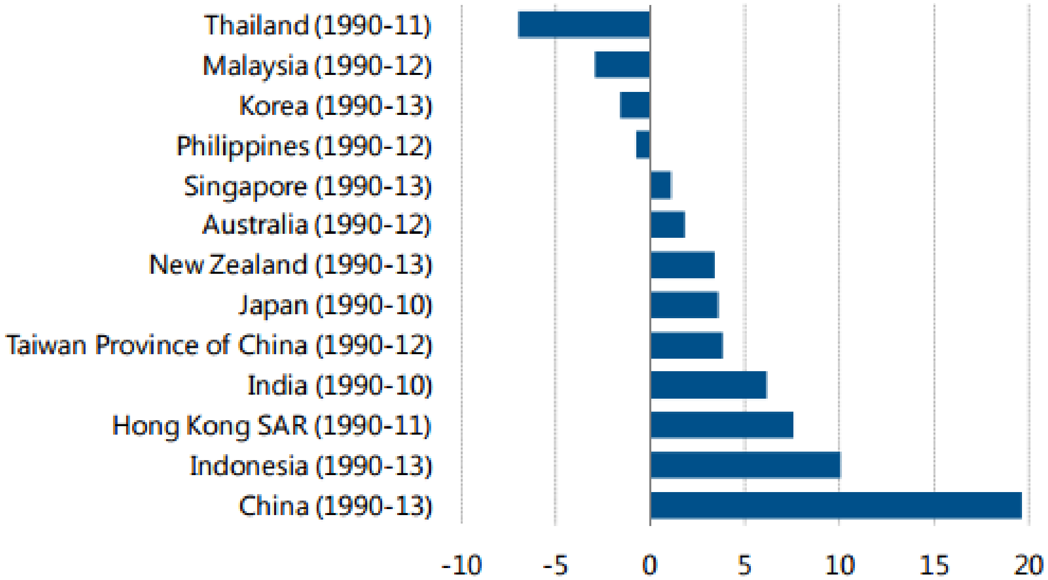
- Fiscal Contracts (Timmons 2005)
  - View governments as quasi-monopolistic providers of public services seeking to maximize revenue
  - Government can increase willingness to pay either by providing goods and services that taxpayers value or by increasing the penalties for failure to pay taxes
  - Those who pay taxes are expected to receive most of the benefits
- Fiscal Contracting (Bird & Zolt 2015)
  - Tax changes result from equilibrium outcomes of political competition
  - Fiscal contracting is the process whereby different interest groups participate in differing extent over time in shaping the tax and expenditure policy

Figure 1: Selected Asia: Income Inequality, Pre-1990
(Net Gini Index; in Gini points; change during the period indicated in parenthese)



Sources: SWIID Version 5.0; and IMF staff calculations.

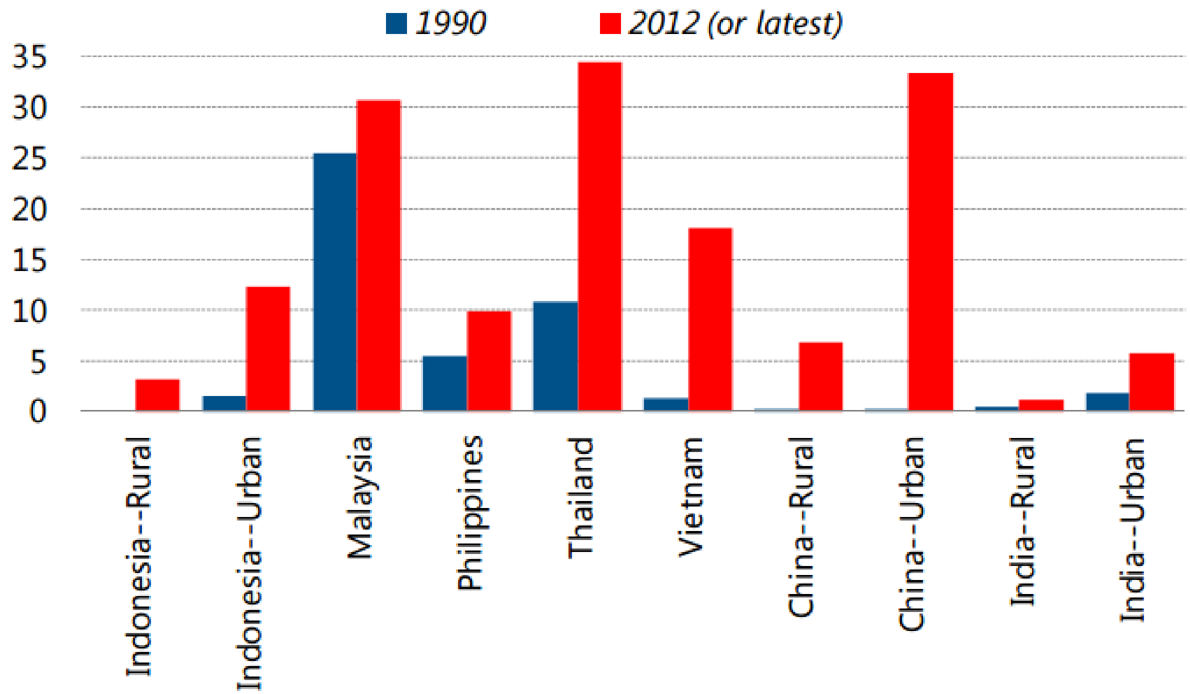
Figure 2: Selected Asia: Income Inequality, 1990-Latest
(Net Gini Index; in Gini points; change during the period indicated in parenthese)



Sources: SWIID Version 5.0; and IMF staff calculations.

Figure 17: Middle Class in Asia

($10-$20 a day in 2011 PPP; in percent of total population)



Source: World Bank, PovcalNet database.

Inequality and taxation

- Relationship of inequality and taxation
  - Taxes influence level of inequality through changing after-tax distribution of income and by influence behavior
  - Inequality influences the level of taxation, as more unequal societies may adopt different tax and spending policies
- Robin Hood Paradox
  - Those countries with lower levels of inequality have greater levels of redistribution through tax and spending policies
  - Those countries with higher levels of inequality have generally lower levels of redistribution through tax and spending policies
- Tax policy and redistribution
  - Countries with more redistributive spending programs generally fund them with less progressive taxes than countries with smaller spending programs

Increasing size of the middle class and changing preferences for tax and spending policies

- Historical perspective
  - In US, Europe and Japan, close link between democratization and government support for policies benefitting the middle class
  - Government investment in infrastructure, education and social assistance programs at a time when per capita GDP was at levels comparable or below current per capita GDP levels of many emerging countries
  - Open question whether governments in these emerging countries will substantially increase investments in social programs
- Choices facing middle class voters
  - Low taxes and low levels of government services
  - Higher taxes and greater investments in infrastructure, education, health and poverty reduction
- Political mechanism for translating policy preferences into government action
  - Median voter (Meltzer & Richard)
  - Political control by elites
  - Changes in political control as different interest group advocate different tax and spending policies