Center for Global Development

Political Economy of Tax Reforms in Developing Countries*

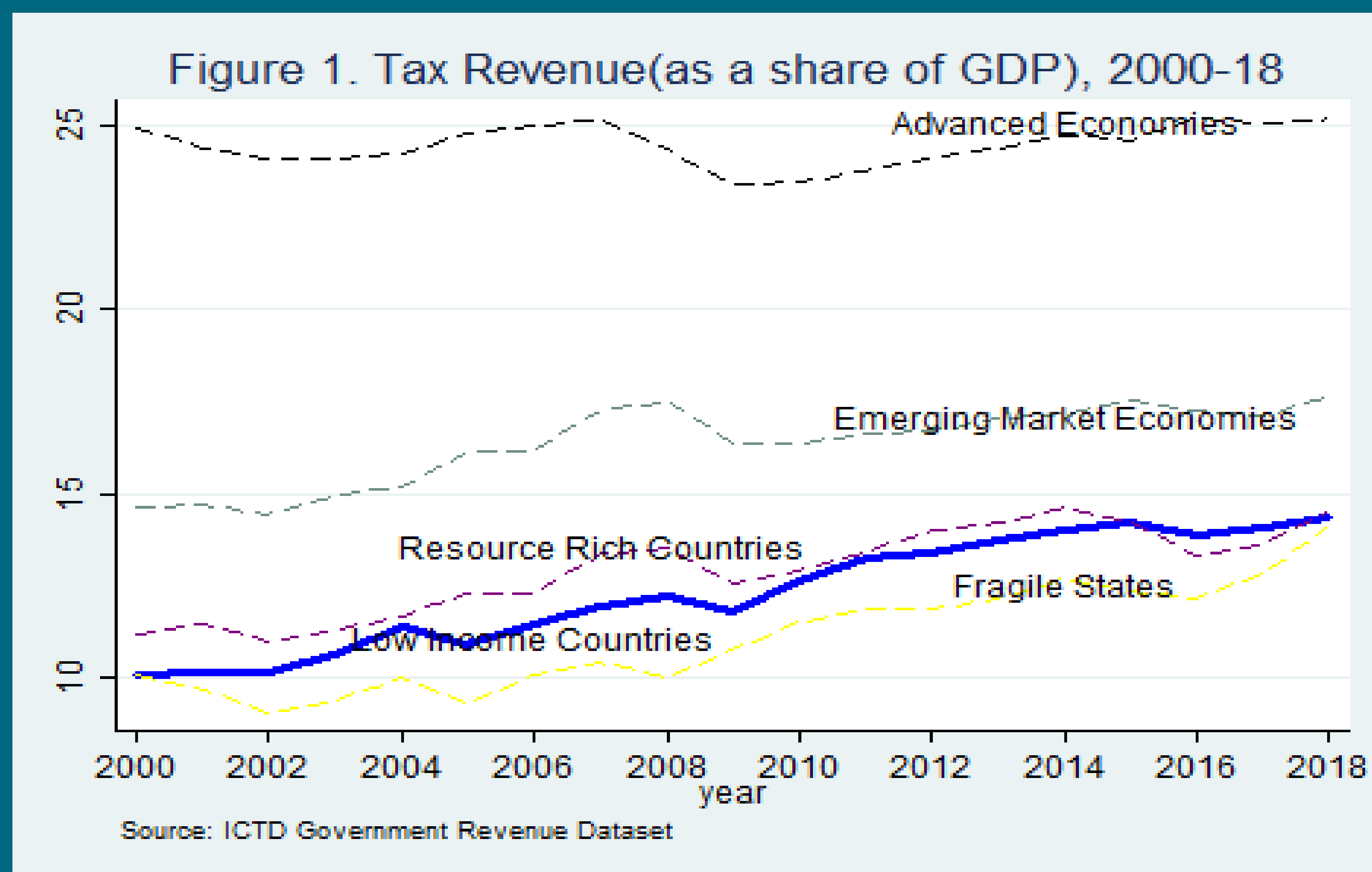
By
Sanjeev Gupta
Senior Policy Fellow
Center for Global Development
G-24 Technical Group Meeting on Domestic Resource Mobilization to Support a Better Post-COVID Recovery
March 5, 2021

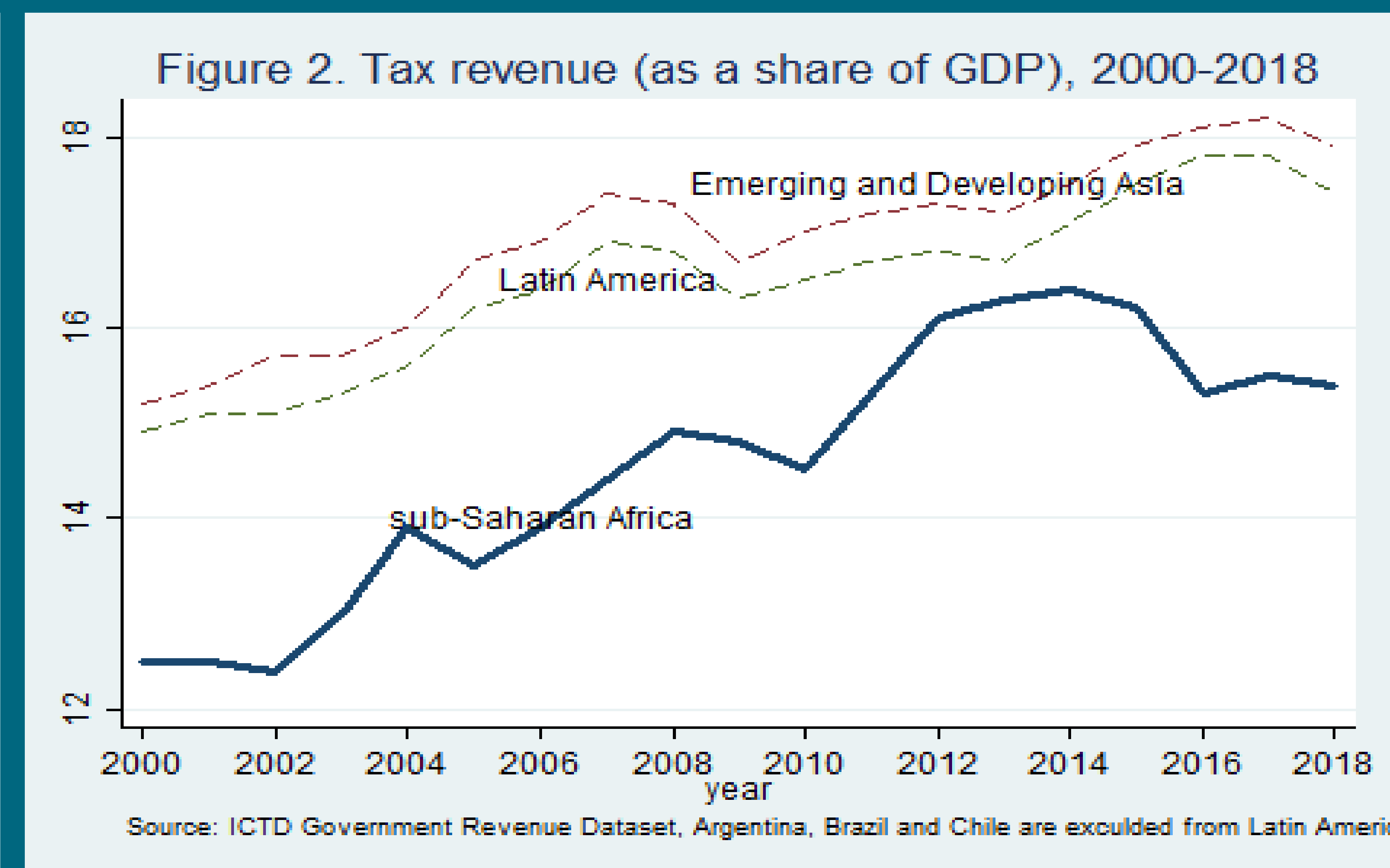
***The views expressed here are those of the authors and do not necessarily represent the views of the authors´ employers.**

Introduction and Context

Center for Global Development

- Low-Income Developing countries (LIDC) need resources for financing development, with domestic revenue mobilization (DRM) critical to achieving that goal.
- Besides, DRM is critical for ensuring debt sustainability and reducing monetary financing for macroeconomic stability.
- Countries made progress in raising revenue: the average tax-to-GDP for LIDCs increased from around 10 percent in 2000 to 14 percent in 2018. BUT this is not enough to meet the SDGs.





Obstacles to Reform

Center for Global Development

- But there are obstacles to raising more revenue: Large and politically powerful players are able to opt out of the tax system.

- This affects the overall tax compliance as the general population becomes unclear about the benefits of paying taxes.

- Furthermore, resistance from vested interest is impairing implementation of tax reforms.
  - For example, favorable tax treatment—popularly referred to as tax exemptions--accorded to certain consumers and producers has eroded the tax base in these countries.

- The need for more revenues in these countries to support developmental needs has led to calls for undertaking critical fiscal reforms, notably in the tax area.

Political Economy Matters

Center for Global Development

- The economic literature recognizes the important role of political considerations in the implementation of reforms.
- Reforms may not happen because of ideology of the ruling government—left-leaning governments may prefer not to undertake reforms because of the fear of benefiting the rich; there may be extreme political divisions in the country; or because of the impending elections and the fear that electorate will punish the ruling party for implementing reforms.
-
- In a government with a large number of strong players and fragmented decision making, there is a tendency to preserve the status quo on fiscal matters.
- At the same time, national elections can be a source of policy volatility when the incumbents use tax and spending policies for re-election purposes.

Our Research

Center for Global Development

- We sought to see whether any of these considerations has influenced the implementation of tax reforms in developing countries, both emerging and LIDCs.
- To do that, we used a new "narrative" database of major tax reforms implemented in 45 countries during 2000-2015 as compiled by the IMF.
- This database considers large tax revenue changes in the aggregate but also identifies tax reforms by tax sub-category, that is, whether they were in the area of taxes on goods and services, personal income tax, etc.
- An important novelty and strength of this database is the precise timing and nature of key legislative tax actions that took place over the 15-year period under scrutiny.

Data – key stylized facts

Center for Global Development

- The vast majority of tax reforms in these countries were in goods and services taxes and most reforms were implemented during the period 2010-2015.
- Emerging markets did more reforms in personal income tax, value-added and excises, while low-income focused more on trade taxes.

Reform shocks by group of countries (number of tax reform country-years)

	Emerging Market Economies	Low-Income Countries	Sub-Saharan Africa	Resource-Rich	Fragile
Number of countries	*23*	*22*	*10*	*6*	*13*
PIT	16	8	4	2	4
CIT	23	24	12	4	6
Goods and Services Taxes	99	74	53	14	49
GST	*20*	*22*	*17*	*2*	*10*
VAT	*30*	*18*	*17*	*0*	*17*
EXCISE	*49*	*34*	*19*	*12*	*22*
TRADE	10	21	21	5	15
PROPERTY	1	4	4	0	4
REVENUE ADMINISTRATION	57	45	33	7	24

Main Results

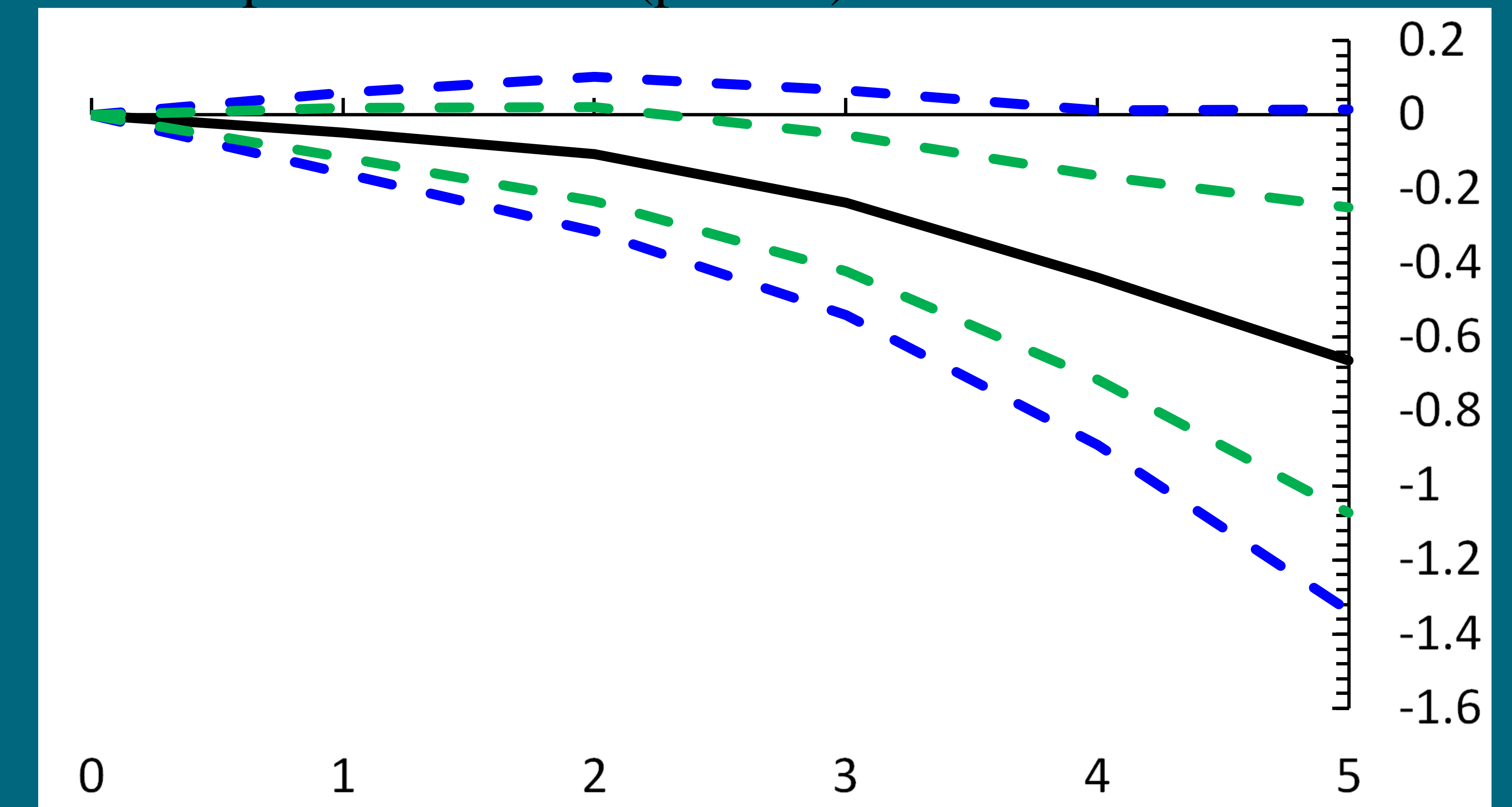
Center for Global Development

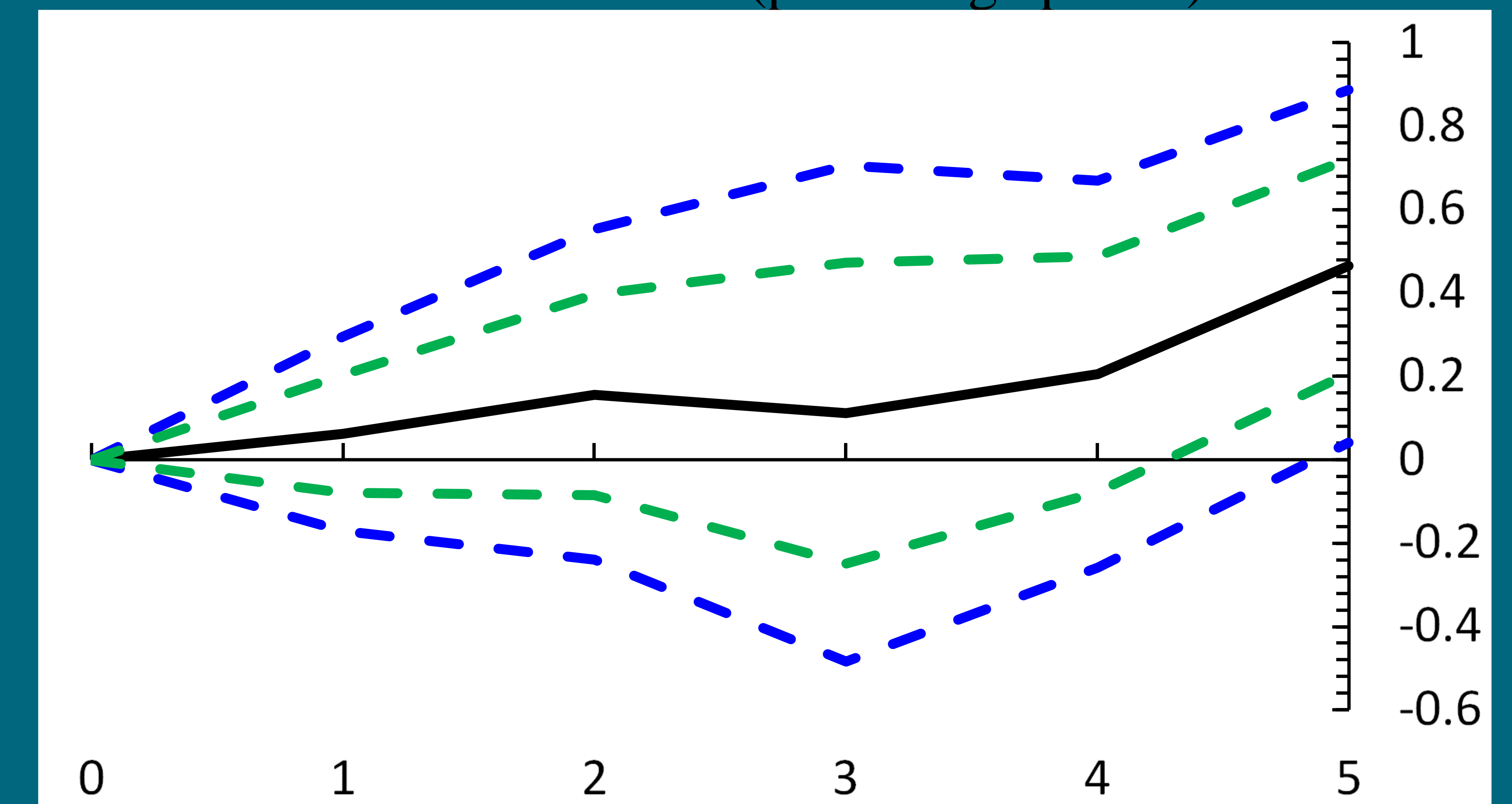
- Results suggest that a left-wing government is less inclined to implement tax reforms while both proximity to elections and political cohesiveness in the government are positively associated with tax reforms.
- It seems that left-leaning governments are distrustful of tax reforms presumably in part because of the perception that reforms benefit the rich.
- The reform-hindering effect of the left ideology is stronger in low-income countries than in emerging market economies.
- Interestingly, revenue administration reforms are resisted the most by left-leaning governments.
- Proximity to elections seems to trigger reforms of PIT but opposite holds for trade tax reforms, reflecting the fear that small businesses may become worse off.
- Notwithstanding the above, political cohesion is a necessary ingredient to reform most tax categories and revenue administration.

But some reforms improve income distribution…

Center for Global Development

- In another study, we find that the perception that reforms benefit the rich is misplaced. When tax reforms include personal income tax and revenue administration, disposable Gini falls and poor's income share rises.
- Finding driven largely by countries outside sub-Saharan Africa. Results suggest that the design of tax reforms has been ineffective in improving disposable income inequality in sub-Saharan Africa; unlike other country groups, personal income tax reforms worsened the Gini coefficient.
- Finally, the smaller the government and the smaller the tax system, the larger the beneficial impact of tax reforms on income distribution: the marginal cost of new taxes is small; the marginal benefit of additional spending relatively high.





Will COVID-19 trigger more reforms?

Center for Global Development

- In another study, we ask the question whether the advent of COVID will induce countries to implement tax reforms.
- We find that COVID has affected the revenue position of developing countries more than that of advanced economies.
- We base our research on the experience gained from past pandemics between 2000-2015: SARS in 2003; H1N1 in 2009; MERS in 2012; and Ebola in 2014.
- We find that countries are likely to implement tax reforms to deal with the challenges arising from pandemics, particularly in areas of corporate income taxes, excises and property taxation.
- Unfortunately, pandemics do not drive these countries to implement revenue administration reforms.

What to draw from our work?

Center for Global Development

- Increasing tax revenues is an ambitious and complex task that depends upon several factors.
- Policy-wise there is great potential to capture more revenue in better ways in many developing countries.
- However, perceptions of policymakers about the impact on the poor and strength of political players in decision making is probably impeding the momentum for tax reforms.
- However, our analysis shows that is not necessarily the case. Properly designed tax reforms can benefit the poor. Given the revenue needs of LICs for developmental purposes, we find that the current COVID-19-induced-crisis may propel them to implement tax reforms in certain areas.

Papers and Links

Center for Global Development

- **Sanjeev Gupta and Joao Tovar Jalles, 2020,**"Tax Revenue Reforms and Income Distribution in Developing Countries"

https://www.cgdev.org/publication/tax-revenue-reforms-and-income-distribution-developing-countries

- **Sanjeev Gupta and Joao Tovar Jalles, 2020,** "On the Political Economy Determinants of Tax Reforms: Evidence from Developing Countries"

https://www.cgdev.org/publication/political-economy-determinants-tax-reforms-evidence-developing-countries

- **Sanjeev Gupta and Joao Tovar Jalles, 2021**: "Can Covid-19 Induce Governments to Implement Tax Reforms in Developing Countries?"

https://www.cgdev.org/publication/can-covid-induce-governments-implement-tax-reforms

Center for Global Development

Thank you!

Center for Global Development, Washington DC – March 5, 2021

Sanjeev Gupta

***The views expressed here are those of the authors and do not necessarily represent the views of the authors´ employers.**