Taxation & Development

Henrik Kleven

Professor, London School of Economics
Co-Director, IGC State Capabilities Programme

Asim I Khwaja

Professor, Harvard Kennedy School
Co-Lead Academic, IGC Pakistan

IGC Growth Week 2014

Outline For Today

I. Outline Overall Approach (Henrik)

- Micro/Field Based Policy Research & Design

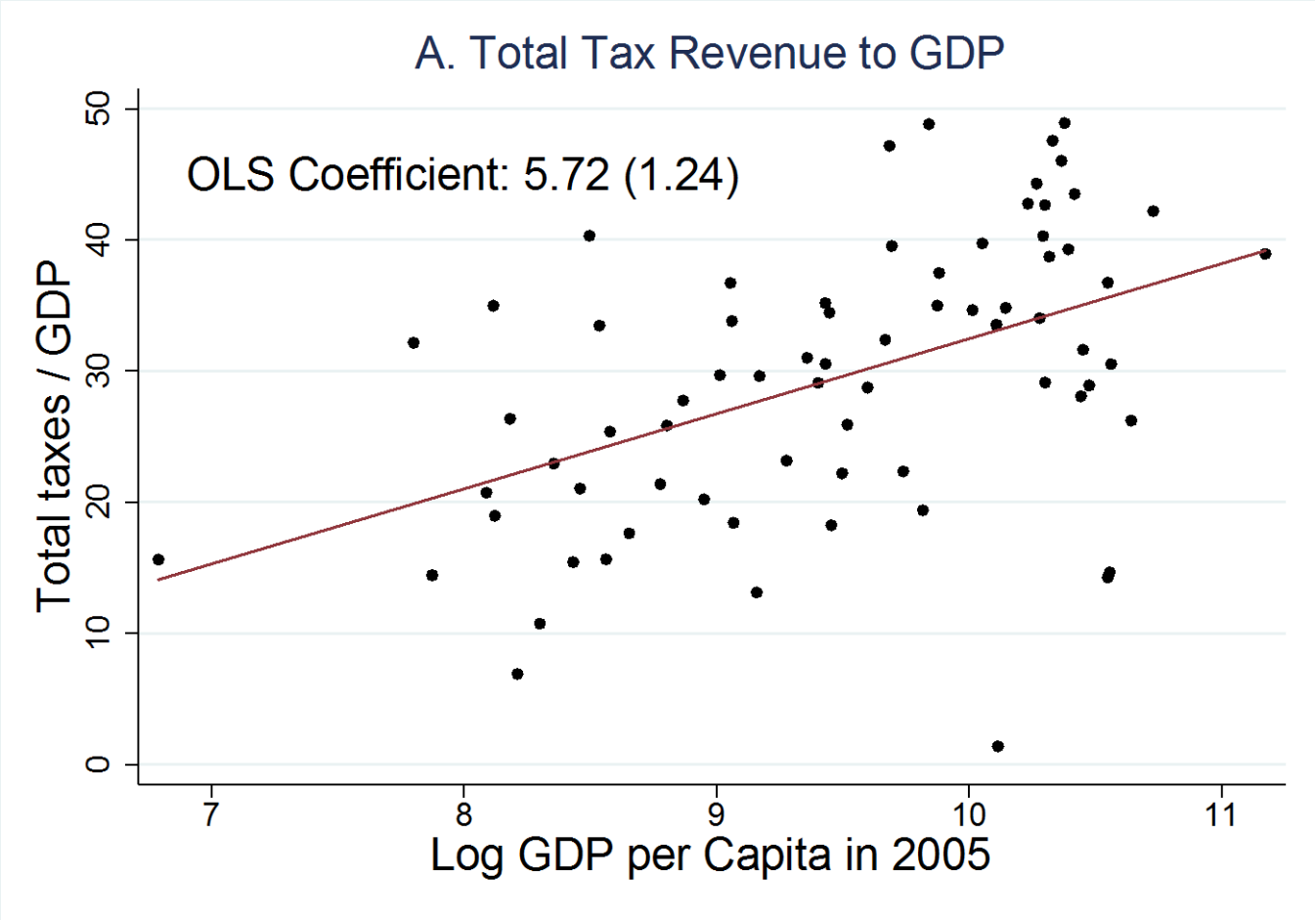
II. Specific Topics I (Henrik)

- Tax Enforcement, Tax Policy

III. Specific Topics II (Asim)

- Tax Administration, Taxpayer Buy-in & Morale

Tax Take vs GDP per Capita



Source: Kleven, Kreiner, Saez (2014)

Public Finance & Development: Two Approaches

1. **Big-picture macro approach:** what shapes tax capacity and tax policy in the long run?
   - "How does a government go from raising around 10% of GDP in taxes to raising around 40%?" (Besley-Persson 2013)

2. **Nitty-gritty micro approach:** given weak tax capacity, what can governments do to incrementally improve
   - **Tax administration**
   - **Tax enforcement**
   - **Tax policy**
   - **Tax morale**

We take the Nitty-Gritty Micro Approach

The big-picture macro approach is intellectually interesting, but unlikely to yield concrete and conclusive policy guidance

We therefore take the more nitty-gritty micro approach

- Start from the specific context and problems of a given country
- Address concrete problems, one problem at a time
- Based on empirically grounded research, design (incremental) policy innovations suited for that context
- Lends itself to—and often requires—collaborations between researchers and policy makers

Taxation is Ideally Suited for such Micro Work

- Tax records represent a great **administrative data** source
- There is often **exogenous variation** in policy parameters due to tax reforms, enforcement changes, policy discontinuities, etc.
- The desired **outcomes are measurable** (e.g. revenue collected)
- Public Finance & Economics more generally has **well-developed theory** that can be brought to bear in helping policy design
- Increased **policy interest** in getting taxes right given that many developing countries are becoming fiscally more independent and self-reliant

Specific Topics I

Henrik Kleven

Professor, London School of Economics

Co-Director, IGC State Capabilities Programme

IGC Growth Week 2014

Tax Enforcement

The key components of tax enforcement are

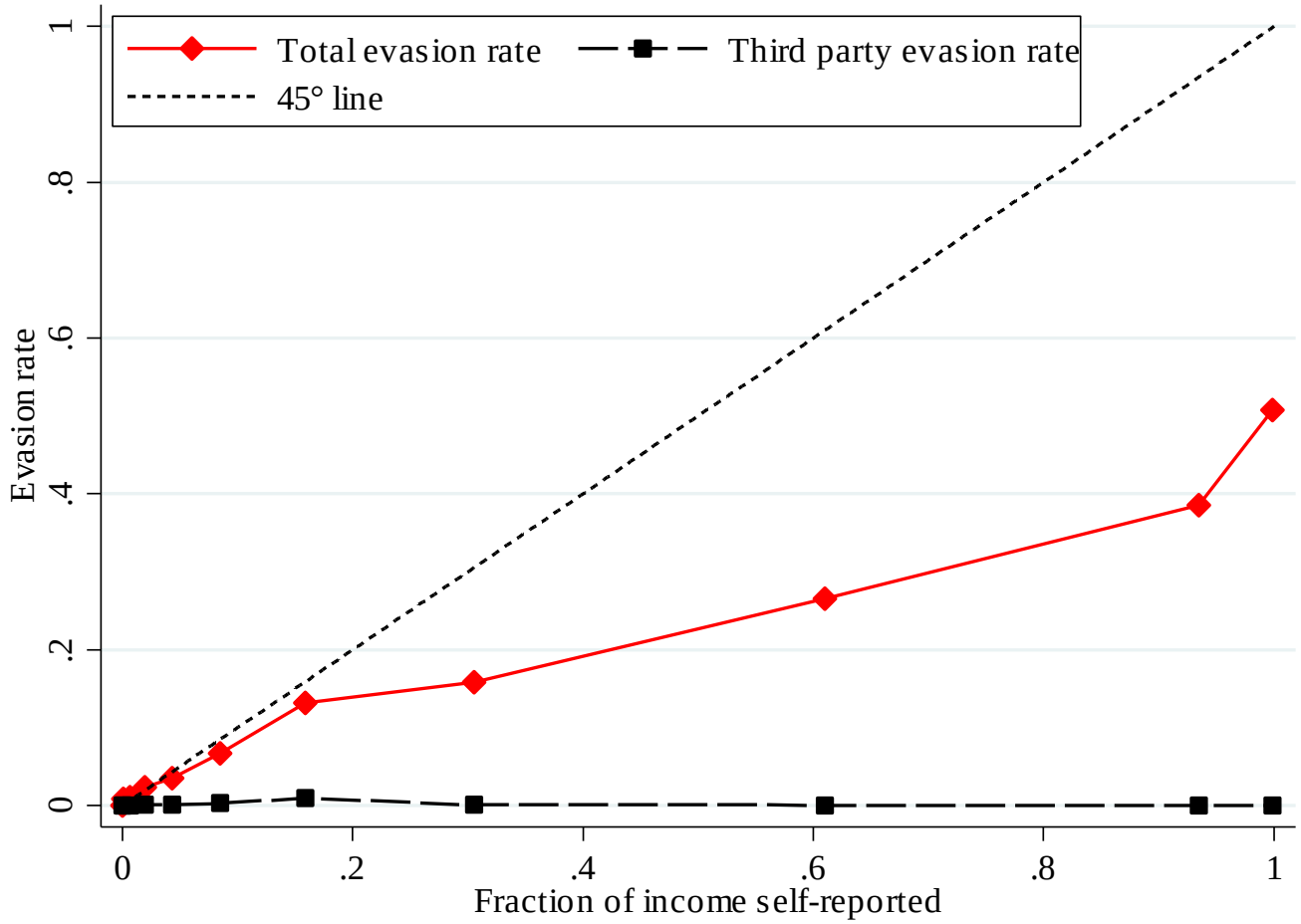
1. Audits
2. Penalties
3. Third-party information reporting & withholding
4. Other verifiable information trails

Kleven et al. (2009, 2011): tax enforcement is successful if and only if verifiable third-party information (3-4) has wide coverage

Absent wide coverage of 3-4, we want to know

- Can we expand 3-4 and what are the effects?
- How should we design 1-2?

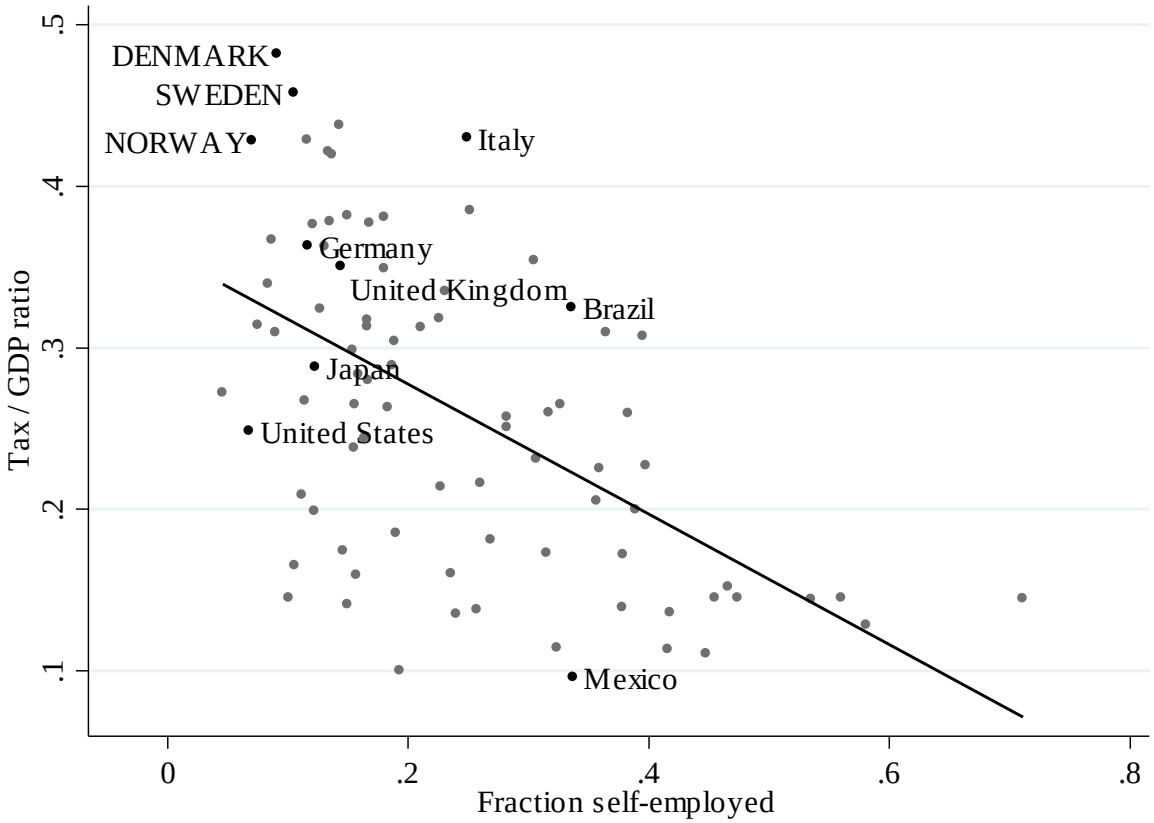
Third-Party Reporting: Evidence from Denmark (World Record Holder in Tax Take: about 50%)



Source: Kleven, Knudsen, Kreiner, Pedersen, Saez (2011)

Third-Party Reporting: Cross-Country Evidence

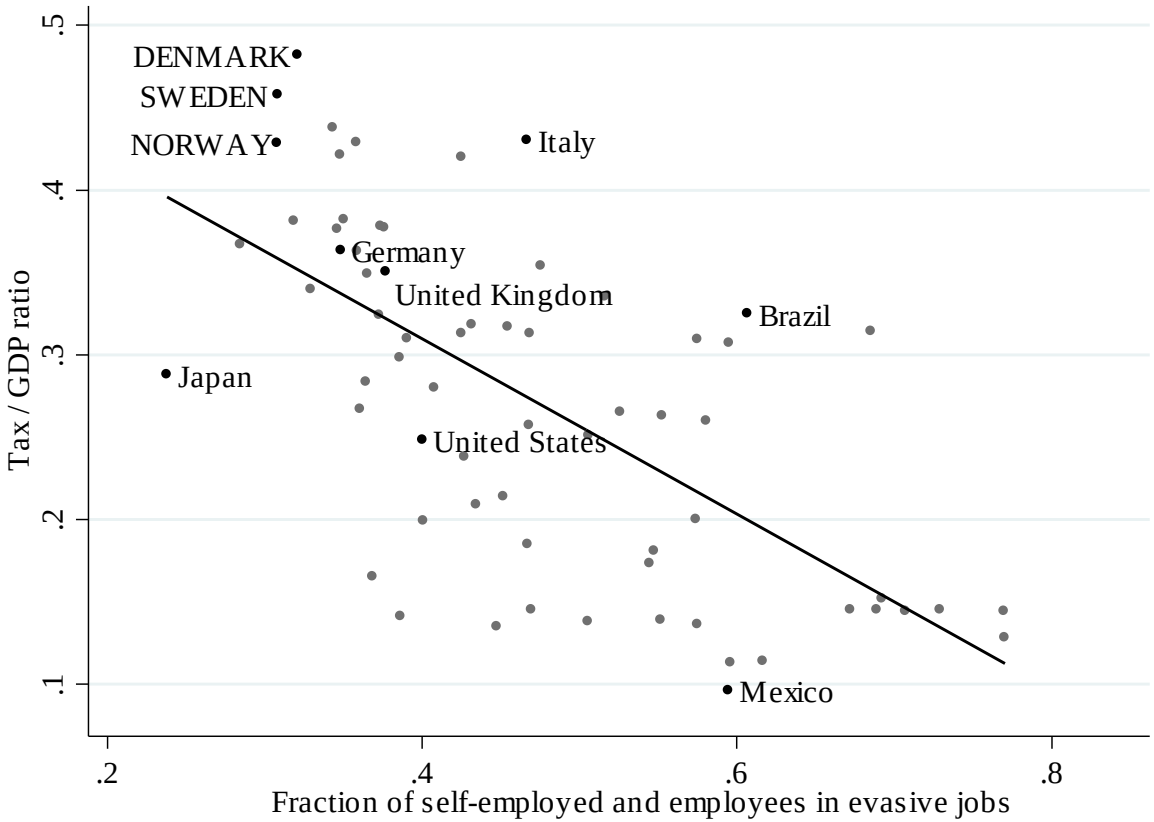
Tax Take vs Fraction Self-Employed



Source: Kleven (2014)

Third-Party Reporting: Cross-Country Evidence

Tax Take vs Fraction of Self-Employed & Employees in Evasive Jobs



Source: Kleven (2014)

Tax Enforcement: IGC Research Agenda

The policy recommendation to IGC country X is not to try and replicate the Danish information reporting system since many context-specific factors are key:

- Tax administration, self-employment; industrial composition; firm size and complexity; financial sector; scope for evasion substitution

Examples of research in weak tax capacity settings

- Pomeranz (2013) on Chile; Carillo-Pomeranz-Singhal (2014) on Ecuador

Local counterparts:

- Tax collection agency; IT/Statistics departments

Tax Policy

Three classic contributions on tax policy design:

Mirrlees (1971), Diamond-Mirrlees (1971), Atkinson-Stiglitz (1976)

Recommendations of this literature:

- Use progressive income taxes and VAT
- Do not use differentiated consumption taxes (except for externalities), capital taxes, and taxes on turnover, trade, and intermediate goods

These results generally assume:

- Perfect tax enforcement
- Full set of tax instruments available to policy makers

From Tax Rates to Tax Instruments

Much academic work has studied optimal tax rates taking the tax policy instrument as given

- E.g., lots of work on the optimal progressive income tax schedule

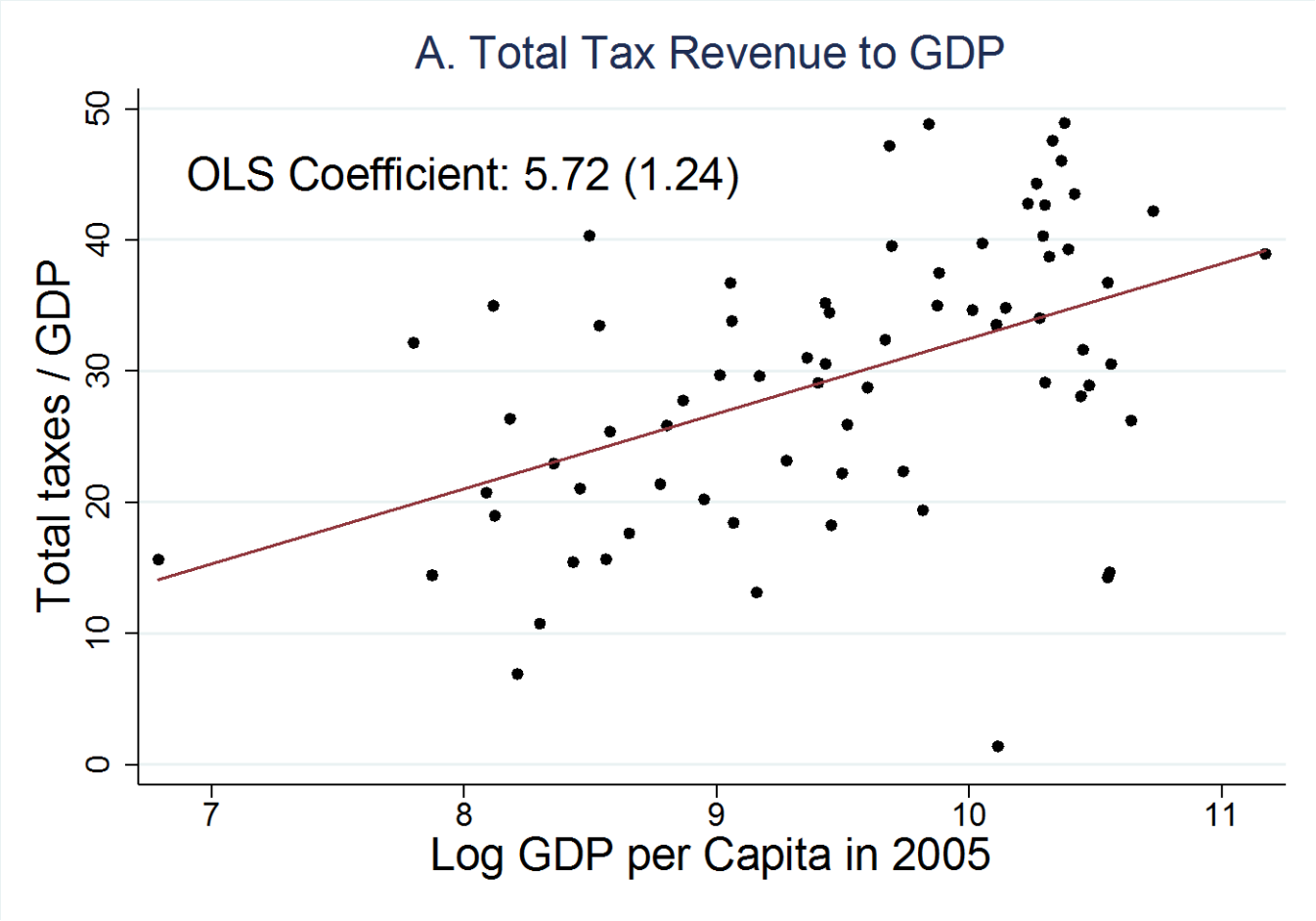
This is typically not first order for developing countries in which personal income taxes are hard to implement and enforce

- Example: Kleven & Waseem (2013) on Pakistan

In settings with weak tax capacity, the choice of instruments is key

- Which instruments represent the best trade-off between standard efficiency-equity concerns and compliance/administration concerns?
- Example: Best, Brockmeyer, Kleven, Spinnewijn, & Waseem (2014)

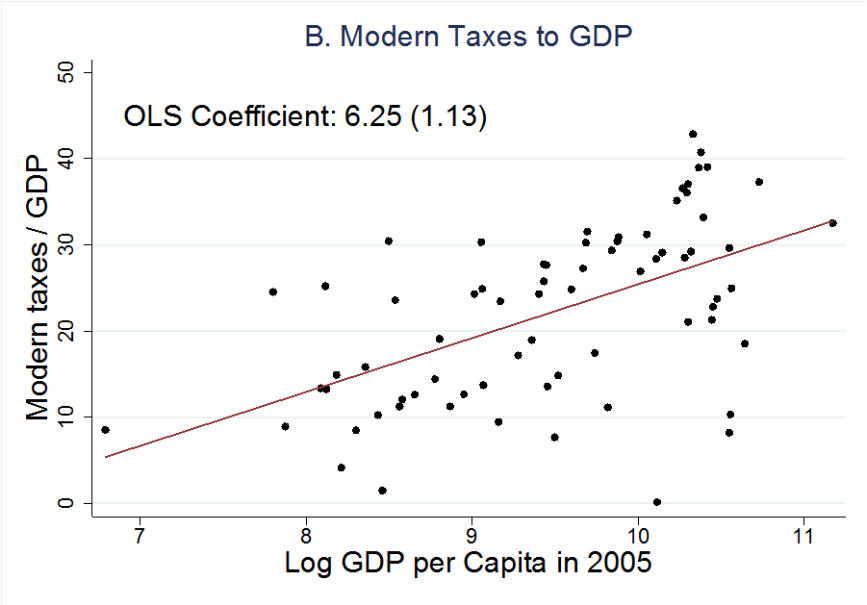
Tax Take across Countries



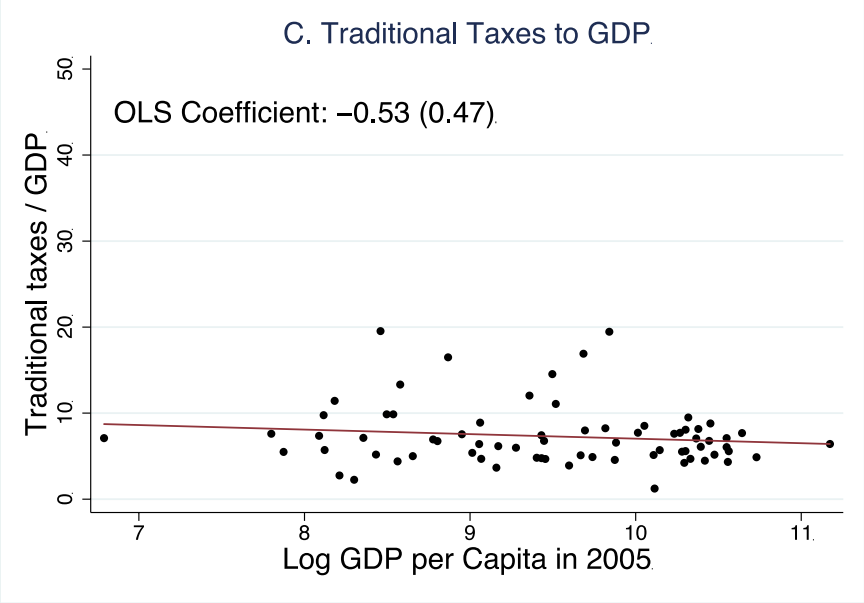
Source: Kleven, Kreiner, Saez (2014)

Tax Structure across Countries

Modern Taxes to GDP

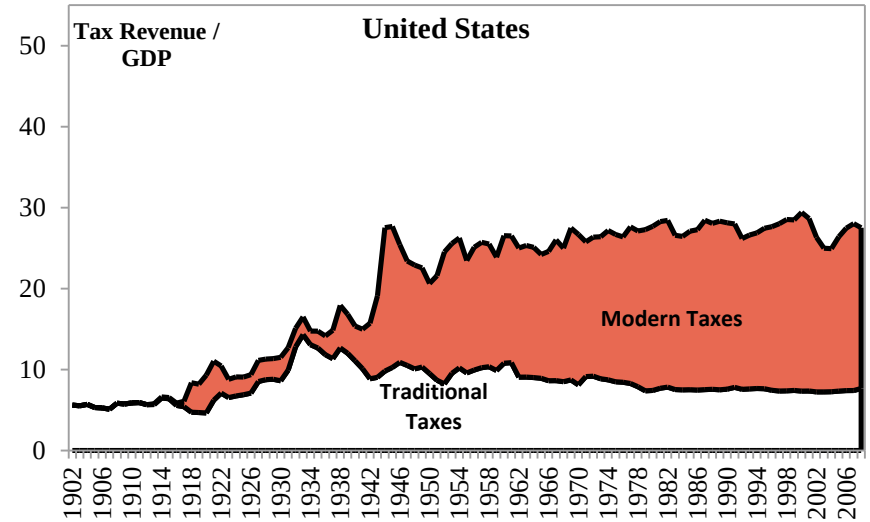


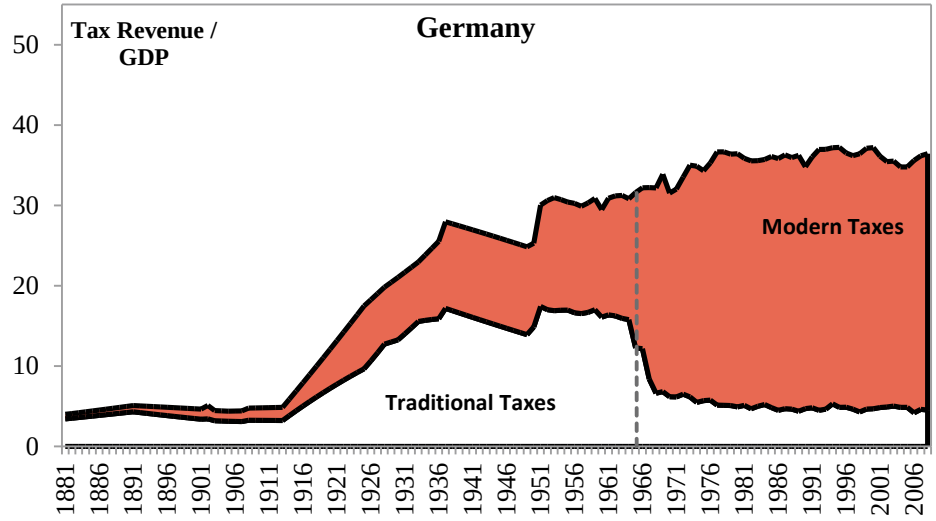
Traditional Taxes to GDP

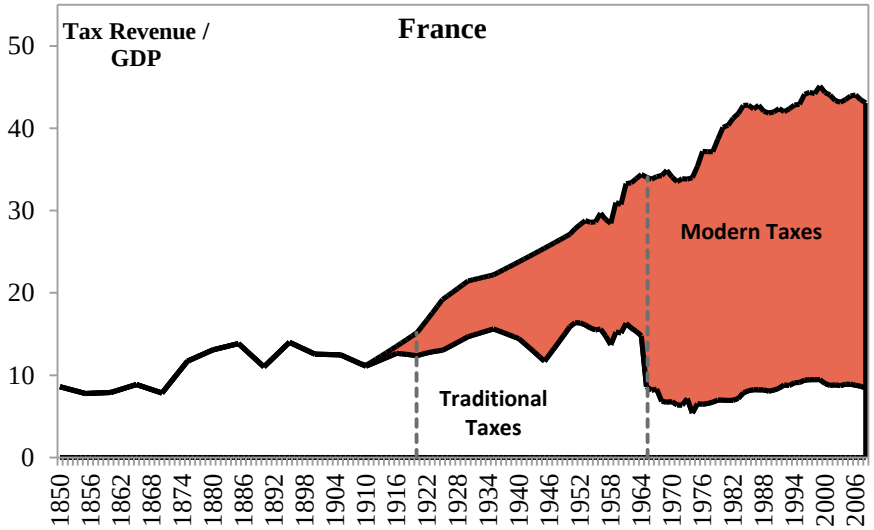


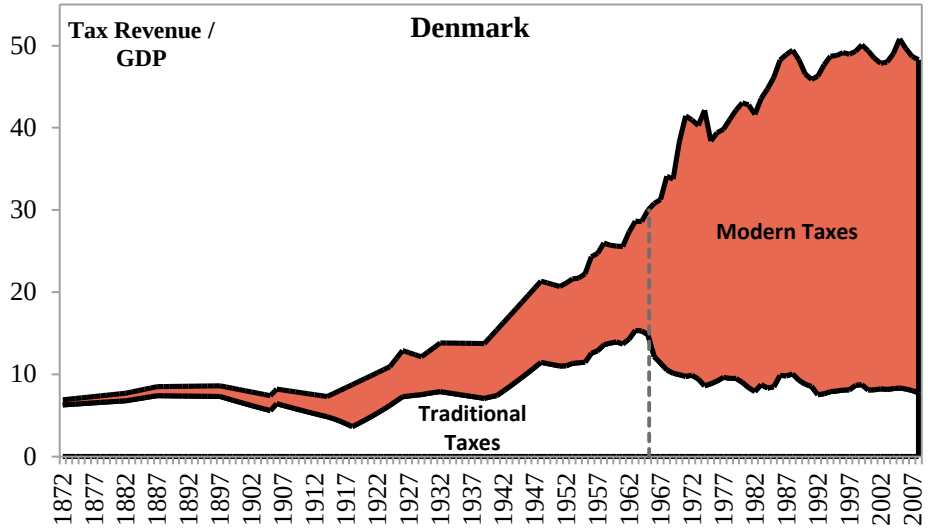
Source: Kleven, Kreiner, Saez (2014)

Tax Take and Tax Structure over Time









Source: Kleven, Kreiner, Saez (2014)

From Macro to Micro

Diamond-Mirrlees (1971): assuming perfect enforcement, only production efficient tax instruments should be used

Ubiquitous production inefficient tax policy in developing countries: *Minimum Tax Schemes* (MTS) whereby firms are taxed on either profits or turnover depending on which tax liability is larger

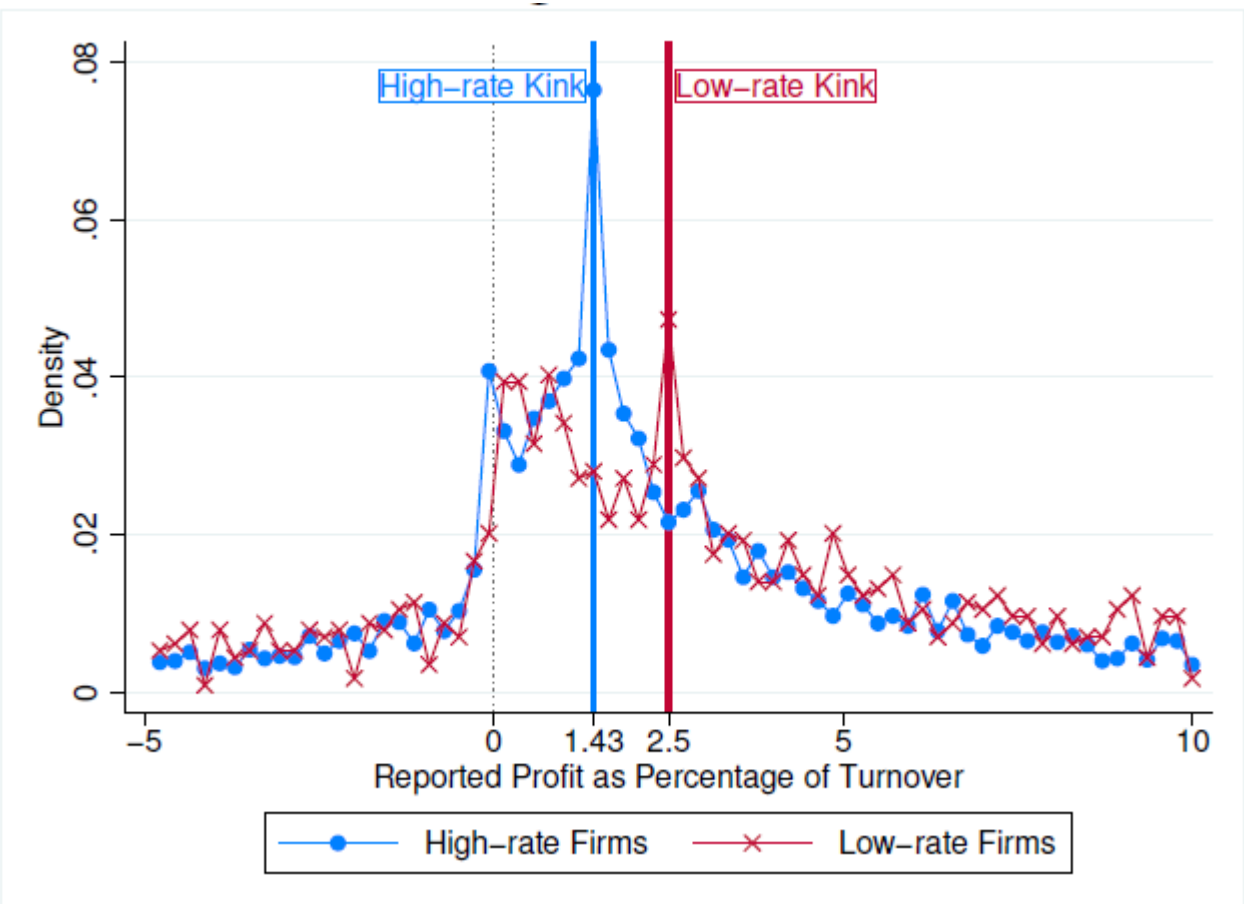
Turnover taxes are production inefficient due to *cascading*, but maybe they are harder to evade?

Best et al. (2014) studies the MTS in Pakistan:

- Turnover taxes reduce evasion by up to 60-70% of corporate income
- These compliance gains outweigh the loss of production efficiency
- So the MTS is a good policy in a weak tax capacity setting

How do Best et al. (2014) conclude that?

They need good data (here administrative tax records) and exogenous variation in tax incentives (here discontinuity created by MTS)



Source: Best et al. (2014)

Tax Policy: IGC Research Agenda

Again, the default recommendation to IGC country X is not to replicate policies from high-income countries, but to consider the specific context

Sometimes the conclusion is that the existing policy is exactly right! (such as the use of production inefficient MTS)

- This is still useful to confirm
- This can inform more incremental policy modifications

Examples of IGC research

- Kleven & Waseem (2013); Best et al. (2014)

Local counterparts:

- Tax policy makers; Ministry of Finance; Tax collection agency

Specific Topics II

Asim I Khwaja
Professor, Harvard Kennedy School
Co-Lead Academic, IGC Pakistan

IGC Growth Week 2014

Outline

I. Tax Administration

- Towards better HR policy for tax officials

II. Taxpayer Buy-in & Tax Morale

- Getting the Citizen on your side

Outline

- Three Key Points:

  i. People (Staff and Citizens) Matter

  ii. People (generally) act in their self-interest (maximize benefits net of costs)

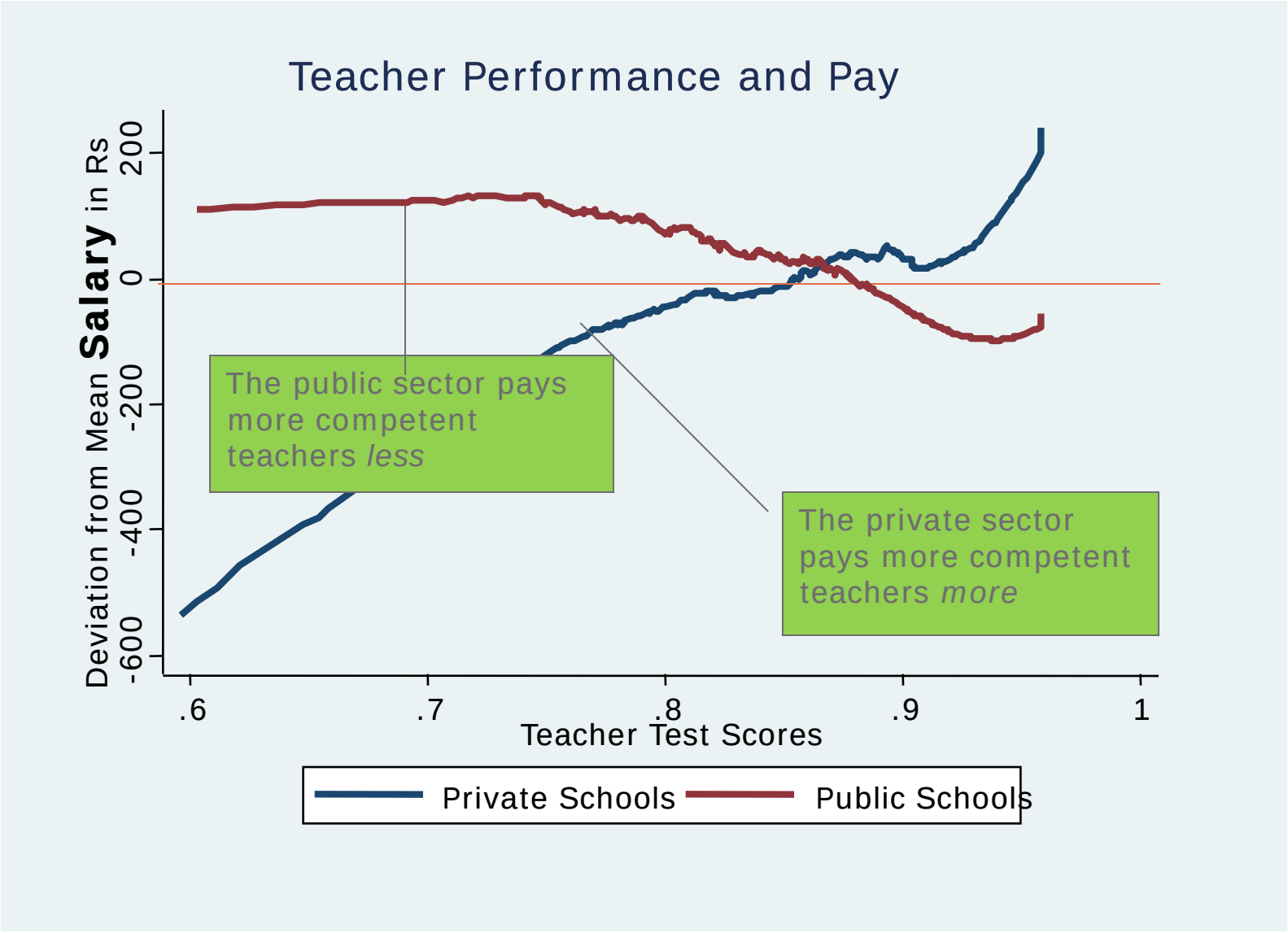
  iii. Incentive Compatibility:

    - Policies/Systems work better when designed to account for the fact that people act in their self-interest

Tax Administration

- Broader Civil Service Reform Issue
  - Most emerging economies have civil service pay that is typically:
    i. Low (relative to private counterparts)
    ii. Untied to performance (mostly based on seniority)
    iii. Limited/uncertain career advancement opportunities
    iv. Substantial non-pecuniary benefits (benign: legal job benefits, social status/influence – Not so benign: rents/corruption)

Depressing Graph from Education



HR Policy

- Why is Performance Pay so Hard in civil service?
  - Often no norm/precedent for doing so
    - Weberian bureaucrat is “socially minded” & pay may adversely select against this (though no clear evidence of this – e.g., Finan et al.)
  - Desired Outcomes are often unclear (do we want enrollment or quality) & hard to quantify/measure (not just educational quality but creativity?)
  - Multiple metrics of performance (test scores in different subjects, civic sense, team skills etc. etc.)
  - Government doesn’t have enough money??

Performance Pay In Taxation

- Potentially more feasible?
  - Clear, measurable objectives/outcomes: raise revenues (though don't want to increase political costs/citizen dissatisfaction)
  - Easy to compare costs and benefits/"ROI"
    - That is, did paying staff more lead to (greater) revenues than cost of incentive pay?
  - But it does require close collaboration between policy makers & researchers…

Example: Pakistan Performance Pay Project

- Multi-year collaboration between researchers (Adnan Khan, IGC; Ben Olken, MIT; Asim Khwaja, Harvard) and Excise & Taxation Department Punjab, Pakistan
- Unique co-funding:
  - IGC, 3ie, NSF
  - Government of Punjab (incentive pay part)
- Focus on Property Tax (allows for independent verification for true tax liability)

Example: Pakistan Performance Pay Project

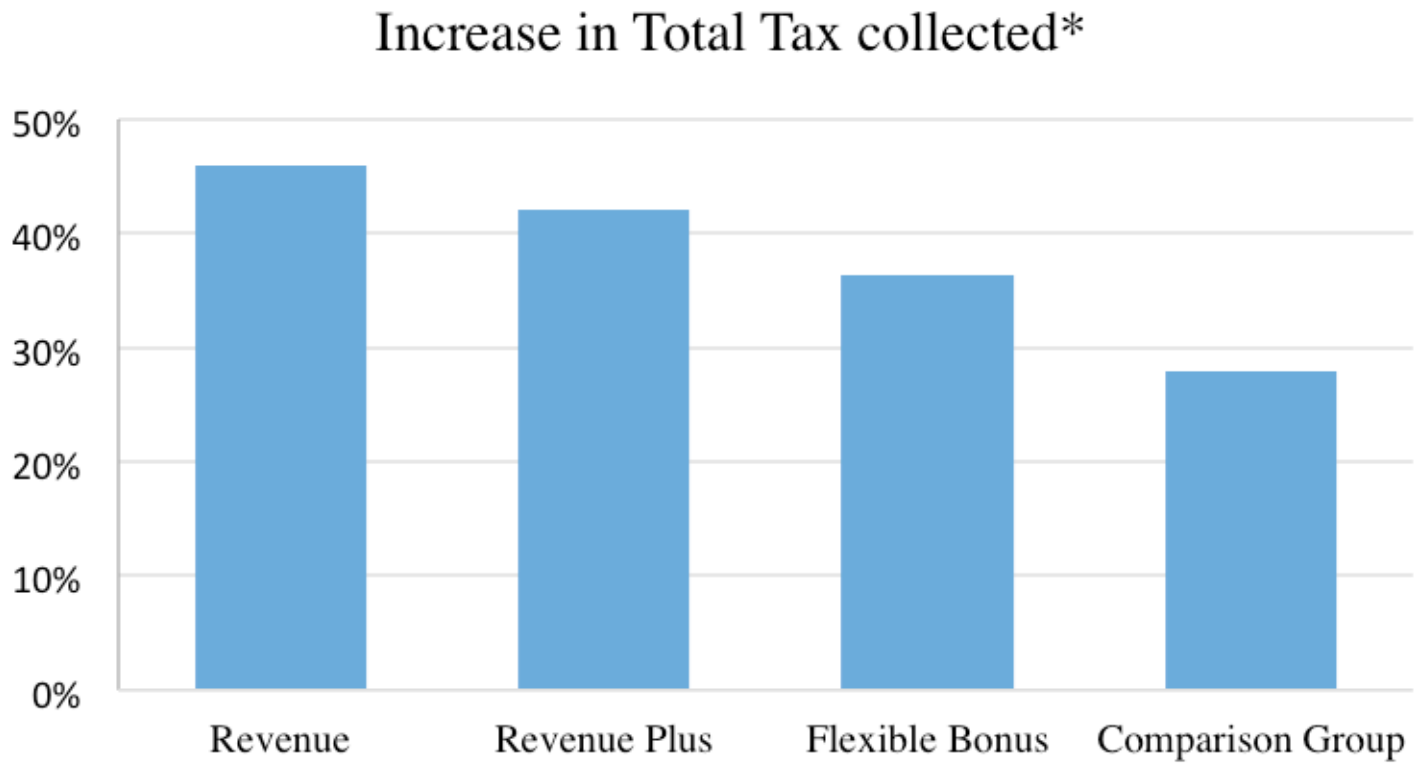
- Don't necessarily follow developed country norms
  - Most developed countries have moved away from incentive pay in taxation (concerns of over-taxation – recall the French revolution)
  - BUT flat pay may work better when have
    - Low corruption; Good data systems; 3rd party data verification
- So then what should one do?
- Use "nitty-gritty" micro approach

Example: A Nitty-Gritty Micro Approach

- Agree on what the objectives are (i.e. how to judge success of HR reform):
  - Raise (tax) Revenue
  - With minimum cost (not just monetary but also in terms of fairness, taxpayer satisfaction)
- Use Theory to Design different incentive schemes that address these objectives to a varying degree
  - Revenue (simplest)
  - Revenue PLUS (reward also in assessment accuracy & taxpayer satisfaction)
  - Flexible Bonus (subjective & flexible but most complex)

Example: A Nitty-Gritty Micro Approach

- Evaluate Rigorously (e.g., RCTs)



- Revenue Scheme – 46% increase in revenue in two years compared 28% for business as usual (comparison) group; RO: 33-50%
- Little Political Costs (no detectable difference in assessment accuracy or taxpayer dissatisfaction)

Performance Pay In Taxation

- Can think of BOTH pecuniary (performance pay) and non-pecuniary rewards for performance
- One big area of reward in civil service (even absent vertical mobility):
  - Postings and Transfers
- Another promising area of research is the usage of merit-based transfers and postings
  - For the past year we have implemented this in the Punjab Excise and Taxation Dept. (Director General Taxation present in audience)

Tax Morale ("Voluntary" Compliance)

A typology of tax morale (Luttmer-Singhal 2014):

1. Intrinsic motivation (within-individual preference)
2. Social norms (depend on other individuals)
3. Reciprocity (depends on the state)
4. Culture (long-run societal effect)

Such effects may be important, but we know relatively little about them

Key questions:

- What is the quantitative importance of tax morale mechanisms?
- Can policy makers affect tax morale through policy design?

Tax Morale and Policy

Two types of policy questions:

- Interaction between tax morale and standard policy measures (enforcement policy, tax instruments, expenditure policies)
- Effect of non-standard policies aimed at providing social incentives (social recognition, social comparison, shaming, reciprocity etc.)

Examples of IGC supported research

- Chetty-Mobarak-Singhal (2014) on social incentives in Bangladesh
- Khan-Khwaja-Olken (ongoing): Credibly Linking citizen tax payment with public goods & services in Pakistan

Recap: Taxation & Development

- Rather than rely on simply transplanting developed country solutions/tax codes/procedures, we
  - take a more **"nitty-gritty micro approach"** grounded in the specific context and constraints of the country in question
- This is more challenging:
  - **Data:** Requires detailed/extensive data
  - **Design**: Have to start from (theoretical) foundations and build appropriate design up from that
  - **Evaluate:** Need to setup rigorous evaluation techniques
  - **Collaborate**: All this necessitates deep engagement between policy makers and researchers
- BUT it **IS DOABLE**
  - Today: just a few examples of what is feasible in Taxation
  - Hope we can see many more in years to come…