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Tax Policy Reform Primer



This publication was produced for review by the United States Agency for International Development. It was prepared by DevTech Systems, Inc. under the Fiscal Accountability and Sustainable Trade Task Order, 7200AA18D00010/7200AA19F00015.

January 2022

TAX POLICY REFORM PRIMER

Program title:	Fiscal Accountability and Sustainable Trade (FAST)
Sponsoring USAID Office:	The Center for Economics and Market Development (EMD)/ Bureau for Development, Democracy, and Innovation (DDI)
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Contract No.	7200AA18D00010
Task No.	7200AA19F00015
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Date of submission:	August 19, 2021
Date of approval:	January 7, 2022

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ACKNOWLEDGMENTS

The team would like to extend special gratitude to USAID staff, Anton Kamenov, Stephen Andoseh, Bryan Byrne, David Dod, Nikolas Foster, Meral Karan, David Kauper, Janine Mans, Steve Rozner, and Samantha Schasberger, among others, for helpful comments. We would also like to thank Mark Gallagher, Welmar Rosado, Niaz Shinwari, and Audra Killian, all of DevTech Systems, Inc., for their guidance and support to our work, and Glenn Jenkins and Sally Wallace for useful suggestions.

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Acronyms

APEC	Asia-Pacific Economic Cooperation
BEAT	Base Erosion and Anti-Abuse Tax
BEPS	Base Erosion and Profit Shifting
COR	Contracting Officer Representative
CSO	Civil Society Organization
DRM	Domestic Resource Mobilization
EAC	East African Community
EITI	Extractive Industries Transparency Initiative
EPZ	Export Processing Zone
ERP	Effective Rate of Protection
EU	European Union
FAANG	Facebook, Apple, Amazon, Netflix, and Alphabet/Google
FAST	Fiscal Accountability and Sustainable Trade
FTA	Free Trade Agreement
FTZ	Free Trade Zones
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GFS	Governance Finance Statistics
GILTI	Global Intangible Low-Taxed Income
GST	Goods and Services Tax
IMF	International Monetary Fund
MFN	Most Favored Nation
MTRS	Medium-term revenue strategy
OECD	The Organization for Economic Co-Operation and Development
PFM	Public financial management
SACU	Southern African Customs Union
SPE	Special Economic Zone
UK-DFID	United Kingdom's Department for International Development Now FCDO – Foreign and Commonwealth Development Office
UNRISD	United Nations Research Institute for Social Development
USAID	United States Agency for International Development
USMCA	United States-Mexico-Canada Agreement
VAT	Value-Added Tax
WAEMU	West African Economic and Monetary Union
WTO	World Trade Organization

Tax Policy Reform Primer

I. INTRODUCTION

This primer provides an overview of tax policy and tax policy reform in developing countries, drawn from international experience and best practices. While tax policy should always be designed with a view of how it can be administered, tax administration is an equally large topic and is addressed at length elsewhere.¹

Here, our core focus is tax policy. We emphasize throughout issues and experiences that United States Agency for International Development (USAID) staff are likely to encounter. We explain the key economic and political economy issues surrounding tax policy reform, including basic principles of taxation, best practice application of those principles in developing countries, and critical design features of main taxes. We feature examples from some of the countries that USAID has supported. These countries include Afghanistan, Bangladesh, Bosnia and Herzegovina, El Salvador, Georgia, Nepal, the Philippines, Rwanda, and Tanzania.² In concluding this primer, we describe a variety of ways that USAID and other development partners can engage governments, parliamentarians, civil society, and the private sector to reform and improve tax policies in our partner countries. Through a combination of technical assistance, capacity building, and dialogue facilitation, USAID support can improve tax policy planning, analysis, formulation and implementation and contribute to more efficient, fair, and transparent tax systems.

The main purpose of the tax system is to mobilize domestic public revenues. How much revenue should be mobilized is a matter of broader fiscal policy. Tax policy is more a

matter of how to mobilize that revenue. Similarly, how much revenue should be invested in the various sectors (health, environment, education, or defense) is a matter of budgeting policy.

Tax policy is a major component of any country's economic governance framework. It affects economic incentives to work, produce, invest, create jobs, and grow the economy. It can have a profound impact on the distribution of income and wealth. It can also address broader social and environmental goals.

A tax is a compulsory, unrequited charge imposed by a government on its citizens or residents. Its main purpose is to fund public expenditures, but the fundamental feature of a tax is that there is generally no "quid pro quo" between paying taxes and benefitting from public expenditures.

In most countries, taxes are the main source of public funds, though governments typically rely on the issuance of debt and nontax sources to supplement tax revenues.

National and subnational tax systems are based on some combination of broad- and narrow-based taxes, including those levied on income, sales, property and wealth, and international trade. The specific policies and structure that underlie a country's tax system reflect revenue needs, but also many other influences, including a country's history and values, its administrative capabilities, the tax system of its main trade partners and neighbors, and finally the extent to which it seeks to ground its tax system in sound

¹ See, for example, Murdoch et al. (2012) and Jacobs et al. (2013).

² Gallagher (2004, 2017, 2018a,b); Bahl (2009); Rozner (2009); Heredia-Ortiz (2015); USAID (2017, 2018a,b); Bolnick and Singh (2018a,b)

economic principles.³ Not surprisingly, with so many influences coming to bear on tax systems, the tax reform process in each country and at any point in time is unique.

This primer is organized as follows. This first chapter presents basic principles of tax policy and reform. Chapters II through IV provide greater detail about major direct taxes: personal income and payroll taxes, corporate income tax, and property and wealth taxes. Chapters V through VII cover the most common indirect taxes: value-added tax (VAT), excise tax, and taxes on international trade. Chapter VIII discusses special topics in taxation, namely interaction among indirect taxes (i.e., VAT, excise, and international trade taxes); taxation of extractive industries; taxation in fragile states; gender and taxation; carbon taxation; and emerging issues on the international tax agenda such as base erosion and profit shifting, transfer pricing, and the digital economy. Chapter IX concludes and provides recommendations for future donor support for tax policy reform in partner

countries. As a handy tool for the user, we include a glossary of terms in the annex.

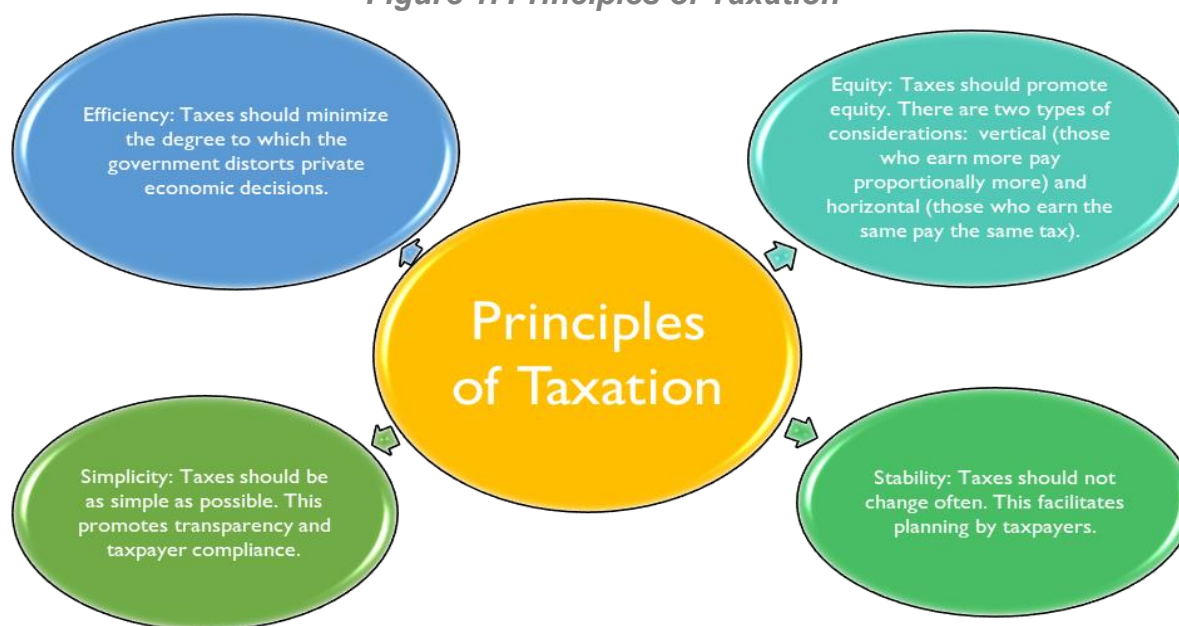
PRINCIPLES OF TAXATION

In this section we outline some key principles of taxation, grounded first in economics and then best practices of governance and administration.

A first principle is that the tax system should be *efficient* in that taxes should minimize the degree to which they distort private economic decisions. This might include decisions about consumption, saving, investment, and production (Figure 1). Taxes change the effective price for an economic activity and thus change economic behavior. When the tax system distorts behavior, it can result in a loss of economic welfare to society that exceeds the amount of revenue collected. In practice, tax design rarely reflects this principle.

Nonetheless, the idea that tax should be as little distortive of economic decision making as possible is an essential insight to underpin reform.

Figure 1. Principles of Taxation



³ Keen and Slemrod (2021) note that tax practices are shaped more by specific and immediate concerns than higher motives.

A second principle is that the tax system should take account of the *equity* or fairness of taxes. In taxation, there are two types of equity: horizontal and vertical.

Horizontal equity refers to the way tax systems treat different taxpayers with equivalent income (or wealth). Tax preferences and other provisions in income taxes, such as taxing income from capital and labor income differently, mean that two taxpayers with the same income but different ways of earning or spending it face a different tax bill. These differences influence labor market and other economic behaviors and have implications for equity or fairness.

Vertical equity refers to how the tax system treats taxpayers with different incomes (or wealth). A progressive tax is one where the average tax rate rises with higher income. A proportional tax is one where the average tax rate is the same. And a regressive tax is one where the tax rate falls with higher income. The income tax is usually seen as the component of taxation that can contribute most to a progressive tax system. However, even value-added taxes (VATs) and other broad-based taxes can influence the extent of fiscal redistribution.

The degree to which countries seek to redistribute income through public finances varies considerably. The tax systems of Scandinavian countries are highly progressive, redistributing extensively from rich to poor through the tax system as well as through public expenditures. There are countries that have a minimally progressive tax system, such as those with no income tax (e.g., United Arab Emirates) or a flat rate income tax (e.g., Russia, Latvia, Estonia). In some countries, the overall tax system may be proportional or even regressive by design or because political pressures erode effective taxation on higher income individuals.

A third principle is that the tax system should be as *simple* as possible to facilitate taxpayer compliance. A straightforward tax system

promotes greater transparency, reduces the cost of compliance, and reduces the administrative challenges and costs. Income taxes and VATs are conceptually simple, but, in practice, tend to have complex provisions. These may relate to identifying the sources of taxpayer income and legitimate cost deductions or specifying when and where a transaction occurs and becomes subject to tax. Customs tariffs are also complex when considering valuation rules, international conventions, and domestic content laws.

A fourth principle is that the tax system should be *stable* and *predictable* to ensure that taxpayers can plan effectively. Many taxpayers, especially those who invest in a significant amount of fixed or immovable assets, care more about stability than the actual tax liability they face if the tax system remains within certain norms. Thus, reforms should be well thought-out so that any changes to taxation can remain in place and do not necessitate frequent adjustments.

These four tax policy principles – efficiency, equity, simplicity, and stability or predictability – each make sense individually. Yet it is often difficult to satisfy all these principles simultaneously. For instance, the trade-off between efficiency and equity is apparent in many decisions on taxation. An efficient tax is one with a low marginal tax rate while an equitable tax may require higher tax rates on some taxpayers than on others. All policy issues must be viewed within the lens of revenue needs and what is politically achievable and administrable. This context varies greatly from one country to the next and over time.

These principles are presented with the caveat that the principles are general and, often, should be applied to the overall system and not necessarily tax by tax.

TAX INCIDENCE

Before we can really understand tax fairness or equity, we must understand who actually bears the burden of a tax, which we refer to as tax

incidence. While tax law might dictate that one type of taxpayer is responsible to make the payment to the tax authorities, this taxpayer is often able to shift the burden of this tax to others. For instance, the share of the payroll tax that is paid by employers is not really borne by them. Rather the employer rightly sees this as simply another part of the cost of employing someone to work at their company. The entire payroll tax is part of the employers' gross wage bill and most of the burden of this payroll tax may be borne by employees by way of lower overall after-tax wages.

Another way that taxes are shifted is when import duties are imposed on imported goods. For the most part, this tax is not borne by the companies that supply goods, but rather by the domestic consumer of these imports. Imposing taxes on imports generally leads to rising prices for the imported good as well as for those domestic goods that compete against these imports. So, while such a tax harms the consumer it may help domestic producers who might otherwise have trouble competing.

Calculating tax incidence is important but it is also complex. It differs from tax to tax, from economy to economy, and from market structure to market structure. Yet it is one of many areas in which USAID can help government partners sharpen their tax policy lens.

INTERNATIONAL NORMS OF TAX POLICY DESIGN AND STRUCTURE

It is difficult to evaluate successful tax reform for several reasons. First, reforms can be motivated by any of several concerns including most commonly the desire to raise revenues but also the desire to improve the structure of the tax system in terms of efficiency and equity or the administrability of the tax system. Each tax reform should be evaluated in terms of the objectives that it seeks to achieve.

Tax revenues vary with the national and international macroeconomic situation and with the underlying economic developments within

an economy. Assessing the success of reforms requires sound data and objective analysis, even when these reforms are based on sound economic principles. Since the underlying economic conditions are also changing, this may be difficult.

Reforms designed to improve efficiency or equity may be based on sound economic principles, but to formally assess their success requires the collection of data and objective analysis. The international community has coalesced over the years in agreeing that successful tax policy reform entails certain key features:

- Tax systems should be based on a balance of taxes on income and taxes on goods and services.
- For developing countries, given the difficulties in administering a personal income tax, corporate income taxes should remain a key component of income taxes. Over time, with improved administrative capabilities, personal income taxes should play a larger role.
- Over time, taxes on international trade should not serve revenue but only limited trade policy purposes.
- Income and general goods and services taxes (like the VAT) should have broad bases and maintain internationally competitive rates. Because capital is so highly mobile, it is especially important to maintain competitive corporate income tax rates.
- There may be a limited role for tailoring the tax system to the achievement of economic and social objectives, through tax preferences or other features of tax design.
- A progressive personal income tax system can be used to achieve equity objectives, but other taxes are not as well suited to this objective.
- Developing countries must find ways to tax the digital economy effectively.

Box I highlights two countries that have successfully incorporated many of these ideas in reform to achieve an improvement in efficiency and equity, higher revenues, and greater transparency. We highlight others examples later.

Box 1. Tax Reforms in Georgia and El Salvador

Georgia provides an interesting example of a country that comprehensively reformed its tax system, with sustained USAID support, from 2005-2009. Following the Rose Revolution, a wave of reform took over the country. Georgia raised its tax-to-GDP ratio from 11.7 percent in 2003 to 24.1 percent by 2011, a level considered appropriate for a lower-middle-income country. The remarkable increase took place within a framework of fewer taxes and generally lower nominal tax rates, as well as reduction in compliance costs to taxpayers and administrative cost to the government. The tax policy of the government sought to harmonize Georgian tax law with the European Union (EU) guidelines on tax structure and best international practices. These reforms focused on centering the tax system on a few productive and efficient taxes, levied at moderate rates, while eliminating nuisance taxes, and improving revenues. Tax rates on personal income, corporate income, and VAT were all brought down to competitive levels and tax bases were expanded. Complementary reforms improved tax and customs administration. The reforms improved tax morale, public confidence, and trust. Georgia has continued to cooperate with international donors in recent years to improve tax policy and in the areas of tax treaties and information sharing. Overall, Georgia represents an example of tax reform that focused on improved structures, administration, and revenues. Donor assistance has been vital to helping Georgia with its remarkably successful tax reform. It is estimated that \$12 million in USAID support contributed to increased revenues of \$4 billion, during the 2005-2010 period.

Source: USAID (2017).

El Salvador is another example of a successful and comprehensive tax reform, achieved with sustained USAID support. El Salvador reformed its tax system in three distinct phases between 1992-2015, more than doubling its tax-to-GDP ratio from 7 percent in 1992 to 15.4 percent in 2013. During the first phase of reform after emerging from more than a decade of civil war, the country introduced - with USAID support - several domestic tax and international tax policy reforms to widen the tax base, including replacing the sales tax with a VAT. USAID supported tax policy reform in the first phase. Income tax rates and the number of brackets were reduced, and the top personal income tax rate was set equal to the single rate on corporate profits. During the second phase in the mid-2000s, El Salvador introduced several reforms in tax administration including creating a large taxpayer unit, introducing risk-based compliance, and tackling fraud and corruption. The third phase, begun in 2012, included several base broadening measures like removing exemptions, reforms in the tax code, and measures to modernize the tax administration. El Salvador, in latter phases, contrasts with Georgia in that the country increased some tax rates rather than reducing them, highlighting the need to take each country's unique circumstances into account when designing tax policy reforms.

Sources: Gallagher (2004); Heredia-Ortiz (2015).

II. DYNAMICS OF THE REFORM ENVIRONMENT

The political economy dynamics of individual taxes are discussed in the sections that follow. This section presents political economy elements of tax policy reform that are common to most taxes.

In most countries, the responsibility for initiating tax policy reform vests exclusively with the political party in power or the executive (Alt, Preston, and Sibieta, 2010). There is usually an asymmetry between the resources available to members of parliament from the opposition and those representing the party in power. Secrecy laws may restrict access to confidential taxpayer records necessary for policy analysis.

Stakeholders outside the finance ministry have a tough time trying to meaningfully challenge the executive and conduct a factual debate on reform implications given this asymmetry in information. Countries like the United Kingdom have highly centralized decision making in tax matters. Many former colonies have inherited these highly centralized and often secretive (e.g., India) tax policy-making institutions.

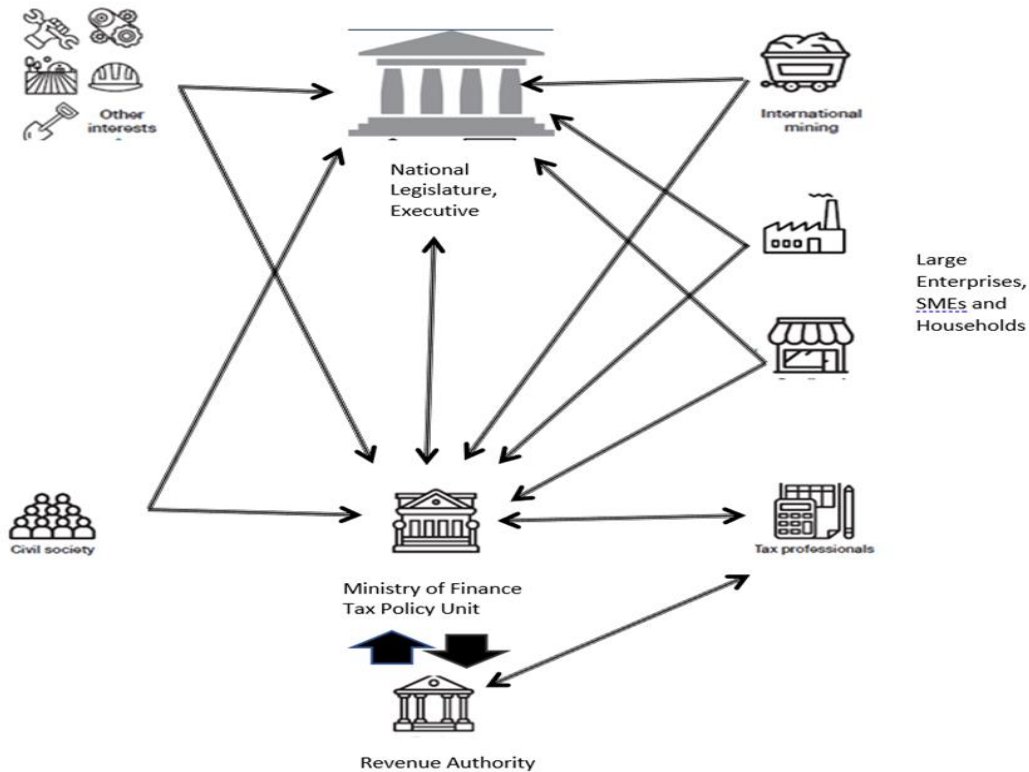
The main actors in tax policy analysis and formulation are presented in Figure 2. These include: (1) The Treasury or Ministry of Finance where the tax policy unit is often situated; (2) The revenue authority or administration, which often plays a significant role in tax reform and policy formulation, either by providing staff who perform the analysis or by supporting legal drafting. In some countries tax policy analysis and legal drafting may be housed in or completely staffed by the administration, or all the necessary data remains within their control; (3) The legislative branch of government (Congress or Parliament) which in most countries must pass finance acts and approve tax policy reforms. Often smaller sub-units such as parliamentary committees perform the real scrutiny and bring to bear technical expertise and present their findings and analysis for

debate to the larger body; (4) Bodies of tax professionals and chambers of commerce as representatives of tax preparers, expert commentators, and taxpayers; and (5) Other industry and pressure groups (e.g., labor unions) interested in specific aspects of tax policy (Arnold, 2013).

Changes to tax policy may result in the shifting of tax burdens from one set of taxpayers to another. As a result, well-designed tax reforms that abide by the principles mentioned above in creating stable, broad-based taxes are often politically challenging. Moreover, powerful actors have an incentive to use their resources and influence to carve out special tax preferences that tend to make the tax system less efficient, less equitable, and less straightforward. Consequently, sound tax policy reform, including changes to the legal and regulatory structures of the tax system, requires determined leaders. Such leaders need to have a vision to improve the tax system and an ability to reach consensus across the executive and legislative branches of government. They will need to rally the support of the tax and customs administrations, as well as civil society and the business community (Box 2) (Di John, 2006; Ahmed, 2013; Hassan and Prichard, 2016; Princen, 2016; Ahmed and Heady, 2020, Gupta and Jalles, 2020).

Governments in developed countries increasingly involve public consultations in the formulation of tax policy. Most ministries of finance have a tax policy unit, a group of professionals who specialize in analyzing and drafting tax policies, who take the process forward. Given the confidentiality surrounding tax data on specific taxpayers, the analyses carried out by the tax policy unit can rarely be challenged meaningfully by external stakeholders or even the opposition (or, for that matter other ministries and lawmakers). The necessity to present major tax reform to the national legislature provides an opportunity

Figure 2. The Tax Policy Ecosystem



for scrutiny and debate.⁴ At this stage, media and civil society can also play a role by publicizing the issues and encouraging debate.

Many countries have tax policy units, usually in the ministry of finance, but sometimes within the tax administration itself, such as in the case of the Tanzania Revenue Authority. A technically competent and motivated tax policy unit is essential to provide analytical support to and guide the process of tax reform. An effective tax policy unit should be able to perform the following functions (1) Guide tax design and policy reform and provide impartial analysis and recommendations in the public interest to inform public debate; (2) Forecast revenues, estimate and publish tax expenditures, conduct incidence and distributional analyses as well as economic

impact studies, analysis of key tax indicators and trends as well as cost-benefit analyses; (3) Initiate, guide and participate in the legal drafting of tax provisions to make sure they reflect the intended policy; and (4) Assist teams in international treaty negotiations by providing them with the requisite analysis of the impact of provisions and other actions (Grote, 2017). Such a unit should have multi-disciplinary staff and include economists, statisticians, lawyers, accountants, and tax administrators.

THE TAX POLICY REFORM WINDOW

Tax policy reform is a continual process. While there are many examples of successful, large changes to tax policies and legislation in various countries, often, changes are smaller, less visible, and more frequent.

⁴ Some changes may be authorized by ministerial action. However, the legislature can weigh in.

Box 2. Contrasting the Results of Tax Reform in Rwanda and Bangladesh

In Rwanda, domestic consensus across the government and taxpaying public for reform, along with donor assistance, brought about significant improvements in tax policies and administration over a period of several decades. In 1998, the Rwanda Revenue Authority was created to bring coherence to tax policy and administration reform, and a new VAT was instituted in 2001. The collections from the sales tax almost tripled with the new VAT to 5.2 percent of GDP in 2016. Other significant changes in tax policy included: increasing the VAT rate from 15 to 18 percent in 2002, increasing the income tax on professional remuneration in 2004, and reducing the corporate income tax rate from 35 to 30 percent, effective in 2005. International donors provided key support to tax modernization efforts in Rwanda, mainly the United Kingdom's Department for International Development (UK-DFID – later FDCO), while USAID assisted with the implementation of the VAT. Additional reforms to bring Rwanda into harmony with the East African Community (EAC) took place beginning in 2009. Complementary reforms on the administration side brought taxpayers into the tax base, streamlined compliance, and educated taxpayers on taxation.

In Bangladesh, in contrast, vested elites, including some in high level government positions, have resisted automation of tax and customs administration and coordination of reform across revenue institutions because it would diminish the scope for arbitrary decision making. The evolution of the VAT is a case in point. External pressure, mainly from the International Monetary Fund (IMF), led the authorities to enact, in 2012, a streamlined and more administrable structure, in line with international norms. However, resistance from vested interests led to a delay in implementation until 2019, by which time amendments resulted in a tax that eliminated the expected gains from the reform. Multiple tax rates, narrowing of the base, and constraints on firms claiming credit for taxes paid on inputs all undermined the structure and revenues from the reform.

Sources: Ahmed (2013); Ahmed and Heady (2015); OECD (2015); Gallagher (2018b).

Tax policy reform is not always positive. Taxes are visible and impactful. Among taxpayers, there is strong interest to lobby for lower tax burdens. In particular, in the years after successful, positive, major tax policy reform, governments are prone to passing changes that slowly erode revenues over time or create inequities or inefficiencies. Even when governments intend to pursue positive improvements, they may not do so due to lack of capacity or because government priorities change. There is almost always a need for adjustment and calibration.

Although the opportunity to pass and implement tax reform is not always present, engaging governments and other policy stakeholders to prepare for reform should always be considered. This is in part because it takes time to understand priorities, develop and analyze options, and garner political support.

There are political and economic circumstances that may help the passing and implementation of tax policy reform. Opportunities, for example, arise after changes in leadership or at times of economic or fiscal crises. Governments and donors must be prepared to take advantage of such opportunities.

USAID HAS SUCCESSFULLY SUPPORTED REFORM

The United States has been contributing to tax policy reform for decades. Perhaps one of the earlier ventures was to create a whole new tax system for post-war Japan. Early tax missions to Colombia in the 1960s helped build a solid basis for personal and company income taxation. USAID advisors working hand-in-hand with local experts helped reform the entire system of direct taxation (personal, corporate, and property taxation) throughout the troubled entities of Bosnia and Herzegovina and supported the jettisoning of myriad indirect

taxes for a comprehensive and cohesive VAT and national excise system.

In El Salvador, as the civil war was ending, USAID provided support to local think tanks competing for ideas to put the post-war economy on good footing. Later assistance to the Ministry of Finance included building computer models of the tax system that enabled the Ministry to demonstrate to leadership, parliamentarians, civil society, and the private sector the impacts tax reform would create. This led to lower tax rates, fewer taxes, less economic distortion, greater administrability and rapidly rising government revenue.

USAID-funded advisors in Montenegro analyzed and consulted on property taxation and local government finance. Upon request of the Ministry of Finance the team drafted a new property tax law that the legislature adopted almost in its entirety. This positively affected revenues of all municipalities of the country.

Capacity building assistance from USAID in Tanzania empowered a small group of freshly minted tax experts to produce a successful proposal to simplify the personal income tax, greatly relieving peoples' burden and making the tax fairer.

In Nicaragua during the 1990s, USAID advisors were assisting the country convert to a market economy, including having undertaken analysis of the tax system and its projected revenue path. The president of the country took the analysis seriously and asked USAID to participate in a tax reform committee. The result was a new tax system that was simpler and burdened people less, was deemed fairer by most, and generated about 25 percent more revenue.

III. PERSONAL INCOME AND PAYROLL TAXES

A personal income tax is a tax imposed on the income of individuals, married couples, or families. Most countries in the world use this tax. The income on which tax is imposed (or taxable income) is broadly defined and includes wages and other compensation for work, gains or losses from the sale of goods or other property, interest, dividends, rents, royalties, annuities, pensions, among others.

In advanced countries, the personal income tax is usually one of the largest sources of revenue and its yield ranges considerably. In developing countries, the personal income tax usually yields a much lower share of revenues and relative to GDP, chiefly because of the difficulties in administering it effectively. As such, the tax mainly falls on formal sector wage income while the large informal workforce escapes the income tax net.

BASIC FEATURES OF THE PERSONAL INCOME TAX

Income tax may be imposed on total income, where various income streams combine to form the total taxable income. We refer to this as the “global approach” to income taxation. However, other countries may tax different income sources differently, such as under separate rate schedules for taxation of income from wages, interest earnings, capital gains in the stock market, or income from royalties on trademarks and similar items. This is the “schedular approach.”

Most income taxes today have evolved to a global approach, but they retain some schedular components, such as taxation of capital gains with special rates. A good example of change is Bosnia and Herzegovina, which moved from a schedular to a global income tax in 2006-2007. This change greatly simplified tax administration and tax compliance burden and increased equity by taxing most incomes and persons in the same way.

Countries differ in whether they tax the income generated from its territory or all income of a

resident or citizen independent of where it was generated. When all income is taxed, countries allow a credit for taxes paid to other countries to avoid taxing the same income twice. Most OECD countries use the territorial approach, whereas most developing countries tax the worldwide income of residents or a mixed approach.

Most personal income taxes are imposed or assessed on the individual. However, some countries impose the tax on a married couple or a household (joint taxation) rather than the individual.

Personal income taxes typically exclude or exempt certain forms of income from taxation. Common exclusions include pensions and allowances for students, the disabled, or war veterans; employer-provided fringe benefits including health insurance; interest on treasury or subnational government bonds; and interest on deposits in the banking system.

Most personal income taxes also allow taxpayers to take deductions to reduce the amount of income on which the tax is applied for certain expenses that the taxpayer incurs that are perceived to affect their ability to pay. Common deductions include some forms of interest expenses, medical or educational expenses, childcare expenses, and charitable contributions. Personal income taxes permit taxpayers claiming income from an unincorporated business to reduce that income with deductions related to the cost of earning that income. Many personal income taxes allow deductions for income put into certain forms of tax-preferred saving for retirement to encourage more saving.

Most personal income taxes allow a reduction in the amount of tax paid (i.e., a credit) for personal income taxes paid to other jurisdictions. A credit may also be available for any of the deductions listed above, taken as a credit instead, which delinks its value to the taxpayer from the taxpayer’s tax rate. Some

countries allow low-income households to claim a credit for earned income from a job, as opposed to income not earned through a job, to motivate these households to seek employment.

RATES

The personal income tax may have a defined schedule of tax rates that increase with increasing taxable income grouped in brackets, contributing to the degree of progressivity of the tax system. For instance, there is normally a threshold amount of income before the taxpayer must pay tax. This income is sometimes referred to as the zero bracket. The next bracket of income would face a tax rate of 10 to 20 percent, the next bracket 20 percent or more, and so on, up to the top tax rate. There could be as few as one and as many as ten or even more brackets, though usually there are around five brackets. A rate schedule with increasing marginal tax rates (i.e., the rate applying to additional income within each bracket) would generate an increasing average tax rate as income rises; this makes the personal income tax a progressive tax. Some personal income taxes are flat rate, with only one tax rate levied on all income (or some component of income).

The brackets and rates are critical in determining the progressivity of the tax and whether it achieves the intended goal of imposing a higher burden on higher income taxpayers. A more steeply graduated marginal rate schedule leads to a more progressive tax. Even with a flat rate, if there is a zero-bracket amount, then the tax will still be progressive to some degree. If special preferences (i.e., exemptions, deductions, and credits) are widely built into the tax, the actual progressivity may be less than the schedule of increasing marginal tax rates would suggest because higher-income taxpayers are more likely to be able to take advantage of these preferences than are those in lower income tax brackets.

Inflation has an important influence on personal income taxes. The brackets may be indexed to inflation and adjusted each year or on a periodic basis. If not, the average tax rate rises because taxpayers move into higher tax brackets simply because inflation is increasing their nominal income, even if in real terms, their income is not rising. This phenomenon is referred to as “bracket creep” and is important in highly inflationary economies. Other aspects of the income tax set in nominal terms may also be indexed to inflation, though less frequently.

Schedules of marginal tax rates vary widely across the globe. Typically, the zero-bracket amount is considerably below per capita income in advanced countries but may be higher or even several times per capita income in developing countries, reflecting the perceived inability of most households in developing countries to be able to afford to pay any significant amount of personal income tax. The highest marginal tax rates are above 50 percent, but this is rare. In 2020, the average in the European Union of the highest marginal tax rate was about 37 percent while the average rate for developing countries was somewhat lower. When there are overlapping personal income taxes, such as when a national government and state or province, city, or other subnational entity levies tax, the cumulative tax rate can be considerably higher than the tax rate of any single entity alone. When also combined with payroll taxes on wage income, the tax wedge (or difference between what the employer pays and what the worker takes home) can be quite considerable. This wedge can lead to significant distortions in behavior, which produces inefficiency in the demand for and the supply of labor and can be a significant deterrent in developing countries for workers to engage in the formal sector.

Let us provide an example of how cumulative taxation produces a wedge and how this wedge grows with higher marginal tax rates. Consider a taxpayer in the 20 percent personal income tax bracket and 10 percent is paid by each of

the employer and employee for social insurance funds. On an additional \$1,000 of wages, the employer would have to pay \$100 in social insurance taxes and the employee would have to pay \$100. The employee would also pay \$200 in personal income taxes. The tax on additional wage income is $\$200 + \$100 + \$100$ or \$400 and the additional wage cost is $\$1,000 + \100 or \$1,100. The effective tax rate (or wedge) is thus $\$400/\$1,100$ or 36 percent. This creates a significant wedge between what the employer pays and what the worker receives. Some would argue that the social insurance tax should not be considered a tax because the worker receives some compensating benefit in the future. However, there is generally no exact matching of what is paid and what is received and there may be differences in how workers perceive this as a tax or as a form of saving.

Different treatment of interest, dividends, and capital gains can lead to distortions in investment behavior and erodes the income tax base. Some argue that the tax rate on capital income should be lower than the top rate on labor income, as international capital mobility renders these taxes distortive and many capital gains reflect inflation, especially on assets held a long time. However, equity objectives suggest an equivalent tax on capital income. In practice, many developing countries struggle to tax any capital income except bank interest. Nonetheless, this remains a goal.

INCIDENCE

Consensus among public finance economists is that the personal income tax is borne by individual taxpayers or their family.

In many developing countries and some advanced countries as well, poor tax compliance can result in the tax being borne almost entirely by wage earners employed in the formal sector, often while others, such as informal sector entrepreneurs, independent professionals, and high-wealth individuals may escape the tax. Efforts to expand the tax base to fully cover non-salary incomes and to

encourage compliance by high-wealth individuals can shift the tax incidence back to those more able to carry the burden.

POLITICAL ECONOMY OF THE PERSONAL INCOME TAX

Often personal income tax reform is motivated by the need to increase revenues, but in some instances, it may also be spurred by the impetus to improve equity or efficiency. Some reforms are motivated by the perception that the income tax should be more progressive to contribute to greater progressivity of the overall tax system or that the income tax has become too unnecessarily distortionary, which is hurting economic growth and incentives for work effort, savings, and investment. In many countries, significant reform takes place at a time of revenue crisis. In others, it takes place because of a change of government or public pressure. Because personal income taxes are so complex, any reform, except around the edges, is typically a protracted process, with many participants, including taxpayers, civil society and academic institutions, the business community, and the national legislature and executive all weighing in. It may take years from the time discussion begins for any significant reform to emerge.

The equity debates are often centered on how to tax high-income individuals effectively and at a high enough rate to create meaningful progressivity. Another focus is how to exempt low-income taxpayers and create incentives for them to work, even when they face a phasing out of government benefits related to their income. There is always an appreciation that the middle class is reluctant to shoulder a higher share of the tax burden. The efficiency debates are centered on creating reasonable but not excessive tax burdens that could discourage savings and investment. Every country is unique in terms of what special interests dominate public discussion.

Income tax avoidance, which is when taxpayers use legal means to reduce their tax burden, is

one of the most difficult challenges in having a productive income tax. Taxpayers have the incentive to pursue many strategies or exploit loopholes to reduce their tax liability. The more complex the income tax, the more likely sophisticated taxpayers will avoid paying tax. Income tax evasion, which is when taxpayers use illegal means to reduce their tax burden, is another problem that plagues income taxes. Without good withholding methods and third-party reporting on income paid through employers and financial institutions, it is difficult to enforce the income tax. Small businesses pose a particular problem for administration because there is no third-party reporting on their income and they may not keep proper books of account. Tax compliance reflects norms and traditions of a society and improving the culture of compliance requires government efforts to demonstrate that it uses public money well and that evasion will be punished.

Taxes distort prices and thus people's economic behavior.⁵ Personal income tax rates should be set to achieve revenue goals on as broad a base as possible to allow moderate tax rates. When tax bases are narrowed excessively, tax rates must be increased to yield revenue goals, and this may incentivize taxpayers to double down on income tax avoidance through sophisticated strategies or outright evasion. This undermines equity.

Box 3 highlights the application of key principles of promoting efficiency and equity in income tax reform in Tanzania.

By way of summary, we state below some key ideas on design, reflecting the principles of equity, efficiency, and simplicity.

KEY IDEAS ON DESIGN

- Individualize the tax because an individualized tax is generally more efficient than joint taxation. It avoids the higher effective marginal tax rate on secondary earners who are usually women and thereby is more gender neutral, enhancing equity.
- Set a threshold below which the taxpayer pays no tax on income, through a general exemption or zero-bracket amount or a general tax deduction or tax credit. This contributes to progressivity and eases administration for households with incomes below the threshold.
- Use a progressive marginal rate schedule, which contributes to vertical equity, but not excessively high marginal tax rates, which contributes to efficiency.
- Use credits for low-income workers to support equity but also encourage their labor market participation.
- Try to align the personal and corporate income tax rates to some degree, to

Box 3. Income Tax Reforms in Tanzania

Tanzania is an example of successful tax reform, achieved with USAID support. The Tanzania Revenue Authority's Research and Policy Department, established with USAID assistance, designed an income tax reform that reduced tax rates while broadening the base through the elimination of exemptions. The ceiling for the zero-tax income bracket was also raised, with little loss of revenue. The reform followed the principles of enhanced equity and greater simplification.

Source: Gallagher (2004).

⁵ Moreover, all taxes impose a cost on society over and above what is paid in tax. In economics, this is a "deadweight loss."

avoid distorting the way taxpayers earn income.

- Limit exemptions, deductions, and credits. The goal is to aim for the broadest possible base, while still allowing some tax preferences that account for taxpayers' differing ability to pay depending on whether they face certain high expenses, like for medical care or childcare.
- Tax different forms of capital income in a similar manner to avoid distorting markets and creating economic inefficiency.
- Adopt a simplified regime for small- and medium-sized businesses to reduce their compliance costs of paying and to encourage them to pay their taxes.
- Use withholding taxes, where feasible, and fully utilize reporting of income by employers and financial institutions to achieve higher compliance.
- Ensure that tax reforms engage broad public input. This will help build a sense of fairness, social acceptance, and may even encourage compliance.

PAYROLL TAX

Payroll taxes are typically levied on wage income alone to fund public insurance programs like a national retirement system. Commonly these taxes are levied at a flat rate up to a maximum amount or a ceiling of income and the employer and employee may both have to remit taxes, at the same or different rates. The

ceiling is used, in contrast to income taxes, because there is a view that if the payroll tax supports a future social security benefit, this benefit will be limited. The idea is to create an equivalence between limiting the amount of income subject to payroll tax and the benefits received.

Payroll tax on employees is withheld at the same time as personal income tax. Self-employed taxpayers pay both the employee and employer share of taxes, sometimes at a slightly reduced rate. Other public insurance programs may also be funded through payroll taxes, including those for unemployment, health care, and other purposes. Any level of government may make use of these taxes, though typically the national level is where most payroll tax is paid. Some countries integrate the payment of personal income tax and tax to fund national insurance programs. The ceiling for taxable income is typically indexed to some measure of inflation.

The political economy of payroll tax reform is usually less complex than for personal income tax because the tax is simpler and because the tax does not involve any final tax assessment for employees. There may be less resistance to this tax because taxpayers perceive a linkage between what they pay and what they will receive in retirement, even if that is not always the case. There has been a distinct upward trend in these taxes over time to support public pensions for retired citizens and their medical and other insurable expenses.

IV. CORPORATE INCOME TAX

The corporate income tax is imposed on the net income (i.e., net profit) of corporations. Like the personal income tax, this tax may be imposed at the national and subnational (usually state or province) level. In advanced countries, corporate income tax yields from 3-4 percent of GDP. In developing countries, the tax yield is on the same order of magnitude but comprises a larger share of overall tax revenue.

BASIC FEATURES OF THE CORPORATE INCOME TAX

The definition of net income for tax and public accounting requirements may differ. In some jurisdictions, the laws and applicable regulations for taxing corporations may differ significantly from those for taxing unincorporated businesses. Some types of corporations may be exempt from tax, including various kinds of non-profit entities. In addition, certain corporate acts, like reorganizations or mergers, may not be taxed.

Taxable net income is defined as revenue from sales less costs of goods sold, depreciation allowances, amortization, financing costs, overhead costs, and other taxes. Depreciation is the wear and tear of capital (plant, machinery, buildings) during the process of production and is another cost of doing business. Ideally, the corporate income tax should use economic depreciation (i.e., the real depreciation of capital due to its use in production). However, it is difficult to establish this annually, especially for complex operations. Various methods are used including straight line, accelerated, immediate expensing, and at loss or realization. Amortization is treated like depreciation, though it applies to intangible assets, such as loan payments.

Most jurisdictions use a “classical” method of corporate tax where corporations are taxed on net income that includes dividends before they are paid, while dividends paid out from this net income to owners of the firms’ capital (e.g., shareholders) are taxed again under the personal income tax. This leads to the

argument that corporate income paid out in the form of dividends faces “double taxation” and may be used to create pressure to reduce corporate income tax rates.

The corporate income tax may apply to entities incorporated in the jurisdiction, foreign corporations doing business in the jurisdiction on income earned there, foreign corporations which have a permanent establishment there, or corporations deemed to be resident for tax purposes. Most jurisdictions tax foreign corporations differently from domestic corporations.

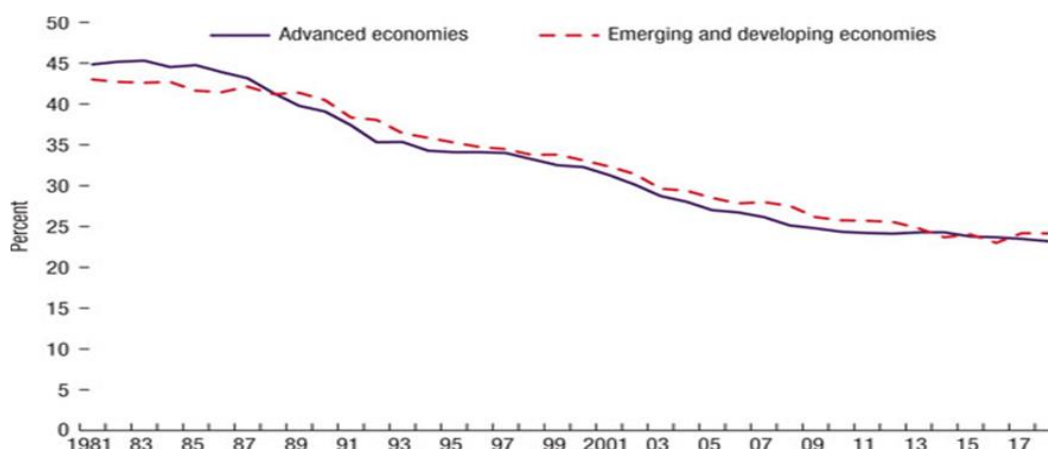
Some corporations have activities in many countries. The place of headquarters is called the home country while others are called the host countries. Most countries negotiate double tax treaties with major trade partners and others, to avoid double taxation in the host and home country.

Most corporate income taxes require that corporations file an annual income tax return. Some corporate income taxes require that taxpayers self-assess tax on the tax return. Others provide that the government must make an assessment for tax to be due, which can lead to bottlenecks. Some corporate income taxes require certification of tax returns in some manner by accountants licensed to practice in the jurisdiction, often the company’s auditors. Tax return due dates vary by jurisdiction, fiscal or tax year, and type of entity. Estimated tax payments may be required on a monthly or quarterly basis. Final payment is due with the annual corporate tax return. Corporations may also be required to withhold tax on dividends, especially if shareholders are foreigners and are not otherwise subject to tax in the country where the income originates.

RATES, TREATMENT OF LOSSES, TAX INCENTIVES, AND TRANSFER PRICING

The corporate tax is generally levied using only one rate applying to all forms of income.

Figure 3. Declining Tax Rates



Source: Hebous (2020).

However, some countries apply different rates to corporations in different sectors or for certain activities, based on assets or other financial characteristics of the firm, or a graduated system based on brackets of income. Corporate income tax rates vary widely by country, leading some corporations to try to shield income from tax by creating offshore subsidiaries or to relocate headquarters or operations to countries with lower tax rates. They may also refrain from repatriating income to the home country.

Corporate income tax rates have been declining since the 1980s all over the world (Figure 3). Most countries have a tax rate below 30 percent. The most common tax rate is between 20-25 percent. The European Union had an average corporate income tax rate of 21.5 percent in 2020. Ireland has been known for its low rate of 12.5 percent, which has been in place since 2003 and has been responsible for many corporations shifting their headquarters to Ireland to take advantage of this low rate. Several countries, mainly small islands, have no corporate income tax. They are known as tax havens.

Corporations can be involved in several types of economic activities through various subdivisions of the corporation. These activities

may even include those that are considered for profit (or taxable) and those that are considered non-profit (or non-taxable, in countries that allow this distinction). This leads to more complex tax situations because the corporate income tax needs to have rules for how the different components of income or related entities are taxed.

Most corporate income taxes allow a loss offset, which is a reduction of taxable income for losses against other income. Many corporate income taxes allow the offset only against activities that are similar (e.g., a manufacturing unit against another). The loss incurred in one year may be allowed against the profits in an earlier or later period through loss “carry backs” and loss “carry forwards.” While this provision seems to lower collections at first sight, it is an important way to encourage appropriate risk taking with variable income, and to make sure the government participates in both the downside as well as upside of investment. Some corporate income taxes provide a means whereby groups of related corporations may transfer losses, credits, or other items within members of the group. Mechanisms include combined or consolidated returns as well as group relief (direct benefit from items of another member).

A key issue in corporate tax is the setting of prices charged by related parties, such as between a subsidiary and its parent company, for goods, services, or the use of property; so-called “transfer prices.” Transfer prices can be a source of abuse when “artificial” prices determined outside of a formal market are used to shift profits from a higher taxed to a lower taxed jurisdiction. For instance, if a subsidiary in a high-taxed country purchases inputs, it may inflate the price it paid for the inputs when transferring them to the parent in a low-taxed country, so that the corporation’s profits in the high-taxed country are artificially reduced. To combat such practices, governments often include transfer pricing provisions in their tax laws that allow tax authorities to adjust the prices used by companies. Such adjustments may apply in both an international and a domestic context. The tax authority of the host country must compare the prices of an input used by the subsidiary with its “arm’s length” prices, which are the prices that would have been set in a formal market between unrelated parties to the transaction. Tax incentives under the corporate income tax are quite common. They can be used to encourage incremental investment, employment, and production. Tax incentives can take the form of investment allowances or deductions, including accelerated deduction or full expense, investment tax credits, and tax rate reductions, including a full tax holiday.

There is considerable research on the effectiveness of tax incentives. The general conclusion is that they are not cost effective because the revenue loss may exceed the tax gain on the new activity undertaken in response to the tax incentive. They distort investments and lead to a loss of equity and transparency. Tax incentives mean that to sustain or strengthen government revenues, higher taxes must apply to other activities. Other non-tax factors such as market competitiveness, barriers

to entry, regulation, transport and utility prices, skilled labor availability, and stability of the political and economic and fiscal system, are often more important to corporations in making investment decisions.

INCIDENCE

Corporate or business income tax incidence is extremely complex and there is little agreement among tax economists as to who really bears the burden of the tax. It is a tax on capital,⁶ but capital can move from place to place to take advantage of both market conditions and tax rates. High corporate income tax rates in one country may result in little investment in that country, lack of jobs, and perhaps lower wages. In this sense, the corporate income tax may be shifted in part to workers. Also, corporations or businesses will seek to incorporate the tax into their prices and thereby shift part of the tax to customers and consumers. In addition, corporations are owned by shareholders, whether institutional investors or individuals, and even the institutional investors are ultimately owned by individual human beings. These individuals have varying income levels but share the corporate income tax burden in a similar way.

The bottom line is that one should not simply assume that a corporate income tax will be borne by wealthy shareholders and not affect consumers or workers. In fact, McKenzie and Ferede (2017) provide evidence that workers bear a significant share of the burden in the form of lower wages.

POLITICAL ECONOMY OF THE CORPORATE INCOME TAX

The political economy of corporate income tax reform is as complex as personal income tax reform. Corporations have very different sales and capital structures and varied presence in different countries. Thus, many features of the tax impinge differently on them. Lobbying by

⁶ Capital bears the primary burden of the corporate income tax (Keen and Slemrod, 2021).

corporations is focused and well-financed. Leadership from some quarters and international initiatives today are trying to ensure that the corporate income tax continues to play an important role in taxation. The best means for ensuring that reform accomplishes revenue, equity, and efficiency objectives is to strengthen the ability of government and civil society to assess the varying effects of different reforms and use this as a guide to reform.

KEY IDEAS ON DESIGN

- Set a corporate income tax rate that fosters a competitive environment for businesses, when compared to the rates and key provisions in other countries.
- Avoid granting tax incentives. If tax incentives are used, they should be accounted for, evaluated on a regular basis, and publicly reported. Tax incentives should not differentiate among industries. Oversight and granting tax incentives allowable by law should be centralized in the ministry of finance.
- Develop legal provisions that ease the compliance burden for small enterprises.
- Provide tax and customs administrations legal and regulatory authority to minimize transfer pricing abuse.

V. PROPERTY AND WEALTH TAXES

Taxes on land and property are among the oldest and most common forms of taxation. Although property taxes typically constitute a minor source of revenue at the central government level, they often play a larger role in funding local public services (Shome, 1995). In 2018, the average contribution of property taxation in OECD countries was 2 percent of GDP, and over 4 percent in the UK and France,⁷ while the corresponding average for developing countries is negligible. Sound reforms can add this tax as an important component of a developing country tax system (Box 4).

There are three basic forms of property taxation (Stotsky and Yucelik, 1995): (1) based on the rental value of the property, i.e., the amount of rent that would be paid for this property in a year; (2) on the capital value of the land and improvements or how much it might sell for; or (3) a tax based on the site (or land) value.

Accurate assessment is the benchmark of a good property tax administration and requires an active property market. The purpose of assessment is essentially to determine the “fair market rental” or “fair market value” of the property. Urban areas typically provide active

markets in property while rural areas may not, making assessment more difficult in rural areas. Owner-occupied property that is neither rented nor sold regularly may pose a valuation problem as does business property.

In practice, the assessed value of a property is generally set below its fair rental or market value because of exclusions and exemptions from the base or because methods of assessment are used that are not based on full property valuation. In environments characterized by high property prices or general price inflation, if assessments are not conducted frequently, this may lead to erosion of the tax base and poor revenue performance. As an alternative to regular assessment, it is possible to use a price index that is appropriate for the asset as a guide to changes in value. A construction price index may serve to measure changes in the value of the structural component, while a land value index may be appropriate to use for the land component.

An effective and fair implementation of the property tax requires information on all property, including its physical size and boundaries, ownership, and the value of land and improvements. These requirements can be satisfied through a reliable set of titles,

Box 4. USAID Assistance in Property Tax Reform

USAID has supported several property tax reform projects (e.g., Afghanistan, Bosnia and Herzegovina, Macedonia, Montenegro, Kosovo, Vietnam). In Montenegro, USAID diagnosed problems, presented options for reform, and at the request of the Ministry of Finance drafted a new property tax law which was enacted almost in its entirety. The 2003 legislation replaced an area-based property tax riddled with exemptions, reliefs, and unclear language with a value-based tax collected directly by municipalities. The most important part of this reform, though, was that the management and ownership were entirely devolved from the republic revenue administration to local municipal governments. Property taxes grew between 2003 and 2006 from 0.2 percent to 1.3 percent of GDP, putting Montenegro above the worldwide average, and allowing local governments to capture the benefits of the subsequent property value boom.

Sources: Bahl (2009); Rozner (2009).

⁷ OECD (n.d.). Tax on Property.
<https://data.oecd.org/tax/tax-on-property.htm>.

ownership records and cadastral surveys. Often such information is lacking in developing countries, which is one key reason these taxes remain so little used. The cadaster consists of an official record of the location, size, and ownership of each parcel of land. In the absence of a reliable cadaster, it is still possible to administer a property tax by using block valuation and applying a common property value to all property within a block, but this is less desirable and can lead to administrative challenges.

Property taxation can be justified in any setting on the grounds of (1) having important revenue potential, (2) being viewed as a more equitable and less distorting tax when properly applied, and (3) having the potential to be a transparent tax as immovable property is difficult to hide. In developing countries, some additional benefits are (1) the potential to partially capture the value created by new public infrastructure investments through the increase of property value in the tax base, (2) promoting efficient land use by imposing costs on owners for keeping property unoccupied or under-utilized, (3) helping to stabilize volatile urban property prices caused by rapid urbanization, and (4) providing an appropriate tax for local government and thereby promoting fiscal decentralization and state building. Urban areas generally have more success in using property taxes because land and property ownership is better recorded and valued.

WEALTH TAXES

Wealth taxes are another way of taxing property, with tax applied to total financial and nonfinancial wealth or a subset of wealth like financial wealth. Taxation of all forms of wealth is rare, but many countries tax immovable property (and certain movables like vehicles), inheritances and transfers of assets (including gifts). Taxation of wealth in all forms raises

between 1-4 percent of GDP in advanced countries and is underutilized in most developing countries.

Since wealth is more unequally distributed than income and consumption (Scheuer and Slemrod, 2021), using wealth as the tax base would shift the burden to the richest sections of society and would be the most progressive of all taxes. Since taxing wealth reduces the returns (after tax) to savings, seen as necessary for capital accumulation, it has not been seriously attempted by many countries in recent decades. That high wealth individuals are also highly mobile and have relocated either their assets or themselves to lower tax jurisdictions in response to high taxation has also deterred many countries from taxing wealth. Certain forms of wealth, such as hard to value and illiquid assets like pension funds and life insurance, art, trusts and closely held family corporations, are very hard to tax.

INCIDENCE AND POLITICAL ECONOMY

Property or wealth tax incidence is mostly borne by the property owner or the owner of the asset. Increases in property or tax on net wealth are often capitalized in the value of the property or the assets. If property tax rates are increased, the value of property is likely to fall nearly proportionately. Similarly, if the tax on net wealth rises, the value of the taxable assets is likely to decline. It is perhaps this incidence that makes the political economy of imposing property and wealth taxes so challenging; it is hard to tax the people who own the real estate and the country's main assets because they are the wealthiest and most politically connected people, especially in developing countries.

VII. VALUE ADDED TAX

A VAT is a broad-based tax applied to the sales of goods and services, levied at multiple stages as a good or service is sold (Ebrill et al., 2001). For this reason, it is sometimes referred to as a general sales tax. It is currently used in one form or the other in 170 countries and typically accounts for at least one quarter to one third of tax revenues in those countries. Some large federations also apply the VAT at the subnational level (e.g., Canada, Brazil, India). The only major country without a VAT is the United States, where most states instead use retail sales taxes. The VAT has become a popular tax because of the relative ease in administering it compared to an income tax and its ability to produce high revenues even in countries with inadequate tax administrations (Box 5).

BASIC FEATURES OF THE VAT

Countries with a VAT almost exclusively use an invoice-credit method. The tax is collected at every stage of a production chain. For example, in the sale of bread, VAT may be collected on importation of inputs like wheat, and then at the manufacturing, wholesaling, and retail stages. Taxpayers pay tax on their sales price but get credit for taxes paid on inputs. For example, a bread retailer, subject to a 15 percent tax, sells the bread for \$10 and pays

\$1.50 in tax on its sales. It has purchased inputs of \$5 dollars, on which VAT was paid at 15 percent. It thus has a credit tax of \$.75 for tax on its purchased inputs. It effectively pays tax on its value added of \$5 at the 15 percent rate, yielding the remaining \$.75 in tax.

A key advantage of the invoice-credit VAT is that the collection at multiple stages has a self-enforcing property. The credit claimed by one seller on its purchased inputs should match the tax paid by the seller of the input. By matching these claims from the two sellers, neither of whom knows what the other is claiming, the tax administration has a ready means to spot tax evasion (or even mistakes on the part of the taxpayer). The paper trail of the invoice credit system makes audit easier than the income tax.

In comparison, consider a turnover tax (or a gross receipts tax or transactions tax), which is an earlier form of a general sales tax levied as a percentage of the sale price (rather than value added) whenever merchandise is sold. One problem is that it leads to tax being levied on tax because the tax is built into the price at each successive sale up the production chain, until the sale to the final consumer (this tax on tax is sometimes referred to as cascading).

Box 5. The VAT in Bosnia and Herzegovina

Starting in 2000, after the collapse of Yugoslavia, Bosnia and Herzegovina set out to reform its complex, corrupt, and distortion-ridden tax system. One of the first reforms was to replace the complex and unwieldy sales tax with an efficient, broad-based VAT that met standards for European accession and removed the impediment to achieving a “single economic space” by equitable sharing of revenues across entity governments. The introduction of a VAT was accompanied by major changes to customs, excises, and direct taxes and in tax administration. The success of the VAT is illustrated by the remarkable growth of its revenues between its introduction in 2006 and 2016. In 2016, VAT amounted to over 15 percent of GDP—far higher than the revenue yield of the VAT in most comparator countries. The European Union, along with USAID and the United States Treasury and other European partners, were the main donors involved in the tax policy reform program.

Source: Gallagher (2017).

Although VATs are widespread, a few countries still use a retail sales tax at the national level, and they are more widely found at the subnational level. For instance, Malaysia introduced a VAT at 6 percent in 2015 to replace the national sales tax but opted to reverse that decision in 2018 and re-introduce a sales regime.

The main disadvantage of a retail sales tax is that the retailer is the weakest link in the collection of tax because many are small and do not keep accurate records or provide receipts to their customers. As a result, it has been difficult for countries to administer a broad-based retail sales tax at rates higher than about 6-8 percent. Because the VAT is collected at multiple stages, before and at the retail level, it can support much higher rates, with 15 percent being the norm.

The invoice-credit VAT has a nice feature that if the tax is evaded at any stage by a supplier other than the retailer, the VAT owed by that supplier is not lost. Further up the chain that value added will be taxed because no input credits will be available for the component of value added on which no tax was paid. If the tax is evaded at the retail level, only the tax on the retailer's value added is lost.

RATES, EXEMPTIONS, THRESHOLDS

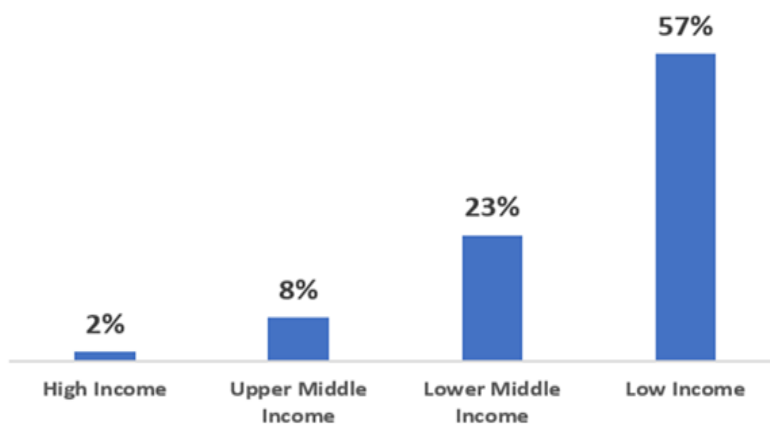
Although a VAT rate of around 15 percent is the norm, some countries choose higher or lower rates. Many VATs have multiple rates, which complicate administration because of the nature of the tax collected in stages, unlike an income tax, which more easily can accommodate multiple rates. It is better to avoid multiple rates, including reduced rates or higher "luxury" rates. Reduced rates mean that sellers whose products are subject to the reduced rate are more likely to owe less tax on sales than credits claimed on purchased inputs, leading to a demand for a net refund. One of the biggest administrative challenges for a tax administration is assessing the validity of net refunds because it is common for taxpayers to

overstate their input tax credits and understate their sales to the point that they do not merely reduce their net tax liability but may in fact even get a net payment from the tax administration. To avoid luxury rates, it is advisable to use simple excises on the goods or services for which the higher rate is desired, to supplement the VAT on those products.

Some countries exempt sectors such as agriculture and basic foodstuffs on equity grounds (or apply reduced rates). Some "hard-to-tax" service sectors are also often exempted (such as margin-based financial services) as well as sectors such as education, health, social services, residential rents, and sales of used housing. Exempting a sector under a VAT means that the seller charges no tax on its supplies but cannot claim a credit for purchased inputs and thus breaks the chain and leads to an unpredictable effective tax rate. Thus, unlike the income tax, exemption does not fully relieve the tax burden but instead only relieves it on sales. If taxes on purchased inputs are large, the seller may gain little or no advantage from exemption because the credit for tax on purchased inputs is lost. Exemptions dilute the self-enforcing property of the invoice-credit system and are an inefficient way to achieve equity objectives or ensure progressivity.

The use of a threshold, usually annual or monthly turnover below which a seller is not required to register or remit the VAT, reduces both the administrative burden of monitoring numerous small taxpayers as well as the compliance burden on small businesses. It is a good practice to allow firms to register for VAT and issue invoices voluntarily even if their turnover is below the threshold to encourage formalization and a paper trail of invoices. Many countries have turnover tax regimes for small businesses that fall below the main threshold or presumptive tax regimes with the option for voluntary registration in the normal VAT regime subject to maintenance of the proper records and filing of regular returns. Normally these simplified schemes allow easier record

**Figure 4. VAT thresholds around the world
(percent of GDP per capita, unweighted averages for 2019)**



Source: IMF. <https://www.imf.org/external/npl/fad/tpaf/pages/vat.htm>.

keeping and fewer periodic returns. Figure 4 gives typical thresholds across the world (Gendron, 2017; Keen and Mintz, 2004). There is no generally recommended threshold, but a high threshold will leave too many sellers out of the system and will result in large revenue losses and may damage the integrity of the VAT system itself. On the other hand, too low a threshold imposes considerable burden on small businesses and the tax administration while bringing in very little revenue. Countries can use benchmark data from comparator countries to help determine the threshold that would work best for themselves.

Most VATs are based on a destination principle: imports are taxed, and exports are relieved of tax. Exports are typically zero-rated, which means, like exempt products, that the supplier does not pay tax on sales, but, unlike exemption, the supplier is still allowed to get a refund of tax on purchased inputs. Zero-rating goods and services other than exports is not recommended because it leads to many claims for net cash refunds and is subject to abuse.

It is important for every country to have clear “place of supply/taxation” rules in place to define what goods and services are liable to

VAT and at what rate in the case of multiple jurisdictions (OECD, 2017). Clear “place of supply/taxation” rules usually stipulate that VAT on goods are due whenever supplies are delivered within a country (usually when the supplier is a registered supplier) or imported into the country (usually for any imports other than personal baggage). They also stipulate that VAT is due on services in the jurisdiction where they are consumed (subject to supplier registration requirements). For business-to-business supplies, the jurisdiction in which the customer is located has the taxing rights.

THE POLITICAL ECONOMY OF THE VAT

The VAT has often been characterized as a regressive tax. This often leads to attempts to have reduced rates and exemptions on “merit” goods and higher rates on “luxuries” to make the tax more progressive. The regressivity is supposed to stem from the poor spending a higher percentage of their income on consumption taxed under the VAT than the rich and thus paying a higher percentage of VAT relative to their income than the rich. In practice, however, Jenkins, Jenkins, and Kuo (2006) find that the poor rely less heavily on taxed goods and services because they buy

more of their consumption from unregistered producers and sellers who do not pay VAT. Even if you could bring all of these informal actors into the tax net, the typical policy prescriptions, such as adjusting VAT rates and thresholds, may not be the best way to address equity concerns. Targeted spending is generally a far more effective tool for various reasons including that it is more transparent and easier to assess. Efficiently raising revenue so that the government can spend more on goods and services for the poor may do more for equity than trying to make a VAT progressive.

The political economy of sensible VAT reform may be difficult but if the tax is seen as a bulwark of the tax system, it may be possible to gain consensus on sensible reforms to broaden the base and maintain competitive tax rates. Nonetheless, just like with income tax reform, determined leadership is essential because anytime the tax system is opened to change, special interests may prevail. With the VAT, industries may lobby especially hard to ensure that their products get special treatment in the form of lower VAT rates or exemptions from

VAT. The Bangladesh example (Box 2) is a case in point and illustrates how VAT reform can make a weak tax worse in the end, despite the passage of what appears to have been a sensible law. The devil is in the details.

KEY IDEAS ON DESIGN

Based on the principles of efficiency and simplicity:

- Set a single standard ad valorem VAT rate levied at or below 15 percent.
- Minimize exempted sectors and products.
- Use zero-rating only for exports.
- Set an appropriate VAT turnover threshold below which firms do not have to pay tax.
- Establish simplified regimes for small enterprises.
- Design special regimes for services, reverse charges, and withholding.
- To address equity concerns consider exempting some basic foodstuffs, education, and other items, but keep these to a minimum.
- Pursue equity objectives more aggressively through targeted spending.

VIII. EXCISE TAX

Excise taxes (or selective sales taxes) are defined as taxes and related levies and charges on select goods, services, and activities. Common types include excises to discourage consumption of unhealthy foods, including sugar sweetened beverages and junk food; to reduce damage to the environment, including taxes on carbon, gasoline or other fuels, and plastics; to curb unhealthy practices, including use of tobacco and drinking of alcoholic beverages (which is why these excises are sometimes referred to as “sin” taxes); to discourage some activities not considered socially useful like gambling; and to capture easy to tax or luxury goods (e.g., international air fares, telecommunications, and digital communications).

BASIC FEATURES OF EXCISES

Excise duties can promote economic efficiency. Whenever all the costs associated with consuming or producing a good or service are not borne by the buyer and seller (and hence not included in the transaction price), these extra uncompensated or external costs are referred to as negative externalities. A good example of external costs are the pollution and consequent climate change caused by burning fossil fuels. By levying excises on activities that produce adverse side effects, the higher price induced by the tax transfers the cost back to the buyer.

Many of the commodities on which excises are imposed are also relatively demand inelastic (i.e., quantity demanded is relatively unresponsive to price changes) so that the tax base can be maintained even with high rates of tax (like that on tobacco or alcoholic beverages). Nonetheless, at a high enough rate, there is still likely to be some erosion of the tax base, and this ultimately limits the rate of tax that can be used, if revenue is a concern. There is typically a revenue maximizing rate, until which, increases in the rate of tax both reduce consumption and raise additional revenue. After

the revenue maximizing rate is reached, however, consumption continues to decrease with a higher rate, but revenue falls. At this point, governments have to decide on which goal is more important, reducing consumption or increasing revenues. Excises applied to more demand elastic goods or services need to be set at a lower rate to avoid excessive loss of the tax base as consumers switch to untaxed products.

The use of excises adds an additional dimension to a tax system, from an efficiency and a revenue perspective. If levied on “sin” goods, excises may also add a regressive element to the tax system because these goods generally figure more prominently in the budgets of lower-income taxpayers.

When these taxes are dedicated or “earmarked” to a particular purpose, they may enjoy greater public support, and this can also lead to a more regular and secure source of money for spending on critical items. Items that sometimes have dedicated excise taxes include transportation systems, environmental clean up, health, and education.

Excise duties are also a relatively easy source of revenue for tax administrations with limited capacity. They can be administered more easily than income taxes and VATs for several reasons. They apply to a limited subset of goods and services. They are often levied on a specific basis (fixed value per unit of the good) based on quantity produced or imported rather than on an ad valorem basis, thus avoiding the need to produce accurate valuation. And, they are generally levied at only a single stage, usually the manufacturing or import level. However, excise tax evasion is still a problem, and the tax administration needs to ensure that sellers do not collect the tax from the public but not remit it to the government.

Some countries levy digital services taxes on cross-border digital service providers (e.g., France, U.K., Australia) due to difficulties in

collecting corporate income taxes from these digital service providers and platforms under existing laws and because demand is quite responsive to income growth.

Studies have shown that developing countries underuse excises. But some countries, such as the Philippines and Liberia, have pursued reforms that demonstrate their revenue potential (Box 6). Liberia, with USAID technical support, recently: switched from an ad valorem to a specific tax approach; reduced the number of excises from 57 to seven; limited excises solely to items hazardous to health and the environment and luxury goods; and introduced a new fuel excise. This reform led to nearly a doubling in excise tax revenues (USAID RG3 Project reporting, Aug 2021).

Estimates of the potential increased revenue range from 1-3 percent of GDP alone for low-income countries (Abdel-Kader and de Mooij, 2020; Cnossen, 2020). Excises on telecommunication services alone can bring in 0.5 percent of GDP in revenues in some African countries.

THE POLITICAL ECONOMY OF EXCISES

The political economy of excises is often more subdued than for broad-based taxes. Nonetheless, both producers and consumers of excisable goods and services may put up fierce opposition to increases in taxes. The low level

of gas taxes and the absence of a carbon tax in most countries reflect the strength of this opposition. There is generally less opposition to high taxes on alcoholic beverages and tobacco. It is difficult to keep excises growing with the economy and rates set in specific terms require regular review. The need for regular revision can make it difficult to keep their share in GDP stable, unlike ad valorem taxes, which do not require any regular adjustment because they adjust with prices.

KEY IDEAS ON DESIGN

- Tax alcohol, tobacco, and unhealthy foods with excises on a specific rather than ad valorem basis, because the focus is on taxing the inherent damage-causing potential of these goods and not their price; and to make administration easier.
- Regularly adjust excises for or index to inflation, if levied in specific form.
- Use environmental taxes on fossil fuels and plastics. Carbon taxes⁸ should also be imposed per unit of emissions at a level directly related to the damages they cause. Possible regressive effects of carbon taxes in low-income countries can be offset through targeted pro-poor spending.
- Use excises on services and on some high-value luxury goods like

Box 6. Excise Taxation in the Philippines

The Philippines Government improved excise taxation in recent years. The Sin Tax Act of 2012 corrected important deficiencies in the taxation of tobacco and alcohol. The policy reforms adjusted specific rates of tax to reflect cumulative inflation for over two decades. They also introduced an annual 4 percent adjustment. In order to overcome resistance to these changes from the tobacco industry and farmers, the reformers engaged the healthcare community and earmarked a large percentage of revenue increases to healthcare spending on the poor and subsidies to compensate farmers for losses. After reform of rates and administrative measures, revenues doubled between 2012-2014 on these products from 0.5-1.0 percent of GDP. Kaiser et al. (2016) found both a significant decrease in smoking prevalence as well as sizeable increase in the public health budget after the law was implemented.

Sources: Bolnick and Singh (2018b) and Kaiser et al. (2016).

⁸ Carbon taxes are discussed further in section X.

automobiles selectively and where appropriate.

IX. TAXES ON INTERNATIONAL TRADE

Taxes on international trade (import or export tariffs or duties) have historically been one of the most widely used and important sources of revenue. Tariffs on imported goods and services are still common in the developing world. Taxes on exports are much less common, except on certain natural resources and foodstuffs. Import tariffs are one of the easiest taxes to collect because there are limited points of entry for goods and customs administration can secure the goods until payment of taxes. This is especially so on highly taxed items such as alcoholic beverages. Because they are relatively easy to administer, tariffs are typically the first form of revenue a nascent economy emerging from violent conflict raises and are commonly used by small, open economies that import most of their consumption goods.

Many developing countries continue to rely excessively on international trade taxes, which can be detrimental to growth. The average international trade tax-to-GDP ratio for developing countries has fallen from about 4 percent in 1990 to about 2 percent of GDP today but remains well above that in advanced countries; and in some countries, the ratio remains substantially higher.

BASIC FEATURES OF INTERNATIONAL TRADE TAXES

Import tariffs create a bias in favor of domestic production by making imports relatively more expensive than domestic substitutes. In addition to the distortion caused by raising the overall price of goods and services in the market, they also protect higher-cost, less-efficient domestic suppliers to replace lower cost imports. This causes losses in economic welfare for domestic consumers as well as would-be exporters. Tariffs that vary by country or source of imports create further distortions.

Tariff schedules usually apply many rates to goods and services falling into various

categories according to an internationally standardized system of codes for classifying traded goods. A typical example of the kind of tariff structures proposed during reforms might include an import duty levied on an ad valorem basis with three or four rates that are multiples of five; a maximum rate of 20-25 percent and a minimum rate of 5 percent to reduce rate dispersion. In practice, this ideal is almost never realized and far too many rates are used, leading to disputes as to which category a good or service falls into.

Today, there are constraints on countries' decisions of import tariff rates. The General Agreement on Tariffs and Trade (GATT), which dates to 1948, and the World Trade Organization (WTO), which was set up in 1994, require that each new member country reach an agreement with other members on the maximum level of tariff for each commodity. This rate is known as the bound rate. A member must commit to liberalizing its international trade regime, and to generally switch to using ad valorem tariffs rather than non-tariff trade restriction measures, such as licenses and quotas, because tariffs are more transparent. Applied rates often end up lower in practice than bound rates.

The WTO has two other important principles that govern international trade collectively referred to as the non-discrimination principle: (1) Most Favored Nation (MFN) status requires each member to treat all other countries equally and not discriminate between trading partners, with some permitted exemptions such as Free Trade Arrangements between groups of countries. The principle states that if a country grants someone special treatment such as a lower customs duty rate for one of its products, it must do the same for all other WTO members.⁹ (2) National treatment requires that a country treat imported goods,

⁹ WTO (n.d.). "Principles of the Trading System." <https://bit.ly/3x5guKZ>

intellectual property, and services the same as locally produced goods and services. This rule only applies after the goods have entered the domestic market, so charging customs duty is not a violation of national treatment. This is meant to prevent discrimination by using internal taxes and regulations.

Besides the fact that trade taxes are relatively easy to administer, the primary argument used to justify trade tariffs is the “infant industry” argument: namely, to allow nascent domestic industry to develop enough behind tariff walls to enable them to withstand international competition. International rules even authorize this kind of tariff protection in certain situations. Specifically, Article XVIII of the GATT (on Governmental Assistance to Economic Development) allows developing country members whose economies “can only support low standards of living” and are “in the early stages of development” to maintain higher trade tariffs. The WTO/GATT rules also permit imposition of “countervailing measures” like “anti-dumping” duties when an exporting country is selling goods below cost (often with the help of export subsidies in the exporting country) and domestic import competing industries are in danger and unable to compete due to these “unfair” practices.

The GATT/WTO has been successful in bringing average weighted tariffs for industrial goods down ten-fold to below 4 percent worldwide over the course of its existence. In practice, certain categories of goods like autos, apparel, and agricultural goods may have higher average tariffs and many low-income countries are also permitted to have higher average tariffs. The average for developing countries is generally closer to 10 percent, but preferential regional arrangements and rates have also proliferated.

There are still some arguments in favor of trade tariffs, particularly in lower income countries. At this point it is sufficient to note that developed countries use trade tariffs very

sparingly (almost exclusively for trade policy) and do not generate significant revenues from them.

While calculating the level of “protection” a trade tariff gives a domestic producer, we have to consider the “effective” protection and not the nominal tariff rate. The effective rate of protection (ERP) is often different from the tariff rate because it is based on how value added is altered by the tariffs. The interested reader is referred to Daly (2016) or Keen (2003) for a more technical discussion of ERP concepts. Second, while duties give domestic producers a price advantage by raising the cost of competing imported goods, at the same time, they penalize domestic producers by raising the cost of imported inputs. Tariffs on imported inputs also directly hurt exporters because they tend to appreciate the domestic currency, by reducing demand for imports and thereby foreign currency, which also hurts exporters.

One category of exemptions from the MFN principle that requires equal treatment of all countries permitted by the WTO is regional integration agreements. Keen (2003) defines two common types of arrangements (1) Free trade areas (FTAs) or preferential trade areas: in which participating countries undertake to eliminate or reduce barriers to trade among themselves without changing their policies about third countries and (2) Customs unions: which are free trade areas in which the members apply a common external tariff to all other countries outside the union but not inside it. Examples of FTAs include the United States–Mexico–Canada Agreement (USMCA), the European Union (EU) and Asia-Pacific Economic Cooperation (APEC); and customs unions including the East African Community (EAC) West African Economic and Monetary Union (WAEMU) and Southern African Customs Union (SACU).

Many countries also establish Free Trade Zones (FTZs) or Export Processing Zones (EPZs) or Special Economic Zones (SEZs) to attract

Box 7. Tariff Reform in Nepal

The difficulty low-income countries have in tariff reform points to the need to carefully design and pursue a proper, well-planned, and multi-pronged strategy, as in the case of Nepal. Despite prolonged political volatility and conflict in the past, Nepal increased its tax to GDP ratio during 1999–2016 from about 9 percent to 19 percent of GDP. USAID and other aid agencies provided support to achieve this remarkable result through Nepal’s accession to the WTO in 2004 and the consequent reform and modernization of its customs law and administration. This remarkable increase in the tax to GDP ratio occurred despite a fall in the share of trade tax revenue to total taxes.

Source: Bolnick and Singh (2018a).

foreign direct investment and provide a better business environment.

There are many tax implications of FTZs, SEZs, and EPZs: Daly (2016) suggests that providing relief from tariffs and domestic taxes is a key policy instrument in such zones.

FISCAL REFORM IN SUPPORT OF TRADE LIBERALIZATION

Several studies show that middle-income countries on average have managed to increase the overall tax-to-GDP ratio despite declining international trade tax revenues following liberalization. The same is not true, however, of low-income countries, which have in general faced difficulty in replacing the lost revenue (IMF, 2011). Having a VAT in place is not a panacea for replacing lost trade tax revenue, and inadequate preparation, planning, and analysis has made the situation worse for some (IMF, 2011). Evidence shows that, on average, trade taxes lost due to reform can be replaced by domestic taxes if backed up by other factors, including targeted development assistance to increase revenues from the VAT and other taxes. Nepal provides an example (Box 7).

POLITICAL ECONOMY OF TARIFF REFORM

The “import-substituting” and “inward-looking” trade policies that promoted development of “infant industries” behind high tariff walls through the 1950s and 1960s gave way in the 1970s and later years to foreign trade liberalization and “export led” strategies. The key components of these reforms have been:

(1) The removal of non-tariff measures such as quotas and replacing them with equivalent tariffs. This generates revenue for the government while achieving the same objectives. (2) Tariff reform aimed at making the tariff reasonable (lower), uniform and transparent (ad valorem). Simultaneously, effort is required to reform domestic taxes to recover the forgone revenues.

A reduction in import duty collections generally is a consequence of trade liberalization, even though the liberalization generally leads to increased international trade. To mitigate these losses, it is vital that tariff reform be accompanied by domestic tax reform that compensates for these lost revenues. Such measures have included raising excise taxes or the VAT and finding other sources of revenues such as income tax and tax on extractive industries. Tax administration reform has also been a way to recoup revenues.

The political economy of tariff reform is intense. For domestic producers in countries that have built a wall for their products, they are reluctant to lose these advantages. The benefits to consumers of lower prices for imported goods and services rarely figure in discussions. The opening up of economies is viewed as critical to the development of internationally competitive industries and the evidence from East Asia has influenced the political economy in this regard. But the actual steps to reduce tariffs are still subject to considerable domestic competing pressures.

KEY IDEAS ON DESIGN

To minimize economic distortions:

- Levy import duties on an ad valorem basis with no more than three or four rates that are multiples of five.
- Levy a maximum rate of 20-25 percent and a minimum rate of 5 percent to reduce rate dispersion and control ERP.
- Develop a strategy to substitute other revenue sources for declining trade tax receipts. This can be done as part of an overall medium-term revenue strategy.

X. SPECIAL ISSUES

TAXATION OF EXTRACTIVE INDUSTRIES

Many countries rely heavily on mining and petroleum for a substantial part of their public revenue – often over 50 percent in oil-rich countries and 20 percent in mining countries. (Lemgruber and Shelton, 2014) The unique feature of this sector is that the government is often the legal owner of these natural resources as well as the taxing authority. In this respect, it is up to the government to decide how to generate revenue from this sector, to share those proceeds (e.g., between resource-rich and non-resource-rich provinces and groups equitably), and to ensure the sector contributes to the growth of the entire economy and not just the “enclaves” surrounding the extractive industries. At the same time, policy should minimize and compensate for the negative environmental impact of extractive industries. Finally, because these resources are exhaustible in nature, they present governments with the unique problem, compared to taxation of recurring production or consumption, of maximizing the country’s income from their exploitation, while planning for the future diversification of government revenue sources.

UNIQUE FEATURES OF EXTRACTIVES TAXATION

Natural resources exploitation faces pervasive uncertainty, with wide fluctuations in commodity prices and uncertainty regarding the results of exploration and discovery. The high up-front costs give the resource firms a bargaining advantage before investment takes place, which disappears rapidly in favor of the host government the moment investments are made. Knowing this, multinational corporations place a premium on “certainty” through advance written agreements for their tax treatment over time.

Many of these global producers often exercise substantial market power (e.g., large oil multinationals) and smaller, low-income countries are usually unable to bargain hard for fear of losing investment. The sophistication of

multinationals is likely to weigh against small and low-income countries’ ability to extract appropriate compensation for exploitation of their natural resources. This would be an area where USAID or other donors could help in ensuring that these countries obtain appropriate assistance at the contract negotiation stage. Additional USAID entry points are described below.

POLITICAL ECONOMY OF EXTRACTIVES

There is generally significant political and social conflict over the control and distribution of the revenues from exploitation of these resources. In advanced countries, these resources play a relatively small role in revenues or where the revenues are significant, their collection and use is well governed (e.g., Norway). However, in many developing countries with significant exhaustible resource revenues, the control and use of these revenues leads to corruption and conflict, often referred to as the “resource curse.” The developing country that has used this revenue well is unfortunately more the exception than the rule.

Botswana is an example of a country that has successfully raised substantial public revenue from minerals such as diamonds while remaining fiscally responsible and politically stable (Jefferis, 2013). Mongolia is an example of successful natural resource taxation and has used these revenues for social spending benefitting a wide spectrum of stakeholders (UNRISD, 2016). Saudi Arabia is one of the very few countries to adopt a go-it-alone strategy successfully using a national oil company (Saudi Aramco) after many years of relying on foreign investment, and along with its Gulf neighbors and perhaps countries like Azerbaijan and Kazakhstan, used their petroleum resource revenues for significant national investment and growth (Nakhle, 2010). On the other hand, despite being able to consistently raise revenues from copper mining since 2005, Zambia has been unable to avoid debt problems and default

(Savoy and Perkins, 2014). Nigeria has had similar problems using its oil resources well.

To promote the open and accountable management of oil, gas and mineral resources and transparency in the sector, the Extractive Industries Transparency Initiative (EITI) was first launched in September 2002. The EITI has established a global standard requiring “the disclosure of information along the extractive industry value chain from the point of extraction, to how revenues make their way through the government, and how they benefit the public. By doing so, the EITI seeks to strengthen public and corporate governance, promote understanding of natural resource management, and provide the data to inform reforms for greater transparency and accountability in the extractives sector” in the 55 countries that implement the EITI global standard.¹⁰ Each of these countries is required to publish an annual EITI Report disclosing information on contracts and licenses, production, revenue collection, revenue allocation, and social and economic spending. USAID Missions can help partner countries engage with EITI and, in doing so, increase the chances that revenues from the extractive industries will provide broad public benefit and development impact. USAID can also assist countries to develop long-term plans and mechanisms to avoid economic shocks when revenues from extractives begin to decline.

KEY ISSUES OF DESIGN

A key design consideration is the ability of the overall tax structure to capture the rents from ownership of mining rights and to properly tax windfall gains from high commodity prices. At the same time, the tax system must provide relief in times of commodity price downturns and not turn away investors or alter their incentives in favor of only the highest grade or yield resources. In practice, most developing countries have failed to collect enough revenue from corporate income taxes and combat base

erosion and transfer pricing by multinationals. To summarize, the main recommended revenue instruments available to governments for taxing this sector are (IMF, 2012):

- Use bonus payments on signature (of contracts or leases), discovery and production. These are single or staggered lump-sum payments triggered by specific events which can be legislated, negotiated, or auctioned.
- Use per unit or ad valorem royalties based on production value or volume. They provide stable revenue to the government as soon as production begins and are not affected by profit shifting, but if imposed at too high a level, royalties can raise costs to unprofitable levels when commodity prices fall and may lead to under exploitation of marginal or higher cost-to-extract resources (high grading) or cause investors to abandon sites prematurely. The norm for royalties for mining is around 5 percent, with lower rates between 2 and 5 percent seen in many cases if royalties are turnover based, and higher rates of 7.5-10 percent when profit based.¹¹ The normal royalties for petroleum are between 10 and 15 percent, depending on the other forms of rent sharing.
- Apply the corporate income tax at the standard rate or higher, with a sector-specific rate or a variable income tax using the corporate income tax base.
- Use resource rent taxes, which are meant to capture “rents” or returns earned by a company over and above the minimum required return to stay in business. They are usually calculated as current receipts less all current expenses and imposed only when this cash flow is positive.
- Require dividends from equity ownership. These serve as the equivalent of rent taxes.

¹⁰ <https://eiti.org/About>.

¹¹ Hogan and Goldsworthy (2010).

TAXATION IN FRAGILE ECONOMIES

Conflict-affected and fragile states often have much lower tax-to-GDP ratios than other developing countries (on average 4 percentage points lower, although this could be up to 15 percentage points lower in some extreme cases). Much of the advice given elsewhere in this note must be modified considerably to account for the economic circumstances in these countries, depending on whether they are in the emergency or conflict phase or in the recovery or consolidation phase. The general principles for tax design in fragile states are (1) a small number of taxes, (2) easy to assess, control, collect, and audit tax bases, (3) few exemptions and single or very few rates, (4) a focus on large taxpayers and limited and easy collection points (such as ports of entry), (5) presumptive or lump-sum taxation of small taxpayers at reasonable rates, and (6) preparation for the future through gradual refinement as the situation improves (Mansour and Schneider, 2019).

Taxes for the conflict phase should be organized by collection points. These include at the border or checkpoints where goods enter government-controlled territory with perhaps three flat rates of 10, 30 and 50 percent applicable to food and essentials, most consumption goods, and luxury goods, respectively; and at the largest businesses in cities under government control applied on turnover at a rate between 7 and 14 percent in lieu of VAT and income taxes. Special provisions would be needed for formal banks and financial institutions that are hard to tax on a turnover basis. Taxes can be withheld at progressive rates on wages in the formal and government sector with a top rate of no more than 25 percent and a generous basic exemption.

Additionally, mining and extractive industries where present in government-controlled areas can generate both tax and nontax revenues (through dividends and equity participation).

Several fragile states with low tax ratios have been able to compensate thanks to nontax revenues from extractive industries.

Telecommunications also generate substantial rents due to licenses and large economies of scale and sunk costs of investment. They can be taxed with additional taxes on turnover of around 10 percent to capture these rents. Sectoral taxes should not be allowed to proliferate and should be limited to include excises on petroleum products, tobacco, alcohol, and selected luxury goods, as well as special taxes for the banking and telecommunications sectors. Earmarked property taxes on the largest property owners can be a source of revenue for local governments as well as a visible vehicle for equity and inclusiveness. Modification of these principles for the consolidation phase and eventual recovery and growth is discussed in Mansour and Schneider (2019).

Afghanistan, Bosnia and Herzegovina, and Rwanda are all examples of states that have emerged from deep conflict and built domestic revenue systems with external help on both restructuring policies and administration (Gallagher, 2017, 2018a,b; USAID 2018a,b). Afghanistan provides an example of a country that, between 2002 and 2016, rebuilt its revenue from a dire situation (Box 8).

Three key lessons for policy that emerged from the work in Afghanistan are (1) Nontax revenue, which is often ignored, was one of the focus areas of the USAID Economic Growth and Governance Initiative Project and saw the greatest growth over the 2014-16 period. (2) Despite bureaucratic opposition to reform, support from the top political leadership was a key to successful implementation; (3) The rate of return to investment in domestic revenue mobilization was \$60 for each dollar invested by foreign donors.

GENDER AND TAXATION

There are many ways tax reform can contribute to gender equality (Stotsky, 2020). The

Box 8. Domestic Revenue Mobilization in Afghanistan

Afghanistan's domestic revenue mobilization made impressive progress over the past two decades, notwithstanding the current political situation of the country. In 2002, the Afghan government collected a total of only \$10 million in total government revenue. In contrast, in 2016, it collected \$2.4 billion. International donors provided training, materials, and technical assistance to rebuild the Afghan Revenue Department. The government did this with the assistance of various international donors by focusing on "the simplest taxes to collect, namely, import duties, a tax referred to as the business receipts tax, and simple income taxes for both individuals and companies. A simplified tax was developed for small businesses that could be paid in place of the corporate income tax and the business receipts tax. For import duties, the Afghans implemented a new, partially rationalized duty schedule, with fewer rates and a schedule following the harmonized system of codes for classifying traded goods to enhance transparency and fairness."

Source: Gallagher (2018a).

structures and administration of tax systems can favor or disadvantage women through both explicit and implicit bias. Explicit biases in tax systems are laws and regulations that discriminate against women (or, in a few cases, favor women) and are most typically found where taxes are individualized, like the personal income tax or, less frequently, wealth taxes. Implicit biases arise because women and men tend to differ systematically in behavior—in the ways they earn and spend and invest income and wealth.

As an example of explicit bias, some personal income taxes include permitting tax preferences only for male taxpayers, assigning joint business or asset income only to males, and allowing only males to have legal standing on tax issues. Although explicit bias is slowly being removed from tax codes throughout the world, it is necessary to ensure, as soon as possible, that tax codes are amended to end all such discrimination.

Implicit gender bias is more pervasive. It is typically found in the design of personal income taxes. Under a joint filing regime, higher effective tax rates on secondary earners, most often women, is a source of implicit bias. If a deduction is available for unreimbursed work expenses that are predominantly borne by men (say, for instance, the purchase of uniforms or tools) but not for work expenses that are

predominantly borne by women (say, for instance, the cost of childcare), this is another source of implicit bias. Progressive personal income tax systems impose, on average, a lower effective tax rate on women, who generally earn less than men. Thus, a well-designed and well administered income tax can help promote gender equity.

Explicit bias is not found in goods and services taxes or the corporate tax because these taxes are levied on businesses, not persons. However, implicit bias may still be a consideration. Under the VAT, exemptions for necessities like food, education, health care, and childcare and other basic needs, help low-income households, and may be especially valuable to the rising share of such households headed by single mothers. There may be additional scope to provide favorable treatment of paid childcare or products disproportionately or entirely consumed by women.

Anecdotal evidence suggests that companies that have benefitted from tax incentives have mostly employed men. Reining in such incentives can be beneficial not only in terms of preserving government revenues, but also in reducing gender bias. Alternatively, offering counterbalancing tax incentives to companies that predominantly employ women is an option, but care should be given to design such incentives to ensure the benefit flows down to

employees rather than simply adding to companies' after-tax profit.

TAX EXPENDITURES

As we have seen, special preferences are a feature of all taxes, through exemptions, deductions, preferential rates, and special regimes. Corporate tax incentives are a particular concern because they remain so prevalent. There may be a large loss of revenue from these preferences, and they may also be distortionary and inequitable. Countries use tax expenditures in place of direct spending for various reasons including that they are not subject to regular appropriation and may be less transparent as a form of subsidy.

The resulting loss in revenue compared to the potential revenue that would be collected if there were no special preferences is called a tax expenditure. Any special preference such as deductions and reduced tax rates results in a tax expenditure. No single standard of how to calculate tax expenditures exists, but many ministries or tax administrations around the world have been reporting them, though many other countries are ill equipped to do so. Most recently the Council on Economic Policies and the German Development Institute/Deutsches Institut für Entwicklungspolitik have produced a "Global Tax Expenditure Database," which has great potential for helping to understand the huge revenue losses this practice of granting tax incentives has created.¹²

Centralization of the power to grant tax incentives in the Ministry of Finance, and regular compilation and publication of all tax expenditures, no matter what the tax, are the best way to keep them in check, encourage transparency, combat corruption, and impose fiscal control. Many countries must submit a measure of tax expenditures in the annual budget exercise. This is routinely done by most advanced countries and several developing countries (e.g., India). Sectoral ministries should

not have the power to issue their own tax incentives or preferences.

CARBON TAX

Carbon taxes are imposed on the carbon content of fossil fuels. They increase prices of fossil fuels and electricity and other products and services that use these fuels. Since they also lower the relative prices of alternative fuel sources, they promote switching to cleaner energy sources. A tax of \$35 per ton on CO₂ emissions in 2030 would increase prices for coal, electricity, and gasoline by about 100, 25, and 10 percent, respectively, based on their carbon content (Parry, 2019). A tax of \$35 per ton would exceed carbon emission reduction commitments under the 2015 Paris Accord in many emerging economies that still use coal heavily and may be sufficient to meet commitments by other countries, such as the United States. Carbon taxes have significant revenue potential; a \$35 carbon price (or a per ton tax) would raise between 1-2 percent of GDP. Carbon taxes are easy to impose and administer and have significant environmental and health related benefits as well.

Carbon taxes tend to be moderately regressive in advanced economies because lower-income households tend to spend a higher share of their income on energy-intensive goods (IMF, 2020). The incidence in low-income countries may be less regressive, where low-income households remain largely in a subsistence economy and gather their own energy resources (e.g., for cooking or heating). A \$70 per ton carbon tax in advanced North America and a \$35 per ton tax in emerging large countries would impose an estimated additional burden on households of 2 percent of their consumption (IMF, 2020). If there is public resistance to high carbon taxation, the bottom 40 percent of households can be given a compensating subsidy. It is estimated that 70 percent of the revenue raised would still be left over for use after this subsidy. In addition to

¹² See Global Tax Expenditure Database. <https://gted.net/>.

being compensated for the extra burden, the bottom 40 percent of households would also participate in the external environmental and health benefits. This level of carbon price would also likely increase investments in renewable energy, electricity-based transport, energy efficient buildings, reforestation, and other climate friendly activities, positively impacting growth and jobs.¹³ To achieve the goals of the Paris climate accord, it has been estimated that the global average price per ton of carbon would have to rise from the current \$2 to \$75 per ton in 2030.

BEPS, TRANSFER PRICING, AND THE DIGITAL ECONOMY

Since the 1920s, international taxation of entities that derive income from multiple countries has been governed by the principle of avoiding double taxation of the same income through treaties. This was achieved by allowing either the country of “domicile” or residence of the taxpayer (“home” country) the first right to tax income (mostly for personal income), or the country (the “host”) where the income originated or was earned or derived (the “source”) the right to tax it first (mostly for business and property income) (Eden, 2019; Mullins, 2020). Many developing countries tax worldwide business income of their “resident” companies but give credits for taxes paid abroad, as does the United States. Many developed countries exempt foreign income instead.

To use the source principle and tax income derived or earned in their jurisdiction, the source or host country must establish some sort of “nexus” or a taxing right, linking income earned and value created by the business to its jurisdiction. The accepted method of doing so since the 1920s has been to stipulate that the host or source country would have a taxing right whenever the business had a “permanent

establishment.” The OECD Model Tax Convention lists three types of permanent establishment: a fixed place of business, a construction or project, or an agency. Some examples included in the convention are mines, branches, factories, warehouses or “places of management.” Proving the existence of a permanent establishment was the first requirement for establishing nexus, or a taxing right for the host or source country. Once a nexus is established, the question of distribution must be solved: how much of the total worldwide income could be attributed to the particular jurisdiction. A central implied feature of the “1920s compromise” is that theoretically, all income earned by any business would be taxed in some source country or the other, and double taxation would be avoided through tax treaties (Elliffe, 2020).

Over time, multinational enterprises began to realize that they could reduce their overall worldwide tax liability by locating offices or subsidiaries in certain lower tax jurisdictions and “shifting” profits solely for tax accounting purposes from high tax countries to lower tax ones (Mullins, 2020). An example of transfer pricing was given earlier. The existence of several tax havens (countries with very low effective tax rates), often also offering financial secrecy, makes shifting income to low-tax jurisdictions relatively easy. Developing countries are encouraged to compete by lowering their effective corporate income tax rates to attract inbound foreign investment, leading to a “race to the bottom.” The result is that many large and profitable multinationals escape corporate income taxation altogether (Palansky, 2019).

In response to this global loss of corporate income tax revenue, the OECD and G20 launched the base erosion and profit shifting (“BEPS”) project in 2013. A program of 15

¹³ IMF. IMF Managing Director’s intervention at the Leaders Summit on Climate, Session 2: Investing in Climate Solutions. <https://bit.ly/3iwoHIR>

“actions” were drawn up of which the first action item was to “address the tax challenges of the digital economy.” Four of the actions require that participating countries maintain minimum prescribed standards (if necessary, by amending domestic laws). The cornerstone of these initiatives was to standardize transfer pricing law and practices based on the arm’s length principle. In 2016, an Inclusive Framework was launched as a forum where all countries could jointly deliberate and formulate standards to implement the BEPS project. Member countries are required to adopt the minimum standards required for the four specified action items. At present the Inclusive Framework has over 130 members.

The increasing digitalization of all businesses, the growth of digital giants like the FAANG (Facebook, Apple, Amazon, Netflix, and Alphabet/Google) companies and the increasing mobility of capital and jobs has called into question the traditional methods of dealing with international taxation and transfer pricing. A digital business can earn income in a jurisdiction without ever requiring a physical presence in that country. This has the implication that many source countries will no longer be able to tax income from remote activities delivered over the internet and lose substantial corporate income tax revenue. Since the income could easily be relocated to a low tax jurisdiction through various methods, every country would lose revenue. Many countries have considered

or imposed “digital services taxes” on these companies in lieu of being able to tax income derived from operations in their countries due to the absence of a nexus. There are growing calls to abandon the century-old framework in favor of a new principle that “profits are taxed where economic activities take place and value is created.”¹⁴

The second issue is that despite the efforts of the BEPS project and related initiatives, many traditional multinationals still face very low effective tax rates on their worldwide income and manage to escape taxes everywhere. The United States introduced two legal provisions in 2017 as part of the Tax Cuts and Jobs Act called the Global Intangible Low-Taxed Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT) in partial recognition of the fact that existing international taxation and transfer pricing laws need to be supplemented by extra measures to protect corporate income tax revenues. In the international arena, in June 2021, the United States introduced a proposal for a global minimum corporate income tax. Following this proposal, G7 nations agreed to tackle multinational tax avoidance by enabling countries to tax profits from revenue generated in the country independent of where the company is located and by setting a global minimum corporate income tax rate of 15 percent.

¹⁴ OECD (2015, p. 1).

XI. CONCLUSION

This primer has touched upon the broad range and complexity of issues required in tax policy reform. Good reforms need to take into account the context of a country, its revenue needs, and sound economic, governance, and administrative principles. In practice, it is hard to achieve comprehensive tax reform that meets all these criteria. Each main tax offers its own technical complexity and political economy issues and the differences are important to recognize.

One of the most important contributions USAID and other international donors can provide is to offer meaningful dialogue and technical advice on all aspects of reform, from improved policies to strengthen the structure of taxes, to analytical work to support application of good principles, to revenue estimation and the collection of data. While providing technical advice, USAID staff and implementers will need to continuously update their understanding of the political context, including the key tax policy stakeholders, which heavily influences the prospects for any reform effort and its sustainability.

Where the partner country lacks a capable tax policy analysis or legal drafting capability, USAID can provide the government with capacity building and technical assistance in these areas. USAID can also provide external stakeholders, industry groups, and civil society with help in these areas to support their demands for reform where they lack these resources.

Support to tax policies units, such as USAID provided in Tanzania, can be a useful contribution to improving a country's tax policies. Such support would include capacity building, sponsoring international conferences and trainings, as well as technical assistance to build models and databases that facilitate the analysis of the tax system, its components, and the development of reform proposals.

Donors can contribute to the reform process by providing the resources and technical

support to stakeholders both within and outside the Finance Ministry to formulate and implement tax reform. At the same time, donor assistance can help sponsor public-private dialogue with civil society, as well as forge private sector engagement in tax policy matters.

Parliaments enact taxes into law, but they often lack the expertise to appreciate the fine points of tax policy. Donors can help strengthen this role by building capacity of members or staff or even by helping create specialized parliamentary offices that deal with fiscal issues. For instance, USAID helped create the Budget Analysis and Monitoring Unit in Bangladesh's Parliament and the Office of Budget Analysis and Monitoring in El Salvador, both of which have served lawmakers in the analysis of the budget and tax policy. Donors can also support lawmakers by providing unbiased technical assistance to assess tax policy proposals. Donors can support parliaments to engage with government officials, the private sector, and CSOs in workshops.

USAID and other donors can help partners develop their own reform agenda. For instance, donors can provide training and technical assistance to analyze the overall tax policy and help define parameters for a medium-term revenue strategy that meets revenue needs but is based on consultation and supports economic development. Technical assistance can be helpful to review and evaluate policy proposals with respect to greenhouse gases, sin tax, tax systems that support competitiveness, or tax policy approaches that support poverty reduction strategies. USAID assistance in setting up methods for calculating the costs and the potential benefits of tax expenditures can support overall reform, add transparency, and help broaden tax bases in a way that sustainably increases domestic resource mobilization.

Often USAID is not the lead agency working on tax policy reform. Organizations such as the IMF, the World Bank, or the InterAmerican Development Bank, may be at the fore, but

USAID also has an important role to play. This might include forming or supporting coordinating groups to meet regularly to ensure that efforts to reform taxation are balanced, non-duplicative, and complementary. USAID provided just such support to the Ghana DRM Coordinating Group, and in Bosnia and Herzegovina where it played a leadership role in establishing and running the Indirect Tax Commission.

USAID and other donor support for international initiatives mentioned in earlier sections can lead to greater international tax policy harmonization, reduce fraud, and combat illicit financial activity. These initiatives include, for instance, BEPS, standards and cooperation for transfer pricing, setting digital standards, promoting international tax treaties, and

encouraging transparency in taxation, especially in the extractives sector.

Over the recent past, donors have focused most of their designated assistance on mobilizing domestic revenues on strengthening tax administration. The goals are to increase revenue, reduce fraud and corruption, and even improve the business enabling environment. Donors that commit to strengthening tax administration should consider how tax the administration challenges that domestic revenue mobilization assistance often addresses are influenced by policy factors, and use that understanding to inform policy reform or simplification efforts.

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XIII. GLOSSARY OF TERMS

Term	Definition
Ad valorem tax	When we charge tax as a percentage of the value of the item being taxed then the tax is ad valorem. For instance, an excise tax of 5% of the value of the good being taxed is ad valorem. This compares to a unit or specific tax, which is a fixed amount of tax per unit produced, sold, consumed, or imported. Income taxes are generally ad valorem as they are taxed as percent of taxable income.
Amortization	Amortization is the declining value of a financial or other intangible asset. For loans it is the amount that is paid down against the loan principle. For intangible assets, such as patents, trademarks, and goodwill, it may be the estimated loss in value of the asset over time. It is similar to depreciation, which is only applied to tangible capital assets.
Capital accumulation	An increase in the value of assets from investments or retained profits.
Compliance cost	The cost a taxpayer must bear in terms of time and effort or to hire tax preparers simply to comply with a tax. The more complex the tax law and regulatory requirements, the higher will be taxpayer compliance cost.
Credit (tax)	An amount of money a taxpayer can directly subtract from their tax obligation that they would owe to the government in the absence of the credit. A tax credit directly reduces an individual's amount of tax owed unlike a deduction, which reduces the amount of taxable income.
Deadweight loss	An economist's term for wastage. It is the cost borne by society due to market inefficiency or inefficiency caused by government policy. To the extent a tax may cause changes in taxpayer's decisions to work, consume, save, or invest, a dead-weight loss may occur. Economists can measure this deadweight loss, which shows the loss to society arising from price distortions caused by taxation or other policies.
Deduction	A deduction lowers a taxpayer's taxable income and thereby their tax obligation. For instance, a cost of doing business, such as to pay for fuel to operate an oven, is a legitimate cost for a baker to do business and is deductible from revenue and lowers that baker's tax obligation.
Depreciation	Decline in value of a tangible capital asset, which can be caused by the wear and tear of machinery, the obsolescence of technology, reduced resale value, and decreased demand. Under most corporate income taxes the taxpayer is allowed to take an estimate or scheduled deduction for depreciation for their business' machinery, buildings, and equipment, lowering taxable profit and tax obligation over time.
Direct tax	A direct tax is on the earnings or wealth of people deriving from their work; capital, investments, and profits; other financial assets; and property, including land and immovable assets (real estate). The major

	direct taxes are personal income tax, payroll tax, corporate (these are legal persons) income tax, and property tax.
Double Taxation	A tax principle referring to income taxes paid twice on the same source of income. It can occur, for example, when income is taxed at both the corporate and personal level, or in international trade and investment, when the same income is taxed in two different countries.
Exclusion	Usually, a value that is not subject to tax or is excluded from the tax base. Property taxes might exclude the first \$10,000 of the value of a property, thus lowering the tax base and tax obligation. Income taxes may exclude certain income, such as retirement pensions or lottery winnings from a taxpayer's taxable income.
Exemption (VAT)	Some goods, such as foodstuffs, medicines, and school supplies may be exempt from VAT. The exemption only applies to when the actual product is sold but it is not applied to the inputs to the product, nor does it apply to products for which the exempt good is an input. For instance, if a consumer buys bread - in this example the exempt good - he does not pay the baker any explicit VAT, but the baker will have paid VAT on all the inputs to the bread, such as flour, eggs, and salt, for which they will have paid VAT, and the butcher cannot claim these earlier VAT payments in a refund.
Export Processing Zone	Selected areas in a country that are designed to attract foreign investment to create jobs, expand the industrial base, introduce technology, and create backward linkages between the zones and the domestic economy.
Flat tax	A flat tax applies only one tax rate. However, in practice, a flat tax on income usually has a bracket of income that is not taxed at all, i.e., a zero rate, and another, greater than zero, tax rate applied to all income above that untaxed income bracket.
Free Trade Area	A grouping of countries that has signed a free trade agreement and maintain little or no barriers to trade in the form of tariffs or quotas among them.
Free Trade Zone	An area of land within a single country that has been designated with special economic status. Within the geographical boundaries of the free trade zone, goods can be stored, shipped in or out, manufactured or handled under a set of specific customs regulations.
Global income tax	One where all income is tallied, regardless of source, to form the gross taxable income, which would be jointly subject to the same income tax.
Haven (tax)	Generally, an offshore country that offers foreign individuals and businesses little or no tax liability in a politically and economically stable environment.

Holiday (tax)	Companies may be exempted or partially exempted from paying corporate income tax for a specified period of time. The exemption for this time is a tax holiday.
Horizontal equity	The notion that two persons of equal means should be treated equally by the tax system.
Implicit gender biases in tax systems	Provisions of the law and regulations that, because of typical social arrangements and economic behavior, tend to have different implications for men and women. Implicit biases may be both inadvertent and intentional. It may be more difficult to identify implicit bias, since this depends in large part on value judgements as to desirable social and economic behavior. Implicit bias often results from increasing marginal tax rates, which may discourage secondary workers in a household from working.
Incidence (tax)	The division of tax burden between stakeholders, such as buyers, vendors, producers, investors, or consumers. Tax incidence does not depend on where the revenue is collected, but rather on the price elasticity of demand and the price elasticity of supply. For example, if there is a 10% tax imposed on alcohol, but there is a 9% increase in price, then most of the burden of the tax falls on the buyer, not the seller.
Indirect tax	Indirect taxes are on transactions or on use or consumption of goods and services. The major indirect taxes are sales tax, turnover tax, VAT, and excises.
Lump-sum taxation	A tax at a fixed amount which does not change with the entity's actions.
Marginal tax rate	The tax rate you pay on an additional unit of income.
Merit good	A good or a service that society deems people should consume, even if they do not or cannot directly pay for it. By its very nature, which are merit goods are is subjective. In general, one person's consumption of a merit good might benefit others, even if the others are not directly consuming the merit good. Typical merit goods include access to fine arts, primary education for all, and health care. These vary from society to society.
Nominal tax rate	The tax rate applied to the tax base without consideration of deductions, exclusions, or other factors.
Non-tariff measures	Policy measures other than tariffs that restrict international trade. Typical non-tariff barriers include quotas, special levies, highly specific standards, licensing, and prohibitions.
Non-tax revenue	The revenue received by government from sources other than taxes. This can include interest, dividends and profits, petroleum exploration licenses, power supply fees, fees for communication services, and road and bridge tolls, among others.

Nuisance tax	Often to address particular revenue requirements that arise at different times, governments create taxes on an ad hoc basis. These taxes individually generate little revenue for the treasury, require oversight by the tax administration, and are annoying to the taxpayer. Sometimes these nuisance taxes lead to petty corruption, where the taxpayer pays an under-the-table payoff to simply be left alone. Examples of these nuisance taxes include the sign tax, river bottom tax, solidarity tax, tax on marketplaces or stalls, tax on amusements, tax on transportation. Usually, these taxes are paid in lesser amounts as considerable bother to taxpayers, who often may not even be aware that such taxes exist or are legal.
Progressive	A tax is progressive if the amount owed relative the taxpayer's income rises as the taxpayer's income rises. For example, under a progressive tax system rich people would pay a large share of their income than would poorer people. The personal income tax is usually a progressive tax.
Regressive	A tax is regressive if the amount owed relative to a taxpayer's income increases as the taxpayer's income decreases. A regressive tax is assessed regardless of income, where low- and high-income earners pay the same dollar amount. Regressive taxes include sales tax, payroll tax, user fees, "sin" taxes, and in some contexts, property tax.
Schedular income tax	Income taxes that are applied differently depending on the source of income. For instance, a tax system might impose separate taxes and rates on wages, interest, capital gain, royalties, rents, dividends, and other distinct forms of personal income.
Secondary earner	A person who is employed and earns less than their partner in marriage or in co-habitation. While historically this term has largely referred to women, the gender makeup has been recently changing. Often couples will file jointly, largely because of the extensive tax benefits, however the marginal tax rate on the secondary earner would rise significantly, possibly discouraging them from working.
Special economic zone (SEZ)	An area in a country that is subject to different economic regulations than other regions within the same country. The regulations seek to be conducive and attract foreign direct investment.
Tax-to-GDP ratio	This is the ratio of tax revenue to GDP expressed in percentage terms. It is a very commonly used and important indicator when discussing taxation in a comparative framework, whether comparing taxation across countries or over time within a country.
Threshold (VAT)	Small business of a size determined by law may be required to register or register and pay VAT on a regular basis. This will be determined by the threshold, where the threshold may be an amount of revenue, sales, or another indicator. For instance, in some countries any business with more than \$100,000 per year may be required to register with the VAT system, collect VAT from customers, and remit VAT to the tax administration.

Vertical equity	The notion that two persons of unequal means should be treated differently by the tax system.
Zero rating (VAT)	When a good or service is zero-rated for VAT purposes, all VAT that has been paid in the production of the good or service will be refunded to the final vendor. Usually, exports are zero-rated and the exporter is the final vendor and will receive a refund from the tax administration. If the export were not zero-rated but rather exempt, then the exporter would not pay VAT on their export, but would also not receive a refund from the tax department.