Besley and Persson contend that “the central question in public finance and development is ‘how does a government go from raising around 10% of GDP in taxes to raising around 40%?’” (Besley and Persson, 2013, p. 2). The academic and policy professions have been resolute (and prolific) in their pursuit of possible answers to that question, but the tax effort in developing countries remains at a level that many believe is too low to support needed investments in public goods including infrastructure, human capital, and health and well-being. The IMF reports tax to GDP ratios for low income countries on the order of 13 percent (IMF, 2011) and the evidence suggests that these ratios have not changed substantially over the last three decades.\(^1\)

There are two parts to tax effort — revenue capacity and revenue collection — and several factors that affect one or both of these pieces. One might argue that the most basic reason for differences in tax capacity among countries is the composition of each country’s economy. Countries with large reserves of scarce, marketable, and extractable natural resources may have a different capacity to raise revenue than non-resource rich countries.\(^2\) Tax structure itself has a lot to do with the ability to collect taxes — tax provisions that are difficult to enforce may reduce tax effort. Tax administration plays a role as well — where voluntary compliance is low and the enforcement mechanism is

\(^1\) Low income countries include Cambodia, Chad, Afghanistan, Bangladesh, Benin, Burundi, Kenya, Haiti, Somalia, South Sudan, Tajikistan, Nepal, Myanmar, and Uganda among others (The World Bank, “Country and Lending Groups,” http://data.worldbank.org/about/country-classifications/country-and-lending-groups/#Low_income). The IMF reports that tax to GDP ratios stayed within a range of 10 to 15 percent from 1980 to 2009.

\(^2\) Because revenues from different sources may be classified differently (as non-tax revenue), it is important to view this discussion in the context of taxes and other tax-like revenues including revenues from special regimes.
weak, tax effort suffers. And finally, among other issues, the legal and political landscape may affect tax effort by enhancing, or detracting from, tax compliance.

In this volume, editors Clemens Fuest and George Zodrow acknowledge the existence of a substantial amount of literature on taxation and development but stress that their approach is to bring together research that focuses on more nuanced issues of tax policy that remain annoyingly difficult to understand. The majority of the chapters of Critical Issues in Taxation and Development address issues related to the taxation of businesses and virtually all chapters incorporate an intuitive theoretical framework backed up by original empirical work. Each chapter does in fact address some variable or variables that affect tax effort, for which we do not have a satisfactory or conclusive understanding regarding the nature of that effect. In addition to the business tax/investment focus, the book includes chapters devoted to federalism and transfers, the role of institutions, and cross-over issues including payroll taxes. Reading through all of the chapters may not result in the ultimate “ah-ha” moment regarding the difficult issues related to business taxation — but taken as a whole, the book takes on a series of often ignored issues and opens up an important agenda for future research while providing a series of important insights into a variety of problems related to revenue mobilization in developing countries.

This volume therefore is different in terms of its content, scope, and implementation than most previous research on taxation and development. In their introductory chapter, Fuest and Zodrow note that this volume does not follow a tradition of looking at all taxes or at several issues related to a specific tax, nor does it focus on the broad issue of taxes and overall economic development. Rather, the book is largely focused on the detailed issues mentioned above. This review will provide a summary of each chapter and identify some of the main threads that permeate the book. I conclude with what I learned from reading the volume, including an agenda for further research for those interested in this important subject.

The chapter by Michael Keen (Chapter 2 “Taxation and Development — Again”) is a good-natured presentation and discussion of the history of advice on revenue mobilization, with an up-to-date view of what really matters. The first section is aptly titled “Developing Countries Differ — Yes, and ...?,” reflecting a serious underlying question regarding what makes sense in terms of reform in developing countries. Throughout the volume, this “difference” argument is not manifested in some new fundamental theory of behavior that pertains to developing (versus developed) countries, but it is reflected in the empirical work which considers the specific context of developing countries and implications for decision making by companies and individuals. Keen reminds us that the economic base, geography, politics, and institutions of developing countries can affect revenue mobilization and efforts at reform. He also briefly reviews the “big ideas” of years past for developing countries, including graduation to direct taxation, implementation of the VAT, and the use of revenue authorities (RAs) and large taxpayer units (LTUs). He suggests that we do not understand well why direct taxation hasn’t taken root and we do not know how effective revenue authorities have been, but he does give the development of the VAT and LTUs good marks across many countries.
In addition, he makes the point that taxing the hard-to-tax (which includes the informal sector as well as non-compliant formal sector activity) should be considered more openly in a cost-benefit framework. Does it make sense to chase down cart vendors where the opportunity cost could be enhanced administrative effort on larger entities? Probably not — yet policy advice often ignores this type of trade-off.

Keen’s final topic in this chapter regards the relationship between state building and revenue mobilization. In this case Keen seems to suggest that the state-building literature gives some support to earmarking revenues and to chasing down the hard-to-tax in order to bring them into the accountability net. I have a minor difference of opinion from that of the author in that he views the latter point as one that could have “profound” effects on tax policy under the state-building perspective relative to what I will call a traditional approach. In fact, much of the traditional literature on the hard-to-tax explicitly discusses the accountability aspect of taxing as an important component of the cost-benefit analysis of devoting resources to taxing the hard-to-tax (Bird and Wallace, 2004). An interesting extension of this chapter might pull together its four major themes/lessons and classify countries on several dimensions — revenue impacting geographical-institutional characteristics, history of direct taxation, use of LTUs, RAs, and the VAT, a “rating” of the size of the hard-to-tax sector, and the level of state-building — to look for more effective and integrated revenue reform approaches. The information from this exercise could be used for econometric analysis of tax effort as a function of the characteristics (measured largely as categorical variables) to shore up some of Keen’s conjectures. Such an exercise would certainly come under scrutiny due to its somewhat subjective classification but would provide a useful starting point. For example, a country such as Jamaica might be characterized as shown in Table 1.

Timothy Goodspeed, Jorge Martinez-Vazquez, and Li Zhang (Chapter 3) and Clemens Fuest, Georgia Maffini, and Nadine Riedel (Chapter 4) provide complementary analytical chapters that examine the interplay among corporate taxes, corruption, and investment. Goodspeed et al. specifically analyze the impact of taxes in the host country on foreign direct investment (FDI) in developing countries. As they note, there is fairly conclusive evidence on the effect of corporate taxes on FDI in developed countries, but very mixed results when assessing the same in developing countries. Many studies find an
<table>
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<th>Geographical-Institutional Characteristics</th>
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<tr>
<td>Scale (low to high)</td>
<td>Openness: 0, 1;</td>
<td>0, 1, 2, 3</td>
<td>0, 1, 2, 3</td>
<td>0, 1</td>
<td>0, 1, 2</td>
<td>0, 1, 2</td>
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<tr>
<td>Jamaica</td>
<td>Openness: 1;</td>
<td>Established: 2</td>
<td>Established: 2</td>
<td>Operational: 1</td>
<td>Mixed use since 1981: 1</td>
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<td></td>
<td>Sound Tax administration: 0, 1, 2</td>
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absence of sensitivity between corporate taxes and FDI in developing countries. Their hypothesis is straightforward — firms treat bribes as a substitute for taxes, watering down the impact of tax variables on investment in standard applied analyses. Where tax administration and the rule of law are weak, payment of bribes in lieu of taxes may be the status quo. In early field work in the countries of the former Soviet Union, my colleagues and I often heard stories from tax administrators where they talked openly of a negotiation process for tax collection that yielded a roughly consistent level of “revenue,” regardless of the details of the tax policy. The “tax collection” did not always end up in the government coffers.

Goodspeed et al. test their hypothesis by comparing the impact of governance (as a measure of corruption) and effective tax on FDI as separate and interacted variables. This strategy allows one to consider taxes and corruption as substitutes or complements. The authors find evidence of the substitution hypothesis — corruption and taxes are opposite sides of a similar coin. The chapter’s analysis and results are very much in the spirit of the book and introductory chapters — developing economies struggle with tax policy that is often layered on top of weak administration and rule of law. Efforts to apply standard theory in the case of corporate taxation might lead us to advise lower tax rates and broader bases. However, the authors note that higher statutory tax rates may be the veil through which bribes can be extracted. A follow-on question is whether the wedge between statutory and effective tax rates in high corruption environments affects FDI. Since tax administration (corruption) is quite difficult to tackle and the veil matters, revenue mobilization might be enhanced by pulling back that veil.

In Chapter 4, Fuest, Maffini, and Riedel investigate a related and in some respects more basic question, which is whether corruption and corporate taxation affect corporate investment in developing nations. Similar to Goodspeed et al., the authors note that existing empirical evidence of the impact of corporate taxes on investment in developing countries is mixed; their empirical analysis finds that higher levels of corporate taxes in developing countries reduce investment while corruption has a more consistently negative impact on the investment of foreign firms.

Fuest et al. use unique annual firm-level data to analyze their hypotheses regarding the impact of taxes and corruption on investment. China features prominently in the data, comprising 82 percent of the firms represented in the data. The authors wisely run their analysis with and without the firms reported in China. Ukraine is also heavily represented (9.2 percent of the firms), which seems a bit odd, but is not explained in the chapter. To estimate the impact of taxes on investment, the authors use the host country’s statutory corporate tax rate. In many countries, there is one “regular” statutory rate. However, in many of the sample countries, there are special regimes that reduce the statutory rate and it is not clear if those special regimes were incorporated into the analysis. Corruption is proxied with two alternative measures — one is Transparency International’s corruption perception indicator and the other is the World Bank’s government efficiency index.

The authors conclude that corruption does hamper investment, particularly in the case of foreign firms. They provide the interesting insight that local firms may be more
accepting of a culture of corruption while foreign companies are more mobile and more likely to invest where there is more transparency. Relating these results to Goodspeed et al., it would be interesting to test the “bribes as taxation” theory at the firm level by interacting corruption and the tax rate. Since the statutory tax instrument may be too blunt to identify the trade-off between taxes and corruption, this would be an interesting extension that could provide further understanding of the corruption-corporate tax-investment relationship.

In Chapter 5, Johannes Stroebel and Arthur van Benthem turn to an important source of revenue for developing countries — hydrocarbon production. The authors note the skewed concentration of hydrocarbon and mineral tax revenues in some developing countries, including Nigeria (78 percent of total government revenue), Angola (76 percent), and Yemen (72 percent). The risks associated with oil exploration, extraction, refining, and distribution give rise to intense negotiations regarding the taxation of this natural resource. Governments may engage private companies in agreements that reduce the volatility of tax payments but Stroebel and Benthem make the point that in many countries, the allure of additional tax revenue in windfall profit situations is too much to resist and windfall profits taxes are imposed or other forms of expropriation may take place once the volume (and value) of extraction is known. In these countries, private oil companies may have little recourse to these actions, which increases the risk associated with mining in these countries.

The authors appeal to a straightforward theoretical model to demonstrate the impact of the increased cost of expropriation on expected private investment. The authors suggest that bilateral and multilateral investment treaties may be vehicles to increase the cost of host country expropriation by subjecting expropriation behavior by the host country to adjudication by international courts. On paper, these treaties provide for a dispute resolution process outside of the host country, thus reducing the uncertainty associated with expropriation of resources when market prices are high.

The authors test the impact of bilateral treaties and the Energy Charter Treaty (ECT) on the nature of the host-home country relationship with respect to investment using data on 2,466 contracts (in 38 countries). The empirical analysis does not test the implications of the existence of these treaties on actual investment, but rather on the level of “oil-price insurance” for the host country. The degree of insurance is calculated for all contracts and is a function of the total undiscounted revenue over the life of the project, the oil price, the change in oil price, and remaining field reserves. The authors find empirical support for their hypothesis that bilateral treaties and ECTs do in fact lead to lower price-risk for the host countries. An interesting extension of this analysis (and, arguably a more direct test of the hypothesis) would be to estimate the impact of the existence of treaties on actual investment. Presumably these data are difficult to obtain.

The complicated nature of corporate taxation is further investigated in Chapter 6 with Boryana Madzharova’s study of the trade-off between corporate tax deductions and payroll tax compliance in Bulgaria. Employee payroll is one of the largest costs for companies around the world, and results in one of the largest deductions under the corporate income tax. It would seem counterproductive for companies to underreport
this deduction. However, in many countries, employee salaries carry another statutory tax burden — that of payroll taxes — with rates that can rival those of the corporate income tax. Payroll taxes are largely used to support public pension programs. Madzharova argues that as corporate tax rates have fallen, the value of payroll deductions from the corporate tax have fallen, and the wedge between the corporate tax “savings” from deductions and the cost of the payroll tax has increased. It is therefore advantageous for companies to concentrate their evasion behavior on reducing reported payroll, increasing their corporate tax marginally but reducing their statutory payroll tax liability substantially in cases such as Bulgaria where the wedge between payroll and corporate rates increased from 10.6 to 19.2 percentage points from 1997 to 2002. Of course, this puts the financing of the retirement system at risk.

Using firm-level data from Bulgaria, the author finds that a 1 percent increase in the payroll net-of-tax share increases reported wages by 0.28 percent. The results of this unique analysis leave us in a somewhat uncomfortable position vis-à-vis policy advice. If reduced corporate tax rates encourage payroll tax evasion, and the payroll tax in many countries is a more administrable tax than the corporate income tax, is the low corporate tax rate mantra misplaced with respect to revenue mobilization? I will return to this point in the conclusion of this review.

Profit shifting by corporations to reduce corporate tax liability has long been hailed as a reason for tax base erosion, but is notoriously difficult to measure and prove. In Chapter 7, Clemens Fuest, Shafik Hebous, and Nadine Riedel use data from German multinational firms to isolate profit shifting through the use of debt shifting among related parties (loans from affiliates in low tax jurisdictions to those in high tax jurisdictions). The authors make an intuitive and theoretical argument that the cost of profit shifting is lower in developing versus developed nations due to the relative lack of administrative capacity.

In the empirical specification, intra-company loans (“debt”) are regressed as a function of the host country’s statutory tax rate. Debt is measured in two ways: (1) the ratio of debt from parent companies and related parties to total assets, and (2) the ratio of debt from parent companies and related parties in Germany to total assets. In both specifications the results show clearly that a higher tax rate in the host country yields higher levels of shifting and that the results are larger in the case of developing countries. In the conclusion to this chapter, the authors return to the question of why developing nations tend to retain somewhat higher corporate tax rates. The implied magnitude of the elasticity of the shifting response is less than one, so the developing host country still obtains higher revenues with a higher tax rate. However, in this chapter the authors examine only one aspect of shifting, and it is plausible that other tools, including intra-company leases and transfer pricing, erode a larger amount of profits. A full picture of income shifting behavior is required to determine the net impact of relative tax rate differentials.

Chapter 8 turns to an often-recommended piece of policy advice regarding revenue mobilization — the use of thresholds to trigger minimum tax payments. Mirko Tonin analyzes two distinct policies. The first is the Italian “Business Sector Analysis” (BSA) which is a hybrid presumptive tool that increases audit scrutiny for certain taxpayers
who report revenues below a threshold. The second is the social security payment system in Bulgaria, where payments are required to be above a certain threshold (utilizing what is effectively a presumed minimum wage). Tonin presents a theoretical model to substantiate the complex relationships among the threshold levels, level of income, audit and penalty rates, and tax rates that affect the optimal threshold level.

The Italian BSA focuses on small and medium enterprises and in 2004 covered 86 percent of taxpayers. The scheme is presumptive in nature in that the firm’s declared revenue is compared to a calculated minimum that is based on a discriminant analysis. The author notes that the scheme does not reduce compliance costs for the taxpayer but is focused on fighting underreporting. There has been no full cost-benefit analysis of the BSA, but Tonin reports that the costs of the system were approximately €7 million in 2004 and, in that year, adjustments made by firms under the scrutiny of the BSA yielded an increase in revenues of €3 billion. This provides some evidence of the cost effectiveness of the Italian BSA approach.

The Bulgarian system, enacted in 2003, applied payroll taxes to a new minimum level of wages determined by imputation across nine occupational groups as an attempt to deal with underreported wages under the payroll tax. The presumptive levels set a new standard for payroll tax payments, presumably whether or not actual compensation was above or below the presumptive levels. In the chapter, there is no evidence presented that attests to the costs or success of the Bulgarian scheme. Tonin does point out that these differentiated minima could affect competitiveness of various sectors if the presumed levels are significantly different from the “true” levels. This would be a very interesting subject for empirical analysis. Tonin also points out that in both cases there is significant involvement of social partners in establishing the thresholds, which may help to provide additional data and also increases the acceptability of the schemes. They provide interesting examples of presumptive methods that may be applicable in other countries and call for additional analysis of their implications for tax compliance.

The final two chapters are not focused on specific taxes but instead are focused on how other institutions can influence revenue mobilization. Chapter 9 by Christian Lessmann and Gunther Markwardt analyzes the impact of decentralization and foreign aid on growth in real per capita GDP using a panel of 41 developing countries. The measures of decentralization used in the chapter are subject to the usual critique — government finance data really do not allow us to determine the actual level of local control and, in this case, expenditure authority and responsibility concerning the type, level, and use of foreign aid. The issue of local control also pertains to revenue decentralization. This is no fault of the authors — it is just a complication of this type of analysis that impacts nearly every cross-country study.

The main findings of Lessmann and Markwardt are that expenditure and decentralization reduce the effectiveness of aid on growth, but decentralization itself is positively correlated with economic growth among the 41 developing nations. The authors cautiously provide a policy suggestion that aid should be targeted to centralized countries that could use the aid to help them through the decentralization process. These relationships are very complex, and accurate and comparable data are difficult to find.
A different interpretation of the results could be that decentralized local governments are not part of the foreign aid conversation within countries receiving aid. In many countries the central governments wield control over large swaths of foreign aid, and they may purposefully reduce the input of subnational governments regarding the use of aid to establish more central control. In such circumstances, the aid may indeed be more wasteful. Measuring the engagement of the subnational governments is critical to understanding the dynamics underlying the results of this chapter. The longevity or growth of decentralization may be a rough proxy for the engagement of subnational governments. In that case, the decentralization variable might be measured as an index, $dec_{i,t}/dec_{i,t'}$ where $t'$ is the first year of the panel. An increase in decentralization may reflect the ability of the subnational governments to engage in the decision making process regarding the use of foreign aid and thus better target the aid — which would increase our understanding of this important dynamic.

In the final chapter, Paola Profeta, Riccardo Puglisi, and Simona Scabrosetti turn to the critical issue of democracy and taxation. As they point out, there is a relatively small literature that analyzes the impact of political institutions on revenue structure. Utilizing a panel data set of 39 countries, the authors test for the impact of demographic institutions on tax structure. When country fixed-effects are included in the estimation, the authors find a significant and positive impact of the strength of democratic institutions on the share of trade taxes and a negative impact of the protection of civil liberties on property tax shares. The authors do not rush to policy pronouncements based on these results, which demonstrates good judgment, given the complicated relationships that are likely among their measures of democratic institutions and tax structure.

Overall the chapters in Critical Issues in Taxation and Development provide us with several new insights, particularly in the case of corporate taxes, and also raise several important issues for future study. The main contributions may be summarized as follows. The corporate income tax is still an important instrument in revenue mobilization, but cutting corporate tax rates may not have the expected impact of increasing investment (and revenue) unless corruption is also reduced. Even if corruption could be addressed, the complexities of corporate tax regimes in terms of transfer pricing and intra-company financing may limit the ability of the corporate income tax to play a significant role in revenue mobilization in developing countries. The lessons of the paper by Stroebel and van Benthen regarding bilateral treaties may be applied to taxes at large and not just to the hydrocarbon industry. The formation of more binding and extensive tax information sharing agreements and systems of tax cooperation could, potentially, reduce the risks associated with investing in developing countries and of paying taxes to those countries. The political will for such cooperation and coordination is not obvious at this time. The book also sounds a renewed call to examine the tax system and not any one individual tax (taking a lesson from the payroll tax in Bulgaria).

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3 The OECD/Council of Europe’s Multilateral Convention on Mutual Administrative Assistance in Tax Matters is a possible model to extend to the developing world. However, there has been little analysis of its effectiveness.
The chapters in the volume suggest a number of areas for further study, including the following: the implications of corruption (does it manifest itself mainly in the corporate income tax or does its influence extend to other taxes as well — for example, how much of an issue is corruption under the VAT?), a fuller analysis of the costs and benefits of various presumptive regimes, and continued attempts to measure the impact of profit shifting on tax bases, among other topics. Some readers of the book may conclude that the corporate tax system is so complex that it cannot be an effective tool for revenue mobilization in developing countries. While Keen’s chapter advises us that tax reform should not pursue the fad of the day and instead requires “persistence and unspectacular effort,” the changing landscape of taxation, particularly the increasing international mobility of capital, the persistence of tax competition, and the availability of well-oiled tax avoidance tools, as discussed in many of these chapters, drives home the point that we may in fact need to think more creatively about taxation in developing countries. Without the benefit of effective international tax cooperation that includes both developing and developed nations, revenue mobilization may be enhanced by further simplifying tax systems and reducing the benefit of avoidance schemes and the veils that allow corruption to substitute for revenue mobilization.

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