



PUBLIC FINANCE

Dealing with Low Income Taxpayers

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Outline

1. Developing country practices are different
2. Institutions matter for incidence
3. Tax policy implications
4. Tax administration implications
5. Conclusions



Three principles (Mirrlees)

- **Lifetime dynamics**

- Misleading to look at current payments of all taxes as a percentage of current income
- ***Lifetime distributional impact***; look at income taxes as a percentage of current income and expenditure taxes as a percentage of current expenditure.

- **Look at the system as a whole**

- For ***progressivity***, we should also look at the ***impact of the system as a whole rather than at its individual components***.

- **Policy drives trade-off between redistribution and efficiency**

- ***Substance over form; it is critical to assess who is actually bearing the economic burden of the tax*** (the legal incidence of a tax can be very different from the economic incidence or who bears the burden)



Tax structures

DEVELOPED VERSUS DEVELOPING

- **Low level of tax-to-GDP ratio**
 - Average tax-to-GDP ratio for LIC is 18.3%, HIC 29.4%
 - The higher tax burden; greater potential for the tax system to redistribute.
- **The higher the level of per capita income, the more countries rely on direct taxes, especially those on personal income**
 - Personal Income Taxes (PIT) play a relatively small role in the tax systems of developing countries
 - PIT is primarily a wage withholding tax on labor in the formal sector. Informal economy is not part of country's tax net
 - Little effective taxation of income from capital for both political and administrative reasons. Difficult to tax capital income from residents because of portfolio assets held outside the country. Additionally, different incentive regimes for taxing FDI
 - Less effective tax administration in the developing countries constrains income tax base
- **Insignificant property taxes**
 - Raises only about 0.6% of GDP, on average, in developing and transition countries.
- **Preeminence in general taxes on consumption - especially VAT**



Developing countries are different

- Different demand and tastes for government services
 - Demand for public services may rise faster than income
- Different capacity to tax
 - The capacity of countries to collect taxes increases as income increases
 - Significant informal economy and agricultural sector; potentially reachable tax base constitutes a smaller portion of total economic activity than in developed countries.
 - What matters is not just the tax base but also the institutional base, especially the extent to which taxpayers trust their governments.
 - **Corruption and poor governance limit the effectiveness not only of taxes but also of public spending (e.g. transfers and other redistributive policies)-linkages provided below:**
 - Other revenue sources, e.g. natural resource revenues, and foreign aid



Taxing low income earners

Doesn't raise much revenue

- About 10-20 percent of the total taxpayers contribute up to 80-90 percent of the total revenues.

It's costly

- Compliance and administrative costs typically high for low income earners.
- Yet tax policy and administration in many low income countries are overly complex.

Developing countries are not well equipped to collect direct income tax

- Public servants become the 'trapped' taxpayers

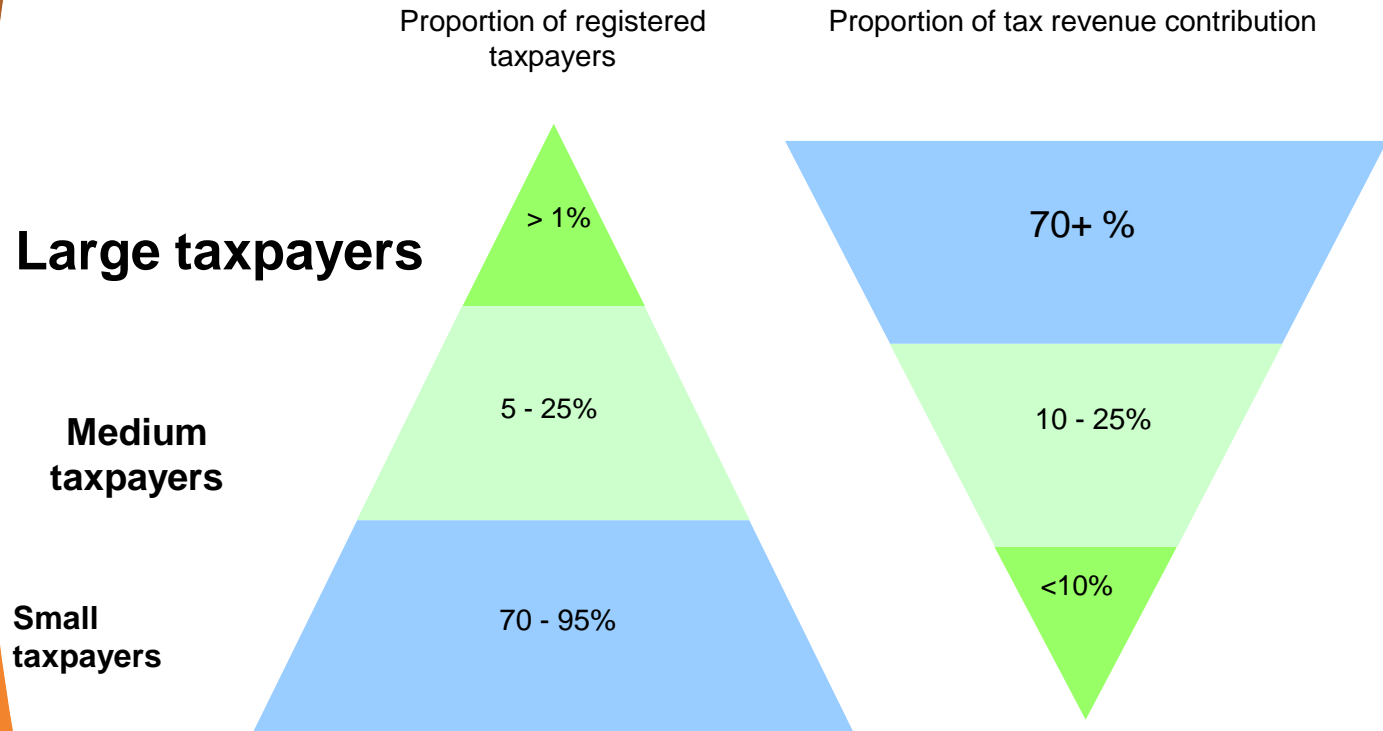
Inequality

- Vertical equity issue – not much ability to pay
- Horizontal equity – lots slip the tax net



Tax collection

LOW INCOME TAXPAYERS DELIVER LITTLE REVENUE



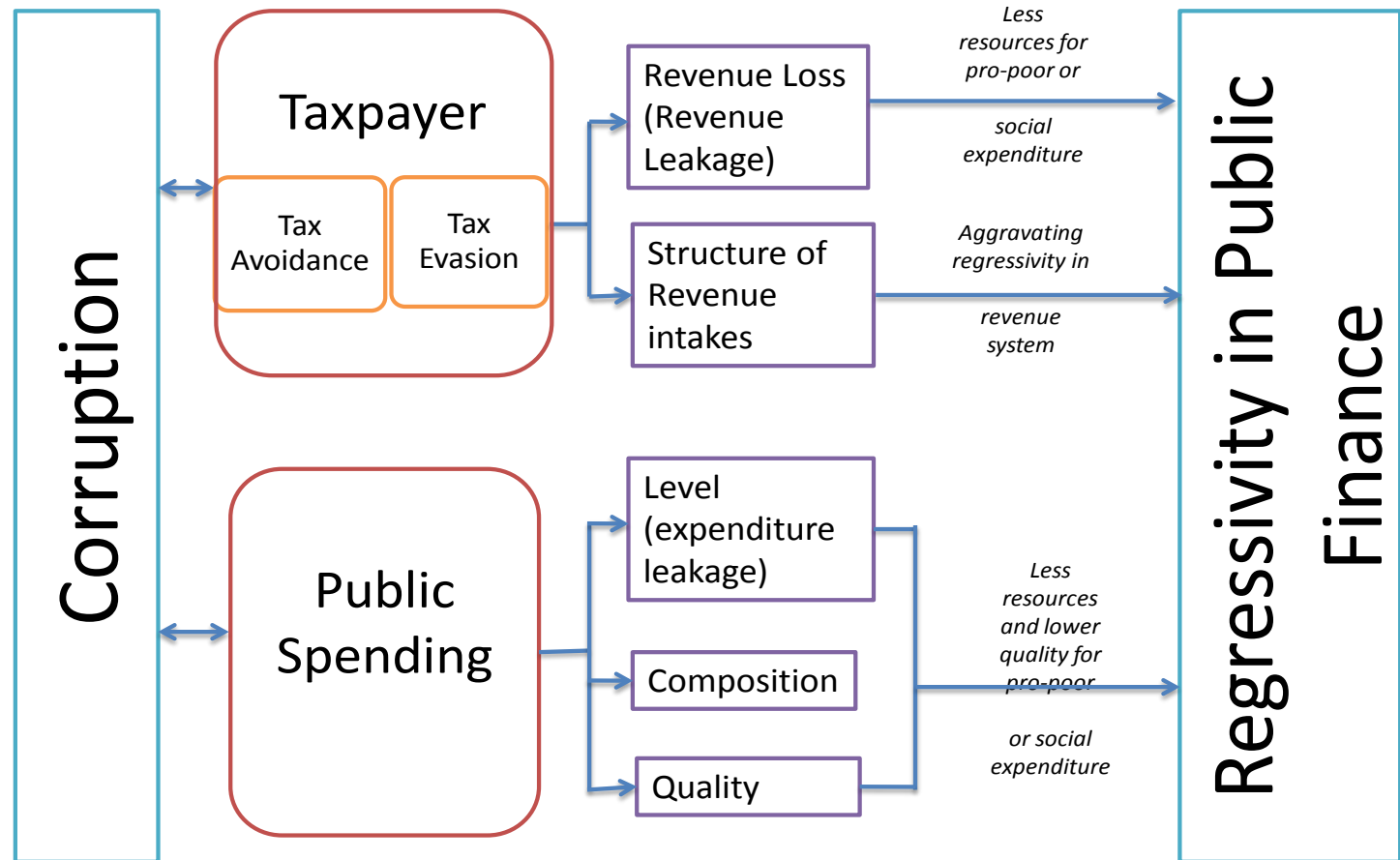
Why tax low income earners

IN DEVELOPING COUNTRIES

- Broadens the tax base (and hence opportunity to lower rate)
- Create fairness in tax regime (equal treatment of those in and outside of formal sector)
- Achieving a politically acceptable degree of fairness in taxation
- Follows principle of a good tax system
 - The benefit principle and ability to pay
- Builds a social contract—taxation induces the public to hold executive to be accountable
 - Distinct but interrelated corruption and shadow economy.
 - Corruption may exert negative impact on the poor through both channels: taxation (loss of revenues and lopsided collection structure – with little to no direct personal income taxes); and public expenditures (lower level of expenditures, lower quality, and less investment in social sectors, particularly health and education).
- Revenue consideration

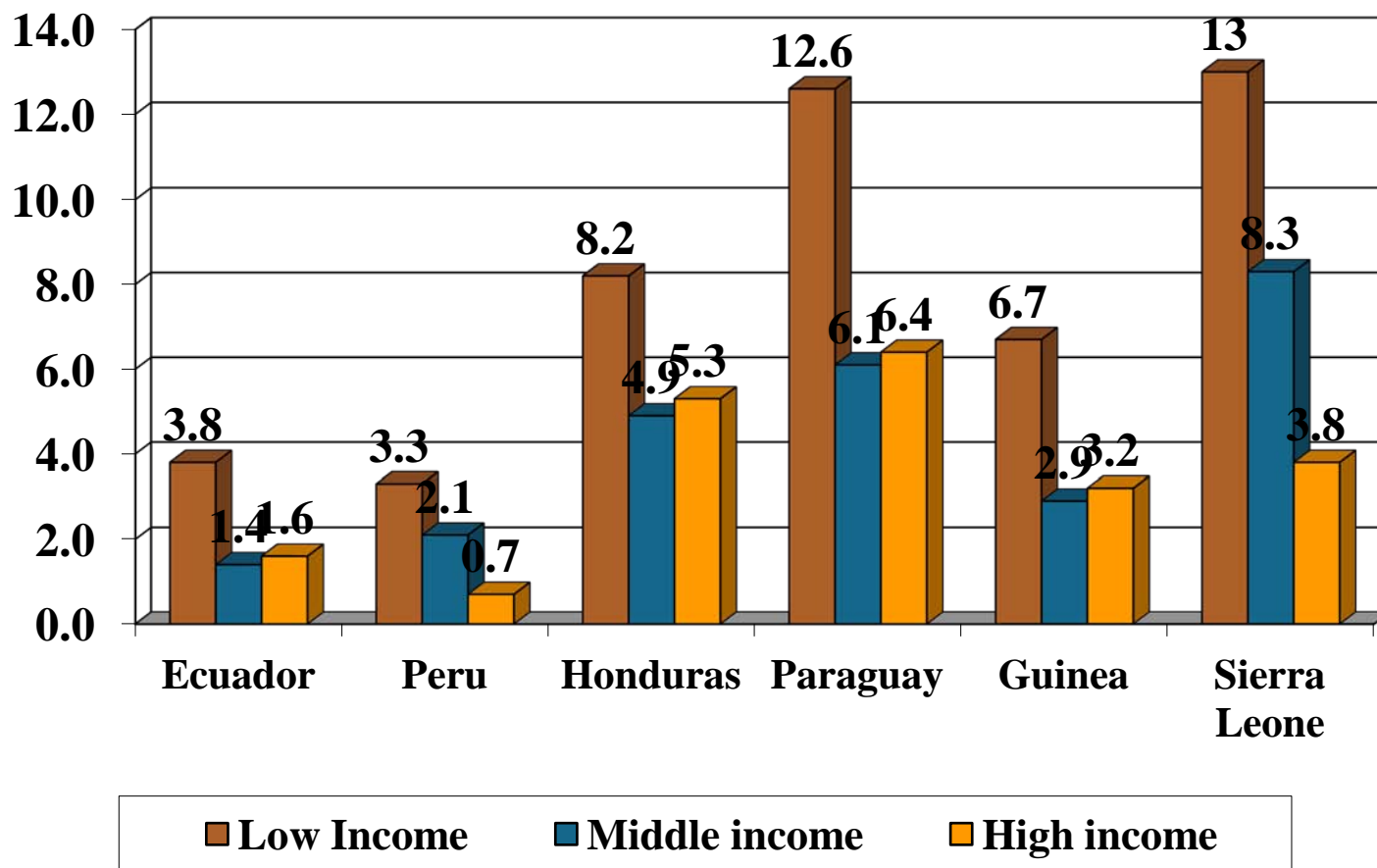


Institutions matter for incidence



Corruption penalizes the poorest most

(% of monthly income paid for bribes as reported by households who sought a public service)



WBI staff calculations. Source: Various Diagnostic Survey for households (1999-2004). <http://www.worldbank.org/wbi/governance/capacitybuild/d-surveys.html>

Figures have been calculated for users who sought a public service and were asked to pay a bribe.

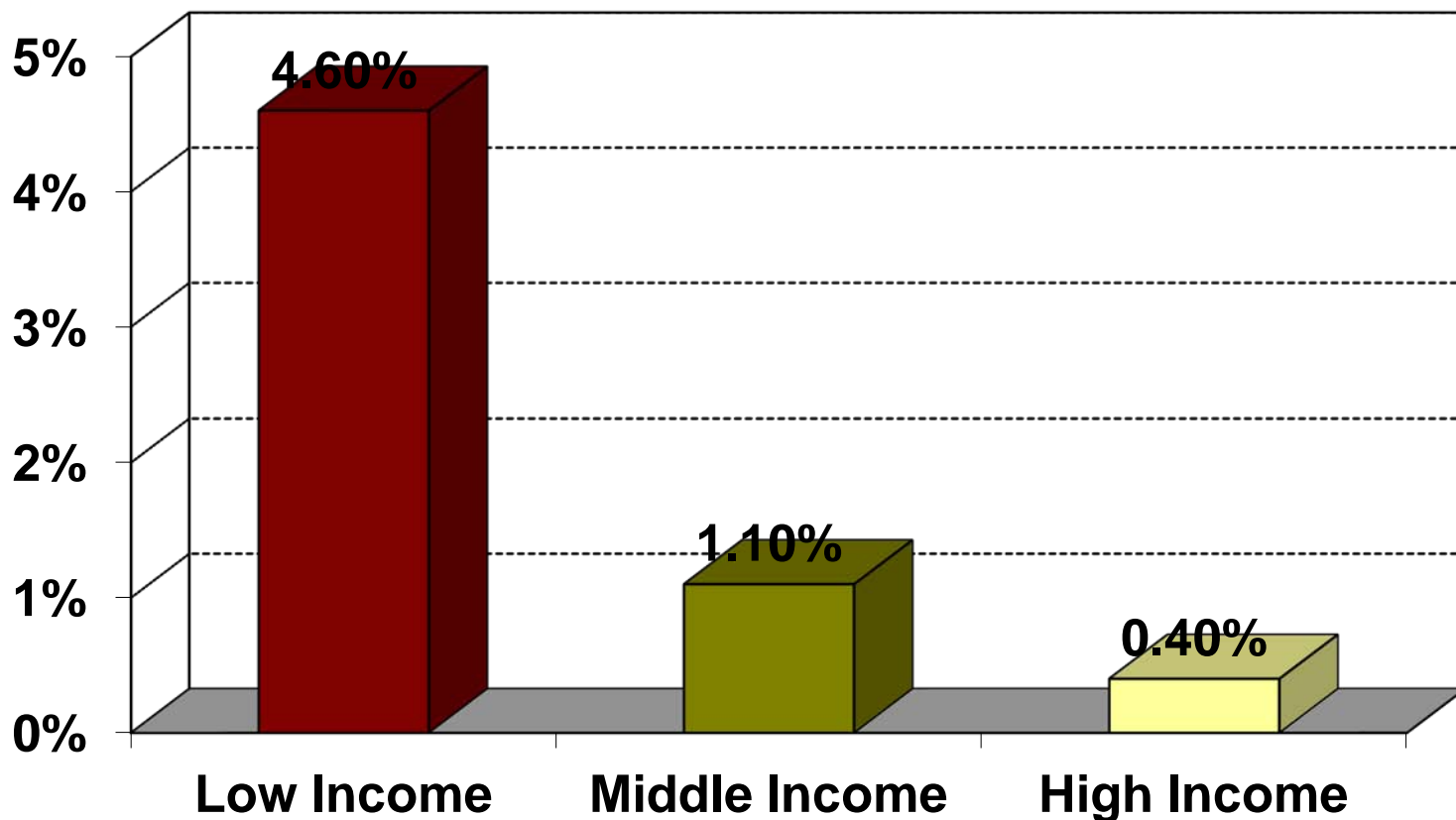
The figures represent the weighted percentage of income spent on bribes by households.



Sierra Leone: Bribes paid to have access to basic medical services

[reported by households]

% of household income spent on gratifications to public health providers



WBI staff calculations. Source: Diagnostic Survey for households, Sierra Leone (2003). <http://www.worldbank.org/wbi/governance/sierraleone/results.html>

Figures have been calculated for users seeking attention at public health Providers, and the question is: On average, how much did you have to pay as gratification each time each time you made an unofficial payment?

Tax Policy for Low Income Taxpayers

DIRECT PERSONAL INCOME TAX

- Worldwide Trends:
 - Reducing personal income tax rates
 - Taxing capital income at the same (or closer) rates as labor income
 - Broad-base, low-rate approach
- Exemption threshold to be considered.
- Inflation index (1) the exemption threshold, (2) credit allowance, and (3) income tax bracket.
- Progressivity of income taxes leads to “perceptions” of fairness (not always feasible in developing countries)
- Minimizing tax concessions expands the tax base and can reduce inequalities
- Fewer tax rates discourage corruption and evasion (progressivity difficult to implement)
- Higher personal income tax minimum threshold levels lead to fairness and easier tax administration without affecting much tax collections



Tax Policy for Low Income Taxpayers

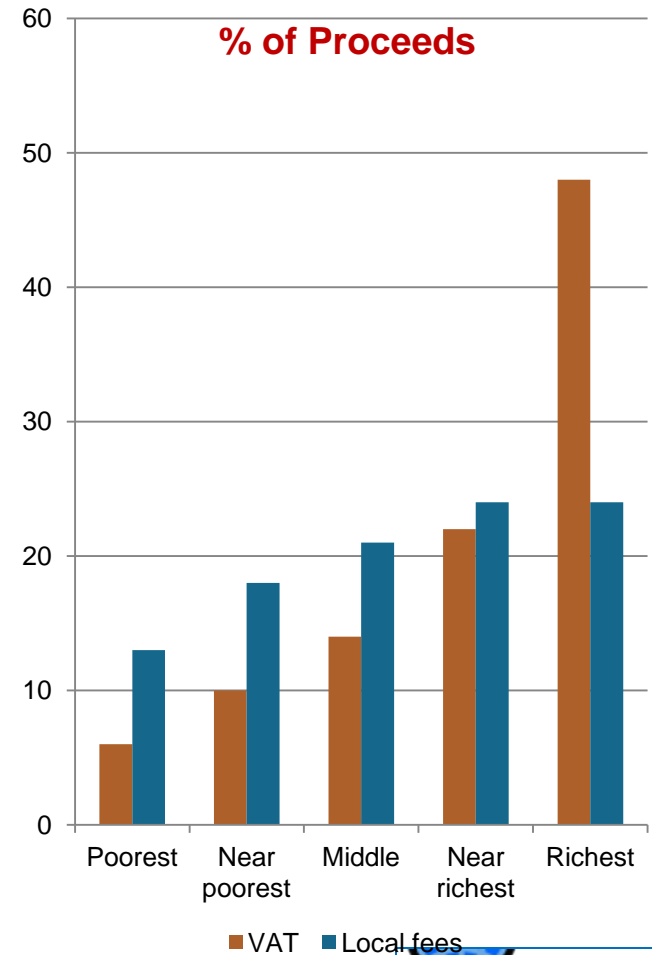
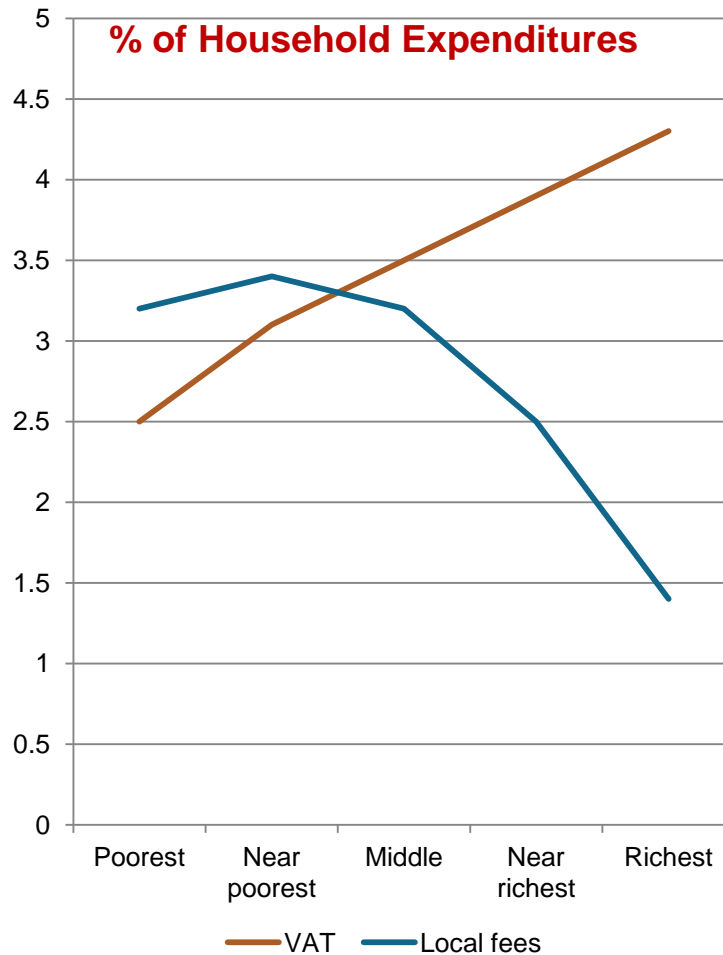
INDIRECT TAXES

- **VAT is not always regressive**
 - Reduced rates on basic consumption goods lower the burden on the poor without affecting tax collections much
- **But avoid complex structure**
 - Such as multiple rates, multi-exemptions and multi zero rate application (i.e., applying the zero rating to other sectors than exports).
 - More progressivity but at cost of revenue and high collection costs.
 - Deal with equity from other indirect taxation:
 - Simplified VAT regime and add on excise with high rates on luxury goods.
- **Fuel taxes**
 - Difficult due to the consumption of petroleum products by low-income taxpayers



Vietnam

COMPARING VAT WITH LOCAL FEES



Source: Vietnam Development Report 2005

Tax Policy for Low Income Taxpayers

AGRICULTURE

- Information costs are reduced if agriculture is taxed at the local/subnational level
- Compliance incentives exist when taxes paid are jurisdictionally retained for provision of productivity-enhancing local public goods

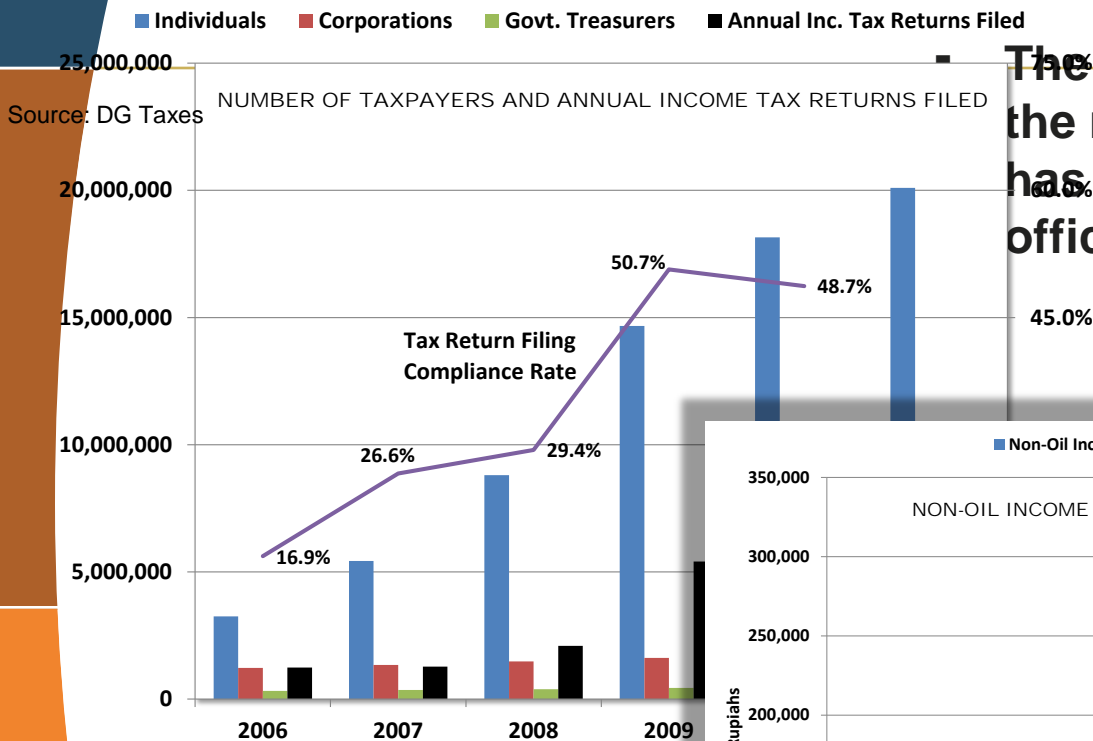


Administration

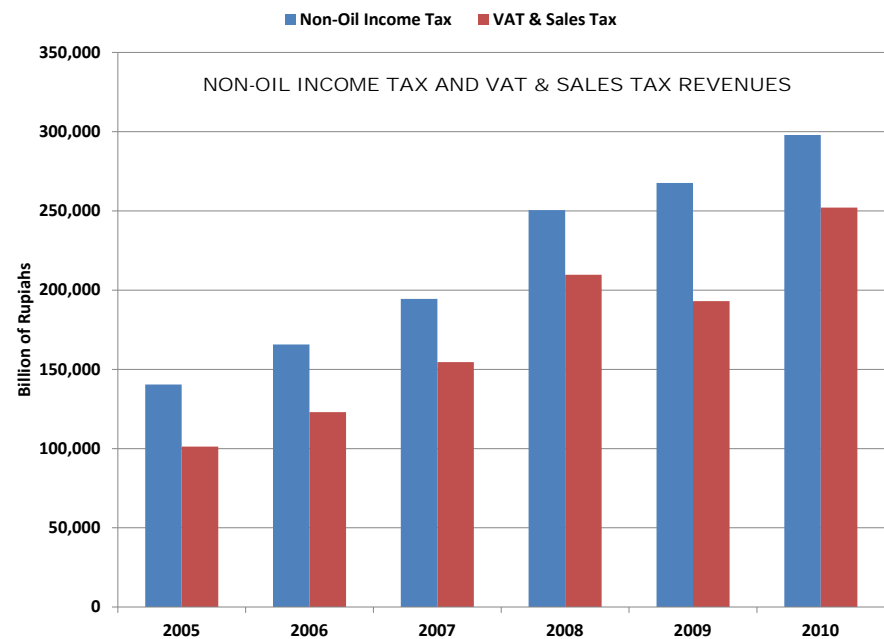
- Segmentation by taxpayer groups (big/medium/small or low income earners):
 - Each has own compliance characteristics and risks
 - Simplified administration procedures to lower costs of compliance and collection.
- Drive anti-corruption measures in revenue administration
- Increased capability to monitor activities;
- Paid preparers - not much of an issue in developing countries.
- In developed countries, demand for preparers likely to be from better-off families
 - Tax administrations should provide additional systems to low income taxpayers with less access to advisors
 - The poor want to use them in expectation to receive the tax benefits (earned income tax benefits/negative income tax) or other social subsidies available.
 - The rich want to use them to cut net income and thereby lower tax liability.
Sign that the tax laws typically complex and making the cost of compliance higher.
 - Tax administration/states need to provide easy access to support low income group to file tax returns/comply...
- KISS



... It's a long haul - registered taxpayer and tax return filing compliance improved ...



The significant increase in the number of taxpayers has put pressure on the tax office processing capacity



... and nominal revenues continued to grow ...

Source: PINTAR

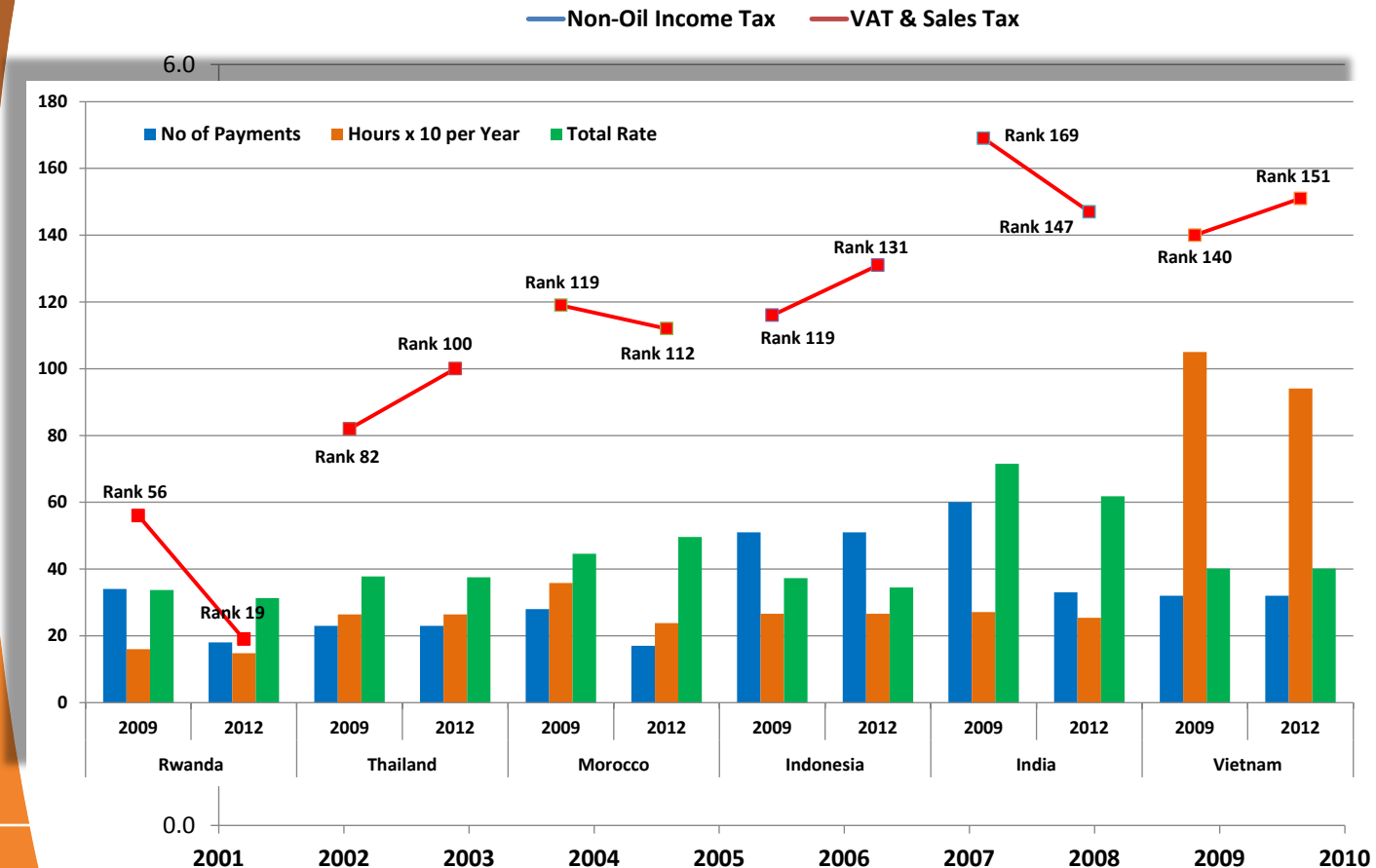
Source: DG Taxes

...tax administrators face lots of challenges ...



... tax revenue to GDP ratio remains flat ...

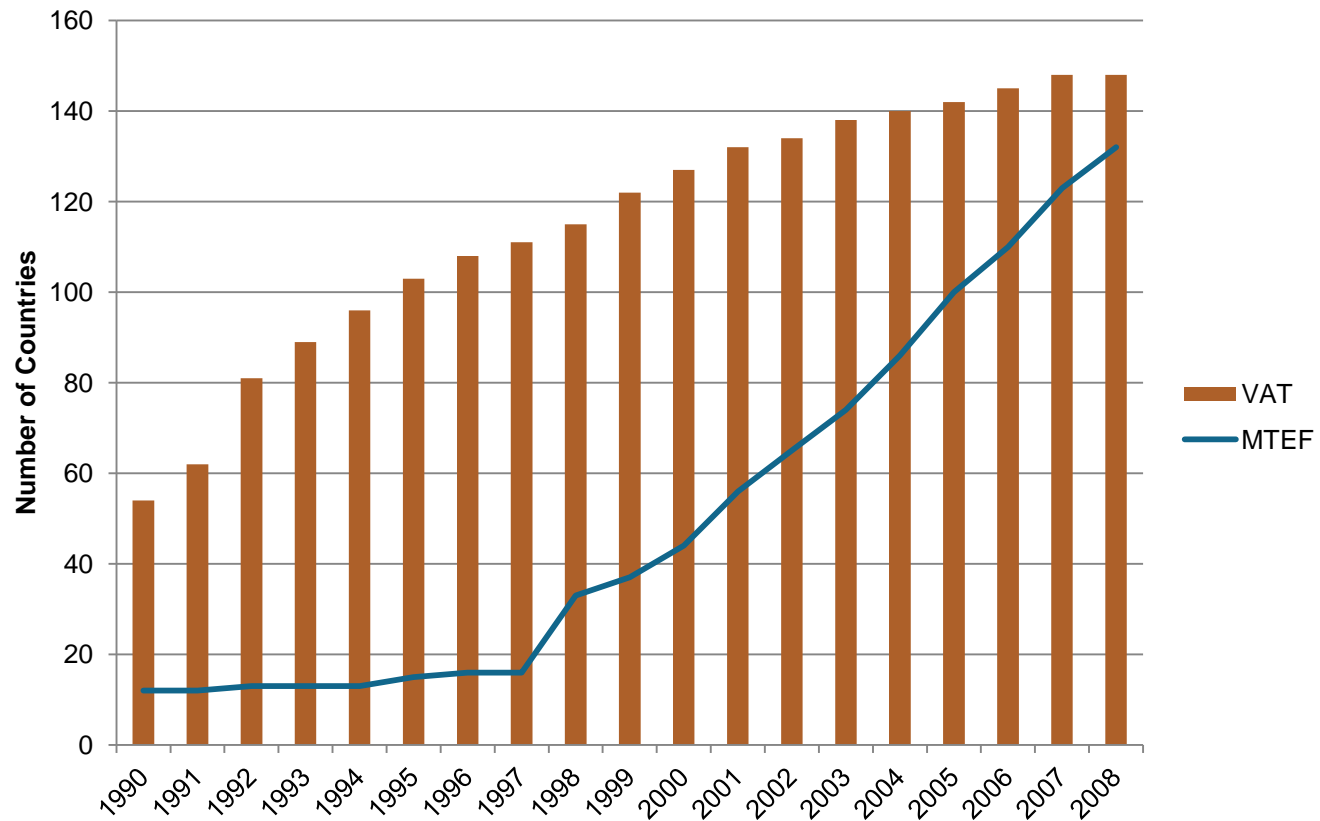
... and rankings do not move favorably for paying taxes in 'Doing Business' Source: PINTAR



Institutional advances

MTEF/VAT: GOOD INSTITUTIONS BEGET GOOD INSTITUTIONS

Spread of MTEF and VAT, 1990-2008



Dealing with Low Income Taxpayers: Final Remarks

- The challenge is greater in developing countries due to a stronger dependency on indirect taxation
- Both tax policy and tax administration can contribute to distribute the tax incidence burden equitably
- Tax policy options promoting fairness should also enhance revenue collection as high income taxpayers avoid/evade more
- But it is not solely about tax



- Thanks

