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in Emerging Countries**

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# *The BBLR Approach to Tax Reform in Emerging Countries*

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## **Abstract**

Fiscal experts have years proposed a holy trinity of tax reform options for developing countries: broader bases, lower rates, and better administration. The review in this paper of fifty years of experience suggests that what might be called the BBLR approach-- broader bases and lower rates -- to tax structure reform holds up fairly well. Nonetheless, some qualifications to the basic BBLR approach are suggested and the continuing fundamental importance of understanding and improving tax administration is stressed.

*Keywords:* tax reform, tax bases, tax rates, tax administration

*JEL classification:* **H20, O23, P41**

## Introduction

No one likes taxes. People do not like to pay them. Governments do not like to impose them. Unfortunately, taxes are necessary both to finance desired public spending in a non-inflationary way and to ensure that the burden of paying for such spending is fairly distributed. Since even necessary taxes impose real costs on society, good tax policy seeks to minimize those costs. Tax policy is not just about economics, however. It is also about justice and hence reflects such political factors as the degree of concern about fairness. In many countries, the increased economic growth of recent years has increased disparities between the rich and the poor. How people see the distributive effects of tax systems matters. In the end, however, no matter what any country may *want* to do with its tax system, or what it *should* do from one perspective or another (ethical, political, or developmental), in reality what it *does* do is always constrained by what it *can* do. A country's economic structure and its administrative capacity as well as its political institutions all tend to reduce the tax policy options available. Nonetheless, some options almost always exist. The holy trinity of tax reform options proposed by most fiscal experts for developing countries are broader bases, lower rates, and better administration. I begin the review of these options by considering what gets taxed – the tax base.

## **Broadening Tax Bases<sup>1</sup>**

Developing countries face many difficult challenges in designing and implementing suitable tax systems. Many countries (like India) have large traditional agriculture sectors that are difficult to tax. Other significant components of the potential tax base lurk in other equally “hard-to-tax” sectors ranging from small business and the informal economy to cross-border investments. The traditional tax base afforded by international trade has also become increasingly hard to exploit in the face of pressures for trade liberalization. On the other hand, economic growth generally expands tax bases and such growth is often encouraged by (and usually results in) closer involvement with the international economy.

As countries develop, the mass modern production and consumption activities on which the tax systems of developed countries rest -- taxes on wages and personal income, on corporate profits, on value-added -- expand. This base needs to be reached without either overstraining administrative capacity or unduly discouraging the expansion of such activities. However, the leading edge of growth -- outward-oriented development -- may become the bleeding edge of the fiscal system as it becomes more and more difficult to levy taxes effectively on capital income, thus potentially exacerbating internal inequalities and political pressures on the tax system. Life is not easy for tax people in developing countries, and it is not becoming any easier.

As World Bank (1991) argues one important aspect of good tax policy is to minimize unnecessary costs of taxation and one important way to do so is to make tax bases as broad as possible. A broad-based consumption tax, for example, will still

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<sup>1</sup> Some of the ideas contained in this paper were also discussed in my recent NIPFP lecture (Bird 2008), although the focus of that lecture on the political economy aspects of the process of tax reform was very different from the more substantive focus of the present paper.

discourage work effort, but such a tax will minimize distortions in the consumption of goods if all or most goods and services are subject to tax.<sup>2</sup> It has also been long argued that the tax base for income tax should also be as broad as possible, treating all incomes, no matter from what source, as uniformly as possible, although some recent discussion is beginning to cast increasing doubt on this once conventional piece of wisdom.<sup>3</sup>

### **Growing Tax Bases**

Much discussion of taxation in developing countries seems to assume, as it were, that “unto each a base (or bases) is given.” If the tax base is indeed ‘given’ then the only policy issue to be addressed is how it can be best exploited -- for example, by reducing exemptions and by bringing non-payers into the tax net. In reality, however, tax bases are not simply ‘given’: they can be ‘grown’ – or destroyed – through the manner in which a given tax burden is collected. Taxes may, for example, discourage, or encourage, the ‘formalization’ of the economy, they may foster or discourage the growth of such ‘tax handles’ as imports, or they may be used to shape and direct economic growth into particular channels in a variety of ways and for a variety of purposes. As Emran and Stiglitz (2005) have recently reminded us, in the long run the manner in which (and from whom) taxes are collected may affect not only growth and distribution but also the future

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<sup>2</sup> In theory, in order to minimize efficiency losses different tax rates should be imposed on each commodity, with higher rates imposed on those goods and services where the changes in behavior are the smallest. To do so, however, requires much more information about how taxes alter behavior than is available in most countries. Moreover, this approach does not take administrative and equity concerns into account. For these reasons, in practice it seems generally advisable to impose a uniform tax rate to the extent possible. A few items, such as gasoline, tobacco products and alcohol, may be taxed at a relatively higher rates, either because of regulatory reasons or because the demand for these products is relatively unresponsive to taxation. Such taxes can be designed to avoid excessive regressivity.

<sup>3</sup> See e.g. Boadway (2005) and Barreix and Roca (2007). I explore this question in more detail in a forthcoming paper with Eric Zolt.

level and mix of revenues itself.<sup>4</sup> The long-run ‘fiscal impact’ (or ‘revenue productivity’) effect of tax policy and administration decisions needs careful attention.

Consider, for example, four questions often raised with respect to the challenges facing tax policy in developing countries:

1. Should more reliance be put on consumption than on income taxes?
2. Are broader tax bases always better than narrower bases?
3. Should tax policy be designed to reduce the size of the ‘informal economy’?
4. What should be done with tax incentives?

Until recently, the answers of most fiscal experts to these questions were more or less that: (1) consumption taxes are better; (2) so are broader bases; (3) every effort should be made to tax the informal sector; (4) and, finally, tax incentives are almost always a bad idea. How do these answers hold up in light of recent analysis and experience?

## **Taxes and Growth**

Over the past 50 years, there have been many policy prescriptions for economic growth (Easterly 2002). Policy advisors have (in rough chronological order) urged increased capital investment, improvements in education, population control, reduction of government controls on market activities, and loan forgiveness programs as “silver bullets” that would result in improved economic performance in developing countries. Unfortunately, none of these cures has worked as advertised. Similarly, there is no magic tax strategy to encourage economic growth. Some countries with high tax burdens have

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<sup>4</sup> Much the same inference can be drawn from such other recent papers as Auriol and Warlters (2005) and Gordon and Li (2005). For a slightly different take on this issue, see the recent survey by Bahl and Bird (2008).

high growth rates and some countries with low tax burdens have low growth rates. Looking at the relationship between growth rates and tax rates in the United States over the last 50 years, for instance, reveals that the U.S. had its greatest periods of economic growth during those years where the tax rates were the highest (Slemrod and Bakija 1996). This does not mean that high tax rates are the key to economic growth since growth rates might have been even higher in those years with high tax rates if the rates had been lower. But it does suggest that there is still much that we do not understand about the relation between taxes and growth.

Nonetheless, if one tried to visualize a purely growth-oriented tax system it might perhaps be one would be one with a relatively low and stable tax on profits and some taxation of the traditional agricultural and informal sectors, but with major fiscal reliance being placed on a broad-based consumption tax that makes some allowance for necessary consumption. What would likely be conspicuously missing in any such design is any explicit concern for fairness in taxation. I return to this point later.

*Consumption or income?* Even from a growth perspective, however, some modifications to the conventional answers summarized above seem required. First, should taxation focus more on consumption than income? In general, Yes: but there is not all that much difference between the two in the context of most developing countries, and some “consumption” in national accounting terms is really “investment” from the growth perspective and hence should not be taxed.<sup>5</sup> Moreover, even though many emerging countries get little or no revenue from taxing capital income, their tax systems may nonetheless have high adverse effects on investment and growth owing to the high

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<sup>5</sup> The careful early work of Carl Shoup (1965) on this subject deserves more attention than it has received.

effective tax rates imposed at the margin (Mintz 2006). Nonetheless, as discussed below, income taxes also have a distinctive role to play in a "good" tax mix.

*Broader base?* Should bases be broader rather than narrower? Often the answer is again Yes. Sometimes, however, as in the productive consumption case and perhaps also in the capital income case broader may be worse.<sup>6</sup> If people lack food to eat or basic clothing and shelter and they are not sufficiently healthy and educated to engage in productive work, they are unlikely to be economically productive. For example, sometimes excluding items that constitute a significant fraction of the consumption of poor people from the VAT base may be a perfectly sensible growth-facilitating policy, although developing and implementing a finely nuanced VAT structure along these lines is a tricky exercise (as Bird and Gendron 2007 discuss in some detail).

Growth in the sense of enhancing the productivity of the labor force and equity in the sense of not taxing the poor may thus sometimes be fully compatible objectives. In addition, from a broader perspective societal disaffection with the inequities accompanying growth may sometimes require a degree of visible fiscal correction in order to make growth-facilitating policies politically feasible. Poverty alleviation is more a task for expenditures than for taxes. At the very least, however, heavy taxes on items that constitute major consumption expenditures for the poor should be avoided.

*Tax informality?* Should taxes be used to punish the informal economy? Yes, but again great care is needed in both design and administration. While even a bad tax on a

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<sup>6</sup> There is also a strong case for heavy narrow excise taxes on a small range of products both in economic and revenue terms. Essentially, a good excise tax system is one that (1) taxes few products, (2) taxes those products correctly, and (3) is administered well. Most excise systems in developing countries fall well short of this standard. Excises are imposed on too many products; the rate structure is not logical; and administration leaves much to be desired. The result is all too often a complex structure that produces less revenue and more distortions than it should and is not well administered: see Cnossen (2006).

good base may sometimes be a good idea (Auriol and Warlters 2005), care must be taken to ensure that the "good" does not become the enemy of the better, as Sally Wallace and I have elsewhere discussed in detail (Bird and Wallace 2004). An easier task than taxing those in the informal sector is to remove the many barriers created by tax and regulatory systems discouraging people from entering entering the formal sector. A recent World Bank (2008) publication, for example, places India near the bottom of the list with respect to the costs to formal business of complying with tax system: this is obviously not conducive to economic growth.

*Tax incentives?* What should be done with tax incentives? In this case, there is no reason to add a 'but' to the conventional answer: eliminate them. Despite their continuing popularity, the evidence is -- as these things go in the social sciences -- virtually overwhelming: tax incentives are usually redundant and ineffective: They reduce revenue and complicate the fiscal system without achieving their stated objectives efficiently or effectively. Excessive use of tax incentives complicates administration, facilitating evasion and corruption. Once created, concessions usually prove hard to remove and are often enlarged at the initiative of taxpayers who lobby for more concessions or simply redefine existing concessions in unforeseen and presumably undesired ways.

Elsewhere (Bird 2000) I have suggested that to maximize the likelihood of beneficial results from tax concessions and to reduce the damage that may be caused by poorly-designed and implemented incentives, countries should at the very least stick to three simple rules:

(1) Keep it simple: incentives should be as few in number and as simple in structure as possible.

(2) Keep records on who receives what concessions and at what cost in revenue forgone and also, if the incentive is intended to achieve some particular objective, on the measurable results. In the absence of such information, government is simply throwing money away.

(3) Evaluate the the numbers at regular intervals to determine whether the incentive is achieving results worth its estimated cost and, if it is not, eliminate it.

Unfortunately, almost no country follows these simple prescriptions, presumably because the political advantages of ambiguity outweigh the potential social gains from transparency. Developing countries cannot waste public money like this.<sup>7</sup> Much more needs to be done to assess and evaluate tax incentives on the basis of evidence instead of relying on the largely unwarranted faith in their efficacy evidenced by their proliferation around the world.

## **Lowering Tax Rates**

Countries can increase revenues in only three ways: raise rates, expand bases, and improve administration. Raising rates within the existing system is the most obvious approach. It is also often the most politically acceptable approach. On the other hand, it is generally the least economically desirable solution. Raising rates when traditional tax bases are not expanding, when new bases can shift abroad, and when administration is weak is unlikely to increase revenue much. Even if revenues do increase, so may

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<sup>7</sup> Of course, in some instances as Bates (2007) emphasizes, such ways of putting public money into private pockets may be a pay-off required to keep the current politicians in power so from their point of view it may not be a waste of money – it's not their money, after all. But it is still a social waste.

inequity and inefficiency. Distortions associated with taxation increase (broadly) with the square of the tax rate, so inefficiency increases with rate increases, especially those affecting economically mobile sectors such as foreign investors. Horizontal inequity may also increase because only those few unfortunates trapped within the tax system bear the burden. When those who comply are penalized and those who cheat escape, a country is not on the path to building a sustainable state revenue system. Moreover, if as seems often to be the case, it turns out to be most expedient to increase taxes most on the politically weaker segments of society, vertical inequity may also be exacerbated.

While as noted earlier statutory rates do not necessarily tell the tale -- effective rates are what matters for many purposes -- the experience of recent years suggests that many countries have been listening to the conventional BBLR advice or, more likely, emulating the neighbors. Statutory income tax rates have in general declined strikingly around the world in recent decades. Although in most countries VAT revenues have replaced declining trade taxes (and excises) and not income taxes, concern has been expressed over this trend by those who view income taxes as the only flag under which tax progressivity sails.

I have some sympathy with this proposition. Historically, reliance on the income tax has indeed been seen as “a mirror of democracy” (Webber and Wildavsky 1986, 526). However, I do not agree that the reduction of nominal income tax rates is always or necessarily a politically and socially retrogressive move. Taxes impose real costs on society as a whole. Developing countries (in which resources are by definition scarce) should strive to keep such costs as low as possible in order to free resources for socially desired objectives.

## **The Costs of Taxes**

Of course, taxes are not themselves a cost but simply a means of transferring resources from private to public use. Economic costs arise only when total resources available for society's use, whether for public or private purposes, are reduced by taxes. There are several ways taxes can reduce the size of the economic pot from which all must draw.

*Administrative costs.* To begin with, it obviously costs something to collect taxes. The actual cost of collecting taxes in developed countries is (very) roughly 1 percent of tax revenues. In developing countries, the costs of tax collection may be substantially higher: Gallagher (2004) reports administrative costs ranging from 0.9 to 3.9 percent for six developing countries; Warlters and Auriol (2005) report results for an additional nine countries in the range of 1.1 to 3.6 percent.

*Compliance costs.* Taxpayers also incur compliance costs over and above the actual payment of tax. Third parties also incur compliance costs. One of the few reported studies of compliance costs in developing countries (by Chattopadhyay and Das Gupta 2002, for the Indian personal income tax) found compliance costs to be more than ten times higher than in developed countries. Similarly, Shekidele (1999) found compliance costs for excises in Tanzania to be more than 15 times higher than similar costs in more developed countries. Costs of paying taxes are generally considerably higher in poor than in rich countries for several reasons. One is the sheer complexity of their tax structures and the cumbersome administrative methods employed. Another is because compliance costs are sensitive to the stability of tax legislation as well as to such changes in

the external environment as inflation, and such factors are more prominent in developing countries.<sup>8</sup>

*Efficiency costs.* Finally – and the major concern of most economists -- taxes impose “deadweight” (distortionary) costs that alter decisions made by businesses and individuals as the relative prices they confront are changed. In most circumstances, the resulting changes in behavior reduce the efficiency with which resources are used and hence lower output and potential well being.<sup>9</sup>

Virtually all taxes affect resource decisions at the margin. Consumption taxes, such as the value-added tax, may discourage the consumption of taxed as opposed to untaxed goods (e.g. housing). Taxes on gasoline, alcohol, and cigarettes may reduce the consumption of these items.<sup>10</sup> Income taxes, because they tax the return to savings, may alter the amount of savings or the form in which savings are held. Failure to tax capital gains until they are realized (when the asset is sold) encourages the holding of assets (lock-in effect). Taxes may also affect investment, and such effects may be especially important when economies are more open to trade and investment. Foreign investors may choose to locate their activities in a particular country for many reasons -- the

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<sup>8</sup> Compliance and administrative costs may sometimes be substitutes to some extent – e.g. when taxpayers are required to provide more information, thus increasing their costs while presumably reducing the administrative costs that would otherwise be incurred to secure that information. On the other hand, administrative and compliance costs may also be complementary, as when a more sophisticated administration both requires more information and makes use of it to undertake audits and other actions.

<sup>9</sup> There are exceptions. First, when taxes are ‘lump sum’ – i.e. the tax burden is the same regardless of behavioral responses – there are no distortionary effects. But such taxes are of no importance in the real world. Second, to the extent that taxes fall on economic rents – payments to factors above those needed to induce them into the activity concerned -- they may not affect economic activity. Well-designed taxes on natural resources and land, for example, may thus to some extent produce revenue without economic distortion. Finally, some taxes may not only create no distortions in economic behaviour but may even induce desirable behaviour. Certain environmental levies, for example (even such crude proxies such as taxes on fuel), may to some extent have such effects. “Good” taxes – those with no bad economic effects – should of course be exploited as fully as possible, but most revenue needed to finance government inevitably gives rise to efficiency costs.

<sup>10</sup> As noted earlier, not all such effects need be bad: for instance, if tobacco consumption falls, people may live longer, healthier and more productive lives.

relative costs of production, access to markets, and sound infrastructure -- but taxes may also influence their choice. When taxes lower the after-tax return on investments, the level of investment and hence growth is lower than it would otherwise be. Corporate income taxes may also influence the decision to incorporate, the composition of a firm's capital structure (use of debt or equity financing) and dividend policy.

The importance of such tax effects is a matter of considerable debate, but the current consensus is that they are much more important than was earlier thought. Efficiency costs of taxation in developed countries are usually estimated to be some multiple of the administrative and compliance costs mentioned above. The lowest estimates of the efficiency costs of taxes for developed countries are at least 20-30 percent of revenues collected, and much higher estimates (ranging well over 100 percent) are common in the literature (Auerbach and Hines 2002).

Such estimates are both hard to make and controversial. Nonetheless, unless public expenditures produce social benefits at least equal to the 'marginal cost of public funds' (MCF), they are by definition not worth what they cost. A recent study found the average MCF in 38 African countries to be close to those found in a number of developed countries, namely, around 1.2 (Warlters and Auriol 2005).<sup>11</sup> This implies that the last (marginal) dollar spent by the public sector would have to yield at least \$1.20 in public benefits – more if compliance costs were taken into account – in order to be worthwhile.

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<sup>11</sup> Warlters and Auriol (2005) do not take compliance costs explicitly into account. They suggest that the similarity observed between developed and developing countries may result from two offsetting factors. First, developed countries tend to have higher taxes and heavier reliance on income taxes, both of which are associated with higher MCFs; second, developing countries tend to have higher administrative costs and larger informal sectors, both of which are again associated with higher MCFs. An additional factor, which also cannot easily be taken into account in the CGE framework used for MCF estimates, is that, as Shah and Whalley (1990) argue, since economic rents are more prevalent in the fragmented economies of developing countries, many taxes that might in more integrated market systems impact economic margins may fall on such rents and hence create less distortion.

Whatever their size, efficiency losses from taxation are real. However, they are not directly visible: they arise essentially because something does not happen -- some activity did not occur or occurred in some other form than it would have in the absence of the distortionary tax. Output that is not produced is nonetheless output (and potential welfare) lost, so poor countries need to design taxes to minimize such possible adverse consequence. Unfortunately, the absence of visible concrete evidence means that there is seldom much political weight behind this concern.

One way to reduce the costs of taxation is to shift to consumption taxes (VAT) instead of income taxes, since this will reduce the extent to which taxes affect the location of businesses, alter the production techniques, or change the forms in which business is conducted. However, as I emphasize shortly, personal income taxes are often politically essential as the primary indicator of the importance governments attach to fairness. Moreover, countries with personal income taxes need to tax corporate income also to prevent tax avoidance by individuals as well as to collect taxes from foreign-owned firms.

To the extent that efficiency costs of taxation result from rational policy decisions (for example, to redistribute income through the fiscal system), they may be worth incurring. A key question is thus whether the income tax is in fact an effective redistributor. If it is, the efficiency cost of taxation may be worth paying -- though one should of course still strive to reduce administrative and compliance costs. But if progressive income taxes do not do much for distribution, and are unlikely to do so except by incurring very high costs, then presumably countries can reduce rates to reduce their marginal distortionary effect at little loss in terms of distribution.

## Progressivity and Fairness

Fairness is a key issue in designing any tax regime. Indeed, from one perspective, taxes exist primarily to secure equity. National governments do not need taxes to secure funds: they can simply print the money required to fund operations. The tax system may be viewed as a mechanism designed to take money away from the private sector in as efficient, equitable, and administratively inexpensive way as possible. Of course, what is considered equitable or fair by one person may differ from the conceptions held by others. Some may stress horizontal over vertical equity, for example, as OECD (2006) argues is increasingly true in developed countries. Others may tilt the balance the other way, as ‘progressive’ thinkers have long done.

Broadly, *horizontal equity* requires those in similar circumstances to pay the same amount of taxes, while *vertical equity* requires appropriate differences among taxpayers in different economic circumstances. Those who have the same ability to pay should of course bear the same tax liability; equally, fairness would seem to require those taxpayers with greater ability to pay to pay relatively higher taxes. Both concepts have appeal. Unfortunately, neither is very useful in actually setting up a tax system.

I consider here only the question of whether ‘growing’ governments in developing countries on the basis of VATs rather than income taxes is an inherently bad idea.<sup>12</sup> First, I ask whether even progressive income taxes in developing countries are very redistributive: the answer is – not much. Second, I then ask whether VATs in such countries are regressive: the answer is – not necessarily. And finally, I ask whether in

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<sup>12</sup> For further discussion of a few of the many complex points touched on (or skipped over) in this section, see Bird and Zolt (2005).

some circumstances a ‘good’ VAT may not be better than a ‘bad’ income tax; the answer is, of course it may, depending upon the details of both the country and the two taxes.

*Are income taxes progressive?* Chu, Davoodi, and Gupta (2000) surveyed 36 studies of tax incidence in 19 different developing countries: 13 found the tax system progressive, and 7 each found the tax system proportional and regressive; the others had mixed findings or insignificant effects. Most of the reported progressivity came from income taxes. So the answer to the first question is that income taxes in most developing countries are likely somewhat progressive. Indeed, to the extent income taxes do not impinge on the poorest – those outside the market sector – they are bound to be progressive. Even within the taxed sector, progressive rates mean that the impact of the tax is progressive at least within the group of those who must pay tax on all (most) of their income-- for example because they receive it in the form of wages from a public sector employer. In most developing countries, however, little if any tax is collected from either capital income or self-employment (mixed) income and that little is most unlikely to be distributed very progressively.

Income taxes may thus help share the burden of government a bit more fairly, but they are unlikely have any significant influence on distributional outcomes (Harberger 2006). As Lindert (2003) shows, it was not by taxing the rich but by taxing the growing middle class that developed countries ‘grew’ large states. Big states may – if those who control them wish to do so – help the poor more than small states; but they do so through expenditures much more than through taxes. In fact, such well-known ‘welfare states’ as Sweden have been very careful not to kill the golden goose of private investment that largely (if indirectly) finances their big public sectors.

*Is VAT regressive?* Three types of taxes are levied on consumption in most developing countries: import taxes, excise taxes, and VATs. For the most part, the growth in VAT replaced the other two types of consumption tax. This change has almost certainly made the tax system more progressive (Gemmell and Morrissey 2003), for a number of reasons. First, the impact of trade taxes (especially including the ‘burden’ imposed by their protective effect) is likely regressive in the context of most developing countries. Second, excise taxes (even those justified by good economic arguments such as external effects) are also generally -- with the notable exception of those affecting motor transport -- regressive. Third, VAT in most developing countries is not particularly regressive and may indeed in some be slightly progressive.<sup>13</sup>

*Can a good VAT be better than a bad income tax?* In some circumstances it can, even if one sets aside the more favorable ‘tax-base’ effects discussed above. Consider the case of a country with a large shadow economy. Income taxes do not reach this sector – and indeed appear to be associated with its expansion (Schneider and Klingmaier 2004). On the other hand, to some extent a VAT functions like a presumptive tax on the informal sector since credits are available only to registered firms and those earning income in the shadow sector are taxed when they purchase formal-sector commodities (Glenday and Hollinrake 2005). Increasing income tax rates in such countries generally impinges primarily on two limited groups. The first consists of government employees, who often soon receive counterbalancing wage increases that eat up any revenue gains. The second are employees of large, formal market firms, which tends to discourage the expansion of the formal sector. Increasing VAT may, on the other hand, to some extent tend to make life in the formal sector relatively more attractive. Such a substitution is not

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<sup>13</sup> The evidence for this conclusion is reviewed in Bird and Gendron (2007).

only preferable in terms of growth but may even in some cases increase the horizontal equity of the tax system by imposing more tax on the informal sector. Indeed, if a VAT is combined with, say, increased excises on such important higher-income consumption goods as motor vehicles, then increasing indirect taxes may in some countries be significantly more progressive than just raising the rate of a personal income tax that affects only a limited group of formal sector wage earners

Of course, there are also good reasons for keeping direct taxes on both income and property in the tax mix as well. Corporate income taxes are needed to buttress personal income taxes, to ensure an equitable share of the returns on cross-border investment, and to tap economic rents to some extent (Bird 2002). Moreover, to maintain and grow the state, the tax system must tap into those sectors that grow and since growth usually results in the growth of the employed middle class, a mildly progressive personal income tax (like a VAT) can be an important way to ensure that state revenues share in the prosperity. Perhaps most importantly, only by visibly taxing the better-off through both income and property taxes can countries use the tax system as a ‘state-building’ tool.<sup>14</sup> Similarly, since sustainable tax policy needs to be accepted as fair by those affected, and automobiles and big houses are much more visible than income, the more taxation can effectively be imposed on such items, the better.

## **Improving Tax Administration**

To this point, I have generally supported, in a qualified way, both prongs of the tax reform fork – BB and LR -- set out in the World Bank (1991) study that I took as my

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<sup>14</sup> The case for property taxes is developed at length in Bird and Slack (2004). On taxation and state-building in general, see Brautigam, Fjeldstad and Moore (2007).

starting point. However, an important lesson that has been learned time and time again in the last few decades is that to get reform not only under way but under way in a sustainable fashion a third horse needs to be harnessed to the BBLR chariot -- better tax administration. This 'third horseman' of tax reform has received much less attention from analysts than it warrants.<sup>15</sup> Reaping revenues from tax rate changes (in any direction) requires effective tax administration. Raising revenues through base expansion requires even better tax administration. New taxpayers must be identified and brought into the tax net and new collection techniques developed. Such changes take time to implement. The best tax policy in the world is worth little if it cannot be implemented effectively. Tax policy design must take into account the administrative dimension of taxation. What *can* be done to a considerable extent inevitably determines what is done.

The importance of good administration has long been as obvious to all concerned with tax policy in developing countries as its absence in practice. One cannot assume that whatever policy designers can think up can be done or that any administrative problems encountered can be easily and quickly remedied. How a tax system is administered affects its yield, its incidence, and its efficiency. Administration that is unfair and capricious may bring the tax system into disrepute and weaken the legitimacy of state actions

### **Assessing Tax Administration**

Tax administration is a difficult task even at the best of time and in the best of places, and conditions in few emerging countries match these specifications. Revenue outcomes are not always the most appropriate basis for assessing administrative

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<sup>15</sup> Not so incidentally, much of what I have learned about tax administration I learned from Amaresh Bagchi and Arindam Das-Gupta when I had the pleasure of working with them some years ago on a paper reviewing the then scanty literature on the subject (Bagchi, Bird and Das-Gupta 1995).

performance.<sup>16</sup> *How* revenue is raised - the effect of revenue-generation effort on equity, the political fortunes of the government, and the level of economic welfare - may be equally (or more) important as *how much* revenue is raised. Private as well as public costs of tax administration must be taken into account, and due attention must be paid to the extent to which revenue is attributable to enforcement (the active intervention of the administration) rather than compliance (the relatively passive role of the administration as the recipient of revenues generated by other features of the system).<sup>17</sup> Assessing the relation between administrative effort and revenue outcome is by no means a simple task. Neither is improving administrative efforts and outcomes.

It is useful to think of the problem of tax administration at three levels – architecture, engineering, and management (Shoup 1991). The first level concerns the design of the general legal framework - not only the substance of the tax laws to be administered but also a wide range of important procedural features. Once the general architectural design has been determined, the engineer takes over and sets up the specific organizational structure and operating rules for the tax administration. Finally, once the critical institutional infrastructure has been erected, the tax managers charged with actually administering the tax system can do their jobs. One cannot assess how well a tax administration is functioning, let alone suggest how to improve it, without taking into account not only the environment in which it has to function but also the laws it is supposed to administer and the institutional infrastructure with which it has been equipped.

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<sup>16</sup>For example, even if it costs only \$1 to collect \$1000, it does not follow that to get another \$100 in revenue one simply needs to spend an additional dollar on tax administration. Not only are such figures sensitive to tax rates but the marginal revenue yield equals the average only under very special circumstances (Vazquez-Caro et al., 1992). More importantly as Slemrod and Yitzhaki (2002) show, the optimal size of a tax administration is likely to be where marginal revenue exceeds marginal cost, perhaps by a wide margin.

<sup>17</sup>In one of the few books on how tax administrations actually function in developing countries, Radian (1980) stresses the extent to which officials tend to be passive recipients of funds rather than active collectors of them.

To appraise the efficiency or effectiveness of tax administration one thus needs to take into account both the degree of complexity of the tax structure and the extent to which that structure remains stable over time. Complexity and its implications for tax administration has long been a concern even in the most developed countries. Even the most sophisticated tax administration can easily be overloaded with impossible tasks (Hood 1976). Such concerns are obviously critical in countries in which less well-equipped administrators are asked to tackle inherently complex tasks in a generally hostile and often information-poor environment. The life of the tax administrator is made even more complicated by the propensity of many governments, reflecting in part the unstable political and economic environment, to alter tax legislation annually, or even more frequently. Both the complexity of the tax structure and its stability are thus important factors to be weighed in assessing tax administration.

Disaggregation of the 'black box' of tax administration along such lines is particularly important since the main ways to improve administrative outcomes are either to alter the tasks with which the administration is charged or to strengthen the tools with which it is equipped. Simple exhortations to "do better" are of little use to resource-strapped administrators faced with impossible tasks. Experience around the world demonstrates that the single most important ingredient for effective tax administration is clear recognition at high political levels of politics of the importance of the task and willingness to support good administrative practices -- even if political friends are hurt. Few developing countries have been able to leap this initial hurdle.<sup>18</sup> The widespread

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<sup>18</sup> See, for instance, the telling comparison in Bergman (2003) of Argentina, which conspicuously has not leaped the hurdle, and Chile, which has. As IDB (2006) notes, there is still much we do not understand about why Chile has been able to do so much: however, as Bergman (2003) shows, the willingness of Chile's leaders -- of very different political persuasions -- to support effective administration stands out.

reluctance to collect taxes efficiently and effectively without fear or favor may be understandable in countries which are fragile politically, but without such efforts no viable long-term tax system can possibly be put into place. If the political will is there, the techniques needed for effective tax administration are not a secret.

### **How to Fix Tax Administration**

Indeed, the basic recipe for effective tax administration has only three ingredients: political will to administer the tax system effectively, a clear strategy for achieving this goal and adequate resources for the task. It helps, of course, if the tax system is well designed, appropriate for the country in question, and relatively simple. But even the best designed tax system will not be properly implemented unless these three conditions are fulfilled.

If the political will exists, the blueprint for effective tax administration is relatively straightforward. The tax administration should be given an appropriate institutional form, adequately staffed with trained officials, and properly organized, which usually means an organizational structure based on function or client groups. Computerization and appropriate use of modern information technology are important (Bird and Zolt 2007), but technology alone is not sufficient and must be carefully integrated into the tax administration. Putting all this into place takes time, resources, direction and effort. But it can be done, as countries from Singapore to Chile have shown.

In addition to giving the administration simpler and more enforceable laws to administer, experience suggests that the best approach to improving tax administration begins by assuming that the taxpayer is a client (albeit probably not a willing one) to be

served and not a thief to be caught. Studies on taxpayer behavior around the world suggest that services to taxpayers that facilitate reporting, filing and paying taxes, or that impart education or information among citizens about their obligations under the tax laws, are often as or more cost-effective in securing compliance than measures (auditing, penalties) more directly designed to counter non-compliance.

Improving tax compliance is not the same as discouraging noncompliance (Slemrod 1992). Low compliance may to some extent be a function of high compliance costs, as well as of such more basic problems as lack of state legitimacy, inadequate connection between taxes and benefits, and perceptions of tax fairness. As a rule, in most countries some taxpayers always pay (often because they have no choice); some always cheat; and some cheat when they think they can get away with it. An important task of tax administration is to prevent the mix from tipping in the direction of pervasive non-compliance. To do so, life must not only be made more difficult for non-compliers but also easier for compliers (Torgler 2007). It is thus important to simplify procedures for taxpayers, for example by eliminating demands for superfluous information in tax returns and consolidating return and payment forms. Once procedures are simplified, the tax administration can then concentrate on its main tasks: facilitating compliance, monitoring and enforcing compliance, and controlling corruption.

*Facilitating compliance.* The first task of any tax administration is to facilitate compliance -- to make sure that those who should be in the system are in the system and that they comply with the rules. To do so:

1. Taxpayers must be found. If they are required to register, the registration process should be as easy as possible. Systems must be in place to identify

those who do not register voluntarily. An appropriate unique taxpayer identification system is needed to facilitate compliance and enforcement.<sup>19</sup>

2. The administration needs a process to determine tax liabilities. This may be done administratively (as with most property taxes) or by some self-assessment procedure (as with most income taxes and VATs).
3. Taxes must be collected. In many countries, this is best done through the banking system. It is seldom appropriate for tax administration officials to handle money directly.
4. The authorities should provide adequate taxpayer service in the form of information, pamphlets, forms, advice agencies, payment facilities, telephone and electronic filing, and so on, to make taxpayer compliance with the system as easy as possible. There should also be a clear and functioning system of review and appeal.

*Monitoring and enforcing compliance.* Since some taxpayers are not honest, a second important task is to enforce compliance and reduce tax evasion. To do so, the administration needs to understand the extent and nature of the potential tax base in order to estimate the “tax gap.” Without some knowledge of the unreported base, and its determinants, no administration can properly allocate its resources to improve tax collection and ensure everyone bears at least a roughly fair share of the tax burden. Close attention must also be paid to ensuring that those who are in the system file on time and pay the amounts due. Adequate interest charges must be imposed on late payments to ensure that non-payment of taxes does not become a cheap source of finance. Similarly,

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<sup>19</sup> Manglik (2008) suggests that India’s PAN system falls short in this respect.

an adequate penalty structure is needed to ensure that those who should register do so, that those who should file do so, and that those who under-report their tax bases are sufficiently penalized to increase the costs of evading tax. All in all, as Harberger (1989) once noted, good tax administration is not rocket science: it's more like being a good accountant. Unfortunately, in many countries good accountants are scarce – not least in the tax department.

*Controlling corruption.* A third major task is to keep not just taxpayers but tax collectors honest. Corruption undermines confidence in the tax system, affects willingness to pay taxes, and reduces a country's capacity to finance government expenditures (Fjeldstad 2005). No government can expect taxpayers to comply willingly if taxpayers believe the tax structure is unfair or that the revenue collected is not effectively used. But even sound tax structure and sound expenditure policy can be vitiated by capricious and corrupt tax administration. Developed countries took centuries to develop and implement systems to prevent dishonest tax officials from corrupt practices (Webber and Wildavsky 1986). Tax officials must be adequately compensated so that they do not need to steal to live. Ideally, they should be professionally trained, promoted on the basis of merit, and judged by their adherence to the strictest standards of legality and morality. Temptation should be reduced by reducing direct contacts between officials and taxpayers and reducing discretion (and increasing supervision) when they do have such contact. Developing countries trying to sustain relatively large governments on precarious fiscal foundations find it hard to deal with such problems.

There is no single prescription - no secret recipe - that, once adopted, will ensure improved tax administration in any country. Countries exhibit a wide variety of tax

compliance levels, reflecting not only the effectiveness of their tax administrations but also taxpayer attitudes toward taxation and toward government in general. Attitudes affect intentions and intentions affect behavior. Attitudes are formed in a social context by such factors as the perceived level of evasion, the perceived fairness of the tax structure, its complexity and stability, how it is administered, the value attached to government activities, and the legitimacy of government. Government policies affecting any of these factors may influence taxpayer attitudes and hence the observed level of taxpayer compliance. Measures sometimes advisable in countries with very low compliance levels such as the massive application of administrative penalties may be inappropriate and even have perverse effects in countries with higher compliance levels.

### **The Resource Problem**

The scarcity of tax administration resources is a constant in most countries. Despite the high potential pay-off in terms of increased revenue, it is usually difficult, and often impossible, for tax departments to obtain and retain qualified staff or even to meet such basic material needs as office space and computers. Tax administrators are civil servants and hence subject to all the constraints affecting civil services. Reform strategies that require substantial additional administrative resources - particularly staff - are hence usually doomed to failure, because the needed resources will not materialize fully or in a timely fashion.<sup>20</sup> Good administrative reform strategies are usually based more on the better allocation of available resources rather than on accretions of major additional resources.

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<sup>20</sup> Salvation through reorganization is not likely to solve the problem. For example, setting up more independent revenue authorities that are to some extent freed from civil service restrictions on hiring and pay may sometimes help, but on the whole the evidence seems to suggest that any country that has the will, strategy, and resources to reform tax administration probably does not need an independent revenue

One important improvement may simply be to reduce unproductive tasks such as processing reams of information of which no uses is made. Another may be to create specialized offices to deal with particular groups of taxpayers (e.g. by size or industry). Yet another approach in some countries has been to privatize certain tax administration activities traditionally performed by government. For example, tax collection can be out-sourced to banks, which are specialized in the handling and control of payments. Of course, simply entrusting banks with the task of receiving payments or returns (and even, in some countries, processing returns) does not assure success. Proper systems must be designed, the tax department must exercise adequate supervision and the remuneration paid to the banks must be appropriate. Much time and effort has been spent on such matters in countries in which collection through the banking system operates successfully.

Most recent attempts to reform tax administration center on information technology (IT). No modern tax administration can perform its tasks efficiently without using IT, but in some countries the expectation of greater effectiveness from computerization has not materialized. Successful modernization efforts do not simply computerize antiquated processes but re-engineer the whole system - for example, consolidating return and payment forms, eliminating unnecessary and unused information required from taxpayers, and so on. Successful computerization requires a fundamental reorganization in both systems and procedures; it is not a way to side-step such reforms. Moreover, even the best computerized system will not produce useful results unless there are real incentives for tax administrators to utilize the system properly.

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authority -- and a country in which these critical ingredients are lacking is unlikely to be successful even if it creates such an authority.

Still, the large-scale information processing and coordination problems facing tax administrations usually require the adoption of effective computerized processes in even the poorest countries in such areas as (1) taxpayer records and tax collection (taxpayer compliance); (2) internal management and control over resources; (3) legal structure and procedures; and (4) systems to lower taxpayer compliance costs. Another reason why tax administrations need IT expertise is simply because some of their most important clients - - multinational companies and, increasingly, large domestic firms -- employ sophisticated computer systems which are beyond the investigative capacity of technologically backward tax administrations. IT is thus in a sense a 'double-edged' tool: in the hands of taxpayers, it may make tax administration more difficult (especially in an open economy); but in the hands of the administration it may enable a more robust response to such challenges (Bird and Zolt 2007).

## **Conclusion**

In the end, as I have recently argued elsewhere (Bird 2008), what countries do to reform their tax systems and how successful they are generally depends less on the economics of taxation than on the politics of taxation. Nonetheless, what we have learned from 50 years of experience and reflection on fiscal issues in developing countries is that what might be called the "Washington fiscal consensus" discussed in this paper -- broader bases and lower rates -- holds up fairly well. Of course, as Alfred Marshall once said "every short sentence about economics is inherently false."<sup>21</sup> In the spirit of trying to get a bit closer to what may be true, I have therefore noted some

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<sup>21</sup> The Marshall sentence – which, it should be noted, is itself short – is cited in Gardner (2006, p.7).

qualifications to and questions about the basic BBLR approach. In addition, I have emphasized the fundamental importance of understanding and improving tax administration. No one can work in this field without recognizing the importance of the administrative dimension of tax reform; too often, however, inadequate attention has been paid to this critical aspect of the problem when thinking about tax policy in emerging countries.

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