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THE ADOPTION OF TAX REFORMS

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ON THE ADOPTION OF TAX REFORMS*

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INTRODUCTION

It is an honor to deliver the first annual lecture honoring Raja Chelliah, whose death in 2009 brought to the end a career of public service that included important contributions to the process of tax reform and liberalization in India. In reflection of Chelliah's interests and contributions, I have chosen as the topic of my lecture, the process of tax reform.

Much has been written in the economics literature about what the tax system should look like. Drawing on the vast literature on optimal taxation, as well as empirical evidence on the behavioral responses of households and firms to taxation, contributions have focused on the choice of tax base, the marginal tax rate schedule, and various other tax rules. As a consequence, we have developed reasonably good ideas of the features needed to make a tax system fair, efficient, and administrable, or at least a reasonable range of opinions about this.[1] But tax reforms don't simply happen because it is possible to have a better tax system than the current one. One need only look around the world at the tax systems actually in place to know this. *How* tax reforms happen – the *process* of tax reform – is a subject about which far less has been written, at least in the scholarly economics literature.[2] It is clear from the fact that we are here to honor the contributions of Raja Chelliah that individuals matter, not simply because of their scholarly contributions but also because of their instrumental role in the tax reform process. But other factors are at play as well, and I have set as one of my tasks to explore what these factors are.

First, though, I must clarify what I mean by tax reform, for there is more to tax reform than simply changes in the tax system. I will then turn to a consideration of what motivates tax reform, what makes tax reform happen, and what sustains tax reform. Because there is so much heterogeneity among countries, I then discuss the special issues that arise in developing countries in the context of the tax reform process before offering some final, concluding comments.

WHAT IS TAX REFORM?

Tax rates change continually as governments seek to adjust revenue levels and to respond to economic conditions. In 1993, for example, the United States under President Bill Clinton raised marginal income tax rates among high-income taxpayers to help increase revenues and reduce budget deficits. In 2001, by contrast, when the United States federal government was running budget surpluses, President George W. Bush engineered a general reduction in marginal tax rates and tax revenues. Few observers referred to either of these episodes as tax reforms, nor has it been common to classify as tax reforms the

1. See, for example, the collection of papers recently produced by the Mirrlees Review project organized by the Institute for Fiscal Studies in the United Kingdom (Mirrlees et al., forthcoming).
2. There have been more popular narratives of how tax reforms happen. One notable example is Birnbaum and Murray (1987), which provides a fascinating account of the political process surrounding the successful enactment of the Tax Reform Act of 1986 in the United States.

myriad changes in specific tax rules that occur every year. On the other hand, the Tax Reform Act of 1986 is by general agreement a tax reform, and not simply because it is officially characterized that way.

If not all tax changes are tax reforms, then, we must start by considering the key characteristics that constitute a tax reform, and then ask whether such distinctions between tax reforms and all other changes in the tax system are useful. Although not everyone will agree with my analysis of what constitutes a tax reform, I believe that there are a number of characteristics that distinguish what are commonly referred to as tax reforms from other changes in the tax system.

First, tax reforms must reach a certain threshold in terms of magnitude and scope. The adoption of an important provision affecting a particular type of income or transaction therefore does not typically qualify, nor would a small amount of base-broadening combined with a small reduction in marginal tax rates. Second, in addition to being significant in size and broad in scope, a tax reform typically involves a shift in the direction of tax policy. This shift could involve a major change in the form of taxation, for example a shift from income taxation to consumption taxation, or a major change in the comprehensiveness of the tax base, involving a decision to rely less heavily on tax expenditures for the achievement of social policies. These two criteria are not entirely distinct, of course, for a tax change that combines substantial base-broadening with substantial reductions in marginal tax rates at some point not only becomes significant, but also reflects a change in the direction of tax policy.

Third, tax reforms involve simplification. One of the characteristics of evolving tax systems is that they have a tendency to get more complex, as new provisions are added that interact with existing provisions to make compliance more difficult. Under the United States federal income tax, for example, there are several different rules determining whether a child is a qualifying dependent for a particular tax provision, such as the dependent exemption, the Earned Income Tax Credit, and the child tax credit. There are different limits on contributions and qualifying income levels applied to different forms of tax-favored saving, such as traditional Individual Retirement Accounts (IRAs) and Roth IRAs. In both of these examples, the complications arose as new provisions were layered on top of existing ones, without adequate consideration of the added complexity caused by the interactions of new and existing provisions. A tax reform, by consolidating disparate treatments that serve little policy purpose, can provide substantial simplification of the tax system and in doing so make the tax system and its objectives more transparent. A tax reform needn't simplify the tax system for everyone. For example, reform of a tax system that is rife with base-narrowing provisions and difficult to enforce can create new taxpayers from groups that previously paid no tax, either through successful tax avoidance or simple evasion. Also, major changes in the tax system, even if ultimately aimed at simplification, may involve periods of transition during which taxpayers need to learn and adapt to new rules. But the overall thrust toward greater transparency and simplicity does seem to be a hallmark of tax reforms, and it is difficult to think of a major tax reform that made the tax system more complex for the typical taxpayer.[3]

In summary, I have characterized a tax reform as a change in the tax system that is broad-based, is significant in magnitude, involves a noticeable change in the direction of policy, and makes the tax system simpler to comply with and more transparent. Other than as a description of what people commonly think of as "tax reform," are these distinctions useful? I believe that they are, because these characteristics, taken together, describe tax changes that can alter tax policy in a manner that other tax changes cannot.

A key consideration here is the political costs that confront changes in tax policy. Any single change in taxation will upset a political equilibrium and thereby create winners and losers. To the extent that the losers have a sufficient political voice that they can block such changes from occurring, specific changes in a socially beneficial direction may be difficult to accomplish. A combination of many such changes may be much more difficult to construct, and therefore cannot be accomplished very often. However, if such a large-scale combination can be achieved, it may create a large enough class of "winners" that the political obstacles to change may be overcome.[4] Thus, tax reform may permit significant improvements in the tax system in a manner that a small sequence of more specific changes cannot. And, for much the same reason, a tax reform, once accomplished, has the potential to sustain a shift in the direction of tax policy. Piecemeal movements toward a reformed system may not only be difficult to accomplish but, if accomplished, may be easy to reverse, as lobbying efforts are concentrated to do so. A large-scale tax reform, though, should be not only more challenging to construct, but also possibly more difficult to reverse, particularly (as discussed further below) to the extent that the reform involves changes in the tax system that are difficult to undo.

There is a semantic issue in the distinction between a series of small changes and one large change, in that one can think of a tax reform as being accomplished through a transition process during which changes are implemented over time. For example, when the Tax Reform Act of 1986 was passed, some of its provisions were implemented over several years, rather than immediately. Indeed, such a transition process may make sense to ease the disruptions associated with a major change in the tax system. But a more

3. One must make a distinction here between the complexity of the language laying out tax provisions and the difficulty of compliance. A provision that is laid out in considerable detail can make compliance easier, for example by making clear how the provision applies to different types of behavior, or by limiting the number of taxpayers who must perform a particular calculation. Thus, the common practice (at least in the United States) of measuring the complexity of the tax system by the number of pages in the Internal Revenue Code is not very useful. A similarly misguided notion is to relate the complexity of an income tax system with its number of distinct marginal tax brackets. The primary complexities in a tax system involve calculating the base that is subject to taxation. Calculating the tax due is then a very simple exercise, regardless of the shape of the tax function that translates the tax base into tax liability.

4. This is basically a weaker version of Wicksell's unanimity principle, that movements toward a more efficient tax system can be constructed in such a way as to make all individuals better off. I do not believe that it is feasible to construct such Pareto-improving policies, but I do think that if there are sufficient social gains in moving from one tax system to another, that it should be possible to shape a tax reform to generate a large consensus in favor of the move.

significant issue is whether one can space out the actual enactment of provisions over time, attacking different issues in sequence rather than trying to deal with them all at once in a single piece of legislation. The key question here is whether such a process can easily be disrupted once put in place. If so, then the piecemeal process does not have the characteristics of tax reform that I have just outlined.

WHAT MOTIVATES TAX REFORM?

As I have discussed, an important element of a tax reform is that it is broad-based and involves significant changes in the tax system. Such packages, if constructed, may succeed in overcoming the political obstacles to reform, but they are also by their nature quite difficult to construct. Thus, there needs to be considerable motivation for tax reform in order for it to happen. What provides the motivation for tax reform? I can think of four sources of motivation: gradual erosions of the tax system, the arrival of new information, changes in circumstances, and changes in the political consensus. To a large extent, the last of these may be attributed to the first three – political consensus should reflect conditions and information – so I will focus on the first three sources in my discussion.

A. Gradual Erosion of the Tax System

Over time, tax systems change, and often for the worse. For the same reasons that it may be difficult to implement small, piecemeal improvements in the tax system, it may be difficult to resist small changes that move in the wrong direction, that introduce distortions and tax preferences that benefit some interest group at the expense of the general public. Although tax reforms may introduce significant changes in the tax system that are difficult to reverse, this does not mean that reforms are entirely impervious to attack. (Below, I discuss the features of tax reforms that may influence the degree to which they may erode.) In recent years, there has been a sense in the United States that some of the accomplishments of the Tax Reform Act of 1986 have been done by subsequent legislation, as the tax base has narrowed again and marginal tax rates have increased from their low levels of the late 1980s. This has led to some renewed interest in tax reform.

For example, in January 2005, President Bush appointed a bipartisan panel of politicians and academic tax experts and tax practitioners to fashion a tax reform proposal. The panel provided a thoughtful report later that year (President's Advisory Panel on Federal Tax Reform, 2005) putting forward two alternative tax reform plans, each of which would have lowered marginal tax rates, broadened the tax base and simplified the tax system. While that report has not led to a tax reform, there is still a sense that tax reform is more likely simply because of the post-1986 erosion.[5]

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5. Some cynics have suggested that the process of erosion and reform is one of intentional design, that politicians can maximize their returns from rent-seeking activities by occasionally wiping the slate clean so that the rent-seeking process can start again. Similar arguments have been made as to why some tax provisions are implemented only temporarily, so as to extract more resources from affected interest groups that wish to see them extended, *see*, for example, McCaffery and Cohen (2004).

B. New Information

Economists like to think that their research uncovers new information, and there are certainly cases where the combination of theoretical advances and empirical evidence sheds new light on what constitutes a desirable tax system. There are many such examples from the public finance literature, some of which have had a noticeable impact on the conception of what makes a good tax system.

Perhaps the most significant example involves the debate over the relative attractiveness of income taxes and consumption taxes. Although broad-based consumption taxes have been in place for many years in many countries in the form of valued added taxes (VATs), until recent decades there was a general consensus that a broad-based, Haig-Simons income tax was an appropriate backbone for any advanced tax system. That consensus has been eroded by research and evidence concerning the economic effects of capital income taxation and the potential administrative benefits of individual expenditure taxes, beginning especially with two influential reports in the late 1970s in the United States (U.S. Treasury, 1977) and the United Kingdom (the Meade Report, Institute for Fiscal Studies 1978).[6] While there are still defenders of the income tax, there is far less of a consensus in support of the proposition that labor income and capital income should be taxed at the same rate. As a consequence, shifts toward consumption taxes, or at least toward distinct taxes on labor and capital income, are more commonly discussed. Although no country has yet to scrap the income tax entirely in favor of a broad-based expenditure tax, the growth of VATs and tax-favored retirement savings schemes represents a shift toward consumption taxation, and even under the income tax there has been movement toward "dual" income taxation, with lower and less progressive tax rates imposed on capital income.[7]

Another development with both a theoretical and an empirical basis involves the desirability of steeply rising marginal tax rate schedules under an income tax. Traditionally, income tax systems have included very high marginal tax rates at the top, aimed at ensuring an adequate degree progressivity in the tax burden. But since the important theoretical contribution of Mirrlees (1971) on the design of the optimal income tax, it has been understood that very high marginal tax rates at the top of the income distribution may not have a part in a progressive tax system, even when there are strong distributional concerns. Because such marginal tax rates can produce considerable economic distortions relative to the revenue they generate , they may be self-defeating. Subsequent research, beginning with the contribution by Feldstein (1995), has emphasized that these distortions can be significant even when labor supply itself is relatively inelastic, if there are other margins at which taxable income can respond to taxation (as through the shift in compensation between taxed cash income and untaxed fringe benefits). Taken together, the theoretical

6. See the general discussion of these developments in Auerbach (2008).

7. For further discussion of recent reforms in the Nordic countries, see Sørensen (2005).

and empirical contributions in this area have highlighted the pitfalls of very progressive marginal rate schedules, and no doubt have provided some of the intellectual basis for reductions in marginal tax rates, as under the Tax Reform Act of 1986 (when the marginal tax rate at the top was reduced from 50 percent to 28 percent) and also in the adoptions of flat rate taxes in some transition economies in Eastern Europe.[8]

C. Changes in Circumstances

Even without any changes in our knowledge about tax systems and their effects, the ideal tax system is not independent of economic conditions. There are several realistic changes in economic circumstances that would lead to a shift in the shape of a desirable tax system. For example, the optimal degree of tax progressivity depends on the overall level of taxation. As taxes rise as a share of GDP, the associated increases in marginal tax rates means that each unit of revenue, at the margin, is raised subject to greater economic distortions – there is more deadweight loss, and hence a higher overall social cost, per dollar or rupee raised. As a consequence, the cost of redistribution rises, for redistribution involves raising revenue from one group to be transferred to others. Thus, as spending needs grow, as for example because of an aging population requiring healthcare and public pensions, it may be necessary to forgo some desired redistribution, making the tax rate schedule flatter as it rises. This may help explain why European countries, which have larger government sectors and hence greater tax-GDP ratios than does the United States, rely more heavily on the relatively regressive but also relatively efficient VAT, and why many in the United States have called for using a VAT to bridge the current gap between revenues and the growing spending on old-age health and pension programs.[9]

While a higher level of revenue might call for a less progressive tax system, a higher underlying degree of inequality might call for a more progressive tax system. There are two reasons for this. First, greater inequality makes redistribution a more compelling social objective. Second, with a greater share of income at the top of the income distribution, the unfavorable trade-off between distortions and revenue associated with high marginal tax rates at high levels of income becomes somewhat less unfavorable, because there is more revenue-raising potential. It is no surprise, then, that the current movement in the United States is toward higher taxes on the wealthy, given the rapid growth of income at the top of the U.S. income distribution in recent decades.[10]

Increasing international capital mobility is another important example of changing circumstances, a phenomenon that likely has contributed to the reductions in corporate tax rates around the world during the last few decades.[11] Changes in the composition of output can also be a factor, for example making consumption taxes that focus on tangible

8. See the discussion in Keen et al. (2006)
9. See Committee on the Fiscal Future of the United States (2010)
10. See Piketty and Saez (2003).
11. See Devereux et al. (2002)

purchases less attractive in an economy that consists more and more of services.[12] Finally, changes in technology – in particular, information technology – can influence tax design by affecting the feasibility of certain types of taxation. For example, it is now much easier to track financial transactions than was true in the past, making the taxation of certain forms of capital income less subject to evasion. Likewise, our ability to keep track of individual transactions makes transactions-based tax schemes more easy to implement.

In summary, all of these factors motivate tax reform: erosion of the tax system from its ideal form; changes in information that alter our perception of what the ideal form is; and changes in economic circumstances and in technology that change what is ideal among the feasible alternatives. But these factors establish the necessary conditions for tax reform to occur; they are not sufficient. There is more to making tax reform actually happen.

WHAT MAKES TAX REFORM HAPPEN?

An understudied question is how various factors – not just circumstances, but also institutions and personalities – work together to precipitate a tax reform. The U.S. Tax Reform Act of 1986 once again provides a useful case study to help us understand what makes tax reform actually happen.

The period leading up to 1986 was one that established the necessary conditions for tax reform. There had been rapid inflation during the later 1970s and early 1980s, and this caused a shifting of the tax burden and an increase in marginal tax rates, because the federal income tax was not indexed for inflation. High inflation also distorted the measurement of capital income, which was calculated in nominal terms. With many special provisions narrowing the tax base, the U.S. federal income tax had become, in the words of then-presidential-candidate Jimmy Carter in 1976, "a disgrace to the human race."[13 14]

While Carter aimed to achieve tax reform, he failed to do so. Indeed, it was *ten* more years before tax reform succeeded, after many other individuals had put forward proposals. It was only through the efforts of a Republican president, Ronald Reagan, working with both Democrats and Republicans in Congress, that the Tax Reform Act of 1986 finally came into being. And, indeed, as already noted above, in the over 23 years since, factors favoring tax reform have led to renewed calls for tax reform and the establishment of an official tax reform panel, but no further reforms like those of 1986 have yet come close to occurring

12. This has become an important issue in recent years among the individual U.S. states, which typically rely quite heavily on traditional retail sales taxes that exclude most services, having been designed in the years before World War II when services accounted for a relatively small share of overall consumption expenditures.

13. Carter used this celebrated expression in his speech accepting the Democratic party's nomination for president on July 15, 1976. His full quote on this subject made even clearer his goal to achieve tax reform: It is time for a complete overhaul of our income tax system. I still tell you: It is a disgrace to the human race. All my life I have heard promises about tax reform, but it never quite happens. With your help, we are finally going to make it happen. And you can depend on it. (http://www.jimmycarterlibrary.org/documents/speeches/acceptance_speech.pdf)

14. For further discussion of the conditions leading to tax reform during this period, see Steuerle (1992).

in the United States. It is clear, then, that the efforts of individuals matter, and that the presence of the necessary conditions laid out above is far from enough.

I have argued that tax reforms may happen if they can be crafted to include enough pieces so that a large share of the population sees the reform as beneficial. This construction can help overcome the large hurdles facing any major policy change. Yet such large-scale legislation does not come into existence on its own. Putting such a package together is no simple political task, leaving aside the technical problems of design, and it is here where the role of the "tax reform entrepreneur" is central. While Jimmy Carter might have had some inchoate sense of what tax reform might look like, he was unable to translate this vision into a tangible reality by determining the right mix of components for a successful tax reform package. With the considerable help of strong leaders in both houses of Congress, however, Ronald Reagan could.

Reforms undertaken on a large scale can have other advantages as well. As already noted, reforms that may be difficult to put together may also be difficult to overturn, for much the same reason. Absent the involvement of a gifted entrepreneur, the same political hurdles facing reform will be present for those wishing to return to the status *quo ante*. Also, if "large-scale" also refers to large changes in the methods of taxation, there may be further obstacles to reversion. If the government decides that it will no longer tax certain forms of income (capital gains, for example) and that taxpayers therefore no longer need to maintain records for related transactions (e.g., purchase price and date of purchase), then it may be difficult to reconstruct such records in the future if the government considers resumption of the tax.

If one interprets "large-scale" more broadly, there are additional benefits to large-scale reform. I have in mind here reforms that occur immediately and without a long period of gradual transition. As discussed above, a series of piecemeal reforms may be difficult to sustain. While a single piece of legislation putting forward a series of changes may be more successful, even this approach may be more subject to interruption and reversal than a bold jump to a new tax system, and it also delays the implementation of provisions that may benefit the economy. Likewise, the sudden adoption of a new policy can avoid the announcement effects of anticipated tax reform, some of which can undercut the benefits of the reform. For example, the shift from an income tax to a consumption tax can improve economic efficiency through at least two channels: by reducing the tax wedge facing saving decisions, and by taxing the consumption of previously accumulated wealth. While the first of these benefits will accrue in general, the second will be compromised by a prior period of expectation, during which individuals can dispose of assets that would eventually be subject to consumption taxation.[15]

Thus, reforms that involve a significant change in direction, occur immediately and without

15. See Auerbach and Kotlikoff (1987).

a long phase-in period may be harder to reverse and may also convey other economic benefits. But reform will not happen on its own.

WHAT SUSTAINS TAX REFORM?

Thus far, I have described a view of the tax system's evolution in which tax systems generally erode over time through a process of lobbying and rent-seeking, as provisions are introduced that narrow the tax base in favor of special interests and reduce overall welfare; this process may be occasionally punctuated by a tax reform that occurs on a large enough scale to overcome special interests and move the tax system in a better direction, perhaps also to satisfy objectives that have changed over time because of the arrival of new information or because of changes in economic conditions. I have also discussed the factors that motivate tax reform and make it happen. But, presumably, there are factors that influence how fast tax reforms erode.

If only bad things could happen to the tax system after a tax reform were passed, then sustainability would always be a good thing, and we would want to impose strong conditions to limit subsequent changes in the tax system, such as constitutional restrictions on tax system changes. But sustainability is a double-edged sword. While making the law easy to change could facilitate erosion of the tax base and also present taxpayers with an excessive degree of uncertainty regarding future tax provisions, casting the tax system in stone could become very costly over time, as new information and conditions called for a change in the tax system. Thus, simply making change difficult can serve not only to preserve good reforms, but also to prevent new and needed ones. We might wish to look, then, at features that make tax reforms more durable in the face of rent-seeking and tax base erosion, but not necessarily with respect to subsequent reforms. In this regard, it is useful to distinguish two types of characteristics: those of the tax reform itself, and those of the political process governing changes in the tax system.

A. Tax Provision Design

The VAT provides a good illustration of how a tax provision's design might influence a reform's durability. The standard way of implementing a VAT is through the so-called "credit-invoice" method, under which specific sales are tracked and taxed and credits provided for prior taxes paid by producers of intermediate inputs. The credit-invoice method is seen as providing an element of self-enforcement, because it obligates each producer to pay full tax on sales unless prior tax has been paid. But this approach to implementing the VAT also makes it relatively straightforward to vary the level of tax on different commodities, and it is common for countries implementing the VAT to do so. For example, VATs around the world commonly exempt or tax at a reduced rate food and other necessities.[16]

16. See, for instance, European Union (2009).

Having a VAT for which different rates are feasible allows for a more progressive tax system, but also opens the door to rent-seeking activity by industries that may seek a more favorable rate of tax on the commodities they supply. While one might see these two effects, one positive and one negative, as balancing each other, as a rule the progressivity that one can obtain using variations in VAT rates is small[17] and also unnecessary given that there are more effective methods of redistribution through the income tax or the government's transfer system. Thus, the variation in rates possible under a credit-invoice VAT may be a net disadvantage to the durability of tax reform. In the case of the VAT, however, there is an alternative method of implementation for which variation in rates would be more difficult, in particular the so-called "subtraction method" VAT under which each firm simply subtracts the cost of purchases (including purchases of capital goods) from sales proceeds in calculating its tax base. Since individual commodities are not distinguished in the calculation, there is no simple way to introduce a variation in rates. What might at first have been seen as a disadvantage, the inability to vary rates, may be an advantage if such variation can serve little social purpose.

In addition to designing provisions that are more difficult to change in an adverse way, one might also make a tax reform more durable by including sufficient flexibility in the provisions themselves so that the tax system remains closer to its ideal form even as economic conditions change. An obvious example is indexation of income tax brackets for inflation, so that real tax liabilities and marginal tax rates are independent of inflation. As noted above, the U.S. tax system in the late 1970s was distorted by the high inflation rates of the period, and this indeed contributed to calls for changes in the tax system.[18] While automatic inflation adjustments are the most obvious to undertake, one could go much further. For example, another change in circumstances noted above is a widening of the income distribution, which might make a more progressive rate structure preferred. If this is understood in advance, then one could index tax rates to the income distribution, an idea that has not been adopted but has been worked out in some detail.[19] Finally, although my focus here is primarily on the tax system, one can find examples within the fiscal system more generally of indexation with respect to other factors, notably demographic factors, in the design of public pension systems where viability depends on longevity and the old-age dependency ratio.[20]

B. The Nature of the Political Process

As discussed, a major potential reason for erosion of tax reforms is the rent-seeking activity of interest groups. The success of such activity depends, of course, on the character of

17. See Sah (1983).
18. The U.S. tax system was indexed by 1981 legislation but starting only in 1985, and so therefore had little impact on perceptions of the tax system when the Tax Reform Act of 1986 was under consideration.
19. See Burman *et al*. (2007).
20. As discussed in Auerbach and Lee (2009), a number of countries, including Sweden and Germany, now have public pension benefit calculations that include such demographic factors.

individual politicians, but it also depends on the environment in which they operate and the incentives they face. A key element in limiting rent-seeking, then, is to influence these incentives in such a way that providing benefits to interest groups is either less beneficial or more costly. Changes in the first category might include, for example, limits on campaign contributions, which would cut off one channel through which interest groups could pay for the benefits they receive. Changes in the second category might include a variety of public disclosure practices, for example reporting requirements for narrow changes in tax provisions indicating the revenue loss caused by such provisions and the name of the legislator responsible for its introduction.

There are negative aspects to such disclosure measures. For example, public disclosure requirements might also discourage individual legislators from undertaking reforms that are in the public interest but opposed by a powerful interest group, out of fear of retribution by the group. Thus, while the durability of tax reforms can, undoubtedly, be influenced by changes in the nature of the political process, such changes need to be approached with great care.

ISSUES FOR DEVELOPING COUNTRIES

Most of my analysis so far applies regardless of a country's stage of development, although the relative importance of different issues will vary. But there are also additional issues, on which I have not yet focused, that arise when one considers developing countries. Even there, the importance of issues will vary by country, but a few seem important enough to deserve mention.

The first issue I would highlight involves the stability of government and democratic institutions. Although some developing countries, including India, have long democratic traditions and institutions, there are many other countries, including several which have been growing rapidly in recent years, where such traditions and institutions are of more recent vintage or still not present. For such countries, a limited track record makes it more difficult to make credible promises, for example that a particular tax regime will be maintained.

This weakness is of particular importance because of another characteristic of developing countries, that they often rely heavily on foreign direct investment (FDI) as a source of capital and expertise.[21] For a country seeking to attract such investors, the durability of a tax regime, as well as the strength of property rights and other protections, can be very important, much more so than for portfolio investment, the "hot money" that developing countries have at times seen as a curse because of its ability to depart quickly during a financial crisis. For countries seeking to attract longer-term capital, as through FDI, the lack of a track record may influence the form that tax provisions take. In particular, it may

21. See Lane and Milesi-Ferretti (2007).

be necessary to give tax benefits “up front” when investments are made, rather than over time as normal tax rules might dictate, if there is concern whether such tax benefits will actually be received.[22]

Another characteristic of many developing countries is an unequal distribution of income and political power, with “ruling elites” sometimes exerting considerable control over how the country is governed. For such countries, which might especially benefit from a progressive system of taxation, tax reform may be extremely difficult to achieve, for it would go against the very interests of those in power. The most important question regarding tax reform in such countries, then, may be whether such elites can be overcome, either through external pressure or by focusing on elements of tax reform for which the elites may be included in the consensus.

Finally, developing countries may differ from their developed counterparts in the sophistication and extent of their information infrastructure. Part of the challenge concerns the general level of education, for it is difficult for individuals who are not fully literate to comply with a tax system that requires their active participation. Facing such a limitation could lead a country to rely more heavily on government-completed tax filing, rather than on the self assessment one sees in many income taxes in the developed world. Beyond education, though, there are the problems that countries may face in collecting information.

Imposing any tax system requires substantial information, but some taxes require more information than others. Thus, while trade taxes may have the potential of being enforced at the border (subject to smuggling, of course) without any information being gathered internally, at the other extreme are direct taxes, like the income tax, where one must gather information at the level of the individual or household. In between these extremes are transactions-based taxes, which require the ability to observe domestic transactions but not the identity of purchasers. Unfortunately, the taxes that tend to be most attractive, in terms of the trade-off between distributional equity and economic efficiency, are also those that require the greatest information to operate effectively.

The lack of an adequate information infrastructure may push countries toward less desirable taxes, and in doing so may alter the way such taxes are implemented. As discussed above, for example, direct taxes are generally superior to indirect taxes for achieving tax progressivity, but a country that cannot effectively impose an income tax would then be rational to use indirect taxes for redistribution. Also, countries might wish to distort the mix of domestic production, so as to shift activity toward firms it finds easier to observe, perhaps using tariffs to alter the mix of domestic activity in this way, or to subsidize financial transactions to facilitate observation.[23]

22. See Hansson and Stuart (1989).
23. See Gordon and Li (2005).

In summary, developing countries face the many challenges that developed countries face in attempting to adopt and implement tax reforms, plus some additional ones as well. Yet, it may be in developing countries where tax reform can deliver its biggest payoff, for such countries may be saddled with far more problematic tax systems, and may have even greater potential for growth, should the right conditions, including a favorable tax system, be present.

CONCLUSIONS

In this lecture, I have tried to make several points, a summary of which follows:

1. Tax reform is an important concept, as distinct from the changes in the tax system that occur on a regular basis. It is distinguished by its size, its comprehensiveness, and the shift in the direction of the tax system that it brings.
2. Reforms are motivated by changes in circumstances and information as well as erosion of the existing system.
3. The durability of tax reforms can be influenced by tax design as well as by the nature of political institutions.
4. Developing countries may face additional challenges to adopting successful tax reforms, and may also have to alter the shape that such reforms take.
5. Finally, individuals matter to the tax reform process. Those with the entrepreneurial ability to move the tax reform process forward can make a difference between success and failure. In a lecture honoring the memory of Raja Chelliah, it is fitting to end on this note.

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