**Tax Structures in Developing Countries:**

**Many Puzzles and a Possible Explanation**

Observed tax structures vary substantially across countries and over time. Why?

To some extent, these differences may simply reflect differences in social preferences for public vs. private goods. Countries differ substantially, for example, in the amount spent on the military, on infrastructure investments, on publicly provided education, or on social insurance. Higher spending levels require higher revenue, leading to higher tax rates.

To some extent, these differences may also reflect differences in the political support for redistribution. More redistribution naturally requires higher tax rates on the rich in order to finance lower tax rates or transfers to the poor. Governments with a stronger preference for redistribution would rely more on progressive personal income taxes, whereas other governments may choose less progressive personal taxes and make more use of proportional taxes such as a value-added tax or a payroll tax.

Other differences, though, are more puzzling based on conventional models of optimal tax structure. Regardless of a country’s tastes for public vs. private goods or for more or less redistribution, Diamond and Mirrlees [1971] forecast that the optimal tax structurewill preserve production efficiency under plausible assumptions. This rules out tariffs in any country that lacks market power in international markets. It rules out differential taxes on goods produced domestically in one industry vs. another. Atkinson and Stiglitz (1976) go further and argue that as long as a country can flexibly choose the rate structure under the personal income tax, then it has no reason to choose differential tax rates on the consumption of different goods. Not only does this rule out differential excise tax rates by good but it also rules out taxes on income from savings, which implicitly impose higher tax rates on goods consumed further into the future. Regarding possible revenue from seignorage, Friedman (1969) argued that a country would optimally choose a deflation rate sufficient to generate a nominal interest rate close to zero, so as to avoid any real costs of liquidity.

While these forecasts of no tariffs, no taxes on capital income, uniform taxes on consumption, and deflation, are not consistent with any existing tax structures, they are not sharply inconsistent with observed tax policies among the most developed countries. With GATT and now the WTO, tariffs are indeed very low among developed countries. At this point, nominal interest rates are very low among most developed countries, even if deflation is rare. While capital income is still subject to tax in various ways, Gordon, Kalambokidis, and Slemrod [2004ab] report evidence that the U.S. collects little or no net revenue from taxes on capital income, and imposes relatively low distortions on investment and savings. While even the richest countries maintain some important excise taxes, e.g. on gasoline, cigarettes, and liquor, an argument can easily be made that these specific taxes help internalize various consumption externalities.

Tax policies in developing countries are much more puzzling, however, in light of these forecasts from the optimal tax models. These differences are laid out in more detail in section I. The corporate income tax is a much more important source of tax revenue among developing vs. developed countries, as are tariffs and seignorage. Poorer countries collect much less revenue from personal income taxes, yet it seems puzzling that distributional preferences should systematically be so much weaker among poorer countries. On net, poorer countries collect on average only two-thirds or less of the amount of tax revenue that richer countries do, as a fraction of GDP. Yet, given the severe needs for investments in say infrastructure and education in these countries, is it plausible that the lack of revenue simply represents differing tastes for public vs. private goods in poor vs. rich countries?

One natural response to these differences between forecasted policies and those observed in developing countries is to conclude that the policies in developing countries should be changed. Newbery and Stern [1987], for example, set out the standard forecasts from optimal tax models as an ideal tax structure that developing countries should emulate. This is also the basis for recommendations, e.g. from the World Bank and IMF, that developing countries should reduce their tariff and inflation rates, and rely more on value-added taxes with a uniform rate across industries, rather than on excise taxes or corporate income taxes. Poorer countries have indeed shifted towards more use of the value-added tax in recent years, in part based on the advice and assistance of international organizations. But otherwise the puzzling differences remain.

This leaves unanswered why poorer countries so systematically choose the wrong policies, and why these wrong policies have remained so stable over time. Perhaps political economy problems are more severe among developing countries, and some important domestic constituency gains from the policies that standard models find perverse. Yet these puzzling policies are found under many different types of governments, drawing their support from many different constituencies.

Perhaps poorer countries lack the best enforcement methods, e.g. based on modern information technology. Certainly computer technology helps pool information from different sources. Bird (1989) argues, however, that the key problem is acquiring reliable information, not processing it.

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