There is no silver bullet to strengthen the tax systems of low-income countries. Dramatic changes in tax systems and tax collection are rare. Successful improvements more often involve a great deal of hard and steady work, and the gradual construction of popular trust and (grudging) support for reform. There remains, however, space for ‘organising ideas’ that can help identify potentially underexplored and underexploited opportunities for reform.

We focus here on a subset of possibilities for reform linked by a common unifying idea: simplification. Rather than repeating the familiar story about the need to increase administrative capacity to improve tax collection, we focus on simplification to better align revenue collection practices with the reality of limited tax administration capacity in many low-income countries. We are sceptical of the value of elaborate procedures (e.g. complex criteria for valuing individual buildings for property tax purposes), so-called best practice (e.g. the introduction of the most complex rules to combat transfer mispricing), and the latest technology (e.g. sophisticated IT systems). In their place, we look for practices and procedures that are easy to implement and ‘good enough’ in terms of revenue collection and equity.

Tax reform for low-income countries: five ideas for simplifying tax systems to fit local realities

Wilson Prichard and Mick Moore
Nothing that we suggest here is novel or ground breaking. We are not the first people to note the disjuncture between formal tax rules originating in Western countries and the complex realities of tax administration in low-income countries (Gordon and Li 2009). But we believe that this is a useful perspective for thinking about reform in general, and generates some valuable specific policy recommendations.

External templates and excessive complexity

One of the most striking features of tax systems in many low-income countries is the extent to which on paper they resemble very closely those of wealthier Western countries – and particularly those of former colonial powers. This has important advantages. But it also means that these systems may sometimes be poorly suited to the reality of lower-income countries.

The transition to independence in former colonies saw broad features of former colonial tax policies written into national laws. Internationally-supported tax reform efforts in the 1980s and 1990s saw domestic tax laws and tax administration increasingly coalesce around what has been dubbed a ‘global tax reform agenda’, modelled on tax systems in the West (Fjeldstad and Moore 2008). Meanwhile, international tax rules have been set almost entirely by OECD countries.

In some respects this global convergence has been welcome. The global tax reform agenda in the 1980s and 1990s had much to recommend it. Total revenue collection has consistently increased in most low-income countries. Administrative capacity, likewise, seems to have improved. There is little support for a wholesale rejection of that reform agenda. However, the particular history of tax reform in Africa points towards one obvious possibility: rules premised on the economic formality and administrative capacity of Western countries may prove excessively complex and difficult to implement in the more informal lower-capacity environment of low-income countries.

The case for simplification

Tax policies and administrative practices adopted from the West were designed to maximise revenue and economic efficiency in the context of largely formal economic transactions and strong administrative capacity. However, those same policies may yield much lower revenue – or create significant inequities and distortions – in more informal environments, and where tax enforcement is highly imperfect.

There is a trade-off between theoretical efficiency and what we might call ‘implementability’. In some cases the best policy option may not be that which in theory maximises efficiency, but that which strikes the best balance between efficiency and ‘implementability’. Elsewhere some such policies have been referred to as second-best, or even third-best, options (Kleven et al. 2016).

Simplified approaches may have both technical and political benefits. It can be difficult to attribute responsibility for poor performance when
systems are complex. Is underperformance the result of a lack of implementation capacity? Of inadequate systems or policy? Or the absence of high-level political commitment to making reform successful? Insufficient capacity can become a convenient scapegoat for poor performance. This ambiguity is reduced with simplified systems because the drivers of poor performance, whether technical or political, are easier to identify.

Historically tax simplification efforts have focused in particular on subnational tax systems and the local taxation of small enterprises, with an emphasis on abolishing ‘nuisance taxes’, excessively complex administrative practices, and complicated principles and systems for granting tax exemptions. The main aims have been to reduce informality, corruption and high compliance costs. The more complex systems appear inefficient both on paper and in practice. Building on these examples, we propose that the simplification principle may have broader value, including in areas in which longstanding approaches appear efficient on paper but work poorly in practice. We are talking therefore of a departure from the orthodox wisdom of many tax specialists.

**Potential reform targets**

We identify five potential applications of the logic set out above. We are not suggesting that these proposals are universally applicable or easily achieved. Rather, they deserve to be placed more centrally on the menu of possible reform options for a wide variety of low-income contexts.

“Is underperformance the result of a lack of implementation capacity? Of inadequate systems or policy? Or the absence of high-level political commitment to making reform successful? Insufficient capacity can become a convenient scapegoat for poor performance.”

1) **Simplify data management and IT systems**

The introduction of sophisticated new IT systems has been a central feature of tax reform efforts in recent decades. They have the potential to dramatically improve the management of data, internal data sharing, control of corruption and human resource management. However, in practice the introduction of new IT systems has frequently been relatively unsuccessful. Even in the more successful cases, IT systems appear to be used far below their potential. This points to the likely value of focusing on simplifying data systems, and implementing streamlined IT systems designed to perform essential functions in ways consistent with local capacity.

The most telling illustration lies in the realm of data sharing, which is the foundation of effective tax enforcement. Comparing data from different
sources allows tax agencies to identify undeclaration of tax liabilities by taxpayers. This data may come from within tax administrations (e.g. comparing data from income taxes, VAT, customs, property), from across government (e.g. business registration, property records, motor vehicles, business registration) or from non-government sources (e.g. bank accounts, utility bills, stock exchange transactions, credit cards).

Facilitating and automating such data sharing is among the basic purposes of most new IT systems. Yet much less data is shared in this way than one would expect in the tax administrations of many low-income countries. In many cases there is not even effective data sharing across departments within the same tax administration. Data sharing among government agencies is still less common, while access to third-party data is very limited, owing to a combination of administrative weakness and policy barriers.

Recent experience suggests that the solution is unlikely to lie in still greater investment in sophisticated IT systems. Significant data sharing can, in principle, be achieved with the most rudimentary IT systems – and, if the focus is on a subset of the largest taxpayers, who typically account for a high proportion of revenue collected, data matching using basic spreadsheets may be adequate to make initial progress (Kangave et al. 2016, 2018). A better reform strategy may thus be to focus first on putting basic strategies for improving data sharing in place, and then invest in comparatively simple IT systems once data sharing has become an accepted routine.

2) Tax revenue rather than profits

It is one of the central principles of contemporary taxation that taxes on corporations should as far as possible be levied on their profits rather than turnover. There are straightforward reasons. Not only does this seem fair, but the more that companies are taxed on turnover, the more likely it is they will be obliged to pay taxes even when their profits are low or they are making losses. This will lead to a reduction in overall levels of investment and economic activity, leaving everyone worse off.

There are, however, potential social costs to an exclusive reliance on taxing profits. Companies can seek to reduce the profits that they declare for tax purposes, either by artificially reducing declared revenue or artificially inflating declared costs. This can be achieved by manipulating sales and purchase prices in domestic
transactions – for example, when trading with a family member or friend who may be less likely to attract the attention of tax authorities. More often it is achieved through international transfer mispricing – shifting actual profits to related companies elsewhere in the world, by over-valuing imported products and services and under-valuing exports. The advantage of a tax of turnover, relative to a tax on profits, is that it reduces the evasion options available to firms. Whereas profits can be artificially reduced either by reducing revenue or inflating costs, turnover taxes are easier to enforce because they are not affected by declared costs, and are thus only vulnerable to efforts to artificially reduce revenue.

Where tax enforcement capacity is weak, as in many low-income countries, reliance on taxes on profit rather than turnover may create a situation in which the societal costs of revenue lost through tax evasion outweigh the benefits in economic efficiency. This is the conclusion of a recent empirical study from Pakistan. This provides evidence that, where declared profits are low, relying on turnover-based taxes can reduce evasion by almost 70 per cent without reducing economic efficiency (Best et al. 2015). Alternative minimum taxes may be desirable in such cases – if assessed profits are less than a certain proportion of assessed turnover (say 1 per cent), then taxpayers are required to pay 1 per cent of turnover rather than a profit tax.

Measures like alternative minimum taxes may be applied universally, or confined to particular economic sectors in which it is easy for companies to engage in avoidance and evasion, like telecoms and mining (Durst 2016). These options are not without problems. But, while they offend against what is theoretically best, they may be very well-suited to the reality of many low-income countries.

3) Simplify systems of property taxation

The laws governing property taxes in many low-income countries are inherited from the colonial period, when typically only a tiny minority of (urban) properties were liable for the tax. This has resulted in overly-complex valuation systems, often made worse by fragmented institutional arrangements and inter-agency rivalry.

Existing property tax systems are generally based on sending professional property valuers to estimate the market or rental value of every property. This is very challenging. There are few skilled valuers, and their services are expensive relative to property tax yields. The task is technically difficult and time-consuming, owing to weakness in public information systems on land title and property value, and the unwillingness of land and property tax departments to share information with one another. The result has been incomplete and out-of-date property valuations, inequity across properties, significant opportunities for corruption, and mistrust among taxpayers rooted in a lack of transparency and legal clarity.

Recent experience indicates a relatively straightforward template for improvement:

(a) simplify property valuation through the use of
methods that rely on easily observable features of properties, combined in simple formulas, to estimate market value; (b) decentralise responsibility for data collection and property valuation – perhaps still under the oversight of central valuation officers – in order to facilitate the hiring and training of human resources; and (c) where necessary, simplify and clarify institutional responsibility for property valuation and tax collection to ensure strong incentives for effective collection.

4) Push for simplified international tax rules

Existing international rules governing the cross-border taxation of transnational firms (TNCs) and wealthy individuals were created through international institutions that are dominated by today’s OECD countries. These have, in turn, continued be the leading voices in shaping more recent reform. Enforcement of these rules requires comparatively high levels of administrative capacity, and even OECD countries often struggle to enforce the rules effectively. Unsurprisingly, the rules tend to work significantly less well in low-income countries. A potentially powerful lens for thinking about reform thus lies in attempting to simplify existing rules, to better align them with the economic and administrative reality in low-income countries.

The most dramatic proposal for this simplification is a move towards formulary apportionment, or unitary taxation. This would eliminate reliance on complex rules for allocating profits across subsidiaries of TNCs – which has facilitated shifting of profits into tax havens – in favour of simply dividing the global profits of a TNC across countries using a simple formula. However, such a solution appears politically very complicated owing to the challenge of agreeing common formulas, and seems unlikely to become law in the short term. It is, however, rooted in part in the logic of simplification, to better match policy to administrative reality in lower-income countries.

More immediately, we can imagine what more incremental simplifying reform might look like in two broad domains:

- **Transfer pricing.** Existing transfer pricing rules, based on the arms-length principle, are frequently too administratively complex to be enforced effectively in low-income countries. However, individual countries have selectively adopted simplified methods designed specifically to overcome capacity constraints. Brazil, for example, applies pre-defined profit margins to the subsidiaries of multinational firms in order to avoid the administrative complexity of evaluating transfer prices for individual transactions. Mexico and the Dominican Republic have sought, albeit in slightly less explicit ways, to arrive at simplified and standardised profit margins within specific sectors using a combination of safe harbour and advance pricing agreements. Despite opposition from the OECD, recent experience suggests simplified alternative methods could be beneficial in practice for countries with limited enforcement capacity – while such rules are in many ways consistent with the spirit of OECD
rules, and with historical approaches to taxing multinational firms (Picciotto forthcoming).

- **Data exchange.** Recent reforms include new processes for the automatic exchange of information among national tax administrations for tax purposes. This is in principle a major step forward, replacing past reliance on bilateral information exchange made in response to specific detailed requests. However, challenges remain. Participation by low-income countries will depend on their putting in place relatively complex systems and data protection in order to access relevant data. Simplifying reform might focus on less demanding rules and systems for accessing and transmitting the data (at least for low-income countries), while working to make some data publicly available (like country-by-country reports and beneficial ownership registries).

5) **Simplify through regional tax cooperation**

Finally, effective tax enforcement is made more challenging by differences – both large and small – between tax systems in neighbouring countries. These differences can prevent useful cooperation, result in duplication of effort, and drive the adoption of complex tax exemptions that undermine the broader integrity of tax systems.

Through greater regional cooperation countries could, for example, adopt common rules governing transfer pricing and other aspects of international taxation. This would reduce the range of options available to firms seeking to engage in tax avoidance and evasion. The adoption of regional strategies for the negotiation of fairer tax treaties – and for the renegotiation of those that already exist – could serve a similar role.

Regional customs unions would eliminate a host of concerns and challenges related to customs, excises and smuggling, while harmonised VATs could contribute to easing the challenges associated with tax refunds and related fraud.

Perhaps most importantly, low-income countries have long struggled with the effective administration of tax incentives and exemptions, which tend to be poorly targeted, prone to corruption and undermine the quality of tax administration. Regional cooperation would at a minimum simplify tax administration by reducing pressure for the adoption of such exemptions. Common regional standards may go further in constraining the type of exemptions that can be offered. While in theory the latter may limit government flexibility in seeking to attract investment, in practice all existing evidence suggests that simple rules and constraints would lead to better and more transparent outcomes.
Further reading


Credits

**Wilson Prichard** is an Associate Professor jointly appointed to the Department of Political Science and the Munk School of Global Affairs at the University of Toronto. He is also a Research Fellow at the Institute of Development Studies at the University of Sussex, and a Research Director of the International Centre for Tax and Development.

**Mick Moore** is a Professorial Fellow at the Institute of Development Studies and founding Chief Executive Officer of the International Centre for Tax and Development.

The ICTD is funded with UK aid from the UK Government and by the Bill & Melinda Gates Foundation; however, the views expressed herein do not necessarily reflect the UK Government’s official policies, nor those of the Gates Foundation. Readers are encouraged to quote and reproduce material from the series. In return, ICTD requests due acknowledgment and quotes to be referenced as above.

ICTD is based at the Institute of Development Studies, Brighton BN1 9RE UK.

First published by the Institute of Development Studies in June 2018

© Institute of Development Studies, 2018