

On selective indirect tax reform in developing countries

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Abstract

The current consensus on indirect tax reform in developing countries favors a reduction in trade taxes with an increase in VAT to raise revenue. The theoretical results on selective reform that underlie this consensus are, however, derived from partial models that ignore the existence of an informal economy. Once the incomplete coverage of VAT due to an informal economy is acknowledged, we show that, contrary to the current consensus, the standard revenue-neutral selective reform of trade taxes and VAT reduces welfare under plausible conditions. Moreover, a VAT base broadening with a revenue-neutral reduction in trade taxes may also reduce welfare. The results raise serious doubts about the wisdom of the indirect tax reform policies pursued by a large number of developing countries.
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1. Introduction

Over the last few decades, a general consensus regarding the indirect tax reform in developing countries has emerged that spans academic economists and policy practitioners

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alike. A reduction in the trade tax with a compensating or revenue-enhancing increase in value-added tax (henceforth VAT) has been the center-piece of such a reform,¹ and it has been implemented in a large number of developing countries under the structural adjustment and stabilization policy conditionalities of the IMF and the World Bank.² The virtues of a consumption tax like VAT are well-known: the elimination of cascading (compared to a turnover tax), and of undue protection to the domestic production of import substitutes (compared to an import tariff), to mention a couple. The trade taxes, on the other hand, are, generally, looked upon as doubly distortionary as they interfere with both consumer and producer prices. There is, however, an important structural feature of a developing country that militates against the desirability of VAT: the existence of a large informal sector that escapes the VAT net.³ This implies that while a radial (across the board) uniform reduction in trade taxes reduces the production distortions and the distortions between tradable and nontradable sectors, a revenue-neutral radial increase in VAT increases the inter-sectoral distortions between formal and informal sectors (see [Emran and Stiglitz, 2000a](#)). As a result, contrary to the prevailing consensus, such a reform reduces welfare under plausible conditions. It casts strong doubts on the validity of the current consensus regarding indirect tax policy reform in developing countries, when the reform under consideration is a comprehensive one (radial reform). This, however, leaves open the question of the desirability of a selective indirect tax reform along the lines frequently prescribed by the IMF and the World Bank.⁴ The objective of this paper is to address this issue by extending the analysis to the case of a selective reform of trade tax and VAT in an economy with an informal sector. More precisely, we consider a reduction in the import tariff or export tax on a given commodity (say commodity k) with a revenue-neutral increase in the VAT on another commodity (say commodity i). The economic costs of a change in the tax on any given commodity depends on its interrelationships in consumption and production with all other commodities in the economy, both formal and informal. While a reduction in the trade tax on commodity k reduces the inter-commodity distortions in both consumption and production relative to all other commodities (including i) in the economy, a revenue-neutral increase in the VAT on i increases the

¹ Among few dissenting views, see [Anderson \(1996, 1999\)](#) who shows that it is almost impossible to ensure welfare improvement from a radial revenue-neutral reform of trade taxes and consumption taxes when nontradables are allowed in the model.

² As of April 2001, 123 countries have some form of VAT. The spread of VAT in developing countries has been dramatic over the decade of 1990s. In 1969, only one country in Sub-Saharan Africa had VAT. The number increased to four over next two decades. As of April 2001, there are now 27 Sub-Saharan African countries with VAT (for a recent discussion of the evolution and spread of VAT, see [Ebrill et al., 2001](#)).

³ The informal sector is defined in this paper to be that part of the economy which escapes commodity tax coverage. It usually includes agriculture, rural non-farm activities (accounted for in the GDP) along with the so-called shadow economy. The recent estimates show that the average size of the shadow economy over 1989–1993 as a percentage of GDP is 39% for developing countries and is 12% for OECD countries. When measured in terms of labor force employed in the shadow economy as a percentage of official labor force in 1997–1998, the average is 50.1% for developing countries and 17.3% for OECD countries. In some developing countries like Nigeria and Egypt, the average size of the shadow economy over the period 1990–1993 is 68–76% of GDP (see [Schneider and Enste, 2000](#)).

⁴ When the tax changes apply only to a subset of the commodities under the tax net, it is called Selective Reform.

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