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Tax-tariff reform with costs of tax administration

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Abstract

As is broadly recognised, the straightforward application of the Diamond–Mirrlees (1971) production efficiency theorem implies that when lump-sum taxation is not available, then it is optimal for the government in a small open economy to rely on taxes on the net demand of households rather than on border taxes to finance its resource requirements. However, the theorem does not hold when taxation is associated with administrative costs. The present paper explores the implications for optimal taxation and for desirable directions of tax-tariff reform of taking into account the costs of tax administration in countries at different levels of economic development. The paper clarifies the reasons for, and lends support to, the criticism by Stiglitz (Presentation to Congress of International Institute of Public Finance, Prague, 2003) of the IMF and the World Bank's recommendation to developing countries to adopt VAT to replace border taxes.

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