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# Globalisation and Developing Countries – a Shrinking Tax Base?

Joshua Aizenman  & Yothin Jinjarak

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## Abstract

This paper evaluates the impact of globalisation on tax bases of countries at varying stages of development. We see globalisation as a process that induces countries to embrace greater trade and financial integration. This in turn should shift their tax revenue from 'easy to collect' taxes (tariffs and seigniorage) towards 'hard to collect' taxes (value added and income taxes). We find that trade and financial openness have a positive association with the 'hard to collect' taxes, and a negative association with the easy to collect taxes.

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## Notes

1. Developing countries' reliance on easy to collect taxes has been explained by their limited institutional capacities, political instability, and polarisation. Studies explaining the reliance on easy to collect taxes in developing countries include Phelps ([1973](#)), Vegh ([1989](#)), Cukierman et al. ([1992](#)), Giovannini and De-Melo ([1993](#)), Aizenman and Guidotti ([1994](#)), Emran and Stiglitz ([2005](#)), and Gordon and Li ([2007](#)). The impact of globalisation on the pattern of taxation in the OECD countries has been the focus of Rodrik ([1998](#)); see also Tanzi and Zee ([2000](#)) and Ebrill et al. ([2002](#)). Space considerations limit our coverage of the large background literature dealing with public finance in developing countries. See Aizenman and Jinjarak ([2006](#)), Slemrod and Yitzhaki ([2002](#)) and Slemrod ([2007](#)) for a comprehensive survey and discussion.

2. This would be the case in countries where, due to political economy considerations, the initial tariff rate was set in order to maximise the tariff revenue. One purpose of our analysis is to quantify the ultimate revenue impact of tariff cuts, allowing us to test which of the two effects dominate. Similarly, macroeconomic stabilisation may increase economic growth, with ambiguous effects on seigniorage. Yet, if most countries operate on the 'proper' part of Laffer's tax curve, one expects that globalisation would reduce the tariff and the seigniorage revenue/GDP ratios.

3. Low\*, middle\*\*, and upper income\*\*\* developing countries classification is based on income and regional classification of the World Bank

(<http://www.worldbank.org/data/countryclass>). Developing countries are: Africa: Cameroon\*, Gabon\*\*\*, Guinea\*, Lesotho\*, Mauritius\*\*\*, Namibia\*\*, South Africa\*\*\*, Zambia\*, Zimbabwe\*; East Asia: Indonesia\*\*, Korea\*\*\*, Malaysia\*\*\*, Myanmar\*, Thailand\*\*; Eastern Europe: Azerbaijan\*\*, Belarus\*\*, Bulgaria\*\*, Croatia\*\*\*, Czech Republic\*\*\*, Estonia\*\*\*, Hungary\*\*\*, Latvia\*\*\*, Lithuania\*\*\*, Poland\*\*\*, Romania\*\*, Russian Federation\*\*\*, Turkey\*\*\*; Latin America: Argentina\*\*\*, Bolivia\*\*, Brazil\*\*,

Chile\*\*\*, Colombia\*\*, Costa Rica\*\*\*, Mexico\*\*\*, Nicaragua\*, Paraguay\*\*, Peru\*\*, Trinidad and Tobago\*\*\*, Uruguay\*\*\*, Venezuela\*\*\*; Middle East and North Africa: Iran\*\*, Morocco\*\*, Tunisia\*\*, South Asia: India\*, Nepal\*, Pakistan\*, Sri Lanka\*\*. High-income countries are: Australia, Canada, Cyprus, Denmark, Iceland, Israel, Japan, Malta, Norway, Slovenia, Sweden, Switzerland, United Kingdom.

4. India, Nepal, Pakistan and Sri Lanka.

5. A review of these methods can be found in Schneider ([2004](#)) and Alm et al. ([2006](#)).

6. See Fisman and Wei ([2004](#)) and Aizenman ([2004](#)) for fiscal implications of trade mis-invoicing.

7. Though interesting, there are no formal tests on the relationship between firm size distribution and tax evasion across countries.

8. Admittedly, Institutional Quality covers a wide range of aspects.

9. We should also note that there is another, hard to measure but easy to collect tax – government revenue from financial repression. Government can impose controls on international capital flows and domestic financial intermediaries as a form of taxation. The resultant wedge between effective external and domestic interest rates of public debt is the financial repression tax, which is essentially a subsidy on interest payments on government liabilities. As discussed in Giovannini and De-Melo ([1993](#)), there are also potential complementarities between financial repression revenue and seigniorage because (i) inflation implies low real interest rates facing savers, and thus interest savings on government liabilities, and (ii) negative real interest rates on savings increase money demand, that is, the inflation tax base. Financial repression revenue is calculated by multiplying the stock of outstanding domestic debt by the financial repression tax rate, which is the interest rate differential in local currency between the effective external and domestic interest rates. Financial repression revenue may be negative (i.e. the effective foreign interest rate is smaller than the effective domestic interest rate), reflecting a lower cost of foreign borrowing relative to domestic borrowing facing a government. We focus on seigniorage because there is a high positive correlation between seigniorage and government revenue from financial repression (about 0.50). Limited data availability on a panel of tax revenue from financial repression prevents us from adding this implicit tax to the figures dealing with

easy to collect taxes. Hence, these figures tend to understate the shrinking of easy to collect taxes in our sample.

10. See for example Anderson and van Wincoop ([2003](#)) and Helpman et al. ([2007](#)).

11. A simple fixed effect regression of gravity trade share on time trend shows a statistically significant increase of 0.3 per cent per year from 1980 to 1999.

12. Argentina, Cameroon, Chile, Colombia, Costa Rica, Hungary, India, Indonesia, Mexico, Morocco, Pakistan, South Africa, Thailand, Trinidad and Tobago, Tunisia, Turkey, Uruguay, Venezuela, Zambia and Zimbabwe.

13. The pan-European VAT system and tax base harmonisation debated in the European communities is a good example. See for example Financial Times ([2006](#)) and Financial Times ([2007](#)).

14. For example, a standard deviation of the Trade Openness for developing countries is 2.2 per cent. Using the coefficient estimate of Trade Openness on hard to collect taxes from [Table 2](#), which is 0.8 and statistically significant, the effect of a one standard deviation change of Trade Openness is to increase hard to collect taxes by  $2.2 \times 0.8 = 1.7$  per cent of GDP.

15. See Rodrik ([1998](#)) for some discussion on globalisation and the size of government expenditures. In addition, the ramification of fiscal adjustment on macro economy in general is less well understood in the case of developing countries. Talvi and Vegh ([2005](#)) study the association between tax base volatility and macroeconomic policies in developing countries. For OECD, Alesina et al. ([2002](#)) found that various types of taxes also have negative effects on profits but interestingly, the effects of government spending on investment are larger than those of taxes.

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