Taxation and the Urban Poor in Developing Countries

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Empirical evidence indicates that the poor, and particularly the urban poor, in developing countries pay a substantial part of their income as taxes. This paper examines critically the procedures employed in measuring the incidence of taxation in LDCs, with a particular emphasis on evidence concerning the tax burdens of the urban poor, and presents a summary of some empirical work in this area. It then provides a review and analysis of fiscal policies which at the margin can assist in improving the position of the urban poor by reducing the regressivity, and increasing the progressivity, of existing or potential revenue instruments, including public service prices, and by improving the fiscal position of the poor through expenditure programs.
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TAXATION AND THE URBAN POOR

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If the principal aim of redistributive policy is to level up—to make the poor better off—the main role that the tax system has to play is thus the limited and essentially negative one of not making them poorer.

Bird and De Wulf, 1973, p. 673

These words from a recent survey of empirical studies of tax incidence provide fitting terms of reference for a discussion of taxation and the urban poor. Once Bird and De Wulf's dictum is accepted, it is only natural to survey studies of tax incidence to determine the extent to which it has been respected—or stated alternatively, to assess the burden of taxes on the urban poor. And in fact, part F of the first section does provide a brief summary of the conclusions of several such studies. But it is necessary, as is done in parts A to E of section I, to preface even this brief survey with a description of some of the pitfalls of incidence studies. After all, perhaps the main point of the survey by Bird and De Wulf (1973) and of a companion survey by De Wulf (1974) is that empirical incidence studies use suspect methodologies and inadequate data to derive estimates that would not be very useful even if they were perfect. The concluding part G of the first section argues that research efforts would be more productive, and the results more defensible, if attention were focused upon the distributional effects of changes in tax systems, rather than upon the incidence of existing tax systems. Ideally research would be devoted to the implications of tax policy for horizontal equity, that is, to changes in tax burdens within income classes—especially among the urban poor, as well as to questions of vertical equity.

The second section examines the possibility of reducing tax burdens and otherwise improving the fiscal lot of the urban poor, given other fiscal objectives and economic, political, and administrative realities. One of the ways suggested to offer most promise is the public provision of services that are of special value to the urban poor. As in the tax field, it is suggested that research should be devoted to the incidence of changes in projects, rather than that of existing budgets. Being policy-oriented and involved with questions of equity and efficiency and the trade-offs between them, this section is more controversial than the first.
I. TAX BURDENS ON THE URBAN POOR IN DEVELOPING COUNTRIES

By and large, it is reasonable to say that empirical estimates of tax incidence involve "quantification of incidence assumptions." That is, incidence theory is called upon to provide presumptions as to who (consumers, labor, capital, etc.) bears the burden of individual taxes. Then these burdens are allocated among income classes, between urban and rural sectors, or among other relevant groupings of the population on the basis of empirical evidence of the various groups' participation in the consumer or factor group thought likely to bear the tax, and are commonly expressed as a percentage of the total individual or household income (effective tax rates) of the group. Because of the theoretical uncertainties about tax incidence and the serious inadequacies of data that generally plague estimates of this kind, the estimates are usually advanced with due caution—and should be.

A. Methods of Calculation

The most common approach to estimating tax incidence is in terms of effective rates at different points in the income distribution.1/ Ideally, this is the distribution of income among households or families, since it is that distribution that seems most relevant for questions of tax equity. But in some cases availability of data restricts the analysis to the distribution of income among individuals or members of the economically active population. Moreover, whether the data on income distribution are taken directly from household surveys, census figures, or other sources, or are constructed specifically for the tax incidence study, they almost certainly rely upon data originally collected for some other purpose that may serve the incidence analyst only imperfectly.

Once the distribution is established, it may be thought desirable to make adjustments to it. At best, the estimated distribution is likely to correspond to something like personal income. If it is thought that some taxes (corporation income taxes and export duties for example) reduce personal income to below what it would otherwise be, it is necessary to add these taxes to the estimated income at various points in the distribution in order to obtain an estimate of what personal income would be in the absence of the taxes. And it is often thought relevant to add a pro rata share of retained earnings of corporations to the estimated personal income of resident shareholders. Of more importance at the lower end of the income scale is the possible omission of income in kind (especially food and owner-occupied housing), for which adjustment should be made if possible. Not all analysts agree on the reasonableness of various adjustments, or indeed upon the proper definition of income, even at the conceptual level, so the definitions used often differ between studies.

1/ Data are usually inadequate to allow calculations for groups that are homogeneous with regard to family size, age and sex of head of household, etc. Demographic heterogeneity clearly limits the usefulness of incidence studies based on the size distribution of income. Use of the typical household approach described below helps overcome these difficulties.
An alternative that allows us to focus more clearly upon the burden of taxes on the urban poor and avoids some of the data problems (but not the definitional and conceptual problems) of the approach just described can be called the "typical household approach." Under it the tax burdens borne by families of given income, size and consumption habits are calculated. This approach allows us to see how tax burdens depend upon sources of income (a consideration which may be especially important for urban-rural comparisons or at the top of the income scale), family size (because of differences in consumption patterns), and consumption habits (especially with regard to alcoholic beverages and tobacco products). One important lesson of this type of analysis, which is performed relatively infrequently, is that families which fall in the same income class may pay substantially different amounts of taxes. While horizontal inequity is generally undesirable, it seems particularly pernicious at the bottom of the income scale where families have difficulty enough making ends meet, without being taxed unfairly.

B. Taxes Included

Surprising though it may seem, it is not always clear what should be considered to be a tax for the purpose of tax incidence analysis. Some taxes might better be excluded from the calculation of effective tax rates. Conversely, some non-tax sources of public revenues deserve to be included.

The first broad category involves sources of revenue that finance services for those who pay the taxes (or other charges). In countries in which social security is more or less universal and benefits are linked only very roughly to contributions, as in many developed countries, it is quite reasonable to treat the payroll taxes used to finance social security as ordinary taxes and the benefits as transfers on the expenditure side of the budget. But where social security is quite limited in its coverage and benefits are related fairly closely to contributions, it seems more appropriate to consider the tax-benefit transaction as more nearly akin to private insurance than to a governmental tax-transfer operation. In these cases the payroll taxes and other contributions should not be incorporated in estimates of tax incidence, regardless of government budgetary and accounting practices and the conventional treatment of such "taxes" in national accounts.

Taxes that do not flow into general revenue, but instead are channeled back into the taxed industry pose a similar problem. (Examples are the replanting cess levied on rubber exports in Malaysia and the earnings on coffee used to finance operations of the coffee federation in Colombia). To the extent that these funds simply replace others that would have been spent privately within the taxed sector, it is probably best to exclude them from incidence calculations. (Of course, there may be some significant redistribution within the export sector that is deserving of attention).
A case that is not so clear, but is virtually always included in incidence studies involves motor fuel and other automotive taxes. To the extent that fuel taxes are set without regard for marginal social costs of highway use it is reasonable to consider them to be on all fours with other taxes. But if a conscious effort is made to base these taxes on marginal costs, then one could argue that they are essentially (if roughly) user charges and should be excluded from the analysis. This is especially true if motor fuel taxes are earmarked for highway construction and maintenance. And even if motor fuel taxes exceed the levels indicated by marginal cost pricing, it can reasonably be argued that only the (positive or negative) deviation from marginal social costs should be included in a study of tax incidence. While this principle may seem clear enough, virtually no study attempts the difficult task of implementing it.

A similar problem arises in the treatment of public utility prices. If a government taxed the output of a private public utility or autonomous agency in the utility field, there would ordinarily be no question about the inclusion of the tax in an incidence study. But what if the utility were operated by the government itself and produced profits? Presumably the profit should be treated as a tax in an incidence study. (And this might be true whether the utility were explicitly a governmental operation or an autonomous agency of the government, though the issues are less clear in the latter case). But should the quasi-tax (or quasi-subsidy) inherent in the public utility rate be measured relative to average costs or marginal costs or even benefits received? Since there is a presumption in favor of short-run marginal cost pricing as the proper allocation rule, it seems most reasonable to use it as the basis for calculating the quasi-tax if our concern is with allocative efficiency. If, on the other hand, our concern is with income distribution, it might be more appropriate to measure the tax relative to long-run average cost (including a reasonable return to investment). But this is an area in which virtually no work has been done, and this conclusion is certainly debatable. Given the importance of public utility pricing from the standpoint of revenue, equity and efficiency, especially in developing countries, it seems essential that the (positive and negative) quasi-taxes implicit in public utility pricing be examined explicitly in future tax incidence studies. This is especially true if our concern is with the urban poor, since in many instances these quasi-taxes may be every bit as important as true taxes in the budgets of poor urban households.

Among the relatively few non-tax revenue sources usually included in tax incidence studies are the profits of liquor monopolies and state-operated lotteries. But care should be taken that only the profits, rather than the gross receipts, are included as a quasi-tax. In certain instances these may actually be negative—as when the monopoly or lottery is operated at below cost in order to provide employment. Of course, in that case the literal interpretation must be that the consumers of liquor and gamblers actually receive consumption subsidies.
A similar problem is posed by the operation of marketing boards or similar public organizations that import goods and sell them at a profit. These profits can reasonably be treated as consumption taxes, just as profits of export marketing boards can be treated as export duties. But import organizations of this type may not sell only at a profit. They may intentionally import food, for example, and sell it at below the world price in the interest of social justice. Their losses in such cases are exactly analogous to import subsidies. Whether these quasi-subsidies should be treated as negative taxes, and therefore included in the incidence study, or as expenditures, and therefore excluded, is far from clear, but they should not simply be ignored.

C. Incidence Assumptions

The most crucial input to a study of tax incidence may well be the assumptions made about the incidence of various taxes. For example, if the corporation income tax is borne by shareholders or all owners of capital it is likely to add significantly to the progressivity of the tax system. If on the other hand, the tax is shifted to consumers, it may be regressive, especially in urban areas. Finally, if the tax is exported to foreigners, it is distributionally neutral, by definition. And more importantly, it provides fiscal resources for the government without burdening local residents. These are probably among the most striking differences that can result from differences in shifting assumptions, but alternative assumptions for other taxes can also affect results importantly.

A quick survey of incidence assumptions actually employed (see Bird and De Wulf, 1973, pp. 658-62) suggests that more or less standard and defensible assumptions are made for personal income taxes, employee contributions to payroll taxes, and most indirect taxes (excise, sales taxes and import duties). 1/ The first two are generally assumed to be borne by the taxed income recipients and the third by consumers of the taxed products. There is substantially less agreement on the incidence of corporation (company) income taxes and property taxes. 2/ Given the substantially different distributional implications of alternative assumptions about the incidence of this latter group of taxes, it seems worthwhile to examine the issue at some length. 3/

1/ In most developing countries only the last impinges heavily upon the urban poor.
2/ Export duties are not likely to affect the urban poor directly, and therefore are not discussed here. But see Gillis and McLure (1975) and Hughes (1974).
3/ Alternative incidence assumptions are sometimes employed; see for example, McLure (1975a). But competing assumptions often produce vastly different results and a choice must be made, at least by the reader.
1. **Company Income Tax**

Special care is required in assessing the incidence of the corporation income tax. In general it will not do simply to refer to either the classical theoretical result that profits taxes cannot be shifted or to the more recent (and questionable) empirical evidence from several developed countries that the tax seems to be shifted. In each case the analyst must examine the objective situation in order to decide the appropriate shifting assumption. This is not to say that each incidence study should include a treatise on the theory of tax incidence. But the theory adopted, as embodied in incidence assumptions, should at least conform to the facts, rather than being carried from country to country and applied without regard for its relevance.

Even for domestic industries it is not generally clear what is the most appropriate incidence assumption for the corporation income tax. If capital is mobile between countries, and therefore in elastic supply to a given country, the tax is likely to be shifted, either to consumers or (perhaps less likely) to labor. In either event it would be borne in part by the urban poor. On the other hand, it may be that in many cases capital will bear the tax, even if it is quite mobile between countries. This could happen, for example, if there are extraordinary investment opportunities that the tax would not render unattractive. The firm would merely find its extraordinary return reduced, but not eliminated. Somewhat less dramatically, a firm might be willing to absorb tax liabilities in order to establish itself, hoping to recapture the lost profits later, rather than leave the market or raw materials to a competitor.

2. **Property Tax**

It has long been conventional to assume that property taxes on land are borne by landowners but that those on improvements are shifted by owners of the taxed property. Thus taxes on commercial and industrial improvements would be allocated to consumers and those on housing would be allocated to renters and owner-occupants. More recently, however, incidence theorists have argued that on the average property taxes on improvements are likely to be borne by owners of the property. This difference in incidence assumptions is generally

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1/ Corporation taxes levied in an export industry may have burdens quite similar to those for true export duties, and are not likely to affect the urban poor to any great extent. Certainly, taxes on these industries generally should not be lumped together with those on what we might call "domestic" industries. Of course, the truly poor in the cities of developing countries are not likely to be employed by corporations, being instead active primarily in the informal sector. Burdens on corporate labor may not be diffused to non-corporate workers via competition in labor markets because of obstacles to occupational mobility, especially unionization of corporate employment.
quite important in that allocation to consumers and renters is likely to result
in a regressive pattern of tax incidence (and important burdens on the urban
poor) whereas allocation to owners of property is quite progressive. Whether
the traditional or so-called "new view" is the appropriate one is not easily
established in the abstract, and may not even be easily determined in
concrete situations. We can however, at least indicate some guidelines
for the incidence analyst.

The accuracy of the new view hinges crucially upon the supply of
capital to the taxing jurisdiction being totally inelastic in response to
property tax burdens. The traditional view, on the other hand, relies upon
elasticity in the supply of capital. Seen from this perspective, the
traditional view does fairly well if we are concerned with the incidence of
(changes in) property taxes levied in only one city. The availability of
alternative untaxed investments outside the taxing city prevents the rate of
return to capital from being depressed by the amount of the tax. A similar
result may prevail even for taxes levied throughout a nation, at least in
those countries with strong links to international capital markets. Aside from
whatever long-run elasticity would result from response of the saving rate to
the property tax rate, a question about which we have relatively little evidence
even in developed countries, the possibility of international capital flows
probably renders the elasticity of supply to many countries quite high. Simply
put, at the margin less capital would be invested in (or remain invested in)
a country levying a property tax, all things equal, since it could earn a
higher return elsewhere. Thus it seems unlikely that the new view is generally
correct, except to the extent that countries are effectively isolated from
international capital markets.

3. **Tariffs with Quotas**

An especially interesting case of fitting the assumptions to the
facts involves import duties levied in the face of pre-existing quotas.
Ordinarily we expect import duties simply to be reflected in higher prices
and hence borne by consumers of the taxed import. But the situation is different
if the import is subject to pre-existing quantitative restrictions. By reducing
supply to below what it otherwise would be, quotas result in price increases and
transfers of real incomes from consumers to importers. Then when import duties
are levied, so long as they do not exceed the amount by which the quota has
resulted in higher prices, there is no further pressure on prices. Rather, the
tax is simply paid from the profits of importers created by the quota-induced
scarcity.

D. **Permanent Income Hypothesis**

Incidence studies commonly reported a U-shaped pattern of effective
rates. (Indirect taxes appear to be heavily regressive at low income levels
and direct taxes are progressive at high income levels). This pattern occurs
because of the tendency for low-income households to consume more than is
reported to accrue to them as current income. Part of the apparent discrepancy
between income and expenditure is probably explained by basic inconsistencies in household responses to questions about income, expenditures, and saving, and may relate largely to exclusion of income in kind (food and housing) from the income side of the picture. But some households who are reported to be in low income classes have low incomes only temporarily and (quite rationally) do not adjust their expenditure habits from accustomed levels to a pattern more consistent with a sustained low income. Thus effective tax rates for these groups, calculated by comparing taxes on habitual consumption expenditures with temporarily low incomes, are artificially high, and not indicative of long-run patterns of tax incidence.

Investigators have tried to get around the so-called permanent income hypothesis in a number of ways. One is to compute indirect (and shifted direct) taxes as a percentage of expenditures (rather than as a percentage of income) for households classed according to expenditures (rather than income). The rationale behind this approach is that expenditure is a better indicator of permanent income than is actual income. But this approach, while requiring more data, can relate only to indirect and shifted direct taxes, since it would be improper to calculate the burden of taxes that reduce disposable income (from which consumption expenditures are made) as a percentage of expenditures. Furthermore, this comparison would be most meaningful if it were decided that consumption were the proper index of taxpaying ability. If income is taken to be the better index, effective tax rates calculated as described above would be misleading, due to the tendency for the average saving rate to rise with income.

These objections might reasonably be given relatively little weight, to the extent that our primary concern is with the burden of taxes on the urban poor, independent of the burden on upper income groups. It matters relatively little whether we include unshifted direct taxes in the analysis, since they are not generally borne in significant amounts by the urban poor. And it matters little whether we compare tax collections with expenditures (which are observable) or with permanent income (which is not). In either event the comparison is better than with actual income.

A somewhat more satisfactory comparison would be to calculate taxes as a percentage of income for households grouped by expenditure levels. This allows the inclusion of all taxes and allowance for the regressivity resulting from the declining (normal) average propensity to consume while dealing more or less satisfactorily with the problems resulting from the workings of the permanent income hypothesis. Unfortunately, the data required to implement this approach are often not readily available.

E. Pitfalls of Comparisons

It should be clear from the previous discussion that only the unwary would utilize the results of an incidence study for a particular country without examining, understanding, appraising, and either accepting or modifying the methodology used. It is, of course, doubly hazardous to attempt comparisons of the results of incidence studies for different countries. For one thing, analysts may use different approaches. It may be difficult, for example, to compare results from a study using the income distribution approach with those derived using the typical household approach.
Second, the basic data underlying the studies may differ, and in
days that would systematically bias the results. This is likely to be
especially true if we are comparing a study in which distribution figures
come from a household budget survey with a study in which the distribution
figures are pieced together from other sources. Aggravating the difficulty,
the former source will ordinarily provide distribution figures for households
while the latter do so for individuals. Finally, an effort may be made in
some cases to achieve consistency with magnitudes from national accounts,
while in others no such attempt is made. How this difference biases the
results is likely to be unclear.

Third, studies being compared may not adopt the same definition of
income, or even if the definition is identical, the data available to implement
it may be different. It is ordinarily quite meaningless, for example, to
compare studies in which effective tax rates are based on taxable income,
disposable income, personal income, personal income adjusted for direct taxes
and retained earnings, and net national product, respectively, or any subset
of these. Moreover, some studies may adopt expenditures as the basis for
calculating relative tax burdens, while others may calculate taxes as a
percentage of income, but group households according to expenditures, rather
than by income. Still others may attempt ad hoc adjustments to offset the
workings of the permanent income hypothesis, while others do not. Only if
there is agreement on some standard approach is it likely that results can
appropriately be compared.

Comparison of aggregate effective tax rates is also most meaningful
if decisions on which taxes to include in the analysis are based on a uniform
set of criteria. This does not mean that in all countries certain sources of
revenue would be included for analysis and others excluded. Rather it means
that in each country those sources that really have the attributes of taxes
would be examined, whereas those that are really just payments for benefits
of public services would be excluded. Moreover, a standard approach would be
adopted for the treatment of subsidies of various forms. Unfortunately, existing
studies demonstrate a variety of practices so far as including and excluding
revenue sources and subsidies is concerned.

A similar line of reasoning is appropriate so far as incidence
assumptions are concerned, but is difficult to implement. It is of no help
simply to compare the incidence assumptions for uniformity, since there is no
reason to believe that identical assumptions are generally appropriate. Rather,
comparisons are useful only if the incidence assumptions for each country are
reasonable. But presumably all investigators think their assumptions are
appropriate. All that can be hoped for is that the author has argued system-
atically and persuasively that given circumstances in the country in question,
the incidence assumptions chosen are appropriate or that he provides alter-
native estimates (or the data necessary to make them) for alternative assumptions.
There is a natural inclination to compare the results of studies done for the same country, in the effort to determine how tax policy has changed over time. But it seems that except under very special circumstances such efforts are doomed to failure because enough uncertainty is involved in individual estimates that wholly spurious differences in results could easily outweigh any systematic changes in the true incidence of taxation and render any comparison meaningless. This constraint is more important than it might appear. After all, additional estimates for given countries are probably made as often because new and (hopefully) improved data are available as because anyone seriously believes that the basic incidence of the tax system has changed. Moreover, new theoretical developments occasionally call for a change in the incidence assumptions used in previous studies for a country. But if we are constrained to employ identical methodologies in the interest of assuring comparability between studies, we may be unable to employ some new data series and we certainly could not change incidence assumptions.

Fortunately, there are other ways of assessing the distributional impact of changes in the tax system. The most obvious is to engage in some simple hypothetical exercises. We might, for example, simply ask what would be the incidence of some previous or potential new tax system, given present income and consumption patterns, etc. and compare it with the incidence of existing taxes. Though this exercise is most easily executed for indirect taxes, it is probably also possible for direct taxes, given the crudity of incidence assumptions and data used and the bunching of corporate ownership and personal income tax payments in high-income classes. This approach has the effect of isolating the effects on tax incidence of changes in the tax law from those that result from changes in consumption patterns, property ownership, etc. This is, of course, both an asset and a liability.

But once comparisons of this type are being considered we see immediately that we can short-circuit the analytical process just described by simply examining the incidence implications of changes in the tax law, without bothering to calculate the incidence of the tax system prevailing at any particular time. Similarly, we can look ahead, as well as back, by estimating the incidence of new taxes or changes in existing taxes, independently of the incidence of existing taxes. As noted in part G of this section such an approach has the further attraction of being methodologically preferable to attempting to determine the incidence of all existing taxes simultaneously.

F. Summary of Incidence Studies

Although a substantial number of studies of tax incidence have been made for various developing countries during recent years, only a handful have treated the urban and rural sectors separately, and even fewer provide the information that is necessary to isolate the tax burden on the urban poor. Table 1 summarizes the results of seven studies that contain an urban-rural breakdown and enough other detail to justify inclusion in the summary. Though our primary focus is upon the incidence of taxes on the urban poor, **per se**, we also include comparative information on tax burdens on the rural poor and upon
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<tr>
<td>Brazil, 1962-63</td>
<td>16 e/</td>
<td>20+</td>
<td>20 e/</td>
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<td>Pakistan, 1966-67</td>
<td>10-1/2</td>
<td>12</td>
<td>22-24</td>
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<td></td>
<td>9-1/2</td>
<td>11</td>
<td>15+</td>
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<tr>
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<td>11-1/2</td>
<td>14</td>
<td>33</td>
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<td>6</td>
<td>7</td>
<td>15</td>
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<td>9</td>
<td>18</td>
<td>6-1/2</td>
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<td></td>
<td>8-1/2</td>
<td>9-1/2</td>
<td>16</td>
<td>6</td>
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<td>Lebanon, 1968</td>
<td>8</td>
<td>n.a.</td>
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n.a. - not applicable.

\( a/ \) Basis of measure is income or expenditure, as reported in studies.

\( b/ \) Urban and rural poor are roughly the 40 percent of households in the two sectors with the lowest incomes.

\( c/ \) The urban rich are the 2 to 5 percent of urban households with the highest incomes.

\( d/ \) This estimate for Colombia is based on the assumption that the corporation income tax is borne in equal proportions by Colombian consumers, Colombian shareholders, and foreign shareholders.

\( e/ \) This is approximate, as the original sources do not allow much precision.

\( f/ \) Indirect taxes only.

the urban non-poor. We do not repeat the caveats and qualifications of the authors of individual studies. Nor do we specify the definition of income and the incidence assumptions used in the studies or comment upon the choice of definitions and assumptions and upon the methodologies followed. For reasons described earlier—and others—the results of individual studies reported here should be interpreted with caution. Moreover, comparisons between studies using such disparate approaches, data sources, incidence assumptions, coverage of taxes, and bases for measurement of burden are inherently hazardous. But they may nonetheless indicate some general patterns that are worth noting.

Several basic tendencies seem apparent from these figures. First, in the studies surveyed, which covered a wide geographical area, if not a representative sample of countries, taxes seem generally to take just under 10 percent of the income or expenditures of the urban poor. (The study for Brazil reports a marked exception to this generalization.) Second, in those studies in which comparisons were possible, it was found that tax burdens on the urban poor exceed those on the rural poor. The differences in effective tax rates or taxes as a percentage of expenditures run about 3 to 5 percentage points, but in several cases the excess equals the rates paid by the rural poor. (Exceptions occur in those cases in which there are important export duties—or equivalents, such as differential exchange rates—on the output of the rural sector. Examples are export duties on rubber in Malaysia and differential exchange rates for coffee earnings in Colombia). One important reason for these differences is probably the greater monetization of the urban sector. Goods and services which might be produced at home in the rural sector must be bought in the urban sector. Of course, the greater the degree of monetization, the greater the exposure to the tax collector. In addition, it seems as though urban life produces expenditure patterns that are more conducive to liability for indirect taxes than does rural life. That is, even abstracting from differences in tax burdens resulting from differences in the importance of income-in-kind in the two sectors, urban households at a given income level are more likely to consume goods that are imported than are rural households, and more likely to consume local goods that are produced or processed commercially rather than by small-scale agriculturists or craftsmen. For example, not only is the urban dweller more likely to purchase a dutiable radio. His food and drink is also more likely to have been processed commercially and his furniture is more likely to be "manufactured" rather than produced by artisans. Thus, the market basket of urban households is likely to bear a heavier burden of import duties, sales and excise taxes, and shifted corporation income taxes. (Another influence which need not concern us here, because it applies primarily to upper income groups, is the tendency for income taxes to be administered less effectively in rural than in urban areas.)

Third, (again with the exception of Brazil), estimated tax rates on high income urban households exceed those on the urban poor by substantial amounts. That is, in almost all cases the effective tax rates on the urban rich (defined as the 2 to 5 percent of urban households with the highest
incomes) are at least twice those on the urban poor. But progression is generally not smooth. Indicative of this is the similarity of effective tax rates in the fourth urban quintile to those on the urban poor. In most cases overall progressivity is primarily attributable to the progressive influence of direct taxes. 1/ But in most countries direct taxes simply do not impose a significant burden except at the very top of the income scale. Thus taxes often account for as great a share of family income for the urban poor, as they do for the more fortunate urban households, with the exception of the few in the very highest income classes.

G. Directions for Future Research

In general, it can be said that the immediate purpose of tax incidence studies is to determine "who pays the taxes." But what the more basic purpose is, is not always so clear. Presumably it involves knowing whether the tax system tends to lessen or to accentuate existing inequalities in the distribution of income, at the very least. Of somewhat more direct relevance for the present purpose, it may involve calculating effective tax rates paid by the urban poor, more or less independently from tax burdens on other groups.

A problem with incidence analysis not noted above involves its basic methodology, which is essentially to assume that the income distribution observed in the world with the existing tax system would prevail in the complete absence of taxes. This assumption may be more or less acceptable if we are "thinking away" relatively small taxes and even some kinds of relatively large taxes. But it is questionable indeed if we are assuming away something like the company income tax, export duties, protective tariffs, etc., and even more questionable if we assume away all taxes simultaneously, as we implicitly do in incidence studies. Such basic fiscal changes would affect the economy radically and there is no reason to believe that the initial no-tax distribution of income would be the same as what we now observe with the taxes in place.

Granted this methodological difficulty, how are we to proceed? Must we simply give up studying the effects of tax policy on the distribution of income? The answer, it seems, is that we need not give up studying tax incidence, but that we should be less ambitious and more realistic by concentrating upon the incidence of marginal changes in tax policy. The

1/ In some cases even indirect taxes are progressive. This is especially true if we take expenditures as the basis for comparison, rather than income. Progressivity of indirect taxes, in turn, results from a combination of varying degrees of commercial integration, differences in consumption patterns, and differential taxation of necessities (low rates) and luxuries (high rates). But these progressive elements are often offset by other regressive indirect taxes.
really important use of incidence studies is in the determination of how
tax burdens at various points in the income scale would be altered by
changes in the tax systems. After all, no one is likely to propose seriously
(or at any rate, effectively) that all corporation income taxes be eliminated
or doubled, that all import or export duties be eliminated or doubled, etc.
Though extreme changes of this kind may occur from time-to-time, the more
frequent pattern is for various taxes to be altered at the margin, and it
seems best to recognize this in framing future research into the incidence
of taxes. In concrete terms, this means that we should concentrate upon
analysis of the effects of increasing or decreasing particular taxes or of
substituting revenues from an increase in one tax for the revenues lost by
reducing another, rather than upon the incidence of entire tax systems.
This, after all, is the type of information that would be most useful to the
policy-maker contemplating changes in the tax law. Analysis of this type could
be implemented using the typical household approach or, provided a household
budget survey exists, the income distribution approach.

It seems especially useful to examine the effect (differential
incidence) of substituting some indirect taxes for others. It is common
to assume that a tax system is more regressive, the more heavily it is
geared to indirect taxation, rather than direct taxes. But for any break-
down between direct and indirect taxation, incidence can differ quite
drastically, depending on the composition of the base and rate structure
of the indirect taxes levied. Most obviously, a tax system is less
regressive if it excludes (or taxes preferentially) such items as basic
foodstuffs, popularly consumed tobacco products and alcoholic beverages,
and public transportation. Similarly, it is more progressive to the extent
that differentially high rates can be applied to private automobiles, luxury
appliances, etc.

Besides revealing effects upon burdens on the urban poor and upon
the progressivity of the tax system, such an exercise could provide information
on alterations in the urban-rural sharing of tax burdens, and perhaps more
important, on the changes in burdens of particular households within income
classes--that is, upon horizontal equity--particularly among the urban poor.

To provide this last piece of information the study would, of
course, have to employ the typical household approach, rather than the
income distribution approach. This approach sometimes more easily handles
disaggregation than does the income-distribution approach, which is dependent
upon the level of disaggregation employed in budget surveys. In addition,
the permanent income hypothesis is more easily dealt with. And this approach
may be somewhat less data-intensive and therefore, somewhat less costly, than
is generally true of the income-distribution approach.

On the other side of the ledger, we need to know just what kind of
family is sufficiently typical to deserve attention. Moreover, studies based
on the typical household approach tend to rank somewhat lower in academic
respectability than do studies of income distribution and tax incidence. But further research using the typical household approach imaginatively and assessing its relative strengths and weaknesses would probably alter this last state of affairs.

The final comment of this section involves what probably should not be done. Someone reading this paper might well conclude that it would be well to examine the incidence of taxes in all (or at least many) nations systematically, in the same way that we now have more or less uniform national accounts, statistics on foreign trade, etc. Ideally such a project would assure us of a uniform methodology, acceptable data, a reasonable definition of income, proper incidence assumptions, etc., and would provide information on tax incidence that would be both useful to policy-makers in the individual countries and comparable across countries. However, it does not seem that this should be a high priority undertaking for several reasons.

First, the data necessary to make studies on a comparable basis in many countries almost certainly do not now exist. Falling back on whatever data are presently available would probably produce a variety of estimates not much better than now exist. Second, so far as questions of methodology, which taxes to include, and proper incidence assumptions are concerned there is substantial room for judgment. Since there is no assurance that judgments would be good ones in all cases, the resulting estimates might be no better individually than what now exists, and they might lack comparability. This is especially important, since such a series of estimates, once given the sanction of a uniform format and nominally comparable data and methods, would probably be accorded a level of acceptability they would not deserve.

The final objection is even more basic. It is that the resources necessary to prepare a series of similar incidence studies for all countries could be better spent. Fundamentally, the point is that from the standpoint of tax policy the incidence of the total tax system, even if it could be known, is of limited value, and international comparisons are more or less irrelevant. The important policy questions involve how changes in the tax system of a given country would affect households at various points in the income distribution. It is to the examination of that question (or others) that resources should be devoted. That is, resources should be devoted to the analysis of tax reform and its implications, including incidence, and not to producing estimates of tax incidence that would be granted undeserved weight.

II. IMPROVING THE FISCAL POSITION OF THE URBAN POOR

Evidence cited in the previous section—and fragmentary evidence not reported here—suggests that it is inaccurate to assert, as is sometimes

1/ See Bird and De Wulf (1973) for a stronger statement of this position than the author would care to make.
done, that the urban poor pay no taxes. But the significance of the effective
tax rates reported is far from clear. For example, taken by themselves, the
percentage at the low end of the scale (say 5–8 percent of income) can be seen
as implying real bargains in the purchase of public services for the urban poor.
Or they can be seen as signaling lost opportunities for the expansion of the
public sector at relatively little cost in terms of reduced standards of
living of the urban poor. Conversely, figures on the high side (in excess
of, say, 12 percent of income paid as taxes) can be interpreted alternatively
as grossly inequitable tax burdens on the urban poor or as evidence that a
concentrated effort is being made to utilize the public sector to improve the
lot of the urban poor by providing vital public services and increasing the
rates of investment and economic development. Which of these alternative
interpretations—or others—is valid depends crucially, inter alia, upon the
size and composition of the budget and cannot be known a priori. Rather, an
appraisal of the tax burden on the urban poor can be made only after a
detailed analysis of both the tax and expenditure sides of the budget in a
given country. While it is impossible to provide a formula for an appraisal
of this type, this section represents an attempt to specify some guidelines.1/

A. Reducing Taxes on the Urban Poor

Perhaps the most straightforward way to improve the fiscal position
of the urban poor, if not the best, and a useful place to begin the discussion
of this section, is to reduce the taxes they pay, assuming the size and
composition of the budget to be fixed. That the budget is not fixed, and
should not be taken to be for policy purposes, is considered further in part
B of this section.

It is a truism that if the budget is fixed, in composition as well
as in size, the fiscal lot of the urban poor can be improved only at the expense
of the urban non-poor and rural households. Thus even if our fundamental
concern is with the amount of taxes paid by the urban poor, and not with
progressivity and regressivity per se, we are brought back to the need to
increase progressivity and reduce regressivity by our concern with absolute
burdens on the urban poor, given the context of a fixed budget. By and large
we do not consider the rural population and the taxes it pays explicitly.

1. Reducing Regressivity

The bulk of the tax burden borne by poor urban families in most
developing countries can be traced to various indirect taxes, customs duties
and general and selective sales taxes. The reason is, of course, that (a)
low-income families often fall below the level of income which statutorily
would make them liable for income taxes, and may be largely outside the
commercial sector, in any event, but (b) many of the goods they purchase
are subject to indirect levies. The weight of the burden and the regressivity

1/ Parts of this discussion draw heavily upon ideas also presented
in McLure 1975b.
of a tax system will depend, as noted earlier, upon the exemptions and
differential rates built into its various parts and upon consumption
patterns, the existence of non-taxable substitutes, etc. There is little
need to go over this well-known ground in detail, but it does seem worth-
while to stress several points.

a. Exemptions from general sales taxes (or at least reduced rates)
for basic necessities seem to be quite common, (see Cnossen, 1974, Table 6),
except in a few of the developed countries. Thus so far as general sales taxes
are concerned, equity is probably fairly well served, subject to several provisos.
First, any country considering adopting a new sales tax should exempt at least
the most basic necessities, countries already imposing sales taxes should be
encouraged to free completely unprocessed food from tax, and tendencies to
eliminate preferential treatment of necessities in the interest of increasing
revenues should generally be resisted.

Second, as important as it is to provide relief from indirect
taxes for low-income families, the effort can easily be overdone, since most
of the benefits in terms of improved equity are likely to be achieved by
exempting only such items as unprocessed foodstuffs. Once exemptions go
beyond the most basic items, administrative complexities and compliance costs
multiply, and with them the chance of evasion. Taking into account the minimal
improvement in equity, the revenue lost through evasion, as well as the loss
inherent in the exemption, the added complexity and cost, and the distortions
induced by an imperfectly operating system of exemptions or reduced rates, one
can easily conclude that in most countries a very simple, if theoretically
less desirable system of rates is preferable to a conceptually preferable,
but infeasible system of highly differentiated rates.

Finally, sales tax relief appears in many instances to be largely
offset by import duties or excises. (See Cnossen, 1974, p. 200). The overall
equity of taxation can be improved by exempting from (or taxing preferentially
under) customs duties and excises, as well as general sales taxes, items
figuring especially heavily in the budgets of the poor. The items to be
exempted or taxed at preferential rates can, of course, to some extent be
identified through an examination of the results of household budget surveys. 1/

1/ But, as noted earlier, an imported item may, in some instances, be
qualitatively different from a domestically produced good of the same type. If
so, a tariff on the imported variety may add to the progressivity of the tax
system to an extent not revealed by the budget survey, which may not discriminate
between imported and domestic products or between products of various qualities.
But caution should be exercised in attempting to add to the progressivity of the
tax system by taxing only imports of certain items, lest unintended and uneconomical
import substitution be encouraged. See also McLure, 1975b.
b. **Sumptuary Taxes** - those on alcoholic beverages, tobacco products, and gambling, including the profits of state monopolies and lotteries—are an important source of regressivity in many countries. Though these taxes are often justified as compensating for external diseconomies generated by those who use the taxed goods and services, there can be little doubt that their primary attractions are ease of collection and reliable revenues. It can be argued, in fact, that these are almost the only redeeming values of these taxes, which ideally would have no place in the tax systems of an enlightened country.\(^1\)

This argument is founded upon the low price and income elasticities of demand for the goods in question. Because the demand for the goods is not very responsive to price, it does but little good to tax the products in an effort to reduce consumption of them, whether consumption generates external diseconomies are not—itself a debatable issue beyond the scope of this paper. All that the high taxes accomplish is a reduction in the incomes of families consuming the taxed goods and services.\(^2\) But because demand for the goods is not income elastic, the reductions in income result in a regressive pattern of tax incidence, that is, in a relatively heavy burden on the poor.

c. **Prices for Public Services** - Fares and charges for transportation and various other public utilities (especially water and sewerage), frequently impose onerous burdens on the urban poor—burdens that are altogether too rarely considered by public finance experts. The design of optimal charges (or tax and subsidy systems) to meet the simultaneous demands of revenue adequacy, equity, efficiency and administrative feasibility deserves careful attention.

Efficient resource allocation requires that prices be set to cover marginal social costs. On the other hand, the need to finance public services implies that it is advantageous to charge at least enough for public services to cover average costs. Third, equity is usually taken to require relatively low taxes on the poor and relatively high taxes on the well-to-do. Finally, any system of charging or taxing must not involve onerous administrative problems. Needless to say, these four goals cannot generally be met simultaneously. If average costs are constant or rising (or if a substantial congestion or pollution charge equaling or exceeding the difference between marginal resource costs and declining average costs is levied) marginal-cost

\(^1\) For a more complete development of this controversial position and references supporting some of the contentions that follow, see McLure and Thirsk, 1973.

\(^2\) It might be countered that failure to tax these goods and services would result in increased lung cancer, public drunkenness, absenteeism, gambling, etc. The low elasticities of demand estimated for many countries suggest that this is not true. Moreover, reducing these taxes would leave more of the family budget for food, education, health care, etc. so long as the elasticities are low. Finally, any government truly interested in these problems would have long since moved to ban advertising of alcoholic beverages, tobacco products, gambling, etc., and even to advertise against them. An effective ban or counter-propaganda effort would reduce the evils described above and leave more household income to be spent for more productive purposes. That few governments seek actively to discourage the activities in question and many actively encourage them suggests that revenue, and not public health, morals, and productivity, is the crux of the issue.
pricing will produce a balanced budget, or even a surplus, and efficiency and revenue adequacy are compatible. But where average costs decline with output it is generally (i.e. in the absence of congestion or pollution charges) necessary to choose between efficiency and revenue adequacy. Finally, in some instances, it is possible to segment the market and treat the poor and non-poor differently, but in other cases it is not. And even if it is possible to segment the market, it may be difficult to reconcile the prices ideally charged either the poor or the non-poor as a matter of equity with the prices required for revenue adequacy or efficiency, much less with both. An example should help to clarify these points.

Equity suggests that the poor should pay little for transportation, but that the wealthy should pay dearly for it. To the extent that there is a natural tendency for the transportation market to segment itself (into buses, mini-buses, jitneys, taxicabs, and private automobiles) tax advantages (and subsidies) provided to buses—presumably used predominantly by those in the lowest income groups—could reduce the burden of taxes on the urban poor without a great sacrifice in revenue from the basically quite progressive taxes on motor vehicles and motor fuels. Moreover, it seems unlikely (though it is an empirical question) that setting the bus fare below marginal costs would interfere greatly with economic efficiency, since much of bus use by the poor is for commuting and may not be price elastic, at least in the short run. Similarly, setting prices to (taxes on) the non-poor above marginal resource costs may not be undesirable, even if demand for transportation by that group is price-elastic, given the pollution and congestion caused by private automobiles. Of course, the extent to which these propositions are valid and the revenue consequence of this type of financial arrangement would need to be examined in each country—or in each city. Finally, it should be noted explicitly that an overall deficit in the transportation budget does not imply that taxes are set too low or a surplus that they are set too high, or even high enough. This can be known only after a detailed examination of the various costs and taxes and alternative revenue sources.

1/ Revenue adequacy is actually also a matter of efficiency. If revenues from charges are inadequate, one of several allocatively undesirable alternatives must be faced: some other (presumably non-neutral) tax can be raised or the service can be under-provided. It will be convenient to continue to compress this complex choice into the short-hand term "revenue adequacy".

2/ It might be argued that those in the very lowest income brackets do not even ride buses and therefore would not benefit from any tax reduction. One could hope that fares could be reduced enough by fiscal assistance (tax exemptions or subsidies) that the relief would accrue to these groups as well. Of course, the very fact that subsidies increase use of the buses by the poor may be evidence that demand is price elastic and excess burdens are created. The charge that it would be unwise to subsidize public transportation in a time of growing shortages of energy can only be countered by arguing that we must walk a tightrope of facilitating transportation within the context of given city structures without artificially encouraging further development of energy-intensive urban forms. How to do this is beyond the scope of this paper. Finally, a particularly troublesome potential problem might be accentuation of the tendency found in many countries of commuting to home and back to work during the long lunch hour. This might effectively be combatted by government mandating of a shorter lunch break.
Though we have focussed upon public transportation, similar problems arise with regard to such public utilities as electricity, telephones, and water and sewerage. Equity, efficiency, revenue adequacy, and administrative considerations should all be taken into account in setting charges. And in many cases it will be advantageous to reconsider existing intergovernmental relations. In the next paragraph we discuss only the last point.

Suppose that each of the three services provided above has been provided historically by semi-autonomous agencies, each with its own budget. In such a case each agency is likely to concentrate on revenue adequacy, with little regard for the other goals discussed above. That is, it may seek to cover costs and provide funds for expansion without reference to whether the prices it charges are economically optimal, whether the expansion is justified, or whether its pricing practices further equity. We might therefore find a situation in which the telephone agency was charging just enough to cover its average costs, even though there was a waiting list for telephone service. By raising its residential rates enough to choke off this excess demand the agency could reduce the real incomes of high-income households, the only ones able to afford phone service in many developing countries. But if the only use to be made of the increased revenue was expansion of service--which might involve a high import content--it might be best not to allow the rate increase. If, on the other hand, the rate increase could be siphoned off into the public treasury through a tax on phone service, supply could be equated with demand and the progressivity of the tax system increased at the same time. The surplus thus appropriated could be used to subsidize other public services where equity and efficiency suggested a deficit, such as education, health, and public transport, or to support the general activities of local government. Alternatively, it might be advantageous to combine the agencies providing the various public services so that the cross-subsidization between users of the services could occur with one "super agency" rather than involving the transfer of funds from one agency to the government and then back to another agency. 1/ In any event, given the importance to the urban poor of such services as public transportation and utilities, the pricing policies of agencies responsible for providing the services and the intergovernmental relations among the agencies and between them and various levels of government should not be allowed to escape the scrutiny of those interested in improving the fiscal (as well as the general) plight of the urban poor.

2. Increasing Progressivity

By increasing taxes on the wealthy we provide the slack that is necessary to reduce taxes on the poor within the context of a given budget.

1/ Of course, the combination of agencies and cross-subsidization of activities should not be allowed to free the super-agency from public scrutiny. All the policies of the super-agency should be established with an eye to equity, efficiency, and revenue, and there is no reason that in total there should not be a budget surplus or deficit for all activities combined.
But the problems posed by increasing progressivity are somewhat more complex than those posed by reducing regressivity. For one thing, once we go beyond the rather limited possibilities of increasing indirect taxes on luxury goods we are plunged into the complicated area of direct taxes, including personal and corporation income taxes, taxes on capital gains, net wealth and property taxes, progressive expenditure taxes, death and gift taxes and such closely related topics as land reform. Not least of the problems that would ideally be examined are administrative possibilities and incentive effects on saving, investment and work effort. Needless to say, in the present paper no more than a cursory treatment can be provided for any of these topics, and most must be ignored.

a. Luxury Taxation can almost certainly be extended in most countries. In particular, selective sales taxes applied to both imported and domestic products, and especially services, figuring heavily in the budgets of the very wealthy could be an important source of additional progressivity. Of course, the most important potential sources of revenue and progressivity are readily identifiable and are already subject to heavy taxes in most cases. But several points can be made even about these items. First, existing rates should be under continuing scrutiny to assure that they are appropriate. This is particularly true where specific rates are involved, as they can quickly become obsolete in a time of rapid inflation. Second, efforts should be made to improve enforcement if the statutory rates are taken to be warranted. If the rates are not warranted, or if experience suggests that at existing rates smuggling is a major and insuperable problem, rates should be reduced in consort with the improved enforcement effort.

Probably the single most important flaw of most luxury tax systems is the failure to include services. Failure to include such services as laundries and dry cleaners in the tax base probably reduces progressivity little, if at all, and the lost revenue may not be great, though it will grow. 1/ But omission of expensive hotel rooms, restaurant meals, charges at country clubs, air travel, and various other items of high-income consumption can reduce both progressivity and revenue substantially. 2/ Each country should remain watchful to see that easily taxed luxury spending is not escaping the revenue net.

b. Personal income tax reform is the object of continuing controversy in almost all countries and therefore cannot be treated adequately here. But it seems worthwhile to make several points. First, if the personal income tax is to contribute significantly to progressivity, it must truly be

1/ Taxation of one important luxury service, domestic employment, is generally infeasible. This is probably just as well, since the tax might be as likely to be reflected in lower wages or higher unemployment as in burdens on the affluent. Care should, of course, be exercised to assure that unintended effects of this type do not result from well-intentioned efforts to increase progressivity by taxing services.

2/ On the other hand, levies on financial and commercial transactions, usually collected through stamp taxes on documents such as mortgages, conveyances, etc., while they may, on balance, add to progressivity, so encumber the free flow of merchandise and property in many countries that they can only be classified as "nuisance taxes" and should be repealed or levied in an easily administered form only at levels adequate to defray expenses of recording documents.
more than just a withholding tax on employees of governments and large firms. That is, it must extend equally to the earnings of professional people and other self-employed persons and to capital income. Otherwise, talk of progressivity and social justice is mere sham, especially since salaries in easily taxed sectors may simply be raised by enough to offset the tax burden. There are, of course, substantial obstacles to even-handed and equitable administration of income taxes, but the most important obstacles may result more from a lack of will than from a lack of a way to administer taxes fairly. A few examples may be instructive.

Professional persons are notoriously difficult for revenue officials to police, because of the ease of concealing income. But it should be possible to require doctors and lawyers, for example, to keep a complete log of patients and clients seen and charges made for services. It would then be a fairly simple matter to run spot-checks by comparing this record with information gained from a sample of persons seen leaving the doctor's or lawyer's office. Any important discrepancies would be prima facie evidence of income tax evasion. 1/

Another source of substantial tax evasion in many countries is the prevalence of bearer shares (unregistered stock certificates). Since the paying corporation does not record the names of persons to whom it pays dividends, there is little reason for the recipient of the dividends to declare them for tax purposes. This loophole could, of course, be reduced, if not eliminated, by outlawing bearer shares and even requiring information returns from paying corporations. And of course information returns should also be required for payments of substantial amounts of interest. A more far-reaching (but perhaps simpler) approach would be to require withholding of tax at a standard rate from both dividends and interest payments.

It seems that it is both worthwhile to insist upon a satisfactory level of administrative performance and compliance, and possible to achieve it in most countries. Among the essential ingredients are a well-trained and honest group of civil servants who are paid enough that they are likely to resist corruption and the development of an expectation among taxpayers that the tax laws will be enforced firmly, but fairly, with suitable penalties for deliberate non-compliance and evasion.

This latter expectation seems to be notably lacking in many countries, where tax liabilities are seen to be different in kind from other liabilities. Citizens must be made to realize that taxes are in fact on a par with other obligations and that failure to pay the tax collector what is due him is equivalent to non-payment of other debts and will be treated as such. It can be expected, though knowing it confidently is difficult, that a publicized intention and a concentrated effort to enforce the laws stringently would bring forth a level of self-enforcement thought impossible in many countries.

1/ Another potentially useful fiscal device is a presumptive income tax, such as recently imposed in Colombia. This approach, under which income is presumed to equal at least some given percentage of net wealth, is most-easily administered if, as in Colombia, there is also a net wealth tax. In any event, determination of net wealth is no easy matter. See also item h: below.
Finally, not all countries levy income taxes on a worldwide basis, limiting their interest in the income of an individual to that earned within the country. In part this practice is a concession to practicality, since it is difficult to obtain information about income earned abroad. But this practice reduces the progressivity of the tax system and can encourage capital outflow, as well as sacrificing badly needed revenue. Thus it seems desirable, where feasible, to move more nearly to taxation on a worldwide basis.

c. Corporation income taxes are sufficiently complex and varied that it is difficult to generalize about them. But a few words seem in order. First, careful attention should be devoted to the foreign tax credits (and even tax-sparing arrangements) allowed firms operating in a given country by their home countries. In particular, it may, in some instances, be possible that full advantage is not being taken of foreign tax credits. Beyond that, every effort should be made to negotiate favorable double taxation treaties, including provisions for tax sparing. The overall income of the country, as well as public revenues, are increased by such arrangements, at the expense of outsiders.

Second, it seems worthwhile to reexamine the policy of granting tax holidays to investors that has become so prevalent in recent years. It seems likely that in many instances public revenues have effectively been given away to firms who might well have located in a given place even without the inducement. Even when this has not been the case it is far from clear that the additional investment actually induced justified the loss of revenue. And it is likely that in many cases the tax incentives have taken forms that have seriously distorted economic choices. In particular, overly capital intensive projects may have been encouraged—a result that is questionable indeed for labor surplus, capital-short countries. Finally, an effort needs to be made—and is currently underway in some of the newer common markets and free trade areas—to coordinate policies intended to encourage industrialization and thereby avoid unproductive fiscal competition for industry.

Another area in which cooperation is possible is the taxation of natural resources, whether through corporation income taxes, export duties, or production taxes. Perhaps no group of countries can hope to duplicate the success of the Organization of Petroleum Exporting Countries (OPEC). But there are probably cases in which cooperative action could lead to the exporting of substantial amounts of taxes to residents of other countries, via increased prices or reduced returns to capital or resources.1/ (See Hughes, 1974 and Gillis and McLure, 1975).

1/ We must note, on the other hand, that the actions of OPEC have severely injured development efforts in many countries and similar actions by other groups of countries would do the same. But it is unrealistic and perhaps unreasonable, to expect any developing country not to give the welfare of its own citizens top priority.
d. **Capital gains taxes** are, in many respects, an ideal vehicle for increasing progressive taxation. Capital gains are often, though not always, virtually unrelated to the productive efforts of those realizing them and they almost certainly accrue in large part to families that are wealthy (or become wealthy as a result of the gain). On the other hand, some gains merely reflect general inflation and others are the result of the productive efforts of those realizing them. On balance, it seem reasonable to subject gains in excess of some annual rate chosen to compensate for inflation, especially those on real estate, to a heavy tax. And it would be desirable, if difficult, to employ periodic constructive realization (at the very least at transfer by reason of death or gift) to avoid lock-in. Needless to say, such proposals should be closely coordinated with income taxation, death and gift taxes, land reform, and betterment and other taxes on increases in site values.

e. **Death and gift taxes** would contribute significantly to the reduction of existing inequality of the distribution of income in developing countries, much of which can doubtlessly be traced to inherited wealth. Two points can be made about this very complicated subject. First, death and gift taxes and capital gains taxes are not good substitutes, though they are often not adequately distinguished in the public mind. Large fortunes on which there have been no taxable capital gains can be transferred at death (or by gift). Conversely, large capital gains need not result in transfers that would be taxable under a death and gift tax. The two taxes have different purposes and both deserve a place in the fiscal system of a country. Second, it would seem that an accessions tax, based upon the total amount of transfers received by a person in his lifetime, is preferable to either estate or inheritance taxes and supporting gift taxes. An alternative, however, is to include gifts and bequests in taxable income, as under the classical Haigh-Simons definition of income.

f. **Property taxes** also deserve more detailed treatment than can be given them here. Thus we focus upon only several important equity aspects of property taxation. First, in many countries the luxurious housing of the rich is probably grossly undertaxed. This has at least two undesirable effects. The progressivity of the tax system is needlessly reduced and revenue is lost. Beyond that, investment in luxury housing for the well-to-do is overexpanded, relative to other more productive uses of capital. Here is an instance in which equity, resource allocation, and revenue needs all cry for the same policy, an increase in taxes on luxury housing.

The same arguments can be reversed, at least in part, to justify tax exemptions for residential property at the other end of the income scale. Burdens on the urban poor—including squatters—and administrative costs can be lessened, with relatively little impact on revenues, if residences with values falling below some minimal level are exempted.\(^1\) This policy may be

\(^1\) To avoid a "notch problem" while at the same time limiting the tax relief to low income groups, the exemption could be made to vanish as the value of the property exceeded some arbitrary low value.
questioned on efficiency grounds, since it would encourage investment in residences by this group. But several points must be noted. First, residential investment can certainly be overdone and therefore become wasteful of scarce resources. But this is not equivalent to the naive and invalid argument sometimes heard that investment in housing is inherently unproductive and therefore wasteful. After all, housing does fulfill a perfectly legitimate human need, and it may even increase productivity. Second, given the imperfections that plague capital markets in many countries, investment in housing is often one of the few outlets for savings of the urban poor. It therefore may be good public policy to encourage this form of investment. This conclusion is strengthened when we recognize that imperfections in capital markets often make it particularly difficult for low income households to acquire adequate housing. Finally, the labor intensity of housing construction and the possibilities of self-improvement by the owner make this an especially attractive form of investment to encourage through public policy. Investment in housing for the poor may actually draw resources primarily from consumption and leisure, rather than from other investment outlets.

\( g. \) Betterment levies and various other types of benefit-related charges can improve the distribution of tax burdens by preventing public expenditures of special value to upper income groups from being financed from general revenues. Moreover, they can substitute for capital gains taxes in appropriating for the fisc part of the private gains that result from public activities. But the use of such financial procedures, best illustrated by valorizacion in Colombia and land readjustment schemes in Korea, to improve the equity of public finance is not limited to the top of the income scale. Experience suggests that in many instances the poor will gladly make voluntary payments in order to obtain access to public services, since the alternative may be to do without the service. As discussed further in part B of this section, many public services may yield a fiscal residual (benefits in excess of cost) to the poor even if beneficiaries must cover the entire cost of the service.

\( h. \) Net wealth taxes and progressive expenditure taxes are conceptually attractive and the former is functioning in several countries. But both are difficult to administer and experience with the expenditure tax has not been especially satisfactory. Therefore it seems best to say nothing about these taxes here.

\( i. \) Land reform is generally discussed as a rural policy, as it usually occurs primarily in rural areas. But it has important implications for the urban poor for at least three reasons. First, it probably affects the flow of migrants from rural areas to the cities. Second, rural land reform has an urban counterpart in the invasion of private land, sometimes with implicit governmental approval, that occurs in cities throughout the third world. Finally, through its traumatic impact on land-owners it almost certainly affects the economic behaviour of the wealthy groups that potentially account for important portions of saving and investment flows. But because these questions are beyond the scope of expertise of the public finance specialist, they are not discussed further here.
j. In sum, there is little doubt that in almost every country taxes could be made more progressive if an effort were made in that direction. There are severe administrative and technical obstacles, but these could probably be overcome if there were a will to do so. The truly important obstacles are more likely to be political. The wealthy families who would be hit heavily by more progressive taxes are, with rare exceptions, probably as influential politically as they are economically. Thus, despite the availability of tools to reduce tax burdens on the urban poor by transferring them to the well-to-do, it may be unrealistic to expect much in this area. Rather, it may be better to focus upon using the public sector to improve the lot of the urban poor by providing services of special benefits to poor families, even if those families must pay for them. Political constraints on improving the plight of the urban poor in this way may not be as binding as are those preventing the implementation of greater progressivity in tax systems.

B. Increasing the "Fiscal Residual" of the Urban Poor

Given the severe political obstacles to improving the fiscal position of the urban poor by reducing the taxes they pay, it seems imperative that we examine a potentially more rewarding avenue for improving the fiscal position of the urban poor, which, for lack of a better term, we shall call the fiscal residual of the poor. We shall see that the kind of research necessary to design programs that have a positive fiscal residual for the urban poor is analogous to the kind argued in Part I above to be the most fruitful form of tax incidence analysis.

1. The Conceptual Framework

If public activities were all being operated at efficient levels (and if the usual unrealistic list of ideal conditions—perfect competition, no externalities, an acceptable distribution of income, etc.—described prevailing conditions) the marginal utility of public services would equal the marginal utility of the private goods and services given up in exchange for them. In such a Pareto-optimal situation no individual's welfare could be increased except by reducing the welfare of someone else. But for any number of well-known reasons it is far from likely that the public provision of any service is optimal. Of particular relevance for our purpose, it seems likely that there are many instances in which the urban poor would be willing to exchange some private goods, by paying higher taxes, for more of certain public goods. That is, in many instances it may be possible that an increase in public services for the urban poor, even if financed by increased taxes or service charges on the recipient groups, would result in an increase in welfare of the group. We can call the excess of a group's benefits over its tax burdens associated with the increment to public services its fiscal residual.1/

1/ Fiscal residual for a particular fiscal group can, of course, also be increased by financing an increase in the supply of public services to the group through taxes on other groups. This approach is more akin to the strategy discussed in Part A of this section and is not discussed further here. A fiscal residual occurs any time taxes used to pay for a service do not equal the entire area under the marginal evaluation curve for the public service (the public sector analog of the demand curve in consumer analysis). In the terms of price theory, the fiscal residual is the consumer surplus resulting from provision of the service.
The object of research in this area is to identify those public activities in which the payoffs to the urban poor, in terms of fiscal residual, are the greatest. Such research must delve into the benefits of various public activities and their quantification on a micro level. As an earlier paper by the author has explained in detail (McLure, 1974), the required analysis builds upon the methodologies of both cost-benefit analysis and incidence analysis, but it is difficult, conceptually as well as in practice, and is as yet only in its infancy. By comparison, the analysis of the incidence of taxes is considerably simpler, except for the thorny problems of how to relate particular taxes and expenditures.

2. Examples of Potential Fiscal Residual

Research currently underway at the World Bank should add to our knowledge of both the methodology of benefit incidence and the fiscal residuals that have been (or could be) created through various public activities. Moreover, there is little doubt that project evaluation reports prepared for any number of Bank-supported activities provide data that would be useful in quantifying fiscal residuals. But rather than summarizing either the author's previous paper on methodology, the research proposals for RPO 670-96 and RPO 671-18, or material available in project evaluations, it seems more instructive to describe several hypothetical examples of potential fiscal residuals. The discussion of hypothetical examples will both point up some of the theoretical and methodological difficulties of the analysis of benefit incidence and raise important empirical questions.

a. Water is now obtained by the urban poor in a number of ways, ranging from standpipes and delivery by truck to installed plumbing. In many instances, because of the diseconomies of small scale and/or the existence of monopoly, poor urban families are doubtlessly paying more than non-poor urban families and perhaps more than the cost of supplying water by the most efficient technique. The additional costs are often monetary, but in other cases they may be measured better in terms of inconvenience of transporting water from standpipes to dwellings or in terms of the lack of availability of an adequate supply of water of acceptable quality. It should be possible in some cases to measure the increase in welfare that could be produced by providing water more efficiently, even if the poor had to pay enough in direct charges (or other taxes) to finance the improved water system.

b. Public transportation is often not available for many of the urban poor. As a result, inordinate amounts of time are spent in walking to work, and sometimes for other trips. In other cases, public transportation may be available, but priced beyond the means of the poor. Useful research


2/ One of the obvious costs of inadequate supplies of good water is poor health, epidemics, etc.
could be done into the fiscal residual that could be created in various cities by restructuring urban transportation or its pricing.

c. **Health and education** often provide benefits that exceed their costs and yield an attractive social rate of return. Of more relevance, the private rates of return from investment in these forms of human capital can be quite high. But for various reasons education and health may be underprovided if left solely to the private marketplace. Thus it is useful to determine the extent to which a positive fiscal residual could be created for the urban poor through the public expansion of expenditures on various forms of education and health care. This is an area in which the vast amount of research by cost-benefit analysts should provide a valuable input.

d. **Low-income housing** may be an area in which both private payoffs and fiscal residuals for the urban poor would be substantial, if only the public sector could break some of the bottle-necks currently stalling private investment, especially by the urban poor themselves. For example, even if the eventual occupants were to pay all the costs of sites and services projects, they might benefit, relative to the situation without the projects.

3. **Complications**

These four simple examples of potential fiscal residuals are considerably complicated once we consider a few additional factors. Though this list of complications is not complete, it will help to indicate just how complex is the problem of improving the fiscal lot of the urban poor.

a. **Pricing policy** is likely to play a key role in the effort to improve the fiscal lot of the urban poor. One can imagine different pricing (and taxing) policies that would yield similar revenues, even as among families, but result in different allocative results. A two-part tariff, for example, might have incidence similar to average-cost pricing but would be preferable due to its resource allocation effects. Thus, though economic efficiency has been relegated to secondary importance in the discussion above, it should not be forgotten, and in fact may condition much of the equity-oriented discussion. As is so often the case, equity and efficiency may sometimes point in quite different directions.

b. **Intergovernmental relations** cannot be treated as static in any meaningful analysis of urban public finance. The role of national and various sub-national governments in supplying particular public services deserves continuing scrutiny. As indicated earlier in this section, there may be instances in which consolidation of services would be advantageous, or the opposite may be true. Transfers or grants from higher-level governments to lower-level governments may be desirable if efficiency requires a deficit at the local level or if taxes can more easily be collected nationally. Cross-subsidization within particular agencies can also be used to improve (or to worsen) equity and efficiency.

c. **Administrative realities** must not be forgotten in the effort to design a conceptually ideal system. A fair amount of latitude may exist in setting fares for urban transportation, for example, especially if buses
are publicly owned and operated, because of the relatively low cost of collecting the fares. The metering of water required by differential pricing schemes, on the other hand, may be more expensive and therefore not economically advantageous. Moreover, if water is to be supplied free of charge to the poor, a way must be found to prevent its waste. In short, it may be necessary in some instances to settle for conceptually inferior, but administratively superior, schemes if the poor are to be helped.

d. **Urban form** could be changed drastically by public policies in virtually all the hypothetical areas mentioned above. This is hardly the place to attempt to consider fully the relationships between distributional objectives and the spatial distribution of economic activities, but it must be remembered that it would be naive to attempt to achieve the former without regard for the latter.

C. **Concluding Remarks: Research Directions**

Whether we are interested in the fiscal impact of government on the urban poor or the more general question of the redistributive impact of the budget, it is desirable to include the expenditure side of the budget in our calculations. That is, it would be somewhat misleading to report that the tax system of a country was regressive or imposed heavy burdens on the urban poor if in fact low income (urban) families received benefits from government services that far outweighed the taxes they paid. (Similar statements could be made about apparently progressive taxes used to finance benefits for the rich). The point is that we can get an accurate picture of the redistributive impact of the budget only by considering both sides of the tax-expenditure question.

But in general it is virtually impossible to determine "who gets the benefits" of public spending, because of severe methodological problems. (These problems are discussed in De Wulf 1975 and McLure 1974). Thus studies of budgetary incidence are probably considerably more suspect than are studies of tax incidence alone. So while it is attractive to ask how the entire budget affects various income classes, on balance, it may be that the answer is almost inherently unknowable. On the other hand, we can usefully study the distributive impact of particular projects or programs and their financing, especially if we are able and willing to devote resources to detailed analysis. We may not be able to aggregate the results of such micro studies into estimates of the incidence of the entire budget. But this is really no great loss. After all, it matters very little for policy purposes what the incidence of the entire budget is, since policy decisions are made at the margin, and not on whether to abolish the government and all its activities.

This conclusion complements those of Section I, that future research should be devoted to identifying ways budgetary changes would improve the fiscal lot of the poor, rather than to quantifying the distributional impact of existing budgets. Given the scarcity of fiscal resources in most developing countries, existing programs, as well as proposed new programs should, of course, be scrutinized. But the scrutiny should be done carefully and in detail, at the micro level, for particular programs, and not broad brush, for the entire budget. Of course, given that analytical talent is also scarce, primary focus should be upon those areas of expenditure where it seems likely that there is the greatest payoff, in terms of net benefits to the urban poor.
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