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Excerpt
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Introduction

"So it has come to this," Subodh Reddy thought, as he sat tapping the retracted tip of his ballpoint pen on his sal wood desk, alone in his office on the second floor of the Andhra Pradesh State Assembly building.

"We are taxing cow urine."

It was late, and most of the other staffers had gone home to their families. His college friends were probably relaxing with a Kingfisher beer at a club in the financial district. There would be music, dancing, tipsy revelers bursting into laughter on the broken sidewalk outside.

And here he was, staring into space and listening to the creaking of his blowing fan, trying to think how, exactly, to start the draft of a bill to establish Andhra Pradesh's newest tax. Should he get right to the point, and put cow urine, "Gomutra," in the bill's title? Perhaps he should find a euphemism to disguise the ridiculousness of the demand? Or should he have listened to his pestering parents, and just become a cardiologist instead of getting a master's in Commerce?

He had heard that the state wasn't always this cash-strapped. Twenty-five years ago, when his biggest pastime was playing cricket with his young classmates, Andhra Pradesh was a very different place. But, in 1991, India had finally accepted that higher import and export taxes were putting them at a genuine disadvantage against multinational corporations, and liberalized its once-protected industries. And there were real, immediate benefits from these changes. So many more things you could buy. The government proudly touted increased growth rates. Indian giants like Tata Steel were given incentive to go conquer the globe. And conquer they did, building manufacturing plants in Europe and East Asia, and becoming one of the lowest-cost producers in the world. Every right-thinking economics student believed that globalization was, without question, a good thing for India.

Yet, Andhra Pradesh's finances were a constant anxiety for Subodh.

His state has always banked on its share of central government taxes to fund the bulk of its spending needs. Now they are facing over Rs. 15,000 *crore revenue deficit. But the Indian government cannot seem to fill its coffers, and this had been true for a long time – over the last two decades, ever since they could no longer tax trade. This new tax was not the first that the government had imposed since liberalizing – to many people's dismay, a value added tax (VAT) was added in 2005 all across India. In Andhra Pradesh, finished goods were taxed at what most grumbled was a ridiculous rate of 14.5 percent. Foodgrains and materials like steel were taxed at a rate of 5 percent.*

Still, government revenues barely sputtered; the money never seemed to come in, and the good times never came along. The government was now in dire need of new sources of income. And Subodh had been tasked with writing a bill to tax one of the few materials that was left out of the VAT discussions. The one industrial sector that had not – at least yet – pushed back against the government's reach.

It was time to tax cow urine.

Subodh inhaled deeply to focus his mind on writing. The only thing that disheartened him even more than the indignity of taxing cow urine was that this tax bill might not even solve the problem. Would local firms be willing to pay this tax? Could his fellow bureaucrats enforce and collect this tax? How would they bring in the money required for all the many projects Subodh had dreamed of when he entered government: better healthcare, education, roads, and infrastructure? Perhaps someday, he could tell his family of the glories of his days as a staffer in the State Assembly. But sadly, not today.

Subodh, our character in the story above, is a work of fiction. But the Andhra Pradesh (AP) tax on cow urine is real. Gomutra is used in many traditional Indian medicines, as well as in a wide range of hygiene and cleaning products. To understand why AP was forced to search for inventive ways to tax – and why governments throughout India and the developing world are struggling to find revenue for their treasuries – we have to step back from seemingly isolated local challenges and take a hard look at that great good of modern economics, globalization.

Could globalization in fact be the cause of these issues?

Stubbornly low – and still dwindling – government tax revenues are not a minor problem. The great philosopher and economist Adam Smith maintained that, alongside peace and justice, taxation is key to a successful society. Tax revenues enable government spending – spending that supports public goods that help reduce inequality and support sustainable growth. There is little doubt that states across the developing world are desperate for new sources of tax revenue to pursue such critical goals. In this book, we argue that the forces of globalization and free trade, in particular, are proving crippling to the finances of developing nations that allow political freedoms to flourish. In stark contrast, some of the world's most repressive regimes are having little problem filling public coffers alongside expanding globalization.

Our book thus finds the following: globalization is *not* the crux of the problem. As more and more citizens today bemoan globalization, we take a step back and ask why it does not seem to be working as anticipated for such large numbers. Our central finding is that trade and economic openness is good for the majority if and when governments can tax and redistribute to those who are falling behind. Somewhat paradoxically, citizens of democracies in the developing world suffer precisely because countervailing political pressures impede the government's ability to tax and redistribute under the auspices of globalization. Essentially, as these democracies open up, they are ill-equipped to address some of the distributional consequences that threaten to make free trade less palatable to the masses.

The Problem

Is globalization – or a side effect of it – triggering a largely unrecognized revenue crisis in a substantial portion of the developing world? The heart of the issue lies in how the governments of developing economies that joined the third wave of globalization, or the "late liberalizing" countries, raised their money prior to the 1990s.[1] Revenues were collected, in large part, from taxes on imports and exports. Specifically, tariffs on consumer goods, particularly luxury goods and intermediate goods produced domestically, as well as agricultural exports, led to high trade tax revenues. These tax revenues accounted for, on average, 40 percent of all total tax receipts in low-income economies, and 35 percent in lower-middle-income countries.[2] Altogether, they comprised almost one-third of tax revenues in the full sample of developing economies (see Figure 0.1).

Reliance on trade taxes persisted through the early 1990s, in large part because they are "easy to collect." This class of taxes includes import duties, export duties, profits of export or import monopolies, exchange profits, and exchange taxes. They are straightforward to monitor and solicit at a centralized location, such as border areas, and do not require a complex administration to manage. However, there are many

[1] Scholars and policymakers have identified three waves of globalization (via reduction in trade barriers and large flows of trade, capital, and migration): (1) 1870–1914, (2) 1945–79, and (3) 1980–today (Collier and Dollar 2002). Collar and Dollar (2002) use the term "new globalizers" to signify integration of developing countries in the third wave.

[2] Khattry and Rao 2002.

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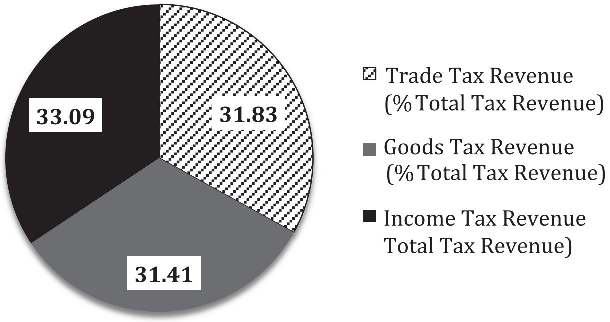

Figure 0.1 Tax Composition of Developing Countries – Early Liberalization Begins (1990)

Note: All tax revenue data taken from the World Bank in this book refers to central government tax revenue.
Data source: World Bank 2016a

arguments – some grounded in sound economic theory and others in market fundamentalism – against the extensive use of trade taxes.

From the late 1980s and into the 1990s, after the Latin American debt crisis, there was a shift toward more open international markets. The substantial lowering of tariffs was the critical component of this opening of markets, including membership in the World Trade Organization (WTO) and the provision of structural adjustment packages. With a general adoption of a more liberal stance towards trade, these "late liberalizers" ostensibly lost permanent access to a primary source of tax revenue.[3]

In effect, liberalizing trade translated into a large and rapid loss of money – i.e., trade tax revenues – for governments across the developing world. We label this a "revenue shock" because it is an event, often triggered in large part by exogenous factors, that produces a relatively sudden drop in government revenues. The repercussions are significant. Overall revenue levels in developing economies have always been far below those of advanced industrialized countries, and in spite of frequent, and sometimes extensive deficit spending, the provision of public goods is inadequate in many late liberalizing countries.

Developing nations thus must urgently replace almost a third of their already low tax revenue base with "hard to collect" domestic taxes. This is no easy undertaking. These reforms include increasing income

[3] Import taxes constituted 85 percent of trade tax revenues in 1990 in developing countries.

taxes on individuals and corporate entities, as well as implementing the value-added tax (VAT). Goods taxes such as the VAT are complicated, involving fees at various levels of production. Broadening income taxes is no less arduous a task, given that a large percentage of citizens (and firms) in poor economies are logistically difficult to tax. Weak bureaucracies, staff, and technologies amplify these problems.[4] In addition, with liberalization, governments are in a conundrum: they face rising political pressures to keep domestic taxes low so that less productive firms can survive in the face of international market competition and, at the same time, more productive exporting firms are demanding even lower tariffs. Tax reform in the liberalizing environment is a challenge for all of these reasons – both in passage and implementation.

The Puzzle

For many, it was expected that trade itself would be the solution. Despite its recent unpopularity in some circles, free trade is frequently touted as one of the keys to economic prosperity. Economists have long considered it a central component of growth and development. As increased trade and capital flows spur growth, the loss in trade tax revenues should be easily replaced with the taxes collected from a more dynamic private sector. Trade liberalization in the developing world has thus been heralded as a necessary step in the path to development success.

Yet, despite this rosy view, many developing countries have been facing formidable challenges recovering from the revenue shock and substituting their lost trade tax revenues with domestic taxes. Cross-national data over the last 22 years shows that a great many developing economies have experienced lackluster improvements in government tax revenues particularly *after* adopting free trade policies, and revenues have even fallen over time in some countries. Nevertheless, this is certainly not the case for all late liberalizing countries. Indeed, a certain subset of countries appears to be performing just as conventional wisdom would expect: government tax revenues are steadily expanding concomitant with trade liberalization.

What accounts for these differing patterns? Why are some governments able to successfully increase domestic taxes and replace the lost trade tax revenue, while others clearly are not? Academic studies up to this point have not been able to explain this divergence. International financial institutions (IFIs) anticipated – at least initially – the domestic tax reforms they recommended would more or less immediately follow

[4] IMF 2011a; Tanzi and Zee 2001.

liberalization. Perhaps the explanation lies more in politics than economics. The question in this book is, then, whether and to what extent *political* factors can play a role, either in making the situation better or worse. Why have only certain governments managed to ensure that the early- to mid-1990s revenue shock did not have long-lasting effects by raising – and collecting – taxes on individuals and capital?

The Challenge For "Late Liberalizing" Democracies

Subodh's problem is far from unique.

But it turns out to be far more common in democracies than nondemocracies.

We argue that, while the turn towards greater trade openness initially disrupted the ability of all late liberalizing countries to gather tax revenue, only in the case of democracies has it resulted in a lasting low-revenue trap. We differentiate late liberalizing democracies from advanced industrialized democracies by focusing on countries that embrace political and civil freedoms, but liberalized in the third wave of globalization with relatively low bureaucratic capacity. For a country to recover from revenue shocks in the global economy, history has shown that policymakers have two critical means to enact successful domestic tax reforms: compulsory and voluntary (or quasi-voluntary) tax compliance. Compulsory compliance depends on a government's willingness to use some form of force to impose its will on its own citizens, while quasi-voluntary compliance derives from citizen perceptions that the tax system is "fair," i.e., that the state is providing sufficient public goods in exchange for tax payments. Late liberalizing democracies fall short on both counts.

Institutional features of democracies limit the use of (extrajudicial) tools for compulsory compliance. By design, democracies are constrained from imposing tax reforms by fiat, and from soliciting tax payments from citizens through fear. The unfortunate result is that evasion is comparatively easy and costless; local businesses struggling to survive in a competitive global economy are even more likely to take advantage of this institutional feature. At the same time, quasi-voluntary compliance is being undermined, first by business hostility to higher taxes as global competition intensifies, and second, by low voter confidence in the fairness of the new tax proposals. Both groups lack confidence that the tax bargain under liberalization is beneficial, not believing their contributions will help them or society at large. For instance, less productive firms – particularly those linked to once-protected industries – lobby for lower domestic taxes as they struggle to compete in national markets with imports. The most productive firms are exporters, and they demand both lower taxes *and* lower tariffs, although they are more likely to privilege the latter. This is perhaps why democracies tend to liberalize faster *and* have lower domestic tax revenues. Fundamentally, hostility from voters and firms creates strong impediments to tax reforms. Such resistance is a deal breaker in late liberalizing democracies, where elected officials rely disproportionately on elite interest groups to stay in power.

Authoritarian leaders, in contrast, are more easily able to generate government tax revenues in response to the liberalization-induced revenue shock. They use different combinations of institutionalized coercion and quasi-voluntary compliance to collect taxes that can compensate for – and perhaps even surpass – the dramatic loss in trade taxes. Though all authoritarian regimes are *not* the same, and various authoritarian subtypes use different strategies to pursue unpopular tax reforms, they share certain traits. Reliance on a smaller subset of the population (and firms) for support and the ability to use extrajudicial force to mobilize tax revenues are two of the main commonalities. And both of these factors make tax reform in the face of a revenue shock far easier to implement.

In order to be certain that it is indeed regime types that vary in their responses to globalization and revenue mobilization, our book investigates whether other factors, such as weak state capacity and low gross domestic income, are responsible for the difficulties of revenue generation post-shock. But contrary to expectations, neither of these alternative explanations helps shed light on our puzzle. Instead, it appears the crux of the matter lies in the politics of liberalizing and freer societies. This is why democracies may find it more challenging to harness the benefits of free trade and globalization, while autocracies are forging ahead.

Why Should We Care?

In some parts of the world, then, the unintended consequence of globalization is stubbornly low government revenues. But the real problem is not globalization; it is how the political constraints of democracies are undermining the positive impacts of globalization. While many assume that democratic governments improve the prosperity of their country and the health and well-being of their citizens, none of these things are possible without the money to provide them. The catch is that, as globalization and free trade expands, democracies are finding it harder to raise money for the provision of critical public goods, such as adequate healthcare, clean water, a working infrastructure, and a school system capable of educating the populace to take advantage of the economic opportunities of the twenty-first century. Put simply, with globalization, political support for liberalization and political resistance to taxation is building in much of the developing world. This is a greater problem in democracies, where such opposition has more power to influence the direction of the country. In essence, this book is about an unfolding confrontation in the globalizing world; a battle between political freedoms and the ability of governments and their people to prosper – a fight that, in the current circumstances, neither can win.

This book is ultimately a reminder that it is time to get serious about understanding the distributional impacts of globalization. As of late, academics, the media, and international institutions have been grappling with an anti-globalization backlash. The unexpected success of Brexit and Donald Trump, thousands protesting against the Trans Pacific Partnership across both the developed and developing world, the rise of far-right nationalist-cum-protectionist movements everywhere, growing global frustration with the rising gap between the haves and have-nots, and increasingly violent anti-immigrant sentiments have set alarm bells ringing. In a great many countries, the general public is beginning to question the benefits of a flatter, more interconnected world. In effect, the voices of pro-globalization urban elites are progressively becoming faint amidst the angry protests of the many who see themselves as "losers" of globalization, despite the very real improvements it may have brought to their lives. And, as a result, international organizations are calling for "urgent action" to address the current discontents and perceived problems of globalization, such as rising disparities in income and wealth.[5] Our analysis can help inform the international community about a heretofore-overlooked reason why globalization may not be working for the average citizen, especially in democratic regimes, and what can be done about it.

India and AP's stubborn revenue crisis and our fictitious Subodh's very real tax dilemma are not what the architects of the post-war multilateral trade system ever anticipated. Indeed, expanding trade *has* raised incomes around the world, and both academics and policy elites have been particularly sanguine about how much citizens of developing countries (among others) benefit from the global economy. For these capital-scarce economies, following the theory of comparative advantage is touted as the best way to bring the much-needed influx of jobs, greater supply and diversity of affordable consumer goods, access to cutting-edge technology, boosts in income, and the path to sustainable growth that has been tried and tested by rich countries. Unfortunately, although this might be true, some of the challenges of distributing such benefits of globalization more widely – especially in developing countries – are

[5] Rowley 2017; Welle 2017.

still coming to light. This book focuses on one that has been grossly overlooked: democracies are finding it much harder to overcome revenue shocks in a global economy. Should the problem continue to be disregarded, it has the potential to both undermine international markets and further weaken fragile democracies. The bottom line is that free trade creates relative winners and losers, alongside the many improvements it brings; but the really big question is if and how democracies can navigate current political labyrinths to help the latter. Pro-globalization advocates and developing country policymakers should address this issue now, while overall public support for free trade is still higher than it is in rich, industrialized countries.

Focus and Plan of the Book

Our central argument is as follows: in an expanding global economy, late liberalizing democracies have greater difficulty recovering from revenue shocks than nondemocracies. To begin, the first section of the book provides a detailed look at the revenue challenge in the current era of globalization and how developing countries are confronting them. We look at why the revenue benefits of globalization are being undermined in democracies in particular. In later chapters, we look at the broader implications of this issue, and conclude by examining several case studies to get a more comprehensive perspective on the problem and its ramifications for developing nations.

Our first chapter presents the puzzle. Why does a pattern of divergence in revenue recovery persist across the liberalizing developing world? We also present a brief overview of previous research on this problem. Next, Chapter 2 provides the theoretical foundation for our argument that the trade-revenue shock is particularly problematic for democracies. It goes into more detail on the institutional differences and contrasting government incentive structures in democracies and authoritarian regimes, and why these impact recovery. Here we also identify two distinct types of authoritarian regimes (“liberal” and “conservative”) and their contrasting taxation strategies in the global economy. A close examination of the data on tax revenue, the trends in different regime types, and consideration of alternative hypotheses is found in Chapter 3.

The next two chapters deal with the resistance to tax reform, particularly in democracies. In Chapter 4 we employ survey evidence to explore if and why citizens and economic elites are resisting domestic tax reform in democracies. Chapter 5 examines the role of firms – previously protected ones in particular – in lobbying the government for lower corporate tax rates. Although the focus of this book is on trade liberalization, this chapter briefly compares and contrasts the impacts of financial liberalization on tax revenue mobilization. We show how democracies are responding to these elite interests and seeing unimpressive corporate income tax revenues as a result.

Chapter 6 addresses the "so what" question, and explores the broader implications of post-trade-reform low-revenue traps. Do these empirical findings confirm doomsday predictions that lower government tax revenue is detrimental to development in democracies? How does the loss of tax revenue affect the poor in democracies? Could lower tax payments perhaps be good for the economy and citizenry? Turning to authoritarian regimes, we ask if political elites are using revenues from successful domestic tax reform to provide public goods or enrich themselves.

The last section of the book (Chapters 7, 8, and 9) presents in-depth, illustrative case studies. We look at examples of different regime types: conservative China; democratic India; as well as Jordan and Tunisia, both liberal authoritarian regimes with slightly more political freedom. We chose regionally important countries that relied on easy-to-collect taxes until they faced significant outside pressures to maintain lower tariffs and implement domestic tax reform. This approach allows us to trace the political forces underlying how and why policymakers in authoritarian regimes have been far more successful at implementing domestic tax reform and overcoming revenue shocks, while democracies such as India have not. The final chapter explores the broader consequences of low revenues in democracies. We ponder if democracies are in peril post-liberalization and suggest policies to modify this tension. Ultimately, this chapter lends insight into how open economies and open societies can be mutually beneficial.

Anyone who is concerned about development and bettering the lives of citizens in the developing world should be attentive to the implications of this book. The problems occasioned by revenue shocks are neither minor nor isolated. And the ramifications of such problems go beyond the immediate crisis of revenue we are discussing here. Citizen dissatisfaction with government and its provision of inadequate public goods leads to even less willingness to pay taxes, which only reinforces the inability of democracies to recover from revenue shocks. This vicious circle could lead to a rejection of trade liberalization, and thus threaten the progress of globalization and, perhaps worse, the validity of democratic governments. These are not problems to be taken lightly.