

Taxes:
Price of Civilization or
Tribute to Leviathan?

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Context: Overall

- The “taxes are bad for economic growth” view is clearly wrong over the long haul as:
 - Taxes as fraction of GDP have increased by *order of magnitude* in OECD countries (from 4 percent to 40 percent) from 1900 to 2000 and growth was absolutely constant at 2 ppa over that period
 - Taxes are *higher* in richer countries than poorer countries
- How is this so when taxes at the micro level clearly have potentially large distortions?

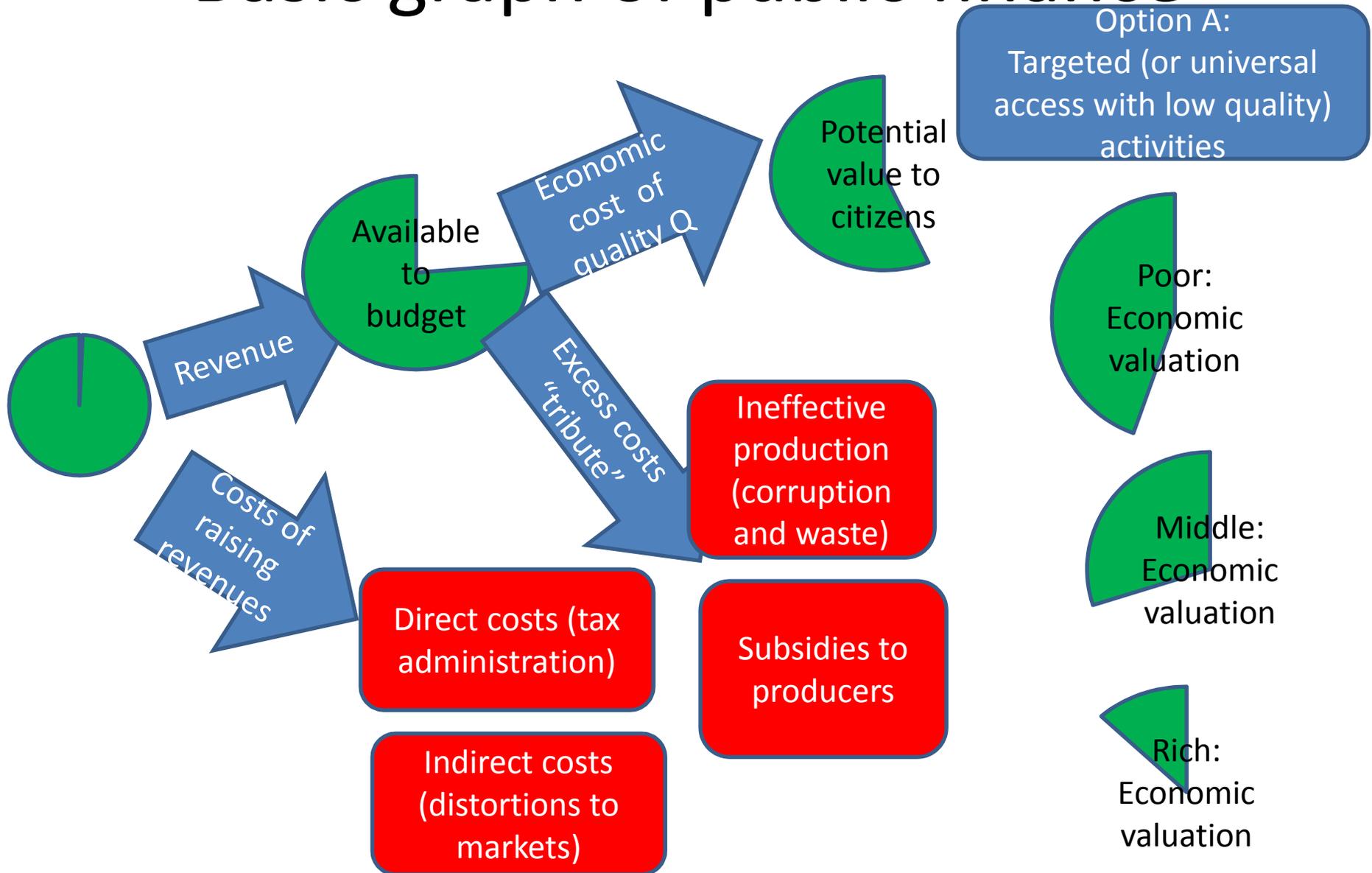
Context: India Debate

- Pressures for more and better public services—especially infrastructure (roads, power, sanitation) including urban—but also better health, education and transfer programs—but with no viable financing plans
- Government already running deficits (and has been for a long time)
- Taxes are low—resulting in other modes of finance (e.g. financial repression)—and costly to collect and regressive so pressure for more and better taxes and tax administration

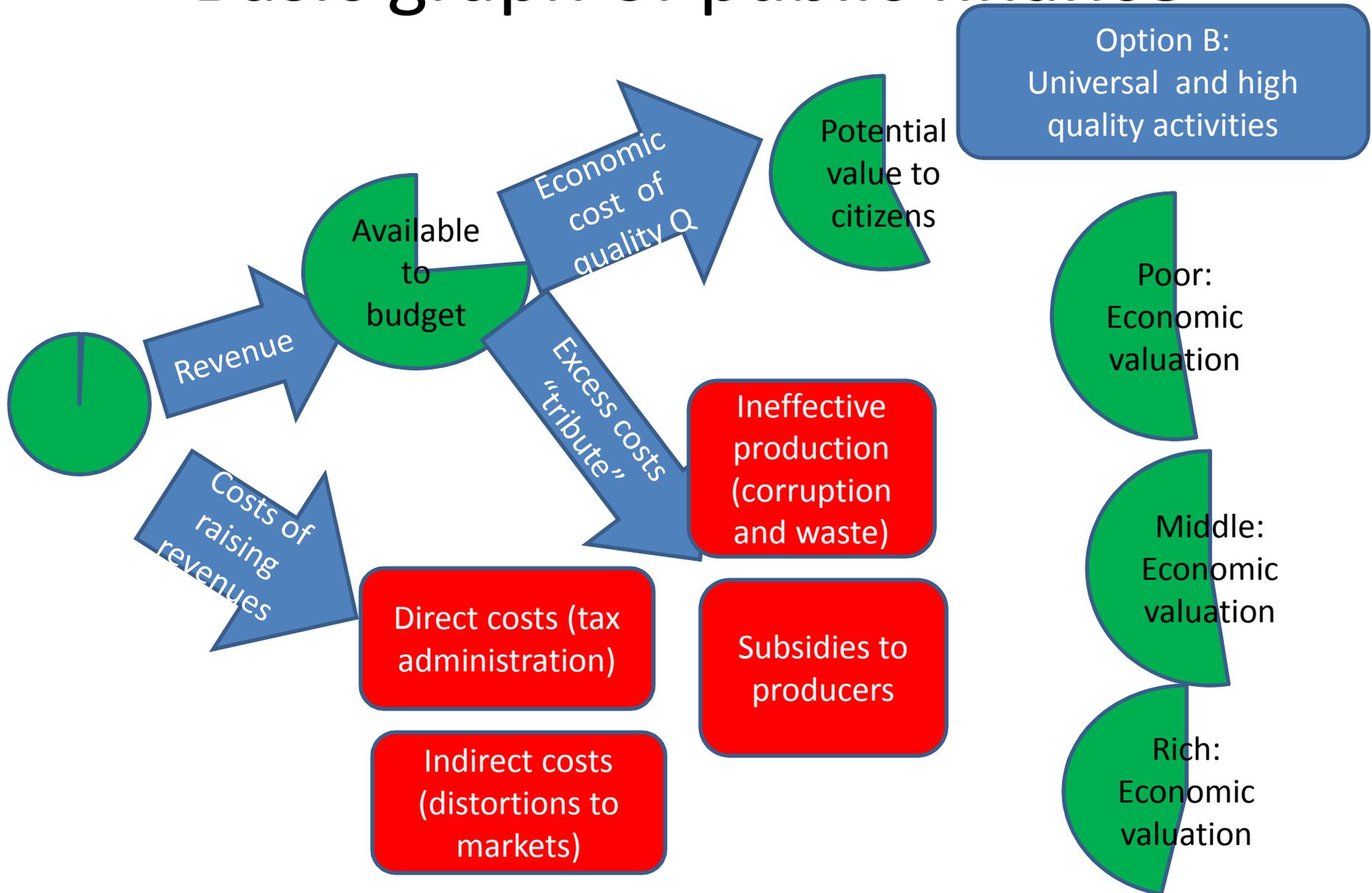
Our contribution: three points

- The existing public economics calculations of tax and benefit incidence and hence net redistributive impact of “taxes and transfers” from pre tax transfer distribution of income are completely wrong because they ignore the “tribute” element of cost ineffectiveness (with some empirical estimates)
- The quality of public services (as valued by taxpayers) can be subject to either virtuous circle or vicious cycle political economy dynamics
- The typical calculations of benefit incidence of redistribution miss the key political point as they don't distinguish between social insurance and poverty transfers (or static and dynamic benefit incidence)

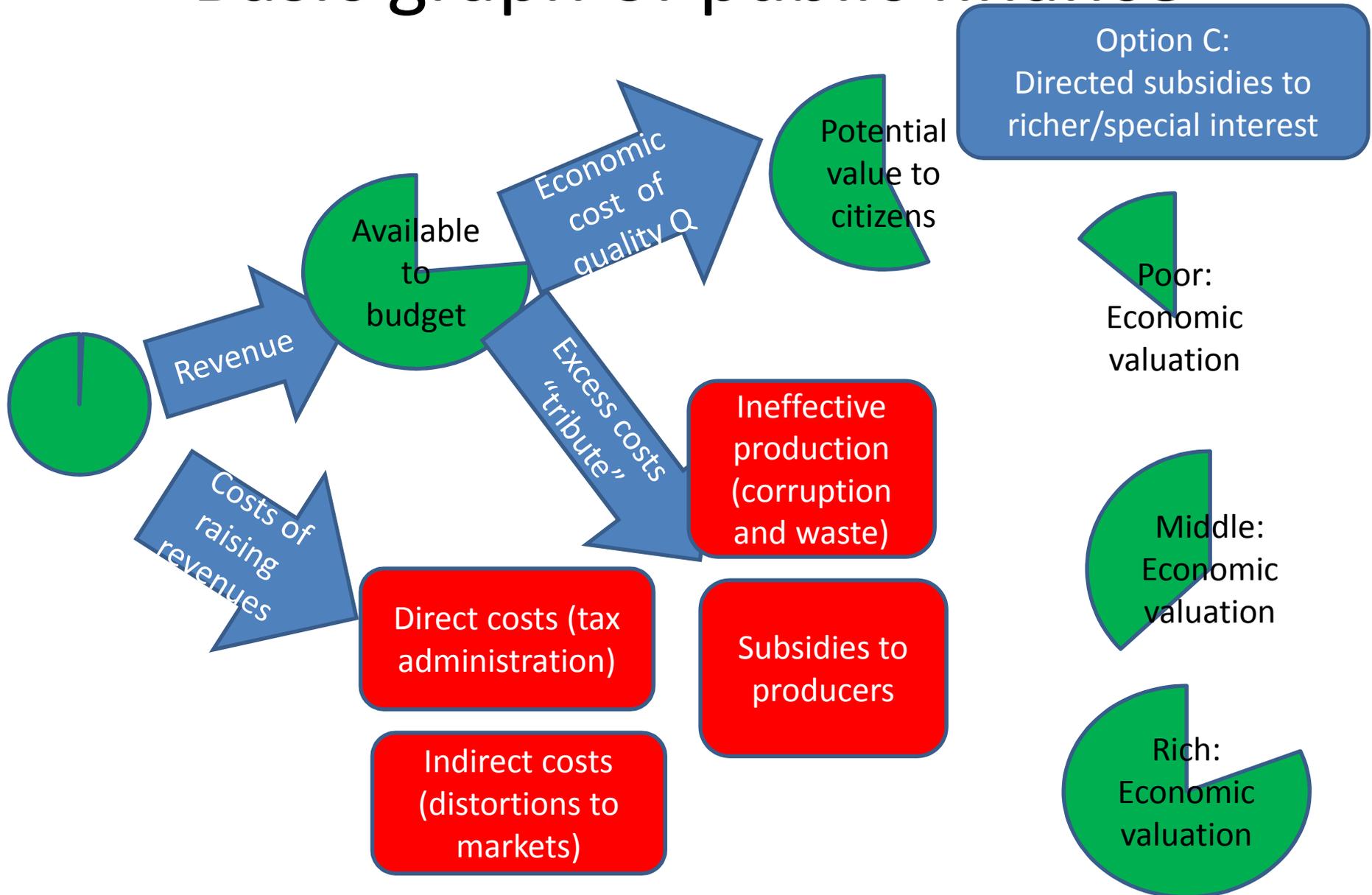
Basic graph of public finance



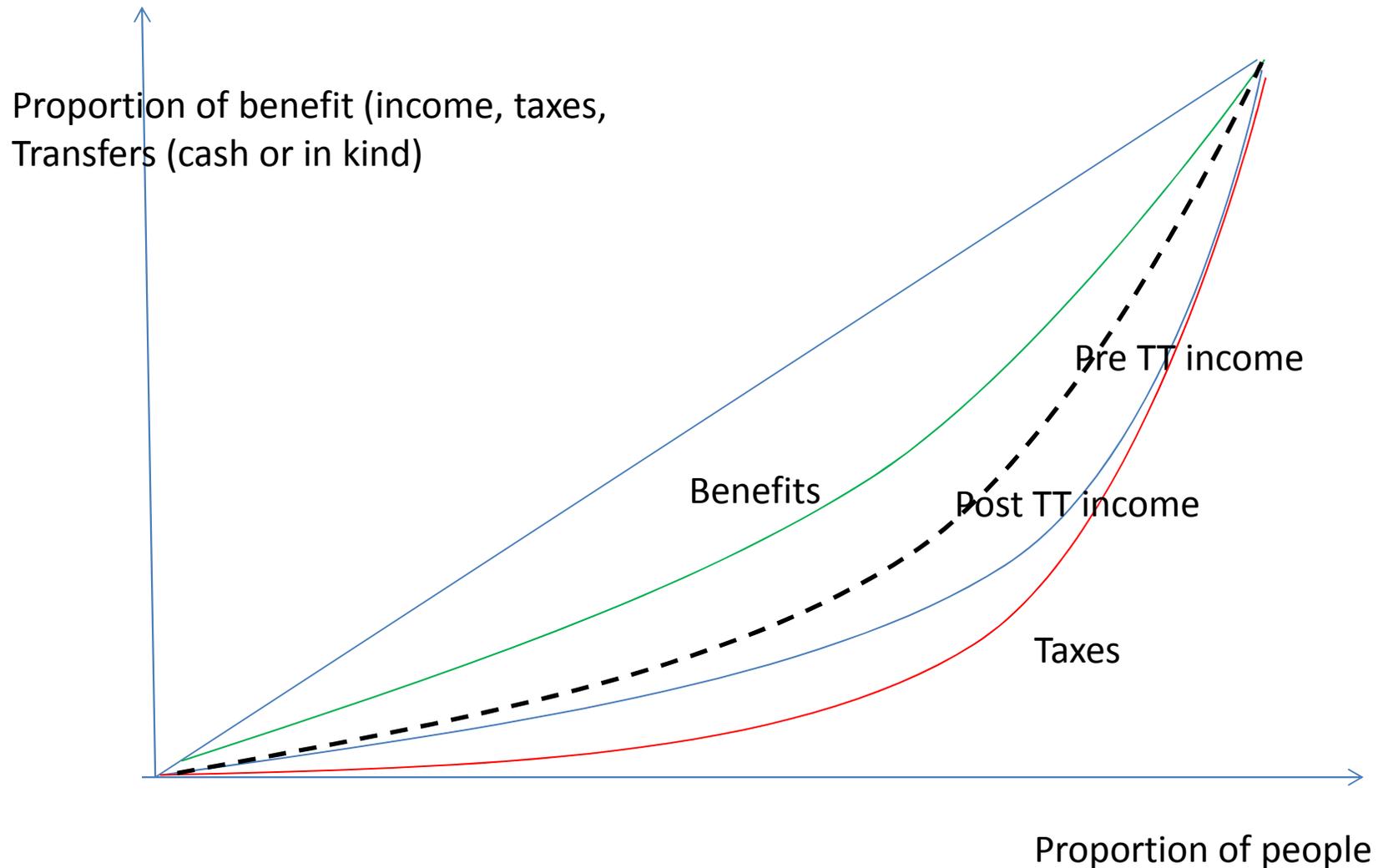
Basic graph of public finance



Basic graph of public finance



Standard Public Finance Analysis of Net Incidence of Government on Economic Inequality



First Point: Accounting versus economic cost of production and “expenditure incidence” versus “benefit incidence”

- “Accounting cost” just adds up expenditures under a budget head
- “Economic cost” is a conceptual notion of the *minimal* cost as which something can be produced
- There is no benefit to a citizen of an excess cost gap between “accounting cost” and “economic cost” in the production of services

Illustration with basic education (because we can, not picking on education)

- Accounting cost per student in government schools has been computed by the Accountability Initiative (Ambrish Dongre and Avani Kapur) state by state
- Reported expenditures on private schools per child enrolled computed and inflated to comparable rupees

Figure 4a: Per state government accounting cost per student less private expenditure

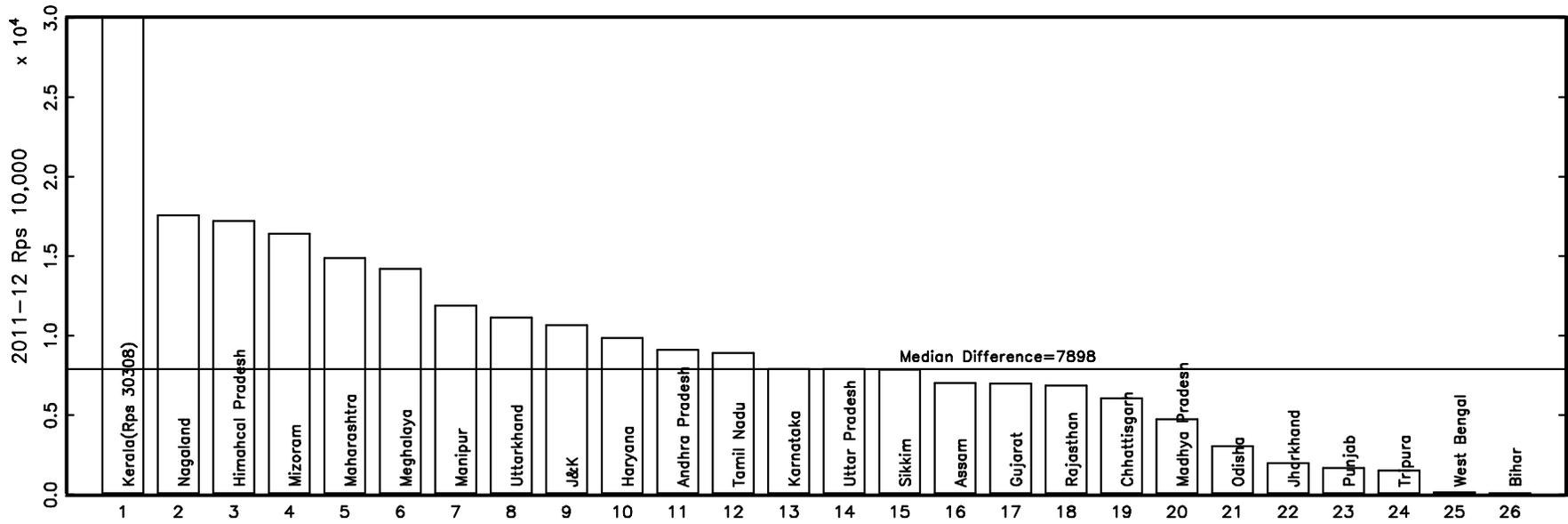
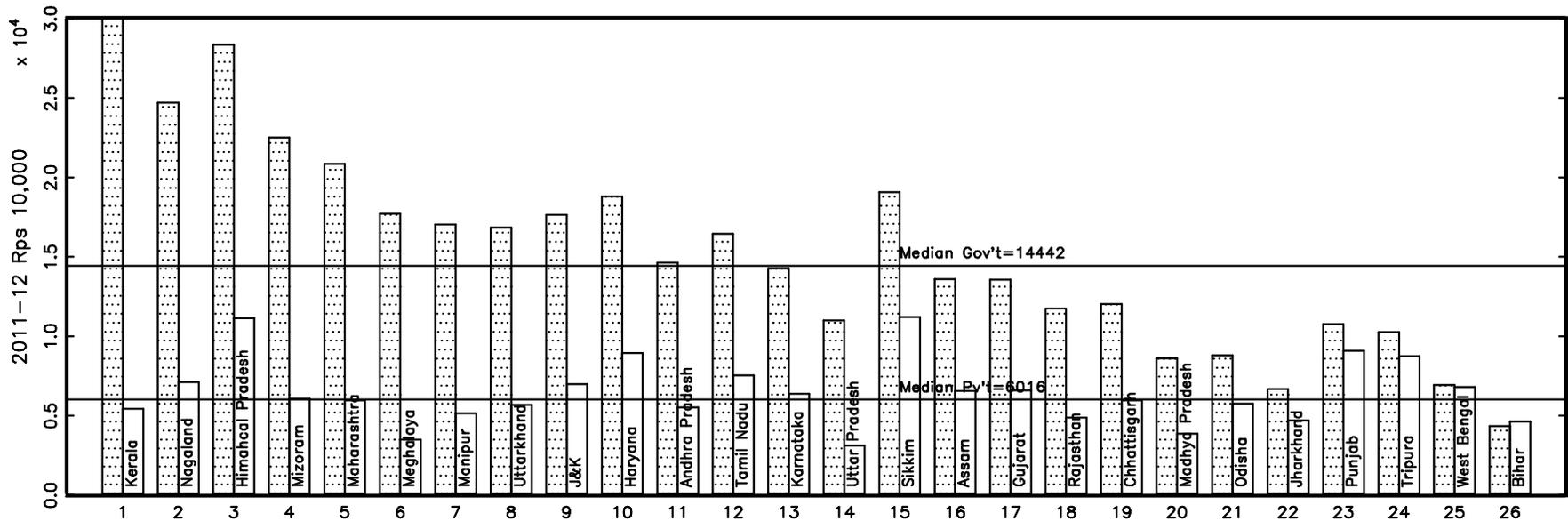


Figure 4b: State by State government accounting cost and private expenditure per student



Source: Pritchett and Aiyar (2014) (not Ayer)

But, we need to adjust for quality, which we super crudely proxy with learning in rural areas

Figure 8a: Raw cost and learning outcomes differences, Government and Private

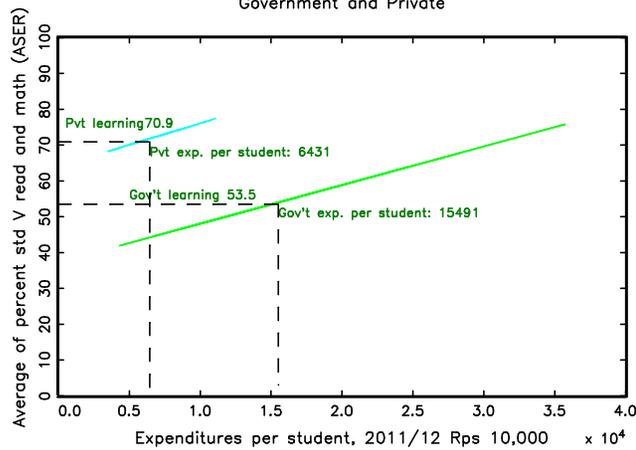


Figure 8b: Learning gaps adjusted for cost differences Government and Private

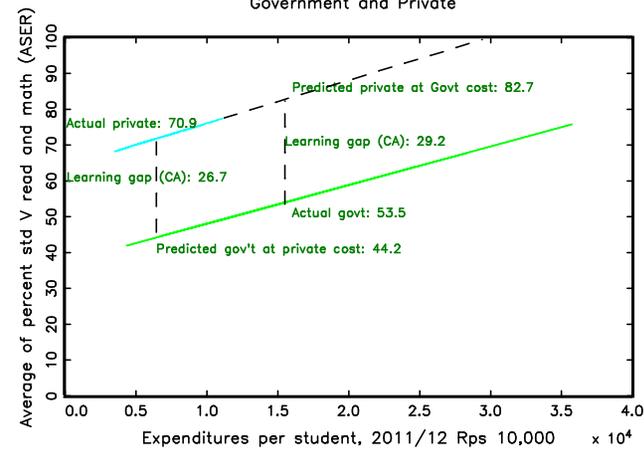


Figure 8c: Achieving Private Learning Outcomes at Government Costs

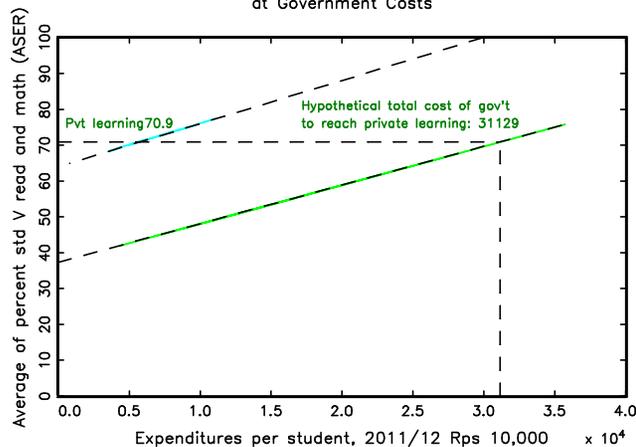
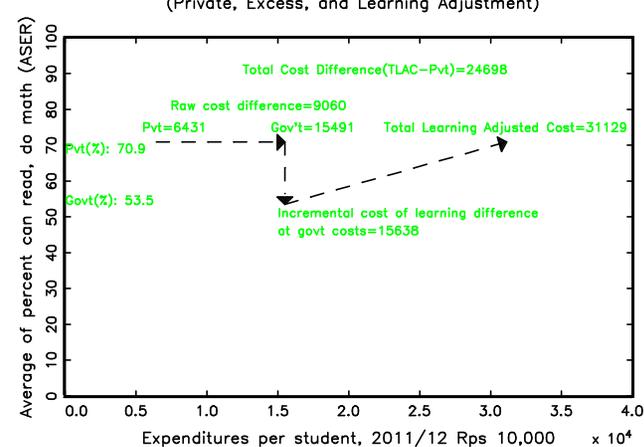
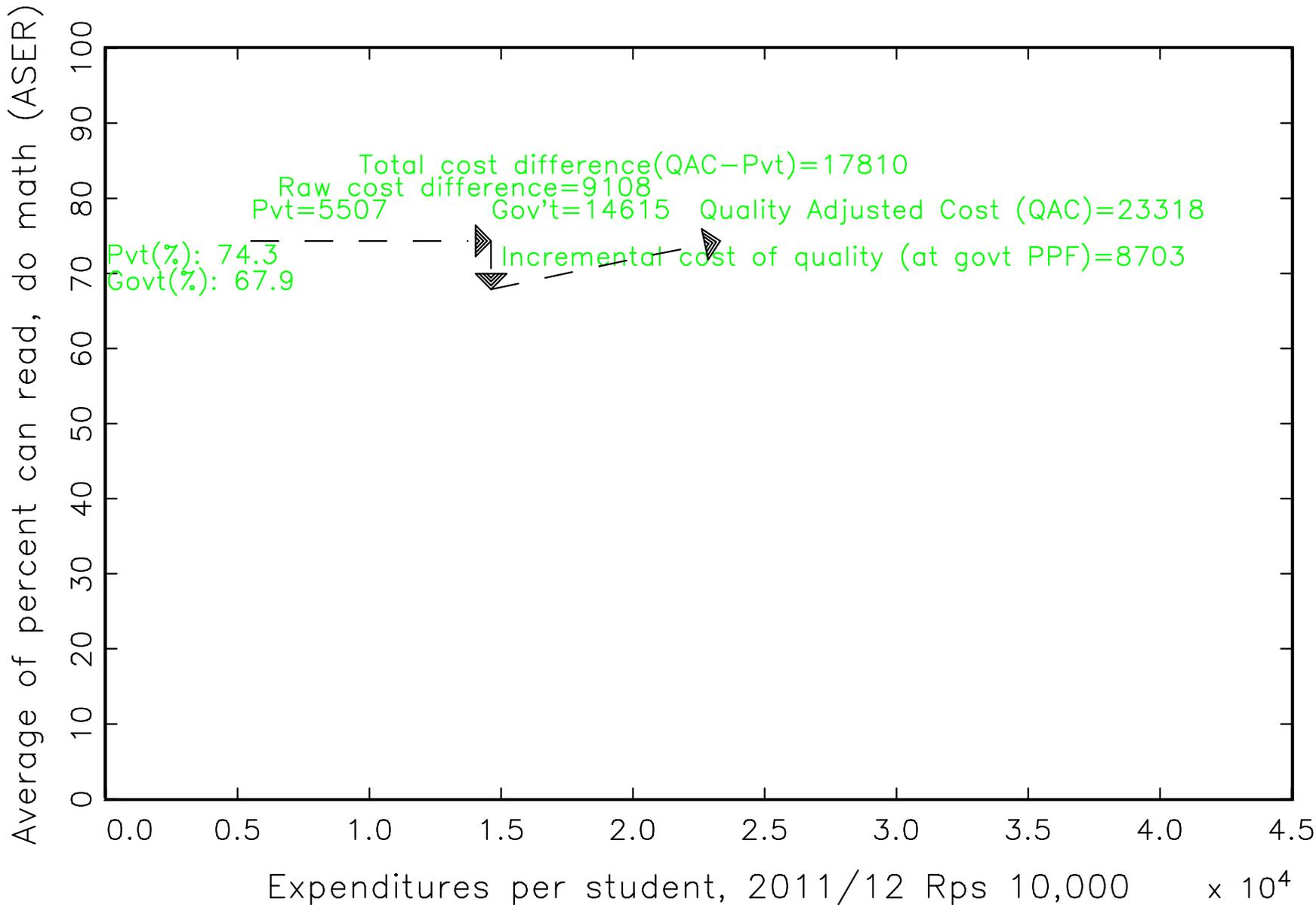


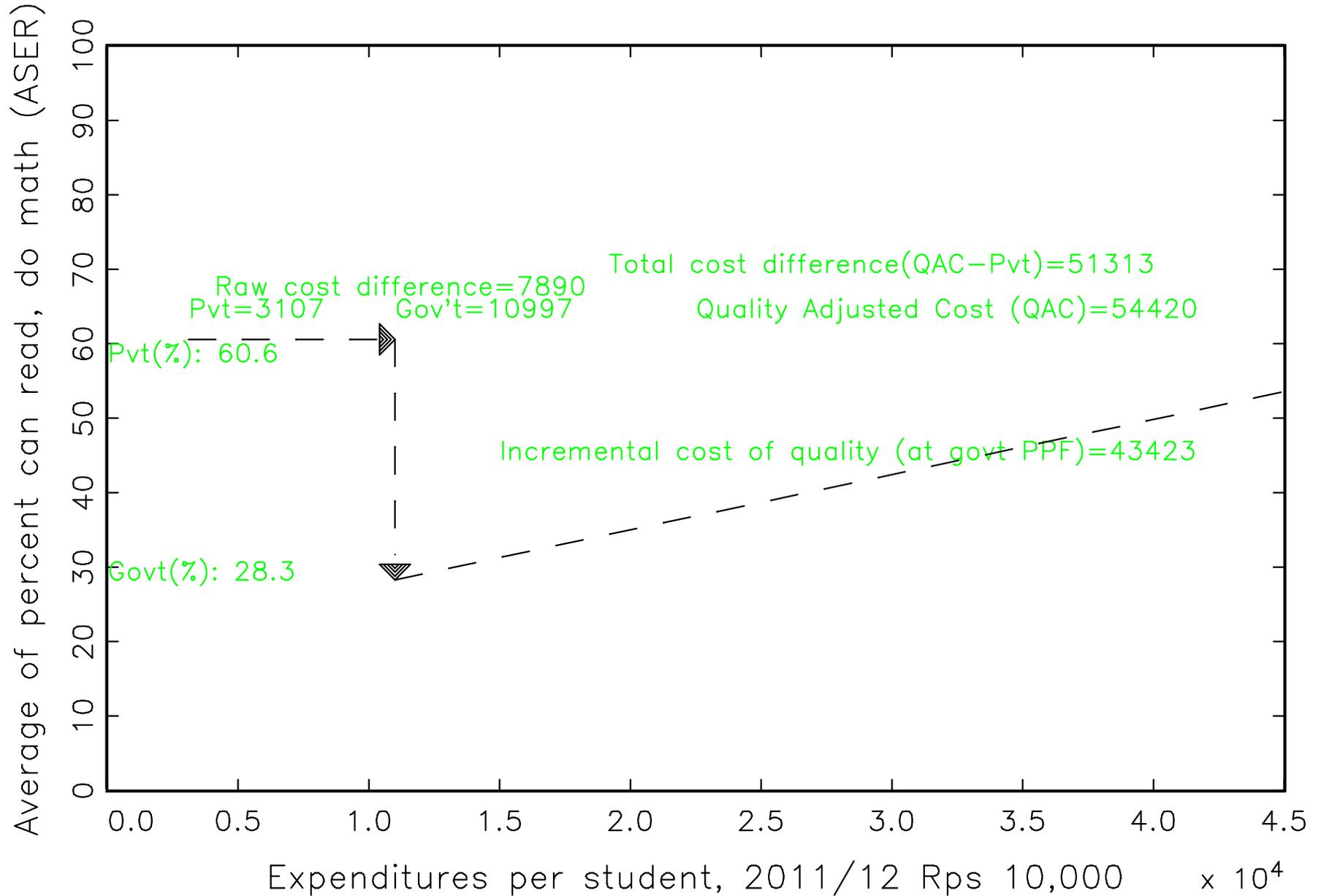
Figure 8d: Total Cost of Government to achieve Private Learning (Private, Excess, and Learning Adjustment)



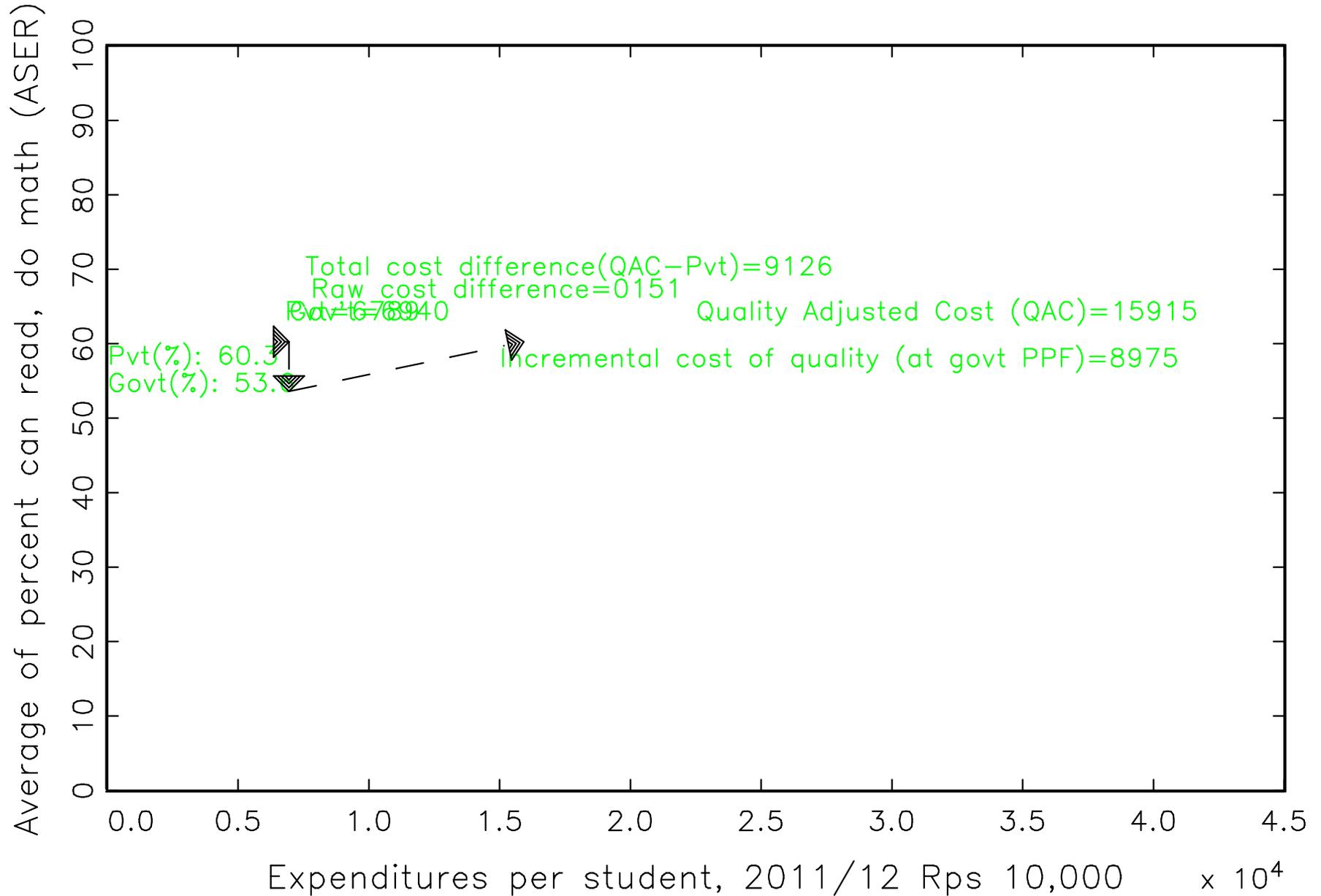
Raw and Quality Adjusted Govt vs Private Cost for Andhra Pradesh



Raw and Quality Adjusted Govt vs Private Cost for Uttar Pradesh



Raw and Quality Adjusted Govt vs Private Cost for West Bengal



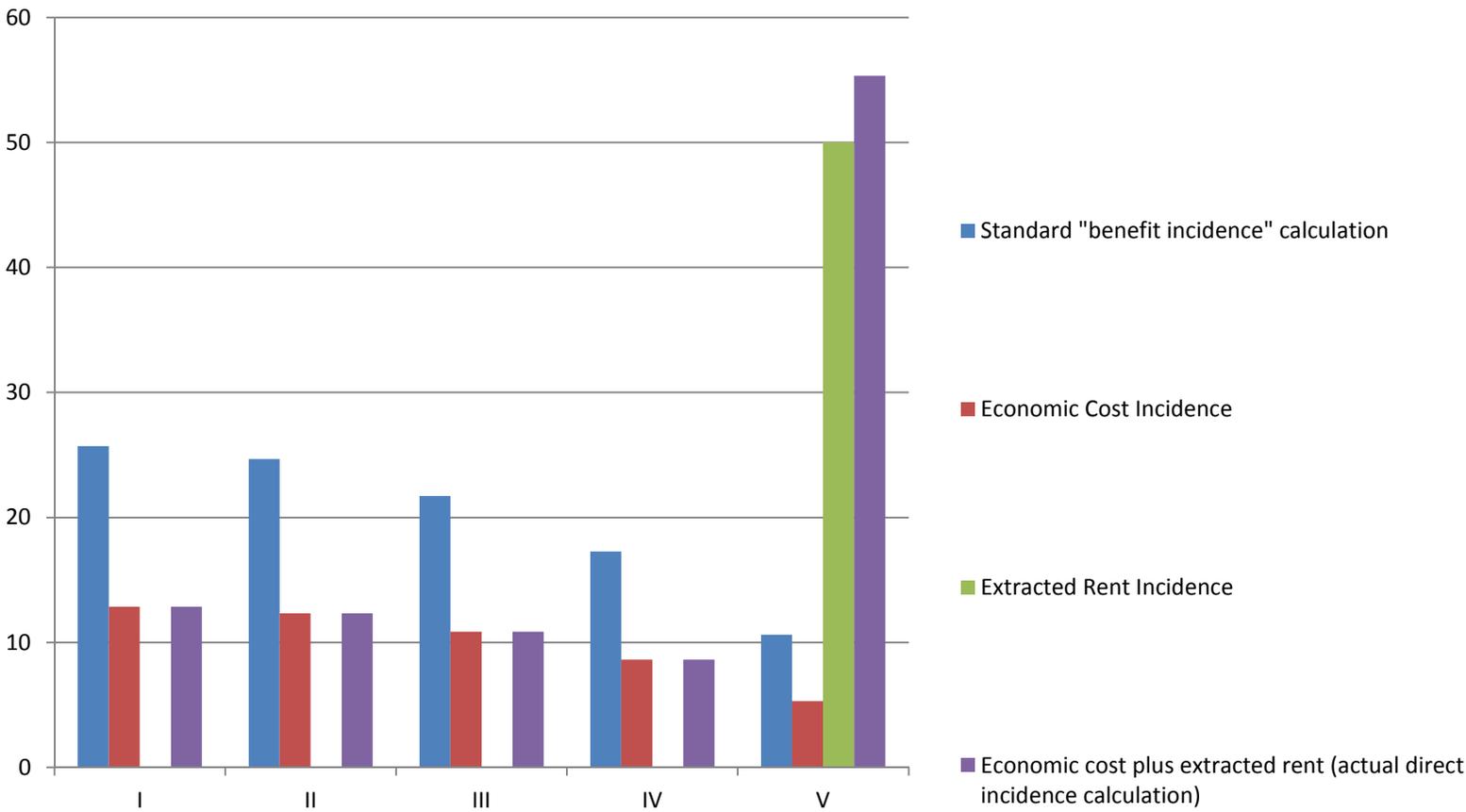
Excess of accounting cost over economic cost are fractions of GDP

Table 6: Total excess raw cost (RC) and total excess total learning adjust cost (TLAC) in Rs. crore					
State Names	Total number of students in government management Col. I	Raw cost difference Col. II	Total excess raw cost (crores) Col III=I*II	Excess public sector cost per student, learning adjusted Co. IV	Total learning adjusted cost (in crores) Col V=I*IV (sorted)
Uttar P	15,049,354	7,890	11,874.4	37,761	56,828.6
Andhra P	3,970,814	9,108	3,616.4	15,094	5,993.7
West Bengal	8,875,151	151	134.0	6,325	5,613.7
Total (in crores)			50,049.7		231,955.0
Percent of GDP			0.60%		2.78%
Percent of PCE			0.99%		4.59%
Percent of GFCE			4.80%		22.25%

Obvious source of excess cost is higher wage bill for teachers—that produces no (or negative) incremental output

- Work of Muralidharan and Sundararaman on contract teachers in AP shows many times the cost, roughly same learning
- Atherton and Kingdon in UP show 8 to 11 times cost per teacher in civil service vs contract and twice as much learning per student for contract teachers
- Private comparisons show similar wage differentials (and not driven by queuing for gov't jobs) and learning quality gaps

Benefit Incidence of standard public economics variety completely wrong

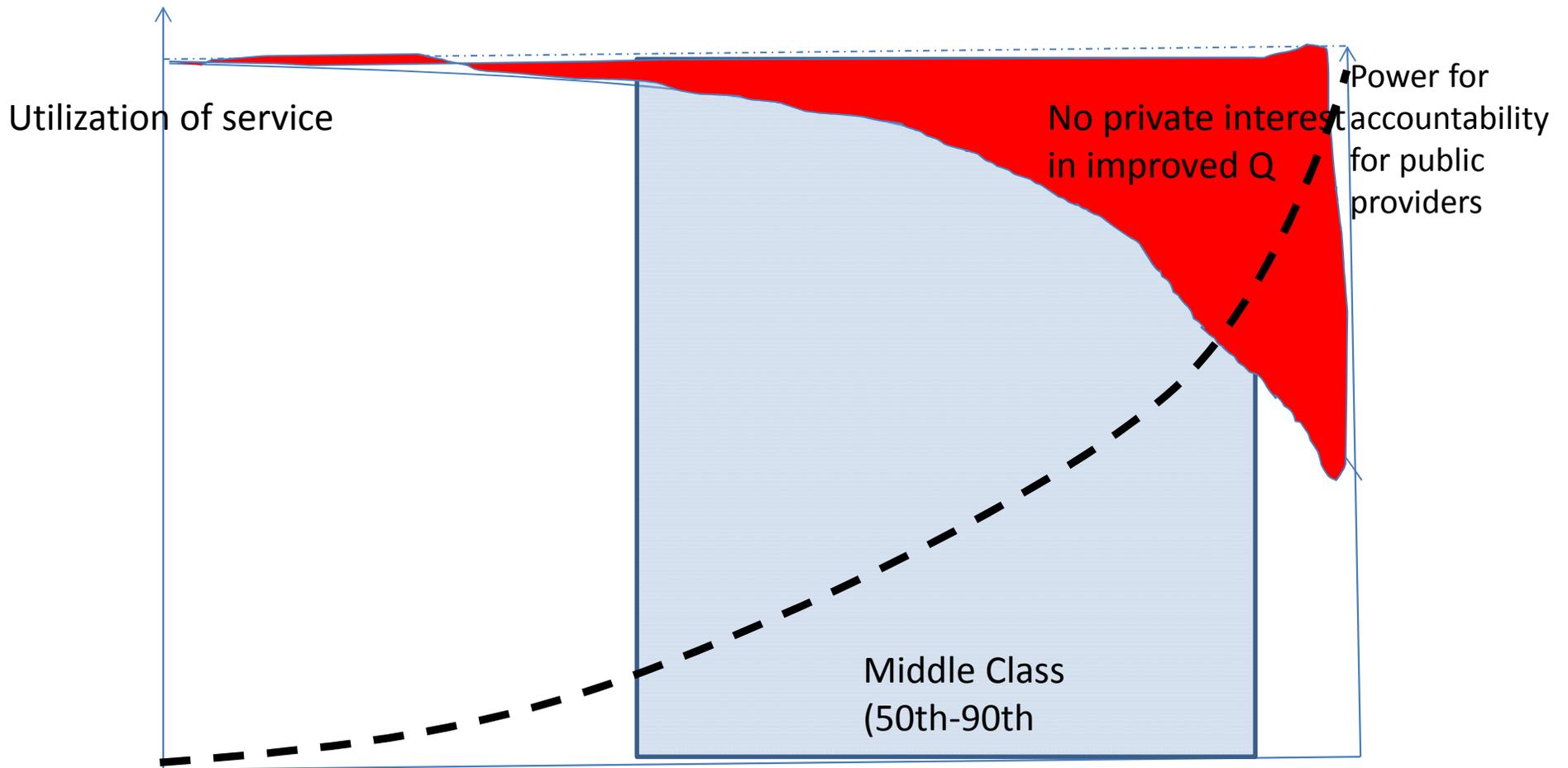


Second Big Point:

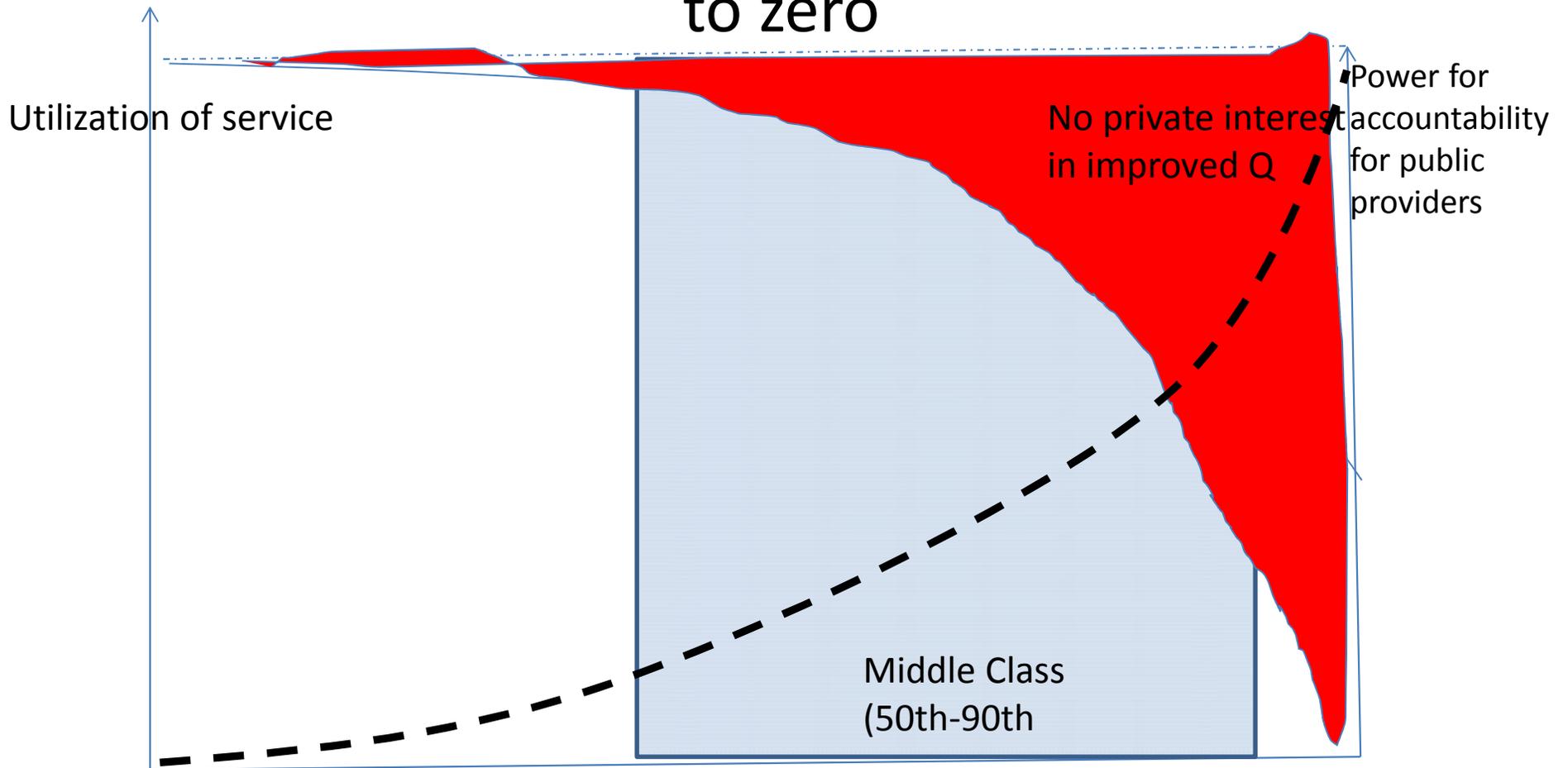
Virtuous Circle versus Vicious Cycle

- Suppose that government provides a service in-kind of quality Q (school, health, electricity, road).
- Demand for quality is increasing in income.
- Three possibilities:
 - Exclusive alternatives public vs private (e.g. basic education, care visits)
 - Supplementation (e.g. electricity, water, security)
 - Pure public good with few/no private alternatives (e.g. roads)

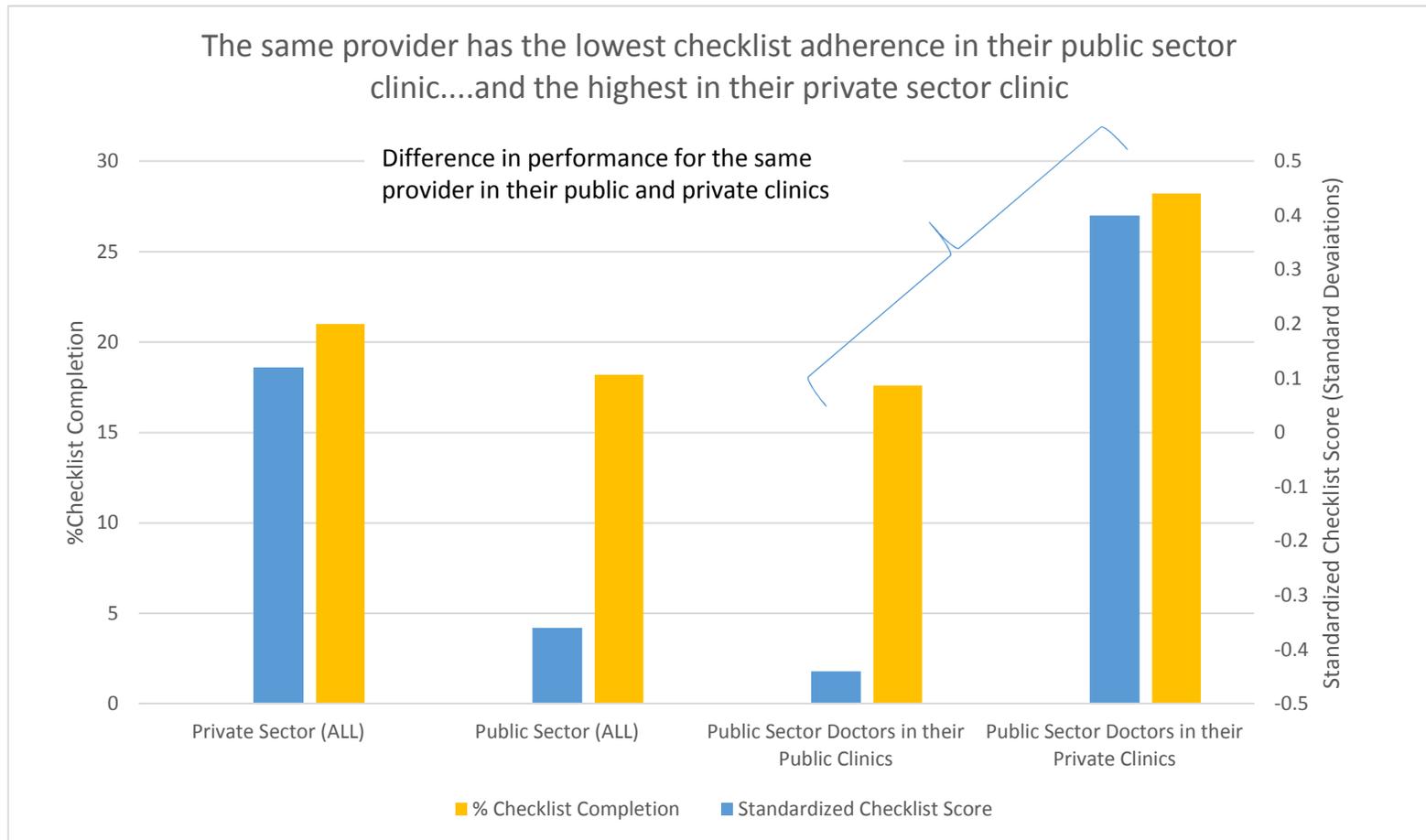
Elements of a virtuous/vicious circle model



An deterioration in the quality reduces the power-sum weighted interest group from accountability—which leads to less Q, can spiral to zero



The incentive problem



So “middle class” political support is going to be fickle

- Things that many see as “important” (e.g. health) go before things that are “irreplaceable” (e.g. roads)
- Once invested in capital intensive “coping” (e.g. generators, bore wells) the support for higher price/better quality is mixed (at best)

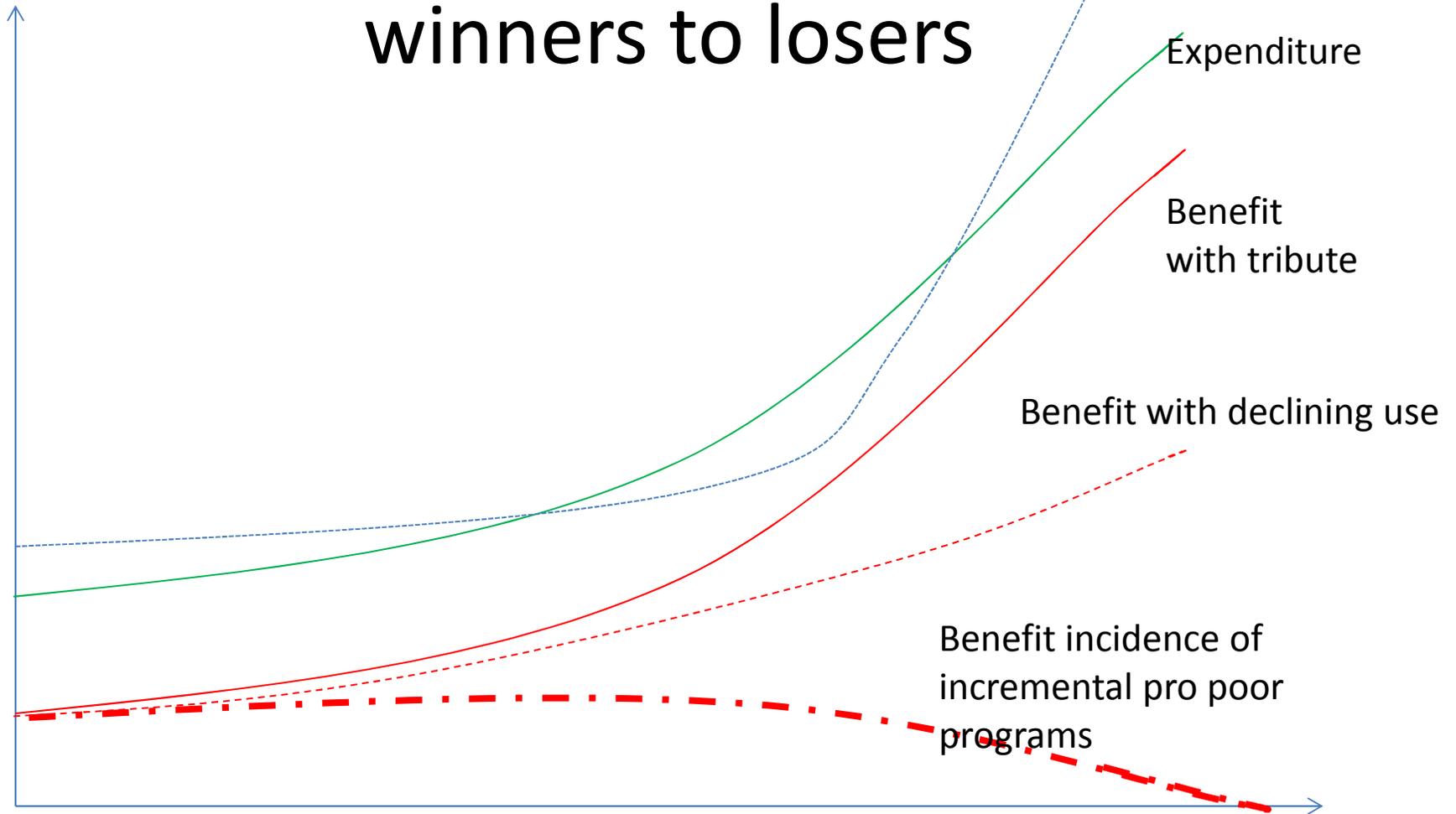
Third point: “insurance” (same person over time) versus “characteristic” (different people) social programs

- Compulsory purchase of actuarial fair value insurance can be a politically very popular agenda
- Bundling targeting with social insurance is a tax on social insurance
- At some point the tax is high enough the political coalition disappears

Three hits on the Indian “middle class” (e.g. 80th percentile urban) on the expenditure side

- Increased “tribute” as pay/performance gap at lower tiers of civil service expands (as pay commissions chase upper tail)
- Lower quality such that “use incidence” falls and increasing proportions opt out of the opt outable
- New programs had less “insurance” like character and hence average “expenditure incidence” fell

Back to standard diagram: One hit—
"tribute" turns middle class from slight
winners to losers



Takeaways

- Tax policy is in the context of expenditure policy and the politics and reality interact as we are “pro-tax as price” but “anti-tax as tribute”
- Reductions in “tribute” are effectively increases in the “tax as price of civilization” increases whatever the tax to GDP number says
- Getting from where we (India) is to a high tax/civilization equilibrium is going to be hard