The least taxing option

Richard M. Bird and Pierre-Pascal Gendron

The VAT in Developing and Transitional Countries

Cambridge University Press, Cambridge, United Kingdom, and New York, 2007, 278 pp., $70 (cloth).

The VAT in Developing and Transitional Countries, by Richard Bird and Pierre-Pascal Gendron, provides a readable, comprehensive, and thoughtful summary of the critical issues related to adopting and operating the value-added tax (VAT) in developing and transitional economies.

The authors are particularly well positioned to provide this analysis. Bird, one of the best-known Canadian public finance economists and a recognized expert on the VAT, has worked with both the IMF and the World Bank, as well as on his own, in more than 50 countries. Gendron, also a public finance economist, has served in the Canadian government and consulted extensively on fiscal and tax matters.

The book gives a feel for the variety and complexity of existing VATs and the numerous problems surrounding them. But the authors still find that the VAT is a suitable fiscal instrument for developing countries. At the outset, they ask whether developing and transitional countries should have a VAT at all and respond with a definitive "yes."

Although the remainder of the book does not break much new ground, it provides both support for this thesis and a nuanced view of how developing countries can best operate a VAT. It points to the general dearth of empirical analysis about the relationship between various VAT design features and particular outcomes in practice and raises a number of critical questions for further study.

The book's main conclusions demonstrate a refreshingly practical view of the feasible versus the ideal in tax policy and administration, doubtless reflecting the authors' extensive experience in working and advising over many years in at least 25 percent of the world's countries.

A better choice

In generally applauding the global rise of the VAT, the authors make the important, and sometimes overlooked, point in the first chapter that government revenue does have to be raised somehow and that, in an imperfect world, the VAT is perhaps the least imperfect solution. The authors note that, in the face of increasing capital mobility, for developing and transitional economies, the revenue possibilities afforded by the corporate income tax and the global personal income tax are very limited. Thus, the key choice to be made in tax design is between the payroll tax and the VAT. In their view, the VAT is better suited than the payroll tax to tap the informal economy.

With this vote of confidence in the VAT, the authors go on to discuss the two themes underlying the appropriate design of the tax for developing and transitional countries. First, it is a mistake, in tax design as in life, to let the best be the enemy of the good—attempts to solve all VAT problems with ever-increasing legal, policy, and administrative complexity are doomed to failure. Second—and this is related to the first theme—the authors urge developing countries not to attempt to go where no country has successfully gone before.

It is far better, they argue, for low-administrative-capacity countries to focus on getting the basics right and to leave the implementation of cutting-edge schemes—for combating EU-type carousel fraud, addressing digital sales, and taxing financial services—to countries that can better afford (both fiscally and administratively) to experiment. As they correctly point out, in developing countries, "tax reality is . . . dominated by administrative capacity and political necessity."

On the specific design features of the VAT for developing countries, the authors in general adhere to the conventional wisdom (which, in some instances, differs from the conventional wisdom of 20 years ago, they point out). This includes, for example, adopting a high threshold for VAT registration, thus limiting the number of taxpayers; minimizing exemptions; avoiding multiple rates; using appropriate audit methodology instead of sophisticated computer matching systems; and avoiding tax amnesties.

Chapter 8—among the most interesting sections of the book—addresses the increasing interest in, and use of, subnational VATs. The authors provide a succinct overview and analysis of the current situation in practice and theory, ending with the characteristically realistic and appropriately cautious observation that "it remains to be seen whether [subnational VATs] can work satisfactorily in countries like India, in which states have some genuine fiscal autonomy but both central and state governments face severe administrative constraints."

The VAT in Developing and Transitional Countries is a valuable addition to the library of anyone interested in tax design, public administration, or development in general.

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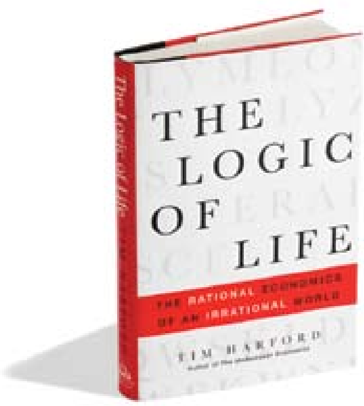
Rational explains the "natural"



Tim Harford

The Logic of Life

The Rational Economics of an Irrational World

Random House, New York, 2008, 272 pp., $25 (cloth).

Dear Economist,

I feel overwhelmed by the current plethora of books on the "new economics of everything." Having read Tim Harford's previous book, The Undercover Economist, *as well as* The Tipping Point, Blink, The Wisdom of Crowds, *and, of course,* Freakonomics, *would I be well advised to read* The Logic of Life: The Rational Economics of an Irrational World, *or should I stick with my economics textbooks? And, for that matter, how do you explain that so many books of this kind are being written?*

Signed: Lost in Pop Economics

Dear Lost in Pop Economics,

Yes, *The Logic of Life* is well worth a read.

First, in what other book could the rational choice assumption be taken for such a wild ride across matters of marriage and divorce, obesity, gambling, addiction, your boss—yes, all the things that really matter in life? And what other recent economic research provides titillating explanations for, among other things, the dynamics of urban population shifts, the origins of the Industrial Revolution, and how our Homo sapiens ancestors may have driven the Neanderthals to extinction?

Second, where else could you find rational explanations for why CEOs are overpaid (hint: it's not because "they're worth it"), or why *Sex and the City*'s Carrie Bradshaw laments the lack of men in Manhattan yet does not relocate to, say, Anchorage, Alaska. If Harford's explanation that "plenty of women seem to have decided they would rather compete for scarce wealthy males than move where the males are poorer but more plentiful" sounds too politically incorrect, try thinking about evolutionary biology, according to which powerful men can protect a family better and younger women can produce more offspring.

Third, where else could you be introduced to such a cast of remarkable characters who confirm that reality can be stranger than fiction, from Chris "Jesus" Ferguson, computer geek turned poker champion who won more World Series of Poker events from 2000 and 2004 than any rivals in a decade applying John von Neumann's poker model (warning: don't try this in Las Vegas), to Nobel laureate Thomas Schelling, who used game theory to save the world from a nuclear war *and* quit smoking (the latter being more difficult than the former, as any smoker could tell you).

And so, after *The Undercover Economist*, Tim Harford is at it again, taking us on a tour of cutting-edge research from a "new breed of economists," to confirm a simple premise: we respond to incentives. Harford's influences are clearly Gary Becker and Schelling, both of whom apply rational choice perspectives to most unlikely areas of life. Add a bunch of exciting new thinkers (Daron Acemoglu, Ed Glaeser, Lena Edlund, Michael Kremer, Mark Granovetter, Justin Wolfers, and many others), and you get a dizzying collection of anecdotes glued together by one central assumption: a lot about life, romance, addiction, urbanization, and even racial segregation can be explained by the premise that people are rational.

But, you might ask, are rational incentives the whole story? Isn't irrational behavior also a staple of human nature? As Dan Ariely's book *Predictably Irrational: The Hidden Forces That Shape Our Decisions* concludes from recent work in behavioral economics, we may not always rationally calculate the value of the different options we face. Think, for instance, about honest people stealing communal doughnuts and office supplies but not money, or patients getting better results from expensive drugs than from cheaper generics. In other words, couldn't we oppose "Incentivomics"—a.k.a. Harford's markets-know-best model—to "Emotionomics," where economic behavior can be influenced by misunderstood forces, such as emotions, impulsions, and social norms?

This is where *The Logic of Life* gets it right: we may at times depart from rational choice, but the standard human rationality assumption retains amazing explanatory range. What seems inexplicable at first sight makes sense once you probe hidden incentives at work and how we respond to them. That is true for New Yorkers and Londoners paying more to live in cities that are way over their wage premium, and even for Disney shareholders, who would have found it rational to pay Michael Eisner an $800 million salary over his 13-year tenure even if he had spent his time only watching "Tom and Jerry."

As for your last question, you are right to note the proliferation of best sellers explaining everything through the economic lens. This confirms—if that was needed—that success brings imitators and that economists are the first to respond rationally to incentives. Fortunately, picking up *The Logic of Life* should be a no-brainer: if you are interested in how human nature and the "dismal science" fit together, it is the rational course of action.

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