Tax Farming

A Radical Solution for Developing Country Tax Problems?

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Ineffective tax administration is a chronic problem in many developing countries. A radical solution is tax farming, whereby the right to collect certain taxes is auctioned off to private sector collectors. Proponents argue that it minimizes administrative costs and results in more efficient collection. The purported gains are largely illusory, however. Because the system leads to overzealous collection, a government would have to expend considerable resources on monitoring private tax collectors. If taxpayer abuse is to be avoided, only unambiguous activities could be privatized. The scope for privatizing the core functions of tax administration thus appears limited. [JEL H86, K42, L33]

Systemic problems encountered in many developing country tax administrations have hindered efforts to increase public saving and have proven to be the weak link in a number of economic stabilization programs. For these reasons, consideration of radical reforms of tax administrations is warranted.

This paper analyzes the merits of the arguments put forward in favor of an alternative tax collection mechanism—tax farming—that was commonly employed in the past by governments facing problems similar to those facing contemporary developing countries. Tax farming is a system wherein the right to collect certain taxes owed the state is auctioned off

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to the highest bidder. The farmer then keeps whatever revenue is collected. A winning bidder wishing to maximize profit will operate at the point where private marginal revenue equals private marginal cost. Tax farming represents a private sector solution to the tax collection problem.

Although some contemporary observers, such as Azabou and Nugent (1988), argue that tax farming should have a bright future, this paper concludes that tax farming was popular primarily because of its ability to generate the maximum gross revenue in a way that obfuscated the government’s role in setting policy. This objective is unlikely to be congruent with that of an enlightened modern tax administration. Although it is certainly true that direct government administrative costs are lower under tax farming, these costs will be borne by the private sector and will be deducted from net government revenue. Moreover, if the government seeks to ensure a fair and proper administration of tax law, considerable effort would be necessary to monitor the process of tax collection by tax farmers. Consequently, tax farming seems to have significantly less to offer developing countries today than its proponents claim.

I. An Examination of Arguments Justifying the Rationality of Tax Farming

This section examines three logically distinct explanations of tax farming’s popularity through history.

Administrative Cost Savings

The most common argument in favor of tax farming was that it enabled administratively weak governments to minimize the cost of collecting tax revenue. Supporters of this view emphasize the savings that accrued to government from avoiding the burden of a large bureaucracy. Webber and Wildavsky (1986) make this case by arguing that, in contrast with Egypt and India, the use of tax farmers in Mesopotamia (ca. 1750 B.C.) implied the government needed only a relatively modest administrative capacity to negotiate contracts and enforce payment of the contract fee. This argument is cited as the reason for the later adoption of tax farming, in varying forms, in Egypt and by many different governments through the late eighteenth century. By economizing on scarce administrative resources, tax farming would offer a potential Pareto improvement compared with government collection.

In determining the merit of this argument, it is important to recognize that some organized entity had to undertake the expense of collection.
The amount generated by a government at auction represented a private sector estimate of the net revenue that could be collected. It is necessary to show how the private sector would have been more efficient in collecting revenue.

There is ample evidence that private tax collectors had to bear the expense of extensive collection networks. In ancient Rome, for example, the Senate negotiated a single contract for all direct and indirect revenues from each distant province. This was a large-scale undertaking: “The syndicate holding contracts in Bynthia during the first century B.C., for example, had tens of thousands of employees” (Webber and Wildavsky (1986, p. 116)). Similarly, in seventeenth-century France:

The tax system was the largest employer . . . giving work to at least 75,000 people for the collection of the indirect taxes alone. . . . The peasant collectors themselves should also be counted among the employees of the system; this would add another 80 to 100,000 people to our total. If we count these collectors, something like 2 percent or 3 percent of the adult male French population worked for the tax system each year (Collins (1988, p. 16)).

In cases where the private sector simply replicates the bureaucracy of the government, there is little to be gained from private collection. Moreover, if the state is committed to the rule of law rather than discretion, it must both set the rules and monitor play. Consequently, the aim of modern developing country tax administrations should be to observe not only the outcome, but the process of tax collection, safeguarding taxpayer rights and determining that the legally obligated revenue is collected properly and at the least social cost. Although tax farming facilitates monitoring the outcome, it compounds the problem of monitoring the process. The greater the decentralization, the more difficult it is to monitor the process and achieve accountability. In the case of tax collection, this problem can be severe. Tax payments, by their very definition, are “. . . compulsory, unrequited, nonrepayable contributions exacted by a government for policy purposes” (International Monetary Fund (1986), p. 102). Therefore, tax collection does not involve two willing participants, and the primary ethical justification for permitting free operation of markets—that transactions are voluntary—is missing. Consequently, one cannot depend on the market to generate an appropriate outcome.

A last problem concerns the access to confidential proprietary information that would seemingly be required to carry out the auditing and investigatory functions of tax collection. Obvious conflicts of interest could arise from private tax farmers’ harassing firms in competition with the tax farmers’ other business interests and using proprietary information to obtain an unfair advantage.
Sovereign Borrowing Facilitated

According to this argument, problems arising from shallow or imperfect credit markets or market failure owing to moral hazard problems were mitigated to the extent that tax farms, representing the right to collect certain established taxes, served as collateral for risky loans by the farmer to sovereign governments. This hypothesis differs in an important respect from the first one above, in that it does not require private collectors to be more efficient than public collectors. It does require, however, that it be more difficult for the state to repudiate the tax farming agreement than a simple loan. This assumption has some validity, since neither the sovereign nor his surrogates would typically have the specialized ability to take over the collection apparatus on short notice. Thus, tax farming may have served as a form of precommitment on the part of the government.

From a more general perspective, it is clear that improvements in tax compliance are an effective way to improve a nation’s creditworthiness. The issue here is whether tax farming is the right way to achieve this goal. Using tax farming to secure foreign debt would certainly set up a disincentive to comply with taxes. Even with government cooperation in the area of tax law, it is difficult for outside agents to enforce tax compliance. Indeed, if foreign commercial banks cannot enforce loan contracts it is difficult to see how they could enforce tax obligations. Thus, the argument for tax farming as simply a substitute for collateral would appear to have little relevance for modern developing countries.

Revenue Collection Maximized

Tax farming will, in general, result in “overcollection,” where this is defined in reference to the wishes of the representative taxpayer (see Stella (1990)). If the state wished to maximize revenue rather than economic welfare, tax farming would efficiently serve this goal. Tax farming generates the maximum amount of net revenue because it gives the farmer profit-maximizing incentives—to maximize net revenue collected is to maximize profit.

This argument is fundamentally different from the first two in that it depicts tax farming as a socially inefficient institution leading to overexpenditure on tax collection. Such an institution may be preserved either because it represents the best option among available technologies—that is, it is a second-best solution—or because the government has an objective function that does not appropriately value citizens’ preferences.
The historical record is replete with evidence that tax farming resulted in overzealous collection. In France, “the practice of farming the indirect taxes to the highest bidder encouraged revolting harshness in collection” (Higgs (1928, p. 71)). De Vries (1976) comments on the Dutch Republic’s experience with tax farming during the seventeenth and early eighteenth centuries: “Here, too, tax farmers controlled the excise tax collections; each year the tax collection privileges on forty-three separate excises were sold to the highest bidders. This system produced social discord that generated the most significant riots in the Republic’s history” (p. 202). Even Adam Smith in 1776 in Wealth of Nations criticized the behavior of tax farmers (Smith (1937)).

Bid rigging and a general lack of competition also characterized the issuance of tax farms. “The leases were awarded by Court favor and led to much intrigue and corruption, always at the ultimate expense of the public. The farmer made large profits. . . . It was on the charge of this fraud that the Farmers-general were guillotined during the Revolution” (Higgs (1928, p. 71)). This problem has important implications for developing countries where the shortage of skilled personnel would not permit effective competition.

II. Tax Farming as a Second-Best Solution

Although tax farming clearly has flaws, in particular the excessive revenue effort, often the practical alternatives are far from perfect and may result in inadequate revenue collections. Although not implying that the best system is the one that generates the most revenue, there are those who argue, such as Tanzi (1989) in the Latin American context, that revenue generation is the most important objective of the tax system. This section examines tax farming as a second-best solution.

As in any situation where reform is being considered, it is important to diagnose the cause of existing tax administration problems before examining the appropriateness of alternative solutions. In some cases the government salary schedule has been compressed and reduced to the point where it is not possible to recruit or retain qualified personnel with the specialized talents required for tax administration. Raising wages may be politically or administratively difficult owing to pressure from the rest of the civil service to be treated similarly. A second problem in some countries is that it is very difficult to dismiss anyone from the civil service, which makes it costly to deal with poor performers or even outright corruption.
One approach to the salary problem is to reward the tax administration based on its revenue performance. Chand and Lorie (1992), in the context of economies in the process of being transformed from centrally planned to market oriented, argue that in response to the likely reduction in real salaries of tax administrators, revenue-related bonuses may play an important role in motivating tax officers. Such incentive systems are akin to tax farming, albeit with the important difference that government officials will presumably be subject to a set of political, ethical, and administrative constraints that a private farmer would not necessarily adopt.

How one structures the incentives is important. In Argentina and Bolivia, for example, the amount retained by the tax authority for its use is based on a percentage of the total tax collection. This, in turn, implies that the percentage rate is quite low and, consequently, the marginal incentive is low. Alternatively, the administration could be rewarded on the basis of a percentage of the collections above a predetermined target. In this latter case a higher marginal reward could be offered with the same overall cost. The current system has the effect of increasing the tax officials’ basic remuneration and does not change incentives very much—particularly since any one individual’s contribution to overall collections is likely to be small. In order to fundamentally change incentives, a higher marginal reward would have to be offered. In the limit, receiving 100 percent of collections above a certain threshold would present the government tax official with the same incentives as a tax farmer.

In other cases the tax administration may be rife with corruption, and drastic measures are warranted. Before tax farming is considered, one must ascertain whether there is a genuine political commitment to reform at some higher level. In the absence of such a commitment, tax farming may merely substitute a centralized form of corruption for a decentralized one. A second consideration is that one may overestimate the net revenue gain to be had from abolishing corruption. If the venal tax collector has merely accepted an average level of bribes that brings his or her wage to the alternative he or she could obtain elsewhere, then the wages the private sector farmer would have to pay his or her employees, presuming corruption were eliminated, would be that much higher. In such a case the tax farmer could not offer the government higher net revenue than is currently being obtained. However, in circumstances where the public collector cannot be fired and entry into the tax collection profession is restricted, the public employee could generate a level of bribes that would bring his or her compensation above the private sector equivalent. This would suggest a need for civil service reform.

In other circumstances, public revenue collection is weak for reasons
that would not be addressed by private collection. Ambiguous or overly complex laws, an ineffective legal enforcement mechanism, or a large underground economy are all situations wherein tax farming is unlikely to improve the situation. Moreover, if the judicial system cannot be relied upon to effectively monitor the behavior of tax farmers, the adverse consequences of private sector collection could be severe.

Up until now, this paper has discussed tax collection and administration as though it were a monolithic activity. In reality, tax administration involves many different identifiable stages beginning with the issuance of interpretations of tax law, regulations, and guidelines, to the collection of court-awarded tax arrears and penalties. Given the wide range of activities that are the responsibility of the tax administration, it is appropriate to consider areas that might be suitable for privatization.

Based on the preceding discussion, only activities that involve little ambiguity, judgment, interpretation, and discretion would be amenable to privatization. The collection of known tax arrears, for example, is a case where the judicial system has already ruled on any issues in dispute and where what is required is simply collection. Data processing services and employer-mandated tax withholding are other cases where the private sector can be usefully involved. In the latter case the employer plays no role in the determination of the ultimate tax liability and merely serves as an agent in the retention process. The core activities of the tax administration—interpretation of the law and issuing guidelines, assessment, and auditing—are areas where, if the government is committed to fairness and the rule of law, a significant degree of monitoring of the government’s agents is required. Under these circumstances, privatization might lead to higher overall costs than an effective internal reform of tax administration. By analogy, one could argue that the privatization of prisons results in efficiency gains, but a society committed to justice and equality before the law could not privatize the process by which an individual is sentenced to prison.

In contrast to those who argue that tax farming has a bright future in areas where tax administration costs are highest, it would seem that efficient and fair privatization of tax administration and collection activities is most likely to occur in situations where monitoring costs are lowest. Such partial reforms have taken place or are being considered in a number of countries. In Argentina it has been proposed that the collection of tax arrears be contracted out to private firms that would retain a share of collections. In this case, since private collection efforts would be aimed only at those with identified tax arrears, there would be little scope for overcollection. Other countries have engaged private companies to administer part of the customs functions, such as to verify
that the value of goods declared by importers at customs corresponds to international price data. The verification task is privatized without ceding the actual right to collect taxes.

III. Conclusion

The argument that tax farming was popular because it was technically a more efficient way to administer taxes is seriously flawed. Fundamentally, some executive must employ a bureaucracy to enforce tax laws. At the microeconomic level private farmers would have to be just as concerned as public officials with issues of monitoring and control of individual tax collectors. Furthermore, in order to restrict abuse, the government would have to monitor the behavior of private collecting agents. This latter consideration would seem to obviate the main benefit of tax farming—that the government is relieved of monitoring the process of tax collection and need only observe the end result. Unlike virtually every private market transaction, tax collection is not a situation of voluntary exchange. Consequently, if the state has an interest in justice, it cannot cede its monitoring role.

In drawing distinctions among the various aspects of tax administration, it was pointed out that certain activities, such as the collection of court-adjudicated tax arrears, might be suitable for privatization. Functions involving an important degree of discretion, interpretation, and the opportunity to transgress taxpayers’ rights, however, are more appropriately left in public hands.

A lasting improvement in tax compliance is likely to take place only when changes in tax administration are undertaken within the context of increased transparency, simplicity, and equity in the tax system.

REFERENCES


