TAX REFORM IN DEVELOPING COUNTRIES
AGENDA FOR THE 1990S

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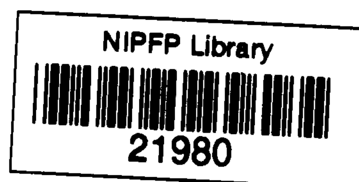

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Amaresh Bagchi*

I. Introduction : Why Tax Reform?

Tax reform has figured prominently in the agenda of governments in recent years in both developing as well as advanced countries. Mexico, Bolivia, Colombia, Korea, Indonesia, Malawi, Zimbabwe, Morocco, Kenya and Turkey, all carried out at least one major reform in their tax system during the 1980s. Several others have either already embarked on or are contemplating extensive reform. Among the advanced countries, the most sweeping reform took place in the USA in 1986. Other advanced countries which have attempted (or were planning) to overhaul their tax system during the 1980s include Australia, Canada, New Zealand, Denmark, France, Japan, Netherlands, Sweden and UK (Pechman, ed., 1988). Indeed, as Tanzi puts it, "very rarely has the world seen so much interest in tax reform as in the past couple of years" (Tanzi, 1988).

In USA and other industrial countries, the urge for tax reform came principally from the widely shared perception that the tax system was unfair, unduly complex and detrimental to economic efficiency. A formally

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progressive structure of income tax riddled with a plethora of concessions and preferences which only the rich and resourceful could exploit gave rise to a widespread feeling of unfairness. Empirical studies lent support to this feeling. Researchers also drew attention to the harmful effects of a regime of high tax rates operating in combination with preferences and concessions which tended to create wide divergences in the effective incidence across activities, investments and forms of businesses, interfering with the choices of economic agents. It was felt that making the tax system neutral - "levelling the play field" - was needed for reducing the excess burden of taxation and promoting welfare. A move towards a fairer and more neutral tax regime would also make for simplicity and transparency.

The motivation for reform in the developing countries too came largely from the quest for fairness, efficiency and simplicity. The tax systems of many of these countries which had taken shape in the 1950s and 1960s though highly progressive on paper were seen as iniquitous in operation and a source of inefficiency in resource use. Heavy reliance on indirect taxes of various kinds coupled with rate differentiation on the one hand and steeply progressive direct taxes with exemptions and preferences on the other made the tax system in many developing countries extremely complex and harmful to the growth of the economy. What lent urgency to the search for better tax systems was the spectre of widening budget deficits and the need to raise revenue from domestic sources to meet them (Thirsk, 1990a).

Impetus for tax reform in the developing countries came also from a change in perception concerning the role of government in general and tax policy particularly with increasing demand for a greater role of the private sector, and the resurgence of faith in conservative economic policies ("supplyside economics"). In the east Asian countries the reforms were thought necessary partly in response to the sweeping tax changes that took place in the 1980s in USA and other advanced countries (Asher, 1988).

Tax reform, however, can never be a one-shot affair. All countries have to mend or even overhaul their tax systems from time to time taking stock of

the emerging needs and in the light of experience gained and findings of research. Moreover, many of the problems of the 1980s which spurred the search for better tax systems - growing gap between revenue and expenditure of governments, the damage caused to the economy by an inefficient tax system and widespread evasion-clouding the equity of the system - persist. How the developing countries are going to address these problems, what should their agenda for tax reform be in the coming years, therefore, call for careful consideration. This paper seeks to highlight the problems and issues after taking a look at the reforms during the 1980s and focus attention on areas for action and possible alternatives. Section II provides a brief appraisal of the content and direction of reforms during the 1980s; Section III reviews the theoretical foundations, and Section IV puts forward suggestions for an agenda for the 1990s.

II. Content and Direction of Reform

The tax reform programmes of the countries where reform has been carried out or is under implementation exhibit several common elements. There are, however, significant differences in the thrust of the reforms and their approach to specific issues.

a. Advanced Countries

In the advanced countries particularly USA the main thrust of tax reform was to move towards a tax regime with moderate rates of individual income tax particularly in the top brackets but with a wider base. The focus on reform of income tax was perhaps natural as income tax is a much more significant source of revenue in these countries than in the countries of the Third World. The lead in rate cutting was given by the US with a reduction of twentytwo percentage points in the top US federal tax rate (from 50 per cent to 28 per cent). The number of tax brackets was slashed from 15 to 2. Other industrial countries also followed the same trail though they did not go as far as the

US. In Japan and Australia the reduction was by 20 and 13 percentage points respectively while in others the cut ranged between 2 to 18 points (Tanzi, 1988).

Reduction in maximum individual income tax rate was accompanied by cuts in corporate tax rates and withdrawal of incentives for investment. UK showed the way in 1984 by eliminating the first year 100 per cent deduction for plant and equipment and reduction in the rate from 50 to 35 per cent. In 1986, the US reduced the federal corporate rate from 50 to 34 per cent contracted the depreciation allowances, repealed the investment tax credit and imposed severe limitations on many other deductions and exclusions. A similar move took place in Canada in 1988. The other highlights of tax reform in the advanced countries are: taxation of non-cash fringe benefits (Australia), elimination of preferential treatment of capital gains (US), restriction on deductibility of entertainment expenses (Australia, Canada, Denmark and UK) and interest payments (US, Denmark, Sweden) and integration of personal and corporate taxes. In EEC countries, a notable trend has been the move towards harmonization of the important taxes starting with the value added tax (VAT).

b. Developing Countries

In contrast with the emphasis in advanced countries, the thrust of reform in developing countries has been towards overhauling the structure of indirect taxes, reflecting concern over the heavy reliance on and detrimental effects of a haphazardly levied mix of turnover type sales taxes, excise tax and unduly high customs tariff. Reform of indirect taxes was also considered urgent for revenue reasons as the scope for direct taxation remained limited, while reliance on inflation tax was proving counterproductive. Attention was paid also to the reform of taxes on income and profits. The primary aim was to secure more revenue at minimum cost in terms of efficiency loss and without hurting the poor. As neatly summed up by Thirsk in a recent survey, the main trends in tax reform among the developing countries have been:

- to rely on the value added tax (VAT) as the main revenue raiser supplemented by selective excises to achieve progressivity;
- to lower personal and corporate income tax rates;
- to align the corporate rates with top bracket personal income tax rates;
- to integrate personal and corporate income taxes at least partially;
- to broaden personal and corporate income tax bases;
- to allow more extensive inflation adjustment; and
- to improve administrative capabilities (Thirsk, 1990a, 1990b).

Since the early 1960s, over 40 developing countries have adopted the VAT form of sales tax (Gillis, et. al., 1990). Among the Asian countries, South Korea was one of the first to introduce VAT. The most recent example of successful introduction of VAT is Indonesia. Others who have introduced VAT are Taiwan and Philippines. VAT is under way also in Thailand, Pakistan and China. Notable exceptions are the two island economies, Hongkong and Singapore, where a retail sales tax is still favoured (Asher, 1988). India introduced a modified value added tax (MODVAT) in 1986 to its excise structure within the framework of its excise duties levied at the federal level. Excises are retained in some countries as a supplement in order to tax luxuries and impart a degree of progressivity to the tax system.

As in advanced countries, the developing economies also have been trying to move towards a broad-based, low-rate regime of personal and corporate income taxes (**Table 1**). Many have tried to align the corporate rates to the top bracket personal rate, facilitating integration of the two. **Table 2** shows the minimum and maximum rates of personal and corporate income tax in selected developing countries prevailing in 1990-91.

TABLE 1

Recent Reforms of Corporate (CIT) and Personal (PIT) Income Tax Rates

Country	Pre-reform CIT rate[1]	Pre-reform top bracket PIT	Current CIT rate	Current top bracket PIT
Indonesia	45	50	35	35
Korea	38	60	30	55
Jamaica	45	57.5	33 1/2	33 1/2
Mexico	42	60	45	40
Colombia	40	49	30	30
Bolivia[2]	30	48	-	-
Turkey	50	66	46	50
Zimbabwe	53	60	50	60
Malawi	60	50	45	45
Morocco	53	76	45[3]	50

Notes:

1 For countries where multiple corporate rates are in operation only the highest rate is shown.

2 Bolivia has replaced personal and corporate income taxes with presumptive taxes on corporate and personal assets.

3 As proposed at the time of writing by Thirsk (1990b).

Source: "Recent Experience with Tax Reform in Developing Countries" by Wayne R. Thirsk in <u>Ricerche Economiche</u>, April-September, 1990, pp. 321-348.

TABLE 2

Minimum and Maximum Rates of Individual and Corporate Income Tax in Selected Developing Countries (as of 1990-91)

Country	Individual income tax		Corporation tax		
	Min. rate (Per cent)	Max. rate (Per cent)	Min. rate (Per cent)	Max. rate (Per cent)	
Bangladesh	10	50	40	55	
Nepal	10	50	40	40	
India	20	50[1]	40	50[5]	
Pakistan	5	45[2]	30	30[7]	
Sri Lanka	10	40	33.3	50	
Indonesia	15	35	15	35	
Malawi	3	45	45	45	
Philippines	1	35	35	35	
Zimbabwe	20	60	50	50	(reduced to 45 for 91-92)
Morocco	14	52	10[4]	40	
Thailand	5	55	30	35	
Jamaica	33.3	33.3	33.3	33.3	
Colombia	0.05	30	30	30	
Turkey	25	50	46	46[8]	
Mexico	3	35	35	35	
Malaysia	4	35	35	35	plus 3% Development tax.
Brazil	10	25	25	30	plus 5 to 10% surcharge.
Argentina	6	30	20 (Res)	36	(Non-Res)
Chile	5	50	15	15	
Korea	5	50[3]	20	34[6]	
Singapore	3.5	33	31	31	

Notes:

1. Taxable income exceeding Rs 75000 is further liable to a surcharge at 12% on income tax.
2. Surcharge at 10% is payable on total income exceeding Rs 200,000
3. A residence based surcharge is levied at 7.5% of income tax.
4. Applicable to certain transfers of gross income (listed in the tax law) to foreign companies resident abroad.
5. Taxable income exceeding Rs 75,000 is subject to a surcharge of 15%.
6. A surcharge of 7.5% is levied on corporate tax.
7. In addition, super tax at varying rates is levied. calculated at 7% of corporation tax are payable.
8. In addition, Defence fund and other fund premiums at 7% of corporation tax are payable.

Source: Bulletin for International Fiscal Documentation and Asian Pacific Tax and Investment Bulletins, various issues.

Rate reduction has proceeded with broadening of the income tax base by weeding out incentives, pruning the deductions and exemptions, tighter taxation of fringe benefits, recourse to presumptive taxation, and minimum tax on assets, etc. (vide **Table 3**).

In Bolivia the income taxes were virtually eliminated and "a trio" of new taxes took their place, viz., (i) a progressive tax at rates between 1.5 to 5 or 3 per cent on vehicles and urban real property; (ii) a 2 per cent tax on net worth of enterprises; and (iii) a simplified tax on very small enterprises to be paid as a lumpsum assessed on the basis of (self-declared) gross sales value replacing all other taxes payable by such firms (Bird, 1990).

Another feature of reform has been to provide indexation in both direct and indirect taxes.

c. Preliminary Results

Most of the reforms noted above have taken place only recently and it is too early to assess the results achieved. However, attempts have been made in several studies to appraise the reforms in order to derive lessons for the future (Asher, 1988, Thirsk, 1990a & 1990b).

The most remarkable result of the reforms has been emergence of VAT as a major instrument of taxation. By and large these are destination-based consumption type taxes levied on goods (and at least some services) upto the retail stage. Not only has this reform proved practicable in developing countries, in quite a few instances VAT has proved to be a more efficient revenue raiser than any tried so far. It has also alleviated cascading and, contrary to apprehensions, the impact on prices too seems to be moderate.

TABLE 3

A. Tax Reform Measures : Personal Income Tax Base Broadening

Country	(2) Inclusion of fringe benefits	(3) Presumptive assessment	(4) Limited deduction	(5) Increased withholding
Indonesia	X		X	
Korea				
Jamaica	X		X	X
Mexico		X	X	
Colombia		X	X	
Bolivia		X	X	X
Turkey	X	X		X
Zimbabwe				
Malawi	X			
Morocco		X		

Notes:

(1) X indicates that a particular measure was adopted.

(2) Indicates that employer-provided benefits such as housing allowance (e.g. Jamaica), heating allowances (e.g. Turkey) and use of a company car (e.g. Malawi) have been incorporated in the definition of taxable income.

(3) Presumptive assessment of taxable income is based on gross turnover (e.g. Mexico), wealth holdings (e.g. Colombia) or consumption indicators (e.g. Turkey).

(4) Many countries have swept aside numerous personal deductions and replaced them with a single personal allowance.

(5) Withholding of tax at source may apply to labor income, all sources of income (e.g. Bolivia), interest income (e.g. Turkey) or product sales (e.g. Turkey).

B. Tax Reform Measures : Corporate Base Broadening

Country	Minimum taxes on assets	Inclusion of public enterprises	Fewer tax incentives
Indonesia		X	X
Korea			
Jamaica			
Mexico	X		X
Colombia		X	X
Bolivia	X	X	X
Turkey	X		
Zimbabwe		X	
Malawi		X	
Morocco	X		

Notes: X indicates that a particular measure was adopted.

Source: Same as for Table 1.

The results on the direct taxes side are less impressive. Even after base broadening, many elements of capital income still slip through the tax net or are only partially brought under taxation. Capital gains continue to be a trouble spot. Fear of capital flight deters taxation of interest income except at a mild rate. Many of the incentives and concessions have been withdrawn or scaled back and the rates reduced but several of the incentive provisions remain in the statute book (e.g. those for saving, investment, technological progress and exports). While the attempt has been to broaden the base by including capital income and fringe benefits, for administrative and compliance ease there is an increasing trend towards schedular taxation. Philippines went in for the schedular system and taxation on the basis of "modified gross income" (Yoingco, 1991). As noted, Bolivia has virtually abolished income tax and gone in for presumptive taxes on corporate and personal assets in its place.

All this signifies disenchantment with taxation as an instrument of vertical equity and redistribution and greater concern for revenue growth, efficiency and simplification of the tax system to secure some kind of "rough justice", rather than trying for fine tuning to achieve "some ideal but administratively hopeless objective". Despite considerable interest shown in the literature, there has been no pronounced move towards replacement of income taxes with cash flow tax or expenditure based direct taxes. The standard pattern that seems to be emerging is a mix of indirect taxes with VAT as the centrepiece and direct taxes with a broad based, moderately rated income tax, made up of large schedular components.

A preliminary evaluation of results of Indonesia's tax reform shows that the aim of raising non-oil revenues has been largely fulfilled. The revenue gain exceeded the ambitious targets of the country's development plan primarily because of VAT. The reforms also seem to have achieved greater neutrality. Differential tax treatment of domestically produced and imported goods has been eliminated by VAT and the cascading effects of pre-reform sales tax have been mitigated. Differential tax treatment of various assets and

sectors has been removed with the reform of income tax. The tax is now neutral to the type of business organisation and form of ownership and control. Care was taken to shield the poor by raising the basic exemption limit for income tax. VAT did not have much impact on prices and so the relative position of the poor was not affected. The Indonesian experience shows that a major overhaul of the tax system and introduction of VAT is possible in a developing country and in a relatively short period of time, given careful preparation. However, improvement in tax administration is a slow and painstaking process. Measures taken to improve the administration of income tax (which included an amnesty programme) resulted in a sharp rise in the number of taxpayers but the numbers actually filing returns are far below those registered. The revenue performance of income tax has turned out to be disappointing. Enforcement of tax laws remains weak (Asher, 1990).

In Colombia too significant neutrality in the allocation of investment, assetwise and sectorwise, choice of instruments for financing business and of business organisation seems to have been achieved through reform. However, while indexation and other measures served to remove the inequities and distortions, the reform of 1988 in Colombia led to scrapping of net wealth tax in 1989 and reduction in the rate of presumptive income taxation. All this is likely to weaken the progressivity of the income tax at the top of the scale (McLure and Zodrow, 1990).

In Korea also tax reform has been instrumental in promoting efficiency in resource allocation and bringing about a strikingly uniform pattern of marginal effective tax rates across different sectors, even though the use of tax incentives to influence sectoral allocation of resources continues. Revenue performance seems to have contributed to the realization of consistent fiscal surpluses. But the tax system is marked by regressivity. Enforcement remains weak and constitutes a source of public discontent (Choi, 1990).

The key role of tax administration in securing the desired results is underlined also by the Indian experience. Although in India there has been no comprehensive tax reform campaign of the kind mounted in Indonesia, the

Central government in India took a series of measures to bring about substantial reform in the income tax and excise system in 1985-86. Maximum rates of personal income and corporate taxes were brought down from about 60 per cent in early 1980s (over 80 per cent in the 1970s) to 50 per cent and the two were brought into alignment. Some of the incentive provisions (like the investment allowance) were removed or rationalised. Several measures were taken to combat evasion (notable among them being assumption of power by the government to preempt the purchase of large immovable properties in metropolitan towns). As noted already, a modified value added tax was introduced to provide for relief in excise duties paid on inputs and attempts were made to rationalise the customs tariff too. Initial results of income tax reform were encouraging. The preemptive purchase provision has had a sobering effect on concealment of investment in real estate transactions. But the momentum seems to have petered out. Revenue figures for the fiscal year that has just ended (1990-91) reveal large shortfalls from estimates. The shortfall seems to be particularly large in corporate tax. On the indirect taxes side, the introduction of MODVAT has given rise to apprehensions of large revenue loss. Although one early evaluation of its operation does not bear this out (Narayana, et. al., 1990), fears of revenue leakage persist. Rationalisation of customs has not made much headway and high levels of tariff with large spread remain, the major impediment to progress being considerations of revenue.

Presumptive income tax for the self-employed, introduction of VAT to replace several other indirect taxes and inflation adjustment have been the keynote of tax reform in Turkey. While there has been improvement in both equity and efficiency, distortions in the form of incentives, etc. remain and it appears that the incidence of both direct and indirect taxes continues to be regressive (Bolutoghu and Thirsk, 1990).

Overall, the reforms seem to have had a wholesome effect on the tax systems of many developing countries in terms of simplicity, transparency and greater neutrality. Any judgement on the impact on incidence must await further studies. The impact on revenue is not so apparent yet, as the tax-GDP

ratios do not reveal any appreciable change (vide **Table 4**) and the proportion of direct taxes in several countries shows a downward trend with the exception of a few, e.g., South Korea (vide **Table 5**).

TABLE 4

Tax Revenue and Overall Surplus/Deficit as a Percentage of GNP : An Inter-country Comparison

Country	Tax revenue as a* percentage of GNP		Overall Surplus/Deficit (Per cent of GNP)	
	1981	1988	1981	1988
Low income economies				
Bangladesh	--	7.18	--	--
Nepal	6.97	8.33	-2.5	-6.2
India	10.64	11.27	-6.0	-7.9
Pakistan	12.53	12.57	-5.4	-7.0
Sri Lanka	15.50	16.36	-12.8	-12.8
Indonesia	22.73	17.09	-2.2	-3.3
Malawi	16.03	17.14	-12.0	-8.6[b]
Middle income economies	12.57	--	3.8[b]	-3.9[b]
Low middle income economies	18.92	9.41	-3.6[b]	-3.7[b]
Bolivia	7.32	11.06	-4.1	-0.1
Philippines	10.37	12.26	-4.0	-2.8
Zimbabwe	23.28	28.26	-7.3	-9.1
Morocco	21.52	21.91	-13.6	-4.6
Thailand	12.93	16.01	-3.5	1.0
Jamaica	--	--	-16.6	--
Colombia	--	1.59	--	-0.7
Turkey	18.39	14.59	-1.8	-4.0
Mexico	13.16	14.85	-6.9	-10.0
Malaysia	24.15 (U.M.I.)	17.62	-15.8	-8.4
Brazil	17.43 (U.M.I.)	15.9	-2.4	-12.2
Uruguay	19.32 (U.M.I.)	18.92	-1.5	0.7
Argentina	14.35 (U.M.I.)	16.0	-8.5	-4.1
Chile	26.46 (U.M.I.)	23.71	2.7	-0.2
Korea, Rep. of	17.34 (U.M.I.)	14.71	-3.7	1.6
High income economies	--	23.33	--	-3.3[w]
OECD Members	--	23.33	--	-3.4[w]
Singapore	19.82	13.62	-2.7	14.96
Sweden	32.90	37.19	-9.2	2.2
United States	19.73	18.10	-2.7	-3.2
United Kingdom	31.80	32.69	-4.7	-0.8

Notes: Data pertaining to 1981 and 1988 have been taken from the World Development Reports (WB), 1984 and 1990 respectively.
w Weighted average.
UMI Upper Middle Income Economies.
b Budgetary data.
* Computed.

TABLE 5

Central Government Current Revenue (Percentage of Total Current Revenue)

Country	Taxes on income, profit & capital gain		Social security contributions		Domestic taxes on goods and services		Taxes on international trade and transactions		Other taxes[a]		Non-tax revenue		Tax revenue as a percentage of current revenue	
	1981	1988	1981	1988	1981	1988	1981	1988	1981	1988	1981	1988	1981	1988
Low income economies														
Bangladesh	--	11.7[b]	--	0.0[b]	--	33.2[b]	--	31.5[b]	--	7.1	--	18.5	--	83.50
Nepal	8.1	8.4	--	0.0	30.0	36.1	34.41	31.1	0.7	5.4	14.0	18.1	80.0	80.0
India	18.4	14.5	--	0.0	41.0	35.3	22.1	30.3	0.0	0.3	16.9	18.5	83.10	80.5
Pakistan	15.0	11.0	--	0.0	33.2	33.0	34.0	31.0	0.3	0.3	17.0	23.0	83.0	78.20
Sri Lanka	13.3	11.1	--	0.0	32.5	40.0	47.0	29.0	1.0	4.3	5.3	13.0	84.70	86.10
Indonesia	72.5	55.0	--	0.0	7.0	24.5	4.0	5.0	1.0	3.0	13.0	11.0	88.10	88.80
Malawi	28.5[b]	33.7[b]	--	0.0[b]	30.3[b]	33.0[b]	23.1[b]	10.0[b]	--	0.4[b]	--	10.0[b]	--	83.20
Middle income economies	43.4[b]	25.0[v]	0.2	--	21.0[v]	20.4[v]	11.9[v]	12.2[v]	--	--	--	--	--	--
Low middle income economies	30.4[v]	20.5[v]	--	--	25.3[v]	35.8[v]	17.5[v]	14.7[v]	5.6[v]	--	13.2[v]	10.0[v]	80.06	88.40
Bolivia	15.2	2.7	--	0.6	37.0	50.7	20.4	20.0	3.7	1.2	13.0	8.3	88.1	83.70
Philippines	21.7[b]	21.5[b]	--	0.0[b]	41.0[b]	37.5[b]	22.3[b]	24.5[b]	2.8	2.2[b]	11.4	14.3[b]	88.80	85.70
Zimbabwe	47.7	47.3	--	0.0	30.5	24.0	0.1	15.0	1.2	1.1	11.5	11.7	88.50	88.30
Morocco	18.5	18.9	5.4	5.0	31.6	46.1	20.0	12.7	7.0	7.0	16.6	10.2	83.40	88.80
Thailand	19.8	19.9	--	0.0	45.5	46.3	22.8	22.0	1.8	2.0	10.2	0.0	82.80	87.50
Jamaica	--	--	--	--	--	--	--	--	--	--	--	--	--	--
Colombia	--	27.0	--	0.0	--	27.7	--	10.1	--	0.2	--	11.5	--	88.50
Turkey	51.7	39.5	--	0.0	10.0	32.0	5.3	6.6	6.7	3.3	16.4	10.5	63.00	81.50
Mexico	37.1 (UHI)	26.0	14.4	11.8	31.0	80.5	20.1	3.4	-10.6	-10.1	0.2	7.5	83.80	82.50

Contd...

TABLE 5(Contd...)

Country	Taxes on income, profit & capital gain		Social security contributions		Domestic taxes on goods and services		Taxes on international trade and transactions		Other taxes[a]		Non-tax revenue		Tax revenue as a percentage of current revenue	
	1981	1988	1981	1988	1981	1988	1981	1988	1981	1988	1981	1988	1981	1988
Malaysia (UMI)	36.9	32.2	8.5	0.7	15.4	18.0	28.3	17.3	1.8	2.8	17.0	29.8	83.0	70.20
Brazil	13.2	11.5	25.7	16.6	27.5	13.8	3.0	1.7	4.0	2.8	25.8	53.8	74.20	46.20
Uruguay (UMI)	7.3	7.9	24.6	25.0	43.9	44.7	11.7	12.2	5.7	5.2	8.7	4.4	93.30	95.50
Argentina (UMI)	5.4	0.5	15.0	20.4	44.0	35.0	10.7	10.3	5.3	11.0	18.9	0.0	01.10	81.20
Chile (LMI)	16.9	22.0	15.3	5.8	40.9	38.0	5.5	9.5	4.7	-0.2	16.8	28.2	83.20	73.00
Korea, Rep. of (UMI)	23.0	38.3	1.0	3.8	44.7	37.3	13.9	14.0	3.7	4.9	13.7	9.8	90.30	90.40
High income economies	--	37.8[b]	--	--	--	20.0[w]	--	1.1[w]	--	--	--	8.5[w]	--	91.50
OECD Members	--	38.1[w]	--	--	--	20.1[w]	--	1.1[w]	--	--	--	7.0[w]	--	92.20
Singapore	35.6	18.1	--	0.0	14.1	14.5	5.6	2.7	15.5	9.7	29.2	54.0	70.00	46.00
Sweden	16.0	17.9	30.7	29.7	29.7	29.0	1.2	0.6	1.2	9.6	13.2	13.3	86.00	86.70
United States	54.2	51.5	28.0	34.2	6.4	3.6	1.3	1.7	1.1	0.0	9.1	8.1	90.90	91.90
United Kingdom	39.7	30.0	15.6	18.5	26.4	30.6	--	0.1	5.9	2.5	12.4	10.2	87.60	89.00

Notes:
- * Computed.
- a Other taxes include employers payroll or labour taxes, taxes on property and taxes not allocable to other categories.
  Data for 1981 and 1988 have been taken from the World Development Reports (WB), 1984 and 1990 respectively.
- w Weighted average.
- -- Not available.
- 0 and 00 : Zero or less than half the unit shown.
- b Drawn from the budgetary data.
- UMI Upper Middle Income (Country-grouping).

Source: <u>World Development Reports</u>.

Although the results of reform have been mixed and progress too has been halting in several directions, there is growing awareness across the world of the importance of getting the country's tax system right.

It is fair to conclude that the trend set by the reforms in the 1980s will continue. Since the recent wave of reform was spurred not only by the pressing revenue needs of governments and the costs of operating a highly progressive tax structure but also developments in the theory of taxation (of which an excellent exposition is given in Newberry and Stern, 1987), a brief look at what theory predicates for a good tax system for a developing economy might not be out of place.

III. Foundations in Theory

Unlike in the 1960s, tax theory in recent years has been concerned more with the issue of efficiency and overall fairness rather than vertical equity. There has been increasing recognition of the harm that an "inefficient" tax system does to an economy. The shift from "equitable taxation" (ET) approach with its preference for a comprehensive income tax base and progressive rates to optimal taxation (OT) has been the contribution of scholars who also took pains to indicate what a good tax system is made up of. One extreme reaction to the welfare concerns underlying the ET approach has been towards a view that advocates less involvement of the government (the "Fiscal Exchange" approach). But this view has been influential mainly in cautioning against expansion of the public sector rather than its abandonment (Hettich and Winer, 1985). The search for an equitable and at the same time efficient tax system continues and in this the proponents of OT have played a significant role. The guiding principles which flow from the recent literature on the theory of optimal taxation may be summed up as follows:

- Ideally, lumpsum taxes and transfers (like poll tax, land tax and poll subsidy) are to be preferred as they cause the least interference with

decisions of economic agents and minimise the costs associated with the various adjustments that producers and consumers make in response to taxes. These taxes are also administratively simple although there are information problems even with lumpsum taxes (Stern, 1990).

The "first" best tax from the efficiency angle may not be acceptable socially and politically. The next best is a combination of income taxes and indirect taxes.

If efficiency costs are to be minimised, indirect taxes should be directed at final consumption and taxation of intermediate goods should be avoided (so that the cost of such goods to the producers reflects only the social cost of production and does not include any element of taxation). Exception can be made only on distributional considerations and in cases where final goods are difficult to tax. A retail sales tax on consumption goods alone meets these requirements best but often poses administrative problems. A good alternative is the value added tax (Stern, 1990, Ahmad and Stern, 1986).

Customs tariffs should be rebated on intermediate goods and linked to domestic taxes on final goods. Tariffs can be used for protection purposes for supporting a domestic industry or discouraging consumption only where the case is strong.

Public sector pricing should follow the same principles. Prices should equal marginal social cost for intermediate goods and may contain an element of taxation in the case of final goods.

If taxes on consumer goods are to minimise the efficiency costs, a uniform tax system is in general not optimal. Inefficiency minimising commodity taxes require a set of differential rates derived from the "inverse elasticity rule" whereby the tax rate is set as inversely proportional to a commodity's own elasticity of demand in response to prices. By this rule goods with inelastic demand (like essentials) will

attract higher tax rates and conversely. However, distributional considerations - to satisfy a given social welfare function or postulated pattern of "inequality aversion" - can be accommodated by taxing at higher rates goods figuring more in the consumption of the rich. A few rates suitably designed can meet to a reasonable extent both efficiency as well as equity requirements which a uniform rated commodity tax cannot achieve. Uniform taxation can be optimal only under very restrictive conditions (Slemrod, 1990).

To the extent other supporting policies on distribution are there, the need for differentiation in commodity taxes to serve distributional goals would be less urgent (Ahmad and Stern, 1986).

On the direct taxes side, the optimal taxation theory favours a tax on consumption (or wages) base instead of income or ability. If, however, an income based tax is to be retained (which may be necessary to supplement commodity taxes for distributional reasons), the rates should be moderate.

While the stamp of the ideas summarised above on the tax reform trends is unmistakable, questions are being raised about the relevance of optimal tax theory for operational purposes especially in developing country context. It is pointed out that the first best model of the optimal tax theory is not workable at all, while even the second best also contains many features which detract from its applicability in the real world (Gandhi, 1987; Slemrod, 1990).

Musgrave (1989) has advanced several reasons why the prescription for taxing only consumption rather than income is not acceptable, given the realities of developing countries. That prescription would be valid only in a competitive setting where there are no monopoly rents, where there are perfect capital markets and foresight, and a person consumes his/her entire income over lifetime. Given the imperfections, it is not all that clear that neutrality is optimal for social welfare. Even in USA the wisdom of

curtailing incentives for saving and investment has been questioned while, as mentioned, the dynamic economies of east Asia (Korea, Malaysia and Singapore) have not thought it fit yet to do away completely with tax incentives.

The optimal taxation principles were hardly of any relevance in the tax reform that took place in USA in 1986 where the major issues were simplification, tackling tax shelters and inflation-induced problems. The reason is that its models are imbedded in "stylized versions of the environment and tax systems". A critical deficiency of optimal taxation is the failure to consider "the technology of collecting taxes" (Slemrod, 1990).

It cannot be denied, however, that the central message of optimal taxation theory, viz., that tax induced inefficiencies are potentially large and must be considered in the design of tax policy, has inspired the recent tax reform movement and led to the search for broad based low rate income taxes. On the indirect taxes side, the conclusion that product taxation should be limited to final consumer goods is also of considerable significance and relevance for policy purposes and provides the theoretical underpinning for the VAT. But it has also to be acknowledged that the standard model leaves out many important details of tax structure which need to be attended to in any practicable programme of reform. Tax reform must take into account the problems of enforcement and optimal tax theory is of no help in this. Many would agree that theory must help evolve <u>optimal tax systems</u> and not simply <u>optimal tax structures</u> (Slemrod, 1990). This is particularly important for developing countries where enforcement is generally weak and evasion is widespread.

Formulating a theory of <u>optimal tax systems</u> for developing countries is a challenge for researchers for the future. For the present, a reform agenda for the 1990s has to provide answers to some of the tricky questions of detail which face tax policy makers in devising a structure which pays heed to the central message of current theory and also takes due note of the realities of the environment and limitations of administrative capability. While time and again it is emphasised in writings on tax reform, that there can be no

universally applicable model of reform - each country has to evolve its specific model based on rules of thumb in the absence of more precise operational guidance from theory - some broad suggestions might be in order.

IV. Agenda for the 1990s

Given the problems of transition from a given system towards a neutral or less distortionary regime while keeping in view the objective of equity, an agenda for tax reform for developing countries may focus on the following tasks: broadening the base of both direct and indirect taxes, restructuring their rates towards greater uniformity and enhancing administrative capability.

a. Base broadening

Although removal of many of the incentive provisions has engaged the attention of tax policy makers in recent years, the base of both direct and indirect taxes in the developing countries still provides considerable scope for broadening. In the case of personal taxes the coverage remains narrow in terms of proportion of population or enterprises coming under the tax net as also in comparison with the potential base. In the case of income tax, narrowness of the coverage stems from the relatively high exemption limit, exclusion of agricultural income (India, Pakistan and Bangladesh) and also the persistence of several of the major incentive provisions and exclusion of certain categories of income from the base. Another factor is the problem of bringing under taxation income earners in the unorganised sector which is usually large in developing countries.

i. Exemption limit

Partly as a measure to spare the poor and also to keep the task of administration manageable, the income tax systems in developing countries usually provide a fairly high threshold for personal income tax. An IMF study

shows that, as of 1985, in 28 developing countries personal income tax became payable at an income level equal to the per capita GDP without the personal allowance and at less than twice the per capita GDP after taking the personal allowance into account. In some of the Asian countries the exemption limit was much higher (6.3 times the per capita GDP in India, 4.8 times in Pakistan and 4.5 in Indonesia) while in Malaysia the ratio was 1.6 and in Korea 0.7 (Gandhi, 1987). According to an NIPFP (1989) study, the "notional exemption limit" (the limit at which a tax rate of 25 per cent becomes applicable) was even higher in some countries, e.g., Pakistan, and Thailand (Nayak and Aggarwal, 1989). With the threshold level as high as in India the number of income tax payers has remained at less than 1 per cent (about 7 million in a population of around 840 million) as the exemption limit has been raised from time to time going beyond what was required strictly for indexation (Bagchi, 1982).

While base broadening calls for lowering the exemption limit, considerations of equity (making allowance for what the Carter Commission called the requirements of "non-discretionary" expenditure) and administrative capability to handle a large number of taxpayers, argue for keeping the exemption limit at not too low a level. Around 3 or at the most 4 times the per capita income with personal allowance could perhaps be regarded as reasonable. In countries where the level is already high, as in India and Pakistan, bringing it down may not be politically feasible. All that can possibly be done is not to raise the exemption limit in terms of real income. The resulting increase in the number of taxpayers has to be handled with a different approach to enforcement (self-assessment coupled with scrutiny or audit of selected cases).

ii. <u>Extending the coverage to agricultural income and the unorganised sector : The presumptive approach</u>

Apart from relatively high threshold, two important factors limiting base broadening in several developing countries are the exclusion or favoured treatment of agricultural incomes and the preponderance of a large unorganised

sector. Partly as a legacy of the past, in South Asian countries agricultural income does not form part of the income tax base. There are, of course, good reasons for the reluctance on the part of policy makers to bring agricultural income into the base of income which is commonly levied by the Central government. Income and costs in agriculture are difficult to determine. Hence, traditionally, some form of land tax has been the principal instrument of taxing farmers. Over time the land tax has fallen into disuse while no substitute has come in its place. In India, a committee set up by the Government of India in 1972 (Raj Committee) recommended a mildly progressive agricultural holdings tax to mobilise revenue from the agricultural sector. The proposals, however, did not find favour with State governments who under the Indian Constitution have the powers to tax agricultural incomes. A scheme of partial integration of agricultural incomes with non-agricultural (taxable) incomes to determine the rate of tax on the latter and punish at least indirectly any attempt to pass off taxable incomes as agricultural on the recommendations of the Committee does not seem to have made any appreciable impact.

Taxation of both agricultural income and also those of the enterprises in the unorganised sector or the self-employed calls for some kind of a presumptive approach. In several countries of the world, taxation of the "hard-to-tax groups" is now made on a presumptive basis. France has a well-established system of presumptive taxation of income. As may be seen from **Table 3**, quite a few developing countries are now applying the presumptive basis for taxation of certain groups of taxpayers. In some countries (Mexico) the presumptive income is assessed on the basis of gross turnover, in some (Colombia) on the basis of wealth holding and in Turkey, on consumption indicators (ownership of assets like houses, cars, etc., foreign travel and domestic servants). Presumptive taxation has enabled the authorities in Turkey to broaden the base and curb tax evasion significantly. In some countries, a presumptive tax is levied on gross receipts in lieu of corporate tax on net profits. Colombia and a few other countries have been levying a net worth tax as a minimum tax on corporate enterprises.

Taxation of real estate is also better based on a presumptive basis. Where property incomes go unreported in large measure and there is no practicable way of verifying what is declared, taxation on the basis of "norms" is the only way of bringing them effectively under taxation. Proposals for property tax reform in Delhi put forward recently by an Expert Committee contain some useful suggestions which if implemented would go a long way to cure many of the ills of the property taxation in the city (Delhi Administration, 1990a and 1990b). Presumptive taxation of assets is also attractive from the efficiency angle as it encourages their optimal use.

The presumptive approach can also be used for indirect taxes. One way to implement the presumptive principle in the scheme of VAT is to impute tax on their potential turnover and allow them to take credit on tax paid on their purchases even when they file no return. In India, purchasers of inputs from small scale units are allowed a notional credit for tax paid on the inputs at a full rate even when such units pay tax at a concessional rate. This practice can lead to abuses and artificial splitting of industrial units. Even so, effective enforcement of taxes in developing countries could improve a lot if the presumptive approach was used more extensively. A variant of presumptive tax is a minimum tax on business assets.

However, presumptive taxation, if it is to find acceptance, requires considerable care in preparing the ground work. The criteria and the parameters need to be set up after a systematic survey of incomes generated in different activities and sectors and in association with taxpayers' representatives (as in Turkey). Otherwise, even a selective application of the presumptive principle may run into problems as has happened in India. Care has also to be taken to see that presumptive taxation does not create special tax regimes and open up opportunities for abuse as happened in Mexico (Thirsk, 1990a).

iii. Taxing fringe benefits, capital gain and other capital incomes and curbing exemptions, deductions, etc.

Efforts towards broadening the income tax base under the recent reform initiatives both for personal as well as for corporate taxation have focussed on more effective taxation of fringe benefits, inclusion of capital gains in the tax base, and limiting if not eliminating the incentives and deductions.

In the reform carried out in 1986, Australia has introduced a tax on employers in respect of fringe benefits provided to employees or their associates at the maximum marginal rate of tax payable by individuals (47 per cent from April 1, 1990). Valuation rules have been laid down for most benefits including motor vehicles, waiver of debts, interest free or low interest loans and reimbursement of expenses. Available data show that a significant amount of revenue is yielded by the fringe benefits tax (A$ 1 billion in 1989-90 of which about half came from motor vehicle benefit, vide Wallschutzky, 1991). An alternative way of taxing such benefits would be to deny deduction for fringe benefits paid in the assessment of employers. Identification of fringe benefits is however not simple as expenditure on many of these can be lumped together under broad heads without allocation to any individual employee. Also, as the recent judicial ruling in the Glynn case of Hong Kong illustrates, benefits can be provided to employees in a circuitous way and bringing them under tax can encounter acute problems (vide recent issues of APTIRC Bulletins). Nevertheless, the success achieved in Australia (and New Zealand) seems to show the way to tackling avoidance or evasion through this route.

Treatment of capital gain is no less tricky. In the absence of a flat rate tax structure, taxation of capital gain like ordinary income invariably gives rise to complaints of inequity. Various devices are adopted to alleviate this inequity (deduction of a specified fraction of the gain, depending on the nature of the asset and the period of holding. Also, several safety nets are provided by way of tax free roll-over etc. In some countries

(UK), indexation of asset prices is allowed to take care of fictitious gains. The problem, however, has proved intractable.

In 1989 a new scheme was proposed for the taxation of capital gains in South Korea, with the aim of countering speculation in housing and land and imposing heavy taxes on gain from accelerating real estate prices. From 1990, a 50 per cent tax was proposed to be levied on windfall gains from public land development. Owners who do not use their land will be liable to pay the "extra land profit tax" (APTIRC 1991, Vol. 7, No. 11). Perhaps a schedular approach like this with some indexation of the cost basis is the only practicable way of bringing capital gains under tax and this seems to be the practice in several countries (**Table 6**).

TABLE 6

Tax Reform Measures : Treatment of Capital Income

Country	Inclusion of interest income[1]	Schedular withholding taxes on interest and/or dividends	Schedular capital gains tax on real assets	Capital gains on stock market transactions
Indonesia	X	X	X	
Korea		X	X	
Jamaica	X			
Mexico	Real basis		X	
Colombia	Real basis		X	X
Bolivia		X		
Turkey		X	X	
Zimbabwe	X	X	X	
Malawi	X			
Morocco		X	X	

Notes: X means that a particular measure was adopted.
1 Small interest earning deposits are exempted in Indonesia, Jamaica, Zimbabwe and Malawi.

Source: Same as for Table 1.

Taxation of capital income also has proved difficult in many developing countries with the result that the burden of the personal income tax falls largely on salary earners. In Korea, it appears, only one third of the economy's capital income comes under taxation as against 75 per cent for labour income. A similar situation prevailed in Bolivia prior to reform and in Morocco (Thirsk, 1990a). Factors inhibiting higher taxation of capital income are fear of capital flight (to Singapore in the case of Indonesia). Such fear has impelled some countries (Colombia and Korea) to permit floating of bearer shares. Attempts to raise the tax incidence on interest income may no doubt cause interest rates to move up, thereby eroding the corporate tax base and adding to the burden of servicing public debt. Non-taxation of interest income however offers opportunities for arbitrage, when companies are allowed to deduct interest in the computation of their taxable income ("back-to-back loan", "round-tripping," etc.). Failure to tax interest income also creates bias in favour of debt as against equity in corporate financing.

In an attempt to neutralise this bias, some countries have introduced "thin capitalization rules" or reduced the tax on dividend income. Some like Turkey has gone in for scheduler taxation of interest income, withholding a modest tax at source. The ease of capital movements in a fast integrating world poses serious problems in the taxation of interest income in the same way as other income. The problem does not admit of a simple answer. Perhaps this is an area which calls for international consultation and consensus as does the question of devising an appropriate rate structure of income tax.

iv. Curtailing concessions and incentives

A consensus seems to have emerged among economists and tax administrators that incentive provisions have been the undoing of income tax system because of the complexities, loopholes and distortions they create, and most of them can be done away with without any detriment to the economy. Few tax systems have, however, been able to abolish incentives completely. Those for saving, investment and exports have tended to survive. This is not entirely irrational either.

In principle, it is necessary to exclude savings from the base of income tax to neutralise the bias against saving inherent in the taxation of income and also because of the critical need for raising saving in developing countries. As Musgrave puts it, the problem is not so much one of fiscal neutrality regarding inter-temporal consumption decisions as of doing what can be done to expedite growth in a framework which is also acceptable on equity grounds. Indeed, this provides the rationale for incentives for saving in taxation or for schemes of compulsory saving as in Malaysia.

Scepticism about the wisdom of providing various incentives in income tax arises not so much from doubts about their need as from evidence against their efficacy and cost efficiency. While in developing countries the case for governmental action to take care of externalities or promoting saving, investment, research and development is generally acknowledged, the suitability of income tax incentives to achieve these objectives is questioned on the ground that they tend to create diverse and unpredictable distortions in the economy (Sanchez-Ugarte, 1987). The incentives also create opportunities for arbitrage through transfer pricing mechanism (Thirsk, 1990b). Even so, as mentioned, incentives for saving continue in most tax systems even after reform. Singapore and Korea are notable examples. (See for an account of tax incentives in Singapore, APTIRC Bulletin, 1990, Nos. 9 and 10.) Withdrawal of incentives for investment in the US under the 1986 reform has been assailed by economists like Feldstein on the ground that this might adversely affect saving and investment. While research findings on the issue are ambiguous, several studies do point to the possibility that personal saving is responsive to changes in effective tax rates and after-tax rates of returns (Feldstein, 1989). Investment in plant and equipment also seem to be responsive to tax rules (Feldstein, 1987). The remedy in the case of saving incentives, according to Feldstein, is not to move towards a system where all saving is excluded from the base - the transitional problems of moving towards a full-fledged consumption-based tax are formidable - but to expand the current incentives provided for saving like the deductions for contribution to

Individual Retirement Account (IRA). In other words, the incentives need to be rationalised and redesigned.

India introduced a "National Savings Scheme" in 1987 as a half-way house towards an expenditure base from personal taxation. Subject to a ceiling prescribed in the law, savings put into this scheme qualify for deduction from taxable income but amounts taken out have to be added to the income of the year of withdrawal. But along with these provisions, tax reliefs for saving through provident fund, small savings schemes, life insurance and a few other specified instruments continue. The result is a wide variation in the rates of return on financial assets entailing unduly high cost to the exchequer which goes unnoticed (Dasgupta, 1988). The operation of so many schemes of concession for saving cannot but be a source of distortion in the channelisation of saving in the economy. It would have been simpler if all the schemes were consolidated into one or at the most two and the divergence in the effective rates of return brought down. Theoreticians acknowledge that a piecemeal approach to the expenditure tax principle can be helpful in correcting the bias against saving inherent in income taxation. To check possible revenue loss the deduction for <u>net</u> saving in specified assets may be subject to some ceiling which may be relaxed in the course of time (Feldstein, 1989). These observations would apply to incentives for investment too. Studies on Indian experience show that the use of tax incentives to promote objectives like industrial dispersion, rural development, etc. hardly help (Rao, Balasubramanian & Tulasidhar, 1991; Aggarwal & Sondi, 1991, and Sarma & Sondhi, 1989). Hence while there is a case for providing incentives for saving and investment, the tax system should not be used to support the myriad objectives which governments in developing countries often set for themselves.

However, more rigorous research there has been in evidence so far needs to be put in to evaluate the costs and benefits of alternative incentive schemes in a given country setting (such as set out in Thirsk, 1989) before schemes of reform can be formulated on the right lines.

b. Rationlisation of Rates

As noted earlier, the most striking feature of tax reform in the 1980s in both advanced as well as developing countries has been to reduce the rates of income and coroporate taxes. Among the developing countries, Bolivia has gone so far as to reduce the maximum marginal rates of income tax from 40 to 10 per cent, practically abolishing the income tax for most people. The 10 per cent levy is now collected through what is called the "complementary tax" whereby all income (wages, salaries, rentals, interest, royalties, etc.) paid to persons is subject to a 10 per cent withholding tax. The tax is levied not on gross income as deductions are allowed for "minimum national salaries" (approximately $ 80) per month and the value added taxes paid supported by invoices (Bird, 1990).

Theory offers little guidance on what could be regarded as the optimal degree of progressivity. The theory of optimal income tax favours a flat rate income tax to minimise the efficiency costs of taxation. When distributional considerations are brought in a degree of progressivity is inescapable. The rate structure of individual income tax, however, depends on the form and shape of the social welfare function and of individual utility functions. On efficiency grounds, progressive taxation can be justified only in respect of scarcity rents and windfall profits (Gandhi, 1987). The conflict between equity and efficiency comes out most sharply in the determination of what should be the degree of progressivity (if at all progressivity is to be there) in the structure of income tax.

One way of resolving the conflict is to widen the base and lower the marginal rates and apply them uniformly across all income categories though there was sharp disagreement among economists over the acceptable trade off between equity and efficiency when the 1986 reform proposals were debated in USA (Aaron, 1987). While moderation in the degree of progressivity is universally desirable, in the developing country context a few caveats are in order. First, a tax cut may lower savings. Secondly, evasion also may not come down merely with a reduction in the rates since compliance with tax laws

is influenced by many complex factors. Also, given the skewed distribution of land and property ownership and also of human capital, progressive taxation has an obvious political appeal as it serves to reduce the private windfalls and economic rents from the ownership of such assets (Gandhi, 1987). However, experience shows that sharply progressive taxation is a highly inefficient instrument of redistribution. It invariably spawns pressures for tax preferences and schemes for avoidance and evasion. The cause of equity is better served by a moderate but less discriminatory and efficiently enforced tax regime. Such a regime also makes for simplicity and reduces the scope for political patronage in the form of concessions, etc. A flat rate tax also removes the incentive for income and asset splitting and facilitates integration of personal and corporate taxation. Thus the case for moderation in rates on a broad base has several points in its favour, even if one may not go so far as to recommend a uniform rate.

On balance, a few rates (three or four) ranging between 20 and 50 per cent with a threshold level which protects the poor would appear to be most suitable for personal taxation. Jamaica has gone the farthest in this direction, by replacing the rate schedule by a single rate (33.5 per cent) with a broadened base that includes capital income and a standard deduction equal to twice the per capita GDP, and removal of tax credits. This seems to have paid off as the ratio of revenue from income taxes has increased by more than two percentage points. Lowering of rates, however, has to proceed in step with broadening of the base if the objectives of both revenue growth and efficiency are to be pursued.

What exactly should be the level of taxation ultimately depends finally on revenue needs and the contribution of the other elements in the tax system to the objectives in view. The worldwide trend towards a low tax regime has no doubt been a reaction to the sense of unfairness which prevailed among citizens in countries with high tax regimes but partly the move reflected "fascination effect" of the US tax reform (Tanzi, 1988) and also the apprehension of brain and capital drain towards US unless other countries also responded. With advanced countries moving in this direction, the developing

countries had little choice but to move in step especially if they were to attract foreign capital and expertise. It is interesting to note that a Taxation Review Committee set up by the Fabian Society in UK and chaired by Atkinson has bemoaned the loss of progressivity of the tax system in UK in recent years and recommended a graduated rate structure for personal income tax with a zero rate band followed by rates rising from below the existing basic rate to a maximum of 50 per cent. The Committee suggests a four rate (or alternatively a six-rate) structure such as 20%, 30%, 41% and 50% (Fabian Society, 1990). However, for a viable regime of even a moderately progressive tax structure would require international consensus or coordination. Perhaps agencies like the IMF and ADB may provide a lead in this direction as suggested by Tanzi (1988).

c. Reform of corporate taxation and integration

Separate taxation of corporate profits ("the classical system") is a source of distortion in decisons of economic agents and so is difficult to defend on efficiency grounds. However, corporate taxation has come to form an integral part of income tax systems everywhere as otherwise accumulation of profits under the corporate cover offers an easy avenue for avoidance especially under progressive taxation. At the same time, it is increasingly acknowledged that independent taxation of corporate profits can distort the choice of modes of financing and the form of business enterprises.

The classical system is believed to be responsible for an undesirably high level of debt and leveraged buyout funds. A cash-flow corporate income tax is suggested as the best remedy for this (Feldstein, 1989). The cash-flow base would complement a consumption base for personal taxation. The suitability of a cash-flow tax needs further examination before it can be recommended for developing countries. Meanwhile, for removing the biases created by the classical system of corporate taxation consideration may be given to the question of integration. Many countries in the world have gone in for integration in some form.

One method of integration is to impute the corporate profits to equity holders even when undistributed. But administratively such a system is not easy to operate. A simpler method is to exclude dividend paid out of taxed profits of companies from the assessment of shareholders. Not many countries continue to tax corporate profits twice (vide **Table 7**). However, the classical system also has its merits in that it encourages retention of profits in companies and thereby promote corporate savings. Besides, operation of an imputation system, whatever be the modality, is not simple (Bagchi 1990). For an idea of the complexities one has only to refer to the proposals of the US Treasury preceding the 1986 reform, viz., that a 50 per cent deduction for dividends might be permitted provided they were paid out of "Qualified Dividend Account" to make sure that the distribution did not come out of tax-preference income of the companies. Nevertheless, efficiency considerations call for at least partial integration of the corporate and individual income taxes.

TABLE 7

Tax Reform Measures : Integrated Treatment of Dividends

Country	Dividend exclusion	Imputation procedure	Double taxation
Indonesia	X		
Korea	X		
Jamaica			X
Mexico	X		
Colombia	X		
Bolivia	X		
Turkey			X
Zimbabwe		X	
Malawi		X	
Morocco			X

Notes: X means that a particular measure was adopted.

Source: Same as for Table 1.

Integration is greatly facilitated by low uniform rates of individual income taxes. Alternatively, if the tax rates for the top brackets of individual income and corporate tax rates are brought into alignment and no concession or preference is allowed in the taxation of corporate profits, double taxation can be avoided easily by dividend exclusion. Yet another alternative is to impose a final withholding tax on dividends at a modest rate. The conflict between equity and efficiency on the one hand and between equity and simplicity on the other is not easy to resolve in this area, as elsewhere.

d. Indexation

Experience of several countries shows that indexation for price movement is necessary not only to avoid unintended distortions and inequities but also in the interest of stability. Absence of indexation of depreciation allowances leads to distortion in marginal effective rates of tax on capital income and thus misallocation of resources.

Colombia and Mexico have introduced indexing schemes whereby only real interest income is taxed and real interest income is deductible. Adjustments are made for inflation in depreciation allowances also. In some countries capital gains too are adjusted for inflation (by adjusting the cost basis). Although it is not easy to devise a simple formula for indexation (the question of which price level to adopt can sometimes be quite troublesome), a rough and ready method can perhaps be formulated. For stock valuation, the last-in-first out rule could be one easy answer to distortions caused by inflation.

It is relevant to note that a major source of disagreement among economists over the tax reform proposals in USA was indexing for the measurement of capital income. The Treasury Department had proposed to index capital gains, depreciation, interest income and expenses and cost of goods withdrawn from inventories but the Congress did not agree. Indexing was considered by some as complex and needless (Aaron, 1987). No doubt,

indexation creates complexities and should be given consideration only when the need seems pressing.

e. Reform of indirect taxes

As the bulk of the government revenues in developing countries is derived from indirect taxes, tax reform in these countries naturally has paid more attention to the restructuring of their taxes on commodities and services than to direct taxes. It may not perhaps be an exaggeration to say that the greatest source of high efficiency costs of taxation in many developing countries prior to reform was the system of indirect taxation. A typical case is that of Indonesia.

Prior to reform, the domestic indirect taxes in Indonesia were made up of three main elements: a sales tax of the turnover type extending through the manufacturing stage, sumptuary excise taxes on tobacco, beer, sugar and spirits and a mix of stamp duties. All these taken together contributed about 11 per cent of the total tax revenue forming about 2.3 per cent of GDP. The harmful effects of a turnover type of sales tax were compounded by multiplicity of rates ranging from 1 to 20 per cent. Because of a plethora of complicated exemptions, the revenue yield of the tax was small. Reforms succeeded in improving the indirect tax system considerably. In 1983, a simple structure with a uniform rate of 10 per cent was brought into operation. It is a destination based consumption type tax relying on the credit method with few exemptions and zero-rating of domestically consumed commodities except for small firms. However, unprocessed food or other staples which do not go through any manufacturing process are not taxed. That itself ensures that the poor are spared. There is, however, flexibility for the government to vary the rate of tax between 5 and 15. Salient features of VAT introduced in selected developing countries are depicted in **Table 8**. This could serve as a workable pattern for other developing countries.

However, good care should be taken to design a VAT otherwise the remedy may be worse than the cure (Cnossen, 1990). First, VAT should generally extend to the retail stage. Cnossen goes so far as to say that pre-retail VATs cause so many distortions and administrative complexities that they should hardly ever be contemplated. Very small firms may be excluded. Other small traders and producers may be brought under a presumptive assessment system. Primary sectors may be left out. Secondly, all services (barring a few like health care and education) should be included in the base. As regards construction activities and buildings, these can be taxed through a uniform levy on new buildings and building materials, and repairs and maintenance services. Thirdly, differentiation in rates should be avoided. Concessional rate may be charged only selectively in respect of essential items. For taxing luxuries, it is better to rely on excises rather than higher rate VAT.

TABLE 8

Main Features of New Value-added Taxes

Country	Present level of coverage	Current rate structure	Basic food (unprocessed)	Processed food
Indonesia (1982)	Wholesale	Single	Exempt	Taxable
Korea (1977)	Retail	Single	Taxable	Taxable
Mexico (1978)	Retail	Multiple	Zero rated	Zero rated
Colombia (1976)	Retail	Single	Exempt	Zero rated
Bolivia (1975 & 1986)	Retail	Single	Exempt	Taxable
Turkey	Retail	Multiple	Zero rated	Taxable
Malawi (1989)	Manufacturers	Single	Taxable	Exempt
Morocco (1986)	Wholesale	Multiple	Exempt	Exempt

Source: Same as for Table 1.

VAT is obviously not as simple to operate as excise (or a first point sales tax) but it has several advantages and can operate well in large

integrated economies with sophisticated production and distribution process. It is not a panacea for the ills of the indirect taxes of developing countries. Several of the merits claimed for it are often exaggerated (e.g. it is not a "self-enforcing" tax as is often imagined, Casanagra, 1990) and administrative capability is a prerequisite for the success of VAT as the experience of Bolivia and Argentina shows. But the success of South Korea in operating a VAT since 1977 and in quite a few Southeast Asian countries shows that it can be a practicable answer to many of the ills of the indirect tax system of developing economies. Apart from being a good revenue raiser, it can help to minimise the efficiency costs of commodity taxation, provided rates are not differentiated to achieve various non-tax objectives and "Gimmicks" like permitting credit for VAT paid are avoided.

An important aspect of indirect taxation in developing countries is the heavy reliance on taxes on foreign trade. Export taxes may have a rationale but only when there are large rent elements in the income of exporters. High level of taxes on imports on the other hand are often a source of inefficiency in the industrial structure. Considerations of protection no doubt argue for taxes on import trade but often the harmful effects of high tariff go unnoticed. As a principle, customs duties should not be used for revenue purposes (except when it is convenient administratively) and there should be some coordination in the taxes on domestic and foreign trade. VAT offers an attractive mechanism for such coordination. Imports should as far as possible be subjected to the same level of taxation as production barring a reasonable degree of protection. Where imports are considered inadvisable (e.g., luxuries), both domestic production as well as imports ought to be taxed at high rates.

In large countries with a federal set-up such as India any reform in the tax system particularly indirect taxes would call for a good deal of coordination among different levels. In the absence of any attempt at harmonization, indirect tax reform can be a futile exercise while the efficiency costs of the operation of overlapping tax jurisdictions can be very high. Unfortunately, there is little awareness of the benefits of tax

harmonization in the countries of the region. It is to be hoped that this finds priority in the agenda for reform in the near future.

f. Administrative reform

The shape of a tax system in practice is determined to a great extent by the way it is administered. It is sometimes argued that while administration is important it is necessary to get the tax structure right first, as nothing is achieved by administering bad taxes better. At the same time no useful tax reform can be contemplated if administrative constraints are regarded as binding. Thus administration reform must go hand in hand with structural tax reform.

In a recent paper, while stressing the central role of administration in successful tax reform in developing countries, Bird has drawn attention to three aspects of tax technology: (i) the role of administrative incentives, (ii) costs of taxation and other quantitative questions, and (iii) the link between expenditure and tax administration.

A major source of weakness in the tax administration of developing countries to which attention is often drawn by foreign advisors is the lack of organizational and individual incentives. Given the level of compliance and opportunities for bribery open to the tax administering agents, a system of rewards for tax officials, it is sometimes argued, might be a less expensive but more efficient way of securing better enforcement. To provide an impetus for the drive against smuggling India introduced a scheme of reward for customs officials linked to the quantum of revenue realised in 1985-86. The efficacy of monetary rewards and what could be the best way to reward tax officials, however, remains to be adequately researched. It is necessary to be cautious in giving large financial rewards as it can demoralise officials who do not have the same opportunity to reap such rewards and breed a mercenary culture which can scarcely be conducive to good tax administration. What is perhaps more important is to drive home the message that honesty is

honoured and also rewarded with out of turn promotion and higher responsibilities while corruption gets punished.

Given the constraint of resources, it is necessary to explore how the resources available to a tax department can be used in a cost efficient way. Despite the attention paid of late in tax literature on what determines taxpayer behaviour, very little is known of what induces a citizen to pay his/her taxes promptly. Presumptions based on the logic that decisions to evade are determined by the penalties likely to be suffered and the probability of detection do not seem to be very convincing in the developing countries since the probability of detection is usually quite low. The utility maximising assumption does not quite explain taxpayer behaviour. Given the low probability of detection, few should be paying their taxes (Spicer, 1986, Graetz and Wilde, 1985). Nevertheless, it is important to devise appropriate enforcement strategies which lend credibility to the sanctions prescribed in the statute for default or misdemeanour in complying with laws. This is not an easy task.

In countries with a large and growing population of taxpayers it is simply not possible to check the returns filed by every assessee. There is no alternative but to proceed on the basis of "self-assessment", accepting whatever is declared by taxpayers on their own subject to random checks. For the threat of sanctions to be credible, the principles for selecting cases for audit need to be scientifically formulated. Much more thought and research in the area is called for than has been devoted to it. It may not be very wise to concentrate only on "large cases" even if that looks more paying. Every taxpayer should be under a credible threat of getting caught for misdemeanour if self-assessment is to work. Also, the task of enforcement has ultimately to be undertaken by the own staff of the country's tax department. The dissolution of the special team made up of foreigners in Indonesia despite striking success clearly indicates that getting foreigners to administer taxes cannot be a long-term solution to a country's administrative ills.

Measures for improving the tax administration and the general environment in which it operates take time to show results. Given the administrative limitations, it is necessary to pay attention to measures which can facilitate enforcement. Tax administration problems in developing countries can be facilitated a great deal by (i) extending the scheme of withholding over a wide area, (ii) adopting the presumptive approach in taxing the hard-to-tax groups and (iii) development of an efficient information system. Alternative approaches to presumptive taxation have been discussed earlier.

i. Withholding: Both in advanced as well as in developing countries, the single most effective method of tax collection has turned out to be "withholding", i.e., to require the tax to be withheld at source and turned over to government before it reaches the taxpayers. The most important reason why tax on salary income cannot be evaded is the universal practice of tax deduction by the employer. In recent years, withholding has been extended increasingly to interest, dividend and even rental incomes.

South Korea has one of the most extensive tax withholding systems. Withholding applies to both residents and non-residents. In the case of resident individuals, apart from salaries and wages, withholding is obligatory in respect of interest, dividend, business income from free-lance occupations, "other incomes", and retirement income. For non-residents and foreign companies, income subject to withholding includes income from using or furnishing personal service and certain businesses (Choi In-Sup, 1987). In 1983, Australia has introduced a new system - the "Prescribed Payments System" - for deducting tax at source from certain labour and services. Under the new system intra-industry payments are subject to withholding in specified industries where compliance was known to be low. These include: building and construction, joinery and cabinet making services, road transport, motor vehicle repair and cleaning industries (Wallschutzky 1991). Pakistan too extended its withholding system in 1989 (APTIRC, September 1989). Development of an extensive and efficient withholding system should be one of the first tasks of tax reform in the 1990s.

ii. <u>Information system</u>: Withholding should go along with the development of a computized information system. The contribution of third-party information matching in tax enforcement cannot possibly be overemphasised. The sanctions against misdemeanour can have no deterrence without a conviction among the taxpayers that the tax department gets to know sooner or later who is earning how much. Simple devices like requiring tenants to file information regarding rents paid can go a long way to check understatement of property incomes. Instances have come to notice in India where even payments made by government agencies (like commissions to lottery operators) go untaxed for lack of information flow. As part of reform measures several countries have gone in for a taxpayer identification number in all transactions. Many of the ills of the tax system in developing countries can be remedied if only they cared to set up a good information system and to secure greater co-ordination and exchange of information among tax collecting agencies within (and if possible, among) countries.

Lastly it must be added that a fast moving machinery of adjudication of tax cases is necessary if tax laws are to be enforced efficiently. Long delays in settling tax cases can frustrate all attempts to punish evasion. In India there are instances where tax cases go on for decades. Thousands of cases involving sizeable amount of revenue remain locked up in disputes. Reform of administration, however well designed, can be of no avail in such an environment. Setting up of special tax courts or tribunals, debarring cases involving points of fact from going beyond one or two appellate stages can help to speed up disposal of tax cases.

Lastly, it should not be overlooked that people's acceptance of the government's expenditure policies, and of the tax department's handling of taxpayers is crucial for success in enforcing taxes. There is a growing perception that the key to tax reform in the future probably lies in linking revenue raising with expenditure programmes more explicitly than done so far. Earmarked taxes, user fees, and narrowly based revenue sources will probably receive more attention than broad based taxes. The acceptance of payroll

taxes in the face of resentment against federal taxes like the income tax in USA is a pointer to where possibilities lie for raising revenue for financing public services (Rivlin, 1989). The success of the Orangi Pilot Project in Karachi (Pakistan) in inducing squatters to contribute funds to set up sanitation facilities also carries the same message (UN, 1990). Taxation of industries or economic agents causing damage to environment or giving rise to social costs which are external to them thus has a greater chance of being accepted than a general tax to preserve environment. There is also scope for using the tax system to reduce environmental degradation (e.g. by raising the prices of petroleum and energy for inducing greater use of energy saving and labour intensive techniques).

Concluding Comments

One important lesson of tax reform in developing countries is that, however urgent the need may be, reform cannot make any headway without political backing. The experience of Argentina is a case in point. Tax systems of many a developing country are in a messy state not because they do not know what needs to be done or they lack talent or expertise to do what is needed but because of lack of political and social support. Many sensible proposals often get blocked by opposition from the articulate sections. However, even in such situations, economists can play an important role in building up opinion in support of what ought to be done. They may also focus attention on areas where knowledge is scanty and further research is needed to show the way and there are many such areas as of now. Taxation in an independent world can have many ramifications which may not be immediately obvious and which still remain to be fully understood (Aaron, 1987). Agencies like ADB would earn the gratitude of developing countries of the region if it helps to build up the expertise, knowledge and opinion on what ought to be done to improve their tax systems.

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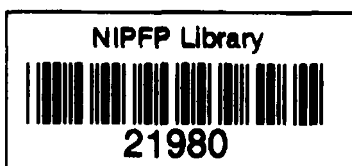
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