ISSUES IN TAX REFORMS

*Azizul Islam**

This paper seeks to describe the principles that have guided recent tax reforms in Asian developing countries. It critically examines the purported rationale underlying these reforms and raises some issues connected with these reforms. The paper first discusses the new direction of the perceived role of taxation as a macroeconomic tool and the principles which have formed the basis of recent tax reforms. It then analyses the implications of the application of these principles for the level and structure of taxes. It concludes with a summary of the key issues raised in the paper.

Developing countries implemented an array of major economic reforms during the 1980s and the 1990s. Tax reforms formed an integral part of these reforms. The impetus for tax reforms was provided by a number of domestic and external factors (ADB, 1993). The last two decades were marked by a fundamental reassessment in developing countries of the role of the Government in economic development. There was a discernible shift in favour of assigning a greater role to the private sector, including foreign enterprises. This required re-examination of the structure of tax systems. Faced with declining external assistance, many Governments came under pressure to reduce budgetary deficits in the interest of macroeconomic stability. Multilateral development agencies required deficit reduction as a precondition for development assistance. There has hardly been an adjustment programme which did not include reform of the tax system and the containment of public expenditure as central objectives. Among other factors which motivated tax reforms was the desire to maintain or enhance international competitiveness as more and more developing countries sought to participate in the process of globalization.

I. THE NEW VIEW OF THE ROLE OF TAXATION

It is logical that the discussion of issues in tax reforms should begin with an assessment of the role of taxation as a macroeconomic tool. In the past, tax systems were used in developing countries to serve multiple objectives. These included, in

* Former Chief of the Development Research and Policy Analysis Division, ESCAP. The views expressed are those of the author and do not necessarily reflect those of the United Nations.

addition to mobilization of resources to finance government expenditure, promoting savings and investment; inducing savings in particular forms to facilitate the process of channelling savings into investment; directing investment into desirable activities; encouraging the use of labour-intensive production techniques; bringing about greater equity in the distribution of income; and correcting externalities. Taxation was viewed as a powerful policy instrument to serve "the dual role of securing resource transfers to the public sector for application to planned uses and inducing the private sector to operate in conformity with plan objectives" (ESCAP, 1983, p. 405).

There appears to have been a fundamental shift in the perception of the role of taxation during the last two decades. The view that has gained wide acceptance in both academic circles and international institutions is that the tax system should be assigned a much narrower role; it should focus on raising revenue. To illustrate, Burgess and Stern (1992, p. 1) write that the main purpose of taxation is to raise resources to finance government expenditure. They see the problem of tax design as one of finding a way of raising these resources in a manner which is administratively and politically feasible and which promotes equity and efficiency as far as possible. In a similar vein, a recent publication by the International Monetary Fund (IMF) notes that taxation creates distortions and the main object of tax policy is to design a system that raises enough revenue to meet a Government's revenue target while minimizing the level of associated distortions (Mackenzie, Orsmond and Gerson, 1997). To be fair, the proponents of such a narrow focus seem to grudgingly recognize the legitimacy of the use of taxation in attaining some of the other objectives, particularly redistribution. But such recognition is typically relegated to footnotes.

The above view of the role of taxation raises two sets of questions:

1. What should a Government's revenue target be and how does one go about determining it? These have to do with the level of taxes in an economy.
2. Why should one virtually abandon tax policy as an instrument to attain the other objectives, in addition to meeting a Government's revenue target? Is it because taxation is an ineffective instrument to achieve these objectives? Is it because even if tax policy can be an effective instrument, the design of the tax system to achieve the other objectives would make the system too complicated, giving rise to fraud, evasion and corruption? Is it because there are other instruments which are in some sense better and more efficient than taxation? These questions have to do mainly with the structure of taxes.

The following sections elaborate on these questions in the light of recent prescriptions for tax reforms and the direction of actual reforms in developing Asian countries.

II. GUIDING PRINCIPLES FOR TAX REFORMS

Based on a fairly comprehensive discussion of various theories of taxation, Ahmad and Stern (1991) prescribe a number of guiding principles for tax reforms. The salient points of these guidelines are summarized below:

(a) Where possible, lump-sum taxes and transfers, or close approximations, should be used to raise revenue and transfer resources.

(b) It can be very misleading to look at one set of tax tools in isolation from what is happening elsewhere in the tax system. For example, redistribution should not be allocated to income taxes and revenue raising to indirect taxes. Both taxes affect distribution and resource allocation and raise revenue. In particular, the desirability of the differentiation in commodity taxes on distributional grounds is closely related to other policies towards distribution. The stronger the other tools, the smaller the redistributive role for commodity taxes.

(c) The focus of indirect taxation should be final consumption. This means that intermediate goods should not be taxed unless there is difficulty in taxing final goods or there are special distributional reasons for taxing these intermediates. This applies also to tariffs, which should be rebated on intermediate goods and linked to other taxes on final goods. They should be used for protection only when the case for supporting a particular domestic industry (and penalizing other industries, particularly their users) is very strong and where other means of stimulating the industry are less satisfactory. It must be recognized that the elimination of tariffs except for protection is a long-term goal which for revenue reasons cannot be achieved in the short or medium term in countries with very few tax handles.

(d) Where producer prices and shadow prices coincide, indirect taxes should be guided by a trade-off between efficiency and equity and, in the absence of well-functioning schemes for income support, there is no prescription for uniformity of the system of indirect taxation.

(e) The main economic rationale, in principle, for corporate income tax, as distinct from personal income tax, lies in taxing foreign incomes and monopoly rents. Occasionally these elements will be of overriding importance. A structured framework for working out the benefits of corporate tax reform is not yet available and, at present, guiding principles should be simplicity, practicality and neutrality.

It is beyond the scope of this paper to comment on the rationale underlying these guidelines explained by the authors. In practice, IMF exerts a strong influence on the design of tax reforms in developing countries. The characteristics of an "ideal" tax system for a developing country, as prescribed by IMF (Stotsky, 1995) are as follows:

- Heavy reliance on a broadly-based sales tax, such as a value-added tax (VAT), preferably with a single rate and minimal exemptions, and excise taxes on petroleum products, alcohol, tobacco and perhaps a few luxury items.
- No reliance on export duties, except possibly as a proxy for income tax for hard-to-tax sectors such as agriculture.
- Reliance on import taxation for protective purposes only – since the domestic sales tax is assigned the revenue-raising function – with a low average rate and a limited dispersion of rates to minimize effective rates of protection.
- An administratively simple form of personal income tax, with exemptions limited, if possible, to personal dependents' allowances, a moderate top marginal rate, an exemption limit large enough to exclude persons with modest incomes, and a substantial reliance on withholding;
- A corporate income tax levied at only one moderate-to-low rate, with depreciation and other non-cash expenditure provisions uniform across sectors and minimal recourse to incentive schemes for new ventures.

Note that there are considerable similarities as well as some significant differences between the two sets of guidelines. But the recent reforms implemented in developing countries in Asia have largely followed IMF prescriptions (for details see Mackenzie, Orsmond and Gerson, 1997; ESCAP, 1995; and Burgess and Stern, 1992). This paper therefore, seeks to examine the rationale underlying those prescriptions and their implications for the level and structure of taxes with a view to identifying the key issues in tax reforms.

III. RECENT REFORMS AND THE LEVEL OF TAXES

It is interesting to note that none of the reform guidelines mentions any "ideal" level of taxation. This omission may be because of three interrelated, but somewhat distinct reasons.

First, it is impossible to lay down any specific amount or proportion of GDP that should be raised as tax revenue by the Government. In the past, efforts were made in this direction through estimation of "tax capacity" by applying cross-sectional parameter values of explanatory variables such as per capita income, sectoral distribution of income and openness of the economy. Raja Chelliah has been one of the pioneers in this line of investigation (Chelliah, and others, 1975). However, there is an increasing recognition that tax capacity depends not only on tangible economic characteristics, but also on a variety of non-economic factors such as political will, administrative efficiency and culture of tax compliance.

Second, the new reform paradigm looks upon taxes primarily as a means to finance government expenditure. As already noted, containment of government expenditure has also been an important feature of fiscal policy reforms. Nevertheless, it is acknowledged that a minimal level of government expenditure is inevitably required in every country in order to enable the Government to fulfil certain inescapable responsibilities, including preservation of territorial integrity, maintenance of law and order, provision of public/merit goods and regulation of certain undesirable activities. These imperatives differ from country to country. The acceptance of taxation primarily as an expenditure-financing instrument implies that the capacity to contain government expenditure is a major determinant of the level of taxation. The other determinants would be the limits to alternative ways of financing (for example, non-tax revenues, monetizing deficit and domestic or external borrowing).

Implicit in the above view is the notion that the level of expenditure is autonomously determined. An alternative view is that the level of expenditure adjusts to receipts. The positive relationship between increased tax revenue and increased current expenditure was noted much earlier (Please, 1967). The nature of the relationship between tax revenue and government expenditure is significant because of differences in policy implications. The policy implication of the line of causation running from tax revenue to government expenditure is that effort to contain government expenditure has to start by cutting receipts (Koren and Stiassny, 1998)!

The third reason for not prescribing any guidelines for the overall level of taxes may be the perception that policy makers should not make any conscious effort to reach any particular tax target; reforms in tax structure would simultaneously determine the level. In general, one of the important motivations behind tax reforms in most countries has been to increase the share of tax revenue in GDP. This is a major rationale behind the introduction of a broad-based VAT. Even in the case of income taxes, one of the justifications provided for reductions in the tax rates, number of tax brackets, degree of progressivity, top marginal rates and exemptions and allowances has been the potential for higher yield, particularly because of the presumed validity of the so-called “Laffer curve” phenomenon.

It should be noted that tax reforms in the developing countries have been largely successful in increasing revenue. This is reflected in the fact that in most countries the buoyancy of central government tax revenue with respect to GDP during 1986-1992 was greater than what was observed during the period 1975-1985 (ESCAP, 1994, table IV.3).

IV. RECENT REFORMS AND TAX STRUCTURE

Value-added taxes

Many countries in the Asia-Pacific region have introduced a VAT (ADB, 1995, p. 40). In most cases, the rates are uniform, but in a few countries there are multiple rates. Typically some essential commodities such as unprocessed food are left out. Exports are zero-rated. Special higher rates in the form of excise/sales tax are levied on luxury items or some demerit goods such as alcohol and tobacco.

Several merits are usually attributed to VAT. In assessing its merit, however, one should carefully specify what it is being compared with. One merit of VAT is that it allows the tax system to be more broad-based and, therefore, to yield greater revenue. Like any other tax, the revenue productivity of VAT would depend on its design (the rate, the coverage, etc.) and the effectiveness with which it is enforced. Higher revenue is not an inevitable consequence of VAT per se. Whether or not it yields higher revenue depends on a specific context. In the Philippines, for example, even three years after its introduction in 1988, revenue from VAT was not substantially above the pre-VAT sales tax revenue in 1987 (ADB, 1993, p. 39). One author, based on a review of VAT experience in 25 developing economies, concluded that the record lends some credence to the revenue advantage of VAT, but its reputation as a money machine appears to have been at least slightly overstated (Gilis, 1990, p. 231).

An argument in favour of VAT is its neutrality as the tax burden falls equally heavily on different products, avoids the cascading effects of a conventional sales or turnover tax and does not distinguish between domestic production and imports. It is obvious that the achievement of neutrality through VAT depends on the universality of its coverage and the uniformity of the rate. Ahmad and Stern (1991) have argued that a comprehensive VAT would be almost impossible to administer in a developing country; economic theory does not suggest that uniformity is a desirable property of an indirect tax system except in special circumstances and the most persuasive arguments for uniformity are administrative.

It is also claimed that VAT is less subject to evasion compared with income taxes. If this were the case, the record of compliance should be better for VAT than for income taxes. The various studies available to measure the difference between the taxes actually paid and the taxes which should be paid under the existing laws and statutes do not indicate that compliance with VAT is necessarily any better than with income taxes (see Silvani and Baer, 1997).

Trade taxes

There is not much to pick on the guidelines prescribed for trade taxes. By now a large body of literature has emerged to convincingly demonstrate the adverse impact of high and multiple rates of taxes on international trade (both export and import) on several economic objectives. There is a large measure of consensus that high average rates of trade taxes in combination with wide dispersion among many different rates provide a disincentive to export, generate inefficiency in domestic production, produce unintended and often undesirable resource allocation and adversely affect growth performance.

Most countries in Asia have virtually eliminated export duties. The maximum as well as the average rates of import duties have been lowered. The number of rates has been curtailed and dispersion among the rates has been lessened (ESCAP, 1995). Partly as a consequence of these reforms, taxes from international trade have significantly declined in most countries as a proportion of total tax revenue (ADB, 1995).

One small comment is that the rationale for using export duty as a proxy for income tax for hard-to-tax sectors such as agriculture is less than obvious. In cases where exporters are not necessarily producers (as is often the case with agricultural products) and there is very little scope for shifting the tax to foreign consumers, the backward shifting of the export tax is likely to cause a disincentive effect on production and/or lead to a reduction in the wages of workers who happen to be mostly unorganized in the agricultural sector. Thus, both efficiency and equity implications could be adverse. In certain situations, export taxes may perhaps still be used to play their traditional role. For example, just as time-bound import duty may be justified for protective purposes, export duty may be used to encourage domestic processing. The other potential justifications are domestic price stabilization, taking a share in producers' windfall gains and exploitation of monopoly position, perhaps only temporarily. A second comment is that in many developing Asian countries, including those that have introduced VAT, trade taxes still account for 15-30 per cent of tax revenues. Given that VAT itself has many problems of implementation, the replacement of trade taxes by VAT as a revenue source can only be a long-term objective.

Income taxes

With regard to income taxes, the guidelines have two principal thrusts: lower rates with reduced progressivity and minimal incentives.

(a) Rate and progressivity reduction

The reduction of rates is supposed to have several beneficial results. It reduces the adverse incentive on work effort, savings and investment. At low rates, the inequities become less important, tax compliance improves and pressures on tax administration are lessened (McLure Jr., 1990).

Most countries in Asia have indeed implemented the IMF guidelines with respect to income taxes. The reforms have been in the direction of reducing average tax rates, lessening their progressivity and reducing the number of taxable income slabs to which the differentiated rates applied. The minimum threshold for personal income tax has generally been increased (ESCAP, 1995). Before examining the validity of the espoused benefits of rate reduction, the revenue implication should be pointed out. If the top marginal rates are reduced in combination with raising the level of exemption, revenue neutrality would require increasing the middle rates, more so when much of the income tax is paid by entities subject to the upper rates. Any across-the-board reduction in rates is likely to bring about a reduction in revenue, unless compensated by the inclusion of a larger number of entities in the tax net, better compliance or any other indirect effect leading to an expansion of the tax base. In this context, it is worth noting that between 1980 and 1992 there was a considerable decrease in the contribution of taxes on income and profits to total tax revenue in most Asian developing countries (ADB, 1995).

The reduction of tax rates is sometimes also advocated on the ground that high rates induce corruption. However, it can be argued that the solution to the problem of corruption may not be as simple as reducing the level of taxes (Tanzi, 1998). The determinants of corruption are complex and many. In-depth investigation is required to establish the link between a reduction of taxes and corruption.

The empirical literature does not support large effects of income taxes on either labour supply or savings. This is not surprising because the reduction of the tax burden brought about by reforms in income taxes produces a substitution as well as an income effect. The sum of these two effects can be either negative or positive (Putterman, Roemer and Silvestre, 1998; Buchanan, 1999). In the case of savings, it should also be remembered that national savings comprise both private and government savings. In order to ensure that government saving does not decline (or dissaving does not increase), the lost revenue must be raised from some other source. The net effect on total savings would thus depend on the relative marginal propensities to save of the groups differently affected by reallocation of tax burden. In this context, it should be noted that a part of the increase in disposable income as a result of reducing the income tax burden will inevitably be spent on consumption. Furthermore, the conceptual link between increased private savings and increased private investment is contestable (Buchanan, 1999). Thus, the beneficial impact of recent tax reforms on work effort, savings and investment is, at best, doubtful.

It is probably accepted that the recent direction of income tax reforms has been inequitable and that is possibly why the claim is made that at low rates inequities become less important. This argument appears to be dubious, especially when revenue lost through income taxes has to be compensated by resorting to indirect taxes, which are, in all likelihood, more inequitable.

The available evidence suggests that in the developed countries income distribution would have been considerably worse without the impact of progressive taxes (Putterman, Roemer and Silvestre, 1998). In the case of developing countries, the proponents of the recent reforms usually advance two arguments in favour of lower rates and reduced progressivity. First, equity objectives are better served by public expenditure through transfers, subsidies and implementation of various other safety-net measures. There is no doubt that public expenditure has a very important role to play in reducing inequities, particularly in alleviating poverty. But this is a poor defence for denying the role of the tax side of the fiscal equation in mitigating inequities. The argument could be more tenable if there was convincing evidence that the pre-reform tax systems adversely impacted work effort, savings, investment and growth. As has been argued above, such evidence is still in short supply.

The second argument is that the apparent progressivity of the pre-reform tax systems was severely diluted by a plethora of exemptions and allowances as well as pervasive non-compliance. The reforms, therefore, essentially rationalize the de facto situation. If this was the case, it would be illogical to allege that the pre-reform systems produced adverse incentives. As regards non-compliance, it could very well be argued that there may be a worsening if the post-reform tax systems are viewed by taxpayers of all classes as being unfair.

(b) Incentives

As noted already, the guidelines for reforms advocate minimal incentives. In the past, incentives were provided to accomplish such objectives as promotion of savings and investment, development of poorer regions and encouragement for the production of specific goods. The rationale for proposing minimal incentives is that they encourage rent-seeking behaviour, undermine the perception of fairness, distort the allocation of resources and complicate tax administration (McLure Jr., 1990).

It appears that developing countries in the Asian region have not heeded the advice on minimizing incentives, particularly investment incentives. Most investment incentives are granted to both local and foreign enterprises. In recent times, the motivation to attract foreign direct investment (FDI) has probably been the stronger influence in retaining many investment incentives. These often take the form of reduction of the standard corporate income tax rate, tax holidays, accelerated depreciation, investment and reinvestment allowance, deductions from social security contributions, specific deductions on gross earnings for income tax purposes or other taxes such as VAT, exemption from import duties and duty drawbacks. A recent study has observed that the number of Asian countries which offered these incentives increased between the mid-1980s and the early 1990s in the case of five categories of these incentives, remained equal in the case of one and declined in two categories only (UNCTAD, 1996).

As to the impact of investment incentives, it has already been noted that the tax regime appears to have little influence on investment. The available evidence suggests that the most significant determinant of investment is the overall state of the economy (Buchanan, 1999), rather than the cost of or return to capital which incentives seek to influence. It is therefore difficult to understand why most developing countries have refused to follow this IMF prescription with respect to investment incentives. One possibility is that these are perceived as a significant tool to attract FDI. Based on an extensive review of the literature, it has been concluded that there is overwhelming evidence to suggest that incentives are a relatively minor factor in the locational decisions of foreign investors. Nevertheless, the impact of incentives is not negligible: if one country offers incentives and another does not, the former may be able to attract FDI, other things being equal (UNCTAD, 1996). This consideration should be an argument for the harmonization of tax incentives, rather than for competition among countries in offering incentives to induce FDI.

CONCLUDING OBSERVATIONS

This paper has taken IMF guidelines as the point of departure for the analysis of issues in tax reforms both as a sensible way of limiting the scope of the paper and because most Asian developing countries appear to have largely followed those guidelines. As a result, many burning issues in tax reforms have not been addressed. They include the problems for tax policy posed by globalization and the attendant increase in the mobility of goods, services, capital and labour. Nor has the issue of fiscal federalism, which is extremely important in large federal countries such as India, been analysed. The paper has also not examined the issues connected with the improvements in tax administration which frequently form an integral part of an overall package of tax reform measures.

Based on the analysis contained in the paper, the following key issues can be identified:

(a) What are the determinants of the desirable level of taxation in a particular country?

(b) Is there a causal relationship between government revenue and government expenditure and, if so, which way does the line of causation run?

(c) Under what circumstances can VAT be more revenue-productive than the taxes it replaces? More specifically, can it be a substitute for trade taxes in the near future?

(d) How much differentiation should be made in VAT?

(e) Is there a trade-off between multiple rates and complexity in tax administration?

(f) Is compliance with VAT any better than with income taxes?

(g) How important can the protective role of tariffs be? How does one draw the line between the protective and revenue roles of tariffs?

(h) Does the reduction in rates and their progressivity really lead to increased work effort, savings and investment?

(i) What is the link between the level and the complexity of the tax system on the one hand and ease of administration, compliance and corruption on the other?

(j) Should income taxes be devoid of any role in equity?

It is not the contention of this paper that the direction of recent tax reforms in Asian developing countries is necessarily wrong, nor are the issues raised above new. But the answers to the above issues on which these reforms seem to be premised have rather shaky foundations.

One of the strong motivations behind the recent reforms has been to bring about simplicity in tax systems. In the context of tax reform proposals in the United States of America, it has been commented: "What reason is there to expect that good taxation – taxation that is equitable as well as efficient – should offer a haven of simplicity in an increasingly complex world?" (Musgrave, 1997, p. 158). This is a non-trivial question for developing countries as well.

REFERENCES

ADB, 1993. *Asian Development Outlook*, Hong Kong (Oxford University Press).

_________,1995. *Asian Development Outlook 1995 and 1996*, Hong Kong (Oxford University Press).

Ahmad, Ehtisham and Nicholas Stern, 1991. *The Theory and Practice of Tax Reform in Developing Countries*, Cambridge (Cambridge University Press).

Buchanan, Neil, 1999. "Taxes, saving and macroeconomics", *Journal of Economic Issues*, 33(1): 59-76.

Burgess, Robin and Nicholas Stern, 1992. *Taxation and Development*, London (London School of Economics).

Chelliah, R.J., H.J. Baas and M.R. Kelly, 1975. "Tax ratios and tax effort in developing countries", *IMF Staff Papers*, 22(1): 187-205.

ESCAP, 1983. *Development Papers No. 3*, Bangkok (United Nations).

_________, 1994. *Economic and Social Survey of Asia and the Pacific* 1993, New York (United Nations).

_________, 1995. *Issues and Experiences in Tax System Reforms in Selected Countries of the ESCAP Region*, New York (United Nations).

Gilis, Malcolm, 1990. "Tax reform and the value-added tax: Indonesia", in Michael Boskin and Charles McLure Jr., eds., *World Tax Reform: Case Studies of Developed and Developing Countries*, San Francisco (International Center for Economic Growth).

Koren, Stephan and Alfred Stiassny, 1988. "Tax and spend, or spend and tax? An international study", *Journal of Policy Modelling*, 20(2): 163-91.

Mackenzie, G.A., David Orsmond and Philip Gerson, 1997. *The Composition of Fiscal Adjustment and Growth*, Washington, DC (International Monetary Fund).

McLure Jr., Charles, 1990. "Appraising tax reform", in Michael Boskin and Charles McLure Jr., eds., *World Tax Reforms: Case Studies of Developed and Developing Countries*, San Francisco (International Center for Economic Growth): pp. 279-88.

Musgrave, Richard, 1997. "Reconsidering the fiscal role of Government", *The American Economic Review*, 87(2): 156-59.

Please, Stanley, 1967. "Saving through taxation: reality or mirage", *Finance and Development,* 4(1): 24-32.

Putterman, Louis, John Roemer and Joaquim Silvestre, 1998. "Does egalitarianism have a future?", *Journal of Economic Literature*, 36(2): 861-902.

Silvani, Carlos and Katherine Baer, 1997. *Designing a Tax Administration Reform Strategy: Experiences and Guidelines*, Washington, DC (International Monetary Fund).

Stotsky, Janet, 1995. "Summary of IMF tax policy advice", in Parthasarathi Shome, ed., *Tax Policy Handbook*, Washington, DC (International Monetary Fund): 279-83.

Tanzi, Vito, 1998. "Corruption around the World", *IMF Staff Papers*, 45(4): 559-594.

UNCTAD, 1996. *Incentives and Foreign Direct Investment*, New York and Geneva (United Nations).