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TAX REFORM AND PRIVATE SECTOR GROWTH

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Preface

The set of papers contained here are the edited presentations made at a one-day conference on Tax Reform and Private Sector Growth held on July 10, 1986 in Washington, DC. The conference, conducted by the Local Revenue Administration Project of the Metropolitan Studies Program of The Maxwell School at Syracuse University, was jointly sponsored by the U. S. Agency for International Development's (AID) Bureau of Science and Technology/ Rural Development and the Bureau for Program and Policy Coordination. The conference was organized around four formal presentations by leading experts experienced in the area of tax reform in developing countries each followed by question and answer sessions. . AID Administrator Peter McPherson opened the conference by saying "I consider tax reform to be one of our policy dialogue priorities."

The recent reform of the federal income tax in the United States is not the only example of efforts to alter the structure of taxes imposed in a country. There have been, and currently are underway, other, similar efforts to analyze tax policy in developing countries with the objective of restructuring the tax system to foster improved private sector performance. The lessons learned in these efforts should have a wide applicability in other settings.

The first paper, by Roy Bahl, Maxwell Professor of Political Economy, and Senior Research Associate in the Metropolitan Studies Program at Syracuse University, reviews the efforts of Syracuse University's Jamaica Tax Structure Examination Project which has been carried out under the sponsorship of AID. While the Jamaica tax reform effort is comprehensive in nature and includes the entire array of taxes imposed in the country, Bahl's paper focuses on the efforts and results of reform of the personal income tax in Jamaica.

The second paper contained here is by Malcolm Gillis, Vice Provost for Academic Affairs and Dean of the Graduate School, Duke University. His presentation highlighted the long-term tax reform efforts recently conducted in Indonesia. That long-term tax reform effort was also comprehensive in nature and resulted in a restructuring of the full package of taxes imposed in the country.

With these two case studies as a backdrop, the third paper, by Charles McLure, Senior Fellow, Hoover Institution, and formerly Deputy Assistant Secretary of the Treasury, focuses more generally on tax reform efforts in developing countries. He elaborates on several of the country-specific issues raised in the first two cases.

The final paper contained here is by Ved Gandhi, Chief, Tax Policy Division, Fiscal Affairs Department, International Monetary Fund. His paper provides a good summary of the practices of the IMF in conducting public finance analysis and reform in developing countries. He emphasizes that the Fund, unlike the projects discussed in the first three papers, is generally concerned with tax policy in a much shorter time frame. As such, the IMF faces constraints not encountered in the longer term tax reform efforts.

This monograph concludes with a summary of the discussions which followed each of the formal conference presentations. While much is already known about tax reform efforts in developing countries, additional analysis is needed to improve these reform efforts. In that context, the final paper, by Larry Schroeder, Professor of Public Administration and Economics and Director of the Metropolitan Studies Program, at Syracuse University, addresses the issues raised during the course of the day-long conference.

The efforts of many individuals were necessary to make this conference a success. The strong interest in the conference by the AID, particularly its Administrator, Peter McPherson who presented the opening remarks at the meeting, constituted a prime ingredient in leading to a successful conference. Likewise, the conference benefitted from the active participation of Lyle Brady, Senior Assistant Administrator, Bureau for Science and Technology, Kenneth Kauffman, Associate Assistant Administrator, Bureau for Public Policy Coordination and Ruth Zagorin, Agency Director for Human Resources, Bureau for Science and Technology.

Finally, we wish to acknowledge the behind-the-scenes efforts of several individuals, without whose efforts, the conference could never have been conducted, let alone conducted successfully. Particularly important in this regard were Robert Shoemaker (Project Development Officer, Near East Bureau, AID, and formerly Institutional Development Specialist, Office of Rural and Institutional Development), Kenneth Kornher (Chief, Institutional Development and Management Division, Office of Rural and Institutional Development, AID), and Luiz Gonzalez of the Pan American Health Organization Conference Center where the conference was held. All of their efforts are gratefully acknowledged.

Carol Swan Babcock, Administrative Assistant, Metropolitan Studies Program deserves special thanks. She oversaw the myriad of details necessary for a conference of this sort and, as well, coordinated the production of these papers based on the original transcripts from the conference. The patient transcription efforts by the Metropolitan Studies Program support staff (Esther Gray, Martha Bonney, Gail Penniman and Cheryl Ackerson) also deserve special mention.

Finally, it must be recognized that a conference such as this can never be deemed a success without the active participation of those in attendance. Obviously, they carried out their "duties" well.

The conference was sponsored by Syracuse University's Local Revenue Administration Project as part of its cooperative agreement (AID/DAN 5303-A-00-5114-00) with the U.S. Agency for International Development. The views and interpretations in the publication are those of the authors and should not be attributed to AID.

Larry Schroeder
Director
February 1987

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CHAPTER ONE

TAX REFORM IN JAMAICA

Roy Bahl

Today I would like to discuss Jamaica's tax reform program, with the objective of describing what has been accomplished so far. The end of today's story will be that, so far, Jamaica has enacted a broad-based, flat rate individual income tax, and that comprehensive reform of the indirect and business tax systems is now being considered. What I'd like to focus on today is first the context in which the work was done; second, the specifics of the income tax reform; and third, the lessons learned about the do's and don'ts in undertaking a tax reform program.

The Jamaica project is an AID-funded project, but I should point out that it is financed under a loan to the Government of Jamaica. In other words, the Jamaicans are paying for the project. This is the important evidence of willingness of the Government to undertake serious tax reform.

Economic Setting and Policy Problems

The Project (the Jamaica Tax Structure Examination Project or JTSEP) began in mid-1983. Most of you probably know the story of the recent performance of the Jamaican economy, and can imagine the setting for this project. The country's economic development performance was very weak throughout the 1970s and the early 1980s. Prime Minister Edward Seaga came to office in 1980 with a platform that he would free up the economic system from many regulations and constraints. His view of the future was that instead of being government-led and focused on import substitution, economic growth would be private sector-led and export-driven. The idea was to deregulate the economy by dropping many of the controls (e.g., on prices, imports, and the exchange rate) that had been imposed. One of the first things on the agenda was to bring the tax system into line with these new economic objectives. That's where we came into the act.

The economic context was not great for a major overhaul of the tax system. The government deficit was high, i.e., there was a revenue gap. The unemployment rate and the inflation rate were well above 20 percent. The main foreign exchange earners, bauxite and tourism, were not among the growing sectors of the economy, and the situation was generally bleak. In short, it was not an ideal time for tax reform. Yet tax reform is being accomplished. The importance of this lesson is that one need not beg off tax reform because the time isn't right when the economy is weak.

The tax policy problem in Jamaica, we thought, was fairly clear. First, taxes were too high. This statement needs qualification. Relative to other countries of similar economic structure and a similar level of income, the tax bite out of GNP in Jamaica was above average. The bigger problem was that the actual taxed base in Jamaica was so narrow that the nominal tax rates had to be very high in order to support the level of public expenditures that the Government of Jamaica wanted. The first thing on the hit list for comprehensive reform, then, were the high marginal rates and the narrow tax bases.

The second problem was that the tax structure was not a designed system, but rather one that had just evolved. There had not been a comprehensive tax reform in Jamaica in modern times. As a result the tax system had become terribly complex, difficult to administer and laden with incentives for evasion and avoidance. A complete overhaul was needed--piecemeal adjustment was no longer possible.

The third problem was tax administration. There's always an inadequate tax administration in developing countries, and such was the case in Jamaica. There were too few good people in the revenue service, because the salaries and the career opportunities were notoriously low and because the training programs available did not allow significant opportunities for advancement. Assessment procedures were antiquated and everything was done manually in a system so complicated that computerization was imperative. So there were great administrative problems, and policy reforms alone were not going to bring about a comprehensive reform.

Objectives and Project Design

Those were the big issues to be faced in designing a comprehensive reform. The first step in the design process is an objective study of the issues and possibilities, and this begins with choosing the people to do the study. This is an extremely important point. When you buy a team to do tax reform, you do buy a point of view. Though there are some common principles that guide thinking about the objectives of good tax reform, everyone doesn't think the same about what is good tax reform. Certainly the group that went to work on this project came with a set of views as to what a "good" tax structure would look like.

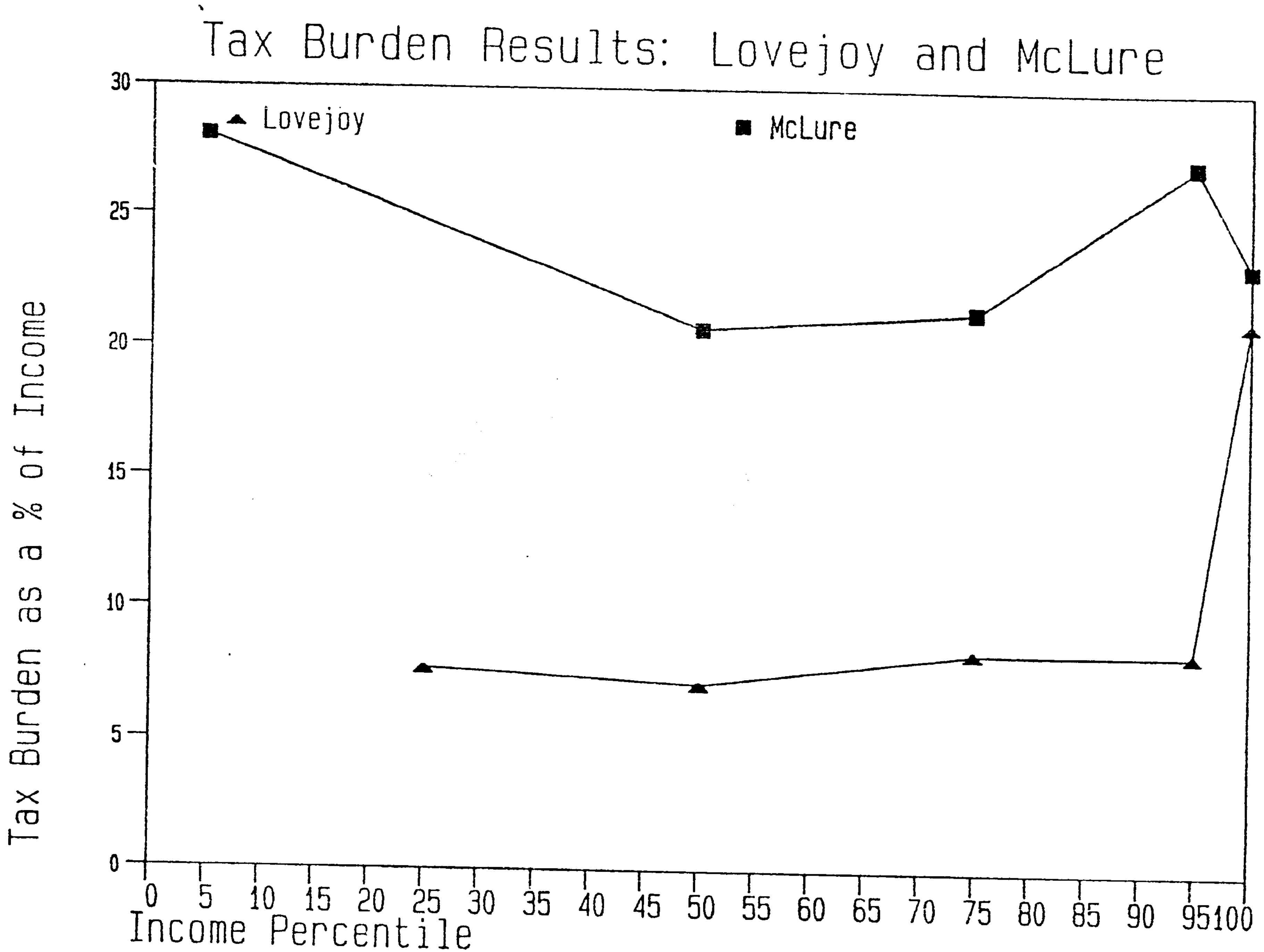
This is a good place for me to digress and I hope put to rest much of the nonsense that grows out of discussions about "supply-side" tax policy. I'm not really sure what this label means, but I can tell you that I don't think that lower tax rates in and of themselves accomplish anything. It's just nonsense to talk about lower tax rates as a panacea. What is more sensible is to say that there are differences amongst economists in terms of the importance they attach to "price effects" in a tax reform. If one's interest is in removing distortions to increase savings, investment and work effort by eliminating biases in the tax system that raise the price of investing, saving and working, and if one believes that the responses to such price changes are important, then one will attach more importance to this neutrality objective of taxation. I think most of the people who worked with us on the Project took that point of view, that the price effects were important. This inevitably leads to the search for broader tax bases, the elimination of special incentives and exemptions, the move to flatter rate taxes and the reduction of the progressivity of nominal rate structures. So lowering the marginal rate, while keeping the level of revenue constant, is perfectly consistent with the view that neutrality is an important objective. Neutrality has played a major role in the work that we are doing.

Second, there is the question of the place of equity in the tax reform. Obviously, if the end of today's story is enactment of a flat rate tax, the critique is going to center on "What were the equity effects?" In many developing countries, certainly in Jamaica, tax systems look more progressive than they really are. This is because legal avoidance, illegal evasion and just poor administration nullify the nominal progressivity. These become accepted as part of the system, and since they are much more available to high income people, the system becomes regressive. In this fashion, what appeared to be a very progressive rate income tax in Jamaica was, in fact, quite regressive. This has been illustrated in an incidence study done by Michael Wasylenko for the entire Jamaican tax system (see Figure 1). A positive slope to the effective tax rates in this graph would mean progressivity, and a negative slope would mean regressivity. Note that when you get out to about the eighth decile, with an income of around J$14,000, the effective rate turns down. So we didn't start with a progressive income tax system in Jamaica. The view of equity that we brought to this situation was that the main issue would be the treatment of the lowest income groups in reformulating the indirect tax system. The equity issue to be faced on the income tax would be horizontal equity, and fairness. We had no intention of trying to build a progressive tax system across the full income range.

Third, what sort of buoyancy does one want in the revenue system over the long run? If you move toward a system of the kind that we'll talk about today--a cleaner, flatter rate, broader-based system--you probably are going to move toward a system whose automatic revenue growth over time is slower than the system that's in place. This has important consequences for the expenditure side of the budget.

Finally, and maybe most important of all is that our primary objective was simplification. Tax structures are terribly complicated in developing countries, as they are in developed countries, but there's less wherewithal to administer the complications. Simplification has to be a paramount objective, maybe the most important objective in an LDC.

There were constraints to undertaking the reform. I've already described the poor state of the economy. There was also a poor state of the fisc in Jamaica, i.e., a very large budget deficit. The Government was



Tax Burden Results: Lovejoy and McLure
Lovejoy
McLure
Tax Burden as a % of Income
0
5
10
15
20
25
30
0 5 10 15 20 25 30 35 40 45 50 55 60 65 70 75 80 85 90 95 100
Income Percentile

talking about tax reform partly to please the donors, but could only go so far with budget cuts without creating much domestic unrest. Still, the Government of Jamaica had to honor an agreement with the IMF to hold their budget deficit to a certain level, so there were constraints on what tax reform could do. It led us to say that the right role for us to play--working under AID auspices, but directly for the Jamaican Government--was to advise on a revenue-neutral reform program. The level of spending and taxing is a Government of Jamaica decision. We helped with estimates but advising on "proper" levels really isn't the role that outside advisors should play.

The reform program in Jamaica is extensive. It covers all taxes and is truly a comprehensive reform program. I'm only going to talk about one component of the program today, the individual income tax. Other policy changes, however, are in the immediate offing. The GOJ is very close, I think, to proposing some kind of a value-added tax to replace the present domestic indirect tax system. Our staff in Kingston is working on implementation, and structural reform could well be announced in the near future. The corporate tax reform will quite likely occur sometime early in 1987.

Income Tax Reform

First, I want to talk about the Jamaican personal income tax system that we found in place. Then I will describe some of the research we undertook, the findings of the empirical research and the structural changes that finally resulted.

The Old System

The legal base of the tax included all income with the major exception of income from bank interest. Interest on bank deposits were tax-free, the idea being to encourage savings. All other income, including income-in-kind, was supposed to be taxed under the individual income tax, with the exception of capital gains which are partially taxed under the transfer tax. The rate structure of the tax is described in Table 1 (J$5.5 ≈ 1 U.S. dollar as of January 1, 1986). There were two rate structures. If income was less than J$7,000 then one was subject to the rate structure shown at the top of Table 1. The first J$4,000 was tax free, but the J$4,000 to J$7,000 slab was taxed at a marginal rate of 70 percent. So if your income was J$5,000 you paid no tax on the first J$4,000 and J$700 on the next J$1,000. In short, you had a very high marginal rate. Individuals with incomes above J$7,000 paid according to the rate schedule at the bottom of Table 1. Most Jamaican income taxpayers are subject to this Schedule. If your income is more than J$7,000, you pay 30 percent on the first J$7,000, 40 percent on the next J$3,000 and so on. When one gets to J$14,000, which is a fairly low level of income, one reaches a marginal rate of 57 1/2 percent. So the rate structure is very progressive, and one gets to the top bracket very fast.

On top of this are the payroll taxes. In most countries we think of payroll taxes in terms of Social Security, but in many developing countries that's not exactly the way it works. Jamaica has five payroll taxes as shown in Table 2. The National Insurance Program (NIS), is a Social Security program, 2 1/2 percent on the employee, 2 1/2 percent on the employer. The last row, the CSFBS, is a 4 percent tax on gross emoluments

TABLE 1

CURRENT RATE STRUCTURE OF THE INDIVIDUAL INCOME TAX

Statutory Income[a]	Marginal Tax Rate
If Income is Less than J$7,000	
J$ 0 - J$4,000	0
4,001 - 7,000	.70
If Income is More than J$7,000	
J$ 0 - J$ 7,000	.30
7,001 - 10,000	.40
10,001 - 12,000	.45
12,001 - 14,000	.50
Over J$14,000	.575

[a]"Statutory Income" is the tax base for the personal income tax. It is the amount that is entered on line C.18 of the personal income tax return. It equals the sum of income from employments and offices; pensions; rent of land, houses, or other property; dividends, interest, annuities, discounts, estates, trusts, alimony, or other annual payments arising within Jamaica; sources outside Jamaica; sources not stated elsewhere; and trade, business, profession, or cultivation of land or farming; less capital allowances.

SOURCE: Income Tax Department (Kingston: Government of Jamaica)

TABLE 2

BASE AND RATE STRUCTURES OF THE PAYROLL PROGRAMS

Program	Self-employed Worker	PAYE Worker	
		Employee Share	Employer Share
Education Tax	1 percent of gross earnings No ceiling	1 percent of gross emoluments No ceiling	1 percent of gross emoluments No ceiling
HEART Trust	NA	NA	3 percent of total employee emoluments No ceiling[a]
NHT[b]	3 percent of gross earnings No ceiling	2 percent of gross emoluments No ceiling	3 percent of gross emoluments No ceiling
NIS	J$.30/week plus 5 percent of gross earnings on income between J$12-150/week	J$.15/week plus 2.5 percent of gross emoluments on income between J$12-150/week	J$.25/week plus 2.5 percent of gross emoluments on income between J$12-150/week
CSFBS	NA No ceiling[c]	4 percent of gross emoluments	NA

NA - Not Applicable.

[a]The employer's payroll must exceed J$7,222 per month; the tax bill is reduced by the amounts paid to HEART trainees (J$2,600 for a full-time trainee); and government agencies are exempt.

[b]A person whose income is less than the minimum wage is exempt.

[c]Only central government employees in pensionable offices are eligible to participate.

SOURCE: Information provided by the relevant government agencies in March 1985.

of all government workers. The Education Tax is another 1 percent on the employee and 1 percent on the employer, but really it is just an income tax rider. The money is not truly used to top up education spending. The Heart Trust is an employee training program, 3 percent from the (private sector) employer on gross emoluments, earmarked for worker retraining. When you start adding these payroll tax rates, depending on the type of worker or employer, and you add in the 57 1/2 percent marginal rate, you come quickly to the conclusion that the tax rate is very high. If the income tax were fully enforced, the marginal rate could be on the order of 65 percent or more.

On the tax base side, there was no deduction system. The law provided for a system of 16 tax credits (see Table 3). These tax credits seemed to cover everything. There were the standard personal allowances, tax credits for household workers and for the encouragement of savings, others were complicated depending on whether your children went to school abroad or in Jamaica. In summary, a very complicated system of tax credits was designed to build some equity into the system to recognize different needs of different people. One can see what must have happened by looking at the structure of credits. Through the years special interest groups managed to get "their" credit put into the system. It didn't really promote equity because the credits were not indexed--they had been fixed for years in nominal dollar terms.

The inevitable happened. When rates rise into the 60 percent-plus range, and where there is not strong enforcement, there will be evasion. Not only is there substantial evasion, but also legal avoidance. I do not know the history of how the prevailing avoidance scheme grew up in Jamaica,

TABLE 3

SUMMARY OF CREDITS FOR PERSONAL RELIEF: 1983

Credits	Amount	Limit of Credit
Personal Allowance	J$600	Not applicable
Wife Allowance	J$140	Not applicable
Wife's Earned Income Allowance	40 percent of wife's earned income	J$320
Children Allowance	J$100 (J$120 for university students)	Not available if child's income exceeds J$200 (J$300 for university students)
Female Relative	J$40	Not applicable
Dependent Relative Allowance	J$40	J$80 (for two relatives); not available if relative's income exceeds J$200
Maintenance and Alimony	40 percent of maintenance or alimony, whichever is less	J$160
Life Assurance Relief	60 percent of premium paid	10 percent of statutory income; 4.2 percent of principal amount; J$360
Pensioner's Allowance	J$400	Not applicable
Donations	40 percent of donations	2 percent of statutory income
Capital Growth Investments	60 percent of investments	J$360
Mortgage Interest Relief	40 percent of mortgage interest	J$60
Medical Expenses Relief	40 percent of medical and dental expenses	J$40
Subscription for Shares	60 percent for subscription for shares	J$360
Household Helper	J$4 per week	J$208
Special Credit	J$156	Vanishes at income of J$12,000

SOURCE: Income Tax Department (Kingston: Government of Jamaica).

but the rates were high enough to where it must have been decided that there had to be some relief provided to taxpayers who could not easily evade. So, instead of reform they instituted a scheme called the "allowance system," a system of nontaxable perquisites. To understand the way the perquisites worked, assume that I'm your employer. When wage negotiation goes on we reach an agreement as to how much of your wage will be taxable and how much will be perquisites, or nontaxable allowances. There were 16 or 17 different kinds of allowable perquisites, each negotiated between employer and employee. So, in a sense, every person had his own income tax. Whatever you could negotiate with your employer was allowed. Once the system became practice in the private sector, the public sector must have felt they couldn't be left out; so each government agency negotiated a different package of perquisites with its workers. None of this had to be reported to the income tax authorities. This system became entrenched and was especially important at the top end of the income scale.

So what the Jamaicans came to have was a terribly complicated income tax system. In some cases, up to 60 percent of what one could call taxable income was outside the system because of these perquisites, the 16 credits, and lax enforcement. The administration of the system was poor, not primarily because of lack of effort, I think, but because of poor procedures, understaffing and because authorities faced the task of administering a very complex system. I should say another word regarding the complication of the system. An analysis of the forms and instructions turned up 101 errors in the instructions to filling out the income tax form. This makes the point that it's not clear that everyone was talking about the same income tax in Jamaica, even in the income tax department.

Research Approach

There were no computerized, usable records, and no publication of any disaggregated statistics of income tax payments or assessments. If you had come in at the beginning of this reform period and asked to see a distribution of taxpayers by income bracket, the answer would be, "We don't have those kinds of statistics because we don't have a complete master roll." The only data available were in the file room. The research method used to gather the necessary data was to pull a random sample from the taxpayer list, which one got by adding up the lists from all the firms on record. Then, a battery of people working for several months in the file room recorded the information according to a prescribed format. That was where the real empirical work of income tax reform began in Jamaica.

In analyzing these data to assess the performance of the tax, we started with the knowledge that about 95 percent of all revenues were collected from the pay-as-you-earn (PAYE) system. Little or nothing was collected from the self-employed. The so-called "hard-to-tax" were completely outside the tax net, and in many cases these tend to be higher income people. Less than one in five of all merchants and professional people even file a return. The sample of taxpayers that we pulled gave up an estimated distribution of taxpayers by type as shown in Table 4. We estimated that around 250,000 people paid the income tax in Jamaica. When we sat down in Syracuse one night with officials from the Revenue Board and laid this distribution out, it was the first time anyone had a good sense of how many taxpayers there were in each bracket.

After creating a distribution of income and taxable income by taxpayer, we gathered information on the tax credits taken. The next

TABLE 4

DISTRIBUTION OF INCOME, CREDITS, AND TAXES FOR PAYE TAXPAYERS
FOR 1983: 1983 TAX RATES
(based on Revenue Board Sample)
(amounts in thousands of Jamaican dollars[a])

Statutory Income Class	Number of Taxpayers		Total Statutory Income		"Straight-Time" Income		"Overtime Income"[b]	
	Number	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Under J$2,000	26,143	10.59	J$ 26,549.1	1.32	J$ 26,549.1	1.43	J$ 0.0	0.00
2,001 - 4,000	32,115	13.01	96,429.5	4.81	96,429.5	5.20	0.0	0.00
4,001 - 6,000	33,163	13.44	170,274.1	8.49	170,274.1	9.18	0.0	0.00
6,001 - 8,000	38,873	15.75	270,505.9	13.48	266,297.3	14.35	4,208.6	2.79
8,001 - 10,000	43,344	17.56	399,975.0	19.93	360,835.1	19.45	39,139.9	25.90
10,001 - 12,000	36,274	14.70	395,154.9	19.69	357,109.9	19.25	38,044.9	25.18
12,001 - 14,000	14,748	5.97	190,549.4	9.50	175,212.6	9.44	15,336.9	10.15
14,001 - 16,000	8,188	3.32	121,756.0	6.07	110,256.0	5.94	11,500.0	7.61
16,001 - 18,000	3,770	1.53	63,819.2	3.18	57,734.4	3.11	6,084.8	4.03
18,001 - 20,000	2,814	1.14	53,312.3	2.66	47,676.1	2.57	5,636.3	3.73
20,001 - 25,000	3,119	1.26	68,947.2	3.44	60,126.6	3.24	8,820.6	5.84
25,001 - 30,000	1,724	0.70	46,943.6	2.34	40,571.6	2.19	6,372.0	4.22
30,001 - 50,000	2,237	0.91	81,442.7	4.06	70,154.5	3.78	11,288.2	7.47
Over J$50,000	312	0.13	20,876.3	1.04	16,206.8	0.87	4,669.4	3.09
Total	246,823	100.01	J$2,006,535.2	100.01	J$1,855,433.6	100.00	J$151,101.7	100.01

TABLE 4 (CONT.), Page 2

Statutory Income Class	Effective Credits Amount	Effective Credits Percent of Total	Taxes Payable Amount	Taxes Payable Percent of Total	Average Tax Rate: 1983 Schedule	Average Tax Rate: 1983 Schedule Without Credits	Difference
Under J$2,000	J$ 5,877.6	2.02	J$ 2,087	0.54	.079	.300	.221
2,001 - 4,000	20,346.4	6.99	8,582	2.22	.087	.300	.213
4,001 - 6,000	31,832.5	10.94	19,250	4.99	.112	.300	.188
6,001 - 8,000	47,310.2	16.25	34,264	8.88	.126	.301	.175
8,001 - 10,000	66,295.8	22.78	59,440	15.40	.149	.314	.166
10,001 - 12,000	60,098.5	20.65	69,399	17.98	.175	.327	.152
12,001 14,000	23,910.8	8.22	42,291	10.96	.221	.347	.126
14,001 16,000	13,471.0	4.63	30,786	7.97	.253	.363	.111
16,001 18,000	6,191.4	2.13	18,253	4.73	.286	.383	.097
18,001 - 20,000	4,438.7	1.53	16,745	4.34	.314	.397	.083
20,001 - 25,000	4,888.2	1.68	23,569	6.11	.341	.412	.071
25,001 - 30,000	2,586.3	0.89	17,863	4.63	.380	.435	.055
30,001 - 50,000	3,369.5	1.16	34,100	8.83	.418	.460	.042
Over J$50,000	437.4	0.15	9,411	2.44	.450	.472	.002
Total	J$291,054.4	100.02	J$386,040	100.02	.192	.337	.145

[a]Except Statutory Income Class which is expressed in Jamaican dollars.

[b]Appendix D describes the method by which the overtime/straight-time breakdown of statutory income was determined. This breakdown was irrelevant for tax purposes in 1983 for individuals earning less than J$7,000 so all of their income is shown as straight time income.

[c]Some totals may not add due to rounding.

[d]Total credits claimed exceed this amount by J$31,815 because some individuals claimed more in credits than they had in taxes due.

[e]Ratio of total tax payable to total statutory income.

[f]Ratio of total tax payable plus total effective credits to statutory income.

SOURCE: Computed from Revenue Board Survey of Allowances for 1983 (see Appendices A and C).

problem was to figure out how much income was not being claimed. Evasion is one part and nontaxable perquisites are another. There was all sorts of popular lore about the amount of allowances. The accounting firms would say that "the ratios are 60:40" or "the ratios are 80:20," but there was no hard evidence at all. So the government took a sample. The Prime Minister required that all employers report the perquisites of all workers. There were reports received on 70,000 workers, about 30,000 in the public sector and 40,000 in the private sector. The final column of Table 5 shows allowances or perquisites as a percentage of statutory income by income bracket. The column total shows that close to 15 percent of statutory income was outside the tax base. It is an important number to estimate, because one wants to see how much the tax base can expand if this income is brought within the net, and by how much you can lower the rate if this income can be captured. Can one trust information from such a survey? In fact, the survey was a test of honesty in a sense, and so it cannot be completely relied upon. Still, it's the only data on allowances that anyone ever had to go on.

We started with these data and built a "model" for these 70,000 taxpayers to estimate the relationship between allowances and income, and imputed the results to our random sample to make an estimate of total income of all taxpayers. So what we had an estimate of the full tax base, if everything was in.

This left us the question of evasion, and the need to estimate the amount that was being evaded. How do you determine who doesn't pay their tax? The only information readily available is about people who do pay their tax. We did the following: First, we decided to focus on

TABLE 5

ALLOWANCES AND STATUTORY INCOME: BY INCOME CLASS FOR 1983

Statutory Income Class	Employees		Statutory Income		Allowances			Allowances as Percent of Statutory Income
	Number	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Average Allowances	
Under J$2,000	7,530	10.7	J$ 7,662.1	1.3	J$ 558.9	.7	J$ 74	7.3
2,001 - 4,000	9,237	13.2	27,690.2	4.9	1,837.4	2.2	199	6.6
4,001 - 6,000	9,396	13.4	48,232.8	8.5	3,621.8	4.4	385	7.5
6,001 - 8,000	10,988	15.7	76,465.3	13.4	6,436.7	7.8	586	8.4
8,001 - 10,000	12,262	17.5	113,149.0	19.8	10,753.6	13.1	877	9.5
10,001 - 12,000	10,256	14.6	111,724.7	19.6	11,050.0	13.5	1,077	9.9
12,001 - 14,000	4,171	5.9	53,894.0	9.4	8,623.4	10.5	2,067	16.0
14,001 - 16,000	2,322	3.3	34,530.3	6.1	7,777.0	9.5	3,349	22.5
16,001 - 18,000	1,068	1.5	18,076.7	3.2	5,047.3	6.1	4,726	27.9
18,001 - 20,000	796	1.1	15,078.6	2.6	4,664.5	5.7	5,860	30.9
20,001 - 25,000	892	1.3	19,726.9	3.5	7,565.2	9.2	8,481	38.4
25,001 - 30,000	496	.7	13,504.1	2.4	4,811.7	5.9	9,701	35.6
30,001 - 50,000	641	.9	23,320.3	4.1	7,637.8	9.3	11,915	32.8
Over J$50,000	100	.1	7,414.7	1.3	1,727.3	2.1	17,273	23.3
Total	70,155	99.9	J$570,469.6	100.1	J$82,112.6	100.0	J$ 1,170	14.4

SOURCE: Computed from Revenue Board Survey of Allowances for 1983 (see Appendix A and C).

professional occupations. Then we compiled a master list. We started with professional registries and we matched that up with the yellow page listings in the telephone book list. We found, for example, 384 accountants in Jamaica. Third, we drew a random sample 176 accountants of the 384. We found that only 45 of them paid income tax in at least one year between 1980 and 1983; the Income Tax Department had never heard of 59 of them; and for the 72 that the department had heard of (they had their name on a list), there was no file on record.

We've gone through this process for five other professional occupations and for twelve other occupations. In each case, we recorded the information for those who actually filed and paid, and then imputed income characteristics to those who didn't. Using this assumption, we built an estimate of the total amount of evasion. It turns out that less than 22 percent of professionals in Jamaica had paid any income tax between 1980 and 1983; and that turned out to be the highest number we found for the self-employed. So the hard-to-tax are indeed very, very hard to tax.

The basic information on the true tax base is complete with these estimates. If you bring in allowances, 15 percent can be added to the base. Credits accounted for about 10 percent of statutory income, hence their abolition would add another 10 percent. Evaders offered an enormous possibility to expand the income tax base. We have put this together in Table 6. This gives an estimate of how much tax would result if all income were fully taxed: J$875 million. From income fully taxed, they were receiving J$388 million (column 1). They were preferentially taxing overtime income, and were losing J$48 million because of that tax preference (column 2). If they fully taxed the unreported, the evaded

TABLE 6

REVENUE POTENTIAL FROM TAXED AND NONTAXED INCOME IN 1983: BY INCOME CLASS
(amounts in thousands of Jamaican dollars[a])

Statutory Income Class	Taxes Payable on Statutory Income	Full Taxation of Overtime[b]	Full Taxation of Under-reported and Unreported Income[b]	Full Taxation of Allowances[b]	Total	Taxes Payable on Fully Taxed Income as a Percent of Total	Total Taxes Payable if All Income Taxed Simultaneously[c]	Taxes Payable on Fully Taxed Income as a Percent of Total
Under J$2,000	J$ 2,083.5	J$ ---	J$ 0.0	J$ 402	J$ 2,485.5	83.8	2,486	83.8
2,001 - 4,000	8,745.4	---	43.1	2,077	10,865.5	80.1	10,866	80.1
4,001 - 6,000	27,835.9	---	300.2	5,130	33,266.1	83.7	33,267	83.7
6,001 - 8,000	40,964.3	660.2	1,083.0	9,099	51,806.5	79.1	51,807	79.1
8,001 - 10,000	48,220.2	3,593.1	2,167.8	12,246	66,227.1	72.8	66,318	72.7
10,001 - 12,000	54,915.1	4,659.5	3,118.2	14,626	77,318.8	71.0	77,605	70.1
12,001 - 14,000	42,912.0	6,420.3	3,129.2	13,931	66,392.5	64.6	67,147	63.9
14,001 - 16,000	29,222.3	4,475.4	8,831.1	10,962	53,490.8	54.6	53,969	54.1
16,001 - 18,000	23,122.5	5,200.5	5,826.3	10,004	44,153.3	52.4	44,529	51.9
18,001 - 20,000	25,770.8	3,441.9	6,026.3	9,919	45,158.0	57.1	45,227	57.0
20,001 - 25,000	32,629.4	6,173.5	42,118.1	14,859	95,780.0	34.1	96,173	33.9
25,001 - 30,000	17,639.3	1,962.1	35,193.5	5,202	54,794.9	32.2	60,123	29.3
30,001 - 50,000	15,666.4	5,244.3	91,932.8	4,359	117,202.5	13.4	117,476	13.3
Over J$50,000	18,453.9	6,384.0	119,102.7	3,957	147,897.6	12.5	148,086	12.5
Total	J$388,181.0	J$48,214.8	J$318,872.3	J$116,775	J$866,839.1	44.8	875,077	44.4

[a]Except Statutory Income Class which is expressed in Jamaican dollars.

[b]Estimated by "individually" adding to statutory income and taxing at regular rates. We added each component to statutory income, assuming all other components to be zero and reestimated tax liability. The difference between this liability and that shown in column (1) is the tax "loss" we attribute to each component.

[c]Estimated by adding all components to statutory income and taxing as one sum.

SOURCE: Computed from James Alm and Roy Bahl, "Evaluation of the Structure of the Jamaican Individual Income Tax," Jamaica Tax Structure Examination Project Staff Paper No. 15, Metropolitan Studies Program, The Maxwell School (Syracuse, NY: Syracuse University, December 1984 [revised March 1985]), Tables 21, 28, 46, 62 and 71.

income, there was another J$318 million to be had (column 3). If they fully taxed the allowances, based on the information we had, another J$116 million was possible.

The 1986 Reform

What do you do when you find a number like that, i.e., when you find that only 45 percent of potential income is being fully taxed? You can't build a tax reform on the presumption that they're going to capture the evaders immediately, because they don't have the wherewithal to do it. What you do is say "What if we would pull all the allowances in, and what if we pulled in all of this overtime (which is a kind of evasion), then how much would the base expand?" That's the way the analysis proceeded.

We went to the Revenue Board with a program. The Prime Minister and the Revenue Board considered all of the alternatives, and came up with a program that they liked. The Prime Minister then appointed a Tax Reform Committee, comprised of private sector citizens, who debated the program for about four months, before coming to a reform they liked. The Prime Minister then took it to Cabinet and it became law January 1, 1986.

Under the new law all allowances were brought into the system to be fully taxed. All 16 credits were abolished, even the personal allowances. Interest income from bank deposits became taxable, like all other income. The first J$8,580 total income was tax exempt, and every dollar above that became taxable at 33 1/3 percent. So, basically, a flat tax was introduced with a fairly high floor and in principle with no loopholes. Now that's a great system, except that the attacks began on it almost from the day that it was put in place, and some loopholes began to emerge. These may not be big revenue loss loopholes, I think, but they are now in place and must be dealt with. The in-kind perquisites are one of the big problems and the treatment of pensioners hasn't been properly sorted out.

The new system fits the maxims of simplicity and neutrality. What about equity? If the system was already regressive because of evasion and if, in fact, you can drag more people into the net with a simpler system like this, then the equity losses should not be great. There is a monitoring activity underway to try to evaluate the early experience with the new system.

Conclusions

In conclusion, I have six lessons to offer on the basis of our experience with tax reform to date. These "lessons" might be useful to AID in its project design work. The first lesson is that the host country government must really want the reform or it can't happen. If AID wants it or the World Bank wants it or IMF wants it, but the country does not, then true comprehensive reform is not going to happen. In the case of Jamaica, the government wanted a tax reform.

The second lesson is that tax reform has to be comprehensive. It must consider all taxes. In the Jamaica case, one can't leave in place a personal income tax at a flat rate of 33 1/3 percent and not touch a corporate rate of 45 percent. You must consider the whole tax system together. As for equity, every tax doesn't have to give you the desired pattern of equity you desire for the system. It is the combined effect of all taxes that have to give you the effects on different taxpayers that you want.

The third lesson is that the reform has to be carefully thought through and worked out, theoretically and empirically. There is great power in data. It's one thing to have loose discussions about what reform will do, and we all know that you can't make precise revenue, allocative and equity estimates, but there's great power in doing careful data work and laying out the best possible information. This is a good mission for an international agency, because the people who can do this in the developing countries are always working about 20 hours a day, and there's no way that they have the luxury to do research. We had simulation models running, at the insistence of the Revenue Board Chairman, where he picked out 200 key occupations and we worked out the effect on the tax bill of each of these 200 occupations. If tax reform is going to stick, it must be well based. It also has to be debated. You really have to say "Who's going to get helped and who's going to get hurt?" It's very important to have the debate, and to have it in the newspapers as well. This cushions some of the inevitable shock. Big changes need that in order to settle in.

Fourth, you can't do tax reform without the training and the administration improvement. That has got to be part of the project, but you must do the policy first. A big mistake, I think, is to send in the administration team first to clean up the administration of the tax system. What sense would there have been in going to Jamaica to try and better administer the existing system? So it's always policy first with the administration and training as absolutely necessary parts of the reform.

Fifth, the working relationship between the host country, the consultants and the USAID Mission is important. In Jamaica the relationship has been very good. The Mission economist in Jamaica is Sam

Skogstad, who actually is an economist, and the tax project really was his idea. He was the person who promoted it and made it happen and has worked hard to keep it alive. And that's really important, because without the economist who understood that it was necessary to have this kind of a tax project, it would have occurred in this format. The Mission economist kept the Project on track, and he made sure that everything was in place to make the Project a success, and perhaps his greatest contribution was that he kept AID from interfering with the work (most of the time). It became a Government of Jamaica project, not an AID project. In fact, AID has very little to offer such projects in a developing country, because they usually don't have a field staff with the capability to carry on a substantive discussion about tax reform in most cases. The staff tend to be generalists and often without the necessary background. The best thing is for them to stay out of it, and in Jamaica they stayed out of it, to their everlasting credit. The Tax Project Office is in the Revenue Board of the Government of Jamaica where project offices ought to be if they are to be part of the country's economic policy planning.

The other thing about the working relationship with AID that is important, and may be as important as anything, relates to the importance of using qualified people on the Project. The Mission in Jamaica told me at the outset that they wanted the best people in every area. They said "go out and get us the best guys around, because that's what the Jamaicans want, and that's the kind of advice that we want to provide." I remember replying something like, "You know, if we get the best guys around, they're going to be expensive and you're going to have to work around their schedule," and USAID said "No problem, that's what we all want." Well, it paid off, because the relationship was much closer with the Government because they felt like they were really getting the best advice money could buy. You couldn't take the more typical approach of sending some guy named Fred down there to do this work because he'll work for $262 a day. It simply wouldn't have worked in the Jamaica case.

And the final lesson: the follow-up is a long process. Tax reform doesn't get done in a year or even two years. The Jamaicans implemented the income tax in the third year. It's a major change, a flat tax. It may well be an important answer to one of their big tax problems. But now it's got to be protected because here come the special interest groups who feel like they aren't treated right, and they want to do what people always do to tax systems (think of our own country); they want to compromise it to satisfy their own objectives. So you need to follow up on the policy work to monitor what's happening and to help the government protect it from the kind of erosion that occurs. Phase Two in Jamaica will computerize the system, which will do an enormous amount to streamline the assessment and collection of the income tax, as well as to monitor and help debug the new system.

Roy Bahl Appendix A

This is a listing of the staff working papers produced by the Jamaica Tax Structure Examination Project for the Government of Jamaica. The papers are available at the price of US$3.00 each and may be obtained by writing to the Publications Officer, Metropolitan Studies Program, Syracuse University, 400 Maxwell Hall, Syracuse, New York 13244-1090.

Staff Paper	Title	Author	Date
1	Defects in Forms and Instructions: Jamaican Individual Income Tax	McLure	February 1984
2	Analysis of the Jamaican Income Tax Forms and Instructions: The Company Profits Tax and Other Tax Obligations of Bodies Corporate	DeGraw	February 1984
3	Deductions and Credits for Personal Relief Under the Jamaican Individual Income Tax: Concepts and Norms	McLure	February 1984
4	Current Administrative Procedures of the Income Tax Department of Jamaica and Some Recommended Changes	DeGraw	February 1984
5	Bauxite Taxation in Jamaica	Conrad	February 1984
6	Revision of the Indirect Tax Structure in Jamaica: A Proposal for a General Consumption Tax	Due	April 1984 (Revised February 1985)
7	Tax Reform and the Foreign Trade Regime in Jamaica	Whalley	April 1984
8	Jamaica's Indirect Tax System: The Administration and Reform of Excise Taxes	Cnossen	August 1984

Staff Paper	Title	Author	Date
9	Jamaican Tax Incentives	Thirsk	August 1984
10	Motor Vehicle Taxation in Jamaica	Smith	September 1984
11	Analysis of Tax Base and Alternative Plans	Follain Holland Miyake	October 1984
12	The Jamaican Income Tax System: A Framework for Policy Formation	Break	October 1984
13	Land Versus Property Taxation: A General Equilibrium Analysis	Follain Miyake	November 1984
14	The Structure of Protection in the Jamaican Manufacturing Sector	Moussavian	November 1984
15	An Evaluation of the Structure of the Jamaican Personal Income Tax	Alm Bahl	December 1984 (Revised March 1985)
16	The Property Tax in Jamaica	Holland Follain	January 1985
17	Comprehensive Tax Reform for Jamaica	JTSEP	April 1985
18	Integrating Tax Policy, Industrial Policy and Trade Policy in Jamaica	Shoup	July 1985
19	The Future Development of the Sales Tax in Jamaica	Cnossen	August 1985
20	Payroll Taxes and Contributions in Jamaica	Alm	September 1985
21	Corporate Income Taxation in Jamaica: A Framework for Policy Formation	Break	September 1985
22	The Taxation of Corporate Income in Jamaica	Wozny	September 1985
23	The Taxation of Financial Institutions in Jamaica	Martinez	October 1985

Staff Paper	Title	Author	Date
24	The Reform of Indirect Taxes in Jamaica	Bird	October 1985
25	The Low-Income Household Expenditure Survey: Description and Analysis	Miller Stone	November 1985
26	The incidence of Indirect Taxes on Low-Income Households in Jamaica	Bird Miller	April 1986
27	The Taxation, Structure, Organization, Economic and Fiscal Behavior of Jamaican Public Enterprises	Davies Grant	January 1986
28	Private Sector Capital Investment and the Company Tax	Break Holland McLure	March 1986
29	General Consumption Tax	Bird Bourgeois	May 1986
30	The Distribution of Tax Burden in Jamaica: Pre-1985 Reform	Wasylenko	August 1986
31	Income Tax Evasion in Jamaica	Bahl Murray	November 1986
32	Tax Policy for Life Insurance Companies, Building Societies, Superannuation Funds and Individual Retirement Accounts in Jamaica	Brannon Martinez	December 1986

CHAPTER TWO

TAX REFORM IN INDONESIA

Malcolm Gillis

I want to describe the genesis of this particular reform program in Indonesia, some of the economic conditions that were present when it was initiated, the approach that we took, the objectives we sought, some of the results obtained, and then some of the lessons I think we may have learned from the experience. One must understand that when the effort began in 1981, the Indonesian tax system was in a state of very serious disrepair. Nonoil tax revenues, that is revenues other than from foreign oil companies, were only 7.5 percent of GDP. Government spending, however, was about 24 or 25 percent of GDP. Nevertheless, the budget was in rough balance because oil revenues amounted to about 17 percent of GDP.

Background

By late 1980, policy makers had recognized that the economy had become extremely vulnerable to any future fluctuations in the oil market. On the one hand, they perceived that continued strength in world oil prices would generate very strong pressures for increased government spending at levels that would be much too high when oil reserves ultimately declined, as they are doing now. On the other hand, they saw that any period of protracted weakness in world oil markets, coupled with their antiquated system of taxation, would require massive cutbacks in government spending over a very short period of time if they were going to constrain inflation to the tolerable levels.

The tax system in 1980 was extremely complex. The structure was riddled with dozens of tax incentives of extremely dubious social value. The tax system was administered with outdated methods with an ill-equipped and, less-than pristine tax administration. Basic tax laws governing the income tax went all the way back to 1925, and were written in Dutch by the former colonial administration. The sales tax dated from 1951. Two-thirds of nonoil corporate revenues came from captive state-owned enterprises and most of the other one-third came from foreign firms. Personal income tax collections were less than 1.5 percent of GDP and the personal income tax covered less than 2 percent of the population. The sales tax was a cascade type tax using eight different rates and containing numerous exemptions; and there were numerous incentives for inefficiency and evasion.

It was clear that the tax system in place in late 1980 could not be used to cushion any shocks that might arise from a decline in oil revenues if that were to occur. Accordingly, in January 1981, we began to develop plans to devise a totally new tax system that might pick up some, but not all, of the slack that might arise from weakness in oil markets in the future. At the same time, we recognized that the old tax system was replete with incentives for waste and inefficiency in the private sector and, since it was so complex, was extremely open to manipulation by taxpayers and tax administrators alike. Therefore, a heavy premium was placed upon devising a new tax system that would involve as few as possible economic inefficiencies as well as a vastly reduced scope for corruption in the payment and collection of taxes. In addition, the decision makers sought a tax system that would free the poorest household from <u>any</u> income tax obligation and involve a minimum of indirect tax burden on them. But it was quite clear from the outset that the tax side of the budget was not going to be used as a primary instrument of income redistribution, primarily because of the administrative and compliance barriers to effective collection of steep and progressive tax rates.

Approach

The approach taken reflected lessons learned from tax reform initiatives in several countries in which I had been involved. Indonesian economic policymakers in late 1980 and early 1981 were broadly familiar with some earlier efforts led by Carl Shoup, Richard Musgrave and myself in countries as diverse as Bolivia, Japan, Liberia, Ghana, Venezuela, and Colombia.

In early 1981 a series of ministerial level decisions regarding tax reform strategy and tactics was obtained. In many instances the decisions incorporated to one degree or another lessons learned from similar undertakings elsewhere. Since time does not allow a discussion of all these decisions, I will focus upon what I think were the four or five most important. The first decision related to the timing of the technical studies. These must be the core of any significant tax reform effort. The Minister of Finance and other members of the economic cabinet considered that in planning tax reform in the Indonesian context, the appropriate time horizon was best expressed in terms not of months, but of years. One reason was because the Indonesian tax administration of early 1981 was, to say the least, not as well prepared for fiscal innovations as, say, Japan in 1948 when Carl Shoup was there. Also, decision makers did not expect any major revenue shortfall until sometime late in 1983 or early 1984. So the Ministers allotted 2 1/2 years for technical studies on tax reform and another year or so to consider their implications.

The second major decision flowed from the experience of the 1968 Musgrave Commission in Colombia, in which Charles McLure and I were heavily involved. There we had a team of domestic and expatriate lawyers under the directorship of the leader of the mission, Dick Musgrave. These lawyers were given the responsibility of converting tax policy decisions made by the cabinet into tightly crafted draft legislation to submit to the Parliament. During this drafting process in Colombia we discovered inconsistencies in policy decisions. These were rectified with the drafts sent to the decision makers for reconsideration. This model proved very effective in Colombia and we adopted it in Indonesia.

A third decision also reflected the experience of the Musgrave Commission in Colombia as well as that of Carl Shoup in several other nations. These efforts suggested that, at least where you have international tax commissions involved, ultimate adoption of reform programs--not just having a nice book--is critically dependent on the degree of involvement of domestic officials and academics in fashioning reform options. We were mindful of dozens of unheeded and dust-gathering reports prepared by consultants on a variety of options for tax reform. In Indonesia we had a problem of a shortage of trained local fiscal economists and tax lawyers outside the government. Therefore, we had to rely very heavily on involvement by senior and middle-level officials; but we were able to do that to substantial effect. The point is that, unless somebody in the country in question feels that it is their reform, you can forget about it. I think that is a fundamental lesson. If it's "my" reform, forget it; or if it's "Roy Bahl's" reform, forget it; it's not going anywhere. If it's their reform, it might go somewhere.

A fourth decision had to do with the scope of the reform effort. In the other tax missions that I have been involved in and that I had read about, there were very tight time constraints. This meant that the design of tax reform was constrained--you had to consider existing levels of training and education for tax officials. People were in a hurry. You had to make do with the training and skills of the tax officials that were there at the time. We had a much longer time horizon. This made it possible to make explicit provision (as part of the project) for both formal and informal training. So we asked the government to invest in the establishment of a cadre of well-trained tax officials to operate the new tax over the coming decades. They accordingly allocated $10 million of their own money for a training budget. That ultimately grew to $25 million. Under these programs alone, 150 people from the Ministry of Finance have been sent abroad, with 125 of these previously or currently in degree programs in the United States. Some of those are back now and are helping in audit and tax administration. We could do that because we knew we were not going to have a reform in a month or even six months, but one that would involve at least three or four years.

A fifth basic decision was that the reform effort was allowed to begin with a "clean sheet of paper". That meant that nothing in the old system had to be retained. At the same time we weren't going to waste any effort repairing parts of the old system that were not broken. That is a very basic consideration--to decide what you are not going to do.

A sixth decision (while important, we didn't follow this up as well as we did some of the others) was to broaden the reform program to include matters that have typically not been covered in these kinds of undertakings. From my own experience in Chile, Colombia, Ghana, Bolivia, and Ecuador, it was clear to me that tax reform could not be confined to mere changes in tax structure. Such efforts are likely to end in abortive reform or no reform at all. Earlier comprehensive studies of tax reform in Japan, Colombia, Liberia and Libya were under such tight time constraints that they could not focus very much on such nonstructural issues as tax administration, taxpayer identification numbers, the tax information system and improvements in tax procedures. The longer time horizon that was allocated for the Indonesian effort meant that our program could go beyond consideration of reform of tax structure to include procedural administrative and implementation issues. In addition, shortly after we began technical studies, the Ministers made another decision to invest several million dollars in the hardware and software required for a new tax information system that was supposed to be onstream by 1984 as part of a new tax regime. With the help of our team members, this system is now in place and it is working about as well as can be expected. It will take time to get all the bugs out. In the end, the approach toward tax reform in Indonesia incorporated a kind of syncretic blend of lessons that were derived from experiences elsewhere and from previous experience in Indonesia.

Objectives

Now what were the objectives? The ultimate objectives (there were many secondary objectives) were four in number. The first objective was to try to replace some major portion of declining oil revenues so as to avoid very large budgetary deficits in the future and therefore avoid ruinous inflation. The second objective, quite explicitly, was to develop more effective, more sensible measures for income redistribution. In the Indonesia context, at least, this means you don't use the tax side of the budget to try to beat up on rich people who are few in number in any case. You try to get the tax system off the backs of the very poor and you try to raise substantial revenues to finance programs in primary education and irrigation and urban water supply and things like that. This was income redistribution in our view. A third objective was to remove as many as possible of the numerous tax-induced incentives for waste and inefficiency in a private sector. And a fourth goal was to reduce the administrative cost of taxation.

I've already told you a little bit about the revenue objectives, but let me tell you more about the nonrevenue objectives. The reform package was geared to two other proximate objectives other than revenue, and we thought these proximate objectives were important for obtaining several ultimate objectives. Proximate objectives are the things that you don't seek because they are important themselves, but because they are important for doing something else. The two proximate objectives were: (1) drastic simplification of the tax structure, and (2) depersonalization of the tax administration. The ultimate objectives, as I noted earlier, were revenue enhancement, more effective income redistribution, removal of tax inducements for waste and inefficiency in the private sector and reduction in the cost of transferring resources to the public sector. By the way, reduction in the transactions costs of transferring resources to the public sector is nothing more than a polite euphemism for reducing the scope of corruption in tax administration which, in turn, was one of the reasons for low nonoil tax revenues. Simplification requires a tax system that is easy to understand. Depersonalization means a shift toward less--not more--frequent contact between tax officials and taxpayers. To do this you must rely much more heavily on withholding methods; you have to rely much more on computerization of tax information; and you have to have a general reduction in the discretionary authority in the hands of the tax official.

Simplification was by far the most important of the proximate objectives. Why? Because over the decades hundreds of amendments intended to serve the nonrevenue objectives were imbedded in the system. In fact, I finally became convinced of the universality of Anne Krueger's rent-seeking theories when I took a broad look at the Indonesian tax system and saw how rent seeking had been at work for so long. Now, as a result, I am a proponent of the whole rent-seeking approach as a way of explaining much of government behavior. What kind of things am I talking about? I'm talking about using the tax system to promote investment in favored industries; I'm talking about using the tax system to promote exports to encourage development of backward regions, or to promote indigenous entrepreneurs, or to encourage construction of bowling alleys, or to encourage chess players. And some others that I'll mention are even more bizarre. These efforts to fine-tune the tax system to serve nonrevenue goals resulted, at least in Indonesia and probably elsewhere, in an unbelievably complicated tax system, unable to perform its basic function of raising revenues, full of anomalies and also very vulnerable to corruption.

Now to some, simplification means little more than lower and more uniform tax rates, with emphasis on the lower. I share Roy's disdain for the naive supply-siders. I'm a supply-sider myself. I think the way you tell a good economist from a not-so-good economist is that the latter might call himself a demand-sider, but there are differences. There are supply-side cults and then there are pragmatic people like us. In Indonesia we did not view simplification in a simple-minded fashion. To us, simplification meant: first, base broadening and, second, lower and more uniform tax rates because a simple income tax is not one under which many income items are excluded or taxed at different rates. A simple sales tax is not one under which a close substitutes are taxed at widely differing rates.

So the consensus view of tax reform, among the decision makers as well as myself, was that efforts to fine-tune the tax system to achieve nonrevenue objectives had been futile in Indonesia and they were also anti-poor. Why were they anti-poor? Because virtually every item of excluded income, or lightly-taxed income, including housing or auto allowances, physicians' fees, civil service income, interest income and most others, were all received by the top 20 percent of the income distribution. The new income tax laws sought to include all of these items in the tax base. But more importantly, simplification required one other thing: the complete abandonment of all tax incentives of all kinds, without exception. There were income tax holidays for priority industries, tax incentives to use public accountants, tax incentives to hold domestic equities, tax incentives to invest in particular regions, on and on. In the end, all of these special tax incentives were abolished and replaced with the greatest tax incentive anybody ever thought of in history--and that is lower tax rates for all firms, large and small.

Income distribution considerations played a role in ways that might not be apparent. Quite clearly we saw base broadening of the income tax and the sales tax as contributing most to income redistribution.

I could go on at length about the steps taken to change procedures and the structure of the tax administration, but that would put most of our audience asleep. It certainly would put me to sleep, although I was happy we did it. But I think I better move on to the results.

Results

I have a couple of papers, one of them in the Journal of Development Economics, that describe the essentials of the old tax system and the new tax system.[1]

The centerpiece of the new system is a value-added tax. Actually it is a very crude value-added tax because it only goes to the manufacturer/importer level. It is not like an EEC value-added tax that goes to the retail level. Indonesia is not ready for that yet. That would be putting too much on the plate at the present time, because of the very large number of small retailers. The law, however, allows for extension of the tax, without any further changes in legislation, to the retail level, when conditions permit. Basically, it is a manufacturers/importer type value-added tax collected using the tax credit method. This most widely

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[1]Malcolm Gillis, "Micro and Macroeconomics of Tax Reform," Journal of Development Economics, Vol. 19, No. 3 (December 1985), pp. 221-254.

used collection method allows taxes paid on purchases to be credited against taxes due on sales. The value-added tax was intended to bring in at least 70 percent of the incremental revenues from reform.

The basic feature of the system was that we hoped to collect about 66 percent of all value-added tax revenues from three pressure points only. The first was at the import stage. Every product, of whatever kind, that comes into Indonesia is subject to a 10 percent value-added tax. There are no exceptions. Every product is taxed, so there is no fooling around as to what is exempt or what is taxed at different rates--it's all 10 percent. That is the first pressure point--the import stage. We figured to collect about 25 percent of the revenues right there.

The second pressure point was the state oil company. Heretofore, gasoline and other petroleum products were not taxed. The reform involved bringing that set of commodities within the base of the tax and collection of all revenues on such products in the central office of the state oil company.

The third major pressure point was about 25 of the largest 250 state-owned enterprises. With these three sources we had almost two-thirds of the revenues that could not get away. Much of the administrative machinery could be focused on the other possible large taxpayers in the economy.

A second major feature of the new value-added tax is there are no exemptions by product. None whatsoever. Everything that goes through a manufacturing stage is taxed at one rate--10 percent. You say, "What about poor people?" I say, "Indeed, what about poor people?" It turns out, and this you have to get from doing your research carefully, that for the lower 50 percent of the income distribution, virtually 60 percent of what they consume does not go through a manufacturing stage, so they are outside the scope of the tax. But there are no exemptions, so nobody can say that their product should be exempted because it is important for development. The policy is: no exemptions for manufactured goods, for whatever reason.

From time to time pressure for exemptions pops up, and it's very strong, and you have to fight it off. Two such proposals arose with substantial political backing in May 1986. They were turned down. With the passage of time it is very important to have a kind of fiscal Magna Carta that you can use to refer all requests for special treatment back to the tradition of not having any exemptions. We have been very pleased about how the tax has worked in the first year. Collections were earlier about 50 percent greater than the old tax and now are running at about 75 percent greater.

That was the revenue centerpiece. The other major part of the reform was fundamental income tax reform. We didn't expect to get a large amount of revenue in the short-run from reform of income taxes. In fact, income tax were designed to be largely revenue neutral at first because there were important principles at stake here. What we have now is a very broad based income tax that is levied on firms and individuals. In other words, there is no corporate income tax--there is an income tax.

Originally, two rates were proposed--a 15 percent withholding rate and a 33 or 35 percent top rate--down from 50 percent for the old income tax and 45 percent under the old corporate tax. We knew there would be slippage in that structure and in the process of making compromises, an intermediate rate was adopted. So the structure became 15, 25, and 35 percent. But virtually everything is taxed. There are no tax incentives and pervasive fringe benefits are taxed simply by adopting the expediency of not allowing firms to deduct a lot of the fringes that were deductible under the old law. This is so much more effective than trying to tax these income items in the hands of millions of people. It's far easier and it's something that other countries might want to look at.

There was fundamental reform of depreciation, thanks, in large measure to Charles McLure and Emil Sunley. There was basic reform of virtually every other feature of the income tax system. The entire income tax law is 18 pages, double spaced. That's how simple the underlying structure is. Of course, the regulations and procedures are much longer than that but the law itself is only 18 double spaced pages. There is still reform in progress on the property tax and stamp tax but those are all secondary.

Lessons Learned

What are the lessons? I could give you a hundred lessons but Dick Musgrave taught Charles McLure and me to pick out the most salient facts about any of our observations. Allow me to try to pick the six or seven most important.

Number one, tax reform seems to work best when major changes in tax structure are coordinated with fundamental reform in administrative procedures and adoption of new administrative technology. And it must be under the direction of one person. You can't coordinate these things by committee. Somebody has to be in charge.

The second major lesson is that getting major tax reform takes time, a minimum of three or four years and usually much more than that. Therefore, if you are an AID donor and you want to bankroll a serious tax reform program, you have to be prepared to stick it out for a while, accept aborted reform, or be the sponsor of a number of books that gather dust in obscure corners in a few libraries around the world. If you are in the business of subsidizing filling up library space, then sponsor these things for a period of six months and see what results; the chances are that you will not get much.

The third lesson is that once you get fundamental reform, someone has got to stay on top of implementation of reform for at least two to three years. That someone has to be someone who has been intimately involved in the inception of the reform process and in its initial implementation. I'll give you some examples. I go back to Indonesia now only once a year and when I go back it's for one purpose, and usually one purpose only, and that is to help control tax termites. The termite principle says that special interest groups will start to eat into a reform as soon as it is enacted, so you have to have very effective insecticide to control the termites. So far we have been very successful in preventing the income tax laws and the sales tax laws from being very much weakened by the operation of the termite principle. That is not going to last forever, we know that.

The fourth lesson is that tax reform is too important to be left only to economists; it is too important to be left to lawyers; it is too important to be left to administrators. Rather, the effective preparation and implementation of tax reforms requires the blending of skills of economists, lawyers, accountants, computer scientists and administrators. In Indonesia we ended up with 28 consultants on my team. These were from eight countries and these 28 made about 75 trips to Jakarta. It's a long way, but you must have the blend of these skills. But I agree with Roy on several points and particularly on one major point. The first thing that you have got to do is get the policy right. You have got to work on the structure first. That comes first. If you do that right, then there is a possibility that you can do the rest of the job right. If you do that wrong, forget about everything else.

The fifth lesson, I believe, is that simplification and tax structure reform pays off and pays off big. In Indonesia it paid off in revenue terms and, so far, it appears to be paying off in equity terms. And I have no doubt whatsoever it pays off in ease of administration.

The sixth lesson from this experience is that many, perhaps most, arguments over the effects of tax reform can be settled by research. In fact, I would say that the first two years of any comprehensive tax reform effort might be best spent identifying and trying to quantify the effects of the present tax system on the economy and on income distribution. Once you do that with most tax systems, you have self-presenting arguments for reform. Without some evidence--without numbers--I think that there are not any of us persuasive enough to sell an idea by itself. As attractive as the idea that was sold in Indonesia is--it was sold by numbers and by hard evidence.

The seventh lesson is that, if you are serious about tax reform, you must recognize the importance of preparing full scale draft laws of the projected tax system once the basic decisions have been made by the decision makers. Then you sit down and actually put together draft laws of the tax system that reflect these decisions.

An eighth lesson is that it is often easier to have tax reform if you are in the process of doing a number of other policy reforms. Fortunately we can look around the world and see a large number of countries, even Africa now, that are engaged in a series of policy reforms ranging from current expenditures to subsidy reform, financial reform, exchange rate policy reform, trade policy reform, and tax reform. The Indonesian experience suggests that, when tax reform happens in the midst of a sequence of other reforms, it seems to work much better. But you have to be very careful where you put tax reform in the sequence and I'll be glad to address myself to this question later. There are no set rules, you just have to be conscious of what is going on elsewhere on the policy front, particularly in regards to exchange rate policy and a few others.

The last lesson may disappoint you and that is that the Indonesia experience may not be all that relevant to other countries. I happen to think that it is, but you need to know one element in the Indonesia experience that may be rare elsewhere. Continuity in decision making in economic policy is critical for the success of policy reform. You have it in Indonesia. The people in charge of economic policy in Indonesia have been in charge for 17 years. They know what they are doing. They have seen other experiments fail, they know from experience what works and what doesn't work. They are willing to lead with their chins when they believe strongly that a given reform will improve growth and equity and efficiency. I think that this was extremely important. It was their reform; we were the technicians, and we had definite ideas, but it was their reform. This continuity, I think, explains 75 percent of the apparent success. When I look around I don't see that kind of continuity in most countries. I see finance ministers (the finance minister is the key of course) with tenures of months, not years. This I think, causes us to be a little more humble when we talk about what the prospects are for a successful tax reform elsewhere.

CHAPTER THREE

ISSUES IN TAX REFORM

Charles E. McLure, Jr.

I confess to feeling somewhat of an imposter at this conference, since I have not been involved in tax reform in a developing country since I worked in Jamaica in 1983, before going to the U.S. Treasury Department.

What I am going to say today will draw to some extent on the Treasury efforts in tax reform, but obviously I will attempt to concentrate on those lessons that have applications in developing countries. For example, I will not say much about such problems as tax shelters that plague us in this country. In most developing countries, you do not need to be so elaborate to beat the tax system. But I think that much of the same motivation for tax reform that drove the Treasury Department proposals for tax reform are also relevant in developing countries.

A Typical Tax System

Let me begin by describing what we might call a typical tax system for a developing country. Rather than trying to be all-inclusive, I will just describe a few of the important characteristics that one is likely to find in various countries. I will focus primarily on countries that do not have substantial natural resources. Obviously, a country that is rich in natural resources will likely tax those very heavily; therefore the tax on what might be called the pure domestic part of the economy will be somewhat more limited. For that domestic part this description is probably applicable, but less important.

First, it is likely that one would find income tax rates that are fairly high and progressive. Certainly that was the case in the two countries we discussed this morning. One does not know for sure, but I suspect this is a legacy of advisors from the developed countries travelling around the Third World at some point in the past, maybe in the 1940s or the 1950s, selling high and progressive rates to achieve vertical equity.

The second thing that one is likely to find is a tax base riddled with exclusions, exemptions, preference--what we commonly call loopholes. Malcolm Gillis talked about termites this morning. Well, usually it is not just termites; rather the tax base is more like Swiss cheese. It has been chewed apart and relatively little of the ideal potential tax base is being taxed. To some extent this is the result of conscious decisions, but to some extent it is not; the holes simply represent the system running downhill, perhaps from a low starting point.

In many countries one does not find inflation adjustment in the tax system. If there is no adjustment of bracket limits and other values that are fixed in nominal terms, you have bracket creep. That is what we saw in Jamaica. I seem to recall that in 1983 Jamaica applied the same tax rates to a given dollar amount of income as it did in 1973 when I was first there and the Jamaican dollar was worth something like US$1.10. Now the exchange rate is something like 5 to 1. And, of course, the U.S. dollar is not worth as much as it used to be either. So the structure that may or may not have made sense in 1973 made absolutely no sense 10 years later.

The other part of inflation adjustment, which is probably the more important part, is that ordinarily there is little adjustment for inflation in the measurement of income from capital. That is, if the country is taxing capital gains, it is probably taxing only nominal capital gains with no adjustment for inflation. And, of course, many countries do not have indexing of depreciation allowances; nor do they allow the use of LIFO (last-in-first-out) inventory accounting; hence, in a period of inflation one is really not recovering capital costs tax-free. Countries may have some kind of ad hoc adjustment for depreciable assets that works fairly well at a given rate of inflation, but at any other rate of inflation the adjustment is wrong. So, again one gets mismeasurement of income. Very few countries allow indexing of interest expense or indexing of debts. It can turn out that one is either over- or undertaxing capital income in total, because of the interaction of these terms; but quite often it is overtaxation.

Another thing that one tends to find in these tax systems is what I would call unproductive complexity. That is, there is too much fine tuning. As Roy Bahl mentioned this morning, in the Jamaican case there were 16 little credits before tax reform; because of inflation, these credits really amounted to very little. But there were 16 of them, they were complex, and people had to collect the paper and file it with their tax returns or keep track of it. The tax administrators wasted time looking at the paper and auditing them. In other words, what happened was a considerable amount of complicated fine tuning that really did not do much for the taxpayer or for the fairness of the system.

One might well ask, "So what? What results from this?" There are a variety of results. To begin with, there is distortion. One finds that there are tax-preferred investments and tax-penalized investments, with tax preferences for particular investments quite often reflecting incentives. It may be natural to believe that the tax rate is so high that no one can operate in the absence of incentives for various activities--tax holiday, accelerated depreciation, or first year writeoff. (The human mind is quite amazing in its ability to think up dumb systems of providing incentives. Each country seems to be capable of devising a new incentive program.)

Moreover, incentives generally provide preferential treatment to particular activities. In other words, somebody is using the tax system to override the dictates of the marketplace. Some bureaucrat or politician is saying "Wouldn't it be a good idea if we did the following thing." Well, I have a general rule: if somebody says "Wouldn't it be a good idea...", the answer generally is "No, it probably would not be." One can see that in this country, too; read letters printed in Tax Notes sometime to see the kind of dumb ideas that people come up with.

Some of these features of tax systems are explicit and intentional, but some are just accidental. There is tax favoritism for various kinds of consumption. That is, if one consumes a certain item, he or she can deduct it, or the producer will be given an extraordinary deduction which results in almost the same thing as giving preference to the consumer. Again, people's preferences are overridden. Various forms of financing are often treated differently, so that financial decisions are skewed. Since quite often this accompanies distortions in financial markets (which means that the markets are not working very well to start with), it is difficult to know whether a given tax distortion makes things better or worse. But certainly it is not neutral.

Another thing one finds is horizontal inequities. That is, if income is earned in one way, it is taxed; if earned in another way, it is not taxed. This may be because the tax law provides for preferential treatment, or it may be as a result of evasion. In some ways, in some sectors or in some occupations one can evade taxes and in others one cannot; but in any event inequities abound. Those inequities not only destroy the actuality of fairness but they create the perception of unfairness. This means that everybody else thinks it is acceptable if they cheat, and the system runs downhill.

That is on the income tax side. One can find some of the same things on the indirect tax side. Although that is not the focus of my presentation, it should be noted that in many countries one will not find a comprehensive, sensible value-added tax or other kind of reasonable broad-based tax like a retail sales tax or even something like a manufacturer-level tax. Rather, what one will find is a system or nonsystem of excises--just a grab bag of excises on various things, the way it was in Jamaica. On the other hand one might find a turnover tax of the type Malcolm Gillis mentioned--every time something is sold, it was subject to tax. Of course, that has the well-known defects in terms of creating distortions and incentives for vertical integration that reduces competition.

Turning to tariffs, one again finds great diversity. From the economist's point of view the system should have a fairly uniform rate of tariffs, not rates that vary all over the board. Wide differentiation in nominal rates results in very substantial differences in effective protection being accorded different activities. Such a system overrides comparative advantage in a way that depends upon the structure of nominal tariff rates and input-output relations.

The preceding brief description suggests that the tax systems commonly found in developing countries fail to achieve what should be the primary purpose of taxation--to mobilize resources efficiently. The public sector will always have a need to raise revenue; that task should be accomplished as efficiently as possible. I think all of us would agree that there are many times we should cut out certain government expenditures, but such a discussion is not really our purpose today; thus in the rest of my discussion I am going to leave aside the questions of whether or not the government is too big; whether or not it is wasteful; or whether or not it is doing things that are beneficial to lower income groups as opposed to upper income groups. Instead, I will focus on efficiency.

This efficiency involves several things. First, tax administration and compliance should not be terribly onerous or expensive. That is, it should be feasible for the taxpayer to comply with the law relatively cheaply, without having to jump through too many hoops. And the administration should be able to know whether or not the taxpayer is complying with the law without spending a large fraction of the proceeds just to collect revenues.

And yet, that is not the only aspect of efficiency; indeed, it is not necessarily the most important one. The one that usually concerns economists the most is, of course, the idea of avoiding economic distortions. Most economists believe that markets do fairly well in allocating economic resources. As a result, it may be fairly difficult to use the tax system to achieve positive goals. But we can, I think, prevent it from having a negative impact by collecting taxes in a way that causes decisions in the private sector not to be distorted.

Tax Reform Criteria

Based on this quick description of what we might find in tax systems around the world and what is wrong with them, I want to turn briefly to a discussion of what I think are the important criteria of tax reform. You will see that they do repeat some of what I have just said.

The first criterion, perhaps most important on my list, is economic neutrality. It probably does not surprise you that I believe in the power of free markets to allocate resources fairly well and that, by and large, one is better off not to try to override those free market decisions by using the tax system to engage in some kind of industrial policy put together by bureaucrats and politicians. This view is probably somewhat less valid in developing countries than in the United States, since in developing countries there are so many nontax distortions. In fact, perhaps the tax system should sometimes be used to overcome or compensate for distortions that cannot be eliminated. But I would still generally try to be more neutral, and try to compensate for some inevitable distortions only as a last resort. Using the tax system to compensate for distortions can lead to less than rational policies. For example, one might say "Since labor unions are causing labor to be artificially expensive and inducing capital-intensive production, let's levy taxes on organized labor to offset their greed and prevent too little of that kind of labor from being used." I think we all agree that that kind of compensatory policy sounds a little crazy.

An aspect of economic neutrality that is important enough to mention separately is the benefit of avoiding disincentives--that is, the disincentives that high tax rates have on work effort, saving, investment, invention, etc.

I concur with what Malcolm Gillis said this morning; we would be better off if we did not have most tax incentives. Now somebody might ask whether my belief in free markets doesn't mean that I am a supply-sider, and doesn't that mean that you should have tax incentives to get some supply-side effects? Well, I think not. The way I characterized the answer when I was at Treasury was to say, I'm a supply- <u>and</u> demand-sider. That is, I think that we should aim for where the supply and demand curves cross naturally, unless there is some good reason to think that the curves give us an inaccurate reading of costs and benefits of various activities. So I would say let's eliminate most tax incentives.

The second objective would be that of horizontal equity, that is, equal treatment of those in equal circumstances. If those in equal circumstances are taxed differently, it is unfair and it creates the perception of unfairness. Horizontal equity and economic neutrality are generally compatible goals; if one taxes everything the same way, one tends to get both economic neutrality and horizontal equity. If one does not tax everything the same way, one gets both distortions and horizontal inequities. As I indicated earlier, it may be more difficult to achieve this objective of uniform taxation in developing countries than in the United States. That is, given the political will in the United States we might, in principle, be able to achieve horizontal equity. In a developing country one has real trouble doing this, partly for tax administration reasons. For example, as Roy Bahl mentioned earlier, professionals and other occupations are often hard to tax; it is difficult to achieve horizontal equity with such hard-to-tax occupations. Another difficulty lies with urban-rural differentials. It is likely that one can get further imposing tax in the urban area than in the rural area, except through such vehicles as export taxes and marketing boards.

I have little to say about vertical equity, since it does not lend itself to scientific discussion in the same way that horizontal equity and economic neutrality do. I think that in most countries the goal should be some form of mild progressivity and the avoidance of regressivity. Regardless of what one happens to think about the issue from a personal point of view, I think it is a political necessity that there be at least mild progressivity. Now that does not necessarily mean the adoption of graduated rates. The Jamaican system is progressive because it has the lump sum exemption and then a flat rate above that. The Indonesian system is presumably more progressive because it has graduated rates.

Another objective of a tax system should be simplicity. Achieving simplicity is difficult in a developing country, and it does not mean the same thing as it does in a country like the United States. Tax administration in developing countries is plagued by the lack of highly organized commercial markets. If market activity consists of street stalls and casual work, it is very hard to collect sales taxes or payroll taxes. Often there is inadequate bookkeeping; and it is very difficult to collect taxes without adequate bookkeeping. And of course the tax administration itself may be poor, in part because the general level of education is low and in part because public servants' salaries are low. Often tax administrators' salaries cannot be higher than those in the rest of the government, and that causes tremendous pressure. Having somebody who is not very well paid looking after a system that is taking a vast amount of money from others creates the opportunity and the attraction of corruption.

I believe the bottom line with regard to simplicity, though, is that one should not try fine tuning. One does not want to try to take something like the present U.S. system and translate it to a developing country; to do so would be an absolute disaster. Even if the U. S. system made sense, in principle, it would not make sense in a developing country, because the tax administration simply could not handle it. Instead, we must try for rough justice, recognizing that the objective is to collect some money in ways that are not too bad.

Turning to the question of taxation and development, I agree with Malcolm Gillis that the best thing we can do is to adopt low rates. That will give us greater incentives for work efforts, saving and investment. Any distortions that are left will be less important with low rates than with high rates. And of course those distortions are very important; if we can avoid the distortions we will avoid wasting resources.

The question was raised this morning of how to tell whether the expenditure on tax reform is justified. Since the tax system can have substantial leverage on decision-making, if the tax system can be improved enough to keep bad decisions from being made, tax reform can pay for itself. Let me give an easy example. It will be a U.S. example, but I think one that can be translated to developing countries. If we can prevent one empty office building from being built through tax reform, we will have paid for the efforts of tax reform.

Now somebody might say "Well, why do you want to avoid incentives? Don't you think that we should encourage various activities for the sake of economic development?" My answer generally is "No." And again, I can illustrate that with a very simple example. Give me enough tax incentives and I can raise orchids in Alaska (and maybe raise salmon in Hawaii--although I am not sure about that latter). Everyone would agree that this would not make much sense. Much of what is achieved with tax incentives basically flies in the face of comparative advantage.

I saw this in Turkey recently; it appears anything that the country does "naturally" is taxed at a full rate. Anything that is not indigenous gets an incentive. In other words, if a comparative advantage exists, the product will be taxed. If a natural comparative advantage does not exist, the system will provide an incentive. The way I learned international trade, such a policy is not sensible. You ought to play <u>to</u> comparative advantage, not play into its teeth. Avoiding distortions, avoiding the waste of resources, will go a long way toward getting reasonable economic development. If one tries to force things that do not come naturally, there is a pretty good chance to make a mistake.

Another objective would be to make tax systems inflation proof. Here I do not mean the bracket limits; I mean the measurement of income. If the tax system is not inflation proof, then it is not what it looks like. That is, it may look like a given tax rate is 50 percent, but in fact the rate of tax on economic income may be 10 percent or 40 percent or 90 or 150 percent, depending on the rate of inflation. Alternatively, the rate may be negative. It does not make sense for the results to depend on the rate of inflation. Moreover, it's very likely that accompanying this problem will be nonneutralities, horizontal inequities, and retarded development.

Income Tax Reform

Now let us look at some of the policy implications of the preceding discussion. First, what should one look for in the income tax? The phrase I used repeatedly in talking about the U.S. income tax was that we should try to tax all real economic income uniformly and consistently and at low rates. That sounds like a reasonable idea, but the implications are far-reaching. First, all income must be taxed in order to achieve neutrality, horizontal equity, and low rates. If you do not tax all income, you cannot achieve any of those objectives. Obviously one should avoid most exemptions, preferences, and exclusions, by whatever name.

One way to get this point across is to see that it is much better to tax all income at a rate of 30 percent than to tax 60 percent of income at a rate of 50 percent. Again, going back to the example of the allowances that Roy Bahl mentioned this morning, I think there is a good chance that untaxed allowances are more or less fixed while the taxable part of income varies with the effort. What does that imply? Rather than having low rates on everything (the 33 1/3 percent in Jamaica's case), what is taxed must be taxed at a much higher rate (the 57 1/2 percent rate). That kind of policy just doesn't make any sense; it is far better to have a rate that is lower on all income.

Let me add that the corollary of this rule is that one should not tax income twice, especially the taxation of corporate income (a subject we may not be able to address today). In addition, I have already said that inflation adjustment may be necessary, particularly with a high and variable rate of inflation.

Now let me turn quickly to the problems with the income tax, and then talk about an alternative. One problem with an income tax is that it is very complex, or it is potentially complex. And the complexities fall in two, or maybe three, areas. One is that measuring income is not easy; in particular it has to do with such things as the right rate of depreciation allowances. With assets that last more than one period, should one allow expensing or should they be written off over time? Moreover, when do you recognize income? These all may sound like simple questions, but they are not.

The second complexity with an income tax is that one must have inflation adjustment to measure income accurately; and yet inflation adjustment is not easy; it adds to the complexity of the system. Another complexity is the desirability of integrating corporate and personal taxes, but we won't have time to address that today.

Another kind of problem with the income tax is that there is a bias against capital formation. The one that we usually think of is the bias against saving; in fact, this may not be too important, since I suspect that the relevant elasticities are not very great. What is worth worrying about is the problem of capital flight that was mentioned earlier this morning. If a developing country taxes income from capital, and interest income in particular, but the countries in the developed world do not (either because they have bearer bonds or, as in the United States, there is no withholding on bank interest), then those who have money to invest will be more inclined to put it in New York or Zurich or someplace else instead of into their local economy. This is an issue that has not received enough attention.

The obvious alternative to the income tax is a personal tax on consumption. By that I do not mean a value-added tax; I mean a tax on income that is consumed. One can find more complete descriptions of such a tax in the volume Blueprints for Basic Tax Reform that Treasury did back in 1977, in the Meade Commission Report in the U.K., or Bob Hall and Alvin Rabushka's proposal for flat rate tax. The obvious advantage of this kind of system is that it does not need inflation adjustment. Also, there are many fewer measurement problems; corporate tax integration occurs almost automatically; and there is no bias against saving.

We do not usually find situations where everything is good and there are no bads, so what's wrong with a consumption-based personal tax system? I see a couple of problems. One is that it is untried. We all may think we like a consumed income tax, but it has never been tried except for a few days in Ceylon a long time ago, and we are not sure that we know what all the problems are. There are potential international problems. Under the Blueprints approach, the possibilities of evasion via international transactions (particularly with suitcases full of money) may be substantial. Also there may be treaty problems or problems of dealing with double taxation. Especially troublesome is the risk that the United States and other developed countries might not allow their corporations foreign tax credits for consumption-based taxes. Finally higher rates are likely to be needed if consumption is taxed instead of income, since usually income is larger than consumption; certainly it is over the long run.

I must note that there is a dangerous middle ground between the income tax and the consumption tax. I say this because there's all too much a tendency to seek that middle ground. Within a system of an income tax, the proper way to treat interest and depreciation is to use economic depreciation, (i.e., tracking the way assets actually depreciate), allow interest deduction by the firm, and then tax interest income of recipients. With a consumption tax, on the other hand, one should have expensing of capital investment, no interest deduction, and no taxation of interest income. The result is that with an income tax one will levy a tax on a base that equals economic income, and the effective tax rate equals the statutory rate. With a consumption tax one is really not levying an income tax at all; the effective marginal tax rate is zero under a consumption tax.

The danger of a middle ground comes with what I call the mix-and-match strategy. Notice what happens if you allow both the expensing of a consumption tax and the interest deduction of an income tax. Expensing and interest deduction together mean that the company involved has a negative effective tax rate. Such policies should give you pause. How can one expect good economic resource allocation with a negative tax rate, particularly if this kind of provision applies only in certain sectors? Does one really want to make the private rate of return above the social rate of return? Or in a more extreme case, does one really want to give a positive rate of return to the taxpayer if, from society's point of view, it's negative? It may even be that the tax rate may be negative as seen by the economy as a whole. Again, do you want to have that much encouragement of investment? I do not think that it makes sense to do so.

Turning quickly to reconsidering incentives and tax holidays, I believe they will result in distortions and the kind of mix-and-match problem described above. Moreover, they ordinarily fly in the face of comparative advantage. Depending on how they are structured, these incentives may also give rise to corruption, as there's an incentive to bribe the civil servant who is responsible for granting the incentives. At the very least, incentives will result in further complication. Descriptions of incentives are quite complex and hence complying with them adds a lot of complication to the system. Moreover, they are open to manipulation. Suppose that income from a certain endeavor is to be exempt; a firm may put together some subsidiaries, one of which is in the exempt activity, and others of which sell to that activity and buy from it. If the accountant is halfway competent, all of the income will be lodged in the exempt sector and there will not be any income in the taxable part. That obviously creates revenue loss, in addition to inequities and distortions that are not consistent with our goals for the system.

CHAPTER FOUR

INTERNATIONAL MONETARY FUND PERSPECTIVES ON TAX POLICY ADVICE[1]

Ved Gandhi

I must thank the organizers of the conference for having invited me. It has been an educational experience; at the same time it has been a shocking experience. It has been educational because I have learned from Bahl's, Gillis's, and McLure's presentations that tax reforms require extensive studies and take many years. It is shocking because we at the Fund cannot afford the luxury of spending that much time and money. It is only AID, with plenty of money and advisors, that can afford these extensive studies. We are fortunate, however, in being able to make use of USAID's expertise.

What I intend to do in this brief presentation, is to demystify the Fund for you so that you know what it does and does not do as far as tax policy is concerned. In order to do this, I will discuss five questions that I think you would like answered.

- What does tax policy have to do with the Fund?
- What are the objectives of Fund tax policy advice?
- Does the Fund have some "favorite" tax policy instruments to achieve its objectives?
- What about the criticisms that have been levied against the Fund "tax packages?"
- Is the Fund in any manner constrained so as not to give the soundest possible tax policy advice?

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[1]Views expressed here are solely those of the author and not necessarily those of his employer.

Tax Policy and the Fund

What does tax policy have to do with the Fund? Tax policy is an integral part of Fund-supported stand-by programs. As you know, these programs aim at reducing balance of payments deficits and achieving macroeconomic equilibrium. While not often part of "conditionality," new tax measures may become "prior actions" before a stand-by request is taken to the Executive Board. This means that the tax measures must be announced and legislated before the stand-by program is taken to the Board for consideration.

We advise countries on tax policy matters in four ways:

- Through the Fund consultation missions or Fund stand-by missions which deal directly with balance of payments problems.

- Through technical assistance missions when a country requests us to look at the tax system and advise on either tax policy in general, or on certain aspects of it. These technical assistance missions are sent only at the request of the member country's government.

- Through research in tax policy. The subjects for this tax policy research frequently emanate from Board meetings' discussions, or from mission work.

- Through courses for member country officials at the IMF Institute; tax policy subjects are covered in courses on public finance, financial policy, and balance of payments methodology.

What is not always realized is that tax policy changes adopted by a member country are that government's own, not ours. We are advisors, like Professors Bahl and Gillis are advisors. Our advice is rejected as frequently as is theirs. This is because tax policy advice must be politically and socially acceptable, and only the politicians and policymakers can make those decisions. We only seek to ensure its economic relevance and revenue reliability in the context of our stand-by programs.

So, what does tax policy have to do with the Fund? Balance of payments equilibrium frequently calls for containing budget deficits. Containing budget deficits calls at times for revenue increases. Revenue increases call for tax policy measures and someone has to ensure that these measures are economically sound and will continue to yield revenues, so that the budget deficit will not re-emerge. Essentially we look at these two aspects, and our role is to review the tax policy proposals made by the authorities and to help them rethink, if necessary.

Objectives of Tax Policy Advice

What is Fund tax advice generally aimed at? Theoretically, taxation can be an instrument of multiple objectives. However, given the Fund's terms of reference, namely, stabilization, certain objectives become more important than others at the time of stand-by negotiations. These are

- increase in revenue in the short-run, to meet the budget deficit;
- ease of administration; and
- effect on the balance of payment problem.

At the time of stand-by negotiations we generally do not advocate fundamental tax reform, e.g., the adoption of a value-added tax, which requires a substantial amount of prior preparation. Tax measures must address the balance of payments problem directly and indirectly. For example, if the problem is caused by excessive oil imports, then any tax instrument that will help discourage the consumption of oil or the importation of oil is welcome. However, we do recognize other objectives, namely, incentives and resource allocation, expansion of tax base, and equity; any or all of these objectives are welcome.

When we send out a technical assistance mission, the situation is different. That mission may take into account equity, incentive, and resource allocation objectives or any other objective that the government has in mind. As we go there at the request of the government, the government can specify its tax reform objectives. In one country I visited a few years ago the authorities wanted to promote private incentives. Nothing else mattered, not revenue, budget objectives, or equity. So we wrote the report on how to restructure tax policy to encourage private enterprise. In another country the authorities said income distribution was their most important objective, so we wrote the report in support of the income distribution objective.

Thus, the objectives of Fund tax policy advice tend to differ from country to country.

"Favorite" Tax Policy Instruments

Does the Fund have favorite tax policy instruments to help achieve its objectives? Given our "priority" objectives, primarily to solve a short-term budget deficit problem, there are a few favorite instruments, I must admit. Frequently a government says yes, they have a revenue problem, but they will improve their tax administration. However, we can never be certain of a major revenue effect of improvements in tax administration in the short-run. Therefore, we do not normally rely upon or accept the improvements in tax administration to reduce a large budget deficit.

Having said that, what do we readily accept? An increase in excise duties: an increase in taxes on liquor, tobacco, and petroleum products. The taxation literature tells us that liquor and tobacco have inelastic demand and that their consumption is socially unacceptable. Why petroleum products? Well, frequently to discourage their consumption and reduce the importation of petroleum products which is generally an important reason underlying the balance of payments problem. Of course, many governments do not like to raise excise duties on liquor and tobacco, on the grounds that they will result in an increase in the prices of these goods often consumed more by the masses than by the relatively well-to-do. In most countries, petroleum price is also a politically sensitive subject.

An increase in the sales tax. An increase in sales tax rates is fine; an increase in the rate differential is better; an expansion in the sales tax base by removing exemptions is even better.

An increase in import duties. We accept an increase in the rates of import duties or the levying of an import surcharge in the short-run, especially if the exchange rate is overvalued and the governments are unwilling to make the necessary correction; an expansion of the tax base by generally or selectively removing the exemptions from the customs duties is also welcome. But we impress upon the governments that these must be temporary solutions, because the Fund's mandate is to promote freer trade. We believe that raising the rates of import duties is protectionist and undesirable. They should be reduced because of their adverse domestic allocational and developmental implications. If the government is willing to accept devaluation or exchange rate reform, we even encourage a selective or general reduction in the rates of import duties, because, in some sense, the customs duty base expands by having an exchange rate reform.

An <u>increase in user charges</u>. We welcome any user charge increase. Frequently telephone rates, electricity rates, water rates, education fees, health fees, etc., are lower than the marginal cost of providing them resulting in large budgetary subsidies. A reduction of these subsidies is always welcome.

An <u>increase in government enterprise tariffs</u>. We also welcome these increases because much of the budget deficit in member countries results from the deficits of public enterprises. Therefore, any price increases which will cut their deficits and losses are desirable.

We often ask member countries' governments to reduce the budget deficit by reducing wage expenditures, cutting subsidies and other nonessential expenditures. But governments find this difficult to do, due to social and political implications. As a last resort, then, further revenues may need to be raised from other taxes. This sometimes means raising the corporation tax rates and levying an income tax surcharge. More often than not, the bases of the income and corporation taxes should be reformed and broadened before raising their rates; but this cannot be carried out unless a comprehensive tax reform study identifying what needs to be changed has already been done. Thus, hesitatingly and as a last resort, and hopefully only temporarily, we agree to increases in rates of income and corporation taxes.

I have stated what the Fund staff likes and what it accepts hesitatingly. The Fund staff does not like:

- Taxes on foreign exchange sales. These taxes become trade and exchange restrictions on freer trade.
- Taxes on exports (mineral exports or agricultural exports) and foreign exchange earnings (tourism, shipping, etc.), unless they follow a devaluation and help the government pick up some of the resulting windfall incomes. These taxes or increases in their rates should only follow exchange rate reform.
- Taxes on bank checks or monetary instruments. Encouraging the monetization of the economy is preferred.

Criticism of Fund Tax Packages

Have any criticisms been levied against the Fund tax packages? Before answering that, let me reiterate that the tax packages adopted in the context of the Fund-supported programs are not the Fund's, but the country's own. However, I will admit that lately some criticism has been levied against the tax policy packages adopted by the governments under the Fund-supported programs; this criticism can be summed up as, "How about some other objectives?" Supply-siders ask us, "How about the resource allocation objective and the objective of reducing the size of the government and getting governments off the backs of the people?" Politicians from the developing countries ask us, "How about income distribution objectives? The Fund-supported programs call for demand contractions, wage freezes, subsidy cuts. Must they also simultaneously involve raising taxes?"

Most policymakers dislike additional taxes, and, of course, they do not want to reduce expenditures. We usually argue that a budget deficit needs to be cut by a certain amount in the interest of demand management, stabilization and inflation control, reducing pressures on interest rates, and avoiding "crowding out" of private sector recovery, etc. The choice between expenditure cut and tax increase is then left to the member country's government to decide. This is also why, in the final analysis, tax packages are really the government's own.

The charge that we ignore income distribution is unfair. We encourage the authorities to adopt tax policy packages which not only yield needed revenues but also further as many other desired objectives as possible, including income redistribution. Furthermore, if a government sees income distribution as the primary objective of tax reform, we provide technical assistance with that in mind.

Finally, in recent years we have started thinking how a given short-run revenue target, in support of reducing the budget deficit, can be achieved more equitably. We have recently published a study that looks at the relationship of Fund-supported programs with income distribution objectives and concludes that policy packages can certainly be reformulated to achieve greater progressivity while achieving the same revenue target.[2] More equity, for example, can be achieved by increasing sales tax rate differentials; by increasing taxes on income-elastic services (hotels, restaurants, electricity, telephones, travel); by increasing excise duties on luxury products irrespective of whether they are imported or

[2] Fund-Supported Programs, Fiscal Policy, and Income Distribution: A Study by the Fiscal Affairs Department of the International Monetary Fund, Occasional Paper No. 46 (Washington, DC: International Monetary Fund, September 1986).

domestically produced; by increasing the burden of land and property taxes through revaluations of properties to bring them up-to-date; by removing import quotas and bans and replacing them with import duties (that is, converting private windfalls into government revenues and illegal trade into legal trade); by broadening the income tax base beyond wages and salaries (which means removing tax incentives and other exemptions, such as agricultural incomes and interest on government securities); and by broadening the base of the corporation tax.

And the incentive effects? The complaint is that we do not worry about them. We have recently carried out a research project on supply-side tax policy, the basic conclusion of which is that if governments are courageous enough to carry out fundamental base-broadening tax reforms, tax rates can be lowered significantly, not only income and corporation taxes, but also customs duties, sales taxes, excises, and export duties, in fact, any tax. This is because of the large and widespread leakages in the tax base one frequently finds in developing countries where the nominal rates are high.

Constraints

Is the Fund in any manner constrained so as not to give the best or soundest possible tax policy advice? Yes, it is. There are a lot of constraints on tax policy formulation in developing countries and tax advisors should be aware of these. Some constraints are, of course, inherent in the very nature of short-term objectives, namely, the urgency of achieving stabilization, acquiring revenue with ease of administration, containing the balance of payments deficits, etc. The inadequacies of tax administration act as yet another constraint and limit the scope of tax policy reform.

There are even bigger constraints, frequently the result of "wrong" government economic policies, wrong at least from the tax policy advisor's point of view. Frequently there are massive quantitative restrictions in practically all developing countries. They contract the import tax base and generate illegal incomes which go untaxed. They benefit urban areas more than rural. Overvalued exchange rates are also quite prevalent in the developing world. They, too, contract the import tax base and export incomes as well as contract income growth. Administered interest rates are prevalent in most of the developing world and they too lower the income tax base and result in a clamor for liberal tax incentives for savings as a compensation. Distorted wage and income policies are also commonplace and frequently have to be compensated for by income tax exemptions and reliefs. Incentives and reliefs are sought for wages and dividends wherever they are constrained.

Removal or reduction of any one of these distortions, all relating to nontax economic policies, will release developing countries' tax policies from their bondage. Certainly whenever I go to these countries I, as a tax policy advisor, feel bound: I cannot give the right tax policy advice because many member countries' macroeconomic policies are wrong. We are not always successful in getting these countries off the track; there are always political and social reasons why interest rates cannot be raised beyond their administered levels, why exchange rates cannot be changed from their overvalued levels, why wages and incomes must remain distorted, or why monetary policy must remain expansionary. Given such realities of life, we tax policy advisors must acknowledge the obstacles that exist to instituting tax reform and making tax policy an instrument of economic efficiency.

CHAPTER FIVE

HIGHLIGHTS OF DISCUSSION

Larry Schroeder

As one might anticipate, the preceding papers elicited considerable discussion during the one-day conference. This paper attempts to summarize the discussion by highlighting the several major points which arose during the question and answer sessions. Of particular interest are those areas in which there remains much more to learn about the process and results of tax reform in developing countries.

The presentations by Bahl, Gillis and McLure suggest a commonality in the objectives sought in tax reform efforts and in the lessons learned thus far. While these long-term objectives were not disputed in Gandhi's presentation, he emphasized that the International Monetary Fund must often cope with shorter term objectives and must do so in a much shorter time frame than was the case in Jamaica, Indonesia or in other developing countries engaging in comprehensive tax reform.

Themes

Several major themes emerged from the Bahl, Gillis and McLure presentations. Eliminating market distortions caused by existing tax systems was one objective continually repeated in these presentations. While the IMF is not unaware nor unconcerned with such distortions, commonly the immediate goal sought in their tax-related efforts is revenue enhancement.

A second theme found in each of the papers is a desire for simplicity. In part this theme is related to the inefficiency effects noted above; but it also relates to the importance of tax administration. The flat rate, broad-based income tax recommended in the Jamaica case and the single rate value-added tax imposed on all imports and largest producers in Indonesia were offered as reforms compatible with concern for simplicity. The authors recognize that administrative difficulties, particularly those due to complex rate schedules, not only may lead to unexpected and undesired disincentive effects, they are also likely to result in significant horizontal inequities. Furthermore, the authors emphasize that long-term tax reform efforts must include attempts to improve the administrative capacity of the tax collection agencies lest alterations in the statutory tax structure produce no lasting effects on the effective structure of taxes.

Again, the Gandhi presentation stands somewhat in contrast to these themes. Improving administration, being a long-term effort, is commonly not a primary concern to the usual shorter term objectives of the IMF, although the choice of fiscal instrument may be influenced by its administrative ease. Likewise, the Fund may be much more willing to sacrifice simplicity of structure so as to attain its goals of revenue yield, international trade stimulation and redressing balance of trade problems.

A third theme, emphasized particularly in the two case studies, is that tax reform in developing countries must be viewed as the country's own reform effort. The reform process is sufficiently traumatic that, if it is viewed as being externally imposed, it is highly unlikely to lead to long-term success. This means that external "experts" conducting studies must work in concert with the host country and provide clear choices for those ultimately responsible for making policies. Essentially, the external team of consultants act as policy analysts, providing the analytical foundation for the government's final policy package. As such, the effort must be a sustained one with continuous contact between the analysts and policy makers.

The one theme that was repeated by each of the participants and that created no disagreements was the importance of empirical analysis underlying tax reform efforts. It was recognized by all that analyses based on hard data would allow policy makers to be more confident that the policies formulated would have the desired economic and political effects.

Discussion Issues

Conference participants raised several issues in the course of the discussion. This is an attempt to outline the primary issues raised and summarize the general response by the speakers. As one might expect, there was not always complete unanimity among the experts.

Income Redistribution

Several times during the day questions arose expressing concern that the effects of tax reform, along the lines described in both Indonesia and Jamaica, might exacerbate maldistribution of income in Third World countries.

All of the conference speakers recognized that both the revenue and expenditure sides of a budget have redistributional effects. It was the opinion of Bahl, Gillis and McLure, however, that it is not desirable to attempt to rely heavily on the revenue side of the budget to redistribute incomes. In order to achieve income redistributional objectives through tax policies, complex tax structures with highly progressive statutory rates are necessary. Such rates, in turn, heighten the desire to avoid or evade taxes and greatly complicate administrative procedures. Furthermore, there are strong political pressures to provide exemptions and allowances enabling particular groups of taxpayers to enjoy relief not available to other taxpayers in otherwise similar circumstances. Once provided, the tax base is narrowed, thereby diminishing the tax yield potential of the tax system which, in turn, creates even greater pressure for further increases in the rates.

Instead of relying entirely on the tax system as a redistributive tool, these speakers noted the importance of the expenditure side of the budget. In this context, Gillis explicitly mentioned the redistributive potential of primary education, irrigation and water supply.

Gandhi was less sanguine about the possibility of relying more heavily upon expenditures and less so on taxes to reach a desirable net redistribution of incomes. He suggested that the IMF consultancies commonly must recognize the political pressures to continue to rely heavily on taxes as a redistribution tool.

During the course of the discussion it was noted that by allowing low income earners to escape income taxation through exemptions, income tax rates are still, overall, progressive. For example, in Indonesia the income tax structure was designed to exclude the poorest 85 percent of all families from the income tax. Likewise, given that much consumption by low income households in developing countries is outside the formal sector, value-added or other sales-based taxes can also be progressive.

Tax Incentives

Another issue arising during the discussions concerned abolition of tax incentives. Some participants felt that such a policy would harm investment in the country and thereby slow economic growth. The authors of the papers argued that lower rates would provide a more efficient stimulus to economic growth while avoiding possibly inequitable tax differentials. Gillis noted that foreign investors in Indonesia are no longer seeking re-initiation of tax incentives and that economic, as well as revenue, growth under the lower rates has been strong.

Additional discussion regarding the efficacy of tax incentives centered on the economic performance of several Southeast Asian countries (e.g., Singapore and Hong Kong) which have provided tax incentives and have experienced very favorable economic growth. McLure noted that, unlike countries which have used tax incentives to encourage exports, many developing countries have attempted to use such incentives to promote import substitution by protecting domestic industries which do not enjoy comparative advantages. It was also indicated that at least Singapore, Hong Kong and Taiwan have very low tax rates, hence tax incentives do not create the kinds of distortions found in countries with high statutory rates.

Other Macro-economic Policies

One issue recognized as important by all the participants is that taxes are commonly only one in a long series of economic distortions found in developing countries. For example, exchange rate policies are often "wrong"; prices may be controlled through marketing boards or public enterprises and do not reflect resource costs; and monetary and interest ate policies are commonly inappropriate.

Although the speakers were cognizant of this issue, no fully atisfactory solution could be provided. Bahl noted that the terms of eference for the Jamaican project clearly provided that tax reform was to e the sole issue to be addressed regardless of the extent of other macro ssues faced by the country. Gillis said that he had been an advisor to he Government of Indonesia for some time prior to undertaking tax reform. s such he had somewhat greater influence on other policies than was the ase in Jamaica. Nevertheless, outside advisors attached to specific donor rojects will nearly always face the problem that there are important ssues outside the domain of the project that may threaten its success.

dministration without Corruption

Everyone at the conference recognized that a characteristic of tax dministration common to most developing countries is corruption. Public ector salaries are low and yet the employees are expected to handle huge mounts of money. Those with the most wealth and power often know ersonally those who oversee the collection of taxes. Finally, corruption n other segments of society may be an accepted fact of life. In such ircumstances, can anything be done?

It was felt that simple tax systems with low rates would help to vercome at least some of the illegal practices, since complexity can make ax evasion easier and high rates make it more profitable. Gillis noted he desire to "depersonalize" the tax collection process and to diminish he discretionary actions that tax collectors undertake in the process.

Training was stressed as a necessary co-product of tax reform. In ndonesia selected mid-level personnel were trained in the U.S. in accounting, computer science and economics. These administrators are provided with special incentive pay, are given their own vehicles and report directly to the Director General. The Jamaica project is providing substantial training both in the country and abroad to a wide range of tax administrators.

Both Bahl and Gillis noted that, while economists might take the lead in designing the tax structure, other skills are also necessary. For example, lawyers must ensure that the legislation, upon which tax administration is based, is written in accord with what was intended. Accountant skills are necessary to ensure proper bookkeeping control over the system. Computer scientists can design automated systems which, again, help to depersonalize the collection process. Finally, administrators must be brought into the final design stage to ensure that the package can be administered.

Tax enforcement includes both detection and, where appropriate, punishment. Bahl noted that, under AID regulations, nothing can be done under USAID-sponsored projects to alter the judicial system to ensure that punishment of those found guilty of tax evasion is carried out. Still, such projects can determine what external information is available to detect illegal evasion and train administrators in the use of such information. Apprehension and adjudication of those suspected of illegal activity must remain in the hands of the host country.

User Fees

Several times during the day it was noted that taxes were not the only revenue source available to governments in developing countries. All speakers voiced support for greater utilization of user fees. Yet, it was also noted that such fees should not be expected to replace the need for a sound tax system.

Further Research

The conference closed with various participants suggesting a research agenda. A review of this list suggests that while the experiences of tax reform throughout the world have provided lessons that can be valuable in conducting further effort in this area, more remains to be known.

Among the research issues noted were:

- Data-based analyses of the various price effects associated with changing tax rates. Some obvious candidates are the capital investment effects of changing tax rates on interest income; labor supply elasticities of after-tax wage rates; and responses of savers to changes in taxes.

- The empirical effects of tax simplification and rate alteration on tax avoidance and evasion. Such work must be carried out through long-term and *ex post* analysis in countries even after the initial reform efforts have been introduced.

- Research on the effects of tax simplification and rate lowering on bringing certain segments of the taxpaying population *into* the tax net. Particularly of interest would be the effects on the self-employed sector of new administrative techniques.

- Empirical work on the efficacy of tax incentives for investment. While work along this line was conducted in Indonesia, additional work in other investment environments is needed.

- Theoretical and empirical work on the implications of international capital mobility for developing country tax policy. Among the implications that might be addressed are the incidence effects of corporate taxes under conditions of high capital mobility.

- Efficacy of various schemes for inflation-proofing tax systems. Different countries have used different techniques; yet empirical analyses of their implications have not been adequately addressed.

- Growth and development implications of taxing financial institutions in developing countries. Exactly what is a neutral value-added tax treatment of financial institutions and how might one implement it?

- Analysis of the costs of tax administration and tax compliance in developing countries. This area of research has only begun in the United States, yet such efforts are greatly needed in the Third World context.

- Building models capable of analyzing the longer term fiscal impacts of short-term fiscal decisions or external shocks. Such models are necessary for longer term fiscal planning including consideration of the spending implications of public sector capital investments.

- Estimates of the benefits associated with the spending undertaken from the revenues provided by the tax system and the distribution of those benefits. While the Conference focused on taxation, that is only one-half of the overall effect of the fisc on the economy of a developing country. Probably even less is known about the expenditure side of the budget than is known about the economic effects of taxation.

- Analysis of the overall central-local government tax and spending structure. Focus exclusively on central government taxation tells only a portion of the story when other levels of government are also taxing and spending. How can and should these tiers of government be organized so as to provide services in a more effective manner?

Conclusion

Additional analysis is, therefore, in order if tax reform efforts are to succeed in encouraging economic growth in developing countries. Nevertheless, participants in the conference tended to agree that a good start has been made. What is necessary is that it be recognized that both the analyses of the sort outlined here and tax reform efforts themselves require a long-term effort. Furthermore, success in such endeavors is ossible only through the full cooperation among the primary actors in the rocess--the funding agency, the host government and the researchers.