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EXECUTIVE SUMMARY

WORLD TAX REFORM

Case Studies of Developed and Developing Countries

EDITED BY

Michael J. Boskin and Charles E. McLure, Jr.

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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Contents of the book *World Tax Reform*

Preface

A wave of tax reforms and tax reform proposals swept the globe in the 1980s. From one country to another, these reforms exhibited several common features: a focus on making taxation economically "neutral" (that is, ensuring that the tax system does not distort people's economic decisions), a trend toward lower marginal tax rates, a response to international tax pressures, and a consideration—particularly in many developing countries—of the value-added tax as a broad-based source of revenue.

In late 1987 and early 1988 the International Center for Economic Growth sponsored a project on world tax reform, directed by Michael Boskin, then of Stanford University and currently chairman of President George Bush's Council of Economic Advisers. That work led to a conference in October 1988, where a group of distinguished scholars presented case studies from developed and developing countries, as well as several broad issues papers. The book *World Tax Reform* brings together the results of that conference and provides convincing evidence that we have indeed learned a great deal about effective tax policy in the past several decades. In addition, *World Tax Reform* shows where current thinking has been neglected in the policy-making process. This executive summary presents the main findings of the book.

At the end of 1988, Dr. Boskin wrote the introduction and overview for the book. At that point, anticipating his new responsibilities in Washington, D.C., he turned the manuscript over to Charles E. McLure, Jr., of the Hoover Institution, who wrote a special conclusion. We list them together as coeditors of the final product.

World Tax Reform reveals the interaction among academic thinking, administrative practice, and political reality that is causing the field of taxation to evolve so rapidly around the world. We hope the study will be useful in the tax reform debates now taking place, at both an academic and a policy-making level.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

March 1990
Panama City, Panama

Summary of Conclusions

1. The reduction of income tax rates is probably the most dramatic manifestation of the wave of tax reform that swept the world during the 1980s, as well as perhaps the most important. Rate reduction mitigates the adverse incentive effects of taxation on work effort, saving, and investment. Any nonneutralities and inequities that remain after reform are less important at low rates. Pressures on tax administration and compliance are lessened by rate reduction. Finally, people may feel that the system is better if low rates are levied on a broad base rather than if high rates are levied on a narrow base.

2. Economically, it makes no sense to levy a separate tax on the income of corporations, just because they are legal "persons." Rather, corporation and individual taxes should be integrated, either by taxing the income of corporations as if earned by a partnership or by providing relief only for double taxation of dividends. An integrated system offers several advantages:

   - It is fairer, because combined corporate-personal taxation reflects the personal rate structure more closely than separate taxation at both levels.

   - It is more neutral with regard to economic decisions, since it does not discriminate against the corporate form of business and products of the corporate sector.

- Finally, it does not favor debt financing, as does the separate taxation of corporate equity income at the firm level and of dividends at the individual shareholder level.

3. One of the striking developments of the 1980s is the elimination or substantial reduction of tax incentives in many countries. The income tax systems of most countries had been cluttered with a variety of tax incentives intended to encourage such "worthy" goals as saving and investment, the production of selected goods, and the development of poorer regions. Actually, incentives encourage rent-seeking behavior and thereby create inequities, undermine the perception of fairness, distort the allocation of resources, and complicate tax administration and compliance.

4. There are two conceptually distinct forms of inflation adjustment of income tax systems.

    - One—and the easier, by far—is the adjustment of amounts fixed in nominal (monetary) terms, including personal exemptions, standard deductions, and bracket limits. These adjustments are needed in order to prevent bracket creep, the tendency for inflation to cause taxpayers with a given real income to pay increasing effective tax rates.

    - The other type of adjustment, which is quite complicated, is the adjustment of the measurement of income from business and capital. If the measurement of income is not protected from the effects of inflation, taxable income will be either understated or overstated. Inflation adjustment is thus needed in order to provide both equity and neutrality.

5. Economists have commonly advocated a consumption-based tax because it is neutral toward the choice between saving and consumption, rather than penalizing saving as

the income tax does. Business has supported the consumption tax for a similar reason; it is more favorable toward capital formation. More recently, an additional important reason for a consumption-based tax has been noted; in many ways it is much simpler than an income tax. Over the years Colombia, Mexico, Sweden, the United Kingdom, and the United States have all considered moving from the traditional income tax to a system of direct taxation based on consumption or (in the case of Mexico) to a more limited cash-flow tax for corporations. As yet none has adopted such a tax. A major concern is that other countries will not allow foreign tax credits for such a tax.

6. International factors played a role in tax reform in some countries. Tax systems can cause factors and goods to flee or to be attracted to a country and can offer opportunities for countries to compete among each other for revenues. In addition, a country's tax policy should take account of foreign-tax-credit arrangements.

An Overview of World Tax Reform

By the mid-1980s, many of the world's countries—both advanced and developing—had either enacted or were considering substantial tax reforms. This extraordinary series of tax reforms occurred in response to intellectual, historical, and political currents that appeared during the 1970s. In some cases the reforms reflected primarily domestic economic and political circumstances; in others they reflected economic circumstances common to many countries. Ideas tried in one country then spread to others. And as the economies of the world have become more closely interrelated, the tax reforms in the largest countries, particularly the United States, have affected their trading partners as well. Although the world's economies have widely varying tax systems even after a decade of reform, some common themes—most notably, the attempt to lower marginal tax rates—run through most of these reforms (see Table 1 for a comparison of marginal tax rates).

Common intellectual themes included concern about the adverse incentive effects of high marginal tax rates and about distortions caused by differential tax treatment of economically similar activities, and a downplaying of vertical equity as a central objective of tax policy. Greater interest in incentive effects started to develop especially in the 1970s, a decade in which relatively high inflation artificially increased tax rates, especially for the middle class. This episode highlighted the inequities and distortions resulting from an unindexed tax system in inflationary times. There was concern about tax evasion and about the effort diverted from productive economic activity into tax

TABLE 1 Tax Rates in Selected Countries, before and after Tax Reform

Country	Top marginal rate for individuals (old/new)	Corporate rate (old/new)
Australia	60/49	46/39
Canada	34/29	36/28
Colombia	49/30	40/30
Indonesia	50/35	45/35
Israel	60/48[a]	53/48
Japan	70/50	42/37.5
Mexico	55/40	42/36
Sweden	75/50	56/30
United Kingdom	80/40	52/35
United States	70/28 (+5)[b]	46/34

NOTE: China is omitted because tax rates have little meaning in a command economy.
a. Assumes scheduled elimination of surcharge at end of 1989.
b. The additional 5 percent represents a surcharge faced by upper-middle-income taxpayers.
SOURCE: Michael J. Boskin and Charles E. McLure, Jr., eds., *World Tax Reform: Case Studies of Developed and Developing Countries* (San Francisco: ICS Press, 1990); John Whalley, "Foreign Responses to U.S. Tax Reform," paper presented at a conference on the Economic Impact of the Tax Reform Act of 1986, Ann Arbor, Mich., November 9–11, 1989.

shelters and unproductive investment, and perceptions of unfairness were growing. Finally, of course, the internationalization of the world economy created competitive pressures on countries to respond to tax reforms elsewhere.

Some of these issues, such as high marginal tax rates, affected developed and developing countries alike. Others had special relevance primarily for one group of countries or the other. Therefore, the lessons to be learned by individual countries from others' experiences varied with circumstance to some degree.

Because the level and structure of taxation affects so many economic decisions, the rapid pace of tax reform in many countries may well have significant, lasting effects on the world economy. Although the reform process continues in a number of countries, it is worthwhile to evaluate what has happened in major countries where reform has occurred and to set forth an agenda of reforms still to be considered. That is the purpose of this study. It brings together leading specialists on taxation and tax reform, writing about economies that have undergone or are considering major tax reform in both the developed and the developing worlds. The study stresses the economics and tax policy side of the reforms, with some reference to their political context. It is hoped that similarities and differences in various country experiences can be highlighted to yield lessons about the differences between good tax policy and bad tax policy and about how to implement a strategy for reform.

Tax Principles

The study begins with two chapters on general tax issues. Writing on tax principles in an international economy, Joel Slemrod points out that the growing internationalization of economic activities raises three considerations for tax reform:

1. Factors, goods, and other potential bases for taxation can flee a country in response to taxation or other regulatory restrictions, or be attracted to a country by relatively light taxation or regulation.

2. The interjurisdictional division of revenues is not a matter of indifference. Each country much therefore "compete" with other countries for revenues.

3. It is more difficult to collect revenue from tax bases located outside the country.

A country's tax policy should be evaluated, then, by how well it achieves the optimal allocation of factors (from a national perspective) and by how successfully it defends or expands its revenue base against other countries.

A capital-importing country, Slemrod notes, should impose source-based capital income taxes if the capital exporter's treasury has a foreign-tax-credit system and will refund the tax payments to the firms. To rescind these taxes merely transfers tax revenues from the home treasury to the foreign treasury. Such a country should also maintain low statutory capital income tax rates, to attract taxable income to its jurisdiction, but should at the same time preserve high effective tax rates by limiting the generosity of depreciation allowances and investment tax credits. The U.S. Tax Reform Act of 1986 moved the

United States in this direction, and several other countries have followed suit.

Although Slemrod sees an extensive multilateral agreement for tax cooperation as unlikely, he proposes an agreement with limited goals. An agreement to keep statutory corporate income tax rates within a small band would limit the ability of multinational companies to allocate income among countries based on tax rates. Countries could maintain control over their marginal effective corporate tax rates by adjusting tax depreciation schedules and investment tax credits. A multilateral agreement to impose a harmonized rate of withholding tax on interest, dividends, and royalties would reduce the detrimental effects of the asymmetrical ability of countries to impose residence-based taxes. Countries that choose not to sign the multilateral treaty (presumably because they wish to levy rates below what the treaty stipulates) would be designated tax-haven countries, and income earned in these countries would be taxed as accrued at the rate of the home country. In addition, residents of tax-haven countries would not be eligible for refund of withholding taxes.

Arnold Harberger presents tax guidelines for developing countries, which share many concerns of advanced economies but also face some issues that are quite specific to their circumstances. He begins by looking at the value-added tax (VAT). Introduced first in France in the early 1950s, the VAT has spread to about forty countries, including many developing countries. Originally it was considered a very general tax, but experience has revealed that it rarely covers more than 50 to 60 percent of the tax base that a fully general tax would reach. Nonetheless, it is a robust and reliable tax, which has a low economic cost per dollar of revenue raised.

A second important advance in tax policy, according to Harberger, has been the recognition of the special merits of uniform tariffs. This recognition arose out of the development of effective-protection analysis in the 1960s. Although few if any would argue that uniform tariffs are better than free trade, such tariffs emerge as a sound policy for a country where protectionist sentiment is too strong to be fully defeated. A moderate uniform tariff provides equal effective protection to all import-substituting activities and avoids the exaggerated economic costs that characterize the tariff structures of most developing countries today.

Next Harberger considers the taxation of income from capital. Recent decades have increased our awareness of the strength of international capital movements, particularly of the virtual impossibility of any small country forcing its own nationals to keep their savings at home. As a consequence, policies that tax the income from capital at home give rise to capital outflows. This capital flight continues until an equilibrium relationship is restored between the rates of return that can be earned at home and in the world capital market. Greater taxation of income from capital at home thus leads to less domestic capital to cooperate with the local labor force. The result is a lower level of real wages.

For capital owned by domestic residents, the best tax treatment based on income is the integration of the corporation income tax with the personal income tax. This solution in effect converts the corporation income tax into a simple withholding device for domestic shareholders.

For foreign shareholders (particularly multinational companies) the problem is complicated by the fact that their income will likely be taxed in their home country, to the extent it is not taxed in the place where it is invested. In this case the developing country should continue to tax such income, while simultaneously integrating personal and corporation income taxes for domestic shareholders. Under this solution, foreign shareholders must turn to their own treasuries to obtain tax credits for corporation tax paid in the developing country.

The result of the recommended treatment is that the developing country's own residents are in effect exempt from corporation income tax, while nonresident shareholders (including multinational corporations) continue to pay it.

Tax incentives for particular types of investment are a fourth set of issues Harberger examines. Developing countries have not only made excessive use of such incentives, but on the whole have selected schemes that were badly designed, inducing investments in low-return operations at the expense of much better and higher-return investments. There are a number of incentive devices that are proof against this type of defect, such as reducing the corporation income tax rate on favored investment categories, granting tax credits on net rather than gross investment, and full or partial expensing of investments in the affected categories. These, then, are the indicated instruments for future investment incentives in developing countries.

Finally, Harberger presents a simple system for the indexation of inflation. This system corrects not only for the understatement of depreciation that inflation typically causes, but also for the complex distortions arising from the effects of inflation on the debt of business firms and on the interest payments on that debt. Adoption of such an indexing scheme is advisable for any country suffering from chronic inflation, as well as for any that runs a significant risk of substantial spurts of inflation in the future.

Tax Reform and Developed Countries

Tax reforms took place in many developed countries during the 1980s. The 1986 U.S. tax reform was particularly important in stimulating reform in other countries, both developed and developing.

Australia attempted to use an unusual political consensus approach to achieve reform, in a process described by Michael Porter and Christopher Trengove. Australia reduced its top personal rate from 60 to 49 percent and adopted an "imputation" system to reduce the double taxation of corporate income, but rejected a broad-based sales tax (retail sales tax or value-added tax). Faced with an erosion of the personal income tax base because of tax shelters and fringe benefits, the country added taxation of fringe benefits. The reforms failed to address, however, the underlying goal of reducing the heavy reliance on direct taxation. And although the reforms were initially meant to be revenue-neutral, tax revenues have ballooned, in part because of bracket creep.

John Whalley, who has been especially active in the Canadian debate on the value-added tax, considers tax policy reform in *Canada*. As the largest U.S. trading partner, Canada initiated reform in part because of international pressures. The country lowered its marginal tax rates, reduced investment credits and depreciation, and replaced a defective manufacturer's sales tax with a VAT.

Eytan Sheshinski discusses the tax reform proposal made in *Israel* in 1988 by a tax reform commission he headed. The proposal shared two features with reforms that have taken place (or are taking place) in other industrialized countries since the 1986 U.S. tax reform. First, it recommended reducing the marginal tax rates on personal income, particularly the top brackets, and broadening the tax base by eliminating tax expenditures (that is, favorable rates and exemptions on earnings). Second, it suggested reducing differential tax incentives for investment. Israel also had galloping inflation, and questions related to indexing, the measurement of real income, and the interaction of inflation and the tax code were therefore important issues.

Tax reform debates in *Japan* focused on hard-to-tax groups. Yukio Noguchi points out that the debates placed little emphasis on vertical equity, but rather concerned the levels of corporate income taxes, the tax treatment of interest and capital gains, the financing of social security, and a proposed land tax. To reduce individual and corporate income tax rates and to increase revenue available for social security payments, the country has instituted a small value-added tax, which has turned out to be tremendously (and surprisingly) controversial. Horizontal equity is an important issue in Japan because of widespread perceptions that tax treatment differs widely among salaried income, small business income, and agricultural income, but little has been done to address this problem.

Ingemar Hansson and Charles Stuart examine tax reform in *Sweden*, long one of the world's most heavily taxed economies. In the 1970s government subsidies to specific regions and industries became so high that they were crippling the Swedish economy; after substantially reducing these subsidies, Sweden has turned to a serious discussion of how to lower its high marginal tax rates. The Swedish tax reform movement has responded to the prevalence of tax shelters and the disincentive effects induced by high tax rates. Sweden has also begun to place relatively more importance on taxes such as payroll and value-added taxes, which are less troublesome and subject to less manipulation than income taxes.

The *United Kingdom* was one of the first countries to reduce rates and eliminate investment incentives. Andrew Dilnot and John Kay discuss recent experiences in that country, noting that changes in tax policy do not appear to form part of a coherent strategy for tax reform. The United Kingdom has greatly simplified its personal income tax rate structure, moving from eleven rates in 1978 to two rates in 1988, as well as reducing the level of rates. Although changes were made to the taxation of married couples in 1988, they do not eliminate the financial disincentives to marriage faced by some couples. To broaden the local tax base, local property taxes have been replaced by a flat-rate poll tax.

John Shoven discusses the *United States* tax reform of 1986 and concludes that it offers as many problems as solutions. The reform reduced marginal personal income tax rates, increased tax thresholds, curtailed tax shelters, limited deductions, and increased corporate taxes. Shoven faults the reform, however, for failing to promote savings at either a household or a corporate level. Nor did the reform address the need to reduce the federal budget deficit. Likewise, the reform failed to index the definition of income for inflation or to establish a direct (or personal) consumption tax, which would greatly increase efficiency.

Tax Reform and Developing Countries

Since 1979 the *People's Republic of China* has reformed its explicit and implicit taxes. As Roger Gordon describes, in a primarily planned economy such as China's, taxes can be implicit in a variety of ways, as well as being levied explicitly. For example, if wages are set by a central authority, setting them at a low level is quite similar to setting them at a high level and imposing a wage tax. Likewise, the collection of "profits' from firms may resemble corporate taxation. One important aspect of the reforms was to create a tax system, and China now has a variety of explicit income taxes, sales taxes, and property taxes similar to those used in Western countries. Another aspect of the reforms was the effort to decentralize decision making for agriculture, rural industry, and state-owned enterprises. Tax rates, however, are very heavy on state-owned enterprises and have led to widespread evasion efforts.

Charles McLure considers tax reform in the mildly inflationary environment of *Colombia*, which has one of the best and most studied income tax systems among all developing countries. (McLure himself directed a 1988 study for the Colombian government on which the 1988 reforms were based.) Although foreign missions in the 1960s advised against inflation adjustment, under the assumption that adjustment would simply institutionalize a high inflation rate, Colombia began a process of gradually adjusting parts of its tax system for inflation in 1974. Inflation adjustment was extended to all interest in 1986 and to depreciation in 1988. Colombia's administrative capabilities, however, have lagged behind its advances in tax design and will require improvement if the tax system is to be truly effective.

Malcolm Gillis looks at *Indonesia* with special reference to the value-added tax, which served as the cornerstone of a far-reaching tax reform in 1983. In recent years much attention has been placed on achievement of a "clean" VAT—one that covers virtually all value added in the economy. This means dealing with concerns for low-income individuals directly (through refundable credits to offset tax paid, for example) rather than by exempting necessities such as food from the VAT. Indonesia's VAT, with a flat rate of 10 percent and no provision for exemption by product category, is one of the simplest types of VAT ever adopted anywhere. In addition, the VAT has contributed greatly to revenues in a period when taxes on oil companies, which had served as Indonesia's largest source of revenue, were declining. In addition, the Indonesian experience with the VAT provides yet another example of the lower vulnerability of the tax-credit type of VAT to the corrosive effects of rent-seeking behavior relative to other types of VAT and to income taxes. Firms accustomed to lobbying for tax exemption as a means of tax relief, for example, quickly find that under the VAT, exemptions are not generally in their interest.

Mexico's experience with tax reform is a lesson in the effects of administrative and human limitations on the ideal tax system. Francisco Gil Díaz writes that Mexican policy makers attempted to keep taxation simple, avoid imposing an excessive tax burden, and institute a system of global taxation of income (in other words, extend coverage of the system to include all sources of income). These goals, however, often conflicted with the administrative capacity and revenue needs of the central and local governments, and the Mexican tax system has become very complicated while still failing to tax global income. Mexico simplified its myriad local indirect taxes by introducing a turnover sales tax and later a value-added tax, but the VAT itself grew ever more complicated as the number of rates proliferated to meet political demands. Likewise, Mexico simplified its corporate tax system in 1987, but the transition to the new tax was characterized by extremely complex procedures. Global income taxation, in particular, faces many practical obstacles, and the partial globalization of income taxation, which Mexico achieved, creates severe distortions and inequities of its own.

Appraising Tax Reform

Arnold Harberger's criteria of good tax policy, though addressed specifically to the problems of developing countries, are probably subject to agreement by most economists working on tax reform in advanced countries as well. It is interesting to apply those criteria to two countries, Colombia and the United States.

The tax policy of Colombia is clearly more consistent with the Harberger guidelines—supplemented to include rate reduction—than that of any of the other countries considered. Colombia has a VAT (although one that does not allow immediate credit for all taxes on investment goods); it provides comprehensive indexation for both nominal amounts and the measurement of income; it has eliminated virtually all important investment incentives; it has eliminated double taxation of dividends; and it has reduced its corporate rate and its highest marginal rate on individual income to 30 percent.

The United States has taken relatively few of these steps, despite all the hoopla over the Tax Reform Act of 1986. Though it has reduced its tax rates almost as far as any nation—to 28 percent (33 percent including the middle-income surcharge) for individuals and 34 percent for corporations—it has no national sales tax; it does not provide any indexation in the measurement of income; it allows no relief from double taxation of dividends; and it still provides substantial incentives for selected economic activities. The absence of a national sales tax is especially noteworthy, given its federal budget deficit.

Many of the other countries reviewed here would not fare much better than the United States in this grading. Most now have VATs;

most (but not necessarily the same ones) now provide dividend relief; most have made progress in curtailing tax incentives; and most have reduced marginal rates. Most have not, however, made substantial progress in insulating the measurement of income—or even nominal amounts—from the effects of inflation.

Several final comments are worth making. First, many important aspects of tax reform have not been considered here. For example, the proliferation of tax shelters during the 1980s was almost unique to the United States; the elimination of most opportunities for shelters constitutes a major achievement of the 1986 U.S. tax reform. It helped restore the perception of equity that had been so seriously damaged by the growth of shelters, as well as improve the actual equity and neutrality of the system.

Second, the fact that a given country has not adopted all the Harberger guidelines does not necessarily mean that policy is wrongheaded—though in some cases it clearly is. Economic and political circumstances simply differ in important ways across countries. This is perhaps nowhere seen more clearly than in the case of inflation adjustment. A high-inflation country can hardly be said to have a tax on net income if it does not index the measurement of income from business and capital. By comparison, in a low-inflation country the complexity cost of indexation may exceed the benefits of indexing.

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