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TAX REFORM POLICIES IN DEVELOPING COUNTRIES

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Tax reform and tax policies in developing countries have long been studied by economists. However, in the last few years, tax reform has gained increased recognition as an important policy instrument for stimulating developing country economies.

In particular, the adoption of growth-oriented macroeconomic and structural policies by the debtor nations is at the heart of the "Program for Sustained Growth" ("Baker Plan") proposed by the United States for the major debtor nations in Seoul, Korea, in October 1985. Under the program, debtor countries would adopt macroeconomic and structural policies that improve growth and reduce inflation in order to qualify for new loans from the International Monetary Fund (IMF), the World Bank, and private banks. Growth-oriented policy reforms include reducing subsidies and costly budget deficits, as well as structural reforms involving the development of efficient domestic capital and equity markets, increased efficiency in the public sector, and growth-oriented tax reform.

Institutional Views on Tax Reform

Among international development institutions, the IMF has had the most influence over tax policies in developing countries. Tax provisions are part of IMF packages, but not of explicit conditionality.

The IMF primarily views the tax system as an instrument of short-term "demand management" involving changes in private consumption and government revenue. Since the IMF aims at stabilization, its revenue concerns are primarily shortrun, and balance of payments and budget deficits are its top negotiating aims. Budget deficits often require a revenue increase. IMF tax measures usually favor quick-impact tax changes such as increases in sales taxes, import duties, user charges, and public enterprise tariffs. They recommend increases in income and corporate taxes only as a last resort.

However, in the context of growth-oriented tax strategies, the role of taxes in long-term "supply managment" and resources allocation also becomes important. This supply management perspective recognizes that the tax structure affects decisions by economic agents, and thus resource allocation, and that growth prospects could be improved with a tax structure that distorts these decisions less. This perspective also suggests close linkages between tax policy and the structural adjustment work of the World Bank. Both the development projects and structural adjustment supported by the bank take place within an environment conditioned in important ways to tax policy.

Characteristics of a Good Tax System

The criteria most widely accepted for a good tax system include:

> Economic neutrality. Tax systems should not interfere with efficient allocation of resources, nor result in bias against capital formation.

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Horizontal equity. Structure tax laws so that those who are able to pay, pay more or less equally.

Simplicity. Aim for easy compliance.

Low rates. Low rates on a broad base bring more development and few bad economic decisions.

Inflation-proof the system. Taxes should adjust automatically high inflation.

Characteristics of Tax Systems in Developing Countries

Statistics on the composition of central government revenues for more than a 100 countries reveal that taxes on income and profits are more important in the industrial countries (33 percent of revenue) than in the developing countries (17 percent of revenue in the least developed countries).[2] The contribution of taxes on international trade and transactions is inversely related to the level of income and the degree of industrialization (42 percent of revenue in the least developed countries). The degree of reliance on domestic taxes on goods and services is greatest in the semi-industrial countries.

In many low-income countries, direct taxes on agricultural producers tend to be very light, since the sector, particularly if comprised of smallholders, is difficult to tax. Instead, taxes on agricultural producers are more commonly levied through price and trade taxation. For instance, the incomes of ejido farmers in Mexico are not taxed directly. Agricultural producers in India also do not pay income taxes on agricultural income. A number of countries provide income tax incentives to commercial agricultural development. For example, commercial income from animal husbandry and poultry farming is tax exempt in India, Pakistan, Bangladesh, and Sri Lanka. Both Brazil and Mexico apply lower, preferential corporate income tax rates to income earned from commercial agricultural enterprises.

Tax Reform Issues

In most developing countries, existing tax systems do not necessarily represent a neutral or equitable mechanism for raising revenue. Tax systems have often developed in piecemeal fashion with the purpose of protecting specific sectors or interest groups, or of raising more revenue. Thus, the tax structure many not fit together to achieve development goals. Tax rates are often high and imposed on a narrow base, which provides incentive for tax evasion. Complex systems prove too difficult for tax officials to administer.

A survey of recent tax reforms undertaken by five developing countries presents evidence that, in most cases, the reforms represent attempts by countries to reduce the negative effects of tax systems on economic incentives and to increase purchasing power. The reforms also illustrate attempts to raise revenue by reducing top corporate and individual income tax rates and, thereby, broadening the base to which they apply.

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[2]U.S. Agency for International Development. "Conference Reviews Country Tax Reforms," Front Lines, Sept. 1986.