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Tax Reforms in Developing Countries

Given the low level of tax revenue and the contradictory structure of tax legislation in many developing countries, there is broad agreement on the need for tax reforms in those countries. The following article reviews the problems associated with instituting such changes.

As the changing role of the state in developing countries has aroused increasing discussion, this has generated demands for liberalization, deregulation and the withdrawal of public-sector involvement in those areas which might attract private-sector investment: thus it is recommended that publicly owned enterprises producing goods and services which can have their prices established via the market ought to be privatized. Taxation policy in developing countries has also been coming in for critical scrutiny; as part of this process, the experience gained with tax reforms in recent years by international organizations and individual Third World countries while executing structural adjustment programmes has been evaluated.¹ The tax authorities have had a considerable amount of literature available to them for this purpose.²

Only very few developing countries have managed to establish their tax systems in such a way as to achieve an appropriate level of revenue and to keep tax-generated misallocations within tight bounds (one such example is the city state of Singapore). In most other countries, neither has it been possible to ensure the financing of public expenditure nor have the tax systems operated in conformity with economic policy objectives such as growth and combatting poverty.³

The most striking evidence of the need for reform comes from the revenue side: estimates made by the World Bank for the period 1975-1985 showed that in industrial countries the average taxation ratio as a proportion of gross domestic product lay between 29% and 32%, whereas the corresponding range for developing countries in the medium-income category was from 17% to 22%. The average taxation ratio in the poorest countries lies between 13% and 16%. The proportions are relatively high in the Middle East and North Africa because of the royalties and other levies raised from oil exports, which are classed as taxation. In sub-Saharan Africa, Latin America, the Caribbean and in East Asia, the corresponding values

lie between 14% and 18%, whilst they are in the range 10% -14% in South-East Asia.⁴

Developing countries do not normally tend to be low taxation countries because they have a particularly thrifty approach to managing public finances. Rather, the problem is that a vast gap exists between the tax payments required by law and those actually surrendered to the state. The levels of tax evasion show up the deficiencies in taxation policy and in the tax-collecting authorities. On the other hand, attempts to prevent tax avoidance and to dry out tax havens have created contradictory and unduly complicated sets of regulations. It is then quite easy for tax-payers to find whichever stipulations best suit their situation and to take advantage of them. The taxation authorities – often inadequately staffed, institutionally weak and lacking in political support – are not in a position to collect the amounts outstanding. Because the registers of tax-payers are incomplete, because obligations to keep proper accounts are not complied with and it is unusual for tax-payers, including small and medium-sized

¹ Cf. K. Fertig, D. Kebschull: Auswirkungen von Eigenanstrengungen auf den Entwicklungsprozeß, Forschungsberichte des Bundesministeriums für wirtschaftliche Zusammenarbeit, Vol. 70, Cologne 1985; A. Borrmann et al.: Soziale Marktwirtschaft. Erfahrungen in der Bundesrepublik Deutschland und Überlegungen zur Übertragbarkeit auf Entwicklungsländer, Hamburg 1990.

² Cf. among others M. Gillis (ed.): Tax Reform in Developing Countries, Durham, London 1989; D. Newbery, N. Stern (eds.): The Theory of Taxation for Developing Countries, New York etc. 1987; R. M. Bird, O. Oldman (eds.): Taxation in Developing Countries, 4th ed., Baltimore, London 1990; S. R. Lewis Jr.: Taxation for Development. Principles and Applications, New York, Oxford 1984; R. Goode: Government Finance in Developing Countries, Washington, D.C., 1984; V. P. Ghandi (ed.): Supply-Side Tax Policy. Its Relevance to Developing Countries, Washington, D.C., 1987.

³ Cf. S. Acharya: India's Fiscal Policy, in: R.E.B. Lucas, C. F. Papanek (eds.): The Indian Economy. Recent Development and Future Prospects, Boulder, London 1988, pp. 301 ff.; Schwere Rezession in Peru. Pläne Carlos Boloúas für eine Fiskalreform, in: Neue Zürcher Zeitung, No. 53, 6 March 1991; K. W. Menck: Mobilisierung interner Ressourcen durch die Steuerpolitik in Entwicklungsländern – eine Fallstudie für ein fortgeschrittenes Land: Singapur, HWWA-Report No. 85, Hamburg 1990.

⁴ Cf. World Bank: World Development Report 1988, Washington, D.C., 1988.

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businesses, to keep formal accounts, tax authorities are forced to rely on estimates when making tax assessments. The payments normally lie below the levels which tax-payers ought to be paying.⁵

These weaknesses are especially apparent in the countries of sub-Saharan Africa. The widespread phenomena in this region of economic instability, ethnic conflicts, political unrest, corruption and the lack of a sense of duty have all contributed to the creation of low taxation countries. Individual groups of firms or of private citizens thus finance a small government budget by means of indirect taxes which are determined by chance, unless they are able to avoid their obligation to pay taxes altogether, either legally or by other means.

Erosion of the Tax System

In Latin American countries, the tax system has been eroded because high inflation rates have devalued public revenue in real terms. Tax-payers, on the other hand, have been able to benefit from the long time-lags between being assessed for taxes and levies and actually having to pay them. Attempts to raise government revenue by bringing forward payment deadlines, by indexing the amounts due and by threatening defaulting tax-payers with legal penalties have had little effect in practice. The tax authorities have had to face increasing resistance from tax-payers, who have been transferring their capital abroad for fear of its value being eaten away by inflation. Since government economic policies have only been half-hearted in trying to deal with inflation, tax-payers for their own part have not been willing to exercise more discipline in making their payments.⁶

There is general agreement that the gulf which exists in

many developing countries between actual tax receipts and those stipulated by law has to be narrowed. Increased recourse to the capital market by the state drives up interest rates, thus crowding out would-be borrowers from the private sector. Tax laws which are essentially contradictory lead to inefficient resource allocation. The scope for using high levels of indirect taxation to counteract the government deficit has now been largely exhausted. If customs duties are also included, more than 60% of government revenue is now raised from this source. Any further increase in indirect taxation would only serve to encourage tax-payers to shift their transactions into the informal arena. The exchange of goods for money would then be substituted by barter trade, which would further impair the guiding function of markets, which in any case are already regulated in many developing countries.

Academic Approaches to Reform

While it is one thing to be aware of the necessity for tax reforms, there is a good deal of uncertainty as to how to proceed in practice. The interrelationships between taxation and economic development are considerably more complex than tended to be assumed in the literature of the 1970s.⁷ For example, econometric models to establish the correlation between the degree of development, tax levels and tax structures had to take unreliable statistics as a basis and also ignored important non-economic factors influencing taxation policy such as the understanding of the role of the state, the efficiency of the administrative system and the enforcement of the law. Similar considerations apply to the suggestions made for the optimum utilization of taxable capacity, which was not defined any more closely.⁸

The analyses conducted in the 1980s in the name of welfare theory were also irrelevant to taxation reforms in developing countries.⁹ Although the poll tax proposed at the time is efficient from an allocative point of view, it is also impossible to enforce because it is not fixed on an income-related basis and therefore cannot be reconciled with objectives relating to the distribution of income. The same difficulty arose when trying to solve the problems associated with presumptive taxation. As long as estimates have to be used due to a lack of more complete or up-to-date information on taxable incomes, losses of income and/or disincentives to produce will continue to occur.

It is now widely recognized that taxation reforms not only need to consider taxation rates, the tax structure and economic development, but also non-economic circumstances. Per capita incomes, the level of industrialization, dependence on foreign trade, and the importance of exports of mineral raw materials determine tax revenues together with factors such as literacy levels,

⁵ Cf. V. Tanzi: Quantitative Characteristics of the Tax Systems of Developing Countries, in: R. M. Bird, O. Oldman (eds.), op. cit., pp. 6 and 21; R. A. Musgrave: Reaching the Hard-to-Tax, in: *ibid.*, p. 330; R. M. Bird: The Administrative Dimension of Tax Reform in Developing Countries, in: M. Gillis (ed.): Tax Reform in Developing Countries, Durham, London 1989, pp. 315 ff.

⁶ Cf., among others, M. Casanegra: Coping with Inflation, Inflation Adjustment in Chile, in: R. M. Bird, O. Oldman (eds.), op. cit., pp. 259 ff.; V. Tanzi: Fiscal Policy and Economic Reconstruction in Latin America, IMF Working Paper WP/89/94, unpublished manuscript, dated 2nd November 1989; World Bank: Argentina, Tax Policy for Stabilization and Economic Recovery, A World Bank Country Study, Washington, D.C., 1990.

⁷ Cf. e.g. R. J. Chelliah, J. H. J. Baas, M. R. Kelly: Tax Ratios and Tax Efforts in Developing Countries, 1969-71, in: International Monetary Fund Staff Papers, Vol. 22, 1975, pp. 187 ff.

⁸ Cf. A. Lindbeck: Taxation in Market-oriented Developing Countries, in: R. M. Bird, O. Oldman (eds.), op. cit., p. 62.

⁹ Cf. N. Stern: The Theory of Optimal Commodity and Income Taxation: An Introduction, in: D. Newbery, N. Stern (eds.), op. cit., pp. 22 ff.; N. Stern: Aspects of the General Theory of Tax Reform, in: D. Newbery, N. Stern (eds.), op. cit., pp. 60 ff.

¹⁰ Cf. R. K. Gordon, Jr.: Income Tax Compliance and Sanctions in Developing Countries, in: R. M. Bird, O. Oldman (eds.), op. cit., p. 464.

the extent to which businesses keep proper accounts, the efficiency of the tax authorities, the nature of tax legislation, honesty in paying taxes and their level of acceptance.¹⁰ Other important areas to be attended to in taxation reforms are the organizational and institutional frameworks under which the fiscal authorities operate.¹¹ A completely new road to taxation reform is proposed by the school of thought deriving from the New Political Economy. Its proponents advocate that changes should not be made until a redistribution of power within society has taken place; taxes, they say, would have to be charged to complement an exchange of property rights.¹²

The Predominance of Rules of Thumb

Experience with tax reforms in the developing countries during the 1970s and 1980s shows that it is often impossible to take into consideration the type of comprehensive explanatory approach often provided in academic literature. Those who execute policy in practice are normally guided by economic rules of thumb, taking account of social and political conditions on a case-by-case basis.¹³ Accordingly, more recent tax reform proposals have tended to be rather simpler and more modest in their approach. Whereas proposals were made for an expenditure tax at the time the new state of India was founded today only gradual changes on the basis of existing regulations are recommended.¹⁴

Past experience has shown that it is desirable to carry out tax reforms when economic and political conditions are stable. However, such opportunities are usually missed in practice.¹⁵ Evidently politicians, the authorities and tax-payers alike are only prepared to see adjustments in tax levels if these are forced by large budget deficits, by structural adjustment programmes imposed by international organizations, or because a misallocation of

factors of production can be attributed to taxation policy. Further reasons for going ahead with reforms are publicly criticized deficiencies in tax administration or severe cuts in public expenditure which make far-reaching cuts inevitable in the education system or in health care.¹⁶

Tax reforms should always be made with clear objectives in mind. The most important of these should be raising government revenue, followed by other criteria such as achieving a just distribution, allocative efficiency, and integration into the world economy. In practice, however, the latter criteria are often neglected. In other words, those responsible tend to act upon their realization that the optimization models developed in economic research are likely to be of little help in applying tax reforms in practice. Moreover, the political and economic policy demands made upon tax reform in practice contradict each other, and for that reason alone can only ever be met in part.¹⁷

Tax changes ought not to be made in isolation; they need to be accompanied by parallel, complementary economic policy measures. It has now become commonplace to make use of the interfaces between different taxes. For example, income tax reforms may be combined with the introduction of value added taxes, since both types of taxation rely on the information submitted by tax-payers themselves. Customs duties and indirect taxes ought to be harmonized and to be charged as part of a parallel procedure.¹⁸

Another important point suggested by experience is that tax reforms ought also to lead to a simplification of the tax system. The application of this basic principle means the removal of special regulations, and other such changes. The only exceptions which ought to be allowed to this principle are taxation measures designed to compensate for the failure of market mechanisms, or else justified by priority goals for the aggregate economy. Proposals on how to deal with such problems have to be drawn up to suit the individual cases concerned. They ought not to leave the door wide open for arbitrary actions by interest groups which are politically strong and able to assert themselves through the media and other means.

Adjustments to tax régimes are normally made under a good deal of pressure to rapidly increase government revenues. However, there is also the view that reforms should be made gradually and systematically in order to create the right conditions for increased revenues in the longer term without jeopardizing overall economic goals. Measures which have proved effective in the past have included increased duties on tobacco and tobacco products, alcoholic liquor and petroleum. In an intermediate stage, it may be possible partly to eliminate deficits by accelerating the procedures for submitting tax

¹¹ Cf. *Tax Administration and Tax Policy*, in: R. M. Bird, O. Oldman (eds.), op. cit., p. 449.

¹² Cf. *A Cost-Benefit Analysis of Tax Incentives*, in: R. M. Bird, O. Oldman (eds.), op. cit., p. 189.

¹³ Cf. E. Ahmad, N. Stern: *Optimal Tax Reform*, in: R. M. Bird, O. Oldman (eds.), op. cit., p. 47.

¹⁴ Cf. N. Kaldor: *Indian Tax Reform. Report of a Survey*, Ministry of Finance, Government of India.

¹⁵ Cf. W. Thirsk: *Lessons from Tax Reform. An Overview*, World Bank Working Papers WPS 576, pp. 14 and 27; W. Ascher: *Risks, Politics and Tax Reform: Lessons from some Latin American experiences*, in: M. Gillis (ed.), op. cit., p. 464.

¹⁶ Cf. R. Goode: *An Overview of Experience*, in: R. M. Bird, O. Oldman (eds.), op. cit., p. 124; C. S. Shoup: *Retrospectives on Tax Missions to Venezuela (1979), Brazil (1964), and Liberia (1970)*, in: M. Gillis (ed.), op. cit., p. 310.

¹⁷ Cf. J. Khalilzadeh-Shirazi, Anwar Shah: *Tax Reform in Developing Countries*, in: *Finance & Development*, Vol. 25 (1991), No. 2, p. 45.

¹⁸ Cf. W. Thirsk, op. cit., p. 24.

returns and assessing the amount to be charged, by collecting taxes at source and by introducing preliminary charges based on an indexed estimate of taxable income (presumptive taxation). Long-term revenue increases can then be achieved by relieving the tax authorities of all duties which do not form part of their task of chasing up tax obligations and of assessing tax charges. In the same context, there is a need to apply stricter penalties in the event of tax payments being delayed or failing to comply with the amount charged.

Beyond the above general considerations, there is no patent remedy when it comes to the sequence in which individual measures are applied; however, experience does show that whatever measures are taken to increase short-term revenues, other adjustments with more long-term effects ought also to be planned and implemented.¹⁹ Once the latter reforms begin to generate higher revenue, the earlier tax increases ought to be repealed. In reality, however, this readjustment has often never been made because the exchequer was not prepared to see any reduction in the levels of receipts it had now begun to collect. As a general rule, though, the only adjustments which stand the test of time are those which set in motion a continual process of tax reform.²⁰

Governments and parliaments ought to fully emphasize the importance of reform and ensure that they make a good case for adjusted tax charges even when faced with the resistance of interest groups. Another vital aspect is that the tax authorities need to be provided with the necessary material and staff resources for them to fulfil the tasks required of them. Proper support needs to be given to the revenue authorities in the legislative process so that they are provided with the right legal and institutional framework to allow them to enforce their tax demands on tax-payers.²¹ The reform is more likely to receive support if it is possible to involve those who will be required to pay taxes in the reform process. If they express justified wishes for a simplification of procedures and a reduction in the assessment costs which tax-payers have to bear themselves, due consideration should be given to these requests as this may help to alleviate resistance to tax demands.

The tax reforms must be based on precise, up-to-date, sound information. If this condition cannot be met, the reform should not proceed until a proper assessment of the situation has been made.²² If this stage is missed out – often as a result of the urgent need to take action and/or of the lack of sufficient finance for the necessary inquiries – the result often turns out to be the opposite of what was desired. Further tax increases pushed through to compensate for reduced revenues and/or to rectify errors which were not discovered until it was too late serve only to

create uncertainty, to impede the collection of taxes and to raise resistance to them.

Tax reforms ought to increase the efficiency of the tax authorities. Hence it is important that the local tax authorities in the individual developing countries concerned participate in the reforms; foreign advisors may help by making their experience available and by motivating and training staff in order to reduce resistance within the authorities. However, some reforms have failed in the past when the tasks involved were performed exclusively by foreign advisors and the developing countries concerned had ready-made solutions imposed upon them, often without any consideration of the absorptive capacity of the local tax authorities.²³

Reports on past experience clearly show how confined the scope for tax reforms proves to be in many developing countries. Weak governments, high deficits, strong interest groups, and the tasks of dealing with high foreign debt are all factors working against a carefully planned procedure taking a long-term view. Countries which are endeavouring to integrate the shadow economy need to apply different formulae from those needed by countries seeking to liberalize the movement of capital. In view of the different requirements from country to country, it is impossible to give any standard recommendation for reforms which would apply to all developing countries.

Introduction of Value Added Tax

Currently at the heart of the tax reforms in many developing countries is the introduction of value added tax; this is intended to replace the indirect taxes widely applied to individual products or all-stage turnover taxes. A look at recent developments shows that value added tax is now in normal use in a number of developing countries, particularly in Central and South America. Fourteen countries in those regions have now introduced the tax; two countries in each of the regions of the Caribbean, Africa, Asia and the Middle East have also established it. It is common to find the tax being charged at a number of different rates, also varying from one product to another; for small and medium-sized businesses which do not keep formal accounts, the rebate procedure has been replaced by a blanket assessment method geared to external characteristics which can easily be established. Although such characteristics – in the case of turnover, capital,

¹⁹ Cf. W. Thirsk, *op. cit.*, p. 32; G. P. Jenkins: *Tax Changes Before Tax Policies*, in: M. Gillis (ed.), *op. cit.*, p. 250.

²⁰ Cf. W. Thirsk, *op. cit.*, pp. 28 and 30.

²¹ Cf. *ibid.*, p. 28.

²² Cf. *ibid.*, p. 29.

²³ Cf. *ibid.*, p. 30; R. M. Bird, *op. cit.*, p. 315 ff.

number of employees or the industry to which the firm belongs—are not strictly in accordance with the underlying principles of value added tax, they are nevertheless accepted because this allows administrative procedures to be simplified.

Value added tax has a large number of advantages attributed to it. It is neutral to the allocation of resources and also to the preferences of consumers; it increases international competitiveness by avoiding cascade effects, and it gives equal treatment to goods produced at home and abroad. Value added tax has its own in-built monitoring mechanism because it forces businesses at each level to declare the taxes paid in order for them to obtain the credits to which they are entitled; as a result, the tax can be collected with a relatively low level of supervisory outlay. However, the proper effect of these advantages is not felt unless other indirect taxes are reduced to the necessary extent at the time value added tax is introduced. In reality though, the search for public revenue often leads to value added tax being imposed as an additional tax charge.²⁴ The result is to raise the overall level of indirect taxation while retaining the disadvantages of traditional indirect duties.

Absence of the Right Preconditions

On the basis of experience so far, the introduction of value added tax cannot be recommended as a point of general principle. With regard to the tax yield obtained and the administrative expense involved, this is a type of tax which is only really suitable for relatively large countries with high per capita incomes and with close interconnections between firms which already have good accounting practices in operation. Furthermore, there is no place for value added tax in federal constitutional structures under which the powers to raise indirect taxes are exclusively in the hands of the individual states or provinces.²⁵

Developing countries have indeed already experienced some of the difficulties associated with value added tax. In

an open economy, VAT has to be charged on imports in the form of an import turnover tax or supplementary tax. There are various explanations, including widespread smuggling, tax exemption for important or specially favoured imports and also the incomplete monitoring of deliveries from abroad, as to why value added tax on imports is collected only to a limited degree in developing countries. Conversely, the system of providing VAT rebates on exports often breaks down because of administrative bottlenecks or a lack of government funds in developing countries. The application of tax to investment and to proprietors' personal use of resources calls for continual scrutiny by tax auditors, and the facilities are often not available for this purpose. Wherever value added tax concessions are provided in the form of zero-ratings or preferential rates, the definitions of which goods or services qualify are inevitably arbitrary.

Ecological Taxation

The need to protect natural resources in developing countries also has new tasks for taxation policy associated with it. Along similar lines to those already followed in many industrial countries, the idea is that tax concessions should be increased for limited time periods for investment which will reduce energy consumption, which promises to create less harmful emissions or which will restrain the use of non-renewable resources. Other possibilities which have also been proposed involve using taxes to make polluters and others who generate environmental damage bear the external costs thus caused. It is proposed that the various charges which are normally made by local government bodies such as vehicle taxation, land taxes, water and sewerage charges include an additional component intended to finance environmental protection. For this purpose, the rates charged and the basis of assessment used need to be calculated with reference to external costs, and preference should be given to investing the income raised in measures to protect natural resources.²⁶

Quite justifiable doubts have been raised in industrial countries as to whether ecological taxes really will effectively protect natural resources. Unless and until a clear picture of the chains of cause and effect can be obtained, neither taxation and public expenditure nor regulatory intervention will be able to curb the exploitation of non-renewable resources on a sustained basis.²⁷ Such measures will only have a limited amount of bite as long as other economic policy measures simultaneously generate external costs elsewhere, indirectly favouring over-exploitation.²⁸ Ecological taxes have an inflationary effect if they are passed on to wages and prices, and therefore run counter to any development policy intended to encourage stability and economic growth.

²⁴ Cf. The Value-Added Tax, in: R. M. Bird, O. Oldman (eds.), op. cit., pp. 367 ff.; A. A. Tait: Value Added Tax. International Practice and Problems, Washington, D.C., 1988, p. 3 ff.; C. S. Shoup: A Growth-Oriented Tax System, in: R. M. Bird, O. Oldman (eds.), op. cit., p. 39.

²⁵ Cf. J. F. Due: Some unresolved Issues in Design and Implementation of Value-Added Taxes, in: National Tax Journal, Vol. 43 (1990), No. 4, p. 383 ff.; A. A. Tait, op. cit., p. 30 ff.; B. C. Helan, T. Monson: The VAT in Côte d'Ivoire, in: M. Gillis, C. S. Shoup, G. P. Sicat (eds.): Value Added Taxation in Developing Countries, A World Bank Symposium 1990, Washington, D.C., 1990, pp. 147 ff.

²⁶ Cf. R. Bahl, D. Holland, J. Lines: Taxation in Urban Areas, in: R. M. Bird, O. Oldman (eds.), op. cit., p. 412 ff.

²⁷ Cf. OECD: Economic Instruments for Environmental Protection, Paris 1989, p. 111 ff.

²⁸ Cf. OECD: Strengthening Environmental Cooperation with Developing Countries, Paris 1989, p. 29.