

Holthus, Manfred; Shams, Rasul

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Manfred Holthus and Rasul Shams*

Tax Reforms and Equity in ACP Countries

While the tax reforms which have been instituted as part of the Structural Adjustment Programmes in ACP countries primarily aim at simplifying tax systems and raising their efficiency, they are also intended to improve distributional equity. This article assesses the equity effects of taxation policies in two selected ACP countries and points out what scope still exists for taxation measures to improve distributional equity without impairing allocative efficiency.

Fiscal policy plays a crucial role in the context of structural adjustment programmes. Its importance lies not only in the contribution it can make towards achieving short-term stabilization objectives, but also in its part in laying the foundations for sustainable growth. During the first half of the 1980s, fiscal policy reforms in developing countries concentrated on tax increases and expenditure cuts, with the latter applying especially to public investment and to social welfare expenditure. These moves generated widespread criticism directed at the social consequences of structural adjustment programmes. The IMF and the World Bank responded to these criticisms by taking steps to provide social cushioning for the reforms. As part of the latter process, adjustment programmes increasingly began to be complemented with additional social programmes.

On the revenue side of the budget, too, considerations of equity (distributional policy) began to find their way into fiscal policy reform proposals. Nevertheless, the expenditure side is still widely regarded as offering more suitable means of reaching low-income groups directly. For example, a combination of income transfers and well-thought-out, target-group-oriented measures for combating poverty can indeed slightly raise the incomes of these population groups. In view of the sheer scale of the problem of poverty, however, one inevitably has to ask what

contribution can, or indeed must, be made to the struggle against poverty by taxation policy.

This article begins with a brief survey of the tax policy reforms which have typically been carried out in African-Caribbean-Pacific (ACP) countries. It then makes an assessment of the equity effects of taxation policies in two selected ACP countries, namely Jamaica and the Ivory Coast, and points out what scope still exists for taking taxation measures to alleviate the living conditions of low-income groups without impairing the competitiveness of the economy in question.

Revenue Collection Systems and Tax Reform

The traditional tax systems in place in ACP countries generally tended to be very complex, making the allocative and distributional effects extraordinarily difficult to discern. The level of taxation is generally rather high, and this applies especially to the countries of sub-Saharan Africa. Because the tax base is often relatively limited, personal income taxation plays a relatively minor part. Accordingly, corporate income taxation is of relatively greater importance, and this is raised almost exclusively from a small number of large foreign corporations in the export sector. The structure of tax rates is normally progressive. However, tax avoidance and evasion are both widespread.

Systems of value-added taxation are now being put into practice more and more frequently. However, the majority of countries continue to use other forms of sales taxes, normally taking imports only as their tax base.

* Hamburg Institute for Economic Research (HWWA), Hamburg, Germany. This article summarizes the main findings of a report written for the Commission of the European Communities, Directorate General for Development. The full report will be published shortly.

Excise duties also constitute a widely used instrument. As in the case of direct taxation, the large number of different indirect taxes, applied at different rates and with different exemption patterns, add up to a highly complex system.

The most prevalent form of taxation on wealth in ACP countries is property tax, but its significance has been in steady decline due to the administrative problems it raises.

Dependence on foreign trade taxes is greatest in sub-Saharan Africa. That applies particularly to taxes on imports, while taxes on exports chiefly function as a form of taxation on agriculture. Both types of tax or duty generate substantial distortions in the relative prices of domestic and foreign goods.

User charges by public utilities, any surpluses earned by public-sector enterprises, and social insurance contributions all make up further potential revenue sources. However, they are of little significance within the picture as a whole, and if anything they tend to represent a burden on the government budget rather than a contribution to it.

Due to countless deficiencies as regards the number of experienced staff, the procedures used and their organization in general, tax administrations in ACP countries have a reputation for inefficiency. Particularly in view of the complexity of the tax system, they are often overstretched and unable properly to perform the tasks expected of them.

The tax reforms which have been instituted as part of the structural adjustment programmes in ACP countries have placed their prime emphasis on simplifying tax systems and raising their efficiency. As part of these moves, greater importance is attached to the goal of horizontal equity, while vertical equity is considered virtually unachievable.

In accordance with these goals, the essence of the reform policies lies in simplifying the tax system as a whole, lowering taxation rates, broadening the tax base, and eliminating tax advantages, exemptions and incentives. The same approach is also normally taken to value-added tax, which tends to take the place of a whole range of existing indirect taxes. Endeavours to take account of distributional policy objectives are manifested, in the case of income taxation, by the introduction of lump-sum standard deductions and, in the case of indirect taxation, by exempting or zero-rating a number of staple goods. At the same time, excises are used to increase the rate of taxation on luxury items.

In the field of foreign trade taxes, the reforms aim to reduce or completely eliminate taxes on exports, while

also reducing and standardizing import duties. Revenue administrations, too, have been the object of reforms designed to improve their efficiency.

The Case of Jamaica

Jamaica is a good example of a country which has had a very high tax burden and a complex taxation system in the past. Individual income taxation was strongly progressive, but had a large number of different credits allowable against it. Bonuses or other special payments to employees (known in Jamaica as "allowances") and interest income were not taxed at all, and overtime pay only at a low rate. Two cumulative rates were applied in the case of corporate income taxation, once again with a large number of tax concessions. In addition, the system included five different forms of payroll taxes and also a property tax charged on site values but including a large number of concessions. Indirect taxation consisted of countless individual taxes applied at widely differing rates. Three types of duty were imposed on imports. The revenue administration was weak and inefficient.

Accordingly, the tax reform set itself the objective of simplifying the tax system and enhancing its efficiency. At the same time, though, the wish was to avoid making the new system any more regressive than the old, or imposing any higher a tax burden on low-income households.

The income tax reform carried out in late 1986 and early 1987 introduced a uniform rate of 33 $\frac{1}{3}$ %, the old tax credits were abolished, and a standard deduction was introduced in their place. "Allowances" and interest income were both now liable to taxation, and the special treatment given to overtime earnings was also abolished.

At the end of October 1991, a large number of different indirect taxes were replaced by General Consumption Tax (GCT) at a uniform rate of 10%. Goods which make up a particularly large part of poorer households' spending were zero-rated, while excise duties were maintained in the guise of a Special Consumption Tax (SCT).

Only slow progress was made in reducing the burden of taxes on imports. Nor were payroll taxes reformed, while the reform of property tax was confined to a revaluation of the sites which are taxed.

Côte d'Ivoire

With an average taxation ratio of 27% of GDP, the burden of taxes and charges in the Ivory Coast was above the level of other African countries in the last decade. Nevertheless, government revenue proved very unstable over the course of time.

The pre-reform system of direct taxation consisted of a series of individual, schedular tax types which had been introduced to deal with different types of income and were all charged at different rates. These were all supplemented by a general income tax payable on all types. This meant in practice that wages and salaries, for example, were subject to four different tax deductions at source. Then there were another four types of payroll tax on top of that. The direct taxation system was completed by a number of different property taxes. Indirect taxation, too, was just as multifarious. The most important revenue source in this category was value-added tax (TVA), but there was also a different sales tax on services, and there were several different excises and stamp duties or licence fees. Apart from that, not only imports but also exports were taxed both directly and indirectly. The large number of taxes, exemptions and special provisions imposed an unmanageable burden on a revenue administration which was inadequately equipped and trained.

The prime aim of the tax reform introduced at the end of the 1980s was to put a stop to the decline in revenue, while also strengthening the country's competitiveness by improving allocative efficiency. When set against these two prime objectives, that of fiscal equity had only a subordinate part to play.

The main emphasis in the tax reform implemented to date has been placed upon indirect taxation. The key change here has been an extension in the coverage of value-added tax to take in sectors which used to be exempt, coupled with the almost complete abolition of the earlier alternative sales tax on services. The taxation of petroleum products has also been reformed, tourism tax abolished, and licence fees and stamp duties lowered. The rate of customs duty has been unified for almost all goods, and the various special duties abolished. Differentials in rates of protection still persist by way of fiscal duties. Reforms in the field of direct taxation have been confined to a reduction in the rate at which the profits of joint-stock companies are taxed from 40% to 35%, while payroll taxes have been reduced with a view to their eventual abolition.

Evaluation of Tax Reforms: Jamaica

Now that it has carried out its tax reform, Jamaica has a vastly simplified tax system. The following aspects may be highlighted when assessing the changes against the objectives which had been set:

- Little change has occurred in the revenue buoyancy of income taxes. It is too early as yet to assess the effect of GCT in this regard, but it is quite probable that there has been an increase in the buoyancy of indirect taxation.
 - The stability of revenue from taxes on income has increased.
 - The allocative distortions resulting from the earlier tax system have been eliminated in a number of areas, left untouched in others, and in one other at least, namely dividend taxation, have been exacerbated. In common with other structural reforms, the tax reform has also contributed to an improvement in macroeconomic frame conditions.
 - The old tax system led to major instances of vertical and horizontal inequity. Even so, the reform has not managed to bring about any marked improvement in distributional effects. The main reason for the vertical inequity of the old system lay in the large amounts of tax avoidance and evasion it made possible. The simplification of the tax system and administrative reforms have still not been enough to have any major effect in curbing these practices. The reformed system has also failed to meet expectations with regard to horizontal equity.
 - The burden faced by low-income groups due to indirect taxation has remained largely unchanged. The regressive effects of GCT have been partly counteracted by zero-rating the types of food normally purchased by those groups in particular.
- Political and economic factors on the one hand and the *faits accomplis* established by the tax reform both impose constraints upon the scope for relieving the burden on the poorer strata and increasing that upon the richer ones. Nevertheless, measures with that purpose could still be taken in the following spheres:
- A thorough improvement of the revenue administration in order effectively to combat tax avoidance and evasion.
 - Index-linking of the standard deduction against individual income tax, to avoid increases in the burden on low-income earners due to erosion by inflation.
 - Introduction of a small number of tax credits, geared to clearly defined criteria, to ensure horizontal equity among low-income households.
 - Reform of payroll taxes, especially including the abolition of upper limits, thus eliminating favourable treatment of the better-off.
 - A reduction in the number of concessions granted and continual site revaluations for property tax purposes, thus improving the taxation of real estate.
 - The development of a system of charges on intensively used property sites in order to recover the additional costs incurred by local authorities.
 - Extension of the range of zero-rated GCT to also cover

certain services much used by poorer people, to further reduce the tax burden they face.

□ Introduction of a higher rate of GCT for luxury goods, to increase the burden on richer population strata.

Evaluation of Tax Reforms: Côte d'Ivoire

The reforms carried out so far in the Ivory Coast have served mainly to simplify the system of indirect taxation. Now that the ambit of value-added tax (TVA) has been extended, this has contributed towards halting the decline in the tax load ratio. It is also reasonable to assume that the reform of TVA will have improved the tax system's revenue buoyancy.

The extension of TVA to cover wholesaling and retailing, services and petroleum products eliminates many discriminatory features, and as such has improved allocative efficiency. The resulting reduction in the cost of such an important industrial input can be expected to strengthen competitiveness substantially. The reforms of direct taxation so far carried out will also have had similar effects in this regard.

An incidence analysis for the tax system before the reforms began showed that it was responsible for a considerable amount of income redistribution within society. However, that redistribution did not always necessarily flow from the rich to the poor. Instead, different groups of households were favoured or placed at a disadvantage by different types of taxes. The reforms so far instituted have probably brought a slight improvement in the redistributive effect of the tax system.

However, there remains a certain amount of scope to reduce the tax burden on poorer population strata by moving ahead with the reform policy. One aspect of this would be a carefully prepared further extension of TVA to cover the transport and agricultural sectors. However, considerably greater scope for improving equity is offered by the field of income taxation. Apart from that, the introduction of a uniform income tax would simplify the task of the revenue administration and help to close existing loopholes.

Differing Degrees of Commitment

In both Jamaica and Côte d'Ivoire, the traditional tax systems were characterized by the typical deficiencies prevailing in the ACP countries. In both countries too, therefore, the overriding aims of tax reform were to simplify and rationalize the system. Distributional equity was not a priority objective in either instance.

Probably the most significant difference between these two countries' tax reforms was the manner in which they

were carried out. In Jamaica, a comprehensive reform was largely implemented in practice within a short period of time. In Côte d'Ivoire, on the other hand, the reform policy was only realized in small steps, and indeed a reform of income and property taxation has yet to be undertaken. Behind these two different approaches, there lie strongly differing degrees of commitment to tax reform on the part of the respective countries' governments. That is particularly clearly manifested in the way the ground was prepared for the reforms.

In both countries, various reform measures still remain to be taken. That is especially true of Côte d'Ivoire, where the reform of direct taxation has not yet progressed beyond the issue of proposals by the World Bank, and a number of declarations of intent. Furthermore, there is still ample scope in both countries to decide upon and implement additional tax policy measures to relieve the burden on the poorest members of society. In both cases, though, further investigations are needed to work out how such measures ought to be designed in detail.

Conclusions

Despite the differences which are apparent at the more detailed level, the findings of this enquiry into tax reforms in Jamaica and the Ivory Coast do point up many common fundamental problems as regards the approach taken towards distributional equity. It is indeed therefore possible to draw some general conclusions applicable to the design of tax reforms. A trade-off usually exists between allocative efficiency and distributional equity. Nevertheless, there are some situations, especially prevalent in developing countries, in which a tax may improve allocative efficiency and distributional equity at the same time. In the former case, though, a compromise must be reached between the two conflicting objectives.

The reforms promoted by organizations chiefly including the World Bank and the International Monetary Fund are oriented towards simplifying the tax system, eliminating market distortions and incentives to capital flight, and avoiding the imposition of a higher burden upon the members of low income brackets. In view of the fundamental tension cited above, and also of the experience made in the past with the distinction between nominal and effective progressiveness, these reforms are undoubtedly aiming in the right direction.

Reform of the taxation system can only be a sustained success if it is supported by a broad societal consensus established before the reforms are instituted. Explanation and participation are the two crucial elements needed to ensure such a consensus. The objectives of the tax reform

and the planned reform measures should be explained in detail to the general public using all available communications media. At the same time, representatives of all major interest groups should be involved in the committees and working parties discussing and preparing the tax reform agenda. Careful analysis of the pre- and post-reform systems by influential and well-informed experts can help convince the tax reform's opponents of the soundness of the proposed measures.

In order to minimize the adjustment costs, the tax reform should be implemented at an early stage of the adjustment process. This ensures higher budget revenues, thus also lowering the pressure to make cuts in expenditure or to take ad hoc measures to overcome the fiscal crisis. Especially in cases in which tariffs contribute a significant share of total government revenues, the tax reform should precede tariff reform.

The distributional effects of taxation will only be improved in conjunction with such reforms on the proviso that the revenue administration is efficient enough. The need to strengthen tax administration must not be neglected as it so often has been in the past. Rather, this needs to be accorded equal priority as a prime aim of reform policy. If it is not, the situation will deteriorate as the rich benefit by lower tax rates and their persisting indulgence in tax evasion.

A certain degree of consideration to distributional equity can only be given by means of differential taxation. Yet only an effective revenue administration will be able to prevent the full exploitation of the loopholes for tax avoidance that such differentiation is likely to create.

In the field of direct taxation, the most effective means of relieving the burden on the poor is to have a uniform tax applied to all forms of income with a generous basic deduction to protect a subsistence level of income. For the sake of better horizontal equity, attempts ought also to be made to compensate for the burdens of differently sized families by granting additional deductions or tax credits which vary with family size.

In the field of indirect taxation, the best means available of protecting the poor from undue tax burdens is to zero-rate or exempt the goods and services which make up the bulk of these population groups' consumption.

It is quite possible to increase the income tax take from the rich by having just a small number of rate bands. However, the point of prime importance is that clarity and greater simplicity must prevent the emergence of loopholes for tax avoiders or evaders. The top rate of income tax should be set at a level which will not create an undue incentive for tax evasion, capital flight or flight to tax

exiles. The rates of tax prevailing in neighbouring countries will influence this decision.

In the area of indirect taxation, the opportunity to impose higher taxation on so-called luxury goods and services ought not to be missed. Although the objection is often made that the progressive effect of such surcharges is only limited and that the additional revenue raised is hardly enough to justify the increased administrative effort, it is still the case that it is frequently especially difficult to leave the introduction of such taxes until later on when the situation has probably changed. It should also be borne in mind that an element of luxury taxation may increase the acceptance in society for the reform proposal as a whole.

The question of which goods and services should be exempted from indirect taxation because they make up the bulk of low-income households' consumption or which should be taxed particularly heavily as luxury items will be answered very differently from one country to another, just as changes within a single country may occur over time. Hence systematic household surveys are required, along the lines of Living Standards Measurement Studies (LSMS). Only by gleaning the information such studies provide can the necessary careful selection of goods and services be made. Such studies also provide a working basis for the incidence analyses which are also vitally needed both before and after the reform.

Neither customs duties nor user charges raised by public utilities provide any great deal of scope for taking distributional factors into account. In the case of customs duties, the reform policy's objective is generally to establish a uniform, non-discriminatory level of import protection. Distributional goals can be achieved just as effectively by imposing taxes on luxury items imported or produced locally. The restraints on using public utilities as a channel for distributional measures come both from the cost recovery principle and from moves to privatize the enterprises concerned. Apart from that, there are better means of alleviating poverty available on the expenditure side of the government budget.

When assessing the tax burden on the poor, the overall effect of all tax types taken together ought to be considered. A burden imposed by one form of taxation need not necessarily give grounds for concern if relief is provided from elsewhere in the tax system. Above all, it is important to keep in mind the connection between the revenue and expenditure sides of the government budget. It may be more beneficial for low-income groups to accept the burden imposed by a certain form of tax if this can then be compensated for by way of transfer payments and/or the provision of essential public services such as a water supply.