

CPF-DS-1. .

JOINT TAX PROGRAM OAS-IDB-ECLA

Conference on Fiscal Policy

FISCAL CAPACITY OF DEVELOPING ECONOMIES:  
ISSUES OF TAX POLICY

Santiago, Chile  
December 5-14, 1962  
Document: CPF-DS-1T

PRELIMINARY

NOT TO BE QUOTED



## INDEX

	<u>Pages</u>
<u>Issues of Tax Policy</u> . . . . .	1
Canons of taxation . . . . .	1
Revenue <u>versus</u> incentives . . . . .	2
Revenue <u>versus</u> equity . . . . .	4
<u>Aggregate Fiscal Capacity</u> . . . . .	8
Upper limits of fiscal capacity . . . . .	8
Determinants of fiscal capacity . . . . .	10
Fiscal capacity and national income . . . . .	11
Fiscal performance . . . . .	12
<u>Avenues of Fiscal Expansion</u> . . . . .	17
Taxation of foreign trade . . . . .	17
Taxation of internal transactions . . . . .	24
Taxation of incomes . . . . .	27
Taxation associated with benefits . . . . .	33
Taxation of agriculture . . . . .	34
Problems of administration . . . . .	36
<u>Conclusion</u> . . . . .	39
Annex . . . . .	40



## FISCAL CAPACITY OF DEVELOPING COUNTRIES

Issues of tax policy

1. Requirements of economic growth have compelled the governments of developing economies to entice a large proportion of resources away from consumption and much of it away from the private sector in order to invest it in economic and social infrastructure for growth. The task is rendered difficult since per capita incomes are low and the average propensity to consume remains high. Evaluating fiscal capacity or potential of developing economies, therefore, has to be preceded by a common agreement upon policy issues, since these issues call for a shift in emphasis from the principles traditionally accepted in economic discussions relating to taxation.

Canons of taxation

2. The principal reason for all tax levies is, of course, the need of the government to secure resources to implement its "functions of state". In the context of the developing countries - of Africa, of Asia, of Latin America - taxation problems have to be viewed in relation to not only the functions of law, order and literacy directly undertaken by the government, but in relation to the programmes of economic growth promotion - under the aegis of both government and private sectors. The relative mix of the two sectors may vary from one country to another, but the growth objective remains common to all of them. To the extent that co-operation of the private sector is sought - not only as entrepreneurs and employers, but also as wage-earners and farmers - the question of incentives becomes relevant to the discussion of taxation problems. In other words, account has to be taken of the effects of specific tax measures and of the tax system as a whole upon the direction and efficiency of capital investment and of individual efforts. Finally, problems of taxation, more than of any other field of economic discussion, are affected by considerations of equity. The government is called upon to collect revenue (and reallocate spendable incomes)

/in such

in such fashion as would mitigate inequality, realistically assumed to be a concomitant of the prevailing institutional arrangements for sharing (and inheriting) incomes and wealth. Evaluation of a fiscal system, therefore, contains a blend of three considerations - revenue (i.e. transfer of resources to the government), incentives (largely for the private sector) and equity (in sharing the "burden" of taxes and also the benefits of public spending).

3. The three aspects, conceptually distinct, are obviously inter-dependent. Revenue measures may adversely affect the incentives to work and to invest. Concentration upon incentives or extensive relief for low-income groups, on the other hand, by reducing public revenues, may actually hurt the poor themselves if such giveaways were to hamper growth by decreasing government spending on economic or social overheads. There cannot be, therefore, any absolute rules prescribing an optimum for the mix of revenue, incentives and equity in framing or evaluating a fiscal pattern or system. A teleological and pragmatic approach is required. Growth being the prime concern of economic policy, economic efficiency in the use of resources must provide the guiding principle in such an approach.

#### Revenue versus incentives

4. The lagging behind of fiscal performance in relation to fiscal potentials in most developing economies would suggest, however, that increasing the fiscal yield constitutes the principal direction of tax reform. If that is the case, what importance should be given to the related questions of incentives and equity?

5. The question of incentives is phrased in two forms: it is a plea for a low average rate of taxation taking all taxes together, and it is a plea for generous but specific incentives irrespective of whether the average level of taxation is high or low.

6. The plea for a low average rate of taxation is advanced more generally in those developed countries where the private sector is the

/major provider

major provider of economic growth. It is argued there that the established tax levels are high, they dampen private sector incentives to produce, to save and invest and they are thus injurious to growth.

7. In the context of developing economies, however, this view has meaning only if the average level of taxation impinges on subsistence, or at the most, on the basic amenities of life. On the other hand, in these countries revenue is essential to provide the needed resources for government investment in infrastructure or other public activities which constitutes a prerequisite for activating private investment and economic expansion.

8. The alternative of leaving these resources in private hands raises the question of how much they would contribute to growth. The propensity to consume is inordinately high in some countries of Asia and more generally of Latin America where the "demonstration effect" with respect to consumption is significant and inflation has discouraged savings. The outflow of capital from the latter region, especially to the United States, is of substantial importance. And the relatively low level of private domestic investment is often channeled into "investment" in luxury buildings and the like. The "discouragement" of too little taxation provides perhaps a more general instance of the misuse of resources in developing economies than the "disincentive" influence of too much of it.

9. As to specific incentives, a gamut of these has been evolved in order to encourage the private sector to save and invest into new and necessary ventures as several of the investment promotion laws describe them. The concessions aim at reducing the cost of capital goods through relief from excise or import taxes or at increasing the profitability (or, conversely, reducing the period for recouping initial investment and thus the initial risk of investment) through income tax concessions. While these incentives were widely welcomed and generously implemented in the fifties, a doubt seems to be emerging with regard to their efficacy and desirability of suffering the revenue loss which they entail.

/As the

As the 1960 Survey of the Economic Commission for Asia and the Far East (ECAFE) puts it:

"Tax incentives are rather a delicate instrument of economic policy; they can be effective only if the general climate is favourable to private investment. Tax liability is only one of several factors taken into account in arriving at investment decisions; although it is an important consideration, it is not necessarily the most important one. If the concessions are to be effective, they have to be co-ordinated with other factors having a bearing on private investment. The most powerful incentive for private investment in the postwar period has perhaps been provided by the aggregate effect of fiscal policy on the level of effective demand in the economy and by the assurance that the demand will continue to expand and that competing products from abroad will be shut off by protective tariffs." 1/

Indeed, general tax stimuli seem to be no longer advisable once industrialization has passed beyond the initial stage.<sup>2/</sup> By exempting the new, growing and sheltered industries from paying taxes, governments have suffered revenue losses which can be hardly justified if account is taken of how well these industries have done as judged by their capital appreciation in the stock markets of their countries. General concessions such as broad tax holidays ought to be replaced by more limited and selective directional incentives such as investment and depreciation allowances geared closely to reinvestment.<sup>3/</sup>

#### Revenue versus equity

10. If more revenue is to be obtained in poor countries, what importance should be given to the question of equity in apportioning the tax burden between the different groups of taxpayers? This question also must be approached from the standpoint of efficient utilization of the resources

---

1/ Economic Survey of Asia and the Far East (ECAFE Survey) 1960, p. 99.

2/ A special problem of the Central American Common Market is the competitive race to grant costly and wasteful concessions to attract industries to be located in the territory of one country rather than that of its neighbour. A special treaty has now unified tax incentive laws to overcome this problem.

3/ See United Nations, The Promotion of the International Flow of Private Capital (E/3325, 26 February 1960), paragraphs 146-159.



of a developing economy for growth. It is obvious that if all the resources over and above those necessary to maintain subsistence living - the "economic surplus" of the community - were to accrue to or remain with those with relatively low incomes, they would tend to be almost exhausted in further consumption. Undoubtedly, augmented consumption levels are in themselves the object of economic development and by reacting favourably on sanitation and health would in turn enhance economic productivity. But beyond a certain basic need for individual action, collective measures for public health and education undertaken by the government are more economical, efficient and effective. Whether the "economic surplus" accruing to those with high incomes should be left with them will similarly depend on the use to which the high income groups are putting the resources at their disposal. If the presumption is that they behave as rentiers and use their incomes (or accumulated or inherited wealth) for luxury living, then again the government should collect these incomes to build up the necessary capital for economic growth. Such a society would, therefore, call for heavy taxation both of the low and high income groups. It would be a society in which the attempt of the government might well be to obtain most, if not all, of the "economic surplus".

11. If, on the other hand, those with high incomes save - in the sense of abstaining from consumption - and invest in productive endeavour, or could be made to do so by judiciously selective government action, including incentives, then taxation of the rich becomes a subject for delicate handling. Although considerations of equity may demand a sharply progressive taxation of high incomes, those of economic growth may dictate otherwise. The compromise to be favoured is the one which would secure the largest proportion of the "economic surplus" to be devoted to activities which would promote growth in the community, that is, the public and private sectors taken together.

/12. It is

12. It is in this area that governments of several developing economies seem to be caught on the horns of a dilemma. Democratic and often socialistic in their orientation, to-day's legislators consider it a political mandate to reduce inequalities of income and wealth in their societies. In doing so, they increase the potentialities for consumption at the expense of those for saving (and investment). By legislating for a low revenue yield (or a high volume of income transfers to the private sector) they expose their governments to two alternatives: giving up programmes which would have helped economic growth or pursuing them under conditions of inflation, which again is a highly inequitable way of obtaining resources.

13. The question of equity, therefore, has to be seen from a new angle. Even from the point of view of those with low incomes, economic growth is the best guarantee for relief from poverty. They are going to be hurt if the economy stagnates. Secondly, inflation is also likely to injure them, since their bargaining power is weaker than that of the well-off. In under-developed countries, their best hope, therefore, lies in avoiding both stagnation and inflation, even if this means submitting to higher levels of taxation. Equity would, of course, suggest, a sharp progression in taxing those with high incomes. But the latter may have to be rewarded if (and only on that condition) the necessary impetus and effort for growth could be secured from them in return. While, therefore, taxation of the low-income groups becomes almost mandatory, taxation of the well-off, approached from the standpoint of economic growth, requires a particularly discriminate and pragmatic handling.

14. A minor conundrum may be removed in concluding this discussion of equity. In many instances of tax advice, considerable attention is given to equity aspects of single taxes. It is true that if every tax in a fiscal system is equitable, the system as a whole is equitable. But a similar result can be obtained also by a combination of taxes some borne primarily or wholly by the poor and others by the rich. It is not the equity of every single tax that is important. What is relevant is the equity of the tax system as a whole.

/15. Even the

15. Even the question of the aggregate tax system has to be related to the distributional consequences of aggregate government spending which normally is biased in favour of the low-income groups. Thus, it is the equity of the whole gamut of government operations which is relevant. In any case, seeking equity through government operations, and further still, equality through government legislation, has complex ramifications for economic growth. An adequate discussion of these ramifications would be beyond the scope of an inquiry primarily directed to problems of fiscal policy. Here it would suffice if it is recognized that considerations of equity may have to take second place to those of economic productivity in devising for developing economies fiscal systems which are geared to growth.

16. Of course, it is not inconceivable that governments may fritter away resources (for instance, in inflated payrolls, military adventures or luxurious government buildings) which, left in private hands, could have been utilized in economic activities conducive to growth. If the governments are to enjoin and enforce upon the citizens the need to refrain from unnecessary consumption or ostentation, the governments, in their turn, owe to these citizens the same utmost economy and growth-oriented use of resources. Frivolous spending becomes as much a habit with governments as it is with individuals. Measures for tax reform, therefore, cannot be advocated in dissociation from concern with the purposes and pattern of government spending.

/Aggregate fiscal

### Aggregate fiscal capacity

#### Upper limits of fiscal capacity

17. Theoretically, the whole national income over and above the subsistence level existence for the community (or even more if capital levy is brought into the picture) can be channeled into the state coffers. Such a level of taxation has been conceived of in the context of centrally planned economies, where all entrepreneurial activity is taken over by the state and where the state enforces rigorous savings on its citizens for rapid capital formation. In practice, even in the centrally planned economies of the world, resource control of this magnitude has hardly endured, although attempts have been made at various times to almost reach such a level.

18. In mainland China, for instance, the state collected for "the state-owned economy" as much as 33.2 per cent of the country's "net material income" in 1957, shared in the 64.0 per cent of the income which went to "joint state-private economy" and "co-operative (collective) economy" and left only 2.8 per cent at the free disposal of the "individual economy".<sup>4/</sup> Considering the low absolute level of the national income of the country, it is conceivable that almost all income above subsistence levels must have gone to defray the costs of national investment (all investment having been nationalized) and other government expenditure.

19. The economic upper limit of taxation may, as a rule, be considered to be set at that level beyond which taxation would tend to reduce the (potential) rate of economic growth. This economic upper limit has, however, got to be distinguished from the political upper limit of taxation, which may lie below or above the economic limit. In the case of mainland China, the political limit may have gone beyond the economic limit, since, following an economic setback, the Government was subsequently compelled to relax the extent of its control over resources.

---

<sup>4/</sup> State Statistical Bureau, Ten Great Years, Peking 1960, p. 42.

Even in free enterprise economies, in an extreme emergency such as war, the government may, for a short period, stretch its "long arm" beyond the economic limit. This may also happen in countries where the government's zeal for redistribution of economic power through the employment of fiscal mechanism may be pushed to a point where it retards growth.

20. In practice it is more usual to find that the political upper limit of taxation remains substantially below the economic upper limit of taxation. Taxation, beyond a certain limit and in specific areas of economic activity, may evoke so strong a political opposition that such reform has to be treated as impracticable. Closely allied to the political factors are the institutional arrangements of a society - institutions such as those of ownership of property, systems of family and inheritance, etc. Institutions get so entrenched that it may be almost impossible, in the short run, to alter their pattern. In other words, the discussion of tax policy has to reckon with the limiting constraint of what may be described as the political and institutional milieu of the society under consideration. Even if it may be permissible to ignore these factors in considering taxable capacity from the standpoint of economic theory, in any discussion of economic policy, it is prudent (and realistic) to acknowledge the existence of this restraint upon fiscal reform - at least over the short run.

21. Recognition of the political and social barrier, however, does not mean the acceptance in toto of existing political alignments or of a given institutional structure; all potentialities of change and improvement must be explored. Nor does it preclude the possibility of a difference of opinion as to where the political limit stands or as to the prospect of bringing about institutional changes. It should, however, be feasible to obtain a more or less general agreement upon the criteria for measuring fiscal capacity within a given institutional

/pattern, or

pattern, or within a projected change in it, even if this change has to be considered as an exogenous element representing the political or social will of the community.

Determinants of fiscal capacity

22. In principle, the capacity of a country to raise taxes would be a function of the absolute level of per capita national income. The higher this absolute level of per capita income, the greater is the size of the "economic surplus" and, therefore, the capacity of the community to spare resources for common functions.

23. Given the absolute level, the distribution of national income becomes relevant, since those with high incomes have proportionately greater capacity to contribute to the fisc than those with low incomes.

24. Empirically, however, it is found that tax performance has largely varied with the institutional and economic facilities for tax collection. Thus a community with a higher ratio of foreign trade to national incomes collects usually a larger proportion of the national income as revenue than another at a similar level of national income but with greater domestic orientation of its economy. Primarily institutional factors such as the relative significance of the monetary sector as compared with the non-monetary sector in the economy, of the corporate sector as against unincorporated enterprises, of plantations as against peasant farms, seem to have had a determining influence on the proportion of aggregate national resources governments have been able to collect in revenue. In other words, if the institutional pattern of a society provides a number of accessible tax bases, it vastly augments its fiscal potential.

25. Finally, taxable capacity is related to the competence and integrity of the civil service of the country. The widespread evasion of taxes and corruption of public officials in several under-developed countries point towards potential which could be realized even without altering the substantive structure of the tax systems.

/Fiscal capacity

Fiscal capacity and national income

26. As noted above, the linking of fiscal capacity to national income stems from the concept of "economic surplus", which represents the proportion of total output in excess of the amount required for subsistence. This surplus is what is available for additional consumption and investment (in functional terms) and for distribution between the private and public agencies (in sectoral terms). In a low-income centrally planned economy, where all investment is nationalized, in attempting to attain a rapid rate of growth, little allowance is made to augment consumption (in the private sector). The fiscal performance of such an economy, therefore, tends to encompass almost the whole of the "economic surplus". In economies on the other hand, where the private sector is counted upon to contribute a substantial proportion to national investment, the government, due to economic and political reasons, has to allow some proportion of the "economic surplus" to remain with its citizens for augmenting their average levels of consumption over and above bare subsistence and for private investment. Where precisely the line is drawn between these two extremes is a matter of an implicit or explicit political decision. It does, however, remain true that the larger the size of the "economic surplus", the higher is the fiscal potential.

27. The lower per capita income of the developing economies would thus normally indicate a lower ratio of fiscal potential to national income. There are, however, considerations which suggest that, as a norm, the developing countries may rather approximate or exceed the proportions of national income actually attained by advanced countries. In the first instance, the distribution of incomes in the newly developing countries is generally more unequal than in the advanced countries - a fact which favours a higher tax potential. What is more important, however, is the significance of this inequality for economic growth. In many developing countries, the rich tend to use their wealth (and inordinately high incomes) to a great extent for purposes inconsistent with raising economic productivity of the communities. The second main reason, partly following  
/from the

from the first, is that governments of the developing economies are called upon to assume responsibility for a relatively larger proportion of national investment than in the advanced countries. Since, therefore, more of the "economic surplus" is needed for investment, and more of the needed "investment" is to be made by the public sector, the proportion of the "economic surplus" required to be channeled to the government in the developing countries is larger than in the advanced countries. Thus, on the one hand, the size of the "economic surplus" tends to be small in the developing economies because of their lower per capita incomes; on the other hand, a larger proportion of it has potentially to be made available to the state to undertake the tasks of development. Nevertheless, the wide discrepancies between the absolute levels of per capita national incomes of the developing and the advanced countries would continue to be reflected in the absolute volumes of per capita fiscal yields.

28. Again, whatever the average ratio of tax potential to a given level of national income, it should be possible to increase this ratio with a rise in the national income. In other words, it should be possible to secure higher proportions from marginal rises in national income. The tax system as a whole could be "progressive" in relation to the rise in the level of the national income. And still, in several countries (particularly in Mexico and Central America), while the national income has increased, the ratio of revenues to national income has tended to stagnate or even fall.

#### Fiscal performance

29. In advanced private enterprise economies, revenues obtained seem to vary from one fifth to one third of the net national income. In the less developed countries, the ratio of government revenue to net national income falls within a wider range - for instance, from 7 to 27 per cent in Latin America (see table 1). Similar discrepancies can also be observed in Asia. The fiscal products in the centrally planned economies run much higher.<sup>5/</sup>

---

<sup>5/</sup> In the Soviet Union and Poland, for instance, government revenue was 53 per cent of net material income in 1959 (Revue de Science Financière, January 1962, pp. 33-34).



Table 1

LATIN AMERICAN COUNTRIES: GOVERNMENT REVENUES IN PERCENTAGES  
OF ESTIMATED NET NATIONAL INCOMES, 1959 <sup>a/</sup>

Countries with a high level of tax revenue	Countries with a medium level of tax revenue	Countries with a low level of tax revenue
Venezuela ..... 27	Peru ..... 19.5	Panama ..... 15
Argentina ..... 24	Chile ..... 18	Mexico ..... 14
Brazil ..... 23.5	Costa Rica ..... 16	Colombia ..... 14
Ecuador ..... 22	Guatemala ..... 16	El Salvador ..... 13.5
		Honduras ..... 11
		Bolivia ..... 7 <sup>b/</sup>

Source: Compiled from national publications.

Notes: Government revenues include all current receipts - from taxes, sales and charges, surplus of government enterprises, etc. - of central and local governments (except in Bolivia, Peru and some Central American countries, where local revenue is of minor importance). Certain earmarked taxes for quasi-governmental funds and enterprises have not been included insofar as they do not appear in available official statistics; the omitted revenue from these taxes may be quite important in countries such as Colombia, for instance. Capital receipts are excluded. Social security or pension contributions are also excluded. The gross receipts of the social security systems are quite significant in Chile (14 per cent of national income) and Argentina (8 per cent), and only somewhat less so in Brazil (6 per cent), Ecuador (4 per cent) and Mexico (3 per cent). The net revenue contribution to the social security taxes, however, is considerably lower than these gross levels, from which government contributions and benefit payments to the private sector have to be deducted.

<sup>a/</sup> Except Argentina (1960), Bolivia (1958) and Peru (1956).

<sup>b/</sup> Per cent of gross national product. Tax revenue in real terms increased by about 50 per cent during 1958-1961.

30. The ratios in table 1 could serve only as rough indicators since, as stated in the notes to the table, the coverage of "total" government revenue, as given by official statistics, varies from country to country, and since the estimates of national income also differ widely in coverage and reliability. Despite these limitations, the statistics suggest that tax performance is not really related to the level of the national income. The revenues in Venezuela, Argentina, Brazil and Ecuador in Latin America or Ceylon and Taiwan (22-23 per cent of national income in 1958) in Asia, correspond with the levels reached in several advanced countries. And this does not necessarily mean that their potentials have even been fully exploited. Thus, for instance, the high level of Venezuelan revenues is derived primarily from taxation of petroleum. The oil companies directly pay substantial amounts in income taxes and royalties. If this direct contribution of petroleum industry is excluded, the rest of the Venezuelan economy, accounting for about three-fourths of the national income, contributed some 12 per cent; here there may be scope for further expansion of revenues. Or taking into consideration the major tax groups as given in table 2, with the aforementioned exception of Venezuela, no country in Latin America seems to have collected more than 5 per cent of its national income from taxes on income in 1959. There is, therefore, room for enlarging the scope of income taxes even in those countries which altogether collect a substantial proportion of national income for government revenue.

31. The high-revenue countries thus still permit a margin for further increase in revenues and there is no reason why this margin should not be further exploited. But in their case it is a matter of concern that, after such a high proportion of national income is gathered into government hands, in a few cases through fortuitous circumstances, an excessive proportion of it is applied to non-developmental expenditures. Venezuela and Brasil with 27 and 24 per cent of there national incomes collected in revenue, spent almost 20 per cent of national income as current expenditure.<sup>6/</sup>

---

<sup>6/</sup> A classification of government expenditure into current and capital is extremely unsatisfactory in this regard since a considerable proportion of current expenditure is developmental and a sizeable volume of capital expenditure may consist of monumental frivolity.

/Here there

Here there is some scope for pruning non-developmental expenditure, since the amount saved from being so spent is tantamount to an equivalent gain in revenue which could be utilized for growth. A rational allocation of government expenditure promises as fruitful a reserve of growth resources as an expansion in revenue in almost all developing economies, but this comment particularly applies to those countries which already collect a high proportion of national income as government revenue.

32. The problem of fiscal expansion per se is acute for countries which collect 15 per cent or less of their net national incomes in revenue. This situation is typical of Asia and Africa, but less so of Latin America, even though five<sup>7/</sup> out of a total of fourteen countries listed in table 1 fell into this category in 1959. Bolivia provides a striking example of low revenues: in 1958, it collected only 7 per cent of its gross national product as government revenue, mostly from taxes on consumption on imported or domestically produced items, while other sources yield insignificant amounts. Such a situation suggests the questions: are there ways and means for Bolivia to double the proportion of its national income which is collected for revenue in 1958? Can the medium level countries raise their proportions to bring them into the 20-25 per cent range? The answers, as outlined in the annex to this paper, can only be provided by analysis in terms of national studies, taking into account the data (on income distribution, consumption and saving patterns, distribution of existing tax burdens) available, and the specific alignment of political and economic forces in each country. In a global or regional approach such as the one necessarily employed in the main body of the paper, it would be more fruitful to consider the subject of fiscal expansion by major tax groups and review in broad terms the potentialities for growth each of these groups offers to serve the purposes of economic development.

---

<sup>7/</sup> Colombia has been excluded, since earmarked taxes would significantly raise its ratio of total revenues to national income in table 1.

Table 2  
LATIN AMERICAN COUNTRIES: SOURCES OF GOVERNMENT REVENUES, 1959  
(Per cent of net national income)

Country	Total revenue	Export taxes	Import taxes	Internal transaction taxes a/	Income taxes	Property taxes b/	Other receipts c/
Venezuela	27	9.7 d/	3.8	2.0	10.0	-	1.5
Argentina e/	24	2.8 d/	2.8	6.1	4.4	2.0	5.9
Brazil	23.5	0.1	1.3	10.5	3.3	0.5	7.8
Ecuador	22	1.3	5.4	3.7	1.8	0.6	9.2
Peru f/	19.5	2.5	4.4	4.0	3.8	-	4.8
Chile	18	-	2.6	6.0	5.2	1.5	2.7
Costa Rica	16	3.1	9.0	1.1	1.8	0.6	0.4
Mexico	14	1.1	1.6	2.3	3.4	1.6	4.0
Colombia	14	1.2 g/	1.9	1.6	4.8 h/	1.2	3.3
El Salvador i/	13.5	2.8	4.8	2.3	1.2	-	2.4
Honduras	11	0.5	5.0	2.5	1.7	-	1.3
Bolivia i/	7	0.2	3.6	2.2	0.6	-	0.4

Source: Compiled from national publications.

Coverage: See Notes to table 1.

- a/ Commodity and sales taxes (including turnover taxes), insofar as they could be determined or estimated. Other indirect taxes such as those on property transfers, stamp taxes, etc., are excluded. Sales taxes in some countries also apply to export sales and these may account for a significant part of sales tax revenue (this would appear to be the case in Brazil especially). Where the revenue corresponding to export sales could be determined, as in Argentina, it has been included under export taxes.
- b/ Taxes on urban and rural property, insofar as they could be determined or estimated, and where they represent a significant amount. In some countries, however, taxation of urban property is effected through municipal fees and revenue would be included under other receipts.
- c/ "Other" taxes, fees for government services, profits of public enterprises, income from government property, etc. These receipts have been so grouped because they could not be properly itemized for most countries.
- d/ Including oil royalties (Venezuela) and internal tax on export sales (Argentina).
- e/ 1960.
- f/ 1956.
- g/ Including government receipts from exchange differential transactions.
- h/ Including patrimony tax.
- i/ 1958.

/Avenues of

Avenues of fiscal expansionTaxation of foreign trade

33. The revenue potential of the foreign trade sector is determined by the size of the sector, by the relative productivity of export enterprises, by the structure of imports and by the ease of tax collection. The importance of these factors varies substantially in the different economies of Latin America. In general, however, activities directly connected with foreign trade have typically provided a significant proportion of revenue in these countries.

34. The export segment of this important sector, however, has tended to experience violent short-term fluctuations and relative stagnation on a long-term basis. Income inelasticity of demand for primary products and technological changes making for economy in the use of raw materials have made the market for primary commodities soft in the post-war period with the exception of the short-lived boom during the Korean War. The world prices of a great number of the most important export commodities of Latin America,<sup>8/</sup> have tended to decline during the last decade. This softness in the world markets for primary commodities has not only affected revenue from export taxes, but also from taxes on imports, incomes, etc. Export taxes have suffered directly and often sharply where sliding scales of duty were in operation. The attempts made by countries exporting primary products to improve their long-term position, by curtailing supplies or by entering into commodity agreements in order to maintain prices, have not as yet been wholly successful, even though they have appeared to give temporary relief.

---

<sup>8/</sup> Coffee represents 45 per cent or more of the value of total exports from Brazil, Colombia, Costa Rica, El Salvador and Guatemala; copper 70 per cent of the exports from Chile; tin ore 65 per cent of the exports from Bolivia; bananas 47 and 37 per cent of the exports from Honduras and Costa Rica respectively; and petroleum 92 per cent of the exports from Venezuela.

/35. The ensuing

35. The ensuing balance of payments difficulties have also tended to restrict imports in volume and in terms of the type of goods imported. Essential consumer goods and capital items, received either as aid or paid for by exports, are admitted duty free or bear low rates of duty. Such imports take the lion's share of the total. Imports of amenities and luxuries with high revenue potentials are being edged out. The replacement of revenue tariffs by protective tariffs has also made for a reduction in yields.

36. These trends, partly the outcome of export difficulties and partly of domestic oriented economic growth, seem to suggest a continuing decline in the still predominant importance of taxation on the foreign sector in the revenue systems of most economies of Latin America. International trade, however, is large in relation to national income in these economies. The productivity of the export sector is distinctively higher than the productivity of the domestic sector and imports may still provide a fruitful tax resource. Foreign trade is conducted primarily through a few points of entry or exit by land or sea. The imposition of taxes on foreign trade enables governments to collect revenues efficiently and cheaply. Finally, considerable experience has gone into developing fiscal administration of the customs, and major efforts are under way to overcome the still considerable threat of smuggling. Such accessibility to taxation is an asset which need not be frittered away by governments desiring to raise their revenue.

37. Revenue from the export sector can either be obtained from customs duties, from direct income taxation on exporting enterprises, from sales taxes or from royalties. Revenue may also be obtained from differential charges on foreign exchange transactions or through a wide variety of government trading organizations. These media of tax collection are not mutually exclusive but their accessibility and relative importance vary with the degree of economic and administrative development of the economy, with the structure of the export sector and with the institutional pattern of the country.

/38. Since customs

38. Since customs duties are easy and economical to collect, export duties have played and still play a significant role in less developed export economies. Costa Rica, El Salvador and Peru, for example, obtain some 2.5 per cent or more of their national income as revenue from export duties. Honduras and Bolivia, on the other hand, obtain less than half a per cent.

39. An alternative means of taxing the export sector is direct income taxation on exporting enterprises. This type of taxation is significant in all of the large and more developed economies of Latin America. Chile, for example, has no export duties but obtains a substantial part of its total revenue from direct taxation on a few large copper-exporting corporations. Sales taxes on exported commodities are of importance in the revenue systems of some countries, for example, Brazil and Argentina. Royalties from the petroleum industry constitute the main part of the revenue system of Venezuela. They contribute almost one third of the aggregate fiscal income of the country. Revenue from foreign exchange transactions was of substantial importance in several countries of Latin America during the decade after the Second World War. This kind of "taxation", which recently has been abandoned in many countries in the course of their attempts to rationalize their exchange systems, is still of importance in Brazil and Colombia and, to a lesser degree, in Venezuela.

40. Government revenue from the export sector of Latin America is thus obtained from a widevariety of alternative tax bases. The revenue yields from this sector, however, vary considerably between the different countries. Venezuela obtains some 15 per cent of national income as revenue, Argentina, Brazil, Peru and Costa Rica over 3 per cent and Bolivia and Honduras, for example, about 1 per cent or less. Government mines, accounting for some 75 per cent of the mineral production of Bolivia run at a loss, which means that almost half of the export sector fails to contribute any revenue. This partly explains the low ratio (only 0.2 per cent) of revenue from export taxation to national income in that country.

/Table 3

Table 3

CENTRAL AMERICAN ECONOMIES: COMPARATIVE TAXATION OF THE  
EXPORT SECTOR, 1959

Country	Value of exports (per cent of national income)	Value of main export articles (per cent of value of total export)	Income taxes a/ (per cent of net national income)	Revenue from export taxes	Total
Costa Rica	22	Coffee 50 Bananas 37	1.8	3.1	4.9
El Salvador	23	Coffee 71 Cotton 13	1.2	2.8	4.0
Honduras	23	Bananas 47 Coffee 19 Lumber 10	1.7	0.5	2.2

Source: Compiled from United Nations Statistical Yearbook 1961 and Yearbook of International Trade Statistics 1960, and national publications.

a/ It has not been feasible to estimate from available statistics the revenue obtained from export enterprises under the income tax. It is assumed, however, that the proportion of the contribution of the export industries to total revenue from income taxes does not vary to any significant degree in the three economies.



41. Although the demand for Latin American exports has in general become soft, some countries have succeeded in obtaining considerably higher revenues than others in a roughly equivalent situation. The size and the structure of the export sector, for example, of Costa Rica, El Salvador and Honduras are similar. The fiscal income from the export sector of Costa Rica, however, is higher than that of El Salvador and more than double that of Honduras, where the large banana companies enjoy an old legal concession which forbids the Government to impose new taxes on banana exports. There are also similar discrepancies in the ratios of revenue from export taxation among countries with comparable export structure, which suggests that the export sectors of the low-ratio countries in these groups may constitute fiscal resources of considerable importance. The type of tax which is most adequate for and accessible to a given country or the magnitude of revenue gain will, of course, depend on its special situation.

42. Import duties and excise or sales taxes on domestically retained articles are alternative means of taxing the import sector. All Latin American countries obtain fiscal incomes from import duties. Their relative importance, however, differs substantially, from about 1 to some 9 per cent of national income. Costa Rica and Honduras, for example, receive about half of their total revenues from import duties, El Salvador and Guatemala about one third, and Argentina, Brazil, Colombia, Mexico and Venezuela about one tenth. Argentina, Brazil and Chile on the other hand, obtain some 6 to 10 per cent of national income from taxes on internal transactions while the less advanced economies of Central America only receive some 1 to 2.5 per cent. With the domestic orientation of economic development an increase in revenue from internal taxes at the expense of import taxes is to be expected. First, as soon as domestic production reaches a sizeable proportion of total supply, major reliance has to be placed on internal taxes. These then become an instrument of taxation for both imports and domestically produced goods. Secondly, the process of industrial development is accompanied by protective (and prohibitive) tariffs with adverse implications on the yields from import duties.

/43. The continuing

43. The continuing balance of payments difficulties and the change in the structure of imports suggest a decline in revenues from taxation of imports. Strengthening of import taxation, however, seems possible and can be recommended on economic grounds. Since the poor have to be taxed, customs duties on imported necessities would be a convenient way of collecting such revenue. It may be also worth considering if the general exemptions of duty on imports of capital goods should not be reviewed. In countries or industries where the cost of capital goods is not an important barrier to investment and where foreign exchange and domestic capital are available to entrepreneurs at prices which are low in relation to their basic scarcity, import taxation could be used to bring the prices of capital goods nearer their true economic values (or costs). If government revenues are intended to be spent on growth promotion, such taxation of necessities and capital imports, kept within limits, may be consistent with economic advancement.

44. Government trading monopolies, marketing boards and bulk purchasing or selling arrangements may also secure for the government a sizeable volume of revenues. The successful marketing of rice in Burma and of cocoa in Ghana in the fifties provides good instances of government policies serving a dual purpose; revenues were augmented at the same time as domestic price stability was maintained. A contrary example is provided by Ceylon where the price of rice for domestic consumption was maintained for a number of years at lower than world prices through production and import subsidies entailing the government into incurring a substantial volume of net spending.

45. The choice between import duties and taxes on internal transactions would depend basically on the degree of self-sufficiency of the economy concerned. Countries with a low level of self-sufficiency would continue to rely primarily on import duties levied upon the large volume of their needs obtained through imports. In countries with a medium level of self-sufficiency, expansion of the fiscal system may require enlargement of the scope of both import duties and internal taxes. But the latter group of taxes will be more productively deployed in the more industrialized countries such as Argentina, Brazil and Mexico, for reasons already mentioned.

Table 4

LATIN AMERICAN COUNTRIES: REVENUE FROM COMMODITY TAXES, 1955

Country	Import duties		Taxes on internal transactions	
	Per cent of net national income	Per cent of total revenue	Per cent of net national income	Per cent of total revenue
<u>At low level of self-sufficiency</u>				
Bolivia <sup>a/</sup>	3.6	51	2.2	31
Costa Rica	9.0	56	1.1	7
El Salvador <sup>a/</sup>	4.8	36	2.3	17
<u>At medium level of self-sufficiency</u>				
Colombia	1.9	14	1.6	11
Ecuador	5.4	25	3.7	17
Peru <sup>b/</sup>	4.4	22	4.0	18
<u>At high level of self-sufficiency</u>				
Argentina <sup>c/</sup>	2.8	12	6.1 <sup>d/</sup>	26
Brazil	1.3	6	10.5 <sup>d/</sup>	45
Mexico	1.6	12	2.3	16

Source: Compiled from national publications.

<sup>a/</sup> 1958

<sup>b/</sup> 1956

<sup>c/</sup> 1960

<sup>d/</sup> Including sales taxes on export commodities.

/Taxation of

Taxation of internal transactions

46. Taxes on internal transactions - excise taxes, sales taxes, license fees, etc. - constitute the second major group in the fiscal systems of most of the Latin American countries. These taxes are, in general, mainly intended to procure revenue, but may also be used for the purpose of curtailing consumption and saving on imports. For revenue purposes, the most suitable items are those which have a low price-elasticity and high income-elasticity of demand. On the other hand, objectives of direct curtailment of consumption and import saving, if achieved, would not particularly be revenue yielding. The items selected will have to possess a high price-elasticity and a low income-elasticity so that when prices are raised consumption will be reduced more than proportionately, or when incomes go up consumption will not rise pari passu with incomes. In either case, taxation is likely to secure the major requirements for economic growth, viz. the enlargement of the proportion of "economic surplus" which can be enticed away from consumption and towards saving or investment, assuming, of course, that the amount transferred to the government would be spent on purposes conducive to growth.

47. Among the group of consumption taxes, those on alcohol and tobacco have been the mainstay of fiscal systems almost everywhere in the developing economies. In countries where smoking or drinking is almost universal they siphon off a substantial amount for revenue, although in a regressive fashion. But in countries where these habits are confined to a small group, as in some African and Asian countries, the yield is small and heavy taxation of a few while others are let off introduces an ethical judgement which may be difficult to uphold. From the economic standpoint it cannot be argued that teetotalers or non-smokers ipso facto make a more productive use of incomes left in their hands.

/48. Expansion of

48. Expansion of the yield from excise taxes calls not only for an increase in the existing rates of such taxes on the traditional items - tobacco, liquor, gasoline, entertainments - but for introduction of new commodities to the list of items already taxed. Since the low-income and even the middle-income groups remain exempt from taxes on income, levying taxes at relatively low rates on necessities - such as sugar, matches, fuel - would not seriously pinch the individual family, but through their almost universal application such taxes could collect a sizeable amount in revenues for the government. Luxury spending of the well-off can also be directly tackled by the heavy taxation of commodities and services favoured by the rich - automobiles, domestic appliances, jewelry, luxury apartments, travel - particularly of those which specifically serve ostentatious purposes or use up scarce foreign exchange. Commodities such as textiles could be taxed more flexibly to take in and discriminate between several classes of taxpayers.

49. In order to obtain revenue from general spending as distinct from spending on individual commodities, sales or turnover taxes are being increasingly favoured by governments of the developing economies. These taxes could also be used as effective counter-inflationary measures. In advanced countries, sales taxes provide an additional means of taxing the well-off, since further steepening of income taxes is considered as disincentive. Sales taxes have the advantage over income taxes in that they can catch incomes which may have avoided or evaded income taxes, and spending from accumulated wealth. In the developing economies, however, they provide a means of primarily getting at the low and middle income groups, who generally escape income taxation altogether and whose spending tends to be tax-sensitive. They still permit differentiation of tax burden according to income levels through the media of rate differentials, basic exemptions, etc.

50. The pricing policy of public enterprise involves basically the same issues as those related to taxes on internal transactions. It is more than common to find most of these undertakings operated at a loss to

/the government

the government except where they are specifically operated as fiscal monopolies. The reasons for this loss operation are varied (and a prominent one is operating inefficiency) but one of the most common factors is undoubtedly that consumers of government services or of products of government enterprises expect these services and products to be provided cheap, if not free. As a result the enterprises become vehicles of large-scale subsidization of employees and consumers. Instead they should serve as sources of government revenue since they offer an ideal base for tax collection. Indeed it is greatly to be desired that public opinion in the developing economies could be brought to recognize that standards of amenity in public services of the advanced countries could not follow and not precede the growth in national economic productivity.

51. In the meanwhile, the government's major task is to raise savings, and one effective way governments can do this is by providing government services at profit. A good example of revenue productivity of public enterprises is provided by the railways of India.<sup>9/</sup> Government ownership of enterprises, by permitting "monopoly profits" - the wide gap between costs of production and the prices charged to consumers - has provided the centrally planned economies with their major source of resources for growth. "Socialist" orientation of economic policies in the developing economies elsewhere seems to lead to general giveaways causing a diminution in the wherewithals for growth. The demands for medium or short-term benefits by the citizens of the developing economies are here clearly in conflict with their long-term interests either as workers or as consumers.

52. It may be concluded, therefore, that taxes on internal transactions (including amounts collected through public enterprises) have a legitimate function to perform within the fiscal systems of developing

---

<sup>9/</sup> The Railway Budget is separately introduced in the Parliament of India. This practice makes it quite clear that an essential part of railway finances is revenue collection.

economies and afford a very important source of additional revenue for many developing countries. The evidence available from table 2 shows that many Latin American countries can capture at least an additional 5 per cent of national income through these taxes and that, in the case of those countries which rely more heavily on import duties, this ratio could be further increased as import duties decline in importance due to the factors mentioned in the preceding section.

#### Taxation of incomes

53. Taxation of incomes, with built-in features such as exemption limits, allowances, dependency credits, progressive rates and differential treatment of individuals and corporate units, satisfies almost all the broad requirements of fiscal policy. In many ways it is the fiscal instrument par excellence from the standpoint of economic growth. It promises revenue yields progressively related to the growth in national product, and a substantial volume of unexploited revenue potential in view of its inadequate development. At the same time, it permits delicate refinement to suit both general and specific growth objectives.

54. Although many developing countries had introduced income taxation even before the war, and most others have taken steps since to add it to their fiscal arsenal, it does not cover a substantial portion of the incomes earned nor is it a mass tax as it is in the advanced countries. In fact, it touches only a fringe of the total population. In India in 1957/58, after some seventy years of continuous existence, "99 per cent of the population and about 93 per cent of the potentially taxable income in the country remained outside the pruvieu of the income tax system".<sup>10/</sup> The situation is similar in other countries of Asia and Latin America.

---

<sup>10/</sup> ECAFE Survey 1960, p. 94.

Table 5

LATIN AMERICAN COUNTRIES: COVERAGE OF INCOME TAXATION

Country	Income tax revenue (per cent of national income) <u>a/</u>	Number of returns	Number of taxpayers
		<u>b/</u> (per cent of urban population)	<u>b/ c/</u>
Venezuela	10.0	3.0	2.0
Chile	5.2	n.a.	1.3 <u>d/</u>
Colombia	4.8	n.a.	5.7
Argentina	4.4	6.9	2.9 <u>e/</u>
Peru	3.8	n.a.	n.a.
Mexico	3.4	n.a.	n.a.
Brazil	3.3	5.0	2.8 <u>e/</u>
Costa Rica	1.8	9.7	5.4
Ecuador	1.8	n.a.	2.9
Honduras	1.7	8.8	3.9
El Salvador	1.2	n.a.	1.1
Bolivia	0.6	n.a.	n.a.

Source: Compiled from national publications. Urban population for 1960 is given in the Statistical Supplement to the Economic Bulletin for Latin America. Volume VI.

a/ For 1959, except as indicated in footnotes to table 2.

b/ 1957 (Colombia and Venezuela), 1958 (Ecuador and Honduras), 1959 (Argentina and Costa Rica) and 1960 (Brazil and El Salvador).

c/ Individuals and companies.

d/ Complementary tax only.

e/ Excluding persons who derive income solely from salaries, and whose income tax liability is completely covered by the withholding system (in Brazil, only up to a certain level of income).



55. In interpreting table 5, the relative importance of the export sector and the differences in the tax treatment of this sector must be taken into account. In Venezuela and Chile, for instance, income taxes on oil and copper companies accounted for 72 and 50 per cent respectively of the total revenue from income taxes in 1959. In Costa Rica, on the other hand, the low ratio of income tax revenue, notwithstanding its relatively high ratio of taxpayers, is partly explained by the fact that the export sector is largely taxed through export taxes which amounted to 3.1 per cent of national income in 1959. Apart from this, the available data show that taxes on business enterprises, including withholding taxes on dividends or profits remitted abroad, as a rule, account for 75 per cent or more of income tax revenues. The non-corporate sector, however, is not of minor importance in this field. In Argentina (1959) and Colombia (1957) taxes paid by individuals (including proprietors of businesses), as distinct from corporations or "juridical persons", accounted for 57 and 40 per cent respectively of income tax revenues.

56. The major direction in extending the scope of income taxes in the developing countries seems to be downwards towards the base of the social pyramid. "Any effort in a poor country to raise savings at the expense of consumption will have to obtain these from the poor; the standard of minimum taxable capacity might have to be placed at a lower level. As for there being no taxable capacity in the low-income groups owing to the incidence of indirect taxation, there is no clear evidence."<sup>11/</sup> In Asia personal incomes up to a multiple of 10 to 20 times the average per capita income remain altogether exempt from income taxes, whereas the corresponding multiple is 1 to 3 in most advanced countries. The coverage problem is more acute in Asia than in Latin America, where schedular taxes (many of which have no exemptions) make a difference, the incidence of indirect taxes on the lower income groups is greater, and the situation with regard to tax exemption coefficients is somewhat mixed. In countries such as

---

<sup>11/</sup> ECAFE Survey 1960, p. 95.

Brazil, Chile or Peru the exemption coefficients (based on a family unit of husband, wife and three children) are more or less similar to those in Asia, whereas the coefficients in other countries, particularly in Argentina, Colombia, Ecuador and Mexico, correspond more closely with those in the advanced countries. No doubt, the absolute level of per capita income is in general relevant in choosing the exemption level. And since per capita income remains low in the developing countries, the exemption coefficient has got to be relatively high. Moreover, relative circumstances of the specific economy will have to be considered in determining the exemption coefficient. The major factors to be taken into account are the income distribution (importance of the middle class, for instance), the extent to which lower income groups need to be taxed, and the ways and means that are and could be devised to take in these groups by means of the more economically administered commodity or sales taxes.

57. Another area promising a fruitful exploration of revenue potential is expansion of the coverage of the tax base, viz. "taxable income". In some countries of Asia, where the land tax is in operation, agricultural income used to be exempt from income taxation. Similarly in both Asia and Latin America capital gains, which constitute an important proportion of the total incomes of the well-off, are either tax-exempt or receive preferential treatment. Capital gains are not taxed on the principle that it is the income and not the source of income which should be taxed. But from an economic standpoint, or even that of the taxpayer himself, capital gains constitute income like any other income from property. Basically, therefore, capital gains (including especially gains for transactions in land) ought to be taxed, but whether, because of their long-term and irregular nature, they should be taxed on a differential basis from personal incomes is a matter which requires further consideration and which permits a difference of opinion. In any case, so long as capital gains remain tax-exempt or receive a preferential treatment, conversion of taxable incomes into capital gains will constitute a major avenue for tax avoidance. Other "loopholes" available to the well-off to avoid paying

/income and

income and wealth taxes consist of undistributed profits in closely-held companies, earnings retained in trusts, incomes earned from capital holdings abroad, gifts given during the lifetime of the donor to escape death duties, and the widely prevalent "tax-deductible" expense accounts and "perquisites" which hardly merit description as economically useful expenses or as "expenses that are wholly, exclusively and unavoidably incurred" in earning the income.

58. "All these loopholes have been so universally exploited that there is a considerable amount of truth in the popular aphorism that taxable income is the only luxury the rich cannot afford".<sup>12/</sup> And all these "loopholes" available to those with high incomes have co-existed with very high marginal rates - 75 per cent and above - for the upper brackets of assessed "taxable income". Henry C. Simons, before the war, described such co-existence as a "subtle kind of moral and political dishonesty ..... a grand scheme of deception, whereby enormous surtaxes are voted in exchange for promises that they will not be made effective. Thus, politicians may point with pride to the rates, while quietly reminding their wealthy constituents of the loopholes."<sup>13/</sup>

59. In the developing economies, the income-tax system is not that much a product of deception. Largely copied from the models prevalent in the advanced countries, it has been made even more blunt in the course of its adaptation to the conditions (rather than requirements) of the developing economies. It has let off the lower and middle income groups altogether by high exemption limits and a considerable portion of the incomes of the well-off by retaining the "loopholes" in the tax systems of the advanced countries. The developing countries had also the further disadvantage of poor administrative systems, which has tolerated and by doing so encouraged straightforward tax evasion. While they have adopted tax rates which approximate to those of the advanced countries, they have not attained the level of enforcement prevalent in the advanced countries necessary to

---

<sup>12/</sup> ECAFE Survey 1960, p. 96.

<sup>13/</sup> Personal Income Taxation, 1938, p. 219

make such rates effective. The high rates have only increased the premium on evasion without attaching any commensurate risk. Even in an administratively well-endowed country like India, tax evasion in 1955/56 was estimated by Nicholas Kaldor to be of the order of three-quarters of the incomes assessed to tax, and the volume of revenue lost about one and a half times as much as the revenue obtained.<sup>14/</sup> In Argentina, the Central Bank estimated underreporting of 50 per cent in 1952 and 60 per cent in 1957. The income assessed to complementary tax in Chile was estimated to have been underreported by 65 per cent in 1956. Tax evasion in other developing economies may be of the same order of magnitude. In countries where foreign trade and foreign capital constitute a large element in the economy, a considerable amount of revenue (and foreign exchange) may be lost through accounting malpractices such as padding of invoices, fictitious charges for commissions, and the use of tax havens for the sole purpose of reducing tax liabilities in both the capital-exporting and the capital-importing countries.

60. It may be concluded, therefore, that there is at present a considerable margin for increasing revenues from the income tax even in the case of those countries which have reached relatively high levels of yield from income taxation. The potential of this fiscal base will substantially grow in importance with the economic advancement of the countries concerned and through improvement of the administrative systems and application of stiffer penalties to tax evaders in order to close the great gap of unreported incomes. But this is not enough. In those instances (particularly schedular taxes) where income tax rates have been prescribed at very high levels on the assumption that a major portion of incomes will in fact evade reporting, these high rates will have to be scaled down to the intended "effective" levels, as a precondition to any serious effort to achieve full income disclosure. The full task of correcting tax evasion is assuredly not

---

<sup>14/</sup> The Central Board of Revenue of the Government of India estimated that income evading income tax was about 30 per cent of the income assessed to tax. Even so, revenue loss might well have exceeded one-half of the revenue received.

easy, and it may be quite a long way ahead before major increases in revenue are obtained, but it is a real possibility. In addition, more revenue may be obtained if the income tax is extended downwards to cover the middle and lower incomes, but this will depend on the extent to which consumption taxes can be employed to take in these groups.

Taxation associated with benefits

61. Although, in principle, it would be unwise to tie down revenue to providing direct benefits to specific taxpayers, such taxes could be effectively used to supplement the revenue system since they employ a form more acceptable to the taxpayers. Social security taxes, for instance, provide an example of an essentially regressive type of income taxation which is still acceptable to the low-income groups because of eligibility for benefits. This form of taxation is relatively well developed in several Latin American countries as indicated in the notes to table 1. The nationalized life insurance scheme of India also serves a somewhat similar purpose. Several countries, for instance Brazil and Colombia, have experimented with compulsory savings schemes. The gambling instinct has also been turned to advantage in obtaining revenue through taxes on lotteries (and bonds) and on pari mutuel betting, which exist in several countries of Asia and Latin America.

62. In any case, to the extent that the amount collected as social security taxes, life insurance premia, compulsory savings or receipts from the sale of lottery tickets exceeds the amount given out as current benefits or repayments, the net receipts of the government constitute an additional fiscal resource which could be put to developmental use. Furthermore, insofar as social security coverage extends to hospitals and other health services, it replaces direct government expenditure on these services and thus is equivalent to a gain in revenue. In other words, through the social security system a major part of the provision of these services can be placed on a self-sustaining basis, whereby the strain on general government revenue is reduced and resources freed for alternative use.

/Taxation of

Taxation of agriculture

63. The process of economic growth in developing economies requires that some part of the population move away from land, and the remaining population produce enough over and above its own subsistence to provide food and raw materials for the non-agricultural sectors. Price inducements often fail to attract increased "surpluses" from the agricultural sector as the phenomenon commonly described by economists as the "backward sloping supply curve" comes into operation. These conditions are more likely to be encountered in countries with small farm units and subsistence cultivation. Taxation of consumer commodities also fails to bring out this surplus, since a large portion of the sector remains outside the monetary economy. It is, therefore, essential to tax cultivation which may be a device not only to increase revenue but also to induce larger agricultural output and which may, incidentally, lead to further monetization of the economy.

64. The traditional tax on agriculture, the annual land tax, is operating in many developing countries, but its yield and impact is being eroded by the rise in prices and the lagging process of valuation. On the other hand, economic growth almost invariably tends to turn the real terms of trade in favour of agriculture and increase land values, excepting, of course, the special difficulties of export agriculture. It would, therefore, seem rational to revitalise agricultural taxes and impose betterment levies, although these taxes appear to evoke substantial resistance on the part of farmers who have come to appreciate the economic value of their political strength.

65. The situation in Latin America, however, differs from the one described above which basically applies to Asia. First, the traditional land tax can be and is of less importance in Latin America. The ratios of property tax revenues to national income in table 2 cover the taxes on both urban and rural property; although exact figures could not be generally obtained, indications are that a major portion of those revenues is from urban property taxes. In Chile, for example, agricultural land tax accounted for only

/5 per cent

5 per cent of the total property tax revenues in 1958. Secondly, export agriculture and the reliance on export taxes (and internal sales taxes) to raise revenue from this sector are more important elements in Latin American countries. Thirdly, a number of countries rely on income taxes to include (rather than exclude) agriculture, although it appears that the use of the income tax in this field has been only partially effective. In Brazil, for example, official statistics show that agriculture accounted for only 1 per cent of total taxable income of individuals and juridical persons (excluding incomes subject exclusively to the withholding tax). This extremely low ratio could be largely attributed to the fact that in Brazil, as in other Latin American countries, a large proportion of agricultural taxpayers are assessed on the basis of imputed income which is derived as a percentage of the valuation of the property, which is usually both underassessed and out-of-date.

66. However, the most characteristic difference of Latin American from Asian agriculture is the sharply unequal distribution of land. The latifundios, with over a thousand hectares each, take up two-thirds of the cultivated area, although they number only 2 per cent of total land-holdings. At the other end of the scale, the minifundios, almost three-fourths of the total number of holdings, cover only 4 per cent of the area under cultivation.<sup>15/</sup> There are, therefore, good economic, social and administrative reasons to deploy the fiscal instrument as one of the weapons in a broad programme of land reform. The often absentee large landowners tend to keep their holdings partially or fully idle or inefficiently cultivated, since land is held by them mainly for reasons of prestige or speculation. The heavy concentration of property in a few hands makes it more necessary and at the same time relatively easy to devise fiscal measures. In doing so, technical factors of assessment and

---

<sup>15/</sup> In Guatemala, 516 farms (0.15 per cent of all farms) represent 41 per cent of the agriculture land. In Ecuador, 705 units (0.17 per cent) include 37 per cent of the farm land. Half the farm land in Brazil is in the hands of 1.6 per cent of the owners and in Nicaragua 362 owners have control over fully one-third of the agricultural acreage. (Latin American Issues, edited by Albert O. Hirschmann, The Twentieth Century Fund, New York 1961, pp. 163-165.)

collection do not present an insuperable obstacle, as is often assumed. A land tax, progressive (or even punitive), based on the potential productivity or market value of land, would force the rich landowners to cultivate their lands more efficiently in order to pay the taxes, or to part with some of their holdings to lower their marginal rates of taxes.<sup>16/</sup>

Problems of administration<sup>17/</sup>

67. The expansion in the scope of the revenue system thus calls for an increase in taxpayer coverage and in the number of items constituting the tax base. Implementation of such a reform would undoubtedly make further demands on the administrative machinery. However, there is considerable scope for rationalizing the existing administrative structure, even if it is conceded that the structure is both weak and strained.

68. First, there is scope for legislative simplification of the tax system. Assessment would be simplified if two or more taxes operating on the same tax base could be amalgamated into one. It is not unusual to find the same commodity paying a number of separate taxes. Moreover, some of the imported finesse (particularly in the income tax systems) may be quite unrelated to the situation of the developing economies and could be abandoned. Lastly, almost all tax systems carry dead wood in the form of antiquated taxes which absorb administrative resources quite out of proportion to their yields.

69. The second aspect of simplification would consist of measures to secure economy in the use of administrative resources. Taxation of the low income groups does not call for approaching or assessing every taxpayer as would be the case with a poll tax. A few necessities taxed at the source may suffice. The middle income group employees and industrial workers could be covered by payroll deductions and by commodity taxes again levied, as far as possible, at the source. Multiple stage sales

---

<sup>16/</sup> For a fuller discussion of tax policies in relation to land reform, see United Nations, Progress in Land Reform, Third Report (E/3603, 5 April 1962), Chapter 5, Section A.

<sup>17/</sup> Problems of administration have been already dealt with at the preceding Conference on Tax Administration at Buenos Aires in October 1961.



taxes could be replaced by single stage taxes levied once and for all at the manufacturing or wholesale stage. The small traders and professions could be assessed on their gross turnover both for the collection of sales and income taxes. Keeping accounts could also be simplified for the taxpayers. The government could prescribe standard simplified book-keeping models, and distribute this material and tax tables for ready reckoning to taxpayers once a certain level of literacy is reached.<sup>18/</sup> They can then be switched to a system of self-assessment under oath. Finally, the workload of revenue offices could be considerably lightened by the use of accounting machines and modernization of other office equipment.

70. The administrative resources released by these and similar steps could then be employed to service the new or extended measures described above, and to check evasion. Tax evasion would greatly decrease if the governments could be stricter than they are with tax evaders and corrupt officials and prescribe deterrent punishment for the evasion exposed. At the moment, the discoveries of evasion are infrequent, and the penalties lenient. This encourages the taxpayers to evade paying taxes in the hope that evasion will not be discovered at all or if caught they will be let off lightly. The ordinary legal courts and procedures for civil suits should be replaced, where constitutionally possible, by special economic courts and legal machinery tailored to the specific problem of economic crimes such as tax evasion, black market transactions, etc. The operations of company accountants and tax lawyers could also be supervised more intensively.<sup>19/</sup>

71. Rationalization of tax administration is a comprehensive subject in itself. In considering issues of tax policy, it would suffice if it is recognized that such rationalization is feasible and if achieved could

---

<sup>18/</sup> Illiteracy, on the other hand, is not as big a handicap as it is usually made out to be. In India, the ryotwari land tax, coming down the ages, is in many ways nothing but a gross income tax paid largely by illiterate peasants.

<sup>19/</sup> See Karl Lachmann's "Comments" on the paper by Oliver Oldman on "Controlling Income Tax Evasion" at the Buenos Aires Conference.

release perhaps the most important reserve of untapped fiscal potential. However, if administrative facilities are a real handicap in the short run, it is possible, as noted, for governments to increase their revenue from a number of alternative tax bases. The design of the tax system in that event may be guided, at least in part, by the principle of giving priority to those taxes which are easy to collect and difficult to avoid or evade. An exemplary case for reform is provided by the income tax on business units in Brazil, where almost 85 000 (31 per cent) business taxpayers were assessed to income tax on a presumptive basis to yield only 1.5 per cent of the total yield from this tax. Land taxes in India also require an administrative machinery out of proportion to their yields. In such cases, administrative machinery could be thoroughly overhauled, legislation revised or such taxes eliminated altogether in favour of alternative tax bases. In the long run, however, fiscal administration has to be developed to match the complexity of the fiscal system as it expands and gets more refined in its application. Only then would tax reform become a potent instrument of economic growth.

/Conclusion

### Conclusion

72. To sum up, fiscal upper limits, whatever they are and wherever they exist, either in economic or political terms, are at some distance still in relation to the current tax performance of the developing economies. There is both the need and scope for further taxation of the low income groups by means of taxes on consumption commodities, whether imported or domestically produced. The middle income groups, at present mostly covered by commodity taxes, could be further reached by expanding the taxpayer coverage of the income taxes, by sales taxes and by making new commodities subject to excise and customs duties. The well-off could also be made to pay through a more progressive land and urban property tax, heavy taxation of luxury articles of consumption, more effective expansion of the concept of "income" subject to income-tax, plugging of "loopholes" for tax avoidance and rigorous measures to deter tax evasion. There are also other alternative or complementary avenues which could be explored. Finally, there is broad scope for improving the efficiency of tax administration all round and the effectiveness of penalties against evaders to secure larger yields from existing and new taxes.

73. In recommending these measures, greater attention has been given to their revenue yielding capacity than to provision of incentives. A lower priority has also been assigned to considerations of equity, since in the developing economies the poor have to be forced and the well-off permitted to save. Undertaxation of the poor and overtaxation of the rich are easily the fallacies into which these governments may stumble in their concern for equality and equity although, for the moment, there is undertaxation of both these groups. On their part, governments have to expose themselves to the same scrutiny of the purposes and efficiency of their spending as of those in the private sector, from the standpoint of attaining an optimum utilization of national resources for economic growth.

Annex

ESTIMATION OF NATIONAL FISCAL CAPACITY

1. Having reviewed the current tax performance and explored the potentialities for revenue of the major tax groups, the next step is to translate these broad recommendations on tax policies into a specific and quantitative assessment of national fiscal potentials. The latter task calls for a set of economic data which are at present only inadequately available. As already noticed, it calls for fiscal techniques which may be simultaneously less refined and more delicate than those in force in the advanced countries. Some of these techniques have been suggested in many country studies and reports but remain largely untried. Finally, it requires working out ad hoc adjustments to fit variant institutional situations, since in this regard the developing economies remain further apart than the advanced ones. In other words, there cannot be a general method. Fiscal potential has to be estimated for each economy in terms of its specific conditions.
2. Still it would be useful to summarize a few steps in the process. The first step would be to ascertain what constitutes the "economic surplus" of the community. If it is a very poor economy almost all the surplus above subsistence levels would constitute the economic surplus which has to be utilized for growth. If it is a more advanced economy, a level of living correspondingly above subsistence levels will have to be allowed for in determining the surplus.
3. There is, however, another concept which has been used in centrally planned economies, which may be more suitable for fiscal analysis. In these economies, since the public sector theoretically controls all output, it may determine what proportion of the total output should be devoted to non-public consumption - the saleable output - and what proportion it will retain for governmental implementation of collective consumption needs and national capital formation. The latter proportion is known as the non-saleable output. Although the term "non-saleable" /is clearly

is clearly inapplicable, the economic planner of a developing free enterprise economy may also make an assessment of the proportion corresponding to the non-saleable output of the centrally planned economy, viz. the proportion which is required to be devoted to national (public and private sector) capital formation and governmental current needs, with a certain growth rate in mind.

4. Having decided upon the magnitude of the "economic surplus" or the "non-saleable output" (the two are not the same thing), the second major decision that the planner takes into account is the extent to which growth resources should remain in private hands. This decision will depend not only upon criteria of economic efficiency but also upon the political and social philosophy of the community.

5. In any case, once the decisions on the magnitude of "non-saleable" output and the part of it which has to be retained in the private sector are made, the fiscal target is set. The target for government revenue thus consists of all national output which is not required to be retained in the private sector for maintaining essential or accepted levels of consumption and the requirements for growth.

6. The magnitude of such output to be mobilized by the government would, of course, depend on the size of total output, that is, the size of per capita national income, on its distribution and on the dynamism of the private sector. The higher the per capita national income and the more unequal its distribution, the greater are the resources that could be devoted to collective consumption and growth. Finally, political philosophies apart, the more dynamic the private sector, lesser is the burden on the government to provide directly for economic growth.

7. Having set the fiscal target, the next step is to determine who is to pay the taxes and through what mode or means revenues will be gathered.

8. Since all taxes ultimately bear upon the citizens in one way or the other, it would be useful, at the outset, to have a broad idea of existing tax burdens. In assessing these burdens, the following information is required:

- i) The size and distribution of personal incomes;
- ii) Spending, saving and investing patterns of major income groups;
- iii) The proportion of incomes paid out to defray existing income and commodity taxes.

/9. Such data

9. Such data are, of course, inadequately available. But for administrative purposes it is not difficult to obtain these. The facilities of censuses and national sample surveys could be effectively used for this purpose as has been done in India.

10. It may also be necessary to study the distribution of national income in other forms: by economic activity - farming, industry (small and large), professions, etc., by economic organization - monetary and non-monetary sectors, unincorporated and corporate sectors, domestic and foreign trade sectors, private and government sectors, etc. Comprehensive information may be sought on the size of these sectors, incomes, commodities or transactions they comprise of, and on the burden of existing taxes.

11. Another query would be studying the supply and demand elasticities of commodities, and some judgement may have to be formed independent of the market criteria, as to what commodities constitute necessities, amenities or luxuries. Information is also required as to the number of hands or stages of manufacture a commodity passes through before it is finally consumed by citizens, or exported or used up in the process of manufacturing. Is the commodity produced and/or consumed by large units or is it produced and/or consumed by diffused small units?

12. Such a micro-economic study of incomes (distributed by persons and economic sectors) and commodities, and of existing taxes on these, would thus supplement the macro-economic evaluation of the national fiscal potentials. Of course, since the incidence of some taxes would remain quite diffuse and of others more or less precise, any assessment of existing or projected tax burden is likely to remain arbitrary. However, if the estimates are broken down into a criss-cross detail in terms of persons, economic sectors and commodities, it would be possible to make an assessment of acceptable accuracy to form the basis for governmental policy and action in the fiscal field. The micro-economic analysis would not only bring to view the myriad minor streams which together constitute the national aggregate potential, but it would reveal a number of accessible tax bases.

/13. Since all

13. Since all tax potentials have not only to be theoretically assessed but realized in practice, the question of accessible tax bases is of particular importance. Bearing in mind the policy issues outlined in the paper, the problem of fiscal expansion can be approached from the standpoint of tax administration, since in almost all underdeveloped economies administration remains a scarce and valuable factor. Which taxes are the most productive of revenue vis-a-vis their cost of collection in terms of administrative resources? Which of the new tax bases can be easily administered? Which of the existing ones have been already well-developed and which of them permit of further expansion? Is it not possible to abandon unremunerative taxes? Is it not possible to simplify the present legislation or administration? How each of the tax bases, when exploited, reacts upon personal incomes, upon types of economic activity or organization or upon demand and supply schedules of commodities? What is the scope of government undertakings? Can they not be run efficiently to yield profits? Do they permit of a change in wage and price policies?

14. These and many other questions can be asked. But as is obvious, there cannot be a definitive answer. So far as the answer can be given in general terms it has been attempted in the main body of this paper. In any given economy, the answer will depend on its specific economic situation and on its alignment of political, economic and social forces. A fiscal planner will be called upon to make judgements at every step on matters both within and beyond the realm of economic calculation. But his judgements would be more sound if he were to start out with a broad agreement on policy issues on the lines described in the paper and the type of economic and statistical data described in this annex.

