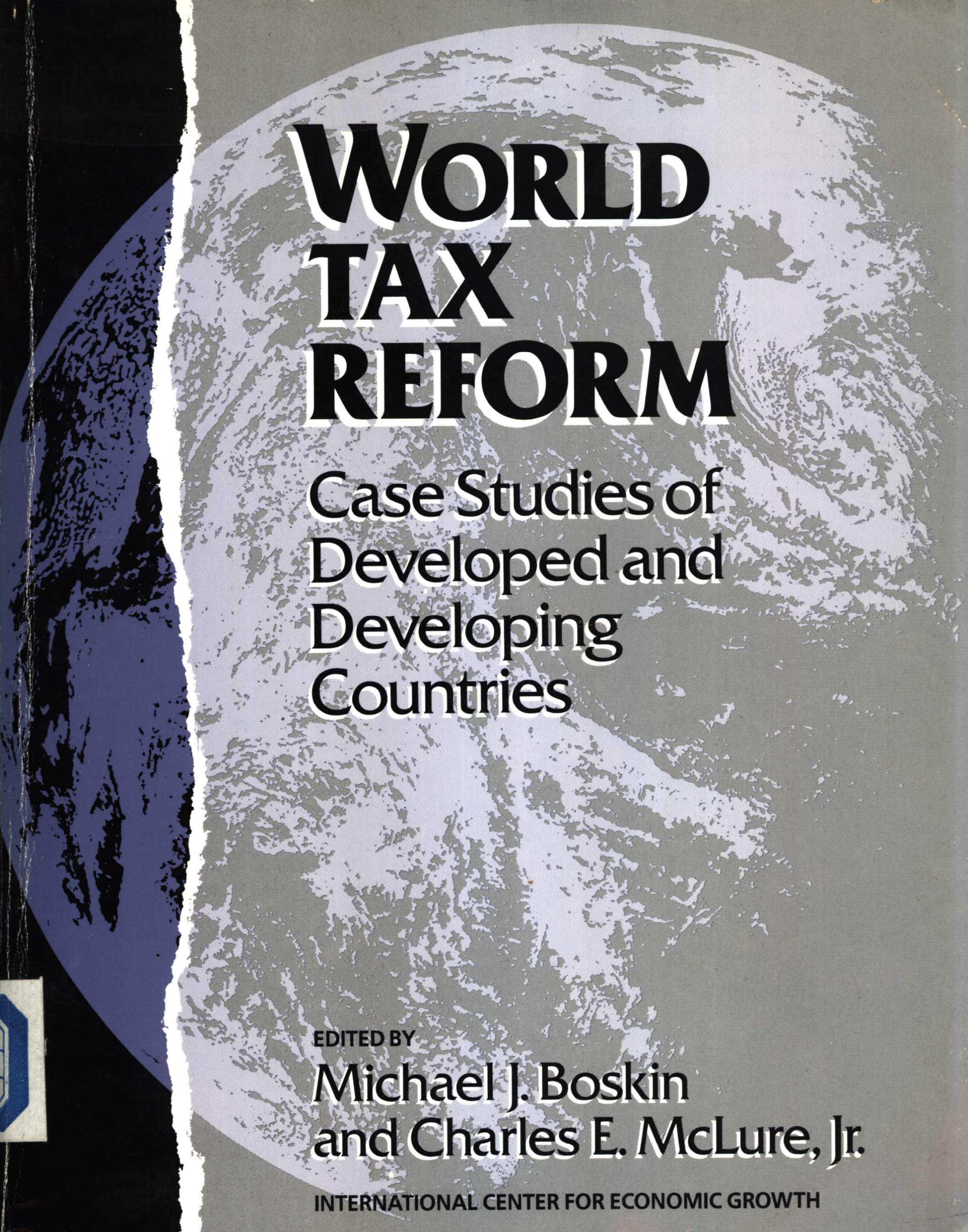

WORLD TAX REFORM

Case Studies of Developed and Developing Countries

EDITED BY

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INTERNATIONAL CENTER FOR ECONOMIC GROWTH

WORLD TAX REFORM

Part I

Introduction and Overview

New Directions in Tax Policy

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

Common intellectual themes included concern about the adverse incentive effects of high marginal tax rates and about distortions caused by differential tax treatment of economically similar activities, and a downplaying of vertical equity as a central objective of tax policy. Interest in incentives started to develop especially in the 1970s, a decade in which relatively high inflation artificially increased tax rates, especially for the middle class. This episode highlighted the inequities and distortions resulting from an unindexed tax system in inflationary times. There was concern about tax evasion and about the effort diverted from productive economic activity into tax shelters and unproductive investment, and perceptions of unfairness were growing. Finally, of course, the internationalization of the world economy created competitive pressures on countries to respond to tax reforms elsewhere.

In the United States, the case with which I am most familiar, tax reform took place in response to many of the same factors that encouraged reforms in other places. Between 1965 and 1980 the number of U.S. taxpayers facing high marginal tax rates quadrupled, creating a powerful political constituency for tax reform.

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

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

The volume grew out of a project the International Center for Economic Growth (ICEG) asked me to organize in 1987. I invited leading tax experts and scholars who had participated in or observed tax reform movements in various countries, and this volume is the result of their work. Several of the authors were the primary technical participants in the tax reform process, either in their own country or in other countries. Others played a key role in evaluating alternative proposals and assisting government officials in deciding among them. I attempted not only to achieve substantial coverage by including a wide number of countries that had undergone, were undergoing, or were contemplating, tax reform, but also to represent a wide range of views on tax policy questions. As a consequence, the authors represented here express very different views on some major tax issues.

Each author was asked to write on a particular topic. The authors remain solely responsible for the views expressed in their own chapters. No attempt was made either by me, while I was still participating in the project, or by Charles McLure, to change anyone's opinions or expressions of them. But in order to offer the perspective, judgment, and experience of all of the participants as a potential input into the drafting of individual chapters, ICEG sponsored a working session for the authors to discuss first drafts of their papers. The seminar, held in San Francisco in October 1988, yielded an extremely useful interchange of information and views, and new insights and perspectives emerged.

The volume begins with two general essays on tax principles: Joel Slemrod, writing on tax principles in an international economy, focuses on the need for tax policy to include considerations of international trade in goods and capital and features of tax rules that affect multinational organizations. Arnold Harberger presents an evaluation of principles of taxation applied to developing countries, which share many concerns of advanced economies, but also have some issues that are quite specific to their circumstances, including the administrative capabilities of their tax regimes. Harberger puts these together as a set of lessons about good tax policy.

The next set of essays turns to discussions and evaluations of recent tax reform, or tax reform debates, in advanced economies. This section begins with a chapter by Michael Porter and Chris Trengove discussing tax reform in Australia, which attempted to use an unusual consensus political approach to achieve reform. Faced with an erosion of the personal income tax because of tax shelters and fringe benefits, Australia reduced its top rate from 60 to 49 percent and adopted an "imputation" system to reduce the double taxation of corporate income, but rejected a broad-based sales tax (retail sales tax or value-added tax). It also added taxation of fringe benefits, which is unusual.

John Whalley, who has been especially active in the Canadian debate on the value-added tax (VAT), then considers tax policy reform in Canada. As the largest U.S. trading partner, Canada is especially interesting because of its response to international pressures, as well as its consideration of a VAT. Whalley discusses that country's reductions in marginal tax rates, its reductions in investment credits and depreciation, and its replacement of a defective manufacturer's sales tax with a VAT. He then tries to estimate the allocative and distributional effects of reform.

Eytan Sheshinski discusses the tax reform proposals made in Israel in 1988 by a tax reform commission he headed. Israel had galloping inflation; hence, questions related to indexing, the measurement of real income, and the interaction of inflation and the tax code were among the important issues in Israel. As in many other economies, there was a concern in Israel that the tax base was eroding, and tax rates were far too high.

Yukio Noguchi discusses the tax reform debates in Japan, which focused on the hard-to-tax groups. With little emphasis on vertical equity, the debates have considered the levels of corporate income taxes, the tax treatment of interest and capital gains, the financing of social security, and a proposed land tax. To reduce individual and corporate income tax rates and to increase revenue available for social security payments, the country has instituted a small value-added tax, which has turned out to be tremendously (and surprisingly) controversial.

Ingemar Hansson and Charles Stuart address tax reform in Sweden, long one of the world's most heavily taxed economies. In the 1970s government subsidies to specific regions and industries became so high that they were crippling the Swedish economy; after substantially reducing these subsidies, Sweden has turned to a serious discussion of how to lower its virtually confiscatory marginal tax rates. The Swedish tax reform movement has responded to the prevalence of tax shelters and the disincentive effects induced by high tax rates. Hansson and Stuart explore issues such as reliance on debt finance, rate reductions, consideration of a consumption-based direct tax and cash-flow tax on corporations, and planning for additional reform.

Andrew Dilnot and John Kay discuss recent experiences in tax reform in the United Kingdom, which was one of the first countries to reduce rates and eliminate investment incentives. The authors consider the evolution of tax policy in the United Kingdom, including attempts at reforming the individual, corporate, and social security taxes. They discuss changes in the income tax, VAT, social security taxes, and local finance. They also consider constraints on the VAT imposed by the European Community, the interaction between income and social security taxes, the recent emphasis on economic neutrality, and the lack of a cohesive view of tax reform or tax policy in that country.

John Shoven discusses U.S. tax reform—especially the tax reform of 1986. He takes a professor's report card to it and concludes that it offers as many problems as solutions. Although Shoven gives the reform relatively high marks for fairness, economic efficiency, and neutrality, he fails it on the issue of economic growth, because it encourages neither savings nor investment. He gives the reform a moderate grade for simplicity, but faults it for not taxing real income and for not instituting a consumption tax.

The next set of chapters turns to a discussion of tax reform in several important developing economies. Roger Gordon leads off with his discussion of reforms of explicit and implicit taxes in the People's Republic of China. In a primarily planned economy, such as China's, taxes can be implicit in a variety of ways, as well as being levied explicitly. For example, if wages are set by a central authority, setting them at a low level is quite similar to setting them at a high level and imposing a wage tax. Similarly, the collection of "profits" from firms may resemble corporate taxation. Gordon discusses how a command economy works and does not work, the incentive effects of its tax system, and how the subject of tax reform fits into the overall aspects of economic reform in China.

Charles McLure considers tax reform in a mildly inflationary environment in Colombia, which has one of the best and most studied income tax systems among all developing countries. He discusses the need for inflation adjustment, the advice by foreign missions in the 1960s against adjustment, and the history of adjustment that has occurred since 1974. Inflation adjustment was extended to all interest in 1986 and to depreciation in 1988. McLure himself cowrote a 1988 report for the Colombian government on which the 1988 reforms were based.

Malcolm Gillis looks at Indonesia, with special reference to the value-added tax. In recent years, much attention has been placed on achievement of a "clean" VAT—one that covers virtually all value added in the economy. This means dealing with concerns for low-income individuals directly (through refundable credits against tax paid, for example), rather than by exempting necessities such as food (which may represent as much as half of GNP) from the VAT and making up the lost revenue by imposing a higher VAT rate on goods that are subject to the tax. Although Indonesia's VAT covers only the manufacturing stage (and therefore does not apply to unprocessed food and some other staples of the low-income population), it allows no exemptions, making it a relatively clean tax. Gillis also discusses the country's explicit revenue goals, distributional equity, economic neturality, and tax administration and compliance.

Francisco Gil Díaz presents a historical overview of policy and tax policy goals in Mexico. He notes the lack of a clear objective in policy, as well as the enduring complexity of the system. The government considered introducing a consumption-based direct tax, but did not do so, in part because of fears it would not be creditable in the United States.

Let me end with a personal note. After assembling the group of authors, receiving first drafts of the papers, convening the conference in October 1988, and then providing detailed comments to the various authors, I found myself in early December 1988 nominated by President Bush to be chairman of the President's Council of Economic Advisers. At that point, it became clear that I would have to end my participation in the project. I would like to thank all of the authors involved for their tremendous cooperation on the project, especially Charles McLure, who did me a great favor by agreeing to take over some of the work I would have been scheduled to do had I not entered government service.

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Part II

General Issues

Joel Slemrod

Tax Principles in an International Economy

One of the most profound economic changes of the postwar period has been the growing internationalization of economic activity. Sparked by the rapidly declining cost of transportation and communication, the volume of international trade has mushroomed and today is fifteen times higher than it was in 1965. The volume of foreign direct and portfolio investment has grown similarly.

The internationalization of economic activities has profound implications for tax systems, both directly and because it affects the technology of tax collection. It raises new questions and changes the answers to old ones. Openness introduces at least three important new considerations into a country's choice of tax system:

1. Factors, goods, and other potential bases for taxation can flee a country in response to taxation or other regulatory restrictions, or be attracted to a country by relatively light taxation or regulation.
2. The interjurisdictional division of revenues is not a matter of indifference. Each country must therefore "compete" with other countries for revenues.
3. It is more difficult to collect revenue from tax bases located outside the country.

I am grateful to Daniel Frisch for helpful comments on an earlier draft.

This chapter discusses the implications of these three aspects of openness for the design of capital income tax policies, beginning with a reassessment of the benefits and costs of openness in a world where distortionary taxes must be raised. The next section discusses the efficiency of alternative capital income tax structures, first from a national and then from a global perspective. The following sections treat the incidence of capital income taxes in an open economy and the promise and problems of international tax harmonization. The chapter concludes by offering some warnings to the myopic domestic tax policy maker and some challenges to the guardians of rational policy making from a global perspective.

The Benefits and Costs of Openness

The classical theory of international trade argues that cross-border trade can unambiguously improve the consumption possibilities of domestic residents. With trade, a nation's pattern of consumption need not conform exactly to its pattern of production. Furthermore, specialization of production according to a nation's comparative advantage allows resources to be used more efficiently.

The same argument applies to intertemporal trade. In the absence of international borrowing and lending, national savings would have to be exactly equal to national investment. International capital movements allow, for example, a nation with relatively favorable investment prospects to import capital (borrow), thereby raising the present value of its consumption stream. Nations with relatively unfavorable investment prospects can profit by lending capital to be utilized in other countries.

These results all pertain to a case where there are no tax-induced or other distortions in the allocation of resources. But no country is devoid of such distortions, and in their presence the case for free trade is more ambiguous. It is possible that freer trade, by raising the cost of existing distortions, is welfare-reducing. By increasing the elasticity of a country's tax bases, openness may raise the minimum level of distortion that must accompany a certain revenue requirement. As an extreme example, consider a country where the only feasible tax base is domestically located capital. The autarky rate of return to capital is less than the world rate of return, so that if the economy is opened to international capital movements, capital flows abroad to earn the higher world rate of return. However, because only domestically located capital can be taxed, too much (from an efficiency perspective) capital is exported. In equilibrium, capital will be exported until $f(1 - t) = r$, where f is the marginal product of domestic capital, t is the effective tax rate on domestic capital, and r is the world rate of return. Thus, the tax system causes investors to pass up some domestic investment whose pretax return (its contribution to national income) exceeds the world rate of return in favor of foreign investment. The welfare loss from the excess foreign investment may exceed the welfare gain from taking advantage of the favorable world rate of return.

The point of this example is that openness is a mixed blessing when the taxing authority has limited ability to tax cross-border movements of factors and goods. A discussion of tax principles in an international economy must come to terms with the real world, where the implementation of certain tax systems, which may be desirable in theory, is extremely difficult.

Efficiency

National perspective. When the goal is to minimize deadweight loss, the basic principles of taxing capital movements in a small open economy are as follows. Capital exports should occur as long as the return, *excluding* tax paid to foreign governments, exceeds the opportunity cost of these exports, which is the return on domestic investment (*including* any tax paid to the domestic government). Under certain tax systems, this condition will be ensured by the return-maximizing decisions of domestic residents. If capital income of domestic residents is taxed at the same rate regardless of origin (a residence-based system) and the tax payments to foreign governments are treated as deductible expenses, this condition will be met. This is because domestic investors treat the foreign tax as a cost like any other, as it is from the domestic standpoint. A residence-based tax system will not, however, maximize national income when used in conjunction with a foreign tax credit. Because foreign tax payments are offset by a credit against domestic taxes, they are not treated as a cost by the investor, as the domestic national interest demands. Capital exports will exceed the efficient amount.

Capital imports should occur as long as their contribution to the domestic economy, the marginal product of capital, exceeds the cost to the economy. A small country must compete with investment opportunities elsewhere, so it must offer the foreign investor the going after-tax rate of return. This level of capital imports will be achieved if such imports are completely exempt from taxation by the importing nation, because in this case foreign investors will, in their own interest, invest until the domestic marginal product equals their opportunity cost, the after-tax world rate of return. Any attempt to tax capital imports will cause the country to forgo domestic investment whose contribution to national income exceeds the cost to the nation.

There are many reasons that the supply of capital to a country may not be perfectly elastic. For a large country, the very act of importing capital will drive up the rate of return in the rest of the world, thus increasing the cost of capital. Capital exports from a large country will drive down the world rate of return. Thus a large country faces an increasing supply curve for capital. A small capital-importing country may face an increasing cost of funds if there is country-specific risk. Investors will then require a risk premium that increases with the size of the total investment in the country. Investors will also require an increasing risk premium when there is a probability of expropriation of foreigners' wealth that increases as the volume of the investment (and thus the return to expropriation) increases.

Although a tax penalty on capital flows would have an adverse effect when capital supply is perfectly elastic, it can generally enhance national income when the supply curve is upward sloping. The welfare cost of an inefficient domestic capital stock can be offset by the advantageous effect of the tax on the terms of borrowing and lending. By taxing capital flows, a country can induce an increase in the rate of return on its capital exports and a reduction in the cost of borrowing. The large country accomplishes this because its capital flows are large enough to affect the rate of return that can be earned in other countries, so that, for example, a reduction in its capital exports increases the scarcity of capital abroad and drives up its rate of return. The small country can accomplish this because restricting capital imports reduces the risk premium that must be paid, either lowering the likelihood of expropriation or the cost of country-specific risk.

Optimal policies can look very different when the possibility of strategic behavior—either cooperation or retaliation—is considered. If countries can cooperate on tax policy and thereby agree on how to divide up tax revenues, then all countries—even those with market power—can profit from allowing uninhibited capital flows. In the absence of cooperative behavior, the optimal policy of any one country depends in a complicated way on its perceptions of its rivals' likely strategic reaction and on the range of policy instruments that are subject to choice (that is, nondiscriminatory tax rates, discriminatory tax rates, worldwide versus territorial system).

Another important consideration arises when foreign investors come from countries with a foreign tax credit. If the foreign-source income is taxed on an accrual basis, then raising the tax on capital imports toward the tax rate of the capital-exporting country does not reduce the after-tax return to the investor (because the tax payments are offset by credits against their own domestic tax liability), and does not deter capital imports. Because the credit is limited to domestic tax liability, a capital-importing country that reduced its tax rate on capital imports below the rate imposed by the exporting country would lose tax revenue without seeing its domestic capital stock increased. In practice a country generally imports some capital from countries with a territorial system that exempts foreign-source income from domestic taxation. The foregoing argument does not apply to this source of capital. If feasible, the capital-importing country should levy lower taxes on capital income emanating from countries with territorial tax systems. If such differentiation is impossible, then its policy should reflect a weighting of the net benefits of taxing capital imports in the two cases. The argument must also be modified if, as in most foreign-tax-credit systems, foreign-source income is taxed upon the repatriation of profits (and not on an accrual basis) or if the firm can consolidate its worldwide income in calculating the credit.

In either case, the host tax rate may affect the after-tax return to investing, even if the tax rate is below that of the investing country (Gersovitz 1987).

A country's tax policy should be evaluated both by how well it achieves the optimal (from a national perspective) allocation of factors and by how successfully it defends (or expands) its revenue base against other countries. I argued earlier that a capital-importing country should impose origin- or source-based capital income taxes if the capital exporter's treasury will refund the tax payments to the firms. To rescind these taxes merely transfers tax revenues from the home treasury to the foreign treasury.

The inherent difficulty of allocating the income of multinational firms' income among its countries of operation makes clear the distinction between the resource-allocation and revenue-defense standards of tax policy. Multinationals can set inter-country transfer prices, management fees, and financial transactions to reduce the worldwide tax burden of the enterprise. It is notoriously difficult to police transfer pricing, and countries have not, for the most part, even developed policies concerning intrafirm financial transactions designed to reduce worldwide taxes.

It is in a country's interest to set its tax policy to attract taxable income to its jurisdiction, holding constant real activity such as investment. A country can achieve this by imposing low *statutory* rates on its source-based taxes. It is the difference in statutory rates that provides the incentive to use transfer pricing and financial strategies to move taxable income from one jurisdiction to another. It is, however, the difference in marginal effective rates of tax that will determine the allocation of investment. The marginal effective rate of tax on new investment depends not only on the statutory rate but also on such factors as the pattern of depreciation allowed for tax purposes, the extent of investment tax credit, and the rate of inflation. Thus, consider a country that wished to retain the effective taxation of investment so as to defend its revenue against the treasuries of capital-exporting, foreign-tax-credit countries, but wished also to defend its revenue base against transfer pricing and financial manipulation. It should maintain low statutory capital income tax rates but at the same time preserve high effective tax rates by limiting the generosity of depreciation allowances and investment tax credits.

Note that the Tax Reform Act of 1986 moved the U.S. corporate income tax system exactly in this direction, lowering the statutory rate that applies to most income from 46 percent to 34 percent, but eliminating the investment tax credit and modifying depreciation allowances so that the effective marginal tax rate on investments has probably slightly increased. Because 34 percent is at the low end of the observed range of statutory rates (except for "tax-haven" countries), it turns the United States into a magnet for internationally fungible taxable income, while not substantially disturbing its attractiveness as a locus for investment and not forgoing revenues to foreign-tax-credit countries that export capital to the United States. This is a strong argument for a low-rate, low-credit corporate tax system as opposed