WORLD TAX REFORM

Case Studies of Developed and Developing Countries

EDITED BY
Michael J. Boskin
and Charles E. McLure, Jr.

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

WORLD TAX REFORM

Case Studies of Developed and Developing Countries

Edited by
Michael J. Boskin
and Charles E. McLure, Jr.

An International Center for Economic Growth Publication

ICS PRESS
San Francisco, California

Publication signifies that the Center believes a work to be a competent treatment worthy of public consideration. The findings, interpretations, and conclusions of a work are entirely those of the author and should not be attributed to ICEG, its affiliated organizations, its board of overseers, or organizations that support ICEG.

Inquiries, book orders, and catalogue requests should be addressed to ICS Press, 243 Kearny Street, San Francisco, California, 94108. Telephone: (415) 981-5353; FAX: (415) 986-4878.

Cover design by Judy Hicks.

Second Printing

Distributed to the trade by National Book Network, Lanham, Maryland.

Library of Congress Cataloging-in-Publication Data

World tax reform : case studies of developed and developing countries / edited by Michael Boskin and Charles E. McLure, Jr.

p. cm.

Includes bibliographical references.

ISBN 1-55815-092-7. — ISBN 1-55815-077-3 (pbk.)

1. Taxation—Case studies. I. Boskin, Michael J. II. McLure, Charles E.

HJ2305.W68 1990

336.2'05—dc20 89-26902

CIP

Preface

A wave of tax reforms and tax reform proposals swept the globe in the 1980s. From one country to another, these reforms have exhibited several common features: a focus on making taxation economically "neutral" (that is, ensuring that the tax system does not distort people's economic decisions), a trend toward lower marginal tax rates, a response to international tax pressures, and a consideration—particularly in many developing countries—of the value-added tax as a broad-based source of revenue.

In late 1987 and early 1988 the International Center for Economic Growth sponsored a project on world tax reform, directed by Michael Boskin, then of Stanford University and currently chairman of President George Bush's Council of Economic Advisers. That work led to a conference in October 1988, where a group of distinguished scholars presented case studies from developed and developing countries, as well as several broad issues papers. This volume brings together the results of that conference and provides convincing evidence that we have indeed learned a great deal about effective tax policy in the past several decades. In addition, *World Tax Reform* shows where current thinking has been neglected in the policy-making process.

At the end of 1988, Dr. Boskin wrote the introduction and overview that appears as the first chapter in this book. At that point, anticipating his new responsibilities in Washington, D.C., he turned the manuscripts over to Charles E. McLure, Jr., of the Hoover Institution, to complete the editing and to write a special conclusion, which also appears herein. We list them together as coeditors of the final product.

World Tax Reform reveals the interaction among academic thinking, administrative practice, and political reality that is causing the field of taxation to evolve so rapidly around the world. We hope the book will be useful in the tax reform debates now taking place, at both an academic and a policy-making level.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

March 1990
Panama City, Panama

Contents

List of Tables

List of Figures

Part I

Introduction and Overview

Chapter 1 *Michael J. Boskin*

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.