

Taxation Policy and Economic Development in Underdeveloped Countries (I)

—With Special Reference to Korea—

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Part-I

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Introduction

Much has been said of taxation policy obtaining in the presently underdeveloped countries by many experts at theoretical as well as practical level in recent years. Particularly, United Nations has been active in studying the subject matter as a part of broader economic survey through their specialized agencies. As a result of this work, the knowledge and understanding of problems in regard to the policy of taxation in underdeveloped countries have been considerably enriched.

The indispensable link between the taxation policy and economic development has been much recognized by many writers as an important subject of discussion. In most of underdeveloped countries at present day, it is now customary to have a development program and the government has been assigned a great significant role in the process of economic development.

One of the important problems of economic development in these areas is how to finance the resources that are needed for development program. It is fairly recognized that within the fiscal policy, although the expenditure policies are important, if the tax receipts are not sufficient, there would be formidable difficulties in implementing the developmental program. It would seem, therefore, that the effective financing of resources needed to the program is one of the premises within which the effective implementation of developmental program is to be initiated.

It has been argued that the sufficient revenue of the government could not be

raised through the taxation in many of underdeveloped countries, where the vicious circle of poverty goes on, in general, and the lack of adequate book-keeping system, the existence of large proportion of illiteracy in the population, the inefficiency in the tax administration, and the considerable proportion of non-monetized sector, have been predominant in particular.

Nevertheless, taxation has to be utilized as an instrument for raising the saving ratio to national income and channelling it into desirable investments. It is generally accepted that in the context of taxation policy in underdeveloped countries, it must be concerned not merely with the need to increase the government revenue for meeting the increasing expenditure, but also with the need to provide the incentive aspects of taxation for the rapid expansion of entrepreneurial activities, in the initial stage of economic development.

The purpose of present thesis is firstly to analyse the fundamental problems of taxation policy in underdeveloped countries, secondly, to describe the basis features of taxation structure in Korea, and finally to evaluate the taxation policy which has been followed by the government of Korea.

The thesis is divided into two parts. The first part deals with the importance of the subject, the basic characteristics of taxation structure and its problems, and principal arguments on taxation policy in underdeveloped countries. The second part contains the taxation policy in Korea, with the emphasis on important problems—the characteristics of economic structure in Korea, the basic features of taxation structure in Korea, and the trend in taxation policy in Korea.

A review of the whole study is discussed in conclusion stating how the taxation structure in underdeveloped countries has to be shaped in the light of the objectives of taxation policy in the transitional period, and how certain tax reform may be introduced in Korea.

The Approach to Taxation Policy in Underdeveloped Countries

The purpose of this section is to understand the significance of taxation policy and to seek its objectives in the process of economic development in underdeveloped countries.

It has been recognised among experts in the subject matter that the taxation policy is of increasing significance as an instrument in the process of capital formation and technological change in underdeveloped countries. The crucial reasons for this seem to be implicit in a country where the level of income is extremely low as saving, which serves as the source of capital formation.¹⁾ We can approach, however, the present subject from two fundamental aspects relevant to taxation policy in these regions in general.

Two crucial aspects in the context of tax policy are concerned with firstly the need to finance the social overhead capital and secondly the need to raise the

1) *Walter W. Heller, Fiscal Policies for Underdeveloped Economies. Taxes and fiscal policy in underdeveloped countries, 1954, United Nations, p. 2.*

saving ratio to national income.

A. The problems of economic development in the underdeveloped countries comprise a rather broader facet of a given society. It impinges upon not only economic aspects but also non-economic aspects such as political, sociological, religious, ethical factors and the like. Thus it does not only require accumulation of capital but adaptation of technological processes of production and spirit of enterprise among the people.

It would be worthy at this stage to look at the statement of Prof. *Arthur Lewis* on the essential causes of economic growth in brief. He puts that the proximate causes of economic growth are the effort to economize, the accumulation of knowledge and its application, and the accumulation of capital.¹⁾

The first requirement above is related to the aspects of economic attitudes in underdeveloped countries. Substantial change in social belief and practices must take place within more or less the stagnant society. As Prof. *Frankel* stressed, this aspect of change is of importance in the sense that technological change **Presupposes a basic alternation in the economic structure of the society and a complete re-casting of the traditional values of the community.**²⁾

The second requirement is concerned with the provision of social and economic overheads, such as the formation of social infra-structure. In this connection it must be kept in mind that the supply of capital would be of little avail without the supply of other factors favourable to economic development.³⁾

Economic growth is the outcome of a combination of economic, social, cultural and political factors. It would be of interest to note the following statement made by Prof. *Bauer*: **It is misleading to think of investment as the only or the principal determinant of development. Other factors and influences, such as institutional and political forces, the qualities and attitudes of the population, and the supply of complementary resources, are often equally important or even more important—capital is created in the process of development rather than development is a function of capital.**⁴⁾ **Economic development has much to do with human endowment, social attitudes, political conditions—and historical accidents. Capital is necessary but not a sufficient condition of progress.**⁵⁾

If we put the above three causes of economic growth in another way, it could be as follows:—

- i) The development of economic attitudes
- ii) The development of institutional framework of economic activity and social-economic overheads; and

1) *A. Lewis*, *The Theory of Economic Growth*, p. 11.

2) *F.S. Frankel*, *The Economic Impact on Underdeveloped Countries*, 22-99.

3) It can be argued in the reverse way, that although given all socio-political factors favourable to economic development, the development can't take place without adequate capital. As some economists stress, in underdeveloped countries the capital is the more strategic concept in the context of development as compared with the socio-political factors.

4) *Bauer*, *Economic Analysis and Policy in Underdeveloped Countries*, p. 119. Also, *Bauer & Yamey*, *The Economics of Underdeveloped Countries*. Chapter X.

5) *Nurkse*, *Problems of Capital Formation in Underdeveloped Countries*, p. 1.

iii) The accumulation of capital.

Of the three foregoing requirements of economic growth the second factor seems to be the most important. The serious obstacles to economic development in the now underdeveloped countries are due to the absence of adequate institutions and socio-economic overheads¹⁾ such as a satisfactory banking system, money and capital market, communication, transportation, education, public health services, irrigation works and so forth. It is commonly recognized that this very social overhead capital is of great significance, particularly in the initial stage of development in the sense that the various forms of social overhead capital as such create the **external economies** by which the widening of the market, the increase in the productivity of labour, and reduction in the cost of production can be promoted in general.²⁾

Here we come to the role of the government which shows the most striking feature of the capital formation process in the underdeveloped economy in providing social infra-structure as a prerequisite to the development process. It seems that the investment in the formation of social infra-structure cannot be undertaken by private investors in spite of the fact that it promises large social gains. There are several grounds for this. Firstly, there is a sharp divergence between the private gain and social gain. Its benefits often return to the society as a whole, indirectly rather than directly to the initiating entrepreneurs. The investment in human capital such as education, health and sanitation measures pay rich social and economic dividends, although it doesn't offer opportunity for private investors. Examples of physical investment in this category are transportation, communication, irrigation etc. Secondly, the gestation period of capital is usually long. Thirdly, the necessary amount of capital is too huge to be undertaken by private investors. Power installations, river development, irrigation and various conservation projects fall in the second and third category.³⁾

The foregoing reasons give enough ground to state that the government must play a role in the process of building up overhead capital.⁴⁾

However, the point which one must observe in connection with the vital role of government in providing social overhead capital, is that it requires a vast amount of resources as pointed out above. Especially the fact that the government needs a large amount of capital for building a social infra-structure in turn calls for the strengthening of the tax system to yield adequate revenues for financing a desirable investment as such. This is of primary concern and one of the reasons why taxation has been increasingly assigned a far more positive role in the process of economic development.

1) The economic overheads consists of such investments of capital as highways, railroads, communications, power installations, ports and technical training facilities; whereas the social overheads consist of schools, hospitals, libraries and public health measures.

2) *H. Liebenstein*, *Economic Backwardness & Economic Growth*, p. 106.

3) *Rostow*, *A Non-Communist Manifesto* Economist: August 1959, p. 411.

4) The United States of America in the early 19th century created enormous social overhead capital by which the rapid economic growth took place. Japanese economic development also occurred to a large extent in the same ways. Now, the same is required for the economic development of underdeveloped countries.

Now then what are the feasible possibilities to finance the government's developmental program in the situation of presently underdeveloped countries. Let us examine the various possibilities of mobilization of domestic resources.

There seem to be three means of financing the resources needed for sustained economic growth.

- 1) Borrowing from the public
- 2) Inflation (=credit creation)
- 3) Taxation.

The first method is borrowing from the public or mobilization of voluntary savings. This method is not likely to result in a substantial supply of funds over a short period. The most obvious reason for this is the paucity of savings of individuals. Borrowing is the device to acquire private resources for governmental purpose. A government can successfully borrow from the people only where they are enough saving. If the government borrows from individuals or institutions that would diminish resources at the disposal of the private sector, it would diminish capital fund in the private sector. However, borrowing creates the problem of interest payments which taxation does not. Once tax receipts are realised it does not create any problem, but borrowing leaves a legacy of interest payments. In other words, borrowing is a deferred taxation and the community has to increase taxation in later years for meeting interest charges and repayment of the debt. It must be borne in mind that in the context of economic development, the problem is not merely diverting funds from private to public sector, but rather increasing the total pool of resources for investment both in the private and public sectors. This could be raised effectively not borrowing but by taxation.

Another form of domestic financing is the credit creation by printing notes of the central bank on the strength of government bonds. This method is inflationary in nature. **As a general principle** such devices, because of their inflationary tendencies, are the least desirable method of financing.

In view of the inflationary conditions already prevailing in many underdeveloped countries this must in the general case be considered a dangerous method of financing.¹⁾ However, the method of taxation can do more effectively in financing the resources, in such a way that taxation can prevent the economy from inflation and can divert the resource which otherwise turn to flow into unproductive directions of economy and could force the community to save at a higher rate than it does.

Of the foregoing three methods of financing the development it is obvious that taxation is the most important, and this one of reasons why the taxation has been increasingly assigned a significant role in the process of economic development and taxation thus remains to be one of the main instruments for economic development.

B. We come to the second point which is the need to increase the saving ratio to national income, in understanding the importance of tax policy for economic

1) U.N. 1950, Domestic Financing of Economic Development, p. 6, and U.N. 1949 Methods of Financing Economic Development in Underdeveloped Countries. pp. 19-20.

2) Ragnar Nurkse, Problems of Capital Formation in Underdeveloped Countries, p. 51.

development in the now underdeveloped countries.

There is a direct relationship between the saving and capital formation in an economy.¹⁾

Saving is a crucial factor in the process of economic growth. By saving, factors of production are diverted from consumption to production. Saving measure the difference between income and consumption in a given period. Therefore, the wider the gap between income and consumption the more saving. Saving is a function of consumption in the economy. We could explain it in the following way:—

$$\text{National Income} = \text{consumption} + \text{saving}$$

$$\text{National Income} - \text{consumption} = \text{saving}.$$

If we assume that national income is 1 and the propensity to consume is 9/10, then saving is $1 - 9/10 = 1/10$. Thus we see that saving could be increased by reducing consumption and vice versa.

TABLE 1. Gross Savings and Investment in some Countries of the World

(as a per centage of gross national product)

	Year	Per centage
Australia	1949	28.7
Canada	1950	20.6
U.S.A.	1950	17.7
U.K.	1950	18.5
Cuba	1948	14.0
Colombia	1947	11.4
Mexico	1948	13.3
Brazil	1948	10.1
Chile	1950	10.6
India	1960	5.0
Japan	between 1900-1909	12 to 17
Russia	"	25 to 30
Norway	"	15.0
Finland	"	18.0
Poland	"	20 to 25
Hungary	between 1947-1949	10 to 18

Source: quoted from "Fiscal Policy and Economic Development of Underdeveloped Countries" by *Divakar Jha*, The Indian Journal of Economics, July, 1956, p. 84.

Saving has been attributed to be the primary cause of current inadequate investment in the now underdeveloped countries. Apart from significance of saving it may be of interest in this connection to look into the figures of saving in the advanced countries during the last decades of economic development. Table 1. gives us an interesting idea on the saving in the context of development during the last decades of economic development, in both developed and less developed countries:—

From Table 1., we find that the high rate of saving has taken place in the process of economic development in the now advanced countries. About 15-20 % of gross national product was made the saving which has enabled the

1) As Prof. *Harrod* states, the rate of growth of output in relation to existing national income, is a function of savings (=investment) and the inverse of the capital—output ratio (=output capital ratio). In his model the rate of growth is given by the equation as follows:

$$\frac{\Delta y}{y} = g = \frac{s}{v}, \text{ where } g \text{ is the rate of growth, } s \text{ is the savings}$$

ratio and v is the capital output-ratio. To maintain full employment rate of growth or a continued full-capacity income, s and v must grow at constant rates. The rate of savings will have to be increased if steady economic growth is to be achieved. *R.F. Harrod*; Towards a Dynamic Economics; Macmilland & Co. Ltd. New York 1956, p. 81

economy of a country to finance the investment resource. In contrast to these advanced countries, the underdeveloped countries of today save a small percentage of their national income, as shown in Tabl 2 which includes a number of countries in ECAFE regions.

TABLE 2. ECAFE Countries: Foreign & Domestic Saving:
Level in 1957-1959 and change from 1950-1952
 (Per cent of net growth national product)

Country Period covered	Gross total saving		Foreign saving		Gross domestic saving	
	Level	Change	Level	Change	Level	Change
Burma						
1951-1952	15.7	4.8	-7.0	11.0	22.7	-6.2
1957-1959	20.5		-4.0		16.5	
Ceylon						
1950-1952	11.9	0.9	-1.2	3.0	12.1	-2.1
1957-1959	12.8		2.8		10.8	
China: Mainland						
1950-1952	5.1	9.5	1.4	-0.7	3.7	10.2
1955-1957	14.6		0.7		13.9	
Taiwan						
1951-1952	17.3	0.4	4.9	2.8	12.4	-2.4
1957-1959	17.7		7.7		10.0	
India						
1950-1952	13.5	5.1	0.3	2.7	13.2	2.4
1957-1959	18.6		3.0		15.6	
Indonesia						
1951-1952	6.9	-1.2	0.3	—	6.6	-1.2
1957-1959	5.7		0.3		5.4	
Japan						
1950-1952	28.3	3.2	-1.0	0.7	29.3	2.5
1957-1959	31.5		-0.3		38.1	
Korea, South						
1953-1954	14.8	-1.0	6.6	2.2	8.2	-3.2
1957-1959	13.8		8.8		5.0	
Pakistan						
1950-1952	5.1	5.0	0.7	2.4	4.4	2.6
1957-1959	10.1		3.1		7.0	
Philippines						
1950-1952	7.5	1.4	0.7	1.2	6.8	0.2
1957-1959	8.9		1.9		7.0	
Thailand						
1952-1953	15.3	1.4	2.1	0.8	13.2	0.6
1957-1959	16.7		2.9		13.8	

Source: U.N. 1962: Economic Survey of Asia and the Far East, 1961, p. 46.

Particularly in some countries, like Indonesia and South Korea, the saving has been decreased. If we look into the figure of gross domestic saving excluding the foreign saving, a large number of countries have shown a steep decline in saving. (e.g. Burma, Ceylon, Taiwan, Indonesia and South Korea). The inflow of foreign saving has enabled the country to be moved up into the higher saving rate (in some countries especially South Korea, Laos and South Viet-Nam).

One of the crucial causes of underdevelopment and economic stagnation in underdeveloped countries is their inability to save enough and to channel their savings into desirable fields of the economy (like social overhead capital).

Now, at this stage, we turn to the description of availability of domestic saving in brief in the underdeveloped countries.

Personal savings in these regions are estimated at around 1% of the gross national product or even less, whereas the advanced countries like the United States and Canada show that personal savings range from 4 to 6 per cent of their gross national product.¹⁾

The business savings retained by enterprise for depreciation and investment is also small. The predominant agriculture in underdeveloped countries is managed on a small-scale farming. In addition, industrial and service establishments are organized on a small scale basis as well. They yield small savings over and above their expenditure on maintenance of their meager equipment.

The government saving which may be defined as the excess of the budget can hardly be realized for the reason that unfortunately it must cover a very large burden of expenditures.

Taking the above feature of savings into consideration, it is obvious that **the present rate of aggregate saving has to be increased considerably if the economy is to undertake investment at a rate sufficient to employ the increasing population and secure a modest rise in per capita income, without inflation.**²⁾

Moreover, particularly in the pre-industrial societies, agriculture contributes more than half of the national output, and a significant part of this accrues to what we may call **feudal proprietors**. Economic development can be accelerated if the larger part of this **surplus** can be made available for productive investment. One of the central tasks of fiscal policy is to mobilize such surplus for purposes of economic development. The concept of economic surplus is somewhat tricky. The surplus can be used for what the classical writers called **unproductive consumption** or **unproductive investments** (palaces and pyramids).

According to Professor *Baran*, we may distinguish between actual economic surplus and potential economic surplus.³⁾ Actual economic surplus is the difference between actual current output and actual current consumption, and potential economic surplus is the difference between the output that could be produced in a given natural and technological environment with the help of employable pro-

1) *Taxation & Economic Development in Asian Countries*. p. 1. Economic Bulletin for Asia and the Far East, Vol. IV, no. 3, Nov. 1953, U.N.

2) *Taxation & Economic Development in Asian Countries*, p. 1. Economic Bulletin for Asia and the Far East, Vol. IV, no. 3, Nov. 1953, U.N.

3) *P.A. Baran, The Political Economy of Growth*. Monthly Review Press. New York, pp. 22-23.

ductive resources and what might be regarded as essential consumption. Economic progress requires that, in the initial stage, a high proportion of this surplus be channelled into productive investment. In an agrarian country, a great part of the surplus originates in the agricultural sector and is appropriated by landowners, moneylenders and merchant who usually do not possess the habit of productive investment. What is needed for this purpose is a comprehensive mobilisation of the economic surplus currently generated in the economy.

It might be useful to elaborate on the ultimate reasons for the low ratio of savings in these regions in order to be able to find the precise method of raising it.

1. The low income level makes it difficult to save. Little remains for saving after meeting the subsistence living with the meager level of income, particularly in the lower income strata.
2. The traditionally lavish living reinforced by the **demonstration effect** of America consumption standards retards the increase of the saving ratio, particularly in their higher income strata.
3. The traditional way of life especially in the celebration of marriage, birthday and funeral on a large scale, provides the negative function in the increase of saving.
4. There is the lack of adequate institutions for saving, like modern bank systems, capital market etc.
5. Considerable funds tend to flow into speculation in economy where inflation is prevailing and a considerable amount of savings goes to flow into real estate.¹⁾
6. Unstable political situations make people hesitate to save.

Thus the way to increase the saving ratio has to be sought from various angles as mentioned above.

As has been pointed out in the foregoing section, it appears that in raising the ratio of saving and channelling it to desirable investments, taxation plays a vital role. It can be done by utilising some tax tools which will be explored at some length in chapter 3.

Some major reasons for the fact that taxation can do much more than any other method (like borrowing or credit creation), are as follows:—

Firstly, the consumption of people can be reduced through taxation. Secondly, taxation can provide the positive inducements for saving and investment. Lastly, it can create the government saving so as to enable the government to undertake development projects. Particularly, the second reason is of paramount importance in the process of economic development.

In the foregoing section, we have proved that taxation remains to be one of the main instruments for economic development in underdeveloped countries from the method of financing point of view. But in the second section we have tried to prove it from the point of view of saving which is one of the crucial factors

1) *Reuben E. Slesinger*, Fiscal Policy Considerations for Underdeveloped Countries. *Kyklos*, Vol. XV, 1962, p. 627.

in the capital formation.

As has been discussed so far, it is evident that the fundamental problem in underdeveloped economies is to raise the rate of savings in the economy as a whole. This must be treated as the paramount question.

It seems reasonable to quote Prof. *Heller's* statement as this stage, in the context of significance of taxation in underdeveloped countries. **To break out of this vicious circle, apart from foreign aid, calls for vigorous taxation and government programmes; on this point, expert opinion is nearing a consensus.**¹⁾

On the basis of the foregoing discussion, some important objectives of taxation policy as a part of general developmental policy in the process of accelerating economic growth can be drawn as follows:—²⁾

- 1) Restraining or curtailing consumption and thus transferring resources from consumption to investment;
- 2) Increasing the incentive to save and invest;
- 3) Transferring resources from the hands of the public to the hands of the government to make desirable public investment.
- 4) Mitigating economic inequalities.

Thus, Tax structure must be designed so as to be conducive to the accomplishment of these objectives.

The Characteristics of Tax Structure and its Problems in Underdeveloped Countries.

The present chapter aims to show the general characteristics of taxation and to approach to the major problems of it in the underdeveloped countries.

The major characteristics to be inquired into in this chapter of tax structure in underdeveloped countries fundamentally stem from basic features of underdevelopment of these countries.

The first characteristic is that tax revenue as not only a proportion of total government revenue but also of national income, is relatively small as compared with that in advanced countries. We find the fact that in relation to gross national product, the tax revenue of the underdeveloped countries is typically much smaller than in the advanced countries. Whereas the developed countries collect 25-30 per cent of their G.N.P. in taxation, the underdeveloped countries typically collect only 8 to 15 per cent.³⁾ We are aware that the main reason for this is the low income level at or below the subsistence of the majority of people. Especially, when the income level is just enough for subsistence, it is not possible to collect tax from the people of that income group.

The second important factor that causes low tax yields in underdeveloped countries is that the size of the monetary sector is much smaller than in devel-

1) *Walter W. Heller*, *Fiscal Policies for Underdeveloped Economies. Taxes & Fiscal Policy in Underdeveloped Countries*, 1954, United Nations, p. 3.

2) *R.J. Chelliah*, *Fiscal Policy in Underdeveloped Countries*, p. 53

3) *Nicholas Kaldor*, *Will Underdeveloped Countries learn to tax?* *Foreign Affairs* Jan. 1963. p. 410.

oped countries. There is no doubt that tax collection is much easier in an economy with monetary and market transactions than in an economy where the monetary sector is less developed, simply because of difficulties of assessing real income in the latter. In many underdeveloped countries the home-produced goods and other goods obtained by barter, as Dr. *Richard Goode* has pointed out, occupy a larger part of total real income of the population.¹⁾ Particularly Prof. *E. de Vries* has estimated in connection with the problem of saving in rural areas in underdeveloped countries that upward of 80% of all capital formation at least in agriculture, is in the form of real terms which makes it difficult to assess for collecting the taxation.²⁾

There are a number of other reasons, such as illiteracy, lack of systematic

**TABLE 3. Direct Tax Revenue as per centage of Total
Central Government revenue, 1959³⁾**

High income countries (above \$500 per capita per annum)		Medium income countries (\$200-500 per capita per annum)		Low income countries (below \$200 per capita per annum)	
U.S.A.	80	South Africa	50	Syrian Arab Republic	33
Venezuela	63	Japan	47	Turkey	27
Netherlands	61	Colombia	42	Burma	25
Australia	59	Spain	40	Pakistan	24
Canada	56	Mexico	35	Peru	23
U.K.	51	Brazil	34	Korea	22
New Zealand	51	Chile	32	Honduras	21
Sweden	49	Portugal	31	Thieland	21
Denmark	43	Ireland	26	Ceylon	20
Belium	41	Panama	25	United Arab Republic	20
Israel	35	Argentina	23	Indonesia	18
Austria	33	Italy	22	India	17
France	29	Greece	20	Equador	16
Switzerland	27	Lebanon	18	Philippines	13
Norway	27	Costa Rica	17	El Salvador	12
Finland	23	Malaya	15	Iraq	10
Germany	20			Chana	10
				Haitai	8
				Guatemala	7
Median	43	Median	29	Median	20

1) From an address by Dr. *Goode* on "Reconstruction of Freign Tax Systems" before the Fourty-fourth Annual Conference of the National Tax Association, 1951, published in the proceedings of that Conference, pp. 213-214.

2) See proceedings of the International Conference on Agriculture & Cooperative Credit Berkeley, Calif. 1952, p. 311 f.f.c.c.

Liang, Mobilization of Rural Savings with special reference to the Far East.

3) Quoted from *U Tun Wai*, Taxation Problems and Policies of Underdeveloped Countries, Staff Papers, International Monetary Fund, Vol IX, No. 3, Nov. 1962 p. 431.

accounting, inefficient tax administration, tax evasion and avoidance, social codes of behaviour not requiring voluntary compliance, political influence, etc.

A second characteristic of the tax structure in underdeveloped countries is that the reliance upon direct taxation as proportion of government total revenue is markedly less, as compared with the advanced countries, as shown in Table 3 which presents the countries according to per capita incomes—high, medium and low.

The median for direct tax revenue as a per centage of total revenue in the high per capita income countries is 43, whereas that in the low per capita income countries is 20. The main reasons for the narrow scope of direct taxation as such are mainly connected with the reasons mentioned above in the case of low yielding of revenue to G.N.P. Therefore, there is little doubt about the fact that direct taxation could not become an instrument of mass taxation during the first stage of development in underdeveloped countries in view of the above conditions.¹⁾

**TABLE 4. Taxes on Foreign Trade as Per centage
of Total Government Revenue. 1959 ²⁾**

High income countries (above \$500 per capita per annum)		Medium income countries (\$200-500 per capita per annum)		Low income countries (below \$200 per capita per annum)	
Switzerland	30	Costa Rica	59	Chana	63
Israel	25	Malaya	53	Haiti	60
Venezuela	22	Lebanon	35	Ceylon	55
New Zeland	14	Colombia	34	Honduras	49
Finland	13	Panama	33	Cuatemala	43
Canada	10	Greece	29	Equador	40
Netherlands	9	Mexico	23	El Salvador	37
Austria	7	Portugal	23	India	36
Norway	7	Italy	22	Sudan	35
Australia	6	Chile	20	Indonesia	30
Sweden	5	Brazil	15	Thailand	30
Belgium	4	South Africa	15	Korea	28
United States	2	Spain	8	Burma	28
		Japan	6	Philippines	25
		Argentina	5	Iran	24
				Pakistan	24
				Iraq	22
				Peru	18
				Syria	18
				Turkey	12
Median	9	Median	23	Median	30

1) U.N. Taxes and Fiscal Policy in Underdeveloped Countries. 1954, p. 31.

2) Quoted from *U Tun Wai*, Taxation Problems and Policies of Underdeveloped Countries. Staff Papers, International Monetary Fund, Vol. IX, No. 3, Nov. 1962, p. 434.

Nevertheless, despite the above fact, one must conceive that there are important significances of direct taxation in the process of economic development. It appears that in this regard, two points of view have to be taken into consideration. These two points of view to be considered are firstly the income-elastic tax system and lastly the incentive aspects of taxation. We now leave this discussion which will be elaborated upon in Chapter III.

A third characteristic of tax structure in these territories can be strikingly seen in the pattern of indirect taxation. The dependency of the government revenue on indirect taxation is considerably heavy. This is marked in contrast with the advanced countries where taxes on income and wealth form a large part of the revenues of the government. Particularly the taxes on foreign trade (import duties, export duties and exchange taxes) occupy the larger part of tax revenues as shown in Table 4.

The reason for this seems obvious in a country where the international trade is large in relation to national income and therefore constitutes a substantial proportion of total transactions in the market. In addition to that, it is easier to collect indirect tax in the absence of proper records, book-keeping and literacy than direct taxation. Especially this is so in the case where the foreign trade is conducted only through a few seaports or points of entry.

We have seen in Chapter I that the taxation is of significance in the process of economic development in underdeveloped countries in the sense that the taxation has to be utilized as an instrument in raising the saving ratio and channelling it into desirable investments. We are aware at this stage of its objectives, mentioned in the foregoing chapter, to be accomplished in the light of requirements of economic growth.

And we have also seen the basic characteristics of tax structure in the now underdeveloped countries, by showing the weak position of taxation in the government's total revenue, the narrow scope of direct taxation there and the heavy reliance on indirect taxation, particularly on the taxes accruing from foreign trade.

We now come to the problems in which the existing tax structure presenting deformed phenomena in character as compared with the advanced countries will have to be reformed into a tax structure by which the objectives of tax policy in underdeveloped countries can be achieved and the fulfilment of taxation as an instrument on the part of economic development could be accomplished.

In an effort of applying the tax structure of advanced countries of that of underdeveloped countries, the most careful attention must be drawn to the different situation in a setting that presents various numbers of factors obstructing the process of industrialization. Therefore, the problems to be tackled in modernizing the existing tax structure in underdeveloped countries appear to occur from the factors which are related to the fundamental features of underdevelopment. It would be worthy to quote here at some length in this connection the comprehensive study done by Dr. *Richard Goode*, in finding out the problems involved in the process of modifications of tax structure in underdeveloped countries.¹⁾

1) The address by Dr. *Richard Goode* before the Forty-fourth Annual Conference of the National Tax Association, 1951. (Proceedings of that Conference, p.p. 213-215). Quoted from *Agricultural Taxation and Economic Development*. Cambridge, Massachusetts, 1954, pp. 82-83.

1. The first condition is the existence of a predominantly money economy. The subsistence farmer cannot be satisfactorily reached by an income tax, not so much because he does not have money to pay—that may mean that he cannot pay a tax of any kind—as because the greater part of his real income can not be satisfactorily assessed. Even highly skilled administrators have made little progress toward including the value of home-produced and consumed foods in the taxable income of farmers. In many underdeveloped countries these products and other obtained by barter make up a major fraction of the total real income of large segments of the population. Admittedly these groups are usually the poorest in the society, and failure to subject them to direct taxation may not be seriously objectionable from the equity point of view. It does, however, encourage use of other taxes.

2. Another condition that may not be strictly necessary but is very helpful is a high standard of literacy among taxpayers. In many underdeveloped countries the majority of the population is illiterate. For example, among the eleven Latin American republics for which data are readily available, seven have illiteracy rates higher than 50 percent.¹⁾ In many regions of Asia and Africa the figure is higher than that, as it probably also is for several Latin American countries for which data are not available. Illiteracy, like exclusion from the money economy, is most characteristic of the poorest farmers, but often wage earners, independent craftsmen, and small shop-keepers cannot read and write well enough to fill out the simplest income tax return with the guidance of printed instructions. Wage earners may be covered by withholding, but in any refined system they must be able to file claims for exemptions and refunds.

3. Prevalence of accounting records honestly and reliably maintained is another prosaic but important condition for satisfactory income taxation. In most underdeveloped countries many business men keep no books at all; others maintain two or more sets. Vigorous tax administration can do much to improve accounting standards if combined with an educational campaign, but more trained people, personnel and office equipment are essential.

4. A fourth requirement for satisfactory income taxation is a large degree of voluntary compliance on the part of taxpayers. The best administrative organisation cannot satisfactorily collect income taxes from the self-employed when, as in many countries, evasion is generally attempted and incurs little or no moral disapproval from the public. The roots of a tradition of voluntary compliance with tax laws are not easy to trace, but it is fairly clear that such a spirit does not grow up overnight. Although something can be done in the short run, a long period of popular education and efficient and equitable administration of those taxes that can actually be enforced seems necessary to establish firmly the habit of general voluntary acceptance of the fiscal responsibilities of citizenship. Adaptation of elaborate measures that will not be uniformly applied delays improvement of taxpayer morale.

5. The political conditions for development of income taxes into a major revenue source, like the spirit of voluntary compliance, are intangible and hard to explain.

1) United Nations Statistical Year Book 1949/50, pp. 486—494.

The environment most favourable to progressive taxation seems to be one of free political democracy. In many underdeveloped countries wealthy groups have enough political power to block tax measures that they consider threats to their position. Until the popular will is stronger and more united or until the rich are ready to accept the ability-to-pay principle—whether from altruism or a sense of guilt or fear—steeply progressive taxes will not be collected.

6. Honest and efficient administration is needed for any tax, but minimum acceptable standards appear to be higher for income taxes than for many other levies. Difficult as the task of establishing a satisfactory administration may be, it is probably the condition for successful income taxation that can be met most quickly. The expert, nevertheless, must guard against the assumption that a tidy organisation chart and nonpolitical staffing assure good administration. Nor can he be confident that the best obtainable administration will eliminate obstacles to heavy reliance on income taxes.

It suggests the fundamental problems involved in the existing tax structure of underdeveloped countries. The action must be taken to remove the barriers, along with the above lines.

It calls for not only especially improving tax administration, but also a large degree of voluntary compliance on the part of taxpayers. At the same time, there must be adaptability to be considered for the existing conditions of underdeveloped countries, in introducing the fiscal instruments of advanced countries to underdeveloped ones. Now, our task to be followed is how these problems are rooted in the aspects of each taxation in particular and this enforces us to look to the recent principal arguments in the context of taxation policy in underdeveloped countries.

Principal Arguments on Taxation Policy in Underdeveloped Countries

The present chapter is devoted to review a certain amount of principal arguments involved in utilizing taxation as an instrument in the process of economic development in underdeveloped countries, bearing in mind the objectives of taxation policy and its major problems studied in Chapters I and II and to find the way in which the problems in modernizing the tax structure can be overcome.

A number of subjects of argument considered principal and essence are chosen in the light of the result of the study in the foregoing two chapters as well as the view and opinion of experts in the context of tax policy in underdeveloped countries.

Those subjects chosen here are (a) the problem of taxable capacity, (b) direct taxation, (c) indirect taxation, and finally (d) the problem of incentive aspects of taxation.

A. The problem of Taxable Capacity.

As has been suggested already in Chapter I, the government of underdeveloped

countries requires a huge amount of resources. However, their means are insufficient to cover all those expenditures (especially the cost of building the social infra-structure prerequisite to the development).

In connection with this, one is confronted with the problem of capacity of financing the developmental programme through **taxation**. Therefore, students of public finance, so often, have referred to the taxable capacity which is the subject of this section, in seeking the methods of domestic financing.

The concept of taxable capacity used here is concerned with the potential capacity that can be mobilized for supplying the developmental program through taxation, rather than the problem of ability to pay. That is to say, the seeking of resource upon which tax can be imposed, otherwise likely to be spent in undesirable fields.

With regard to the present subject, the important question is how much the increasing resources can be collected in taxes for development without creating a disturbance in the economy.

There has been a general statement on this question by many experts in the field, that there is a certain limit beyond which the increase in tax rates should not exceed, otherwise the effect of taxation on economy will work negatively. The basic thesis of this argument can be seen particularly in the study of statistical data relating to a number of advanced countries, done by Prof. *Colin Clark*. He came to the conclusion that **data appears to give very considerable support to the hypothesis that once taxation has exceeded 25 per cent of the national income (20 per cent or less in certain countries) influential sections of the community become willing to support a depreciation of the value of money, which has injurious effects on production.**¹⁾ When taxation reaches 25% of the national income, he thinks, a number of forces begins to work against stability and progress of economy. Good examples for this may be that the employers and wage-earners are likely to be reluctant to undertake extra effort, thereby it may slow down production. That is to say, the incentive to work or to invest would deteriorate. Not only has Prof. *Colin Clark* made these suggestions, but other writers like *Bastable*, *Lutz* and *Anderson* thought that reduction in taxation would encourage the production and lead to increase in national income. However, the view which Prof. *Colin Clark* has shown seems to be political, not economic. If the tax burden becomes too high to pay people feel uncomfortable, then another political group will take power so as to relieve the heavy burden of taxation, as pointed out by Prof. *Benjamin Higgins*.²⁾

It is the general feeling that taxpayers usually overestimate the burden of taxation and underestimate the benefit of expenditure. If taxation imposed on the people brings unfavourable effect on the economy, no government would impose taxation. One must consider, apart from the burden of taxation, the benefit of expenditure financed out of that taxation. One may refer in theory, in this connection, to the principles of public finance.³⁾ Namely, a government can collect

1) *Colin Clark*, "Public Finance and Changes in the Value of Money", *The Economic Journal*, December 1954, pp. 371-89.

2) *Benjamin Higgins*, *Economic Development*, 1959, London, pp. 494-495.

3) *H. Dalton*, *Principles of Public Finance*, pp. 9-10.

tax out of the pockets of people, and spend it till the marginal sacrifice of taxation equals the marginal benefit of public expenditure. It is, however, very difficult to say that how much per centage of national income should be collected in taxes by the government, for the reason that it is impossible to measure the marginal benefit of expenditure as well as the marginal sacrifice of taxation. It may vary according to the different place and time, and particularly the different nature of government expenditure pattern.

In many underdeveloped countries, as mentioned in Chapter II the low proportion of the national income has been collected as taxation over the last years as compared with advanced countries. The specific reasons for this fact, apart from the reason of the meager living standard of the people in general, seems to lie in three phenomena in particular. Firstly, there is the existence of nonmonetized sectors in the economy on a large scale. This makes it difficult to increase tax receipts through the usual forms of taxation which means in cash. Secondly, there is the lack of benefit feeling conferred by the government with the taxation paid by people. For the general nature of benefits like defense, law and order, are often likely to be ignored by the taxpayers. Finally, there is a general feeling of inefficiency of government spending financed by the taxation, owing to the corruption and inefficiency in the government administrative machinery on the whole. The action has to be taken, therefore, in view of the foregoing specific reasons, in mobilizing the resources needed to the developmental program.

It might be interesting to note Prof. *Benjamin Higgins'* statement on the question of taxable capacity in the presently underdeveloped countries. He says that if the people of underdeveloped countries could have the same unity of purpose with respect to the war effort during World War II as happened in the advanced countries, the ratio of tax collections to national income for the purpose of financing the developmental program, could be high.¹⁾

One has to agree with him in the sense that if the people of the country could recognize the importance of economic development and try to cooperate with the government policy, then the financing of resources would considerably increase, especially with the help of improvement in tax administration. But the point which should be taken into account in this statement appears that the economic situation in advanced countries during the last war could not be compared with that in the now underdeveloped countries. This brings that in the absence of certain amount of capital formation, to some extent, they would have been unable to divert an adequate amount of resources from the private to the government for the war, even if they were eager to do it. The actual factor which could finance the war was the economic power had reached the stage of matured capitalism. Certainly, there is no doubt that the living standard of the Western world during the war was uncomparably much higher than that of the now underdeveloped countries. That is to say in general, the people of the West were not in the situation of a meager subsistence level as is prevailing in the underdeveloped countries at present.

Nevertheless, his statement is of significance in so far as the recognition,

1) *Benjamin Higgins*, *Economic Development*, 1959, p. 496.

willingness and endeavours of the people towards the development will undoubtedly increase the taxable capacity which will result in the increase in the resources for financing the developmental program.

In bringing about the unity of people with respect to the effort of economic development, the people should be convinced that the government has the capacity and the competence to spend the tax money wisely.¹⁾ On the contrary, there must be a large degree of correspondence between taxes and the benefit of expenditure. This requires an efficiency in administration at all levels and high standards of honesty and morality in government departments so as to diminish people's unwillingness to suffer an increase in tax burden. Particularly, it is generally agreed that improvement tax administration can increase the amount of tax collection considerably.²⁾

The taxable capacity will increase as the development plan is under way. In this respect, it might be desirable to revise the estimates of minimum consumption levels.³⁾ Especially in agricultural sectors of underdeveloped countries the income may not be a satisfactory indication of taxable capacity owing to the fact that the assessment of agricultural income is unknown and book-keeping is virtually not available within the agricultural sector.

B. Direct Taxation.

Direct taxation in underdeveloped countries is of great significance in the process of economic development, despite the fact that its contribution to the total tax revenue of the government is meager as shown in Chapter II, thereby it can't be an instrument of mass taxation under prevailing conditions, for the following two view points which enforce the direct taxation to be utilized as an instrument in the process of mobilization of domestic resources as well as of providing the incentive to save and invest. The first point of view is concerned with income-elasticity of tax systems.

As Dr. *Prest* stresses in this connection **it is desirable that the tax system as a whole should be income-elastic in character to meet the long run growth of government expenditure**⁴⁾

As economic development takes place, the national income will increase, and the income of the population will move up to higher income scale than before. If the tax structure can be set up in an income-elastic form, those who were paying taxes earlier will pay larger taxes, and some of those who were below the exemption limit, will start to pay taxes. The income elasticity of tax structure would seem to require direct tax which is graduated in a progressive manner. The direct tax system as such, thus, will give a built-in structure for meeting the government expenditures of long run growth, without changing the level of taxation. In doing so, however, care has to be placed on the possible discouragement of incentive to save and investment. The major point to be emphasized in this context is that as

1) *R.N. Bhargava*, *Indian Public Finance*, 1962, London, pp. 49—50.

2) *Higgins*, *Economic Development*, p. 497.

3) Conference on Agricultural Taxation and Economic Development, under auspices of International Program in Taxation, Cambridge, Massachusetts, 1954, p. 16.

4) *A.R. Prest*, *Public Finance in Underdeveloped Countries*, Weidenfeld and Nicholson, 1962, pp. 25—26, and *Sahota*, *Indian Tax Structure and Economic Development*, 1961, p. 7.

large a portion as possible of the increments in income generated by economic development should be channelled into saving and investment either of public or private.

The second point in the context of significance of direct taxation is, quite apart from the above point, concerned with the problem of incentive aspects of taxation. The steep progressive direct tax system may retard the incentives to work, to save, and to take risks for investment. We find here lies the dilemma in which the subject of taxation policy in underdeveloped countries comes to fall, that is to say, the dilemma between the problem of increasing the government revenue with direct taxation and that of incentive aspects of taxation. For the purpose of this section, however, we leave the problem of incentive aspects of taxation, which will be dealt with in the next section in further detail.

One point to be added finally before reviewing several direct taxes, is that the direct taxation in general for the complete establishment of its system calls for some important questions such as the development of monetary economy, system of proper book-keeping, the efforts to eliminate the illiteracy, the efficiency in tax administration and the like.

The number of taxes in the category of direct taxation, chosen for the discussion in this section are—

- 1) Personal income taxation;
- 2) Company taxation;
- 3) Land tax; and
- 4) Expenditure tax;

and will be studied, considering the significances of tax policy in the process of economic development, particularly pursuing the possibilities to increase the proportion of direct taxes.

1) **Personal Income Tax**

If we compare personal income tax in terms of the number of taxpayers in relation to the whole population, of underdeveloped countries with that of advanced ones, there appears a great deal of difference between the two.¹⁾ However, if economic development is to be secured through domestic financial resources in a poor country, it might be desirable to raise the amount of personal income tax.

It would seem that in the process of performing the personal income tax in underdeveloped countries, there are three difficult problems, in the main, to be seen below:

- 1) the problem of defining income;
- 2) the problem of assessment of income;
- 3) the problem of rates and allowances.

We start by tackling the first problem. For the most part, the two fundamental difficulties have been obstructing the definition of personal income in underdeveloped countries. Those are found in, firstly, the presence of many subsistence

1) Approximately 30-40% of the total population in the United Kingdom is included in the group of personal income taxpayers, whereas 2 or 3% of the total population is the case in underdeveloped territories. See A.R.Prest, *Public Finance in underdeveloped countries*, Weidenfeld and Nicholson, 1962, p. 28.

farmers and secondly the differing nature of transfer payments and income creating transactions. First of all, concerning the first factor, the fact that the subsistence output is overwhelming importance in the economy of underdeveloped countries, makes it difficult as to whether it must be included in income or not. Many students of public finance in the subject-matter have argued over the years, and it is likely that a national income total which does not include subsistence output is unacceptable.¹⁾

Then the argument is that a subsistence producer by definition earns no cash and so how can he pay tax if he doesn't have cash income? It is difficult, however, to generalise about it for the reason that there are various different ranks of subsistence producers. Some are partly subsistence producers and some are purely subsistence producers.²⁾ However, it must be kept in mind that it is undesirable to levy tax on the people living on subsistence level, as has been pointed out in the foregoing chapter. Nevertheless, what one must be aware in this connection is that the tax on agricultural income could enforce the agriculturalists to produce cash crops by which the monetization of rural sector can be promoted.

The next factor is concerned with the fact that in underdeveloped countries, one can see many sorts of payments which make it difficult to define the income such as bribes, gratuities remittances to relatives etc. This stands for the second difficulty in defining income.

The second problem of personal income tax is how to assess the individual incomes. This raises serious difficulty in many underdeveloped countries. It seems difficult to assess the personal income as it is, in a society where a large number of illiterate peasantry are incapable of keeping accounts, or semi-literate groups are unwilling to do so, and particularly a large proportion of output is not exchanged in the market for money.

Thirdly we come to the problem of fixing rates and allowances. There are two basic methods of levying the personal income tax. One is the schedular method and the second is the unitary system. Under the unitary system, the tax is levied on the total income from all sources, at a progressive rate related to the size of income. Under the schedular system, income is differentiated between sources, and the rate levied varies according to the size of income.

The main argument for the unitary system is that it levies taxes according to ability to pay, whereas, the main argument for the schedular system is that different rates can be levied according to the source and nature of income. The wages are **earned** while profits are **unearned**, and the windfall profits should be taxed at a higher rate than wages. The government servants receive lower remuneration than workers in private enterprise and therefore should be taxed at a lower rate. However, as a result of the Geneva Conference, 1951, it is felt that it is more realistic and administratively more efficient to recognize that in come tax systems generally contain features of both: schedular and unitary

1) A.R. Prest, *Public Finance in Underdeveloped Countries*, 1962, p. 30.

2) In most of the agricultural areas, one finds some cash element in economic life, however irregular.

system.¹⁾

2) Company Taxation.

It would seem that company taxation has some advantage as compared with other taxes. Some obvious reasons for this are firstly, companies (a corporate business) are easily identifiable, secondly keep accounts, and finally they cannot easily from tax liabilities, e.g. difficulty of rapidly changing their place of residence.

One of the most controversial points in regard to company taxation is the question of incentive. Company taxation directly affects the large-scale productive sector of the economy and provides in its structure the incorporation of incentives to save and invest. It is obvious that the incentives to existing companies to take risks in investment will be discouraged if the rate of company tax is high, thereby retarding the economic growth. As a matter of fact, large number of countries have, in recent years, made very considerable concessions to companies in the form of exemption, tax holiday, accelerated depreciation and so on.²⁾ Particularly, it must be stressed in connection with the tax on company that if the tax is levied on profit, the new investment as well as the process of industrialization on the whole will be considerably retarded. Hence, it is desirable to offer full exemption of profit from tax for encouraging the new investment thereby enhancing the accelerated economic growth.

It would seem that companies with limited liabilities are usually taxed more heavily than unincorporated enterprises or private partnerships. This may seem justifiable on the grounds that the larger the business the easier it is to earn income. However, in order to promote investment and to expand the number of companies, it is desirable that preference be given to the corporate form of enterprise. It is certainly true that high company tax rates may discourage the formation of new companies and thereby inhibit the growth of joint-stock enterprise. Furthermore, the absence of competition from new companies may very well lead to the monopoly among existing companies.³⁾

One of the difficulties in raising the level of private investment in underdeveloped countries is that even the rich do not have sufficient funds to establish industries using modern methods of production. This difficulty can be overcome only by encouraging large number of investors through the adequate tax devices.

3) Land Tax

Since the majority of the population in underdeveloped countries is engaged in agriculture, the land tax affects the overwhelming mass of population. By the same token, the prevalence cultivation seems the most characteristic feature of agriculture in these regions.

The yield of land tax in the government revenue is relatively of less importance in most of underdeveloped countries.⁴⁾ The two reasons for this state of affairs can be pointed out as follows.

1) U.N. Taxes and Fiscal Policy in Underdeveloped Countries, 1954, p. 32.

2) U.N. Economic Bulletin for Asia and the Far East, vol. IV, No. 3, Nov. 1953, p. 13.

3) A.R. Prest, Public Finance, 1962, p. 41.

4) U.N. 1961, Economic Survey of Asia and the Far East, 1960, p. 87.

In many of these countries, the ratio of reproducible fixed capital to land is likely to be smaller than in economically advanced countries. We find the farmers who have not got the right to own land but only to cultivate, even after the land reform. This may lead to the fact that the landowner is likely to shift his burden to the tenant, thereby retarding the increase in the agricultural production. In this respect the reexamination of land reform carried out already in many countries, must be done especially with regard to the establishment of market and credit program for those peasants who have already received land.¹⁾ It is very often argued that large private land owners should be taxed on a progressive basis. However, the difficulty in doing so is that the political influence of the large land owners often offered great obstacles to effective taxation. In some countries, in spite of the effort of land redistribution, certain large land holdings are owned by powerful interests who are very lightly taxed. Some of them are found to have been using their land uneconomically, holding it for prestige reasons or for purposes of speculation. A heavy land tax will have the advantage of forcing landowners to utilize their land as productively as possible and will therefore be beneficial to the community.²⁾ On the contrary, it is desirable that small farmers at or below the subsistence level should hardly be taxed.

It is a general tendency in many of underdeveloped countries to levy tax on land rather than the agricultural income. This has resulted in the decline in the amount of land tax revenue (e.g. India).³⁾ The main reason for the decline in importance of the land tax seems that the amount of the tax was fixed originally in relation to the yield per acre when the surveys were made, and this yield may have increased later.⁴⁾

It has been argued that to remedy such defect, the introduction of a separate income tax on agriculture rather than on land has to be adopted. However, the tax on agricultural income is probably a difficult way of taxing agricultural sector, in view of the fact that the farmers keep inadequate records.⁵⁾

4) Expenditure Tax

The idea on expenditure tax has been expounded at length by Mr. *N. Kaldor* in his book **Expenditure Tax**. It has been one of the controversies in the question of taxation. He brought a fresh and vigorous mind to bear upon the tax problems of underdeveloped countries. In recent years his idea came into practice in some of underdeveloped countries like India and Ceylon. It is, therefore, no longer a dream of an academic economist.

His main idea on expenditure tax is that the taxation of individuals should be based not on their incomes, but on their expenditures.

There seem to be three grounds on which he supports this proposition. These are namely based on the point of views of equity, economic effects and administ-

1) Conference on Agricultural Taxation and Economic Development, 1954, p. 8.

2) U.N. Taxes and Fiscal Policy in Underdeveloped Countries, 1954, p. 37.

3) Taxation Symposium 43, p.45, published by Seminar, New Delhi, March 1963.

4) *U Tun Wai*, Taxation Problems and Policies of Underdeveloped Countries. Staff Papers, vol. IX, No. 3, Nov. 1962, p. 440.

5) Conference on Agricultural Taxation and Economic Development, Auspices of International Program in Taxation 1954, Cambridge, Massachusettes, p. 20.

rative efficiency. According to him, from the point of view of equity, the tax system should not contain a bias in favour of particular groups of taxpayers; from the point of view of economic effects, the major consideration is that the tax system should be prevented from weakening the incentive to work, save and take risks; and from the point of view of administrative efficiency, the main requirements are simplicity and comprehensiveness, which make for ease of administration.¹⁾ He thinks that the usual type of income tax is very defective on all three points mentioned above; it is not levied in accordance with the real ability to pay of different taxpayers, and it weakens the incentive to work, save and take risks. The idea in itself is not new. Other economists like *J.S. Mill* and *I. Fisher*, have criticized the income tax as being unfair and harmful. Let us look into their arguments in further detail.

If the income tax is to be equitable, it must be levied on a base that is a satisfactory index of the taxable capacity of the individuals. According to him the taxation based on income is defective and biased.²⁾ The true index on taxable capacity is not income but spending power. The spending power of individual in any given period of time depends on the wealth which he possesses, his regularly recurrent receipts, and his casual receipts.³⁾ **Each of these three elements makes a distinct and separate contribution to a person's spending power.**⁴⁾

The first element, the possession of wealth endows an individual with taxable capacity which is not touched by income tax. The second consists of receipts which are ordinarily included in the concept of taxable income. The third element is concerned with the receipts like capital gains and gifts that are usually excluded from income taxation. Mr. *Kaldor* concludes that the net result of the exemption of many kinds of receipts from the taxable capacity arising from the possession of wealth **is to introduce a systematic bias in taxation in favour of property owners, since the liability of occurrence of such casual or windfall gains is closely associated with the ownership of property.**⁵⁾

If an expenditure tax is substituted for income tax, a larger proportion of any given income is likely to be saved, and substitution effects working in favour of more saving. However, the expenditure tax has some difficulties in applying it in practice in underdeveloped countries. Firstly, the expenditure tax requires more information from taxpayers. In view of a grave shortage of skilled tax administration in underdeveloped countries, it would seem to disqualify the adoption of this tax at present. One must measure both income and saving, not just income. This may incur much heavy administration expenses.

Secondly, the expenditure tax grants a favourable treatment to all savings irrespective of the form in which the savings are held. In advanced countries the large part of savings would flow automatically to productive investment, whereas in underdeveloped countries, a substantial share of total saving is kept in relatively unproductive investment. What is needed under these conditions is a

1) Indian Tax Reform, Ministry of Finance, India, 1956, p. 10.

2) Ibid., p. 1.

3) *N. Kaldor*, An Expenditure Tax, pp. 30-31.

4) Ibid., p. 31.

5) Ibid., p. 36.

scheme which would channel it into desirable investment.

The effort will have to be devoted to tackle the complexity of administration particularly in respect of assessment of both income and saving, not just income, in introducing an expenditure tax to underdeveloped countries.

C. Indirect Taxation

It is a generally accepted idea that the indirect taxes play a very important role in the finances of underdeveloped countries as we have seen in Chapter II.¹⁾

However, the core of the problem in indirect taxes in underdeveloped countries lies in the fact that the majority of people are living at or below the subsistence level of living standard, so how can the government enforce them to contribute to the cost of development particularly viewing the regressive nature of indirect taxation.

How to design the indirect tax system in accordance with the objectives of tax policy mentioned in Chapter II is the paramount question.

There seems to be one justification for the taxation of articles that are widely consumed by the mass of the people. It is likely that in underdeveloped countries it becomes necessary to raise the greater part of tax revenue through commodity taxation. However, the question arises whether taxation of mass consumption has any role to play at all in developmental financing. It would be clearly undesirable as well as unjustifiable to force them to contribute to economic development out of their meager incomes for there is scarcely an element of surplus in the incomes of the masses of the people. There is no scope for reducing the consumption expenditure of the masses as it is already very low. However, in so far as a substantial part of the increase in incomes accrues to the mass of the people as a result of increase in national income they are in a position to consume more than before.²⁾

It is generally accepted rules that high rates on luxuries and low rates on articles of common consumption are to be imposed. This might be called the progressivity in indirect taxation, instead of regressive as usually labelled about indirect taxation.³⁾

For purposes of this analysis, let us classify consumer goods under three heads:

- (a) necessities: required by all but the only goods available to the those who are on the margin of subsistence;
- (b) non-necessaries: these can be and are being consumed by a fairly large number of people who are above the subsistence level; and
- (c) luxuries: these are consumed mainly by the well-to-do.

Let us assume that if there is net investment the real income of the people will increase. This means that people will have higher incomes. When an individual's real income rises, he attempts to move in the scale of consumption from necessities to luxuries. If this movement is restricted, we can have increased production of non-necessaries and luxuries. Therefore, it has to be used to restrain a rapid expansion in the output of non-necessaries and luxuries.

1) U.N. Taxes and Fiscal Policy in Underdeveloped Countries, 1954, p. 38.

2) R. J. Chelliah, Fiscal Policy in Underdeveloped Countries, 1960, p. 86.

3) W. A. Lewis, The Theory of Economic Growth, p. 403.

From the above analysis it is clear that the main role of mass commodity taxation is to check a rapid rise in mass consumption. This conclusion has some important implication for policy. Firstly, there is no case for taxing necessities. Secondly, non-necessaries and mass luxuries can be taxed at fairly low rates to begin with. The rates on articles of mass consumption should be raised only when there is a clear indication that per capita output of such articles is rising.

We now turn to look to the main arguments involved in each indirect taxation that are import duties, export duties, sales tax and excise duties in brief.

It has been suggested already in Chapter II that the import duties seem to be good tool for indirect taxation in view of the relative advantage of its administration. But, it must be remembered that they have to be shaped in accordance with objectives of indirect taxation. Those are particularly concerned with the necessity of protecting domestic growing industries that are especially related to the substitution industry for import goods. The heavy rates on luxuries and those commodities which can be substituted by domestic industry, are desirable from the point of view of economic development. On the contrary, the relatively low or even tax free on capital equipment which are indispensable for the development are evidently justifiable. For the most part, the question of the development of domestic industrial production has to be taken into consideration in shaping the import duties appropriate to the goal of given economic program.¹⁾

Concerning export duties, the most important thing to be considered is the encouragement of export manufacture in view of the shortage of foreign exchange. However, it is desirable to impose a high rate on the raw materials that are needed for the expansion of domestic industries.

Excise duties are widely used in underdeveloped countries. They are levied on such commodities as tobacco, cigarettes, spirit, matches etc., and yield relatively large revenue. However, these taxes cannot be considered to be a fruitful tax field for underdeveloped countries for the reason that in many of underdeveloped countries the extent of domestic production of manufactured goods is extremely limited, and it is often a major object of policy to extend it. Therefore, there must be a consideration to exempt domestic output, but to tax import goods. Nevertheless, as development proceeds, the development of indigeneous production of liquor and tobacco can be made to yield a gradual increase in tax revenue. The sales taxes have to aim at directly curtailing the spending power in two ways. Namely, reducing the ability to spend by taking money away from consumers, and lessen to some extent, the incentive to spend.

If sales taxes are levied on essential commodities whose demand is inelastic, it may occur bad social effects. The basic necessities like food, are to be exempted from the tax. On the contrary even prohibitive rates on luxuries and demand for import goods are necessary. In this connection the distinction and discrimination between necessities and luxuries are to be made so as to introduce the element of progressivity in indirect taxation.

D. Incentive Aspects of Taxation.

1) U.N. The Economic Bulletin for Asia and the Far East, vol. IV, Nov. 1953, p. 10.

A good deal of attention has been devoted to the question of **incentive taxation** in the literature of public finance. The subject of incentive aspects of taxation seems to be vital particularly in the underdeveloped countries where a large field of economy is to be initiated through the role of government, furthermore the problem is not to sustain a process of steady growth but to initiate it, and entrepreneurship is scarce. In this sense, the question of incentive taxation is of more importance than the case in advanced countries.¹⁾

The purpose of incentive taxation is to stimulate an efficiency in work, savings, and investment.²⁾ In general, it is closely connected with the problem of exemptions which are widely accepted in many underdeveloped countries. It is evident that if tax is heavily levied on profits it may sharply inhibit the growth, both by removing the incentives to invest and also by depriving firms of finance for new investment.³⁾ In the matter of this very incentive taxation, what one must remind is that it is not sufficient merely to avoid weakening incentives to save and invest, but to stimulate and strength on incentives. We shall review a certain number of strategic taxes in the following paragraphs.

First, one of the incentive taxes can be applied to the exemption of new investment from taxes for a certain number of years. Investment in new industries always carries more risk than expansion of old ones, and expansion of old ones is more risky than mere replacement. However, care must be taken in exempting new investment from taxes. It should be introduced only where it is quite certain to encourage investment that would not otherwise take place.⁴⁾

It would appear that the complete tax freedom which is an enormous concession to make is necessary for industries that prove profitable in the early years of their lives. For industries that can make no profits in the early years the tax freedom is no incentive and no help. This calls for a selective treatment in applying the incentive taxes.⁵⁾

Second, the incentive tax can be imposed to persuade people to take certain action for the development in underdeveloped countries. There are lands unused for cultivation and large amounts of goods hoarded for the purpose of speculation. If tax is levied on those with high rate, considerable amount of resources can be converted to investment and speculation can be removed by forcing the goods into market, thereby diminishing the inflationary pressure.

Thirdly, the incentive can be given to accelerate depreciation by offering exemption from tax. This is one of the most important factors which enables the enterprise to reinvest and expand, in promoting industrialisation.

Fourth, the exemption of capital gains from tax seem to be usual case. However, care must be paid to the fact that if capital gains are again invested the lenient treatment is desirable whereas if they are spendable, the tax must be

1) *B. Higgins*, *Economic Development*, 1959, p. 514.

2) *J. Tinbergen*, *The Design of Development*, 1958, p. 54.

3) A.E.A. series, *Readings in the Economics of Taxation*, *Allen and Unwin*, 1959, p. 471.

4) An Example of injudicious application of this policy is to be found in the philippines, where a very wide range of enterprise has been classified as "new and essential and accorded tax freedom," with no very clear stimulus to private investment.

5) *B. Higgins*, *Economic Development*, p. 515.

charged, so that the possibility of discouraging people from investing can be avoided.¹⁾

Lastly, concerning the stimulation of savings a **spending tax** rather than income could give incentive to save, as has been already studied in the section of Income Taxation in the present chapter. Saving should be encouraged, and the part of income that is saved should be left tax-free as much as possible. Under appropriate conditions, a general sales tax is a close approximation to a spending tax. Some progression is possible in a general sales tax, in such way that rates on luxury items can be much higher than on necessities.



1) *R.J. Chelliah*, Fiscal Policy in Underdeveloped Countries, p. 72.