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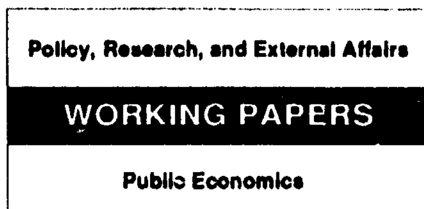

Country Economics Department
The World Bank
January 1991
WPS 576

Lessons from Tax Reform

An Overview

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Wayne Thirsk

More administrative simplicity (making avoidance and evasion difficult) and horizontal equity (uniformly imposed across units at the same income level) are strong selling points for tax reform. Harder to sell are more economic efficiency (not well understood by the public) and vertical equity (a matter of personal judgment).

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This paper — a product of the Public Economics Division, Country Economics Department — is part of a larger effort in PRE to document and understand how developing countries may improve the performance of their tax systems. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Ann Bhalla, room N10-059, extension 37699 (52 pages).

Thirsk identifies general lessons about tax reform, drawing on ten developing countries' experience: Columbia, Indonesia, Jamaica, Korea, Mexico, and Turkey (which have carried out comprehensive tax reforms) and Bolivia, Malawi, Morocco, and Zimbabwe (which are currently reforming their tax systems).

Research for each country study focused on which policies and procedures worked reasonably well (or didn't), using four standard public finance criteria: revenue adequacy, allocative neutrality, equity, and the efficiency of tax administration.

The goals of tax reform are more modest but realistic than they once were. Simpler tax rules ignore the fine distinctions that equity demands but serve the broader interest of tax equity by encouraging fuller compliance with tax laws and making their evasion more difficult. Less emphasis is placed on redistributing welfare through the tax system and more on achieving the goals of revenue adequacy, economic neutrality, and simplifying the tax system to make it conform to administrative capabilities.

Common elements in successful tax reform include:

- A clear perception of the flaws in tax systems before reform and a well-thought-out program of action to correct them.
- The support of major policymakers and technocrats.
- Careful, systematic implementation and monitoring.
- Minimal use of tax incentives and more reliance on broader, simpler tax bases on which lower marginal rates are imposed.
- Efforts not only to avoid raising taxes on the poor but to reduce their tax burden.
- Avoidance of procedural demands that overwhelm tax administration capabilities, and investment of more resources in training and in upgrading administrative performance.
- Attention to revenue adequacy and to how different components of the tax system interact.
- Direct targeting of tax measures mainly, if not exclusively, to their intended objectives.
- Emphasis on the importance of horizontal equity, neutrality, and simplicity.
- Recognition that accepting crude justice in taxation is better than fine-tuning in the search for the unattainable goal of perfect justice.

Successful tax reforms share common structural elements. For indirect taxes, countries often use value-added tax to replace a hodgepodge of commodity taxes, thus producing more revenues and fewer disincentives for exports and investment. Typically, foodstuffs are exempted to protect the poor, excise taxes are redesigned to fall more heavily on luxury items, and trade and domestic taxes are better coordinated.

Personal and corporate income taxes are typically modified so lower tax rates are applied on a broader base. Personal income taxes are expanded so that fringe benefits are more heavily taxed, deductions and exemptions are consolidated, and more use is made of presumptive levies for certain hard-to-tax groups. No trend is discernible toward replacing income taxes with cash-flow or expenditure-related taxes.

To curb corporate tax evasion and achieve more uniform tax burdens, some countries employ minimum taxes on a company's net worth.

Many elements of capital income escape taxation altogether or are only partly captured in the tax base. Few countries successfully tax capital gains, for example. And interest income is often exempted or taxed at a low rate out of concern for capital flight.

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LESSONS FROM TAX REFORM: AN OVERVIEW

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LESSONS FROM TAX REFORM: AN OVERVIEW

Summary

A World Bank research project, initiated in early 1988, examined the experience with tax reforms in ten developing countries with a view to drawing lessons that may be useful for other countries contemplating similar reforms. The countries included in this study are Turkey, Indonesia, Korea, Bolivia, Colombia, Mexico, Jamaica, Morocco, Malawi and Zimbabwe. These can be separated into two distinct types of tax reform experience. Colombia, Indonesia, Mexico, Jamaica, Korea and Turkey have all carried out at least one comprehensive tax reform and each has been analyzed more extensively than countries found in the second group. That group, including Morocco, Malawi, Zimbabwe and Bolivia, consists of countries currently in the process of reforming their tax systems. Because their experience is so recent, greater weight must necessarily be given to ex ante rather than to ex post judgements in assessing their efforts.

For both groups, attention was focused on the impetus for reform, how it was accomplished, and its substance. In each country study, the same basic set of questions was addressed with the goal of gaining a better appreciation of the tax policies and procedures that have worked reasonably well in these countries plus, those that have been less successful. Each study used the standard public finance criteria of revenue adequacy, allocative neutrality, equity and the efficiency of tax administration in evaluating the merits of a tax reform episode. Since there is no consensus on an "ideal" profile of a developing country tax system, especially when tradeoffs among objectives are required, reforms were judged according to

their ability to render improvements along each of these four dimensions. Some reforms seem capable of delivering simultaneous gains in each dimension, such as the replacement of turnover sales taxes with a comprehensive single rate value-added tax, while others offer a choice among competing tax policy objectives. Korea, for example, has relied on a combination of consumption taxes and savings and investment incentives to promote higher rates of economic growth at the expense of equity. Colombia and Mexico, on the other hand, have decided that an indexed tax system is worth the extra administrative complexity in light of the benefits of greater neutrality and enhanced vertical and horizontal equity.

Most of these countries have faced a common set of fiscal problems including, but not necessarily limited to, persistent fiscal deficits, bouts of high inflation, excessive reliance on trade taxes and tax incentives, partial coverage of income taxes, difficulties in reaching and consistently taxing capital incomes, the need to streamline the system of indirect taxes, the coordination of trade and domestic indirect taxes, weak tax administration, and widespread tax avoidance or evasion. A number of important lessons can be drawn from their efforts to grapple with these issues. They are discussed in some detail in the paper under the headings of the process and substance of tax reform. Here a composite and stylized depiction of successful reform measures is given.

Successful tax reforms have a number of common elements: they have a clear perception of the problems that perplex the pre-reform tax system and a well thought out program of action; they enjoy the support of major policymakers and technocrats; they are carefully and systematically

implemented and monitored; they eschew the profligate use of tax incentives and instead aim for broader and simpler tax bases on which lower marginal rates are imposed; they not only avoid raising taxes on the poor but make some effort to reduce tax burdens on this group; they refrain from making procedural demands which overwhelm tax administration capacities while investing more resources in training and in upgrading the level of administrative performance; they pay attention to interactions among different components of the tax system and do not neglect the importance of revenue adequacy; they rely primarily, if not exclusively, on tax measures which are directly targeted to the objectives which they are intended to achieve; they emphasize the importance of horizontal equity, neutrality, and simplicity, and they recognize that accepting a state of crude justice in taxation and avoiding fine-tuning is better than seeking some unattainable goal of perfect justice.

Successful tax reforms also share a number of common structural elements. In the indirect tax area, countries have frequently turned to the value added tax to replace a hodge-podge of commodity taxes on relatively small bases and have enjoyed greater total revenues and fewer disincentives for exports and investment as a result. Typically, exemptions for basic foodstuffs have been provided in an effort to reduce indirect tax burdens for the poor. In order to obtain even greater progressivity in the distribution of indirect tax burdens, many countries have also redesigned their excise taxes so that they fall more heavily on items of luxury consumption. Coordination between trade and domestic indirect taxes has also been improved. In the income tax area, both the

personal and corporate income taxes have typically been modified so that lower tax rates a applied to significantly broader bases. The personal income tax base has been expanded in a variety of ways including the heavier taxation of fringe benefits, the consolidation of deductions and exemptions and greater reliance on the use of presumptive levies for certain hard to tax groups in the economy.

Despite these efforts at enlarging the size of the personal income base many elements of capital income have either escaped altogether or are only partially captured in the base. Few countries nave successfully managed to tax capital gains. Interest income is frequently exempted because of concern over capital flight and when such income is subject to tax it is often at relatively low withholding rates. These holes in the tax net have induced many countries to eliminate the double taxation of dividends by exempting dividends at the personal level. In many countries the corporate and top marginal personal income tax rates also have been unified, a step which has assisted the effective integration of these two income taxes and has eased the burden of administering both taxes. The impact of integration in moderating the incentive of firms to rely on debt finance has been reinforced in several countries by the indexed treatment of interest income that taxes only the real component of that income and permits only the real component of interest expense to be deducted. Typically, indexation has been extended to other parts of the income tax system that are sensitive to inflation.

Most countries have also significantly scaled back their use of investment and other tax incentives while at the same time reducing the nominal corporate tax rate. In order to curb corporate tax evasion and

achieve a more uniform pattern of inter-firm and inter-sectoral tax burdens, a number of countries have begun to employ minimum taxes on company's net worth. Moreover, most tax reforms have been accompanied by substantial improvements in all facets of tax administration. This has involved more extensive reliance on withholding mechanisms, the use of the banking system to collect and to some extent process tax payments, the concentration of audit resources on the country's largest taxpayers, and the use of computers to assist in the processing of tax returns and the registration of taxpayers.

As a result of these developments, there is now much less emphasis placed on achieving a redistribution of welfare through the tax system and a correspondingly greater emphasis on achieving the goals of revenue adequacy, economic neutrality, and simplifying the tax system in order to make it conform with current administrative capabilities. Consequently, the goals of tax reform are now more modest but perhaps also more realistic than they were previously. The tax system may work much better if the aim is to achieve a measure of rough justice rather than a ideal but administratively hopeless objective. Simpler rules may ignore the fine distinction that some equity considerations demand but they also serve the broader interest of tax equity by encouraging better compliance with tax laws and making evasion of those laws more difficult. Finally, it is impossible to discern any trend towards the replacement of income taxes with cash flow or expenditure related taxes. Most countries continue to operate with a hybrid system of income and consumption based taxes.

It is fitting to conclude with the caveat that extreme caution should be exercised in transferring solutions to particular tax problems across different countries. Inter-country variations in administrative skills, in initial economic conditions, and in behavior all suggest the need to prescribe tax remedies that are appropriate to the patient's ills. In surveying the experience of different countries there are still some tax reform issues which remain largely unresolved such as how best to treat interest income and expense, whether good tax incentives exist, and whether to apply the value-added tax at the manufacturers, wholesale, or retail level, or, alternatively, use business size rather than sector/stage in determining coverage.

LESSONS FROM TAX REFORM: AN OVERVIEW

The World Bank's Tax Reform Project is an attempt to document and analyze the experience with tax reform in ten developing countries. The purpose of this project has been to try and obtain a better appreciation of how developing countries may improve the performance of their tax systems. Towards this end, each country study has delved into the questions of what motivated these tax reforms, what they were intended to accomplish, how they were implemented and how successful they have been in achieving their objectives. The basic thrust of this paper is inductive; that is, it attempts to discern empirical regularities and see whether there are some general lessons that can be extracted from a comparison of the experience with tax reform in different countries.

The countries encompassed by this project are Turkey, Indonesia, Korea, Bolivia, Colombia, Mexico, Jamaica, Morocco, Malawi and Zimbabwe. All of these countries have undertaken a significant tax reform within the last two decades. They can be divided into two different groups. Colombia, Indonesia, Mexico, Jamaica, Korea and Turkey are distinguished from the others by the fact that they have completed at least one fairly recent major reform whose effects can be observed and analyzed. More resources have been committed to studying the effects of tax reform in this group than in the other group of countries. The second group, including Morocco, Malawi, Zimbabwe and Bolivia, consists of countries that are currently in the process of reforming their tax systems. Within the latter group, Bolivia has made more progress than the others in laying down the foundations of a new tax system but important administrative reforms remain unfinished in that country. Due to the contemporary nature of this tax

reform experience, the evaluation of specific reforms in these countries rests more heavily upon anticipated or prospective outcomes of the reform process. Consequently, the results of these reforms are necessarily more tentative than in the other cases that have been considered.

Each country study attempts to set out the motivations for tax reform, to describe the manner in which they were implemented and to offer an assessment of how successful different tax policies and procedures have been. In appraising the outcome of the various reforms, each study has adopted the traditional public finance criteria of revenue adequacy, allocative neutrality, taxpayer equity and administrative capability. Almost all of the reforms were judged according to their ability to produce improvements along these four dimensions of economic performance.

Seen as a whole, the collection of tax reform experiences in this project reveals a number of striking similarities in the problems that beset the tax and revenue systems of these countries. Moreover, most of these countries have exhibited a surprisingly uniform response in grappling with these problems. This makes it possible to draw up some general lessons about both the process and the substance of tax reform in developing countries. These lessons appear in the final section of this paper. First, however, there is a brief introduction of the recent literature on tax reform which is relevant for developing countries. Then the major fiscal issues that have surfaced in most of the countries are examined. That is followed by a discussion of some of the common responses to these problems that were found in the project's sample of tax reform experience. The lessons of experience follow immediately afterwards. It should be noted at the outset that this paper is an overview rather than a

summary of the country studies and, in lieu of having read the individual study, at least some of the claims must be accepted on faith. Moreover, the range of broad generalization is almost always restricted to the ten countries included in the project.

I. INTRODUCTION

Only a relatively modest literature exists on the subject of tax reform in developing countries. Much of that literature is descriptive in its approach and typically refrains from asking whether alternative policy measures might have been more successful than the ones that were actually chosen. Further, as Gillis (1988) has noted, even the measurement criteria by which the success or failure of a tax reform are to be judged are not well established. In his own appraisal of developing country reform efforts, Gillis (1988) has evaluated the merits of a reform according to whether or not the announced goals of the reform have been met.

Newbery and Stern (1986), on the other hand, have attempted to immerse tax reform in the normative framework provided by the theory of optimal taxation. This theory attempts to account for the impact of a tax reform on the goals of minimizing tax induced losses in the efficiency of resource allocation and of respecting vertical equity norms. The former dimension of a reform is captured by the responsiveness of taxpayers to tax induced relative price changes while the latter relies upon particular specifications of a social welfare function. Optimal tax reforms in this context tend to be those which settle on a configuration of tax rates that

minimize the efficiency costs (excess burden) of taxation and pay some heed to society's revealed aversion to income inequality. An interesting feature of these reforms is that they hardly ever endorse a uniform pattern of tax rates.

While optimal taxation has been erected upon an impressive theoretical edifice, its operational content has been called into question by many tax practitioners. As Deaton (1986) and McLure (1989) have emphasized, the information requirements of optimal tax reform are sufficiently daunting to the point of being almost overwhelming. In no country, but least of all in the case of developing countries, is it possible to obtain robust price elasticity estimates for a complete system of consumer demands. Moreover, very little is known about the exact nature of the social welfare function -- even its existence has been called into doubt by public choice theorists -- and the suspicion lingers that specific optimal tax proposals may be highly sensitive to the particular choice of that function's key parameters.1/

A further limitation of the optimal tax approach, as pointed out recently by Slemrod (1990), is that it neglects entirely the tax administration component of tax reform by assuming perfect tax administration, analogous to the physicist's simplifying assumptions of a frictionless world. Once the task of implementing a tax reform and enforcing the collection of taxes is recognized, the appeal of a highly differentiated structure of tax rates, one that would seriously complicate the ability to administer taxes effectively, is considerably diminished. In a more realistic policy framework in which the resource costs of implementing tax measures is admitted, the proper focus of attention, as urged by Slemrod (1990), is not optimal taxes but optimal tax systems.2/

Despite the flirtation with the undeniable logic of optimal tax theory, the operative guideline of many recent tax reforms has been broader based taxation at more uniform rates which is in direct violation of the dictates of optimal taxation. In a sense, the ostensible clash between theory and practice is more apparent than real. Unlike earlier pleas for broader based taxation that were aimed at achieving greater progressivity, those who are recommending broader based taxes seek lower marginal tax rates and reductions in the level of tax induced distortions that are prompted by high rates. In this manner, the lessons of optimal tax theory have infused recent tax reform efforts with a new respect for the importance of enhanced economic efficiency. Perhaps the major difference between optimal and uniform taxation is not the primacy of achieving economic efficiency in taxation but rather with the way in which it can be accomplished. Proponents of optimal taxation aspire to attain the most efficient tax structure while advocates of uniform taxation have embraced the more limited objective of securing improvements in the efficiency of taxation.

From a wider political economy perspective, Aaron (1989) has recently spelled out two basic requirements for sound tax reform proposals. Analogous to the physician's creed of "do no harm", it is imperative for tax reformers to be sure that they "have got their signs right". On this ground alone, uniform taxation is a much more attractive principle than the uncertain and computationally difficult dictates of optimal tax theory. Uniform taxation usually promises to deliver efficiency gains even though it may fall short, in some unknown way, of the goal of minimizing tax induced efficiency losses. Also, it is equally important to advance tax reform proposals that are politically robust and that will not become badly

warped when they are refracted through the political prism. On this ground as well, uniform taxation that is directly opposed to preferential tax treatments seems likely to deliver a better outcome than the highly differentiated approach favored by optimal tax theory.

If there is now a growing consensus on the desirability of uniform taxation as the appropriate tax reform target, there is also an increasing recognition of the high degree of complementarity that exists between the efficiency payoff of uniform taxation and the other tax reform goals of horizontal equity and greater simplicity. If tax bases are broader and tax rates are lower and more uniform, there is a greater likelihood that households in the same economic circumstances prior to the application of taxes will continue to resemble each other after taxes have been applied. Lower tax rates reduce the rewards for rent seeking, evasion and tax incentive relief, thereby improving the odds that equals are treated equally. Moreover, if differential tax treatment is ruled out and various distinctions among taxpayers and different sources of income are swept aside, it is possible to simplify and streamline the operation of the tax system. Thus tax reform proposals in a number of countries stress the basic harmony that exists among the objectives of economic neutrality, horizontal equity and tax simplification.

II. THE MAIN CONCERNS OF TAX POLICY

Although tax reforms in the various countries have typically dealt with a diverse set of issues, there is still a universal core of fiscal problems that runs through the entire collection of tax reform experiences. A brief discussion of these problems helps to make clear what successful tax reforms must accomplish.

A. <u>The Quest for Better Indirect Taxes</u>

With the single exception of Zimbabwe, all of the countries included in the tax reform project have recently adopted the value added form of sales tax. Behind this development has been increasing disenchantment with the haphazard effects of turnover taxes on the treatment of investment and tradeable goods, as well as some dissatisfaction with the random incidence pattern associated with these taxes. Adoption of the VAT has been viewed as a reasonably reliable method of promoting both exports and investment while achieving a more predictable, and often more equitable, distribution of tax burdens.3/

Often the VAT has been seen as a panacea for a wide variety of fiscal ills including the need for higher revenue. The large revenue potential of the VAT has made it the marginal source of funds in many countries and has shifted the mix of taxation away from income and more towards consumer expenditure. Experience in a couple of countries, however, tempers this enthusiasm by illustrating what can happen if a VAT is poorly designed. If the preparation for the VAT is inadequate and enforcement is weak (as it was in Bolivia when the tax was first attempted there in 1975) or if the VAT has numerous rates and is riddled with extensive exemptions (as in Morocco), it may operate with the same defects and, indeed, may be even worse than the indirect taxes that it replaced.

In undertaking a reform of their indirect taxes, most countries have attempted to coordinate the operation of their trade taxes with their domestic indirect taxes.4/ Nonetheless, very few countries have tackled tariff reform simultaneously with indirect tax reform. In large part, this is because it often proved impossible to get trade taxes on the table during the fiscal reform discussions. Perhaps because of its close

relationship with the World Bank, Malawi alone has managed to overcome this restriction on the scope of indirect tax reform. From the very beginning of the reform initiative in Malawi, concerted efforts were made to adjust both indirect taxes and tariffs and to apply them with less discrimination in favor of domestic over foreign sources of supply. It is true that Bolivia reformed its tariffs at the same time as its tax system but these activities were separate parts of a general restructuring rather than a deliberate attempt to integrate trade and domestic taxation.

In this area, however, as in all other areas of tax policy, it is important to have a broad perspective on the impact of tax reform proposals as a recent experience in Zaire indicates. Although it was not a part of the tax reform sample, the case of indirect tax reform in Zaire illustrates the dangers of relying on a narrow trade focus for achieving indirect tax reform. Prior to the reform activity, Zaire operated a sales tax that effectively rebated the tax imposed on the purchase of business inputs. At the same time, tariffs were significantly higher on final consumer goods than on intermediate inputs and capital goods. In order to eliminate large variations in effective rates of protection, it was recommended that Zaire move towards a uniform tariff structure by imposing substantially higher tariff rates on both intermediate inputs and capital goods. To forestall undesirable import substitution in these latter two activities, it was also recommended that import competing production of intermediate inputs and capital goods be taxed at equivalent rates. The net effect of this series of recommendations would have been to introduce a turnover tax and all of its undesirable consequences into Zaire through the back door. Fortunately, none of these compromising measures was ever adopted in Zaire.

B. The Relatively Small Size of the Income Tax Base

There are several reasons why it is difficult to broaden the bases of the personal and corporate income taxes in developing countries. In addition to the intractable measurement problems posed by capital gains, imputed housing rents and fringe benefits, there are political preferences accorded to certain sectors, such as the favored status accorded to agriculture in Colombia, Turkey and Morocco, plus widely recognized weaknesses in tax administration. The presence of a large number of workers employed in small businesses, in urban professional occupations and in the agricultural sector poses a serious challenge to the capability of tax administrations properly to assess and collect income taxes in most developing countries.

A number of countries, including Turkey, Bolivia, Colombia, Mexico and Korea have attempted to apply various forms of presumptive taxation in an effort to include these groups in the income tax base. In principle, these measures should expand the size of the tax base, raise total revenues, improve both horizontal and vertical equity and produce gains in economic neutrality. In practice, however, efforts at introducing presumptive taxation may take the form of special tax regimes that have just the opposite effect. While special tax regimes may incorporate additional taxpayers into the tax base, they may also create new tax evasion opportunities for other taxpayers who may be induced to seek reclassification as members of the hard to tax group or who may try to shelter their taxable income in more lightly taxed activities. Mexico offers some interesting examples of these revenue reducing tendencies. To include trucking services in the overall tax base, Mexico used to tax this activity on a per unit basis. As a result, many companies used transfer

pricing techniques to channel their taxable income into this fixed tax category. Mexico also tried to encompass construction activity in the overall tax base by levying a three percent tax on gross construction receipts. Many companies responded to the disparity between this tax treatment and the standard treatment under the corporate income tax by issuing false invoices to corporations and enabling them to achieve significant reductions in their taxable income and corporate tax liabilities.

C. **Capital Income: Slipping Through the Tax Net**

Just as some activities are not easily brought into the tax net, some sources of income are much harder to tax than others. In a number of countries, the personal income tax is little more than a burden on labor incomes earned in the modern sectors of the economy. Reaching a significant share of capital incomes through either the personal or the corporate income tax poses a serious problem for most developing countries. In Korea, for example, slightly less than a third of the economy's capital income is included in the base of the personal income tax compared to an inclusion rate of about 75 percent for labor income. Similar kinds of differential coverage were also found in Bolivia, prior to its tax reform, and in Morocco.

Part of the problem springs from the global mobility of capital, financial capital in particular. Fear of capital flight and the inability to tax residents' worldwide income have persuaded a number of countries to exempt interest income from the personal income tax and to tolerate, as in the case of Colombia and Korea, the existence of no-name bearer shares. Indonesia, for instance, made no serious effort until very recently to

include interest income in the personal income tax because such income goes untaxed in nearby Singapore. More generally, foreign tax systems seriously constrain the tax options of developing countries and nowhere is this better illustrated than in the recent decision by the United States not to tax the U.S. source interest income of foreigners.

As the study of Mexico suggests, attempts to tax interest income may only result in higher interest rates in the economy if domestic investors are able to reallocate their portfolios towards more lightly taxed assets elsewhere in the world. Higher interest rates will also reduce the size of the corporate income tax base and add to the cost of servicing public debt on the expenditure side of the budget.5/ On the other hand, failure to tax interest income while letting companies deduct interest expense offers significant opportunities for tax arbitrage. So-called back to back loans or the practice of "round tripping" as it is referred to in Indonesia, in which companies obtain interest deductible bank loans in exchange for making bank deposits, (which was found to be fairly common in Indonesia, Mexico and Jamaica) provide useful demonstrations of the ease with which tax exemptions can swing open the door for widespread tax evasion.

In countries where there is zero or low taxation of interest income at the personal level while only equity income is taxed at the corporate level, sizeable financial distortions have been created because companies have been encouraged to put excessive reliance on debt. Many countries have attempted to offset this debt bias either by imposing thin capitalization rules, as in Korea and Indonesia, or, as also in Korea, by reducing the rate of taxation on dividend income. This bias has been further reduced by the inability to tax stock market related capital gains

and the exclusion of dividends from the personal tax base in countries such as Colombia, Mexico and Indonesia. Perhaps only Zimbabwe has managed to tax most interest incomes successfully but Zimbabwe's situation is special as capital markets are tightly controlled in that country. Other countries, such as Turkey and Korea, have turned to a schedular approach in taxing interest income in which a modest amount of tax is withheld at the source.

D. The Pursuit of Non-Revenue Objectives: The Problematic Impact of Tax Incentives

Further undermining the revenue potential of taxes on capital income has been the propensity of many, if not most, developing countries to offer generous savings and investment incentives. In the 1960s, a complex and detailed system of tax incentives was part of the overall planning process in countries as diverse as Colombia, Korea and Turkey. More recently there has been a wavering of faith in the ability of tax incentives to perform a useful role in promoting economic development. Some countries, such as Indonesia and Bolivia, have abandoned them altogether while other countries, such as Mexico and Colombia, have substantially pruned them. However, a residue of countries, such as Turkey, Korea and Morocco, continue to rely upon them and offer tax holidays and investment tax credits to a wide variety of activities in an effort to influence both the total volume of investment and its allocation. In very few countries has the impact of tax incentives on total revenues and tax equity been ascertained, let alone their effectiveness in redirecting resources.6/ In many countries, however, there is a growing appreciation of the ability of tax incentive firms to shelter the income of non-incentive firms from taxation through transfer pricing and other income shifting devices.7/

E. **Achieving Greater Vertical Equity in Taxation**

In light of the limited revenue capacity of income taxes, most developing countries have been forced to rely upon a variety of indirect taxes as their revenue workhorses. Typically, sales and excise taxes, along with taxes on international trade, comprise at least two thirds of the total amount of revenue collected. Only in Zimbabwe and Malawi have income taxes approached anywhere close to one half of total revenue. Many countries have, therefore, been concerned to design their structure of indirect taxes to either reduce or remove the burden of these taxes on low income groups. Exemptions of basic necessities from the value added or other form of sales tax, plus the imposition of differentially higher tax rates on items of luxury consumption, have been the instruments most frequently used to achieve this goal. The effects of these kinds of policies on horizontal equity have ordinarily been neglected.

Some countries, such as Zimbabwe, have discovered that certain kinds of indirect tax ay be highly progressive in their impact. For example, raising import duties in the presence of quantitative restrictions may be an effective way of raising taxes from wealthy holders of import licenses. Nevertheless, almost all of the incidence studies that are cited by the studies in the tax reform project indicate that the bottom 20 percent of taxpayers in these countries typically spend 10 percent or more of their income in satisfying various tax obligations. None of the reforms have achieved notable success in significantly reducing tax burdens on the poor.

F. The Spectre of Fiscal Deficits and Inflation

A majority of the countries in the tax reform project have been plagued by large and persistent fiscal deficits. Continuous fiscal deficits have frequently signalled the need for fundamental tax reform, and the aura of growing fiscal crises has served to relax many of the political barriers standing in its way. This was clearly the case in Bolivia, Jamaica, Turkey, Morocco, Mexico, Malawi and Zimbabwe. Many of these countries had relied upon a combination of easy access to foreign lending and substantial revenues from trade taxes to finance their expenditures. With the onset of the international recession in the early 1980s and the ensuing debt problem in many developing countries, private foreign lending evaporated and revenues from trade taxes declined precipitately, leaving a legacy of fiscal deficits that could not be adequately financed from domestic revenue sources.

In three other countries, Indonesia, Korea and Colombia, comprehensive tax reforms were fashioned without the underlying threat of an immediate fiscal crisis. What distinguishes this group of countries from the rest is their relatively stable political structures and, in Korea and Indonesia, a lack of political opposition, a situation that has allowed these governments the luxury of anticipating future fiscal needs. In Indonesia, for instance, the government was able to take the long view and introduce tax measures that promised to compensate for the expected decline in petroleum revenues. In Colombia, on the other hand, during the 1970s, the government invoked its constitutional powers in order to secure passage of its tax reform legislation. For the most part, however, fiscal deficits, whether current or projected, have been the primary impetus

behind tax reforms. Consequently, tax reforms that pay insufficient attention to the issue of current and future revenue adequacy are unlikely to meet the fiscal needs of developing countries.

In a number of the countries studied, fiscal deficits have supplied the macro-economic spark igniting an inflationary fire that eventually produced severe distortions in relative prices, particularly in the value of the economy's real exchange rate and real interest rates. In Bolivia, for example, the inflationary flame spread quickly out of control as the effects of inflation ate away at the foundations of the revenue system and created ever larger deficits and higher rates of inflation. Eventually, a severe hyper-inflation led to the virtual collapse of the fiscal system. Although less severe in their consequences, inflationary impulses in Turkey and in Mexico have also been fueled by large fiscal deficits. However, not all countries that have experienced significant fiscal deficits have financed them in an inflationary manner. Morocco, for instance, relied upon implicit taxation during the 1970s in financing its deficits by running up substantial arrears in its accounts with the private sector. Zimbabwe has also been successful in imposing implicit taxes on consumption through the device of quantitative trade restrictions. By reducing the supply of imported consumer goods, and in the absence of domestically produced substitutes, Zimbabwe's private savings rates have risen to offset the negative amount of public saving.

G. <u>Simplifying the Tax System and Making It Work as Intended</u>

Weak tax administration is a characteristic shared by most developing countries. Inability to collect accurate and timely information on taxpayers circumstances, to determine who has paid tax and who has not, to check the accuracy of taxpayers declarations, to detect the presence of

fraud and to collect taxes already assessed are typical administrative shortcomings. What is needed to overcome many of these problems is not only more administrative resources but also better utilization of existing resources, including improved training of staff. If both direct and indirect tax laws were significantly simplified, administrative resources could be concentrated on audit and collection functions with likely gains in both total revenue and equity. Stiffer sanctions for non-payment, more frequent audits to compel better compliance, shorter lags in the collection process, the computerization of tax information (to determine who has filed a tax return and paid their taxes) and streamlined legislation may all be prerequisites to achieving true tax reform.

Experience in a number of tax reform countries gives ample evidence of the important gap between the way in which the tax system works in practice and the way it is spelled out in the tax laws. In Korea, for example, when the Office of National Tax Administration was created in 1966, total revenues increased by 50 percent due to its vigorous efforts at improving administration. In Morocco, auditing revealed massive fraud since, on average, audits in that country raised taxable income by approximately a factor of three. As is discussed in greater detail in the next section, one result of weak tax administration is a disturbing discrepancy between the nominal and effective tax rates on different activities and sources of income in the economy.

H. Widespread Tax Evasion As a Way of Life

One consequence of weak tax administration is the prevalence of endemic tax evasion in most developing countries. In many of the countries studied, it was estimated that as much as one half of all income tax is evaded and that the greatest opportunities for evading taxes were available

to richer rather than poorer taxpayers. In Bolivia, for example, it was estimated that only about 20 percent of capital income ended up in the personal income tax net compared to 75 percent of labor income.

Tax evasion occurs through a myriad of different channels. Failure to file a tax return, the temptation to misrepresent income and expenses, the use of fraudulent invoices, and resort to transfer pricing practices involving exempted or preferentially taxed activities are among the most frequently used methods of evading taxes. In Jamaica, for instance, it was discovered that only about one in ten of the self employed bothered to file a tax return. The situation with doctors in Zimbabwe was similar. Evasion also occurs as frequently with sales taxes as it does with income taxes. Issuing no invoice and thereby under-reporting sales for tax purposes or resorting to fake invoices in order to claim higher input tax credits have been serious problems with the VAT in several countries as has the practice of collecting sales tax revenue and failing to turn over the proceeds to the tax authorities. With rampant tax evasion, tax systems in many countries are neither efficient nor equitable.

III. TRENDS IN TAX REFORM

In response to the issues outlined above, the developing countries in the sample have all recently reformed their tax systems in ways that suggest that there is a considerable convergence of opinion on how best to deal with these problems. Although there are some notable exceptions, the tax reforms examined in this study reveal some clearly discernible trends in taxation:

1. In most of the tax reform countries, the value added tax (VAT) has become the mainstay of the revenue system.

The VAT typically accounts for a third or more of total national tax revenue in the countries studied. Although most countries have chosen the consumption type of VAT levied on a destination basis, a few countries, such as Colombia and Turkey, have moved closer towards the GNP type of VAT under their policy of only partially refunding taxes paid on capital goods. Indonesia recently moved the VAT from the manufacturer's to the wholesaler level of application. The VAT still operates at the manufacturers' level in Malawi as it will in Jamaica if the plans for a VAT materialize in that country, but it applies at the retail level in the rest of the countries that have adopted a VAT. Countries with VAT at the retail level have put in place special tax regimes for small retailers for whom some simplified bookkeeping procedures are desirable on administrative grounds. Most countries have operated with VATs that have a single rate and allow exemptions for basic necessities and certain hard to tax sectors. Exports are invariably zero rated, although in some countries the poor timeliness of VAT refunds implies that exports are subject to some unknown tax burden. Multiple rate structures, such as those found in Mexico, Malawi and Turkey, appear to have been the political price that was paid for raising the basic VAT rate significantly above 10 percent.

2. A number of countries have turned to a wide assortment of measures to create broader personal and corporate income tax bases.

These measures include reduced reliance on tax incentives, granting of fewer exclusions and exemptions, greater use of presumptive methods of taxation, increased withholding under both sales and income taxes, the introduction of minimum taxes on assets and generally tighter tax administration. Korea, Colombia, Mexico, Turkey and Bolivia, for instance, have all given greater priority to presumptive methods of taxation in recent reforms while a variety of fringe benefits have been incorporated into the tax base in countries such as Jamaica, Malawi and Turkey. In other countries, notably Malawi, Zimbabwe, Colombia and Bolivia, public enterprises have been successfully incorporated into the corporate income tax base.

3. In the area of capital income taxation, there is perhaps greater recognition in many countries that the corporate income tax may be the only effective way of reaching capital incomes in equity form and that some schedularization in taxing non-equity capital income may be necessary to compensate for weaknesses in tax administration.

A few countries, such as Bolivia and Mexico, have concluded that it is administratively easier to tax either the net worth of companies or the expenditures made by the recipients of capital income rather than the income arising from capital ownership.

There is considerable diversity in the ways in which countries treat the taxation of interest income. While some countries, such as Jamaica, Malawi and Zimbabwe, tax nominal interest incomes fully, in other countries, such as Colombia and Mexico, only real interest income is taxable. Until recently Indonesia exempted interest income while other countries, such as Bolivia, Morocco, Korea and Turkey, have taken an intermediate path by imposing low withholding taxes on interest income. Only Colombia has made any serious effort to tax capital gains from the stock market. A few countries make a half hearted attempt to tax the capital gains arising from real estate transactions.

4. In recent years, double taxation of dividends has become considerably less onerous, due to either the development of imputation schemes or, more commonly, the exclusion of dividends at the personal level.

   Dividend exclusions currently apply in Colombia, Bolivia, Mexico, Indonesia and Korea, while imputation schemes can be found in Malawi and Zimbabwe. Only Jamaica and Turkey continue to tax dividends at both the corporate end personal levels. Korea has also recently abandoned its presumptive dividend tax that had been applied to retained earnings. In many countries, therefore, there is less incentive for corporations to rely heavily upon debt finance, although the

common practices of either excluding or lightly taxing interest income at the personal level still contributes to the debt bias, if only in an attenuated form.8/

5. Complementing the effort to broaden the income tax base are reforms in the rate structure that flatten the amount of nominal tax progressivity and align the nominal corporate income tax rate with the top bracket rate of the personal income tax.

Only a few countries, namely Zimbabwe and Korea, now have top bracket personal income tax rates which exceed 50 percent. In Jamaica, there is now only a single personal income tax rate which has been set equal to the corporate rate of 33.3 percent. This movement to less nominal progressivity in the rate schedule is a response to the realization that almost no taxpayer ever paid tax at the highest rate because considerable taxpayer resources were devoted to avoiding that outcome. Consequently, any loss in vertical equity is significantly less than a comparison of nominal rate schedules would suggest. In countries such as Colombia and Mexico, the top bracket rate has been halved in comparison with its value only a few years ago.

The merging of the corporate and top bracket personal rates in countries as diverse as Indonesia, Jamaica, Malawi and Mexico has made it easier to tax small businesses by reducing the temptation to convert capital income into labor income

and vice versa, while at the same time achieving closer parity of tax treatment between firms located in the corporate and unincorporated sectors. The alignment of these two rates, moreover, enhances the effective integration of these two income taxes through the technique of the dividend exclusion.9/

This simplification and unification of the rate structures reduces opportunities for tax avoidance while the lower personal rates may also weaken the incentive to evade personal tax.10/ As a result, whatever loss of vertical equity may have occurred as a result of these developments, there may be offsetting gains in administrative simplicity and the attainment of greater horizontal equity. Similarly, the introduction of a single deduction under the personal income tax in Colombia, Mexico and Jamaica may also improve horizontal equity at the expense of some unknown cost to vertical equity. Flatter rate structures also contribute to more accurate withholding and easier tax administration.

6. Increasing indexation of the income tax system in response to persistent inflation and the problems of capital flight.

Many countries, particularly Colombia and Mexico, have progressed from ad hoc inflation adjustments and partial indexation measures to more satisfactory and virtually complete indexation of the entire tax system. Colombia and Mexico are unique among the countries in tax reform sample in

trying to tax only real interest income and in allowing only the deductibility of real interest expense. Depreciation allowances are also fully indexed in these two countries. A number of countries, particularly Bolivia, Turkey and Mexico, learned that the failure to index brackets for the personal income tax triggered a profusion of untaxed fringe benefits. There has also been a shift in commodity taxation towards the use of ad valorem rather than specific tax rates. During the inflationary 1970s, many countries discovered that specific tax rates were quickly eroded by the effects of inflation which contributed to decli ing real tax yields.

7. Most countries have shown an interest in designing excise taxes that extract larger tax payments from non-poor households.

To some extent, this tendency reflects the growing specialization of tax instruments rather than having a multiple rate value added tax which serves a variety of different purposes and renders the administration of that tax much more difficult. The VAT has typically been assigned the role of raising revenues while excise taxes have been given the task of imparting greater progressivity to the system as a whole.11/ By the same token, there is increasing acceptance of the notion that tariffs should be used for protective purposes rather than for raising revenues.

8. The vast majority of tax reforming countries have recognized that improvements in all facets of tax administration are required. To obtain better compliance, all of the countries considered have made efforts to create a unique taxpayer identification numbering system. This, along with the computerized processing of tax returns, has enabled governments to maintain a much better check on non-filers and stop filers. Collection efficiency has also improved through the increased use of banks to receive, and to some extent process, tax payments and the concentration of audit resources on the country's largest taxpayers. Some countries, for example Colombia, have made greater use of withholding as a form of final tax payment, thus freeing up administrative resources for the tasks of collection and audit.

There is also a growing awareness of important complementarities that may exist in tax administration. A number of countries now seem to recognize that if the administration of the VAT is weak, it will be much harder to obtain satisfactory compliance with the personal and corporate income taxes. Conversely, a well administered VAT may generate improvements in documentation that make it significantly easier to administer both income taxes. A few countries have turned to innovative approaches in their efforts to secure greater compliance with the VAT. Turkey's expenditure rebate system and Bolivia's complementary tax

both offer limited income tax credits to households for their collection of tax-paid invoices and are examples of the attempt to use the fiscal carrot rather than the fiscal stick to obtain better tax compliance. Both schemes offer some resistance to the temptation to accept a seller's offer of a lower price and no purchase invoice.

9. Taken together, most of the major elements of recent tax reforms have the potential to reduce the extent of tax evasion significantly. Fewer tax incentives, the development of broader tax bases and lower tax rates, administrative improvements in the area of information, audit and collection, greater reliance on indirect taxes, the exemption or schedular treatment of many forms of capital income and the experimentation with special compliance measures can all help make tax evasion both less feasible and less desirable.

IV. SOME LESSONS FROM TAX REFORM

The lessons of tax reform can be usefully separated into those that throw some light on the process of tax reform and those that have something to say about the substance of tax reform. After these lessons are spelled out and discussed, the concluding section of this paper tries to identify some of the critical ingredients of a successful tax reform.

A. The Process of Tax Reform

1. Tax reforms are more likely to be introduced when the need for them is clear to politicians, policy makers and the population alike.

Fiscal crises typically signalled by persistent and growing deficits create a sympathetic political environment in which governments are seriously prepared to contemplate reform. The tax reforms of Mexico, Colombia, Bolivia, Malawi, Morocco, Jamaica, Turkey and Zimbabwe all fit into this mould. Conversely, and perhaps more controversially, fiscal surpluses may give governments the latitude to engage in various kinds of tax deform (a "reform" which authorizes additional distorting tax preferences). Although few countries have enjoyed the luxury of sustained fiscal surpluses, the periodic coincidence of these surpluses and tax deform in a few countries lend some support to this view.

2. Strong and stable governments that enjoy continuity of office may be in a position to take a long view of the economy's future course of development and to adopt preemptive tax reforms that may avert the threat of potential fiscal crises.

   The tax reform experiences of Korea and Indonesia seem to fit this pattern fairly well. In both of these countries political longevity has enabled governments to refashion their tax systems in ways that were consistent with the economy's long term economic objectives and plans. Conversely, as the experience of Bolivia and Turkey's non-military regimes suggests, weak and internally divided governments may be unable to cope adequately with fiscal crises and may suffer from continuous fiscal deficits as a result of this debility.

3. It is extremely important to have the appropriate policy measures "on the shelf" before a fiscal crisis occurs in order to forestall the adoption of ad hoc and ill advised tax reforms.

   For example, the governments of Jamaica, Morocco and Malawi, had no clear, well thought out plans on how to deal with the fiscal crises that beset them in the early 1980s. Consequently all of them attempted to stem their revenue shortfall by raising tax rates on badly distorted tax bases. Fortunately, none of these countries saw this response as a sustainable long run policy option and all of them subsequently undertook fundamental tax reforms, with varying degrees of success. One implication of this is that desirable tax reforms may have a long gestation period before they are finally adopted, as was the case in Colombia. Moreover, consulting with local people and officials about the options for reform in an ongoing fashion before a fiscal emergency arises can give economic planning a greater chance of success.

4. Influential and well informed advisors have often played a critical role in bringing about satisfactory tax reforms.

   The imprint of tax policy experts in setting the broad agenda for reform, in guiding the discussion of reform possibilities and in supporting particular tax measures while rejecting

others is clearly evident in the reforms that have been carried out in Jamaica, Indonesia, Malawi, Zimbabwe, Colombia, Korea and, to a lesser extent, Turkey. Mexico and Bolivia have shown a greater propensity than the rest to develop home grown tax reforms. Large amounts of foreign aid on the other hand, as illustrated by the experience of Turkey, may have delayed the adoption of desirable tax reforms by relaxing the balance of payments pressures created by sustained fiscal deficits.

5. From an historical vantage point, tax reform is best seen as a continuous process in which there is substantial learning by doing, continual adjustment and refinement of the tax system and a gradual groping towards the achievement of a better tax system.

   The experiences of Korea, Mexico, Colombia and Turkey all suggest that the process of tax reform is never finished. As new ideas and fashions take hold, as the technology of tax collection changes and as a country's economic circumstances are altered, new opportunities will arise for improving a country's tax system. This is not to deny that countries may occasionally stray from the path of true tax reform as Colombia did in the late 1970s when it partially reversed some of the reforms introduced earlier in the decade.

6. Undue haste and inadequate preparation in introducing tax reforms may create substantial waste and eventually doom them to failure.

Bolivia's ill fated effort to introduce a value added tax in 1976 provides the best illustration of this lesson. Few resources were committed to educating the public on how a VAT operates, to creating an administrative apparatus to deal effectively with its implementation and to a careful designing of the tax forms. Not surprisingly, the new sales tax failed to live up to its promise. The much more successful reforms introduced in Jamaica, Indonesia and, more recently, in Malawi all benefitted from detailed and careful planning and preparation plus close monitoring after their implementation.

7. Good data and a reliable empirical analysis of the effects of the pre- and post-reform systems are vital prerequisites to convincing doubters of the soundness of proposed tax changes.

Successful tax reform measures ordinarily require a detailed knowledge of the defects of the current system, particularly a sense of who pays taxes at the industry, firm and household level. They also require a feeling for how the distribution of tax burdens will be affected by tax measures that are supposed to make matters better. The recent tax reform efforts in Jamaica, Colombia, Malawi and Indonesia all display this attribute. The marginal effective tax rate methodology is also increasingly being applied to measure the allocative impact of different tax policies.

8. Reforms are more likely to be adopted if local policymakers are actively involved in their design and implementation and if the reforms result in the formation of a cadre of local tax experts.

   Recent reforms in Colombia, Malawi, Indonesia and Jamaica have proved the importance of securing a strong commitment to the reform process and the measures themselves. Without active local engagement the reforms are not woven into the country's institutional structure and important opportunities for institution building are missed.

9. Comprehensive tax reform, insofar as it creates winners as well as losers, may meet with less political resistance than piecemeal tax reform.

   The recent reforms in Colombia, Mexico and Jamaica seem to suggest that if everyone has both a little to gain and a little to lose from a tax reform package, political opposition to the reform will be unable to coalesce around a particular issue. Alternatively, if the number of winners from a reform is large enough, they may be able to inflict a political defeat on any coalition of losers. If, however, a reform took aim at a particular tax distortion, the political outcry from those who benefit by its existence might be sufficient to destroy the initiative.

10. Potential improvements in simplicity and horizontal equity are strong selling points in favor of a tax reform. Gains in economic efficiency and vertical equity, on the other hand, are much harder to sell.

    Support for the recent reforms in Indonesia, Colombia, Mexico and Jamaica seems to spring in large part from the public expectation that the reforms would produce a more uniform distribution of tax burdens across different firms and industries in the economy and across different households at the same income level. Similarly, complex tax rules were seen as invitations to avoid and evade them which undermines the ability of the tax system to achieve horizontal equity. Efficiency arguments, on the other hand, are not well understood by the public and vertical equity is very much a matter of personal judgement.

11. An unstable macro-environment may threaten and even eclipse tax reforms that are popularly perceived to be a source of the instability.

    While the reform in Jamaica and a few other countries demonstrates that recession is not a barrier to introducing reforms, the experience of Colombia, Turkey and, perhaps to some extent, Mexico indicates that if some macro-economic difficulty occurs after the reforms are put in place, the reforms may be blamed for the coincident macro distress. In some cases the weight of this accusation may be sufficient to force the repeal of the tax reforms.

12. In general, there seems to be a logical sequence to fiscal reform, although the empirical evidence in favor of this proposition is embarrassingly thin.

Implicit in much of what has been said thus far is the assumption that the expenditure policies of developing countries are selected and executed in an efficient manner. Stories of white elephants abound to cast great doubt on this supposition. It clearly makes no sense to make tax policies more efficient and effective if the revenues which they produce are used to finance an inefficient set of public expenditures. In this sense, if expenditure reform does not accompany tax reform, it should precede it. Moreover, reform of structural tax policy should ideally precede the reform of tax administration since there is not much merit in making a bad tax system work somewhat better; that is, improved tax administration can never compensate for bad tax design. At the same time, however, improved tax policies will never work properly unless they can be effectively administered. In this sense, improved tax administration is frequently the key element in a successful tax reform. Finally, the experience with tax reform in Morocco makes it clear that tax reform should logically come before tariff reform. If tariffs constitute a significant fraction of total revenues, as they did in Morocco, tariff reductions will bring fiscal deficits in their wake unless, or until, the tax system can be effectively revamped to replace the foregone tariff revenue.

B. The Substance of Tax Reform: Major Themes

The reform experiences we have examined have addressed a host of technical issues concerning the choice and application of various tax instruments. This section focuses on the major themes that emerge from the efforts of these countries to improve the performance of their tax systems. These lessons, or bits of practical advice, constitute a core of basic tax reform principles on "what to do."

1. Tax reform measures need to conform to existing administrative capacities.

   Exceeding administrative limits almost always results in poor compliance and widespread evasion that will compromise the goals of revenue, equity and efficiency. Administrative feasibility can be met in several ways, in particular by keeping the tax system simple and avoiding fine tuning, by broadening tax bases and reducing both average and marginal tax rates, by relying primarily on indirect sources of revenue, by devising workable presumptive income taxes (or minimum taxes), by looking to the expenditure side of the budget for redistribution, by aligning the corporate and top bracket personal tax rates and last, but not least, by investing in improved administrative capability.

   High tax rates on narrow bases are arguably more inefficient because they distort decision making to a greater degree by encouraging savings, investment, consumption and the earning of income in tax preferred forms. They are also more prone to perpetuate horizontal inequities (although inefficiency

may eliminate some apparent horizontal inequities) and they are certainly more difficult to administer because they invite greater tax evasion and raise compliance costs. Broader and simpler tax bases have been chosen by Jamaica, Korea, Malawi, Colombia, Mexico, Bolivia and Indonesia. The undesirable features of narrow and administratively complex tax bases have been amply demonstrated by the experience of Morocco which has functioned with a narrow and highly differentiated tax system for a number of years.

Although in principle special tax regimes should broaden the tax base, in practice many of them may narrow the base by inducing ordinary taxpayers to take advantage of the disparate tax treatments accorded under the special regime and the normal tax system. Consequently, at least some special tax regimes may result in a loss of total revenue and may impair the tax system's ability to generate equitable and efficient outcomes.

As a result of the unification of corporate and top bracket personal rates, there is a much smaller pay off to the conversion of labor income into more lightly taxed capital income on the part of corporations and small businesses. Also, in conjunction with the exclusion of dividend income at the personal level rate, this unification has provided a reasonably effective method of integrating the tax treatment of dividend income. In every country it has proven much easier to tax the flow of dividend income at the corporate rather than the personal level.

A number of countries also recognize that different parts of the tax system can provide mutual support for one another. Thus, for example, a well functioning value added tax can assist in the administration of both corporate and personal income taxes by providing detailed information on important items such as gross receipts and deductions. In Colombia, on the other hand, a well administered net wealth tax was indispensible for the effective operation of both the presumptive income tax and the tax on capital gains.12/ Other countries besides Colombia either have not tried net wealth taxes or have had only limited success in applying them.

In reforming taxes, is it better to build on existing tax instruments or to replace them instead with fresh ones? As the contrasting experiences of Malawi and Bolivia indicate, both approaches may be required if tax reform measures are forced to conform with current administrative capacity. Malawi felt it was easier to refashion existing tax instruments while Bolivia reacted to its inability to administer an orthodox income tax system effectively by discarding it and replacing it with a set of simpler taxes that promises to be easier to implement.

It is unlikely that future tax reforms, like those in recent years, will be driven by vertical equity considerations. Because of the interplay of weak tax administration and political preferences, the effective progressivity of both

personal and corporate income taxes has been found to be substantially less than that implied by legislative rates. Nominal progressivity has accordingly been tailored to suit administrative realities in most countries. Top marginal rates under the personal income tax have been substantially reduced in several countries while the nominal corporate tax rate has been significantly lowered as well. Concern over triggering capital flight and increased recognition of the distorting effects of high marginal tax rates have reinforced this tendency to adopt lower rates.

2. It is important to design tax and expenditure systems that will minimize current deficits and the prospects of future fiscal deficits.

Small, open economies such as Bolivia, Malawi and Morocco which have relied heavily on export taxes as a revenue source have been particularly prone to experience fiscal deficits as a result of any downturn in the international economy. Countries such as these that cannot easily cultivate more stable revenue sources require either flexible expenditure systems or the establishment of a stabilization fund if they are adequately to contain the size of future fiscal deficits. Revenue elastic tax systems also help to prevent the emergence of fiscal deficits during periods of stable economic growth.

Because they are more often than not financed through Central Banks, fiscal deficits may be more pernicious in their inflationary impact in developing than in developed countries. Of all of the methods of taxation available to governments, the inflation tax has been shown to be among the least desirable of tax instruments. The inflation tax is both highly inequitable and highly distorting, particularly in an unindexed tax system. Either by levying higher tax rates or by administrative or statutory efforts to expand the size of the tax base, explicit taxation is almost always preferable to the implicit inflation tax. Choosing between these two explicit tax options turns on a comparison between the efficiency costs of higher rates and the resource costs of greater administrative effort. If rates are already high, there is a presumption in favor of more diligent tax administration.

If, however, a high rate inflation is viewed as unavoidable, it is important to index both direct and indirect taxes in order to maintain real tax revenues and avoid inflation induced inequities and distortions in the tax treatment of both capital and labor incomes.

Contrary to conventional wisdom, the absence of indexing measures may frequently be destabilizing and may make inflation more rather than less likely. As the experience of Bolivia graphically illustrates, unindexed commodity tax

bases are especially vulnerable to inflationary erosion and can contribute to explosive macroeconomic instability as accelerating rates of inflation create ever larger fiscal deficits.

As was particularly evident in the case of Turkey, inflation in an unindexed tax system will often raise effective tax rates on labor incomes while reducing them on capital incomes. This effect occurred as more workers were elevated into higher tax brackets and as nominal interest deductability reduced the size of the corporation income tax base. Inflationary episodes in Turkey, Bolivia and Mexico, and also to some extent in Colombia, suggested that an unindexed personal income tax that results in bracket creep is an important stimulant to the growth of untaxed fringe benefits. However, the provision of these fringe benefits occurred very unevenly across different groups in the labor force with consequent damage to both vertical and horizontal equity.

In the absence of indexation inflation also produces substantial inequities and distortions in the tax treatment of capital income. Debt finance is artificially encouraged while taxes on nominal interest income are transformed into covert wealth taxes.

Explicit and comprehensive indexing is preferable to a variety of ad hoc measures intended to provide partial relief from inflationary tax effects on capital income. Under the indexing schemes recently introduced in Colombia and Mexico, only real interest income is taxable and real interest expense is deductible. Both of these countries have also adopted inflation proof methods of measuring depreciation, and Colombia also provides for indexed treatment of capital gains.

3. Despite the desirability of obtaining broader income tax bases, there are significant structural and economic constraints on the achievement of a comprehensive and global income tax.

The substantial size of the informal sector in most developing countries severely limits the reach of the income tax. Besides these enforcement restrictions, the scope of the income tax is also restricted by measurement difficulties, the provision of tax incentives and the power of special interests to obtain exemptions and exclusions. No example could be found of a personal income tax that included more than a third of the economy's capital income in its tax base. The corporation income tax, moreover, cannot adequately compensate for this skimpy coverage because it is a tax on only one form of capital income, that part which is received in the form of equity. Large portions of labor income in the form of fringe benefits are also excluded from the personal tax base in many countries.

The increasing integration of the world's capital markets and the dismantling of capital market controls in most countries have exerted considerable pressure on developing countries to either reduce or even eliminate their taxes on interest income. At the same time, reluctance to tax interest income when combined with the deductibility of interest expense opens up significant opportunities for both tax arbitrage and tax evasion. Highly levered company financial structures also become a by-product of this unequal tax treatment of debt and equity.

It is not entirely clear what the appropriate policy for treating interest income should be. If fear of capital flight and inability to enforce the residence principle causes interest income on domestic deposits to be exempt from tax, this exemption will probably create pressures to reduce tax burdens on other forms of capital income, especially dividend income and capital gains, if for no other reason than to mitigate the financial distortions that would otherwise occur. On the one hand, if a country attempts to include interest income in the tax base, the effect is likely to be higher domestic interest rates as the effective tax burden is shifted forward to domestic consumers in general and to owners of immobile land and labor in particular. If this were the case, it might be argued that reliance on an income tax excluding interest income and other components of capital income (an expenditure tax), or on a general sales

tax, would be preferable since, with either of these taxes, the distribution of tax burdens could be more easily predicted and a tax induced distortion in the capital market would be avoided. If, on the other hand, interest income were excluded from the tax base, there is an argument for making interest expense non-deductible in order to curb tax arbitrage. Such an approach, however, could very easily jeopardize the availability of foreign tax credits and raise the economy's cost of capital from foreign sources. There seem to be no easy answers. What is clearer, however, is that a global capital market exerts powerful pressures on developing countries to replace conventional income taxes on individuals with either direct or indirect taxes based on consumption.

Given these weaknesses in the personal taxation of capital income, a pivotal role for the corporate income tax is to see that the equity component of capital income is taxed at least once. The other role for this instrument is to tax the domestic source income of foreign corporations and any economic rents received by both domestic and foreign companies.

An important design feature in the reform of the corporate income tax is the trade off between low nominal rates and no investment incentives versus nominal corporate rates and liberal investment incentives.13/ Most of the countries examined have opted for the former policy. Malawi, however,

has recently opted for a relatively high corporate tax rate combined with a partial first year write off for investment in the manufacturing sector. Zimbabwe remains the only country in which complete expensing of investment is allowed, but it also unwisely permits interest deductibility, thereby subsidizing investment.

4. Tax measures and instruments need to be closely targeted to the objective they are intended to achieve and the number of non-revenue objectives should be kept to a minimum.

Indirect or poorly targeted tax measures almost always create new problems and often generate undesirable side effects. For example, Colombia adopted for a number of years an accelerated depreciation scheme in an attempt to compensate for the impact of inflation upon corporate income taxation. Such measures are crude at best and can only offset inflation for a particular rate of price increase. At the same time, however, such a scheme injects significant non-neutralities into the tax system by influencing the choice of investment among different sectors and assets. As a further example, many countries grant an outright exemption for all food purchases under the value added tax in an effort to reduce or even eliminate the regressive features of that tax. However, by exempting all food purchases rather than only the items purchased by low income households, the exemption may confer larger absolute benefits on the rich than on the poor. Protective excise taxes and revenue raising tariff policies provide further examples of poor targeting.

In many developing countries, there is now considerably more doubt about the ability of tax incentives to achieve their intended objectives. Many, though not all, of the tax reform countries have restricted the scope and application of tax incentives as part of a growing awareness that their costs may be substantially higher and their benefits significantly lower than was previously thought to be true.

5. Most tax reform measures will ordinarily require making trade offs among the normal criteria that are used to evaluate tax changes. However, the goals of simplicity, neutrality and horizontal equity frequently complement one another; all three of these objectives clash with the pursuit of vertical equity.

For instance, attempts to obtain greater vertical equity typically invoke the use of differentiated tax rates and tax treatments that clash with the policy requirements for simplicity, neutrality and horizontal equity. In an inflationary environment, indexation may be required for greater tax neutrality and equitable treatment among investment choices but it almost always adds to administrative complexity. Further conflict may occur between growth and equity since the former objectives stress reliance on consumption taxes while the latter goal calls for the elimination of taxes on the consumption of the poor. Korea provides an example of a country that, at least until recently, placed more priority on achieving higher rates of

economic growth than on attaining greater equity in taxation. There may also be some tension between the size of total revenue and the pursuit of an equitable distribution of tax burdens. In Zimbabwe, for instance, the relatively large government sector has already exhausted the use of tax instruments that fall primarily on the rich and has forced the government to turn to marginal revenue sources that impinge very heavily on the poor. On balance, most of the recent reforms have stressed the importance of achieving greater simplicity, neutrality and horizontal equity and have pursued these goals at the expense of vertical equity.

Despite the prevalence of policy trade offs, opportunities may exist in many countries for simultaneous improvements in many dimensions of tax policy performance. For example, presumptive taxes, such as those levied on net wealth in Colombia and on indicators of the standard of living in Turkey, may usefully compensate for weaknesses in tax administration and produce unambiguous gains in neutrality as well as both horizontal and vertical equity. Minimum taxes along the lines of those recently enacted for Turkish and Mexican corporations may do likewise.14/ The replacement in several countries of numerous cascaded commodity taxes by a value added tax has also contr. uted to unambiguous gains in efficiency, equity and ease of administration.

The goals of tax reform are now more modest and perhaps also more realistic than they were previously. Many tax experts would argue that rough justice is the best target to aim for

rather than some ideal but administratively hopeless notion of perfect justice. From this standpoint, for instance, the policy of excluding dividends from the personal income tax is preferable to the more conceptually accurate but administratively more complex imputation approach as a method of integrating corporate and personal taxes. By the same token, a single VAT rate accompanied by an exemption for food is considered to be better than a multiplicity of VAT rates. Similarly, many would argue that a single rate personal income tax combined with a generous personal exemption is better than a system that has sharply progressive tax rates and a variety of deductions and credits. Colombia, Mexico and Jamaica, for instance, have all recently eliminated a variety of tax deductions and replaced them with a single deduction that more or less approximates the minimum wage in each country.

Streamlining deductions, disallowing deductions for losses against unrelated income and the imposition of thin capitalization rules for domestic as well as foreign companies are all examples of attempts to tailor the tax system to fit existing administrative capabilities. Although these measures and others like them inevitably create some inequity by ruling out finer distinctions among taxpayers, they may also curb larger inequities arising from tax evasion and avoidance and are considered to be the lesser of two evils. These simpler measures may succeed where more sophisticated measures would fail.

In keeping with the more modest aims of recent tax policy, avoiding tax induced resource misallocation and administratively complicated measures have assumed more importance than using the tax system either to spur economic development or to redistribute income. These latter tasks are now thought to be handled much better on the expenditure side of the budget. Attempts to use the tax system for these purposes may fail if for no other reason than that they impair effective tax administration and encourage tax evasion.

6. The value added tax (VAT) has worked well in most countries, having succeeded in raising substantial amounts of revenue and in removing the burden of indirect taxation from exports and investment expenditures.

However, experience has shown that it is possible to design bad VATs and to impair their effectiveness by adopting multiple rates and adding numerous exemptions. Like any other tax, the VAT must be carefully crafted and implemented if it is to work well. Experience seems to suggest, however, that as the general rate of the VAT increases, the political process in many developing countries will extract concessions in the form of a multiple rate structure. For example, concern over the regressive impact of a higher value added tax in both Mexico and Turkey compelled policymakers to accept a VAT with numerous rates with all its administrative complexities.15/

In choosing a destination based VAT to replace an odd assortment of taxes on imports and domestic inputs, many developing countries have significantly enhanced the coordination of their trade and domestic indirect taxes. Nevertheless, there are a few instances where commercial and tax policies were reformed simultaneously and the danger remains that efforts to reform tariff policies may inadvertently distort a country's indirect tax system. For example, tariffs on imported inputs may produce greater uniformity in effective rates of protection but, by making accurate border tax adjustments more difficult, at the cost of more distortion in the configuration of indirect tax burdens.

Besides contributing to total revenue, luxury based excise taxes have the important role in most developing countries of securing a more equitable burden of indirect taxation. In order to accomplish this objective, developing countries need to produce reliable income and expenditure data since what is deemed to be a luxury in one country may be otherwise for other countries.

Given the relative importance of indirect taxes in the revenue systems of developing countries, the key equity concern under a tax reform is to design and apply both sales and excise taxes that impact as little as possible on low income groups in the economy. However, almost all of the

incidence calculations that are included in the tax reform sample indicate that the bottom quintile of households bears a significant tax burden, on occasion reaching as high as 10 percent or more of household income.16/

V. CONCLUSION

Successful tax reforms have a number of common elements: they stem from a well thought out program of action and a clear perception of the problems of the pre-reform tax system; they are staunchly supported by major policymakers and local technocrats; they are carefully and systematically implemented and monitored; they use tax incentives only sparingly and instead aim for broader and simpler tax bases on which lower marginal rates are imposed; they not only avoid raising taxes on the poor but make some effort to reduce tax burdens on this group; they refrain from making procedural demands that overwhelm tax administration capacities while investing more resources in training and in upgrading the level of administrative performance; they pay attention to interactions among different components of the tax system and do not neglect the importance of revenue adequacy; they rely primarily, if not exclusively, on tax measures that are directly targeted to the objectives which they are intended to achieve; they emphasize the importance of horizontal equity, neutrality and simplicity; and they accept a state of crude justice in taxation rather than striving for the unattainable goal of complete justice.

The preceding guidelines for reforming taxes are, however, of an extremely general nature. Extreme caution should be exercised in transferring solutions to particular tax problems across different

countries. Inter-country variations in administrative capability, in initial economic conditions and in behavior all suggest the need to prescribe tax remedies that are appropriate to the patient's ills. For example, sophisticated indexation may work in Colombia but not in Morocco where administrative complexity is already at high levels. Regressive indirect taxes may be of greater concern in Bolivia than in Korea where household income disparities are less marked. It may be feasible to tax interest income in Zimbabwe where capital markets are highly regulated but not in Mexico. What is a luxury in one country and, therefore, highly eligible for excise taxation may not be perceived as a luxury in another country. Despite reservations of this kind, the broad lessons outlined above suggest that several important facets of tax reform experience can indeed be generalized and that countries can learn a great deal from each other's successes and failures.

FOOTNOTES

1/ Yitzhaki and Thirsk (1990) use the concept of welfare dominance to illustrate how it may be possible to identify welfare-improving tax reforms that are virtually free of value judgements concerning interpersonal equity.

2/ Once the resource costs of collecting taxes are recognized, the optimal use of a tax instrument is determined by equating the marginal administrative cost of raising another dollar of revenue from better enforcement with the marginal excess burden per dollar of revenue that results from raising the rates of existing taxes.

3/ Some countries such as Turkey, restrict crediting for purchases of capital capital goods under the VAT while others, such as Colombia, deny a credit except for imported capital goods. The rationale for this practice rests partly on revenue grounds but also in the awkward attempts of these countries to offset the impact of subsidies to capital use found elsewhere in either the tax or foreign exchange rate systems. This is also one example of poor targeting discussed later on in the paper.

4/ Prior to the adoption of its VAT, Indonesia, for instance, taxed imports at differentially higher rates under its sales and excise taxes. Colombia, on the other hand, granted a VAT exemption to purchasers of foreign, but not domestic, capital goods after it adopted the VAT.

5/ The situation is further complicated by the provision of foreign tax credits. If foreigners are able to credit host country tax liabilities against their obligations to their own tax authorities, interest rates in the capital receiving country may not increase when taxes on interest income are imposed.

6/ To some extent, this issue of effectiveness depends on the negotiation of tax treaties that permit tax sparing. Unless developed countries allow foreign tax credits for taxes that are "spared" by the host country, tax incentives for foreign firms may simply transfer revenues to foreign treasuries. Tax sparing, however, is not an issue if the home country either exempts foreign source income from tax or, under a credit system, firms generally have excess to foreign tax credits.

7/ The opportunity for evading taxes may be influenced by the form in which the tax incentive is provided. Tax holidays, for example, may be much more susceptible to transfer pricing abuses than other kinds of tax incentive.

8/ Indexation measures in a number of countries have also helped to mitigate the debt distortion.

9/ In part, the universal decline in corporate tax rates reflects the effects of international tax competition as developing countries have responded to the lower rates recently introduced by a number of developed countries. The diminished availability of foreign tax credits has also contributed to this phenomenon.

10/ The presumption in this instance is that lower tax rates will make it worthwhile for the taxpayers to devote fewer resources to concealing his true income from the tax authorities. Unfortunately, none of the tax reform studies could shed any empirical light on this issue.

11/ This statement does not apply to the traditional excises on alcoholic beverages, gasoline and tobacco products which have quite different rationales as revenue instruments.

12/ The presumptive income tax in Colombia served a number of beneficial purposes. In addition to curbing evasion and improving progressivity, it was a useful instrument for reducing lock-in effects, taxing imputed income from real estate, and generally correcting for a number of "timing" problems inherent in the application of income taxes. Approximately one third of all companies and individual taxpayers were taxed on this basis before the tax was repealed in 1989.

13/ Here the tax design issue is that of striking a balance between the desire to tax economic rents on previous corporate investment and establishing an attractive tax environment for new investment.

14/ In the case of both Turkey and Mexico, these taxes are creditable against corporate tax obligations so they imply no extra burden for profitable companies that comply with the law.

15/ On the other hand, Colombia unified its VAT rate structure for administrative reasons when the tax was extended to more retailing outlets in 1983.

16/ The collection of tax reform studies suggest that it is important to avoid blindly adopting the rules of thumb that often dictate the calculation of tax incidence in developed countries. That is, the incidence of a tax must be examined within the specific context of a particular developing country and there is no reason to believe that an incidence rule that is appropriate in one developing country would also be appropriate in another. For example, some indirect taxes, such as tariffs that are levied in the presence of quantitative restrictions, may be significantly more progressive than any direct tax. Moreover, the rules of thumb appropriate for a closed economy may be wholly unsuitable when applied to an open economy.

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