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Issues in Income Tax Reform in Developing Countries

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Revenue, efficiency, and equity should be the three main goals of income tax reform. Add to those enforceability — which furthers the other three goals simultaneously.

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Of all taxes, income taxes are the most difficult to implement. Developing countries are usually able to generate large amounts of income tax revenue only from large corporations or foreign investments. They are rarely effective in taxing wealthy individuals or small or medium-size businesses.

How can income taxes be made more effective in developing countries?

Using recent tax reforms in Jamaica, Indonesia, and elsewhere as examples, Gray discusses the pros and cons of specific tax reform elements and makes the following suggestions:

- Limit the distinctions between business and individual income taxes. This has the advantage of simplicity and avoids an abrupt shift in tax liability on incorporation.
- As a general principle, broaden the tax base while keeping tax rates low to moderate. Avoid special tax incentives when possible.
- Tax the full range of income under a country's jurisdiction — taxing residents on their worldwide income (with a foreign tax credit) and nonresidents on all income earned in the country. This helps to close a wide loophole for tax avoidance.
- Include all types of interest income in the tax base, including interest on bank deposits and government bonds.
- Fully tax capital gains (particularly under a flat-rate or nearly flat-rate income tax).

- Deal with the thorny problem of fringe benefits (which go disproportionately to the better-off employees) by allowing as deductions for the provider only those benefits for which the recipients pay tax.

- Require that all nonprofit organizations file tax returns, and exempt only certain types of their income from taxation, to guard against abuse.

- Develop “presumptive” methods of assessing taxes for groups (small firms and the self-employed) that are difficult to tax.

- Carefully limit deductible expenses for firms to the necessary costs of earning income.

- Simplify depreciation rules by avoiding “fine tuning” of categories or rates. As an alternative, allow full writeoff (“expensing”) of capital investment in the first year, but disallow the deduction of interest paid on loans to finance such investment.

- Collect as much income tax as possible on both labor and capital income through withholding and current payments (P.A.Y.E.), but keep the procedures simple.

- Enforce tax compliance by charging reasonable interest and penalties on late payments. Seizure and auction of property and/or criminal penalties may also be necessary to enforce compliance. However, these enforcement tools need to be counterbalanced by fair avenues for taxpayer objections and appeals.

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During the 1980s, the World Bank has become increasingly involved in issues of fiscal policy as part of its adjustment lending. The bulk of this involvement has been in the exploration of macroeconomic issues of public finance and the close scrutiny of expenditure plans and budgets through public investment and expenditure reviews. Although the Bank has often stressed the need to increase public revenues, Bank staff working on adjustment programs have tended to be less involved in detailed analysis of revenue options. Interest in revenue options is growing, however, as indicated by recent Bank reviews of tax systems in Bangladesh, China, Malawi, Morocco, and Turkey. Given the fiscal dilemmas faced by many of the Bank's borrowers, there is little doubt that issues of revenue mobilization are crucial to economic adjustment and will continue to be for years to come.

Of all the types of taxes, income taxes--particularly on individuals and small businesses--are the most difficult to implement efficiently. Developing countries tend to be successful at generating large amounts of income tax revenue only from large corporations or foreign investments. They are rarely effective in taxing wealthy individuals or small and middle-sized businesses. How can the effectiveness of income taxes be improved in developing countries?

This paper attempts to acquaint the reader with common issues in the design of income taxes in developing countries, and to suggest (where possible) the "best practice" for addressing these issues. Two recent comprehensive income tax reforms--in Jamaica and Indonesia--provide helpful illustrations, and limited reforms in other countries provide further examples in selected areas.

GOALS.

The three main goals of income tax reform are revenue, efficiency, and equity. Often these goals are mutually reinforcing, but at times they are not. The goals of any attempt at reform should be clearly defined, in order of priority if possible.

The immediate need for more revenue is obvious in countries with significant budget deficits. Other countries may not have acute revenue problems but may seek higher elasticity in their income taxes to insure that the tax to GDP ratio rises--or at least does not fall--over time. Still others may want to increase income tax revenues to offset revenue losses from other structural reforms. Unfortunately, short-term revenue pressure can lead to changes that are counterproductive in the longer-run. Long-term improvements in income tax design rarely occur in times of budgetary crisis.

With regard to efficiency, the goal of income tax reform should be to minimize the effect of taxes on economic behaviour, including savings, investment, production, and individual work. In general, higher marginal tax rates lead to larger economic distortions, so that simply raising tax rates to increase revenue conflicts with the goal of efficiency. Care in defining the tax base, setting the tax rates, and designing the rules regarding the taxation of savings income and capital write-off can reduce the effect of taxes on economic behavior.¹

¹ Public finance literature makes a strong case, primarily on efficiency grounds but to some extent on grounds of simplicity as well, for replacing an income tax with a direct "consumption" or "expenditure" tax. Such a tax would tax only consumption and exempt the returns to savings, thereby eliminating the income tax's inherent bias against savings (i.e. future consumption) in favor of present consumption. See, among others, Andrews (1974), Pechman (1980), and Zodrow and McClure (1988). While the idea of an expenditure tax has many attractive

Equity is an oft-cited goal of an income tax. In fact, if equity were not an issue, one might question having an income tax at all, given the relative administrative convenience and nondistortionary character of broad-based domestic sales taxes. Income taxes are considered desirable in large part because their burden is related to ability to pay.

In industrial countries with strong tax enforcement mechanisms, the goal of equity often conflicts with the other two goals. For example, a flattening of the income tax rate schedule, as occurred in the 1986 U.S. tax reform, tends to lessen distortions but can also reduce progressivity. The conflict can also arise in developing countries. Raising withholding rates on wage-earners is a way to increase income tax revenues quickly in developing countries, but the burden is heaviest on the middle class rather than the richest segments of the population.

These conflicts between goals tend to be less severe in developing countries, however; in many cases all three goals can be furthered simultaneously by strengthening tax enforcement and compliance. Income tax laws in developing countries may impose high marginal tax rates-- usually reaching 60 percent and sometimes as high as 95 percent, but in practice they are rarely applied anywhere near to potential.² Because the easiest income taxes to collect tend to be individual income taxes

features, it has not yet been accepted in practice. This paper focuses on the income tax, which--for better or worse--is and will probably continue to be the norm in both developed and developing countries for some time to come.

2 For example, an internal study in Indonesia in the early 1980s estimated that only 10 to 20 percent of potential income tax revenues were actually collected prior to the reform. A similar study in Jamaica estimated that over one-half of all potentially taxable income was outside the income tax net. Bahl and Murray, p. 5.

on employees and company income taxes on foreign companies and state-owned enterprises, the wealthiest individuals often escape much of the tax burden. Simplifying the income tax structure and narrowing its scope in order to make it easier to administer and enforce can lead over time to increased revenues, efficiency, and equity in an income tax system. For this reason, enforceability should be counted as a fourth major goal of income tax reform in developing countries.

THE DEFINITION OF TAXPAYER.

Domestic Coverage.

Ideally the definition of taxpayer is as broad as possible, covering all income earning entities (individuals, partnerships, and companies).³ For example, the public sector need not be exempted; state-owned enterprises should be on the same footing as private firms, and civil servants should be the first--not the last--to pay tax.⁴ *Ex-ante* exemptions for other large sectors of society, such as agriculture,⁵ are also usually ill-advised. They open up scope for tax evasion and abuse. Poor farmers will be exempted through the workings

3 Even though the burden of all forms of income taxation ultimately falls on individuals, corporations and other income-earning entities should be included in the tax net. As legal entities, they receive benefits from the state. And as repositories of large amounts of income with accompanying records, they are easier to tax than individuals.

4 Some countries, including Bangladesh and Indonesia (prereform), have treated salaries of government officials as if taxes had already been withheld at source (although no such withholding was actually calculated and paid) and therefore have exempted them from further tax. This treatment is inefficient, because government agencies are given a competitive advantage in the labor market vis-a-vis private firms. It is also inequitable, because higher-level civil servants are not forced to aggregate their employment income with other income in calculating tax due. Under the new Indonesian law, civil servants are legally liable for income tax, and government agencies are responsible for withholding in the same way as private firms are.

5 As is Pakistan and Morocco.

of the personal exemption; wealthy farmers should pay tax. Even many charitable organizations need not be exempt from income tax *ex-ante*. In an atmosphere with weak administrative capability, profitable business activities can easily hide behind the "charitable" characterization. Income earned specifically from charitable activities can be effectively exempted through the definition of taxable income⁶ rather than the definition of taxpayer.

In most countries two separate income tax regimes coexist, one for businesses and one for individuals. Each has its own rules for determining taxable income and its own rate structure. Most revenue tends to come from the business income tax,⁷ which is easier to enforce (especially for medium and large firms). Specifying the dividing line between the two regimes can be problematic. Questions such as these must be faced: Should the business tax apply to unincorporated firms such as partnerships or only to corporations? If it applies only to the latter, why should the mere act of incorporation throw a business into a completely separate tax regime? If it applies to unincorporated firms as well, where do individual entrepreneurs fit? Does the business tax cover small family-run businesses such as restaurants, or do these fall under the individual income tax law?

Many countries draw the dividing line between the application of individual and business income tax laws at the point of incorporation, arguing that having the corporate form confers certain legal advantages that offset the tax consequences. Other countries try to cover all firms--incorporated or not--with their business tax law, leaving the dividing line between firms and individuals rather ad hoc. Indonesia's

6 See pp. 15-16 below.

7 World Development Report 1988, p. 84.

1983 income tax reform addressed the problem by applying virtually the same tax treatment (with the same definition of tax base and the same rate structure) to both businesses and individuals. The new income tax law applies to all individuals and business entities, with the only major difference in the method of calculating tax for the two groups being the personal exemptions granted to individuals but not to corporations or partnerships.⁸ Jamaica and the Phillipines also moved recently to similar treatment of businesses and individuals--with the same marginal tax rates (33 1/3 and 35 percent, respectively) applied to each. This approach has the advantages of simplicity and relative certainty, and it avoids an abrupt shift in tax liability--and any resulting distortionary effects--upon incorporation. These advantages must be weighed in each individual case against the flexibility and revenue that separate tax regimes for businesses and individuals can bring.

International Jurisdiction.

Foreign-source income?

Under generally accepted international tax principles, a country's jurisdiction to tax extends to all income earned within its borders and all income earned outside its borders by its residents. Some developing countries, including Argentina, Bolivia, Ecuador, and Taiwan, have limited their tax net to income earned within their borders, opting not to tax foreign-source income of residents. Such a limitation can lead to major tax avoidance, however, because wealthy citizens can easily transfer money to overseas tax-free accounts. An alternative is to

⁸ See page 29 below for a discussion of personal exemptions. The only sector of the economy explicitly exempted from the application of the new Indonesian income tax is the oil sector, which is taxed instead under other government regulations and production-sharing contracts.

impose tax on the full range of income subject to a country's jurisdiction, taxing residents on their worldwide income (with a foreign tax credit) and nonresidents on all income earned in the country. Although such a provision does not guarantee full taxation of all foreign-source income, it does close a wide loophole for legal tax avoidance.

The new laws of both Jamaica and Indonesia tax the worldwide income of residents. In the case of Indonesia, for example, it is extremely easy for Indonesian residents to hold money in Singapore bank accounts or other financial assets. If only domestic source income were taxed, transferring assets to Singapore (where foreign bank accounts are untaxed) would provide a fully legal means to avoid taxes. Taxing foreign source income of residents may not stop tax evasion through capital flight, but it does close an obvious legal loophole.

The definition of resident.

How should a tax law define resident for tax purposes? The resident/nonresident distinction is an important one, for residents are taxed entirely differently from nonresidents. Generally residents are defined to include anyone intending to reside indefinitely in a country or anyone who in fact stays in a country over a particular length of time (typically six months). In the case of business entities, both firms established under the laws of a country and "permanent establishments" of foreign firms located in the country are usually taxed as residents. (Permanent establishments might be excluded from the technical definition of resident but taxed in the same way.) Taxation of permanent establishments is generally limited to worldwide income

attributable to such establishments and does not reach unrelated income of the foreign head office.⁹

Source rules.

How does one know if income is earned in the country or abroad? Surprisingly, this can be a tricky question in transactions involving foreigners. Manipulating the location where income is "earned" can be a potent means of tax avoidance. Aside from defining the reach of the tax net for various types of taxpayers, an income tax law should lay down clear "source" rules--rules for determining the source of various items of income and thus clarifying what income of a foreigner is subject to domestic income tax and what income of a resident is eligible for a foreign tax credit. For example, the "source" of interest, dividends, and royalties is usually considered to be where the payor (whether business or individual) resides. The source of income (including capital gains) from immovable property is typically where the property is located. The source of payments for personal services is generally considered to be where the services are performed. Some countries extend this reach to include services performed abroad but paid for by residents (and thus easily subject to withholding); however, such an extension is often not matched by the tax treatment of the same income abroad and can lead to double taxation of the income.

THE CONCEPT OF INCOME.

General definition.

Old-style schedular tax systems tended to have relatively narrow definitions of taxable income, omitting taxpayers and income not

⁹ See page 14 below.

specifically named. Salaries would be subject to one rate, business income to another, capital income to yet another, and so on until the categories were exhausted. Some types of income were left out altogether. For example, the old Moroccan income tax law imposed separate schedules--with different rates and rules for calculating the tax base--for wages and salaries, agricultural income, urban real property income, dividend and interest income, business profits, and capital gains.

The current trend in income tax reform is to define income as broadly as possible to reach a truly "global" income tax. The general definition is all-inclusive--income is "any increase in economic prosperity" or "any net addition to wealth" received by a taxpayer. Starting with such a general definition provides the tax authorities with a strong legal tool to combat tax evasion. Of course, numerous questions inevitably arise when individual cases are considered. Some of the more controversial issues are considered below.

Interest income.

Among the most controversial issues that can arise in income taxation is how to treat interest income, particularly interest earned on domestic bank deposits. Policy makers often fear that taxing interest, by lowering the return on savings, could have a negative impact on domestic savings and could encourage capital flight. Much depends on the structure of the financial system and the institutional mechanism for setting interest rates. To the extent interest rates are free to move in response to market forces, any tax on interest will be borne in part by borrowers through higher bank lending rates. In such case, the incentive to move funds out of domestic banks will be

lessened. (There will of course be a cost at the margin in terms of foregone investment due to the higher lending rates.) If interest rates are controlled, the tax will be borne fully by depositors. Even then, term deposits may not be very responsive to changes in after-tax interest rates, especially in low income countries and for small depositors in most countries. And to the extent bank deposits are "captive"--for example, owned by state-owned enterprises required to keep their deposits at home--they will not be affected at all by changes in after-tax interest rates.

Strong arguments--along efficiency, equity, revenue, and tax administration grounds--can be made in favor of including all categories of interest income in the tax base. First, exemption of certain categories of savings acts to discriminate artificially against others to the extent the latter are taxed. Exemption of bank deposit interest, for example, can put stocks, bonds, promissory notes, and other nonexempt savings vehicles at a competitive disadvantage and inhibit the development of a mature and diversified financial system. Furthermore, exemption of interest on government bonds tends not only to favor this form of saving artificially but also to obscure the true economic cost of public deficits; government agencies are not forced to pay the same return on borrowed money that their private counterparts would.

Second, interest income is earned overwhelmingly by persons in higher income brackets, and thus the exemption of interest generally has a regressive impact on the distribution of the total tax burden. This is ameliorated if the exemption is limited either to savings channels traditionally used only by small savers--as, for example, in Korea--or to interest income below a modest limit--as, for example, in Jamaica.

Finally, an exemption for interest can be very costly in revenue terms. A tax on bank deposits is easy to implement through withholding and can raise large amounts of revenue. Even more importantly, such an exemption opens an enormous loophole for tax avoidance as long as interest paid in the course of business is considered a deductible expense for the payer. A taxpayer can reduce tax liability at will by borrowing to finance operating costs while depositing savings in a tax-free account. These savings can be used as collateral for the loan, thus eliminating any risk to the lender.¹⁰

Both the Jamaican and the Indonesian income tax reforms brought interest income, which had previously been excluded, into the tax net. In the Indonesian case, such taxation was suspended by supplemental regulation, in large part due to fear of capital flight, and full taxation of interest was not actually realized until late 1988.

Capital gains.

Taxes on capital gains are very difficult to administer and enforce even in industrial countries, and they are notoriously problematic in developing countries. However, excluding capital gains from the tax net opens up major avenues for tax avoidance. In developed countries (such as Australia and the United States) that have in the

¹⁰ For example, assume bank deposit interest is tax free, while other types of interest are taxable and interest is a deductible expense for the borrower. Further assume a marginal tax rate of 33 1/3 percent. Company A can deposit \$1 billion in Bank B at 10 percent interest (tax free) and borrow \$1 billion from Company C at a deductible cost of 12 percent. Bank B can indirectly finance this loan by using A's deposit as collateral for a \$1 billion loan to C at 12 percent interest (presumably taxable to the bank). The net result of this "sham" triangular arrangement will be a 2 percent before-tax profit margin (12 percent minus 10 percent) by Bank B, no gain or loss to Company C, and an after-tax gain to Company A of 2 percent (10 percent minus 8 percent, because of the deductibility of interest paid) of the \$1 billion. The only loser will be the government.

past fully or largely exempted capital gains from tax, many schemes have been invented for converting ordinary income into capital gains. For example, rather than carry out a large sale of inventory directly (ordinary income), a separate company can be formed with such inventory as its assets, and the company can be sold (capital gain). Or rather than distribute cash dividends (ordinary income), stock dividends can be issued on a pro-rata basis, and the stock can first be sold by the shareholders (capital gain) and then redeemed by the company at face value. Developing country taxpayers would undoubtedly begin to discover such schemes over time if capital gains were exempt from tax. And efforts to plug those loopholes would only further complicate tax law, as they have in industrial countries.

Taxing capital gains in full is not as problematic under a flat-rate or nearly flat-rate tax as under a tax with steeply progressive rates, because the flat rate lessens the problem of "bunching".¹¹ The tax incurred on the gain will be the same no matter when it is realized. If the realization of a large gain does propel a taxpayer into a higher rate bracket, the "excess" burden can be relieved by treating only a fraction of the gains (particularly longer-term gains) as income or by breaking the gain up into annual increments and applying an average effective rate to each increment.¹² The latter approach is being followed in Indonesia, where capital gains are fully taxable. Capital

11 "Bunching" refers to the problem caused in a progressive tax system when a large capital gain earned over several years is realized in the final year, thus pushing the taxpayer to a higher tax bracket than normal.

12 Virtually all countries that tax capital gains do so on a realization basis (i.e. when the gains are realized through transfer), because of the administrative difficulty of taxing such gains as they accrue. A mildly progressive tax might be justified because it counteracts the built-in incentive for taxpayers to defer realization and thereby postpone tax liability.

gains are not taxed under the income tax in Jamaica, but a separate tax of 7.5 percent of total receipts (or a maximum of 37.5 percent of the gain) applies on the transfer of land and buildings.

Fringe benefits.

The taxation of fringe benefits can be a thorny technical and political problem. Large firms in developing countries often provide such benefits as housing, automobiles, travel, and medical benefits to their employees, either in kind or as money allowances. Exempting them from tax gives a strong incentive to provide more income in the form of fringe benefits, thus eroding the tax base.¹³ A typical method of handling fringe benefits is to treat them as a deductible expense to the provider and as income to the recipient. This method was adopted, for example, in the recent Jamaican income tax reform. While in theory this is reasonable, in practice these benefits--particularly if provided in kind--can be very difficult to identify and value and are thus generally taxed lightly if at all.

Another way of handling in-kind fringe benefits (adopted in Indonesia) is to disallow any deduction to the provider while exempting such income from tax in the hands of the recipient. Under such a system, if a company wants to deduct wages and salaries paid to employees in calculating taxable income, such wages and salaries must by law be paid in money rather than in-kind. This rule in effect taxes fringe benefits at the marginal tax rate of the company, which may be lower or higher than the marginal rate of the taxpayer. To the extent it is easier to enforce than a tax on fringe benefits in the hands of

¹³ Two examples of countries that have exempted such fringe benefits from taxation are Jamaica (pre-reform) and Bangladesh. Before the Jamaican tax reform, nontaxable allowances had grown to an estimated 40 percent of taxable wages.

the recipient, the revenue impact may well be positive. Furthermore, because fringe benefits tend to go disproportionately to the better-off employees, the rule is likely to further equity goals as compared to a system where fringe benefits are taxed little or not at all. While narrowing a well-known tax loophole, such a rule stimulates a trend toward money wages away from less transparent in-kind payments.

Income of Permanent Establishments.

As mentioned earlier, a foreign firm operating in a country is generally taxable on the income attributable to such operations. This is done by considering "permanent establishments" of foreign firms--i.e. branches, representative offices, construction sites, etc.--to be residents of the country for tax purposes, or by taxing them as residents even if they are not legally defined as such. If the country taxes the worldwide income of its residents, permanent establishments can similarly be taxed on any worldwide income attributable to them, and remittances from a permanent establishment to a head office abroad can be subject to the same withholding tax as that applied to remittances of dividends from a local subsidiary to a foreign parent firm. Income of the multinational firm earned in other countries without the assistance of the local branch would not, however, be attributed to such branch.

A broad definition of attributable income can help to close loopholes for evasion of tax by foreign corporations. Such a definition would not only include any income arising directly out of the operations of the permanent establishment, including income on sales made by the branch abroad, but it would also incorporate the "force of attraction" principle; this would bring into the tax net of a permanent establishment any income from activities carried on in the country by

the head office or a related company of a type similar to the activities normally carried on by the branch itself. For example, if the branch is in the business of selling shoes, profits made from shipments of shoes by the head office directly to local customers would be automatically attributed to the branch, even if it took no official part in the sale. Thus, tax could not be avoided simply by bypassing the branch in a particular sale.

Income of Foundations and Cooperatives.

Because of the potential for abuse and tax evasion, tax laws must be carefully worded when exempting "nonprofit" groups and/or cooperatives from income taxation. Many profitable activities masquerade as nonprofit or cooperative ones in order to escape the tax net. Even if governments want to support public interest activities, it may be desirable to include foundations and cooperatives as taxpayers. A specific exemption can then be granted for certain types of income-- for example, for:

- income earned by a foundation from activities exclusively in the public interest,
- other income of such foundation (such as dividends) if used to fund public interest activities, and
- income of a cooperative if derived from service to its members (or if distributed to its members, if distribution of profits is the principle goal).

Such treatment would increase the accountability of these organizations by requiring that they file regular tax returns and by increasing the likelihood that they would occasionally be audited. It would guard against abuse by including in the tax net most regular commercial activities unrelated to the foundation's or the cooperative's public interest mission.

Income of "Hard to Tax" Groups.

A major problem with income taxation in developing countries is the lack of complete and reliable books and records among many taxpayers, particularly small and medium-sized businesses and professionals. For example, a study in Jamaica estimated that the self-employed as a sector paid taxes equivalent to only 3.7 percent of their earnings in 1983, well below the 42.5 percent legally due.¹⁴ Any attempt to apply a complex income tax to these taxpayers is likely to result in a tax that is arbitrary and open to "negotiation". Yet these "hard-to-tax" groups still need to be reached if the tax burden is to be distributed fairly across the population.

Many countries, including not only low-income countries but also middle- and high-income countries such as Korea and Japan, have resorted to methods of "presumptive" taxation to assess these taxpayers. Such methods rely more or less on industry-specific norms rather than individual books of account to estimate taxable income. The new Indonesian income tax law, for example, allows any business with annual turnover less than a certain fixed amount to choose to be taxed based on published "assessment guides" rather than an individualized calculation of taxable profit. Such a taxpayer needs only to keep a record of gross turnover, and guides are used to determine taxable income. Turkey also recently introduced a system of presumptive taxation for workers in agriculture, trade, and the professions. Under the "Living Standard Assessment System", a base income is presumed, and certain amounts of additional income are assumed to be associated with such personal characteristics as ownership of houses, cars, boats, airplanes, and race

¹⁴ Bahl and Murray, p. 19.

horses, employment of personal servants, and foreign travel. The presumed income sets a floor, so that tax is assessed on the greater of presumed or declared income.

These methods can help to reduce discretion and bargaining and to ration scarce administrative resources in a developing country environment. To be as fair and reliable as possible, any system of presumptive taxation should have a clear legal basis, and should be based on careful study of industry standards. Each guide would need to be adjusted from time to time to maintain accuracy.

DEDUCTIONS FROM INCOME.

To broaden the tax base, an expansive definition of taxable income should be accompanied by a careful limitation of deductible expenses. The necessary costs of earning income--including materials, wages and salaries, honoraria, interest, rent, royalties, travel costs, bad debts, administrative costs, and taxes other than income taxes--are in general deductible in determining the taxable income of firms. If a country wants to avoid the double taxation of dividend income (i.e., to "integrate" corporate and personal taxes), dividends paid to shareholders can also be exempt from tax at the corporate level, or the shareholder can be given a credit for the taxes paid on the dividend income at the corporate level. The latter is done, for example, in Malawi. Alternatively and perhaps preferably from an administrative perspective, dividends can be exempt from tax in the hands of the recipient, as is done in Turkey. If dividends are not exempt from tax,¹⁵ certain other payments should also be disallowed as deductions,

¹⁵ For revenue and equity reasons, both Indonesia and Jamaica decided to maintain the double taxation of dividends.

including expenses incurred for the benefit of shareholders and excessive compensation paid to employees who are also shareholders, both of which constitute "disguised dividends".

Other types of expenditures that can well be disallowed as deductions in the interest of simplicity and enforceability are fringe benefits (as discussed earlier), gifts and bequests,¹⁶ and charitable contributions.¹⁷ If they are not allowed as deductions, they should not be taxable to the recipient. In all three cases, the expenses are not necessary for business purposes and allowing deductibility (whether for firms or individuals) can open serious loopholes for tax evasion and avoidance.

Some countries grant special exemptions and deductions to individuals depending on their particular profession. For example, although the new Moroccan individual income tax is assessed on global income (replacing the previous schedular system), it grants deductions of from 17 to 45 percent of salary income of certain professions (the rate depending on the profession concerned) for costs "inherent in employment". These profession-specific deductions mean that different sources of income are effectively taxed at different rates, and the problems inherent in a schedular tax system emerge.

¹⁶ A country may want to impose a separate gift tax if it also has an inheritance tax. Without an equivalent gift tax, people would give away their assets before death to avoid inheritance tax.

¹⁷ Charitable contributions are not deductible in Indonesia. They are deductible, to a maximum of 5 percent of taxable income, in Jamaica.

Pensions and Life Insurance.

Although private pensions and life insurance plans are not as commonly used for individual long-term saving in developing countries as they are in industrial countries, they are growing in use as financial systems grow in complexity and sophistication. Tax policy need not necessarily stimulate their growth through highly preferential treatment, especially considering that high-income groups are the most likely to have access to them. However, it can facilitate their growth by avoiding any artificial barriers to their use.

To facilitate the use of pension plans, both employee and employer contributions can be allowed as deductions, with employer contributions not taxed as income to the employee. (If pension benefits are not yet vested, such contributions do not "belong" to the employee anyway.) Pension funds may then be exempt from tax on income they accrue. The payouts of pension benefits should then be fully taxable when paid to the extent they exceed the personal exemption.

Whole life and endowment insurance policies involve a significant savings element (when compared to term insurance), and they can substitute for pension plans as vehicles for providing funds for retirement. However, in practice it is difficult to tax proceeds of life insurance policies paid at the time of death of the insured. Rather than allowing a deduction for premium payments and taxing payouts, the same economic effect can result if premiums are not deductible (whether paid by an individual or by a company on behalf of an employee), but neither the proceeds nor the build-up of savings in the life insurance reserve fund is taxable. This tax treatment was chosen, for example, in the Indonesian tax reform. The time of the tax

is different from that for pensions, but the present value of the tax take remains the same.

Depreciation.

The standard way of handling capital investment for income tax purposes is to allow a firm to depreciate that investment over several years. Such depreciation can be on a straight-line or declining balance basis, or it can be accelerated--as is often done for "favored" investments. An alternative, widely discussed in the literature but rarely applied in practice,¹⁸ is to allow full writeoff ("expensing") of investment in the first year, while disallowing the deduction of interest paid on borrowing to finance such investment. Such treatment is often favored by economists because it implies a zero marginal effective tax rate on investment.¹⁹ It would also be relatively easy to administer once put into place, and it would tend to avoid distortions caused by inflation. However, critics claim that the transition costs of switching to such a system could be large. They could include significant revenue losses in the early years of introduction, when revenue-generation is often of prime concern. Furthermore, the nondeductibility of interest that should accompany expensing could initially be opposed by businesses, who might not understand the theory

¹⁸ Full expensing exists for some favored investments in Bangladesh. The idea was recently rejected in Turkey, Indonesia, and Jamaica.

¹⁹ Why a zero marginal effective tax rate? With full expensing, the government in essence becomes a full partner in the venture. The government "pays" (through the tax deduction) a certain portion of the investment (the portion being determined by the marginal tax rate) and earns a "return" through taxes charged on later profits on that investment. The profits earned on the investor's "share" of the investment (the share being 1 minus the marginal tax rate) are in essence tax-free. A zero METR does not imply a zero average tax rate. The average tax rate can still be positive because taxes continue to be charged on any remaining ("inframarginal") returns from previous investment. For a thorough explanation of this approach, see Zodrow and McClure (1988).

behind it and tend to view interest as a significant cost of doing business. In addition, such nondeductibility would need to be accompanied by tax-free treatment of interest in the hands of the recipient. Critics do not believe that financial institutions--whose income is primarily in the form of interest--should largely if not fully escape the corporate tax net.²⁰

A major objective for developing countries in designing a system of depreciation should be to keep it simple. For example, efforts at "fine-tuning" depreciation by using a large number of categories and a wide range of possible useful lives within each category should be avoided. They are difficult to oversee because of the problems in classifying individual assets. Furthermore, they facilitate tax avoidance by giving wide latitude to companies--particularly companies in tax holiday periods--to select useful lives and schedule depreciation deductions so as to minimize total taxes paid over time.

One easy method of depreciation adopted in the Indonesia tax reform is a system of open-ended accounts. Under this system, all movable assets are assigned to one of several (three in the Indonesian case) open-ended accounts based on useful life. The purchase price of any newly acquired asset is added to the value of the relevant account, and any proceeds from sale of a retired asset are subtracted from such value. No record of book value by asset need be kept.²¹ Depreciation is then calculated by applying the relevant percentage to the total

²⁰ For an interesting discussion of these issues, see World Bank, Fiscal Policy and Tax Reform in Turkey, pp. 69-73.

²¹ In the case of an extraordinary loss, as a result of casualty or termination of a large segment of the business, such loss may be fully deducted from income in the year it occurs. Thus, in this particular case the book value of the relevant assets must be calculated separately and subtracted from the amount in the relevant asset class.

account. The 1-4 year account is depreciated at 50%, the 4-8 year account at 25%, and the over-8 year account at 10%. Buildings make up a fourth category of assets, and they are depreciated individually on a straight-line basis over 20 years.

With only three classes of movable property, problems of classification of assets are minimized and calculation of depreciation deductions is simplified. Auditing can concentrate on determining that the assets included in the accounts in fact exist and are in use, rather than devoting valuable time to fine points of asset classification. Furthermore, if at a later point in time the Indonesian tax system is indexed for inflation, the open-ended accounts are easy to index. The only additional step required is to multiply their total value by the index factor each year before depreciation is calculated.

Interest Expense.

Although interest is a legitimate business expense,²² policy makers should be aware of the problem of "disguised equity". Many firms, including subsidiaries of foreign firms, report debt:equity ratios far in excess of those normally viable in firms with exclusively arms-length debt. Ratios as high as 5:1 or even 10:1 are not unheard of in some countries. Much of the debt, however, is from parent companies or other related parties, and therefore it substitutes for equity investment. If interest is deductible and dividends are not (i.e. if

²² This assumes that investment is depreciated over several years rather than fully expensed in the first year. Interest incurred for personal consumption--such as home mortgage or credit card interest--is not a necessary expense for earning income and therefore need not be deductible under a strict definition of an income tax. Mortgage interest deductions are essentially "tax expenditures"--government subsidies, in this case for home ownership.

the business and personal taxes are not integrated), such "disguised equity" presents a method of avoiding taxation of distributed earnings.

One way to control this method of tax avoidance is to impose limits on the debt:equity ratios that are permissible for tax purposes. A ratio as low as 1:1 may not be unreasonable for manufacturing firms, while a slightly higher ratio may be allowed for non-manufacturing firms. One single ratio of, say, 2:1 would be reasonable for all firms and easier to administer. Debt above such ratio could be reported in financial statements, but interest on such debt would not be deductible in calculating taxable income.²³

TAX RATES.

Residents.

The concept of a global income tax for residents means that all income is aggregated and a single rate structure applied. Although the choice of rate structure will always be influenced by the basic goals of tax reform, certain general guidelines are helpful. First, given the low level of per capita income and the difficulties of tax administration in developing countries, the exemption level (or standard deduction) should be high enough--at least two to three times per capita income--to exclude the great majority of individuals. Jamaica's income tax law, reformed in 1985, allows a standard deduction equal to two times per capita GDP and thereby legally exempts over 80 percent of the

²³ In addition, the law could provide authority for the tax administration to recharacterize debt as equity for tax purposes if such debt is between affiliated firms. Such provision could be used, for example, if the debt had characteristics (such as a nonmarket interest rate or an overly flexible payment schedule) not typical of arm's-length transactions. Even if not applied much in practice, the mere existence of this provision would provide some means to police and could thus inhibit obvious abuses of interest deductibility.

population. Indonesia's standard deduction is even more generous, legally exempting over 90 percent of the population. In general, the poorer the country, the greater the percentage that should be excluded to satisfy both administrative and equity concerns. As a country's per capita income grows, the reach of its income tax can then effectively expand.

Second, above the exemption level the rate structure should be progressive only to the extent that the tax remains enforceable. A large exemption level results in a highly progressive tax incidence in and of itself. Sharply progressive rate structures above that exemption invite widespread evasion and avoidance even in the most advanced countries, and would be particularly problematic in a country with more limited administrative resources. In fact, to the extent possible given the need for some degree of progressivity on equity grounds, the marginal tax rate should be flat over a wide band of income for both middle-income individuals and large business firms. A flat tax avoids the problems associated with the "bunching" of income earned over several years (such as capital gains) or by several persons (such as family members combined in a joint tax return). In addition, given the ease of calculating tax liability under a flat tax system, withholding of taxes on wage or investment income can be a more accurate approximation of final tax liability than under a progressive system.

Third, tax rates should be low enough to serve by themselves as a form of generalized tax incentive for entrepreneurial activity by an individual or firm. If a country wants to attract foreign investment, for example, a relatively low tax rate (on the order of 30 to 40 percent) may well be easier to understand and more effective than a

plethora of investment incentives with a high underlying tax rate. Of course, this consideration must be balanced against revenue needs.

Recent income tax reforms have tended to follow the above prescriptions. Jamaica's new income tax has only one rate--33 1/3 percent--while Indonesia's new tax has three rates--15, 25, and 35 percent. The 15 and 25 percent brackets cover most middle-income individuals and small businesses, while the 35 percent marginal rate applies only to wealthy individuals and most businesses. The Phillipines also recently lowered its maximum rate from 60 to 35 percent.

Nonresidents.

Nonresidents are in general taxable only on income with its source in the taxing country, and the tax is usually collected through withholding (on interest, dividends, rents, royalties, and payments for services). Nonresidents are not usually required to file tax returns. Withholding tax rates are typically set somewhere between 10 and 20 percent. The choice of a withholding rate should be influenced by several concerns.

First, the rate of withholding on dividends and other remittances of foreign investors to their parent companies abroad should ideally be set so that local earnings do not bear a total tax significantly in excess of the home country tax on such income. For example, if company income were first taxed at 40 percent, and then a 10 percent gross withholding tax were applied to the dividends or other profit remittances paid out of after-tax income, the total effective tax rate on the underlying corporate income would be 46 percent. Combinations of 35/15, 30/15, or 30/20 would yield total tax burdens of 44.75, 40.5, or

44 percent, respectively. If the home country grants a foreign tax credit for this amount (as in the United States), the host country might as well tax up to the home country rate. But any combination of company and withholding tax rates that exceeds the home country rate will lead to a real extra burden that may discourage foreign investment. If the home country exempts foreign source income altogether (as in some European countries), any reduction in host country rates will be favorable for the investor.

Second, the rate should ideally leave some room to be lowered by treaty in return for concessions by the treaty partner.²⁴ This consideration would tend to support a rate somewhat higher than 10 percent, itself a common rate in treaties. A higher withholding rate also has the advantage of encouraging retention of profits in the host country, particularly when combined with a modest underlying rate.

Third, the rate should ideally be the same for all types of income remitted abroad to minimize the incentive to recharacterize payments. For example, if interest were subject to a lower rate than dividends, there would be an even greater incentive than already exists (because of interest deductibility) for a foreign investor to be highly leveraged.

Taken together, these considerations push in the direction of a withholding rate of between 12.5 and 20 percent, depending on the basic income tax rate structure. The Indonesians impose a basic rate of 35 percent and a withholding tax rate of 15 percent. If the basic rate is

²⁴ For example, Jamaica's 33 1/3 percent rate of tax "deduction at source" has been lowered to 10 to 15 percent in treaties with several industrial countries. This is not to say that developing countries should consider tax treaties with industrial countries as high priority. In fact, the benefits to be gained from such treaties are often questionable, while the costs in lower tax collections can be significant.

as high as 40 percent, a lower withholding rate is called for. If the basic rate can be kept at 30 percent, a rate as high as 20 percent is not unreasonable.

INVESTMENT TAX INCENTIVES.

Many developing countries provide generous tax incentives to investors in the form of tax holidays and investment allowances. In some cases these incentives are applied across the board, while in others they are targeted to certain types of investment, such as investment in particular locations or sectors. They are often complex, costly, inefficient, and inequitable in reaching their goals. Complexity can arise if a system of tax incentives is "fine-tuned" to fit the incentives offered to particular characteristics of an investment project. In such a case it may be unclear to investors and government officials alike just what incentives are available. High cost can arise not only from tax revenue legally foregone, but also from firms' ability to avoid even more tax by manipulating accounts. This is especially true in the case of tax holidays. Income can be transferred into the holiday period and expenses out of it (whether within the same firm or between related firms), thereby raising net income in the holiday period and reducing it in later years when taxes are due. Tax incentives can be inequitable if only large firms are eligible for them or if only large firms have the resources to wade through cumbersome government procedures to obtain them. Finally, tax incentives can be inefficient if they reward activity that would occur anyway. For example, few firms would relocate to a backward area for only one extra year of tax holiday. In fact, in many cases tax incentives have little

if any impact on the decision to invest. Empirical research on foreign investment indicates that tax incentives are less important to most potential investors than other characteristics of the host country, such as political stability, market size, economic growth potential, production costs, and the general policy environment.

Before offering tax incentives, countries are well-advised to reduce domestic distortions and encourage investment in other ways, such as correcting overvalued exchange rates or investing in needed infrastructure. If incentives must be offered, investment allowances are preferable to tax holidays. They are relatively easy to understand and implement, and they provide less scope for abuse. Their economic impact is to lower the marginal effective tax rate ("METR") on new investment. At the extreme, a 100 percent investment allowance (full expensing) reduces the METR to zero.

INDEXING FOR INFLATION.

High levels of inflation can lead to significant distortions if the calculation of taxable income is based on historic costs alone. Historic-cost depreciation understates investment costs, leading to an overstatement of taxable income. On the other hand, fixed nominal interest overstates the cost of capital in inflationary times; the inflation component is in effect a payment of principal, while only the "real" component is a true cost. Allowing full deduction of nominal interest provides highly-leveraged firms with a very effective means to understate taxable income. Indexing the tax base for inflation involves adjusting four accounting items--depreciation, interest, inventories, and capital gains--to remove the effect of changes in the general price

level from the calculation of taxable income.²⁵ Although helpful in correcting for distortions in the measurement of income, indexing does add to the complexity of an income tax. As a rough rule of thumb, indexing is probably not worth the trouble if inflation is low--say, less than ten percent per year. If inflation is over 20 percent per year, indexing is probably much more important. In between, the decision should rest on an assessment of administrative capacity.

Whether or not the tax base is indexed, absolute amounts fixed by the tax law--such as tax brackets, personal exemptions, and penalties for noncompliance--can quite easily be indexed through regular adjustment. Indexing of penalties is particularly important to prevent their becoming obsolete.²⁶

THE TAX TREATMENT OF THE FAMILY.

Personal exemptions for individuals provide a method of excluding those with low income from the income tax net. Most countries allow personal exemptions for each member of a family in order to take into account the larger expenses of larger families.²⁷ As noted earlier, setting relatively high personal exemption levels--on the order of two

25 A simple and accurate method of indexing involves the following three steps. First, all real assets (primarily depreciable assets and inventory) are written up by the index factor, and this amount is included in profit on the income statement. Second, all real liabilities (owners' equity) are written up by the index factor, and this amount is subtracted from profit on the income statement. The net effect of these two steps is to add back into income the pure inflation element of interest deductions taken on debt used to finance purchases of real assets. Third, depreciation is calculated on the written-up value of depreciable assets (Harberger, 1982). For a discussion of indexing methods, see World Bank (1987), pp. 74-77.

26 Penalty clauses in the old Indonesian tax laws typically called for "six months in jail or a fine of 600 rupiah [less than U.S.\$1]"!

27 Exemptions for children are sometimes lower than exemptions for adults. Some countries limit the number of children for whom exemptions can be taken in order to support a trend toward smaller families.

to three times per capita GDP--is an excellent way both to insure progressivity in tax burden and to concentrate scarce administrative resources on firms and high-income individuals. However, deciding on the structure of personal exemptions--that is, the tax treatment of the family as a unit--can involve some difficult tradeoffs.

The following concerns are generally considered in designing the exact structure of personal exemptions, tax rates, and filing requirements of various members of a family:

- a. Incentives for work: Ideally the system should create no disincentives to additional work; i.e. no one should be worse off after-tax by earning more income before-tax.
- b. Incentives for marriage: Ideally there should be no tax penalty for marriage, i.e. the tax burden on two persons should not rise automatically simply because they marry.
- c. Equal tax for equal income: Two families of the same size with the same income should ideally pay the same tax, no matter who earns the income.
- d. Ease of withholding: Employer withholding should be kept as simple as possible and should constitute the final tax payment for employees who earn no outside income.

Although everyone can agree on these goals, it is difficult to satisfy them all simultaneously if the tax rate structure is at all progressive and personal exemptions are given for dependents. If each spouse in a family files and pays tax separately, there will be no "marriage penalty" and no "work penalty", but they together will pay less tax than one-earner families with equal income if they each get the benefit of exemptions for dependents and lower rate brackets. If each family must consolidate income and file one joint return, families of equal size with equal income will pay equal taxes. However, two working married individuals will be taxed heavier than two single individuals with comparable incomes to the extent the consolidation pushes the

former into a higher tax bracket. Furthermore, withholding cannot be final because an employer has no way of knowing the income of an employee's spouse.

Given administrative constraints, a developing country may want to opt for a structure of personal exemptions and tax rates that is easy to administer through withholding. Such a system would minimize the extent of progressivity in the tax rate structure and would allow full personal exemptions (and the full benefit of any lower rate brackets) to each spouse if both work.²⁸ (If it is possible to implement effectively, only one spouse should be allowed to claim deductions for dependents.) Given no outside income, employer tax withholding could then constitute the final tax payment by a couple, and they would not be required to file individual tax returns. Such a system would also avoid any work or marriage penalty. The only disadvantage would be that families with only one earner might pay more tax (to the extent effective rates are progressive) than families with two earners and the same total gross income.

ADMINISTRATIVE PROCEDURES.

Tax reform in developing countries should be concerned not only with substantive provisions of tax design, but also with the procedures by which taxpayers meet their tax liabilities and the administrative structure within which tax officials carry out their responsibility. Indeed, given the low level of tax compliance in most developing countries, improvements in procedures and administration are critical to

²⁸ Such a rule was adopted in both Jamaica and Indonesia.

the success of any substantive reform. Some important procedural issues are discussed below.

Withholding Mechanisms.

Withholding of tax at the source is an extremely important tool of tax administration, particularly in developing countries where enforcement after-the-fact is hampered by a shortage of administrative resources. As with other aspects of tax design, withholding mechanisms should be as simple as possible.

Employment income.

Withholding of income tax on employees is an indispensable tool for collecting income tax revenues. Both Jamaica and Indonesia collect over 90 percent of personal income taxes through withholding. Employers should be required to withhold income tax on all payments to employees of wages, salaries, and honoraria, in whatever form. Withholding should also be required on payouts of pension benefits by pension funds, provided that the contributions were tax-deductible.

Care should be taken to insure that the withholding tax is not simply a gross payroll tax. This requires that the tax be personalized - that the amount to be withheld be calculated separately for each employee by applying the general tax rate schedule taking into account the personal exemptions for which that employee is eligible. Employers should be required to supply the tax department with a record of taxes withheld for each individual employee and to inform such employee of the amount withheld. Making an employee aware that taxes are being paid on his or her behalf can be an important first step in introducing that employee to a system of personal income taxation. As discussed above,

with simple rules regarding the tax treatment of the family, withholding can be final unless the employee earns significant outside income.

Capital income.

Withholding is also a convenient way to collect tax on many types of income from capital, including interest, dividends, rents, and royalties. This is particularly true for income paid to nonresidents, because of the inability to enforce their taxpaying obligations any other way. Virtually all countries impose withholding taxes on capital income paid to nonresidents.

In the case of domestic payments, the recipient must file a tax return, and there is thus less need to require withholding. However, if the payer is a large organization making regular payments of interest, dividends, rents, or royalties, such as a bank or a large firm, withholding at a rate of 10% or 15% (later creditable by the recipient against final income tax due) can lead to greater tax compliance without an unreasonable administrative burden.²⁹ Extending the withholding requirement to all payers of such forms of income, including individuals, however, would complicate its administration and weaken its enforceability.

Current Payment (P.A.Y.E.) System.

Aside from being subject to withholding by other parties, taxpayers in any country should be required to make estimated payments of taxes during a year both to speed up tax collections and to lessen the burden of one large lump-sum payment at the end of the year. Such payments can be monthly or quarterly. Perhaps the easiest way to

²⁹ For example, Thailand, Pakistan, Turkey, Indonesia, and Korea are examples of countries that tax domestic interest income through withholding. Indonesia also imposes analogous withholding requirements on other types of capital income.

calculate the amount due is as a fraction (one-twelfth or one quarter) of the previous year's tax liability. Although such a method of calculation is not as accurate as one based on current records, it is easy to apply in a country where reliable records are often nonexistent, and it is preferable to a system based exclusively on gross turnover. As accounting and auditing standards improve, a more accurate system of estimation can be used, accompanied by fines for underpayment.

Self- vs. official assessment.

Given administrative constraints, one goal of tax reform in developing countries should be to place more responsibility on the taxpayer (or tax withholder). A move from a system of official assessment of all taxpayers by tax authorities to a system of self-assessment is one way to further this goal. Under a self-assessment system, taxpayers are legally required to obtain and file a tax return, and official assessments are issued only if a taxpayer fails to file a return, if an audit concludes that tax was underpaid or a refund wrongly given, or if the taxpayer does not keep books and records that are adequate for calculating the amount of tax due.

Such a move to self-assessment can address several administrative problems simultaneously. First, it can reduce the number of cases that tax officials must address each year, leaving more time to study each case more carefully.³⁰ If strong penalties are imposed when wrongdoing is found in a few cases, the example should have a deterrent effect on other taxpayers. In addition, the move toward self-assessment reduces

³⁰ For example, Pakistan recently implemented a simple self-assessment procedure for individual tax payers with income less than Rs. 100,000. This allows tax authorities to concentrate their auditing efforts on a smaller number of taxpayers (approximately 30,000) who account for 90 percent of total income tax receipts. World Bank (1989), pp 42-43.

the contacts between taxpayers and tax officials, thereby reducing the opportunities for collusion between them. A taxpayer is no longer forced to depend on the issuance of a tax assessment to determine his final tax liability, and the possibility of "bargaining" exists only if the taxpayer is chosen for audit.

The success of a tax regime based on self-assessment depends critically on a well-managed system of audit. The choice of cases to be audited must be out of the hands of the auditors themselves, and each audit must be conducted thoroughly, with appropriate sanctions applied in full and publicized to create a deterrent effect. Developing such an audit system should be a primary goal of tax administrations in developing countries.

Refunds.

For any tax system to be respected by the public, it must provide for dependable refunds in cases where taxes are overpaid. Such overpayments are common if income tax is withheld by third parties.³¹ The ability to obtain a timely refund of any excess payment will greatly enhance the willingness of a taxpayer to comply with the tax laws.

Operation of a tax refund system has proven, however, to be difficult in many countries. Given budget constraints and the difficulty of raising revenues, officials are understandably hesitant to return amounts already collected. Furthermore, as with any mechanism for distributing public funds, the power over tax refunds can be misused by the officials in charge for personal gain. Refunds may be difficult

³¹ The need for refunds is also likely to arise under a VAT, if VAT is payable on the purchase of capital goods or inventory by a new or expanding business.

to obtain without making significant side payments to those in control of the refund process.

As with so many issues involving tax reform in developing countries, decisions on refund procedures must strike a balance between the needs of taxpayers and the capacity of the tax administration. Refunds should be available, but tax authorities may want to audit refund requests more stringently than other documents. Interest should be payable on refunds if they are not made quickly; the government may want to set some period after which interest will accrue.

Enforcement mechanisms.

Improving compliance with tax laws will depend in part on the ability of tax administrations in developing countries to increase the effectiveness of enforcement mechanisms. The first line of enforcement is the imposition of interest and monetary penalties for late or non-payment. The interest rate should be adjustable and should always match or exceed the market rate to eliminate any monetary benefit from delay. Setting monetary penalties can be difficult; they need to be large enough to provide some deterrence but not so large that tax officials would hesitate to apply them in practice. Late payments should be subject to a penalty (in addition to interest) of a certain percentage of the amount owed (in the range of 2-5 percent) per month. Larger penalties (again calculated as a percentage of amount owed) should apply if a tax return is not filed at all or if adequate books are not maintained and produced upon audit.

If monetary penalties do not induce compliance, the second line of enforcement is the seizure and auction of property. While this is a very important tool for tax enforcement, tax authorities may be hesitant

to use it if they question the quality and/or legitimacy of the tax assessment being enforced. Strengthening collection mechanisms must go hand in hand with strengthening administrative procedures as a whole.

The last line of enforcement is criminal penalties. The threat of prison is certainly a strong inducement to pay taxes; however, countries vary in their willingness to send tax evaders to jail. Each country must make this decision individually, considering the cultural and legal norms of the community.

Objections and appeals.

Any tax system needs avenues for taxpayers to air grievances and objections to official action in order to offset the power of tax officials to collect taxes through seizure of property and other enforcement action. In general it is a good idea to have a hierarchy of appeals mechanisms under which a taxpayer has to submit a dispute to internal review by the tax administration before proceeding to independent review by the courts. Given the complexity of many tax issues, an independent tax court--such as exists in Mexico--may be a better avenue for external review than more general courts. In any case, the integrity of the review process--and of the tax system more generally--will be preserved only if each level of review is subject to time limits, if cases are handled objectively, honestly, and professionally, and if the government must pay interest on awards won by a taxpayer. The integrity is further safeguarded, and the educational function of the review process is enhanced, if external appeal decisions are published and widely distributed. Without such integrity, taxpayers with large amounts at stake will avoid official complaint mechanisms and

opt for using whatever channels of influence might be available, thus heightening the "bargaining" element in tax administration.

One difficult issue that must be faced in setting policies regarding objections and appeals is the question of how much of a contested assessment must be paid before an objection or appeal is accepted for review. Requiring that 100 percent of an assessment be paid can undermine the usefulness of the appeal process, particularly if corruption is a problem. If official assessments are unreasonably excessive, the costs of paying and waiting for later relief may be so high that taxpayers prefer to "negotiate" before assessments are issued. On the other hand, waiving any requirement to pay might cause frivolous objections to proliferate simply as a device to delay payment of tax legally due. Some intermediate solutions might involve requiring partial payment or payment into an escrow account.

Books and records.

A major impediment to income tax administration and enforcement in developing countries is the failure by many taxpayers to maintain and submit books and records that are accurate and adequate to calculate tax due. The majority of taxpayers are likely to be small and not well-trained in modern accounting techniques, and many of those taxpayers who are sophisticated enough to keep complete books try to avoid revealing them to taxpayers. It is often said that taxpayers keep three sets of books--one for the tax office (showing low profits), one for the banks (showing high profits), and one for the owners (showing actual profits).

A system of "presumptive" taxation for small taxpayers, as described earlier, can avoid some of the problems associated with the keeping of books and records. Under such a system a taxpayer need keep

only a record of gross turnover; industry-specific norms are then applied to determine taxable income. For most taxpayers, however, there is no way to avoid the need for complete books of account, including records of cash and bank transactions, accounts receivable and payable, and inventory, as well as balance sheets and income statements drawn up at the close of each taxable year. Strict penalties need to be applied when taxpayers fail to submit books when required or produce falsified books or records. Adequate bookkeeping is the foundation upon which income taxation rests; without it, sophisticated tax policy analysis and reforms in laws and procedures can only be of limited value.

This paper has summarized the major issues typically faced in reforming income taxes in developing countries. More revenue, increased efficiency, and a better distribution of the tax burden are usually the underlying goals. Improving enforcement and compliance by simplifying the tax structure and increasing the legitimacy of the tax process is usually the major challenge.

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