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SEMINAR ON THE PROGRAMMING OF ECONOMIC DEVELOPMENT

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THE ROLE OF TAXATION IN ECONOMIC DEVELOPMENT
by
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I. Fiscal aspects of development policy

1. Problems of taxation, in connection with economic development, are generally discussed from two different points of view, which involve quite distinct and often conflicting considerations: the point of view of incentives and the point of view of resources. Those who believe that it is the lack of adequate incentives which is mainly responsible for insufficient growth and investment are mainly concerned with improving the tax system from an incentive point of view through granting of additional concessions of various kinds, with loss regard to the unfavourable effects on the public revenue. Those who believe that insufficient growth and investment is mainly a consequence of a lack of resources are chiefly concerned with increasing the resources available for investment through additional taxation, even at the cost of worsening its disincentive effects.

2. In my opinion a great deal of the prevailing concern with incentives is misplaced— except in particular cases, such as in the matter of tax concessions granted to foreigners which may increase the inflow of capital from abroad 1/ it is limitation of resources, and not inadequate incentives, which limits the pace of economic development. Indeed the importance of public revenue from the point of view of accelerated economic development could hardly be exaggerated. Irrespective of the prevailing ideology or the political colour of particular governments, the economic and cultural development of a country requires the efficient and steadily expanding provision of a whole host of non revenue-yielding

1. See below, para. 13

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services - education, health, communications systems, etc., commonly known as "infrastructure" - which require to be financed out of government revenue. In addition taxation (or other compulsory levies) provides the most appropriate instrument for increasing savings for capital formation out of domestic sources. 1/

3. The only feature that is common to most "under-developed" countries is the shortage of revenue which makes it impossible for them to provide essential public services on the required scale. The common assumption is that these countries are unable to lift themselves out of their predicament because of their very poverty. No doubt the "taxation potential" of a poor country - the proportion of its gross national product that can be diverted to public purposes without setting up intolerable political and social pressures - is generally lower, and in many cases appreciably lower, than that of a rich country. But more important, in my view, is the low "coefficient of utilization" of that potential - due to bad tax laws, bad tax administration, or both - which in turn is only partly to be explained by lack of knowledge, understanding, or of administrative competence - it is also the result of resistance by powerful pressure groups who block the way to effective tax reform. Accelerated development in all such cases is predominantly a political issue: expert advice can point the way, but overcoming resistance to more effective policies for mobilising resources must depend on the collective will, operating through political institutions.

1. The only alternative is inflation which by comparison is a clumsy and ineffective instrument for mobilising resources, since a large part of the "enforced" reduction in the consumption of the mass of the population, brought about by the rise in prices in relation to incomes, is wasted in the increased luxury consumption of the profit-earning classes. Also, it is difficult to conceive of inflation as more than a temporary instrument for mobilising resources; once wages rise in consequence of the rise in prices, the rate of price-inflation is accelerated, without securing any further savings.
4. The inadequacy of public revenue has two important consequences. It forces undue economics precisely in those fields of public expenditure (like health and education) which are more easily sacrificed in the short run, but are the most important from the point of view of long run development. It also yields persistent budgetary deficits which force the monetary authorities to follow highly restrictive credit policies (to protect the balance of payments and to limit the pace of inflation) which in turn has highly undesirable effects on the pace of economic growth, without fully compensating for the effects of the weakness in the state of public finances on the stability of the currency.

5. Many underdeveloped countries suffer, not only from lack of revenue, but also from an irrational scale of priorities in the allocation of public funds. Too much may be spent on the (real or fancied) needs of defense; or for ostensions purposes of various kinds - such as public buildings and ornaments, lavish diplomatic missions etc. There is nothing much to be said about all this, beyond noting the fact; and for the rest of this paper we shall consider the problem entirely from the revenue side: what determine a country's "taxation potential", and how can that potential be more fully exploited?

6. The "taxation potential" of a country, as above defined is obviously greatly dependent on (i) real income per head; (ii) the degree of inequality in the distribution of income; (iii) the sectoral distribution of the national income, and the social and institutional setting in which the output of particular sectors is procured; (iv) the administrative competence etc. of the tax-gathering organs of the government.

7. It is a commonplace to say that taxes can only be paid out of the "economic surplus" - the excess of production over the minimum subsistence needs of the population. Moreover, in so far as such surplus is not consumed by the people to whom it accrues, but is saved and invested, it can only be made available for the purposes of public expenditure at the cost of reducing the rate of capital accumulation of the community. This is bound to react adversely on the country's economic development except in so far as investment is diverted from inessential or "luxury" purposes (such as luxury housing) to purposes important for development. It would be more correct to say therefore that the taxation potential of a country depends on the excess of its actual consumption over the minimum essential consumption of the population, and of its investment which serves the needs of future luxury consumption.
8. In practice however the "minimum essential consumption" of a community cannot be defined or measured; it is not just a matter of the biological requirements of subsistence (which themselves vary greatly with climate and location) but of social conventions and habits, and the actual standard of living to which the bulk of the population of any particular community has become accustomed. Since governments ultimately depend on the consent of the people whom they govern, it is impossible as a matter of policy to compress, by means of taxation, the actual standard of living of the mass of the population outside fairly narrow limits, though in a progressive country, with a rising income per head, it is always possible to raise the taxation potential over a period by slowing down the rate of increase in consumption.

9. It can happen, on the other hand, that the amount of food or other necessities produced in a country is limited not by the availability of natural resources (land), or by knowledge or ability, but by the costumary way of life of the agricultural population, who prefer a maximum of leisure and a minimum of material income, and therefore work just hard enough to cover their immediate and traditional needs. In such circumstances additional taxes levied on them would tend to make them work harder and produce more — i.e., to reduce their leisure, rather than their standards of material consumption. Taxation would then act as an incentive to produce more (as opposed to forcing the people concerned to consume less) and this may not encounter the same kind of resistance, particularly if the increase on taxation is a gradual one. From this point of view the countries of Africa — where, in general, shortage of land is not a critical factor in agricultural production — are more favourably placed than the under-developed countries of Asia.

10. Excluding however the case where taxation may itself serve as an instrument for increasing real income per head, the taxation potential of a country will be strongly dependent on the prevailing inequality in the distribution of the national income, which in turn is closely linked to the relative importance of incomes derived from property, as against income derived from work, and to the degree of concentration in the ownership of property. As between two countries with the same real income per head, the

1. If this were not so, the taxation potential would vary enormously with the actual level of real income per head. Supposing this potential were 10 per cent in a country with an income per head of 60 dollars a year, it would be no less than 82 per cent in a country whose income per head is 300 dollars a year. Yet even the richest countries with incomes per head of over 1000 dollars a year find it very difficult to raise more than 30-35 per cent of their G.N.P. in taxation.
 accustomed standard of living of the bulk of the population will evidently be the lower, and the share of unecessary or luxury consumption larger, in the country in which a larger share of total incomes accrues to a minority of wealthy individuals. 1/

11. From this point of view the under-developed countries of different regions of the globe (or even individual countries within the same region) show the widest differences. At one end of the scale a country such as India, with one of the lowest incomes per head of population, has a high ratio of property income in total income (a ratio that is comparable to that of the country with the highest income per head, the United States) and in consequence has a relatively high taxation potential in relation to real income per head. 2 At the other end of the scale there are some under-developed countries (particularly in Africa) in which incomes derived from property ownership are relatively insignificant and in which a wealthy property-owning class can hardly be said to exist.

12. The share of the national income of under-developed countries accruing to property is largely dependent on the pressure of population on the land, and the prevailing system of land ownership. In the relatively over-populated countries of the Middle East and Asia, a considerable share of income accrues (or has accrued, until recently) to a wealthy land-owning class who not only pre-empt an undue share of the national resources for their personal ends, but whose very existence bars the way to the development of a more efficient agriculture. Even in countries where the ratio of population to natural resources is relatively favourable (as in many of the countries of Latin America) where the fertile or accessible land is firmly held by feudal absentee owners, incomes derived from the ownership (as distinct from cultivation) of land account for a considerable share of incomes produced. This results in a high ratio of resources being devoted to unnecessary consumption. The same is true of countries in the earlier stages of industrialization, where fortunes made in

1. This is not to suggest that either the inequality of incomes or the inequality in standards of consumption could be eliminated by taxation. It is not possible or expedient to prevent the owner of the successful business from enjoying the fruits of his success during his lifetime — any more than it is possible to prevent scarce talent from earning its high reward in a Socialist state. But clearly not all forms of economic privilege fullfill any positive social function — absentee landlords, for example, and the experience of Western Europe and North America has shown that the consumption of the entrepreneurial class can be reduced within wide limits by means of progressive taxation without interfering either with incentives or the means of continued growth and accumulation. (It is consumption, rather than savings out of profits which show wide difference between countries, according to the nature of their tax systems.)

2. Although the 'coefficient of utilization' of that potential appears to be rather low.
the course of industrial development escape taxation, and where in consequence a much higher share of the profits earned in industry and commerce are devoted to personal consumption. 1/ In view of this, expressed as a proportion of G.N.P., the "taxation-potential" of the

1. In a study of Chile some years ago I found the following percentage allocation of the gross national product between various categories of expenditure:

**Chile: Allocation of Gross National Product in 1953 by Categories of Expenditure, in Percentages**

- **Gross Domestic Investment (Public and Private)**
  - of which
    - **Gross Fixed Capital Formation**
    - **Increase in stocks**
  - Government Current Expenditure
  - **Personal Consumption**
    - of which
      - Wage and Salary Earners (69 per cent of active population) 37
      - Self Employed (31 per cent of active population) 18
      - Recipients of profits, interest and rent 22

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Gross Domestic Investment</td>
<td>12</td>
</tr>
<tr>
<td>of which</td>
<td></td>
</tr>
<tr>
<td>Gross Fixed Capital Formation</td>
<td>9</td>
</tr>
<tr>
<td>Increase in stocks</td>
<td>3</td>
</tr>
<tr>
<td>Government Current Expenditure</td>
<td>11</td>
</tr>
<tr>
<td>Personal Consumption</td>
<td>77</td>
</tr>
<tr>
<td>of which</td>
<td></td>
</tr>
<tr>
<td>Wage and Salary Earners</td>
<td>37</td>
</tr>
<tr>
<td>Self Employed</td>
<td>18</td>
</tr>
<tr>
<td>Recipients of profits, interest and rent</td>
<td>22</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
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The total share of property in G.N.P. was 34% of which direct and indirect taxation took up little over 12% (i.e. 4.5% of G.N.P.) and about one-fifth (or 7.5% of G.N.P.) was saved. If an effective system of taxation had existed which compressed property owners' consumption by one-half, this would have released resources sufficient to double government current expenditure, or alternatively to increase gross fixed capital formation by 125 per cent.

In the highly industrialised countries of the U.S. and the U.K. the share of G.N.P. accruing in the form of gross profits, interest and rent is much smaller (less than 25 per cent in 1953) and the proportion paid in taxation much greater. Property-owners' consumption accounted for only about 7.5 per cent of G.N.P. in the U.K. in 1953 as against Chile's 22 per cent.
semi-developed countries of Latin America (with incomes per head of $200 – $300 a year) must be fully as large as that of the highly developed countries, although their actual tax revenues is typically only one-third or one-half as large. 1/

13. There are some under-developed countries which, while they lack a domestic property-owning class, have important foreign enterprises in their territory (for the exploitation of valuable minerals or the product of plantations), so that a considerable share of their gross domestic product accrues to non-residents. Since the right of a country to tax all income arising within its jurisdiction is now firmly established, this provides a source of taxation that is essentially similar to that of a wealthy domestic property-owning class. There is a danger however that owing to the comparative ease with which this source can be tapped (by means of export duties, or taxes on income and profits) such taxation may be carried to the point where it inhibits the development of export industries which may be vital to the development of the economy. 2/ On the other hand many underdeveloped countries have recently been competing with one another in according all kinds of tax privileges and immunities to newly established foreign enterprises in an attempt to attract foreign capital to their own territory, with adverse consequences on their ability to collect revenue. Whilst it can plausibly be argued that an underdeveloped country gains from the inflow of foreign capital even if the income acquiring from the investments is left untaxed – owing to the wage and salary incomes generated as a result, and the increased export earnings – it is an uncertain matter how far the total flow of capital investment from the developed to the under-developed areas is enhanced in consequence of such policies, and if it is not, such "beggar-my-neighbour" policies on stimulating development deprive the under-developed countries of revenue without any compensating benefit. /

14. Under-developed countries differ also as regards the relative magnitude of the "non-monotized" or subsistence sector, and the "monotized" or market-exchange sector, as well as the nature of the prevailing type of enterprise in each. The most appropriate forms of taxation will

1. Tax revenue accounts for 9 per cent of G.N.P. of Mexico, 14 per cent of Chile, 10 per cent of Brazil, 16 per cent of Venezuela (excluding oil royalties).

2. It is said, for example, that the excessive taxation of the foreign owned copper mines of Chile was largely responsible for the decline in the saharo of Chile in the world copper market.

3. This point will be further discussed in paragraph 36–38 below.
differ as between an economy where commercial and manufacturing activities are carried on by small traders and one where they are concentrated in the hands of large-scale business enterprises. Similarly, the prevailing forms of land tenure, the nature of social and family relationships, the extent of economic inequality, etc., call for differing methods of taxation of the subsistence sector. The general tendency in most underdeveloped countries is to throw a disproportionate share of the burden of taxation on the "monetized" or market sector, and an insufficient amount on subsistence agriculture. The reasons for this are partly administrative and partly political — taxes levied on the agricultural community are far more difficult to assess and collect, and are socially and politically unpopular because they appear unjust — the people in the "subsistence sector" are, individually, always so much poorer than the people in the market sector. Yet for reasons set out in paragraphs 17–18 below, it is the taxation of the agricultural sector that has a vital role to play in accelerating economic development; the disproportionate taxation of the "monetized" or market sector tends to retard economic progress by reducing both the source and the incentives to accumulation.

15. The general conclusion is that the efficient utilization of the taxation potential of an under-developed country raises problems which vary with the circumstances of each country, though certain features may be common to all of them. The term "under-developed countries" covers a wide variety of different situations, and it would be more appropriate to group the different under-developed countries into three or four separate classes, but for the fact that any attempt at such a classification would raise as many new problems as it solves. From the point of view of taxation and taxable capacity, the extent and importance of a domestic landowning class; the nature of enterprise in the secondary and tertiary sectors; the role and importance of foreign enterprise; and finally the competence and integrity of tax administration are the main issues.

16. In the remaining sections of this paper we shall consider separately the issue raised by (i) the taxation of the agricultural sector; (ii) the role of indirect (commodity) taxation; (iii) direct taxation on income and capital; (iv) the taxation of foreign enterprises and of foreign income; (v) compulsory savings and (vi) problems of tax administration.

II. The taxation of the agricultural sector

17. The most important common feature of under-developed countries is that a high proportion of the total population is occupied in the so-called "primary" or subsistence agricultural sector; indeed the proportion of the population engaged in the provision of food supplied for domestic use is the best available index of the stage of economic development of a country.
In the poorest and most backward economies it reaches 80-90 per cent; in the relatively poor but semi-developed economies it is around 40-60 per cent; in the highly developed areas it is 10 per cent or less. This means that as development proceeds, the proportion of the working population engaged in producing food for domestic consumption is steadily reduced, and the proportion engaged in manufacturing, commerce and services is steadily increased. In order to make this possible, the proportion of food produced on the land which is not consumed by the food producers must steadily increase; this in turn inevitably involves that each family engaged in food production should sell a steadily larger part of its output for consumption outside the agricultural sector. Unless this happens it is impossible for the non-agricultural sector to expand so as to occupy an increasing proportion of the community's man-power. Such an expansion of the "agricultural surplus" cannot be relied upon to arise automatically as part of the over-all process of growth in the economy. Economic incentives do not operate in the same way in the "subsistence sector" as in the case of industry and commerce. A shortage of food is not likely to call forth increased production; a rise in the price of locally produced food may even lead to a decrease of the amounts which are offered for sale since it may cause the agricultural families to reduce their amount of work (or increase their own consumption) if their own needs for things which can only be procured with money can now be satisfied in exchange for a smaller quantity of foodstuffs. But since, on account of the nature of food as a primary necessity, a very large part (and if necessary, an increasing part) of the urban worker's income is spent on food, it is the supply of foodstuffs to the non-agricultural sectors which limits the effective demand for the products of the non-agricultural sectors. Hence it is the growth of the demand for labour outside agriculture which is limited by the proportion of food production which goes to the market (as against the food consumed by the food producers themselves), and not the other way round.

18. It follows that the taxation of agriculture, by one means or another, has a critical role to play in the acceleration of economic development since it is only the imposition of compulsory levies on the agricultural sector itself which enlarges the supply of "savings" in the required sense for economic development. Countries as different in their social institutions or economic circumstances as Japan and Soviet Russia have been similar in their dependence on heavy agricultural taxation (in the case of Japan, through a land tax, in the case of Soviet Russia, through a system of compulsory deliveries at low prices) for financing their economic development.
19. An annual tax on land, expressed as a percentage of the value of the produce per acre, is one of the most ancient forms of taxation both in Europe and in Asia. Up to the beginning of this century the land tax still provided the principal source of revenue in the countries of the Middle East, in India and many other areas (in Europe its relative importance had been declining for a century or so as a result of the diminished relative importance of agriculture in the total national income).

Since that time, however, political pressures, combined with monetary changes, have succeeded almost everywhere in "eroding" the weight of this tax almost completely, and its rehabilitation now faces heavy political and administrative obstacles. Yet there can be little doubt that with heavier agricultural taxation the rate of development of all countries could be much accelerated.

20. The main political objection to this tax is that it is socially unjust in its incidence since (taking into account needs) it hits the poor farming families far more heavily than the rich. However, it would be possible to avoid the anti-social features of the tax by making it a progressive tax varying with the total size of family holdings. Since in most countries that are relatively over-populated, and in which land is scarce, the distribution of the ownership of land is very uneven (with something like one-half of the available land being owned by 10 per cent or less of the agricultural families in typical cases) it is quite possible to exempt the very small farmer from this tax altogether and yet collect adequate revenue by making its incidence progressive on the owners of the larger holdings. Nevertheless, a progressive land tax naturally raises the most fierce resentment in all countries where a land-owning class exists, and, to my knowledge, it has not yet been put into practice anywhere.

21. Another objection frequently made against a land tax is that it requires relatively frequent periodic reassessment of each individual holding - a task which is extremely costly and difficult to perform. It would be possible however to assess the potential fertility of individual pieces of land in relation to the national or regional average on the basis of more or less permanent criteria (such as average annual rainfall, irrigation, slope and inclination of the land, porousness or other qualities of the soil, etc.), and once this work of evaluation of "potential relative fertility" is accomplished, it need not be repeated at frequent intervals. On the other hand the actual tax liability could be
changed year by year by estimating the average value of output per acre for the country or region as a whole, and multiplying this by the coefficient which relates the fertility of any particular acre to the national average.

22. It would be technically feasible therefore, to revive the ancient land tax in a way that would make it both more effective and more in keeping with present day conceptions of equity by (i) a system which assesses the potential yield of any particular piece of land not in terms of the actual value of output, but in relation to the yield of the average land in any particular region; (ii) by making the tax a progressive one, the effective rates of taxation of which vary with the total value of landholdings of the family unit. Such a tax would preserve the merit of the ancient land taxes in that it would be a tax on the "potential output" rather than on the actual output of any piece of land, meaning by "potential output" the output which the land would yield if it were managed with average efficiency. Thus the inefficient farmer whose production is less than the average for the region and for the type of land concerned would be penalized, whereas the efficient farmer would be correspondingly encouraged. Such a tax on potential output is far superior in its economic consequences to any tax based on actual income or profit; and it is technically feasible to impose it in the case of agriculture (where the nature and quality of land provides a measurable yardstick) in a way which is not feasible for other types of economic activity. It would thus give the maximum incentive for efficient farmers to improve their land and expand their output; it should also greatly encourage the transfer of land ownership from inefficient to efficient hands, and thereby raise the average productivity of land nearer to that obtained by the best managed farms.

1. One way of doing this is by making an estimate of the total output of foodstuffs for the country or region and then dividing it by the estimate of the number of cultivable acres in that region. Once statistical estimates had been made for a sufficient number of years, the average value of the produce per acre could be calculated as a moving average of, say, the past five years. In years of drought the tax could be remitted altogether or either on a local or a national scale, as the case may be.

2. A tax reform of those lines would of course be the more efficacious in raising agricultural productivity if it were combined with other measures for improving agricultural productivity - e.g., the provision of cheap credit facilities, the institution of agricultural extension services, etc.
23. Another important advantage of a tax on these lines is that it would operate as a potent instrument of land reform, and its efficiency in this respect could be enhanced to any desired extent by increasing the rate of progression of the tax. It could be made to operate so as to induce the owners of large estates - particularly when the tax schedule is expressed in terms of effective rates, rather than marginal rates - to sell part of their holding in order to bring themselves into a lower tax bracket, thereby making the distribution of land ownership more equal and at the same time creating a freer market in land. In many countries agricultural stagnation is largely the result of absentee ownership, and of the unwillingness of existing owners to part with any of their possessions, even if they are incapable of putting their land to good use. By making the land market more fluid, a progressive land tax would enhance the chances of able and energetic cultivators to get hold of the land.

24. Some under-developed regions - as e.g., in most areas of Africa - the traditional social customs and the prevailing system of land tenuro, etc., have made the establishment of a system of an annual land tax hitherto impossible. Instead resort was often had to an inferior substitute - the poll tax - which is levied generally on the basis of the number of adult males in each region. The great advantage of the poll tax is the case of assessment; and in countries where there is not much economic inequality in the rural areas this tax is not so obnoxious as it would be in older, over-populated countries where a high degree of economic inequality prevails. Nevertheless, a poll tax can never fulfil the same functions as a land tax based on the potential fertility of land. A poll tax, unlike a land tax, does not give the same incentives to improve cultivation; it does not make for greater fluidity in the ownership and/or occupation of the land. And because it can take into account economic inequality, a land tax is not only capable of yielding a much larger revenue than a poll tax, but it should also be politically more acceptable.

25. The importance for economic development of an efficient system of taxation of the agricultural or subsistence of the community cannot be over-estimated. In the absence of a direct tax on the subsistence sector - whether in the form of a land tax or a poll tax - this sector can only be taxed indirectly through taxes on commodities which are bought by the agricultural sector. Such methods of indirect taxation can never however fulfil the same function; they do not provide the same incentives for increased production or an
increase in marketable supplies, and may even tend to retard the development of the rural regions. Since, moreover, it is impossible to differentiate in indirect taxation between various classes of consumers, and since only a small part of the real income of the subsistence sector may be absorbed by the consumption of products bought for money, the scope for such indirect methods of taking the subsistence sector are strictly limited.

III. Taxes on commodities

26. Whilst commodity taxes are not an adequate method for taxing the agricultural sector, they are bound to be one of the principal methods of taxing the economy at large and one of the principal sources of government revenue. As a method of taxing the "monetized" or exchange sector they are superior to direct taxes whenever the economy largely consists of small enterprises, with few employees in each; in those circumstances income tax is not a convenient or efficient instrument for taxing either the profits of the employer, or (through the P.A.Y.E., or deduction-at-source method) the wages and salaries of employees. To assess and collect taxes on commodities which pass through the frontier is relatively simple, particularly where imports and exports pass through a port. And, to an extent not always realized, such taxes may fall partly on the profits of producers or suppliers (domestic or foreign) and not only on the consumers of the taxed commodities.

27. Thus, in the case of commodities imported for domestic consumption, where particular imports are under the control of a single company, or a limited number of companies (either because the bulk of the local market is controlled by a single great merchanting house, or because the imports are controlled by world-wide concerns, as with oil and petrol) the price to the domestic consumers may tend to be fixed at the "optimum monopoly" price; so that it may not pay the importer to pass on the full incidence of the tax to the local buyer. In this case the import duty is partly a method of taxing the profits of the importer (which is often a foreign company) and only in part a method of taxing the domestic consumer.

28. Similarly in the case of exports of minerals or plantation products, an export duty may be a more effective method of taxing the profits of producing companies than an income tax, particularly where the local operating company is a subsidiary of a foreign company which is also its trading partner, so that the profits shown by the local company may be arbitrary. The danger is, however, that once the export duties are imposed, the exigencies of revenue lead them to be fixed at excessive levels with the result that the development of export industries is inhibited. 1/

1. The expansion of the Ceylon tea industry is said to have been severely hampered through excessive taxation by means of export duties.
29. Though it is possible to vary the rate of commodity taxes according to the degree of luxuriousness of the commodity, thereby introducing a certain progression into the tax system, the revenue potentialities of taxes on luxurious goods are limited, since total imports may be small and consumption may be substantially reduced by heavy taxation. To get maximum revenue it is necessary to tax articles of mass consumption—cotton cloth, sugar, flour, beer, tobacco, kerosene, etc.—and this raises all the political difficulties associated with a reduction in accustomed standards of living of the mass of the population. But this is not a peculiar feature of such taxes, but of taxation in general. It is impossible to increase the amounts raised in taxation suddenly or substantially without public resistance—whatever form the taxation takes—though of course any community is the more ready to accept sacrifices the more they are convinced of their necessity.

30. There is finally the possibility of a general sales tax collected from retailers on a very wide range of articles. Such taxes are a common feature of many developed countries; the experience of India shows that they can be successfully imposed also in underdeveloped areas, at least where a relatively high standard of public administration exists.

IV. Direct taxes, on income and capital

31. The importance which progressive direct taxes on income and capital should play in the tax system necessarily varies with the stage of economic and social development. The experience of a wide variety of countries shows that taxes on income or profits can only be successfully imposed on large scale enterprises or on the employees of such enterprises. In many undeveloped areas the bulk of income tax revenue comes from a few large business firms and from government employees. The extension of the tax to small traders, artisans or professional persons meets with serious administrative difficulties—as there is no way of ascertaining income where no proper books are kept, no regular accounts are prepared or audited. It has often been suggested that a more promising form of bringing small and medium traders within the scope of direct taxation would be by means of a tax assessed on the value of their property—by means of a net wealth tax—since property (whether in the form of land and buildings, plant and equipment or stock-in-trade) is more difficult to conceal than income. However, in the few underdeveloped countries where graduated taxes on net wealth have been introduced (such as India and Ceylon) they operate with a large exemption limit, and they are intended as an additional form of taxation on wealthy individuals and not as a tax on small and medium business, so that there is no actual experience to show how successful such a tax would be in practice.
32. In "semi-developed" countries which possess large-scale enterprises engaged in industry and commerce, and where a wealthy domestic capitalized class exists, progressive taxes on income and wealth are potentially very important both for mitigating the growing economic inequalities between different classes (and the political and social tensions which are attendant on this) and for reducing the share of national resources devoted to socially unnecessary luxury consumption. 1/

33. There is hardly any "semi-developed" country however an efficient system of personal taxation can be said to exist (with the exception of taxes on salaries and wages). In most countries of Latin America, for example, though nominal tax rates mount to fairly high levels - to levels comparable to those in the U.S. or the U.K. - the proportion of large incomes effectively paid in taxation (according to all available evidence) is considerably lower than that falling on small or medium incomes. This is partly due to defective tax legislation - e.g., many countries follow the so-called "cedular" system of income taxation which imposes a separate tax on different sources of income (and which leaves important sources entirely untaxed) instead of a single comprehensive tax on all income, as in the U.S. or Western Europe. In part it is due to prevailing legal institutions which permit anonymity in the ownership of wealth (mostly on account of the prevailing system of "bearer shares" in the case of companies or the system of

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1/ This objective cannot be attained by a graduated system of commodity taxation alone. Since the same commodities are bought by people of very different wealth - the richer people buying more kinds of goods and services, and not just more "luxurious" goods - and since many of the things on which the rich spend money cannot be effectively taxed - domestic service, foreign travel; antiques, etc. - the spending power of the wealthy classes can never be tapped by means of commodity taxes to anywhere near the same extent as by means of progressive taxes on income or wealth. It is sometimes argued that in under-developed countries the "luxury consumption" of the rich is largely spent on services (e.g., domestic servants, etc.) which increases the volume of employment, and thereby performs an important social function. This view overlooks however that it is the supply of wage-goods (particularly food) which sets a limit to the total volume of employment that can be offered outside the agricultural sector without creating inflation; if more people are taken into unproductive employment, there is less room for productive employment. The more existence of surplus labour in a community does not imply therefore that such luxury consumption is harmless or that it does not involve the use of scarce resources.
"banami" in India) and which prevents any effective taxation on incomes derived from capital or on wealth (either in the form of inheritance taxes or of annual taxes on capital). It is also due to sheer inefficiency (and to an unknown extent perhaps also of corruption) in administration; which prevents the existing provisions from being effectively enforced even to the limited extent to which existing system of tax laws would permit.

34. In the context of Latin America the most important reform is undoubtedly the creation of a single uniform tax on the total income of individuals from all sources, based on a comprehensive notion of income which embraces all such gains or benefits which increase an individual's potential net worth over a period. Some Latin American countries already levy, in addition to the codular tax, a supplementary tax - the "global complimentary tax" - on the aggregate income of individuals. As the evolution of the British income tax has shown, however, it is not necessary to levy two separate taxes in order to have an effective progressive tax on total income. It is possible to merge the existing codular system (whilst preserving its administrative advantages) into a single comprehensive tax by making provisional assessments under each schedule (with the maximum use of the deduction-at-source system) and adjusting the final liability on the basis of the over-all return. Whichever method is used, however, there is no justification for retaining different tax schedules and rates of progression for the different sources of income - except in so far as it is desired to differentiate between incomes from work and incomes from property, but this latter objective could be better secured through a supplementary tax on net wealth, discussed in paragraph 37 below. With regard to the profits of companies on the other hand, it is best to follow the U.S. system of a separate corporation profits tax levied at a flat rate which is separate from the income tax liability or shareholders on the dividends distributed to them.

35. Effective income tax reform in Latin America countries has, in my opinion, four major requirements.

a. The first is that the tax should be made comprehensive. It should encompass capital gains as well as income which takes the form of dividend interest, etc. It should extend to income from land and houses, including the imputed rent of owner-occupiers. It should avoid exemptions; such as interest on government bonds or mortgages, which at present undermine its effectiveness in so many countries.

b. The second requirement is that it should treat the family, rather than the individual, as the basic economic unit for purposes of personal taxation. This means that the income of husband and wife and minor
children should be aggregated for tax purposes (as is the case in Franco) but there should be generous personal allowances which differentiate the effective burden according to the size of the family. It is a matter for consideration whether this is best done by the adoption of the French "quotient system" (which divides total income according to the number of adult units, and taxos each separately) or by some variant of this which sets a minimum and a maximum to the tax allowance for each member of the family.

c. The third requirement is that, as far as possible, tax should be deducted at source on each particular kind of income at some standard rate (which is preferably the maximum rate), any excess deductions being repayable when the final liability is computed. To protect the interests of the taxpayer it is advisable that the government should pay interest on excess deductions for the whole period during which the taxpayer is out of pocket.

d. The fourth, and perhaps the most important requirement is that the rate schedule should be both simple and moderate. There is no point in starting to levy tax at a very small rate; 10 per cent should be regarded as the minimum chargeable rate for the excess of income above the exempted amount; and there is no point in having too many steps. I think the schedule should provide for no more than 6-8 separate income brackets, any incomes in excess of a certain level being charged at a uniform rate. The rate of tax on the successive levels of income should rise by steps of 5 per cent to a maximum of 40 to 45 per cent. It is an essential precondition of an effective and loophole-free system that the maximum rate of tax should not be an immoderate one; marginal rates of over 50 per cent militate against the introduction of effective tax reform. Where normal tax rates mount to very high levels (to 80 or 90 per cent in a number of cases) it is in practice impossible to extend the tax to all forms of income (as for example, to capital gains) or to get rid of the numerous exemptions. It is also impossible to secure the compliance of the taxpayer and to administer the tax laws effectively - high tax rates are often no more than an excuse for maintaining an inefficient system - and the amount of revenue lost to the State through a defective tax system is likely to be many times the revenue actually collected from individuals who are subject to the high marginal rates of tax.

36. It would go far beyond the scope of this paper to consider these requirements in more detail - the more so since the detailed requirements of tax reform vary considerably with the circumstances of each particular country. I am convinced however, as a result of studying the problems in a number of countries, 1/ that in all countries which have attained the

1/Two of these studies have been published. Cf. Indian Tax Reform, Report of a Survey, (Ministry of Finance, New Delhi, 1956) and Suggestions for a Comprehensive Reform of Direct Taxation. Sessional Paper IV - 1960 (Government Publication Bureau, Colombo, Ceylon).
stage of development at which the need for an effective system of direct personal taxation arises, there are no insurmountable technical or administrative obstacles to its introduction, provided the need is adequately recognized, and the opposition from vested interests to the necessary legal and institutional reform can be overcome.

37. Apart from a tax levied on the income of individuals and of companies, an effective system of direct taxation also requires that there should be taxes levied on personal wealth which could be administered conjointly with the income tax. Such a tax should be levied in two different forms. The first is a relatively small annual tax on the net wealth of the individual (which is now administered in a number of European countries, and in India and Ceylon) which is the most appropriate method of tapping the additional taxable capacity inherent in the possession of wealth as such. Clearly, as between different individuals who have the same income, the man who possesses property as well as income is better off, and has a higher taxable capacity, than the man who has no property. Since different individuals possess disposable wealth and money income in widely differing proportions, a tax assessed on net wealth which is additional to income tax is a much fairer method of allowing for such differences than the alternative method of charging income derived from property (the so-called unearned income) at a higher rate than income from work. Also, it has been the experience of many countries that a combined system which levies an annual tax both on wealth and on income improves the efficiency of the tax administration considerably, since it makes evasion and concealment more difficult than a system which levies tax either on income alone or on wealth alone. Here again an effective system requires that such an annual tax on wealth should be levied at moderate rates, (starting at 0.5 per cent per annum, with a total exemption for property under 10,000 - 20,000 U.S. dollars) and that the maximum rate should not exceed 1.5, or at most 2 per cent per annum.

38. The other form of taxation on wealth arises in connection with the gratuitous transfer of property from one generation of owners to the next. This generally takes the form of an inheritance tax which is levied in connection with the passing of property at death, though a number of countries recognise that gifts inter vivos form an easy method of inheritance tax avoidance, and levy a complementary tax on inter vivos transfers (usually called the gift tax) as well. The ideal system would be to levy a single tax on all gratuitous transfers which is payable by the individual recipient of the gift, bequest, or inheritance, and which is levied on a progressive scale, depending not on the size of the individual gift or legacy, but on the total wealth
(including the gift or legacy in question) of the donee. Most countries recognise the need for inheritance taxes as a means of counteracting the tendency of an increasing concentration of wealth through the accumulation of successive generations. A system which levies the tax according to the wealth of the recipient, rather than the wealth of the donor, is evidently fairer, and is more conducive to the promotion of a wider distribution of ownership. However, its administration raises greater difficulties; and it can only as a feasible proposition to those countries which are prepared to maintain a comprehensive record of the personal balance sheets of all wealthy individuals. This is in any case necessary for the effective taxation of incomes derived from property (including the taxation of capital gains) and for an annual tax on net wealth, as well as for a tax on gratuitous transfers.

39. Apart from taxes on income, some Latin American countries impose considerable pay-roll taxes in connection with their social security systems. These raise difficult problems of their own which cannot be gone into here. It should however be pointed out that wide differences in the social security taxes of different countries (in the same way as wide differences in the systems of income and profit taxation) can be a potent source of distortion in the allocation of resources between countries; and if the countries of Latin America move towards economic integration, in an analogous way to the countries of the European Economic Community, it would be highly desirable to introduce greater uniformity in their systems of social security taxes as well as in their systems of taxation of income and profits.

V. Taxation of foreign enterprises and of foreign income

40. The tax treatment of foreign enterprises and of foreign investment raises two distinct problems to under-developed countries. The first concerns the question of how far under-developed countries should go in the offer of special concessions – in the form of immunity from taxation, etc. – in order to attract foreign capital and enterprise to their country. The second relates to the most appropriate method of taxing the profits of foreign enterprises when they are not exempt. Both questions raise difficult problems as a result of developments which have occurred since the Second World War.

41. Foreign investment in its various forms holds out the best hope of accelerated development to many under-developed countries; it may be indispensable at critical stages of development when industrialization gives rise to greatly enlarged imports of equipment and materials but before there is any corresponding increase in export availabilities to pay for these. Foreign enterprise may be indispensable also in imparting the know-how necessary for the efficient develop-
ment of local industries. Moreover, in the case of many countries, the production and export of valuable minerals found in their area holds out the only hope of generating the "economic surplus" which is a necessary pre-condition for their internal development. For many countries, the production of minerals for export forms a considerable share of their gross national product and is the principal source of their public revenue. It is evidently in the interest of under-developed countries that the production of such minerals be developed, and that this should be followed up by the development of processing facilities which gives rise to industrial development; it is better to export aluminium than crude bauxite, or refined copper than copper ore, it is better for oil-producing areas to have their own oil refineries so as to export their oil in refined form. Most under-developed countries have neither the money nor the know-how to undertake such developments on their own; the marketing of many of these commodities is closely controlled by large international concerns.

42. On the other hand it is broadly true that the amount of investment which the large international concerns are ready to undertake both in mining and in processing depends on their over-all view of the requirements of the world market, and their estimate of the annual growth of world consumption. It is therefore a priori unlikely that any special concessions (in the form of tax holidays, etc.) granted by the producing countries are likely to have any appreciable effect on the total flow of international investment. They can have important effects however on its allocation: since most basic minerals are to be found in many different regions, it is naturally in the interests of international capital to develop them in those countries which offer the most favourable prospects, both from the point of view of production cost and also from the point of view of the tax treatment of the resulting gains. But this in turn tends to bring about an unhealthy competition in the offer of special concessions to foreign capital. Whilst any particular country will normally stand to gain by the offer of such tax concessions; if the concessions offered are relative to the existing tax treatment of foreign enterprises in competing countries, the very fact that the various countries are in competition with one another for getting a larger slice of such investments will cause any new concession offered by one country to be copied by the others so that in the end they are all deprived of the prospect of obtaining their due share from those developments without benefitting any one of them - the competing concessions will largely cancel out each other.

43. The situation is basically different when the concessions offered to foreign enterprise serve the purpose of developing domestic industries largely catering for the internal market. In such cases tax concessions may well have the effect of increasing the total flow of international investment - some
particular project of developing a local textile mill, a cement factory or an assembly plant may appear sufficiently attractive when tax concessions are offered when it would not be attractive without.

44. This question of how far under-developed countries as a group should go in offering privileged tax treatment to foreign investment (or for that matter, to domestic enterprise) is therefore a complex one which cannot in general be answered one way or another. In cases where the concessions serve the purpose of increasing the aggregate flow of investment it is clearly to their interest to forego additional tax revenue, even for a considerable number of years, since their rate of economic development may be greatly enhanced as a result. But in other cases it is not; in view of the haphazard multiplication of tax privileges of various kinds in recent years there is a clear case for international discussions possibly leading to conventions or agreements, that would eliminate the element of unhealthy competition which undoubtedly exists at present. It is to the interest of under-developed countries as a group that the tax treatment — both the scope and the rates of taxation of enterprise and of the nature and extent of tax holidays, etc... granted — should, as far as possible, be uniform, and that individual countries should not offer additional concessions except in agreement with the others.

45. The second important issue concerns the manner in which the profits of foreign enterprises engaged in production for exports (or in the import trade) are to be taxed. The most satisfactory method is a tax on the profits arising from local operations. An export duty, as we have noted, can be a potent form of taxation, but it is not a satisfactory substitute for taxation on the basis of profits; if the export duty is heavy, it may have an inhibiting effect on development; if it is light, it cannot secure adequate revenue. Taxes based on profits are less discouraging to the foreign investor, precisely because their burden depends on the gains actually made; if the operations turn out to be unsuccessful (either because there were unexpected costs in local operations; or because the market conditions are unfavourable) the entrepreneurs are relieved of them.1/

1. It is for this reason that export duties, in many cases, are fixed in terms of some sliding scale, the incidence of which varies with the prices actually realized in relation to some average.
46. The problem with profit taxation on the other hand is to ascertain the true profit in all those cases where the resident operating companies are merely branches or subsidiaries of international concerns whose trading operations are not at "arm's length" - since they sell to (or buy from) non-resident companies belonging to the same group. The prices in such transactions are in fact internal accounting prices of the concerns; it is well known that an international concern operating through a chain of subsidiaries can easily "shift" its profit from one place to another by changing the price which the subsidiaries (or associated companies) charge to one another. So long as profits are everywhere subject to tax and so long as the rates of taxation are not too different, the incentive for such "profit shifting" will not be strong particularly when the rates of taxation are heavier in the countries where the parent companies are situated than in the under-developed countries where the branches and subsidiaries operate. But since the war, international companies have made increasing use of the so-called "tax-havens" - they established holding companies or subsidiaries in territories where the profits are not subject to tax (or only at nominal rates) or in countries which do not bring into charge the profits earned in the overseas operations of their resident companies. 1/ The result has been that an increasing proportion of the profits made by such concerns have been syphoned into such tax-havens, thus depriving both the producing and the consuming countries of revenue. 2/

47. Thus the profits made in the extraction and processing of minerals may be understated by invoicing exports at unduly low prices. The profits made in the importation and local distribution of foreign commodities or services may be understated by invoicing imports at unduly high prices. 1/

48. Sooner or later the arbitrary allocation of profits in the production or distribution of commodities which enter into international trade will make it necessary for countries to look beyond the accounts of the local companies, and if necessary, to impute profits to them based on an appropriate share of the total world profits of the companies which operate local branches or subsidiaries. Here again there is a fruitful field for international cooperation. If it were possible to get agreements between the various countries

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1. In the case of the international oil industry, the tendency has been to fix the price-structure in such a way that the profits arising from the whole complex of international operations are concentrated on the production of crude oil, and not in refining and distribution of oil products. The reasons for this are partly to be sought in tax considerations (since the royalties paid to the governments of the oil producing countries qualify as a tax offset in the "parent" countries) and partly political and strategic. But the result has been that the oil-producing areas obtained more revenue than could have been obtained if a free competitive market had existed; whereas the oil consuming countries (both developed and under-developed) have been deprived of revenue (other than in the form of import duties or excise taxes).
of how they should deal with such problems, they could be dealt with far more effectively than if each country tried to act in isolation.

49. A related problem which is perhaps best considered here and which has considerable importance for Latin American countries is the question of the taxation of income received by residents from abroad. The majority of Latin American countries leave such income untaxed at present (though they are subject to withholding taxes paid in the foreign country where the income originates). On the other hand, the prevailing practice in most countries with a developed global income tax is to tax both the foreign income of residents as well as the income which originates in the country and accrues to non-residents; though, in the majority of cases (and as a result of the numerous double taxation agreements concluded since the War) the tax which is levied on the income in the country of origin is allowed as a credit against the domestic tax liability of the recipient of the income.

50. There is undoubtedly a strong case on equity grounds for extending the liability to income taxation to income received from abroad and it is known that the residents of many Latin American countries own very substantial amounts of capital abroad. Indeed one of the frequent arguments against an effective tax reform is that it would "drive" capital abroad, to the detriment of the economy. The difficulty is the practical one of compelling residents to declare their foreign assets and the income received from these. The effective solution of this problem requires the cooperation of the governments of those foreign countries where the assets are held. Some countries already provide such information on a mutual basis under international tax treaties, and such countries could no doubt be induced to provide the same service to Latin American governments as well. The question should also be explored how far it would be possible to follow the British system under which all foreign nominees securities (outside the Sterling Area) must be registered not in the owner's own name, but in a "recognised marking name" (in the name of one of the local financial institutions) who deduct income tax at source from the dividends, etc., paid to the individual owner. If the cooperation of the U.S. and of some European countries could be obtained in disclosing to particular Latin American governments the assets owned in their territory by their nationals; the countries should be in a position to ensure a fair degree of compliance with such a provision.

I. Compulsory savings

51. A relatively new form of raising internal resources for development purposes which has recently been introduced in a number of countries (e.g. Turkey, Ghana, British Guiana, Brazil, and some others) is compulsory savings. This obliges individuals and businesses to apply a certain percentage of
their income to the purchase of interest-bearing but non-negotiable bonds which are repayable (together with accrued interest) after 5, 7, or 10 years. The scheme is usually administered in connection with income tax or (as in the case of Ghana) in connection with the purchase of cash crops by a marketing board. The advantage of the scheme, as against straightforward taxation, is that as people are merely asked to postpone their consumption and not forego it altogether, considerations of equity do not require the same kind of differentiation or graduation as is the case with income tax, and in consequence, more substantial amounts can be raised at relatively modest rate. Thus the compulsory levy is generally imposed on wage and salary earners at a flat rate of 3 or 5 per cent on the whole of income, though the obligation only extends to people whose incomes are above certain minimum levels. There may be a similar obligation on businesses and professional persons, generally with a higher rate of contribution.

52. It is possible to combine such a scheme with a lottery scheme (like the "premium bonds" in the U.K.) which might make it more attractive to the majority who are given a chance to win large cash prizes even before bonds are due for redemption. But the lottery element makes the administration of this scheme far more complicated; also, it was found in some cases that there was a great deal of moral opposition (by the churches, trade unions, and farmers' organisations) to compulsory lottery.

53. It is possible also (though this requires far more administrative preparation) to make the scheme into a universal contributory pensions scheme, drawn up on an actuarial basis whereby the repayment of the compulsory loan takes the form of a pension upon retirement, graduated according to the amount of the contributions made during working life. A compulsory savings scheme which results in a universal old age pensions scheme is likely to be far more popular than a scheme where the contributors are supplied with non-negotiable bonds repayable after a fixed number of years.

54. A scheme of this kind is only appropriate to under-developed countries which have already attained a stage of development which makes it possible to bring a considerable section of the population within the scope of direct taxation; or where there is a major cash crop (such as cocoa in Ghana) which is purchased by a central marketing board at fixed prices.

VII. The problem of tax administration

55. It cannot be emphasised too strongly that the efficacy of the tax system is not just a matter of appropriate tax laws but
of the efficiency and integrity of tax administration. In many underdeveloped countries the low revenue yield of taxation can only be attributed to the fact that the tax provisions are not properly enforced, either on account of the inability of the administration to cope with them, or on account of straightforward corruption in the administration. No system of tax laws, however carefully conceived, is proof against collusion between the tax administrators and the taxpayers; an efficient administration consisting of persons of high integrity is the most important requirement for exploiting the "taxation potential" of a country. 1/

56. One important condition for this is that the government departments concerned with the administration of taxes should not be overly burdened and this in turn requires that complicated taxes should be avoided unless there is an administration able to cope with them. Yet in many countries there are hundreds of different taxes with a negligible yield - the cumulative result of the gradual accretion of imposts which have long since lost their justification, but which have never been formally withdrawn - the administration of which is a great deal more costly than the amounts collected. Indeed, there is no other field where bureaucracy can be so cumbersome and absurd as in the administration of taxes; and in many countries there need to be an infusion of a new spirit, which makes it possible to apply modern techniques of business administration, before any major reform can be accomplished.

57. Many under-developed countries suffer both from an insufficiency of staff and from the relatively low grading of the staff of the tax administration departments. Persons of ability and integrity can only be found for these jobs if sufficient recognition is given to the importance of the tasks which they are asked to perform, and this should be fully reflected in their status, pay, prospects of promotion, etc. Any additional outlay incurred in improving the status and pay of the officials of the revenue department is likely to yield a very high return in terms of increased revenue.

1. There is a glaring discrepancy, in most under-developed countries, between the amount of incomes of various types as computed by the method of national output statistics and the incomes declared in tax returns or computed on the basis of tax receipts. In the "developed" countries the national income estimates based on the "income" and the "output" method of computation are more easily reconciled, and do not reveal such glaring differences. It is probably not exaggerated to say that the typical under-developed country collects in direct taxation no more than one-fifth or possibly only one-tenth of what is due.