Initiative for Policy Dialogue

IPD Tax Task Force

Summary from 30 March 2005 Task Policy Meeting

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Some Observations on Tax Reform in Developing Countries

The workshop organised by the IPD on tax policy and reform in developing countries on March 30, 2005 at Columbia University was extremely insightful. I would like to personally thank the organisers for providing such a forum for discussing such an important issue. I had a few observations and comments on the presentation by Prof. Stiglitz on "Development Oriented Tax Policy" and made a brief presentation on Indian tax policy and reform since the 1990s. These are summarised below:

The major shortcomings of the Value added taxation detailed in the important papers by Prof. Emran and Stiglitz (2002, 2004) and highlighted in his presentation refers to the fact the redistributive effects of VAT is limited and more importantly, VAT being a tax on the formal sector, it discourages the growth of the formal sector.

On the issue of progressivity of the question is how progressive should the tax be? As argued by Harberger (2003), based on the empirical studies by Pechman (1985) in the case of United States and the more recent Engel Eduardo et. al (1999) in Chile, the ability of the tax system to undertake redistribution is limited. Besides, it is useful to interpret equity in fiscal policy not as 'reducing the incomes of the rich', but rather 'increasing the incomes of the poor' which implies that the expenditure side of the budget has a greater role in ensuring equity. Of course, this does not mean that the tax system could be regressive. However, the VAT can be made progressive by exempting the unprocessed food items and if necessary by having two rates than one.

On the issue of VAT encouraging non-formal sector, I think the issue is also applicable to many taxes levied in developing countries. In fact, most taxes in developing countries are levied on the formal sector. By being in the non-formal sector, the economic agent will have to contend with high transaction costs. Therefore, the choice will depend on the tax savings from being in the non-formal sector versus the transaction cost and in the long run the better growth prospects for the business. The extent to which VAT encourages non-formal sector will also vary from country to country and it would be difficult to generalise whether VAT for a country is desirable or not. Besides, the formal sector has dynamism of its own as it opens up avenues to expand businesses. (According to a report in Financial Times of 6th April, 2005, last year in India, the use of credit card by foreigners increased by 42% to USD. 75 million).

Much of the discussion on the welfare implications of VAT is when it substitutes import tariffs. In countries like India, the introduction of VAT at the state level is to replace the existing cascading type, predominantly first point tax. Besides the tax on tax, mark up on the tax and tax on the mark ups, the tax on inter-state sale of goods divides the country into several tariff zones, makes the tax system origin based and causes significant inequitable inter-state tax exportation. If the domestic producers in the country have to face international competition, the prevailing tax system needs to be replaced by a less cascading type destination based tax.

While it is important to have this discussion and much more work needs to be done to clarify issues, I tend to agree with Richard Bird (2005) when he says, "One may criticise VAT in both theory and practice, and much more such analysis and criticism in not only to be expected but also welcomed. In the end, ….VAT almost certainly works better both in theory and practice in most countries than any feasible alternative". Again, as Bird states, "…the most basic lesson that may be drawn from experience to date with implementing VAT in developing and transitional economies (DTE) is simply that doing it right is in most respects a matter more of art than of science. ….the behaviour of the informal sector depends, as some recent literature (Gerxhani, 2004) suggests, largely on the interaction between formal institutions such as the tax administration and the prevalent norms and customs in a country…."

Reform of Indian Tax System:

1. The US Tax Reform Act of 1986 has had, in some ways impact on tax reform in India. The broad framework of tax reform – of broadening the base, reducing rates, reducing rate differentiation, making the tax system simple and transparent have been the thrust of reforms. Although tax reforms committee submitted the reports in 1991 and 1992, the real implementation phase began in 1996 when the major tax reforms exercise was undertaken. Although not always unidirectional, the reforms had broadly the above thrust.

2. In many ways, implementation has been patchy mainly for revenue reasons. While over the decade of reforms, the reduction in import duties led to decline in revenue – GDP ratio by about two percentage points from 3.6 per cent in 1991 to 1.8 per cent in 2003-04, the internal indirect taxes did not make up the revenue. In fact, the Union excise duty (which is a manufacturers' sales tax), rather than showing an increase, actually declined by one percentage point from 4.3 per cent to 3.4 per cent. Thus, even as the income taxes increased by one percentage point, there was a decline in tax-GDP ratio by over percentage points after the reforms were introduced.

3. At the state level, a major reform effort is under way and from April 1, 2005. As many as 21 of the 28 states and 2 Union territories will be switching over to the VAT regime from the existing cascading type sales tax. The reform envisaged is only the beginning and is likely to take another two years before it is completed by phasing out the inter-state sales tax.

4. A major initiative taken by the central government recently involves reform in tax administration. The introduction of Tax Information Network (TIN) by outsourcing the entire program to National Securities Depository Ltd (NSDL) is likely to help in collating information from the banking and financial system with tax returns. It will help to check whether the tax deducted at source is indeed deposited with the government and help to process the refunds faster. The project has a tremendous

potential to create a proper information system and help enforce tax compliance by linking the tax returns from different taxes, processing the information received from the financial system and when VAT comes i9nto operation, this could strengthen the enforcement machinery even more.

References:

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