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PROVISIONAL SUMMARY RECORD OF THE THIRD MEETING

held at Santiago, Chile
on Thursday, 6 December 1962, at 4.10 p.m.

Chairman: Mr. LYNN

Contents: Fiscal capacity of developing economies: issues of tax policy

NOTE: Participants wishing to make corrections in the provisional summary record of their statements, for inclusion in the final printed report, should submit them in writing to the Editorial Section, either through the Conference Officer (Miss Eyzaguirre) during the Conference, or subsequently, by post, before 31 December, addressed to The Editorial Section, ECLA, Avenida Providencia 871, Santiago, Chile.

Mr. DESAI referred to the previous afternoon's discussion in which there had been almost complete agreement that economic development was the prime objective of fiscal policy. That was also the basic assumption in his paper. The questions he wished to ask concerned the ways in which fiscal instruments could be used to attain such development and the extent to which they could be so used. In exploring those questions he had taken it for granted that fiscal performance in under-developed countries fell far short of its potential level. He regretted that the role of tax advisers on measures of reform could not be discussed separately, since it was clear from Mr. Schlesinger's paper that their views differed considerably, and it would have been interesting to ascertain the reasons for their disagreement.

The first point he had tried to bring out in his paper was the great importance of revenue for fiscal policy. He had then reviewed the capacity of Governments to obtain revenue, which had two ceilings - the economic and the political. Neither seemed to have been reached in the less-developed countries.

The three main policy issues were revenue, incentives and equity, of which the first was the most important. With respect to the question of incentives, it was thought in some circles that they had been used too liberally, since they were apt to lose the Government a great deal of revenue, particularly from the industrial sector, and it had not been proved that they played a decisive part in ensuring the success of new industries. The whole question should be reassessed. With regard to the third aspect, he felt that the need for every tax to be equitable had been overstressed. It was more important to have an equitable tax system as a whole and an equitable government expenditure policy.

He disagreed with Mr. Urquidi on the importance attaching to considerations of equity in planning economic development objectives. The assignment of first priority to the redistribution of income was apt to impede the achievement of economic growth, and could therefore not be regarded as wholly desirable.

/His treatment

His treatment of the question of fiscal capacity had been exploratory and derived from the need for a more precise quantitative criterion than the idea of obtaining more revenue. He pointed out that the political and economic upper limits of fiscal capacity were not necessarily commensurate. In rather poor economies the ceiling was fixed by the balance that remained over and above subsistence levels. The political limit might be higher, as in the centrally-planned economies or in other economies during an emergency such as a war. In the short run the political limits were the determining factor, but over the long run opposition to institutional changes could be overcome and public opinion educated.

It was thought in principle that fiscal capacity was essentially determined by the absolute level of per capita national income. Income distribution was also a factor, especially when it tended to be unequal, in view of the great potential of the wealthy groups as a source of revenue. In practice, however, tax performance was largely dependent upon the technical facilities for tax collection and to a lesser extent upon the efficiency and integrity of the public administration. That was a particularly important point for the under-developed countries where good administration was hard to find.

His view of the relationship between fiscal capacity and national income was rather pragmatic, since he did not consider that the economic surplus should inevitably accrue to Governments, but should go to those who would make the best use of it, and there were specific cases in which a Government had frittered away the resources at its disposal.

There was no real reason why the ratio between revenue and income should be lower in less developed countries, because, owing to the inequality of income distribution and the fact that the private sectors often used resources in a less productive way, the Governments had greater responsibilities than in the more advanced countries and therefore needed a larger proportion of the national income.

He pointed out that fiscal yield as a proportion of national income varied greatly in the different Latin American countries, and no one level could be taken as a definite yardstick. For instance, a critical level of 15 per cent had been mentioned, but that was exceeded by at least

/eight countries

eight countries in the region. What could not be denied, however, was the existence of a potential capacity for raising more revenue in each one.

The question of fiscal policy could be viewed in different ways according to the conditions obtaining in particular countries. When a national revenue represented a large proportion of national income, the Government's expenditure policy became more important. When the proportion was low the question was primarily one of obtaining more revenue.

He then reviewed certain broad categories of taxes, which should ideally be considered in relation to the political, economic and institutional structure of each Latin American country. Export taxes were becoming less useful than they had been because of the increasingly vulnerable state of the primary commodity market. Import taxes, on the other hand, could be made to yield more revenue, although not if present trends continued. He suggested that one way of helping under-developed countries to progress was to tax the lower income groups by means of small levies on imported staples, which would undoubtedly yield a considerable amount of revenue. One type of tax that should be discussed was the levy on capital goods, which were currently made available to entrepreneurs in under-developed countries at preferential rates of exchange. If Government revenue was to be spent on the promotion of economic growth, the taxation of capital imports might be consonent with economic advancement. The preferential treatment of new or developing industries was also another aspect that should be re-examined. What was important was to determine the best source of revenue, if it was the customs administration, which had been efficiently developed in Latin American countries, then particular stress should be laid on import taxes.

With respect to excise taxes Mr. Urquidi had rightly pointed out that they might be gradually developed to replace import taxes as a source of revenue. His main doubts with respect to progressive indirect taxes concerned the possibility of tax evasion on the part of the wealthier groups - which could be dealt with by the choice of commodities with a fairly inelastic demand for the application of punitive tax rates - and the fact that most of the items subject to heavy taxation were imported

/and might

and might therefore have to be restricted because of balance-of-payments considerations. Income tax offered a large field for future exploitation. There were two aspects that required consideration: firstly, the expansion of the coverage to include more groups and, secondly, the tightening up of the concept of taxable income and sealing of loopholes for evasion. Other types of tax were acceptable because of their association with benefits, i.e. social security systems and government lotteries.

As agricultural taxes were to be discussed as a separate item, he would merely point out that their application posed very different problems in Asia and in Latin America because of the sharp disparities in land ownership in the latter. Land taxes were probably easier to apply than other types provided that they did not meet with undue political opposition from landowners, and he hoped that the practicability of the different kinds would be discussed at the conference.

The improvement and simplification of tax legislation and administration should also be taken into account as an additional source of revenue.

Mr. HARBERGER agreed with Mr. Desai that the cases in which tax exemption was granted to particular industries in Latin America required revision. It was justifiable to accord exemptions and subsidies to those activities which deserved encouragement because the resulting social benefits were different from and greater than the private advantages reaped. But in many countries exemptions had been established without clear proof that they were really necessary. A case in point was Chile, where special treatment was granted to the small and medium-scale mining companies, although investment in that sector had not increased thereby, while a few private individuals had amassed inordinately large fortunes.

He differed from Mr. Desai with regard to the significance of indirect taxation, although he agreed that if a high tax was levied on very precisely specified goods and their substitutes were tax-free, the former were simply ousted by the latter and the tax produced a very low yield.

/Given that

Given that the income-elasticity of luxury goods was higher than unity and the income-elasticity of other consumer goods was usually very close to unity, so that an average income-elasticity approximating to unity could be assumed, 50 per cent of goods had an income-elasticity in excess of unity; and if those goods could be taxes, an element of progresiveness would be introduced in that part of the tax system which might compound for direct taxation when the latter proved difficult to apply.

Mr. PINTO congratulated Mr. Desai on his sound interpretation of the concept of tax capacity, which had usually been a sort of futile and ineffectual figment of the imagination, because it had been estimated on the basis of abstract and unrealistic figures which took no account of the conditions in which the analysis had meaning. It was impossible to talk of tax capacity without due regard to the purpose of taxation. Thus, several basic factors of tax capacity had to be taken into consideration, such as (a) the nature of expenditure; (b) the source of funds; (c) tax collection capacity, which was in his opinion, at any rate in Latin America, limited over the short term; and (d) political capacity to appropriate resources of which the State thought it would be able to make better use than the private sector. If a more realistic approach to tax capacity were adopted, great progress could be made in that field.

Mr. HERSCHEL expressed the view that it was necessary to analyse the distribution of tax potential or the tax burden over the various areas of a given country. He endorsed the opinion of other speakers that empirical studies should be carried out to ascertain the degree of eficacy - if any - of the incentives provided.

Another interesting subject for study would be the evolution of tax revenue as income levels rose. In Latin America specialists in the field were concerned with the problem of the inflexibility of the tax system when taxable or real income increased - an inflexibility attributable to evasion, exemptions and deductions.

/Mr. NUÑEZ

Mr. NUÑEZ felt that all the speakers who had referred to incentives had judged them very harshly, and that the matter merited more careful analysis, since there had been cases in which the desired effect had apparently been produced. Perhaps too little imagination had been exercised in their application for the purpose of encouraging an activity or suppressing it, and in the use of the fiscal system to bring about changes in income distribution.

The most striking feature of Latin America's tax systems was that Mr. Desai had so felicitously described as the statistical jungle, namely, the proliferation of low-yield taxes which had developed because they constituted a means of procuring funds without giving rise to serious concern on the counts of equity or incentives.

The public sector had to weigh the merits of the alternative methods of obtaining revenue, and the decision as to which it would adopt was affected by what Mr. Desai called the political upper limit of tax capacity, apparently referring to the whole series of powerful factors involved.

Mr. Desai had been right in describing income tax as a farce; it was disturbing to think that all the countries were its victims, and it was therefore desirable to seek ways and means of ridding income tax of the stigma.

Mr. NAHARRO wondered what value attached to the estimate of an average income-elasticity of consumption approximating to unity, to which Mr. Harberger had referred. If that assumption was realistic, 50 per cent of consumer goods would surely have an income-elasticity higher than unity; and that would invalidate the traditional notion of what constituted a luxury article. However, in considering the revenue yielded by progressive indirect taxation on the consumer goods in question, another variable would have to be taken into account, namely, the volume of actual spending. Even if income-elasticity were high, the volume of expenditure could not equal it, and the progressiveness of the tax on consumer goods would be justifiable from the standpoint of equity, but might mean little from that of the transfer of sums on any substantial scale to the Treasury.

/Mr. BACA

Mr. BACA, referring to the allussion in document CPF-DS-1, footnote 2, to the competitive race by the Central American countries to attract industries, said that the problem no longer existed, as the countries concerned had recently signed an agreement to standardize the incentives accorded to new industries.

Mr. HART said that in table 2 of the same document the situation existing in Chile was not accurately presented; no figure appeared under the head of export taxes, whereas actually 50 per cent of the figure for income tax revenue was constituted by taxation applied to foreign companies engaged in export activities.

Mr. KALDOR doubted whether indirect taxes on luxury goods could be applied in such a way as really to represent a progressive tax. The income-elasticity of a consumer good could only relate to a specific income, and it became very difficult to ensure progresiveness, because there was no way of equating the goods consumed, with income levels. That did not affect the social need to tax luxury consumption, but merely implied that progressive income taxes were much easier to adjust to the individual tax payer's capacity to pay. Those indirect taxes which were really progressive - for example, on domestic help, living space, etc. - would be politically unacceptable.

Mr. GOODE agreed that there was no group of indirect taxes which could be efficaciously applied to obtain the same results as might be derived from a progressive programme of taxation on income, net wealth or total expenditure. But it was unfair to compare indirect with direct taxes on the assumption that the operation and administration of the latter would be flawless, and indirect taxes should not be discarded altogether, even if they did no more than reduce the degree of progresiveness of the tax system as a whole.

Mr. URQUIDI was in agreement with the general tenor of Mr. Desai's remarks, especially with respect to the political upper limits of taxation. For instance, when such expressions as "taxing the low income groups" were employed, he thought advisable that even in technical

/meetings heed

meetings heed should be taken of the unnecessary opposition which might be aroused by the very terms in which such measures were couched.

With regard to the need to institute severe penalties for evasion and official corruption, he attached more importance to the private sector's willingness to accept taxation. A milder policy of fiscal education would be more fruitful than punitive methods.

Mr. PREST felt that table 1 of document CPF-DS-1 was inconsistent with the discussion in the actual text, since it referred to the proportions of national income represented by tax revenue and not to the proportion of the "economic surplus". Nor did it give a very realistic picture of the revenue of the public sector, since in many instances it failed to include transfer payments.

With respect to the need for a tax system sensitive to variations in national income, he thought that difficulties would arise in two fields: (a) incentives; and (b) the situation of a country whose fiscal revenues largely depended upon the export sector, when abrupt fluctuations in export prices were registered.

Mr. LEWIS thought it was essential not only to calculate total tax capacity, but also to ascertain in which fields it was least efficiently utilized. In Latin America, apparently, the real estate sector was the one in which the level of tax collection was relatively lowest.

Mr. DESAI did not quite understand whether Mr. Pinto agreed with him or not. To call tax capacity a figment of the imagination was doubtless correct if any claim was made to define its limits with absolute precision. But an estimate was useful even if computing it was a purely academic exercise, since without it there would be a risk of formulating nebulous tax recommendations for want of an over-all framework into which they could be fitted.

In the discussion on indirect taxes, the differences of opinion were not fundamental, but related rather to ways of defining luxury consumption. Nobody called the usefulness of such taxes in question, especially if progressive income tax had a ceiling. But no general rule could be laid

/down for

down for indirect taxation, since all kinds of problems arose in connexion with substitution, the need to restrict imports, administrative difficulties, and so forth, which would affect its application in each country.

He differed from the opinion put forward by Mr. Nuñez, since in his experience the apparent success of tax incentives in the establishment of new industries had been mainly due to other concomitant factors.

To meet Mr. Hart's criticism, a footnote explaining Chile's special situation would be included in the final version of document CPF-DS-1.

The point elucidated by Mr. Baca had already been incorporated in the English version of the document.

Mr. Urquidi's objections did not seem to him valid. He could not see why it was politically undesirable to refer to taxation of the low-income groups. It might be that such a possibility had not yet arisen in Latin America because of the extreme inequality of income distribution, but sooner or later the relevant decision would have to be adopted. Taxation of the low-income groups, besides teaching them fiscal discipline, served other ends. In the first place, the expenditure of the well-to-do was much easier to control and guide into appropriate channels than the spending of the lower-income brackets. Again, as national income rose, the proportion contributed by the various sectors would increase, and the day was bound to come when in order to further economic development the Government would be compelled to require certain sacrifices of the whole population, and to make its demand explicit.

<u>The meeting rose at 5.55 p.m.</u>