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The role of taxation in economic development

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THE ROLE OF TAXATION IN ECONOMIC DEVELOPMENT

A THESIS
SUBMITTED TO THE FACULTY OF ATLANTA UNIVERSITY
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DEPARTMENT OF ECONOMICS

ATLANTA, GEORGIA
DECEMBER 1972
Capital formation and innovation are regarded as the two most important things in economic development. The main purpose of this thesis is to try to inquire as to the nature and extent of taxation as a manipulator to the capital formation as well as to the economic development in developing countries. Special emphasis is placed upon the discussion of the role of various taxes in the take-off stage.

Taxation is the important hope of capital formation in developing countries—the important instrument of underdeveloped countries to break the vicious circle of poverty and to emerge from poverty. Taxation has many facets: it can be a source of capital formation, an incentive for investment, an instrument of equalization, and an implement of curtailment of consumption of those above the subsistence level. There is no doubt that it will play a very important role in economic development.

Taxation, here we try to explore in a broad sense includes inflation, government monopolistic enterprises and levy of various taxes. Levy of various taxes is the most important and will be the center of this thesis.
Even today, capital formation and innovation are regarded as the two most important things in economic development. But we can only manipulate some on the former, whereas, we can do little on the latter. The main purpose of this study is to try to inquire as to the nature and extent of taxation as a manipulator to the capital formation as well as to the economic development in developing countries.

There are many sources of capital formation, but we consider that the taxation is the most important one. Because foreign aid is unreliable and often connected with political strings, the external debt is scarce and difficult to get. On the other hand, internal debt is restricted by the low level of savings. Therefore, taxation is the important hope of capital formation in developing countries—the important instrument of underdeveloped countries to break the vicious circle of poverty and to emerge from poverty. Taxation has many facets: it can be a source of capital formation, an incentive for investment, an instrument of equalization, and an implement of curtailment of consumption of those above the subsistence level. There is no doubt that it will play a very important role in economic development.

The most urgently needed investments in developing countries are overhead investments: railroads, highways,
harbours, public health, and education, etc. The mass investments in these fields are the bases of economic development, but these investments are either unprofitable or require large amounts. Therefore, private concerns are unwilling or unable to invest, and governments have to take the responsibility. What sources does the government use to finance these investments? Once again, that is taxation.

Taxation, here we try to explore in a broad sense, includes inflation, government monopolistic enterprises, and levy of various taxes. Among these, levy of various taxes is the most important one, it will be the center of this research. Economic development is more than a change of economic life, it is a struggling process. There must be some gain and some loss, no matter whether in the view of nation or individual. Furthermore, we must have determination to pay the prices, especially the 'elite in developing countries' they have to sacrifice some of their earned advantages. Perhaps taxation is one of the greatest prices we have to pay.

I wish to express my sincere appreciation to Dr. Ranjit Singh, without whose inspiration and consultation this research could not have been materialized.

Atlanta, Georgia

Yu-Liang Yeh

November, 1972
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>PREFACE</td>
<td>ii</td>
</tr>
<tr>
<td>TABLE OF CONTENTS</td>
<td>iv</td>
</tr>
</tbody>
</table>

## CHAPTER

### I. INTRODUCTION

1. The Change of Relationship Between Governmental and Economic Activities ... 1
2. Deficit Budget or Balance Budget? .... 2
3. Expenditure Measures Revenue or Revenue Measures Expenditure? .... 4
4. The Public Revenue and Economic Development in Developing Country .... 6
5. Direct Tax or Indirect Tax? .... 7
6. The Public Expenditure and Economic Development in Developing Country .... 9
7. Summary .... 10

### II. INFLATIONAL TAX

1. The Nature of Inflational Tax .... 12
2. The Collection of Inflational Tax .... 15
3. Inflationary Finance to Exploit the Surplus Labor .... 18
4. The Effect of Inflation Upon Economic Development .... 21
5. Summary .... 22

### III. CUSTOMS DUTIES

1. The Nature of Customs Duties .... 26
2. Import Duties .... 27
4. Is Protective Tariff Necessary? .... 29
5. Export Duties .... 32
6. Summary .... 35
<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>SALES AND EXCISE TAXES AND GOVERNMENT MONOPOLY</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>IV.</td>
<td>The Levy of Tax on Domestic Trade.</td>
<td>37</td>
</tr>
<tr>
<td></td>
<td>The General View of Sales Taxes.</td>
<td>37</td>
</tr>
<tr>
<td></td>
<td>The Turnover (Multiple-Stage Sales) Taxes.</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>The Single-Stage Sales Taxes.</td>
<td>42</td>
</tr>
<tr>
<td></td>
<td>The Value-added Tax.</td>
<td>43</td>
</tr>
<tr>
<td></td>
<td>Can We have an Optimum Sales Tax for</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Economic Development?</td>
<td>45</td>
</tr>
<tr>
<td></td>
<td>Excise Taxes.</td>
<td>49</td>
</tr>
<tr>
<td></td>
<td>Government Monopoly.</td>
<td>51</td>
</tr>
<tr>
<td></td>
<td>Summary.</td>
<td>53</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>V.</th>
<th>REAL PROPERTY TAXATION</th>
<th>55</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The General View of Real Property Taxation</td>
<td>55</td>
</tr>
<tr>
<td></td>
<td>Rural Land Tax.</td>
<td>59</td>
</tr>
<tr>
<td></td>
<td>Urban Land Tax.</td>
<td>61</td>
</tr>
<tr>
<td></td>
<td>Building Tax.</td>
<td>62</td>
</tr>
<tr>
<td></td>
<td>Summary.</td>
<td>63</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>VI.</th>
<th>INCOME TAXATION</th>
<th>65</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The General Review of Income Taxation</td>
<td>65</td>
</tr>
<tr>
<td></td>
<td>in Developing Countries</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investment Incentives</td>
<td>67</td>
</tr>
<tr>
<td></td>
<td>Income Tax Concessions</td>
<td>68</td>
</tr>
<tr>
<td></td>
<td>Summary.</td>
<td>70</td>
</tr>
</tbody>
</table>

| BIBLIOGRAPHY |                                        | 71   |
CHAPTER I

INTRODUCTION

1. The Change of Relationship Between Governmental and Economic Activities

Before the 1930's, the period of worldwide great depression, although governmental activities in every country was restricted to the smallest realm, so as to minimize its influence on the economic activities. But since the publishing of Smith's "The Wealth of Nations" and the establishment of laissez faire doctrine in 1776, the governmental share in the economy had increased continually. Nevertheless the balance of revenue and expenditure was still followed.

After the U. S. President, F. D. Roosevelt, adopted Keynes' advocation, New Deal solved the unemployment problem.

Since then the deficit budget was widely accepted; the small scale and neutral role of governmental activities were no longer observed and the governmental share in the whole economy has progressively increased and the influence of government activities on the economy was no more comparable to its size in the past. Therefore the night watcher's finance was substituted by the functional finance. The increase of government activities in the economy reached the climax during the Second World War. Although it was decreased postwar, no longer later owing to the cold-war, space competition, social
security and the economic development, the public revenue and expenditure increased greatly. Even today, in many countries total revenue occupies more than one-third of its gross national product.

2. Deficit Budget or Balance Budget?

After the Second World War, many countries tried to reconstruct from the war ruins and debris. So did the newly emancipated from the control of colonialist and imperialist launched development programs. The problems of growth and development are the biggest issue among scholars since then. Therefore, the choice between deficit and balance budget becomes the important issue.

Those in favor of deficit budget argue that deficit budget solved the unemployment problem during the great depression and there is unemployment in the developing countries, therefore deficit budget is still applicable in those countries. Those in favor of balance budget argue that deficit budget is apt to induce inflation and most of the developing countries have inflationary tendencies, if the deficit budget is adopted. It is rather easy to have derivative hyper-inflation; even in developed countries, if unlimited deficit budget is adopted.

As a matter of fact, financial policy is different in different nations; even in the same country it will be different at different times. Therefore the policy, which is recommendable in the developed countries, is not necessarily
recommendable for the developing countries. Generally speaking, the economic problem of developed country is that of steady growth, that is how to manipulate the share and direction of public revenue and expenditure to abirritate the fluctuation to the less degree. While the problem of developing country is that of take-off, that is how to manipulate the share and direction of public revenue and expenditure to break the vicious circle of poverty. From the production and distribution points of view, the developed country emphasizes upon distribution, while the developing country emphasizes upon production.

Moreover, from the employment point of view, the developed country has to maneuver its public revenue and expenditure to stimulate the increase of effective demand so as to maintain the full employment of production factors; whereas the developing country has to maneuver its public revenue and expenditure to stimulate the supply of production factors so as to increase the production. Furthermore, the developed country often owing to lack of effective demand could not reach the full employment, therefore the levy of progressive taxes, the enforcement of negative income tax, unemployment insurance and relief works, etc., are the necessary means to promote the propensity to consume so as to increase effective demand. Whereas the developing country often owing to the lack of capital, technical know-how, entrepreneurship, and high quality of labor (those unemployed are unskillful labor) could not accelerate economic develop-
ment, therefore the private investment should be encouraged on the one hand and public investment should be increased on the other hand.

According to the aforesaid statement, we would like to say that deficit budget could be recommendable in the developed country but not necessarily so in the developing country. Probably it is more advisable for the developing country to follow the balance budget, especially since the problem of inflation has occurred already.

3. Expenditure Measures Revenue or Revenue Measures Expenditure?

The traditional scholars and financers regarded that since a nation could levy as much as it wishes within the reach of its territory, therefore, the portion of revenue should be measured by the scale of expenditure, that is to say the scale of expenditure decides the scale of revenue; the portion of revenue in the national product will not be paid any special attention. Before 1930, most of the financers followed classical school, considered that "government is a necessary evil"; the activities of government should be restricted to the role of neutrality and the levy of taxes should not interfere with the operation of price mechanism; therefore the role of taxation in the whole economy was minor and regarded "a necessary evil," and the expenditure was contracted to the smallest scale; since the expenditure was limited the revenue which was scaled by the expenditures would be limited too. Therefore, there would not be a
problem even if we scaled the portion of revenue by the scale of expenditure.

After the general acceptance of functional finance and the effectiveness of public expenditure in promoting the effective demand, the limit of public revenue was neglected, but the role of taxation in the whole economy became important. Until the 1930's, some scholars came to realize that even if there is functional finance, the public revenue should be limited and they advocated that twenty-five percent of gross national product is the limitation. If the public revenue is over twenty-five percent of gross national income, the national economy will be overburdened. In other words the scale of public revenue should not be measured by the scale of expenditure, although it is not necessary to act as private concerns to measure expenditure by expectant revenue, the maximum burden of national productivity should be considered.

How much percentage of gross national income can afford to public revenue? that is a difficult problem. Although we would not like to say that there must be fixed percentage, the so-called twenty-five percent, yet we would like to regard these percentages to depend on national productivity and other social factors, other things being equal the greater productivity the higher the percentage will be; and that the golden rule "not to kill the golden goose" should be followed anyhow!

It is not appropriate for the developing country to measure its revenue by the scale of expenditure alone. This
is owing to the fact that the developing country is vulnerable to inflation and its productivity is small. Although the developing country when financing its economic development need not measure its expenditure by its revenue, but the overtaxing should be avoided.

4. The Public Revenue and Economic Development in Developing Country

Generally speaking, the sources of financing economic development are taxes (including government monopoly revenue), debts, sale of public property, and issuing of currency, but which one is the best for the developing country to adopt, is a problem. Among these, the easiest way is to issue currency, but since developing country is vulnerable to inflation and the issuing of currency is apt to be abused, therefore, this method is limited to some extent.¹

The second way is to run into debts; the external debt is scarce and difficult to get while internal debt is restricted by the low level of savings, besides you have to pay back principal with interest, how can you pay for that, taxation, the last resort. The third is the sale of public properties. Since public properties are limited in sources, this can be an emergency way of financing only and cannot be regarded as a normal way of revenue. Taxation is the last resort yet is the most important one. It is said that there would be no modern nation if it could not have power to tax;

¹We will discuss this method in detail in the next chapter.
we would like to say that there will be no economic development if the government does not have power to tax. Taxation has many facets; it can be a source of capital formation, an incentive for investment and an instrument of equalization. No doubt it will play a very important role in economic development.

5. Direct Tax or Indirect Tax?

The developing countries often depend upon indirect tax as their major source of revenue and are labeled in the status of backwardness, therefore the change in their tax structure is advocated vigorously. But we would like to say that developing countries rely on indirect tax as their major source of revenue is a natural phenomenon and is not a symbol of backwardness.

According to Dr. Harley H. Hinrich's study,\(^1\) the course of tax structure change during economic development is in the form of "direct tax—indirect tax—direct tax"; in the stage of preconditioning\(^2\) land tax, cattle tax, and poll tax predominated in tax structure, since land tax, cattle tax and poll tax cannot shift, therefore, we can regard them as "traditional direct tax." As the economy developed into the take-off stage, the taxes which levied on the production and exchange increased and became predominant in tax structure,

\(^1\) In his "A general theory of tax structure change during economic development," Harvard University Press, 1966.

\(^2\) The stages of economic growth are adopted from W. W. Rostow's model.
since these taxes can shift, we regard them as indirect taxes. As the economy developed into the stage of drive-to-maturity, the income tax—"modern direct tax"—emerged and gradually increased its share in total revenue along with the course of development; as the economy developed into maturity stage the modern direct taxes became predominant.

Therefore we prefer to say that the developing countries depend upon indirect taxes as their major source of revenue is a kind of natural course of tax structure change during economic development and the intention of changing their tax structures seems unnecessary.

Some scholars regarded that to strengthen the levy of direct tax is necessary if the developing countries want to prevent the over-concentration of properties. Thus the developing countries can avoid some social problems already happened in the developed countries, therefore, advocate to establish a direct tax system with income tax as its backbone. As a matter of fact, the establishment of income tax has to wait until the social-economic conditions have evolved to some degree, otherwise the badly enforced income tax could be worse than the worst indirect tax. Even the economic condition has reached to some degree which can support a revenue system with income tax as its backbone, if the social-cultural backgrounds are not appropriate to enforce income tax as the prominent tax we cannot do it likewise. For instance, West Germany and France, although their economies have reached the stage of beyond maturity their tax structure
are half indirect tax and half direct tax and are not like the United States which has eighty-five percent of its total revenue coming from income tax\(^1\); this is the result of different social-cultural factors. The well developed countries such as West Germany and France still have to adapt to the differences of social-cultural factors; it is needless to say that the developing countries cannot challenge these differences.

Recent research reveals that cooperation income tax has the shifting phenomenon, thus the distinction of direct and indirect taxes seems not so important as it used to be. It seems that developing countries need not be in a hurry to establish the direct tax system to prevent the over-concentration of wealth. Because direct taxes are not necessary progressive, for instance poll tax is regressive, indirect taxes are not necessary regressive, for instance luxury tax is progressive. If developing countries want to prevent the over-concentration of wealth, the choice of tax bases and adjustment of tax rates so as to increase the progressiveness of current indirect taxes is more advisable. It seems unnecessary to regret the dependence of revenue upon indirect taxes.

6. The Public Expenditure and Economic Development in the Developing Country

If developing countries want to accelerate their

\(^1\)Federal budget.
economic development, the investment must be accelerated. Although tax inducement can stimulate the increase of either domestic or foreign investment, this alone is not enough. Generally speaking, the most urgently needed investments in developing countries are overhead investments; these are railroad, highway, harbour, public health, and education, etc. The mass investments in these fields are the bases of economic development, but these investments are either unprofitable or long run and large amount investment, therefore private concerns are unwilling (unprofitable) or unable (lack of capital) to invest and governments have to take the responsibility. Thus the public investment, so does the public expenditure, becomes the major investment of economic development and the direction and scale of public expenditure have great influence over the economic development. Since the national product of a country is limited, so the available fund for government is limited. Therefore the developing countries must be very prudent; the consumption expenditure should be checked, even if the investing expenditure should be carefully selected so as to stimulate the acceleration of economic development.

7. Summary

The public revenue and expenditure in the developing countries are as important as the aforesaid statements, thus the public financers of the developing countries must be very prudent in drafting their public revenue and expenditure. In the case of public revenue, the financers should find the
way between the contradiction of tax incentives for encouraging investment and tax augmentation for financing economic development. In the case of public expenditure, the duplicated effort of public and private investment and gorgeous investment should be avoided. For preventing over-concentration of wealth, the profit motive should not be killed, thus the increase of domestic and foreign investment becomes possible. Therefore the relationship between taxation and economic development in developing countries is not only very close and complex, but even contradictory, that is to say this is not a problem of black or white, but is a mixture of both; thus it is rather easy to induce misunderstanding and criticism. The financers should awake to these circumstances and be firm in distress so as to find a way for the economic development of the developing countries.

Taxation—here we try to explore in a broad sense—includes inflation, government monopolistic enterprises, and levy of various taxes. Among these levy of various taxes is the most important one, it will be the center of this research. We will discuss them in the following chapters from economic development point of view.
1. The Nature of Inflational Tax

As we said before, the easiest way to finance economic development is by increasing the issuing of currency, therefore it is rather difficult for the government in need to resist the temptation of accelerating the printing machine, especially when the central bank is under the command of the treasury department (we assume that the central bank has privilege to issue the bank notes). But accelerating the printing machine is not necessarily equal to accelerating economic development, even if all of the increased bank notes are used to finance development projects. Because the accelerating economic development depends on the success of development projects and the increase in money supply only cannot guarantee the success of development projects.

It is conceivable that before the new consumer goods are increased by the new projects, the increased bank notes will increase the aggregate demand. Since there is no increment in aggregate supply, the price level will be increased; a demand-pull inflation will be created. Furthermore the

---

1 The increase in money income of which paid from the increased money supply can only be taxed away partly. We will discuss this at length in section three of this chapter.
new projects will bid production factors away from other industries, and thereby decrease production in other industries, thus aggravating the inflation. The shifting of production factors from other industries to new projects will increase the social transportation cost\(^1\); this too will add some pressure to inflation. If new projects want to bid the production factors from other industries the higher price must be paid. If the industries want to keep their production factors from shifting the higher price must be paid too. Thus the cost of production will be increased, so does the price of consumer goods—a cost-push inflation will be created.

No matter which kind of new project is financed by the printing machine as long as the new project has to bid away production factors from other industries; the products of other industries will be decreased by this kind of bidding; the new projects cannot produce consumer goods immediately; the social transportation cost will be increased by this kind of movement, the inflation will be created more or less. The degree of inflation will be decided by the time lag between the investment in the new project, the hit of consumer goods to the market by the new projects, the cost of production factors increased by the bidding of the new projects, the decrease of consumer goods of other industries by the shifting of production factors from the industries to the new projects,

\(^1\)The increased social transportation cost includes the cost of shifting production factors and the cost of supplies and maintenance for production factors owing to the shifting.
and the increased social transportation cost by the shifting of production factors. Of course, if there is no time lag between the investment and production of consumer goods in the new projects, no decrease of consumer goods in other industries, no increase of cost in production factors and shifting of the factors, there will be no inflation, even if the new projects are financed by the printing machine.

Since inflation will be created more or less if we finance our economic development by printing more currency, then the purchasing power of the idle money—currency and demand deposit\(^1\) holders will be decreased via inflation. This is just like the government taking away the purchasing power from the taxpayers via taxes without special compensation,\(^2\) therefore, we consider government's inflational finance is a kind of tax—inflational tax. Although some economists consider that inflation is the worst form of tax, yet we do not quite agree with them if inflational tax is used to finance economic development; but we do not agree that development inflation will correct itself either. There are so many factors that contribute to the success of inflational finance, without these factors development inflation cannot correct itself. That is the reason why we said that inflational tax had some limits before.

\(^1\)The saving and time deposits will suffer the loss of purchasing power too, but in less degree since both of them yield some interest.

\(^2\)Government will compensate the taxpayers through general provision of public goods and services.
2. The Collection of Inflational Tax

Inflational tax seems very easy to collect; just to accelerate the printing machines and the faster the machines run the more revenue is collected. Actually it is not so simple, if inflation develops into super degree, not only can we not collect any more inflational tax but also the other revenues collected in fixed monetary term will be eaten away by inflation—the loss of purchasing power of the government revenues. Therefore, the increase in money printing does not necessarily result in the increase of purchasing power available to the government. Since inflational tax is taxing idle balance—currency and demand deposit, the collection of the tax depends on the people's willingness to hold the balances, but the willingness to hold currency and demand deposit is a kind of mental status which we cannot trace. Fortunately, the willingness to hold idle balances is embodied in the velocity term of the equation of exchange. Thus, if we can only analysis the increase in money printing and its influence upon the velocity of money circulation, national product and general price level, then we can say if inflational tax is a success or not.

If the development projects are very successful and produce a considerable amount of consumer goods within a short period (say one year), then the result could be illustrated in the following equation.

\[
\frac{\Delta M}{M} + \frac{\Delta V}{V} = \frac{\Delta P}{P} + \frac{\Delta Y}{Y} \quad 8\% \text{ revenues}
\]

\[
10\% - 1\% = 2\% + 7\%
\]
Here $M$ stands for total money supply, $M$ stands for increased bank notes, $V$ stands for velocity of money circulation, $V$ stands for change of velocity of money circulation, $P$ stands for general price level, $P$ stands for increased general price level, $Y$ stands for national products, $Y$ stands for increased national products. Thus in the above equation we can see ten percent increase in money supply, of which one percent is willingly absorbed (the one percent fall in the velocity of money circulation, since national products increase in large proportion and people's confidence in money increases, too), seven percent is absorbed by increased national products and only two percent is washed away in inflation.

Thus, the government's inflational tax amount to eight percent ($10\% - 2\%$) of the total money supply.

If the development projects are successful but only have a moderate increase in consumer goods within a short period, the increased money supply of which washed away in inflation will be increased. Let us illustrate in the following equation:

$$\frac{\Delta M}{M} + \frac{\Delta V}{V} = \frac{\Delta P}{P} + \frac{\Delta Y}{Y} \quad 6\% \text{ revenues}$$

$10\% - 1\% = 4\% + 5\%$

In this case, since there is a five percent increase in national products, we assume that a ten percent increase in the money supply of which one percent is willingly absorbed, if the money illusion still exists so that cost-push inflation does not happen; since the increase in national products cannot meet the increase in aggregate demand, the demand-pull infla-
tion prevails and the increased money stock of which four percent is eaten away by inflation. Thus the government's revenue is only six percent (10% - 4%) of the total money supply.

Suppose the development projects are not successful and only have a small increase in national product, the people are reluctant to accept the increased money stock and the money illusion is no longer in existence, so that the velocity of money circulation increased, therefore both demand-pull and cost-push inflation prevail. If we illustrate the situation in equation, it will be like this:

\[
\frac{\Delta M}{M} + \frac{\Delta V}{V} = \frac{\Delta P}{P} + \frac{\Delta Y}{Y} \quad 1\% \text{ revenue}
\]

\[10\% + 2\% = 9\% + 3\%\]

Thus we can see the ten percent increase in money stock of which nine percent is eaten away by inflation, the government's revenue is only one percent!

If the government neglects the above situation or owing to other reasons keeps accelerating printing the bank notes up to a tremendous amount, say up to eighty percent, the hyper-inflation will prevail. The situation could be like the following:

\[
\frac{\Delta M}{M} + \frac{\Delta V}{V} = \frac{\Delta P}{P} + \frac{\Delta Y}{Y} \quad -9\% \text{ revenues}
\]

\[80\% + 10\% = 89\% + 1\%\]

When hyperinflation becomes too intense, people expect further rise of price level in the near future, thus demand-pull and cost-push inflation feed back each other and accelerate the
speed of inflation; hyperinflation thus happens.

In this case, even if the money stock increases eighty percent since people refuse to accept, the velocity of money circulation increases ten percent, as a result of hyperinflation price level increases eighty-nine percent. Not only is the increased money stock all eaten away by inflation but also the revenue of other taxes is washed away for nine percent by inflation in terms of purchasing power. Therefore, the government cannot get any inflational tax but the negative revenue, in some sense.

From the above discussion we know that a successful collection of inflational tax depends on the success of development projects and people's willingness to absorb the money increased, or on the relative relation between the increased national products which are produced by development projects and the increased money supply which financed development projects and the time lag in between.

3. Inflationary Finance to Exploit the Surplus Labor\(^1\)

It is widely recognized that the underdeveloped countries, those which have dense population, suffered from "disguised unemployment"—a phenomenon of the existence of surplus labor. As Professor W. Arthur Lewis asserts the marginal productivity of surplus labor is "negligible, zero,\)

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\(^1\)As for the exploitation of surplus labor to increase the capital formation, please consult with Professor W. Arthur Lewis' famous article, "Economic Development with Unlimited Supplies of Labor," from The Economics of Under-development, selected and edited by A. N. Agarwala and S. P. Singh, Oxford University Press, 1963.
or even negative," therefore we can draw surplus labor by inflationary finance for development projects without the decrease in original production,¹ then the products in these projects will be the net gain in whole economy. Thus we can regard these disguised unemployment labor forces as a potential savings.

According to Professor Lewis the sources of surplus labor forces are the farmers, the casuals, the petty traders, the retainers (domestic and commercial), women in the household, and the population growth; and we would like to say that the increase in productivities owing to technological progress and the increase in life expectancy owing to economic progress will add to the source of surplus labor in some sense.

We believe that with the crude and domestic made tools such as shovels, hoes, weeding devices, and earth-moving devices to create dams, irrigation system, canals, roads and field terracing can increase the capital formation in agriculture so does agricultural product. Of course, money wages from an increased money supply must be paid to the workers, thus money income of the workers increase, although we can tax a part of their income (if we tax all of their income nobody will work), they still will spend a large part of their new money income, more or less, immediately, thus an increment in

¹Of course there are some leakages; the increase of consumption of workers in development projects and farmers who sell foodstuffs to workers and the increase of transportation cost of food and supplies for workers. All of these will decrease the capital formation of which development projects created.
demand for consumer goods with no immediate increment in output will happen. Suppose that the workers buy food (it is conceivable that income elasticity of demand for food of those workers is rather high, as their incomes increase they not only eat more but eat better) from those who are still remaining on the farm, the income of farmers thus increase. In order to prevent the farmers from increasing their consumption they must be taxed too. Since we have to keep the incentive to work (directly and indirectly) for development projects both the money income of workers and farmers cannot be taxed away wholly. The implementation of the kind of tax required to prevent inflation would challenge the most sophisticated of taxing bureaucracies, and the tax levying and collecting skills in most underdeveloped countries are far from sophisticated.

Furthermore, we have to pay the wages which are higher than the average wages in agricultural sectors so as to attract the surplus labor in which sector and the transportation of food and supplies for workers will increase the burden of the economy. Thus the pressures are added to the inflation and the net gain from the development projects will decrease owing to the increment of consumption (both workers and farmers) and the cost of transportation. Therefore, the competence of taxing bureaucracies in the underdeveloped country has crucial influence upon the control of inflation, so does the success of taxation in checking against inflation have crucial influence upon the success of inflational
development.

4. The Effect of Inflation upon Economic Development

Since the result of inflational finance for economic development will lead to inflation more or less, its effect upon economic development deserves our attention.

Generally speaking, inflation tends to benefit profit earners and to have adverse effect upon fixed income earners (the earners of wages, salary, pension and so forth), since the income of the former increases with the rise of price level while the latter remains the same or is slower than increase in price level. Thus the inflation has income redistribution effect in favor of profit earners, since profit earners have a higher propensity to save than wage and salary earners, saving of the former increases while the consumption of the latter decreases. Then the profit earners have more income to reinvest, the capital formation is increased and economic development is thereby accelerated.

Inflation increases entrepreneurial profits, thus increasing the taxable income of entrepreneurs. Moreover, the tax collecting powers of the government may be increased since income is much more concentrated than ever as a result of inflation. Both of the above results will increase the tax revenue of government to finance economic development, thus economic development could be accelerated due to the increment of available fund to invest.

But if inflation is out of control and becomes hyper-inflation, even if savings is successfully forced inflation
brings about the wrong sort of investment.

Since the higher price in the near future can be expected, it is much easier to earn inflational profit by speculation than by usual investment-production.

Savings will be directed into nonproductive forms of investment, such as the hoarding of gold, precious stones, foreign securities and similar assets, and the acquisition of real estate and the construction of luxury apartment blocks (as it happened in Brazil) and accumulation of inventories of goods and materials. Because in rapid inflation, investors look for ways of accumulating wealth that will appreciate in terms of money but at the same time will be quickly realizable. Thus not only the usual investment will be dampened, the development projects will be impaired also.

5. Summary

As we said in the end of the first section of this chapter, some economists consider that inflation is the worst form of tax. They regard that inflation may have very adverse effects on habits of voluntary savings while its ability to force savings is limited, and it will lead to very unproductive forms of investment; it will increase a considerable social cost since the decreased consumption of fixed income earners cannot be fully compensated by the increased investment of profit earners from the viewpoint of the whole society. But we recognize that the capacity to save in underdeveloped countries is small due to low real income. Therefore, the voluntary savings could be small even if the prices are stable,
if this is the case that the adverse effects of inflation upon voluntary savings could be neglected.

As to the fact that inflation will promote unproductive investment if more fundamental causes are preventing savings from going into production, it is beside the point to say that inflation leads to unproductive forms of investment. "Deep seated institutional causes hold down personal saving and divert them from productive investment."¹ Savers in underdeveloped countries seem to be reluctant to lose direct control over their wealth, and prefer to invest in a manner which leaves it in their possession, as Professor Lewis has argued,² the basic cause of unproductive investment may be the absence of entrepreneurial class which thinks in terms of reinvestment of its income productively. Thus inflation could be only one of the factors which act against voluntary saving and productive investment. On the other hand, if other factors are already so great as to prevent development, perhaps inflation may help to the initial breaking of bottleneck.

As for increasing social costs, we recognize that the inflationary finance is at the expense of the consumption of the poor, but it seems necessary in the course of economic development that the benefit of some people will be sacrificed for some period. What we can do is to use the taxation instru-

¹E. Bernstein, "Financing Growth in Underdeveloped Economies" in Heller, Boddy and Nelson, Savings in the Modern Economy (University of Minnesota Press).

²W. A. Lewis, "The Theory of Economic Growth," Chapter V.
ment to confine this sacrifice to the people who are best able to bear it and to the smallest group of people in the shortest period of time possible. Just compare this sacrifice with the endless suffering vicious circle, perhaps this sacrifice is the price worthy us to pay.

We are concerned about the deficiencies of inflational development but we are concerned much more about the success of the development; according to the above discussion we can summarize the factors contributing to the success of inflational development as follows: 1) the existence of surplus labor which can be used for capital formation with little cost; 2) the presence of money illusion so that a part of increased money can be willingly absorbed (needless to say the stability of the price level must exist before the operation, otherwise the experience of severe inflation has mopped away this illusion already); 3) entrepreneurial class has high rate of reinvestment in the course of inflation; 4) the new development projects can produce consumer goods within a short period (say one year); and 5) taxation machinery can levy a part of profit of entrepreneur, of wages of workers, and of income of farmers in the course of inflation so as to confine the demand-pull and cost-push inflation within control. This is obvious that most of the underdeveloped countries cannot have all of these conditions. Thus the application of inflational finance and the possibility of success are limited. Nevertheless, taxation is one of the important factors which
decide the success of inflational tax, that is one of the reasons why we emphasize more upon the levy of other taxes than upon inflational tax.
CHAPTER III

CUSTOMS DUTIES

1. The Nature of Customs Duties

Customs duties are duties which are levied upon commodities as they cross a national frontier. They can be taxed on imports or on exports, but the latter are more scarcely employed nowadays. Customs duties are no longer deemed important as they used to be, especially export duties are almost neglected and have never been popular with economists in these days. But from the economic development point of view customs duties deserve more attention, especially during the early stages of economic development. Since the tax administrative agencies of the developing countries are not highly developed so as to cope with sophisticated taxation, the simplicity in tax enforcement is very desirable, taxation on foreign trade can satisfy this requirement; once tax agencies are installed on the strategic thresholds of the frontier and smuggling and corruption are successfully prevented, then the revenues can be increased along with the increase of international trade (of course there are factors which decide the amount of revenues besides these) during the early stages of economic development.
2. Import Duties

The objectives of import duties are: 1) to raise revenue so that there will be more funds available for financing economic development; 2) to protect domestic infant industries so that the economic development can be accelerated; 3) to equalize the tax burden of the domestic products of which the excise tax is imposed and the tax burden of foreign products of which the excise tax will be imposed if they are produced within the taxing country, so that the excise tax can be successfully enforced (of course there are factors in regard with the success of excise tax).

A tariff imposed for the first purpose is a "tariff for revenue only"; the tax rates are moderate so as to produce the maximum revenue and usually are imposed on commodities which are not produced in the taxing country but whose entry is easily watched. The second purpose is a "protective tariff"; the tax rates are high so as to reduce the competition of imports with the domestic products and is usually decided by the difference of production costs between export and taxing countries minus transportation costs. The third purpose is a "compensatory tariff"; the tax rates are usually equal to the excise tax rates and so are the economic effects of this tariff and excise tax.

Actually in practice a tariff imposed could be just for one of these purposes or two or even three of them. The above cataloguing is just for the convenience of further analysis.
3. Does Revenue Tariff Conflict with Protective Tariff?

Some economists regard that "the protective purpose of a tariff is always fighting against the revenue purpose; the more successful (a tariff) is in one direction, the less successful it will be in the other."\(^1\) Actually it is not always like this; we recognize that there is a conflict between them, but the degree of conflict need not be like the above statement; if we restrict a tariff for the revenue only and impose upon the commodities which are not produced in the taxing country, there will not be any conflict between them; if we impose a tariff for the purposes of revenue, protection, and compensation, the revenue loss in import duties due to the decrease of imports can be recouped from the revenue gain in excise taxes due to the increase of domestic products.

The problem often arises from the fact that we impose a tariff both for the purpose of revenue and protection; if this is the case and the duty rates are increased on the minor revenue sources, the loss of revenue should not be significant and could easily be recouped by marginal increases in the duties imposed on the major revenue sources even if the duty rates are increased on the major revenue sources, if the price elasticities of demands of imports are less than unity, the loss of duty revenue would not be significant. Furthermore, even if the price elasticities of demands of imports are greater than unity, the decrease in demands for the import of

finished products can switch to the increase in demands for the import of raw materials used to produce finished products or to the increase in demands for substitutes, the loss of duty revenue could be partly recouped from duties on raw materials or on substitutes. Thus the conflict between revenue and protective tariffs does not deserve too much attention.

4. Is Protective Tariff Necessary?

There are many arguments about pros and cons of protective tariff; on the affirmative side we can trace back from mercantilist to nationalist; on the negative side we can trace back from classicist to cosmopolitan.

Mercantilist argued that protective tariff was used to restrict imports and to encourage exports so as to develop a "favorable balance of trade," this argument had gone with the wind after the great depression of 1930's. Friedrich List's infant industries argument seems still valid even from an economic development point of view. John Stuart Mill's terms-of-trade argument seems more convincing than favorable balance of trade argument, but if only we consider that when all nations pursue this terms-of-trade tariff policies so as to beggar-my-neighbor, the world pattern of production and exchange will become less efficient, and all nations could be worse off instead of better off! Some nationalists argued that protective tariff must be used to foster the national defense industries, this is a kind of political reason we cannot refute by economic reasoning.
As for the unfavorable side of protective tariff, Adam Smith's free trade advocation so as to promote specialization and production to increase national wealth is the first and the most vigorous argument, but his argument could not hold its ground everywhere, if a country is inferior in producing every thing what can it specialize in? Ricardo's comparative advantage theory gave us the answer, this is the difference of the comparative costs not the absolute costs and the transportation costs that decide the direction of specialization; every country profits most by producing and exporting those goods and services for which it is relatively most suited and by importing items produced under relatively favorable conditions in other countries. The protective tariff offsets such comparative advantages so as to demote the living standard of every nation, therefore it must be abolished.

Since we are much concerned about the manipulation of taxation to accelerate economic development, List's infant industries theory deserves our further study. According to this theory, there are industries in which a country could have some comparative advantages, only if the industries can be protected from foreign competition by tariffs during their infancy, so that the industries can overcome the initial period of experimentation and financial stress, then they can develop into the production of high efficiency, thus the costs and prices can be reduced and the protective tariffs can be withdrawn accordingly.

At first prices to the consumer will rise, but once the
industries grow up they will be so efficient that costs and prices will fall. If the benefit to consumers after the growth of the industries could be more than to compensate the loss of higher prices during the period of protection, then the protective tariffs can be justified.

The infant industry theory is not contradictory to the principle of comparative advantages. On the contrary the validity of the infant industry theory rests upon the assumption that the industries thus protected must have potential comparative advantages, but only after a period of protection these advantages can emerge to the surface; perhaps we can say that this is a dynamic shifting of the production-possibility frontier toward a new one which has comparative advantage and is induced under a period of protection. W. W. Rostow argued that newly favorable international environment is one of the important factors which stimulate the beginning of take off,\(^1\) perhaps we can regard that the protective tariff is a kind of manipulated factor which stimulates the beginning of take off just like newly favorable international environment does but only in a different direction (shielding from foreigner's competition). We discussed in the second chapter that the surplus labor in overpopulated countries is a kind of potential savings. If we can use the protective tariffs to establish some industries so as to absorb the surplus labor and transform this potential savings into a substantial one, the

\(^{1}\text{See his "Stages of Economic Growth."}
capital formation increased in this way is just like the one increased by the increase of exportation which is realized due to newly favorable international environment. If this is the case, then the appropriate usage of protective tariffs could stimulate the beginning of take-off in the overpopulated developing countries.

5. Export Duties\(^1\)

Although export duties are considered obsolete and even condemned these days, yet export tax has many advantages in underdeveloped countries. Generally, export duties are used for: 1) to raise revenue during the period of export boom; 2) to protect the domestic processing industries; and 3) to exploit monopolistic benefit.

Export duties are easy to collect, particularly when the important exports are marketed through marketing boards or a few large dealers, collection of tax is much easier than collection of income tax from numerous small farmers. Thus the advantage of administrative simplicity makes export duties as a supplement to the income taxes in a developing country.

World prices of some raw materials often fluctuate substantially; in good years the government can obtain a large sum of tax revenue from export duties for use in economic development. At the same time export duties can check domestic inflation due to the sharp rise in incomes of the export

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producers not accompanied by an increase in domestic and foreign consumer goods (both increase in consumption of domestic and foreign consumer goods are not desirable to the interest of economic development). For the purpose of taxing on windfall gains due to higher world prices, the export duties must have rates that are nominal when world prices are more or less normal so as not to retard the growth of exports but that climb steeply with an increase in prices so as to seize the large part of the windfall gains.

As for the protection of domestic processing industries, export duties are imposed upon the raw material such as raw hides and skins, lumber, tin, ore, etc., so as to encourage local tanning, pulpmills, and plywood works, melters, and so forth. If a country can dominate the world market just like Chilean nitrates, South African diamonds and Peruvian guano have a monopoly, then most of the export tax burden will be borne by the foreigner. The optimum tax rate can be decided by the total-revenue and total-cost functions so as to exploit maximum export tax revenue. For instance if the functions are:

\[ R = -\alpha Q^2 + \beta Q \quad (\alpha, \beta > 0) \]
\[ C = aQ^2 + bQ + C \quad (a, b, c > 0) \]
\[ T = tQ \]

Here

- \( R \): total revenue from export
- \( C \): total cost
- \( Q \): output
- \( T \): total tax revenue
t: tax rate

Then the total cost after the imposition of export tax will be: \( C + tQ = aQ^2 + (b + t)Q + C \) if we use \( C^* \) to represent the total cost after tax and \( \pi \) for profit, then the profit function is: \( \pi = R - C^* \) thus:

\[
\frac{dC^*}{dQ} = 2aQ + b + t = MC^* \quad \text{(Marginal cost function after tax)}
\]

\[
\frac{dR}{dQ} = -2aQ + \beta = MR \quad \text{(Marginal revenue function)}
\]

for after tax equilibrium output \( Q \) is \( MC^* = MR \) that is \( 2aQ + b + t = -2aQ + \beta \) therefore \( Q = \frac{\beta - b - t}{2(a + \lambda)} \)

thus the tax revenue function at \( Q \) is \( T = t \left( \frac{\beta - b - t}{2(a + \lambda)} \right) \)

if we want to optimize total tax revenue \( T \), we must set the first derivative of \( T \) equal to zero, that is

\[
\frac{dT}{dt} = \frac{\beta - b - 2t}{2(a + \lambda)} = 0
\]

but we know that \( a, \lambda > 0 \), therefore \( \beta - b - 2t = 0 \)

\[
t = \frac{(\beta - b)}{2}
\]

Is this \( t \) maximum or minimum?

Since \( \frac{d^2T}{dt^2} = \frac{-2}{2(a + \lambda)} = \frac{-1}{a + \lambda} < 0 \) (since \( a, \lambda > 0 \). \( \therefore a + \lambda > 0 \))

therefore we can say that if we have the functions like above, when we set tax rate equal to \( (\beta - b)/2 \), then we can have the maximum export tax revenue.

The export tax is often condemned for its distinctive effects to export industries and for its expelling the marginal producer out of market and thus retards economic growth.
But if we set the tax rates that are nominal when world prices are more or less normal, as we said before in the case of revenue purpose, perhaps these undesirable effects could be alleviated to the less degree. The export tax is also criticized for its unreliability, this is owing to instability of world prices of exports, that is the reason why export duties cannot be used as a main source of revenue but as a supplemental one only.

6. Summary

Although import duties decline in the course of economic development, but they still occupy the prominent position both as instrument of revenue collection and as promoter of economic development, we can have evidence both from the early stages of development in the advanced countries and the present stages of developing countries.

A tariff for revenue is not necessarily contradictory to a tariff for protection, we recognize that there is conflict between them but it is not so serious as some economists exaggerated. There is opportunity to have both of them, although it is not always so.

The infant industry theory does not conflict with the comparative advantage theory, on the contrary the former is derived from the latter. But a lot of consumers are sacrificed in the name of protective tariff, that is the reason why the protective tariff is condemned by some economists. Therefore we regard that protective tariff is necessary but the indus-
tries protected must have potential comparative advantages, if the infant industries have never shed their diapers, those kind of industries are not worthy of protection.

Export duties are important during the period of export boom, the extra revenues are collected and domestic inflation due to the sharp rise income of the export producers is checked. Both are crucially important in the early stages of economic development. If a country can dominate the world market in some field, the export tax rate can be arranged so as to get the maximum tax revenue.

According to the above discussion, perhaps it is safe to say that customs duties are important in the early stages of development.
1. The Levy of Tax on Domestic Trade

As the economy develops into the take-off stage, taxation on foreign trade gives its way to taxation on domestic trade. This is not only owing to the absolute decrease of custom duties revenue but also to the decrease of the relative portion of duties revenue in total revenue. Because one of the important phenomena in the take-off stage is the booming of domestic industries, this phenomenon reduces the relative share of foreign trade in the whole economy and the rise of import substitute industries reduces the absolute share of foreign trade in the whole economy, the latter reinforces the former, thus aggravates the decline of the foreign trade. When the foreign trade is fading away, taxation on domestic trade—sales and excise taxes will be one of the crucial factors to decide the speed of economic development. Because the taxation on domestic trade will be the main source of tax revenues to finance economic development, the instruments to curtail consumption and to discourage the investments do not help the acceleration of economic development.

2. The General View of Sales Taxes

Sales taxes are levied on transactions, they could be
imposed upon every stage or just one stage of production and distribution, and could be imposed upon the whole or part of sale receipts. In the former case we have single and multiple stage taxes, in the latter we have sales and value-added taxes; in practice we have turnover taxes, the manufacturer's, the wholesaler's, and the retailer's sales taxes, multiple-stage and single-stage value added taxes. Besides these there are many kinds of the hybrid of sales and value-added taxes.

The objectives of sale taxes are: 1) to raise more revenue, especially when the revenues of customs duties are declining more revenue is not only needed for governmental general expenditure but also for developmental plans; 2) to prevent consumption from rising as much as income rises this could be the result of the increase of general income level and the result of demonstration effect; when economy develops the national income per capita increases, since the marginal propensity to consume is very near unity in developing countries the consumption will tend to rise almost as much as their incomes. If this phenomenon has happened, the increases in productivity will be almost fully absorbed by increased consumption, but if sales taxes are successfully enforced the consumption could be prevented from rapidly increasing, therefore the forced savings could be developed by sales taxation and more funds (factors) will be available for development; 3) to tax those who cannot be reached through direct taxation, because direct taxation cannot reach everyone (this is particularly true in underdeveloped countries) some measures should
be taken to compensate this deficiency. Sales taxation is an ideal instrument to get to those who escape from direct taxation since everyone has to consume.

Sales taxation is vigorously criticized for its regressiveness, but we regard that this deficiency can be remedied if only necessaries can be exempted from taxation or the taxes paid for necessaries consumption can be credited against personal income tax (this method is restricted to the countries where the filing of personal income tax returns is rather popular). There is a controversy about the definition of necessaries since consumer's preference is different in large extent, one's luxuries could be other's necessaries. But we would like to say that the definition of necessaries still can be confined within some limits. Necessaries are the goods required by those who are living on the margin of subsistence, the price elasticity of demand of these goods are very low almost equal to zero and the consumption of these goods is a necessary condition to maintain the subsistence level of life, for instance, cheap foods and clothes and so-called wage-goods are necessaries. The exemption of necessaries from taxation is very important in over-populated developing countries, this measure cannot only remedy the regressiveness of sales taxation but also encourage the increase in the output of necessaries (wage-goods). As we have discussed in the second chapter, once the surplus labor in the subsistence sector is attracted to the capitalistic sector, the consumption of wage-goods will increase. (Furthermore as a result of economic
development the infant mortality rate will drop rapidly so that the natural increase rate of population will rise, this will reinforce the increase in the consumption of necessaries.) If the output of wage-goods could not meet this increase, the price of wage-goods would increase so as to slow down the expansion of the capitalistic sector (the acceleration of development); this is particularly true in the case of export industries, the rising of the prices of wage-goods increases the cost of exports thus weakens the competitive power of exports in world market and slows down the growth of export industries. Therefore goods for exportation should be exempted from sales taxation so as to increase the competitive power of exports.

3. The Turnover (Multiple-Stage Sales) Taxes

Turnover taxes are multiple stage sales taxes which use the whole sales receipts as their tax bases, and can therefore produce the maximum possible yield at a given rate, or permit the lowest rate to obtain a given revenue; they can spread the impact of the taxes out among various types of business firms, instead of concentrating them on relatively few firms.

And if they could be applied in a completely uniform fashion at low rates (say, less than 1%), the administration of taxes could be simple without great inequality and discrimination, but with the tax rate as low as less than one percent the adequate revenues cannot be obtained. Because of the different numbers of transactions through which goods pass on
the path from producer to the final consumer, the cumulated tax burden on various commodities will constitute widely varying percentages of the retail selling prices of the goods, therefore under the turnover taxation the consumer's burden is quite different. By the same token from the business firms' point of view even the same kind of commodity when it passes through integrated production and distribution channels the total tax burden is less than when it passes through non-integrated channels, thus the non-integrated firms find it virtually impossible to shift the differentially higher tax, therefore the vertical integration will be enhanced, this has the adverse effect to specialization so does to economic development. Furthermore, the imported goods are subject to sales tax at the time of importation and on subsequent sales but there is no tax applied to pre-import sales of the goods, or to items used in their production, thus they are favored relative to domestic goods; to remedy this deficiency some countries apply a higher sales tax rate to the imported goods to compensate for this, but it is difficult to obtain exact equality yet we are sure that the system is made more complicated. A similar situation is faced in the case of exportation that the exact amount of accumulated sales tax before exportation is very difficult to calculate, how much of the cumulated sales tax should be refunded for exported goods, this is a difficult problem, even if the tax is refunded the exporters may feel that they are placed at a disadvantage relative to foreign firms; it is needless to say that the
system will be further complicated.

4. The Single-Stage Sales Taxes

There are three kinds of single-stage sales tax, namely, the manufacturer's, the wholesaler's, and the retailer's; like turnover taxes each one uses the wholesale receipts as its tax bases yet it is imposed on one stage of production or distribution only.

The single-stage sales tax can avoid the pyramiding effect of turnover taxes, therefore the discrimination against non-integrated firms and incentive toward further vertical integration can largely be eliminated. Since the tax strikes only once without the pyramiding accumulation of tax burden, the difference of consumer's tax burden owing to the difference of turnover from initial production to final consumption can be eliminated, thus making the ratio of tax to consumer expenditures on various goods closer toward uniformity. By the same token, the discrimination against firms owing to the difference in distribution channels which produce the difference in times of tax shifting forward to final consumers can be eliminated also. In case of foreign trade, the difference of tax burden between imported and domestic goods can be freed from taxation, thus the problem of refund can be avoided. Single-stage tax is easier to administer than multiple-stage tax, since the former has fewer firms to manage than the latter.

Just contrary to multiple-stage sales tax, single-stage sales tax produces smaller revenue at a given rate, or
is required the higher tax rate to obtain a given revenue since the entire impact of the tax is concentrated on one group of firms. The single-stage sales tax is strongly opposed by its higher tax rate concentrated on one group of firms and gives firms the incentive to evade and the means to complain the tax, therefore its advantage in easier administration is thus offset.

5. The Value-Added Tax

The value-added tax is the newest form of sales taxation, it could be a multiple-stage or a single-stage tax; the tax base is the value which has been added in the manufacturing and distribution process, it can be calculated by the difference between the material and parts' cost of goods produced (or the cost of goods sold in the case of distribution) and the selling prices of the products, or by adding the total wages, salaries, interest, rent paid, and profits made by the firm; the former is called subtractional method, the latter is called additional method. In practice, we can apply the French method which applies the tax rate upon the selling prices of the products then minus the tax paid for purchasing material and parts (of course, these must be the amount used in products sold). This method is easier than the above methods, but if the materials and parts are exempted from the tax the subtractional method should be used. Since the sums of the values added at the various stages in production and distribution are equal to the selling prices of the final products to
the ultimate consumers, a multiple-stage value-added tax which extends to all production and distribution sectors is basically the same as a retail stage sales tax and requires the same tax rate to produce the same amount of revenue. When a single-stage value-added tax confined to the manufacturing sector is essentially the same as a manufacturer's sales tax but requires the higher tax rate to produce the same amount of revenue, this will be the same as in the case of wholesaling.

The multiple-stage value-added tax can avoid the deficiency of turnover taxes without concentration on the impact of the tax as heavily on one group of firms as in the case of single tax. But its system is much more complicated than turnover taxes and it needs a higher tax rate to produce the same amount as turnover taxes do. Besides, it has more firms to manage than turnover taxes do. Thus the difficulties in tax administration are further enhanced. As compared with a retail sales tax, like we said before, the multiple-stage value-added tax which extends to all production and distribution sectors is essentially the same as a retail sales tax. But the former offers some advantages; it can spread the impact of the tax over all firms while the latter concentrates on retailers only. It provides a cross-checking of returns of firms since the tax liability would be calculated by subtracting tax borne on purchases from gross tax liability on all sales; cross-checking of the return of various firms is facilitated and thus under-reporting of tax can be detected
more easily. By the same token the method to solve the problem of exemption of producers' goods is facilitated—the capital goods, materials, and parts are taxed when sold, but the buyer is permitted to deduct tax on them. But the value-added tax has more taxpayers than a retail sales tax and the calculation of tax liability is much more complicated than that in the case of the latter.

6. Can We have an Optimum Sales Tax for Economic Development?

Since there are many kinds of sales tax among them, which one is the optimum type to economic development will be our great concern. According to the above discussion we know that no sales tax is perfect in its operation. But the deficiencies of single-stage tax of imposing a relatively high rate on a single group of firms are much less serious than some economists expected. Besides, these deficiencies of single-stage tax can be outweighed by its advantages. The success of many countries with the single-stage tax is the evidence of the above statement. The greater equity and uniformity of single-stage tax makes shifting much easier and thus reduces the injury to the firms upon which the impact rests, and the incentive of these firms to evade the tax.

Since the simplicity, the greater equity, the overall administrative feasibility, and the economic neutrality of the single-stage taxes far outweigh the effect of the higher tax rate and the greater concentration of the tax impact, and that although the value-added tax which extends to all produc-
tion and distribution sectors can spread the impact of the tax over all firms and provide a cross-checking of returns of firms, its overall administrative feasibility is very low in underdeveloped countries (the enforcement of the value-added tax needs highly sophisticated tax administrative agencies which usually do not exist in underdeveloped countries, that is the reason why up to now there are few developing countries employing value-added taxes). Therefore we considered that the single-stage tax is more feasible in developing countries, but which type of single-stage tax is optimum to economic development needed further study.

There are three levels at which a single-stage tax may be levied: the sale by the manufacturer, the sale by the wholesaler, and the sale by the retailer. Which stages is the most appropriate one to collect the tax in developing countries? Before we answer this question we have to discuss the advantages among the manufacturer's, the wholesaler's, and the retailer's sales tax.

When compared with the manufacturer's and the wholesaler's sales taxes, the retail sales tax can ensure the actual ratios of tax burden to consumer expenditures on various goods, and coincide with the desired ratios; but in the case of non-retail tax, the ratio of tax to consumer expenditures will vary according to the size of the margins of distributors of various goods, therefore the consumers of low margin items such as basic necessaries will bear a much heavier burden than the consumers of high margin items such as luxuries; for
instance, if we impose a five percent wholesaler's sales tax and the margins of the retailer are ten percent and fifty percent in respect to necessaries and luxuries, then $100 of goods sold from wholesaler to retailer will be $105, but retailer will charge $115 \([100(100\% + 10\%) + 5\text{(tax)}]\) and $155 \([100(100\% + 50\%) + 5\text{(tax)}]\) in respect to necessaries and luxuries. The tax burden of necessaries' consumer will be \(4.5\%\left(\frac{5}{110}\right)\) but in the case of luxuries it is only \(3.3\%\left(\frac{5}{150}\right)\), thus aggravating the regressiveness of the tax.

If we tax at the manufacturing level, the situation will be worse since the margins of wholesale in necessaries and luxuries are quite different too these will have the adverse effect to the capitalization of the surplus labor as we have discussed in section two of this chapter. The rate of the retail sales tax can be applied to the actual selling prices in all cases without discrimination but then taxes levied at the manufacturing or wholesale levels will discriminate against certain forms of distribution channels unless upward or downward adjustments in prices are made for tax purposes in various cases. Even if the adjustments are made we cannot make sure that all inequity is eliminated but we can be sure that the adjustments themselves complicate both compliance and enforcement. This is not desirable in developing countries since both compliance and enforcement of tax law are the serious problems in these countries.

Because distributor's margins are included in the base of the retail tax, the tax base of retail tax is broader than
that of other single-stage tax. Besides, the retail tax can seize the transactions which do not pass through manufacturing or wholesale stages, thus with the given tax rate the retail tax can obtain more revenue than other single-stage tax. This is significant to developing countries since these countries need more revenue to finance economic development. The retail tax can easily be made clearly evident to the consumer through quotation of tax separately from the price of the product. This is helpful to cultivate tax consciousness while the lack of tax consciousness is one of the important obstacles to the enforcement of tax law in the developing countries, thus the retail tax is more desirable than other single-stage tax in underdeveloped countries. Therefore, we may conclude that a simple and well designed retail sales tax can make an important contribution to economic development.

But when the number of taxpayers are so many and the amounts so small that they could not keep the adequate record for correct auditing and assessment, the cost of collection and the danger of evasion in retail tax are greatly enhanced, this is particularly serious in some developing countries. Therefore the decision with respect to the use of a retail tax must depend on the actual conditions of each developing country.

If a developing country has so many small retailers that make the collection of retail sales tax almost impossible, the choice between the wholesale and manufacturers' sales taxes becomes our last resort. This is not a clear cut question,
although they are roughly equivalent in magnitude that in large part the same firms will be the taxpayers under wholesale and manufacturer's sales tax, yet the problems with each type of sales tax are somewhat different. The wholesale type can use a lower tax rate than the manufacturer type does, its tax impact is somewhat closer to the retail level than that of the latter, thus it suffers less from the undesirable effects which follow inevitably from any deviation from the use of the retail level. But the manufacturer type can avoid the need for uplift of price for tax purposes in the case of large retailers essentially performing wholesale and even manufacturing functions. Therefore the choice between the wholesale and manufacturing levels should depend on other factors; if there are relatively few, large scale retailers can perform wholesaling, the wholesales tax is more preferable. On the other hand, the tax on manufacturers will be less troublesome if direct selling from manufacturers to retailers is popular.

7. Excise Taxes

Excise taxes are a kind of sales tax imposed upon the production or sale of particular commodities or groups of commodities, they can be called commodity tax or special sales tax. Thus a widespread excise tax system will resemble a sales tax, especially when sales tax has many exemptions. The objectives of excise taxes are just like the objectives of sales taxes. Since excise taxes have much more freedom to maneuver, they can apply different tax rates upon different
commodities, thus sumptuary and luxury taxes are developed. For administrative feasibility, excise tax should be imposed at the point of greatest concentration, usually this will be on the manufacturer or wholesaler.

For the purposes of revenue and progressiveness of tax structure, excise taxes are imposed upon non-necessities and luxuries; generally we regard that non-necessities are goods and services such as tobacco, liquor, beer, wine, non-alcoholic beverages, sugar, tea, coffee, motor fuel, telephone, entertainment, etc. These are consumed by a fairly large number of people who are above the subsistence level in varying degrees. Luxuries are goods and services such as motor vehicles, jewelry, fur, electrical appliances, luxury housing, travelling abroad, etc.; these are consumed mainly by the well-to-do.

Alcoholic beverages and tobacco products are heavily taxed so as to curtail their consumption, these are so-called sumptuary taxes. The reasons for heavy taxation on these articles are: they are harmful commodities and over-consumption of these commodities not only endangers the health of an individual but also the whole society—the consumption of cigars and cigarettes may be responsible for lung cancer, for aggravating the air pollution problem, and for considerable losses through fires; or increased liquor consumption may require increased facilities to care for alcoholics and their dependents; the prices of liquor and tobacco do not reflect the social cost which is derived from the excessive consumption of these commodities. Therefore, heavy taxes must be imposed.
Although we do not quite agree that heavy taxation on liquor and tobacco can curtail their consumption (since both of them are low in price-elasticity) we believe that the relative (not extreme) high tax rate imposed upon them can restrain the rapid increase in the consumption of them and raise more revenue at the same time. When general income increases, both of these are desirable to the abatement of social problems and to the promotion of economic development.

The high excise tax rate is imposed upon luxuries to curtail the consumption of luxury goods so that more factors can be released for economic development. It is much easier to conceive we do not need further discussion here.

8. Government Monopoly

The problem of choosing between the State and private enterprises to render goods and services must be solved partly on fiscal and partly on non-fiscal grounds. There are two extremists, one advocates to transform all economic activities into public functions, the other group asserts that the State should never attempt anything that can be done by individuals. The former hold that labor for personal profit can and must be eliminated and capital should be owned by the State so as to work for the benefit of all, not for one class or person. The latter hold that industrial operation is inherently adapted only to private enterprise and that the State is inherently ill-adapted for industrial operation, the State operation is inevitably accompanied by loss in efficiency. It is needless to say there is no way for government monopoly.
But we believe that the truth must lie in between, there are some but not all enterprises suitable for State operation. For instance, most of the public utilities, especially when there exists a natural monopoly or where competition fails to effect economical and otherwise satisfactory service, are fitting for government monopoly. The other reason is to use government monopoly as an instrument to collect revenue. This is particularly important in underdeveloped countries because most of the efficiencies of their tax administration agencies are not high enough to raise more revenue for financing economic development, while government monopoly is one of the more effective ways to raise revenue for that purpose; for instance, some countries have a monopoly on tobacco and/or liquor industries instead of imposing excise taxes on tobacco and liquor and are proved excellent for collecting revenues.

Government monopoly, no matter in the case of natural monopoly or as a device for taxation, profit maximization is both applicable. We can employ the similar tactics which we have discussed in export monopoly to set the prices so as to get maximum profit (revenue) for financing economic development. When the submarkets can be divided, the price discrimination policy should be employed. This is not only for the purpose of profit maximization, but also for acceleration of economic development. For instance, if power plants are operated by the government alone, the government can charge higher prices on the consumption of residential
electrical power users since their price elasticity is lower and charge lower prices on the consumption of industrial electrical power users, since their price elasticity is higher; thus we not only can get maximum profit but also can release more power for industrial power users this is especially important in the early stage of development when production is constrained by the limited supply of power; the same principle can be applied to transportation.

9. Summary

When the foreign trade is fading away, sales and excise taxes are sprotting and becoming the main stream of the revenue besides putting a constraint upon the rapid increasing of consumption when national income is rising. By raising more revenue and putting a constraint upon consumption, sales and excise taxes not only providemore funds for economic development but also release some production factors for development plans. This is crucially important in the take off stage, if sales and excise taxes cannot perform these functions, economic development will be locked in the bottleneck--the shortage of available funds and factors--and it could be dwarfed if the bottleneck could not be broken.

Sales taxes are not so regressive as they are criticized. The exemption on basic necessaries is not only to decrease the regressiveness of sales taxes but is also important to the transformation of surplus labor into net capital formation in overpopulated developing countries.
Generally speaking, single-stage sales tax is more desirable than turnover taxes. Although multiple value-added tax has more merit of spreading tax burden than retail sales tax but its complexity and numerous business firms to handle deter developing countries from employing it.

The excise taxes on tobacco and liquor are excellent revenue producers, besides they can abate some social problems. The high excise tax rate on luxuries can curtail the consumption of luxury goods, thus some factors are released for further production. Government monopoly is not only necessary in the case of natural monopoly but also a good device of taxation in developing countries.
CHAPTER V

REAL PROPERTY TAXATION

1. The General View of Real Property Taxation

The reason why we exclude the discussion of personal and intangible properties from this discussion is that the assessment of these properties are extremely difficult. The levy of these properties always induce unequity and result in abandonment. The experiences of United States property taxation give us the evidence that even highly sophisticated tax administration agencies still cannot handle well the taxation of personal and intangible properties; it is needless to say that the taxation on these properties in developing countries is not recommendable.

Real property consists mainly of land and buildings (improvements on the land), yet for convenient discussion we classify land into two categories, rural and urban. Therefore we will discuss real property taxation in three sections, rural, urban land, and building taxes. Taxation on real property is an age old levy, although it is not so important today as a source of revenue as it was yesterday, it still can act as a crucial role in the early stages of economic development.

According to the study of economic histories we understand that people accumulate their wealth in different ways
when time and space are different, but generally speaking there is a tendency we can trace. In the nomadic age (area) people accumulate most of their wealth in the form of cattle; in the agricultural age (area) people accumulate most of their wealth in the form of real properties and in the industrial age (area) people accumulate most of their wealth in the form of intangible properties (stocks, bonds, securities, deposits, etc.). Most of the developing countries are in the agricultural age, therefore, the real properties taxation in these countries are very important. Since people accumulate most of their wealth in the form of real properties, it is important to levy taxes on real properties; and since people's total wealth corresponds roughly to the values of their real properties, to tax real properties is consistent with the ability to pay doctrine and the beneficial principle since the people who own most real properties receive the most protection and benefits from the State and pay the most in real property taxes. If we consider the real property taxes in terms of equity, we would like to say that real property taxes are progressive taxes, even if the tax rates are proportional, since the rich are taxed more and the poor are taxed less. Yet the government expenditure which property taxes finance are generally "pro-poor," thus there is an income redistribution effect from the rich to the poor and "vertical equity" is thus developed. But "horizontal equity"¹ is not reached

¹Horizontal equity is defined as equal treatment of equals.
through the inequalities in assessments.

There are three ways to the problem of assessment:

1) Market prices method—The market prices of comparable real properties can be used as indexes to assess the property. The market prices of recent transfers of properties which can be roughly similar to the item to be assessed, can be used as measures to assess the item also. 2) Capitalization method--The net rental income (gross rental income minus depreciation charge and maintenance) of the property is capitalized by annual return rate of capital (annual interest rate), the capitalized value can represent the value of the property. Suppose that the net rental income of a particular real property is $10,000 per year. If the annual interest rate is five percent, then the value of the property will be $200,000 ($10,000 ÷ 5%). 3) Reconstruction cost method--The value of the building in assessment is equal to the reconstruction cost of that building minus accumulated depreciation charges. It is rather difficult to say which method is better, perhaps it is desirable to use more than one method. The periodic reassessment of all properties is recommendable in a growing economy, because the older and long-occupied properties are underevaluated relatively to newer and recently-transferred properties, so that the distortion in assessments due to the growth of economy can be corrected.

The main purposes of real property taxes are: 1) To stimulate the growth of productivity in the subsistence sector--This is crucially important in the take-off stage, once pro-
ductivity is increased in the subsistence sector, there will be more surplus labor, cheaper foodstuff and raw materials, a larger market for the capital sector. (The subsistence sector consumes the products of the capital sector, once the productivity in that sector is raised the income will increase and so will the demand for the products.) The expansion of the capital sector is thus accelerated, so is the economic development. Besides, the growth of productivity in the subsistence sector itself contributed to development. 2) To raise more revenue for financing economic development—Real property tax not only can raise more revenue for development but also can siphon a part of the increased income (wages) in the subsistence sector so that the dilemma in development can be solved. According to Professor Lewis, after productivity is increased in the subsistence sector the real wage rate in that sector will rise and this will force the real wage rate in the capital sector to increase also, otherwise the sector could not draw more labor from subsistence sector, and this would worsen the terms of trade of the capital sector, therefore we face the dilemma in the course of development; if the larger part of the increased income in the subsistence sector can be taxed away by the government so that the real wage rate could not increase as fast as productivity rate, then the dilemma could be solved. 1 3) To tax the unearned income due to the incre-

1 See Professor W. Arthur Lewis' famous article, "Economic Development with Unlimited Supplies of Labor."
ment of land value—When economy develops, population grows and the urbanization accelerates, so does the value of urban land; this is the effort of a whole society, the landowners contribute little to the increment of their land value. On equity grounds most of these gains should be channeled to development resources via real property taxation; thus not only revenue can be increased but also the speculation in land can be curbed—both are beneficial to economic development.

4) To tax luxury housing and imputed income (of owner-occupied housing)\(^1\) which income tax fails to levy—Since the construction of luxury apartments contributes little to economic development, the luxury housing should be heavily taxed; we can regard this as a kind of excise tax imposed upon the consumption of luxury housing. Most of the income tax systems up to today do not tax imputed income of owner-occupied housing; real property taxation can compensate this deficiency to some degree.

There are so many kinds of real property taxes, yet what we are going to discuss in the following are rural land tax, urban land tax, and building tax.

2. Rural Land Tax

Rural land tax is the most important tax among all real property taxes, because it is one of the main sources of government revenue in developing countries. Rural land is the main source of foodstuffs and raw materials to the capital sector

\(^1\) When we calculate national income, this kind of income is included.
(the other source is importation). We may say that in underdeveloped countries most of the wealth is accumulated in the form of rural land. In most of the developing countries, when a man becomes rich the first thing he wants to do is to buy a piece of land in the rural area so that he can enjoy higher social status as well as economic benefit. A big landlord enjoys high prestige in an underdeveloped society just like a big capitalist does in a developed society. This widespread desire to hold land, for prestige reasons, as an inflation hedge or as a tax avoidance device leads to a rise in land prices and contributes little to development. Perhaps rural land tax can be designed to correct this situation to switch this kind of investment to the promotion of the productivity of the subsistence sector or to the expansion of the capital sector, in a more concrete term this is the problem of how to switch absentee landlords into entrepreneurs. In order to stimulate better utilization of land, rural land tax should be based on potential output not on actual output or rental income of the land to levy, thus forcing owners of large holdings to use their land more productively (for instance, employ more complementary resources to increase output or converse cattle grazing to intensive cultivation) in order to meet tax. To discourage absentee landlord and speculative holding of idle land and to promote the sale of such land to small-scale intensive, land-utilizing farmers so as to increase productivity of the subsistence sector, the tax rates of rural land tax must be progressive. The strong income effect of
rural land tax not only promotes the productivity of the subsistence sector but also forces the farmers to sell their surpluses for cash to pay the tax thus orienting investment activity toward the raising of cash crops, the subsistence sector is thus further monetized and developed. As the farmers increase the supplies of agricultural products flowing to the urban area, the prices of foodstuff and raw materials could be lower, thus the terms of trade for the capital sector could be improved\(^1\) and would lead to larger savings and investments and allow a more rapid growth of the capital sector. To reinforce rural land tax effect upon the subsistence sector, the levy of tax must be accompanied by the infusion of fertilizers, education, and other improved inputs at relatively low cost, so that the promotion of productivity in the subsistence sector can be realized.

3. Urban Land Tax

As for urban land taxation we can trace back to Henry George in 1879. Georgists advocate that site value taxation is not only as a panacea for urban land use but also as a cure for unemployment and a preventative for inflation. Although we do not agree with Georgists wholly, we do agree with them partially. We believe that site value taxation can solve some of the problems of urban-land use.

\(^1\)We have discussed this problem in section one of this chapter and section two of chapter four from other directions. That is, how to improve the terms of trade for the capital sector via taxation to siphon off a part of increased income in the subsistence sector and via exemption of necessaries from sale taxation to check real wage rate in the capital sector from rising too fast so that the capital sector can expand
When economy develops, population grows faster, urbanization accelerates, and the prices of urban land rise rapidly, then the speculation in urban land prevails, the problems of urban land use become worse; this is an obstacle to urbanization and to economic development also. Urban land taxes are thus introduced to tackle this problem. Heavy taxation of urban land increases the cost of holding land thus can constrain the prices of urban land from rapidly rising. When vacant sites and increment of land value are severely taxed, the speculation in urban land could be curbed and intensive utilization of land could result also.

The value of urban land does not stem from the nature of improvements, grading, site preparation, and soil condition for farming, but from the location it occupies. This is the phenomenon of location rents, which constitute a surplus and taxing them will not reduce the supply of sites offered. The taxes on land will be capitalized into land prices, which will decline since the net after-tax return on land is now lower, this is desirable to economic development.

4. Building Tax

Some economists advocate that heavy taxation on site value can produce enough revenue for local government, so that the building tax can be abolished. Although we recognize that exemption of improvements can relieve the housing problem to some degree and is helpful to urban renewal, the failure to tax improvements may easily encourage construction that contributes relatively little to economic development. For
example, construction of luxury apartments, hotels, and office buildings appear to be excessive in many developing countries. Besides the construction of additional buildings necessitates additional services from government, for which building owners are directly responsible. Furthermore, most of the income tax systems do not tax imputed income of owner-occupied housing, the building tax can plug this loophole to some degree. Therefore, we regard that building tax is necessary. Perhaps it is the best way to impose a lower building tax upon usual buildings and a higher rate upon luxury housing so that both problems of housing and development can be tackled at once.

5. Summary

A well designed real property taxation system can serve as a major revenue source to finance economic development, an instrument to accelerate the expansion of the capital sector and as an implement to achieve a peaceful redistribution of income in developing countries. Tax evasion is difficult and tax shifting is a long-run project, these offer great advantages to developing countries, since the tax administration agencies are not sophisticated enough in these countries.

If rural land tax is properly designed it may lead to better utilization of rural land, since the owners will be under greater pressure to maximize revenue from it, and to transference of the land from absentee-landlords to land-utilizing farmers; both of these promote the productivity of the subsistence sector so as to accelerate economic development.
Taxation of urban land serves to recover for the government a portion of the gain from increases in land values which are the result of development and population growth. By checking the speculation in land the taxes provide additional revenue and curb the prices of land from rapidly rising; both are beneficial to economic development.

Building tax if heavily imposed upon luxury apartments can serve as a progressive excise tax upon luxury housing expenditures. If the tax can check upon the excessive construction, it does help economic development.
CHAPTER VI

INCOME TAXATION

1. The General Review of Income Taxation in Developing Countries

Income taxation is not as important in developing countries as it is in developed countries; yet it is not negligible either as a means of investment incentives or as a preparation for the later stage of development. As a source of revenue, income taxation is not important in developing countries; this could be the result of the low level of income, lack of voluntary compliance with income tax laws, lack of accounting-record keeping habit, and effective administrative.\(^1\)

Usually most of the developing countries have corporation income tax. Although returns are audited each year, as we noted previously owing to the incomplete records, a lot of taxpayer's tax liabilities are inferred arbitrarily. Even if net income is inferred in accordance with books and records, there is a lack of uniformity in the way different auditors construe and apply the law and much negotiation between taxpayers and auditors over the ultimate tax liability. There are possibilities for collusion, bribery, and wholesale tax

evasion under such a system.

Perhaps individual income tax in developing countries is reasonably effective in reaching wage and salary income, because these incomes are difficult to conceal. But far less effective in reaching business income where concealment is much easier, especially when many business transactions are conducted in cash rather than through check payments. Property income may also be difficult to reach where tax evasion is sanctioned by tradition and customary behavior among certain groups. Therefore, individual income tax bears more heavily on income from work than from ownerships, this is just opposite to the direction which we expect to develop.

Although income taxation has so many deficiencies but we have to set up even in the early stages of development. The history of individual income taxes in advanced countries reveals that without the earlier years of administrative and compliance preparation the individual income tax could not work on a mass basis even if the national income per capita is high enough. Since most of the complications in individual income tax derive from the progressive rates, it is advisable to start income tax at a flat rate. If so, the income tax law could be much simpler since there is little need to be concerned about bunching of income in particular years, timing of deductions, capital gain and other features which occupy a disproportionate share of the statutes in countries with progressive income taxes. A flat rate income tax accompanied by withholding on several types of income still has the
advantage of possessing revenue flexibility, although less than that would be desirable.

2. Investment Incentives

Investment incentives can be designed either to stimulate domestic investment or to attract foreign capital or both. Investment incentives can be offered only to pioneer industries, that is, those which are totally new to the country in question, or generally available to new investment which may be merely for the expansion of an existing industry. But in developing countries generally in order to increase capital formation so as to accelerate economic development, investment incentives are given to both domestic and foreign investment and to general new investment no matter whether the industry is new or old.

Some countries provide investment incentives on a case-by-case basis; others offer these incentives generally to any enterprises that qualify. The incentives are sometimes graduated with the size of investment or with the amount of new employment created. To qualify, a certain percentage of final product value must be added within the country offering the investment incentive, so as to prevent the assembly operations that avoid tariffs without actually fostering local manufacturing. There are many kinds of investment incentives, such as favorable customs duties, reduced property tax assessments, and income tax concessions, or in other ways outside the tax system. But the attraction of investment incentives to foreign capital will be decreased if every developing country adopts
the same measures, therefore the cultivation of investment climate should be emphasized.

3. Income Tax Concessions

Generally, income tax concessions are given in the forms of accelerated depreciation, investment credits, generous depletion allowances, and income tax holiday. Among these income tax holiday is the most popular one. Many countries feel that new industries deserve a temporary tax holiday for several years, until they become established on a profitable basis. Other countries grant either reduced income tax rates or total exemption from income taxes for a period, such as five years, to any new enterprises established in the country. The second popular one is accelerated depreciation, it could be given in the form of shorter tax life of properties concerned or higher depreciation rate, or both. Investment credits are given in the form of some percentage of new investment to offset income tax liability. Generous depletion allowances are given to mining industries, in the form of some percentage of gross receipts every year.

Income tax holiday will be nullified if capital-exporting countries still tax those incomes from abroad without tax-sparing; that is to say, the foreign business income tax which is spared (exempted) by the capital-importing country is still considered as paid by capital-exporting countries and therefore allowable as a credit against the capital-exporting countries tax liability. Therefore the attraction of income tax holiday to foreign capital depends on the
cooperation of the capital-exporting countries; otherwise this will be a shifting of revenue from the treasury department of the capital-importing country to the treasury department of the capital-exporting country. Both, the countries which give tax holiday and the firms which are given tax holiday, can get no benefits at all. On the contrary, accelerated depreciation does have some merits. This method can postpone the tax liability to later days, so that the firms will have more funds available and be free from the financial stress of their early years. The governments can be free from the suffering of losing too much revenue which is vitally important in the course of development. Thus both government and firms enjoy benefits without paying much price.

Tax concessions are important since they can attract extra capital, which is crucially important during the early stages of development, both from domestic and foreign sources. The revenue loss in the early period of tax concessions will be compensated after the concession period has expired since the size of the tax base will be enlarged later on. But tax concessions favor investment in new industries over investment in established industries, in this case only new industries are entitled to tax concessions, this is not always in accord with the maximum increment of the social productivity. Furthermore, sometimes tax concessions encourage the expansion of uneconomic enterprises which may have difficulty in facing the test of competition after the expiration of tax concessions. But nevertheless we believe that the well designed tax con-
cessions do contribute something to the acceleration of economic development.

4. Summary

Income taxation is important in developing countries not as a source of revenue but as a means of investment incentives and a preparation for the later stage of development. It is desirable for the developing countries which are going to have income tax, to start it at a flat rate and accompany with withholding on several types of income, thus both the simplification of the income tax law and the advantage of possessing revenue flexibility could be obtained. There are so many qualifications for firms which are entitled to investment incentives and so many kinds of income tax concessions which are available for use; yet in the course of design, both effectiveness and simplicity of the measures should be considered so that heavier demands on tax administration can be mitigated without much sacrifice of the effectiveness of measures. Tax holiday is the simplest way to stimulate capital formation yet without the cooperation of the capital-exporting country, its effectiveness to attract foreign capital will be nullified. Accelerated depreciation could be the best way of tax concessions, the augmentation of capital formation could be developed by this method without paying a high price. No matter which kinds of investment incentives are employed, without the improvement of investment climate the attraction of measures to foreign capital are decreased since very developing country can adopt the same measure.
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