

**USAID ECONOMIC GROWTH OFFICERS CONFERENCE
OCTOBER 15-19, 2007
WASHINGTON, D.C.**

Session Title: Priorities in Assisting Tax Reform

Date and Time: October 15, 2007, 2:30 p.m.- 3:45 p.m.

Type of Session: Plenary

Speaker(s): Prof. Arnold Harberger, Mario Mansour, Mark Gallagher

Moderator: David Dod



David Dod addresses workshop attendees. Photo by Paul Goodman.

Overview of Session:

- Each of the speakers had fighting words for tax incentives: we should be wary even of a “neutral” tax incentive—they can often unintentionally penalize good investments.
- You can get more job creation from a good tax reform than business development services.
- There is consensus: good tax reforms include lower tax rates, a broader base, and reasonable provisions for enforcement. (not a flat tax, but a “flattening”)

Speaker's Remarks:

Arnold Harberger:

Tax reform in Central & South America

There have been big strides in tax reform and economic policy around the world in developing and advanced countries. Import tariffs of over 100% were really quite common; average tariffs of 80% were realities in the 60s and early 70s. We also had arbitrary

surcharge tariffs on top of the tariffs. Things are a lot better now.

When Prof. Harberger's team worked in Central America in the late 80s and early 90s, they tried to persuade people to squeeze their tariff range down to 30 or 40%. They eventually got down to 5-10% percent. People began to see the light about freeing up trade.

Maximum tax rates have come down. Administration is better, with lots and lots of room for improvement. On the taxation of income from capital, it is a mixed bag. That message applies as far as FDI is concerned. Except for mining, etc., firms are footloose, and they will go to environments that are more favorable. Equilibrium capital stock with a 30% tax would be only a little more than half what it would have been. (Prof. Harberger's estimate, using a Cobb-Douglas production function).

Prof. Harberger has been interested in studying capital and rates of return to capital since the early 60s:

- In India, he did a study of real rates of return to capital in the private sector at that time: they ranged between 12 and 18%.
- In El Salvador, where he worked a lot and did such a calculation in the 1990s. He asked: what is the earning of business investment? It started out at 20% in 1970, and drifted downward during

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the coffee boom. When civil strife broke out, it went way down; and began to recover during civil strife. By 1995, it was crossing 30% (31% real) return on all capital stock of the country, as measured by a perpetual inventory technique of accumulating real investment.

- In Mexico, for project evaluation purposes, tried to do a similar calculation. There, it never got below 20%.

The theory tells you to go easy on these guys; but when they are making 30% and more, how can we not tax them?

We need to start thinking more about the distinction between more and less footloose capital. Some of the high return is from monopoly profits in segmented part of the economy where one group has monopoly power. Other parts come from when people in host country are especially shrewd: they manage to siphon off a substantial portion of the gravy.

Why don't people pay more? In Mexico's Salinas administration, they introduced an Assets Tax (pay 2% of your assets each year as tax, similar to our alternative minimum tax, but for businesses). This went on for years. In the new administration, they introducing a unified rate: 16.5% tax on a broad base; something like VAT, but with all investment items deducted. Prof. Harberger has not analyzed that tax in detail, and he does not know why this one replaced the other, but it is clear they were not happy with the collections even after many years of working with the Assets Tax.

In Central America, things are worse. Members of the oligarchy have said in his presence that they will not pay more taxes until the government starts performing better.

Putting people in jail in Mexico had more effect than the assets tax. With a little hyperbole, Prof. Harberger says putting less than 100 people in jail produced an increment of tax revenue equal to 2-4% of GDP.

In Central America, one of his former students was in the MOF, and he had a list of all taxpayers. That student found he was among the top 10 taxpayers of the country. His whole attitude changed when he talked to members of the board of leading foundations, etc., who were much lower on that list.

There is a tension between greater enforcement and lighter enforcement – is there any way to match these two? A broad base and low rate is what everybody has been advising for the last many, many years. But when you lower the rate and broaden the base, the level of enforcement becomes even more important.

One word about tax incentives: there are many flaws in design of tax incentives, even in things like investment tax credits. This is the same in most countries, where their base is in gross investment. It amounts to giving an incentive to the depreciation of assets (what you should do, is to give an incentive based on net incentive, where depreciation is deducted first).

Anytime one is confronted with a specific proposal for a tax incentive, one should view it with great skepticism. Even if neutral, it may not be good. If a country does enter with tax incentives in certain



Professor Harberger addresses workshop attendees. Photo by Paul Goodman.

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arrangements, then it is infinitely better to do it in a good way. Under a neutral tax incentive, there will tend to be a cutoff point of productivity of investment. The flawed ones will be stimulating ones with a negative rate of return while de-stimulating positive ones.

Mario Mansour:

Revenue Mobilization in Sub-Saharan Africa: Challenges from Globalization

Presentation focused on:

- Corporate tax competition: tax incentives are important in almost all countries, including Africa. How does corporate tax competition affect revenues—what can governments do?
- Trade liberalization: decline in tariff rates over time (from rates of 100% or greater, to much less)
- Surcharges: purpose to collect trade data for national accounts (and other such taxes)

The presentation did not focus on: excise taxes and regional directives. Excise is very much an issue: they are effectively tariffs, because there is no production. It also does not cover natural resources (oil & gas & mining). These are still subject to tax competition...why are they competing? In theory they should not need to.

Tax/GDP ratios in SSA

- Excludes South Africa, which accounted for 45% of GDP of the region.
- In majority, tax ratios are below 20%; some below 15%; 4 below 10%.
- Resource rich countries tend to have the highest tax take (from resources, not traditional domestic taxation)

Trends in tax revenues in SSA

- In 80s, some stagnation
- Starting in 1992, clear upward trend in tax/GDP ratios.

Corporate Income Tax (CIT) Competition in SSA

- Average CIT rate has been stable for most of 80s, and declined steadily since the early 90s. Why are tax rates going down, but the tax take has remained somewhat constant?
 - The structure of GDP (e.g. profit share) has increased over the 90s; but we don't know which areas have contributed to this. It is hard to find good profit data for Africa.
 - Pressure on rates to further decline is still there: they are likely to go down...but then what will happen to the revenue ratio? There are structural issues, like whether profit share in GDP will continue to rise.
 - How will governments react in terms of policy? Though CIT raises a lot of money, it could do more, because the base is still not as broad as it could be. Policy issues regarding the base should be addressed.

Tax Incentives: We looked at tax holidays, reduced CIT rates, investment allowances, incentives for exports, free zones, investment code.

- Most FDI has gone into oil & gas, so these incentives are not clearly working. There may be design issues. But also, the tax factor is not necessarily the most important one.
- There are many more tax incentives now than there were in 1980.

Trade liberalization in SSA: Collected tariff rate (tariff revenues/imports) declined from 30% to 20% between 1980 and 2004. Preferential tariffs will expire and be replaced with some package EU has put in

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place to help them upgrade their technological capabilities. Complete tariff elimination will not materialize until 2020 or 2025. The issue here: this will continue, so what should policy makers do?

Role for tax coordination: CIT

Coordination in incentives is potentially more beneficial than coordination in rate setting. But how to do it is less clear, given the absence of a regional institutional framework.

Mark Gallagher:

Continuing tax concerns in Central Europe

Outline:

- First and second generation of reforms
- Flattening or the flat tax
- Tax wedge on labor
- EU concerns
- Property tax challenges
- Who cares?



Mark Gallagher addresses workshop attendees.
Photo by Paul Goodman.

Countries now need to rely on taxes to run government. This is different from the past. In the Balkans, for example, they had payment bureaus, which in the past allowed government to just take money from coffers of state-owned enterprises, and transfer it to the government. Now, they are dealing with private actors, and need to get them to pay their taxes. In the old model, the tax administration would fill out your forms for you. Now, companies need to do it themselves.

Many countries are improving tax administration. Though many people in tax administrations forget that they need to update their systems from time to time. They lie fallow, and become obsolete.

VAT concerns in central Europe: you need to be consistent with the 6th directive of EU, which prohibits any zero rates on anything but exports. Countries need to harmonize excises with EU guidelines: they actually need a certain minimum number of excise taxes.

Some key recent reforms:

- Elimination of citizen taxes: (Balkan term): taxes on income according to specific taxes – taxes on dividends, copyrights for music ... if you earned income from producing rock and roll in Sarajevo canton, it was subject to 20% tax. If you earned income from copyright on classical music, it was only taxed 5%.
- Elimination of wasteful and unproductive tax incentives and tax holidays. People want to lower tax rates, and get rid of incentives, broaden base, etc. If you live in Croatian islands, no tax! There continue to be concerns about reducing the size of government: when you take social contributions into account, especially: these taxes are quite high.

Flattening or Flat tax?

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Estonia introduced this, and it is the ideal country to mime if you would like to become a modern tax administration. It is not really a flat tax. It is only a flat tax on your next bracket of income (more like a marginal tax rate). IMF has done a couple of studies, particularly in Russia. They did increase revenues post flat-tax, but they also put big guys in jail, improved tax administration; introduced stricter leadership; and the price of fuel increased (for gas-exporting Russia). The IMF says that flat tax was not responsible for bringing the increase in revenue.

There is an ideological melee on this issue. Delaware claims to be rich because of the flat tax.

Croatia was considering it. Now they are having a flattening instead—fewer rates.

Where business is not as modern, it is better to broaden the zero tax bracket so that you can dump a lot of people out of your system. (Croatia, for example, could eliminate 1 out of 1.9 million taxpayers...this would seriously help tax administration.)

EU concerns:

VAT, Excises, Customs, Common treatment of companies / tax competition, race to the bottom/tax competition. As countries accede, they need to make sure they are not running deficits higher than Germany or France.

Property tax:

Information is not something insurmountable. Everybody in this part of the world knows what their property is worth. Old people living in beautiful apartments downtown do not have income, so they cannot pay. But there are ways to defer the tax on their estates.

Who cares?

Europe cares. Central Europeans are not interested in coordination. The US cares. The tax wedge on labor gives a disincentive to businesses to use labor. Employment is growing at half the rate of the economy. Investment is more capital-intensive than it ought to be. Unemployment may be increasing, despite economic growth. The US cares because we care about the competitiveness of these countries, job creation, etc. You can get more job creation from a good tax reform than business development services.