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TAXATION AND ECONOMIC DEVELOPMENT

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TAXATION AND ECONOMIC DEVELOPMENT

Promoting the economic development, or more narrowly economic growth of a developing country requires considerable outlays of resources each year to be directed to the enlargement of the productive capacity of both the public and private sectors. Productive capacity is varied and could range from the concrete to the less tangible, i.e. plant equipment that forms part of the physical capital and the managerial skills and health of the labour force.

The tax system has often been identified as one powerful instrument available to government to move the economy from that sorry state of underdevelopment to a distinctly happier position that invariably characterize the final year of a development plan. The link between taxation and economic development as the title of this paper implies is the link between a universally desired end and a form of government action widely believed to be a means to that end.

Without government intervention, bottlenecks which cause slow growth of the potential output of the economy would be difficult to remove, or to be reduced considerably. Lack of a healthy and skilled labour force, for instance, could be a major obstacle despite massive dosages of economic and other social infrastructure.

Government outlays, particularly when a public investment programme's expenditures are aimed for the improvement and enlargement of the country's productive capacity, require enormous amounts of tax revenues to finance them. With tax revenues being the principal source of government or public savings, financing of developmental activities would be more generally acceptable, and more so, highly commendable. However, in the years following independence, developing countries experienced the inability to realize sizeable public savings. Their public finances were characterized mainly by it.

A trend in recent years in these countries was the reduction of recurrent non-developmental expenditures in order to obtain more public savings. Their attempts, however, were negated by the phenomenon of two-digit inflation. Demand of public servants for wage and salary increases and the rising costs of supplies and materials paid by governments including other contractual services supplied by the private sector account mainly for their failure to make substantial reductions in non-developmental expenditures.

When a tax system is used to finance large and growing expenditures, such effort ought to be in an orderly, efficient and fair manner. Certain limitations somehow are confronted and they indicate usually, together with the economic issues, political and administrative problems. Latin American countries, for instance, have the experience of deciding to finance their expenditures by other methods than taxation, which could be attributed to little political visibility. Administrative problems more commonly arise from a tax machinery and administration inherited from the country's colonial past.

The need to plan for tax reform becomes more imperative if tax policy is to play that role of an effective instrument of resource mobilization. Any attempt in this direction must of course be mindful that taxation influences private saving and affects incentives and capacity to save. A tax policy which faces the delicate responsibility of obtaining large amounts of revenue to meet the provision of public capital formation and current services must also provide, not remove, the means to stimulate private saving and investment. Tax systems must be revised periodically to remove the lack of coherence and inadequacies in the tax structure. The system must be easily manageable for both tax collectors and tax payers. This means administrative improvements to introduce simplification where feasible and elimination of unnecessary burdens on taxpayers.

Taxation systems, however, should be designed not to damage economic efficiency. This means enhancing productive capacity, inducing incentives and promoting allocation of resources. The influence of taxation on economic incentives should be carefully considered for taxes have two kinds of effects on incentives: a substitution effect and an income effect. The substitution effect is the reduction of the rate of reward obtained by working, saving, investing, making innovations and carrying on other productive activities. Taxes tend to discourage these activities. With progressive taxes, this kind of effect is more severe. The income effect is the reduction of income caused by the payment of a tax. Often the income effect stimulates the taxpayer to work more in an effort to maintain a standard of living or to attain a desired standard. A similar income effect may operate with respect to investment and other economic activities.

An increase in the saving-investment rate is one of the conditions of economic progress in developing countries, which are seeking the means of increasing saving and capital formation. Most of these countries have accepted the goal of mixed economy and seek this means. Even in countries that have assigned to the state the major share of investment, private saving may be an important source of finance for public investment. They have not been oblivious of the advantage of promoting private saving and the sale of government bonds.

Programmes for fostering private saving by means of the tax system are intended to concentrate on consumption and to leave private saving subject to lower rates of tax, if not entirely free. The general admonition heard from time to time is that progressive taxes should be minimized or wholly avoided in developing countries. Progressive taxation of income cuts more deeply into the return on saving than will proportional or regressive taxes. If interest and profits receipts are a rising fraction of income as the size of income increases as in capitalist countries, progressivity would make remarkable cuts. In preindustrial societies, where landowners were often the richest members of the community this had not been clearly so or true. Evidence is they were the biggest consumers. These events marked the character of the developing countries in the sixties.

Since then, the promotion of private investment for development became an integral part of the growth strategy in many countries, particularly among the developing ones. Incentive policies particularly in taxation aimed at both domestic and foreign investors were experimented in these countries. Analysis of both costs and benefits need to be taken account whether these incentive programmes have been useful. On the cost side it would seem proper to compute the tax that would have been due if tax holiday benefits had not been offered and if accelerated depreciation had not formed part of the incentive programme. Import duties waived as part of the incentive programme could also be regarded as part of its costs. Any computation of the real costs to the government would have to depend on a judgement as to the extent the benefits offered were a necessary condition for the investments to take place; and as to whether the same investment could have been achieved by some other means, the costs of which would have been less than the computed costs of the tax benefits.

The benefits of any incentive programme are equally difficult to assess. One has to estimate to what extent the incentive programme has actually promoted ventures that would not have been undertaken without it, and the other to find out what beneficial effects for the economy the enterprises have brought with them. The first count would have the problem parallel to that of estimating the real costs of the incentives: if an investment would have been undertaken even without any incentive offered, the actual cost in terms of revenue foregone is equal to the nominal tax waived under the incentive programme, and the benefit of having offered the incentive in terms of new investment induced by it may be zero. On the second count, measurement of benefits might be oriented to factors such as new employment opportunities (net of employment lost by introduction of labour-saving techniques, obsolescence of old production and marketing patterns, etc.), foreign exchange saved through import substitution or earned through increased exports, improved market conditions for local production of raw materials and other supplies, etc. The measurement will also be influenced by the stability of the new ventures, in particular, the likelihood of their viability beyond the point when the incentives will expire.

It is quite reasonable for countries to offer incentive programmes, if they find themselves in competition with other countries in a similar position that also offer investors benefits. Following are described the common types of incentives :

1. Tax holiday, which is defined as total (or partial) exemption of new or expanding firms from direct taxation for a specified period.
2. Accelerated depreciation of investment to determine tax liability which allows the asset to be written down for tax purposes faster than would be possible under normal accountancy practices. Under this category, a further percentage of the asset's cost may be deducted from taxable income usually by either: (a) tax credits; (b) investment allowances; or (c) developmental rebates. This is over and above the depreciation.
3. Exemption of imported plant and machinery (and sometimes also parts and raw materials) of new or expanding firms from customs or other import taxation.
4. Investment grant whereby a given share of the investment cost of a firm is paid for by the government. Few countries extend this type of grant and usually to the hotel construction sector.

Reliefs from import or customs duty and also from income taxation are further elaborated in the following discussion.

Import or Customs Duty Relief

Customs treatment of capital goods and noncapital goods may be distinguished due to the different implications for the structure of production, effective protection, prices and profits. A third category would be duty exemption for nonbusiness imports.

The treatment of capital goods should be viewed and considered in the face of scarcity of capital. It would probably be in the best interests of the economy to permit duty-free entry of capital goods at least those that are not domestically produced. Such policy would help reduce the financial requirements of establishing a new industry because of lower capital charges. It would also result in lower production costs. If a tariff policy includes tariff protection for local producers of capital goods, tariff exemptions offered as an incentive to new investors may conflict with the interest of protecting the local firms. Then this will be a good reason to look out for other forms of incentives.

Incentive policy with regard to noncapital goods has two aspects, namely, first, the form in which protection is offered to the products of the prospective business venture, second, the effective protection offered, as computed on the basis of the tariff differential between the final product and the inputs in relation to the domestic value added. As part of the incentive package offered the new investor aiming at production for the domestic market, outright prohibition against competing imports, or restrictive licensing may be introduced. The alternative form of protection would be an almost prohibitive tariff wall. This could have the advantage that such imports would still take place in spite of the protective barrier wall and will, potentially, bring in some revenue instead of all being funnelled through illicit channels. The existence of an infinite degree of protection such as given through an outright prohibition may be an undue incentive to an economically nonviable production.

Nonbusiness imports may require a restrictive attitude. Some prospective investors require for themselves duty-free privileges and also for their expatriate staff with regard to imports not material to the business. Such privileges should as much as possible be avoided for they could constitute dangerous leakages, and abuses can be stopped only with great difficulty.

Income Tax Relief

Virtually all investment incentive codes provide relief from income taxation in one form or another. With the postponement, reduction or elimination of the government's claim to earnings, the prospective returns on investment in a new project is increased. It also reduces risk of capital in as much as it reduces the time in which the original investment is earned back.

Corporate income tax concessions generally take two different forms, one based on capital investment, and the other based on outright exemption from income tax.

Investment-related benefits are usually given in the form of investment allowances, initial allowances, or both. These allowances reduce the taxable profit in the year of investment by an amount related to the capital investment. Investment allowance is given in addition to depreciation allowances, without reducing the latter. Initial allowance implies an acceleration of the regular depreciation allowances in as much as the allowance reduces the basis for future cost depreciation.

Income tax exemption, popularly known as a tax holiday, is less directly related to the size of the capital investment and in principle is less biased than investment allowances in the choice of technology. It is more in harmony with the objective of developing countries to increase employment. Income tax exemption also is more widely used and is believed to have greater appeal to business than investment or initial allowances.

The exemption of dividends from income tax presents a question for it must be viewed from the point of view of the foreign investor and the domestic investor.

Dividends paid abroad may in many cases be legally subject to income tax in the country of residence. This is especially true of United States residents and those of other countries that do not have a "tax-sparing" agreement or that do not provide unilaterally for exemption of income derived from foreign countries. If the country waived tax on distributions abroad, it would in many cases benefit the foreign treasury of the investor. Taxation of dividends of domestic investors would make new venture less attractive than their exemption; incentives would nevertheless be greater than for investment in other businesses not qualifying for an income tax holiday. Taxation of distributions may provide some inducement for the retention of earnings and their reinvestment

for expansion. Under a tax holiday provision where dividend distributions are included though limited in time may be a forceful incentive to distributing profits rather than plowing them back if postponing implies that the tax exemption will be foregone.

Employment objectives of a developing country would be better served by techniques that lower the cost of labour than the cost of capital. Proposals of various types of labour subsidies have been advanced but no developing country has provided such employment incentives in its investment code. Instead of providing outright income tax exemption, income tax relief for a number of years could be based on the amount of local employment. An employment allowance or an additional deduction from taxable income equal to a specified amount for each equivalent full-time domestic worker employed during the year. It could be based either on the minimum wage established by the government or the average wages of unskilled workers. Any allowance in excess of profits otherwise taxable in any year could be carried over to future years. This form of income tax relief would give incentive to increase employment rather than use more capital-intensive methods of production.

Some guidelines would be essential to give the incentives some degree of attaining the purposes for which they were instituted as well as insuring the interests of the government. Projects should be effectively screened to ensure viability and permanence. The host country must be on the guard against the fly-by-night investor who is ready to skim the cream off the investment programme only to disappear after his benefits have been obtained. Incentives should be selected that do not cost the government more than the benefit is worth to the investor. The value an investor is ready to apply to a benefit in the distant future is dictated by the rate of interest at which he discounts future earnings. With the general estimation of risks involved in investments in developing countries an interest rate well above 15 or 20 per cent is reasonably fair to be assumed. Benefits should not be open-ended or excessive. The certainty of

extremely high profits would make an investor interested in a venture even if his profit will be taxed. Benefits and conditions should conform with national objectives. What most developing countries are especially interested in is investment that will utilize labour, of which there is an abundance. The production technology of such investment, must be competitive from the point of view of total cost and adapted to the relative cost factor characterizing the country's economy, i.e., abundance of labour and scarcity of capital and technical know-how.

Incentives should be adequately controlled in order the stated objectives are observed. One important aspect of control is that enterprises enjoying tax incentives should file tax returns and have them scrutinized in the regular way. This is an important obligation regardless of the fact that a majority of these returns will probably not result in any actual tax payments in the year in which they are filed. Investors not fulfilling their obligations under the investment agreement should be liable to the taxes waived. Bank guarantees and/or the involvement of local business could be used to prevent investors from escaping such obligations by dismantling their plants and repatriating their assets.

What has been discussed is an obvious attempt to examine taxation as an integrated instrument in achieving developmental goals in developing countries. It pointed out the importance of public investment needs, which would be influenced by factors such as the type of political system and the level of development already attained. Thus, the volume of investment to be generally borne by government need to be determined by the level of development already there. This should also be true of public and private saving.

If economic development is the sole objective, promoting both public and private saving and investment could be considered very desirable. The problem that often arises is the difficulty to balance out the allocations to public and private capital formation.

If public investment is aimed to be very substantial and taxes on the private sector would be increased considerably, a point is reached when funds are channelled away from private investment. Similarly, if incentives are stepped up quite progressively, a shortage of resources to finance public investment could result.

It should also be a worthwhile effort to investigate investment incentives which are supposed to stimulate growth, especially when they are widespread and could be apparently ineffective in achieving their stated purposes. Notwithstanding that economic growth, as measured by the national accounts, could be proceeding quite rapidly, investment or fiscal incentives could also be one of the causes of sluggish growth of tax revenues.