Abstract

This paper reviews recent experience of technical assistance on tax policy provided by the Fiscal Affairs Department to a selected but diversified group of countries that differ both in their geographical locations and in the nature of their economies. The review finds in the technical assistance advice both common themes applicable to all countries and special elements designed to address issues unique to a specific country, or a subset of countries. It also attempts to assess, to the extent possible, the policy impacts of such advice.

JEL Classification Numbers:

H20; O53; O54; O55; O57; P35; P52

* Views expressed represent the opinions of the authors and, unless otherwise indicated, should not be interpreted as official Fund views. The coverage of countries is mentioned, even though country-specific information has been deleted from this version of the paper for reasons of confidentiality. The paper was coordinated by Howell Zee.
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Summary

The review has a twofold objective. First, it describes the nature and scope of the advice that the Fiscal Affairs Department (FAD) has offered to countries through recent technical assistance missions. It identifies themes applicable to all countries and special elements designed to address issues unique to a specific country or a subset of countries. Second, it ascertains, to the extent possible, the impact of FAD’s tax policy recommendations by assessing the extent to which the countries receiving technical assistance have subsequently implemented measures based on the recommendations.

FAD tax policy advice has tended to emphasize the need to enhance the neutrality of different taxes and, in line with international reform trends, to ease the resource demands on tax administrations. In general, FAD missions have recommended two courses of action: (1) simplifying the structures of existing taxes (such as by reducing the number of rates, broadening the bases, and eliminating preferential treatment of particular economic agents or activities); or (2) introducing new and simple taxes (such as a single-rate value-added tax to replace old and complicated ones (such as a multi-rate turnover tax).

When countries have sought FAD’s advice for the express purpose of identifying policy options to mobilize additional budgetary resources, technical assistance missions have been uniformly guided by the principle of designing measures that would generate adequate revenue to meet the countries’ budgetary needs in as economically neutral a manner as possible. However, as circumstances warrant, they have also suggested interim measures that deviate in varying degrees from the long-term goals of tax reform.

In general, FAD tax policy advice has had a discernible impact on the course of tax reform in many countries. By type of tax, reform recommendations on the domestic consumption and international trade taxes have met the greatest success in terms of the extent to which they have subsequently been implemented. By geographical location, technical assistance advice has had the greatest influence on Western Hemisphere economies and selected economies in transition. As is to be expected, timely and concrete policy actions have materialized more frequently when the technical assistance advice was given in the context of Fund programs. But even when Fund resources were not involved, the missions’ analytical work supporting their recommendations often provided significant assistance to the authorities in their policy deliberations.
I. Technical Assistance on Tax Policy: A Review  
(Prepared by Howell Zee)

This is a summary review of the recent experience of FAD technical assistance on tax policy in a selected but diversified group of countries that differ both in their geographical locations and in the nature of their economies. The countries have been divided into five broad categories, on each of which detailed background notes have been prepared and are presented in Chapters II-VI of the paper.  1/

1. Introduction

The review has a twofold objective. First, it intends to provide an account of the nature and scope of recent FAD advice given to countries in response to their requests for technical assistance on tax policy, and to identify in such advice both common themes applicable to all countries and special elements designed to address issues unique to a specific country, or a subset of countries. Second, it attempts to ascertain, to the extent possible, the policy impacts of FAD’s tax policy recommendations, primarily in terms of the extent to which the countries receiving technical assistance from FAD have implemented the recommended measures subsequent to the issuance of the missions’ findings.

Reforming the tax system in any country is an endeavor of enormous complexity, with its scope and direction frequently circumscribed by a multitude of both political and economic factors. Yet, even a casual survey of a broad spectrum of international tax reform experiences in recent years would reveal an unmistakable common goal in all such efforts--the simplification of the existing tax systems. The pursuance of simplicity in tax structures has clearly been the result of the recognition by the authorities in many countries that complicated tax systems tend to generate costly distortions in resource allocation, provide scope for tax evasion that leads to revenue loss, and increase the administrative burden of their enforcement. In many cases, simplicity has been sought in full awareness that the degree of progressivity of the overall tax system might be reduced as a consequence.

1/ Chapters II-VI cover countries among economies in transition (Albania, Bulgaria, China, Czechoslovakia, Hungary, Mongolia, Poland, Romania, Viet Nam, and selected countries in the Commonwealth of Independent States (CIS); Chapter II), Western Hemisphere economies (Argentina, Brazil, Colombia, Costa Rica, Mexico, Nicaragua, and Peru; Chapter III), francophone African economies (Cameroon, Madagascar, Morocco, Rwanda, Senegal, Togo, and Tunisia; Chapter IV), anglophone African economies (Ghana, Lesotho, Sierra Leone, South Africa, Tanzania, Uganda, and Zambia; Chapter V), and Asian and Middle Eastern economies (Egypt, Iran, Jordan, Pakistan, and Thailand; Chapter VI).
FAD tax policy advice has tended to emphasize the need for enhancing the neutrality of different taxes and for easing the resource demands on tax administration, in line with the international trend of tax reform. In general, FAD missions have recommended achieving these goals through either the simplification of the structures of existing taxes (such as a reduction in the number of their tax rates, a broadening of their tax bases, and the elimination of preferential tax treatments granted to specific types of economic agents or activities) or the introduction of new and simple taxes (such as a single-rate VAT) to replace old and complicated ones (such as a multi-rate turnover tax).

As requests for technical assistance on tax reform almost always originate from countries in the process of undergoing economic adjustment of one sort or another—with the alleviation of their fiscal imbalances usually being a critical element in the adjustment effort, the specifics of the missions' recommendations rarely could have been formulated without also addressing at the same time the revenue needs of the countries in question. Operationally, this has meant that the details of the recommended measures, including their prioritization, could only be determined after the missions have thoroughly assessed the particular fiscal situations at hand.

Not infrequently, FAD advice has been sought by countries—especially those which have implemented, or are at (or close to) the stage of implementing, Fund programs—for the express purpose of identifying policy options to mobilize additional budgetary resources. In these cases, FAD missions are uniformly guided by the principle of designing tax policy measures that would generate adequate revenue to meet budgetary needs in as economically neutral a manner as possible. However, past missions to countries (such as the economies in transition from central planning to a market orientation) where revenue needs were deemed to be particularly severe, or where existing administrative capacities were thought to be seriously inadequate, had also shown flexibility in suggesting interim measures that had in varying degrees deviated from the long-term goal of tax reform. Hence, tax policy recommendations by FAD technical assistance missions are typically arrived at after a balanced assessment of what is desirable in theory and what is feasible in practice.

The scope of FAD tax policy advice has also tended to vary in response to the different nature and circumstances of the countries requesting technical assistance. In the Latin American countries, for example, their relatively advanced economies functioning in an environment of high inflation have necessitated the missions' attention on special issues relating to the tax treatment of the financial sector, while in countries whose economies are at a lesser stage of development, such as the francophone African countries and many of the economies in transition, the missions'...
focus has typically been placed on the proper implementation of a few traditional taxes, as well as on the necessary institution building for the development of a modern tax system.

The following section examines in greater detail, by major type of tax, the scope and nature of FAD advice on tax policy provided to the countries covered in this review. Section 3 discusses the policy impacts of the missions' recommendations. The review concludes with some brief summary remarks.

2. Nature and scope of the missions' recommendations

a. Domestic consumption taxes

The missions' recommendations in the area of domestic consumption taxes have overwhelmingly concentrated on the VAT, dealing with issues related either to its introduction in countries (most notably the economies in transition) where it is to replace a cascading turnover tax, or to its simplification in countries (most notably the Western Hemisphere economies) where the tax's structures have become increasingly complex over the years. In arriving at their recommendations, the missions frequently sought guidance from the extensive international experience with the tax, particularly that of the countries of the European Community (EC).

There is general agreement among experts that a VAT should be designed to be primarily a major and buoyant source of revenue, and should not be overburdened by equity considerations leading to a large number of items (typically foodstuffs, medicines, and other basic consumer goods and services) to be either exempted or taxed at a multitude of low rates. Studies have shown that these features of the VAT are not only relatively ineffective in achieving their intended goal (since they benefit the wealthy as well), they complicate the administration of the tax and reduce its revenue yield. Hence, FAD advice on the VAT's rate structure has tended to emphasize the virtues of a single rate within the range of 10-20 percent depending on revenue needs. In countries where a single-rate VAT was deemed politically infeasible, a dual-rate structure (a normal rate coupled with a reduced rate on a limited number of items) was proposed by the missions. The missions generally argued strongly against the adoption of a VAT with more than three rates (in addition to a zero rate for exports).

As regards the base of the VAT, the missions' recommendations largely followed the EC practice and focused on limiting the scope of exempted items to a few standard ones for administrative reasons, such as rental incomes from housing, financial services, and the agricultural sector, 1/ and on taxing all other goods and services, including construction materials and

1/ An exception was made in one of the economies in transition, where the mission recommended that farmers be taxed under the VAT because they are few in number and their farms are large in size.

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services, sales of new buildings, and purchases by government, public, and nonprofit entities. In a few countries, the missions expressed a preference for taxing essential items (at a reduced rate) over exempting them; but if they were to remain untaxed, exemption was preferable to zero-rating. For reasons of maximizing efficiency and international competitiveness, the missions uniformly recommended the adoption of a consumption-type VAT on a destination principle, that is, all inputs, including capital goods, are given tax credits; all imports are subject to tax; and zero-rating is limited to exports. 1/ The coverage of the VAT was recommended to be extended to the retail stage in a few countries, and in most cases the missions expressly stated the need for establishing a threshold level for exempting small traders to ease the administrative burden.

The successful introduction of a VAT generally requires substantial start-up costs in education (for taxpayers) and training (for tax administrators). For this reason, the missions suggested that the replacement of existing turnover taxes by the VAT be given adequate preparation time in many countries, especially the economies in transition but also some of the anglophone African, Asian, and Middle Eastern economies. In the interim period, the missions' recommendations focused on simplifying the existing structures of the turnover tax in these countries, primarily through reducing the number of rates significantly, and broadening the base by removing exemptions and bringing excluded sectors (such as services and imports) into the tax net; 2/ they also emphasized the importance for appropriately reforming the turnover tax so as to pave the way for the eventual introduction of the VAT. The same principles were applied to countries where some form of the turnover tax was to be introduced for the first time.

In the area of excises, the missions' recommendations generally consisted of (1) limiting the list of excisable items to a few traditional ones such as tobacco products, petroleum products, alcoholic and nonalcoholic beverages, vehicles, and some luxury consumer goods; 3/ (2) replacing specific with ad valorem rates to protect the erosion of revenue through inflation; and (3) choosing excise rates at comparable international levels.

1/ For interstate trade among the countries of the CIS, the missions did not object to the adoption of an origin-based VAT, but alerted the authorities of its revenue consequences.

2/ The mission also recommended in one economy in transition, for revenue reasons, the introduction of a temporary gross receipts tax of 2 percent on those activities not covered by the existing turnover tax.

3/ In one economy in transition, the mission recommended the extensive use of excises to minimize relative price changes (a constraint imposed by the authorities) if and when its highly differentiated turnover tax was replaced by a VAT.
b. International trade taxes

The missions tended to recognize that the primary purpose of import duties was to provide temporary protection to domestic industries, and revenue generation only as their secondary objective. Hence, the missions' recommendations largely dealt with the rationalization and consolidation of duty structures, eliminating ad hoc exemptions, and establishing a uniform minimum duty rate on all imports. Recommendations were also made for specifying duty rates in ad valorem terms, and for valuing imports on the basis of market-related exchange rates.

For reasons of international competitiveness, missions generally recommended the abolishment of export duties (except to capture windfall gains), or at least their reduction if revenue needs require them to be maintained in the short run.

c. Income taxes

The recent international trend in personal income tax reform has been unambiguously in the direction of reducing the progressivity of its rate structure, coupled with a broadening of its base through limiting the scope of allowable exemptions and deductions. Countries have increasingly realized that excessively high marginal rates are often not only ineffective in achieving redistributive goals (primarily because they induce significant tax avoidance or tax evasion behavior), they also distort economic decision-making and result in revenue loss. In line with the international trend, the main ingredients of the missions' recommendations on the personal income tax have been the flattening of its rate structure--typically consisting of no more than three brackets with a top marginal rate of no more than 40 percent--the narrowing of deductions (e.g., the number of dependents and the maximum amounts of mortgage interest payments, medical and education expenses, and life insurance contributions that could be claimed), and the list of incomes exempted from tax (e.g., certain social welfare receipts). 1/ Although a global concept of income taxation was supported by missions in general, in the short term many missions recommended final withholding taxes on wages, interest, and dividends in countries (such as those with economies in transition) where tax administration is weak.

Missions uniformly recommended a single, proportional rate for the corporate income tax, 2/ typically within the range of 30-40 percent, with a few exceptions at slightly higher rates. The emphasis here tended to be on neutrality in the taxation of company profits to ensure the efficient

1/ The limits on the number of brackets and the level of the top marginal rate are usually set somewhat higher in the francophone African economies, due to the complexity and high progressivity in their existing rate structures.

2/ Frequently referred to as the enterprise profits tax in the economies in transition.
allocation of capital. In this regard, all missions argued against the granting of sector- or activity-specific tax incentives (e.g., tax holidays, reduced tax rates, and other preferential tax treatments) and recommended the uniform treatment of all domestic enterprises under the tax. The uniform treatment between domestic and foreign enterprises was also recommended by some missions, as there was no convincing evidence that tax incentives alone had been effective in attracting foreign investment. In the economies in transition, special emphasis was placed on the equal treatment of the state and nonstate sectors.

Missions also advised on a number of issues related to the base of the corporate income tax. In the economies in transition, missions emphasized the necessity of formulating clear rules on deductible business costs (such as interest but not loan repayments), inventory valuation (such as last-in-first-out (LIFO)), the period of loss carry-forward (for about five years), and depreciation (such as straight-line and declining-balance methods). In these economies, the missions frequently recommended a drastic simplification in their depreciation systems—reducing the number of schedules to no more than ten and allowing some form of accelerating depreciation to partially compensate for the effects of inflation. Inflation issues figured prominently in both these and the Western Hemisphere economies, and recommended measures to deal with them included the indexation of taxable income, revaluation of assets and liabilities, and, in a few anglophone African economies, taxing only the real portion of capital gains. Missions which addressed the taxation of capital gains provided varied recommendations. Some missions argued for taxing capital gains as regular income and profits, while others, most notably those advising the Western Hemisphere economies, tended to recommend treating such gains depending on the specific circumstances, sometimes taxing them at lower rates or exempting them if reinvested in similar assets. As a measure to ensure adequate revenue generation from the corporate sector in the Western Hemisphere economies, missions also recommended some type of a minimum corporate tax at a rate of 1-2 percent on the corporations’ gross assets. 1/

d. Other taxes and issues

In a few economies in transition, missions recommended the continuation or introduction of some form of an excess wage tax in state-owned enterprises (SOEs), pending their privatization. The purpose was to both ensure adequate investment and prevent erosion of the profit base in these enterprises through excessive wage distributions. In the Western Hemisphere economies, missions began engaging the authorities on exploring the use of various forms of environmental taxes to protect the environment, such as a carbon tax on emissions and a tax on the felling of trees. Some missions also provided advice on wealth-related taxes, such as those on assets,

1/ A minimum corporate income tax of 1 percent of turnover, creditable against actual assessment, was also recommended by the mission in one Middle Eastern economy.
property, inheritance, and land. Generally, missions recommended the elimination of a variety of small, nuisance taxes that yield little revenue but require substantial resources to administer.

3. **Policy impacts of the missions’ recommendations**

Many of the Western Hemisphere economies have carried out sizable reforms in domestic consumption taxes, such as broadening the VAT base, implementing a consumption-type VAT, reducing the number of VAT rates, and exempting agriculture from the VAT net. Most of the economies in transition covered in this review are in the process of adopting, or have already adopted, a VAT as a replacement of the turnover tax with features in line with those recommended by the missions, such as specifying its rate structure to contain no more than three rates (inclusive of a zero rate) and limiting the number of exempted items to include only the standard ones. Some countries are in the process of adopting a turnover tax as recommended by the missions, while tax reforms in a few others are moving, albeit at a much slower pace than the missions had hoped for, in a direction which is in broad agreement with the missions’ recommendations. Positive response to, and progress as a result of, FAD technical assistance have also been reported regarding domestic consumption tax reforms in various anglophone and francophone African economies as well as in Middle Eastern economies.

Missions’ recommendations on international trade taxes have also been successful in prompting authorities to implement concrete policy measures. Reform of customs duties have been rapidly carried out, often in conjunction with World Bank technical assistance, in many of the Western Hemisphere and francophone African economies with respect to both base broadening and rationalization of the rate structure. Missions’ advice on customs duty reform has also had a positive impact in several of the economies in transition.

The degree of success in reforming the income taxes has been less uniform in the countries which received FAD advice. With respect to the personal income tax, the implementation of recommended measures has only been partial in many of the Western Hemisphere economies—while the rate structure has been brought down, it cannot be said that it has always been accompanied by a significant reduction in allowances and deductions. Similarly, some of the francophone African economies have also achieved only partial progress in this regard. The economies in transition have, however, been somewhat more successful in their efforts in reforming the personal income tax in line with the missions’ recommendations.

As regards the corporate income tax, most of the economies in transition have adopted, or are in the process of adopting, a single tax rate on enterprise profits that is well within the range of international practice; some of them have also simplified their depreciation schedules. In a number of countries, reductions in the corporate income tax rate have been implemented, but progress in eliminating tax incentives has been mixed in most
countries. Many Western Hemisphere economies have now introduced a minimum corporate tax, thus expanding their tax bases considerably.

4. Concluding remarks

In general, FAD tax policy advice has had a discernible impact on shaping the course of tax reform in many countries. By type of tax, missions' recommendations on the reform of domestic consumption as well as international trade taxes have met the greatest success in terms of the extent to which they have been subsequently implemented by the authorities. By geographical location, the work of the missions has perhaps been most strongly felt in Western Hemisphere economies and the economies in transition. As is to be expected, it seems that timely and concrete policy actions have materialized with a much higher frequency when FAD technical assistance was given in the context of Fund programs. But even in instances where the use of Fund resources was not involved, the missions' analytical work supporting their recommendations often provided significant assistance to the authorities in their deliberations on policy options.

The most prominent obstacles in implementing necessary tax reform programs faced by many countries have been various factors that render certain reform measures politically or socially sensitive and, in the case of the economies in transition, also the lack of adequate institutional structure to fully support a market-oriented tax system. As such, these obstacles can only be overcome with time, continued external technical assistance, and domestic political will.

II. Economies in Transition
(Prepared by Howell Zee)

1. Introduction

This chapter reviews the experience of FAD technical assistance on tax policy in 24 selected economies in transition since 1990, on the basis of reports and aide-mémoires issued by the technical assistance missions 1/ and, for the purpose of investigating the policy impacts of the missions' recommendations, various other official and unofficial Fund documents 2/ subsequent to the issuance of the missions' findings. The primary topics addressed by the missions included the reform of the turnover tax, the introduction of a VAT, the taxation of enterprise profits and personal incomes, and customs reform. In all cases, tax reform recommendations were

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1/ A few reports issued in 1990 were in connection with missions that took place in 1989.
2/ These include Fund program papers, Staff Reports, REDs, back-to-office reports, and other memoranda written in connection with area department missions to the sample countries. Consultations with some relevant mission members have also been carried out.
given in the context of the comprehensive market-oriented reform programs being undertaken by the authorities in the sample countries. The missions' recommendations in several countries also contributed to the design of the Fund's stand-by or extended arrangements with them.

While economic circumstances differ across the countries under consideration, they share similar reform objectives and face similar constraints. In the area of tax reform, the common goal has been to transform existing tax systems, which had been largely complex and nontransparent mechanisms for carrying out centrally directed resource transfers between the state budgets and SOEs, into ones that would be compatible with a more decentralized economic environment. The common constraints, at varying degrees of severity, faced by these countries in their tax reform efforts have been a widening of fiscal imbalances during the transition and the lack of administrative machinery to effectively implement tax systems typically found in market economies. The above goal of tax reform and its associated constraints have had a direct bearing on the kind of recommendations put forward by the missions. On a number of specific issues, such as the choice of appropriate tax rates and the tax treatment of certain forms of income and expenditure, most missions also made explicit references to the international practice as a guide in arriving at their recommendations.

A central theme in all of the missions' recommendations has been the design of tax systems (or specific taxes) capable of generating adequate revenue to meet budgetary needs in as neutral a manner as possible, that is, the minimization of tax-induced distortions in resource allocation subject to given revenue requirements. In practice, tax neutrality has been sought through such recommended measures as a drastic reduction in the number of tax rates for each tax, the elimination of special tax exemptions and preferences, and a uniform application of tax rules between the state and the nonstate sectors. It so happens that these basically neutrality-driven recommendations also lend themselves to addressing the two constraints of tax reform identified above quite effectively; if successfully carried out, they would have the effects of (a) broadening the tax base, which should bode well for revenue generation, and (b) simplifying the tax structure, which should ease the administrative burden.

In those instances where revenue needs were particularly severe, or existing administrative capacity was seriously inadequate for the implementation of certain features in a market-oriented tax system that are commonly deemed desirable, the missions' recommendations would typically allow for interim measures that might in varying degrees deviate from the long-term goal of tax reform. Examples of such measures included a delay in the introduction of the VAT, a temporary surcharge on imports, a tax on gross

1/ Usually in the form of a great number of implicit and explicit tax rates, and a myriad of special tax exemptions and provisions that could either be found specifically in the tax codes or be granted simply at the discretion of tax officials.
receipts in the short run, and the continuation of final withholding of taxes on interest and dividend incomes.

The policy impacts of the missions' recommendations in the sample countries fall broadly into three categories. First, for some countries, the findings of the missions provided important input to their tax reform efforts, and many of the missions' recommended measures, or some variants of them, have been adopted by the authorities. Second, for the CIS, whose economic transformations have just begun and to which technical assistance has been provided only recently, it is still too early to ascertain in concrete terms what policy impacts the missions' recommendations might eventually have in these countries. Third, in a few other countries, their present political situations are such that the implementation of substantive tax reforms in these two countries is inevitably going to be a lengthy process. But even here, the necessity of reforming their tax systems in line with the missions' recommendations is well understood by the authorities.

The following section reviews in greater detail, by major type of tax, the nature of the missions' recommendations provided to the countries covered by this chapter, identifying in them both the common and the country-specific elements. To the extent possible, the policy impacts of the recommendations will also be discussed.

2. **Nature and policy impacts of the missions' recommendations**

   a. **Domestic consumption taxes**

      (1) **Turnover tax**

      Almost all of the covered countries are in the process of adopting, or have already adopted, a VAT as a replacement of the turnover tax. Hence, specific reform recommendations on the turnover tax were provided only to a few countries, and then only as interim measures for the majority of them.

      The common elements in the recommendations were a reduction in the number of tax rates to no more than two, and a broadening of the base by bringing many exempted transactions into the tax net (usually with exclusion thresholds for small traders). For those countries with express plans for the introduction of a VAT, the missions emphasized the need for choosing the rates and bases of the turnover tax that would pave the way for the eventual implementation of the VAT. For one country, the mission also recommended the introduction of a temporary gross receipts tax of 2 percent on those activities not covered by the existing turnover tax.
There is general agreement among experts that a VAT should be designed to be primarily a major and buoyant source of revenue, and should not be burdened by equity considerations. For this reason, the thrust of the missions' recommendations on the VAT was for a simple rate structure with a very limited number of exemptions or zero-rated items. In all cases a single standard rate in the range of 10 percent to 15 percent (with a zero rate for exports) was strongly recommended, but a dual-rate structure (a standard rate and a reduced rate in the range of 5 percent to 10 percent on certain essential items such as basic foodstuffs, medicines, and energy) was also considered to be acceptable. As regards exemptions and zero-ratings, the missions generally followed international practice and recommended that exemptions be limited to standard items such as financial services, housing rents, and some health and welfare services. They also recommended that construction materials and services, the sale of new buildings, and transactions conducted by public, nonprofit, and government entities should all be brought to tax; capital and intermediate goods be given tax credits; an invoice-credit method be used; an exemption threshold be established for excluding small traders (but for whom an option to register for the VAT be given); and zero-rating be limited to exports only. The missions pointed out that the choice of the tax rate(s) would depend on revenue needs, and that for any given revenue requirement, the larger the scope of exemptions and zero-ratings, the higher the standard VAT rate would have to be.

The missions also addressed several country-specific issues. For example, in one country, the mission recommended that farmers, in contrast to the practice in the EC, be taxed under the VAT because they are few in number and large in size; and in another country, the mission supported the authorities' intention to move its VAT more in line with that in the EC by reducing the standard rate from 25 percent to 20 percent, eliminating the intermediate rate of 15 percent, and subjecting food and other necessities (which were zero-rated) to a reduced rate of 10 percent. Other examples included an acceptance of a three-rate VAT structure, given the constraint imposed by the authorities concerned of minimizing the perturbations to relative prices if and when the VAT replaced a complicated system of turnover taxes; and a strong recommendation against a planned implementation of a VAT experiment that would cover only selected industries. For the CIS, the decision to adopt a VAT at a single rate of 28 percent had already been taken by the authorities at the time the missions provided them technical assistance. Hence, the missions' recommendations on the VAT to these countries focused on certain issues that arose in their unique circumstances. In particular, the missions stressed that a distinction must be made between trade transactions conducted with countries outside and within the CIS; for trade with non-CIS countries, the VAT should be implemented on the destination principle, that is, imports be taxed and exports be zero-rated; for trade within the CIS, the missions explained the difference between an origin-based and a destination-based VAT, pointed out their economic implications, and alerted the authorities of the revenue consequences of the choice between the two.
The policy impacts of the missions' recommendations on the VAT have been most discernible in the Eastern European countries.

(3) Excise duties

The general recommendation by the missions on excises was that all traditionally excisable items, such as alcoholic and nonalcoholic beverages, tobacco products, petroleum products, vehicles, and luxury consumer goods, should be subject (irrespective of origin) to duty rates that are comparable to international norms, for the dual purpose of generating revenue and avoiding the need for an excessive number and level of rates in the turnover tax or VAT. The precise recommended coverage of the excises varied, however, depending on the particular situations of the countries concerned. For example, for the CIS, the emphasis tended to be on revenue generation and ease of administrative burden, so that excises were only recommended on a limited number of high revenue-yielding goods; in one country, however, it was recommended that an extensive system of excises be used to minimize relative price changes (as desired by the authorities) and prevent the proliferation of VAT rates.

b. International trade taxes

A common theme in the missions' recommendations on customs duties was that of base broadening through the elimination of exemptions and uniform application in all sectors of the economy of relatively few duty rates on all imports. As a result, several countries have implemented or are considering the implementation of measures that are in broad agreement with these recommendations. In the CIS, the missions have also recommended that the authorities impose a broad-based minimum import tariff at a moderate rate, abolish implicit taxation on trade through nonmarket-related exchange rates or surrender requirements on hard currencies, eliminate export duties except to capture windfall gains, and formulate a comprehensive strategy of taxation of energy and natural resource products in the form of royalties.

c. Income taxes

(1) Personal income tax

The missions' recommendations on the personal income tax were dominated by two themes: a reduction in the degree of progressivity through a combination of limiting the number of brackets (usually to three) and reducing the top marginal rate (usually to 40 percent), and a broadening of the base through the elimination of exempted incomes, a narrowing of the scope of deductions (such as the handicap and child allowances), and bringing the incomes of farmers and self-employed persons, as well as the value of fringe benefits, into the tax net. While the concept of uniform taxation on the basis of global income was generally supported by the missions, administrative concerns also prompted them to accept, at least in the short run, some form of a schedular personal income tax. Most missions recommended, for example, a final withholding tax, usually of 20 percent, on
interest and dividend incomes. In some countries, final withholding was also recommended on capital gains on immovable property and on wages. In one country, the mission recommended the indexing of brackets and capital gains for inflation.

Most of the countries undertaking personal income tax reforms adopted measures broadly in line with the missions' recommendations.

(2) Enterprise profits tax

Under central planning, there was little need to separate the roles of the state as owner and tax collector of SOEs, since almost all allocative decisions were centrally determined and productive activities carried out by the SOEs. Consequently, the taxation of enterprise profits was little more than a mechanism for transfers of profits that was invariably complex, arbitrary, and often negotiable. However, with the onset of decentralization and the burgeoning of private sector activities in the sample countries, the proper functioning of their economies clearly required that tax policies be enforced by rules of law rather than discretion, and that tax obligations arising from all economic activities be calculated on the basis of a level playing field. Hence, in their recommendations the missions emphasized the need for a single, proportional tax rate on realized enterprise profits, usually within the range of 30 percent to 40 percent, and for eliminating ad hoc tax exemptions and differential tax treatment of profits by type of activity or sector. Recommendations on specific issues relating to the tax base included the need for a clear definition of deductible business costs (such as wages and interest payments on loans), a simplification in the classification of assets for the purpose of depreciation, an increase in the depreciation rates, the adoption of LIFO method for inventory valuation, and allowing enterprise losses to be carried forward for about five years.

In some countries, the implementation of a market-oriented enterprise profits tax in place of the earlier profit transfers could lead to a substantial revenue loss for the state budget. In these countries, the missions recommended, as a short-run measure pending privatization, some form of a surtax on after-tax profits of SOEs to simulate the dividend payment on past investments by the state in these enterprises. The desirability of uniform tax treatment of domestic and foreign enterprises was explicitly stated by the missions to a number of countries. An exception to the single-rate recommendation was made by the mission in one country. Pending its legislation of a global income tax, the mission recommended that agricultural, self-employed, and rental incomes be taxed under the enterprise profits tax at either a single rate or two progressive rates for administrative simplicity.

Many countries have now adopted, or are in the process of adopting, a single enterprise profits tax rate that is well within the range of international practice and is to be applied uniformly to all sectors in the
economy, as well as measures to simplify the tax structure and broaden its base.

d. Other taxes and issues

The lengthy and difficult process of privatization in many of the economies in transition implies that SOEs will continue to play an important role in these countries. To prevent the excessive distribution of SOEs' profits to their workers, which could lead to a serious erosion of the enterprise profits tax base as well as the foregoing of otherwise sound and necessary investment expenditure, some missions have supported either the continuation or the introduction of some form of an excess wage tax, which could be an explicit tax on, or the nondeductibility (in computing taxable profits) of, wages paid in excess of some established norm.

For both revenue and equity reasons, some missions have welcomed the introduction of wealth related taxes (on assets, property, inheritance, and land). The general thrust of the missions' recommendations in this regard was to have these taxes implemented on the basis of simplicity and uniformity, although they also took note of valuation difficulties that were certain to arise.

3. Concluding remarks

Four guiding principles stand out in the missions' recommendations on tax policy in economies in transition: revenue generation, neutrality, administrative simplicity, and conformity with international practice. These principles led to the recommendations that the VAT be implemented with at most two positive rates and few exemptions, excises be used on traditionally excisable items for revenue and sumptuary purposes, the personal income tax be broad-based with moderate progressivity, and the enterprise profits tax be uniformly applied with a single proportional rate. At the same time, the missions have shown flexibility in their recommendations in addressing special problems that might arise in individual countries, as well as a willingness to temporarily deviate from the long-term goals of tax reform in the face of severe revenue and administrative constraints. With few exceptions, the missions' recommendations have had readily discernible positive impacts on the sample countries' tax policies.

III. Western Hemisphere Economies
(Prepared by Parthasarathi Shome)

1. Introduction

This chapter reviews the recent experience of FAD technical assistance on tax policy in seven selected Western Hemisphere economies. Many of the Latin American economies have mature tax systems. Over the last two decades, their tax systems tended to become complex, with multiple rate structures and eroded bases as a result of incentives, exemptions, and
short-run or emergency measures that were superimposed on the basic tax structure. Technical assistance, therefore, very often attempted to simplify the existing tax systems and reorient them toward greater neutrality in their impact on economic activity. While tax reform need not necessarily be linked to the generation of increased tax revenue, many of the technical assistance requests were made in the context of need for greater revenue. Improved revenue productivity was, therefore, a goal in many technical assistance efforts, especially those that were carried out for Fund program or near program countries. Finally, as the experience with the implementation of tax policy increasingly revealed the difficulties of administering certain tax reform measures, the need for administrative feasibility became an essential factor in tax policy recommendations.

The record of implementation of the recommended measures is almost always subject to the political environment in which the reform package is constructed. For example, many tax reform proposals appear in a charged political atmosphere. Increasing the rates of a tax is often met with popular resistance. FAD has, in any event, tended to stay away from increasing tax rates unless absolutely necessary and has, indeed, normally recommended their reduction whenever possible. Expanding the tax base--while maintaining low tax rates--has also met with forceful, even if imperceptible, resistance from interest groups which have been the recipients of special treatment in earlier tax regimes. What is apparent from the Latin American experience is that tax reform tends to carry with it a definite element of unpopularity whether linked to Fund programs or not, until the benefits of a reformed tax system become clearly visible to the public in general, and to interest groups and lobbies that have political clout, in particular.

The following section reviews in greater detail, by major type of tax, the nature of the missions' recommendations provided to the countries covered by this chapter. To the extent possible, the policy impacts of the recommendations in individual countries will also be discussed.

2. Nature and policy impacts of the missions' recommendations

a. Domestic consumption taxes

The overall objective of domestic consumption taxes is to tax the consumption of as many goods and services as possible at a low rate, so that the maximum revenue is obtained with as wide a spread of the overall burden as possible, while achieving efficiency through neutrality of treatment across sectors. A good tax for this purpose is the VAT.

Latin American countries were the pioneers of the VAT. They were the architects of the idea that greater economic efficiency can be obtained through the use of the credit principle applicable to taxes paid on input, while collecting taxes from output. Over the last two decades, however, necessary ingredients to such a tax structure (e.g., wide sectoral coverage and minimization of exemptions and incentives assuring cross-sectoral
neutrality) were increasingly sacrificed for the incorporation into the VAT structure of multiple objectives through the special treatment of particular sectors, activities, or regions. Recommendations of the missions have, therefore, focused on re-establishing an appropriate VAT base to include, for example, construction activities, professional services, luxury services such as hotels and restaurants, personal services such as dry cleaning, and other services such as utilities and communications. Aspects of VAT base expansion appear in the missions' recommendations for almost all of the countries under review. At the same time, agricultural products are encouraged to be exempted for both equity and administrative ease, and since the efficiency objective is best achieved through a consumption-type VAT, missions have tended to recommend full credit to be given for taxes paid on all inputs including capital goods—something which has not been allowed in many Latin American countries. Multiplicity of VAT rates has also been discouraged; usually a normal rate, in conjunction with a lower rate for essential goods and a higher rate for a limited number of super luxuries like yachts and jewelry, has been recommended in an environment in which a single-rate VAT is politically impractical.

In those countries that have had long lists of excises—with each item having a rate structure, an incentive or exemption code, and a tax treatment of inputs of its own, missions have recommended the incorporation of most of the items into the VAT base, leaving only a few for the excise list, whose objective is to levy higher taxes on scarce or luxury items or those whose consumption is harmful to health or the environment. The common pattern for all countries reviewed has been to recommend the select excises on top (or inclusive) of the VAT, typically on petroleum products, alcoholic (and sometimes nonalcoholic) beverages, and tobacco products, with some variation in the excise list across countries; and to usually recommend higher ad valorem rates, often with revenue in mind while recommending rates based on international standards.

Most countries have carried out sizable reforms in domestic consumption taxes, many of which are in broad agreement with the mission's recommendations. While the tax rate reflects revenue needs to a great extent, overall the countries that have been introducing VAT reform seem to be opting for higher tax rates than those recommended by the missions. This could reflect, to some extent, the subjective judgment on the part of the authorities on their tax administration capacities. It may also reflect their inability to expand the VAT base to the extent that the missions have typically recommended.

b. International trade taxes

The main objective of import duties is to provide temporary protection to infant industry. Over the years, however, Latin American countries have experienced extreme complexity in their customs duty structures, often requiring several volumes to list the rates by nomenclature. The countries themselves embarked on major duty revisions during the 1980s, often with World Bank technical assistance. FAD missions have typically provided some
coordinated technical support toward this effort. In addition, the missions have recommended a minimum import duty with the objectives of raising revenue and reducing effective protection in a number of countries. The preference has been to eventually equate all duty rates. In those countries in which exemptions eroded the base, the recommendation has been to rationalize them.

Missions have strongly opposed the levying of export duties except on windfall profits, mainly because such duties unnecessarily put the domestic competitor at a disadvantage in the international market. At the same time, special export subsidies have also been discouraged.

The implementation of the reform of customs duties has proceeded most successfully and according to schedule in several countries. The various governments tended to adhere to the reform plans, possibly reflecting the relative ease with which customs duties reforms can be carried out, with revenue needs being the only main constraint. Thus, once alternative sources of revenue have been identified, authorities are able to quickly implement such reforms. Yet, they have been relatively slow in removing subsidies to nontraditional exports or taxes on traditional exports, clearly reflecting a policy objective to change the composition of exports through tax-subsidy policies.

c. Income taxes

(1) Personal income tax

Common features found in the existing personal income tax structures are relatively high rates coupled with a very high threshold and various types of allowances and deductions, such as those for education, interest payments, insurance premiums, savings, and contributions to specified funds. As a result, the revenue from this tax is often extremely low, while at the same time its demands on administrative resources are considerable. Missions' recommendations have almost always centered on reducing the rate structure--typically to 10-20-30 percent or slightly higher--pari passu with eliminating allowances and deductions other than personal and family allowances. And in those cases in which the personal allowances are too high by international standards, they are recommended to be reduced to between 1-2 times per capita GDP. In certain countries, equal treatment of all income earners (such as private and public employees) and of all incomes (such as wages, interest, and dividends) through the increasing use of withholding has also been recommended. The primary objectives of the recommended measures have been revenue productivity through the amplification of the base, greater neutrality of treatment, and concomitant simplification for administrative ease.
One area in which most authorities have tended to introduce measures that erode the revenue base is that of personal income taxation. In general, while the rate structure has been brought down, the reduction has not been usually done pari passu with an elimination or, in some cases, even reduction of allowances and exemptions. Indeed, personal allowances have been increased in many cases while select exemptions have remained at high levels and in many forms, which tended to erode revenue collection. In a few instances, the role of withholding for wages, interest, or for professional salaries has been increased per missions' advice, while in others, such advice has not yet been implemented. There has been a tendency in many of these countries to decrease the role of personal income tax, thereby reducing the progressivity of the overall tax system, as this is one tax through which progressivity might be achieved.

(2) Corporate income and related taxes

Recommended corporate income tax reform measures typically covered a wide ground: eliminating multiple taxes on capital; equalizing existing corporate income tax rates to between 35 percent and 45 percent, often reducing the normal rate in the process, and bringing that rate as close as possible to the top marginal personal income tax rate; determining taxable income based on an appropriate inflation index on both the assets and liabilities side; reducing, if not eliminating, the provision of incentives for the promotion of specific sectors or objectives such as employment or development of geographical areas; and reorienting the capital gains tax depending on the specific circumstances (e.g., its exemption if reinvested in similar assets, or for revenue purposes if it is retained--but at a considerably lower rate than the corporate income tax rate). In some instances, the treatment of the financial sector received particular attention especially when, in an environment of high inflation, it was reaping windfall gains. In general, the overall structures of the corporate income tax meet the modern criteria of appropriate rates and bases. Thus, missions have focused on international comparability of rates, which is especially relevant for attracting foreign investment while keeping in mind the need to curb any erosion of the tax base during inflationary times. The extent of remittance taxes, applicability of credits against tax obligations in home countries, and related matters, also featured in the advice provided.

Despite the existence of appropriate corporate tax structures in general, it is often the case that only a small proportion of all corporations actually pays the tax. Therefore, missions have often recommended that a minimum corporate tax be paid by all corporations with their gross assets as the base at a rate of 1-2 percent depending on revenue needs. In countries in which this tax already existed at a higher rate on an alternative base (such as net assets), missions recommended reducing the rate while switching the base to gross assets, mainly for easier calculation of the base, greater administrative ease, and possible improvement in revenue productivity.
In the area of corporate income tax, countries have tended to follow the advice on: rate reduction and base expansion, maintenance of international competitiveness of rates—especially for withholding taxes—and a minimum corporate tax based on gross assets. The success with the elimination of nonuniform tax rates for different sectors has been mixed. The fact that many countries have now introduced a minimum corporate tax expands the tax base considerably and again makes Latin American countries pioneers in this form of taxation. In general, countries have also modified the rules for inflation adjustment, such as the treatment of interest—real or nominal—or valuation of assets, per missions’ advice.

d. Other taxes and issues

Increasingly, the focus has been to reduce dependence on too many taxes since the result is often that actual collection may suffer even while the same base may be taxed many times. Missions have attempted to identify these small taxes with a recommendation to eliminate taxes that yield little revenue.

Recently, however, increasing concerns regarding the preservation of the environment have led to the recommendation of introducing a pollution tax (such as a carbon tax on emissions or an urban tax on vehicles), eliminating investment tax credit and other incentives to the logging industry, or taxing the felling of trees. The recommendations on environment taxes are new in technical assistance missions on tax policy. These taxes are being contemplated, albeit within limited circles, in Latin American countries. Their implementation may take a while, but the seed of debate has certainly been sown.

3. Concluding remarks

The implementation of missions' recommendations is very often a relatively slow, yet equally steady, process. The most important element is the seriousness with which the authorities want to treat the issue of tax reform. Another important factor is the political climate in which the reform is proposed to be carried out. In general, there is often an overall recognition of the need to carry out tax reform, but the process is often likely to get bogged down in the political process.

Certain conclusions can be drawn from the above review. First, the missions' recommendations reflect state-of-the-art thinking on tax policy issues based on the objectives of neutrality, equity, efficiency, and revenue productivity. Second, the recommendations are certainly affected by administrative feasibility. Third, despite the overall pattern, each country's reform package is tailored to its own needs as is clear from the differences that emerge even from a very basic comparison of the packages' content. Fourth, while countries have implemented many of the measures recommended by the missions, the completion of tax reform programs is a long process, as they are subject to popular and political debate and their effects are often misunderstood. Finally, even as FAD continues to respond
to requests for technical assistance, the pace of implementation in the Latin American countries--which have been pioneers in developing new tax reform ideas over the past three decades--gives hope that these countries will continue to achieve steady progress in their tax reform efforts.

IV. Francophone African Economies
(Prepared by Zühtü Yücelik)

1. Introduction

This chapter reviews the experience of FAD technical assistance on tax policy in seven selected francophone African economies, based on the mission reports prepared since 1985 covering turnover taxes, excises, import and export duties, income taxes, and tax incentives.

Revenue neutrality constituted an objective in cases where customs duty rates were to be reduced and simplified, and a shift to be made from turnover taxes to the VAT. Elimination of distortions was sought in the reforms of tax incentives granted by governments, and tax and customs exemptions in tax laws. In many instances, tax reforms encompassed VAT and excise reforms, a shift from scheduled taxes to global income taxation, and a reduction of company and personal income tax rates. They have also been used to support structural reforms (e.g., the liberalization of foreign trade and domestic markets) and energy conservation programs (e.g., increasing excise duties on petroleum products). The revenue objective was also pursued in many parts of the recommendations through extension of the coverage of the VAT and excises, elimination of exemptions from the VAT and customs duties, rate increases in the VAT and excises, adoption of a minimum duty on all imports, and revision of tax incentives.

Some reports contain elements of assessments of an earlier mission's recommendations in the same country. In other cases, staff and program reports have been used for assessing the policy impacts of the missions' recommendations. The following section reviews in greater detail, by major type of tax, the nature of the missions' recommendations provided to the countries covered by this chapter. To the extent possible, the policy impacts of the recommendations will also be discussed.

2. Nature and policy impacts of the missions' recommendations

a. Domestic consumption taxes

Most reports recommended a shift to the VAT over the medium term from existing cascading turnover or sales taxes. Unification of various turnover tax rates was suggested initially while preparing for a shift to the VAT. Elimination of exemptions from turnover taxes or the VAT was generally advised. A shift to the VAT was initially suggested for imports and domestic manufacturing and wholesale trade. With sufficient administrative experience and strength, the VAT was advised to be extended to retail trade
and services. Uniform application of consumption taxes to both imports and local production was recommended. The VAT was generally suggested with a single rate, or at most two to three rates, and a zero rate applied only to exports. Excises were suggested to cover tobacco and petroleum products, cement, soft drinks, alcoholic beverages, electricity, water, and telecommunication services. Petroleum excises were recommended for raising revenue and energy conservation, as well as to supplement the VAT. In one country, a high rate of VAT was advised to be reduced to 30 percent with a larger coverage.

The VAT and excises were recommended for raising revenue from both locally produced goods and imports, whereas import duties at economically justified rates were recommended for the protection of domestic industries over a reasonable period.

b. International trade taxes

In many countries entering into structural adjustment programs with the Fund and World Bank, liberalization policies usually involved drastic customs duties reforms. The recommended measures included a lowering of the number and level of duty rates, and a consolidation of the duty structure. As mentioned above, import duties were recommended only to provide protection for local production, leaving the role of revenue raising to the VAT and excises.

Elimination of exemptions, except those agreed to by international conventions, and the introduction of a minimum duty rate of 5 to 10 percent on presently exempt goods, have also been advised. As recommendations on trade taxes were closely monitored through Fund adjustment programs and World Bank sectoral loan programs, their implementation was more effective than that of other taxes. The practice of granting ad hoc exemptions from customs duties was discussed in many reports and its elimination was recommended because it reduced revenue and created distortions in economic transactions.

Export duties were discussed in two mission reports. They suggested that such duties either be eliminated or be reformed so as to minimize their disincentive effects on production.

In several countries, reforms of trade taxes were implemented consequent to the missions’ recommendations.

c. Income taxes

On the personal income tax, missions recommended a shift from schedular to global income taxation with four to five brackets and a top marginal rate not exceeding 50 percent. In one country, the top marginal rate was suggested to be lowered eventually to 35 percent and the zero-rate bracket to be set at a level to relieve the tax administration from processing a large number of individuals with low incomes and very little or no tax
liability. Missions also suggested a reduction in the ceiling on the number of dependents that could be claimed by taxpayers, and recommended that the traditional French income-splitting system be replaced by a flat dependent deduction or preferably by a tax credit for each dependent for both equity and revenue reasons.

On the company income tax, missions recommended a single rate in the range of 35 percent to 50 percent. In cases of a company tax with several rates (progressive or differentiated by sector), unification was recommended. Some reports advised the lowering of top marginal rates of both the company and personal income taxes only after an effective improvement in tax administration methods and performance, as well as the elimination of exemptions (in order to expand the tax base and avoid a sudden revenue loss). A shift to the current payment of income taxes was also generally recommended.

Implementation of recommended rates has not, however, been uniformly satisfactory with the francophone African economies under review.

d. Other taxes and issues

(1) Property taxes

Only one mission recommended rate increases in agricultural land taxes to compensate for the revenue loss from reduced export duties. No implementation has been reported.

(2) Tax incentives

Countries covered by this chapter have granted generous tax incentives to foreign investors in the form of import duty exemptions or reduced duty rates on investment goods, raw materials, and intermediate goods; sales tax exemptions on their local purchases and sales of their products; and income tax exemptions for periods of 5 to 10 years. In many cases, large investments have benefitted from a stabilized tax regime over extended periods of 10 to 25 years, during which they are protected from tax rate changes. In addition to a loss in revenue, these incentives created inequity and distortions in economic operations. Abuses have also been widespread because governments do not generally monitor investors on their use of incentives. Many goods claiming exemptions or reduced tax rates have been used for purposes other than those for which they were qualified to receive preferential tax treatments. Therefore, all missions discussed tax incentives and advised drastic reductions in their scope. Tax holidays were suggested to be limited to five years; open-ended customs reliefs to be avoided; tax benefits to be concentrated during the initial stages of investment; exemption of export-related profits to be limited to five years; and extension of incentives to the same undertaking to also be avoided. In addition, harmonization was advised in both the UDEAC (Central African States Customs Union) region and the UMOA (West African Monetary Union)
3. Concluding remarks

In the seven countries covered by this chapter, missions recommended tax reforms to varying extents. The most common features of the recommendations are a reduction of rates with simultaneous elimination of exemptions, a streamlining of incentives, and administrative improvements to expand the tax net. Revenue requirements are to be satisfied through the VAT and excises, income taxes, and other duties; and import duties are to be assigned the role of providing economic protection for local industries at internationally accepted levels for a reasonable period of time. Neutrality of the tax system is another feature strongly advocated by the missions.

Implementation of the recommendations has been mixed so far. While customs reforms have proceeded rather rapidly, the lowering of income tax rates and the reduction of exemptions and incentives have not been achieved at the same pace. One result of the tax reforms in these countries has been the expansion of their informal sectors, because (a) sales tax reforms (mostly VAT type) have not been enforced effectively, thus leading to an increase in unrecorded transactions, and (b) customs reforms have strengthened foreign competition through lowered import duties, thus creating incentives for local producers to shift their transactions out of the formal sectors of the economy.

V. Anglophone African Economies
(Prepared by Jitendra Modi)

1. Introduction

This chapter reviews the experience of FAD technical assistance on tax policy in anglophone African economies, based on seven selected mission reports prepared since 1986. After gaining independence in the 1960s, these countries initially operated on inherited tax systems of their colonial past under British rule. Over the next two decades, these systems went through several modifications, reflecting both the growing revenue needs of these countries and unprecedented development of their economies with greater engagement of the indigenous population. However, the modifications were mostly made in a piecemeal fashion, which proved inadequate to respond to the demands of continuously changing economic circumstances. It was in this context that these countries sought FAD technical assistance for tax reform. While each country might have faced different problems or the same problems to a different degree, such as the erosion of the tax base, ineffectiveness in enforcement machinery, necessity of raising additional revenue, and inefficiencies caused by distortions, the mission reports contain several major themes which are of relevance to a number of countries, such as the broadening of the bases of existing taxes (through eliminating exemptions and preferential tax treatments), reducing the tax rates, and introducing...
new taxes. The overall objectives of the recommendations have generally been the simplification of the structure of the tax systems, improvement in their revenue elasticities, and reduction in the degree of tax-induced distortions.

The implementation of the recommended tax reform measures in all of these countries (except one) is being carried out in the context of Fund programs. In some countries where Fund programs have been in effect for quite some time, the extent of implementation has been substantial; others which entered into Fund programs more recently are still deliberating on some of the major reform recommendations. However, there have been exceptions to this pattern: one country, which entered into a Fund program well before seeking technical assistance for tax reform, has delayed the implementation of most of the recommended measures until recently; and another country, which entered into a Fund program only recently, has already been implementing recommended reforms over the past three years.

The following section reviews in greater detail, by major type of tax, the nature of the missions' recommendations provided to the countries covered by this chapter. To the extent possible, the policy impacts of the recommendations will also be discussed.

2. Nature and policy impacts of the missions' recommendations

a. Domestic consumption taxes

Several considerations have guided the missions' recommendations in each country, including the stage of economic development (as indicated by the extent of manufacturing activity) the country has reached, the level of its administrative capacity, and above all the type of consumption tax already in existence. At one extreme is a country with a substantial manufacturing base, relatively high level of administrative skills, and extensive experience in operating a general sales tax. It therefore met the conditions necessary for a switch over to a VAT. At the other extreme is a country which has had a much smaller industrial sector, limited administrative capacity, and only the experience of having implemented excise duties on a limited number of domestically manufactured goods (albeit on more items than traditionally considered to be excisable). The introduction of a general sales tax in this country, therefore, was not judged to be appropriate by the missions until the late 1980s. The thrust of missions' recommendations in the case of intermediate countries, which had already introduced a general sales tax in the 1960s, has been on the disentangling of excise duty elements from the general sales tax, broadening the sales tax base, simplifying the rate structure, and minimizing the distortionary impact of cascading (e.g., replacing the "ring" system with a credit system), thereby paving the way for an eventual switch over to a VAT. In fact, one country is already preparing to do so.
Specific examples of some of the main recommendations of the missions to the different anglophone African economies under review have included the following:

- The introduction of a manufacturer's sales tax;
- The switch from a general sales tax to the VAT;
- The removal of sales tax exemptions extended to government and public enterprises;
- The removal of certain tax exempt items, such as food (except basic staples such as maize flour), farm machinery, locally manufactured medicines, school supplies, etc.;
- The replacement of specific by ad valorem rates of excises to improve the elasticity of the tax;
- The separation of the excise element in the domestic consumption taxes; and
- The extension of domestic consumption taxes to services.

b. International trade taxes

Historically, most African countries have been dependent on trade taxes as by far the single largest source of government revenue. In the context of their growing revenue needs, these countries opted for the politically most expedient options of increasing import duty rates, thereby unintentionally providing heavy protection to domestic industries, and of increasing export duty rates on primary exports, thereby penalizing domestic primary producers of mainly agricultural and mineral products. Exchange rate adjustments by most of these countries in the context of programs with the Fund and associated trade liberalization yielded substantial additional revenue from imports and exports without resorting to further increases in duty rates. In this context, the technical assistance missions mainly recommended the simplification of tariff structures, the broadening of the import duty base, and a drastic reduction in export duty rates. Specifically, these recommendations included the following in different countries:

- The reduction of excessively high export duties;
- The reduction of excessively high import duties;
- The removal of import duty exemptions on cars, returning students, nongovernment organizations, and government and public enterprises; and
- The valuation of imports at market rather than official exchange rates, and the application of a minimum import duty rate.
c. **Income taxes**

At independence, countries under review inherited an individual income tax proper, which applied at a fairly moderate rate to both self-employed persons and individuals earning moderate to high incomes largely in urban areas, as well as to traders. They also inherited a personal (or poll) tax, which applied to a large segment of the indigenous population in the rural areas earning incomes close to the subsistence level. A separate corporate tax was applied to all limited liability companies, but it was mostly paid by foreign corporate entities. Over the next two decades, this tax structure was substantially modified in several respects in the context initially of the rising revenue needs and subsequently of the deteriorating performance of the economy. First, governments stepped up the individual income tax rates on employees, the self-employed, and unincorporated trading entities several times in successive years, but accompanied by increased levels of personal allowances and tax-exempt thresholds which were already much higher than those in developed countries. Second, the central governments of these countries transferred jurisdiction over the personal tax to the local authorities, thereby eliminating the possibility of consolidating it with the individual income tax proper. Third, the governments raised company tax rates sharply several times, but at the same time increased the number and level of tax deductible expenses, including the introduction of tax holidays (five to seven years with a possibility of extension of similar durations) for pioneering industries in order to attract foreign investment.

The evolution of the tax systems described above led to substantial distortions in resource allocation, as steep tax rates discouraged compliance and arbitrary extensions of tax shelters by government officials created a breeding ground for patronage and corruption. The deterioration of the economy compounded these problems, as an increasingly overvalued exchange rate gave entrepreneurs more incentive to conceal their parallel market operations (including the cost of buying patronage for tax shelters) in their books. This in turn forced them to underreport to tax authorities profits generated from such operations with the resultant erosion of the tax base.

In the context of Fund programs, the missions concentrated on simplifying the tax structures and removing existing distortions. Specifically, their recommendations included the following in different countries:

- The broadening of tax bases, such as removing excessively high levels of exemption and generous deductions in the personal income taxes, removing tax holidays, removing company income tax exemptions accorded to certain public enterprises, and bringing into the tax net fringe benefits and agricultural income;

- The reduction of excessively high rates of income taxation;

- The provision of inflation adjustments in personal allowances, capital gains, and tax brackets in the personal income tax; and
The switch over of taxing company profits from preceding- to current-year basis.

Some of the countries have already implemented measures in line with the missions' recommendations.

d. Other taxes and issues

For revenue-raising purposes, the missions also recommended such measures as the application of proxy taxes for capturing elusive sources of income (such as the taxing of land and property of large cattle ranches and estate farmers) and the imposition of a development charge on real estate appreciation.

3. Concluding remarks

The overall experience with the implementation of the missions' recommendations in the anglophone African countries covered in this chapter has been mixed. Some of these countries have encountered major problems in implementing certain recommendations for a variety of reasons, namely: the political sensitivity in respect of certain measures affecting the entire population; delays in getting consensus on certain proposals; resistance of vested interests or pressure groups; and the lack of adequate technical capacity to administer proposed changes. Others, however, have benefitted from adopting tax reform measures which are broadly in line with the missions' recommendations.

VI. Asian and Middle Eastern Economies
(Prepared by Jitendra Modi)

1. Introduction

This chapter reviews the experience of FAD technical assistance on tax policy in five selected Asian and Middle Eastern economies, based on mission reports prepared since 1987. These are a diverse set of countries with varying patterns of economic development and different tax structures. At one extreme, there are well-diversified economies with a reasonably sound tax structure needing limited modifications, while at the other extreme, there are economies with extremely uneven sectoral developments and tax structures needing substantial broadening, or economies with weak growth requiring the removal of tax distortions. Nonetheless, a common objective of tax reform in all these economies has been to improve the elasticity of their tax systems.

FAD also extended extensive assistance to some other Asian countries in the late seventies and early eighties which had a major impact on their tax reforms (e.g., the restructuring of the tax system, rationalization of income tax structures, and the introduction of the VAT).
FAD has provided technical assistance to these countries (except one) on a continuing basis since the 1960s. The implementation of tax reforms in these countries represents, therefore, the culmination of FAD technical assistance to them on a long-term basis. In a number of them, tax reforms are being carried out in the context of Fund programs.

The following section reviews in greater detail, by major type of tax, the nature of the missions' recommendations provided to the countries covered in this chapter. To the extent possible, the policy impacts of the recommendations will also be discussed.

2. Nature and policy impacts of the missions' recommendations

a. Domestic consumption taxes

The structure of domestic consumption taxes has reached different stages in these countries. Three of them have had general sales taxes at the manufacturing and import level for 10-15 years, operating alongside the excise duties. One of the five countries has had excise duties on a somewhat broader range of goods than the traditional excisable items, while another, has had a similar system of excise duties covering over 40 assorted types of goods which it recently consolidated into a so-called "consumption tax." The missions found several shortcomings in these prevailing structures of consumption taxes. With respect to the sales tax, in one of the three countries which have it, it was found to be narrowly based, applied at internally inconsistent rates, and while the overall effective rate was still low, the actual tax burden fell heavily on most inputs. The sales tax base in the other two countries either excluded many commodities and services (e.g., utilities), or the tax contained "tailor-made" reductions and exemptions, and--despite its cascading nature--was overprotective of domestic industries and extremely biased against exports. Turning to excise duties, one country applied them at specific rather than ad valorem rates on certain major consumer goods like petroleum products; while in the other, the so-called "consumption tax" was applied mostly at specific rates at the retail stage (rather than at the ex-factory stage more commonly found in most developing countries), and with numerous exemptions.

The main recommendations of the missions to the different Asian and Middle Eastern economies under review included the following:

- The introduction of a VAT;

- The switch from a broad system of excise duties to a manufacturer's sales tax (together with a more selective system of excise duties);

- The replacement of specific by ad valorem rates of excises/import duties to improve the elasticity of the taxes;

- The separation of the excise element in the domestic consumption tax; and
The extension of domestic consumption taxes to services.

b. **International trade taxes**

Several shortcomings in the prevailing structures of import duties in these countries were identified by the missions. First, traditional resistance in most of these countries to adjust the exchange rate in line with the free market rate until they entered into a program with the Fund, had given rise to the erosion of the tax base. Second, since import duties were often a significant source of revenue, the countries tended to increase duty rates over time which resulted (often unintentionally) in the overprotection of domestic industries. Third, by yielding to various pressure groups, most of these countries had extended blanket or conditional exemptions. Fourth, the rate structures of the import duties were often complex, sometimes with multiple levies on imports under different names.

To remedy these shortcomings, the missions recommended the following measures to the different countries: (1) imports be valued at market rather than official exchange rates; (2) a reduction in the level of import duties and the elimination of exemptions; and (3) the reform of import tariff structure (reduction in rates and the number of dutiable categories of imports), and a reduction in the effective rate of protection to domestic industries.

c. **Income taxes**

The income tax systems of these countries have been influenced by those of certain industrial countries, for example, by the characteristics of the European schedular taxes, by the American system of standard deductions, and by the British system of comprehensive global income taxation with personal allowances and specific deductions. Corporate income taxes also reflect similar influences in varying degrees. Over a period of time, these systems have grown in complexity with many tax brackets, high tax rates, and numerous deductions and allowances. Examples of major distortions in the different prevailing systems can be identified as follows. First, the taxable incomes contain several exemptions, namely: interest from specified sources; capital gains; business incomes of stock exchanges, Chambers of Commerce, charitable institutions, and agricultural income; incomes from certain factors of production; exemptions of subsidiaries of many trading firms, industries, buildings, and mines; and fringe benefits. Second, there are overgenerous deductions and allowances available and these include the following: deductibility of interest payments on all borrowings under the individual income tax, housing and other allowances, investment incentives and tax holidays, high degree of administrative/political discretion and selectivity in granting incentives; and gifts and allowances. Third, excessively high top marginal tax rates (up to 75 percent of personal and company incomes) and varying degrees of steep progressivity of rate structure. Finally, the existence of two separate income taxes: regular and supplementary super tax.
The main recommendations of the missions to these countries have included one or more of the following:

- The broadening of tax bases, such as removing excessively high levels of exemption and generous deductions in the personal income taxes, removing tax holidays, and bringing into the tax net fringe benefits and agricultural income;

- The reduction of excessively high rates of income taxation and a full integration of the personal and company taxes; and

- The removal or limiting of the scope of ad hoc tax exemptions granted to certain firms and types of economic activities.

3. Concluding remarks

Mission reports to some of the countries have been submitted only recently so that it is still too early to assess fully the policy impacts of the missions' recommendations. A few countries are, however, already reporting some success in their tax reform efforts.