Economic development (tax policy for developing countries) essay

Business, Industries

The world is clearly bifurcated between developed countries, which comprise of 37 countries spread over North America, Europe, Asia and ANZ, and the rest of the world. Considering that a vast majority of the developed countries are very small nation states in Europe, it is evident that an overwhelming population of the world lives in countries that are not developed. While it is no longer politically correct to refer to these nations as third world countries, all of them share some common characteristics that pertain primarily to their human development and economic progress. Countries that do not belong to the ranks of developed countries come under various umbrella definitions like Lesser Developed Countries (LDCs), Lesser Economically Developed Countries (LEDCs), underdeveloped countries or developing countries. These countries house practically 90 % of the world's population and include nations in various stages of development, with different political systems and enormously different traditions, cultures and histories. However, they do bond because of a history of European oppression, poorer economic status, low human development and inferior living conditions. The political systems in these countries range from emancipated and free democracies like India to the Arab Sheikhdoms of the Middle East, Military Juntas of Burma and North Korea and State controlled countries like the PRC. Developing nations suffer from low industrialization, poor per capita income, extensive and widespread poverty and inadequate human development.

This also means that these countries have poor roads and infrastructure, low literacy levels, abysmal educational and healthcare facilities, rich poor divides, feudal social systems, gender inequality and myriad social problems. Most of these countries are in the process of building their economies,

improving all round infrastructures and increasing the living conditions of their people. Their governments are strapped because of unavailability of finance and necessarily have to raise resources through taxation. It is the objective of this essay to analyze and understand the relevant issues that pertain to the collection of taxes in developing nations, commonly adopted strategies as well as related social, economic and political factors. 2.

Commentary. Developing countries normally face a pincer like situation when it comes to allocation of resources for development. The number of areas that need improvement and investment is immense, practically every area be it infrastructure, roads, drinking water, power, irrigation, housing, schooling, public health services suffers from enormous deficiencies. On the other hand, the availability of money is very limited, finance ministers being hard pressed to decide the areas that need to be supported, or inversely the sectors that can be taken up later. It becomes an anguishing choice to decide between putting in money into preventing female feticide and saving children from malaria. Raising money for governmental use is necessarily dependent upon taxes. The tax policy of a nation envelopes a number of avenues that include direct and indirect taxation, namely income tax, sales tax, which is progressively getting replaced by Value Added Tax (VAT), production tax, also known as excise, export and import taxes, customs duties and the like.

Many countries use taxes like service tax, professional tax and a host of levies, both short and long term to raise taxes from citizens. Raising money from taxes in developing countries is a different exercise from that in

affluent and developed nations and thus needs to be strategically different, both in formulation of tax laws and in the mechanism for collection. India, for example, provides a very relevant example of the multitudinous factors that shape and lead to the evolution of tax laws.

The evolution of tax laws in India is also pertinent because while the country has been a free democracy for more than half a century, its leaders adopted a mixed socialist economy for many years. The apparent sluggishness of change led the country to liberalize its economy in the early nineties with startling results, evidenced by sharp increases in GDP, exports and tax revenues. Developing countries, because of their inadequate socio-economic development, need to necessarily struggle with some very difficult constraints. Most of these countries are primarily agricultural.

The production and movement of the produce from the fields to the consumer involves farmers, transporters, wholesalers and small retailers, many of whom deal in cash, and sometimes even in barter, and thus effectively keep the whole transaction chain outside the banking and governmental recording system. India, for example, is even today a primarily agricultural economy where the majority of the population lives in villages, outside the pale of the taxation system. The lack of infrastructure in tax collection accentuates this problem. The tax collectors are primarily governmental employees, unsupported by sophisticated systems, work force, machinery or software.

Recording and tracking of hordes of documents is primarily manual with progress of work being slow and behind deadlines and targets. Tax law and collection in such countries thus revolves around individuals and establishments that are much easier to track, monitor and control. Tax assessees and payers, perforce need to be from urban areas and comprise of corporates, businesses, salaried individuals and businesspersons. The millions of people who work in the unorganized sector and are paid in cash are thus out of the tax collection system. Political ideology and the necessity to appeal to vote banks also play major roles in influencing tax policy. The rich often suffer from heavy taxation, leading to increase in tax avoidance, falsification of papers and the emergence of a parallel economy, in which all transactions take place in cash. In India, the “ black” economy, in the eighties, had assumed dangerous proportions and was supposedly as large as the regular economy. The tax policies in developing economies largely depend upon the amount of public spending needed annually by the economy of the country.

This is possibly a question impossible to answer satisfactorily and most governments work on five-year plans and targets governed by social, political and economic targets. Governmental spending is primarily a percentage of national income and depends upon the amount of budgetary deficit the leaders of a country are ready to accept, a reflection of the final acceptable balance between unleashing of inflationary forces and the developmental needs of the country. The objective of a taxation policy is to raise resources on a short, medium and long-term basis.

One of the primary decisions regarding framing of tax policies relates to deciding between taxing incomes through direct taxes and taxing consumption through indirect taxes. Income tax relates to the taxation of income in the hands of individuals and businesses, be they corporates, partnership firms or sole proprietors. Consumption tax however involves levying of taxes on goods or services by way of production tax, sales tax or VAT. This debate on the social equity of taxing income and consumption has been going on for many years. The conventional belief that taxing income entails a higher welfare (efficiency) cost than taxing consumption is based in part on the fact that income tax, which contains elements of both a labor tax and a capital tax, reduces the taxpayer’s ability to save.

Doubt has been cast on this belief, however, by considerations of the crucial role of the length of the taxpayer’s planning horizon and the cost of human and physical capital accumulation. The upshot of these theoretical considerations renders the relative welfare costs of the two taxes (income and consumption) uncertain. (Tanzi and Zee, 2001)Taxes on income happen in stages and are dependent upon the individuals’ earnings and thus their ability to pay. Taxes on consumption, in the form of production or sales tax or other uniform levies, work on a universal rate and thus affect the poor much more than the rich. Ironically, the incidence of consumption taxes comes into play because of a small tax-paying base and ends up taxing the people who are outside the tax net, primarily because of lower incomes, more than the affluent.

It is but natural that increase in all round development leads to improvements in the share of income tax in the total revenue pie. Data from industrial and developing countries show that the ratio of income to consumption taxes in industrial countries has consistently remained more than double the ratio in developing countries. (That is, compared with developing countries, industrial countries derive proportionally twice as much revenue from income tax than from consumption tax.

) (Tanzi and Zee, 2001) Consumption taxes also suffer from the disadvantage of being inflationary and that too in economies that necessarily have large budgetary deficits. Their use needs great political maturity and their imposition or increase have often led to widespread protest, especially when applied on items of mass consumption like diesel, cooking oil or primary items like bread. Computation of taxes on income happens in stages to ensure that individuals or organisations who earn less do not have to undergo higher outgoes of tax. Developing companies use taxes on income in various ways to spur and encourage investments leading to creation of capital assets and improvement in business infrastructure.

This occurs primarily through the granting of rebates that are dependent on amounts of corporate investment, through the application of varying depreciation rates and specific allowances for different types of investments. Tax holidays are also much in use for encouraging fresh investment in businesses. Fresh businesses in priority sectors receive incentives through exemption from taxes for specified period to encourage entrepreneurial activity. The other taxes that are in use in developing countries as integral

components of their fiscal policies relate to taxes on imports and exports. Import taxes, apart from boosting revenues serve the purpose of protecting domestic trade and industry by making cheap foreign goods expensive and thus uncompetitive.

Export taxes, on the other hand serve the opposite purpose and while leading to some incremental revenue are not favored because of their negative impact on external trade. However, in an increasingly globalised world import and export taxes are often out of the control of individual governments and are part of international trade agreements. Norms and policies of international financial institutions often play a vital role in dictating the fiscal policies of nations with regard to import and export taxes. 3. Conclusion The role of finance ministers in developing countries is fraught with vast difficulties, paradoxes and contradictions.

The enormous developmental needs of their countries necessitate the collection of significant level of taxes from their citizens, an exercise that is subject to the interplay of various interlinked social, economic and political factors, which in turn involve equity and empathy with the citizens of the land. The raising of income tax beyond acceptable levels results in large-scale avoidance and generates dishonest avoidance. On the other hand, increase in consumption taxes spurs inflation and leads to social inequity. Import and export taxes again have very limited scope because of their effect on international trade. In the midst of these veritable minefields, governments have to continuously strive for greater revenues and corporate investment in revenue yielding and productive infrastructure without

aggravating financial hardship and disturbing political equations. The increasing democratization of the world and isolation of totalitarian governments also ensures that autocratic regimes cannot force unacceptable and discriminatory tax policies.

Progressive governments thus try to ensure a liberal tax regime that aim to bring about development and infrastructure in a phased manner over structured periods such that policies, collection mechanisms, incentives and taxes work in tandem to achieve growth in revenues and increase in GDP, which in turn leads to increases in various tax bases and slowly prod nations into the ranks of the developed countries. BibliographyFiscal Policy Issues in Developing Countries. (1996). 63+. Retrieved December 14, 2006, from Questia database: http://www. questia.

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