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REFORM OF INDIRECT TAXES IN DEVELOPING COUNTRIES: SELECTED ISSUES

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I. INTRODUCTION

Tax reform is almost universal and it has taken a prominent place in the agenda of many governments. In developing countries alone, there have been over 100 identifiable attempts at major tax reform since the mid-1940s (Gillis, 1989). The pace of reforms, particularly in developing countries, has accelerated in recent years mainly due to the increasing realization of the need to make the tax systems simpler, more transparent, less distorting and broad based. Although the directions for reforming taxes and the success of tax reforms depend upon the particular country situation, the analysis of the experiences can immensely help in formulating appropriate strategies to raise the required revenues in an efficient and equitable manner.

This article attempts to summarize the important lessons of reform of indirect taxes, particularly those relevant to developing countries. It first outlines the objectives and motivations for reforming indirect taxes and sets out the major issues. It then summarizes the special features of developing countries and their implications on the structure of indirect taxes and highlights the major lessons of tax reform. Finally, the article discusses some selected issues on the reform of indirect taxes requiring greater attention.

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II. STRUCTURE OF TAXES AND TRENDS IN TAX REFORM IN DEVELOPING COUNTRIES

a. **Tax Reforms in Developing Countries.** The level and structure of taxes in developing countries has been a subject matter of a number of studies[1]. Although wide variations are seen in both the level and structure of taxes among developing countries, it is possible to infer some broad general characteristics. On the level of taxation, two important inferences are notable. First, a number of factors other than per capita income such as urbanization, monetization, relative importance of the primary sector and openness of the economy determine the tax levels (Chelliah, Baas and Kelly, 1975). Yet, broadly, tax-GDP ratios were found to vary with the level of per capita incomes. Second, there has been a "ratchet" - like shift in the tax ratios over time. In the mid-1960s tax ratios in developing countries were less than 10 per cent of GDP. However, by the late 1980s tax revenues constituted almost a fifth of GDP.

In regard to the structure of taxes in developing countries, the predominance of indirect taxes is notable. Revenue from these taxes constitutes almost 60 per cent of total tax revenue. While for the developing countries as a whole, the shares of domestic and international trade taxes are broadly the same, the latter is the most important source of revenue for the countries with per capita income below $ 350. It is also seen that the substitutability between domestic and international trade taxes is significant, and as the economy develops, the former is increasingly substituted for the latter. However, even in countries where domestic indirect taxes predominate, the coverage is very narrow as the commodity taxes extend mostly up to manufacturing or at best, wholesale levels and services do not get

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1. For a recent review of structures in developing countries, see, Tanzi (1987).

included at all. It is therefore not very uncommon to see relatively high nominal rates imposed to collect the required revenues.

b. **Objectives of Tax Reform.** The major motivation for undertaking tax reform exercises has been the large and growing fiscal deficits, particularly the current account budgetary deficits in developing countries. Given that correcting fiscal imbalances is at the heart of macroeconomic management of the economies, and given further the difficulties in cutting down expenditures to the extent needed to achieve the balance, tax reform exercises have had to be undertaken to raise additional revenues. Sometimes, particularly when a severe fiscal crisis is faced, *ad hoc* tax reforms without sufficient preparation are undertaken mainly to raise larger revenues in the immediate context, but such reforms may not improve the long-run productivity of the tax system. The objective of tax reform is to enhance the built-in flexibility of the tax system so that the need for periodic discretionary changes to raise larger revenues is minimized.

However, improving long run revenue productivity is not the only motivating factor for tax reform. The perception that the tax system was unfair, unduly complicated and distorting had also been an important reason for tax reforms. The narrow coverage of the tax violates horizontal equity. The plethora of exemptions and concessions give rise to serious loopholes and unduly complicate the tax laws. This has necessitated the "levelling of the play field" in order to simplify the tax systems and correct distortions in relative prices to make the tax system growth oriented and growth responsive (World Bank 1988). In particular, the shift in emphasis in recent years from planning for growth to increasing efficiency has necessitated a thorough reappraisal of the tax structures.

Another important objective of tax reform is equity. Traditionally, the tax system was designed to ensure vertical equity or to level down the incomes of the rich. The distortionary effects of high marginal tax rates and the high degree of evasion and avoidance in the tax structures arising from complicated structures, which most developing countries are ill-equipped to administer, has shifted the focus of equity to ensuring horizontal equity. The emphasis in recent years is to collect larger revenues through broadly uniform taxes and use them towards poverty alleviation through the spending policies. This levelling-up strategy has emphasized the need to have a simple, uniform (neutral) tax structures which correspond to the administering capacities of developing countries (World Bank, 1988, 1991).

c. **Approaches to Tax Reform: Optimal Theory and "Best Practice" Approaches.** While tax reforms have gained renewed emphasis, the direction of tax reform has continued to be broadly the same. Of course, substantial progress has been made in building analytical foundations for the design and reform of the optimal tax systems with the objective of minimizing welfare losses. However, these important analytical contributions on optimal tax theory and the attempts to apply the theory to the design and reform of tax systems in developing country situations have not made appreciable difference to the operational approach to tax reform. This is mainly because the data requirements to estimate demand and supply elasticities to compute the optimal tax rates have been found to be insurmountable[2]. The approach also ignores the administration and compliance costs. In short, it provides a few workable guidelines and, therefore, is yet to wield much influence in shaping actual tax policies (Gillis, 1989). On the practical plane, therefore, the "best practice" approach continues to be applied. According to this, the tax

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2. For a detailed analysis of optimal tax theory and its application to tax reforms in India and Pakistan see, Newbery and Stern (1987) and, E. Ahmad and N. Stern (1991).

system is made less distortionary by broadening the tax base, levying lower and a uniform tax rate, simplifying the structures and exempting the taxes on inputs. Similarly, the designing of protective duties warranted by efficient production considerations have not been found to be easy to apply in practice, and reforms have continued to be in the direction of levying lower and less differentiated nominal import duties.

III. Structure of Indirect Taxes in Developing Countries: Major Lessons of Reform

The analysis of the special characteristics of developing countries is helpful to enable a better understanding of the structure of their indirect taxes. In this section, an attempt is made to bring out the important special characteristics to analyze their role in shaping the structure of indirect taxes and to highlight the salient features of tax reform strategies adopted in them.

a. Special Characteristics of Developing Countries and their Implication for Tax Structures. The characteristics of the tax structure in developing countries and the changes in the structure during the process of development have evoked great interest among a number of researchers. A recent study by Newbery (1987) analyzes the special characteristics of developing countries and draws important inferences on their tax structures and tax policies. Although individual countries do differ from one another in economic characteristics considerably, common broad features of developing countries and their implications in tax policies are notable.

(i) The predominance of the primary sector in developing countries has resulted in a large portion of this traditional economy not amenable to taxation, mainly due to low productivity and unstable earnings. In 1981, for example, the contribution of the agriculture sector to GDP in developing countries was 37 per cent, but it had to accommodate almost 70 per cent of the population (Newbery, 1987). This overconcentration on land naturally results in low productivity. Besides, in most of these economies, there is no assured source of irrigation, and the fortunes of agricultural activity oscillate with the vagaries of the monsoon and, therefore, agricultural incomes are highly unstable. Further, with the landed elite in these countries wielding a great deal of political power, taxing of land or agricultural incomes faces severe political difficulties, and hence, often, taxes on this sector are virtually confined to marketed surpluses or input purchases.

(ii) The existence of dualism in the structure of developing economies affects the tax design in two important ways. First, it determines the extent to which the transactions of the traditional sector can be taxed and, second, the differences in the degree of market penetration determine the extent of market segmentation in the economy and the allocative effects of a given tax policy are different in the segmented economy.

The existence of a large traditional sector and the predominance of primary production limits the range of tax instruments in developing countries. The conceptual and practical difficulties render recovery of substantial revenues from personal income taxes infeasible in a predominantly traditional economy. At the same time, the attempt by the politically powerful groups to shift the tax burden to the unenfranchised makes it easier to levy indirect taxes. Thus, as observed earlier, the revenue structure of developing countries is dominated by indirect taxes. Initially, when domestic production is not very well organized, international trade taxes dominate, and gradually with increasing production activity, the share of domestic indirect taxes increases.

(iii) The high population growth and low literacy levels present administrative and political constraints on tax design and reform. Adult literacy rates in low-income countries are less than 50 per cent, and the proportion of poor people is very large (Newbery, 1987). The low literacy levels pose severe difficulties in administering an information-based (as opposed to check-post based) system of indirect taxes. Given the predominance of indirect taxes, a substantial differentiation in nominal tax rates is introduced to make the tax system appear progressive. At the same time, the literate, articulate population, though non-representative, is an important coalition, and its attempt to reduce the tax burden results in lower effective progressivity.

(iv) In general, in developing countries the internal indirect taxes are designed not just to raise revenues, but to subserve a number of other objectives such as bringing about egalitarian income distribution, resource reallocation and regulating consumption of specific commodities. In particular, the income distributional objective has received very high weight in the design of indirect taxes in many countries, and even here, the emphasis has been to adopt a strategy of levelling down or to ameliorate relative impoverishment through highly differentiated nominal tax rates - *albeit*, on the basis of policymakers' judgements regarding income elasticity of demand for various commodities. This has greatly contributed to the complexity in the indirect tax system, and the weak administrative apparatus in these countries renders effective enforcement of such taxes extremely difficult. In fact, taxes in most developing countries, many a time, are hardly designed to conform to conditions prevailing in them (Gillis, 1989).

(v) Most developing countries have adopted the strategy of centralized planning in a mixed economy framework to accelerate economic growth. The emphasis has been to enhance public sector investments year after year, but this could be achieved only by transferring successively larger volumes of savings from the household sector. At the same time, increasing public sector outlay is not accompanied by emphasis on efficiency in resource use. In the event, the capital-output ratios have shown an increasing trend and the burden of debt-servicing and inflationary pressures have created severe fiscal imbalances in the current account.

The pressure to finance the ever-increasing consumption and investment requirements of the public sector and the difficulties in mobilizing resources in a traditional economy have led to the adoption of measures to raise revenues at convenient tax points, without much regard to their adverse effects on resource allocation in the economy. Given that taxes had to be confined to a narrow base for administrative reasons, the required revenues could be raised only by levying commodity taxes at very high rates. The using of tax instrument to fulfill the objective of equity has naturally led to the emergence of archaic commodity tax structures with multiple tax rates, generous tax preferences and levy of taxes on inputs, outputs and capital goods alike.

(vi) In many of the developing countries, the urge for self-sufficiency, attempts to insulate from external shocks and the acute scarcity of foreign exchange have led to the adoption of an import-substituting strategy. The inward-looking policies such as quotas, restrictions, licenses and high tariff barriers have resulted in high and substantially differentiated (mostly unintended) rates of effective protection and very high domestic resource costs. Generally, such policies have an in-built bias against exports. In addition, the real interest rates kept at artificially low levels and relatively high wage rates have not only led to capital intensity in production, but also have encouraged capital flight. The consequence of these has been to introduce a high degree of distortion in the production structures.

(vii) The predominance of cottage and small enterprises in manufacturing activities in these economies has accentuated administrative difficulties in extending the coverage of commodity taxes to them. Further, as these enterprises are presumed to be labour intensive, encouragement to them is sought to be provided by extending tax concessions, thereby not only introducing additional complications in the tax systems but also providing easy avenues for avoidance and evasion.

(viii) The multilevel decision making in larger developing countries poses additional problems. In a federation, when commodity taxes are assigned to both the federal (central) and State governments, proper designing of the indirect tax structure becomes extremely difficult. Both the layers try to levy taxes on the same base at various stages, and given the dire need for revenues, both levy taxes on inputs as well as outputs, resulting in the loss of transparency and a high degree of cascading. Besides, even when the individual units of government act in the best interests of their respective citizens, the overall decisions of the governments may not be in the best interests of all the citizens (Gordon, 1983). This is because the sub-central levels of government ignore the effects of their decisions on the utility levels of non-residents. Such externalities can lead to severe distortions and inequities in the economy.

The issues pertaining to policies on indirect taxes in a multilevel decision-making set-up are best illustrated by taking examples from the Indian federation. In India taxes on commodities are levied at all the three levels of government. The Centre levies Union excise duties at the manufacturing point, the States levy sales taxes mostly at manufacturing or wholesale stages and the urban local bodies in most of the States impose "octroi" - a tax on the entry of goods into a local area for consumption, use, or sale. At all the three levels, taxes are levied both on inputs and capital goods, each levying its tax at several rates.[3] To know the total tax burden on any commodity, a detailed exercise to estimate effective tax rates using an input-output model has to be undertaken.[4] At the State level alone, the sales tax is levied

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3. Some rationalisation in Union excise duty was done in 1986 when Modified Value Added Tax (MODVAT) was introduced in respect of some commodities. However, the growth rate of Union excise duty actually decelerated after the introduction of MODVAT. Between 1980 and 1985, the growth of union excise duty was 14.8 per cent, and after the introduction of MODVAT during the next 5 years, it decelerated to 14 per cent. This is mainly due to the shift from ad valorem to specific duties.

4. Ahmad and Stern (1987, 1991) have actually done such an exercise for both India and Pakistan.

predominantly at the first point of sale, but on some commodities, tax is levied also at wholesale or semi-wholesale stages, and in some States, multipoint levy is also prevalent. The number of sales tax rates varies from six in Orissa to as many as 17 in Bihar and Gujarat. Besides these, there are surcharges on sales tax or additional turnover taxes in many States.

Distortions arise not merely due to the vertical overlapping of commodity taxes levied at multiple rates; the strategies played by individual States to collect more revenue or to attract capital have caused severe horizontal overlapping. To maximize revenues, the States attempt to divert trade by competing with one another in reducing tax rates. This has resulted in a bizarre situation wherein foodgrains are subject to tax while consumer durables like colour television sets are exempt or are subject to lower tax rates. In order to attract manufacturing activity, the States compete with one another in giving generous sales tax incentives. In fact, some States give open-ended (without any ceiling) and comprehensive (applicable to all industries) schemes of sales tax incentives involving very high tax-expenditures, the efficacy of which is doubtful (Tulasidhar and Rao, 1986). Even more distortionary is the strategy adopted to export the sales tax burden to the residents of other States. As the sales taxes are levied by the exporting State, producing States can easily transfer the burden of the tax to the consuming States. This is further aided by the fact that in India there is actually a tax on inter-State sale of commodities and revenue from it accrues to the exporting State. As input taxes are not given a set off, exportation of the tax burden from the more advanced to the less advanced States is actually accentuated. Thus, besides the distortions caused on account of hindrance to free movement of goods, the taxation of inter-State sale has contributed to the accentuation of inter-regional inequity.

b. **Distortions in the Indirect Tax Structure and Practical Approaches to Tax Reform**. As the bulk of tax revenues is collected from indirect taxes, the thrust of reform in developing countries has been towards overhauling the structure of indirect taxes. The structure of taxes as described above is broadly characterized by high rates and narrow coverage. Severe distortions are caused by a plethora of rates, taxation of inputs, tax concessions and preferences, levy on the basis of origin rather than destination, externalities on account of inter-State tax competition and tax exportation and a high and differentiated degree of protection. These archaic and inefficient structure of indirect tax is one of the major reasons for the manifestation of a very high degree of inefficiency in manufacturing resulting in high cost and low quality products. At the same time, three very important factors have posed serious constraints on reform in developing countries. These are (i) powerful unrepresentative coalitions; (ii) weak administration; and (iii) virtual absence of an information system necessary for proper administration and enforcement of taxes. In fact, given the complexity of the tax systems, proper understanding of the prevailing tax structure itself requires detailed studies to understand even the initial conditions.[5]

c. **Tax Reform Experiences: Important Issues**. The analysis of the experiences of tax reform undertaken in countries with varied economic structures and differing stages of development can be of great help in identifying the necessary and sufficient conditions for successful tax reforms. Some recent studies providing useful guidance to successful reform of indirect taxes in developing countries are, Newbery and Stern (1987), Gillis (1989), Ahmad and Stern (1991) and World Bank (1991).

The best practice approach to successful tax reform is a pragmatic combination of theory and the past reform experiences and takes into account the administrative, political and

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5. Such as studies by Ahmad and Stern on India and Pakistan, See, Ahmad and Stern (1987, 1991).

information constraints. Generally, the reform exercises attempt to make the tax systems more comprehensive, simpler, more transparent, less distorting and practicable. Broadening the tax base, reducing the tax rates and lowering the rate differentiation of internal indirect taxes are common features of tax reforms undertaken in recent years. A broader base yields larger revenues and the lower tax rate needed to raise the required revenue reduces unintended distortions, ensures greater degree of horizontal equity and makes the tax administration simpler. The lower tax rate reduces distortions and also lowers returns from evasion and avoidance. The reform towards having greater uniformity in taxation on commodities or neutrality is presumed to be less distorting besides being easier to administer. In fact, the emphasis on neutrality was most marked in most of the recent reforms undertaken in Indonesia, Jamaica and Bolivia (Gillis, 1989).

One of the major features associated with successful reform measures on indirect taxes has been the introduction of valued-added tax (VAT).[6] Given the predominance of indirect taxes in developing countries, the introduction of VAT helps to broaden the base by extending taxation to stages beyond manufacturing and including some of the services.[7] The introduction of value-added taxes also helps in reducing the reliance on foreign trade taxes. In fact, in over 40 developing countries that have adopted the VAT in tax reform programmes in the last two decades, adoption of one of the variants of VAT has been an important component of reform, and this has considerably improved the revenue productivity of the tax systems (Gillis, 1989). At the same time, reforms not

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6. The success of the reform here is judged in terms of fulfilling its basic objective, viz., improving revenue productivity.

7. For an analysis of extending VAT to financial services, see Gillis (1987).

involving VAT have not been very successful.[8] In principle, retail sales tax may be preferable in some respects, but that option in many developing countries is simply not available as the retail establishments are "small, informal and unstable", making it difficult to accurately determine the sales and enforce the tax (Musgrave, 1987: p. 259). Thus, the introduction of value added taxation has been the single most important feature which has raised the revenue productivity of tax systems in developing countries.

A notable feature of reform of indirect taxes in developing countries is the emphasis on moving towards a neutral or more uniform tax structures. This is in contrast to the justification given to a differentiated tax structure on the grounds of equity in the past. In an ideal system, for equity purposes, basic (unprocessed) food items are exempted, and this alone is expected to lift the tax burden off the poorest households substantially. The rest of the commodities generally are subject to a uniform tax rate, but sometimes, items of luxury consumption are taxed at higher rates or a separate excise is levied on such commodities. In fact, there has been a tremendous shift in the understanding of the concept of equity itself from levelling down or reducing the incomes of the rich to levelling up or enhancing incomes of the poor. The latter is achieved better through the expenditure side of the budget (World Bank, 1991, Gillis, 1989).

Another important feature of tax reform exercises has been the emphasis on designing import duty purely as a protective instrument and not a revenue measure. In general, it is presumed that simplifying the import tariff structure by reducing the variance in nominal rates would improve efficiency and simplify

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8. The notable exceptions are Hong Kong and Singapore, where a retail sales tax is preferred (Asher, 1988).

the administration of tariffs. Attempts have been directed to lower the tariffs and export taxes and inculcate outward orientation to the development strategy (World Bank, 1991).

The primary motivation for tax reform in many countries has been to raise revenues to achieve fiscal balances. However, tax reform is not necessarily the appropriate solution to deal with the problems of fiscal imbalances for various reasons.

First, the experience has shown that reforms have not usually succeeded when enacted in response to a crisis, mainly because they have to be well thought out, properly planned and administered.

Second, increase in tax revenues is not necessarily the ideal solution to the problem of fiscal imbalances. It is important to consider the alternatives of lowering expenditures, increasing user charges and generating higher returns from public enterprises. Often, given the political difficulties in undertaking the alternative, tax reform is preferred as a softer option, but this does not remedy the basic causes of imbalances and therefore can not be successful. For example, when imbalance is mainly due to profligacy in spending, unless this is tackled through expenditure reform, the tax revenue cannot be enhanced continuously to meet the growing expenditures.

Third, tax reform is not costless; changing the structure of taxes does involve additional administrative, compliance and efficiency costs and unless the benefits from the change are higher than these costs, the reform is unviable. Another important matter that can greatly contribute to the success of tax reform is its sequencing. In fact, in most successful experiences such as in Japan (1949-1950), Republic of Korea (1962-1965) and Indonesia (1983-1984), in the sequence of policy changes, tax reform was initiated quite late. In the Republic of Korea, for example, the successful financial trade policy reforms during 1963-1965, ensured stability and accelerated growth and the confidence thus built up smoothened the way for tax reforms in 1966. Indonesian tax reform in 1983-1984 too was last in a sequence of structural reforms.

Finally, tax reform is not merely confined to designing the tax structures. Its administration and acceptability to the taxpayers are equally important. Strengthening the administration is critical to the successful implementation of tax reform. Tax administration should be placed at the Centre rather than at the periphery of reform efforts. Bird (1987) goes as far as stating that "tax administration is tax policy ". In fact, many reforms have failed because of inadequate attention given to implementation aspects, lack of continuity in decision making and overreliance on "quick fixes" on tax administration. At the same time, emphasis on administrative aspects has played a significant role in ensuring success in the reforms undertaken in countries such as Indonesia and Malaysia (Gillis, 1989).

IV. Selected Issues in Tax Design and Tax Reform

While the growth of analytical literature on the theory of tax reform and the practical experiences in several countries over the years have helped to identify the directions and preconditions for successful tax reforms, a number of issues, at both conceptual and practical levels, have remained unclear. Much more work needs to be done to gain a better understanding of these areas. In this section, some selected issues requiring greater emphasis are discussed.

a. **Optimal Tax Theory and Optimal Tariffs**. With greater emphasis given to increased efficiency in the allocation of resources and increasing awareness of the harm that an inefficient tax system does to an economy, the importance of designing the tax structures to minimize welfare losses has increased considerably. In fact, the development of theories of tax design and reform has helped to focus attention on the efficiency issues.

The analysis of tax reform proceeds by calculating the social marginal cost of raising revenues through alternative methods and identifies the least-cost method or the measures yielding the largest social gain. From this point of view, lum-psum taxes are ideal as they do not interfere with the decision of economic agents and also they are simpler to administer. However, they may not be acceptable socially and politically and therefore a "second best" alternative has to be sought. Revenue from commodity taxes with minimum efficiency loss can be raised when the tax rates are so chosen as to reduce the compensated demand by an identical proportion. This implies that, other things being equal, goods with lower price elasticity would have to be taxed at higher rates and vice versa. Thus, the optimal structure of indirect taxation will not imply uniform taxation[9].

The rate of differentiation thus designed, however, may not correspond to the optimal tariffs. Trade theory puts forth a set of nominal tariffs intended to minimize distortions in production, and optimal tax theory develops rules for minimizing distortions in consumption suggesting a different set of tax rates. The divergence between production and consumption efficiencies can be resolved if indirect taxation is designed only to raise revenues and desired protection to domestic industry is accorded only through production subsidies. Such a system, however, is extremely difficult to operate. Much more work to harmonize the conflicting requirements of production and consumption efficiencies is clearly called for.[10]

b. Optimal Tax Approach versus the "Best Practice" Approach.. As mentioned earlier, the structure of taxes required to achieve equi-proportionate reduction in the compensated demand

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9. In addition, for equity consideration, rate differentiation has to be made on the basis of income elasticities of demand for commodities.

10. See W.M. Corden (1974, 1980). For a simpler presentation, see Nizar Jetha (1981).

for commodities is necessarily non-uniform. However, the literature has not yet produced operational rules and parameters that can be readily understood and applied by policymakers. The information required to estimate direct and cross-price elasticities are simply not available even in developed countries. The approach also assumes frictionless tax administration and compliance. The preference for uniform taxation, therefore, is simply a matter of practicability arising from the operational difficulties of designing a complex set of differential tax rates which would minimize deadweight losses and spread the tax burden to conform to the weights prescribed in the social welfare function. Of course, rate differentiation is only a necessary, but not a sufficient, condition for optimal taxes. The prevailing differentiation in indirect taxes, for instance, has been determined, at best, arbitrarily, and at worst, "by the politics of tax evasion rather than pursuit of efficiency objective" (Musgrave, 1987).

The crucial issue, however, is how is uniform taxation any superior to the existing arbitrarily differentiated taxes. Clearly, neutral taxes do not distort producers' choices and are, therefore, desirable from the efficiency point of view, but are not optimal. Then, from the point of view of reducing deadweight losses, how can we conclude that uniform taxes are superior to even the taxes differentiated on grounds quite unrelated to optimal tax considerations? Then, does the case for neutral taxes lie merely on administrative convenience? Is it a mere presumption that uniform taxes are superior to the existing differentiated tax systems?

In any case, tax reforms undertaken in the near future would have to continue the best practice approach of broadening the base, lowering the rate, levying the tax at a uniform rate, and avoiding taxes on inputs. But it is necessary to emphasize the need to undertake research towards evolving more satisfactory tax systems from the point of view of efficiency and equity.

c. **Tax Design and Reform in a Federal Set-Up**. Irrespective of which approach is preferred, it is important to note that designing a tax system in a federal set-up presents a challenging task. Even when the Central (federal) government and each of the sub-central units act in the best interests of their respective residents, it may not maximize a country's social welfare. This is because the externalities created by the strategies adopted by each of the sub-central units to transfer the tax burden to non-residents or competing with one another to maximize revenue or to attract capital to their jurisdictions may not only result in severe allocative distortions but also cause severe inequities. While in the aggregate this has to be weighed against the welfare improvements resulting from the decentralized provision of public services conforming to the preference patterns of the residents in different jurisdictions, surely, the indirect tax structure thus evolved would violate the norms of both efficiency and equity.

Inter-State tax competition and tax exportation are the two major issues faced in all federations. But in developing countries, the problem is accentuated if the levy is on the basis of origin rather than destination, inputs and capital goods are taxed and sales tax incentives are provided to attract capital, either by way of tax holiday or tax deferment. In addition, if the Constitution permits the levy of tax on inter-State sale as in India, the system ends up with having several tariff zones within the country, besides causing inter-regional resource transfers in inequitable ways.

One of the major reasons for tax rate differentiation is equity. If the objective of equity is pursued at both Central and State levels, whose perception of equity would prevail? In the literature on fiscal federalism, the redistributive role is assigned mainly to the Central government because potential mobility of labour and capital makes the pursuit of the objective by the States ineffective (Brown and Oates, 1987). Yet, in actual practice many of the States design the sales tax systems to fulfill, among other things, the objective of equity. This, as already mentioned, has substantially contributed to complications in the tax system.

Designing an efficient indirect tax structure in a federal set-up is rendered difficult when different levels of government separately levy the tax broadly on the same base. Levy of Union excise duty on all manufactured commodities at the Central level and sales taxes at the State level in India and Brazil is a case in point. There is virtually no control over the effective rate of tax on commodities and as inputs too are taxed, the determination of effective tax rates itself becomes a difficult exercise and designing a tax system on intended lines becomes virtually impossible.

As mentioned earlier, in all reform exercises the introduction of VAT has helped to improve revenue productivity considerably. When the power to levy sales tax is vested with the States and when sales taxes actually levied are neither general nor are at retail stages, introduction of VAT at the State level, unless it is levied on the destination principle or border tax adjustment is provided for, can create severe inter-regional inequities. The developed federations have resolved this problem in many different ways but do not provide useful lessons to follow. In the United States, for example, the federal excise is merely a sumptuary levy and retail sales tax is assigned to the States. Indeed, Musgrave (1990) prefers the levy of retail sales taxes instead of a VAT in federal countries. In Canada both federal and provincial governments levy commodity taxes. The federal government levies the goods and services tax which is a comprehensive valued added tax. The provinces are empowered to levy the retail sales tax. The experience of VAT and tax harmonization among different member countries in the European Community can, however, be of great value to developing federations. But complete tax harmonization may violate the federal principle, and even with this, border tax adjustments may be required (Musgrave, 1990).

Thus, in a large federal country, indirect tax reforms call for a good deal of coordination among different levels of government. Unless serious attempts towards harmonization of policies are made, indirect tax reform can turn out to be a futile exercise. Unfortunately, this is an area where very little research has been done.

d. **Taxation of Services**. One of the major problems in many developing countries is inclusion of services in the tax base. Taxation of services is extremely important because: (i) in many of the countries it is the fastest growing sector, and revenue productivity of the tax system cannot be improved unless it is included; (ii) non-inclusion distorts the relative prices in favour of the sector; and (iii) output of the sector is consumed more by relatively richer sections of society and exclusion results in inequity. In many developing countries, even direct taxes cannot satisfactorily be levied on the sector, as these are "hard-to-tax" groups.

The introduction of VAT has helped to incorporate services into the tax net considerably. Although in some countries, particularly in the European Community, taxation of services has been integrated with those on goods, by and large, the approach is to include the services selectively (Cnossen,1990). Even in the countries with integrated systems, exemptions are given to certain types of services either because they do not represent value added (in respect of some financial services), or it is difficult to tax them or it is desirable to exempt them in the public interest. Enforcing taxes on services is particularly difficult in developing countries even when VAT is levied, and therefore, much more work is needed in both designing and evolving an appropriate administrative and enforcement machinery.

e. **Distributional Coalition and Success of Tax Reform**. One of the crucial issues not very well understood and therefore, not taken account of by economists is the political constraint on tax reform. A major precondition for a successful tax reform is the coordinated approach by economists, administrators and politicians who have to design, implement and explain the reform to the people respectively. However, the existing tax structure itself is the outcome of the policies resulting from the pursuit of special interests by distributional coalitions, and there is no reason why politicians should be interested in tax reform. In fact, in a developing country, tax reform usually means tax increase which enhances opposition and may even dim the prospects of successful tax reform (Goode, 1990). However, when fiscal imbalances spill over into a severe balance-of-payments crisis, adjustment becomes unavoidable and then, tax reform may even be preferred to other more painful adjustment processes. Often, the proper solution to fiscal imbalance is to reduce expenditures, but given the sociology of fiscal politics, expenditure reduction may be extremely difficult, and the tax reform exercise may be carried out as a substitute, sometimes under pressure from international lending agencies. Even then, political and administrative compulsions may necessitate piece meal, incremental, rather than a principled, comprehensive tax reform. Unless a way is found to deal effectively with distributional coalitions, tax reform exercises may not meet the desired success. To ensure success, the economic reforms, particularly fiscal reforms, must "endogenize" this political constraint, and to do so, the operations of distributional coalitions must be understood much better.

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