

FISCAL POLICY AND ECONOMIC DEVELOPMENT

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I. INTRODUCTION

THE CLASSICAL economists developed esoteric arguments to justify the role of government and define the areas of public wants [29, Chaps. 4 & 5]. Their arguments were designed to restrain government interference in the private sector because government was viewed with apprehension and fear, was suspected of corruption and inclined through mismanagement to waste valuable resources. The position of classical economists as epitomized by "the less government, the better" has been arrived after careful observation of economic and social conditions, and has been dictated by their desire to enhance social welfare. Their philosophic stand was consistent with the premises they employed in elaborating their policy prescriptions. The gradual rejection of their premises has forced a restatement of the theory of government functions.

Present realities as well as the progress made in economic theory have reduced substantially the acceptability of the classical economists' premises and have consequently changed government responsibilities and legitimized an enlarged public sector. A partial explanation of the expansion of public sector is provided by Wagner's law, although the complete rationale should be sought in the framework of Keynesian economics and in the true conditions of each country [3, pp. 954-70].

The Keynesian system has furnished a conceptual structure for state intervention, and according to J. K. Galbraith, "for a doctrine that excluded government it substituted one that made government indispensable...[and] opened the way for a larger expansion of government services and activities" [11, pp. 80-81]. The sharp and versatile tools of economic analysis are used under various conditions to achieve several objectives, but within the context of macroeconomics it is essentially the variety of real conditions that determines the specific nature of tools used in economic policy. Advanced countries are known to employ generally similar tools in pursuing policy objectives because their institutional and economic characteristics exhibit predominant uniformities. Developing countries are characterized by striking environmental differences rather than similarities, and the strict application of economic analysis pertinent to the problems of advanced countries to underdeveloped economies is basically inappropriate. The vast differences in the social, cultural, political, and economic institutions of developing countries prevent the use of generalizations with respect to the role of fiscal policies [21, pp. 284-85]. Operational fiscal policy must recognize this diversity of conditions, otherwise as W. W. Heller emphasizes:

Failure to comprehend the nature and significance of these differences could result—in fact, in the past sometimes has resulted—in mistaken and costly transplanting of inapplicable experience to the economies of the underdeveloped countries. [18, p. 2]

Because of this multiformity of institutional and economic realities, no single economic model can explain the behavior of all such economies. Instead of a general model, economic analysis highlights the basic principles which fiscal policy can follow in developing countries. These principles are the subject of this paper.

The next section examines within the confines of traditional public finance the legitimacy of development activities and their relationship to public wants. Section III looks into the alternative methods of financing government development expenditures and shows that underdeveloped countries are compelled to rely heavily on taxation for carrying out their development plans. Section IV discusses in general terms the purpose of taxation in developing countries, while section V investigates the factors which determine revenue-raising capacity. The predominance of indirect taxes in the tax systems of developing countries is briefly discussed in section VI. Finally, the advantages and disadvantages of direct and indirect taxes are outlined in section VII with a view to establishing their appropriateness to development needs.

II. PUBLIC WANTS AND DEVELOPMENT EXPENDITURES

Public expenditures are at the center of interest in the theory of public finance where they are examined in conjunction with the satisfaction of public wants. The history of economic thought traces a tendency to define public wants in increasingly broader terms and consequently to assign larger responsibilities to government. A discernible change is observed from the narrow confines of "laissez-faire" and the prescriptions of Adam Smith who regarded defense, the administration of justice, and the maintenance of certain public wants as the main functions of legitimate government involvement to the expanded role assumed nowadays by the public sector. In developing countries, the public sector, in the absence of an enterprising private sector, is called upon to shoulder heavier responsibilities than in industrialized countries and is expected to become the initiator of economic development in addition to its various other duties.

The discussion of public wants frequently gives the impression that in industrialized countries these wants are satisfied through current nondevelopmental public expenditures. This impression is particularly strengthened by the stand of a few laissez-faire advocates who exclude economic growth from the list of government policy objectives. This view tends to cast some uncertainty as to whether development expenditures undertaken by governments in underdeveloped countries constitute legitimate public sector activities. As argued, later on, the principles on which the analysis of public wants is based are broad enough to justify the development role of government.

Public goods are collective goods which the market either (1) fails entirely

to produce or (2) if left unhampered will produce in quantities or qualities which the whole society or some segment of the public consider unsatisfactory. The wants satisfied by the former class of public goods are defined by R. A. Musgrave as social wants while the wants satisfied by the latter are defined as merit wants [29, Chap. 3]. The private market fails to satisfy social wants because consumers although valuing the goods or services provided, nevertheless are unwilling to reveal their true valuations or preferences as they are able to reap the benefits from externalities that are associated with the supply of this category of public goods. The production of collective consumption goods of this nature depends upon state coercion and is undertaken by government. Goods used in defense or the administration of justice are individually unmarketable, their benefits are external and must be produced by government if they are to be produced at all. In the case of merit wants, the market solution is considered inadequate and because of the high degree of externalities, the public interest is viewed as being served better by providing public goods concurrently with private ones instead of relying exclusively on the private market.

Public goods because of their intrinsic attributes act as market corrective devices, being produced by the public sector in order to offset or counterbalance various market imperfections. Imperfections due to monopoly, to inadequate information, to high transaction costs, to socially unacceptable slow responses of market forces to society's needs, are all accepted as normal areas of government intervention. It is often claimed that even in the absence of market imperfections, namely even if perfect competition prevailed, government would still interfere in order to correct the socially undesirable income distribution that would result from the free interplay of market forces. In a world imbued with innumerable imperfections in which perfect competitive forces are the very exception rather than the rule in economic behavior, this argument loses much of its substance and assumes a metaphysical texture. Even in those instances where government interferes with some competitive sectors that provide goods and services whose quality and nature is of public concern, government intervention can be justified as an attempt to protect ignorant citizens from the consequences of their consumption.¹

Public goods are characterized by their ability to shape the environment of the entire country or a part of it. Similarly, from the point of view of their impact on people, public goods possess the property of affecting either all citizens of a country or a certain group of people. Concern over environmental conditions is a legitimate area of government responsibility, and government intervention is justified on the grounds that it creates an atmosphere of social cohesion and a milieu in which the quality of life and the development of human talents are vigorously pursued.

¹ Regulations regarding narcotics and other dangerous drugs could be considered as a conscious policy by a patronizing government to protect those consumers whose judgment is viewed as defective and therefore do not satisfy a basic requirement of perfect competition.

How compatible is this briefly outlined philosophy of government intervention with development expenditures? What is the relation between development expenditures and public wants?

Government activities in the field of economic development generally satisfy merit wants rather than social wants. Except for government investment in certain infrastructural projects, like road building and construction of port facilities, that could be regarded as satisfying social wants in view of the lack of interest of private entrepreneurs in such projects, most development initiatives are designed to modify the unacceptable results of existing market forces. Some theories of economic development suggest that the basic strategy for eliminating economic backwardness requires, among other things, a change or constant direction of market forces. Government action taken in this respect can hardly, however, be looked upon as satisfying social wants. Similarly, the communist model of economic development that relies almost exclusively on government direction and downgrades the significance of market forces, the theory of the big-push associated with the name of Paul N. Rosenstein-Rodan, the theory of balanced growth mainly connected with Ragnar Nurkse, the explanation of underdevelopment through the vicious circle of poverty, all stress the weakness and difficulty of private initiative to generate development. Gunnar Myrdal also recognizes the inefficiency of private forces in fostering economic development and advocates government intervention to reinforce through various means the "spread effects" which the dynamic cumulative processes of circular causation produce, one of which is the manipulation of prices [30, pp. 37-43]. The essence of all the above is that market forces are imperfect, calling for state intervention, not that the market mechanism is useless and should be eliminated. Consequently, such government assistance to economic development satisfies a merit want rather than a social want. Only where it can be established that the private market fails to function at all and government initiative is needed to fill the vacuum does government satisfy a social want. This condition is often met when government in the absence of private interest undertakes projects that normally fall within the domain of the private sector, but the moment private investors are willing to take over such projects from government, it could be said that social wants evolve into merit wants.² This gradual evolution of some social wants into merit wants coupled with the fact that only rarely do the development activities of the public sector satisfy the criterion of social wants combine to assure merit wants of a dominant position among public wants.

Market imperfections, which give rise to merit wants, are not uncommon among developing countries. Agriculture in most developing countries constitutes the largest productive sector and is reputed to be organized in rather pure competitive lines. Nevertheless rigidities in traditional agriculture are legendary and without active government intervention progress in this sector is rather difficult, if not impossible. Likewise, the industrial sector usually grows behind tariff walls and is beset by entrepreneurial bottlenecks, hardly responds to market

² Because of this element of evolution these social wants could be called temporary or pseudo-social wants.

signals, suffers from inefficiency, and tends to be organized along monopolistic or oligopolistic lines. Government supervision, guidance, and assistance designed to encourage industrialization by eliminating obstacles to growth and strengthening the growth-generating forces of the market are obvious contributions to the satisfaction of merit wants.

A high degree of externalities is an inherent characteristic of merit wants. The value of government expenditures on such traditional merit wants as education and health is well recognized among students of economic development. The satisfaction of public wants in general and of merit wants in particular condition the quality of environment of society. In the context of economic development, government expenditures aim exactly at changing the climate of economic stagnation, removing the obstacles to investment, and generally establishing the conditions of economic advance. Investment in infrastructure is an invitation to the private sector to take advantage of new profitable opportunities while tax incentives offered to pioneer industries is another proof of government interest in developmental environment.

Samuelson has shown that the satisfaction of social wants enhances the welfare of society and that people are better off with public expenditures than without them [34, pp. 387–89] [35, pp. 350–56]. His analysis is applicable to government development expenditures and his conclusion is strengthened by the nature of these expenditures which tend to move the production possibility curve outward and to benefit practically all people.

The answer to the two questions raised earlier now becomes evident. Development expenditures have been found in harmony with the classical philosophy of government intervention and the principles of public finance can therefore be used to support the development role of the public sector. It is further suggested that development expenditures satisfy public wants and that most of these expenditures satisfy merit rather than social wants.

III. METHODS OF FINANCING DEVELOPMENT EXPENDITURES

Governments discharge their development responsibilities by generally following three alternative policies or some combination thereof. First, they can finance development expenditures by borrowing from the public; however, the very small amounts of private savings compared to the required large amounts of development investment restricts severely the effectiveness of this approach. Borrowing from overseas or invitations to private foreign capital accompanied by various incentives should not by themselves be expected to change appreciably the picture in developing economies. Though foreign aid to developing countries has been growing in absolute figures, it is questionable whether it has kept pace with the fast growing needs of these countries.³ Dependence on foreign capital involves political dangers, but more importantly as Roy Harrod states: "...exclusive

³ The recent increases in oil prices has been estimated by the World Bank to cost developing countries approximately \$10 billion annually. This cost exceeds by far the amount of aid flown to these countries.

reliance on foreign capital for additional investment would lead to hopeless bankruptcy in the long run, owing to the mounting burden of foreign service charges" [16, p. 7]. The practice of using tax incentives to attract foreign capital ignores the fact that investment decisions are influenced by many factors, which are demonstrably absent in developing countries, and that taxation has not yet been empirically established as a significant determinant of investment behavior.⁴

Second, governments can finance their expenditure by printing new money. Such an approach calls for an examination of the role of monetary policy in the context of economic development in general, and the stimulation of capital formation through inflation in particular. Both topics are beyond the scope of this paper. Suffice, however, to state that there seems to exist a consensus among economists that, except for its contribution to stability, monetary policy is powerless in attaining development objectives.⁵ The use of inflation as a means of accelerating capital formation is counterproductive, as a rule, and contributes only marginally to economic development under the most auspicious circumstances [2, pp. 130-48] [12, p. 157] [38, pp. 29-30].

Third, government relies principally on taxation to finance its development needs, especially in view of the obvious limitations of the above two approaches. Dependence on taxation is basically an "up by the bootstraps" operation and finds wide support among economists [5, p. 168] [22, p. 410] [39, p. 2].

IV. PURPOSE OF TAXATION IN UNDERDEVELOPED COUNTRIES

The composition of taxes in each country is determined by such factors as economic and political conditions, literacy and civic standards, history, the use made of revenue collected, and the aims of taxation per se. The large variation of these factors among countries is responsible for the different tax structures observed in the world.

Taxation is viewed by E. R. Rolph as serving two objectives, an economic one consisting of fighting inflation, and an ethical one being used as a tool for redistributing income and wealth according to the social norms of each country [33, p. 54]. According to R. A. Musgrave, fiscal instruments serve three objectives, namely, they (1) secure adjustments in the allocation of resources, (2) redistribute income and wealth, and (3) serve economic stability [29, pp. 3-27]. Musgrave's analysis more or less coincides with the requirements of developing countries except for the fact that he, as well as Rolph, considers growth as depending almost exclusively upon the private sector. His approach reflects realistically the growth-generating potential of the private sector in advanced countries, but is of limited value to developing countries in which the private sector is usually unresponsive to development opportunities and the public sector frequently becomes the major contributor to growth.

⁴ The book by J. Heller and K. M. Kauffman provides a thorough analysis of the subject [17, pp. 3, 5, 57-60].

⁵ U. K. Hicks states that "...in backward countries a much greater burden of achieving the optimum rate of growth falls on fiscal policy....because in such countries monetary controls are largely unusable or ineffective" [19, p. 303].

The importance of redistribution of income and wealth is well recognized but developing countries pursue it with moderation by compromising equity and capital formation. With political power in the hands of the rich, such a compromise is inevitable though it is also justified on purely economic grounds. Policies that pursue equality to the extreme discourage private saving and put an extra burden on government to increase saving and finance economic development that may not be feasible [7, p. 254] [14, pp. 23, 25, 29]. Considering the needed compromise between equity and capital formation, the main purpose of taxation in developing countries is therefore stability and growth with taxes and subsidies being used to promote investment to avoid waste and generally to allocate resources in desirable directions. The primary objective of developing countries is the expansion of their productive capacity, and as W. Arthur Lewis states:

...the best way of insuring the success of a production programme is to tax the activities which one wishes to discourage, and to subsidize (in one way or another) the activities one wishes to encourage. [25, p. 390]

A complete analysis of the efficacy of taxation in promoting development requires knowledge of the impact, incidence, and economic effects of taxes. These subjects continue to elude accurate measurement and their treatment presents enormous difficulties especially in the environmentally heterogeneous developing countries in which statistical data are as a rule unreliable. The particular features of developing countries suggest a more or less unique fiscal system for each country. These fiscal systems without neglecting their influence on the private sector should aim at increasing tax revenues as a share of gross national product, thus allowing the public sector to perform its development role through a rise in productive investment.

V. REVENUE-RAISING IN UNDERDEVELOPED COUNTRIES

The required outlays for economic development are so large that governments can most often usefully invest any amounts they can reach [31, p. 386]. As A. R. Prest remarks:

The very minimum that a government is expected to do nowadays in any country is to remove or cut the obstacles to economic growth met by the private sector, and much more frequently, it is deemed to have the task of striving for growth in a positive manner both by example and by precept. [32, p. 18]

What limits the size of development expenditures is the inability of the tax system to provide government with enough revenue. Most underdeveloped countries could, according to expert opinions, increase the proportion of national income taken by taxation [23, p. 226], not only without causing undue disturbances in the economy, but with beneficial results in the face of inflationary pressures prevailing usually in them [6, p. 395]. Success in the pursuit of raising the share of government in national income depends frequently upon changes in tax structures but most importantly upon taxable capacity.

The taxable capacity of an economy organized on the principle of private enterprise is defined "as the capacity to raise revenue without extreme interference with productive activity and the operation of the economy" [24, p. 5]. Sir Josiah Stamp examined in depth in the early 1920s the concept of taxable capacity and distinguished between absolute maximum and absolute optimum taxable capacity [37, pp. 113–15]. The absolute maximum taxable capacity is defined as the difference between aggregate income and aggregate subsistence level that could be practically taxed away by the state had it not been certain that production and saving would have been adversely affected.

Because of this adverse consequence, the state is interested not in the absolute maximum but in the absolute optimum taxable capacity through which it raises the maximum amount of revenue over the long run and not in one year.

Revenue-raising though dependent upon taxable capacity is not identical with it, and could be regarded as the coefficient of utilization of taxable capacity. The main factors which influence over time the size of this coefficient or, in other words, the revenue raised through taxation are:

(1) the use made of tax revenue; government investment in social and productive projects leads, *ceteris paribus*, to a future increase of taxation potential;

(2) the spirit and national psychology of taxpayers; factors such as patriotism, civic obedience, and the sense of justice determine the psychological limit of taxation and influence taxpayers' reactions to taxes, thus establishing a certain ceiling to revenue-raising;

(3) the methods employed in raising revenue as well as the rate of tax increases; a strategy which avoids unnecessary hardships to taxpayers and uses a multiplicity of taxes in a manner that the social costs of each tax are equal at the margin is a desirable feature of a tax system;

(4) the total wealth of the country and its distribution both at present and in the future; it is generally believed that, *ceteris paribus*, the more unequal the distribution of wealth the greater the tax potential of a country because it is administratively easier to tax few rather than many; equality of wealth distribution coupled with the small amount of wealth owned by each individual result in higher wealth marginal utility loss through taxation and cause greater resistance to taxes by taxpayers;

(5) the standard of living of people; the amount of income in excess of subsistence determines the range within which the tax potential of a country can be established, and *ceteris paribus*, the larger this excess the greater the tax potential.⁶

Developing economies experience continuous changes in their taxable capacities that call for periodic changes in the composition of their taxes. Governments must be prepared to adapt their tax systems to the unfolding socioeconomic

⁶ For an analysis of the above factors of revenue-raising capacity, see [37, pp. 118–30] [24, pp. 6–14] [27, pp. 105–10], for factor No. 2 see [9, p. 9], for factor No. 3 see [28, p. 8].

conditions in order to take advantage of the ever changing taxable capacity and to protect their revenue.

The task of increasing tax revenue is affected by the administrative efficiency of tax authorities. The greatest handicap of underdeveloped countries is probably not their inability to enact proper tax laws but their inability to implement them. Stressing the importance of civil service efficiency, N. Kaldor writes:

Of course no underdeveloped country has the manpower resources or money to create a high-grade civil service overnight. But it is not sufficiently recognized that the revenue service is the "point of entry"; if they concentrated on this, they would secure the means for the rest. [22, p. 417]

Under the constraints of tax administration, taxes should be selected in a way that reflects the realities of the environment in which they are enforced, they must provoke the least resistance possible from taxpayers, and establish through their multiplicity the necessary tax illusion which enables government to increase its share in gross national product and effectively contribute to economic development.

Compared to development needs the tax systems of developing countries do not make good use of their tax potential [26, p. 496]. More revenue is required not only to finance development capital projects but also to cover current government expenditures which generally exhibit a secular upward trend throughout the developing world and exert an alarming long-term pressure on public spending [32, p. 15]. Underdeveloped countries must fully exploit their tax potential and approach their absolute optimum taxable capacity. Because this goal necessitates either the introduction of new taxes or increased rates of existing taxes, it will certainly be opposed by politically powerful vested interests. Though tax measures cannot be separated from political realities, the battle for increased revenue cannot be easily won without some victory over vested interests that tend to violate equity and create enough tax distortions which force tax systems to deviate from optimality [4, pp. 94-95].

VI. TAX SYSTEMS IN UNDERDEVELOPED COUNTRIES

The study of underdeveloped countries presents various difficulties which are mainly due to lack of reliable data and the vast dissimilarities of these countries. Researchers have not, however, been daunted by these difficulties, but have further complicated the statistical problems by examining developing and developed countries, together despite the fact that they do not belong to the same statistical population.

The determination of the possible revenue pattern or the system of taxes that is compatible with different levels of development has been the subject of several studies.⁷ The conclusions reached depend on arbitrary classification of countries,

⁷ A. M. Martin, and W. A. Lewis, "Patterns of Public Revenue and Expenditure," *Manchester School of Economic and Social Studies*, Vol. 24, No. 3 (September 1956); J. G. Williamson, "Public Expenditure and Revenue: An International Comparison," *Manchester School of Economic and Social Studies*, Vol. 29, No. 1 (January 1961); D. Dosser,

sometimes are contradictory and can be challenged on the ground that the studies implicitly assume that economic history repeats itself. The latter weakness of these studies is contrary to the readiness of developing countries to break with tradition and the past in devising their tax structures.

Underdeveloped countries raise a relatively small proportion of their total revenue through direct taxation mainly because of (1) administrative difficulties associated with direct taxes, (2) the poverty of the countries that results in small tax bases, and (3) the fact that their economies are dominated by agriculture which is difficult to tax. The small tax base is usually further eroded for administrative convenience by setting a high minimum tax-free income which amounts to a multiple of the average per capita income. The predominance of nonmonetary transactions in agriculture is a barrier to the enforcement of income taxes, although even in fully monetized agricultural sectors tax compliance is rare [15, p. 297]. Developing countries certainly do not satisfy the strict conditions for effective use of income taxes as envisaged by Richard Goode [13, pp. 213-15]. His prescriptions help as a caution against excessive reliance on income taxes before certain requirements are met. In the meantime, the use of income taxes can be considered as providing the tax authorities with much needed experience.

Indirect taxes, and among them taxes on foreign trade, dominate the tax systems of developing countries. Administrative considerations are responsible for the heavy reliance of developing countries on taxes on foreign trade. Because international trade (1) constitutes a large proportion of GNP of many developing countries, and (2) is conducted through a few seaports or points of entry, it enables governments to collect revenues efficiently and cheaply. Furthermore, these taxes are difficult to evade except in island countries where smuggling of goods is relatively easy [40, p. 435]. The same administrative advantage is enjoyed by sales and excise taxes when production is carried out in large quantities at a few factories and the demand for the goods taxed is price inelastic.

VII. TOWARDS A TAX SYSTEM FOR DEVELOPING COUNTRIES

Direct as well as indirect taxes will always exist side by side in all tax systems. The issue which concerns this paper is not the enumeration of which particular taxes must be adopted by developing countries but whether the tax systems of these countries should be biased in favor of direct or indirect taxes. Because of this limited objective, the analysis pursued will be general rather than specific

"Indirect Taxation and Economic Development," in *Government Finance and Economic Development*, ed. A. T. Peacock and G. Hauser (Paris: OECD, 1965); S. R. Lewis, Jr., "Government Revenue from Foreign Trade: An International Comparison," *Manchester School of Economic and Social Studies*, Vol. 31, No. 1 (January 1963); H. H. Hinrichs, "Determinants of Government Shares Among Less Developed Countries," *Economic Journal*, Vol. 75, No. 299 (September 1965); V. Tanzi, and C. McCuistion, "Determinants of Government Shares Among Less Developed Countries: A Comment," *Economic Journal*, Vol. 77, No. 306 (June 1967); J. R. Lotz, and E. R. Morss [26].

and restricted to the two broad categories of direct and indirect taxes. Furthermore, from all direct taxes, the personal income tax is used, because of its importance, for comparison with indirect taxes.

The principal advantages of progressive income taxes are that (1) they promote economic stability and (2) contribute to equality in income distribution. The built-in-stability of these taxes, though important in itself, is of limited value to underdeveloped countries whose cycles are often caused by entirely exogenous factors connected with international trade and weather conditions. Through progressivity resources are transferred from consumers to governments in greater proportions than the increase in incomes to augment public investment. Progressivity need not, of course, be missing from indirect taxes, yet N. Kaldor argues that there is no substitute for progressive income taxes as practically all people buy the same commodities with the rich buying more and not just more luxurious ones [22, p. 415]. Despite the popularity of equality in income distribution and the contribution of progressive income taxes to it, power politics and the probable damage to private capital accumulation force developing countries to pursue this objective with relative moderation, thus reducing the appeal of progressive income taxes to these countries.

The case against progressive income taxes rests on the grounds that they complicate tax laws and tax administration while they simultaneously dampen incentives and private capital formation. Complications arising from the enforcement of tax laws are undoubtedly real but should be viewed as a small price paid for raising revenue and for moderately pursuing the objective of equality in income distribution, which is regarded by Henry Simons as the *raison d'être* of income taxation [36, pp. 18–19]. The impact of income taxes on incentives, on work effort or risk-taking, is theoretically indeterminate as it depends on the unpredictable outcome of the conflict between the income and the substitution effects. More important, in the context of economic development, is another criticism that progressive income taxes penalize the most progressive elements and reduce investment. Income taxes neither reduce by their amount the sum devoted to future investment nor do they reduce consumption without affecting in the least the investment plans of entrepreneurs. They affect both consumption and investment, but because investment is somewhat affected is not enough reason to discard them completely. There is some truth in the criticism that income taxation becomes discriminatory through the inability of tax administrations to reach the nongrowing or no-growth contributing sectors for which tax evasion is a way of life, a practice not generally followed by the dynamic sectors of the economy. The remedy of this injustice is to strengthen the tax administration, although it could be argued that government expenditures on infrastructure and social overhead benefit the progressive, not the stagnant sectors, so that the former are not really overtaxed [1, p. 600].

The major indirect taxes of developing countries are import duties, excise taxes, and to a lesser extent export taxes usually found in countries whose exports are dominated by a few items. These taxes are popular not only because of their administrative simplicity, but also because they can satisfy the principles of

progressivity and build-in-stability as well as equity if their rates are determined through statistical budget studies. Two additional properties of indirect taxes are of particular interest to developing countries, namely, their ability to raise the incremental saving ratio by restraining consumption and to allocate resources to desired areas of development.

Equity is served by exempting necessities and the produce of peasant farmers from taxation while graduated taxes imposed on nonessentials and luxuries, especially if established through scientific studies of family budgets, allow indirect taxes to satisfy the principle of ability-to-pay and the built-in-flexibility property. By raising the cost of consumption relative to saving, indirect taxes encourage the latter at the expense of the former. In a system of indirect taxes, saving is stimulated as it virtually escapes taxation and resources are released from consumption to capital formation whose contribution to economic development cannot be overemphasized.

Indirect taxes serve the purpose of industrialization by diverting resources to desirable activities. On the one hand, import duties being graduated according to the degree of luxury of imported commodities provide incentives for domestic production. The particular stimulation given to semiluxury or luxury goods should be dealt carefully and their local production discouraged at times by heavy sales or excise taxes or even by outright prohibition because resources should be used for the production of more urgently needed commodities. Indirect taxes imposed on locally produced goods are, on the other hand, designed to divert resources from the production of luxuries, to semiluxuries and necessities, by affecting the rate of return. This goal is not always easy and its attainment depends in the final analysis on the diversionary effect of taxes on particular commodities with different elasticities of supply and demand. If, however, indirect taxes fail to change the allocation of resources and the pattern of investment, other measures affecting relative prices and relative profitability must be employed. The structure of indirect taxes should be such as not to stifle altogether the production of semiluxury goods defined as those widely consumed by people above the subsistence level, but keep it at low levels as a stimulant for increased participation in the development process. The favorable tax treatment of necessities should not be taken to mean that the majority of resources released through taxation are used to expand the production of necessities. It is important that the production of necessities does increase at least at the same rate as the population growth, but due to the prevailing poverty in underdeveloped countries, it is easy for income increases to be spent exclusively on consumption. To protect the long-term development interests of these countries part of the increased incomes must be diverted to investment through mass commodity taxation. Indirect taxes have an important role to play in this respect by transferring resources from consumers to the public sector, which in turn uses these resources for investment. Mass commodity taxation is therefore fully justified as it serves to raise the incremental saving ratio [8, pp. 88-94].

Indirect taxes are criticized for being regressive, therefore inequitable, and possessing limited built-in-flexibility. Income taxes are structurally superior in

these areas, but the gap between the two systems of taxation can be reduced if indirect tax rates are set on the basis of family budget studies. A more serious criticism claims that indirect taxes are proinflationary by lubricating the known wage-price spiral wheel. This argument is particularly valid in countries with strong labor unions but the labor union movement is generally weak in underdeveloped countries. Under certain assumptions, indirect taxes can actually be used as an antiinflationary weapon [10, pp. 385-96]. Under other assumptions, they exert a proinflationary bias, which, to a lesser degree can also be claimed for progressive direct taxes if their high rates cause taxpayers to reduce their work effort and indulge in dissaving.⁸

An appraisal of direct and indirect taxes indicates that the structural superiority of the former in contributing to stability and equality in income distribution is of limited usefulness to developing countries because economic fluctuations in these countries are often exogenous while political and economic realities dictate that income redistribution should proceed with moderation. This superiority of direct taxes is furthermore greatly lessened when indirect tax rates are scientifically determined following wide family budget studies. Indirect taxes thus become effective instruments of economic stability and redistribution of income in addition to inherently possessing the properties of raising the incremental saving ratio and of controlling economic development through the allocation of resources. Because of these properties, indirect taxes will dominate the tax systems of underdeveloped countries for a long time.

Developing countries must overhaul their tax systems in order to raise more revenue and accelerate their economic development. Whether the increased revenue should be raised through direct or indirect taxes is a matter to be decided by such factors as the incidence of taxation, the incentive or disincentive nature of different kinds of taxes, the educational and civic standards of taxpayers, and the administrative capabilities of the civil service. Poor tax administration and tax enforcement seriously distort the incidence of direct taxes, which end up being undesirably regressive. The administrative ease combined with the special attributes of indirect taxes as instruments of intervention in the market and of resource allocation insure their extensive use in developing countries. As economic development gains momentum and poor countries gradually leave behind them the signs of economic primitiveness, illiteracy, and political immaturity, they will be able to exercise more choice in shaping their tax structures and rely more on direct taxes than at present. That developing countries rely heavily on indirect taxes cannot be held against them. What one can criticize is the enforcement of these taxes and how good a use of them developing countries make in the pursuance of their economic development.

⁸ F.D. Holzman claims that the predominance of commodity taxes in Russia and the relative neglect of income taxes are due to the above two adverse effects of income taxation [20, pp. 426-27].

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