

TAXATION, ECONOMIC GROWTH, AND LIBERTY

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The Third World, often called the less developed countries (LDCs), consists of over 100 nations in Africa, Asia, the Middle East, the Western Hemisphere, and the Mediterranean. Most of these countries are former British, French, or Dutch colonies that received independence after World War II. Although Central and South American countries were long independent, their failure to sustain economic growth consigns them to the category of Third World economies. A few oil-exporting nations enjoy higher per capita incomes than the majority of non-oil exporting countries, but even these select nations recently fell on hard times as world oil prices declined.

Although the British and French bequeathed constitutional democracy to their former colonies, representative institutions proved to be fragile in the Third World. With some exceptions, such as India, Sri Lanka, Malaysia, Costa Rica, and some island mini-states in the Caribbean, many LDCs succumbed to military dictatorships, one-party states, lifetime presidents, extended states of emergency rule or martial law, and totalitarian regimes of the left or the right (though democracy made a strong comeback in Latin America in the mid-1980s). Some authoritarian rulers permitted, indeed encouraged, the development of private enterprise-based market economies; most relied on state planning and control. Few allowed a free press, freedom of speech, and other civil liberties that are constitutionally guaranteed and that flourish in Western democracies.

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Development specialists paid considerably less attention to taxation than such other aspects of development policy as international transfers, central planning, import-substitution schemes, the role of multi-national corporations, and raising expenditure levels. The relationship between taxation and liberty for more than three billion inhabitants of the Third World remains virgin territory.

Taxation and Development: Changing Views

In the early postwar years, Peter Bauer and Basil Yamey (1957) were nearly alone when they warned that taxation could adversely affect economic development:

It is therefore likely that in many under-developed countries taxation falling on activity in the money sector will reduce the supply of effort to that sector below what it would be otherwise. This reallocation of resources affects adversely total real income. The lower national income and the retardation of the spread of the exchange economy in turn impede long-term growth [p. 199].

The proceeds of compulsory savings are not a simple addition to total saving. It is not even certain that total saving will be increased in the process. Even when savings are increased in the short run, the repercussions of the taxation may reduce the flow of savings in the long run by retarding the spread of the exchange economy and the growth of specialization [pp. 199–200].

Bauer and Yamey also warned that restricting private saving would dampen the supply and effectiveness of local entrepreneurship because state control over savings would be diverted to expand public undertakings.

In contrast, mainstream development economists and such international institutions as the World Bank and the International Monetary Fund generally pushed tax increases, both as an overall share of national income and specifically to “soak” the rich through punitive tariffs on luxury imports, steeply graduated rates of personal income taxation, wealth taxes, and strengthened enforcement. Richard Bird and Oliver Oldman (1975) compiled a representative cross-section of readings on taxation in developing countries. In their introduction to part one, “Fiscal Policy and Economic Development,” they refer to an “orthodox” position among development economists: “[M]ost developing countries tax little, and should tax more, particularly through progressive taxes and land taxes.”

A cross-section of citations from this literature demonstrates the prevailing intellectual background against which tax planners in LDCs worked:

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- A personal income tax with a narrow base but high rates on large incomes, buttressed by administrative efforts concentrated on this area, may be a suitable instrument for achieving some of the ends of economic policy and distributive justice [Heller 1975, p. 27].
- The shortfall in revenue is thus largely a reflection of failure to tax the wealthier sectors of the community effectively. Though progressive income taxes and inheritance taxes exist on paper in most of the underdeveloped or semideveloped countries—sometimes imposed at high nominal rates, mounting to 80 percent or more on the highest incomes—there are few cases in which such taxes are effective in practice [Kaldor 1975, p. 31].
- Most economists have advocated a development strategy aimed at raising the level of domestic savings through budgetary policy—i.e., reducing personal consumption by increasing taxation. . . . Yet most economists argue for still more taxes. . . . The World Bank attaches importance to increase in tax revenues from country development plans [Please 1975, pp. 39–40].
- Taxation not only can help to bridge the gap between savings and investment but can also be used as one of the instruments for resource allocation, income redistribution, and economic stabilization [United Nations Secretariat 1975, p. 58].
- In taxing foreign income and the income of foreigners, one might latch on to the principle of equality: tax the foreigner the same as the national is taxed; a second starting point might be the principle of charging as tax whatever the traffic will bear: soak the foreigner as much as he will pay without his ceasing to engage in activities the LDC wants him to engage in [Oldman 1975, p. 203].
- The Declaration of Punta del Este, which set up the Alliance for Progress, established as one of its goals: To reform tax laws, demanding more from those who have most . . . to satisfy concerns of equity and meet pressure for more revenues to finance added government responsibilities [Tanzi 1975, p. 233].
- An important economic function of the capital gains tax is to curb speculation . . . and to encourage investments that are economically productive [Amagong 1975, p. 246].
- A net wealth tax, if well designed and effectively administered, can supplement a personal income tax and achieve greater equity in personal taxation [Tanabe 1975, p. 269].
- Owing to the heavy responsibilities that governments are assuming, not only for capital formation, but also for the provision of current services, the underdeveloped countries cannot promote saving merely by maintaining low taxes. Most underdeveloped countries need to raise more revenue, many of them, much more [Goode 1975, p. 273].

The impact of tax rates—especially marginal tax rates—was largely ignored or at least underemphasized, in the traditional development

literature. Why? In a paper prepared for a 1985 Conference on Taxation and Development sponsored by the U.S. Agency for International Development, Vito Tanzi of the International Monetary Fund answered:

First, there has been the traditional view that, in developing countries, high incomes do not originate from work effort or entrepreneurship; they are assumed to reflect mostly inherited wealth. Thus, they are more in the nature of rents than of genuine incomes. As a consequence, they could be taxed away with little negative effects. Second, that high incomes inevitably result in high consumption and/or capital flight. Third, that in any case the government can generate a high rate of saving for the country by raising taxes while holding down its own consumption. In this way, whatever negative effect high marginal tax rates might have on the individuals' propensity to save could be more than compensated by higher government saving. Fourth, because of lack of knowhow and entrepreneurship in the private sector, the government had to take the initiative in carrying out investment. The government was seen as the engine of growth in the economy. Fifth, the negative effect on labor supply could be ignored because of the overabundance of labor. Some influential studies assumed that the supply of labor schedule was perfectly elastic at a subsistence level of wages. Sixth, that private investment in desirable sectors could be stimulated through the use of specific tax incentives, so that low tax rates on corporate income were not necessary. Seventh, that in any case there was little *solid* evidence that marginal tax rates were important in determining the propensity to save, invest, or to supply greater effort [pp. 1-2].

Although all development economists did not share these assumptions, Tanzi notes that many of the assumptions were prevalent throughout much of the literature on economic development and taxation until recent years. How did they prove to be faulty? According to Tanzi (1985, pp. 2-4):

First, in developing countries, large incomes are often more the result of . . . implicit taxes, than of property ownership. In many developing societies today it is more important to have access to subsidized credit, to scarce foreign exchange at official exchange rates, to import licenses, or to be able to produce behind a protective wall than to own property. . . . Rents based on government policies have replaced rents based on property ownership.

Second, the assumption that high income inevitably results in high consumption has been challenged in various theories of the consumption function. Some of these challenges are as relevant for developing countries as they are for industrial countries.

Third, . . . in many countries the increase in the tax burden that took place over the years did not result in higher public saving, as had been anticipated, but in higher public consumption. Further-

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more, whatever public investment did take place, it was often misallocated resulting in very low or negative rates of return.

Fourth, . . . the government does not have a monopoly over know-how or entrepreneurship. A country without entrepreneurs in the private sector is not going to produce them in the public sector.

Fifth, it has been recognized that even though the overall labor supply may be abundant . . . it is rarely abundant for particular skills.

Sixth, the argument on whether one can stimulate more investment by low corporate tax rates or by investment incentives is still a debatable one.

Finally, while in the past it was often argued that there was no evidence that high marginal tax rates had any effects on the propensity to save, invest, and work harder, in recent years more and more studies using sophisticated techniques have shown that taxation may in fact have some negative effects.

This changed worldview is reflected in recent publications by Keith Marsden and Chad Leechor of the Industry Department of the World Bank. Marsden (1983) argued that on the basis of a sample of 21 countries in the Americas, Asia, Africa, and Europe, countries that imposed a lower effective tax burden on their populations achieved substantially higher real growth than did their more highly taxed counterparts. Marsden (1985) later specifically examined 17 LDCs in Asia and Africa and concluded that low tax rates stimulated economic incentives and economic growth in the high and medium growth economies.

Leechor (1986) contended that tax policy influences private saving and capital formation and that tax increases often shrink the tax base or foster tax evasion and damage the private sector. Instead, tax policy should aim at improving incentives. Based on a comparative study of Colombia, Korea, Mexico, and Thailand, Leechor recommended reducing marginal tax rates, broadening the tax base, exempting savings from the tax base, indexing the tax system against inflation, restructuring corporate taxes by permitting expensing of investment costs in the first year, and granting exporters full tax rebates and duty drawbacks on purchased inputs.

Despite the recent transformation in thinking that Tanzi summarized and that Marsden and Leechor illustrate, the old views have not yet been fully rejected by both scholars and policymakers in LDCs. It is still common to find countries with marginal income tax rates of 70, 80, or 90 percent that take effect at relatively low incomes (by industrialized nation standards). Even though these top marginal tax rate thresholds represent several multiples of per capita gross domestic product (GDP) in LDCs, multiples of per capita GDP do not determine incentives to work, save, or invest. Individuals with

entrepreneurial talent, specialized skills, or capital are generally aware of the better opportunities that exist in other countries; and it is critical for developing nations to retain these talented people. The loss of this minority of potential entrepreneurs, scientists, engineers, professionals, and skilled laborers could grind the entire process of development to a screeching halt. High marginal tax rates that affect a small minority of the population and supply less than one-tenth of total revenue in many LDCs could have severe repercussions on economic growth. People and human capital are no less internationally tradeable and transferable than are commodities and capital.

Some development analysts believe that the emphasis marginal tax rates receive in current thinking about fiscal policy and incentives for growth is misplaced. Even if marginal tax rates are important in the development process, these analysts contend that income taxes are insignificant compared with the wide range of other government policies that discourage growth. These forms of "implicit taxes" also deny people a rate of return on work, saving, or investment that is effectively equivalent to a tax levied on a market rate of return. In some LDCs, implicit taxes overwhelm the impact of the statutory tax system on levels of economic activity.

The statutory tax system, however, serves as something of a proxy for a range of government policies. For purposes of analysis, it is easier to obtain quantitative data on taxation than on such other governmental interferences with the market as overvalued exchange rates, farmgate prices, and minimum wages. There are almost no data on many of these important factors—at least none that are available to researchers. But a variety of government agencies and commercial firms publish data on statutory tax systems, and the IMF publishes substantial figures on aggregate levels of taxation.

Principles of Taxation for Developing Countries

An ideal tax system should meet five practical requirements that foster a climate of growth. First, sufficient revenue should be generated to finance a major part of overall public expenditure—to pay for the limited, legitimate activities of government—and maintain fiscal reserves at a satisfactory level.

Second, the tax system should remain neutral toward the internal cost/price structure, the supply of human effort, and private investment decisions. This means, in effect, that the emphasis should be on proportionality apart from a modest degree of progressivity on personal taxation to leave the poorest classes untouched by direct taxation.

Third, the laws governing the tax system should be revised from time to time to make them consistent with changing commercial practices.

Fourth, each and every levy—direct or indirect—should be simple and easy (and, therefore, inexpensive) to administer and not encourage evasion.

Fifth, the tax system should be only exceptionally used to achieve nonfiscal objectives. Such policy objectives should be pursued directly through public expenditure programs and by appropriate legislative measures, not indirectly by adjustments to tax rates and amendments to tax laws. Once a government starts to use the tax system to pursue economic and social policies, the consequences are unpredictable and usually irreversible and the costs are unquantifiable.

Taxation, Growth, and Liberty

Analysts of American and European taxation enjoy access to a wealth of generally reliable data on national income accounts, tax systems, and other aggregate economic indicators. Analysts of LDCs are less advantaged; they have to patch together often incomplete, unreliable, or downright inaccurate data from a variety of private and public international sources. The most helpful and most frequently consulted sources are “World Development Indicators,” published annually by the World Bank, and “Government Finance Statistics” and “International Financial Statistics,” published monthly and annually by the International Monetary Fund. The IMF also publishes an annual “Supplement on Economic Indicators.” But mixing and matching these sources into a unified data file is not an entirely straightforward process. The IMF roster of developing countries numbers 104, but World Bank indicators are available for only 98. The gap of six is compounded by some non-overlapping; the British Crown Colony of Hong Kong, for example, is not a member of the IMF and its financial statistics are not published in IMF bulletins, whereas Hong Kong’s development indicators appear in World Bank publications. Only a few basic indicators appear in World Bank tables for small countries with populations under one million.

This picture overdramatizes the availability of data on LDCs. Among the 104 LDCs for which the IMF publishes financial statistics, complete national income accounts exist for only 57. Partial GDP information is published in the “Supplement on Economic Indicators” for 95 LDCs, but the accuracy of many of these numbers are suspect.¹

¹Kuwait, Oman, and the United Arab Emirates were eliminated from the data file because all receipts are derived from oil exports and their various high-score devel-

The percentage of public receipts collected in the different forms of taxation is available for 104 LDCs. The timing of IMF financial statistics ranges from as recent as 1984 to as far back as 1978 or 1979 for some countries. Many African nations have been slow to get their financial statistical houses in order.

Neither the World Bank nor the IMF release detailed information on the structures of their member countries' tax systems. Details on the rates of direct and indirect taxation, what is and is not taxed, along with exemptions, deductions, credits, special incentives, and other features of taxation, must be culled from other sources. For information dating from 1975, the most readily accessible data appear in the publications of two commercial international tax service organizations. Beginning in 1975, Price Waterhouse has published the structure of tax rates and tax brackets for individual income taxes in those countries, numbering 94 in 1985, in which it maintains offices. Since 1982, Coopers and Lybrand has published a competitive volume. When colonies and dependent territories are excluded from the two firms' joint listing of 104 separate taxing entities, only 77 countries remain, some of which are mini-states of little consequence. Several of the 77 are oil-exporting nations that rely solely on oil proceeds for revenue.

The best source of tax data before 1975 is an annual series published between 1958 and 1973 by Great Britain's Inland Revenue Department. The series contains annual tax specifics for approximately 40 countries between 1958 and 1973. The early volumes were titled *Income Taxes in the Commonwealth* and *Income Taxes Outside the Commonwealth* (1958–66); the successor series combined both into one annual volume titled *Income Taxes Outside the United Kingdom* (1966–73). Comparable data on overseas French and Dutch territories are not readily available, nor are data on Latin American nations before 1975. To assemble these data requires the scrutiny of legislation on a country-by-country basis, which no clearinghouse has yet assembled on a historical basis. The International Bureau of Fiscal Documentation in Amsterdam publishes current information on explicit taxes for all regions of the world and maintains an extensive library, but its historical collections are sporadic and incomplete. As a result, attempts to link indicators of economic performance to long-run changes in effective marginal tax rates on individuals and effective tax rates on businesses, industries, and economic sectors

opment indicators are due solely to the interplay of high oil receipts and small populations. These three cases constituted serious outliers and were removed to eliminate unnecessary distortion in the analysis.

cannot encompass the entire developing world and are severely restricted by the paucity of longitudinal data to the most recent decade (1975–85).

More data are available for economically important and heavily populated countries than for extremely poor, economically unimportant, lightly populated LDCs. Neither Price Waterhouse nor Coopers and Lybrand maintain an overseas office or local correspondent in those developing countries with the least attractive business opportunities.

Few scholars have attempted to link tax policies and other indicators of economic performance with measures of political and civil rights. If sustained economic growth has no effect on the evolution of democratic institutions or civil liberties or if overly rapid growth engenders totalitarian regimes that repress individual freedom, then stressing growth policies would require serious reconsideration. On the other hand, if a necessary condition of democracy and improving individual liberties was high growth, policies that fostered prosperity would also nurture free institutions and individual rights.

Data on political freedoms, civil rights, and democratic institutions are routinely published in the annual January-February issue of *Freedom House*, which allows us to assess the relationship between economic performance and several measures of political and economic liberties. *Freedom House* ranks virtually all nations by civil liberties and political rights on a seven-point scale from “most free” (a score of 1) to “partly free” (3–5) to “not free” (a score of 7). Political rights range from the presence of a fully competitive electoral process to a limited role for opposition parties within a predominantly one-party state to the complete absence of free elections where despots rule unconstrained by public opinion or popular tradition. Civil liberties encompass freedom of the press, court protection of the individual, free expression of personal opinion, and free choice in occupation, education, religion, residence, and so on, to the other extreme of pervading fear, little independent expression even in private, and swift imprisonment and execution by a police-state.

A complete analysis of developing countries, therefore, should encompass both economic and political dimensions. Economic development takes place within a sovereign political entity that maintains specific institutions of government that permit or suppress political freedoms and civil liberties. It is important to know whether growth, the chief indicator of development, is correlated with the spread of democratic institutions and individual freedoms.

A fully specified model linking important economic and political variables with growth cannot be tested because extant data excludes

potentially important factors. Available data include such standard measures as tax shares of gross national product; the composition of taxes; top marginal rates and thresholds of the individual income tax; long-term annual average changes in exports, imports, investment, public and private consumption, industrial and agricultural output, public and external debt, and several political indicators. Data on implicit taxes that affect growth and development, however, are even more difficult to obtain than evidence on changing tax rates over time. Precise, statistical information on farm-gate prices is available only on a sporadic, case-by-case basis. Another crucial implicit tax on exporters (and subsidy for importers) is exchange-rate overvaluation, for which quantitative estimates may be available only in the confidential files of the IMF. The World Bank's preliminary study of exchange rate distortions for 31 countries shows only 12 with medium or high distortions, which limits the ability to include these data in analyses encompassing between 50 and 100 developing countries.

There are two other potentially important variables: (1) the extent to which the tax laws are enforced (compliance) and (2) the extent to which the presence of an underground economy vitiates the disincentive effects of statutory systems of taxation. Data on these variables are virtually nonexistent. Indeed, the overriding difficulty in analyzing taxation and development is the lack of data by which hypotheses can be tested. An important aspect of future work must be the extent to which one counterproductive dimension in a tax code is a proxy for an entire system of explicit and implicit taxation that retards growth.

Findings

Analysis reveals that *rates of taxation are more important than overall tax burdens in affecting growth in LDCs*. For 49 LDCs, countries with higher incomes have somewhat higher levels of aggregate taxation; the simple correlation of taxation as a share of GNP with the prior 22 years of average annual economic growth rate (on a per capita basis) is a relatively modest .274 (significance = .028). High growth countries, which became prosperous, have relatively larger aggregate tax burdens than slow growth countries; their economies are based more on industry than on agriculture. As these countries prospered, their governments took away a higher percentage of national income in taxes, which is what happened in Western industrial democracies. But larger aggregate tax burdens in LDCs do not necessarily reflect higher rates of tax on individuals, corporations, and commodities. For example, Hong Kong's aggregate tax burden

is higher than that found in many LDCs, even though its tax *rates* are the lowest.

The overall level of taxation in 49 LDCs is not significantly linked with high or low rankings on political or civil liberties.

When the analysis is shifted from aggregate tax levels to the composition of taxes, the universe of LDCs expands to over 100, reflecting more abundant data. Greater dependence on direct taxes (individual income taxes, corporate taxes, social insurance contributions, and property taxes) is positively related to overall economic growth, the growth of private consumption, per capita income, and the level of public spending. Rich, high-growth countries collect a higher share of receipts in the form of direct taxes than do poor countries. They have developed an urbanized, industrial, commercial economy on which direct taxes can be imposed (though, as shown later, tax rates matter significantly).

As dependence on indirect taxes rises, countries fare less well in their annual growth rates of imports, investment, industry, overall economic growth, and, consequently, private consumption and per capita income. Most of this adverse effect is due to the application of international trade taxes, not domestic excises or sales taxes. Most LDCs depend heavily on exports and imports; the correlation between per capita income and international trade taxes, for example, is $-.415$. Over-reliance on indirect taxes may retard export-led growth from either the industrial or agricultural sector.

To the extent that the system of taxation and the structures of tax rates influence economic growth, taxation indirectly affects the prospects for individual liberty in LDCs. The relationship between annual average rates of economic growth over 22 years and the scale score for political rights and civil liberties shows that countries with negative growth have very poor scores on individual rights. But once economic growth exceeds 3 percent, political and civil rights scores significantly improve. In particular, I found that for 93 LDCs on which both growth and freedom measures exist, countries with sustained low growth show negative ratings on political rights and civil liberties; high-growth countries show a more encouraging distribution. High growth may not be a sufficient condition of individual liberties, but it appears to be a necessary condition for the gradual emergence of political and civil rights.

Furthermore, countries with low per capita incomes, the result of decades of no growth to slow growth (not necessarily low starting points, since even the high-growth Pacific Rim economies began their postwar ascent with per capita incomes of below \$200), fare badly on political rights and civil liberties. Twenty-five countries

had per capita GNP figures below US\$400 at the end of 1982. Of these, only six received a score of 1–4 on political rights and four received a score of 1–4 on civil liberties. Fewer still earned scores of 1–3. In contrast, 19 of 25 received dreadful ratings on political rights and 16 received equally dismal ratings on civil liberties. The leaders of the economic basket cases of the world inflict the greatest political deprivations on their subjects.²

Tax Rates and Economic Growth

The link between tax rates and development is revealed in Table 1, which groups countries by top marginal rates and the brackets at which the top rate applies in that country. I have subdivided countries into nine working classifications, based on a high, medium, or low top marginal rate, and whether the top rate applies at high, medium, or low thresholds of income. Only one country, Hong Kong, maintained a low top marginal tax rate. Hong Kong also enjoyed the highest growth rate in per capita income. In general, countries with high thresholds turned in consistently higher growth than those with low thresholds. For medium tax rate, high threshold countries, the average was 4.5 percent; for high tax rate, high threshold countries, the average was 3.9 percent. Even the high rate, medium threshold countries averaged 3.1 percent.

This point is worth belaboring. So long as high top marginal rates do not bite at low levels of income, they do not inhibit human endeavor on a wide scale. No individual is deterred from moving out of the subsistence sector into the cash economy by the disincentive of high marginal rates of tax on low cash incomes. The effective marginal tax rate remains low for the overwhelming majority of the economically active population. Even at the medium threshold, between \$20,000 and \$50,000, most taxpayers face effective low rates. It is the low threshold countries, where the top marginal rates take hold at very low incomes for professional, skilled, mobile, middle- and upper-middle-class populations, that show the worst performance. Even if only a small proportion of a country's population is caught in the income tax net, that small fraction is the human engine that drives growth through decisions to invest, work, save, or shift money and human capital abroad and substitute leisure for effort.

Like commodities and capital, people can be viewed as internationally tradeable or transferable. Individuals export their talents as

²Tables showing the long-run relationship between economic growth and civil and political liberties, as well as the relationship between per capita income and freedom, for selected LDCs, are available from the author upon request.

well as their capital. For those residents of developing countries who possess highly valued skills that are in demand in other countries, they may be tempted to migrate to earn higher after-tax returns on their human capital. Therefore, to view the earnings of this small, but important, minority who provides entrepreneurial, technical, professional, and other skills and services as a multiple of per capita income in their own countries is potentially misleading as an indicator of this group's economic well-being and incentives. Even if a Pakistani, Indian, Jamaican, Briton, or other foreign resident enjoys a relatively high income in his own country, he may still migrate to another country in which the application of his skills or talent provides a sharply higher after-tax real income and, equally important, a lower top marginal rate on incremental units of output.

Bangladesh, Ghana, Jamaica, and several East African nations show especially dismal economic performances. The high rate, low threshold average for 21 countries is 1.9 percent, and this grouping includes many of the economic basket cases of the world. *Even moderate top marginal rates that bite at relatively low incomes cripple growth.*

It is possible to refine each of these categories. When the last category is recalculated to include only those countries with thresholds below \$10,000, or whose marginal tax rates exceed 70 percent when the threshold falls between \$10,000 and \$20,000, the average growth rate of this subgroup of 14 nations was only 0.8 percent. Of the 14, 4 had negative growth and only 3 displayed average annual growth rates of over 2 percent.

Overall, per capita income for 63 developing countries is negatively correlated with high marginal tax rates ($r = -.443$; significance = .000). (This relationship is much stronger than that reported earlier for aggregate tax burdens and growth.) The poorest countries of the world consistently maintain systems of individual income taxes with the highest marginal rates. A similar pattern holds for per capita income and tax thresholds for the top rate: lower thresholds go hand-in-hand with smaller per capita incomes ($r = .26$; significance = .026).

Finally, higher top marginal tax rates correlate negatively with the size of the budget surplus/deficit as a percentage of gross national product. To be specific, countries with lower rates tend toward balanced budgets or modest deficits; countries with higher rates tend to run the largest deficits. High tax rates do not foster balanced budgets, and raising tax rates to further reduce deficits seems counterproductive.

A cursory examination of corporate tax rates shows a large measure of uniformity throughout the developing world. I could find no statistically significant patterns relating corporate tax rates with per

TABLE 1
MARGINAL TAX RATES AND AVERAGE ANNUAL ECONOMIC GROWTH IN LDCs, 1960-82

Country by Tax Rates and Thresholds	Marginal Tax Rates (%)	Tax Thresholds (\$)	Economic Growth Rate (%)	Mean Growth per Tax Group (%)
<u>Low Tax Rates—All Thresholds</u>	0-24	All		7.0
Hong Kong			7.0	
<u>Medium Tax Rates— Low & Medium Thresholds</u>	25-49	0-50,000		2.1
Argentina			1.6	
Bolivia			1.7	
Ivory Coast			2.1	
Paraguay			3.7	
Solomon Islands			1.3	
<u>Medium Tax Rates—High Thresholds</u>	25-49	50,001+		4.5
Indonesia			4.2	
Singapore			7.4	
Venezuela			1.9	
<u>High Tax Rates—Medium Thresholds</u>	50+	20,001-50,000		3.1
Belize			3.4	
Botswana			6.8	
Brazil			4.8	
Cyprus			5.9	
Dominica			-0.8	
Malaysia			4.3	
Morocco			2.6	
Nigeria			3.3	
Philippines			2.8	
Senegal			0.0	
South Africa			2.1	
Trinidad & Tobago			3.1	
Zimbabwe			1.5	

<u>High Tax Rates—High Thresholds</u>	50 +	50,001 +		3.9
Dominican Republic			3.2	
Ecuador			4.8	
Egypt			3.6	
Korea			6.6	
Liberia			0.9	
Mexico			3.7	
Nicaragua			0.2	
Panama			3.4	
Taiwan			7.0	
Thailand			4.5	
Tunisia			4.7	
<u>High Tax Rates—Low Thresholds</u>	50 +	0–20,000		1.9
Bangladesh			0.3	
Barbados			4.5	
Chile			0.6	
Costa Rica			2.8	
Fiji			3.2	
Ghana			-1.3	
India			1.3	
Jamaica			0.7	
Kenya			2.8	
Malawi			2.6	
Malta			8.0	
Pakistan			2.8	
St. Lucia			3.4	
St. Vincent			0.6	
Sudan			-0.4	
Swaziland			4.2	
Tanzania			1.9	
Turkey			3.4	
Uganda			-1.1	
Zaire			-0.3	
Zambia			-0.1	

capita income, economic growth, macroeconomic trends, or political variables. A more complete analysis of the effect of corporate taxes on development would have to take into account depreciation schedules, investment credits, provisions for special deductions against foreign exchange losses, bad debts, and so forth. Given the widespread variability of these factors affecting actual corporate tax liabilities, it is somewhat surprising that statutory rates are so uniform.

Apart from the overall rate of economic growth, other indicators of macroeconomic performance did not emerge as significantly correlated with political rights or civil liberties. High-growth, high-income nations are more likely to evolve competitive party, democratic systems of government. Democracies, of course, are more respectful of political freedoms and civil liberties. Growth, which leads to rising prosperity, is a necessary but not sufficient condition of democratic institutions and individual freedoms. *Stagnation, which breeds poverty, is almost a sufficient condition for authoritarian governments, political repression, and the denial of civil liberties.* A humanist view of the developing world dictates the application of low tax rate, growth-oriented economic policies.

Postwar Trends in Individual Income Taxes

The importance of the personal income tax varies among LDCs, but reactions to using the tax to achieve income redistribution and other political objectives reflect an overall attitude about economic and fiscal policy in general.

Economists readily agree that low tax rates introduce minimal distortions into an economy. High tax rates, on the other hand, seriously distort allocative decisions and erode incentives to work, save, and invest. Individual income taxes contribute varying shares of total revenue in developing countries. Excluding the oil-exporting countries, 23 countries in Africa receive less than 10 percent of total revenue from individual income taxes, 11 from 10–20 percent, and only Liberia, South Africa, and Zimbabwe collect over 20 percent. In Asia, the individual income tax is a more significant source of revenue: 4 countries collect less than 10 percent, 5 collect from 10–20 percent, and 2 more than 20 percent. Outside Israel, virtually no Middle Eastern country depends on the individual income tax. Among developing countries in the Western Hemisphere, the highest take is 17.5 percent. For IMF-reported data, 10 countries collect less than 10 percent and 10 collect from 10 to 17.5 percent. These relatively small proportions are often compared with the industrial countries

in which individual income taxes range from as low as 8.4 percent to as high as 57.2 percent, with the average running well over 20 percent.

Because of these figures, many analysts of LDCs are concerned that attempts to link the structure of marginal tax rates and the income tax base with the determinants of economic growth are misdirected. But the economic damage caused by a tax that raises little revenue can be substantial. For example, a 100 percent tax on any import may raise little or no revenue, but it could completely retard an industry that depends on imported inputs. High import duties also foster smuggling. Similarly, high export taxes on agricultural goods collect little revenue, yet they discourage commercial production in favor of subsistence agriculture. A system of high marginal tax rates may raise little revenue, yet prevent the emergence of equity markets, discourage prospective entrepreneurs, drive people into the underground economy, foster tax shelters, and so on. Thus, any system of high tax rates has the potential to wreak economic havoc far out of proportion to any revenue it generates and any social objectives it is designed to attain.

Table 1, which clusters countries by the level of top marginal rate and the threshold at which the top rate takes hold, suggests that sound, growth-oriented policies cohere in packages. The low top rate/high threshold countries racked up consistently higher average growth rates than did countries with high rates or low thresholds or both.

In the appendix to this paper are plots of the annual changes in top marginal tax rates and thresholds for selected developing countries. Depending on the availability of data, the periods plotted for some countries encompass 1956–85; others include only the years 1963–85, 1974–85, or 1979–85. The ready availability of tax information published by Great Britain's Inland Revenue Department on British commonwealth countries permits 30-year trend lines to be drawn for those countries. The combined commercial reports of Price Waterhouse and Coopers and Lybrand omit tax information for 1975, 1977, 1978, 1980, and 1983. Missing data appear in the trend lines as dots connecting reported observations.

The graphs illustrate three radically different experiences with developing country policy toward the individual income tax. Four countries (Hong Kong, India since 1974, Indonesia, and Singapore) show a commitment to supply-side, low marginal tax rate policies. One (the Philippines) briefly attempted marginal rate reductions with little success. The remaining countries show excessive concern with equity, "soaking the rich," and a general disregard for the adverse effects of eroding incentives due to high tax rates.

The British Crown Colony of Hong Kong is the quintessential neutral, low-tax, supply-side revenue system (Rabushka 1976, 1979). Throughout its entire postwar development, public officials emphasized the need for low, stable tax rates and preventing inflation from pushing taxpayers into higher brackets by adjusting, when necessary, the thresholds on which tax rates are applied. Hong Kong's low tax system goes hand-in-hand with budgetary balance, free trade, sound money, and reasonable regulatory requirements.

Singapore also enjoyed high rates of growth for several decades. Shortly after independence, Singapore's leaders stretched the top rate from 30 to 55 percent by 1961 on taxable income exceeding US\$30,000. Because per capita income in Singapore was below US\$1,000, only a handful of the population paid high rates. But Singapore's leaders remained conscious of the disincentive effects that would confront its citizens as growth pushed the middle class into high tax brackets. Accordingly, they raised the threshold for the top rate from US\$30,000 in 1970 to beyond US\$100,000 by 1977. Moreover, in 1979 the government announced a series of rate reductions that slashed the top individual rate to 40 percent in 1985. In 1986, employer contributions to social insurance taxes were also reduced. With per capita income of \$6,800 in 1985, most taxpaying Singaporeans face an effective tax rate (disregarding personal allowances) of 10 percent. Even millionaires get to keep 60 cents of each additional dollar.

The graphs that display changing thresholds in nominal U.S. dollars do not take inflation into account. Between 1967 and 1984, the domestic price level in the United States tripled. If thresholds were expressed in constant dollars, \$10,000 in income in 1967 would represent the same purchasing power as \$30,000 in 1984. A falling threshold trend line expressed in nominal or current dollars thus grossly understates the true extent of bracket creep. It would be necessary to triple thresholds between 1967 and 1984 to reflect changes in the price level. A modest upward trend line may not fully offset the effect of inflation on purchasing power.

Take the case of India. The first phase of tax policy consisted of increases in the top marginal rate from 73.5 percent to an incredible 97.75 percent in 1973. Through 1969, the government partly offset the effects of higher rates by raising the threshold from approximately \$14,000 to \$33,000. But as tax rates peaked, the threshold was slashed to a mere \$7,500, thus exposing greater numbers of Indians to the top rate. The final phase of income tax policy consisted of maintaining a relatively constant threshold in nominal terms (thus falling in real terms), while systematically reducing the top marginal rate of tax. A

declining threshold offset some beneficial effects of lowering the top rate. With Rajiv Gandhi's ascent to power, India successfully installed supply-side tax-rate reductions, and the Bombay stock exchange boomed through 1985 and early 1986.

Since 1979, Indonesia undertook a concerted effort to inject incentives into its economy, minimize tax avoidance and evasion, and reduce dependence on oil receipts in the face of declining oil prices. Indonesia reduced its top marginal rate from 50 to 35 percent and raised the threshold from US\$15,000 to US\$50,000. Receipts from the income tax rose in 1985, both in absolute terms and as a share of total revenue. Cutting tax rates and increasing thresholds had a positive effect on revenue collected from the income tax, and economic growth was a healthy 4.5 percent in 1984. These results were especially important to Indonesian planners during the oil price decline in 1986.

The Importance of Threshold

The Philippines illustrates wild swings in fiscal policy. During the early 1970s, a top marginal rate of 55 percent applied to taxable incomes exceeding US\$90,000. By 1979, the government raised the top rate to a prohibitive 70 percent and at the same time cut the threshold to \$60,000. Recognizing that these trend lines were counterproductive of efficiency and revenue, fiscal authorities cut the top rate to 35 percent in 1982. Any efficiency gains that might have ensued were suppressed by the international recession that affected the Philippines and its trading partners. In addition, a portion of the supply-side gains was dissipated by the sharp decline in the threshold. By 1985, the worst of both trends materialized: the top marginal rate stood at 60 percent and the threshold fell to \$25,000.

Anti-Growth Tax Systems

The socialist revolution in Portugal was accompanied by a dramatic transformation of the individual income tax system. The new rulers raised the top marginal tax rate of 45 percent in 1969 to 90 percent by 1976; they rolled it back slightly to the mid-1970s by 1984. In addition, they reduced the threshold from over \$100,000 in 1969 to \$20,000 in 1979. The middle classes faced confiscatory rates of personal taxation on modest levels of taxable income.

Four countries in the Western Hemisphere have the same pattern: Brazil, Chile, Jamaica, and St. Vincent. The top marginal tax rate in Brazil rose from 50 to 60 percent at the same time that its threshold declined by nearly two-thirds, from \$76,000 to \$28,000. Chilean

authorities lowered their statutory top rate from 70 to 55 percent, but domestic inflation and currency depreciation eroded the applicable threshold from a high exceeding \$100,000 in 1975 to a meager \$3,000 by 1984. The entire economically active population faced the top marginal tax rate—a flat tax of 55 percent—on almost all taxable income.

Through virtually its entire post-independence era, Jamaicans faced a top, stiff tax rate of 75 percent, ranging as high as 80 to as low as 57.5 percent since 1981. As the lower rates came into effect during the 1980s, the threshold collapsed from a comfortable \$20,000, which excluded the overwhelming majority of the population, to a low of \$2,800. Small wonder that Jamaica exports talented people. Any skilled or successful individual faced an effective flat-rate tax of 57.5 percent on all taxable earnings beyond the first \$2,800. Jamaica recently announced changes in its tax system that sharply lower marginal tax rates.

The final example in the Western Hemisphere, the Caribbean island of St. Vincent, recorded a paltry annual average growth rate in per capita income of below 1 percent since 1960. Although the country's leaders reduced the top rate from 65 to 55 percent in 1981, they let the threshold slip from \$8,700 to \$3,700, thus providing an incentive for talented people to migrate.

African countries especially demonstrate the twin effects of rising rates and declining thresholds; the continent also turned in the poorest record of economic growth among developing countries. Almost every negative growth country is located in sub-Saharan Africa; the most distressed are Ghana, the Sudan, Uganda, Zaire, and Zambia. Other disappointments include Kenya and Malawi (with growth rates of under 3 percent), and Tanzania (below 2 percent). These figures do not compare favorably with annual average increases in per capita income of 7 percent in Hong Kong, Taiwan, Korea, and Singapore.

By now the story is straightforward. Inflation pushed the entire Ghanaian nation into the top 60 percent bracket on incomes exceeding \$450; Sudanese pay a top rate of 70 percent at a threshold that declined from \$30,000 to \$10,000; Ugandan taxpayers confront marginal rates of 70 percent on taxable incomes exceeding \$4,000; in Zaire, the threshold collapsed from over \$50,000 to a rock bottom \$2,000 in 1984; and in Zambia, the government steadily increased the top rate from about 50 percent in the early 1960s to 80 percent.

Kenya, Malawi, and Pakistan enjoyed higher growth than the preceding five nations. Although Kenya sustains a 65 percent top rate, until 1984 the threshold remained well above \$20,000, thus exempting all but the upper middle classes. Between 1970 and 1980, Malawi

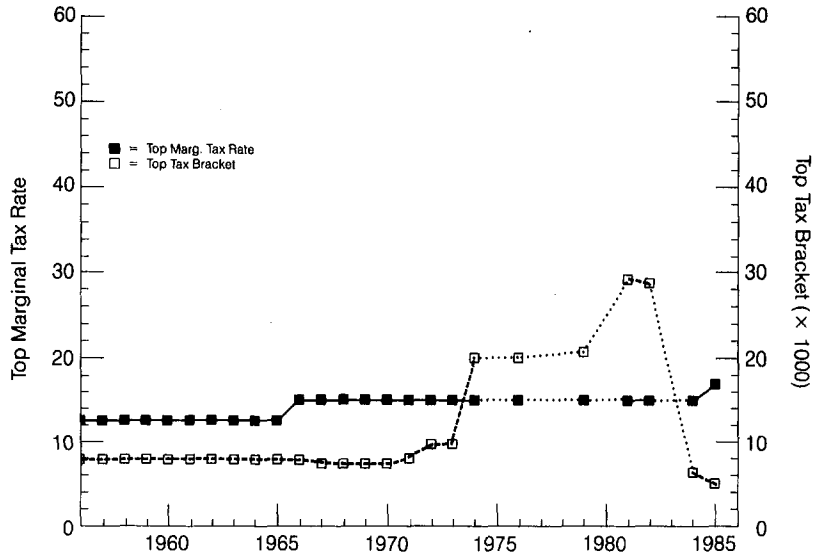
enjoyed a relatively low-tax regime by African standards, hovering in the 40 percent range. Malawi's slower progress since 1980 may be attributed partly to its rising top rate and declining threshold, which has now fallen below \$10,000. Pakistan illustrates the hazards of failing to adjust thresholds to offset inflation and changes in exchange rates. The effective marginal tax rate faced by successful Pakistanis has sharply increased since 1979, as the threshold declined from nearly \$40,000 to under \$10,000. Finally, Tanzania is a preposterous case, with a top marginal rate of 95 percent coupled with a rapidly shrinking threshold.

The majority of poorly performing developing countries reveals the same pattern of high and often rising tax rates applied to lower and lower thresholds of income. It is no accident that individual income taxes contribute small proportions of revenue in many of these countries. High tax rates have frustrated the efficient use of labor and capital and have discouraged entrepreneurship, thus holding down growth. As Hong Kong's expatriate rulers have always maintained—and as the Indonesians and Indians have recently discovered—low tax rates applied to high thresholds stimulate growth and provide growing revenue.

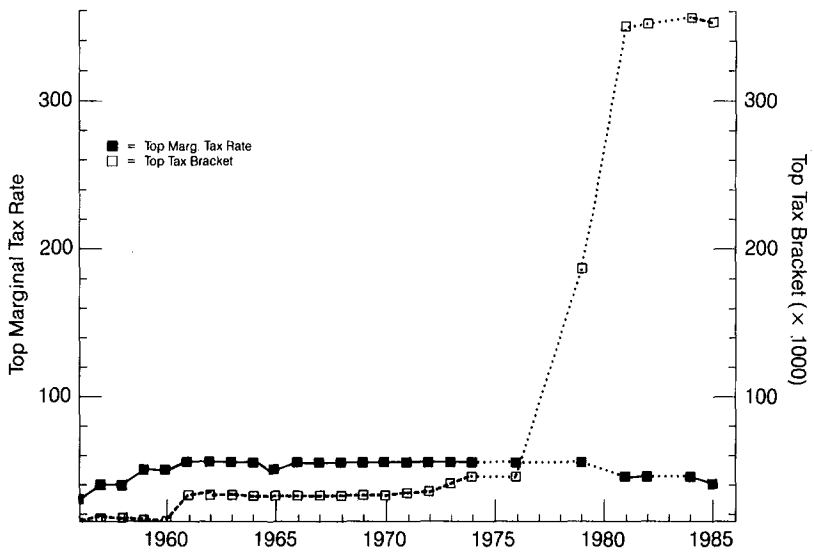
Appendix: Annual Changes in Top Marginal Tax Rates and Thresholds for Selected LDCs

The graphs that follow display annual changes in top marginal tax rates and thresholds for selected developing countries from the late 1950s through 1985. Solid lines and bold dashes connect annual observations, and dotted lines connect observations where one or more years are missing in between. As the text indicates, the high growth countries are characterized by low top marginal tax rates or high thresholds, while low growth countries suffer both high rates and low thresholds.

APPENDIX FIGURE 1
INCOME TAX POLICIES: HONG KONG

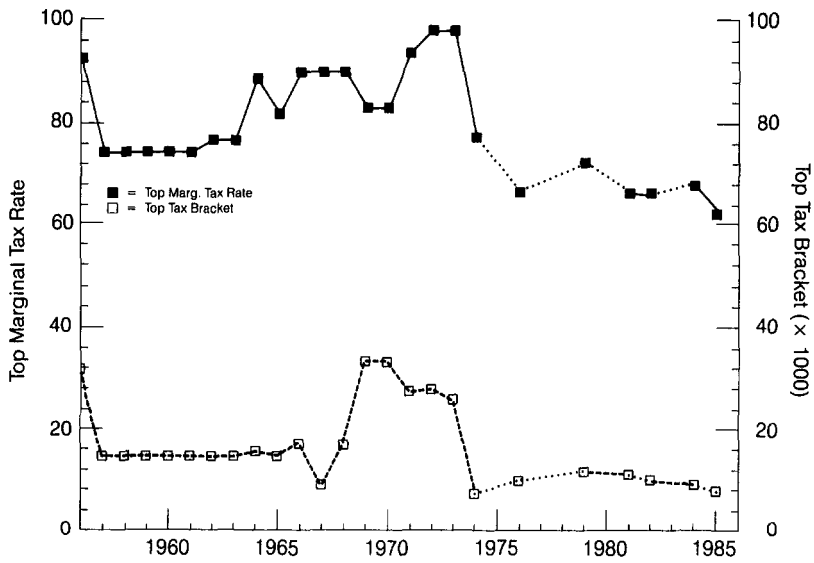


APPENDIX FIGURE 2
INCOME TAX POLICIES: SINGAPORE

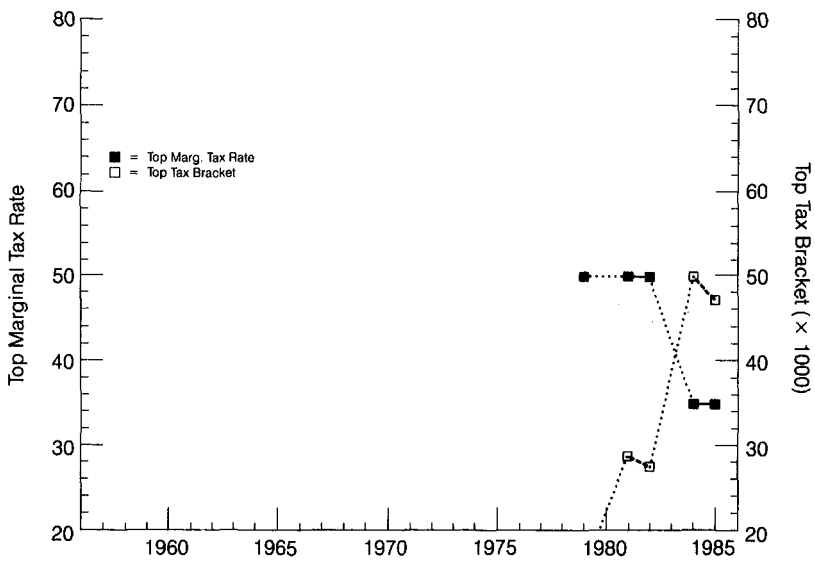


TAXATION, GROWTH, AND LIBERTY

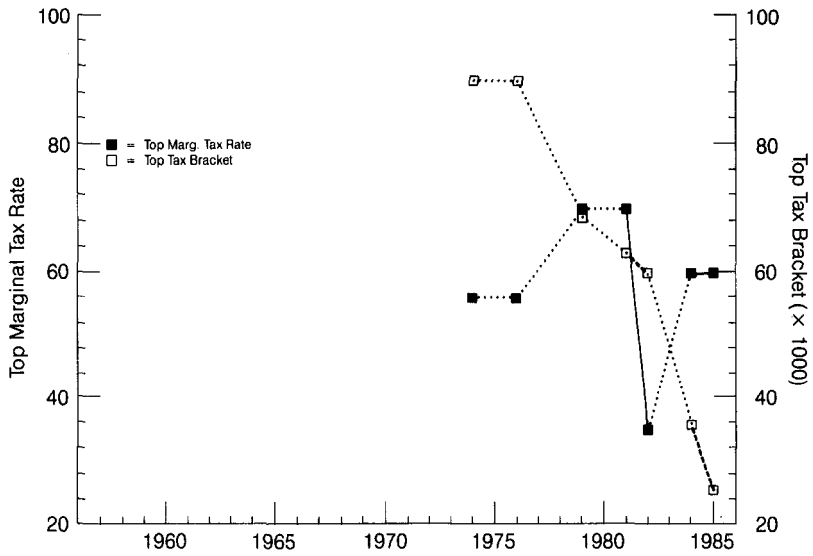
APPENDIX FIGURE 3 INCOME TAX POLICIES: INDIA



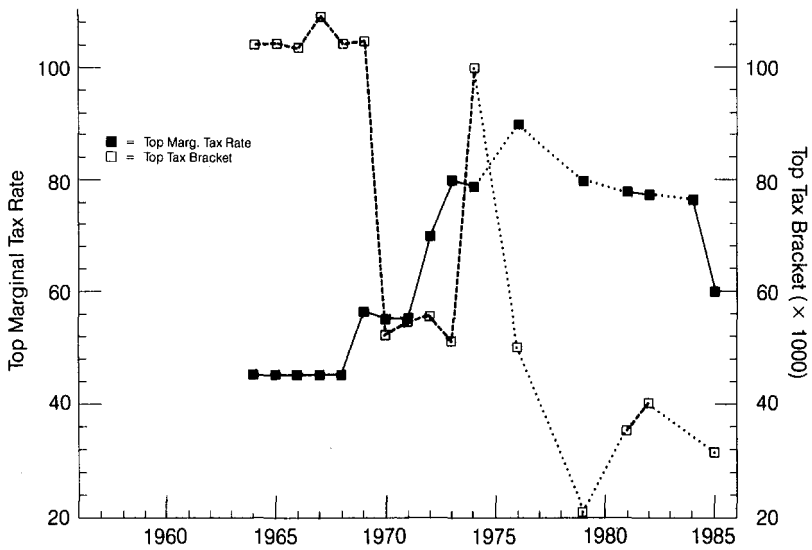
APPENDIX FIGURE 4 INCOME TAX POLICIES: INDONESIA



APPENDIX FIGURE 5
INCOME TAX POLICIES: PHILIPPINES

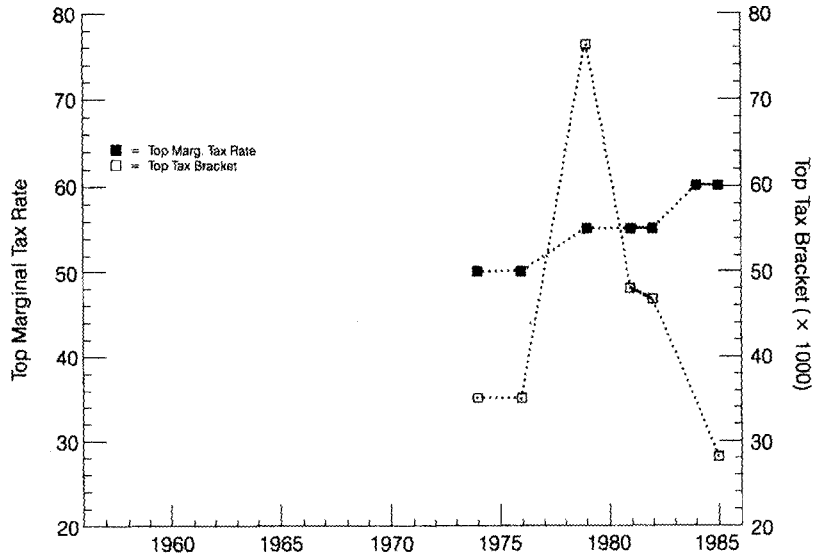


APPENDIX FIGURE 6
INCOME TAX POLICIES: PORTUGAL

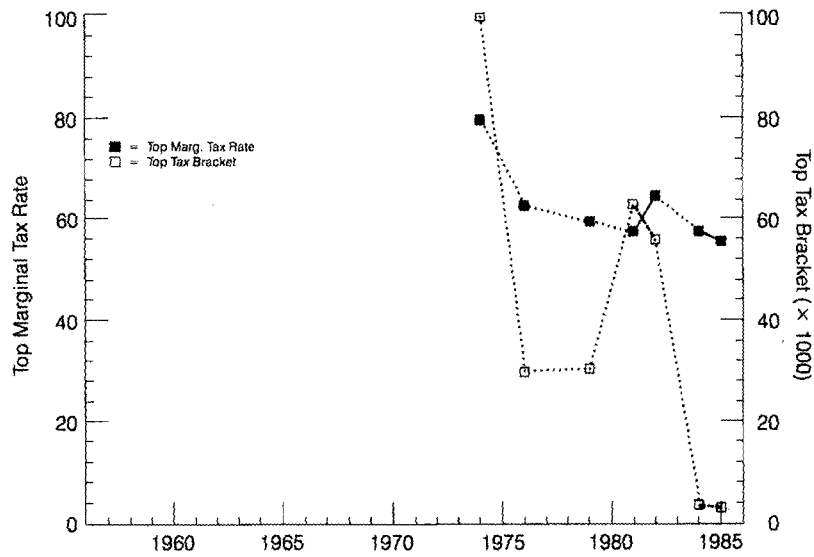


TAXATION, GROWTH, AND LIBERTY

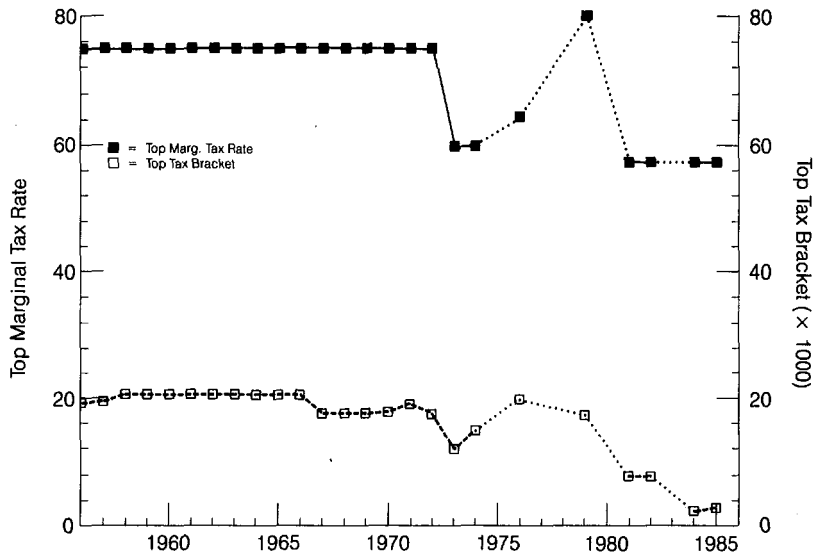
APPENDIX FIGURE 7
INCOME TAX POLICIES: BRAZIL



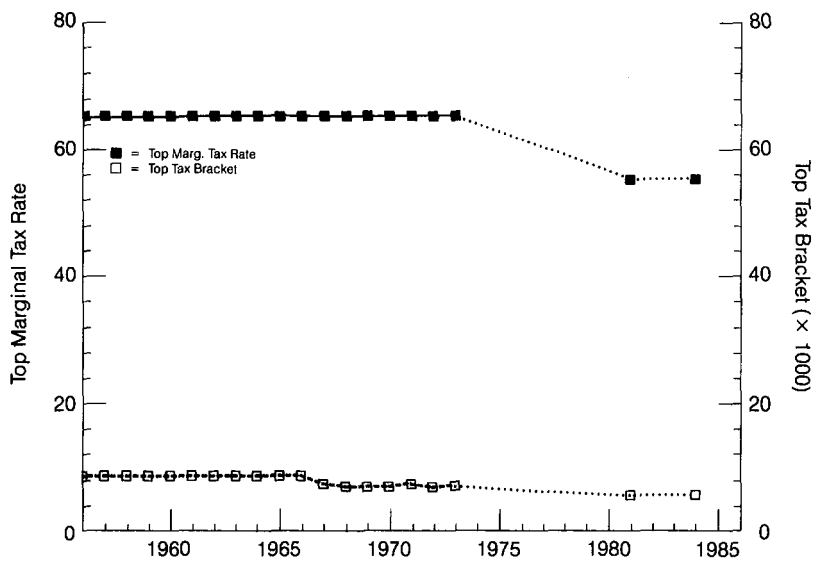
APPENDIX FIGURE 8
INCOME TAX POLICIES: CHILE



APPENDIX FIGURE 9
INCOME TAX POLICIES: JAMAICA

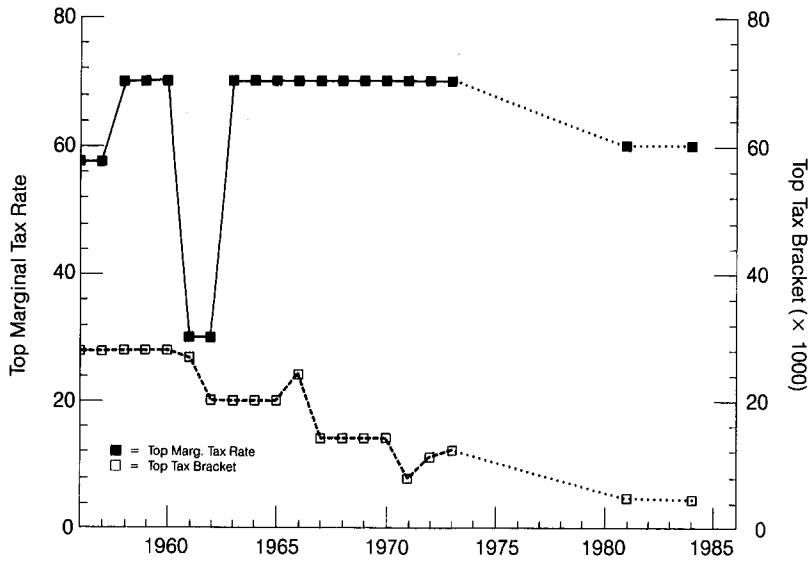


APPENDIX FIGURE 10
INCOME TAX POLICIES: ST. VINCENT

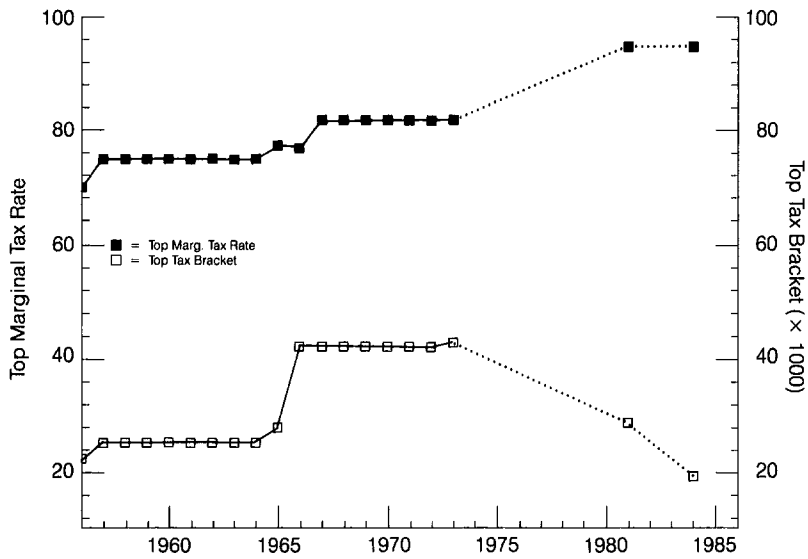


TAXATION, GROWTH, AND LIBERTY

APPENDIX FIGURE 11 INCOME TAX POLICIES: GHANA



APPENDIX FIGURE 12 INCOME TAX POLICIES: TANZANIA



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THE REAPPRAISAL OF DEVELOPMENT STRATEGIES

Keith Marsden

Before commenting on Alvin Rabushka's (1987) stimulating paper, I would like to reminisce briefly about Lord Bauer. Thirty-three years ago I had the good fortune to be supervised for several months by Peter Bauer while I was reading economics at Caius College, Cambridge. Peter was then, and still is, a fellow of Caius. I regret that I did not absorb as much of his wisdom as I should have. Moreover—and probably as a consequence—the quality of my essays did not impress him. But one day my photograph appeared in the *London Times* following the Oxford–Cambridge track meet, which was considered a significant sporting event in England in those days. At the next supervision, he congratulated me and added, somewhat wistfully, “The only time an economist gets his photograph in the *Times* is when he appears in the obituary columns.” I am delighted to say this is one of the few prognoses of Peter's that has proved wrong. His stamina, persistence, and integrity in presenting unfashionable ideas have been remarkable. Their fundamental truth has increasingly become recognized in recent years, and he has been deservedly honored with a peerage and even won grudging respect from the most ardent interventionists. We all hope that we will be seeing his photograph, and reading his articles, in the *Times* and elsewhere, for many more years.

Alvin Rabushka's paper makes some important contributions to the reappraisal of development strategies. After burrowing assiduously into not very accessible data, he has come up with convincing evidence that high marginal tax rates create serious disincentives to savings, investment, entrepreneurship, and the application of skills

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in countries at widely different stages of development. Their economic performance has been adversely affected as a result. Rabushka has brought out the significance of the income threshold at which top tax rates are applied. He has shown how the combined effects of domestic inflation and exchange rate depreciation have lowered those thresholds, and so influenced the behavior of a large proportion of their populations. He has made very innovative use of data on political freedoms, civil rights, and democratic institutions to question the insidious notion (which many of us have been trying to resist) that the most successful developing countries are those that combine authoritarian political systems with promotion of the private sector and market-oriented economic policies.

Rabushka also has reminded us that, in the field of taxation, as in many other areas of development policy, Peter Bauer's prescience has been striking. As early as 1957, Lord Bauer warned that higher taxation of the monetized sector would retard the spread of an exchange economy and impede long-term growth; that compulsory savings through taxation might not increase total saving; that restricting private saving would dampen the supply of entrepreneurs; and that use of public savings to expand public undertakings would lead to inefficient resource utilization.

Why were Lord Bauer's warnings rejected or ignored for so long? There are many reasons, but I would stress four. First, when many former colonies in Africa, Asia and the Caribbean gained their independence during the 1950s and 1960s, the prevailing political ideologies around the world stressed the role of government in managing the development process. Government was supposed to be benevolent and omniscient, and resources could be allocated more efficiently by central planning than by haphazard market mechanisms, it was believed. Market failures and distortions should be corrected by regulations and administrative controls. The strategic "commanding heights" of the economy must be owned by the state on behalf of the people and not exploited for capitalist greed.

It took several years for these countries to learn from their own experience that those who wield excessive political power over resources often exercise it for narrow self-interest, especially if they are not subjected to the checks and balances of a democratic political system. It also took time for such countries to realize that the information and the know-how available to government officials was generally less precise, and more often than not misused, than the information and know-how possessed by market participants themselves (buyers and sellers). Failures of bureaucratic systems turned out to be more pervasive than market failures. Inefficiency and abuses

resulting from state monopolies were more pernicious in their effects on peoples' welfare than entrepreneurs striving for profit in a competitive market.

Second, the leaders of many newly independent Third World countries were convinced that genuine political independence required economic independence. They saw that their economies were dominated by foreign companies and ethnic minorities. They had little faith in the entrepreneurial flair or managerial skills of indigenous people engaged in small-scale artisan and trading activities. Small-scale industry was thought to be a relic of the past and a barrier to the adoption of modern technology and economies of scale. So they believed that large-scale public investment had to take the place of foreign private investment as the driving force of self-reliant development. Only recently has the reality of world economic interdependence become evident to the political leadership of these countries: that poor countries can participate in world trade to their advantage and become stronger and more prosperous as a result; that indigenous entrepreneurship is more prevalent than they thought, and only needs a positive, free environment to flourish and time to gain stature and experience; that foreign investors and commercial partners abroad can provide scarce, complementary resources to generate substantial benefits for the national economy, shared by all parties.

Third, development analysts and technocrats must bear part of the blame. Too many were hypnotized by abstract models that reduced the process of development to the interaction of a few key variables, inevitably those that were most easily quantified. Such intangible factors as entrepreneurship, innovation, risk taking, incentives, participation, drive, commitment, opportunities, consumer preferences, freedom to choose, mobility, and liberty were left out of the equations.

Fourth, during the 1970s the debates in international development forums focused on absolute poverty and basic needs. Growth-promoting strategies were said to leave the poor behind. Trickle-down was not enough. Redistribution of assets and incomes became the answer, it was argued. Given the political stance of the main protagonists, evidence of the success of high-growth market economies against such social welfare indicators as nutritional standards, educational levels, life expectancy, and Gini coefficients for income distribution tended to be ignored. Against this background, it is not surprising that fiscal policy was viewed from a narrow, one-sided perspective for many years. Taxes had to be increased in order to raise government revenue. Higher expenditures on government ser-

vices and public investment were considered indispensable if ambitious social and economic goals were to be achieved.

However, the harsh realities of economic stagnation and decline in Africa, as well as mounting government deficits and public debt in much of Latin America, have begun to raise serious doubts about this strategy in the minds of policymakers and donors of foreign aid. The costs of failed policies are being driven home in the most entrenched political systems. Substantial rethinking of fiscal policy is also going on within the International Monetary Fund, as evidenced by the quotations in Rabushka's paper from Vito Tanzi, director of the fund's fiscal affairs department.

Rabushka's empirical findings, coupled with the cogent analysis of my colleague at the World Bank, Chad Leechor, are contributing significantly to this reappraisal. Reforms of the tax systems are being undertaken in several countries, including Ghana, Zaire, Malaysia, India, and Singapore, to name a few. These reforms are aimed at reducing the disincentive effects of high taxes on private enterprise and personal initiative. They contribute further to the reduction and harmonization of foreign trade taxes, which have been underway for some time in many countries, reflecting a shift from import substitution to outward oriented strategies. These reforms are sometimes accompanied by other measures, such as liberalization of price controls, devaluation of inflated currencies, deregulation of financial markets, and elimination of subsidies to state enterprises. Their aim is to create an environment more conducive to private sector development and open, competitive markets.

There is clearly a long way to go in many countries. But if the initial momentum is maintained, Peter Bauer may need to find other conventional wisdoms to challenge if he is to keep his reputation as the *enfant terrible* of development economics.

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