This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: The Political Economy of Tax Reform, NBER-EASE Volume 1

Volume Author/Editor: Takatoshi Ito and Anne O. Krueger, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38667-8

Volume URL: http://www.nber.org/books/ito_92-2

Conference Date: June 14-16, 1990

Publication Date: January 1992

Chapter Title: Introduction to "The Political Economy of Tax Reform, NBER-EAS
Volume 1"

Chapter Author: Takatoshi Ito, Anne O. Krueger

Chapter URL: http://www.nber.org/chapters/c8510

Chapter pages in book: (p. 1 - 6)

Introduction

Takatoshi Ito and Anne O. Krueger

The rapid emergence of the East Asian region as an important geopolitical-economic entity has been one of the most visible and striking changes in the international economy. In that new role East Asia raises a number of issues of economic interdependence that call for considerable economic analysis and increased trans-Pacific understanding.

For the world economy as a whole, there were two major themes of the 1980s. A first identifiable trend was growing interdependence among countries, as communications and transportation continued to become quicker and cheaper. The growth in the volume of world trade continues to outpace the growth in world output, as exports and imports account for an increasing share of most countries' GNPs. At the same time domestic firms are increasingly sensitive to events in the world as a whole: changes of 1 or 2 percentage points in costs, which before would have been buffered by transport costs of 20 or 30 percent of factory price, instead have been reflected quickly and entirely through shifts in competitive position.

The second trend, evident in most industrialized countries, was heightened sensitivity to the implications for economic efficiency, living standards, and growth of incentives confronting individual producers. This was reflected in concerns with, inter alia, deregulation, removal of trade barriers, and changes in tax structure, as there was increasing recognition of the importance of the effects of these on productivity and "international competitiveness."

All of these concerns were reflected in the economic policy debates in East Asia and in the United States. Increased interdependence means that each individual's and each firm's competitive position is affected by all of the circumstances. When competitors are perceived to be producers in other countries,

Takatoshi Ito is professor of economics at Hitotsubashi University. Anne O. Krueger is Arts and Sciences Professor of Economics at Duke University. Both are research associates of the National Bureau of Economic Research.

concern focuses not only on what domestic economic policies are, but on how they position the individual relative to those foreign competitors.

Because East Asia has been so successful in economic terms, attention has turned to that region of the world perhaps more than to any other. It seemed natural, therefore, to focus the first NBER–East Asia Seminar on Economics on one such problem of interdependence and to investigate how the different countries addressed it: tax reform.

Because of heightened concerns with incentive effects on the functioning of markets and for other reasons, all of the major countries of East Asia and the United States considered and undertook major tax reform programs during the 1980s. Analysis of these programs is interesting in its own right. In addition, it sheds light on the ways in which interdependence interacts with domestic economic and political concerns in affecting issues as politically vital as tax reform. One of the interesting findings to emerge from the conference was that, in all countries, international considerations had become secondary when domestic political interests were focused on issues of tax structure and reform.

Part I contains two background papers. The first, by Assaf Razin and Efraim Sadka, provides a theoretical basis for considering some of the important issues of interdependence in tax policy. Razin and Sadka consider linkages between systems of taxation and domestic capital formation in open economies. They note that a great deal of attention has been paid to the ways in which exchange rate management and monetary policy are affected by integration of capital markets across countries, but that much less attention has been given to the effects of alternative tax structures in the presence of capital mobility. Investors may decide to invest abroad because of differences in tax structure (or in the enforcement of taxation of foreign source income) when the economic rate of return is higher on domestic investment if the tax structure is inappropriate. Razin and Sadka show how these considerations are likely to affect not only tax structures but also governmental fiscal policies, as countries' capital markets become increasingly integrated.

In the second background paper, Vito Tanzi and Parthasarathi Shome provide a survey of taxation structures in eight East Asian economies, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand, paying attention to similarities and differences among countries as well as to tax reforms. On the basis of their analysis, they conclude that distortions in tax structure become important impediments to growth once macroeconomic stability has been achieved; it is probably preferable to have a distortionary tax that closes the fiscal deficit than to let the deficit persist. Interestingly, countries with macroeconomic instability included those with high and low levels of taxation: fiscal deficits were not necessarily associated with low levels of taxation. Once macroeconomic stability is achieved, Tanzi and Shome conclude that undertaking tax reforms that substitute other revenue sources (such as the value-added tax) for highly distortionary taxes (such

as customs duties and high rates of income taxation) is worthwhile and can contribute significantly to growth.

Part II contains four papers, on Japan, the United States, Korea, and Taiwan. Each paper is designed to provide an analysis of the political-economic interactions that underlay the tax reforms undertaken in that country. Authors were requested to focus on both the economic considerations pertinent to the reforms in their countries, and the political factors that affected the outcome. An interesting observation made at the conference is that domestic political considerations were such an important element that international issues hardly surfaced in any of the four countries when decisions were being made. Of equal interest to conference participants was the extent to which the "political" considerations and behavior that apparently determined outcomes were similar in all four countries.

The Japanese tax reform, analyzed by Masaaki Homma, represents a ten-year struggle to introduce a value-added tax. The first attempt was made by Prime Minister Masayoshi Ohira in 1979. The effort was abandoned when the LDP was defeated in the next general election because of the tax reform issue. Opposition to reform arose both from distributors who believed that they would be forced to absorb the value-added tax and from consumers who believed that distributors would pass it on to them (see also the discussion in Yukio Noguchi's paper on the bases for opposition to the reform). The next attempt at introducing a value-added tax, then called a sales tax, was made by the Nakasone government in 1986 and also failed, again with serious political consequences. The third attempt, this time called a consumption tax, was introduced by the Takeshita government and won approval in 1988. However, the LDP was defeated in the next election. In his paper, Homma traces the history of the tax reform effort and analyzes the differences between the three reform proposals.

The American tax reform, analyzed by Charles McLure, had a very different history. It was believed to be politically impossible to remove a large number of very inefficient exceptions, complications, and special treatments that had been introduced into the American tax code over a long time. In the early 1980s, however, a group of technocrats was encouraged to start developing a tax reform package that would not change overall tax revenue but would simplify the tax structure. The technocrats were enabled to formulate their proposals without public scrutiny; once the proposals were public, the political appeal of simplification turned tax reform from political suicide to political necessity. The ensuing simplification of the tax structure and reduction of the high marginal rate of income tax constituted in fact a very significant tax reform.

In contrast to the Japanese and American tax reforms, which were aimed at major changes in the structure of taxation that would greatly reduce distortions emanating from the tax structure, Taiwan's tax reform represented a much smaller effort. The government introduced a business tax in 1986,

which was presented as improving economic efficiency and social equity of the tax system. In fact, however, Chuan Lin considers the 1986 reform an important building block for the future, as Taiwan continues to have high income tax rates applied to a small base and high commodity taxes on a few items. The Taiwan reforms to date would thus appear to be much more partial than those of Japan and the United States.

Among the four countries, Korean tax reform has progressed least. Although there have been a large number of changes in the tax code and in tax administration during the period of Korea's rapid growth, Taewon Kwack and Kye-Sik Lee show that the tax system remains highly distortionary. In part, the problem is one of tax administration and compliance, as the absence of a "real-name system" in Korea prevents the identification of holdings and thus the tracing of assets and income. However, many of the tax changes to date have focused on the government's efforts to contain real estate speculation through increasing taxes on holdings of land and real estate. Until the time of writing, these taxes had not had their intended effect. Kwack and Lee conclude that more fundamental reform of the tax system, to make it less distortionary, is a task that still remains for the Korean government.

The tax reforms in the four countries (as in the eight surveyed by Tanzi and Shome) thus ranged from far-reaching attempts at simplification and unification of rates to more partial efforts to remedy particular problems. Taiwan and Korea are at earlier stages of their development than are Japan and the United States. Perhaps for that reason, they have still further to go in reforming the tax system. Interestingly, in light of the conference focus on the implications of tax reform for interdependence, it is significant that in none of the four countries did issues of interdependence have any political weight in the consideration of tax reform possibilities. Even in the United States and Japan, domestic political concerns seem to have entirely dominated consideration of the issue.

The final part of the volume contains papers on individual aspects of the linkages between tax structure, economic efficiency, growth, and interdependence. Tatsuo Hatta and Hideki Nishioka evaluate the efficiency effects of changing the effective marginal capital income tax rate by simulating the Nakasone-Takeshita reform. They estimate that the efficiency effect of eliminating the maruyu (exemption of taxation for interest income) was between −0.2 percent and 0.9 percent of consumption wealth; in addition, the maruyu had constituted a major avenue for tax evasion. Tax reform therefore was economically efficient and closed an effective tax loophole. However, taxation of other sources of capital income was not reformed. If the marginal capital income tax rate had been reduced to the average, Hatta and Nishioka estimate that there could have been an efficiency gain of 0.77 and 1.69 percent of consumption wealth without any loss in tax revenue.

Irene Trela and John Whalley analyze the linkages among the Korean tax structure, Korea's outward orientation, and its rate of economic growth. They

show how the tax structure was modified over time to support Korea's growth strategy, shifting away from taxation of exportables and toward other sources of taxation as the growth orientation changed. They also develop a general equilibrium model with which to estimate the contribution of the tax structure to Korea's growth rate. Recognizing that tax structure is only one of many contributors to growth, they nonetheless note that the model does capture the resource reallocation effects of shifting from import substitution to export promotion, and conclude that less than 10 percent of growth, or 1 percentage point of the growth rate, was contributed by the tax structure.

Yukio Noguchi considers the impact on the Japanese need for savings, the aging population structure, and the tax reform. He notes that, despite the political discussion, a major issue that went virtually unnoticed was the need to finance future social security expenditures as the Japanese population ages. Noguchi traces the implications of the aging population for social security expenditures in the coming decades. He shows that tax comparisons with other countries currently indicate that Japanese taxes are low, but that this finding is questionable when the younger age structure of the current Japanese population is taken into account. In the coming decades, the demographic structure of Japan relative to other industrialized countries will change markedly. It is this phenomenon that made a reform of the Japanese tax system essential: in years to come the number of working people relative to the number of pensioners will decline so much that raising adequate revenue through an income tax would require extremely high marginal rates. Noguchi notes that there are also macroeconomic implications of the changing demographic structure, especially on the likely level of national savings and the current account balance, but he does not focus on those in the present paper.

Thomas Barthold and Takatoshi Ito describe and contrast the gift and estate tax systems of the United States and Japan, and calculate the magnitudes of intergenerational transfers induced by the two systems. Among the several differences between the two systems, the chief are that (1) the American tax is based on the estate, while the Japanese tax is based on the size of the bequest to each individual; (2) land and real estate is valued at very low rates in Japanese bequests relative to its true value, whereas there is no such bias in American taxation; and (3) spouses are entitled to receive an estate tax-free in the United States, whereas only half of the relatively large estate in Japan may be given to a spouse tax-free. Barthold and Ito show that three-quarters of Japanese taxable bequests consist of real estate, whereas only one-quarter of the value of American taxable bequests consists of real estate.

The implications of tax policy for foreign investment are important in all countries, but are often neglected. In his paper, Kun-Young Yun reviews the taxation of foreign capital in Korea and examines whether the tax system distorted resource allocation. He calculated the effective tax rate for investment financed with foreign capital and concluded that the overall tax burden on foreign investors appeared to be reasonable. Despite this, he regards the tax

treatments provided in the Foreign Capital Inducement Law as being "extremely generous."

For Taiwan, Ching-huei Chang and Peter W. H. Cheng consider the same issue. In Taiwan, tax rates for foreign investors have been about two-thirds of those confronting domestic owners, as the authorities have sought to encourage foreign investment. Chang and Cheng obtained data covering both Taiwanese and foreign-owned firms and attempted to estimate the impact of these special tax incentives on rates of return. They found that, for all manufacturing industries, tax incentives appeared to have no effect on firms' net worth, with the exception of the electronics industry. They conclude that further work needs to be done before their findings can be translated into policy terms, although they note that, as the Taiwanese economy grows, the case against distorting treatment of capital from different sources grows stronger.

Three conclusions emerge from these studies. First, there is a striking similarity in the tension between political considerations and good economics in the formation of tax policy in all the countries covered. The political economy of tax reform is not well understood, and there is much in common across countries. Second, consideration of tax policy in the individual countries has thus far proceeded with little attention to the implications of interdependence for its formulation and administration. There is clearly a lag between the fact of increased interdependence and recognition of it in ways that result in modified policy discussions. Third, although the studies contained in this volume shed considerable light on the structures of taxation and their economic effects in the countries concerned, a great deal of work remains to be done to understand the effects of alternative tax structures on income distribution, resource allocation, and economic growth. We hope that the results reported here will stimulate further work on these issues.