3. TAX POLICY AND TAX REFORM

3.1 INTRODUCTION

The general features of tax policy are as much a neglected area as the definition of tax. Discussing these features is crucial before embarking on our case studies, in order to permit us to distinguish between the particular features of a specific case and features common to many tax systems or that part of a general global trend. Unfortunately, very few studies conducted by political scientists and sociologists pay attention to this issue. For example, such a general feature is that tax policy contains multiple, sometimes competing, goals, ambitions and grounds. Governments use taxes for redistribution purposes, to promote investment, to discourage certain behaviour, to stimulate economic growth, and to improve international trade flows, to name just a few objectives. In other words, there is nothing special to a particular country when tax policy reflects the government’s wish to use taxes as an instrument (effective or not) for political and economic purposes (Steinmo 1993).

Another general feature is that tax is a policy area characterised by the absence of enthusiasts offering to increase their tax burden, although interest groups often propose to increase taxes for somebody else. Protests against increases in taxes are common in every society although the shape and form and intensity of the protests obviously depend on the specific circumstances.

Such general background features are important precisely because they apply to any tax policy-making and not only to one particular case. It would be naïve to seek to ‘explain’ them in a local context. This chapter deals with the main characteristics of tax policy formulation and tax policy before it explores some of the key factors that trigger tax reform. It also pays some detailed attention to tax policy in Southeast Asia (the setting for both case studies), the US (home country of key foreign tax advisers during Indonesia’s 1983 tax reform) and Sweden (the Swedish National Tax Board played a role in parts of the Vietnamese tax reform between 1987 and 1994).

3.2 GENERAL CHARACTERISTICS OF TAX POLICY

Tax policy formulation, generally the primary responsibility of a country’s ministry of finance, involves three steps (Thuronyi and Gordon 1996, p.5):

1. Policy development (often involving economists)
2. Technical analysis (often involving lawyers, accountants and tax administrators)
3. Legislative drafting (involving legislative draftsmen and lawyers)

In some countries, for example Canada, the three groups are combined in one department within the tax policy and legislation branch of the Department of Finance.

(Thuronyi and Gordon 1996, p.5). In most countries these steps will involve experts from different ministries.

The first step is crucial, for it is at this stage that tax policies are shaped. It can make a big difference if the economists involved are employed within the state bureaucracy rather than being external and hired for the particular task of proposing reform options. In the first instance, operating within the government framework, they will generally be aware of the political and practical realities of any proposal. In the second instance, the advice comes from people who can provide independent views about ideals and goals that are often based on widely accepted economic theories, but often turn out to be politically unrealistic once the bureaucracy and the government start to discuss the proposals (Heij 1996; Heij 1997).

As pointed out by Gordon and Thuronyi (1996, p.1), in most member countries of the OECD the tax legislation process\footnote{I use the word process to mean, a set of activities that must be performed to achieve some goal. The activities are usually conceived as a sequence of steps.} has developed into a complex ritual whereby different groups compete to pass through the legislature their vision of an appropriate tax policy. A major bill in a country like the United States involves the input of thousands of professional lobbyists, policy analysts, lawyers, accountants, economists and even ordinary citizens.

Most developing countries have a less complicated process, with far fewer people involved.

Generally, the people involved have a background in economics or finance. The use of jargon is widespread and many with no background in this area will indeed feel that they have no clue as to what is going on. The development of tax reforms often involves a number of experts including (Thuronyi 1996, p.xxix):

- Macroeconomists and public finance specialists, who assist with revenue targeting and cash flow requirements.
- Economists, who project revenues from various tax proposals and advise on the possible economic impact of different taxes.
- Tax administration specialists, who advise on the administrative feasibility of proposed taxes.
- Technical tax specialists, such as lawyers, accountants and economists, who assist with the details of specific types of taxes and their design.
- Legislation drafters.
Obtaining revenue

A principal purpose of most tax laws is to create revenue for the state in order to cover state expenditures (Howlett and Ramesh 2003, p.110). How much revenue is required depends on the level of government expenditures (see below) and other possible revenue sources available to the government. In communist countries the government will largely depend on revenue obtained from state-owned enterprises and in most cases the (explicit) general tax burden on its citizens will be quite low. In countries rich in natural resources, for example various oil-producing countries, the tax burden may also be low since the government will obtain significant funds from selling resources.

Tension between budgetary and instrumental goals

In addition to the task of providing revenue, taxes can also be used as an instrument to allocate resources, stabilise economic activity or reallocate income.

Many neo-liberal economists (who gained popularity in the late 1970s onwards) prefer to stick to the revenue task of taxes (Campbell 2004, p.152). They believe that it is best that a tax system be neutral between economic choices (such as consumption and savings), between economic activities, and between different sections of the economy (Noord and Heady 2001, p.16). It is their belief that interventionist tax policies are more likely to create market failures than to correct them. Many of them believe that there is actually very little role for governments to play in correcting the markets. Some others believe that the government needs to deal with market shortcomings, but in other ways than via the tax system: private sector competition policy, public investment in areas such as education, infrastructure and research, and so forth (see for example, (Noord and Heady 2001, p.16).

In line with this thinking, Owens (head of the Fiscal Affairs of the OECD), developed a set of principles for the design of a tax system (Owens 2006). These include simplification, fairness, removal of tax obstacles to growth, and an efficient tax base. It is important to note that what is fair and efficient is very subjective and can be widely interpreted by national tax policy makers. These principles may mean something very different to a Vietnamese government policy maker (fairness may be viewed as those who have a high income should be subject to high income tax rates) than to Owens. Furthermore, the ‘neutral’ approach favoured by many economists is not always implemented in the real world of policy making, the realization of outwardly similar tax principles often getting lost in the political process, as illustrated in the work of various researchers focusing on OECD countries (Steinmo 1993; Ecleston 1998). Politicians face pressures from all sides and the handing out of tax incentives can be a powerful tool to buy votes or other support (as well described by Kardell (2004).

Although a large group of economists, including Owens, is concerned with the use of tax as a policy instrument because this may cause undesirable distortion in the economy, there are supporters of this approach. The supporters, including Keynesians, neo-Keynesians and institutional economists ((Campbell 2004, p. 152-
154) often on the left of the political spectrum, point to successful examples of using taxation as an active tool in shaping the economic development of a country like Sweden (Steinmo 1993).

During the last twenty years of the 20th century most OECD countries moved away from using tax policy as an instrument of economic management (Swank 1998). Many OECD countries have in this connection lowered tax rates and at the same time reduced government expenditures and incentives. In the 1908s and 1990s, there has been a general trend toward making tax systems more neutral with regard to different types of income and investment (for example interest income versus wages). However, the manner in which such changes have been implemented and the extent to which different countries have adopted these goals varies widely (Steinmo 1993, p.30). When one examines closely the reforms that many countries implemented in the 1980s, it becomes clear that reform often meant redistributing existing tax burdens downwards. The argument of social justice dominant in the 1960s and 1970s had been overtaken by the aim of stimulating economic growth. And part of economic growth is international competitiveness. As Steinmo points out, in the late 20th century most economists accepted that a successful capitalist economy depends not only on a successful capitalist class, but also on that class’s willingness to use and invest its money in the domestic economy (Steinmo 1993, p.158).

Since the turn of the century, we see a slightly different trend with various types of income and investment receiving sometimes different tax treatment depending on their international mobility (Asher 2005).

The desire to increase international competitiveness means that tax incentives continue to be popular among tax policy-makers and tax administrators particularly in Asia. For example, tax holidays are still often found in many countries. Academic and expert opinion on fiscal incentives differs quite markedly from the actual behaviour of the policy-makers and tax administrators. Tax policy-makers tend to favour the use of fiscal incentives while academic and expert opinion on the other hand assigns them at best an extremely limited role. Experts warn that the apparent effectiveness of fiscal incentives is actually dependent on non-tax factors in a country, rather than depending on the tax incentives’ characteristics (Tanzi 1992, p.58).

In addition, many experts believe that it is better to focus on the capacity to sustain growth rather than focusing on incentives per se. This was in line with international

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19 In my professional experience as international tax adviser, businesses may say publicly that the level of tax plays a major role in their business decisions, but in reality it plays a far less important role. As most business people act in a very pragmatic way, they will try to get as much tax reduction as possible and play this argument as often as they can (Heij, G. and T. Stromback (1997). Australian Service Companies in Indonesia: Learning from Experience. Murdoch, Asia Research Centre, Murdoch University.).

20 There are several problems associated with the use of tax holidays. One could argue that they are actually useless because in the first years of operation most companies would not make any taxable profits anyway. And secondly, they can give rise to tax fraud as a company may set up a new company to conduct similar activities once the tax holiday period is over.

21 Transparency of the formal and informal fiscal incentives’ regimes has been rather low in Southeast Asia. Except in Singapore, there has been a noticeable lack of post-incentive evaluation of performance of firms granted formal fiscal incentives (Asher, M. G., Ed. (1992). Fiscal Incentives and Economic Management in Indonesia, Malaysia and Singapore. Singapore, Asian-Pacific Tax and Investment Research Centre.).

22 The symbolic aspect can be important in the use of tax policies. Use of tax incentives to introduce a new activity or advanced technology into a country when there is negligible presence of existing firms may have
thinking in the 1970s in the US. For example, foreign adviser Lou Wells (involved in the 1980 Indonesian tax reform) recommended in a 1981 memo\textsuperscript{23} that “the existence of tax incentives to offshore plants” was not very effective.

In another memo in the same period he argued that the role of tax incentives in influencing investor decision-making is likely to be quite small.\textsuperscript{24} If tax incentives are used, he argued, they should be easily advertisable and simple. Another foreign advisor to the Indonesian Government at that time, Bob Conrad, supported this view. He pointed out that tax incentives might be of very limited value in inducing firms to go public.\textsuperscript{25}

With the possible exception of Thailand, all Southeast Asian countries have had an active fiscal policy of tax incentives to help attain economic and social objectives. (Asher and Heij 1999, pp 25-34) Government policy has focussed not just on particular tax incentives but has also included equity participation by government-linked entities, public funding for requisite manpower training, provision of land at concessional rates etc. Southeast Asian countries have operated on the assumption that in a globalised world those able to attract a particular activity or a plant to their country will be in a better position to grow. Thus, it is the insecurities of globalisation that have been driving formal tax incentives in these countries.\textsuperscript{26}

At the same time, formal tax incentives are only a part of the overall picture. Negotiation of informal tax incentives with particular tax officials is not uncommon in some Southeast Asian countries.\textsuperscript{27} So even though formal tax incentives may not be available, taxpayers may still enjoy significant tax benefits. As with formal incentives, informal incentives are likely disproportionately to benefit large companies, both domestic and foreign.

Another source of tension between budgetary and instrumental goals derives from the political ideal of ‘equity’. The belief that a tax system should be equitable (both horizontally and vertically) makes tax systems very complicated because equity as a goal brings with it exceptions, exemptions, deductions etc. A good example of such a system is the US, which is very equity-oriented.\textsuperscript{28} US tax policy-makers have created a very complicated tax system that avoids high revenue regressive taxes (like a value-added tax), traditionally has highly progressive tax rates, and has thousands of exemptions, deductions, write-offs and special rates designed among other things to accommodate taxpayers’ varying ability to pay (Steinmo 1993, p.34). In summary,

\begin{itemize}
\item Internal memo from Wells to Gillis and Williamson regarding tax incentives dated 24-7-1981.
\item Internal memo from Wells to Gillis and Williamson dated 28-7-1981.
\item Internal memo from Conrad to Gillis and Williamson dated 20-8-1981.
\item This strongly suggests that prospects for co-operation in the area of fiscal incentives have become even dimmer than before the financial crisis in Asia in the late 1990s. Thus, any harmonisation of fiscal incentives or of tax treatment of foreign investment is not likely. In addition, foreign investors do not envisage benefit to them of greater co-operation among the Southeast Asian countries in this area. Indeed, they may increase their pressures on local governments to provide more tax incentives.\textsuperscript{26}
\item Lax enforcement, even when it is not politically motivated, has often acted as an arbitrary and capricious form of tax incentive. On the other hand, in some cases, benefits conferred by fiscal incentives on a firm may be negated by irregular and unofficial levies, often at local levels.\textsuperscript{27}
\item This is not to say that the American system is actually more equitable than other systems. There is no evidence for that. The main result has been a complex and low revenue yield tax system.\textsuperscript{28}
\end{itemize}
the American system is the opposite of the simplicity and transparency most economists strive for when designing an ideal tax system.

In contrast with what many would expect, the US income tax system has traditionally been more progressive than the Swedish or the English system. Capital income (interest and dividends) in the US has been more heavily taxed than earned income. This is in sharp contrast with Sweden of the 1970s and early 1980s, where income in the form of dividends and interest was so heavily supported that the government would actually have gained revenue if all taxation on capital had been abolished. The Swedish system was designed to encourage the use of capital because this is supposed to contribute to growth and jobs. The tax system provides very attractive incentives to those who place their wealth and income back into the economy’s active working capital stock rather than consuming it (Steinmo 1993, p.37-44). The Swedish tax system relies heavily on the high revenue yield of a broad tax base. Far from being progressive, the system taxes earned income of ordinary workers heavily both directly and through its high indirect taxes. The drastic Swedish tax reforms of the 1980s changed this only to some extent. By 1990 the income and corporate tax system had been simplified, their base broadened and their rates reduced. Tax incentives for capital income were scaled back and the heavy reliance on income tax decreased as indirect taxes increased.

In Southeast Asia, tax revenue traditionally relied heavily on indirect taxes, mainly trade taxes such as import and export duties, and in that sense the historical developments have been different from those in many Western countries (Asher and Booth 1983, p. 4). For example, over the period 1970–76 the ASEAN countries of Indonesia, Malaysia, Philippines and Thailand received the majority of their tax revenue (excluding oil and gas) from indirect taxes such as sales tax, excise tax, import and export duties (Asher and Booth 1983, p.3). Personal and corporate income tax formed a small part of overall revenue and although the nominal rates were over 50% in some cases, many incentives were available to reduce the tax burden for those subject to these taxes. The debate on the political ideal of ‘equity’ was not a priority for fiscal policy-makers in ASEAN (except Singapore) in the 1970s and early 1980s.

3.3 FACTORS INITIATING AND INFLUENCING TAX REFORM

Various factors give rise to changes in tax systems (Tilly 1975; Campbell 1993). Geopolitical conflicts, fiscal crises as well as economic conditions create pressure on those in power to increase tax revenue or to change the existing tax system to shift the burden.

**Taxation, state-formation and warfare**

The need for funds to finance wars is an important element in understanding the historical development of many tax systems. An excellent analysis of this phenomenon is given in *The Formation of National States in Western Europe* edited by Charles Tilly (1975). In their contribution to this standard work, Ardant and Braun

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29 In a 1982 OECD study, taxes were found to be least progressive in Sweden (Steinmo, S. (1993). *Taxation and Democracy: Swedish, British, and American Approaches to Financing the Modern State*. New Haven and London, Yale University Press.).
demonstrate the important role tax systems play in shaping the formation of national states (Ardant 1975) (Braun 1975). Ardant shows that building up armies and conducting wars were the main force behind increases or changes in domestic tax systems and tax burdens in the course of European state-making. At the same time, the most serious conflicts between European rulers involved disputes over exemptions from taxation, while in the early periods of state-building the most important motivation to expand and reorganise officialdom was in order to collect taxes from an unwilling population.

One could argue that all this is no longer relevant in the modern world. But in fact defence budgets still form a large part of government expenditures for many countries. For example, the limited expenses on defence after the Second World War undoubtedly influenced the Japanese tax system. In 1982 Japan spent only 5% of its total government expenditure on defence, comparable to Hong Kong with 4%. This is in sharp contrast with countries like Thailand (20%), Indonesia (14%) and Singapore (23%) (Urrutia, Ichimura et al. 1989, p.20). It is no coincidence that Japan and Hong Kong have been among the few countries in the Asian region that escaped a value-added tax, a revenue-spinning tax for many other countries.

**Economic conditions**

In some cases, the overall tax burden as a percentage of GDP has changed in conjunction with economic prosperity. This can be explained as a result of a Keynesian approach to economic policy, whereby stimulation of consumer demand is seen as an appropriate response to economic down-turn, and vice versa. For example, Japan introduced significant tax cuts in 1997 and 1998 to cope with its recession. It was expected that a decrease in the tax burden would stimulate domestic spending and it was hoped that this in turn would stimulate economic activity. The Bush administration adopted a similar strategy in 2001–02 to prevent the economy from entering recession.

The role of internationally mobile capital is a factor to be considered in tax policy. But opinions are divided, according to Steinmo (1993). Redistributive tax policies are difficult to maintain when capital can cross borders easily and Freeman (Swank 1998) argues that the free flow of capital has intensified the tax avoidance measures of multinationals and diminished the power of governments to finance public services. Others believe that capital mobility has undermined the power of labour unions and social democratic parties in their struggles for redistributive tax policies (Steinmo 1993). Most economists argue that although tax is only one consideration for capital investors, potential tax liability can be a disincentive to investment and many presume that at the end of the day, capital will flow to those countries with the lowest tax burden (Swank 1998; Noord and Heady 2001).

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30 No precise figures are available for Vietnam. Defence expenditures were subject to secrecy during the 1980s.
31 Hong Kong is considering such a tax, though, to fund its greying population.
33 The small and inconclusive amount of work on the effects of international capital mobility on domestic tax systems focuses on OECD countries rather than developing countries. Nevertheless, it offers some valuable insights into some of the general characteristics of tax policy.
One of the most interesting studies in this area is by Swank (1998). He argues that the domestic context of a particular country plays an important role in determining the influence of international capital mobility on the relevant corporate tax levels. He mentions a number of factors that are important in this context (1998, p.677). To begin with, non-tax factors including a nation’s domestic markets, skilled labour and related human capital investment, political stability and low levels of labour unrest are of importance to capital investors. Swank points out that even if policy-makers advocate a diminishing role of the welfare state (i.e. during the Thatcher and Reagan administrations), the impact is often limited due to adverse political costs and a myriad of institutional impediments. Domestic economic dynamics and structures also need to be considered. Swank refers to the work of Wallerstein and Przeworski (Swank 1998, pp.671-92) who argue that when extensive investment credits are available, it is irrelevant what the actual tax rate is for uninvested profits, regardless of the possible mobility of capital. Finally, the role of mobile capital may differ according to the sectoral and product diversification of domestic capital and the extent of international focus of the domestic economy.

The same does not apply for trade openness (Steinmo 1993; Swank 1998). Although rather weak, there is a relationship between corporate tax rates and the openness of a country’s trade: the overall business tax burden decreases slightly under international trade openness. Countries with an internationally dependent economy tend to adopt a policy of low corporate tax rates with few tax incentives. If the corporate tax rate is too high, profits will be transferred out of the country via transfer-pricing methods.34

The result is that the overall corporate tax burden has not been reduced as a result of an increase in capital investment flows (Campbell 2004, p.143). Campbell actually compared the tax regimes for 17 OECD countries between 1990 and 1998 and concluded that there was very little change. Those taxes most likely to be affected by globalisation (capital gains tax, corporate income tax, and individual income tax) did not change significantly (Campbell 2004, p.143). Earlier in 1993, Steinmo concluded the same, although some lower corporate tax rates have been offset by the abolition of specific corporate tax incentives such as investment-related allowances, credit and exemptions, resulting in an unchanged tax burden for the corporate sector (Steinmo 1993). A related factor is the clear shift in many OECD countries from market-regulating to market-conforming policies (Boskin and Mclure, 1988). Once this shift had been accepted as the appropriate policy to stimulate domestic and foreign investment, the policy of specific tax incentives is seen as an inefficient allocation of investment, prone to tax avoidance and a form of lost revenue (Swank 1998, p.691).

**Fiscal crisis**

In many countries tax levels are raised when revenue falls short. The case study on Indonesian tax reform (see chapter 5) clearly illustrates that over-dependence on oil

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34 Transfer pricing can be described thus: “A transfer price is the price charged by a company for goods, services or intangible property to a subsidiary or other related company. Since these prices are not negotiated in a free, open market they may deviate from prices agreed upon by non-related trading partners in comparable transactions under the same circumstances (...) Abusive transfer pricing occurs when income and expenses are improperly allocated for the purpose of reducing taxable income. The manipulation of transfer prices by multinational enterprises has attracted the attention of tax authorities worldwide” (International Bureau of Fiscal Documentation (1996). *International Tax Glossary*, International Bureau of Fiscal Documentation.).
revenue, creating a risk of a future fiscal crisis, forced the Indonesian government to reform its tax system. The tax history of most Asian countries illustrates that reform is often a response to a fiscal crisis (as seen in the late 1990s).

3.4 THE LIMITS OF TAX REFORM

Tax laws do not escape the limitations of law as a tool for change (Allott 1980). Several studies have been published regarding the successes and failures of tax reforms in developing countries where foreign advisers and the use of foreign tax laws as models have been important.

One well-known case is the tax reform in Colombia in the 1960s, under the guidance of the Canadian professor Bird. At the start of his task, Bird was rather optimistic: "My principal thesis is that tax policy in a developing country ought to be considered as an essential instrument of development policy" (Bird 1970, p.xi). However, after completing his task Bird came to the conclusion that: "The prospects of substantial tax reform can be no more than a reflection of those for real change in the political and social balance" (Bird 1970, p.197). His findings are confirmed by Diaz who headed the tax reform team in Mexico in the period 1978–82. His judgement was, "It must be emphasised that we should not expect too much. The highest aspiration of a tax system is the modest goal of not interfering too much in allocation while exacting a fair contribution from all members of society," (Diaz 1987, p.356).

In conclusion, in most countries the key objective of tax policy is to fill the state coffer. And this objective is often the reason for tax reform. If other sources of government revenue are declining or under threat, the need for tax reform increases. But despite the objections of many economists, most governments will use taxes as an instrument for non-revenue purposes to serve their social and economic policies. These instruments may be in the form of tax incentives, subsidies etc. Over the last two decades, tax incentives have lost their popularity in many OECD countries where governments have favoured overall lower tax rates rather than specific incentives. In Southeast Asia there continues to be a tendency to use tax incentives particularly to promote private investment (both domestic and foreign). Tax revenues in OECD countries rely on a mix of income taxes on both individuals and corporate entities and indirect taxes, particularly various forms of consumption taxes. Indirect taxes, the oldest sources of government revenue, are those tax imposed on goods, transactions or events. They may include sales tax, a value added tax, excise duties, stamp duty, services, and registration duties. In Southeast Asia there has been a heavy reliance on indirect taxes, particularly on trade taxes. However, in recent times there has been a move away from such dependency and tax revenue increasingly comes from income tax and some forms of consumption taxes.

In most countries, tax policies often are initially developed by experts; however, political realities can prevent the adoption of the proposed policies. The final product is often very different from the initial draft. Each country has its own policy processes and in many cases thousands of people are involved. Governments are often lead by electoral considerations in their tax policies, for example in the US with its traditional focus on equity, which has resulted in a very complex tax system. In most developing
countries these processes may be less complex and there is less emphasis on equity. And as we will see in the following chapters, although the electoral process may be not as important in non-democratic countries in the Asian region, that does not mean that governments are not sensitive to their citizens' needs. They need a support base to stay in power and this is a very powerful factor in tax reform processes.

Like most legal reforms both in developing and developed countries, one should have modest expectations regarding the expected outcome of such reforms. Moreover, in developing countries, governments are faced with additional barriers such as inadequate administrative capacity and lack of resources to implement legislation.

These reflections lead us to the next chapter: what model can we use to capture the above complexity of tax reform with so many factors and actors involved?