Progressive Taxation
in Underdeveloped Countries

1. It may be affirmed that the whole of the financial literature of the nineteenth century was concerned to stress the negative economic effects of progressive taxes. And those who took the opposite view on taxation based their case on grounds of equity or on certain economic principles such as diminishing returns. These arguments were countered by reference to the harmful effects of progressive taxes on the incentives to produce, save and invest.

This position which covers, perhaps unconsciously, certain interests of the privileged classes, is still fairly widespread in discussions on what is a sound fiscal policy for the underdeveloped countries. Yet it would seem that, for backward economies, a progressive income tax is imperative for particular reasons which are typical of these economies, just as it is essential in advanced countries (1).

It must be born in mind that in the former countries the index of concentration of income is extremely high. At the apex of the social pyramid, the more affluent classes, which account for an insignificant proportion of the population, are in possession of a very large percentage of the national income or of landed property, which in those countries is the most obvious indication of income, whereas, at the bottom, the vast majority of the population has only a tiny share of income itself. Although complete statistical data are lacking, the numerous pieces of information available, particularly those prepared by the United Nations (2), make it

(1) R. N. Thakurty (Fiscal Policy and Economic Development in India, World Press, Colombo, 1958, p. 13) regards progressive taxation as a prerequisite for the increase of fiscal pressure in a poor country.

possible to affirm, as has been shown by, among others, Marrama in his essay on economic development in backward countries (g), that there is undoubtedly a "more acute maldistribution of income in backward than in advanced countries". The fact that the concentration of income is more marked in underdeveloped countries is a basic consideration in any attempt to deal with the problem of the role that progressive taxation can play in these countries.

2. Thus, side by side with a handful of privileged persons with a high standard of living, there are vast sections of the population who are living in what amounts to destitution, often with just enough to keep body and soul together. The maldistribution of income constitutes a serious obstacle to the economic development of the country. For the poverty and apathy of the population makes it impossible to make efficient use of people in the productive process. If industry is to expand and agriculture is to achieve a certain level of intensive cultivation, the workers must be prepared for this task. They must be trained, specialized and must have progressed from the technical and social point of view. The absence of a working class with these prerequisites leads to a lack of external economies in the labour field, and thus sets a rigid limit to economic progress. What is needed in such circumstances is a policy of income redistribution by the government authorities — a policy designed to lighten the tax burden on the poorest classes to the greatest possible extent and to effect an adequate increase in the basic services from which they will benefit, such as education and hygiene which are usually sadly neglected in countries with a backward economy. These measures would increase the productivity of the economic system and create the prerequisites for the expansion of the economy.

In other words, we may regard as having a positive effect any financial measure which relieves the less well to do classes of taxes, raises expenditure on services enjoyed by them, and makes the richer classes shoulder the cost of these two moves. This policy must


(g) V. Marrama, Saggio sulle tendenze economiche dei paesi arretrati, Economia, Turin, 1953, p. 37.

naturally be qualified by the observation that any progressive tax is bound to constitute a disincentive to produce for those who pay it. For that matter, any fiscal imposition, even if proportionate, can have this result. But, if we consider the economy as a whole, from a macroscopic point of view and not only from that of the taxpayers affected, it will not be so easy to assert that progressive taxation is definitely a disincentive for the national economy as a whole. To make such a case, it is essential to prove that the discouragement created by progressive taxation in the case of the largest income holders (who pay a higher amount of taxes than they would under a proportional system) outweighs the relief, and hence the encouragement to produce which the smaller income holders receive by paying less in the way of taxes than they would under the proportional system. *A priori*, it is impossible to prove which is greater — the disincentive or the incentive — if we take as our starting point the assumption that fiscal receipts will be equal.

Not only so. Let us drop the hypothesis that the amounts raised by the two kinds of tax are equal, and let us suppose that the State allots the greater part of the proceeds of what is now progressive taxation to the creation of fundamental public services calculated to raise the standard of living, both economic and social, of the poorer classes. We then have to prove that not even the greater productivity (of these classes) which can be attributed to the improvement in their circumstances is sufficient to offset the production disincentive to the wealthier classes, who now have to pay a greater amount in taxes. This proposition is, it must be admitted, extremely debatable.

All the more so as the concentration of income is due to a large extent to inheritance as is shown by the fact that the frequency curve of incomes is not symmetrical. Either, as Tripathy (g) has proved, a substantial part of the largest incomes does not belong to the entrepreneurial class. Hence, this income or wealth is in the hands of people who have no tradition of saving. Or else, it is not used for productive investments but is squandered in non-functional consumption or in unproductive investments. The asymmetry of the curve of income concentration cannot be linked with an asymmetry in the productive capacity of the present generation (g). But, as has been amply demonstrated by, among others, Benini, Gini and Pigou, (g) R. N. Tarrant, Fiscal Policy, op. cit., p. 33.

this capacity depends on the influence of the inheritance factor accentuated by the opportunities of earning higher incomes resulting from the possession of such wealth, quite apart from the productive capacity of the actual income holders. This means in effect that the asymmetry in income distribution depends on the productive capacity or attitudes of past generations. If this contention is accepted, it will be seen that, if the higher incomes are taxed more than proportionately, there is a greater probability of striking harder at undeserved incomes, that is, incomes to some extent independent of an actual productive capacity or relation. It follows that progressive taxes, both on successions and incomes, within the limits at present under consideration, will act as a disincentive to present production only to a very restricted degree.

The fact is that, in general, the influence of progressive taxation on production incentives does not depend as much on the progressive nature of taxes per se as on the marginal rate of taxation, that is, on the increase in tax in relation to the increase in total income. For, if we assume that the rate of a progressive tax increases, for example, from 10 to 12 per cent, the loss in the increased income resulting from the rise in the rate of taxation will be only 14 per cent if the two rates in question are applied respectively to incomes above 100,000 and 200,000 lire, but becomes 52 per cent if the two rates are applied respectively to incomes above 105,000 and 205,000 lire, that is, if the taxes are steeply progressive. It is obvious that, in the second case, the obstacles in the way of increasing production, and hence of obtaining a larger taxable income, will be much more formidable than in the first example. And it is equally obvious that a proportional tax, for example one of 30 per cent, will constitute a greater obstacle to an increase in the taxpayer's activity and income whenever the marginal rate of progressiveness is kept below 30 per cent.

In other words, the problem is not so much to choose between proportionate and progressive taxation as between different types of progressive taxation. If it is desired to reduce to the minimum the negative effects on incentives to produce, it is essential to avoid types of progressive taxation with a high marginal rate of taxation.

3. The redistribution of income to be effected through a highly progressive type of income tax and of death duties does not have the negative effects ascribed to it even as regards the incentives to save and to invest. On the contrary, in an underdeveloped economy such taxation can play a positive part in regard to these two fundamental development factors as well.

Everyone who has concerned himself with the economic problems of the depressed areas, however superficially, will remember the vicious circle that afflicts such countries — low national per capita income, hence a modest volume of saving, and thus of the level of investment which is often inadequate even to enable national income to keep up with the increase in the population, and therefore impossibility of raising the per capita income. It must be borne in mind that, while the developed countries devote 15-20 per cent of their annual income to investments — in the public or private sectors — many underdeveloped countries cannot allocate more than 2-3 per cent.

If any one of the links in this vicious circle can be broken, the development process will go forward as a result. Now it can easily be shown that progressive taxation can have a positive effect on national saving. In fact, the high propensity to consume noted in underdeveloped countries, contrary to what might be supposed or desired, is not caused so much by low per capita income as by the demonstration effect amply illustrated by Duesenberry (6) and extended to international economic relations by Nurkse (7).

It is now generally agreed that, if we disregard short term factors (for example, rapid quantitative variations in national income), the propensity to consume is strongly influenced by the concentration of income (that is, the internal maldistribution of income) and the coexistence of poor countries with rich ones (that is, the international maldistribution of income).

In the underdeveloped countries, the very well-to-do classes have close relations with the highly developed nations and make frequent and lengthy journeys and pleasure visits to the latter countries, even if the expenditure involved is considerable, since they are attracted by the standard of living there. In the same way, young people are sent abroad, often for several years, to study, because, among other things, of the lack of good schools in their own country. When they come back home, all these persons are inclined to import the way of life

(7) R. Nurkse, Problems of Capital Formation in Under-Developed Countries, Oxford University Press, 1953, pp. 61 et seq.
that they have seen abroad and to copy, both quantitatively and qualitatively, that standard of living. This imitation spreads to all those of the same social class through constant contacts between those who have been abroad and those who have not. These close relations between advanced and less advanced countries lead to an extensive consumption of new and better goods in the latter countries. These goods, by a chain reaction caused by the spirit of imitation, give rise to new stimuli and new needs, thus increasing the propensity to consume in general, and the propensity to import consumer goods in particular.

This change in tastes is not confined to the upper classes but trickles down to the lower classes which are attracted by the very high standard of living of the rich and, in their turn, show an increased propensity to consume. The poor are dissatisfied with their standard of living not so much in absolute as in relative terms. That is, they are acutely aware of what others have which they do not possess.

As a result of these chain reactions, the standard of living of the better off classes, measured in terms of consumption, is much higher than is justified by the economy as a whole. The formation of savings is sacrificed to the consumption of goods of the greatest luxury (highly expensive cars and swimming pools, private clubs run on a lavish scale, and often most exclusive) (8). This type of consumption sometimes stems from a mentality that could be called feudal, from a desire to be one up on the others.

These considerations can, it is true, be supported by only partial and perhaps inadequate statistics, but whoever has had any experience of underdeveloped countries has a clear recollection of this state of affairs, which is particularly obvious if neighbouring countries with a similar economy are visited, and a comparison made between, for example, Costa Rica, with its relatively even distribution of income, and the other Central American countries where there is a higher degree of concentration.

The upshot for the economy as a whole of such a maldistribution is a high propensity to consume which deprives the underdeveloped country of the possibility of building up the savings needed for investment. From this point of view, there is a certain advantage in the isolation of certain depressed countries from those enjoying a higher standard of living. This has been the case in Russia and Japan where the demonstration effect did not extend to consumption. This isolation makes it possible to keep down the propensity to consume and to speed up economic development. The same limitation is met with when the higher standard of living of the upper classes cannot be extended to the others, either because of the type of consumption or because of the cost, or because it is confined to aristocratic circles which form a closed group, as was perhaps the case in Europe in the Middle Ages.

Hence it will be seen that a policy of income redistribution effected by means of progressive taxation does not have a negative influence on the national savings of underdeveloped countries, partly because it does not cut down the income saved, but the income consumed, and partly because, by forcing the wealthier classes to moderate their expenditure, it induces the lower classes to adopt a greater degree of austerity as regards consumption. Thus, progressive taxation has in fact a favorable effect on savings and investment. In this connection, the income tax is more effective the greater the importance it attaches to the expenditure factor. This approach may be reflected in a personal tax on expenditure, a tax preached by Einaudi, and more recently by Kaldor, who developed his theory in his report on Indian public finance. Alternatively, the income tax should be based more or less on an inductive assessment in the light of indications of the taxpayer's expenditure or standard of living.

Indeed, a vast policy of redistribution can be forced through in a backward country in a fairly short time, even by very drastic measures, although these might not be directly justified by the purely economic considerations discussed above.

As Kindleberger points out (9), experience shows that social stability is not a function of economic development but of the relation between social and economic aspirations and the rate at which these can be satisfied. That economist reminds us that the stagnant feudal society was characterized by poverty and hunger, but also by order. Only with the advent of economic development did the question

---


of order arise when the increase in the standard of living was not matched by the conviction that there was a proper share in it.

In fact, it can be argued that the lower and more numerous strata of the population do not even react to the demonstration effect as long as their standard of living is so low that they can hardly keep body and soul together. Besides, in some ways this standard cuts them off from the rest of the community. But, when economic development gets under way, the full impact of the demonstration effect begins to be felt. For, as a result of development, communications become possible or better owing to the construction of a network of roads. Knowledge is spread by wireless and in some cases by public television sets, by the cinema, the press and so on. Public works afford employment to previously unemployed workers and thus give them a taste, even if only for a time, of a higher standard of living than the one that they are accustomed to. New desires and unsatisfied needs come to light. And where formerly these social classes were reduced to the darkest poverty but were contented or resigned, now that they have got to know a better level of living, they are eager to improve it still further and to put several years progress into one. Their income, though higher, no longer satisfies them, nor can they increase it as they desire by stepping up their efforts, since their productivity is still low, and because there is not yet enough industry in the area to create a demand for labour.

The result is the emergence of a widespread social instability which has in mind the overthrow of the social and legal order as a result of this burning desire not to have a lower level of consumption than the next man. In such circumstances, order can only be preserved if the national income increases at a very rapid rate, which in practice, for various reasons including technical ones, cannot be achieved, or if there is a radical redistribution of income which will satisfy their dissatisfaction. Their discontent is relative. That is, it depends not so much on the amount of income but on the percentage of their income in relation to the percentage in the hands of all the others. Now is the time for land reform and for other structural reforms of the same kind which can be explained on economic grounds but also on the other grounds set out above.

This evolution in the attitude of the less well-to-do classes towards the social order has become very obvious of late in Italy, especially in the South in the course of the attempts to develop that region. And the same attitude is bound to make itself felt sooner or later in numerous countries of Latin America, especially Central America, or in Africa, when the demonstration effect takes hold of large masses of the population, especially the peasants, at present plunged in the most fearful poverty.

Once this stage has been left behind, and this range of income is passed that lies between destitution and a higher income (but still far from the maximum), the problem can be formulated in terms of a gradual improvement in the relative situation within the existing social framework. Now in this transitional stage, highly progressive taxes on incomes or death duties are essential, and should even be drastic, as making for social cohesion. This problem has in recent times interested economists, who, even if they do not go deeply enough into these sociological considerations, regard progressive taxation as a means of social stability (10).

4. Since progressive taxation corrects the maldistribution of national income, it produces additional positive effects in a depressed economy in the process of development, especially as regards investments and the balance of payments.

The savings of private persons are not always used for sound productive investments. This is now generally accepted in the relevant literature. Savings are often hoarded in the form of jewels, foreign exchange, gold and so on in underdeveloped countries, and this practice is due only in part to fears related to the economic and political risks attaching to the manner in which the savings can be used or to liquidity preference. Savings may be hoarded, or they may often be invested abroad in huge amounts, usually in current bank accounts. In general, these ways of employing savings are attributable to lack of incentives to invest or to the inability to do so. Moreover, savings are channeled towards the construction of luxurious residences, cinemas and theatres on a lavish scale, all of which uses are considered, from the statistical point of view, as investments. But they are really either durable consumer goods or, if they can be classified as investments, they are certainly much less productive than for example factories or workshops.

The distinction between productive and unproductive investments is not simple because it rests on value judgments. However,

(10) C. F. KRAUSBERG, op. cit., p. 230.
Marrama (11) has suggested a criterion that, in default of other principles, can be regarded as satisfactory. In order to distinguish between the two categories, it is not enough merely to refer to the productivity of the investment in terms of national income. It is necessary to consider its capacity to reduce the ratio of capital to total income. This is why, in the early stages of development, when any infrastructure is lacking, investments by the State, even if they replace or supplement private investment (which has been reduced by progressive taxation), prove useful.

Lastly, progressive taxation leads to an increase in the purchasing power of the poorer classes, who usually consume domestic products, at the expense of the wealthier classes. This switch is another factor making for an increase in the demand for home products, since it reduces the propensity to consume imported goods, and in this way opens up new possibilities of internal investment.

5. The considerations set out above suggest that, in underdeveloped countries, progressive taxation must not be regarded only from the angle of national finance but also and indeed above all from that of the redistribution of income. A whole series of circumstances militates against the type of broad based income tax that affects most of the income taxpayers, and points to the advisability of a tax confined to few persons, i.e. those belonging to the wealthier classes. Actually, a broad based income tax is very difficult to apply. For the assessment of taxes is seriously complicated by the lack of the minimum of education needed to comply with the formalities involved in such a taxation system. Many of the taxpayers have no real estate that could guarantee the collection of the tax in the event of failure to pay. Then there is the widespread dishonesty in fiscal matters which gives rise to extensive evasion. And there is the indignation of a large percentage of people who are not able to contribute their share as regards the social burdens.

It has been argued that progressive taxation is not advisable in poor countries because it can never be an effective instrument of public finance. This view seems to me to be untenable, partly for the not strictly fiscal reasons mentioned above and also because progressive taxation of incomes, if seriously implemented, is likely,
even if limited to a few persons, to yield a higher return than would seem to be the case, and anyhow, one higher than in advanced countries, other things being equal. In the underdeveloped countries, half of the national income is often drawn by 5-7 per cent of the population, while the share of the poorest third of the population is hardly as much as 6-7 per cent. This high concentration of income makes it possible to obtain a good yield, even when taxation starts at a very high level. We may therefore say that, all other things being equal, including the average income, the receipts from a progressive tax will be greater in countries with a high concentration of income than in others. In any case, the level at which taxation starts for personal taxes in underdeveloped countries is usually very high, and, against all economic logic, they are often, as an absolute sum, higher than the corresponding figure for the most advanced countries (12).

6. In underdeveloped countries, income tax raises two particularly difficult problems. There is the taxation of certain basic commodities and that of capital gains.

As regards the former problem, it should be remembered that export levies on certain agricultural products and other raw materials are characteristic of some of the underdeveloped countries, and are an attempt to institute a rudimentary form of income tax. This is the case in respect of the levies on coffee exports from numerous Latin American and African countries.

There are several dozen countries using this device, especially in Latin America. Asia and Africa. And for many of them such taxes represent a major source of income for the State. In Pakistan, for example, they provide 40 per cent of all government receipts (13).

If the country that taxes its own exports is responsible for only a small percentage of world exports of the product in question, and if other countries do not follow suit, the tax is not likely to affect world prices of that product. It follows that the export levy is borne

(11) V. Marrama, Saggio sullo sviluppo, op. cit., pp. 150-151.

(12) Cf. United Nations, ECLA, La política tributaria y el desarrollo económico de América Latina, p. 89; INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT, Base de un programa de fomento en Colombia, Informe de una misión, Bogotá, 1951, p. 561.

(13) P. H. Janossy, "Political Aspects of Export Taxation", in Public Finance, No. 4 of 1937, pp. 255-256. The question of levies on exports has been discussed at length by U. Huete, "El problema de las impuestas en los países poco desarrollados", in Essays sobre el desarrollo económico, Instituto de estudios políticos, Madrid, 1951, pp. 155-211.
in the main by the local producers who, on the other hand, are exempted from income tax, since the levy is regarded as an equivalent thereof.

This type of tax is defended by the financial authorities of the various countries in the main because it is easy to assess and collect, for there is no possibility of evading it. From the economic point of view, there is another advantage. Superprofits obtained by producers of the commodity as the result of unforeseen increases in world prices can be skimmed off, and do not therefore increase the domestic demand for goods. Such export levies, then, have an anti-inflationary effect. Lastly, there is a political advantage, since the method of raising the money is not specially obvious to the consumer. These factors weigh heavily with the officials of the country raising the taxes, even if the anti-inflationary function can be discharged only if the proceeds are not used in such a way as to give rise to another burst of inflation from a different direction.

But these merits, which are basically administrative, are offset by quite a few economic disadvantages which definitely operate against development. Taxation, whether specific or ad valorem on the quantity produced or exported, does not make it possible for the production of that commodity which is usually of fundamental importance to the country’s economy to be extended to marginal land. There are therefore pieces of territory that are not brought into cultivation for this commodity because the cost of production is already high and will not bear the further burden of the tax which more than swallows up the potential profits. A tax on net income, on the contrary, would enable the fiscal load to be shifted from that land to more productive farms, and thus give rise to an increase in production. There seems no point in dwelling further on the harmful effects of taxes on exports, since this practice has been widely criticized in most studies of public finance in underdeveloped countries (14).

Considerations of equity are also relevant, since the tax falls very unevenly on those paying it; it is materially regressive, since the poorest soils are actually split up into the smallest holdings and are in the hands of the poorest owners, whereas the large income holders avoid the impact of the progressive taxes levied on other

citizens. The data collected for the purpose of showing how a levy on coffee exports acts as a regressive tax on income are more than conclusive (15). In order to do away with these regressive implications in respect of marginal producers, some experts have put forward partial remedies which were termed “sophisticated” at the 1954 United Nations Conference in Geneva (16). The way out is clear. It is to transform these levies into taxes on income (17).

While this is undoubtedly the correct solution, we must first of all solve the basic technical problem of finding a system whereby income can be assessed by a simple, clear and foolproof fiscal device which will rule out extensive evasion. And here we cannot help thinking of the detailed register of land. This ascertainment of the average income—the normal income in the light of the physical coefficients of the yields and costs, but valued in monetary terms sufficiently mobile and flexible to follow the variations in prices. The register thus modified to meet modern needs retains all its advantages as a stimulus to production and a premium to the best farmers (18).

7. There remains the problem of capital gains. This takes a different form in underdeveloped countries. There, such taxation aims not so much at matching potential expenditure, as Kaldor maintains, as at cutting down profits and thus combating excessive speculation by removing or reducing incentives thereto, especially in periods when the price of land is rising and there is inflationary pressure (19). The exclusion of capital gains from taxation was criticized by Kaldor (20) both in his book on the tax on expenditure

(17) United Nations, ECLA, La política tributaria, op. cit., p. 29.
(19) Oviedo Naranjo, Taxes and Fiscal Policy, op. cit., p. 36. The problem is discussed more fully in Oviedo Naranjo, ECLA, La política tributaria, op. cit., pp. 60-69.
(20) N. Kaldor, Indian Tax Reform, Report of a Survey for the Government of India, New Delhi, 1956, chapter 2. D. T. Panday, Kaldor’s views, ed. H. T. Panday, Delhi, 1973, pp. 102-104. As against this, R. Reckendorf, is opposed to this type of taxation, also with reference to India. Cf. his Recent Trends in Indian Finance, University of Madras, Madras, 1955, p. 99.
and in his report on fiscal reform in India where he came out against the Commission of Inquiry nominated by the Indian Government. Kalder feels that such exclusion cannot be defended either on grounds of equity or of economic efficiency. Nor does he agree that the taxation of capital gains can have a negative psychological effect on investment and on dealings in shares. What is achieved is a reduction in the incentives to acquire land or other capital items which are held on to solely with a view to waiting until the price goes up — for reasons which have no connection with the intentions of the owner. It is obvious that, during the time when the land is in the hands of the speculator, it is diverted from the normal productive process, since the current income from it is of no interest to the owner, who therefore is not interested in investing in it. However, the taxation of capital gains solely attributable to market movements and not to the merits of the owner does not in any way act as a disincentive to production or investment.

Rome

The Problem of controlling Liquidity in France

The idea of liquidity finds expression in more or less the same terms in France as in the other western countries. It has now become the established practice to distinguish between, on the one hand, the "liquidity of the economy", which in its narrowest sense corresponds to the money supply (compared with the national income) and, on the other hand, the "liquidity of the banking system", which comprises the banks' holdings of notes and coins and their balances on sight accounts with the Bank of France, together with the total amount of the items which they can put into the Bank of France under the current regulations without incurring a penalty.

The methods adopted for influencing liquidity are also similar to those employed in other countries. To make them easier to understand, however, it has been thought useful to recall, by way of introduction, certain special features of France's monetary institutions, namely of the banks, the specialised institutions and the Treasury.

Brief notes on the French institutions

First of all, a few words about the banks' activities and the organisation of credit:

- Bank deposits consist of 85% sight deposits and only 15% time deposits or medium-term notes (bons de caisse). For one thing, the banks do not deliberately seek to attract savings; secondly, the "deposit" banks (banques de dépôts), which constitute the most important section of the banking system, are not allowed to receive deposits at more than two years.

- More than four-fifths of the total of the short-term credits granted by the banks (NF 30.4 billion out of 36.87 billion on