

XII

The following chapter was prepared for and presented at a Conference on Fiscal Policy for Economic Growth in Latin America, which was held in Santiago, Chile in December, 1962, under the auspices of the Joint Tax Program of the Organization of American States, the Inter-American Development Bank, and the United Nations Economic Commission for Latin America. The conference was concerned with measures of tax reform that might be feasible for meeting the revenue needs of the Latin American countries in the decade of the 1960s, and the paper accordingly focused on this issue. In this context, it should not be surprising that this chapter reveals more than most of the others in this volume about my value orientation with regard to tax policy and is correspondingly less involved in theoretical details.

The general line of argument runs as follows. We take as given the fact that the personal income tax is subject to substantial and widespread evasion, the degree of evasion varying significantly among different groups of taxpayers. It would therefore be inequitable to look to this tax alone as a source of overall progressivity in the tax system. Accordingly, it is proposed that a system of excise taxes be instituted that is itself progressive, to help ensure that even those categories of higher-income taxpayers who are able to shirk on their income-tax payments will still not elude the tax net entirely.

In a similar spirit is the notion that the income from capital should, at least in the Latin American context, be taxed more heavily than the income from labor. What is proposed here is that the effort be made to tax the income from capital equally in all its uses. This avoids discrimination among uses involved in the corporation income tax as such by imposing supplementary taxes at approximately equal rates on the income from capital that is in forms other than corporate equity.

The taxation of residential and agricultural properties takes on special importance. Here, in what has been the most widely discussed aspect of the paper, I propose (though not for the first time) the economist's solution to the problem of property valuation — namely, market-enforced self-assessment. This is a scheme whereby property owners declare the taxable value of their properties, subject to the sole constraint that their declaration implies an offer of sale to any buyer who is willing, *bona fide*, to pay *X* percent more than the owner's self-declared valuation for the property. Although this proposal has given rise to some heated debates, my own reaction has been one of pleasure and, to an extent, surprise at its ability to survive these controversies. If nothing else, the self-assessment proposal dramatically calls attention to the inequities usually involved when assessment is done arbitrarily and without a direct and automatic relationship to the true market value of the property.

Chapter 16

Issues of Tax Reform for Latin America

INTRODUCTION

I should like to begin this paper with a statement of its scope and objectives. The topic assigned to me is a general one which could easily be interpreted to cover a hodgepodge of separate, essentially unrelated issues. I do not want this paper to be such a potpourri; yet at the same time I do want to meet the requirements of the title by covering more than one or two limited issues of tax reform. In drawing the line between very narrow focus, on the one hand, and "complete coverage," on the other, I shall deal briefly with two matters connected with the general philosophy with which tax problems are approached and shall then concentrate on two substantive areas which appear to me as likely candidates for tax reform in Latin America. The two matters of general philosophy are (a) the problems and goals of tax planning in Latin America and (b) alternative views of the role which elimination or reduction of tax evasion can play in meeting the future tax needs of Latin American countries. The two substantive areas for tax reform that I shall consider explicitly are (c) possibilities for the development or expansion of progressive excise tax structures and (d) possibilities for improving and rationalizing the taxation of income from capital.

I should like also to point out in this introduction that it is virtually impossible to discuss issues of tax reform without at the same time making a series of value judgments, either explicitly or by implication. I have tried to base the discussion which follows on value premises which are widely held: that a tax system should be progressive, that it should not interfere significantly with the achievement of an efficient allocation of resources, that it should not artificially direct investment into low-productivity uses, that it should provide adequate revenue to meet expected levels of government expenditure without chronic resort to inflationary financing, and that it should, on equity grounds, tax income from capital somewhat more heavily than income from labor. I have also argued that a tax system

Reprinted with permission from Arnold C. Harberger, "Issues of Tax Reform for Latin America," in *Joint Tax Program, OAS/IBD/ECLA* (Baltimore: The Johns Hopkins Press, 1965), pp. 110-121.

should be so designed as to minimize the injustices resulting from the differential capacities of different groups to evade particular taxes. Those readers who object to some or all of these premises are likely, on this account, to disagree with some of the conclusions drawn from the analysis which follows. I can only at this point express my hope that most readers will find the premises sufficiently congenial to provide a reasonable basis for a discussion of issues of tax reform.

SOME ISSUES OF GENERAL PHILOSOPHY

Given that the demands of economic development and social improvement will almost certainly require that an increasing fraction of the national income be channeled through the public sector, the tax authorities should develop a planning mechanism by which they attempt to foresee and provide for the necessary increases in revenue. It seems obvious that adequate tax planning should be part of any overall, coordinated development policy; indeed, tax planning would probably be one of the most rudimentary and least difficult parts of such a policy. Yet many Latin American countries have conspicuously failed in the past to levy taxes sufficient to cover their existing levels of government expenditure. Adequate public sector support for future growth will require substantially increased expenditure even in such traditional areas of public sector activity as education, road building, and public utilities. Increases in health and welfare expenditures are also likely in the future as governments take increasing interest in the welfare of the poorer classes. If these added tasks of the public sector are to be accomplished without disrupting the economies of the countries concerned, there must occur a drastic improvement in the capacities of many governments to raise revenue. What I have here called tax planning — the sorting out of alternative ways of achieving needed revenue increases and the decision in advance as to which ways appear most acceptable — is simply the first step toward obtaining such a drastic improvement.

Given that unforeseen contingencies are likely to arise, requiring on occasion rapid increases in tax receipts, the tax-planning authorities should maintain a series of specific plans as to how they would suggest raising given amounts of extraordinary revenue within given periods of time. In addition to the budget instability which might come from natural disasters, etc., many Latin American countries face potential instability due, on the one hand, to the variability of the international prices of their principal exports and, on the other hand, to the tendency for public sector wage levels to move in brusque and discontinuous jumps and in response to circumstances and pressures that cannot always be foreseen. If periodic budgetary crises are to be surmounted, the tax authorities must have available to them, in moments of crisis, acceptable ways of capturing such short-run increases in revenue as the situation appears to require. This can be done only on the basis of a reasonable amount of advance planning.

Up to a certain point, evasion must be accepted as a continuing phenomenon. Some taxes are more susceptible to evasion than others, and some groups can more easily evade any given tax than others. The maintenance of adequate tax

equity is accordingly more likely if each individual's or group's tax burden is distributed among a number of taxes with distinct tax bases rather than concentrated heavily on particular taxes which some groups may have an extraordinary capacity to evade. This classical principle of taxation is well observed in the regressive components of most existing tax structures but inadequately observed in their proportional and progressive components.

This should not be taken to condone laxity in tax administration or to suggest that much existing evasion cannot be eliminated. It should be taken instead to suggest that 100 percent compliance is an absurd goal for tax planning and that the design of a tax system, even with the best administration, should recognize that the capacity for evasion will differ significantly among groups.

It should also be recognized that such gains in yields as can be achieved by improved administration are likely to accrue only slowly through time. The idea that improved administration will provide funds to meet an immediate crisis or contingency is surely erroneous; yet this is, in fact, the ground on which the opposition to many proposed increases in taxation in Latin America rests its case. To consider the reduction of evasion as a means for providing short-run increases in revenue is itself a gross evasion of responsibility. It is probably also true that the demands for increased revenue which will arise in the next decade or so in Latin America will substantially exceed the additional revenue that can be obtained through improved administration within this longer period.

THE CASE FOR A PROGRESSIVE EXCISE TAX STRUCTURE

A progressive structure of excise taxes has much to recommend it as a way of meeting part of the foreseeable increase in revenue needs while at the same time reducing the relative importance of inequities due to evasion. Increasing the rates of personal income taxation would yield added revenue, but attempting to meet the entire burden of increased taxation in this way would augment the inequity between those who are able and willing to evade this tax and those who comply with their full obligations. Increasing the regressive component of the tax structure would, on the other hand, result in an unjust division of the burden of added taxation among income groups.

A progressive structure of excise taxes is also an almost ideal basis for meeting unexpected contingencies. The rates of these taxes may be raised or lowered on short notice, and the administration of these changes is comparatively simple. Moreover, if the excise tax structure is reasonably progressive, a just sharing of the burden of meeting contingencies can be reasonably assured by an across-the-board percentage adjustment of rates in the excise tax structure as a whole. Up to now, in Latin America, contingencies have typically been met by increases in the regressive components of the tax structure (cigarettes, sales tax, etc.) or by inflationary finance.

The case for progressive excise taxation is a good one, but the well-known arguments favoring nondiscriminatory (e.g., income) as against discriminatory (e.g., excise) taxes remain valid. The benefits of progressive excise taxation in

terms of equity, administrative feasibility, and aptness for meeting contingencies are bought at a cost in terms of the distortion of individual choices among commodities. This cost increases with the rate of tax and with the substitutability of products which are taxed (or taxed at high rates) for products which are not taxed (or taxed at low rates). In the design of a progressive excise tax structure, care should accordingly be taken to avoid excessively high rates of tax and the effort should be made to tax products which are close substitutes for each other at similar rates. As a rough approximation, it may be stated that tax rates higher than the 30 to 40 percent range should be subject to careful scrutiny, as there is a presumption that beyond this range indirect taxes can impose substantial costs by artificially distorting the choices confronting individual consumers.

It is recognized that the Latin American countries have for a long time had progressive import duties. These were levied not for the purpose of protecting domestic industries but for the dual purpose of restraining the use of foreign exchange for luxury consumption and of obtaining a just distribution of the total tax burden. The second of these objectives corresponds well with the arguments made above; indeed the correspondence is complete in the case where imports are the only source of supply of the goods included in the progressive tariff structure. However, when domestic production of goods suitable for luxury taxation exists, a progressive import-tariff structure on these same goods yields less revenue (due to the substitution of domestic for imported goods) and serves less well than before the purpose of achieving progressiveness and equity in the tax structure. Latin American countries have been slow to place excise taxes on locally produced luxury consumption goods. This may not have been an important step to take in a period when there was little or no local production of these goods, but today, with luxury consumer goods production growing in virtually every Latin American country, and large in magnitude in several, it merits the most serious consideration.

Special attention should be given to the taxation of automobiles. It is implicit in what has already been said that in those countries where there is local production of automobiles, this production should be subject to excise taxation, though not, of course, necessarily at the same rates as the tariffs applying to imported cars. But a tax on locally produced cars, together with an import duty on cars imported through commercial channels, leaves out a source of supply which has been quite important in many Latin American countries: namely, those cars which are imported duty-free by foreign diplomats or other functionaries or by returning nationals fulfilling certain requirements. These privileged groups receive, in effect — as personal capital gains — large sums that might otherwise have accrued as tax revenues to the government. There are a number of ways of coping with this unfortunate state of affairs. One which I find particularly appealing, and which fits well in an overall scheme of progressive excise taxation, is a system of progressive license or use taxes on automobiles. To illustrate, the annual license tax for a new Cadillac might be \$1,000; for a 10-year-old Cadillac it might be \$200; that for a new Jeep might be \$200; and that for a 10-year-old Jeep might be \$20. Such a system could be made much more neatly progressive than any prevailing system of import duties on

automobiles, and it would at the same time greatly limit the extent of capital gains which the privileged groups mentioned above would be able to extract from the Latin American countries.¹

THE SPECIAL TAXATION OF INCOME FROM CAPITAL

I entitle this section "The Special Taxation of Income from Capital" because I mean to isolate for consideration those taxes or tax provisions whose tax base is either the amount of capital, the income from capital, or parts thereof, in particular sectors or activities, or generally. A tax striking all value added in the economy at an equal rate hits both the income from labor and the income from capital; it is therefore not a special tax on income from capital in the sense in which I am using the term. Likewise, a progressive personal income tax which takes the same amount from all individuals of given income, regardless of whether that income came from capital or from labor, is not a special tax on income from capital. On the other hand, a tax on corporation income, in cases where income received as interest, dividends, and possibly as capital gains is additionally taxable as the personal income of the recipient, is clearly a special tax on the income from capital. So also is a property tax, in cases where the income of the property owner is additionally taxable under the personal income tax law. I shall also consider in this section special treatments, whether favorable (exemptions) or unfavorable (surtaxes or special additional taxes), falling on property or on the income from property in specific sectors or industries. This set of distinctions is simple to make for countries with a unified personal income tax structure, but some adjustments of the basic data are required before it can be applied to countries where "category taxes" are in force. For example, in a country where the category rate for wages and salaries is 10 percent and the category rate for corporate profits is 50 percent, the analysis of this section would treat the system as consisting of a basic tax rate of 10 percent plus a special tax of 40 percent on corporate profits. A more complex system with a category rate of 10 percent for wages and salaries received by persons, of 20 percent for dividend income of persons, and a 50 percent rate for corporation income would be treated in this analysis as consisting of a basic tax rate of 10 percent and a special tax rate for corporation income of between 40 and 50 percent (the precise rate depending on the fraction of profits paid out in dividends). Actual systems are still more complex than this, and the required adjustments would necessarily vary from case to case, but the basic principle for adjustment is simple: one only has to find the total tax paid out of income from capital in each line of activity (and perhaps by type of capital), estimate the amount by which total tax receipts would fall if the recipients of income from capital had received the same sums as additional labor income, and express

¹ This proposal does not preclude a simultaneous direct attack upon the problem of capital gains by the privileged groups, such as requiring that cars imported duty-free either be re-exported or, at the option of the owner, be sold to the government of the host country at their original purchase price or at their original purchase price minus a reasonable charge for depreciation.

this difference as a percentage of the income from capital in the activity (or of the type) involved. The result is the rate of special taxation of income from capital in that line of activity or of that type.

The principal argument for the special taxation of income from capital runs in terms of equity. A man receiving a given income as the fruit of his own labor "deserves" it more than a man receiving the same income as the return to his capital. This argument is particularly strong where inheritance and/or gift taxes are low or ill enforced, for then the income received from capital will in large measure be income coming from assets which were built up by people other than the income recipient himself and which were transferred to him without the prepayment of a tax reflecting the recipient's less meritorious claim to income from them.

The argument above could be used to justify special taxes on income from capital at rates which were progressive according to the amount of income from capital received by an individual or according to the amount of property owned by an individual. The equity argument does not, however, easily justify rates of taxation of income from capital according to the sector or activity in which the income is generated or according to the type of claim (stocks, bonds, etc.) which the ultimate income receivers may own. Given that, in practice, most "special" taxes on the income from capital take a certain percentage of the affected income or (what amounts to much the same thing) a certain percentage of the value of the affected capital, we may conclude that equity considerations would be well met if tax rates were designed so as to take roughly the same fraction of income from capital of all types and in all activities or alternatively to take each year roughly the same fraction of the value of capital of each type and in each activity.

Considerations of resource allocation argue even more forcefully than considerations of equity for the application of equal rates of special taxation to the income from capital in all sectors. Even in poorly organized capital markets, there exists a strong tendency toward the equalization of the net (after tax) rates of return on capital of different types and in different activities. For a variety of reasons (risk differentials, inadequate information, indivisibilities, legally protected monopoly positions, dynamic change in the conditions of technology and of demand), actual equalization of net rates of return is never achieved in the real world. But it remains true that investment decision makers prefer a 20 percent net rate of return to one of 10 percent and that unless they are unaware of the differential or are otherwise prohibited from exercising their preference, they will tend to concentrate new allocations of funds and resources in the high-return sector, driving down the rate of return there and simultaneously tending to raise the rate of return in the low-yielding sector. Where the rate of tax on income from capital is the same in all sectors, this tendency is an exceedingly healthy one from the standpoint of economic efficiency and the promotion of economic growth. The contribution of a unit of capital to the national income can (with some qualifications) be measured by its gross-of-tax rate of return. If, in the above example, the tax rate applying to income from capital were 33 1/3 percent, the contribution of additional capital to the annual national income would be roughly 30 percent of the value of the capital in the

high-return sector and roughly 15 percent of the value of the capital in the low-return sector. Concentration of new allocations of capital in the high-return sector would accordingly tend to enhance the rate of economic growth. And such concentration is the natural consequence of the preference of investment decision makers for high rates of return.

Suppose, however, that in the sector with a 30 percent gross-of-tax rate of return a tax amounting to half the income from capital is levied and that in the sector with a 15 percent rate of return no tax at all is applied. Then the net rate of return will be 15 percent in both sectors, and there will be no tendency to concentrate new investment in the high-return sector. The presence of differential rates of taxation (here 50 percent and zero percent, respectively) produces and tends to maintain an inefficient pattern of resource use and reduces the contribution of capital investment to economic growth. There is a strong presumption that virtually any pattern of taxation which strikes the income from capital at different rates in different sectors or activities will have similar effects. Desirable results in terms of economic efficiency and economic growth are produced when there is a tendency to equalize gross-of-tax rates of return, while the natural operation of market forces tends to equalize net-of-tax rates of return. When the rates of tax applying in all activities are the same, the market forces are harnessed to promote the objectives of efficiency and growth. When different rates of tax apply in different sectors or activities, the natural operation of market forces tends to frustrate the achievement of maximal efficiency and growth.

I appreciate that the discussion above may sound a bit too idealized for direct application to the situations of many Latin American countries. Market imperfections there may be too big to warrant great reliance on the effectiveness of the tendency for equalization of net rates of return. Accordingly, in this paragraph, I discuss the policies which would be desirable for the achievement of the objectives of efficiency and growth in the presence of substantial capital market imperfections. These objectives clearly demand the concentration of new investment in areas with a high (gross-of-tax) rate of return. If capital does not flow naturally into such areas, it is a reasonable objective of tax policy to attempt to induce such a flow. This could be achieved by taxing the income from capital more heavily in sectors and areas with low rates of return and less heavily in sectors and areas with high rates of return. But this is precisely the opposite pattern of discrimination from that which prevails in most Latin American countries. The sectors in which capital is taxed at low effective rates (e.g., real estate and agriculture) are precisely the sectors in which capital has relatively low marginal productivity, while the sectors in which capital is taxed at high effective rates (e.g., industry) are precisely the sectors of relatively high marginal productivity. Thus, the prevailing tax systems discriminate in the opposite way from that which would presumably be required to correct for capital market imperfections.

Imperfections in the labor market appear to work in the same direction as imperfections in the capital market. The use of the gross-of-tax rate of return to capital as a measure of the social marginal productivity of capital in a sector is correct when the wages paid by the sector reflect the alternative productivity

of the labor it employs. If a sector pays wages which are higher than the alternative productivity of its labor, the social rate of return on the capital employed in that sector will exceed the gross-of-tax rate of return perceived by the enterprises in that sector; and if a sector pays wages which are lower than the alternative productivity of its labor, its social rate of return on capital will be less than the gross-of-tax rate of return which it perceives. I believe I am correct in stating that in every Latin American country the agricultural, service, and construction sectors have relatively low wage scales, whereas the industrial and mining sectors have relatively high wage scales. I believe, moreover, that these differentials persist even after differences in capacities and skills are taken into account. That is, agriculture, the service industries, and construction pay less for *equivalent* labor than do manufacturing and mining. I conclude, therefore, that the social rate of return on capital is likely to be lower than (or at most equal to) the perceived gross-of-tax rate of return to capital in agriculture, services, and construction, whereas the social rate of return almost certainly exceeds the perceived gross-of-tax rate of return in industry and mining. The pattern of taxes on income from capital which would tend to correct for these labor market imperfections would entail rates of tax on the income from capital in agriculture and real estate which were higher than the rates applying to income from capital in manufacturing and mining. Once again, the prevailing tax structures create incentives in precisely the opposite direction from what would be required to correct for existing market imperfections.

Granted (a) that the estimation of the degree (as distinct from the direction) of market imperfections and the design of a tax structure to offset them would be exceedingly difficult tasks; (b) that the move to a system of equal taxation of income from capital in all sectors would itself entail a major and fundamental reform of existing tax structures; and (c) that the gradual elimination of imperfections in the labor and capital markets, itself a desirable goal of economic policy, would render a pattern of equal, nondiscriminatory taxation preferable to a discriminatory system — I propose as a proximate *and* long-term goal of tax reform in Latin America the special taxation, at roughly equal rates, of all income from capital, regardless of type or source. By "special" taxation I mean, to reiterate, that after the payment of special taxes, all net income from capital accruing to individuals would be fully taxable as personal income to them. In still other words, the policy I propose is a policy of conscious but nondiscriminatory double taxation of all income from capital.

Before turning to problems connected with the implementation of this proposal, let me suggest the possible orders of magnitude of its yield. It is conservative to estimate that in most Latin American countries 'somewhere between 30 and 40 percent of the national income accrues to capital. It is unlikely that in any Latin American country capital earns (before taxes) less than 30 percent of the national income; on the other hand, it is highly likely that in at least a few Latin American countries capital's return (before taxes) amounts to more than 40 percent of the national income. The potential yield of a tax which took 20 percent of all income from capital would (conservatively) lie between 6 and 8 percent of the national income; and the potential yield of a tax which took 30 percent of all income from capital would likely be between 9

and 12 percent of the national income. Thus, without resort to "exorbitant" rates of tax, this proposed reform could by itself overcome the chronic fiscal disequilibrium of many Latin American countries and at the same time provide the fiscal base for an expanding contribution of the public sector to economic and social development.

In dealing with problems of implementation, I shall discuss (a) the taxation of income from owners' equity in the corporate sector, (b) the taxation of income from owners' equity in the noncorporate sector, (c) the treatment of interest payments, (d) possible special provisions relating to income from agriculture, (e) possible special provisions relating to income from real estate, and (f) problems connected with valuation of capital. In order to give some flavor of realism to the discussion, and because at certain points the relative magnitudes of different tax rates become a matter of some importance, I shall assume that the goal of policy is to take, by means of special taxes, something like 30 percent of all income from capital. Needless to say, the order in which the various provisions are discussed below does not reflect their order of priority or importance.

The special taxation of income from corporate equity capital is already an established part of virtually all national tax systems. The vehicle by which this is accomplished is the corporation income tax. To achieve this part of the overall objective would require nothing more than the imposition of a 30 percent rate of tax on all corporate income. The most important way in which current practice in Latin America fails to meet this goal lies in the frequent exemption of income in particular lines of activity from the corporation income tax. Such exemptions are often claimed to promote economic development because they help corporations in new lines of activity over their difficult early years. There is a grain of truth in this assertion, but it should be noted (a) that the most difficult early years are those in which the corporations in question sustain losses — years in which they would have no taxable income in any case; and (b) that with a moderate (e.g., 30 percent) rate of tax even a new corporation is not grossly penalized when its investments begin to bear fruit and produce net income. Against the dubious claims made in favor of exemptions, we must weigh the following facts: (a) although exemptions are easy to grant, they appear to be considerably more difficult to remove; (b) in the short run, at least, exemptions tend to create within the corporate sector certain islands of privilege, wherein abnormally high private returns to capital can be earned even though the social returns to capital are not abnormally high and may be abnormally low; (c) in the long run, at least, exemptions tend to attract excessive amounts of capital to the affected industries, thus promoting an inefficient allocation of the economy's scarce capital resources. I conclude that the nondiscriminatory treatment of income from corporate equity capital is an important part of a program aimed at achieving the nondiscriminatory taxation of all income from capital.

Countries with a category tax system are in a good position to adopt the measures required to capture the desired fraction of the return to capital in unincorporated enterprises, for in these countries some special tax on the income of unincorporated enterprises typically already exists. Countries without a

category tax system would do well, in this respect at least, to adopt similar measures. If we take for granted that a tax on the income of unincorporated enterprises does exist or will be imposed, we may confront the real difficulty facing the taxation of income from capital in this area: namely, the difficulty of apportioning the income of an unincorporated enterprise between "return to proprietors' labor" and "return to capital." It is fruitless, I believe, to hope for a precise method of apportionment, given the number and the variety of types of unincorporated enterprises in any country and given the difficulties of administrative control over their record keeping. I would therefore propose, as a second-best solution, the introduction of a progressive special tax on the income of this broad class of enterprises. It is to be presumed that the contribution of proprietors' labor to the total income of the enterprise will tend to be larger in those enterprises with small total incomes and smaller in those with large total incomes. One might think of a minimum rate of special taxation of 10 percent (applying to enterprises with low total incomes and presuming, implicitly, that some two-thirds of the total income of these enterprises is due to proprietors' labor) and of a maximum rate of around 25 percent (applying to enterprises with high total incomes and presuming, implicitly, that only one-sixth of the total income of these enterprises is due to proprietors' labor), with appropriate gradations in between. The rate of special tax applied to the total income of unincorporated enterprises should in no case exceed the rate applied to corporate income, because the income of unincorporated enterprises invariably includes some return to the labor of proprietors. If the proposed progressive tax were to be adopted, it would be necessary to take some measures to prevent tax avoidance by the artificial splitting up of enterprises. One step in this direction might be a requirement that all unincorporated enterprises owned by a single tax-paying unit (person or family) be treated for tax purposes as a single enterprise.

The interest paid by an enterprise on bank loans, other loans, or bonds is just as much a part of the income from capital generated by that enterprise as the profits accruing in it. One simple way of assuring that interest payments would be subject to the special tax on income from capital would be to disallow their deduction as a cost in computing the income (corporate or noncorporate) subject to special taxation. This simple device has much to recommend it. My only reason for considering alternative measures stems from my confidence that some of the main recipients of interest payments (banks and other financial intermediaries) are more reliable taxpayers (in the sense of being less prone or able to evade or avoid their tax liabilities) than some of the entities that pay interest to them. In short, it may be administratively simpler for the government to capture the tax "due" to it on the interest paid by enterprises by taxing that interest when it is received by banks and other financial intermediaries than by taxing it at the source of payment. Likewise, in a country in which interest payments on industrial bonds are significant and in which bond issues must be publicly registered, the tax on bond interest might be made payable to the fiscal authorities at the time of each periodic interest payment.²

² If interest paid to financial intermediaries and interest paid on bonds were to be taxed separately, as suggested here, an issue arises as to whether the tax should be paid by the borrowing

If in line with this proposal, interest paid to banks and financial intermediaries and possibly interest paid on bonds are subject to distinct tax treatment, there are two alternatives for the treatment of other interest payments. The first is to allow the deduction, for purposes of computing income subject to the taxes on corporate and unincorporated enterprises, only of such interest costs as were paid to banks and financial intermediaries or on bonds. Other interest payments would not be deductible and hence would automatically be taxable at ordinary income tax rates. Alternatively, other interest payments could be made deductible, but a special tax could be levied on such interest payments (other than those on bank loans, bonds, etc.) for which deduction was claimed. The rate of tax applicable to these other interest deductions could in no case be greater than the rate of tax applicable to corporate or noncorporate income (else no enterprise would claim deductions, and the system would reduce to that discussed under the first alternative).

Under any system of taxing interest payments, it would be necessary to accord special treatment to financial intermediaries. If the interest paid by enterprises to banks is subject to a special tax, the interest paid by banks to their depositors should not also be subject to a special tax.

There is no strong argument for treating the return to capital in agriculture differently from the return to capital in other activities. Corporations operating within agriculture could easily be subjected to the same tax treatment as other corporations, and ordinary (unincorporated) farms could be treated in the same way as other unincorporated enterprises. The difficulties of assessing farm income are great, however, and they have led some countries to impute farm income on the basis of the value of the property. This same procedure can be used for approximating farm income within a system, such as that proposed in this paper, designed to strike all income from capital with special taxes at roughly equivalent rates. If, for example, the annual income from agricultural property was imputed to be 7 percent of the value of the property, the special tax on the annual return to capital in agriculture could be set at, say, 2 percent of the value of the property. It is important to realize here that the value of the property assessed should include not only the value of the land but also the value of all improvements, equipment, and inventories. For example, the value of irrigation canals, barns, machinery, orchards, vineyards, and livestock should be included in the capital sum on the basis of which income from property is imputed. And unless an additional special tax is levied on the imputed income from residential housing in rural areas, the value of residences should also be included in the total from which income is imputed. It is also

enterprise, in addition to the contractual interest, or whether the tax should fall on the recipient. This issue is not a serious one as far as the long-run results of the tax are concerned, for the long-run results depend only on the existence of the tax and not on which group is nominally liable for its payment. In the short run, however, there are real differences in incidence, depending on which group is nominally liable. The appropriate policy on this issue would depend on whether it was deemed important that the special tax on interest payments have its full impact in the short run and whether one group or the other seemed a more likely subject for bearing the short-run impact of the tax, from the standpoint of the general policy of the country concerned. The long-term effect could be achieved without having any special short-term impact on either group, simply by making the tax on bank (bond) interest payments payable only on the interest on loans made (or bonds issued) after the law became effective.

important to realize that the special tax we are discussing here is not a substitute for the personal income tax. If income subject to personal tax is also imputed, then, using the same figures as in the above example, 5 percent of the value of the property (7 percent imputed yield less 2 percent paid in special tax) would be the annual imputed income from property on the basis of which personal income tax would be levied.

In the case of residential housing, the income obtained from rented properties could be treated in just the same way as other return to capital and taxed at the rates of special taxation applicable to the (corporate or unincorporated) enterprises concerned. The income from owner-occupied houses would, however, have to be imputed; or, what amounts to essentially the same thing, the special tax, at least on owner-occupied residences, would have to be expressed as a percentage of the value of the property. Administrative considerations might dictate giving the same treatment to all residences, whether or not they are owner-occupied. In this latter case, an annual tax of, say, 2 percent of the value of the property might be levied on all residences. If this were done, however, it would not be correct to subject interest payments on mortgages to an additional tax.³

As in the case of other forms of income from capital, the income (actual or imputed) from residential property should be subject to personal income taxation in addition to the special taxation just considered. Rental income is everywhere subject to personal income taxation, so we need not discuss it further here. The imputed income from owner-occupied residences, however, is not subject to personal income taxation in many countries; the purpose of this paragraph is to emphasize that it should be. The failure to tax imputed income on owner-occupied residences introduces an extraordinarily regressive component into a country's tax system. The poor owner-occupier, whose marginal personal income tax rate is zero, receives no benefit from the exemption of imputed income. The middle-class owner-occupier, whose marginal personal tax rate is, say, 20 percent, receives a benefit equal to 20 percent of the rental value of his dwelling as a result of the exemption of imputed income. The wealthy owner-occupier, whose marginal personal tax rate is, say, 50 percent, receives a benefit equal to half the rental value of his dwelling. Not only is the exemption of imputed rental income inequitable; it also creates artificial incentives for investment in luxury housing, an area where (precisely because of the exemption) the marginal productivity of capital is likely to be low and also where investment is unlikely to carry with it the beneficial external effects (associated with improved techniques and possibly with transfers of labor from sectors of low to sectors of high marginal productivity) that might be expected normally, for example, from investment in industrial capital equipment.

³ This same proviso holds in the case (discussed in the paragraph above) in which the special tax on income from property in agriculture is based on the value of the property rather than on the actual income received. Where the tax is on actual income and interest payments are deductible in the computation of income subject to tax, there *should* be — according to the principle of roughly equal special taxation of all income from capital — a special tax on interest payments. Where interest payments are not deductible in computing the income subject to special taxation, or where that income is imputed on the basis of the value of the property, there *should not* be a special tax on interest payments.

If taxes are to be levied, or income imputed, on the basis of the value of agricultural and/or residential properties, it is important that assessment procedures be adopted which estimate the true economic value of property with reasonable accuracy. Assessment procedures have been notably weak in most Latin American countries and are badly in need of reform. The economist's answer to the assessment problem is simple and essentially foolproof: allow each property owner to declare the value of his own property, make these declared values a matter of public record, and require that an owner sell his property to any bidder who is willing to pay, say, 20 percent more than the declared value. This simple scheme is self-enforcing, allows no scope for corruption, has negligible costs of administration, and creates incentives, in addition to those already present in the market, for each property to be put to that use in which it has the highest economic productivity. The beauty of this scheme, so evident to economists, is not, however, appreciated by lawyers, who object strongly to the idea of requiring the sale of properties, possibly against the will of their owners. The economist can retort here that if owners value their property at the price at which they would be willing to sell, they should not be unwilling to sell at a price 20 percent higher. But there are also other ways of accommodating the objections of the lawyers. Perhaps the simplest way is to create, within the office in charge of property assessments, strong incentives against underassessment — penalizing assessment officers whenever properties assessed by them sell for prices substantially above the assessed value and rewarding assessment officers with “good” records (i.e., whose assessed values turn out to be reasonably close to the actual sales prices of those properties which are sold). Within a framework which stimulates high assessed values, the interests of the property owner can be protected by permitting him to make a bona fide offer of sale and to use as the assessed value in this case a figure 20 percent below his offer price. Under this procedure, a property owner is never required to be in the position of being *forced* to sell, although he may *voluntarily* place himself in that position if he considers the value put on his property by the assessing officers to be too high. Regardless of which of the two assessment schemes outlined above is adopted, it would be important for assessed values and/or the offer prices placed on their properties by owners to be linked to a price index, so as to avoid the possibility of owners' being required to sell their properties simply because inflation had rendered unrepresentative prices which, when they were initially set, reflected fairly accurately the true market values of the properties in question.

CONCLUSION

I believe that the proposals outlined in this paper would provide the basis for tax systems sufficiently robust to meet the demands of the next decade in most Latin American countries. Where more than 30 percent of the national income accrues to capital, it should not be excessively difficult to capture 6 percent of the national income through the special taxation of income from capital. If a serious effort is made to develop a system of progressive excise taxation, it should be possible to capture an additional 6 percent of the national income as revenue from this source (this could be accomplished, for example, by taxing

one group of commodities accounting for 10 percent of the national income at a rate of 30 percent, by taxing another group of commodities accounting for 10 percent of the national income at a rate of 20 percent, and by taxing a third group of commodities accounting for 10 percent of the national income at a rate of 10 percent). In addition to these taxes, it should not be difficult to obtain a yield equal to a further 6 percent of the national income from the personal income tax. With 6 percent of the national income being taken in special taxes on the return to capital, and allowing something like 4 percent of the national income for corporate saving and the return to capital owned by government, we can estimate that some 90 percent of the national income would accrue as income of persons after the special taxation of return to capital. Two-thirds of this amount could be exempted entirely and the remainder taxed at progressive rates averaging out to 20 percent, and the yield would still be 6 percent of the national income. Thus, without resort to excessively high rates of taxation, it should be possible to garner something like 18 percent of the national income out of the two sets of taxes treated in this paper, plus the personal income tax. Moreover, these components of the tax structure would definitely be progressive. Additional revenue would still be obtainable from import duties, from taxes (as in Chile) or exchange profits (as in Brazil) on certain export commodities, and from social security taxes. And side by side with a genuinely progressive set of taxes such as those discussed above, some resort to broad-based taxes on sales or value added could be had without introducing serious injustices into the total tax structure. In short, the reforms suggested in this paper can contribute substantially to improve the equity of tax structures, to provide for required secular increases in revenue, and to create the possibility for a rapid and equitable response of the tax system to unforeseen contingencies.