Progressive Taxation in Developing Economies:

The Experience of China and India

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The concept of fairness in taxation is as old as the Bible, and applies to young or developing economies no less than large industrial democracies. Yet the debate on progressive (and especially progressive income) taxation has been conducted primarily in the wealthier countries. This results in part from experience: the most advanced and frequently studied progressive tax systems have been in developed countries, and the principal theoretical work was done in them. There is also a certain condescension here, a sense that poorer countries can perhaps not afford too much progressivity, and should content themselves with the collection of sufficient tax revenues—no small task in its own right—without indulging the "luxury" of a progressive or redistributive tax system. Yet tax equity is an issue that applies to all societies, and there is no inherent reason that it should be less important in a new or developing country than a more established nation.

This paper considers the issue of progressive taxation and tax equity in younger, developing economies. The issue being extremely broad, it is necessary at the outset to impose some limitations. Thus I will limit myself to tax rather than spending policy and, within the tax system, provide special emphasis on progressive income taxes, although I am well aware that the income tax is only one of several revenue sources and, in many developing countries, is less important than other, less high-profile taxes. I will likewise eschew a statistical evaluation of progressivity, which I am in any case ill-equipped to do, in favor of an abstract but I hope engaging discussion of the issue in theoretical terms.

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I will discuss progressivity in the context of globalization and of the conflict between economic competitiveness and social justice which is (or is perceived to be) of central importance in developing nations. While this tradeoff exists in all countries, it takes on a starker nature in younger economies, both because they are poorer to begin with and because Marxist or post-Marxist ideologies often remain powerful in them. The fairness vs. efficiency tradeoff must further contend with developing countries' limitations in tax administration, which restrict policy choices and may compromise the effectiveness of even the best-intentioned tax.

I will place special emphasis on the experience of two countries, China and India, each of which maintains a progressive income tax although it represents only one part of the much larger tax system. While China and India are in some ways unrepresentative, being both larger and wealthier than most developing nations, they are also leaders whose experience is likely to be followed by other countries in the years and decades to come. China and India have also followed rather different models of progressive taxation, and many other things besides, so that an examination of their differences provides a preview of the issues that will be faced by developing nations generally in the future.

Part I of this article provides background on current theoretical approaches to developing country taxation, with an emphasis on progressivity issues. Part II considers the experience of post-independence India with an emphasis on the period since 1991, during which the country has reformed its tax system as part of a more general opening toward the outside world. Part III considers China, again emphasizing the recent period of accelerating economic development and (some would suggest) economic inequality. Part IV presents the author's conclusions and suggestions for future work.

I. Tax Policy in Conditions of Scarcity:

Developing Country Taxation and the Progressivity Issue

I think it was George Bernard Shaw who said that the rich are the same as the rest of us except that they have more money. It might be said that tax policy is the same in poorer countries, except they have less of it. While all of the issues that characterize taxation in developed nations remain relevant in developing economies, the issues take on a different character, both because of economic differences and because of the political and ideological differences that accompany them. For this reason tax policy in developing countries has become something of a self-contained field, with beliefs and assumptions that frequently differ from "ordinary" rich country experience.[2]

The starting point for developing country tax policy is the relative lack of administrative resources and (what is closely related) the real or perceived lack of sophistication on the part of potential taxpayers.[3] Because of these limitations many of the options available in wealthier nations are simply not feasible in developing countries. For example, computerized enforcement mechanisms, which are a way of life in the wealthy countries, may be beyond the reach of developing country tax administrations. Taxpayers themselves may lack the ability or inclination to make complex calculations: or they may engage in nontax transactions that are wholly unsusceptible to tax reporting. According to some experts, the income tax itself is too complex and time-consuming to be worth the effort in developing nations.

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[2] I have tried to avoid using the term "Third World" preferring "developing country," "young economy," and other less historically charged terms. They are intended to mean more or less the same thing.

[3] These factors are a modified version of those presented in Vito Tanzi & Howell Zee, Tax Policy for Developing Countries (IMF 2001). Tanzi and Howell identify four principal factors (undeveloped or informal economy, lack of efficient tax administration, difficulty in generating statistics, and high level of income inequality) that restrict tax choices in developing countries. I have condensed the first three into one item and added additional factors relating primarily to political as opposed to economic concerns.

A second, related difference lies in the mix of taxes. Whereas the income tax tends to take or at least share center stage in developed countries, in developing ones it is likely to be one of a large number of levies and frequently limited to a relatively small segment of the economy—much like our own income tax in (say) the 1920s or 1930s, but rather unlike our income tax today. Even a sales or value added tax (VAT), which appears relatively simple in advanced countries, may present problems of enforcement, calculation, or even knowledge of the tax on the part of the taxpaying population.[4] For these reasons developing countries often rely on excise taxes, import or export duties, or so-called cascade taxes (essentially a VAT without any deductions) to meet a large part of their revenue needs. Since these taxes are frequently unprogressive or even regressive in character—and since wealthy taxpayers are most able to take advantage of loopholes and other administrative gaps--achieving vertical equity is that much more difficult. **[**Excise and other nonincome taxes will be discussed further here.**]**

If developing countries differ in economics, they also differ in politics, albeit in a less systematic and predictable way. In most developed nations Marxism is either a fringe movement or has morphed into a reformist socialist party that does not seriously question private property. By contrast Marxist or similarly anticapitalist thinking (*e.g.*, Gandhi's philosophy in India or Islamic thought in certain countries) remains important in many developing nations, even if it is often honored in the breach. The tax systems in such countries must face the reality of high and often increasing economic inequality at the same time that part of the population is ambivalent or even hostile to the very concept of private wealth—a difficult circle to square.

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[4] A business turnover tax in India, based on a flat percentage of receipts, had to be changed because people were not comfortable with the percentage concept.

Finally there is the simple fact that developing countries, almost by definition, tend to have less economic power than wealthier nations and thus be more vulnerable to outside pressures. In some cases this manifests itself in effective foreign control over the national tax system by means of IMF or similar veto power over domestic tax structures. For more powerful countries, like China or India, this is less of a problem. But even larger developing countries feel strong pressure to keep taxes low in order to attract and retain foreign and domestic investment, and to conform internal tax norms to accepted international (read Western) norms. That international tax bodies are dominated by the OECD countries contributes further to this imbalance.

The challenge faced by developing countries—to balance the goals of fairness, efficiency, and adequate revenue collection under conditions of limited resources—is especially apparent with respect to progressivity issues. Progressive taxation refers to the imposition of higher tax rates on higher taxable amounts, so that the tax burden is borne disproportionately by the wealthier segments of society. Although theoretically applicable to any kind of tax, the term is most frequently applied to the income tax, given the difficulty of applying progressive rates to (*e.g.*) a sales, VAT, or other excise levy. Progressivity is conceptually distinct from vertical equity, which refers to a tax system's capacity to achieve equity between social classes, since the latter might (again in theory) be achieved by careful definition of tax bases or the use of generous exemption amounts without need for progressive marginal rates. In practice, however, the two terms are sometimes used interchangeably, so that the "progressivity" of a tax system becomes a synonym for its overall equity or fairness, including tax rates, tax base, and other factors affecting the distribution of the tax burden.

The arguments for and against progressivity have been discussed in detail in previous pieces and will be only quickly alluded to here. The arguments in favor include the diminishing marginal utility of money (the concept that rich people derive less utility from each additional dollar of income and hence should be more ready to part with it); the overt or intentional redistribution of income; and the so-called benefit theory (the wealthy benefit more from Government activities and should pay more to support them). The arguments against the individual's presumed right to retain the fruits of his labors and the negative effect of progressive rates on incentives Even when it is accepted as a goal of tax policy, progressivity may clash with other goals such as economic efficiency, simplicity or administrability, and competitiveness with other nations. In recent years there has been a sense of progressivity being on the defensive in the advanced countries although with the exception of Eastern Europe most countries retain some version of a progressive income tax.[5]

Progressivity is thus a contested issue even in advanced societies: but in developing ones it is likely to be even more so. While the politics of such countries makes vertical equity arguably even more important than in developed nations, the lack of administrative resources makes it substantially harder to achieve. In some countries it may be impossible even to maintain an effective income tax, while in others the rich may

[5] *See generally* Michael A. Livingston, Blum and Kalven at 50: Progressive Taxation, "Globalization," and the New Millenium, 4 Florida Tax Review 731 (2000). For a classic statement of the arguments for and against progressive taxation, *see* Walter Blum and Harry Kalven Jr., The Uneasy Case for Progressive Taxation, 19 University of Chicago Law Review 417 (1952). On the current status of the debate on progressivity in three countries (India, Israel, Italy), *see* Michael A. Livingston, From Milan to Mumbai, Changing in Tel Aviv: Reflections on Progressive Taxation and "Progressive" Politics in a Globalized But Still Local World" (forthcoming American Journal of Comparative Law). Both flat and nonincome (primarily consumption) taxes have been proposed as a substitute for the progressive income tax in the United States but neither has come close to enactment.

be well-positioned to avoid it by means of various tax shelter mechanisms.[6] The VAT and similar taxes may achieve a measure of vertical equity but are more frequently regressive in nature.[7] Even when the means are available, developing economies face strong pressures to keep taxes low in order to compete in the international economy; this is especially true for export-driven economies as an income tax is not rebatable on exports in the manner of a VAT or similar tax. Beyond this some developing nations may simply assign a low priority to tax equity, believing that it is more important to let "the pie get bigger for everyone" and assigning the goal of equity to health, welfare, or other spending programs.

Developing nations thus have many good reasons to maintain a progressive tax system, but may lack the practical capacity or, in certain cases, even the political will to do so. Of course this situation varies between countries, depending on their size, reigning political ideology, and historical circumstances. In particular there is a large gap between countries like China, India, or Brazil—perhaps better described as "transitional" than as purely "developing" countries—and (*e.g.*) the subsaharan African nations, who are at an earlier stage of development and perhaps less capable of asserting a wholly independent tax policy. Nevertheless the experience of the former, who increasingly act as leaders of the developing country movement, may be relevant to the entire category. It is to this discussion that we now turn.

[6] Two respected scholars have argued that an income tax is as a general rule a poor policy choice for reducing inequality in developing countries, since the administrative resources consumed by the tax tend to outweigh the gains, and alternate taxes can achieve these same goals in a more efficient manner. *See generally* Richard M. Bird & Eric M. Zolt, Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries, 52 UCLA L. Rev. 1627 (2005)..

[7] Although a VAT is typically thought of as a regressive tax, it may have some progressive effect if (*e.g.*) cash transactions are limited to the upper segments of society, or if the tax is limited to a defined category of upmarket or luxury goods. To varying degrees, this situation will apply in many developing nations.

The Gandhian Legacy and the Post-1991 Reforms: Progressive Taxation in India

Tax policy, together with much else in India, calls to mind the image of a giant who was long asleep and only recently revived. Twenty years ago there would have been no hesitation to label India as a poor, Third World nation with a long colonial past and an uncertain economic future. Today it is headed toward second or third place among national economies: but it retains much of the essential structure of a developing country, including low median incomes (per capita income is in the $700 range), a high level of economic inequality (a substantial portion of the population lives on less than $1 a day), and political and bureaucratic structures that are still in the early stages of transition from “old” to “new” ways of thinking. While India is thus not an average or typical country, it remains an attractive place to begin our study. India’s relative political transparency, and the fact that tax policy debates are conducted largely in English, make the endeavor particularly appealing.

For the first four decades following independence (1947), Indian taxation was part of a broader economic policy that emphasized equality and independence (autarky) over private enterprise and international trade. Central to this approach was the philosophy of India’s founder, Mahatma Gandhi, who believed that colonialism and the caste system were responsible for India’s backwardness and that a policy of economic self-reliance, coupled with social and economic egalitarianism, were the correctives to these evils. Gandhi and Nehru were likewise believed that high accumulations of wealth were inappropriate in an Indian context and supported policies including high tariffs, strict economic regulation, and near-confiscatory taxes consistent with this philosophy.

India's economic policy began to change in the 1990s following the collapse of Soviet communism and the success of the East Asian "tiger" economies which threatened to leave India permanently behind if corrective action were not taken. On a wider level this involved the reduction and/or repeal of import tariffs, dismantling of the so-called "license raj" which regulated most aspects of domestic production, and the adoption of market-oriented policies consistent with India's democratic nature and the Government's interest in social and economic justice. Tax reforms followed the work of various expert reports beginning with the Chelliah Commission in 1991 and proceeding through the Kelkar Commission in 2002 although not all recommendations were accepted. In general the reforms involved the reduction of marginal income tax rates from an astronomical 95 percent-plus in the 1970s to a current 30 percent maximum rate[8], together with a significant increase in the exemption amount; attempts to expand the tax base by imposing more efficient taxes on the small business and service sectors; and increasingly assertive efforts to improve tax administration and identify potential taxpayers. An important goal was increasing the share of direct vs. indirect taxes which had fallen during the previous decades. Although initially undertaken by the Congress Party the reform policy has continued through two changes of Government if attracting somewhat reduced attention under the current leadership (ironically headed by a Prime Minister, Manmohan Singh, who first came to prominence in the earlier tax reform process). While attracting widespread support the process has been slowed down by political issues and the persistence of numerous, seemingly illogical factors, most notably the exemption of agricultural income from the federal income tax base and difficulty of coordinating various state policies with respect to value added tax (VAT) and other excise taxes.

[8] The maximum rate including surcharges is actually 33 percent.

The current Indian tax system includes an income tax imposed at rates of 10, 20, and 30 percent, with the 10 percent rate starting at Rs 100,000 or about $2,000 per year[9] and the 20 and 30 percent rates being reached at Rs 150,000 ($3,000) and 250,000 ($5,000) respectively. A 10 percent surcharge is imposed on incomes exceeding Rs 1,000,000 ($20,000) for an effective 33 percent top rate. There is also a flat 20 percent tax on inflation-adjusted capital gains; a company (corporations) tax having a maximum 30 percent rate for Indian companies and floating rates, depending on the type of income, for foreign entities; and a wealth tax although the latter is limited to “unproductive” assets and reported to be easily avoided. In addition there is a 10 percent tax on specifically designated services, although the 2006 Union Budget proposed adoption of a new, comprehensive Goods and Services Tax not later than 2010. A uniform VAT having a 12.5 percent “standard” and several reduced rates replaced previous state sales taxes in 2005. Additional taxes are imposed at the State level.

It is difficult to come by comprehensive statistics regarding tax incidence in India; but a number of factors seem clear from the above. The first is that the income tax, while on its surface progressive in nature, reaches only a relatively small number of affluent, largely urban wage-earners—even assuming it is imposed fairly and comprehensively—can account for only a modest amount of economic redistribution. This is apparent from the fact that the tax begins at about three times the median income and the number of returns remains relatively low (although income tax receipts have increased with the growing economy in recent years). Widespread reports of tax evasion, particularly on nonwage income, contribute further to this perception.

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[9] Increased to Rs 125,000 for women and 150,000 for senior citizens.

A second point is that tax administration and tax culture—the ability to encourage or (if necessary) compel people to pay taxes—remain at least as important as the laws written on the books. This is no less true for the business, VAT, and the (proposed) Goods and Services Tax levies than for the income tax. A large amount of resources and creativity have been invested in tax administration, including anti-tax shelter programs and the identification of specific factors (ownership of a car, cellphone, foreign travel, etc.) which have been used to target individuals for nonpayment of the income tax. These have undoubtedly had, and will continue to have, an effect; but changing an established culture is difficult and likely to take many years.

Finally, one must note the effect of politics on India's tax choices. While there has until now been a broad consensus in favor of tax reform, that consensus disappears when more radical proposals such as an end to the exemption for agricultural income or intrusive enforcement measures are introduced. The issue is less foreign interference as in African or perhaps Latin American countries than India's internal political dynamic, including regional and caste issues that are magnified by the country's federal system and tradition of brokered politics. Incremental rather than radical change is thus likely to remain the order of the day in the coming years.

What all this means is that progressivity/redistribution in India are likely to be achieved primarily by nontax programs—subsidized water and energy for farmers, affirmative action for poorer or "scheduled" castes, and so forth—for some time to come, with the tax system playing an important symbolic role but as yet incapable of achieving large-scale redistribution on its own terms. Put in slightly different terms, tax reform in India is likely to remain less a process of making the system "fairer" and more a process of making it "rational," broadening the tax base and improving compliance so that the Government can tap into the growing economy more effectively, providing the necessary revenues with minimum political controversy and minimum damage to the country's emerging prosperity. If successful these efforts will advance the cause of vertical equity both directly (since broader-based, better-enforced taxes, even with a lower nominal tax rate, are likely to be more progressive than high-rate, leakier ones) and indirectly (since more money will be available for health, welfare, and other important social programs). But progressivity itself seems unlikely to be the driving force.

A related conclusion is that, if the progressivity of the tax system is to improve in the coming years, it is likely to be as a result of improved enforcement and publicity rather than changes in nominal tax rates. While there appears to be little sentiment for a flat rate or proportional tax in India neither is there support for a massive rollback of the marginal rate reductions contained in the 1990s-era tax reforms. This is even more clear with respect to the services, value added, and other nonincome taxes: while the latter is applied at different rates it seems an exaggeration to call it progressive in nature, and its contribution to tax equity must come for fairer and more effective enforcement rather than a progressive rate structure.[10]

The Indian situation suggests the continuing importance of progressivity in developing countries, but also the difficulty of achieving it, and the competing pressures which express themselves in tax policy. The case of China provides a further example, to which we now turn.

[I plan to supplement this section with information on tax incidence in India and other statistical data.**]**

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[10] *See supra* note __.

II. Development, "Harmony," and the Issue of Chinese Exceptionalism: Taxation and Vertical Equity in China

China requires no introduction although its current economic situation may. As the reforms initiated in the late 1970s and accelerated in the past decade continue, the country's per capita income has risen from a few hundred to $2,000-$3,000 but substantially higher in coastal regions (average salaries have been estimated at $5,000-$6,000 in Beijing and Shanghai and a figure of $8,000-$10,000 has been cited for Guangzhou (Canton) in the south although this depends on the measuring tool used). Beginning in 1994 the country has also possessed, at least on the surface, a modern or modernizing tax system including various Western-style elements. Until recently these included a progressive individual income tax rates with rather steeply progressive rates from 5 percent on the first 500 yuan to 45 percent on incomes exceeding 100,000 yuan on salary income.[11] (1 yuan = $0.13 at official rates). The progression is (was) roughly logarithmic in nature with a 10 percent rate being reached at 500 yuan, 20 percent at 5,000, and 30 percent at the 40,000 yuan level. Somewhat lower rates apply to self-employment income together with the inevitable collection problems in a country only recently adjusting to the concept of private property and taxpaying obligations. Individual income taxes as a whole account for only 7-10 percent of tax revenues, the remainder deriving from a 33 percent company tax (24 percent in selected areas and with special tax breaks for many foreign companies); a 20 percent tax on capital gains; a VAT with a standard 17 percent rate but a reduced 6 percent rate for legally defined small businesses; a services tax at rates from 3 to 20 percent; and other levies.

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[11] China has frequently distinguished between wage and nonwage income in its national tax system. *See* Thomas Piketty & Nancy Qian, Income Inequality and Progressive Income Taxation in China and India, 1986-2010 **[**add Interent link.**]**

In recent months China has embarked on its largest tax reform since 1994, including the equalization of tax rates on domestic and foreign corporations (phased in over a five-year period); an increase in the threshold for imposition of income tax, with the effect of reducing or eliminating taxes on lower wage-earners and (in theory) concentrating the tax on those in higher brackets; a series of new compliance measures including the requirement to file individual tax returns over a specified level of income; and other changes. (The individual income tax has historically been paid mostly by foreign companies and their employees, on an essentially withholding basis, and only recently has begun to hit significant numbers of other workers.) These changes are consistent with the Government's emerging theme of "harmony" (Chinese = *he*) which involves an effort to balance economic growth with its social consequences and, unofficially, to deal with some of the emerging contradictions resulting from the continued co-existence of a capitalist economy and an authoritarian, at least nominally socialist society. **[**Update tax rules and changes.**]**

One problem with China is that it is so big that it tends to swallow any "comparative" project. Thus, since my recent trip, I have increasingly been moving beyond the progressivity issue to consider the overall impact of China, and its decidely non-Western mindset, on tax policy generally. Among the many topics for consideration are the significance of "harmony"—a term with vague echoes in mainstream tax policy but a uniquely Chinese emphasis on collective rather than individual rights--as an argument for redistributive taxation; the historic Chinese emphasis on administration over litigation, and accountants or businesspersons over lawyers, and its implications for tax practice and policy; and, most immediately, the sense of Chinese uniqueness or exceptionalism—in some ways reminiscent of our own as Americans—and its implications for the global tax system. (The decision to raise taxes on foreign companies, who continue to be at the center of China's economic boom, is an example of this counterintuitive thinking.) This is not to say that China is immune from ordinary economic concepts or that the more general issues applying to developing countries (lack of administrative resources, conflict between individual wealth and collectivist ideologies, etc.) are not relevant to it; rather that China presents so many issues that it is difficult to contain within the scope of a more general project. One possible approach is to visit additional countries that share China's cultural heritage (Taiwan? Hong Kong?[12]) or aspects of its political history (Vietnam?) and begin working on a separate project ("The Asian Century: China, India, and the Future of the Global Tax System") distinct from the broader issue of taxation in developing countries, generally. Indeed one purpose of the presentation/posting of this admittedly incomplete paper is to solicit suggestions on this point.

Fairness, Efficiency, Globalization:
On the Future of Progressivity in Developing Countries

The experience of China and India suggests the difficulty of achieving and maintaining a progressive tax system in a developing country but also the persistence of the progressivity ideal. As these countries become wealthier and their tax administrations more sophisticated, so that both the demand for income redistribution and the capacity to achieve it increase, it is likely that this issue will come increasingly to the fore. As in developed nations, the outcome will depend on political, economic, and cultural factors that vary substantially between countries: no single, universal pattern is likely to emerge.

[12] Hong Kong was reunited with China in 1999 but has a distinct economic system for a 50-year period.

One interesting question concerns the relationship between progressive taxation in developed and developing countries. In some circles there has become popular the idea of a “tax life cycle,” in which progressivity becomes a concern at an early stage of national economic development and somewhat less pressing when a country has reached a more mature phase. If this were true countries like China and India would now be entering a period of greater progressivity while the Western countries, Japan, etc. might be moving in the direction of flatter or less progressive tax systems. One problem with this analysis is that it ignores the interchange between different countries and the resulting convergence in tax policies that tends to emerge as a result. Will countries like China and India be able to maintain progressive tax systems when and if they see the advanced nations losing interest in the concept, or will they conform to the newly emerging global norm? The question is at this point hypothetical in nature and depends upon one’s assumptions regarding tax policy in both developed and developing nations. But it may not be for long.