A Not-So-Simple Alternative to the Income Tax for Socialist Economies in Transition

A Comment on McLure

Alan A. Tait

When Keynes was asked in 1940 to refute the propaganda proposals of Dr. Funk (President of the Reichsbank) elaborating a German post-war World Monetary New Order, he refused because he said that on the whole, he agreed with the arguments.\textsuperscript{1} I have some sympathy with this attitude for, in like manner, I agree with many of McLure’s arguments in favor of cash flow taxation (CFT).\textsuperscript{2} However, in the cause of “brighter cricket,” or even “brighter economics,” some questions should be raised. Many of these points have been debated before and I touch on them only lightly; readers who would like to pursue them in more detail are referred to the bibliography.

Let us grant McLure all his statements on the complexity of the income tax. If William Pitt, the British prime minister in 1799, had any inkling of the monster lurking in his original income tax, he would never have proposed it, much less been able to sell it to Parliament. But we should be careful not to compare a perfect CFT to a highly imperfect income tax. What is certain is that no matter how simple the original proposal, the simplified alternative tax (SAT) would become more complex and, given politicians’ inclination to interfere, would gain many of the bells and whistles of the present income taxes.

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McLure's Arguments and Discussions

One of the engaging qualities of McLure's writings is his willingness to admit and discuss the weaknesses of the proposals he advocates. Even so, perhaps, some should be rehearsed and amplified.

Will the Public Accept It?

Interest and dividends received by businesses or individuals are to be tax-exempt under the SAT. Capital gains on financial assets are tax-exempt. A country adopting such a proposal could well become a tax haven for rentiers fleeing (at least on paper) more conventional income tax regimes.

Given the current controversy in the United States over reducing capital gains taxation, what are the prospects that politicians in reforming socialist economies can sell this to their electorates? Remember that many in these economies suspect, rightly or wrongly, that those who have capital to invest and who will enjoy income from capital and capital gains are those who under the previous regimes were the "apparatchiks" or "nomenclatura." To make such people tax-exempt to encourage savings and investment is a courageous political platform. Sinn's remark "A reform that leaves the rentier's returns untaxed cannot be made palatable to any of the world’s parliaments" should be taken from McLure's note 7 (p. 235) and placed forthrightly in the text, particularly in the context of Central and Eastern Europe.

What about Nonfinancial Assets?

Gains on nonfinancial assets are also exempt from the individual income tax but are taxed under the business SAT. Capital gains as such are not taxed under the SAT; what is done is to include the full sales proceeds of business assets in accountable cash flow. McLure (p. 227) does in passing alert us to some complications: "Individuals buying or selling nonfinancial assets would file business returns." So the law would have to define nonfinancial assets, and individuals purchasing land, houses, second homes, farms, yachts, and so on would file under the business SAT. Of course, given the infrequency of many such purchases and sales, records would have to be kept over many years, and presumably, depending on what this portfolio included, many capital losses might be established. It seems likely that little revenue would accrue and administrative and compliance costs would be substantial.

McLure (p. 228) states that "most authorities would treat owner-occupied housing like financial investment." But since the logic of the tax suggests that housing should be treated like any other nonfinancial asset, every householder would be obliged to file under the business SAT, and the capital gain on the house would be liable to the corporate SAT rate "assumed to equal the top individual rate" (McLure, p. 227). And if owner-occupied housing were treated
like other nonfinancial assets, a householder who sold his or her home to move to rented quarters or to emigrate would face a big tax liability. None of these are happy propositions, and no doubt that accounts for the suggestion to break the logic of the SAT.

Even more difficult is the appropriate treatment of land. To prevent capital gains on land from escaping taxation, the activity of holding land would have to be treated as a business. Any country adopting a CFT would have to cope with the "enormous transitional problems, due to the substantial current value of land" (McLure 1988, p. 23). In countries emerging from socialism, where most land has been state-owned, requiring its holding in corporate form may not be the best publicity for privatization. And might it not be politically controversial to give a tax advantage (expensing) for land purchases, which are not even depreciable under the income tax? Realistically, the SAT will need to be substantially modified to accommodate peasant and small agricultural holdings and to deal with housing and the value of the land on which housing sits.

Is This the Way To Deal with Inflation?

McLure's SAT more or less takes the view that if inflation is inevitable, you might as well take the easy way out. All capital purchases are expensed. There are no problems of depreciation, stock valuation, or inflation accounting. This, undoubtedly, is the most attractive aspect of the business SAT. Of course, such accounts are of little use for company financial management; a consideration elaborated below. Even so, there are some points to be made.

If inflation is below, say, 10 percent a year, the problems or distortions due to inflation fade in importance. An indication is the flurry of activity over inflation accounting in Europe in the 1970s and its disappearance from debate now. If inflation is high, the SAT still does not cure the problem, because within the annual accounts, asset valuations will not be comparable and some inflation adjustment will be needed. McLure recognizes this in note 4 (p. 235) and says "this possibility is ignored."

If inflation is neither low nor high, then expensing removes many problems. It does not, however, remove the problem of inflation. As we all know, the effective way to tackle the difficulties caused to accounting and taxation by inflation is to get rid of inflation. When you consider all the advantages of low or zero inflation, you wonder whether we should be designing tax systems to validate inflation.

What about Losses?

Under the SAT, many firms will make capital purchases that outstrip their sales. If the government were to be a complete partner in risk taking, it
should compensate the firm for the tax element in the loss. Gordon (1988, p. 16) asks: “Should a tax refund be made…? To preserve the desired incentive effects, the answer is clearly yes.” What would happen in practice is that losses would be carried forward until absorbed by sales. Of course, if inflation is high, these carryforward losses will be reduced by inflation. Firms will not get the “true” credit for their old losses set off against current inflated value sales. Should such losses be adjusted for this inflation erosion? If so, what index should be used? Not all the problems of inflation are necessarily solved by the SAT.

In addition, tax deferral can lead to tax exhaustion when profitability is low in comparison with the reliefs claimed—an unattractive outcome because the tax system is being administered with all its associated costs simply to spin wheels. Furthermore, unused reliefs are of value to other companies and can be exploited by ingenious methods, such as leasing; even though “such mechanisms constitute the ‘market’ solution, they reduce tax yield and make a parasitic tax-based industry” (Weeden 1988, p. 7).

**Revenue, Equal Yield Tax Rates, and Stabilization**

The more firms expand and invest, the lower will be SAT revenues. This suggests that with equal rates, a CFT would yield less than a conventional income tax. “The main conclusions…are therefore fairly clear. Introducing a company cash-flow tax…would lead to high tax rates on a revenue-neutral basis” (Weeden 1988, p. 6, commenting on the effects of introducing cash flow taxation in the United Kingdom). Proponents of CFT have argued that there would be a revenue gain, on the grounds that although no revenue would be obtained from marginal investments, revenue gained from intramarginal investments would exceed that lost from other investments. It is suggested that this follows because investors are risk-averse. I, like Goode (1992, p. 1), “don’t find this a compelling argument.” The proponents of CFT judge revenue in present value terms and assume that the government discount rate equals the opportunity cost of capital in the private sector. “But,” as Goode continues, “politicians—rightly in my opinion—do not evaluate revenue in present value terms over long periods of time.”

A further point is that SAT revenue would tend to fall during boom expansions and to rise during recessions—not exactly the ideal countercyclical fiscal policy. Taxpayers would resent an increase in their tax bills associated with sensible commercial policy, such as running down inventories in a recession. Undoubtedly in such circumstances there would be lobbying for concessions (just as happens with conventional income taxes). But “with a CFT, quite apart from the loss of tax revenue, such compromise is more damaging than with a conventional income tax, because the inevitable result is a subsidy to the activity” (Weeden 1988, p. 11).
What Happens to the Financial Sector?

As McLure points out, because interest income is exempt and interest expense nondeductible, the profit margin of financial intermediaries under an SAT is exempt. It is, of course, always difficult to tax the financial sector which can, chameleon-like, alter its bundle of charges to reflect a myriad of circumstances. As Kay (1988, p. 17) says, “the central issue is that what is properly a charge for services is disguised as an interest cost, and hence treated inappropriately in any system which distinguishes between operating and financing costs.”

The ingenuity of the financial sector, with interest rate swaps, futures, options, and deep discount bonds, creates a very slippery animal for tax purposes. This is especially so in the tax treatment of across-the-border flows (see OECD 1991, p. 15). For example, instead of borrowing in its local currency, a company may borrow in a currency with a higher interest rate and make a swap that gives it swap receipts based on the higher interest rate and allows it to make payment on the lower interest rate in its local currency. Under the SAT the interest is not deductible, so it pays a company to enter into swaps that minimize its local interest payments. Similarly, the counter party in a futures contract can be a clearinghouse or bank. If the tax treatment of these financial intermediaries is different from that of other commercial companies, returns can be represented as interest payments and receipts that can yield substantial advantages under the SAT.

All these sophisticated instruments complicate conventional income taxation, but the point is that they would not disappear under the SAT; indeed, the SAT’s treatment of interest and dividends could open up new avenues for avoidance. (See the references on “Gaming the System” for transfer pricing, seller financing, defaults, and forgiveness of indebtedness, employer loans, long-term leases, and different accounting years in Sunley 1988, pp. 16–20, and Mintz and Seade 1991.) Some economic commentators tend to underestimate the importance of such financial transactions and the problems they pose for tax administrators. I would be loath to imply that the capacity for sophisticated financial manipulation is any less in reforming socialist economies than it is in other countries.

U.S. Foreign Tax Credits and Corporate Mobility

Whether or not the CFT can qualify for foreign tax credits has been presented as a major problem for any variant of CFT. “Neither the regular CFT (which does not purport to measure income) nor the dividends tax would qualify as an income tax because the predominant character is not that of an income tax in the U.S. sense.... The dividends tax associated with the CFT would not qualify as an ‘in lieu’ tax because it would not be imposed in substitution for an income tax, otherwise generally imposed.... For multinational companies, a dividend tax may eliminate most of the simplicity aspects of a CFT” (Sunley

Alan A. Tait
1988, pp. 30–32). In other words, to know whether the distribution to a foreign shareholder is a dividend or a return on capital, income still has to be measured, so you might as well have an income tax.

McLure states that “the case for creditability should be presented carefully, to avoid dooming the SAT to the ranks of noncreditable taxes” (note 9, p. 235). I agree, and reading McLure’s competent treatment of the subject, I am willing to leave the presentation in his hands.

Under a CFT, there must be an incentive to organize activities to minimize tax and then migrate when tax may be payable on future tax flows. A tax would have to be imposed before companies would be allowed to move, but under a CFT, the tax charge would be based “on the full value of the company’s assets. This would undoubtedly be regarded as inconsistent with the free movement of capital in an increasingly integrated worldwide capital market” (Weeden 1988, p. 11).

An associated problem mentioned by McLure (p. 232) is that imported asset prices may be overstated to maximize the tax advantages of expensing under the SAT. McLure suggests “substantial customs duties” to curb this abuse. This seems a heavy weapon, and one open to abuse, to protect a weak flank of a tax experiment.

**Transitional Problems**

Transitional problems are considerable and are finessed by McLure when he concentrates only on the case for a CFT in reforming socialist economies. The U.S. Treasury suggested that a transitional period of ten years might be needed during which taxpayers would compute tax liabilities under both CFTs and the old income tax and pay whichever was higher (U.S. Treasury Department 1977). Obviously, this would nullify most of the immediate simplicity of the CFT. The problems concentrate around companies that make investments before the introduction of the CFT. The advantage for most countries emerging from socialism would be that such investments would be trivial and the transition could be made “cold turkey” (Sunley 1988, pp. 22–24; Gordon 1988, p. 17). Basically, the transitional problems are a major difficulty for introducing a CFT in an environment with a longstanding corporate income tax. I am willing to grant McLure the argument that these problems will be much less severe in socialist economies in transition, and that this is a substantial advantage.

However, if eventually these countries wanted to join the European Community (EC) and the EC has not adopted a CFT by that time—and given the glacial speed of corporate tax reform in the EC, that appears unlikely—then the emerging economies would have to reform their corporate taxes yet again. That is, the SAT would be seen as a transitional measure in itself. Is the advantage worth the cost as a transitional measure? This leads us to consider the position of emerging economies and whether or not their peculiarities are such that they should be treated as a laboratory for tax experiments.
The Circumstances of Socialist Economies in Transition

Currently, the two overwhelming preoccupations of economies emerging from socialism are the need to secure revenues and to control government expenditure. Although defense expenditures, subsidies, and many transfer payments can be reduced quickly, many demands on the state are likely not only to remain large but, during a prolonged transition, to grow. Unemployment will increase, and with it unemployment benefits. The huge restructuring of industry will involve large retraining payments. Neglected housing, transport, communications, and environmental hazards demand government expenditure. The whole social security system is a time bomb that will be enormously expensive to defuse. In short, the governments of these nations need revenues.

This need occurs at a time when revenue itself is threatened. For all intents and purposes, personal income taxation has to be invented afresh in economies emerging from socialism. It will be some years before it will yield a substantial revenue to the treasury. State enterprise profits used to be securely transferred directly between accounts at the central bank. Now, state enterprises will be able to bank commercially, and the central bank loses its control. State enterprises should find their profits squeezed by competition, reduced output, and restructuring. Liquidity squeezes will likely make them delay payments, including taxes. Generally agreed accounting principles are also likely to reduce sharply their so-called profits. Private sector enterprises should grow rapidly and ought to provide a source of tax revenue from profits. Of course, there will be problems of registration, assessment, and collection, in addition to the usual lags in corporate tax, liability, and payment. All this suggests that even conventional income taxes may not be a buoyant source of revenue.

This is hardly the time to propose innovative taxes that will yield even less revenue—or taxes that, to yield revenue equivalent to the conventional profits tax, would require a much higher corporate tax rate; such a measure would presumably create its own problems of avoidance and evasion.

It is acknowledged that the corporate SAT levied when firms are restructuring and investing in new buildings, plant, and equipment is not going to yield revenue. If the answer is that all this investment is desirable and revenue should be sacrificed, then it would be much easier not to tax the corporate sector at all. But we recognize this as impractical and so acknowledge that there must be a corporate tax administration, compliance costs, and, we should expect, revenue. Given that a western-style corporate tax will secure a conventional corporate revenue base, it seems reasonable to support it.

McLure argues that the corporate profits tax will impose unreasonable costs in socialist economies in transition with inadequate administration and compliance. We have already seen that a corporate tax administration is necessary, and quite complex audits would be needed even under an SAT, given the potential complexities (especially in the financial sector).
On the question of compliance, we should be clear that no economy is offered by using an SAT. As McLure mentions in note 8 (p. 233), SAT rules are inappropriate for judging business performance. Therefore, all businesses will have to keep conventional accounts to monitor their own performance and to report to their owners. Foreign-controlled companies and joint ventures (presumably common in economies emerging from socialism) must measure income to report to their foreign shareholders and satisfy foreign taxation authorities. In fact, having to recast their accounts to accommodate SAT rules represents an additional compliance cost, although a relatively minor one.

A tax paid in any particular year might be quite different from the tax that auditors would wish to set against profits in that year to report to management and shareholders. Presumably, under the CFT the tax deferred would have to be allowed for under conventional reporting. As a result, "introduction of CFT could lead to increased difficulties for accountants and the uses of company accounts for establishing proper measures of future tax liabilities and the level of post tax profits or earnings attributable to a particular accounting period" (Weeden 1988, p. 14).

Three Suggestions on Accounting and Value Added Tax

The way to tackle this accounting problem (for all countries and not just socialist economies in transition) is to face up to the options and to choose the most sensible. In France, Germany, Italy, and Norway, the tax authorities "accept as taxable income the profits shown in the company’s accounts usually with some minor modification" (OECD 1991, p. 172). In Denmark, the Netherlands, the United Kingdom, and the United States, for example, accounting and tax standards are for the most part independent. All the post-socialist economies are now introducing corporate accounting standards. It is this opportunity that should be seized, rather than the SAT, to reduce administrative and compliance costs.

If accounting practices could be legislated sufficiently carefully to be relied upon for tax purposes, major economies in administration and compliance could be made. Of course, it is no use having official accounting rules that are so malleable that they undermine the tax system. "Germany’s gloriously flexible accounting rules let firms bury earnings in reserves for accelerated depreciation and the like, which results in less revealed profits and a lower tax bill" (The Economist 1992, p. 53). Clearly, if countries could legislate the accounting rules to be followed to represent profit and loss and the balance sheet entries for both shareholders and the tax authorities, this would be a major simplification.

In addition, tax advisors and tax preparers should, in my opinion, have a fiduciary responsibility to the state, in much the same way that accountants have a fiduciary responsibility to stockholders in their auditing function. Given the powerful position of accountants and auditors, their present authority to

246
sign off on accounts should be countered by the risk of having their licenses yanked, should the relevant tax authorities find these accounts ill prepared for tax liabilities. (And in view of recent questions about accounting standards raised in connection with the Bank of Credit and Commerce International and with the Robert Maxwell case, who could deny that some tightening is needed?) If the accounting rules were accepted for tax purposes and policed through government-monitored professional standards for accounting firms backed up by sanctions, then tax administration might also be simplified.

A further opportunity for simplification other than the SAT suggests itself. A problem of all fiscal systems, but particularly those in the reforming socialist economies, is that the number of tax handles is limited. When governments tax profits at, say, 30 percent and wages under a withholding tax also at 30 percent, they are taxing value added at 30 percent and tripling the value added tax (VAT) already applied at, say, 15 percent. Clearly it would be simpler to rely on one tax. A VAT levied on corporate profits and wages (collected monthly on wages and quarterly on profits) would provide a secure, buoyant source of revenue.

McLure (p. 234) puts the question, “Should the country have both a VAT and the SAT?” His answer is that “one can imagine substituting the SAT for the VAT, individual income taxes, and payroll taxes.” We could equally well imagine the VAT replacing the company income and payroll taxes (and the VAT is a much more familiar tax). Moreover, a VAT levied on a direct basis (wages and profits) can be equitably applied to the financial sector (as happens in Israel, for example) and may get around the impenetrable difficulties of being unable to apply a CFT to financial intermediaries. Personal income taxes under any system will remain a more complex administrative problem if we wish to use progressive personal income tax rates.

In the long run, only households pay taxes. No matter how corporate and sales taxes are levied, they end up being paid by households. But we need some variety of tax handles to capture revenues equitably. The SAT is certainly an alternative that “deserves consideration” (McLure, p. 235). But I question whether its case has been proved beyond reasonable doubt; the expanded VAT deserves, perhaps, a better and more favorable consideration.

Notes

Alan Tait is a deputy director in the Fiscal Affairs Department of the International Monetary Fund. Richard Bird, Richard Goode, and Emil Sunley commented on a draft of the article.

1. “In my opinion, about three quarters of the passages quoted from the German broadcasts would be quite excellent if the name of Great Britain were substituted for Germany and the Axis” (Keynes, in Moggridge 1980, p. 2).

2. Charles E. McLure’s article, “A Simpler Consumption-Based Alternative to the Income Tax for Socialist Economies in Transition,” appears on pages 221–37. Where I refer to “McLure” only, with no date, that reference is to the article in this journal.

Alan A. Tait
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WORLD BANK RESEARCH OBSERVER
CUMULATIVE INDEX, 1986–1992

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Easterly, William (See Stanley Fischer), 5, no. 2 (July 1990): 127–42


Eskeland, Gunnar S., and Emmanuel Jimenez, “Policy Instruments for Pollution Control in Developing Countries,” 7, no. 2 (July 1992): 145–69

Feder, Gershon (See Monika Huppi), 5, no. 2 (July 1990): 187–204


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Gross, David J. (See Stephen K. Mayo), 1, no. 2 (July 1986): 183–203


Hegstad, Sven O. (See Mahmood A. Ayub), 2, no. 1 (January 1987): 79–101

Huppi, Monika, and Gershon Feder, “The Role of Groups and Credit Cooperatives in Rural Lending,” 5, no. 2 (July 1990): 187–204

Jimenez, Emmanuel (See Donald Cox), 5, no. 2 (July 1990): 205–18

Jimenez, Emmanuel (See Gunnar S. Eskeland), 7, no. 2 (July 1992): 145–69


Jimenez, Emmanuel, Marlaine E. Lockheed, and Vicente Paqueo, “The Relative Efficiency of Private and Public Schools in Developing Countries,” 6, no. 2 (July 1991): 205–18


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Liviatan, Nissan (See Miguel A. Kiguel), 7, no. 1 (January 1992): 35–59

Cumulative Index, 1986–1992

251
Lockheed, Marlaine E. (See Emmanuel Jimenez), 6, no. 2 (July 1991): 205–18
Malpezzi, Stephen (See Stephen K. Mayo), 1, no. 2 (July 1986): 183–203
Markandya, Anil, and David W. Pearce, “Development, the Environment, and the Social Rate of Discount,” 6, no. 2 (July 1991): 137–52
Meesook, Oey Astra (See David L. Lindauer), 3, no. 1 (January 1988): 1–25
Melo, Jaime de (See Vittorio Corbo), 2, no. 2 (July 1987): 111–42
Melo, Jaime de (See Carl B. Hamilton), 7, no. 1 (January 1992): 17–35
Milner, Chris (See David Greenaway), 5, no. 1 (January 1990): 47–68
Monson, Terry (See Bruce Fitzgerald), 4, no. 1 (January 1989): 89–114
Nash, John (See Vinod Thomas), 6, no. 2 (July 1991): 219–40
Noronha, Raymond (See Gershon Feder), 2, no. 2 (July 1987): 143–69
Paqueo, Vicente (See Emmanuel Jimenez), 6, no. 2 (July 1991): 205–18
Pearce, David W. (See Anil Markandya), 6, no. 2 (July 1991): 137–52
Portes, Richard (See Barry Eichengreen), 5, no. 1 (January 1990): 69–94

The World Bank Research Observer, vol. 7, no. 2 (July 1992)


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Suebsaeng, Parita (See David L. Lindauer), 3, no. 1 (January 1988): 1–25


Takacs, Wendy E., "Options for Dismantling Trade Restrictions in Developing Countries," 5, no. 1 (January 1990): 25–46


Tzannatos, Zafiris (See George Psacharopoulos), 4, no. 2 (July 1989): 187–201


Cumulative Index, 1986–1992

253


Winters, L. Alan (See Carl B. Hamilton), 7, no. 1 (January 1992): 17–35


**Titles**


“Changes in Poverty and Inequality in Developing Countries,” Gary S. Fields, 4, no. 2 (July 1989): 167–85


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"Lessons from the Southern Cone Policy Reforms," Vittorio Corbo and Jaime de Melo, 2, no. 2 (July 1987): 111–42

"Macroeconomic Adjustment in Developing Countries," W. Max Corden, 4, no. 1 (January 1989): 51–64

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"Policy Instruments for Pollution Control in Developing Countries," Gunnar S. Eske-land and Emmanuel Jimenez, 7, no. 2 (July 1992): 145–69

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“The Relative Efficiency of Private and Public Schools in Developing Countries,” Emmanuel Jimenez, Marlaine E. Lockheed, and Vicente Paqueo, 6, no. 2 (July 1991): 205–18

“The Relevance for Developing Countries of Recent Developments in Macroeconomic Theory,” W. Max Corden, 2, no. 2 (July 1987): 171–88

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“Stabilization Policies in Developing Countries,” Liaquat Ahamed, 1, no. 1 (January 1986): 79–110


Cumulative Index, 1986–1992

257
“The Value Added Tax and Developing Countries,” Carl Shoup, 3, no. 2 (July 1988): 139–56
