The VAT AND FINANCIAL SERVICES

By

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February 1987

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ABSTRACT

This paper seeks to identify workable options for the VAT treatment of financial institutions in developing nations. A workable option is defined as one that is as consistent as possible with neutrality in the tax treatment of financial institutions, but which is administratively feasible and does not hamper the overall development of the financial system. Finally, some workable but by no means fully satisfactory options are presented. The author argues against complete exemption of financial services; full taxation is at least tolerable. This paper was prepared for the Conference on Value Added Taxation in Developing Countries, sponsored by the Public Economics Division, Development Research Department, The World Bank.
# The VAT and Financial Services

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I. Introduction

It has long been realized that financial institutions present peculiar problems for both the design and administration of income taxes. 1/ Value-added is clearly present in financial transactions, no less so than for transactions involving goods and other services. This does not necessarily imply that value added in finance is easily taxed nor that all financial services should be taxed under a value-added tax (VAT). After 25 years of experience with value-added taxation in Europe, it is now clear that truly satisfactory solutions to problems of taxing financial institutions under this tax have yet to be devised, much less implemented. The European experience with taxation of financial institutions under the VAT therefore does not furnish an abundance of positive lessons for developing countries considering adoption of a VAT. This is lamentable, since inappropriate choices in applying VAT to financial services in such countries may impede the orderly development of their financial sectors. In turn, this outcome would tend to slow the process of growth and development, by hampering not only the emergence of efficient financial intermediation activities, but also efforts for mobilizing domestic capital resources as well as the capacity of the financial system to transform and distribute risk.

This paper seeks to identify workable options for the VAT treatment of financial institutions in developing nations. A workable option is defined as one that is as consistent as possible with neutrality in the tax treatment of financial institutions, but which is also both administratively feasible
and which does not place needless barriers in the way of orderly development of the overall financial system.

In the search for workable options, Section II sketches common features of financial structure in less developed countries (LDCs) to remind that even in relatively low-income countries, diversity in finance and fragility in emerging financial institutions may be ignored in tax design only at some peril to financial development.

Section III examines the extensive developed country and the limited developing country experience with the VAT as applied, or not applied, to financial services, in hopes of deriving lessons that may be instructive for LDCs in general. Section IV presents generic issues in applying VAT to financial institutions in any setting. Section V examines possible options for the VAT treatment of financial services in LDCs. Finally, Section VI presents workable, but by no means fully satisfactory options.

This paper is concerned primarily with design of options for the type of VAT that extends through the retail sector. Moreover, it focuses only upon the treatment of financial services under a consumption-type VAT, imposed on the destination principle, collected be the tax-credit method.\(^2\) Restriction of the scope of the paper in this way is justified in Section V.

II. Financial Sectors in Low and Middle-Income Countries

It was not until the mid-sixties that analysts and policy-makers began to widely recognize the role of the financial system in the processes of
growth and development in LDCs. Economists such as Shaw (1973), McKinnon (1973) and Adams (1978) had by 1980 clearly established the importance of "deep" finance in mobilization of domestic resources, promotion of employment, growth and diversification or risks in both rural and urban settings. Successful financial reforms in Korea, Taiwan, Colombia, Brazil, Indonesia and a host of other countries tended strongly to support the "financial deepening" thesis. It is now widely appreciated that policies, including tax policies, that lead to "shallow" finance (a shrinkage in the real size of the financial system) are inimical to growth and development.

Differences in financial structure as between different developing countries are at least as great as differences in levels of income among LDCs. Therefore, generalizations about financial structure in such nations are difficult to defend. Nevertheless, some commonalities may be cited.

In virtually all LDCs, the financial system consists of a remarkable variety of interconnected financial institutions, both formal (organized) and informal (unorganized). In very low-income nations, or in countries with long histories of strong inflation, the size of the unorganized financial sector may equal or exceed that of the organized sector. Except in Liberia and a few Francophone African countries, a central bank lies at the core of the financial system. But in all LDCs, the commercial banking system (public and privately owned) is not only the most visible, but the most critical component of the organized financial system. Commercial banks are virtually everywhere the principal recipients of financial savings and the primary sources of domestic credit to the private sector. Development of other elements of the
organized financial sector, including investment banks, savings bank and the non-bank financial intermediaries is vitally dependent upon a well-functioning commercial banking sector. Non-bank financial intermediaries include life insurance companies, casualty insurance firms, reinsurance agencies, and pension funds.

Co-existing with the more modern organized financial sector is the so-called "unorganized" sector that may in some countries have antedated the organized sector by several centuries. This sector includes pawnshops, local money lenders, trade credit, cooperative credit and other informal arrangements involving the borrowing and lending of money, including intra-family transfers. Taxes, whether income or value-added taxes, typically do not apply to the unorganized sector, whether by design or by default. This of course does not mean that the unorganized financial sector will be unaffected by taxes imposed on the organized sector.

In some countries, particularly in Latin America and East Asia, the organized financial system has been a major vehicle for mobilization of domestic savings. In other countries, and especially in Africa, the organized financial system has remained small and poorly developed, contributing little to resource mobilization or to the pooling of risks across the economy. A major consideration in the design and implementation of the VAT in all developing countries is that of insuring that the tax does not jeopardize either of the vital functions of the financial system.
III. Comparative Treatment of Financial Services Under The VAT: Developed and Developing Countries

The base of a consumption-type value-added tax extends to - and is intended to be confined to - all personal consumption spending, including all services of a consumption nature. Failure to tax any consumption item, whether goods or services, favors the excluded services relative to taxed items. Nevertheless, certain services including some types of financial services, may be legitimately excluded for the VAT base because of administrative reasons, or because they do not represent consumption. Full inclusion of financial services in the VAT base has not proven practicable in VAT countries, for both reasons. Two methods have been utilized in attempts to free financial institutions from obligation to pay VAT: ordinary exemption and zero rating. As explained by Shoup (*) the exemption method frees a firm from paying tax on sales of exempt items (services), but it does not free the items (services) from tax. Zero rating, however, achieves both.

The remainder of this section sketches the tax treatment of services under the VAT in several countries. A subsequent section discusses reasons why VAT countries have chosen one or another option for handling such services.

1) European Community (EC)

After nearly two decades of experience with VAT in most EC states, satisfactory methods for full taxation of financial services have yet to be developed. Rather, practical problems in including banking services in the base of the VAT have led all EC countries to exempt, rather than zero rate, the "core" activities of banks. No EC country attempts to apply VAT
to such intermediation activities as loans, deposits or security transactions. Six out of nine EC countries do, however, apply VAT to several so-called "secondary" activities of banks, including rentals of safe deposit boxes, printing of checks, and foreign exchange transactions. However, EC countries such as Germany do zero-rate banking services when these are "exported" to countries outside the EEC. Britain, however zero-rates all financial services supplied to persons outside the U.K.

While a portion of services supplied by banks is included within the VAT net, the entirety of services provided by insurance companies is non-taxable to the customers of such firms. Specifically, all EC countries have exempted all insurance services.

It is noteworthy that although EC countries do not generally attempt to apply VAT to financial services, many do impose other forms of indirect taxes on such services. In particular, all EC countries have special levies on insurance, sometimes expressed as a percentage of the premium, sometimes as a percent of the value of the policy. In certain cases, these taxes are substantial. Taxes on life insurance premiums are 4.8% and 4.4% in France and Belgium respectively, and 6% on several types of insurance in the Netherlands.

2) Other Countries

Israel has been the only country to attempt to apply VAT to a wide variety of financial services. However, the VAT imposed on financial institutions in Israel was not of the "subtraction method" tax-credit type.
where tax liability is computed by subtracting taxes paid on purchases from taxes due on sales. Rather, a special "addition" type of VAT was imposed on the financial sector. A 12% VAT rate applied to the sum of payrolls and profits of financial institutions. No offsets were allowed for ordinary VAT paid by financial firms on their purchases, nor could customers of banking firms credit the "special" VAT against the ordinary VAT due on their sales.

The special VAT on financial institutions proved unworkable and unpopular. Firms using banking and insurance services, for example, could not utilize the special VAT as a credit against taxes due on their sales, and financial institutions could not use ordinary VAT paid on their purchases as a credit against the special VAT applied to their supply of financial services. In response to complaints from both groups, the government abolished the addition type of VAT on financial institutions in 1981, replacing it with a separate tax of identical coverage, but completely divorced from the VAT. Since the 1981 tax on financial institutions is not labeled a VAT, it is quite clearly noncreditable.

The principal lesson from the Israeli experience seems to be that efforts to apply an addition method VAT to financial services while other sectors employ the subtraction method leads to complications with tax credit offsets. The solution adopted in Israel was to ignore the credit problem through enactment of special taxes on financial institutions, as in Europe.

The VAT treatment of financial institutions in New Zealand has been the topic of extended debate, as that country moved toward implementation
of the VAT, (called the Goods and Services tax, or GST in that country) in October of 1986.

The Ministry of Finance originally proposed that most financial services (including all life insurance premiums) be exempt from the GST. Fire and general insurance as well as reinsurance services were, however, to be fully taxed. Firms in the financial sector that would be affected by exemption reacted strongly, primarily on grounds that exemption without credit would seriously complicate the GST compliance tasks for a large number of registered persons. There were also concerns that exemption of financial institutions would endanger their international competitiveness, even with zero-rating of exports of financial services, as proposed by the government. And zero-rating of financial services was seen as complicating compliance with the tax, not to mention tax administration.

The Government's special advisory panel, which included experts from the financial sector, proposed instead that the VAT be fully applied to all financial services except certain insurance. For insurance, the panel endorsed the government's proposal for full taxation of premiums for fire and general insurance policies, as well as reinsurance. The panel however, also strongly recommended full taxation of premiums for "pure life insurance" (both term and whole life policies), and exemption of that portion of any whole life premiums that involve a savings element for the policy-holder.

Further, in the event that full taxation of financial services proved unacceptable to the government, the Advisory Panel recommended zero-
rating instead of exemption. The Government subsequently rejected the Panel's recommendations on the VAT treatment of financial institutions, and announced in August 1985 that it would proceed with its original proposals virtually intact: exemption of all financial services save fire and general insurance and reinsurance. Exports of all financial services, including both exempt life insurance services and taxable non-life insurance, are, however, zero-rated under the GST.

Developing countries that have employed the retail form of the consumption VAT have in general opted for the EC treatment of financial services. The Korean VAT provides exemption, not zero-rating, to all insurance services and to financial services generally. However, in Korea as in Europe, services rendered outside the country are zero-rated. Latin American VAT countries also tend to follow the EC pattern. Both Argentina and Brazil exempt all financial services from VAT. Brazil, like most European countries also employs special taxes on financial institutions, called the Imposto Sobre Operacoes Financeiras (IDF). Chile, however, taxes general insurance under the VAT, but not life insurance companies, and exempts the "core" activities of banks.

IV. Generic Issues in Application of VAT To Financial Institutions

A) VAT Choice Criteria and The Financial Sector

Developing countries contemplating adoption of the VAT face a large array of possible forms of the tax from which to chose. (Shoup, __, this volume). Nevertheless, the scope of this paper is largely confined to discussion of issues in the taxation of financial services under one
particular type of VAT: the EC type tax extended through the retail level, imposed upon consumption only, collected through the tax-credit method, and levied on the basis of the destination principle. Restriction of the scope of the discussion in this way is justified for three reasons.

First, major issues in the tax treatment of financial services ordinarily do not arise, or are unimportant, under pre-retail types of VAT such as those employed in Indonesia after 1984 and in Colombia before that date. This is particularly true in the case of consumer banking services, life insurance services and pension funds, less so in the case of casualty insurance. For example, under a VAT extended only through the manufacturers' level, these institutions would not be defined as taxable "manufacturers". In any case, the fact that no component of interest paid to banks is subject to VAT is immaterial where registered firms are concerned: interest is an element of value-added by manufacturing firms. (See Section V) Furthermore, to the extent that purchases of life insurance services do represent consumption, this service is rendered essentially to final consumers, and is therefore best seen as a "retail" activity. Exclusion of casualty insurance services from a pre-retail VAT does give rise to problems, since in LDCs a high proportion of these services tend to be rendered to taxable manufacturing firms, if the Indonesian experience is typical. But this is merely one of the unavoidable costs of operating a pre-retail VAT. On balance, there are few good reasons for including financial institutions in the base of a pre-retail VAT.

Second, the discussion is limited to the EC type of VAT issues under consumption because this has been overwhelmingly the VAT of choice for
the 25 - odd LDCs that now operate a VAT, and because there are good economic and administrative reasons for that choice./17

Third, other alternative methods for imposing VAT, including the "addition" method, have never been successfully implemented by and central government anywhere, and the lone attempt to apply a special "addition" VAT to financial institutions was finally abandoned after five years of disappointing experience in Israel.

B) Neutral Tax Treatment of Financial Services Under a VAT

There is no reason to presume that neutrality should be the overriding goal of tax policy. Governments may and often do make deliberate departures from neutral tax treatment of certain sectors of the economy, including the financial sector, in order to achieve other policy goals. Departures from neutrality, however, may involve costs, not only in terms of economic efficiency, but in administrative and equity terms as well. It is therefore essential that the conditions for neutrality be portrayed as clearly as possible in order to make these costs as transparent and possible, so that policy-makers can weigh them against presumed gains from non-neutrality, including possible efficiency gains. In this section we seek first to identify conditions for neutral VAT treatment of financial services, and second, to determine whether neutral treatment is administratively feasible (given present technology) in both developed and developing countries.
1. Conditions for Neutrality

"Neutral" taxes are not necessarily "efficient" taxes or "optimal" taxes. A neutral tax is defined as one that do not lead to material changes in the structure of private incentives that would prevail in the absence of the tax. While not nearly as intellectually satisfying a guide to tax policy as "optimal taxation", neutral taxation is to be preferred as a benchmark until such time as analysts are able to identify optimal departures from neutrality in real world policy settings, and until such time as administrative capacities are equal to the task of operating necessarily complicated optimal tax structures. In both developed and developing countries that time will not likely arrive before the 21st century.

Achievement of the aims of consumption taxation requires taxation of all personal consumption expenditure. Neutrality under a consumption-type VAT will be interpreted to require uniform taxation of all current personal consumption expenditure. It should go without saying that any divergences from neutrality thus defined would be gladly accepted by most decision-makers in LDCs, whenever these divergences can be shown to satisfy the goals of optimal taxation at acceptable costs of tax administration and compliance.

Having established that neutrality in taxation is a less-than-hallowed concept and that optimality in taxation is less-than-practical, under existing technology and institutions, we may now proceed.

Neutral treatment in applying VAT to the financial sector involves four principal features:
a) Neutral treatment of financial services relative to other taxable goods and services.

b) Neutral treatment as between all types of financial institutions.

c) Neutral treatment between firms that specialize in financial services (banks, insurance companies) and other firms that do not specialize in finance but which offer financial services complementary to the principal activities (trade credit offered by wholesale houses and manufacturers, factoring and leasing firms etc.)

d) Neutral treatment between domestic and foreign suppliers of financial services, and particularly, avoidance of unintended discrimination against maturing (infant industry) domestic financial institutions.

Full neutrality thus defined is, at least at the present time, not feasible under any administerable VAT. Let us see why.

2) Difficulties in Achieving Neutrality

The principal sources of difficulty in achieving neutral treatment of financial services under a tax-credit consumption type VAT have to do with (a) problems in defining the value of taxable financial services (b) the degree of substitutability between different types of financial assets and services and (c) the "openness" of the domestic economy, particularly when capital is mobile internationally and (d) administrative capacities.
a) Defining Financial Services

This problem has two facets: (i) identifying the service element in financial payments by and to financial institutions (ii) isolating the consumption element in financial services thus identified.

i) Identifying The Service Element in Financial Payments

The taxable component of most non-financial services may be defined easily: the value of legal, advertising and barber services is measured by gross sales value. Value-added in such services is defined as gross sales minus purchases from other firms. But the gross value of payments from and to financial institutions is generally not a good measure of the monetary value of the service rendered. Further, the service component of many payments for financial services is rarely identified as a separate, free-standing charge to customers.

1) Banking

Consider first the case of banks. We focus here on the "core" activity of banks: financial intermediation. Determination of the value of "secondary" financial services is not at issue here. For so-called "secondary" services such as safety deposit box rentals, the value of the service is the account of rental paid. For other "secondary" services such as "free" checking accounts ascertaining value of the service is more difficult.

For banks, the value of loan repayments is not a measure of the value of the service to the borrower; the repayment consists both of nominal
interest paid by the buyer, and amortization of principal. Amortization must clearly be excluded in determining the value of the service. But what about interest paid by borrowers? Does this measure the value of the service provided by the lender quite apart from the fact that (when inflation is anticipated) nominal interest rates are inclusive of inflation? Interest charged by banks must cover not only the costs of deposits, but also the gross margins of banks. Interest paid on deposits is clearly investment income to the recipient, not a component of "services" provided borrowers. The service element in bank lending then is the gross margin of the bank: this consists of intermediation costs plus profits associated with financial intermediation. This is a small fraction of total debt service, even in LDCs.

For loans to business firms registered for VAT, the entire discussion is largely irrelevant. Interest expenses of registered firms are part of their value-added, and this value-added is taxed at the level of the firm. It would therefore be inappropriate to tax any component of interest received by banks from registered firms.

Therefore, the value-added tax base for banking services would, at most, be the gross margins of banks in their lending to households and non-registered firms.

2) Insurance

Neither the value nor the value-added in insurance services is measured by the gross premium paid by policy-holders. We examine first the case of casualty (accident) insurance, Consider a very simplified insurance
arrangement under which 10 people cover their risks of accidents by each paying a "premium" of $100 into a common pool. Administering this pool costs $50, net of any interest earnings on the pool. The arrangement provides that a total of $950 will be paid to the first one of the ten who suffers an accident. It is clear that neither the premiums nor the payment of the claim represent value of the service. Rather both are transfers of money. The value of the service in this case is the cost of administering the pool: the cost of getting the money to the victim, where it is most needed. The "loading" charge, or net premium is $50. The loading charge is merely the excess of gross premiums over and above accounts required to cover losses (pay claims. The "loading charge" for each policy-holder is $5.00. The value of the service to each is also $5.00. Had the pool paid out only $900 instead of $950 to the victim, the loading charge would now include both expenses and profit of the pool. The value of the service would then be $10 per policyholder. This is also the value-added be the insurance activity./21

The case of life insurance is only slightly more complicated. Services under pure term life insurance policies are analogous to that in the simple illustration for casualty insurance. But for whole life policies, part of the premium represents an addition to savings of the policy-owner. The value of the insurance service is clearly again the loading charge of the company, which consist mostly, but not wholly of wages and salaries. In both cases (casualty and life insurance) it is however clear that value-added is present in the supply of the service. The existence of value-added in an activity, however, does not necessarily imply that it can be easily taxed.
ii) **Identifying the Consumption Element in Financial Services**

We have seen that, in principle, the service element in financial transactions can be defined. And taxation of financial services rendered to business firms registered for VAT involves no problems *per se*, since any VAT paid by them on purchases becomes a credit against taxes due on sales. Services rendered to households, however, do present problems. A consumption VAT is meant to be confined to personal consumption. It is not altogether clear that household outlays for all types of financial services represents "consumption".

1) **Banking**

Establishing that there is both value-added and an identifiable service element in bank lending to households (the gross margin of banks) does not imply that all such services are consumption in nature. Services involved in mortgage lending to households may be viewed as having both a consumption and an investment element. What proportion of the service should be taxed as consumption? The appropriate answer probably lies somewhere between zero and 100 percent, depending upon one's point of view. It should be noted however, that any purchase of an investment good by a non-registered entity, including households, carries with it a value-added tax burden. If the VAT rate were 10%, then if a household, for example, buys a lathe to make furniture for the home, the price paid for the lathe will include a 10% VAT element.
2) **Insurance**

Classification of insurance services into consumption and investment presents vexing problems not resolved in this paper.

Purchase of insurance contract by a household might be viewed as "consumption": the household could be viewed as "consuming" reduced variance in future income. But there are other considerations that argue in favor of treating at least some insurance services not as consumption, but as investment.

1) **Term Life Insurance**

Under ordinary term life insurance, a policy is purchased to cover risks of death over a specified period, say 5 years. The premium is fixed for the whole period, and there is no build-up of savings; the policies have no cash value to the policy-holder. Although term life insurance policies are not nearly so widespread in LDCs as in say, the U.S. or Canada, the cost advantages of term relative to "whole" life will not likely go long overlooked in LDCs.

A purchase of a term-life insurance contract involves essentially a transfer of wealth from the policy-holder to the beneficiary. Payment of the premium by the policy-holder reduces the lifetime consumption of goods and other services for the policy-holder and increases the lifetime consumption possibilities of the beneficiary; the increased consumption of the latter would be taxed under the VAT. It would seem, then, that inclusion of this service in the base of the VAT would amount to double taxation.
2) Ordinary Whole Life Insurance

Like term insurance, "whole life" insurance provides pure insurance protection. But unlike pure term insurance, "whole life" also provides investment income to the policy-holder. The yearly increase in the cash value of this income adds to the net worth of the policy-holder; it cannot then, be defined as consumption.

3) Casualty Insurance

In most developing nations, it is likely that most casualty insurance contracts in LDCs are purchased by businesses, not households. However, forward-looking tax policy should take into account the possibility that household purchase of casualty insurance may eventually be as widespread in LDCs as in industrial countries.

Taxation of casualty insurance services to business firms presents no major problems except as noted below. Again, taxes paid on purchases may be credited against taxes due on sales. Households are again the source of difficulty. One could argue that casualty losses do not reduce households' VAT liability, since casualty losses reduce net worth rather than consumption. That being the case, it might be argued that net premiums (loading charges) paid by householders for casualty insurance should be taxable under a VAT.

However, it should be recognized that for casualty losses on such household assets as autos or other consumer durables, restoration of the asset would result in spending that would be taxable under the VAT (the same would
apply to housing if the VAT base included housing. Would this then mean that taxation of net premiums for casualty insurance coverage would constitute double taxation? This question is not resolved in this paper.

b) **Substitutability of Financial Assets and Competitiveness in Financial Markets**

Where there is not a high degree of substitutability between financial assets, and where competition between different types of institutions is weak, there may be justification in aiming only at rough justice in the design of VAT police toward financial institutions. In such circumstances, the fact that application of VAT (or exemption from VAT) provides a small competitive disadvantage to one segment or one asset in the financial system (say, insurance companies, savings banks) will not result in major shifts in financial resources away from the disfavored segment, and towards favored segments.

In LDCs with "shallow" financial systems (and which are relatively closed economies), we would expect to find a less well-developed financial sector than in countries with "deep" financial systems. A limited range of financial assets and limited competition among financial institutions are hallmarks of shallow finance. Non-neutral treatment of different types of financial services will not per se cause much additional damage in such circumstances.

But in LDCs with "deep" financial systems, we ordinarily expect to find a richer variety of financial assets, more types of financial institutions, and greater competition among them for savings. Where different
financial assets are reasonably close substitutes, and where competitiveness prevails, even a small arbitrary tax advantage to one type of asset may cause major shifts of funds into that asset, and into the institutions that specialize in offering them. For example, life insurance services may be easily taxed when the industry is highly concentrated (as in Indonesia), but if pension funds and investment management companies faced slightly more favorable VAT treatment, large flows of resources may be drawn from life insurance companies. If banking in developing countries particular becomes more and more open and competitive, then to the extent that assets can be more easily tailor-made by different types of institutions to fit the needs of the public, the problem may become more serious.

c) Openness and International Capital Mobility

1) Nature of The Problem

The difficulty of attaining even rough neutrality of treatment of financial institution under the VAT increases with the degree of openness of the domestic financial sector and with the international mobility of capital.

With open capital markets and international capital mobility, inappropriate tax treatment of financial services under a VAT may induce movements of capital out of the taxing country. It also may reduce the ability of maturing (infant-industry) financial institutions in LDCs to compete with foreign banks and insurers, particularly in their own domestic markets. In such circumstances, even a relatively small amount of additional VAT burden could result in some disadvantages for domestic banks and insurance companies competing with foreign financial institutions in the domestic
market, even if exports of financial services are zero-rated. This is because although under the destination principle, imports of financial services are nominally subject to VAT, such imports are not easily detected, let alone taxed, in any country.\textsuperscript{23}

The major concern for most LDCs then is not whether inappropriate application of VAT will hinder the ability of maturing financial institutions in LDCs to compete in external markets, although this possibility would be a source of concern for such higher-income nations as Singapore, Hong Kong, Malaysia and Korea in the very near future, and perhaps for Brazil, Argentina and Colombia in the more distant future. For middle-income LDCs such as Indonesia, that are not likely to become international financial centers very soon, the major concern should be the possibility that inappropriate VAT treatment of financial institutions will provide a competitive edge, however small, for foreign banks and insurers over struggling domestic financial firms.

2) Evidence on Openness and Mobility

To the extent that economies in LDCs are closed and to the extent that international mobility of capital is slight, LDCs considering adoption of a VAT may safely ignore the possible implication of VAT for both competitiveness of domestic financial institutions and for capital flows.

Indeed, capital controls, both explicit and implicit, do abound in the world economy, and particularly in LDCs. Explicit controls are defined as restrictions on inward and outward movements of foreign exchange, usually in
the form of limitations on purchase of foreign exchange by residents for purposes of international trade policy. Implicit capital controls include laws and regulations unrelated to trade policy which nevertheless limit the domestic holding of use of assets denominated in foreign exchange. Kimbrough and Greenwood (1986) find that explicit controls on the international movement of capital existed in 72% of IMF member countries throughout the entire five-year period 1978-1982 (inclusive), while only 19 percent of IMF members had no explicit capital controls at all during the period. Furthermore, even in countries that use no explicit capital controls, implicit controls may hinder international mobility of capital./*24

These observations suggest that the international mobility of capital may be limited. There are, however, other considerations that lead to quite different conclusions. First, the fact that explicit (and implicit) controls on capital are widespread, particularly in such LDCs as India, Pakistan, and Ghana, is not any indication that the controls are effective in limiting international mobility of capital./*25 In any case, presumptions that capital controls are administered with anything close to 100% effectiveness lack any significant empirical support. Second, there is a small but growing body of empirical evidence that suggests a fairly high degree of international mobility of capital countries, as attested by the work of Harberger (1980) Summers (1985) and Hartman (1983)./*26 Third, not all LDCs utilize explicit capital controls. Indonesia for example, has not utilized explicit foreign exchange controls of any kind since 1970.

Fourth, even the presence of implicit controls does not necessarily restrict the ability of foreign financial institutions to operate in domestic
markets. For example, foreign firms wrote 75% of all non-life insurance issued in Canada in 1980, and 25% of life insurance./27 Foreign insurance firms have gained a major share of the total insurance business in Indonesia in spite of laws forbidding foreign equity ownership in insurance, and in spite of ostensibly tight limitations on foreign participation in reinsurance. And although foreign banks are required by law to limit their operations to the capital city of Jakarta, this restriction did not prevent the Jakarta branches of American banks from becoming very major profit centers of the worldwide operations of the parents in 1971-81.

In sum, it appears unwise for any LDC to frame VAT policy toward financial services under the assumption that the effects of the tax on international capital flows and domestic competitiveness of financial institutions can be safely ignored.

V. Possible Options For VAT Treatment of Financial Services

A) General Issues

Like their counterparts in Europe and New Zealand, LDC tax authorities face three principal options for the VAT treatment of financial services.

1. Full taxation, with VAT credits on inputs.
2. Exemption, with no credits.
3. Zero-rating, also known as exemption with full credits.
The complexities involved in achieving neutral treatment of financial services when all are subject to VAT has led all EEC countries, New Zealand, Korea and most Latin American nations to adopt option #2: exemption. This choice has been dictated by expediency. Exemption violates all four conditions for neutrality outlined in Section III. No country has gone so far as to zero-rate all financial services, largely because of fear of revenue loss. Virtually all VAT countries, however, do zero-rate the export of financial services./28

In what follows, banking and insurance issues will be discussed separately. Although common problems affect VAT design toward both, the nature of several other difficulties calls for separate discussion.

B) Banking Services

1) The Full Taxation Option

In only one country has there been strong sentiment for application of VAT to the full price of 'core' banking services./30 The Government's Advisory Panel on GST in New Zealand proposed this option /31, which was rejected by the Government.

The merits of full application of VAT to financial services (when these are properly defined) are not inconsiderable. First, full taxation generally involves greater VAT revenues than other alternatives. Further, this option would best satisfy all four neutrality conditions. When financial services are appropriately defined, full taxation preserves neutrality between financial services and other goods and services, between different types of financial institutions, between the latter and non-specialized providers of
financial services and between domestic and foreign suppliers of financial services (assuming zero-rating of the latter). Indeed, the "full taxation" approach was favored strongly in New Zealand over the 'exemption' approach by some financial institutions and retailers./32

Other considerations suggest the need for great caution in applying the "full taxation approach. First, taxation of interest paid by registered firms to banks is both unnecessary and anomalous under a retail type tax credit VAT. Value added of firms is defined as the difference between receipts from the sale of goods and services minus purchases of other goods and services from other firms. Interest enters in the calculation neither as minuend or subtrahend. Rather, interest paid by registered firms to banks is a constituent of the remainder; it is in fact part of the value-added of firms, and is taxed at that level.

Full taxation of banking services provided to non-registered firms and to households might, however, be advisable on both neutrality and revenue grounds. But this approach also encounters problems. First, if transactions with non-registered firms and households were the only taxable transactions for banks, the latter would have to distinguish carefully between transactions of this type and those with firms registered for VAT. This could result in significant compliance difficulties, particularly since non-registered firms tend to be a higher proportion of total firms in LDCs than in industrial countries./33 Also, except in the unimaginable situation where households and non-registered firms were made responsible for withholding VAT on their "sales" to banks (deposits in interest-bearing accounts), banks would have to
be required to collect and remit VAT on both their "purchases" (deposits) and their "sales" (interest-bearing loans), a requirement that would be at the least unusual for a VAT. In addition, taxation of bank loans to households and non-registered firms would create incentives for financial disintermediation: persons would be faced with incentives to borrow from sources other than banks and financial institutions./34

Further, the "full taxation" approach, even when confined to transactions between banks on the one hand and households and non-registered firms on the other, involves transitional problems not encountered under either the exemption nor the zero-rating options. Application of VAT to all loans to these groups would cause banks to suffer windfall losses on existing loans and would also involve enormous compliance difficulties./35 Either intricate phasing-in provisions would be necessary, or the VAT would have to be limited only to financial contracts consummated after the effective date of the tax.

Finally, there is the issue of first defining the value of financial services and then deciding which definable services are to be considered as consumption. The nominal interest rate, we have seen, is not a good measure of the value of banking services provided in loans, particularly since a portion of the nominal rate reflects compensation for inflation risks assumed by banks. The value of the service provided by lenders is, arguably, measured by the costs of transferring funds from savers to investors: the costs of financial intermediation. In the U.S., these costs, measured roughly by commercial bank "spreads", may be as low as 1 to 1.5 percent, of the amount
of bank loans, but are at least twice that high in most LDCs. In any case, the value of the service rendered will ordinarily be a small fraction of the nominal interest rate.

2) The Exemption Option

Exemption of banking services is fraught with problems. Exemption means only that the sales of the exempted service are not subject to tax; firms supplying exempted services, however, pay tax on their purchases. Banking services provided to registered business firms are exempt (as opposed to zero-rated), value-added at the exempted banking stage is recaptured, for tax purposes, in sales at the registered business stage because there are no VAT credits to applied from "purchases" from financial institutions. If this were the only effect of exempting banking, few problems would arise. But in addition, the registered business firms bear (under usual forward shifting assumptions) the tax paid by the exempt banks on their purchases. Thus, when a registered non-financial business firm sells to a final consumer, VAT is due on his sales, unreduced by any credits arising from application of VAT to banking services. As a result, final sales of products sold by firms utilizing exempt banking services will be taxed more heavily than if banks were fully taxed.

The amount of VAT not allowed as credits under the exemption option may be considerable. Brannon (1986) estimates that in the U.S. financial sector, for example, purchases from other firms are as much as twenty to thirty percent of value-added ("loading"). Therefore, if financial institutions were exempt from VAT, they would still bear 20 to 30 percent of
the full VAT because they would receive no credits (refunds) on their taxable purchases from other firms.

Exemption involves other non-neutralities as well as administrative compliance difficulties. First, exemption would likely place domestic banks at some relative disadvantage vis-a-vis offshore banks, even if exports of financial services were zero-rated. Banks from other VAT countries of course benefit from zero-rating of their offshore activity, and the U.S. does not yet have a VAT. Therefore, in the domestic market, the services of home banks would appear less attractive to borrowers, given the difficulty of applying VAT to imports of all financial services, which may be easily concealed.

Second, exemption provides financial institutions with incentives to produce intermediate goods themselves (in-house computing, printing, and advisory services) rather than purchasing these inputs from specialized firms, with consequent loss in efficiency.

Administrative problems abound in the exemption option. First, exemption tends to create complicated apportionment problems for firms supplying both taxable goods and services and exempt financial services. Any VAT paid on inputs would have to be apportioned to insure that such firms do not claim credit for taxes paid on inputs used in the provision of exempt banking services.

Second, as noted by the New Zealand Advisory Panel (1985: p. 4-5) exemption makes the VAT highly vulnerable to sophisticated tax evasion
devices. With exemption of domestic transactions and the usual zero-rating of export transactions, customers of financial institutions would quickly discover how to secure non-taxable financial services from offshore affiliates of domestic banks. For example, a bank in an LDC country using the exemption option for domestic banking services could first lend to an offshore affiliate. This would be deemed a zero-rated export transaction. The offshore affiliate would then lend to the LDC customer. With domestic financial services exempt, tax would not apply on the transaction, and refunds would have been paid on. All input taxes of the domestic bank that lent to the offshore affiliate. These and similar types of offshore arrangements are not uncommon even in Non-VAT countries in Southeast Asia and the Caribbean. A VAT with financial services exempt would enhance the attractiveness of such practices, thereby substantially reducing any revenue that otherwise would be gained by the exemption option (relative to zero rating).

3) The Zero-Rating Option

There are two principal disadvantages of zero-rating of banking services. The first, and most obvious, is the revenues that would thereby be foregone. We first compare revenue loss from zero-rating with that associated with exemption. Suppose that taxable purchases from other firms are as high as 20 to 30% of value-added by banks (as in the U.S.). In a middle-income country such as Indonesia where value-added in the financial sector (banking plus insurance) is 7% of GDP /37, revenues under exemption of all financial services would account to no more than 0.02 percent of GDP, at a VAT rate of 10%. Zero-rating, then would involve, at most, a revenue loss of 0.02 percent of GDP, assuming 100% collection efficiency under the exemption option. And
actual revenues under the exemption option would likely be considerably smaller, because of the availability of offshore tax avoidance devices.

Revenues from a fully collected, perfectly administered, 10% VAT on financial institutions would be about 0.7% of GNP for a country such as Indonesia. This is not a trivial number, but then again the assumption of perfect administration overstates actual revenue potential. In countries with relatively large financial sectors, however, the revenue consequences of zero-rating could be quite significant. For the U.S. Brannon (1986) estimates this loss at 9% of the yield of a hypothetical broad-based VAT.

The main problem involved in zero-rating is administrative in nature. Many LDC tax systems are not well geared to operation of rebate structures, whether for zero-rating of financial services or for exports. But inasmuch as a rebate system will have to be devised and operated for exports in any case, the incremental costs of applying zero-rating to financial services should not be too great, particularly given the relatively small number of financial firms involved in most LDCs.

C) Insurance Services

Choices regarding the tax treatment of insurance services are somewhat are clear-cut than for banking.

1) Full Taxation Option

Full taxation of insurance services involves certain administrative and conceptual difficulties, but may still be advisable for some types of
insurance. This is particularly true for non-life insurance services, provided in LDCs primarily to registered business firms. Taxation of these services under a VAT would give rise to credits for firms purchasing insurance. By itself, this presents no major problems.

There remains the issue, discussed earlier, of defining the value of insurance services in general and deciding which types of insurance services rendered to households are properly classifiable as consumption. Clearly the full value of the premium is not the appropriate measure of the value of the service. The best measure of this value is the net premium, or the "loading" charge. But it is not entirely clear that purchase of life insurance services represents consumption that should be taxable under a VAT. This issue however, cannot be resolved here.

Taxation of insurance services, however these services are measured, does involve some risks, because of the openness of the sector and because of the apparent mobility of international capital. Exports of insurance services, if any, would of course be zero-rated. If it is clear that imports of insurance services can be fully taxed on the same basis as that applicable to domestic insurance services, then taxation of insurance premiums will not result in any significant competitive disadvantages for domestic firms. It is not, however, altogether obvious that imports of insurance services can be easily detected, let alone taxed.

2) Exemption

Exemption of insurance services would give rise to the same types of problems with uncredited VAT on inputs as in banking. And, particularly with
regard to the ability of domestic insurance firms to compete in the domestic market with foreign firms, full taxation is preferable to exemption.

3) Zero-Rating

Here again, zero-rating involves the disadvantage of revenue loss. But given the small present size of the insurance sector in most LDCs (e.g. less than 2% of GDP in Indonesia) the losses would not be large. Zero-rating also involves some additional administrative demands, including that of providing rebates to insurance firms which, however are not numerous in most LDCs. Finally, zero-rating would favor somewhat the purchase of insurance services relative to taxed goods and services.

VI. Conclusions

Apart from administrative considerations, the best option is likely to be that of zero-rating. This option violates only one of the conditions for neutrality, whereas exemption violates all four. In addition, zero-rating of exports of financial services will be required in any case, in order to implement the destination principle. If a rebate structure is required for this purpose, and to accommodate new and rapidly growing firms, provision of rebates to the relatively small number of firms in the financial sector should not engender significant complications.

Also, the revenue consequences of zero-rating of financial services are not likely to be consequential in most LDCs considering an EC type of VAT, whereas this is not the case in Canada, the U.S. or Europe.
Moreover, the administrative and definitional problems involved in both the full taxation and the exemption options appear to at least as formidable in the LDC context as in industrial countries. Zero-rating is not, however, without its own administrative problems, but these are by no means insurmountable.

Finally, zero-rating is also most supportive of financial deepening in LDCs, an important consideration in countries where the financial sector is expected to shoulder a substantial share of the task of resource mobilization.

Complete exemption of all financial services is arguably the most unsatisfactory solution of all for LDCs, on almost all counts. Full taxation of all services is at least tolerable, provided the value of taxable services can be appropriately defined, and provided there is some assurance that imports of financial services will be effectively taxed. Neither proviso is likely to be satisfied in the LDC context.

If zero-rating of all financial services is however deemed impossible on administrative grounds then consideration might be given to the following alternative schema:

1) Full taxation of all non-life insurance, on grounds that these are provided primarily to registered firms (in the LDC setting). VAT paid on such services would be fully creditable against taxes due on sales of registered firms.
2) Zero-rating of bank transactions with registered firms, on grounds that full taxation of such activity is unnecessary under a VAT since interest expenses constitute a part of value-added of taxable firms.

3) Exemption, rather than zero-rating, of the value of life insurance services on grounds that these services are provided primarily to individuals, and that exemption is not likely to erode significantly the ability of life insurance firms to compete with foreign firms, provided that net, not gross premiums are taxed.

4) Exemption of banking services provided to households, and non-registered firms, on administrative and compliance grounds.

This last alternative is not in any sense preferred; it merely represents the maximum concessions that could be made to expediency, consistent with openness, financial deepening and administrative constraints.

Finally, this paper has examined issues in application of VAT to financial services in isolation from several other questions of VAT design. But resolution of these "other" issues may have an important bearing on the advisability of selecting one or another option for the tax treatment of financial services. For example, if all housing services are included in the base of a VAT, zero-rating of all intermediation costs in mortgage lending to households may not only be justified, but required for neutral treatment of housing. But, as is much more likely, VAT coverage of housing services is deficient because of practical difficulties in taxing imputed rent in owner-
occupied housing or full taxation of mortgage interest may be indicated as one means of redressing VAT discrimination in favor of consumption of housing services.
FOOTNOTES

1. Complex questions are involved in the tax treatment of reserves for bad debts of banks, foreign exchange gains and losses of banks, reserves of insurance companies, the taxation of income from reserves of pension funds, the relative tax treatment of mutual relative to stockholder owned insurance companies, and limiting the scope for transfer pricing by banks through such devices as related party loans. See for example, Aaron (1983).

2. For a clear discussion of the features of a consumption type VAT of the tax credit type, imposed on the destination principle, see Shoup, chapter ___, this volume.

3. The term deep finance, or financial deepening, is usually attributed to Shaw (1973). Financial deepening refers to growth in the real size of the financial system, as measured, for example, by the ratio of liquid assets to GNP. The essence of deep finance is avoidance of sharply negative real rates of interest.

4. See for example, Gillis, et al. (1983), chapter 3.


7 Gillis, 1984.

8. See Shoup (*) in this volume for a full description of the "subtraction" and "addition methods" of imposing VAT.

9. The special "addition type" VAT applied to a broad variety of financial institutions, including not only banks and insurance companies, but companies or cooperative societies receiving money on current account and withdrawable by check, and "any class of persons as determined by the Minister of Finance". (Shamus Diagnun, "Basis on Which Banking and Insurance Might Be Brought Within The Scope of VAT", Unpublished, Washington DC, 1984.

10. Exemption of financial services increases compliance difficulties because many firms in New Zealand provide both goods and financial services. For such firms exemption of financial services would require difficult apportionment problems for VAT paid on inputs for many firms, particularly those who extend credit as part of a normal sale. Office of the Advisory Panel on Goods and Service Tax, Second Report of the Advisory Panel on Goods and Services Tax to the Minister of Finance (Wellington: July 24, 1985), 4,5.

11. Ibid., at 4.
12. Ibid., at 19-20.

13. Ibid., at 17.


18. An efficient tax system is one that involves a minimum amount of deadweight loss (excess burden) for raising the required amount of revenue. An optimal tax system pursues both equity and efficiency goals; optimal tax analysis focuses on the trade off between equity objectives and the deadweight efficiency costs of raising a given amount of revenue. In general, either an efficient tax system or an optimal VAT system would involve different rates of tax on different goods, with tax rates inversely proportional to their demand elasticities. Quite clearly, neither a neutral tax structure, and in particular a uniform structure of tax rates clearly satisfies the requirements for efficient or optimal taxation. However, the informational and administrative requirements for imposing a set of optimal taxes across any economy are, under present technology, so great as to preclude its practical application. For a thorough survey of modern theories of excess burden and optimal taxation, see Auerbach (1985).

19. For a more optimistic view on how the tenets of optimal taxation can be applied, or at least considered, in a developing country setting, see David Newbery and Nicholas Stern (1986).

20. Uniform taxation of all current consumption expenditures will not, however, be neutral in its effects on the choice between present and future consumption, except under very special conditions. See McLure (1980).

21. The outlines of this example are due to Gerald Brannon (1986).

22. This will be more likely in a world where a) VAT nations zero-rate exports of financial services b) VAT nations do not impose special indirect taxes on financial institutions and c) Non-VAT nations do not impose sales or excise taxes on financial services. The first condition prevails almost universally among VAT nations. The second condition does not prevail universally in insurance services, as many EC countries (for example) impose special indirect levies on insurance. The third condition prevails in the U.S. and Canada (both Non-VAT Nations). Practices in other Non-VAT nations vary considerably.
23. Competitive disadvantages to domestic financial institutions will of course not occur to the extent that the "equivalence theorem" applies. This theorem holds that any competitive disadvantage for domestic firms arising from unrebated taxes on exports (and untaxed imports) will be vitiated by subsequent depreciation of the exchange rate, restoring the previous pattern of incentives to export and import. But the equivalence theorem applies fully only under a set of very restrictive assumptions, including 1) freely fluctuating exchange rates 2) no international capital flows 3) initial balanced trade between countries 4) no net transfer payments between nations (Shoup, 1969:205). In particular, then competitive disadvantages to domestic financial firms could easily result from both full application of VAT or a VAT exemption. Only zero-rating of financial services would insure that this would not occur.

24. For example, Feldstein and Horioka (1980:328) identify several types of institutional restrictions that account to implicit capital controls. In the U.S., these include laws that require savings institutions to invest in local real estate, and the "prudent man" rules governing many pension funds that deter them from investing abroad.

25. Long standing capital controls in Colombia before 1968, India, Argentina before 1979 and numerous other countries did not prevent the buildup of large resident-owned foreign currency holdings outside these countries in the past. Presumed stringency of capital controls did not prevent Indian multinational firms from exporting substantial capital while becoming significant foreign investors in Southeast Asia before 1975 (Wells, 1977).

26. Harberger (1980) concludes as follows: "In looking at rates of return in different countries and finding them basically uncorrelated with the capital labor ratio, concluded that there must be some force operating to prevent such a correlation from emerging, and the most natural explanation was that the world capital market was alive and well in Zurich". The Harberger sample of countries included both developed and developing nations.

Summers (1985) found significant evidence of a high degree of international capital mobility in a study embracing 115 countries, including both developing countries and OECD nations. The results were almost unchanged when the OECD countries were excluded from the sample.

Hartman (1983) found that foreign direct investment is very sensitive to tax rates in host countries; a conclusion also difficult to reconcile with capital immobility.

27. Shearer, Chant and Bond (1984:229)

28. In the EEC, however, it is more common to find zero rating only for export of financial services outside the EEC. The U.K. and Ireland in
the EC however, as well as Sweden and New Zealand, zero-rate all exported financial services.

30. It is taken for granted here that VAT will apply to "secondary" banking services.


38. See Conrad (1986).
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