JOURNAL OF ECONOMIC GROWTH

VOLUME 3 NUMBER 1

Tax Policy and Economic Growth in the Four Asian Tigers

Alvin Rabushka

Since the end of the Second World War, a handful of developing nations grew so fast that they leapfrogged from third-world to first-world status—literally from rags to riches—in one generation. Scholars coined a new phrase to identify this remarkable achievement; they renamed this small set of less developed countries (LDCs) as newly industrializing countries (NICs). Today NICs are found in the "upper middle-income" category of economies, defined as those with per capita gross national product (GNP) above $1,850 in 1985, which are listed in The World Bank's annual summary, *World Development Report*. What makes their rise so dramatic is that 25 to 35 years ago, this handful of nations was situated within the "low" or "lower middle-income" brackets with per capita GNP in the range of several hundred dollars or less. Their economic rise is historically unparalleled, even in the Western industrial world.

Within the upper middle-income economies, it is necessary to separate the NICs, which enjoy their current high living standards as a result of one generation of breakneck growth rates, based on a formula of hard work, high rates of capital formation and investment, and heavy dependence on exports, from their fellow members, who enjoy upper middle-income status through oil (e.g., Trinidad and Tobago, Venezuela, Iran, Iraq) or from much longer trends of modest growth (e.g., Mexico, Uruguay, Argentina, Greece). The entire upper middle-income category averaged 3.3 percent per capita income growth during 1960-1984, but the superstars of the developing world grew at the much more robust rate of 6 to 7 percent. For this select high-growth club, living standards doubled in 10 years, quadrupled in 20 years, and turned in an extraordinary eightfold increase in just 30 years.

These post-World War II success stories are found in the Pacific Area Basin. The four most successful cases are Hong Kong, Taiwan, South Korea and Singapore. They are often labeled as the "four Asian tigers" or "dragons," which reflects their Chinese (or Korean) ethnic populations and Confucian tradition.

Scholars of economic development, as well as leaders of LDCs that remain mired in poverty, have given increased attention to analyzing the tigers. Yet, few scholars have examined the role of tax policy in accounting for the tigers' economic miracles. And, when they do, the emphasis has been placed on the need for developing nations to increase their tax collection efforts by imposing higher tax rates and improving the efficiency of tax administration to raise the level of government savings. Much of this literature has focused on issues of redistribution and the progressivity or regressivity of the tax systems, rather than on growth. Development specialists have often counseled leaders of LDCs to use their tax systems to foster equity by imposing steeply progressive rates of tax on upper-income households.

Until the supply-side revolution of recent years, virtually no one studied the effect of tax rates on economic

Alvin Rabushka is Senior Fellow at the Hoover Institution, Stanford University. He is the author of several books on Hong Kong and economic development in East Asia. His most recent book is The New China *which is jointly published by Westview Press and the Pacific Research Institute.*

growth, especially tax rates on individual and company (or corporation) income and capital. From the viewpoint of promoting growth—the main focus of modern-day supply-side economics—little emphasis has been placed on how best to structure the systems of direct and indirect taxation to provide positive incentives and minimize disincentives. The object of this article is to summarize the evolution of the tax systems of the four tigers to determine how tax policy assisted the process of growth.

The Basics of Economic Policy

Although the choice of sound tax policies can go a long way in fostering the quintessential ingredients of growth—investment, saving, risk-taking, and hard work—tax policy by itself is not and will never be a panacea for the economic ills of retrograde, stagnant, or slow-growing developing nations. Financial leaders[1] in all four nations stress the importance of first getting the "basics" right in order for tax policy to play a positive role in stimulating economic growth. What are the basics?

- Political stability.
- Honest, dedicated, incorruptible government.
- Efficient administration with a minimum of red tape.
- The rule of law.
- Labor stability.
- Sensible trade union leaders.
- Reliance on private enterprise.
- A correctly valued exchange rate.
- An export orientation.
- Prudent conduct of the public finances.
- Controlling the overall growth of public spending.
- Avoiding the protection of inefficient industries through high import duties.
- Focusing public spending on infrastructure, not programs for redistributing income.
- Positive interest rates to encourage saving.
- Development of capital markets.
- Minimum of subsidies and state-owned enterprises.
- Monetary control.
- Productive use of foreign aid for a limited period.

When these basics are right, the incentives embodied in supply-side tax policies stimulate capital formation, attract investment, encourage risk taking, and induce hard work.

Responsible officials in Hong Kong, Taiwan, South Korea, and Singapore got the basics right. They were, therefore, able to utilize tax policy to stimulate high rates of economic growth. Their experience affords valuable insights for leaders of the other more than one hundred slower-growing developing nations.

Two Models of Tax Policy

An analysis of the tax systems of the tigers illustrates two alternative approaches to using tax policy to foster growth. The first model is that of a broad-based, low-rate, neutral tax system with no capital gains taxation. This model gives primacy to the free play of market forces to determine the composition and quantity of output. The government plays a minimal role in directing economic activity through preferential tax treatment of one sector over another, or of one industry over another within any sector. It does not discriminate between resident and nonresident firms or individuals for any line of economic activity. Hong Kong exemplifies this model.

The second model is more complex. It includes the widespread application of selective incentives given to domestic and foreign investors. Although the second model encompasses systems of graduated personal and company taxes and complex schemes of indirect taxes, *the overall burden of taxation, especially direct taxes, is deliberately kept at very low levels and capital income is taxed extremely lightly*. Large exemptions are given to dividend and interest income and capital gains transactions (with the exception of real estate) are taxed lightly or not at all. Taiwan, South Korea, and Singapore reflect the second approach through the mid-1980s.

Within the past few years, national tax reform commissions were created in Taiwan and South Korea and taxation was examined by an economic review committee in Singapore. In all three countries, the consensus that emerged was in favor of *greater tax neutrality* and reduced reliance on selective incentives. Each review committee recommended gradual movement in the

direction of a more broadly-based, lower-rate system of taxation along the lines of that found in Hong Kong. Government officials in all three nations have reduced the top marginal rate of income tax in recent years and are reviewing various investment statutes to see which selective incentives they should repeal in favor of across-the-board lower rates of taxation.

It should be noted that some scholars and government officials who served on these commissions insisted that the early incentives were appropriate to their countries' capital-starved circumstances of the 1950s and 1960s, and that movement in the direction of a broad-based, low-rate tax system only now befits their countries' greater level of development. Despite growing consensus, those officials responsible for evaluating and approving applications for tax incentives maintain that incentives are essential to attract new, especially high-technology investment.

Model One: Broad-Based, Low-Rate Neutral Tax System

The British Crown Colony of Hong Kong exemplifies the first model. Since the British occupation of Hong Kong in 1841, the colonial government adhered to a set of free-market economic policies and conservative fiscal policies. Hong Kong maintained a system of low taxation and balanced budgets, which was initially rooted in historical precedents of financial administration under guidance given to colonial governors and the general laissez-faire economic policies of the nineteenth century. These principles continue to be practiced in modern times in the belief that low tax rates stimulate risk-taking, investment, and hard work. Financial authorities in Hong Kong consistently stress one tenet of tax policy: *low rates of direct taxation facilitate economic growth*. Moreover, low tax rates combined with rapid economic growth produced budget surpluses in thirty-two of the thirty-five years during the 1947-1982 period. These surpluses were obtained after charging against current receipts all current and capital expenditures.

To reiterate, Hong Kong's financial secretaries deliberately maintained a system of low rates of direct taxation.[2] They set the standard tax on corporate profits and salaries at a flat rate of 10 percent in 1947, increased it to 12.5 percent in 1951 in response to a budget deficit, and then to 15 percent in 1966 in response to another deficit. A 10 percent surcharge was added to the corporate profits tax in the 1975-76 fiscal year for a total rate of 16.5 percent. Another two percentage points were added to both tax rates in 1984 to reduce a string of deficits that erupted in 1983 due to a loss of confidence resulting from uncertainty surrounding the Sino-British talks on the future of Hong Kong. In his maiden budget address in February 1987, the new financial secretary reported that economic growth exceeded eight percent in 1986, and that a sizeable unexpected surplus had materialized. He seized this opportunity to reverse a postwar trend and shaved both the standard corporate and personal tax rates half a percentage point to 18 and 16.5 percent, respectively. Despite the reduction in rates, an even larger surplus materialized in 1987.

Personal allowances are extremely generous. A mere 43,000 taxpayers (eight percent of all taxpayers) account for 52 percent of direct tax revenue, and only a quarter million salaried taxpayers, of a total population of 5.5 million, bear any direct income tax liability. Hong Kong's individual income tax is highly progressive, despite a statutory system of low rates.

Within Hong Kong, trade formalities are few and inexpensive. As a duty-free port, Hong Kong allows the entry and exit of most raw materials, consumer goods, and commodities with only a registration charge. The scope for indirect taxes on imports is severely limited in a free port: to raise revenue, duties are only imposed on liquors, manufactured tobacco, and hydrocarbon oils.

The government's reliance on the private sector extends to public utilities and public transport: electricity, gas, telephone services, buses, ferries, and tramways are lodged in private hands. In the provision of public economic services, the government depends on fees and user charges to recover costs without assessing a general charge to the taxpayer. Government's management style follows the doctrine of economic self-support except when, as in the case of such specific subsidies as low-income housing, education, health care, and transfer payments, it has overriding social reasons not to do so, and resorts to general tax revenue to pay for those programs.

The government levies a property tax at 17 percent of rateable value on investment property after expenses, and owner-occupants are exempt from the charge. It also depends on a wide mix of revenues from land and property sales, stamp and excise duties, entertainment taxes on admission charges to movie theaters and race meetings, a hotel accommodation and airport departure tax, and fees and charges from publicly supplied commercial services.

Hong Kong does not offer any special concessions to overseas investors that are unavailable to local residents. Nor does it provide specific investment incentives by type of industry or level of investment; rather, it tries to maintain a neutral, attractive overall environment.

The Hong Kong government does not employ any means of compulsory procurement of agricultural or industrial goods at below-market prices and thus imposes no implicit taxes on Hong Kong producers.

Hong Kong levies no tax on interest earnings or capital gains transactions, which effectively exempts most capital income from taxation. These policies encourage saving, investment, and risk-taking.

Since World War II, Hong Kong has enjoyed four decades of remarkable economic growth. Per capita income rose from $180 in 1950 to $7,800 by 1988. Despite a tripling of its population, and several crises of confidence arising out of the uncertainty over the colony's future under Chinese rule, annual real gross domestic product (GDP) growth exceeded eight percent, productivity grew steadily, unemployment declined and remained below three percent, and rates of capital formation exceeded 20 percent. Total trade grew more than two-hundredfold between 1947 and 1985, pushing Hong Kong into the ranks of the 15 largest trading communities in the world. In per capita terms, Hong Kong is the world's largest overseas purchaser of American goods. The number of families below the poverty level steadily declined. The World Bank reported that since 1960 both public and private consumption increased at an annual rate approaching 10 percent. These improvements took place without foreign aid.

Model Two: Selective Incentives

The remaining three nations exemplify the second model, though two of them are beginning to reduce dependence on selective incentives in favor of a more neutral, broadly-based, low rate system of taxation.

Taiwan

The semi-tropical, 36,000 square kilometer island of Taiwan, home to 20 million Chinese, is among the most densely populated nations in the world. A rugged, mountainous island, Taiwan has few mineral resources and its manufacturers must import the bulk of their industrial raw materials. Although the island's Japanese occupiers made considerable progress in developing the infrastructure during 1895-1945, Allied bombing and lack of maintenance left the island's economy in tatters. When Generalissimo Chiang Kai-shek's Nationalist Party seized control of Taiwan in 1949, his government immediately had to cope with low production, rife inflation, inadequate housing, and one million displaced mainlanders who accompanied their leader to Taiwan.

The first decade of economic policy, 1949-1958, included a comprehensive land reform program to broaden the base of rural landownership and increase agricultural output, arresting inflation through a series of financial reforms, and developing local industry behind a wall of government tariffs and other restrictions on free trade. During this period, Taiwan depended heavily on U.S. aid.

As a consequence of the gradual exhaustion of the protected domestic market, by the mid to late-1950s the process of primary import substitution began to slow down and the annual growth rate of industrial output declined. Further industrial growth depended on new market outlets overseas.

The effort to eliminate budget deficits, which were financed by the printing presses in the late 1940s with destructive inflationary effects, received priority during the 1950s through watchful control of spending and American financial assistance, not by increases in taxation which could have deterred economic growth. Holding down government spending made it possible to maintain light taxation.

Phase Two of Taiwan's economic policy began with a series of commercial, industrial, investment and tax reforms that were implemented during 1958-1962, and which were steadily augmented through the 1980s. These reforms transformed Taiwan's economy into a predominantly private enterprise, competitive market system.

In Taiwan, tax policy largely served the two aspects of raising revenue to finance agreed upon government programs, with heavy emphasis on infrastructure, and promote economic development through tax incentives. The groundwork for the use of tax policy to encourage capital formation and investment was laid in the 1950s. Prominent officials were authorized to identify bottlenecks to investment and capital formation, and propose new laws, regulations, and policies to increase capital formation. Officials were dispatched overseas to study the postwar incentive measures employed by West Germany and Japan. From these findings, they prepared a bill that became the basis of the far-reaching "Statute for Encouragement of Investment" which was enacted in 1960, and revised fourteen times through 1986. The statute was designed to promote investment in productive enterprises, encourage domestic saving and capital formation, and stimulate export expansion.

The statute fostered an improved business climate through specific incentives. It included a five-year tax holiday to approved export-oriented enterprises, cut the maximum rate of business tax on approved enterprises from 32.5 percent to 18 percent, waived or reduced the stamp tax, and provided for the deduction of reinvested profits and two percent of annual export proceeds, and a reserve of seven percent of pretax profits against possible loss caused by exchange rate changes. A related statute, designed to facilitate the duty-free import of capital goods, established an export processing zone in 1965. Three zones grew so fast that they created seven percent of all manufacturing jobs by 1970 and turned out a tenth of all exports.

Subsequent amendments to the 1960 statute included: (1) an additional four years of tax exemption or accelerated depreciation for new investments in machinery and equipment; (2) expensing of all research and development expenditures; (3) exemption of specific industries from duty on imported machinery and equipment; (4) special reduced tax rates on high technology firms; (5) investment tax credits of 5 to 20 percent on machinery and equipment; (6) tax-free treatment of stock dividends; (7) incentives for firms to list their shares publicly; (8) tax exemption of interest from bank deposits and bonds and dividends received by resident individuals up to $10,000 (double per capita income); (9) tax breaks for foreign executives and technicians living in Taiwan; (10) investment incentives to venture capital enterprises in the form of reduced corporate tax rates, investment tax credit, and tax-free capital gains transactions; among others.

While there is a capital gains tax on the statute books, it has been suspended every year by the directive of the minister of finance. The lack of an effective capital gains tax, the large exemption for interest and dividends, and the collection of tax holidays, credits, and depreciation provisions means that capital in Taiwan was taxed extremely lightly. Tax refunds to business persons ranged as high as 50 percent of total income, stamp, customs, and commodity taxes, which enabled firms to finance expansion from internal cash flow.

Financial authorities maintained a strict regime of a low aggregate tax burden. Receipts from all taxes averaged 17 percent of GNP during 1961-1985. Tax and monopoly revenue contributed about 70 percent of all government revenue, with the balance from the profits of public enterprises and utilities and a wide range of fees and charges.

Direct taxes grew from 22 to 37 percent of total tax receipts between 1960 and 1985, reflecting economic growth and an increase in the number of residents with taxable incomes, but the income tax itself only supplied about one-fifth of tax and monopoly revenues, or only about 14 percent of overall government revenues. Although the personal income tax imposed a top marginal rate of 60 percent on high incomes, scholars estimate that the few taxpayers who were affected at these income levels paid an effective tax rate below 35 percent due to generous deductions and preferential treatment of capital income. The government reduced personal and corporate tax rates in 1985 and future reductions in marginal rates are likely as the government moves to implement a more broadly-based, lower-rate system.

As part of a continuing process of liberalization, customs tariffs have been repeatedly lowered or exempted. In 1986, the government enacted a value-added tax (VAT) set at five percent to replace the antiquated multi-stage business tax. Taxing consumption rather than income is more conducive to growth.

Taiwan's leaders successfully turned the island into a prosperous, independent economy. Per capita income

rose from a low $70 at the end of World War II to nearly $5,000 in 1988. Real GNP grew at the astounding annual average rate of 8.2 percent in the 1950s, 9.1 percent in the 1960s, and 10 percent in the 1970s. By 1985, real GNP was fifteen times that of 1952, and the country's external assets exceeded $75 billion in 1988. Export expansion, fostered by tax incentives, created millions of new jobs. Total trade reached $50 billion in 1985. The unemployment rate, which was six percent in the early 1960s, fell and remained below two percent after 1968. Real wages rose sharply as Taiwan's economy changed from a state of surplus labor to full employment in the 1960s. The wage share of national income rose from 43 to 61 percent between 1952 and 1985.

The various savings incentives worked wonders. Between 1951 and 1959, the average ratio of net domestic savings to national income was only five percent. In 1963, it jumped to 13 percent (after U.S. aid was withdrawn). During 1967-1971, it ranged from 20 to 27 percent, and exceeded 30 percent every year during 1972-1980. The growth of new capital accumulation contributed to a steady rise in labor productivity; the value of capital per worker doubled between 1965 and 1980.

Personal consumption tripled during 1963-1985, and the Taiwanese today enjoy consumption of health and medical care, education, and consumer durables on a par with Western industrial democracies. Moreover, Taiwan enjoys the most equitable pattern of income distribution in the entire developing world.

Economic prosperity has permitted the government to undertake further political and economic reforms. Since 1987, exchange controls have been largely eliminated, visits to mainland China permitted, and opposition parties allowed to function freely in a growing democratic environment.

South Korea

The Republic of Korea is a small, 99,000 square kilometer, densely populated mountainous (only 23 percent of the land is cultivated), country of forty million people, with limited natural resources. Despite the fact that during its colonial occupation of 1910-1945 Japan introduced capital and new agricultural practices, and laid the foundations of an industrial base, the Korean War wreaked massive destruction. Three-fifths of the cultivated land was laid to waste, most industrial facilities were demolished, property damage exceeded $3 billion, the death toll was estimated at over three million people, and one-quarter of the population roamed the countryside as refugees. Ten million people were homeless and five million survived purely on relief. The international community regarded South Korea as the world's foremost "economic basket case," with dim prospects for its future.[3]

U. S. financial aid kept South Korea afloat during the 1950s. It financed the bulk of the country's budget and capital investments. Growth averaged 5.5 percent during 1954-1958, but fell to an annual average of 3.6 percent between 1959 and 1962. When General Park Chung Hee consolidated political power in 1962, South Korea was a very poor country with a per capita income of about $80, meager total output of $2.3 billion, and a high population growth rate of 2.9 percent. The reduction of foreign aid in the 1960s prompted the new South Korean leadership to adopt growth-oriented, outward-looking policies. The key to growth would be the rapid expansion of exports. This decision brought changes in the area of taxation, with bold new incentives for exporters.

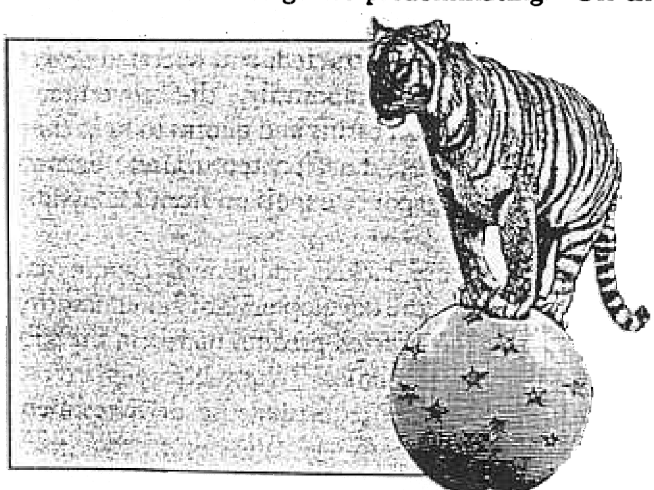
The South Korean approach to tax policy as a tool of economic growth rested on a few key principles. *First,* tax rates were kept low to encourage expanded private sector investment. Taxation of capital income was extremely light. Income redistribution through the tax system remained a distant concern to economic growth. *Second,* tax measures focused on improving the tax treatment of business. Changes were periodically made to increase the rate of investment by granting tax exemptions, accelerated depreciation, investment tax credits, export credits, and others. *Third,* increases in revenue required to pay for needed infrastructure were derived from real economic growth, not from increases in tax rates. *Fourth,* the burden of direct taxation was kept low, and indirect or consumption taxes were a main source of tax receipts. *Fifth,* whenever the government faced an urgent need for additional revenue, it strengthened tax administration rather than raising tax rates.

In 1948, the government set up a committee to prepare a modern tax system, which resulted in a personal income tax, corporation income tax, liquor, inheritance, travel, and various commodity taxes. Wartime needs for additional revenue raised all tax rates, imposed graduated schedules on the personal and corporation income taxes, and imposed an in-kind land tax. After the armistice, the government became concerned about the disincentive effects of high direct taxes on capital accumulation, and thus in 1956 reduced rates on direct taxes and shifted to a greater reliance on indirect taxes. Park Chung Hee's emphasis on exports brought fundamental changes in the tax system in 196: reductions in direct tax rates, incentives for export industries, and tax breaks for reinvestment in plant and equipment. The government adopted a VAT in 1976 to shift the burden of taxation onto consumption.

Indirect taxes supply about two-thirds and direct taxes about one-third of receipts from internal tax payments. The total internal tax burden (total tax receipts divided by GNP) averaged 10 percent during 1981-1985. Direct taxes consumed a meager 3.4 percent of GNP, with the individual income tax burden taking 1.9 percent and the corporate burden claiming 1.4 percent.

South Korea also relies on customs duties, liquor and tobacco taxes, the profits of government monopolies, and an education tax on interest and dividend income, which together generate about 61 percent as much revenue as the narrowly defined internal taxes (and twice as much as internal direct taxes). Indeed, when customs duties and government monopolies are added into overall taxation, direct taxation falls to 24 percent of total taxation.

The base of the personal income tax consists of wages and salaries, business income, property income, dividends and interest, and other miscellaneous sources, with the first two categories predominating. On the books, the personal income tax is steeply graduated with rates of up to 60 percent, but this statutory high rate is more symbolic than real. To begin with, through the early 1970s, 70 percent of wage earners did not pay personal income taxes; in 1985, 60 percent of the working population still remained below the personal income tax threshold. Substantial personal allowances exempt about 43 percent of all wage and salary income from taxation. A family of four receives total exemptions exceeding per capita income. Taxpayers in the lowest six percent tax rate category account for 53 percent of all taxpayers but they pay only 4.2 percent of personal income taxes. In contrast, taxpayers in the top one percent category account for 44 percent of all personal income taxes paid. In terms of marginal rates, about 92 percent of individual income taxpayers face marginal rates below 22 percent; less than four percent face rates exceeding 30 percent.



Taxation on capital is extremely light. Gains on transactions in shares are completely free of tax, and dividends and interest income are generally subject to flat rates ranging from 5 to 20 percent. Since 1983, the rate has been set at 10 percent.

Overall, the low aggregate level and effective low marginal tax rates on personal income, combined with ultra-light taxation of capital, drain few resources from the private sector, and do not discourage work, saving and investment.

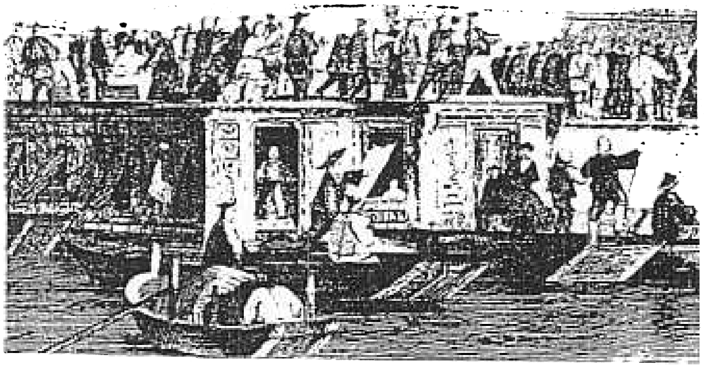
To promote the growth of the corporate sector, the government granted a steady stream of tax incentives to corporations. During the early developmental phase, it exempted all income from ships and aircraft employed in international transportation. It granted large tax exemptions on income from export business which reached 50 percent by 1961. It established tax free reserve systems to accommodate for losses in export business and granted deductions for overseas market development. Special depreciation was also given to exports. Generous tax holidays were provided to industries deemed important to national economic development—shipbuilding, machinery, basic metals, petrochemicals, and chemical fertilizer. Qualified investments received a five-year tax holiday.

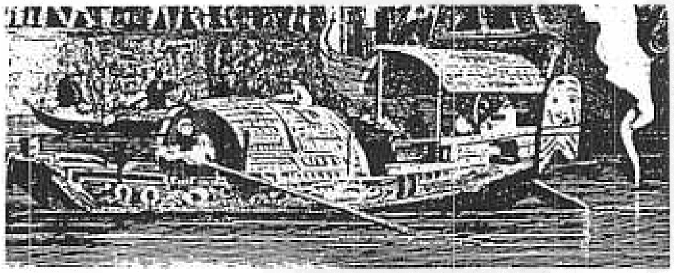
To this repertoire, the government added investment tax credits and special high rates of depreciation for fixed assets in key industries. South Korea now grants foreign investors special privileges under the Foreign Capital Inducement Act, which gives inward investment a five-year tax holiday with a 50 percent exemption for the ensuing three years. The government has also periodically lowered the corporation tax rates. Studies show that even the limited corporation income taxes reduced corporate saving more than they increased government revenue.

South Korea's financial planners emphasized tax policy as a tool of economic growth, relying heavily on commodity taxes both to discourage consumption and to hold down income tax rates. Annual income increased from under $100 in the 1950s to $3,000 in 1988. Since 1975, the unemployment rate has generally remained below four percent. Average monthly earnings in industry almost doubled during 1980-1985. The South Korean economy was transformed from a largely primary products based economy to one based on manufacturing, chiefly for export; agriculture fell from 45.2 to 15.3 percent of GNP during 1953-1985, while manufacturing grew from 13.6 to 28.1 percent. Foreign trade growth was positively spectacular; exports rose from $40 million in 1961 to $30 billion in 1985, growing at an average annual rate of 33 percent. The gross domestic savings rate rose by three percent during 1960-1962 to 18.7 percent by the mid-1970s and 28.3 percent by 1985. South Korea's heavy accumulation of $47 billion in foreign borrowing was reduced for the first time in 1985 as gross capital formation was fully financed from domestic sources. During 1987 and 1988, South Korea's massive trade surplus permitted a substantial paying down of the country's external debts, even as its currency appreciated.

Singapore

Singapore, "the Lion City," is an island city-state, located on the equator. About 77 percent of its 2.5 million people are Chinese with the remainder consisting of Malays and Indians. Its land area of 600 square kilometers is largely devoid of natural resources. Singapore's major assets are its strategic location on the trade routes connecting Europe and Japan, an excellent harbor, a diligent workforce, and an honest, efficient government inherited from British colonial days.





Since its founding in 1819, Singapore prospered as a free port, resting on the Victorian doctrine of free trade. Taxes were held to a minimum and the government maintained a nineteenth-century laissez-faire approach to economic affairs. Singapore moved to internal self-government in 1959 under the leadership of Lee Kuan Yew, the first prime minister, and attained full independence through a merger with Malaysia in 1963. The merger was shortlived when Singapore was expelled from Malaysia in 1965. It became a separate country in August 1965.

Singapore's leaders faced the daunting tasks of rehabilitating a war-ravaged economy, putting down a communist insurgency that threatened widespread labor instability, and coping with the British military withdrawal announced in 1965. At independence, British military spending accounted for 20 percent of GNP and six percent of employment.

During the initial union with Malaysia, Lee Kuan Yew pursued an industrial strategy of import substitution. Expulsion destroyed this strategy as Singapore-produced goods faced a Malaysian tariff wall. Lee set about creating jobs through a policy of export-oriented industrialization, shifting from the historical reliance on the entrepôt trade.

In 1959 the government adopted legislation exempting approved "pioneer industries" from the 40 percent company profits tax for five years, and granted generous depreciation allowances. It created an Economic Development Board in 1961 to grant loans to approved companies and take equity positions. The Board also planned, constructed, and operated several industrial estates. Temporarily, the government imposed modest import tariffs and quotas to help these fledgling companies, but protectionism became irrelevant after Singapore's expulsion from Malaysia.

Because Singapore lacked indigenous capital and local entrepreneurs, the development of manufacturing industry for export occurred predominantly in the subsidiaries of foreign companies. To attract foreign investment, Singapore made extensive use of investment incentives.

The Economic Expansion Incentives (Relief from Income Tax) Act of 1967, with subsequent amendments, is the primary law that sets forth the government's use of tax incentives to foster saving and investment and spur growth. The main features included: (1) exemption from the 50 percent corporate tax rate for a period of 5 to 10 years for enterprises receiving pioneer status (with dividends paid out of exempted profits, tax exempt in the hands of shareholders); (2) exemption of profits for expansion investments exceeding S$10 million; (3) a preferential four percent tax on export profits in excess of a specified base (with dividends paid out of exempted profits, tax exempt in the hands of shareholders); (4) tax deductions for new fixed investment when existing operations are upgraded; (5) exemption of 50 percent on profits earned from investment in warehouse buildings and equipment; (6) exemption of 50 percent on international consultancy services profits; (7) exemption of tax on interest for approved foreign loans; and (8) exemption of withholding tax on royalties.

By 1972, foreign investors were responsible for 80.4 percent of all investment commitments. By 1982, this percentage had declined to 66.2 percent. In 1981, foreign companies employed 58 percent of the manufacturing workforce and accounted for 76 percent of output, 66 percent of value added, 76 percent of total sales, 87 percent of direct exports and 72 percent of capital expenditures.

In addition to broad investment incentives, the Singapore government also offered personal saving incentives to both citizens and nonresidents. Taxes on interest paid to nonresident individuals on deposits held in Singapore banks were reduced from 40 to 10 percent in 1967, and fully exempted in 1969. To encourage domestic savings, interest paid by the Post Office Savings Bank was fully exempted in 1969. As a result, virtually the entire population participated in this tax-free inducement.

Although the personal income tax was graduated to a top rate of 55 percent in 1961, individuals were able to claim generous personal allowances and other permissible deductions. The top rate applied on taxable income exceeding S$90,000, which was 90 times per capita income, thus affecting a trivial percentage of the population. In 1977, the government widened the brackets and the top rate took effect only for taxable income exceeding S$750,000 in 1982. It also reduced the top marginal rate in stages to 33 percent by 1987. Singapore has no capital gains tax.

The key principle in the design of Singapore's tax system was the decision to tax capital lightly to increase the returns to capital, thereby encouraging foreign investors.

It was a general policy of the Singapore government not to subsidize public services. Overall, Singapore received about one-quarter of total public revenue from nontax sources. Government services were usually supplied at cost plus profit. Statutory boards have made large contributions to overall public sector nontax revenue.

During its entire post-independence period through 1983, the budget was consistently in surplus. These surpluses were available for investment and purchases of foreign assets. The government financed its development expenditures without recourse to foreign borrowing through Central Provident Fund (employees mandatory pension fund contributions) purchases of government securities.

Rapid increases in aggregate taxation and public spending during 1980-1984, coupled with the effects of a mandated high-wage policy, contributed to a severe recession in 1985. An Economic Review Committee recommended comprehensive tax reductions to restore Singapore's competitiveness. In all, the committee proposed tax reductions worth S$1.2 billion for 1986 and for the longer term proposed structural reforms in the direction of a uniform, low corporate and personal income tax regime. It recommended reducing the corporate tax rate from 40 to 30 percent, with a further reduction to 25 percent in later years. It called for retaining automation, research and development, and other selective incentives, but gradually eliminating them in favor of a neutral tax system. Other measures included a nine percent investment tax credit, three-year write-off of plant and machinery, expensing of computers and automated equipment, a reduction from 25 to 10 percent of the employers' payroll tax, exempting foreign source income of foreign companies with operational headquarters in Singapore, slashing property tax rates by half, granting a post-pioneer tax rate of 10 percent for five additional years, and shifting from direct to indirect consumption taxes.

Economic growth averaged 9.3 percent during 1960-1983. Foreign investment grew from S$82 million in 1966 to surpass S$1 billion every year since 1978. The total value of gross fixed assets increased from S$239 million in 1966 to S$9.6 billion by 1982. Gross domestic capital formation grew from 11.2 percent of GNP in 1960 to 40 percent in 1971 and has since averaged above 40 percent. The balance of payments was consistently in surplus as exports grew from S$3.6 billion in 1960 to S$67 billion in 1985.

Summary

The four Asian tigers adopted supply-side tax policies decades before the Reagan and Thatcher revolutions. Finance ministers oversaw systems of taxation that featured low rates and/or low levels of direct taxation of individuals and businesses, the absence of or very light charges on capital income (interest, dividends, capital gains), and a smorgasbord of inducements for domestic and foreign enterprises to invest and reinvest in each economy.

Hong Kong maintained the simplest approach, approximating the economist's notion of tax neutrality. Across-the-board, low rates of direct taxation neither discourage nor distort investment or overall economic activity. The revenue system is flushed out by a wide range of indirect taxes, fees, charges, licenses, and land sales. Where possible, the provision of public services is left to private enterprises, and government-provided economic services follow commercial practice.

The other three nations followed a strategy of granting selective incentives to encourage capital investment and accumulation. These incentives insured that capital income would be lightly taxed. In addition, emphasis was placed on taxing consumption. Taiwan employed a mixture of domestic and foreign investment, South Korea relied on its own domestic financial sources along with foreign borrowing, and Singapore's rush to prosperity rested on the direct investments of foreign-owned subsidiaries. All three sought to avoid disincentives to work, save, and invest by minimizing dependence on direct taxation.

None of the four governments has grown complacent in the late 1980s. Hong Kong and Singapore have reduced their top marginal rates of taxation on individuals and businesses in the past few years and their overall budgets remain solidly in surplus. Taiwan has embarked on a massive revamping of its tariffs and other impediments to free trade in goods and capital movements. South Korea is now beginning to liberalize and open its economy to foreign imports and business activities. In the first quarter of 1988, South Korea's economy grew at an annual rate of 16 percent. Both Taiwan and South Korea are likely to implement additional supply-side tax reforms in coming years. Confucius may have had little to say about tax policy in his *Analects*, but his descendants have been the world's foremost practitioners of supply-side economics in the post-World War II era.

Notes and References

[1]In September, October, and December 1986, I visited England, South Korea, Taiwan, Singapore, and Hong Kong to conduct research on tax policy in the four tigers. I interviewed as many past and current ministers of finance as I could contact to collect an oral history of the early years of tax policy in these nations.

[2] In the British colonial structure of Hong Kong, the determination of overall tax policy and specific tax rates is the prerogative of the financial secretary, the colony's equivalent of a minister of finance. Thus one man, not an executive committee or a legislature, makes tax policy decisions. In general, Hong Kong's financial secretaries have played a major role in picking their successors, though this practice has lapsed in the 1980s. Every postwar financial secretary in Hong Kong has reiterated the doctrine of low taxes.

In 1997, sovereignty over Hong Kong reverts to China on the expiry of the British government's lease on the New Territories. The Chinese have drafted a proposed constitution for Hong Kong, which will become a Special Administrative Region (SAR) of China on July 1, 1997. Article 107 of this "mini-constitution" stipulates that the HKSAR shall continue to practice a low tax policy [for 50 years until 2047]. China recognizes the important role that low taxes play in Hong Kong's growth. Whether China applies this lesson to its own development remains to be seen.

[3]One story that circulates in South Korea concerns a visit by the World Bank, whose officials regarded South Korea's future prospects as hopeless. Rather than invest bank funds in South Korea, so the story goes, the bank's officials suggested that the money be used instead to fly South Korea's leaders to Tanzania to study Julius Nyere's model of socialist development. One can't help but wonder if the reverse World Bank story now circulates in Tanzania.