Theory and Practice of Tax Policy and Reform in a Globalizing Era

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Modern Tax Systems developed mainly in the period between 1930 and 1960 when there were:

a. Restrictions on trade;
b. Very limited capital movement;
c. Limited mobility of individuals;
d. Little cross-country investments;
e. Limited cross-country shopping; and
f. Limited role of multinational enterprises.
At that time, tax burdens were low in most countries and Welfare States had not yet been established,

Tax levels were normally well under 30 percent of GDP, and

Economists did not show much concern about “welfare costs” of taxation.
During this period, there were two major “technological” developments in taxation that would have enormous consequences:

a. The introduction and affirmation of the “global income tax”. See Henry Simons’ book in 1938;

b. The introduction of the value added tax. See Maurice Lauré’s book in 1956;

c. They would become the work horses of tax systems for the rest of the century.
These two taxes (together with social security taxes) made possible large increases in the tax burdens (T/GDP) and the creation of Welfare States with universal public programs.

These two taxes now raise as much as 35 percent of GDP for Denmark, 25 percent for New Zealand and Sweden, and close to 20 percent for OECD countries.

Adding corporate income taxes (about 3 percent of GDP) and social security taxes (about 10 percent of GDP) we are close to total taxes.
In recent decades, important developments, often put under the umbrella of globalization, started to change the economic and fiscal scene. These developments accelerated in recent years leading some to argue that the World is Flat.

Some of these recent developments have major implications for both the theory and the practice of tax policy.
The most important of these developments are:

a. Opening of economies and growth of international trade;
b. Growth of cross-border capital movements;
c. Growing international mobility of individuals;
d. Growing role of multinationals, and
e. The process of outsourcing.
Tax administrators are facing great difficulties to deal with these changes.

The full implications of these changes for the tax systems are yet to be fully understood or felt.

Future tax reforms will need to reflect these changes.
A country can now try to attract and tax:

a. Foreign financial capital;
b. Foreign real capital;
c. Foreign consumers;
d. Foreign workers;
e. Foreign high income individuals; and
f. Foreign pensioners.
This means that, to some extent, part of a country’s tax burden can be exported.

Especially smaller countries, can “raid” the tax bases of other countries. This was not possible in earlier times, except through invasion.

In some sense, the “world tax base,” like the air and the ocean, has become a kind of “commons:” a common ground that all countries can try to exploit.

This is particularly important for the taxation of financial capital, but also for other tax bases. It has imposed limits to the rates that can be used.
This situation has created “tax competition.” Through “tax competition,” countries attempt to attract to them real and financial capital, foreign consumers, and foreign individuals with high incomes.

Tax competition has become an important real phenomenon.

At the moment it is more important for small countries but its scope is likely to grow.
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- Tax competition is related to the importance of taxation for the location of productive activities. However, this importance depends on several factors:
  a. Tax rates;
  b. Tax burdens (T/GDP);
  c. Tax burden with respect to specific tax bases (say corporate profits);
  d. Tax practice (administrative and compliance costs);
  e. Predictability or certainty of taxes over time (see work by Kydland and Prescott);
  f. Legal certainty (transparency of system);
  g. Use of tax revenue – services rendered by government; and
  h. Present and expected fiscal deficits and public debt.

Any of these factors can now influence economic decisions and must be taken into account in tax policy.
The tax climate of a particular location influences:

- The amount of investment and the choice of investment made within that location;
- The choice of its financing;
- The legal form of the enterprises that make the investment.

Countries that plan tax reforms should pay particular attention to that climate.

There is now growing competition among countries in providing a good tax climate to foreign investors.
When the people of a country face high tax rates, they may:

a. Vote with their feet; or
b. Vote with their portfolio (i.e. send their money abroad); or
c. Go underground with their activities;
d. Increase tax avoidance and tax evasion;

Remarkably all these options were ignored by the tax literature until the late 1970s;

“Supply-side economics” and globalization have made these options difficult to ignore.
A relevant question.

- Is tax competition a positive and welcome, phenomenon? Or a negative, unwelcome, phenomenon? On this, views diverge sharply.
- Some, and especially, theoretical economists, and those with a “public choice” bent, see it as a positive phenomenon.
- Ministers, directors of taxation and more practical economists often see it as a (major and growing) problem.
Arguments in favor of tax competition:

- It forces countries to lower tax rates, especially on mobile tax bases, such as financial capital, highly skilled workers, and so on. Lower tax rates imply lower “welfare costs”. Marginal rates of personal and corporate income taxes have fallen dramatically over the past two decades.
  
  a. By reducing tax revenue, it forces governments to reduce inefficient public expenditure. This is the “starve the beast” theory.
  
  b. It may allocate world savings toward areas where the savings are used more productively. An argument at times made in the USA.
  
  c. It may force politicians to reduce the economic role of the state.
  
  d. e. It may bring about a tax structure that is more dependent on immobile tax bases (wages and land) that theoretical economists consider less damaging to economic efficiency.
Arguments Against Tax Competition:

a. Because public spending is often inflexible downward (say pensions and interest on public debt) tax competition increases fiscal deficits and public debts.

b. If public spending can be cut, there is no guarantee that what will be cut will be the “inefficient” part of it.

c. Tax competition leads to “tax degradation.” Good taxes are replaced by bad taxes.

d. The shift of the tax burden on immobile factors makes the tax system less fair at a time when Gini coefficients are increasing in most countries.
Arguments Against Tax Competition:

- Increased burden on labor income is likely to stimulate underground economic activities and lead to populist policies.

f. Tax competition (and reactions to it) will make tax practice more difficult and will reduce the predictability of the tax system, affecting negatively the investment climate (see again the work by Kydland and Prescott).

g. For a country with high public debt and fiscal deficit and a growing need for revenue, because of the impact of ageing on public spending (see Japan), tax competition can clearly create difficulties.
Effects of Tax Competition on Tax Systems

a. Effects on tax revenue are statistically not very strong or obvious yet. However, T/GDP have stopped rising and have started falling in many countries.

b. The rates of personal income taxes and corporate income taxes are sharply down in the past two decades.

c. The rates of excises on luxury products are also sharply down. Revenue from excises are also sharply down.
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- Effects of Tax Competition on Tax Systems
  
d. The popularity of “global income taxes” has fallen sharply.
  
e. “Dual Income Taxes” (a return to the schedular approach to income taxes) are becoming popular.
  
f. There is growing interest in “flat rate taxes” in a world where the income distribution is becoming more uneven.
In addition, there is:

- The rise of “Fiscal Termites” as a result of the interplay of globalization, tax competition, and new technology. “Fiscal termites” will weaken the foundations of the current tax systems. They are growing in importance with the passing of time. Let me mention some of them.
First Termite: Electronic Commerce

a. Growing fast both nationally and internationally (example e-bay website)
b. Discussion on whether it should be taxed. And on whether it can be taxed.
c. Shift from physical to digital products.
d. Problem with origin principle when the origin can be anywhere, even in space.
e. Destination principle? How do you administer it?
f. Meaning of jurisdiction? Tax address?
Second Termite: Electronic Money

a. Real money replaced by electronic money embedded in chips of electronic cards. Bancomat, etc.

b. Online e-cash – a “purse” software purchased from a participating bank for specific uses. Telephone cards.


d. Both can be accounted (record of transactions is kept); and unaccounted (no record of transactions is kept).

e. Just think of secret bank accounts (Switzerland, Austria, Belgium, Lichtenstein, etc.) which feed unaccounted e-purses.
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- Third Termite: Intracompany Transactions

a. Trade within parts of a multinational enterprise located in different countries and use of transfer prices for:
   - Copyrights
   - Trademarks
   - Headquarter costs
   - R&D costs
   - Loans and Thin Capitalization

In 2004, 42% of all U.S. trade was intra corporate transaction and this figure does not include licensing
Third Termite: Intracompany Transactions

b. Determination of these costs-difficulties.
c. Advanced price agreements.
d. The luck of the Irish. In 2002, U.S. companies reported profits in Ireland equal to 15% of Irish GDP. Little profit reported in Germany.
e. Increasing frictions between countries on share of taxes.
f. A poll by Ernst & Young of 476 companies in 22 countries. Two-thirds had been challenged. 40% of audit had resulted in higher tax payments.
g. IRS demanded US $7.8 bn in back taxes from Glaxo Smithkline.
h. Complexity of supply chains has increased the problems with transfer pricing.
i. Transfer pricing part of a tax planning strategy.
Fourth Termite: Off-Shore Financial Centers and Tax Havens

a. Growth
b. Characteristics
c. Size of deposits
d. Tax addresses, tax evasion, money laundering
e. OECD, FATF, IMF actions
f. Their future?
Fifth Termite: New Financial Instruments

a. Hedge funds and market for derivatives.


c. Complexity of instruments.
   Rocket scientists – Role of
   LTCM experience & role of Nobel Prizes in Economics
   Clarification of gains
      capital gains
      incomes
   Spatial allocation of gains

d. Fannie Mae and Overstating of profits by U.S. $12 bn.

e. ENRON, PARMALAT?
Sixth Termite: Global Financial Market

- Taxation Theory;
- Capital mobility and tax rates;
- And global income tax;
- Falling marginal tax rates;
- Banking secrecy;
- Minimum taxes?
- And exchange of information
- EU savings directive
Seventh Termite: Foreign Activities of Individuals

- Earning income abroad and not reporting it to national authorities
- Foreign shopping to avoid high excises at home

Other Termites? Combination of them?
How much do we understand their work?
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- Effects of Termites on:
  - Tax Burdens
  - Tax Structure
  - Use of Tax Bases
Can Fiscal Termites be neutralized? Possibilities:

- Fighting Tax Havens: Problems
- Fighting Bank Secrecy: Problems
- Promoting Exchange of Information: Problems
- Tax harmonization or coordination
- Promoting source-based taxation

Obvious implications for tax policy and tax reform.
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- Exchange of Information
  - Tax treaties
  - Transaction costs
  - Legal obstacles
  - Incentive incompatibility
- Other obstacles: linguistic, definitional, commercial secrets, etc.
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- Tax Harmonization and tax coordination?
  - Is tax harmonization feasible? Possible?
  - Tax Coordination with surveillance?

- Creation of a World Tax Organization?

- Financing Global Public Goods?

- Globalization and the future of Welfare States?
Some Comments on Theory of Taxation:

- Analogy with capital in centrally planned economies: input-input system.
- Factors to take into account in Tax Reforms:
  i. Link to macroeconomic policy and to current and future revenue needs. Too much tax theory is delinked from macroeconomic reality.
  ii. Tax reforms are not made by economists but by policymakers who are often lawyers. Tax reforms must be understood and accepted by policymakers.
  iii. They do not understand the finer points of tax theory. Use the Kiss principle (“keep it simple stupid”). If it is complex, avoid it. Importance of intuitive understanding.
Some comments:

iv. Theories that are not obvious to the general informed public will not have much chance.

v. Problem of “optimal taxation theory”: often economists have difficulties in understanding the points made. How can it influence the practice of tax policy? Practical problems are pushed under the rug.

vi. Worry about the obvious, immediate distributional aspects.
These are the ones that concern policymakers.

vii. Make sure that tax changes do not make the tax system more complex. This is happening on a large scale. U.S. experience.
Some comments:

viii. Worry about administrative and compliance costs.

ix. The lower is the Gini coefficient of a country, the more acceptable are tax systems with low marginal tax rates. You cannot ignore the income distribution.

x. Flat-rate taxes should have no place in countries with high Gini coefficients and worsening income distributions.