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The Crisis in Tax Administration
- The problem of complexity -

"Two steps forward, one step back"
Some observations on the experiences and innovations of other countries

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[1] The views expressed in this paper are those of the authors and do not commit the OECD or its Member Governments.

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A crisis in tax administration?

It is fitting that we are at a conference discussing the crisis in Tax Administration here in the United States of America. This great nation was born out of a crisis in taxation and its administration.

Some may ask "What crisis?", but globalisation, the increased complexity of modern business structures, their financing and the nature of their transactions are bringing a host of new challenges for international and domestic taxation systems. I remain an optimist that out of these challenges will emerge a more robust, cost effective and efficient tax systems and administrations – but it will not be a pain free transition and some hard questions have to be answered.

I should say at the outset that there is no one right answer on how best to fund government infrastructure and services – nor on how best to administer the tax system. While all OECD countries operate conceptually similar tax systems they differ considerably in the relative size of the government sector and in the specifics of the tax system's policy, thresholds, rates and administrative practices.

While there is significant diversity in OECD tax systems there are also many similarities. OECD members generally collect the bulk of their revenues from the payment of individual income tax and associated social security contributions and from value added or sales taxes. Other taxes and duties such as those on property make up a much smaller cut of the tax pie. For those interested in the detail, Annex I of this paper provides an overview of the tax levels and structures in OECD countries.

One key point to make is that, whatever a government's approach is to tax rates and the tax base, having the best tax policy and laws in the world will not help you if your tax administration is under-funded, incompetent, corrupt or overzealous. In the OECD this is generally not the situation, though I will return to the issue of funding later.

In most countries in the OECD I would suggest that the issue is not so much the behaviour of the tax administration (although some may disagree), but about what it is they have to administer. In looking at the root causes of problems in tax administration you need to consider what it is that is being administered. The tax law and how it is interpreted.

And you cannot really consider problems caused by the law until you reflect on the efficacy and practicality of the tax policy that the law is meant to implement.

The entire system, all of its players, their behaviors, and drivers of those behaviors need to be considered in an objective, holistic and systemic manner if countries are going to tackle successfully their crisis in tax administration.

For it is not just a crisis of taxation complexity in the United States - all countries, OECD members or not, face a similar set of problems and have the same desire to simplify their tax systems.

Some Observations on Tax Simplification Strategies

At the start I should say that this paper is not an academic treatise. Good data on tax system comparability, particularly regarding tax administration, is unfortunately lacking, so the bulk of this paper is constructed around my observations and experiences with a range of OECD member country tax systems.

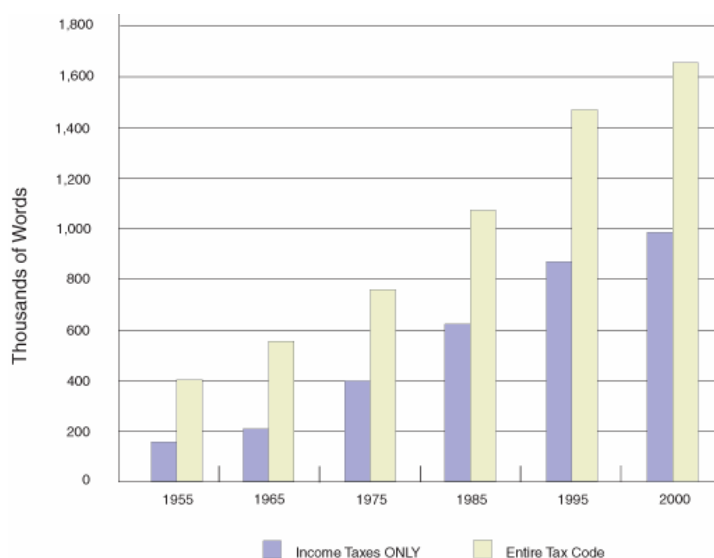
The issue of tax system complexity is not new nor confined to the United States. Your Treasury Secretary, Paul O'Neill, noted in February 2002: *"Our tax code is an abomination. It strangles our prosperity . . . and it is a drag on our ability to create jobs in this nation." "It's as though we've hired 110,000 well-meaning, highly educated people and we've said to them: 'You've got to climb up this vertical steel wall ... and we're going to grease the wall to make it impossible for you to do,' and then we make fun of these people because they can't climb up the wall."*

Over two hundred years before that, the first Secretary of the Treasury, Alexander Hamilton, noted that: *"Tax laws have in vain been multiplied; new methods to enforce the collection have in vain been tried; the public expectation has been uniformly disappointed."*

This has continued to be true in all OECD member countries. For example the UK's Tax Law Review Committee noted in 1996 that much of the UK's tax legislation is impenetrable and incomprehensible, and even tax experts cannot understand parts of it.

Why is this and can anything realistically be done to address it? Looking at what has been tried in the past in OECD member countries yields some observations – but no quick fixes.

For example, much has been made, here and in other countries, of the growth of the number of pages of tax legislation, a phenomenon common to all countries, as a measure of this growing complexity. This US Tax Foundation graph illustrates the growth in the US Tax Code:



Growth of the Number of Words in the Internal Revenue Code - Selected Years 1955 – 2000

A recent New Zealand review of business compliance costs noted: *"Prima facie, tax compliance costs will increase over time unless the rate of removal of tax rules and regulations at least equals the rate of introduction of new rules and regulations. Even then, the act of changing from one set of policy initiatives to another will in itself create temporary increases in compliance costs."* http://www.businesscompliance.govt.nz/index.html

Not rocket science - but it is right. Some would say that this growth in size and complexity is a natural outcome of a complex evolving world interacting over time with the demands placed on our democratic systems of government and the responses to those demands.

Coming from a consensus based organisation where 30 member countries have to reach agreement on each word used in our documents I have a degree of sympathy for the plight of politicians trying to garner support for a policy in the community and then in Congress. I have seen first hand how a seemingly simple principle can become a larger work of tortured and twisted text. Staying in government in a democracy often results in difficult policy formulation process it seems.

That said, it is clear that there is a necessary degree of complexity in tax law if it is to be relevant to modern business structures and transactions. The US Joint Committee on Internal Revenue Taxation summed it up concisely when it said back in 1927 that: *"It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not."*

The world today is hardly like the world when income and consumption taxes were first introduced to replace customs and excise duties as the main source of government revenue.

Just as a Boeing 747 is more complex than the Wright brother's flyer, things have moved on. Modern financial innovations and globalisation, the rise of multinational organisations, the formation of trading blocks such as NAFTA, the EU, and the development of new communication technologies which enable corporations to exploit the integration of national economies, all make the world of today inherently more complex than that of the past. The law largely reflects this.

There is also, no doubt, a large degree of clutter and duplication in the law, reflecting the incremental, some would say band-aid, approach to law making that all governments by necessity use. Legal structures that seemed appropriate to legislators years ago do not reflect modern best practice in law design. Clearly stated objectives, plain English drafting, checklists, and consistent definitions of key terms all feature in modern law design and they can make things simpler - to an extent. Unfortunately to a limited extent.

Tinkering with the details can only get you so far. Evolution has to occasionally give way to revolution – a complete rewrite – but also the chance to reflect on and rethink tax concepts and approaches.

Just as you cannot bolt a 747 jet engine onto the Wright Flyer and expect it to work all that well, periodically governments need to completely rework their tax legislation if it is going to perform effectively in today's world.

Observation: Just simplifying tax law doesn't work

A number of countries - Australia, Canada, New Zealand, the United Kingdom for example - have already been down the path of extensive legislative simplification. What they have found is that without simplifying the underlying tax policy you cannot really simplify the law. And if the law cannot be made simple then it is inevitably going to be difficult to understand and administer.

For example New Zealand's law, while simplified into plain English, still generates essentially the same administrative and compliance burden for taxpayers as it did before it was simplified. Here's what a review of the extensive New Zealand simplification efforts said: *"From 1989-2001 11 tax simplification/compliance cost reduction policy documents have been published. Eight of these have been released in the last five years. Despite their relative frequency, and their effort to simplify various taxes and processes, the initiatives have had little impact on the volume of tax regulation, its complexity, and the compliance loading on business taxpayers."*

"Businesses considered taxation their most significant business compliance cost. Individuals expressed their anger, frustration, confusion and alienation about their attempts to meet their tax commitments. There was a great deal of support for the basic tax system itself, but very high levels of frustration in the way it was implemented. Business people told us that the complexity of the law made compliance difficult and very time consuming." Report of the Ministerial Panel on Compliance Costs, available at: http://www.businesscompliance.govt.nz/reports/final/final-11.html

Similar results emerge in Australia, where a major simplification effort has been underway for some years. They devoted significant drafting resources to their Tax Law Improvement Project, rewriting their tax act into what they thought was plain English.

When they did a readability test on Australia's simpler Tax Act, which by political necessity preserved existing tax policy, they found that while things had improved a bit, the level of readability still fell well below the benchmark considered acceptable for the general public. Indeed the majority of the new act still required a university level education to understand and the length of the tax code had increased. Five lines of one key section became five pages of plain English legislation.

No reduction in the length of the tax code nor in the complexity of complying with it is going to emerge from such a process. It seems clear that complex policy results in complex law and consequential difficulties in complying. I would note that much of the complexity in tax laws globally appears to relate to policies designed to provide tax breaks, but at the same time tries to limit those breaks or pre-empt tax avoidance activity. Complexity also results from the desire of some governments to ensure that the tax law always reflects the detailed circumstances of each and every individual, putting fairness and equality ahead of efficiency and administrative feasibility. Complexity also reflects the difficulties that governments face in targeting anti-abuse provisions to taxpayers at risk.

To me it seems as if we were back in the cold war engaging in a policy of escalation and mutually assured destruction. In this case mutually assured tax complexity and compliance costs. While avoidance behaviours should rightly be seen as a key driver of tax complexity, perhaps legislative complexity is the wrong answer to the problem. A theme I will return to.

Observation: Anti-avoidance and equity rule! Policy simplification needs a stronger voice

The competitive pressures generated by globalisation has led to a general trend towards base broadening simplification in many countries and reductions in tax rates, particularly on more mobile capital income. The OECD has encouraged this trend and Europe has led the way in cutting the top corporate and personal income tax rates – admittedly from a relatively high base. Annex I provides more details on these trends.

In many of these efforts, while reducing headline tax rates, have amplified seemingly simple economic distinctions between the nature of the income, the type of entity earning it, or the nature of the transaction, as governments try to shore up their revenue base. Each of these distinctions provides a point of complexity that builds over time. As taxpayers try to tailor their activities into categories that reduce tax, the Government counters.

For example, the Nordic countries, to a lesser extent Austria, Belgium, and most recently Italy, all adopted differing forms of dual income tax systems. In these systems all capital income, including corporate profits, is taxed at a lower uniform, proportional headline rate, reducing the debt/equity distinction. Less geographically mobile labour income is taxed at higher, generally progressive rates for vertical equity reasons. These dual income tax systems are somewhat similar in effect to the US Treasury's 1992 Comprehensive Business Income Tax proposal.

The difference in tax rates between labour and capital encourages a blurring of the concept – wage and salary earners become sub-contractors overnight. Anti-avoidance legislation based around master-servant concepts (i.e. a factual approach that appears to me to actually encourage avoidance opportunities) has been introduced or strengthened - increasing the complexity of the system.

Italy has tried one of the more innovative and conceptually simple ways of dealing with this. Rather than follow the path of complexity they essentially deem a rate of return (7% in the years 1997 – 99) on the capital invested that is taxed at the concessional corporate rate. They don't try for a false level of equity – near enough is good enough in this case. They have accepted that you cannot have "designer" regimes that try to produce exactly the right results for all taxpayers - a path that the US and most other countries have taken. It is rough but workable justice.

On the Consumption tax front only New Zealand stands out as having a relatively simple system. In Australia, as in Canada, Mexico and in Europe, the left of politics (who had the numbers in parliament) insisted upon an exemption from VAT for basic food because they argued the tax was regressive. And it is if taken on its own. Poorer people consume more of their income on food than rich people do.

The fact that rich people spend twice as much on basic food as the poor seems to have escaped them. That the poor also spend proportionally more on taxed take-away food than the rich also escaped them.

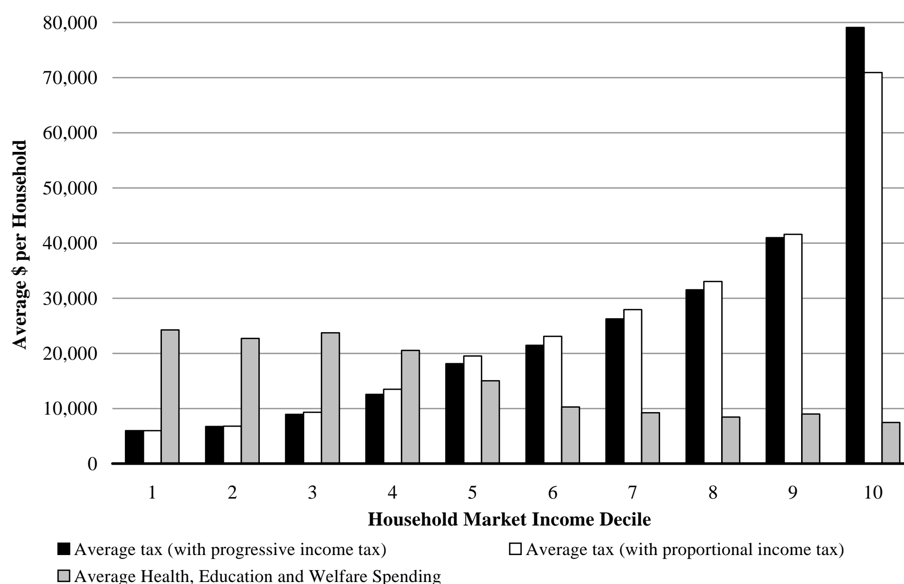
So once again complexity was introduced in the name of vertical equity - when carefully targeted low income welfare payments may well have achieved a much better overall equity result with lower administrative and compliance costs.

Think of the difficulties a small mixed business in these systems has in keeping track of what is taxed and what is not versus a system where everything is taxed at the same low rate. The calculation of tax could have been a simple matter of a percentage of receipts less expenditure for a period. Instead they have detailed record keeping and checking by the businesses and the tax administration.

A hot roast chicken is taxed while a cold roast chicken is not. Does anyone expect tax administrators and business owners to have thermometers on hand when they do their tax calculations? I'm exaggerating here a bit to make the point that some perfectly legitimate distinctions made for policy reasons create uncertainty, extra compliance burdens and opportunites for abuse.

I guess I need not note that of OECD members only the USA does not operate a VAT now. It is something that I suspect your government may have to confront, particularly in light of the falling revenues from sales taxes, the desire to reduce revenues from income taxes, and the pressure to increase spending on pensions, health, infrastructure and homeland defence.

Many of the attempts to introduce greater vertical equity into the tax system appear to be evaluated in isolation without considering that tax revenues are used to finance public expenditures that in turn have major distributional effects. A different picture can emerge when a more holistic and systemic view is taken. The following chart comes from the New Zealand 2001 Tax Review Final Report, unfortunately I don't have comparative figures for the United States, but I would be surprised if there was much difference in the overall trends.



Average Health, Education and Welfare Spending and Average Tax per Household by Household Market Income Decile in New Zealand. http://www.treasury.govt.nz/taxreview2001/finalreport/download.html

Note two things. One - that there is a significant income redistribution from the upper four income deciles to the lower four deciles. Two - that, at least in New Zealand - but probably also in most

OECD members, this is mainly accomplished via government spending rather than the effect of progressive tax rates. The second column on this slide is tax per decile if New Zealand adopted a 25% flat income tax. Not a large difference in equity outcomes for a lot of tax system complexity!

Serious tax simplification proposals should consider using other means, such as direct payments or non-wasteable tax credits, to achieve desired welfare equity and market correction goals. For example, income based payments to the poor to correct for regressive elements - industry payments for market corrections. Indeed any progressive rate system can be appropriately matched by a flat rate tax coupled with a payment system. And payment systems are generally more transparent and more closely monitored and questioned than tax expenditure based ones.

One trend to note is that a growing number of countries tax administrations are being asked to administer other government functions via the tax system such as welfare credits, child support payments, pension administration, excise rebates and the like.

Some tax administrations – Australia, Canada and UK, for example - are enthusiastically embracing this expansion in their role. They see this expansion as an acceptance by governments of the effectiveness of the tax administration. In most countries, tax administrations are one of the most effective and least corrupt parts of government. They have highly skilled staff spread throughout the country. They have information on the income of most households. All these features make them attractive as agencies to deliver income-related expenditure programmes. Also where benefits can be set off against taxes governments need only make a net payment to citizens or receive a net payment from them. This reinforces the link between taxes and benefits and can simplify the relationship between governments and citizens.

In Canada, this is considered such an important initiative, that in 1999 the tax administration department was assigned agency status to provide the administration with greater freedom to pursue new business opportunities with provinces and territories to reduce overlap and duplication of tax administration. To date the Canada Customs and Revenue Agency has entered into over 50 agreements with other government departments and agencies for joint program delivery.

Other tax administrations (e.g. Netherlands and Japan) have, for the moment, resisted this trend arguing that the expertise of the staff required to administer spending programmes are different from those required to administer taxes. They also consider that such responsibility increases the complexity of the tasks facing tax administrations (at a time when resources are being cut) and that issues of confidentiality arise.

While on the subject of tax system equity I would note that as politicians across the OECD countries appeal to increasingly older voters it seems unlikely to me that they will cut into expenditure programs that target these groups. Governments will continue to rely heavily on the income tax and social security system to pick up the tab for this. Hence they will be forced to either increase tax rates or widen the tax base or move yet further up the complexity spiral to limit the level of avoidance activities in an attempt to gain revenue. I can guess which way the politicians will move in the absence of a push against further complexity.

Simplicity needs a constituency with a stronger voice!

Observation: You may need to hide the complexity of policy and law

There are still large groups of taxpayers that find even simplified tax measures hard to understand and comply with. They always will. These tend to be the most numerous of the taxpaying groups – wage and salary earners, pensioners and retirees, small businesses.

For these people, most of whom are not lawyers or accountants (something I'm sure we are eternally grateful for), any dealing with the government, particularly over financial matters is a daunting and worrisome event. These are people who tend not to keep double entry accounts of their income and expenditure.

People for whom record keeping is a difficult and time consuming task, undertaken periodically at best and with a great deal of frustration. People who keep their receipts in a shoebox - that is if they retain them at all. Yet without records how can you expect taxpayers to be able to file an accurate return. Can we ever make the tax system simple enough for these people to be able to file their own return easily and correctly? I personally think not.

Many administrations have gone down the path of providing extensive assistance and/or encouraging the use of tax intermediaries for these groups of people. Here there is often a trade off between the costs borne by the tax administration (visible) and those compliance costs borne by the taxpayer (generally hidden). A pragmatic balance is needed while recognising that such costs are a key, and often ignored, part of the economic dead-weight waste of the tax system.

While direct administrative and compliance costs can be measured there are many elements that are more difficult to put a number on such as the costs of avoidance and evasive behaviours – of tax driven decisions. Estimates of these are harder to make. In 1997 Schneider[2] estimated the average 1994 OECD tax gap to be about 15% of GDP. Similar to the IRS estimate for the USA from their Tax Compliance Measurement Program. My feeling is that this hasn't changed much.

I believe tax gap figures have to be used with extreme caution around politicians as they tend to get used as a yardstick to measure the tax administration rather than merely as one outcome indicator of the health of the entire tax system.

They are also used to fend off the need for policy or tax rate changes by encouraging complex anti-avoidance legislation that affects all for the sake of catching the few. But the reality is that you are never going to legislate or audit your way to "full" compliance - it is unattainable. A balance is needed.

So, if you cannot make the whole system simpler to comply and administer, what can you do. The answer that a number of countries are increasingly adopting is to hide the complexity from those who don't need to know the detail or who are poorly placed to deal with it and comply.

Just as you don't need to know the detailed complexity of a 747 to fly in it, you don't need to know how the tax system works to use it - if you trust someone else to do the flying for you.

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[2] Schneider F (1997) Empirical results for the size of the shadow economy of Western European countries over time. Working Paper 9710, Instutut Für Volkswirtschaftslehre, LinzUniversity.

For taxpayers with regular income from well defined domestic sources (wages, pensions, welfare benefits, dividends, interest and the like) you can implement withholding and information reporting systems that allow the government to pre-complete the taxpayers entire return. Some thirty-six countries now do this and more are considering this approach.

It makes administrative sense to do so. Most returns from non-business taxpayers do not result in large amounts of additional tax – but they can take just as much time and resources to process. This non-filing can be quite popular with taxpayers too - even if paying taxes never will be.

In Denmark, for example, this system has reached the stage where Danish residents (not the tax administration) have pressured non-resident financial institutions in Sweden to supply the Danish tax administration with details of dividends and interest so that they don't have to file a form. Similarly farmers pressured the national farm co-operative to supply information so that large parts of their tax forms were pre-completed.

The tax administration pre-completes the tax form and indicates the amount payable or the refund due. If the person has no other information or corrections then they just don't respond. And rather than require a taxpayer who owes tax to send in a payment, the tax administration adjusts the main withholding source so that the debt is paid off over the next year.

No wonder it is popular. But it has taken the Danes fifteen years to get to this stage.

It is not a quick fix. I believe that the Internal Revenue Service Restructuring Act of 1998 requires the Secretary of the Treasury to implement a return-free system for appropriate individuals by 2007. It will be interesting to see if all of the pieces - the information flows and the withholding arrangements - can be put in place by that time frame.

The "Big Brother" issues that one may have thought that these processes would engender have not arisen either.

The taxpayer can see and correct any information held about his income. The government is in effect putting all of its cards on the table rather than playing a game of 'gotcha' when a taxpayer omits some interest income from an account. Systems wise it is a better use of the information that is already routinely collected and matched from third party income sources.

Such measures don't work for business income however and a number of countries have tackled the administration issues of this group in differing ways.

Observation: Small business needs special consideration

How do you deal with the tax affairs of small businesses – people who cannot hire a bevy of tax accountants or lawyers to ensure that they get things right. These are people who generally are so caught up in running their business, often until late each night, that they have little time for the seemly costly bureaucratic add-on processes required to comply with tax obligations.

It seems that you have to make the system a lot simpler for such people if you expect them to be able to comply easily. Australia has implemented an optional Simplified Tax System for small businesses – those with a turnover of under a million dollars – that allows for cash rather than accrual accounting, that has simplified depreciation with broad immediate write-off provisions, and that has simplified trading stock rules. Around 85 per cent of all manufacturers qualify for the Simplified Tax System and most use it - although I have seen reports that the complexity savings are not viewed by small businesses as that significant.

France has gone further. Their so-called micro-businesses, essentially sole proprietors, are presumed to have earned a taxable profit on their annual sales with a threshold of 70% of sales (i.e. 30% is profit) for the trading companies and 50% for other companies. So all the small business needs to track is sales. It can't get much simpler than that.

Businesses in France with profits below 115,000 Euro can also get a fixed deduction of 20% applied to their profits if they affiliate to a management support centre (Centre de Gestion Agréé) or a similar institution. These institutions have been set up by providers of financial, accounting and fiscal services, or by professional and trade organisations which provide fiscal and accounting support to associated companies. To get the deduction the business must meet special requirements with regard to their accounting systems, auditing and submitting of tax returns. The books and records of the associated companies must be kept by or under the supervision of a public accountant and all the records of the affiliated company must be audited and certified by a public accountant. So someone else is doing the flying.

In France it seems, if you can't make it simple, you can at least make it less costly - while at the same time getting better compliance. Unsurprisingly most businesses in France belong to these affiliations.

On the international side, e-commerce has opened the door for many small and medium businesses to trade across borders for the first time. Such businesses are very poorly placed to be able to comply with tax jurisdictions that differ significantly from their own. As this international trade by small and medium business grows I believe there will be an increased convergence and greater consistency and simplification across tax jurisdictions. Before we look at enforcing compliance we have to enable it.

This is already occurring to some extent within trade blocs such as the EU. I suspect that new and simpler ways of looking at international tax policy issues will come from it. Why should tax forms, transaction documentation requirements differ so radically between tax jurisdictions? Is there a standard and how can this be tailored so that the greatest burden falls on the highest risk taxpayers rather than on those at low risk?

What is the role of the tax administrator in all of this?

At the OECD we are facilitating meetings between tax administrations and working with business groups to try to derive a more consistent set of tax requirements between countries.

This work on TaxXML and eServices is only in its embryonic stages, but I am hopeful that it will reduce the burdens placed on businesses dealing with multiple jurisdictions and lead to greater standardisation of reporting requirements and approaches.

We have done a lot, but there is a lot more to do, particularly in the realm of small business taxation.

Observation: New compliance approaches are needed

We recently began facilitating meetings of tax administrators so that they could exchange ideas and best practices on small business compliance issues, on taxpayer services issues and more generally on how to manage a tax administration. What is emerging?

A number of OECD tax administrations are putting in place special, highly skilled teams to focus on ensuring that large tax driven arrangements (aggressive tax planning) that lack economic substance are regularly challenged and placed before the courts.

Penalty systems are being reviewed to ensure that they scale appropriately, do not penalise honest mistakes, but do deal progressively harshly with recidivists - those who seek to repeatedly abuse the system. Do we need a 'three strikes and you're out' approach for tax systems? What message would jailing more tax offenders send?

It's becoming clear that punishing the past is not always the most effective way to promote future compliance. Moreover while taxpayers tend to grossly over estimate their risk of being audited, as system complexity drives taxpayers to intermediaries, who are more aware of the true relative risks, this deterrent effect appears to be loosing its potency.

Some countries are looking at reducing reporting requirements for low risk taxpayers and increasing them, in some cases augmented by withholding arrangements, for high-risk taxpayers or groups of taxpayers. Other administrations have been working together with the relevant industry associations to derive a common viewpoint on good compliance and producing reporting measures that are easier to comply with.

Perhaps a combination of these approaches is needed whereby an industry with compliance problems is clearly and transparently warned to get its house in order, and is able to assist in the design of strategies to do this, or face the prospects of targeted documentation, reporting and withholding arrangements.

What if the three worst complying segments of society had such measures introduced for them for a five-year period? Do you think there would be industry pressure to get compliance rates up? I think we have to make the connection between rights and responsibilities – the social compact between society, the citizen and government – much more obvious.

A number of tax administrations have sought to effect what they call leverage approaches to compliance - to get more compliance bang for their buck.

In the UK they have been trailing letters to taxpayers who appear to be presenting a risk, advising them that their return may be selected for audit next year. Sure enough for this group less deductions are claimed and more income is returned. Interestingly when certainty was introduced, i.e. you will be audited next year; the results were less effective.

There is also a group for whom additional compliance tools appear to be needed. Some of the more unscrupulous tax intermediaries use their knowledge of the system and relationship with the

client to peddle tax schemes and arrangements that are unconnected with the underlying economic reality of the clients' situation. Often if these schemes fail, the client wears the penalty and the intermediary moves on to the next scheme, the next client, the next victim.

Unfortunately industry self-regulation does not seem to have been effective in gaining the social compact needed for such a position of trust within the tax system.

A number of countries have now decided to pursue the promoters of these schemes. Tax administrations need a deterrent that works against such recidivist scheme promoters.

A number of countries (Australia, Canada, New Zealand) have introduced promoter penalties to tackle those who aid and abet systemic tax fraud by their clients. The evidence is that those tax administrations that are consistently firm – but fair - in tackling tax avoidance and whose courts decide on the basis of economic substance rather than apparent legal form, end up with a higher level of overall compliance[3].

This enables tax rates to be lower than they otherwise would be - which is of benefit to all.

[3] See for example: Why People Evade Taxes in the Czech and Slovak Republics: A Tale of Twins, Jan Hanousek & Filip Palda

Observation: A new compact is needed

One segment that is a focus for public opinion is high wealth individuals. If this group is seen by the general community not to be abiding by the spirit of the tax laws then the community's confidence in the entire system is undermined.

If Leona Helmsley's attitude towards taxation – "*We don't pay taxes. Only the little people pay taxes.*" – become the norm, voluntary compliance would disappear.

We cannot expect a wage and salary earner, a pensioner or a small business owner to believe in the system when some of the wealthiest in society pay less in percentage terms than they do. In some countries a small number of the very wealthy have used schemes, complex structures, tax havens, political connections and the like, to achieve a total tax wipe-out and some have even become eligible for low income assistance.

And if you think this is limited to a few back room schemers think again. Here is a quote from a letter sent by a USA big 5 accountancy firm to its client: *"As we discussed, set forth below are the details of our proposal to recommend and implement our tax strategy to eliminate the Federal and state Income taxes associated with [the company's] income for up to five (5) years ('the Strategy')."*

This may be just good tax planning. But the danger is that tax becomes just another cost minimisation center in which the use of any scheme is justified even when it moves over the borderline from aggressive tax planning to evasion. The ability of a tax administration to address such systemic non-compliance should be a matter of priority in all countries. But it is difficult. It is not just a matter for the tax administration - it is a matter for all of society.

Achieving a tax result that though a blatantly artificial avoidance sham that does not accord with the economic substance of the situation should not be a matter of pride anywhere. And it should be a matter of shame for those in the accountancy and legal profession who facilitate such unethical behaviour.

The seeds of Enron and WorldCom are in the way society treats such behaviours. You inevitably get what you are prepared to walk past.

What message does it send when a person who commits a few thousand dollars of welfare fraud goes to jail while the perpetrators of a hundred million-dollar tax scheme end up with a relatively small fine?

Hard tax avoidance and evasion should be considered in the same league as other forms of fraud. Is it any wonder we end up with anti-avoidance measures that impose complexity on legitimate transactions when courts and society allow, or even condone, the tit-for-tat tax arms race?

I should add that high levels of non-compliance, besides leading to an arms race in tax avoidance legislation, also leads to increased corruption of the tax system and tax officials. And this has very significant costs to business and society, typically two to three times that of the tax forgone.

A new approach is needed - a new compact.

One that appears to flow from the President's comment that: "*It is time to reaffirm the basic principles and rules that make capitalism work: truthful books and honest people and well-enforced laws against fraud and corruption. All investment is an act of faith, and faith is earned by integrity. In the long run, there is no capitalism without conscience, there is no wealth without character.*"
George Bush 9/7/2002

Observation: Under funded tax administrations

In many countries regular “efficiency dividends” have been carved out of tax administration resources for years. No doubt early on this produced a more streamlined, focused and efficient tax administration. However, in some cases I suspect such measures have now cut clear through to the bone and that tax administrations are under-funded for the tasks they are being asked to achieve.

A tax commissioner faced with pressure to implement tax reforms and to advise and assist honest taxpayers to comply with increasingly complex laws generally only has one pool of talent to turn to: compliance staff.

There are real pressures in this area. If the phones aren't answered, letters not responded to, or refunds not processed you can be sure that there will be complaints to the commissioner and politicians. But if fewer audits are done who complains, who notices, especially when better targeting of cases can keep the immediate revenue stream constant in the short run.

I will say a bit more on the issue of striking the right balance between service and compliance later.

Remaining on the issue of funding however, Australia, Canada, Mexico and Sweden have had independent reviews that established that their tax administration had become under funded - by about 10% in each case. I believe other administrations, such as the IRS, may be in the same boat.

Most OECD tax administrations appear to operate at a staff to population ratio of about 1 to 860. The IRS figures are, if my information is right, roughly 1 to 2,900.

While I have no doubt that the IRS is one of the most efficient tax administrations in the world I have real doubts as to whether it is three times as efficient!

Many countries pay their tax administrators at rates that are below those obtainable externally for the same skill set. In Spain and France the average tax administrator appears to earn less than $US 40,000. In the Netherlands the figure is something like $US 74,000. Often however there is an implicit trade-off of factors such as tenure and working conditions. At the extreme are countries such as Singapore that pay market prices for their tax administrators – but require them to function at the same level of performance, and with the same basic rights, as those in private enterprise. And Singapore probably has one of the most effective tax administrations in the world, partially reflected by a high level commitment from government to re-position the Singapore IRS and give it the resources to carry out its mandate.

Since an effective and efficient tax administration needs to maintain at least a certain core of talented staff, some flexibility in salary arrangements may be necessary. In times of significant tax reform poaching of staff by external firms can be a prime way of buying expertise without paying for the training, although this may be a good long-term investment for government.

If salary arrangements deviate too significantly from the market norm, after taking into account the working conditions trade-off, then it seems likely that an administration will inevitably have lower skilled people than are called for or that corruption will become an influence.

Another impact on under funded tax administrations is that they tend to clamp down on recruitment to cut costs – but this is a policy that has long term ramifications for them maintaining a balanced skilled workforce into the future.

Some administrations are probably looking at a skills and experience crisis in the next few years as a major portion of their senior experienced personnel retire.

The shift towards service-orientated tax administration maybe entirely appropriate – you have to enable and encourage compliance as well as enforce it. But in some countries the emphasis on services has lead to a significant shift of resources out of compliance activities (the IRS's auditing staff have shrunk by 29% since 1995). This has reduced the risk of being audited and has also downgraded the audit function: if you want a high flying career in a service orientated tax administration, you increasing go into the service rather than the audit area. It is also likely to be less confrontational as well!

In some countries I think there may be a need to re-establish the balance between service and enforcement. We can roughly estimate the number of audit staff needed to provide a given level of coverage by the following back-of–the–envelope calculation:

Nas =Nb/RR*At/Wy

Where Nas is the number of audit staff, Nb is the number of businesses, RR is the record retention period, At is the average audit time in days, and Wy is the number of available work days per year.

The US business file size is about 43 million. If each of these businesses had one IRS staff member, who is available to audit 200 days per year, assigned to look at their records for just one day over a five year period the US would need:

Number of audit staff = 43,000,000/5*1/200 = 43,000 audit staff…

I think that the actual figure currently deployed is about 20,000.

Even if we accept, as I do, that appropriate risk management strategies can reduce the number of audit staff required significantly, I suspect that the IRS is somewhat under resourced on the compliance front.

Summary and conclusions

Your Treasury Frequently Asked Questions page notes Oliver Wendell Holmes, former Justice of the United States Supreme Court, statement that: "*Taxes are what we pay for a civilized society*."

The evidence is clear that the US pays a lower price than most OECD members – its tax to GDP burden is significantly lower than the average. It also pays a lower administrative price to collect these taxes than the OECD average.

So, as some may ask, is there a crisis with the US system? My overall response, based on what I have seen in the US relative to other OECD members is "no crisis, but lots of room for improvement."

What might be done – what are some of the lessons from other countries? Drawing together the threads of my observations in reverse order I would suggest the following:

1. The funding arrangements for the IRS need to be closely considered given the task it is being asked to do. To paraphrase Oliver Wendell Holmes *"Tax administration salaries are what we pay to collect taxes in a civilised society."* In particular the long term costs of relative under-funding compliance efforts need to be reflected upon.

2. Politicians, business and the broader community need to broadly understand and accept what they are paying for via their tax system and not denigrate the concept of payment of taxes as part of good citizenship even as they debate the aims, ways and means. The value of good compliance should be explicitly recognised and those that seek to undermine the system need to be called to account.

3. Following on from the point above, new penalties and sanctions that truly impact upon the propensity of tax avoidance and the promotion of tax avoidance activities, may be needed to achieve better compliance at a individual, corporate and industry level. These need to be self-reinforcing and scale so that the value of "trying-on" the system is lessened.

4. The tax system needs to better consider the needs of small businesses and not try for difficult to achieve levels of accuracy. Cash accounting and measures that tax turnover may need to be considered as workable proxies for the income taxation of micro businesses.

5. Reporting and withholding systems on regular forms of income should aim to reach the stage whether the tax administration can essentially complete the tax return of those not in receipt of business income.

6. To enable the above, measures designed to achieve tax equity need to be reconsidered in the light of a more holistic view of wealth and income redistribution. When coupled with additional compliance resources and more effective penalties and sanctions some of the more complex anti-avoidance measures might also be able to be removed.

7. If policy simplification follows from the point above and can be achieved then it might be worthwhile investing the resources necessary to modernise the US tax codes. Politicians and legislative designers would need to ensure that where possible concepts and definitions are co-ordinated across tax types and that the same value is used – at national and sub-national levels.

For example:

- Property definitions and values should be consistent for property taxes, wealth taxes, capital gains taxes, value added taxes on property, inheritance taxes and the like.

- Transaction information and record keeping requirements should be consistent where possible so that the one set of books suits all.

- Taxpayers interactions with government need to be brought together in a way that make sense to the business model of the taxpayer – so that the number of interactions, duplicate information transfers and net financial flows is minimised to the extent possible.

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Annex I

The *US Tax System*: An International Perspective

A. AN OVERVIEW

This Annex addresses a number of complex issues that face tax reformers in OECD countries as they attempt to devise, implement and administer tax systems appropriate for today's (and tomorrow's) global economy. The environment in which modern business is conducted, especially the business of multinational enterprises, has been referred to as "integrating" or "global" or, perhaps more prosaically, "small".

This environment constrains the work of tax reformers by significantly limiting the range of policy options open to them for innovative reform, triggering domestic responses from "tax shocks" occurring elsewhere in the world, and challenging the skills and efforts of tax administrators everywhere.

The taxation of the income and consumption of individuals and households is also becoming more difficult. Highly paid professionals are increasingly geographically mobile. Middle income groups have discovered the joys of tax havens, particularly by using credit cards. Consumers are increasingly finding that they can by-pass consumption taxes by using the Internet. This Annex examines these problems and possible domestic and international responses to them, and presents internationally comparable data on tax systems and trends within the OECD area.

Tax system reform has achieved unprecedented prominence in public debate in recent decades. The last three decades have seen major tax reviews, conducted in public, resulting in voluminous reports:

- the Carter Committee in Canada (1967),
- the Asprey Committee in Australia (1974),
- the "Treasury I" and "Treasury II" documents in the US (1977, 1984),
- the Meade Committee in the UK (1978),
- the McCaw Task Force in New Zealand (1982),
- the Irish Commission on Taxation (1982-1985),
- the Draft White Paper in Australia (1985),
- the *White Paper on Tax Reform* in Canada (1987),
- the Australian *ANTS* I & II (*A New Tax System*) reforms of 1998-2000,
- the 2000 Ralph Review of Business Taxation in Australia;

and many more recent reform proposals in the Nordic countries and North America.

Many countries in the Latin American and Asian-Pacific regions have also undertaken fundamental restructuring of their tax systems, with some (e.g. Chile and Singapore) pioneering new approaches to taxation.

The results of these reviews have been turbulent and wide-reaching and their outcomes are only now being thoroughly assimilated by taxpayers, their advisors and tax administrators throughout the world. The extent of their commonality, and the fact that so many changes happened uniformly, yet not as the result of a concerted and co-ordinated plan, foreshadows the kind and degree of the interconnection among modern economies that is one of the themes which underline the work of the OECD.

The most profound of the recent developments in tax reform was the dramatic and widespread reduction in marginal income tax rates in the 1990s, reflecting a reduction of the number of tax brackets, increasing exemptions and adjusting thresholds (see below).

At the time, these tax reductions were both praised and condemned. Most criticism concentrated on the implicit shift in the tax burden which some feared would accompany the change, reducing the level of tax on the wealthy when marginal rates were uniformly reduced. Others praised rate reductions for reducing tax-induced economic distortions of savings, investment and work patterns, counteracting the deleterious effects of high inflation rates in systems, reducing the incentives for tax evasion and unproductive investments in tax shelters, and, consequently, the pressures on tax administrators.

The unfortunate coincidence of these reductions with the world-wide recession of the late 1990s presented difficulties for many governments needing to find additional sources of revenue. The typical initial response of many governments was to broaden the base of the income tax by including further elements as income and eliminating tax expenditures.

The most common targets for increasing levels of revenue through base broadening were employee fringe benefits, social benefits and capital gains for individuals. Deductibility of mortgage interest was also limited in many countries. For corporations, incentives and concessions were commonly removed, apparently in tacit agreement with the conclusion of a recent OECD study that "the costs of incentives outweigh their benefits in most cases". (see OECD (2001) "Corporate Tax Incentive for Foreign Direct Investment"). Similar rationalisation of incentives occurred in Finland, Portugal, Spain, the US and Austria and in a number of other countries (Indonesia and Chile being the most notable). Foreign-source income was also targeted, but perhaps for different reasons.

Countries with developed tax systems discovered it was difficult to expand the base of the income tax further, so two additional strategies emerged. One was to change the tax mix by switching to new taxes, particularly consumption taxes and higher social security taxes to supplement the income tax. The other was a renewed interest in enhancing the administration ofthe taxes — a concomitant of striving for greater efficiency in government.

This was the case, for example, in Canada, China, Japan, New Zealand, Singapore and South Africa, where consumption taxes were introduced or rationalised, invariably based around the VAT model.

The potential for better administration to yield large revenue gains had been exemplified, for example, in Australia. In 1988, the Australian Treasurer announced an anticipated budget surplus of AUS$5.5bn which was to be achieved by expected substantial increases in net tax revenue, despite the fact that no new taxes were announced, no broadening of the income tax base was to occur, no substantial reduction in budget outlays was planned and lower tax rates were envisaged. The increased revenue was expected to come almost exclusively from enhanced administration. Similarly, the government's 1992 *Statement on Tax Policy* promised increased revenue of almost AUS$1bn by devoting additional resources to the compliance functions of the Australian Taxation Office.

The United States contemplated similar results from the enactment of the *Tax Equity and Fiscal Responsibility Act* of 1982. Almost one-third of the total revenue which the Bill was expected to generate was expected to come from enhanced administrative measures: additional withholding mechanisms, increased information collection and changes to the penalty structure. Similar sentiments were expressed in the recently issued White Paper on improving compliance.

In Mexico, the better compliance measures which accompanied the 2001 Reform was estimated to increase revenues by an amount equivalent to 0.5% of GDP in 2002.

In implementing reforms governments and others seek to ensure that reforms improve the ease of tax administration. Any new tax base must be observable and verifiable since the most important property of any tax is that it can be collected. New technologies[4] and new financial practices have reduced both observability and verifiability.

4 See for example OECD (2000[b]).

B. TRENDS IN TAXATION AND THE FORCES SHAPING THEM

The tax burden

The measurement of tax burdens is subject to controversy. The most commonly used gauge, the ratio of taxes to GDP, is only a rough indicator, for a variety of reasons

- Institutional set-ups differ across countries in ways that significantly affect the reported tax to GDP ratio without having much impact on the burdens imposed by taxation. For example, there are differences across countries, and over time, in the taxation of transfer income, the size of tax payments by the public sector itself and the mix of subsidies and tax expenditures (targeted exemptions, allowances and credits).
- Some taxes may have a stronger impact on economic behaviour -- *i.e.* act more as a "burden" -- than others, and it is therefore useful to examine the breakdown of tax revenues by tax base. Different forms of taxation may also interact to result in pronounced differences in the marginal effective tax rates faced by particular groups, thus heavily affecting their economic choices. Such marginal tax rates have been calculated by the OECD and used to assess tax systems.
- The tax burden needs to be assessed in a wider context, including the "burden" stemming from regulation that mandates the private sector to provide social protection or public goods and services in the government's place.

Even so, bearing these caveats in mind, the ratio of tax revenues to GDP is useful as a "scaling factor": to the extent tax systems matter for economic efficiency, their costs are likely to rise as economic decision makers' exposure to taxation increases.

The evolution of tax revenue as a percentage of GDP in OECD countries since 1965 is reported in Table 1.

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Table 1. Total tax revenue as percentage of GDP

	1965	1970	1975	1980	1985	1990	1995	2000	2001(1)
AUSTRALIA	21.9	22.5	26.7	27.4	29.1	29.3	29.7	31.5	..
AUSTRIA	33.9	34.6	37.5	39.8	41.9	40.5	41.6	43.7	45.7
BELGIUM	31.1	34.5	40.2	42.4	45.6	43.2	44.6	45.6	45.3
CANADA	25.6	30.8	31.9	30.7	32.6	35.9	35.6	35.8	35.2
CZECH REPUBLIC	..	..	..	..	..	..	40.1	39.4	39.0
DENMARK	29.9	39.2	40.0	44.0	47.4	47.1	49.4	48.8	49.0
FINLAND	30.4	31.9	36.8	36.2	40.1	44.8	45.0	46.9	46.3
FRANCE	34.5	34.1	35.9	40.6	43.8	43.0	44.0	45.3	45.4
GERMANY(2)	31.6	32.3	35.3	37.5	37.2	35.7	38.2	37.9	36.4
GREECE	20.0	22.4	21.8	24.2	28.6	29.3	31.7	37.8	40.8
HUNGARY	..	..	..	..	..	..	42.4	39.1	38.6
ICELAND	26.2	26.9	29.4	29.1	28.3	31.2	31.5	37.3	34.8
IRELAND	24.9	28.8	29.1	31.4	35.1	33.5	32.7	31.1	29.2
ITALY	25.5	26.1	26.1	30.4	34.4	38.9	41.2	42.0	41.8
JAPAN	18.3	20.0	21.3	25.1	27.2	30.1	27.7	27.1	..
KOREA	..	..	15.3	17.7	16.9	19.1	20.5	26.1	27.5
LUXEMBOURG	27.7	24.9	37.4	40.2	44.8	40.8	42.0	41.7	42.4
MEXICO	..	..	..	16.2	17.0	17.3	16.6	18.5	18.3
NETHERLANDS	32.8	35.8	41.6	43.6	42.6	43.0	42.0	41.4	40.0
NEW ZEALAND	24.7	26.8	30.5	32.4	32.9	37.6	37.5	35.1	34.8
NORWAY	29.6	34.5	39.3	42.7	43.3	41.8	41.5	40.3	44.9
POLAND	..	..	..	..	..	..	39.6	34.1	..
PORTUGAL	15.8	19.4	20.8	24.1	26.6	29.2	32.5	34.5	..
SLOVAK REPUBLIC	..	..	..	..	..	..	..	35.8	33.1
SPAIN	14.7	16.3	18.8	23.1	27.8	33.2	32.8	35.2	35.2
SWEDEN	35.0	38.7	42.3	47.5	48.5	53.6	47.6	54.2	53.2
SWITZERLAND	19.6	22.5	27.9	28.9	30.2	30.6	33.2	35.7	34.5
TURKEY	10.6	12.5	16.0	17.9	15.4	20.0	22.6	33.4	35.8
UNITED KINGDOM	30.4	37.0	35.3	35.2	37.7	36.8	34.8	37.4	37.4
UNITED STATES	**24.7**	**27.7**	**26.9**	**27.0**	**26.1**	**26.7**	**27.6**	**29.6**	**..**
TOTAL OECD									
Unweigthed average	25.8	28.3	30.6	32.1	33.9	35.1	36.1	37.4	..
EUROPEAN UNION									
Unweigthed average	27.9	30.4	33.2	36.0	38.8	39.5	40.0	41.6	..

(1) Figures for 2001 are estimates.

(2) Unified Germany beginning 1991.

Source: Revenue Statistics 1965-2001.

The stylised facts are the following:

- There has been a persistent and largely unbroken upward trend in the ratio of tax to GDP since 1965 across most of the OECD area, though recent developments suggest the trend may be ending.
- Very few countries have consistently resisted this long-term trend. Only in the Netherlands are tax ratios currently below their 1975 level, and in only three other countries, *i.e.* Mexico, the United Kingdom and the United States, have tax receipts developed broadly in line with GDP over a long period.
- A few more, including Ireland, Japan, Luxembourg and Norway, have succeeded in reducing the tax ratio from peak levels of 1985 or 1990, but not by large amounts. Recent data available for transition countries suggest that these countries are recording falling tax revenues relative to GDP as well, although this may reflect in part "erosion" of their tax bases while they are grappling with the transition process.
- Tax ratios in the European Union, averaging more than 40 per cent of GDP, generally exceed those elsewhere. Outside Europe, only Australia, Canada and New Zealand have tax ratios above 30 per cent of GDP.

Declining tax ratios are currently reported more widely across countries. This largely reflects public expenditure trends[5], although fiscal consolidation efforts during the 1990s have implied that the success a number of countries have had in reducing expenditure ratios has not yet been reflected in tax ratios that are actually falling. Moreover, a favourable cyclical position has buoyed the tax take as a percentage of GDP notwithstanding tax cuts implemented in a large number of countries.

The forces shaping these developments in recent years have been diverse:

- Greece, Portugal and Switzerland show increases in their tax burdens that are well above the OECD average increase. These countries all have tax ratios below the OECD average and could be seen as being involved in a process of convergence within Europe. One immediate reason for the increase in Switzerland has been an increase in public expenditure on health. For Greece and Portugal, it has been a matter of developing social policy systems and infrastructure more in line with these prevailing elsewhere in the European Union and, in recent years, the need to curb deficits to meet the criteria for joining European Monetary Union (EMU). As for the future, the funding of its second pillar pension scheme means that Switzerland is less exposed to the pressures of an ageing population on public expenditure and taxation.
- Iceland, Korea, Poland and Spain experienced tax burden growth that was close to the OECD average, although Poland, like other transition countries, has reduced its burden in the past few years.[6] The data for Korea and Spain suggest that they will face substantial pressure to increase the tax burden over the next few years,[7] but no similar expectation of increase is shown for the other countries in this group.

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5 . See Atkinson and Van den Noord (2001).

6 . For Poland this is based on data contained in the *OECD Economic Survey.*

7 . This is mainly due to growing social security entitlements, associated with ageing, but in Korea the prospect of re-unification with North Korea also poses significant fiscal challenges.

- The Czech Republic, Japan, Mexico and New Zealand have reduced their tax burdens since 1990, but for very different reasons and from varying starting positions. In Mexico, overall tax levels have fluctuated sharply to offset the volatility of oil-related non-tax resources. The mild trend decline over the period here to some extent reflects a deliberate policy choice to lower VAT and import tariffs, but also difficulties of developing a tax base. Japan's tax reduction occurred in several steps from 1994 onwards, mostly in response to cyclical developments. In contrast, the reductions in the tax burden in New Zealand have been more consistent and reflect a definite policy choice. In this case, the choice made was to reduce the role of the state in the economy, as reflected in sharp declines in the public expenditure share in GDP. The Czech Republic has not achieved such a trend decline in the expenditure ratio, and budget deficits have probably reached unsustainable levels.
- The Mexican tax burden is not only the lowest in the OECD area but also less than half of the OECD unweighted average. It is also noticeable that there is very little increase in the tax to GDP ratio over the last decades.
- The US has the fourth lowest tax burden in the OECD area, although over the last 30 years the tax to GDP ratio has increased by 2 percentage points. This low tax burden in part reflects the way in which the US chose to finance education, retirement and health by the private sector – whereas in most other OECD countries these are primarily financed by the public sector.

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Table 2. Tax revenue of major taxes as a percentage of total tax revenue,

Type of	Personal income (2)	Corporate income (2)	Social security and other payroll	Property	Goods and services	*of which:* General consumption
AUSTRALIA	36.7	20.6	6.2	8.9	27.5	12.3
AUSTRIA	22.1	4.7	40.4	1.4	28.4	19.0
BELGIUM	31.0	8.1	30.9	3.3	25.4	16.3
CANADA	36.8	11.1	16.4	9.7	24.4	14.5
CZECH REPUBLIC	12.7	9.8	43.8	1.4	32.0	18.9
DENMARK	52.6	4.9	5.0	3.3	32.5	19.6
FINLAND	30.8	11.8	25.6	2.5	29.1	18.0
FRANCE	18.0	7.0	38.4	6.8	25.8	16.9
GERMANY	25.3	4.8	39.0	2.3	28.1	18.4
GREECE	13.5	11.6	30.6	5.1	36.1	22.7
HUNGARY	18.6	5.7	32.9	1.7	40.5	26.1
ICELAND	34.4	3.3	7.8	7.1	45.0	29.4
IRELAND	30.8	12.1	13.7	5.7	37.2	21.5
ITALY	25.7	7.5	28.5	4.3	28.4	15.8
JAPAN	20.6	13.5	36.5	10.3	18.9	8.9
KOREA	14.6	14.1	16.9	12.4	38.3	17.0
LUXEMBOURG	18.3	17.7	25.6	10.6	27.3	14.3
MEXICO (3)	27.3	..	17.5	1.4	53.1	18.7
NETHERLANDS	14.9	10.1	38.9	5.4	29.0	17.3
NEW ZEALAND	42.8	11.7	0.9	5.4	34.5	24.7
NORWAY	25.6	15.2	22.5	2.4	34.4	19.7
POLAND	23.2	6.9	30.0	3.3	36.6	22.2
PORTUGAL	17.5	12.2	25.7	3.2	39.9	24.2
SLOVAK REPUBLIC	10.0	8.3	41.2	1.7	35.9	22.3
SPAIN	18.7	8.6	35.1	6.4	29.8	17.6
SWEDEN	35.6	7.5	32.4	3.4	20.7	13.4
SWITZERLAND	30.6	7.9	33.6	8.1	19.7	11.5
TURKEY	21.5	7.0	16.9	3.1	40.7	23.3
UNITED KINGDOM	29.2	9.8	16.4	11.9	32.3	18.4
UNITED STATES	**42.4**	**8.5**	**23.3**	**10.1**	**15.7**	**7.5**
OECD TOTAL						
Unweigthed average	26.0	9.7	25.8	5.4	31.6	18.3
EUROPEAN UNION						
Unweigthed average	25.6	9.2	28.4	5.0	30.0	18.2

(1) Rows do not add to 100 because some minor taxes are omitted and general consumption taxes (mainly VAT) are a sub-category of taxes on goods and services.

(2) The breakdown of income tax into personal and corporate tax is not comparable across countries.

(3) The figure for personal income tax in Mexico combines personal and corporate income tax.

*Source: Revenue Statistics*1965-2001.

The structure of taxation

The distribution of tax revenue among major taxes for OECD countries in 2000 is reported in Table 2[8] while Figure 1 provides a graphic comparison of tax structure among the largest OECD economies, *i.e.* the United States, Japan, Mexico and the European Union.

The OECD average shows that the vast bulk of tax revenue, *i.e.* over 90 per cent, comes from three main sources: income taxes, taxes on goods and services, and social security contributions (other payroll taxes are zero or very small in most countries). However, countries vary considerably in the relative importance of these three main revenue sources. Notably, Australia and New Zealand do not collect social security contributions but do collect payroll taxes.

There are also substantial differences across countries in the share of taxes on property, which are generally lower in continental Europe than elsewhere. Overall, the European Union relies more on consumption taxes and social security contributions and less on personal income tax than the OECD average.

In contrast, the United States collects a larger share in personal income tax and property tax but a smaller one in consumption taxes and social security. Japan is similar to the United States in its low share of consumption taxes but collects much less in personal income tax, offsetting this with higher levels of corporate tax and social security contributions.

As tax-to-GDP ratios have risen, the largest part of the increases has taken the form of higher social security contributions (Table 2) reflecting the expansion of social insurance systems substantially financed by such contributions. Higher personal income taxes have also played a significant role, although most of the rise in these had taken place by 1975. Corporate income and wealth, possibly more constrained by the potential mobility of their bases than social security, and personal income taxes, have risen more modestly, as have taxes on goods and services.

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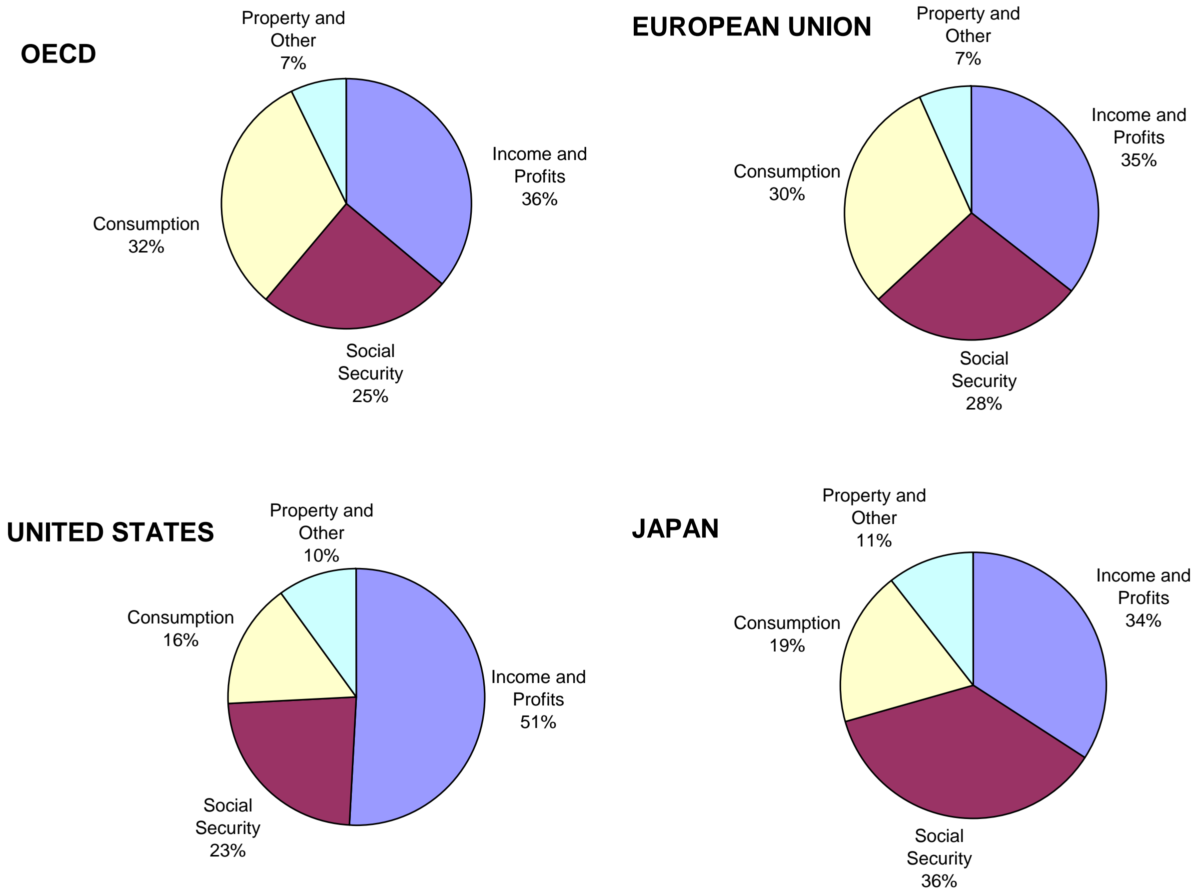
8 . A cautious interpretation of the numbers in this table is called for. The split between personal and corporate income tax, can be seriously misleading for two reasons. First, many OECD countries have some form of integration between corporate and personal income taxes, so that a portion of corporate taxes are refunded to the shareholders as a reduction in personal income tax. This is reflected in the statistics as a reduction in the revenue from personal income taxes, but it could be just as well regarded as a reduction in corporate tax revenue. Second, OECD countries vary in the extent to which businesses are incorporated. For example, German firms are much less likely to be incorporated than firms in the United States. This means that Germany reports a much lower share of tax revenue coming from corporate income tax, even though the taxes on business are higher.

Figure 1. Tax mix by source in year 2000

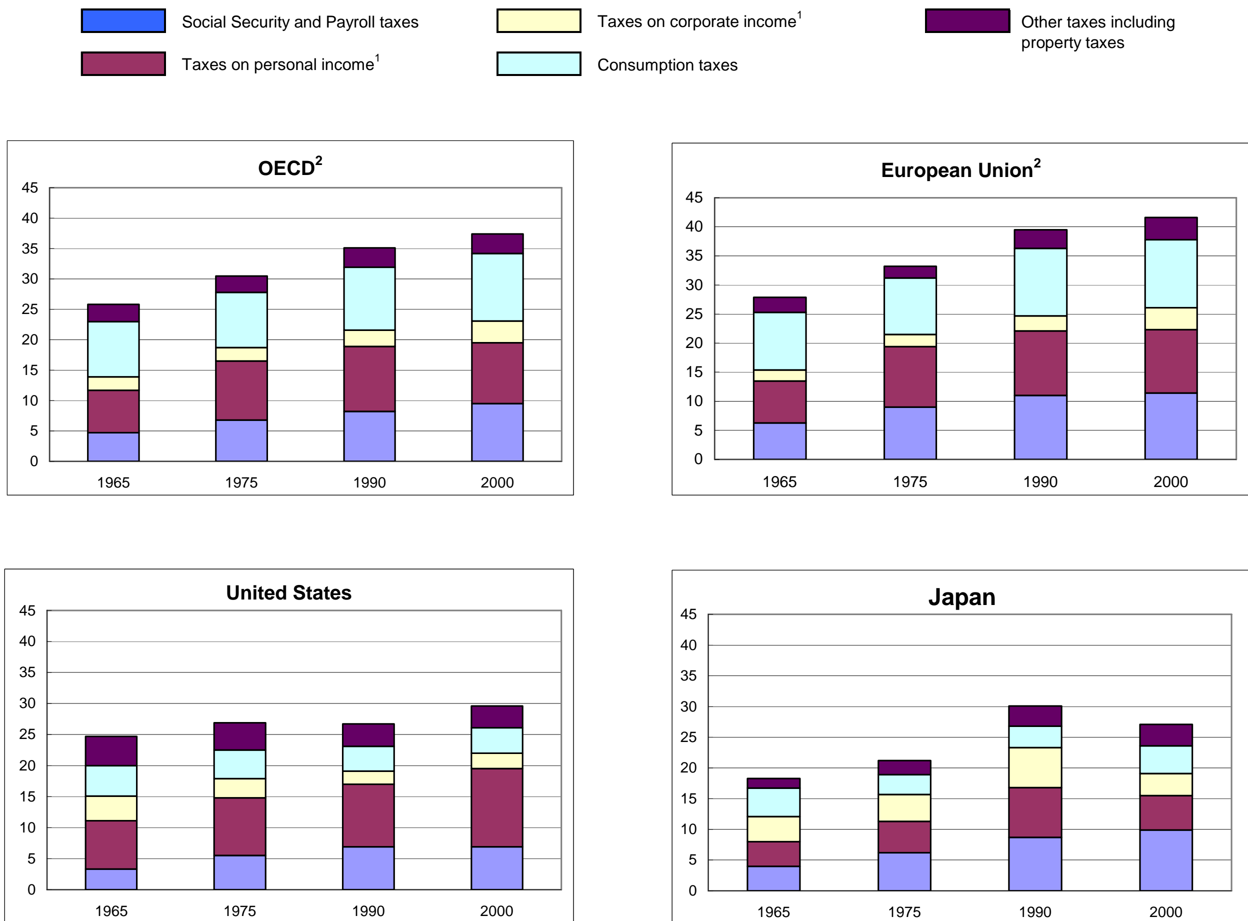
Per cent share of total tax revenue



The category ' Income tax and Profits' includes taxes on Personal and Corporate income.
Unweighted averages for Zones.

Source: Revenue Statistics 1965-2001.

Figure 2. Evolution of the tax mix over time
Per cent of GDP



1. The breakdown of income tax into personal and corporate tax is not comparable across countries.
2. Unweighted average.

Source: Revenue Statistics 1965-2001.

The central-local allocation of revenue and tax-raising powers

Countries differ in prevailing fiscal arrangements between the central and sub-central levels of government.[9] Where federal constitutions as distinct from unitary constitutions apply, substantial fiscal autonomy exists at the intermediate level.

In most countries, the tax revenues allocated to sub-central levels of government are insufficient to meet their expenditure commitments and the balance is made up by borrowing and/or grants from central government.

9 . The economic analysis of these fiscal arrangements is generally referred to as the 'theory of fiscal federalism' even though it applies to both unitary and federal countries. Two classic works are: Oates (1972) and Bird (1986). See also OECD (1999[(b)])

An important exception occurs in Spain, where the Basque Country and the Navarra region have a special arrangement in which they collect most of the taxes and remit a payment to the central government for the services that it provides.

A major factor in determining the gap between sub-central own revenues and expenditures is the share of sub-central taxes in total tax revenues. The combined share of sub-central governments in total tax revenues in 1998 showed a wide variation from 1 per cent in Greece and 2 per cent in Ireland to 45 per cent in Canada.

However, it is not only the share of tax revenue received by the sub-central levels of government that matters. The benefits of fiscal autonomy for sub-central governments depend on their ability to match local public provision to local needs and preferences. This, in turn, requires them to have a degree of discretion or control in adjusting their local tax revenue to the costs of the local public provision.

A recent study[10] analysed information on fiscal autonomy from a selection of OECD countries. It found that, in most countries, the bulk of the revenue comes from taxes where the base and/or rate of the tax are controlled by the sub-central governments (SCGs). Table 3 updates and extends this information.

In several of the other countries, a large part of revenue comes from shared taxes over which SCGs have some control. However, among the survey countries, the Czech Republic, Mexico, Norway and Poland have systems where a substantial proportion of SCG tax revenue comes from sources over which SCGs have no formal control.

Table 3: Local Tax Autonomy

	Level	Sub-national government taxes as % of total tax revenue	SNG sets tax rate and base	SNG sets tax rate only	SNG sets tax base only	Revenue sharing where the CG:SNG revenue split…				CG sets both rate and tax base of SNG tax	*Total*
						…is set by SNG	…can be changed only if SNG agree	…is set in legis-lation and may be changed uni-laterally by CG	…is set annually by CG as part of the budget		
			(a)	*(b)*	*(c)*	*(d1)*	*(d2)*	*(d3)*	*(d4)*	*(e)*	
Bulgaria *(2000)*	Local	*10.0*	-	-	-	-	-	39.0	61.0	-	*100.0*
Czech Republic *(1999)*	Local	*11.1*	2.7	5.6	-	-	-	91.7	-	-	*100.0*
Estonia *(1999)*	Local	*16.2*	-	9.2	-	-	-	90.8	-	-	*100.0*
Hungary *(1999)*	Local	*10.4*	49.2	-	-	-	-	-	50.8		*100.0*
Latvia *(1999)*	Local	*17.1*	-	-	-	-	-	-	-	100.0	*100.0*
Lithuania *(1999)*	Local	*22.0*	-	-	-	-	-	-	-	100.0	*100.0*
Poland *(1999)*	Local	*8.3*	-	41.9	0.6	-	-	57.6	-	-	*100.0*
Romania *(2000)*	Local	*10.5*	-	6.0	0.6	-	-	-	75.0	18.4	*100.0*
Slovak Republic *(2000)*	Local	*4.0*	7.0	28.2	-	-	-	-	64.8	-	*100.0*
Slovenia *(2000)*	Local	*7.9*	16.7	0.6	0.4	-	-	82.3	-	-	*100.0*
Mean (by country)	-	*11.8*	*7.6*	*9.2*	*0.2*	*0.0*	*0.0*	*36.1*	*25.2*	*21.8*	*100.0*
Belgium *(1995)*	Local	*6.0*	13.0	84.0	-	-	-	2.0	1.0	-	*100.0*
	Communities	*13.0*	-	3.0	-	-	97.0	-	-	-	*100.0*
	Regional	*10.0*	8.0	92.0	-	-	-	-	-	-	*100.0*
Denmark *(1995)*	Municipalities	*22.0*	-	96.0	-	-	-	4.0	-	-	*100.0*
	Counties	*9.0*	-	93.0	-	-	-	-	-	7.0	*100.0*
Netherlands *(1995)*	Municipalities	*1.0*	-	100.0	-	-	-	-	-	-	*100.0*
	Polder boards	*1.0*	-	100.0	-	-	-	-	-	-	*100.0*
Spain *(1995)*	Local	*9.0*	33.0	51.0	-	-	16.0	-	-	-	*100.0*
	Regions	*5.0*	15.0	7.0	-	-	78.0	-	-	-	*100.0*
Sweden *(1995)*	Municipalities	*22.0*	4.0	96.0	-	-	-	-	-	-	*100.0*
	Counties	*11.0*	-	100.0	-	-	-	-	-	-	*100.0*
United Kingdom *(1995)*	Local	*4.0*	-	100.0	-	-	-	-	-	-	*100.0*
Mean (by tier)	-	*9.4*	*6.1*	*76.8*	*0.0*	*0.0*	*15.9*	*0.5*	*0.1*	*0.6*	*100.0*

10 . See OECD (1999[b]).

C. THE STRUCTURE OF VALUE ADDED TAX IN OECD ECONOMIES

At the core of the recent tax reform proposals made by many governments is the reform of the value-added tax which is intended to broaden the tax base and thereby contribute to a significant increase in government revenues. Consequently, this section examines the structure of value added tax systems in OECD countries.

There are still many differences in the OECD national VAT systems with the continuing application of reduced rates, exemptions and numerous special arrangements to meet particular policy demands. Much of this was in contradiction of the ethos of VAT as a simple tax to administer and collect. Differences remain even among the member states of the European Union whose VAT laws share the same legislative roots in the form of the EU Sixth VAT Directive. However, there is increasing consideration given by most OECD countries in respect of minimising the tax compliance cost and promoting administrative simplification.

Table 4 shows the rates of VAT as at 1 January 2000. Since 1998 Switzerland and Turkey have increased their standard rates respectively by 1% and 2% though in the case of Switzerland the 3/5% reduced rates have been increased by 0.3% and 0.5%. The table also illustrates the broad spread of current standard rates of VAT from 5 % in Japan to 25% in Denmark, Hungary and Sweden. The evolution of the average standard rate for OECD shows a global stabilisation since 1998.

Table 4 **Current rates of VAT in OECD Member countries**					
	Reduced rate	Standard rate			
		2000	**1998**	**1996**	**1994**
Australia[12]	-	10.0	-	-	-
Austria[1]	10.0/12.0	20.0	20.0	20.0	20.0
Belgium	0/6.0/12.0	21.0	21.0	21.0	20.5
Canada[2]	0.0	7.0/15.0	7.0/15.0	7.0	7.0
Czech Republic	5.0	22.0	22.0	-	-
Denmark	-	25.0	25.0	25.0	25.0
Finland	8.0/17.0	22.0	22.0	22.0	22.0
France[3]	2.1/5.5	20.6	20.6	20.6	18.6
Germany	7.0	16.0	16.0	15.0	15.0
Greece[4]	4.0/8.0	18.0	18.0	18.0	18.0
Hungary	0/12.0	25.0	25.0	-	-
Iceland	14.0	24.5	24.5	24.5	24.5
Ireland[5]	0/3.3/10/ 12.5	21.0	21.0	21.0	21.0
Italy	4.0/10.0	20.0	20.0	19.0	19.0
Japan	-	5.0	5.0	3.0	3.0
Korea		10.0	10.0	-	-
Luxembourg	3.0/6.0/ 12.0	15.0	15.0	15.0	15.0
Mexico	0/10.0	15.0	15.0	15.0	10.0
Netherlands[6]	6.0	17.5	17.5	17.5	17.5
New Zealand[7]	-	12.5	12.5	12.5	12.5
Norway	0.0	23.0	23.0	23.0	22.0
Poland	7.0	22.0	22.0	22.0	22.0
Portugal[8]	5.0/12.0	17.0	17.0	17.0	16.0
Spain	4.0/7.0	16.0	16.0	16.0	15.0
Sweden	0/6.0/12.0	25.0	25.0	25.0	25.0
Switzerland[9]	2.3/3.5	7.5	6.5	6.5	6.5
Turkey[10]	1.0/8.0	17.0	15.0	15.0	15.0
United Kingdom[11]	0.0/5.0	17.5	17.5	17.5	17.5
Unweighted average:	-	17.7	17.7	17.2	17.1

Notes:
1. 16% applies in the Austrian tax enclaves Mittelberg and Jungholz.
2. 15% Harmonised Sales Tax (HST) applies in those provinces that have harmonised their provincial retail sales tax with the federal GST (the 15% HST is composed of a provincial component of 8% and a federal component of 7%).
3. Standard rate is 19.6% as of 1 April 2000.
4. Tax rates are reduced by 30% in some remote areas.
5. Standard rate is 20% as of 1 January 2001.
6. Standard rate is 19% as of 1 January 2001.
7. For long term stay in a commercial dwelling GST at standard rate is levied on 60% of the value of the supply.
8. The rates applicable in the Autonomous Regions of Madeira and the Azores are respectively 4%, 8% and 12%.
9. 2.4% / 3.6% and 7.6% as of 1 January 2001.
10. There are also higher rates of 23/40%.
11. The standard rate is applied to a reduced value on imports of certain works of art, antiques and collectors items resulting in an effective rate of 5%.
12. Rate as at 1 July 2000
Source: National Delegates ; position as at 1 January 2000.

D. STRUCTURE OF PERSONAL INCOME TAX AND SOCIAL SECURITY CONTRIBUTIONS

As noted in Section A, the reform of personal income taxes and social security contributions has figured prominently in the tax reform debate. The general tendency has been for governments to substantially cut the top marginal rates of personal income taxes, reduce the number of income tax brackets and at the same time eliminate tax relief directed at specific segments of the taxpaying population. Table 5 shows the progressitivity of rates of income tax that apply to wage earners who are single and without any children in 2000. It also shows the employee social security contributions for the same group.

Table 5. Statutory income tax progressivity around the income level of the average production worker (1)

Single workers, 2000

	Low-wage progressivity (2)			High-wage progressivity (2)		
	Income Tax	Employee contributions	Total (3)	Income Tax	Employee contributions	Total (3)
AUSTRALIA	5.6	0.0	5.6	5.4	0.0	5.4
AUSTRIA	7.0	0.0	8.7	3.9	0.0	5.0
BELGIUM	9.6	1.0	14.3	5.4	0.1	7.3
CANADA	5.6	0.2	6.5	4.5	-1.1	2.0
CZECH REPUBLIC	2.2	0.0	2.6	1.8	0.0	2.1
DENMARK	6.9	-1.5	5.6	7.1	-0.6	7.5
FINLAND	8.2	0.1	9.2	5.4	0.0	6.1
FRANCE	5.3	0.0	16.6	2.8	-0.5	2.4
GERMANY	8.2	0.0	11.1	6.2	-1.2	5.5
GREECE	2.2	0.0	2.7	3.2	0.0	3.8
HUNGARY	5.1	0.0	4.2	6.4	0.0	7.0
ICELAND	9.4	-0.1	9.3	4.1	0.0	4.0
IRELAND	4.8	5.4	15.1	7.9	0.1	8.7
ITALY	5.7	0.0	6.4	3.6	0.0	4.1
JAPAN	1.1	0.0	1.3	1.8	0.0	2.1
KOREA	1.5	0.0	1.6	2.7	0.0	2.9
LUXEMBOURG	6.7	0.0	7.9	6.0	0.0	7.3
MEXICO (3)	6.8	0.4	6.5	3.9	0.3	4.2
NETHERLANDS	3.0	3.1	8.2	9.4	-6.9	-0.7
NEW ZEALAND	1.0	0.0	1.0	3.5	0.0	3.5
NORWAY	4.2	0.0	4.7	5.5	0.0	6.2
POLAND	1.5	0.0	2.0	0.6	0.0	0.8
PORTUGAL	4.2	0.0	4.7	3.8	0.0	4.4
SLOVAK REPUBLIC	1.8	0.0	2.1	2.3	0.0	2.7
SPAIN	7.0	0.0	7.6	3.0	0.0	3.3
SWEDEN	2.9	0.0	3.3	5.9	-0.8	5.2
SWITZERLAND	3.1	0.0	3.6	2.8	0.0	3.3
TURKEY	1.8	0.0	2.2	2.0	-2.8	-4.1
UNITED KINGDOM	3.7	1.2	6.9	1.5	0.0	2.2
UNITED STATES	2.4	0.0	2.7	4.1	0.0	4.5

(1) Higher numbers indicate higher progressivity; negative numbers point to regressive taxes.
(2) Low-wage" progressivity involves a comparison of the tax burden of a worker who earns the average production worker's wage (apw) with one that earns 67 per cent of the apw, while "high-wage" progressivity compares the tax burden of a worker at 167 per cent of the apw with a worker at the apw. The method used can be illustrated by reference to the formula used in calculating the first column: if t67 is the tax rate for the lower paid worker and t100 is the tax rate for the average worker, "low-wage" progressivity = (((1 - t67) / (1 - t100)) - 1) x 100. High-wage progressivity is calculated in a similar manner, but has been rescaled to reflect the larger wage difference involved.
(3) The total columns include the effect of employer contributions, and so do not simply represent the sum of the income tax and employee contributions.
Source: Taxing Wages 2000-2001 .

E CORPORATE TAX RATES

Table 6 shows the top statutory corporate tax rates in the OECD in 2000. The table shows basic combined central and sub-central statutory corporate income tax rates. Where sub-central tax applies, the sub-central rate is that applicable in the 'illustrative' (most populated) city case.

In the case of the United States the statutory rate is relatively high by OECD standards, although it should be emphasised that these are scheduled not effective tax rates and therefore may not accurately reflect the marginal rate based on a new investment.

Top Statutory Corporate Income Tax Rates (2000)

Country	Rate
Australia	34.0
Austria	34.0
Belgium	40.2
Canada	44.6
Czech Republic	31.0
Denmark	32.0
Finland	29.0
France	36.7
Germany	52.0
Greece	40.0
Hungary	18.0
Iceland	30.0
Ireland	24.0
Italy	41.3
Japan	42.0
Korea	30.8
Luxembourg	37.5
Mexico	35.0
Netherlands	35.0
New Zealand	33.0
Norway	28.0
Poland	30.0
Portugal	35.2
Spain	35.0
Sweden	28.0
Switzerland	25.5
Turkey	33.0
United Kingdom	30.0
United States	45.8[1]

Source: OECD Tax Database

1. Basic federal CIT ratio is 35%, and 29.5% when adjusted to take into account the deductibility of CIT levied at the sub-central level. State and local level income tax is levied at 15.7% in the "illustrative city" (most populated) city case (New York city). This gives the combined US CIT ratio of 45.2%.

Paper review comments by Charles E. McLure: http://goliath.ecnext.com/coms2/summary_0199-6563859_ITM

INTERNATIONAL EXPERIENCE

The chapter on international experience by Jeffrey Owens and Stuart Hamilton should be required reading for all members of the Congress (not that that would help much) as it provides a picture of the forest that might get lost among the trees of the previous chapters. Owens and Hamilton note, "... without simplifying the underlying tax policy you cannot really simplify the law" (p. 350). They continue:

> It seems clear that complex policy results in complex law and consequential difficulties in complying. Much of the complexity in laws globally appears to relate to policies designed to provide tax breaks while at the same time trying to limit those breaks or pre-empt the avoidance activity. Complexity results from the desire of governments to ensure that tax law considers the detailed circumstances of every individual, putting fairness and equality ahead of efficiency and administrative efficiency (p. 351).

Based on this assessment, the authors draw several lessons, which they state in the titles of sections of their chapter: "Policy Simplification Needs a Stronger Voice," and "The Complexity of Policy and Law May Need to Be Reduced."

Comments David Glickman made on the Gale-Rohaly chapter are particularly relevant here. He writes:

> I do not believe that tax simplification has a true constituency in Congress. It is easy to pay lip service to simplification, but most such attempts have been unsuccessful, with some exceptions .... The only real effort at broad-based simplification came with the enactment of the Tax Reform Act of 1986.... I recollect that, when the 1986 act was passed, the members of Congress committed to doing their best not to violate the fundamental underpinning of the law. As we know, this commitment was short-lived (p. 299).

Glickman suggests, "If it is to succeed, tax simplification must be strongly supported by all the tax staffs: the Office of Tax Policy, the staff of the Joint Committee on Taxation, and the tax staffs of the minority and majority leaders in both houses of Congress.... [T]he staffs have to push the idea [of simplification], or the members lose interest" (pp. 299-300).

The question, then, is how to create incentives for the Congress to simplify--and for their staffs to insist on it. I recently offered this suggestion (in McLure, 2006b):

> Unless Congress has strong incentives to quit complicating the tax system and to simplify it, they will never do so. A key question is thus how to create such incentives. I have long thought that all members of the tax-writing committees of Congress (or perhaps the entire Congress) and their staffs, both while incumbents and for a specified number of years thereafter, should be required to complete their own tax returns with nothing but a pad of paper, a pencil, and a calculator. The proposal is, of

> course, impractical, because some members of Congress would have complicated tax situations, even under a simplified system. But if some bright tax practitioner can figure out a workable variant that would accomplish the desired effect, I suspect the public might cram it down their representatives' collective throat (p. 365).

On the possibility of a return-free system, Owens and Hamilton note in their chapter on international experience, "For taxpayers with regular income from well-defined domestic sources (wages, pensions, welfare benefits, dividends, interest, and the like) withholding and information reporting systems can allow the government to precompute the taxpayer's entire return. Thirty-six countries now use this system, as we understand, and more are considering it" (p. 356).

One can only wonder why the United States lags so far behind. Is it our unwillingness to learn from others, or is it our unwillingness to give up the "bells and whistles" that make it difficult to implement a return-free system?

The book can be found at:

http://www.brookings.edu/press/Books/2004/crisisintaxadministration.aspx