# Introduction

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Tax systems, how governments raise money to finance public expenditures, are central to the economic and political institutions and the overall day-to-day and long-term performances of every country. How much is raised in taxes to be spent on public services and infrastructure and how much is left to the private market to provide is eminently a political decision about which economics has little to say. However, taxes can cause important distortions on the behavior of economic agents, and the same exact amount of tax revenue can be raised with very different additional excess burdens to society depending on how tax systems are structured. In addition, all taxes can have significant effects on the distribution of income and even poverty levels depending on their final economic incidence, or who actually bears the burden in terms of reduced disposable income. These two aspects, the economic efficiency and the distributional equity of taxes, have been at the core of the theory and practice of public finance over the past several centuries, from the classical writings of David Ricardo and John Stuart Mill, to Richard Musgrave's *Fiscal Systems* in 1969, to the influential reports produced by the Meade Commission in the UK and the Bradford Commission in the US in the late 1970s, to the most recent 2010/2011 comprehensive report from the Institute of Fiscal Studies in the UK, *Reforming the Tax System for the 21st Century (the Mirrlees Review)*.

Tax systems around the world have changed considerably in the past three decades. Although direct taxation continues to be mainly levied on income, personal and corporate income taxes are today quite different from what they used to be just a few decades ago. Social Security contributions have increased rapidly in importance, especially in the developed world, while wealth taxes have all but disappeared. Change has taken place at an even faster pace in indirect taxation where in most countries, with just a few exceptions, notably the US, the value-added tax (VAT) has become by far the most important indirect tax, accompanied still by an incipient use of environmental taxes that supplement classical excises, and a rapid decline in the importance of customs tariff taxes.

Personal income taxes show flatter marginal rates than 30 years ago, with moderately rising average tax rates, and taxing capital income with generally lower rates than wage earnings, as is the case of the dual income tax approach. Corporate income taxes apply relatively lower statutory rates on broader bases than in the past. Internationally, there has been an increase in country competition and corporate taxation increasingly follows the source-based criterion, with limited gains in the coordination of corporate taxation. In practice, the powerful revenue potential of the VAT, sometimes dubbed a 'money machine', has been limited by design issues – multiple rates, narrow base, and so on – in developed countries and enforcement issues in developing countries.

All these fundamental changes found in tax systems have been the result of powerful economic developments such as increased economic globalization observed in the last 30 years, but also the consequence of new political stances toward the role of the public sector, and quite possibly also the result of developments in the theory and practice of public finance. With this background, it seems clear that the time is ripe to take stock of the changes, to fully understand where we stand now on the subject of tax systems, and to consider what types of reforms are feasible and worth undertaking in the next decade. These perspectives and prospective views need to cover not only tax policy issues but also focus on the important challenges arising in the field of tax administration and enforcement, in the design of sub-national taxes, and in the analysis of the political economy of taxation. The papers in this volume are intended to shed light on and advance our understanding of these questions. In the following paragraphs we briefly describe the contributions of the different authors.

Over the years, many tax innovations have taken place in OECD countries, and trends in the evolution of tax systems in these countries to a large extent provide an advanced look into what we would expect to see happening in middle-income countries and even in some low-income countries in the coming decades, if not years. Chapter 1 by Vito Tanzi reviews the changes in OECD countries for the last four decades. He finds important increases in tax levels, significant and generally positive changes in the structure of VAT and personal and corporate income taxes and VAT, and also changes in tax composition. In this last respect, Social Security contributions and the VAT have continued to gain significance over other taxes. Tanzi also detects several trends that will make things harder for tax policy-makers, including increasing trends towards tax decentralization and heightened international tax competition, accompanied by tax evasion and avoidance schemes. However, for Tanzi, the most important challenge facing tax systems in the OECD is the strong lobbying forces working to increase tax complexity, which, in the end, work as a 'hidden and regressive tax', imposing high costs to society.

One of the most fundamental policy decisions to be made in the design of tax systems is that of direct–indirect tax mix, or how much to rely on direct taxes, such as personal and corporate taxes, versus indirect taxes, such as VAT and excises. Although this choice is generally framed as a choice of the degree of progressivity or distributional impact of tax systems, the choice actually can have many other important implications, including economic growth, macro-stability, and the flow of foreign direct investment (FDI). In Chapter 2 Jorge Martinez-Vazquez, Violeta Vulovic, and Yongzheng Liu revisit this theme by first looking at some definitional issues, since what is a direct tax versus an indirect tax is not always clear, and concluding that, based on current theory, there is no superiority of one type of taxation over the other. Using data for 116 developed and developing countries for the years 1972–2005, these authors find that the direct to indirect ratio has clearly increased, mostly due to increases in Social Security contributions in developed countries and to decreases in customs tariff revenues in developing countries. They also document a policy trade-off. Higher reliance on indirect taxation supports faster economic growth and increases a country's competitiveness for FDI, but this higher reliance on indirect taxation also reduces the effectiveness of automatic stabilizers for macro-policy and weakens the strength of income redistribution policies.

The personal income tax has been for many decades a key component of tax systems in developing countries, raising significant revenues, on average 10 percent of GDP, but also very useful in playing significant roles in the pursuit of redistribution objectives (including the use of negative income tax credits), and macroeconomic stabilization objectives. This role has been much more subdued in developing countries, where this tax raises proportionally much less revenue (between 1 and 2 percent of GDP) mainly because of the lower availability of automatic withholding systems and more widespread informality and evasion. But even in developed countries the personal income tax has gone through a lot of questioning and actual transformation in recent decades. In Chapter 3, Robin Boadway reviews the arguments for and against the choice of income or consumption as the base for direct individual taxation and concludes that nearly all the arguments 'based on administrative ease, efficiency, and equity conspire against comprehensive income as an ideal form of taxation'. A consumption base scores well in many respects, especially in administrative matters, but capital income taxation is supported by solid arguments based on efficiency, equity, or political economy. This explains why the alternative of the dual income tax (or, more generally, schedular taxation) with lower flat rates for capital income is becoming increasingly attractive as a useful compromise for this tax. Boadway also reviews the thorny issue of the degree of progressiveness of individual income taxes, a matter that depends not only on rates but also on base composition, and the reasons for limiting high income tax rates. A number of special issues, which clearly complicate the implementation of this tax, are also addressed in this chapter including the relationship between individual and corporate income tax, coordination with sub-national income taxes, the treatment of pensions, human capital investment, wealth transfers, and the tax treatment of family size.

The corporate income tax has been the constant complement of the personal income tax, acting as a withholding mechanism for some forms of capital, but always with more volatile revenue performance, as its base of corporate profits is more sensitive to the business cycle. In recent times, this tax has been under attack from globalization trends, heightened international capital mobility, income shifting, and cross-country tax competition. In Chapter 4 Emilio Albi makes a good case that the corporate income tax is here to stay and even prosper more than in recent times but in adapted forms, especially focusing on the experience of 15 European Union (EU) countries. Complexity is the unavoidable rule of corporate income tax structures, and therefore reforms have steered toward less distortionary and costly solutions, within the established constraints, as opposed to more perfect, albeit impracticable, alternatives. The classical questions surrounding the corporate income tax such as the ultimate incidence of the tax, distortions of investment and financing decisions, discouragement of dividends distribution, business form, avoidance scheme, or compliance and enforcement costs still have as much relevance today as many decades ago. The future likely holds a continuing trend in base broadening and further tax rate competition with new targets for tax credits and taxation of shareholders; international coordination even at the EU or OECD levels is far more problematic, as are the prospects for radical reform.

One form of direct taxation that has experienced a radical decline in recent times is that of wealth taxes, and more so in the case of annual taxes on net wealth than in the case of the transfer of assets (as in inheritances or donations). Besides raising little revenue, higher capital mobility and competition may have played a role, but unpopularity and ideology have probably been key. In Chapter 5, Cremer and Pestieau focus on the efficiency and equity properties of these taxes from the normative perspective of optimal taxation and in the context of the entire tax system, dominated by income and commodity taxation. This is important because wealth taxes have been traditionally thought of as complementary to income taxes. Cremer and Pestieau show that a crucial factor in designing the tax structure, according to the desirable efficiency and equity properties of the different tax instruments, is the motive underlying wealth accumulation and transfers. Motivations are important because they determine the way individuals react to taxation, and therefore what the excess burdens involved may be. Among the traditional motivations, they consider consumption smoothing (retirement, children's education, precautionary motives), prestige or status, intergenerational transfers triggered either by pure altruism, imperfect altruism (joy of giving) or by exchange motives (e.g., the so-called strategic bequests). Uncovering the true motivations of taxpayers unfortunately provides a difficult basis for policy design in practice. This may help explain the contemporary lack of appeal of different forms of wealth taxation.

The single most important transformation of tax systems around the world in the last several decades has been the massive adoption of an invoice-credit consumption-based VAT. In a relatively short period of time the VAT has become the workhorse of most tax systems around the world. And yet its rather stellar performance has not been free of problematic issues. In Chapter 6, Martinez-Vazquez and Bird provide an analysis of how well the VAT has actually performed, discuss several important policy issues related to the structure of the VAT, and take a closer look at some administrative challenges of the VAT, in particular the issue of fraud. To analyze VAT performance, Martinez-Vazquez and Bird examine the determinants of three different measures of VAT efficiency (VAT efficiency ratio, C-efficiency ratio, and VAT gross collection ratio) using a sample of 107 countries, between 1990 and 2008 and find the share of agriculture in GDP, urbanization, and tax morale to be significant determinants of VAT collection efficiency. They also find that on average the adoption of the VAT led to an increase in revenue collections by 12 percentage points of GDP but with the effect being most significant in developing countries, with positive effects in the collection of income taxes and very substantial substitution for collections from customs duties. In most countries VAT may still be the most economically desirable and administratively effective way to increase revenue collections, but the reality is that the VAT is not always well designed, not that well administered, and that the political economy issues continue to make VAT reform difficult.

Excise taxes are among the oldest forms of taxation and continue to have a significant presence in most tax systems not only as reliable sources of revenues but also as instruments of social engineering for addressing different assortments of negative economic externalities. In his Chapter 7 Sijbren Cnossen examines the rationale of excise taxation by reference to its non-revenue objectives, compares the effectiveness of excise duties (with specific or ad valorem rates) vis-à-vis regulations and permits in the pursuit of those non-revenue objectives, and reviews the issues of discrimination, coordination, and earmarking that are often connected with excise taxation. Although the adoption of excise taxes is directly connected to their ease of administration, they also have the economic rationale of falling on products with inelastic demands and therefore represent low distortions or excess burdens. But this low elasticity, although a cause of revenue productivity, also means lower effectiveness in discouraging behaviors from negative externalities – using tobacco products, drinking alcoholic beverages or using motor fuels. Often, regulations (smoking bans, breath tests, etc.) can be a much more appropriate alternative. Cnossen also points out that using excise-type charges on luxury goods (with high income demand elasticities) for making the tax system more progressive is much less justified or effective.

Raising in some ways similar issues to those associated with excise taxes, environmental or 'green' taxes remain the unrealized promise of most tax systems. In Chapter 8, Agnar Sandmo reminds us that, although with clear roots in Pigou's contribution to the theory of externalities, environmental taxation is a relatively recent innovation in tax systems and largely the creature of academic researchers. So it may take time to overcome practical issues, such as the selection of the 'right' bases and measurement of polluting activities, and political economy issues, such as perceptions about the distributional impact of green taxes. Sandmo also reminds us of the usefulness of analyzing environmental taxes in the overall context of tax systems and public expenditures and that the 'double dividend' of environmental taxes (they improve the environment and also generate revenue that can be used to reduce other taxes with significant distortionary effects) is not always assured. The last part of this chapter examines the relationship between 'green' taxes and regulatory and administrative aspects of environmental protection, the interactions between 'intrinsic' (moral) and 'extrinsic' (tax or regulatory) incentives to act in a socially rational way in environmental issues, the global aspects of green taxes, and the political economy of environmental policy.

As many more countries have embarked on fiscal decentralization reforms over the last three decades, the tax systems of these countries have increased in complexity because of the necessary assignment of taxing powers to sub-national government units, raising issues of tax competition, vertical externalities on tax bases, and so on. However, the scope and quality of those assignments vary considerably across countries. In Chapter 9, Roy Bahl examines the case for assigning taxing powers to sub-national governments, and asks whether the international trend in tax assignments is in step with what economists have prescribed. While sub-national taxes in OECD countries average about 8 percent of GDP, in developing countries it is less than one-half as much and there is much higher dependency on intergovernmental transfers. The core benefit from increased tax autonomy is the enhanced accountability of sub-national government officials toward the needs and preferences of their constituencies and increased fiscal responsibility. Although it is not entirely clear how much revenue autonomy is needed to realize those benefits, it would seem clear that many tax systems fall short. The choice of decentralized taxes is much more limited in developing countries than in industrialized countries; for example, personal income taxation of any form can rarely be found at the sub-national level in the developing world. Given that corporate income tax is a clearly bad choice for assignment to sub-national governments, and that the sub-national VAT can be too complex, Bahl explores other likely candidates for providing sub-national tax autonomy beyond the already well accepted property tax and vehicle taxes. The list of good possible candidates is short: destination-based excises and perhaps residence-based payroll taxes.

Tax systems can be thought of as the interaction of two fundamental components: tax policy and tax administration. And it is typically the latter that is the most difficult to get right. There is wide consensus among taxation experts that, without an effective and efficient tax administration, no tax systems can function adequately regardless of the quality of the design of tax policy and that this design must always pay close attention to administrative feasibility. In Chapter 10, John Hasseldine reviews the recent evolution and present state of tax administration theory, discussing the separation of operational tasks (audit and risk evaluation, tax payer services, etc.) and the broader, also important, issues of internal management (organizational matters, personnel and information technology management, strategic policy formulation). In the review of the current context of tax administration, especially in Europe, Hasseldine finds increasing emphasis on compliance and risk management issues, greater reliance on the cooperation and service paradigm, and the important role played by the systematic measurement of performance and the sharing of best practices. Regarding this latter, the roles of the OECD and the IMF have been fundamental. Improvements in the future will come through the continued sharing of information and knowledge between tax agencies and from providing more attention to cost-effective management and the successful introduction of technology.

Tax policy reform can easily be one of the most contentious political issues any country may face. Most of the tax systems we observe are the result of complex, highly bargained political equilibriums. And one way to get tax laws approved is to give something to many different interest groups; hence, the complexity we observe in most modern tax systems and the importance of political economy and institutional considerations in the formulation of tax policy. In Chapter 11, Winer, Kenny, and Hettich examine the relationship between the types of political regimes and institutions and the nature of tax systems. To that end they utilize a simple model for explaining tax system outcomes as a political equilibrium, where they show that all types of political regimes will have to face different tax rate–revenue relationships for particular tax bases, although these may assume different shapes for dictatorial and democratic societies. Dictatorships are more likely to emphasize enforced rather than voluntary compliance. Winer et al. do in fact find empirical support for the proposition that democratic regimes rely more heavily on taxes requiring voluntary compliance, such as income taxes, suggesting that the degree of consent may play a vital role in the nature of observed tax systems. The type of institutions within democratic systems also seems to matter. Countries using proportional electoral systems make heavier use of Social Security, payroll, and domestic trade taxes while countries using majoritarian electoral rule rely more on individual income, corporate, and international trade taxes. The reasons behind those results await further research in the future.

The last question is whether economists in volumes like this one or in other forums can actually influence the shape and future of tax systems. The main issue discussed by Richard Bird in Chapter 12 is whether tax systems in the last few decades have been much influenced by tax research or, from an opposite mirror perspective, whether the economic literature actually has focused on the problems and issues that really matter to policy-makers and that finally shape tax systems. This is an issue that has been discussed recently in different forums, as if there were a sudden need to evaluate the effectiveness of academic economists' efforts now that society may be turning away from the profession in the aftermath of the global financial crisis. Bird's scope of tax systems is wide: OECD countries, where research and most advice comes from, and, perhaps for the most part, non-OECD tax structures. It is the experience in the non-OECD world that may provide 'a particularly clear test' of whether economists' advice has been effective. From an optimistic viewpoint, it is true that the influence of tax theory may be found in taxation changes in recent decades. Examples could be the international expansion of VAT, the incipient interest in environmental taxation, the sizeable reduction of income tax rates and the broadening of tax bases, the spread of dual income taxes with lower flat rates on capital income, or even flat rate income taxes. But as Bird puts it, even in these cases 'fiscal history suggests that much tax research takes place precisely because countries change tax policies for their own reasons. Often, tax researchers are not so much leading the reform elephant as mopping up behind it'. All this ultimately means a more humble but nevertheless useful role for economists helping to shape tax systems. Those interested in improving tax systems should focus not on the short-term political game within which policy decisions are inevitably made in all countries but rather on the long-term game of building up institutional capacity, both within and outside of governments, to articulate relevant ideas for change, to collect and analyze relevant data, and to assess and criticize the effects of such changes as they are made.

## REFERENCES

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