

contributions to economic
analysis

Sijbren CNOSSEN / Editor

Comparative Tax Studies

Essays in Honor of Richard Goode

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COMPARATIVE TAX STUDIES

Essays in honor of Richard Goode

Edited by

SIJBREN CNOSSEN

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Introduction to the series

This series consists of a number of hitherto unpublished studies, which are introduced by the editors in the belief that they represent fresh contributions to economic science.

The term “economic analysis” as used in the title of the series has been adopted because it covers both the activities of the theoretical economist and the research worker.

Although the analytical methods used by the various contributors are not the same, they are nevertheless conditioned by the common origin of their studies, namely theoretical problems encountered in practical research. Since for this reason, business cycle research and national accounting, research work on behalf of economic policy, and problems of planning are the main sources of the subjects dealt with, they necessarily determine the manner of approach adopted by the authors. Their methods tend to be “practical” in the sense of not being too far remote from application to actual economic conditions. In addition they are quantitative rather than qualitative.

It is the hope of the editors that the publication of these studies will help to stimulate the exchange of scientific information and to reinforce international cooperation in the field of economics.

The Editors

Preface

This volume of essays is dedicated to Richard Goode by a few of the many colleagues and friends who have benefited from the encouragement, the advice, and the leadership he has provided in the areas of domestic and international public finance and monetary policy during more than forty years of government service, university teaching, research at Brookings, and work at the International Monetary Fund.

As the bibliography at the end of the volume and the many references in the contributions prove, few can match the exceptional wide breadth and sustained high quality of Richard Goode's output. Surely, he has been one of the best and most prolific of the post-war generation of economists. His numerous articles, both conceptual and empirical, his technical assistance reports, as well as his books on the individual and corporate income taxes are landmarks in the professional literature. Each of his publications will be read and reread for many years to come. They reflect the highest standards of scientific inquiry and probity.

No doubt, Richard Goode will be primarily remembered for managing and developing the Fiscal Affairs Department of the International Monetary Fund into the world's leading institution of comparative public finance. Throughout his career as the chief international civil servant in this field, he displayed and imparted a rare and most valuable blend of thoughtful analysis and judicious practicality that is indispensable in dealing with the complex institutions and relations that govern the real world. He was a skilled pilot, always ready to provide an objective judgment on the dangerous banks, currents, and treacherous passages that had to be negotiated if the ship were to continue on a safe course. There are few in the global public finance fraternity whose advice was, and is, so widely solicited and whose counsel is so uniformly respected.

This volume surveys and evaluates the tax systems of industrial countries on a comparative basis in the light of current social and economic changes — a subject in which Richard Goode is closely interested. It is with affection and high esteem, personal pleasure and pride, that the contributors join in presenting this token of appreciation for his many productive years and shared friendship.

Sijbren Cnossen

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PART I

OPTIONS AND TRENDS

CHAPTER 1

Tax policy options in the 1980s*

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The 1970s saw two interesting developments with respect to tax policy. In the first place, in many industrial countries popular dislike and resentment of existing tax levels and structures flourished as never before. Slower growth of real incomes, increased distortions resulting from inflation, growing dissatisfaction with government's ability to solve these problems and to provide services effectively — these and other factors contributed to the so-called “taxpayer revolt” which received so much publicity, particularly in the United States, at the end of the decade. Similar pressures were felt in other countries, and one result was a growing search for forms of taxation that might prove more acceptable.

At the same time, recent developments in the public finance literature have provided some interesting new answers to the on-going search for the good tax system. As yet, academic writings on such themes as optimal taxation and expenditure taxes have had little direct impact on policy, though they have surfaced in such widely-read public documents as the Meade Report in the United Kingdom and the U.S. Treasury Department's *Blueprints for Basic Tax Reform*.¹ These studies, and such other major tax inquiries as the Carter Report in Canada

* An earlier version of this paper was presented by the first author to the Victoria Branch of the Economic Society of Australia and New Zealand.

¹ Meade et al. (1975) and *Blueprints for Basic Tax Reform* (1977).

and the Asprey Report in Australia,² have produced an interesting and varied array of possible tax policy options for the 1980s which deserve careful consideration by both scholars and practitioners.

The purpose of the present chapter is to introduce the major tax policy alternatives now open to Western countries, drawing in large part upon the four major reports cited above and the basic public finance contributions underlying those studies. The taxation of persons and of companies receives most emphasis in this discussion, in part because it is these subjects that have been the focus of both popular and academic discussion, and in part because this emphasis is obviously appropriate in a volume in honor of Richard Goode, who has made major contributions in these areas.³ Although much of the discussion in this chapter inevitably reflects primarily conditions in the anglophone countries, there is reason to believe, as indeed Kenneth Messere's chapter in this volume brings out, that many of the issues discussed here are important in other OECD countries, although perhaps with different degrees of saliency.

The quasi-constitutional nature of tax systems

Tax policy has always been a controversial topic in the political arena. Since the tax structure determines the price each of us must pay for public goods and services, this controversy is not surprising. If by lobbying or other political activity an individual can obtain concessional tax treatment for his particular source of income, his share of the cost of public services is reduced relative to others. Tax changes are thus often a zero-sum game. Under these conditions no tax economist can hope to satisfy everyone. If, however, we are willing to take a somewhat broader perspective on tax policy, the role of the inevitably controversial zero-sum elements can be reduced, and more fundamental structural questions involving possibilities for mutual gain can be emphasized.

This broader perspective is based on the explicit recognition that the tax system in a modern democratic society has a "quasi-constitutional" character, in the sense that it remains in force, usually with only minor changes, over a sequence of budgetary periods.⁴ There are good reasons why this should be the

² *Report of the Royal Commission on Taxation* (1966), and *Taxation Review Committee, Full Report* (1975).

³ Goode (1951, 1976).

⁴ The "constitutional" nature of taxation has recently been stressed by Brennan and Buchanan (1980) who argue in part that strict constitutional limits need to be put on tax powers in order to restrain revenue-maximizing politicians and officials. They would therefore tend to favor a narrower tax base than that suggested here. This conclusion seems mis-

case. The tax system, and the taxpayer attitudes that go with it, should properly be viewed as a form of public capital. The prevailing tax structure establishes, both in principle and in practice, the way in which the burden of resource transfer is to be shared among different individuals and groups in the community and, in combination with the transfer system, it has a crucial impact on the shape of the income and wealth distribution. Controversial and potentially divisive issues of equity are thus intrinsically of central concern in tax policy-making.

To embark on a fundamental review of the tax system is therefore to open up a veritable Pandora's Box of controversy, in the sense that it puts the existing and often hard-won compromise on cost-sharing and the income distribution up for grabs. Public discussion of far-reaching changes in the tax system generates uncertainty and may inhibit rational planning in the private sector. The implementation of major reforms can thus be costly and disruptive. As noted above, the issue of tax reform is thus intrinsically divisive and tends to be dominated by considerations of short-run economic self-interest. Given the somewhat unpredictable functioning of the political system, we cannot in general be sure that the result of reform efforts will justify the risk involved. There is accordingly much to be said for the view that major tax reform exercises should be relatively few and far between. Nevertheless, for the reasons noted earlier, the time when such exercises are felt necessary may not be far off in many countries.

We might do well in principle to settle for a relatively stable compromise on taxes or cost shares and devote the bulk of our decision-making efforts to the positive-sum possibilities inherent in the provision of those public goods and services which the market cannot supply efficiently. It is only realistic to recognize, however, that under democratic decision-making the tax system will always to some extent be manipulated by the government of the day to serve the economic interests and ideologies of its members and supporters. As one government succeeds another, there is thus a very real danger that any tax constitution will be cumulatively distorted or eroded by acts of short-run political expediency.

By adopting a properly constitutional attitude to the tax reform issue and taking a longer-run view of the functioning of the political system, however, it may be possible to suggest changes which would be of mutual benefit to most sections of the community, even though in practice we all have our own fairly well-defined positions and vested interests in the economic *status quo*, our con-

conceived, however. Even if one accepts the argument that the propensity of governments to waste the sustenance of their citizens is unbounded by the normal political process, it would seem better (and as easy) to impose general constitutional limits on the size of government than to distort needlessly the choice of tax base.

cepts of equity (and especially of vertical equity) vary, and the zero-sum elements tend as a result to dominate public discussion. In particular, an appropriate tax constitution for the long term in a democracy should be flexible enough to accommodate likely changes in the degree of progression desired as one government succeeds another, without the need for major structural upheaval. The tax policy options considered in this chapter are therefore all viewed from this perspective.

Traditionally, tax economists in the Haig-Simons tradition have placed the primary emphasis among possible tax policy objectives on equity and efficiency. Horizontal equity requires that people in essentially similar economic circumstances should be taxed similarly, while the vertical equity objective is to control or limit inequality through suitable differentiation in the tax burdens imposed on people in differing circumstances. It has, of course, been generally recognized that vertical equity is inherently controversial and requires strong value judgments. Horizontal equity, though perhaps difficult to specify precisely, has by contrast usually been taken to be, in principle at least, relatively uncontroversial. The other major objective of efficiency requires that unintended distortion through the tax system of resource allocation in the private sector should be kept to a minimum. The emphasis is therefore on tax neutrality, though a limited role is reserved for planned departures from strict neutrality in order to compensate for market imperfections.

Among other possible objectives of tax policy, economic growth has been viewed by some as a goal in its own right and by others simply as a further (intertemporal) dimension of the efficiency objective. The tax system is also usually assumed to have some role in stabilization policy, both discretionary and automatic, though its possible efficacy in this regard has been disputed in recent years. In addition, increasing emphasis has recently been placed on the objective of simplicity, interpreted to include the ease with which the taxpayer can perceive the underlying principles and purpose of the tax system. Another objective, as noted above, should be a reasonable degree of stability in the tax structure, combined with sufficient flexibility to accommodate inevitable changes in policy emphasis without the need for major structural upheavals which could disrupt rational planning and business confidence. Finally, the tax structure should also be compatible with the effective functioning of multi-level government, and as a further important dimension it must offer a satisfactory solution to the problems of taxing international flows of income.

Although fairly general agreement probably obtains on the various objectives of tax policy sketched above, at least among tax economists working in the dominant Haig-Simons tradition, the precise form of the optimal tax structure in any country will, of course, vary with particular interpretations and also