

# eJournal of Tax Research

Volume 11, Number 3  
Special Edition: 10<sup>th</sup> Anniversary Edition

December 2013

## CONTENTS

- 245 Editorial announcement  
**Binh Tran-Nam**
- 246 Introduction to the 10th anniversary issue of the eJournal of Tax  
Research  
**Binh Tran-Nam, C John Taylor**
- 259 Buenas notches: lines and notches in tax system design  
**Joel Slemrod**
- 284 Designing tax policy: constraints and objectives in an open economy  
**Richard M. Bird, J. Scott Wilkie**
- 321 The European Union constitution and the development of tax policy  
**Nigar Hashimzade and Gareth Myles**



collectively. To put it another way, citizens through their political institutions may choose to consume collectively in the same way as households allocate the family budget.

Just as in a family, of course, not all are income earners so we may as a society may choose to share or redistribute some of our collective revenues to ensure that those with smaller incomes are not excluded from such publicly provided goods as education or health as well as to supplement their ability to obtain such privately provided goods as food or shelter. Moreover, we may as a community use the tax system to alter the risks and rewards associated with various choices that we as individuals may make with respect to how we spend our private incomes.

The larger the public sector, the more important it is to have as efficient, equitable and administrable a tax system as possible. What constitutes a good and feasible tax system for any country at any time depends on a host of primary social, political and economic considerations and choices. This paper considers both the objectives that a tax system may attempt to achieve and some criteria that may guide not only the initial design and implementation of taxes but also subsequent adaptations to changes in domestic and international circumstances that may make the tax system less effective in achieving its objectives.

7KH QDWXUH RIDFRXQWU\|VWD[V\VWHP LQH YLWDE C  
 society through its political institutions decides to place on different objectives and the extent to which tax instruments are explicit or implicitly intended to achieve those objectives. As an eminent American jurist (Oliver Wendell Holmes) once said, taxes are the price we pay for civilization. It is not surprising, then, that many of the criteria commonly associated with identifying and devising good tax policy reflect notions of fairness<sup>1</sup>—sometimes considered the glue of a democratic society—the distribution of tax responsibilities. The collective consumption effected through taxation both facilitates civil society and establishes its boundaries. Private opportunities for benefit and gain to a substantial extent depend on the existence of a civil society that permits





percentage change in GDP (or potential tax base, such as personal income). Elasticity equal to one, for example, means that tax revenues will remain a constant share of GDP. Elasticity greater than one indicates that tax revenues grow more rapidly than income. In principle, over time revenues should on average grow at about the same rate as desired expenditures (that is, the income elasticity for revenues and expenditures should be the same). As an example, over the 1970-90 period the buoyancy of general

occupational choice and a better quality of life for Canadians (Government of Canada, 2008, 62). Of course, similar concerns are important in a solely domestic context. that tax policy involves more than deciding how much revenue must be raised. An equally important policy issue is the design of a scheme of taxation and its impact on individual and corporate incentives and behaviour (Government of Canada (2008), 62). Of course, similar concerns are important in a solely domestic context.

### 1.3 The Costs of Taxation

#### 1.3.1 Administrative Costs







### 1.3.5 Taking account of tax costs

To minimize imposing unnecessary costs through taxation, experience suggests three general rules should be followed.

#### Tax Base Breadth

First, tax bases should be as broad as possible. A broad-based consumption tax, for example, will still discourage work effort but at least such a tax reduces distortions in consumption by taxing a broader range of goods and services uniformly. A more broadly-based consumption tax like a value-added tax that encompasses a wide range of services is thus more efficient than most retail sales taxes like those levied by US states (computers and other office equipment), essentially because the former is less likely to distort consumption (and investment) decisions. A few items, such as fuel, tobacco products and alcohol, may be taxed at a relatively higher rate for administrative simplicity, preferably a rate imposed through separate excise taxes because of regulatory reasons or because the demand for these products is relatively unresponsive to taxation. Finally, for similar reasons, in principle the tax base for income tax should also be as broad as possible, treating all income, no matter from what source, as uniformly as possible.<sup>2</sup>

#### Tax Rates and Rate Induced Distortions





institutions as having resolved all such debates! In the practical policy world if, from the perspective of social and economic inequality, what matters in the end is the overall impact of the budgetary system on the distribution of wealth and income then both expenditures and taxes should be taken into account. Taxes affect equity in many and complex ways, and different citizens may view many of these consequences differently. Some may wish to favour cities and those who live in them, for selfish or developmental reasons; for similar interested or disinterested reasons, others may wish to favour farmers and those who live in rural areas. Similarly, some may wish to favour rich savers in the name of growth and others the poor in the name of fairness and redistribution. However, since presumably all are ultimately interested in outcomes, good tax policy should be based as much as possible on evidence-based research into consequences rather than faith-based presuppositions. Equally, there is much to be said for ensuring that the debate on both evidence and philosophy should be as inclusive as possible and that due attention is paid to ensuring procedural equity through as open, transparent and comprehensive a policy process as possible.

socially or politically essential as one component of maintaining and sustaining the state. On the other hand, if the major concern is to help those who most need it, that objective is much more likely to be achieved through expenditure than tax policy, and the policy balance may shift from progressive to more proportional means of financing northern Europe.<sup>17</sup>

#### 1.4.6 Incidence—Who Pays?

Turning back to economics, in order to determine the fairness of a tax regime, one must of taxation. The person or entity required by law to pay a tax need not be the one whose economic well-being is reduced by the imposition of the tax. In the end taxes always capital) suppliers and not on corporations or other institutional abstractions. For example, although the VAT requires firms to pay VAT on their sales, it is both expected and likely true that the real economic incidence of the tax falls on the ultimate consumer. Similarly, although motor fuel taxes are in practice collected from distributors in most countries, the full burden of such taxes is usually considered to be borne by consumers just as the full burden of the personal income tax is usually assumed to be borne by the person who pays it. In all these cases, however, these are at best plausible assumptions rather than empirically based facts. In other instances, even plausible assumptions about who actually bears the economic costs of taxation are hard to defend. For example, property taxes may be ultimately paid (in the sense of reducing the income of) either owners of land and capital (who also bear the legal incidence) or by the users or renters of the property, depending upon market conditions. Asking for a definitive answer about which groups, let alone individuals, pay the property tax is like asking for certainty about which team will win the league championship in any year.

Who pays the corporate income tax is even more difficult to assert with confidence, especially in an open economy such as Canada, to some extent, most countries. Corporations are in essence simply legal constructs. Taxes imposed on corporations ultimately must fall on individuals: but which individuals? Conceptually, corporate income taxes may lead to shareholders (or, perhaps even the owners of all forms of capital, including houses and pensions) receiving lower returns. Or they may result in consumers paying higher prices, or workers receiving lower wages, or some conceivable combination of these outcomes. In addition, the immediate impact of a tax in the short

<sup>17</sup> A useful discussion of the role tax policy plays in these countries may be found in Lindert (2004).

<sup>18</sup> Although this point is not strictly relevant to the incidence issue discussed in the text, we should note that Canada, like most countries, continues to impose some corporate income tax that is not offset by credits at the individual level. Although we also do not discuss here other possible rationales for corporate taxation as a means of taxing capital, including houses and pensions) receiving lower returns. Or they may result in consumers paying higher prices, or workers receiving lower wages, or some conceivable combination of these outcomes. In addition, the immediate impact of a tax in the short corporate income tax is an important part of the tax system primarily because it can (and does) serve as an important regulatory instrument (Aronson 2011). In this sense,

run may differ substantially from its incidence in different macroeconomic (cyclical)

information supplied by taxpayers and related third parties such as banks, other businesses, and tax practitioners, particularly accountants. Tax officials must be able to know about and collect the information needed for effective administration from taxpayers, relevant third parties, and other government agencies, all of whom need to comply with their reporting responsibilities. The administration must store all this information in an accessible and useful fashion. And, most importantly, it must use the information to ensure that those who should be on the tax rolls, are, that those who should file returns, do, that those who should pay on time, do, and that those who do not comply are identified, prosecuted and punished as appropriate. All this is easy to say but hard to do. However, the task is not impossible and for the most part tax administrators in most developed countries manage to do a relatively good job.

As we discuss further in Section 2, however, globalization confronts tax administrations with new and difficult problems. For example, tax administrations must ensure that revenues and expenses occurring in other countries are properly calculated in determining taxable profits for the corporate income tax, and that export credits and refunds are properly handled under VAT, L N H & D Q D G D E n v o i c i n g a t a 6 7 system is neither an easy nor a static task in any country. It is especially difficult in an open economy with many cross-border transactions and in rapidly changing economic conditions like those in recent decades. Unless this task is tackled with seriousness and consistency, however, even the best designed tax system will fail to produce good results.

## 1.6 Taxation and Growth

### 1.6.1 Is there a connection?

Growth is seen by many as an objective that tax policy should accommodate. Although much has been written and said about the effects of taxation on growth, there is still much we do not understand about this complex subject. Consider, for example, the tradeoff between growth and equity. Most people would like to be richer. Many may also want the increased wealth to be distributed fairly. Are these objectives compatible? As mentioned earlier, collective action through the fiscal system presumably to some extent makes us better off both as a community and individual citizens. However, many may be less aware of the public benefits than of the private costs of giving up control over some of their resources to the government. Measuring public interests through the lens of private interest obviously distorts perceptions of what is good tax policy. For this and other reasons, although many theoretical and empirical explorations have been made of the potential growth-equity tradeoff, no simple or definitive answer to this key question is possible.

What seems clearer, however, is that there is no magic tax strategy to encourage economic growth. Some countries with high tax burdens have high growth rates and some countries with low tax burdens have low growth rates. Looking at the relationship between growth rates and tax rates in Canada over the last 50 years shows, for example, that Canada has had some of its periods of fastest economic growth during those years where the tax rates were the highest.<sup>28</sup> Of course, this does not in any way imply that



high tax rates are the key to economic growth. It may be that growth rates in Canada would have been even higher in years with high tax rates if rates had been lower. The point is simply that the relationship between taxes and growth is complex. Just as nominal tax rates often provide little information as to the real effective tax rates imposed on different individuals and different activities, GDP ratios alone convey no information about the level and productivity of the government infrastructure and services associated with those tax dollars.

### 1.6.2 Growth Strategies

Consider what a tax system might look like if economic growth were the main policy objective. For one thing, to avoid discouraging entrepreneurship and risk-taking, there would probably be little or no taxation of profits since such taxes make these activities less rewarding. In particular, there is little economic rationale for taxing what economists often call normal profits, by which they mean (more or less) the average rate of return available for

A second growth-oriented tax strategy might be to tax consumption more than income. The difference between consumption and income is saving, and from the perspective of encouraging, more saving is usually better than less. If domestic savings are essential to financing domestic investment or if for some (not very clear) reason a premium is placed on having domestic savers invest in domestic investment, an argument can be made for taxing income from savings more lightly or at least for having domestic saving such objective. Most importantly, however, in addition to a relatively low and stable tax on profits a purely growth-oriented tax system may thus place heavier reliance on a broad-based consumption tax such as the VAT.

### 1.6.3 Growth versus other objectives

What is conspicuously missing in this picture, of course, is any explicit mention of a personal income tax or any concern for fairness in taxation. However, from a broader perspective, such a tax may also be considered to be a critical component of the design and implementation of a sustainable tax system in a democratic setting, just as in Canada

In principle, the tax system can certainly be used to encourage or discourage certain activities. For example, taxes can be used to correct market failures such as positive or negative externalities. Externalities exist when market prices fail to reflect all the benefits or costs associated with an activity. The classic negative externality is pollution. Firms that pollute affect the welfare of others, often in a way that is outside the market mechanism. The presence of externalities could prompt different types of government action. The government could regulate the activity by providing rules of conduct and penalties for failure to comply. It could establish clear property rights, such that all affected parties would be brought together and bargain in a manner that could result in the parties accounting for the costs and benefits of their activities. An alternative (or

leakage to unintended potential claimants, their effects may differ substantially from the stated intention<sup>6</sup>. On the whole, it seems all too likely that in most countries far more

W D [ μ W L Q N

objectives that shape Canadian taxation may extend much beyond the conventional trinity of equity, efficiency and administrability with which this section began. Much the same may be said in many other countries.

## 2. TAX POLICY IN THE NEW WORLD ECONOMY

What is good (or even feasible) tax policy becomes even more complicated when one recognizes that the geographic borders do not define the limits within which tax policy decisions focused on the welfare of citizens take place. Countries no longer have the luxury of designing and implementing their tax systems in isolation. The





The increasingly pervasive international aspect of tax policy may surface directly in reVSRQVH WR RWKHU FRXQWULHV¶ FKRLFHV DV HDUO introduced a new system of accelerated depreciation for manufacturing and processing in part as a response to a tax export subsidy established by the United States. More recently, many countries have engaged in competitive downward moves of corporate income tax rates. Reflecting this, much recent discussion of international tax policy reform has been driven by the interests of multinational and global business enterprises in synthesizing a competitive effective international tax rate. Although these enterprises exist as constellations of separate accounting entities, they are economic units that are constantly, through various intrafirm dealings, reestablishing their economic unity in relation to similarly placed enterprises. The transfer pricing issue in tax policy is concerned with detecting when such dealings cross justifiable economic limits and in effect become devices to redefine and shift profits to where tax is less. Since there is no international tax system as such, in effect the artificial subdivision of economic units into legally separate accounting units results in a process of fiscal arbitrage as economic actors mix and match elements of the different tax systems facing them until their tax cost of doing business is comparable (or lower) than that of their competitors.

)URP DWD[UDWKHU WKDQ EXVLQHV SHUVSHFWLYH emerge from the adoption of such tax policy norms, the CEN and CIN approaches mentioned earlier, or most explicitly and collaboratively-- through bargained accommodations by way of tax, trade and other treaties. The main playing ground currently is how to measure and tax international business income earned indirectly through foreign legal constructions, foreign affiliates or more generally controlled foreign corporations. Whether and how taxation of such income should be deferred and any foreign tax recognized, is far from a decided issue. The CEN approach is to apply the home tax system without regard for where the income is earned, crediting foreign tax up to the home (residence) country tax liability. The CIN approach is to give primacy to source country taxation by exempting such income from residence country WD[DWLRQ RQ WKH JURXQGV WKDW GRLQJ VR LV LQ V interest. Both approaches focus on the effective income tax rate and assume, rather optimistically, both that domestic and foreign income measurement is appropriate and that all relevant expenses are appropriately aligned with domestic and foreign revenues respectively.

When national economies are relatively autonomous, countries have considerable latitude in pursuing their own distinct policies. The quite different notions of competition embedded in CEN and CIN are not a big issue when the elasticity of capital flows to effective tax rates is relatively low. However, as the economic context becomes



As already noted, such problems are noticeable with respect to international business income. The commonly accepted OECD Principles for Allocating and Apportioning International Income among Taxing Jurisdictions is intended to provide a basis for national taxation of the correct

becoming increasingly well informed about and influenced by developments and approaches in other countries.

7 D[ S R O L F \ K D V D O Z D \ V E H H Q L W F R I W T R D S S H U R W D F Q W D R I Z E H  
past is not the future. Those concerned with the design and implementation of tax systems need to look ahead and consider carefully whether the policy and administrative





the country in question attribute the financing charge to the foreign underlying income, the final outcome of the national disallowance of a financing charge is unclear since that outcome depends on how both the foreign country and the multinational firm react. Once international considerations are introduced, tax policy becomes enormously more complex because it must consider not only potential taxpayer reactions but also those of other taxing jurisdictions.

#### 2.2.5 Defining the tax base and necessary accommodations

This brief discussion of four of the key building blocks of any income tax system illustrates some of the ways in which why international developments may force some rethinking of tax policy conventions. The underlying theme is that there are increasingly practical as well as theoretical limitations to the usual guidelines of taxation set out in Section 1. No country is likely simply to abandon its tax claims in favour of the interests of another country when it comes to taxpayers having some recognizable connection to both unless there is a significant reason to do so in its own interests. Indeed, it is this axis of interest country to country acting as if they were economic actors in relation to each other through their respective taxpaying accounts for the internationalization of tax policy and rules, and gives rise to the complex administrative web manifest in tax treaties, information sharing, transfer pricing agreements among taxpayers and tax administrations, and the like. However, it is not discern very clear thinking about the objectives of transfers b5(ons)63(t) he 9(s)52(of)-39(i)-4(n)(e)-4(h)11(e)

less and less the prime determinant of where the fruits of economic activity or necessary capital reside, tax systems may need to utilize whatever connections or ties to the potential tax base they can assert.

From a more positive perspective, one might perhaps argue that there is now in effect a larger shared interest among competing tax systems and, correspondingly, heightened awareness and responsiveness in each country to the economic and tax policy characteristics of other tax systems. In other words, tax policy objectives associated with such hitherto theoretical concepts (state-nation equity,  $\mu$  I D L U  $\uparrow$  L Q W H U Q D W L R C arrangements) have arguably become more important. This line of thinking points in the direction of the need for more explicit agreements among jurisdictions as to who should tax what and how much if only to ensure that anyone is to be able to tax much in any fashion.

At the same time, however, the increased importance of border tax bases moves administrability issues to the forefront. Even the best designed international (or, for that matter national) tax will not work if it cannot be reliably collected, for instance, because some key parameters are porous or indefinite, or because simply too complex to expect adequate compliance even from diligent and honest taxpayers or adequate enforcement from even the best tax officials.

### 2.3 Rethinking the parameters of tax policy

One way or another, the message seems clear: a relatively open economy cannot conceive its tax regime in isolation. It must increasingly do so in relation to the tax regimes in place (or expected) in other jurisdictions. International tax policy may perhaps best be thought of as domestic tax policy adjusted to accommodate adequately the nature and transmission of high value economic inputs (factors of production) as well as outputs across borders, in a world in which most economies are relatively open and

LQFUHDVLQJO\ ODUJH VKDUH RI LQFRPH DULVLQJ IURF  
and financial structuring.

Practical tax policy and tax administration is necessarily driven by the observable characteristics of economic systems, legal systems and business constructs on the basis of which potentially taxable tax bases can be identified and measured. The basic problem is that many of the key constructs on which current tax systems rely are essentially fictional- such as corporations and various self-selected outcomes (for example, through elections (optional choices) to characterize a particular activity or tax actor in a particular way). The fictional underpinnings of fiscal outcomes become accentuated as economic systems and business constructs more and more reflect the significance of such intangible inputs as organizational and knowledge-based intangibles that may not even be forms of legally protected property. In some instances the functioning of the tax system may depend not only on the relevant actors (firms and tax administrations alike) using accepted legal norms but also on concepts and procedures that either do not have a normative analogue or simply be made up to suit the immediate needs of tax regulation. For example, much contemporary international transfer pricing now works more or less like this. Such fictions may be useful, even necessary, to make the system work at all. However, as they accumulate over time the system as a whole may become less coherent as the fictions are increasingly tested by circumstances with which they were not meant to contend. The present patchwork of administrative devices and practices may have become intrusive to orderly tax administration that by default it has become the system. National tax systems that rest on such shaky foundations cannot be reliably or compatibly coordinated with the equally shaky systems of other countries. Ideally, the person or persons of a tax system need to be capable of being grounded in a legal system in a cogent and understandable way as well as in a way that reflects a measure of predictable symmetry with the reactions of other countries.

In the international context, for example it may be that the first step towards designing a coherent and practical tax framework is to reverse the current situation and to acknowledge that the focus should be on the source of economic contributions rather than the residence of persons and entities who may or may not be responsible for those





WD[ SROLF\ FKRLFHV FDQ UHDOO\ EH WKRXJKW RI DV  
 be compatible with different choices made by the tax system is joined by force of circumstances. Who really controls the tax base?

### 3. THE NEXT GENERATION OF TAX POLICY OBJECTIVES

#### 3.1 Reconsidering basic tax policy questions

Section 1 discussed several tax policy objectives and design criteria. For the most part, that discussion implicitly proceeded as though countries could decide how to tax in complete autonomy. As discussed in Section 2, however, in the modern world this assumption is increasingly being tested. Some basic questions about tax policy need to be reconsidered in this context, particularly with respect to the taxation of international business and capital income but also, more generally, with respect to such taxes as value-added and income taxes.

What is the tax base? In a more open economy should more attention be paid to consumption-based than income based taxes? The present income tax in Canada, for example, is to a considerable extent already really a consumption tax through its shift even further towards a more explicit consumption base? If it were to be shifted,

extent the last, allocation, is the task of subnational governments. Arguably, however, when forces exogenous to the nation may, as the recent financial crisis shows, effectively override national control over stabilization and distribution to a considerable extent then in many ways the main role left to the central government too becomes the allocation function. In these circumstances, the highest order government in effect becomes little more than a sort of overarching supranational congeries of loose HFRQRPLF DQG OHJDO DUUDQJHPHQWV WKDW UHO\ H μSROLWLNFDVWDIRU HQIRUFHPHQW SXUSRHHV 1DWLR become more like subnational tax systems when the world in which they operate is such that national tax policy outcomes are shaped in part both by international commercial arrangements and by various types of formal and informal regulatory collaboration among tax authorities (as well as specific accommodations in treaties and other legal arrangements). If so, there may perhaps be some lessons for national tax policy to be learned from how subnational tax systems work.

### 3.3 Multilevel Taxation

One principle of taxation in a multilevel system is that, to the extent possible, each level of government should limit the exercise of its taxing authority to what it can do. In effect this is a modified version of the benefit principle that contemplates some measure of correspondence between taxes levied and the benefits garnered by those paying the taxes. Taxes with broader societal objectives, intended either to define the major parameters of the social system or to redistribute resources within it, do not fit easily (h)

these factors more explicitly even within an open economy framework. The traditional





OECD (2013) OECD Secretary-General Report to the G20 Finance Ministers, available at [www.oecd.org/.../2013/OECD-SG-Report-to-G20-Heads-of-Government.pdf](http://www.oecd.org/.../2013/OECD-SG-Report-to-G20-Heads-of-Government.pdf)

Royal Commission on Taxation (1966) Report Y R O V 2 W W D Z D 4 X H H Q 1 V 3 U L Q W H U

Treff, K. and D. Ort (2010) Finances of the Nation 2009. Toronto: Canadian Tax Foundation.

Vaillancourt, F., J. Clemens, and M. Palacios (2008) Compliance and Administrative Costs of Taxation in Canada. In J. Clemens, ed., The Impact of Taxation in Canada: the Case for a Flat Rate. Vancouver: Fraser Institute.