

IV. FORCES SHAPING TAX POLICY

Taxation, public spending, budget deficits and debt all rose faster than GDP in virtually all OECD countries over the past 30 years. On the other hand, the fiscal outlook has improved in several countries with significant tax reforms in the past 15 or 20 years and reductions in deficits (at least in relation to GDP) in the past 10 years. Nevertheless, challenges remain and this chapter focuses on four forces that are likely to shape taxation policy in the years ahead: pressures on expenditures that, if undertaken, would have to be financed either through increased taxes or redeployment of existing revenues; the need to limit and reduce further the adverse economic effects of the distortions caused by historically high tax burdens; erosion of tax bases which has intensified as tax rates have increased; and, as an important special case of tax-base erosion, the threat posed by the increasing geographical mobility of tax bases. Of course, all of these factors have already had significant effects.

Most of the growth in public outlays over the past 30 years has been social spending – both transfers to households and social programmes. There will be pressure in coming years to raise social spending further. Technology and, perhaps, globalisation are tending to increase income inequalities, increasing demands for more extensive income redistribution. In addition, population ageing will, in the absence of reforms, raise public spending on pensions and health care. Thus, other ways will have to be found to contain social spending, or further increases in tax revenues will be needed.

But taxation appears to be increasingly constrained. Past increases in taxes have raised distortionary costs, despite the tax reforms that have been put in place. These reforms have tended to shift marginal taxation from capital and high incomes toward labour and low incomes. Although overall incentives have probably improved as a result, high labour-tax wedges and implicit marginal tax rates at the low end have been blamed for high levels of structural unemployment and low labour-force participation in many countries. Reforms in these areas would be welcome, but could be costly in terms of lost revenue. It is unclear how much more other taxes can be raised without imposing unacceptable economic costs.

There is also increasing concern that high tax rates are undermining tax bases, thereby restricting revenues. To some extent, legal tax avoidance can be reduced by closing loopholes and illegal tax evasion can be contained by better enforcement of tax codes. But the root of the problem appears in many cases to be high tax rates.

Institutional and economic developments have interacted with high tax rates to create a worrying tendency for some tax bases to migrate to low-tax jurisdictions. Such developments include reduced transportation, communication and transaction costs and the consequent increase in the globalisation of markets. Although globalisation has raised overall economic prosperity, it has also made the taxation of certain types of income increasingly difficult. Although there is no evidence that major tax bases – personal and corporate income taxes, and consumption taxes – have begun to collapse, it is almost certain that past trends in this area will continue and the effects on tax bases may therefore intensify.

Pressures on public expenditures

Public expenditures have risen faster than output

Since 1960, general government expenditures in the OECD area as a whole have risen from 30 to nearly 50 per cent of GDP. A little more than half of this increase of some 20 percentage points was accounted for by transfers, with the rest being divided between government consumption – purchases of goods and services and, in particular, public employment – and interest payments on the national debt, which accumulated in many countries as a result of chronic budget deficits. By 1995, overall social spending (transfers plus other social programmes) was equivalent to one-quarter of average OECD GDP and explained virtually all of the variation in overall public spending across OECD countries.

Social expenditures have accounted for most of this

For the OECD as a whole, about two-thirds of social spending is accounted for by health and pension programmes. In terms of changes over the past 15 years, country experiences differ significantly. Pension outlays have increased in most countries due to the maturing of pension plans; in some countries increases in health-care costs pushed up outlays for this item; and in several, mainly European countries, unemployment insurance and assistance benefits have increased substantially, largely reflecting increased structural unemployment.

These large social-spending programmes have to be judged successful in important respects. For example, at least in the limited group of OECD countries for which data are available, transfers and taxes have clearly reduced income inequality and poverty rates, in that both are substantially lower in terms of income after taxes have been paid and transfers received than before (Burniaux *et al.*, 1998). Public pension plans have been particularly successful in increasing the incomes and reducing poverty of the old. And the expansion of public responsibility for health-care financing has improved access to health care, and thus well-being, for many.

At the same time, however, inequalities of disposable income have not generally narrowed since the 1980s. One interpretation of this is that the expansion of taxes and transfers offset increasing inequalities in terms of market income (that is, before transfers are received and taxes are paid). But it is also possible that the expansion of taxes and transfers itself contributed to increasing inequalities of market incomes. Taxes at the low end of the distribution (which, as will be shown below, have tended to increase) have been shifted back to wages, and rising tax and transfer wedges have discouraged firms from offering employment and individuals from taking it, reduced employment and increased inequality.

Pressures to raise social spending will increase in the future

All these factors are likely to persist and even intensify in the future. Lower birth rates, increased longevity and a marked tendency towards earlier retirement will result in sharply rising ratios of retired people to working people in the next century. This development will have many economic and social effects, among which will be upward pressure on public expenditures on old-age pensions and health care. Indeed, in the absence of profound reforms to pension systems, the result is likely to be unsustainable fiscal positions in many OECD countries (OECD, forthcoming).

This pressure on outlays will occur when the labour-tax base will be growing only slowly or, in some countries, shrinking. Increasing tax rates on labour to compensate would only aggravate labour-market distortions, resulting in lower take-home wages or higher unemployment. If higher tax wedges were to increase unemployment, the tax

base would be further eroded and outlays on unemployment compensation and other social programmes could rise. The adverse effect of rising unemployment on public finances is illustrated by simulations of the OECD's INTERLINK model of the fiscal deterioration resulting from the historical increase of structural unemployment in several OECD countries (from an arbitrary 6 per cent) to the levels that prevailed in 1996 (Table IV.1). Indeed, recognition of the high economic and social costs of labour-market distortions has led to increasing emphasis on employment creation, which, as the *OECD Jobs Study* (1997) emphasised, includes the reform of transfer programmes to improve incentives, as well as other important measures.

Table IV.1. **The budgetary impact of a rise in the structural unemployment rate from 6 per cent**

	General government financial balances ¹ (per cent of GDP)		Memorandum item:
	Balance if unemployment were 6 per cent	Actual balance in 1996	Structural unemployment in 1996 (per cent of labour force)
Germany	-0.9	-3.4	9.6
France	-1.5	-4.0	10.2
Italy	-2.6	-6.7	10.6
Belgium	1.4	-3.2	11.7
Denmark	1.6	-0.9	9.1
Finland	3.6	-3.4	14.7
Ireland	3.1	-0.9	11.7
Spain	8.2	-4.7	20.3
Sweden	-2.6	-3.5	7.0

1. Assuming real interest rates and labour efficiency are not affected by a fall in structural unemployment.
Source: Derived from INTERLINK model simulations.

High taxes and economic distortions

Taxes rose along with expenditures over the past 30 years, although not quite as much in most countries because of a tendency to resort to debt financing. It is difficult to reliably estimate the net economic costs of these higher taxes. The dead-weight cost of taxation has been analytically and empirically explored, but there tends to be little cross-country comparability in studies. Even in the same country, estimates can vary by large margins. To take one example, recent estimates of the net cost of raising an extra kroner of income tax in Norway varies between 10 (Holmoy, 1997) and 50 (Vennemo, 1993) per cent. In addition to their sensitivity to modelling methods, such estimates depend critically on demand and supply elasticities, in particular on the supply elasticity of labour. Unfortunately, there is lack of consensus on the empirical value of these crucial parameters.

High taxes to pay for rising expenditures distort economic activity

In the aggregate, to the extent that high levels of government taxing and spending are an economic burden, they should be negatively related to economic performance. For the OECD area, the evidence, though somewhat mixed, suggests a connection between a large government sector – as measured, for example, by expenditures or taxes as a per cent of GDP – and lower economic growth (Leibfritz, *et al.*, 1997). But in general, the effect of the public sector on economic performance is difficult to assess. On the one

hand, the government can adversely affect the allocation of resources and economic performance in ways other than taxing and spending. For example, regulation can also impose dead-weight costs. On the other hand, some government spending would be expected to enhance growth. In particular, infrastructure investment can provide externalities which increase private-sector productivity, and in all OECD countries public education systems are instrumental in building human capital. Thus, aggregate comparisons across countries must be interpreted with considerable caution.

Important reforms have improved the efficiency of tax systems...

Since about 1980, important tax reforms have been implemented in most OECD countries.¹ Personal income-tax schedules of central governments generally became flatter (Table IV.2, first column). Reductions in top marginal rates were often accompanied by base broadening, including limiting exemptions and taxing fringe benefits. This flattening tended to result in convergence of statutory tax rates across countries: between 1986 and 1997 the range (maximum rate minus minimum rate) fell by about 2 percentage points.

Table IV.2. Trends in central-government statutory tax rates

Change in percentage points: 1986 to 1997

	Top marginal rate of personal income tax	Basic rate of corporate income tax
United States	-10.4	-11.0
Japan	-20.0	-5.5
Germany	..	-11.0
France	-11.0	-11.7
Italy	-11.0	0.0
United Kingdom	-20.0	-2.0
Canada	-2.7	-7.0
Australia	-10.0	-13.0
Austria	-12.0	-16.0
Belgium	-15.3	-6.0
Denmark	-14.0	-16.0
Finland	-13.0	-5.0
Greece	-23.0	-9.0
Iceland	-3.1	-18.0
Ireland	-10.0	-12.0
Luxembourg	-7.0	-7.0
Mexico	-15.0	-5.2
Netherlands	-12.0	-7.0
New Zealand	-24.0	-12.0
Norway	-16.5	-7.3
Portugal	..	-6.0
Spain	-10.0	0.0
Sweden	-25.0	-24.0
Switzerland	-1.5	..
Turkey	5.0	-21.0
Average ¹	-12.4	-10.3
Range	-1.5	-9.8
Standard deviation	0.0	-2.8

1. Unweighted average. Excludes Germany, Portugal and Switzerland.

Source: Owens and Whitehouse (1996) *Emerging Issues in Taxing Business in a Global Economy; The OECD Tax Data Base (1997)*; 1986 data for Mexico and 1997 data for Denmark are from national sources.

Basic statutory corporate income-tax rates also fell in nearly all countries (Table IV.2, second column). Base broadening was extensive as incentives, which had often favoured investment in plant and equipment, were limited in many countries. As

1. This historical discussion draws heavily on Owens and Whitehouse (1996).

a result, there was a significant reduction in variations in the taxation of different types of physical capital (Chennells and Griffith, 1997). There was also significant convergence of central-government corporate tax rates across OECD countries. Despite this convergence of statutory rates, however, corporate tax systems still vary markedly in terms of the average, or *ex post*, tax rates they impose and the revenues they generate.² *Ex post* corporate tax rates (total corporate taxes paid divided by pre-tax corporate profits) vary from nearly 50 per cent in Japan, Italy and Australia to around 10 per cent in the United States, Germany, the United Kingdom and Canada. By contrast with statutory rates, there has been no obvious convergence in *ex post* rates.

There has also been increased reliance on social charges, which now raise as much revenue as the personal income tax for the OECD as a whole and in 16 countries account for more revenue than the personal income tax. Since these charges are generally levied at a fixed rate and often have an income cap, they tend to be either proportional or regressive. As a result of higher social charges and flatter personal income-tax schedules, effective tax rates have risen at the low end of the earnings scale (Table IV.3). For the OECD as a whole, tax rates for families with labour income equal to two-thirds of the average production worker's (APW) income rose by more than 7 percentage points, between 1978 and 1995. The pattern for high-income families varied greatly across countries, but tax rates typically increased only modestly or fell.

... but have also reduced tax progressivity and shifted tax burdens to labour and consumption

Table IV.3. Marginal tax rates by income level¹

Change in percentage points: 1978 to 1995

	66 per cent of APW	100 per cent of APW	200 per cent of APW
United States	21.7	18.5	-4.6
Japan	9.0	18.7	7.7
Germany	-18.6	4.2	-5.4
France	10.9	1.1	3.0
Italy	14.5	9.0	8.4
United Kingdom	-4.5	-4.5	7.0
Canada	3.0	20.7	0.6
Australia	..	2.0	1.0
Belgium	36.3	5.3	12.3
Denmark	5.5	-8.9	-0.4
Finland	14.5	3.8	0.8
Netherlands	8.9	-5.8	10.0
Norway	4.2	-6.8	-20.1
Spain	3.4	2.4	4.9
Sweden	-4.5	-22.5	-25.2
Average ²	7.5	2.5	-0.1
Standard deviation ²	-0.7	-4.8	-4.7

1. One-earner couple with two children. Includes personal income taxes, social security contributions by employees and "universal" (not means-tested) cash benefits.

2. Unweighted average. Excludes Australia.

Source: 1995: OECD tax equations. 1978: *The OECD Jobs Study: Taxation, Employment and Unemployment* (1995).

2. Average (or *ex post*) and statutory rates differ due to tax credits, allowances and exemptions, and because leakages can occur as corporations manage their tax liabilities (e.g. by moving costs into high tax environments and profits into low tax ones). Unfortunately, it is not possible to distinguish these factors.

Another important development in tax policy has been the increasing importance of consumption taxes, particularly the value-added tax (VAT). Since 1980, eight countries have implemented VAT and now nearly all OECD Member countries have one (Table IV.4). Once countries put this tax in place, they subsequently tended to raise rates and to broaden bases. Broad consumption taxes are proportional if they are viewed as being levied on lifetime (or “dynastic”) consumption, which would equal income. They are regressive in terms of annual tax burdens because the poor have a higher average propensity to consume than the rich.³ Thus, the shift from income to consumption taxation also tended to reduce the progressivity of the overall tax system.

Taken as a whole, these changes to tax systems probably reduced distortions and thereby helped to improve economic performance. In addition to more general effects on incentives, flatter tax schedules sharpened incentives to invest in human capital. Entrepreneurial incentives were also probably enhanced, as the tax rate on returns to successful business ventures fell and, for lower-paid workers, taxes on the alternative of dependent employment rose.⁴ Reductions in statutory rates on corporate income and narrowing of differences in the tax treatment of various types of physical capital improved the environment for investment decisions.

Table IV.4. Trends in value-added taxation

	Year VAT introduced	Initial standard rate	1996 standard rate
Austria	1973	16	20
Belgium	1971	18	21
Canada	1991	7	7
Denmark	1967	10	25
Finland	1969	11.1	22
France	1964	20	20.6
Germany	1968	10	15
Greece	1987	16	18
Iceland	1989	22	24.5
Ireland	1972	16.4	21
Italy	1973	12	19
Japan	1989	3	5
Luxembourg	1970	8	15
Mexico	1980	10	15
Netherlands	1969	12	17.5
New Zealand	1986	10	12.5
Norway	1970	20	23
Portugal	1986	16	17
Spain	1986	12	16
Sweden	1969	11.1	25
Switzerland	1995	6.5	6.5
Turkey	1985	10	15
United Kingdom	1973	10	17.5

Source: Owens and Whitehouse (1996).

There are gains to further tax reforms...

These improvements worked to mitigate the adverse economic effects of the substantial increases in overall tax burdens in the past three decades. Nevertheless, tax burdens remain very high in some countries, and the pressures on expenditures suggest that there will be significant potential gain from pursuing further tax reform.

3. Consumption taxes often have some progressive elements, for example lower rates on necessities and higher ones on luxuries.

4. The effects of the changes on incentives to entrepreneurship are complex, however, and depend on the interaction between personal taxes and corporate tax reforms, on the current and prospective tax bracket of the potential entrepreneur and on corporate tax rates and on loss provisions.

Past reforms effectively resulted in heavier taxation of labour income which, as noted above, may have contributed to higher unemployment. Recently, some countries, including France, Belgium and the Netherlands, have reduced payroll taxes or social-security contributions for low-paid workers. Other countries have altered tax schedules at the low end to encourage labour-market participation, the US earned income-tax credit being an example. Nevertheless, in the absence of changes in government expenditures, such possibilities are limited because they would tend to be expensive in terms of lost revenue, which would have to be replaced by increased taxation elsewhere.

Both expenditures and tax burdens could be reduced by restructuring programmes to lower the degree of “churning”: the extent to which the same households both receive government payments and pay taxes. In principle, some churning could be reduced without affecting the net financial position of the households that both receive transfers and pay taxes. But there are also limits to such possibilities. Some programmes involve substantial transfers within income groups as well as across them. An example is publicly funded medical care, access to which depends principally on health status, rather than income. Clearly, reducing such programmes and the taxes needed to pay for them would reduce apparent churning, but would not generally leave households unaffected.

Table IV.5. **Churning of taxes and transfers**

	<i>Per cent</i>	
	Churning as a per cent of income before taxes and transfers	Government expenditures as a per cent of GDP
United States, level in 1995	9.0	32.9
Japan, level in 1994	11.6	34.4
Germany, level in 1994	15.7	48.9
Italy, level in 1993	22.7	57.4
Canada, level in 1994	11.7	47.5
Australia, level in 1993/94	6.5	36.8
Belgium, level in 1995	23.7	53.8
Denmark, level in 1994	28.0	59.3
Finland, level in 1995	15.5	57.9
Netherlands, level in 1994	21.1	52.8
Sweden, level in 1994	34.2	68.3
Average	18.2	50.0

Source: OECD. See text for a definition of “churning”.

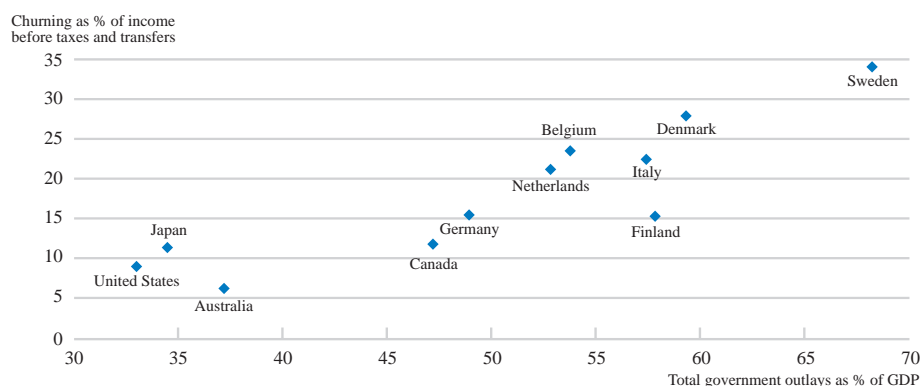
One measure of churning is the amount by which taxes or transfers could be reduced for the average person in each income decile by netting out taxes (where they are smaller than transfers) or transfers (where they are smaller than taxes).⁵ Churning, so measured, varies considerably across countries for which the requisite data are available (Table IV.5). The net gains from reducing churning depend the effects on household incentives, which is difficult to assess in the absence of detailed information on the payment and tax scheduled households face.

5. For example, if the tax paid in the bottom decile were \$100 and transfers received \$200, taxes and transfers could both be reduced by \$100, leaving net transfers unchanged. Adema (1998) adopts the narrower measure of transfers net of direct and indirect taxes paid on them (rather than all taxes paid).

... although the trade-offs are complex

The trade-offs that may be involved in such policy reform, however, are likely to be complex. On the one hand, because of churning households may face both a reduction in transfers and an increase in taxes as their incomes rise. That is, they face a double disincentive. However, churning is closely related to the overall scale of government taxes and expenditures (Figure IV.1), which is in turn related to the degree to which social programmes are universal, rather than more narrowly targeted. Moving from a universal to a more narrowly targeted system would reduce churning but, for a given generosity of transfers at the low end, targeted systems need to claw back benefits more rapidly as income rises. Thus, there is a trade-off between high implicit marginal tax rates due to the tapering off of targeted benefits and high explicit tax rates due to the extra budgetary cost of maintaining universal programmes.

Figure IV.1. Churning rises with the size of government



The tax treatment of different sources of financing and types of investment remains uneven, despite the progress made during the past 15 years. In most countries, corporate taxation still favours debt finance over retained earnings and machinery investment over inventories, although to a lesser degree than 15 or 20 years ago. Likewise, differences in the tax treatment of pensions, housing, equities investments and bank deposits have been narrowed in some countries, but they generally remain large. For seven OECD countries, marginal tax rates between the most and least favoured of these saving instruments differed by at least 30 percentage points, and frequently by more, based on 1994 tax parameters (Owens and Whitehouse, 1996).

Tax-base erosion

High tax rates have eroded tax bases through avoidance and evasion

The tax reforms implemented over the past several years were, at least in part, a response to the need to enhance economic performance. But they can also be understood as a response to the perception that tax bases were being eroded due to high tax rates, increased avoidance and evasion, and the migration of taxable income to low-tax jurisdictions. Thus, reform tended to reduce tax rates on elastic tax bases, and raise them on inelastic ones. Wealthy households and corporations, taxes on which have generally fallen, were (and are) well placed to benefit from opportunities to lower tax liabilities, either by receiving income in forms that bear relatively low tax

rates (capital gains or fringe benefits, for example), or by arranging to receive taxable income in relatively low-tax jurisdictions. In general, such opportunities are more limited for low and medium-income labour compensation, and for consumption.

Tax-base erosion can take the form of legal avoidance or illegal evasion. Examples of avoidance are numerous: individuals receive income in forms that are excluded from taxable personal income (*e.g.* fringe benefits, office amenities, first-class travel, corporate health facilities, slower pace of work, etc.); capital gains are realised in the current fiscal year in anticipation of an increase in the capital gains tax in the following year; or activities are incorporated in order to benefit from corporate tax rates that are below individual rates. Taxes can be illegally avoided, in which case it is referred to as evasion. For example, income may be under-reported, business expenses may be misclassified or consumption taxes may go unpaid. In addition, taxes can be avoided or evaded by shifting the taxable location of the activity to other jurisdictions; the issues regarding the geographical mobility of tax bases are discussed in the next section of the paper.

Tax avoidance and evasion are economically costly. Legal avoidance may entail costs in terms of discovering the best (*i.e.* least taxable) way to organise activity and because it may lead to an inefficient choice of organisation. To the extent that avoidance is easier in some economic activities than others, economic activity is further distorted by (unintended) *de facto* differences in tax rates. Evasion also gives rise to these real costs. In addition, resources must be expended to camouflage income or activities and there are costs related to private contract enforcement, rather than legal enforcement mechanisms. These latter costs are closely associated with the creation of an underground, or black, economy that accompanies illegal tax evasion.

Tax avoidance and evasion are economically costly...

Avoidance and evasion tend to be mitigated by reductions in tax rates. Evasion depends, in addition, on the probability of being caught and the size of the penalty, as well as on the value of public services foregone if economic activity is undeclared (*e.g.* in-work benefits or accumulated rights to unemployment insurance, injury compensation or pensions). Of course, some public services – such as excessive or poorly structured regulation – have negative value and thus increase the incentive to evade. Finally, of course, erosion of a given tax base implies that either taxes must be raised on other bases or government expenditure must be foregone, both of which may have costs.

Not a great deal is known about the costs of avoidance. Feldstein's (1995) estimates, which attempt to account for both dead-weight costs and avoidance, suggest that under the 1994 US tax system the net cost of raising an extra dollar of tax revenue was 300 per cent (*i.e.* one dollar of tax revenue and two dollars of net cost). Taken at face value and by comparison with standard estimates of the dead-weight cost – generally, the extra cost of raising one dollar is estimated to be well under a dollar – this figure would suggest a very high cost of avoidance.

... but little is known about the scale of these costs

For obvious reasons, still less is known about the costs of illegal tax evasion. However, studies of the scale of underground activity suggest that it significantly reduces tax revenues, is increasing over time, and part of this increase can be attributed to higher tax burdens. From the point of view of containing underground activity, however, the effect of high tax burdens can be at least partly offset by effective tax enforcement and by linking the receipt of social benefits to above-ground employment or the payment of taxes. Reservations regarding estimates in this area are worth emphasising: underground activity is intrinsically difficult to measure; only part of it is related to tax evasion; and the scale of underground activity is much larger than its net economic cost.

Geographical mobility of tax bases

Technology and globalisation have increased the mobility of some tax bases

One type of tax-base erosion that has attracted considerable attention and concern is the geographical mobility of tax bases. Changes in technology – notably information, communication and transportation technology – as well as liberalisation of commercial and financial transactions have increased the scope for tax avoidance and evasion through the choice of location of economic activity. Business functions can be moved to low-tax jurisdictions and bank accounts and other financial assets can be held offshore. There are numerous examples of avoidance reducing tax revenues and, in some cases, tax rates have had to be reduced in order to stem the revenue losses. Empirical research also supports the view that taxation influences international investment flows, although some studies find little effect (Leibfritz *et al.*, 1997). And, as noted above, the pattern of convergence in OECD tax systems is broadly consistent with pressures stemming from mobility of capital and highly paid labour.

This could lead to difficulties in raising revenues

The effect of geographical mobility on tax bases raises a number of concerns. The first is the extent to which the overall revenue-raising power of governments has been constrained. Theory offers a wide range of possibilities, with the most pessimistic being that tax rates and tax revenues will be forced progressively downwards, even to the point where it becomes impossible to collect any revenues at all. There appears to be little evidence, however, that major tax bases – household income taxes, corporation income taxes and consumption taxes – have collapsed in this way. Overall, taxes have risen, not fallen, over the past several years, and although tax rates have tended to converge over time there remains substantial variation across countries. And within countries, where there are few formal barriers to geographical mobility, differentials of major taxes also seem to be significant and stable over time (Box IV.1).

Or to greater distortions in tax systems

A second issue is the extent to which the response to the threat of geographical tax-base erosion has resulted in poorly functioning public finances. Again, theory offers a range of possibilities. Severe compression of taxes would clearly make meeting important social needs impossible. An alternative view is that the ability to choose the location of economic activity offsets shortcomings in government budgeting processes, limiting a tendency to spend and tax excessively. Of course, to some extent these two views need not be in conflict. If tax burdens were initially “too high”, pressure to reduce them could increase economic efficiency. But such pressures could go too far, reducing tax bases (or certain tax bases) below the point needed to fund desirable public expenditures.

A variation on this issue is the extent to which the threat to tax bases has resulted in a distorted tax system and therefore in undesirable inefficiencies. Not all tax bases are equally mobile, and so the geographical mobility of tax bases will change the structure of taxation, as well as its overall level. The shift of taxes away from capital and onto low-paid labour has already been described, as have the possible adverse consequences on labour markets. Reducing the tax burden at the low end may be impossible if it would require attempting to raise tax rates on highly mobile tax bases. An important case is taxation of financial instruments. Taxes on transactions of financial instruments have virtually disappeared and the ability to tax income from financial instruments has been weakened by the existence of tax havens. The globalisation of financial markets, the reduction in the costs of financial transactions and the difficulties in tracing such transactions have all played a role in the erosion of these tax bases.

Box IV.1.

Sub-national tax differentials in Switzerland and Canada

Both Switzerland and Canada are federations in which the sub-national government levels – cantons and provinces, respectively – have wide autonomy in taxation. In neither country are there formal restrictions on the geographical mobility of either households or firms; certainly, barriers to mobility are far lower than they are between most countries. Thus, the threat to tax bases from geographical mobility within these countries ought to be greater than the threat from mobility across countries. The pressures to harmonise or even reduce sub-national tax rates in response to such a threat ought to be correspondingly greater as well.

The Swiss Statistical Office calculates indexes of tax burden on individuals (*personnes physiques*) and companies (*personnes morales*) for each canton as a per cent of the national average. In both 1985 and 1996, there were significant differences in individual and company tax burdens across cantons. The 1996 index of company tax burden varied from a low of 57.8 per cent of the average in the canton of Zug, to a high of 148.5 per cent in Glarus; for individuals it varied from 55.5 in Zug to 136.6 in Fribourg. These cantons are obviously extreme cases, but even if they are removed the differential is 58 percentage points for corporate taxes and 59 percentage points for personal taxes. The dispersion across cantons of both types of tax burden has been broadly stable over time; the standard deviations of both indexes increased very slightly between 1985 and 1996. The range of (average) tax rates for

individuals – that is the difference between the top cantonal rate (including all types of cantonal tax) and the lowest rate – was about 11 percentage points in 1996, which is a bit under half of the range of average personal income-tax rates for the OECD as a whole.

Kirchgässner and Pommerehne (1996) conclude that the most important factors explaining concentrations of high-income tax payers are large stocks of infrastructure and a strong service orientation in the local economy; taxes play a “small but statistically significant” role. Geneva, a relatively high-tax canton, had a much higher concentration of extremely affluent taxpayers than can be explained by any of the factors used in their study, including relative tax burdens. Thus, tax differentials appear to affect the geographical location of tax base to some extent, but other factors – political, geographic and economic – also permit significant diversity in tax policies among cantons.

Canada’s experience has been broadly similar, although the available data are not as good for this purpose as the Swiss data. Differences in tax rates, as measured by their range and coefficient of variation, rose between 1987 and 1997 for the personal income tax, the capital tax, and excise taxes on fuel, gasoline and tobacco. The dispersion of corporate tax rates fell, with large-firm corporate tax rates converging towards a higher average rate and the small-firm rate to a lower average rate.

As with the other forces acting on tax policy that have been discussed in this paper, there is reason to believe that the pressures stemming from geographical mobility of tax bases will increase in the years ahead. To take one example, improvements in electronic commerce are likely to make the base for consumption taxes, such as the VAT or sales taxes, more geographically mobile and harder to trace. In general, the location of economic activity depends on many factors, of which taxation is one. An equilibrium taking account of these factors is established that, to date, has both constrained tax rates in many case while still allowing substantial variability of tax rates across jurisdictions. But this equilibrium is likely to shift as, *inter alia*, institutions and technologies develop. The challenge for tax policy will be to respond to these developments in order to fund needed government expenditures with a tax system that has minimal economic distortions.

And such pressures will probably increase in the future

Box IV.2.

Harmful tax competition

In May 1996 Ministers requested the OECD to “develop measures to counter the distorting effect of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998”, a request which was subsequently endorsed by the G7 heads of state in Lyon. The OECD’s Committee on Fiscal Affairs launched a project on harmful tax competition, which has resulted in a report and recommendations for containing and reducing it.

This report addresses practices in the form of tax havens and harmful preferential tax regimes in OECD and non-member countries, focusing on geographically mobile activities, such as financial and other service activities. It defines the factors to be used in identifying harmful practices, makes 19 recommendations to counteract such practices and provides guidelines for implementing the recommendations. Taken together, these elements represent a comprehensive approach by Member countries for dealing with the problems of harmful tax competition.

Some of the recommendations encourage countries to eliminate, or to refrain from adopting, measures constituting harmful tax competition. Others are aimed at offsetting the benefits for taxpayers of certain forms of harmful tax practices. Still others address the issue indirectly by focusing on tax evasion and avoidance.

The effectiveness of many of the recommendations depends in part on their implementation in a co-ordinated way. Thus, a key recommendation is to establish a forum to monitor the application of the recommendations and guidelines. As part of this activity, the forum would undertake an ongoing evaluation of existing and proposed preferential tax regimes and assess the effectiveness of counter-measures. In addition to its recommendations, the report identifies areas where further study that could result in new initiatives, which the forum would examine. The forum would also engage in a dialogue with non-member countries.

*International co-operation will
be a key to dealing with these
pressures*

The challenge for policy makers will be to respond to these developments to ensure that needed government expenditures can be funded and that tax distortions are minimised. In view of trend toward globalisation and the threat posed by the geographical mobility of tax bases, a significant part of the response will necessarily involve greater international co-operation. It is increasingly difficult for individual countries to manage their tax bases in the face of these forces and, in particular, some tax practices have led to harmful and distortive cross-border “tax competition”. The OECD has recently undertaken a study of this emerging issue, which has resulted in a set of recommendations and guidelines (Box IV.2).

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