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Designing tax policy: constraints and objectives in an open economy

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Abstract

This paper is a non-technical discussion by an economist and lawyer, each with long international experience in taxation, of the constraints and objectives that in principle and practice shape tax policy design. After discussing the main factors traditionally taken into account by those charged with designing tax policy in any country – such as revenue, the costs of taxation, equity and fairness, administrability, and the effects of taxation on growth and other non-fiscal objectives – several additional important considerations associated with 'globalization' are then discussed with special attention to income taxes. The paper concludes with a brief reflection on how the 'new world tax order' in which countries must now develop their tax systems may perhaps develop over time.

INTRODUCTION

Why do we have taxes? No one likes taxes. People do not like to pay them. Governments do not like to impose them. To spend, however, countries must tax. If they do not tax the long run consequences are likely to be even less welcome than taxation.[2] Taxes are necessary both to finance desired public spending and to ensure that the burden of paying for such spending is distributed in a way that is administratively feasible, economically sustainable and politically acceptable. Every country must thus have a tax system. But what tax system is best for any particular country at any particular time? The answer depends to a considerable extent on how much governments spend and what they spent it on.[3] Of course, since governments are really 'us' – the community or country -- in a different guise, when governments spend they are spending our collective resources and we, the citizens, are spending together,

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[2] Countries can always print money to pay for public expenditures – the contemporary term is 'quantitative easing'. But excessive or unnecessary recourse to this practice results in inflation which in itself in effect imposes an arbitrary, distorting and often highly unfair 'tax' on people. Formal taxes are a fairer and more efficient way to take purchasing power from people than inflating the currency.

[3] This paper does not consider the many factors that determine the appropriate (or actual) *level* of taxation at any particular time in any particular country but instead focuses on the question of how best to achieve any given level of taxation.

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 – 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 also 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 good 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.

The nature of a country's tax system inevitably reflects both the relative weights that society through its political institutions decides to place on different objectives and the extent to which tax instruments are explicitly 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' -- sometimes considered the glue of a democratic society -- in 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 and encourages people to be engaged in a variety of social, political and economic relations so long as their activities do not cause harm to others. A sustainable well-functioning modern society requires a population that is both physically and intellectually well-nourished. In the modern world, private and material economic success thus needs and depends on good legal, medical, education and public safety systems. Since we all benefit from such systems presumably 'fairness' demands that we should all contribute to their support to some extent. But what is a fair way to do so?

Two distinct fairness 'principles' are commonly employed to assess tax policies. One is the *ability to pay principle* -- that those who can pay more should pay more. The other is the *benefit principle* -- that those who benefit most should contribute most. Although good arguments can be made in terms of both equity and efficiency that the benefit principle should be applied whenever possible, it cannot easily be applied to financing most of the expenditures of governments.[4] It is thus some version of the ability principle, broadly conceived, that most consider relevant when it comes to the design of such broad-based taxes as income and sales taxes.

[4] The scope for such taxation (and charging) tends to be much greater with respect to local as compared to national government as discussed, for example, in Bird (2001).

Whatever one thinks of redistributive taxation, common sense – as well as good economics -- suggests that the 'price' of taxation – the costs of the tax system -- should be kept to a minimum. In order to achieve this goal the tax system must work properly in the sense that the taxes imposed can actually be collected in an observably accurate and accountable way. A second requirement is that people should be as fully aware as possible of what they are paying -- and of what they are getting in terms of both direct personal benefits as well as from more general collective consumption decisions including those that use the tax system to encourage and discourage certain activities.

Section 1 of this paper focuses on such key policy objectives of taxation as revenue generation and distribution and the achievement of non-fiscal policy objectives (such as economic growth and industrial policy). This section also discusses the traditional trinity of tax policy criteria -- equity, efficiency, and administrability. *Equity*, for example, is often divided into two subcategories – *horizontal equity* (the principle that those who are equal should be treated equally by the tax system) and the related but distinct concept of *vertical equity* (the principle that those who are unequal with respect to some relevant characteristic such as income or disability should be treated appropriately unequally by the tax system). Both aspects of equity may or may not be included in the more general notion of fairness mentioned earlier.

As the priority that many attach to equity issues in appraising tax policy suggests, tax policy is by no means just about economics. Inevitably, it also reflects political factors, including concerns about fairness in the sense of the distribution of income, wealth and consumption. Taxes may affect distribution through changing economic incentives as well as by being more or less *progressive*, that is, increasing more than proportionately with respect to the amount of income accruing to particular individuals or families – assuming that is the basis on which comparisons are made.[5] In addition to affecting the distribution of income, wealth, and consumption, taxes almost always impose real costs on society. These costs include not only the obvious *administrative costs* shown in government budgets but also the less obvious *compliance costs* imposed on taxpayers and, even more importantly, the equally real, but largely invisible, *efficiency* costs that are imposed on society as a whole when economic decisions are altered as a result of taxation. Broadly understood, an efficient tax policy is one that keeps the sum of all these costs to a minimum while achieving other tax policy objectives to the extent possible. Finally, regardless of the objectives or goals that any country may wish to accomplish through tax policy, in practice what tax policy accomplishes depends on whether it is administered effectively. *Administrability*, like efficiency and equity, is thus invariably a key criterion that needs to be considered in designing and evaluating tax systems. All this is discussed further in Section 1.

However, the discussion in Section 1 does not go as far as is necessary to cope with some latent, but increasingly evident, forces that now impinge on tax systems everywhere. For the most part, Section 1 follows the traditional path of implicitly assuming that a country can exist in isolation from the rest of the world. In reality, none ever has and none ever will. Good tax policy must therefore take explicitly into account the international setting. Countries cannot, and should not, consider and pursue policy objectives and decisions in isolation. The new demands made on tax policy by international factors suggest a somewhat new framework for guiding tax policy analysis

[5] At a deeper level, as the new fiscal sociology suggests, the perceived fairness of the tax system may also play a critical role in ensuring the long-run sustainability of political and state institutions: see, for example, Brautigam, Fjeldstadt and Moore (2007). However, we do not pursue this point further here.

may be needed, as discussed in Section 2 of this paper. Though much of the contemporary discussion about the need to take international factors explicitly into consideration in designing and developing tax policy has focused on business taxation, the implications are deeper. How businesses (including the legal fictions called corporations) are taxed affects all citizens in one way or other. Taxes are, in the end, always and everywhere paid not by legal entities but by people, whether directly on wages and investment income or explicitly or indirectly on purchases of goods and services. A well-known comic strip (Pogo) once said: 'We have seen the enemy and they is us.' We may or may not want to do what others do, but there is no doubt that our choices must contend with the reality that they have done it, or may do it soon. Section 2 develops some possible implications for tax policy objectives and design arising from the need to accommodate the reality in most countries of increasing integration into the world when making national tax policy.

By reducing the degrees of freedom available to policy designers at the national level, globalization has in some ways shifted the terms of national tax policy discussion in many countries closer to the 'model' commonly set out for tax policy design at the subnational level. This is not an unfamiliar situation for those living in federal countries like Canada, Australia or the United States since in such countries tax infrastructure is in some respects an international tax system in microcosm – a constellation of tax satellites, the provinces or states (and local governments) operating within the gravitational field of a central tax sun, the federal regime. The concluding Section 3 of this paper therefore considers briefly whether there are any lessons to be found in subnational experience for national tax policy in an evolving world of international tax forces, experiences and influences that affect all countries to varying degrees, but with none being uniquely accountable or in a controlling position.

1. THE TRADITIONAL APPROACH

1.1 Introduction

Most discussions of tax policy objectives in any country begin by stating that the fundamental objective of taxation is to secure the resources needed for public sector purposes in an equitable, efficient and sustainable fashion and then proceed to set out a series of criteria that may be used to evaluate the suitability of different tax instruments to achieve this basic aim. In reality, of course, in the end tax policy is often determined largely by political factors (such as the federal nature of a country), but in this section we follow this general tradition, considering the design of an appropriate tax system largely in economic and administrative terms (other than the discussion of the critical equity issue), essentially in isolation from other policies, and largely without paying attention to the international context.

1.2 Revenue

1.2.1 Reliable revenue flows

To begin at the beginning, the most basic and essential characteristic of a good tax system is that it raises sufficient revenue to fund government operations and programs. The rate at which revenues increase over time depends on the tax structure, the quality of tax administration, and the pace and nature of economic growth. The income elasticity of a tax system measures how fast revenues grow relative to the economy. Tax elasticity is defined as the percentage change in tax revenues divided by the

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 government receipts (including both taxes and non-tax receipts) in Canada was 1.2, compared to only 0.9 for the 1990-2008 period; interestingly, since the buoyancy of total government expenditures was 1.4 in the first period and 0.9 in the second period, the tax system has done a better job in terms of financing public expenditures in recent years.[6]

1.2.2 Effects of Tax System Structure

The overall elasticity of any tax system is simply the average of the elasticity of individual taxes, weighted by the percentage of total taxes raised by the tax. The elasticity of a tax depends on the specific characteristics of its structure. The elasticity of personal income taxes generally reflects the progressivity of their rate structure and, most importantly, the level of the personal exemptions (or zero bracket) relative to average income levels. Consumption taxes are more elastic if they cover more rapidly growing goods and services rather than just more slowly growing traditional goods (such as the traditional 'excise' goods of tobacco and alcohol) and if they are levied as a percentage of the price (like the GST) rather than on the specific quantity purchased (as with most tobacco and fuel taxes). Property tax revenue increases more rapidly when reappraisals occur on a regular basis and when property is fully and regularly valued.

1.2.3 Revenue growth

Revenue growth generally slows during recessions and accelerates during expansions. Revenue elasticity also tends to rise in expansions and fall in recessions, thus exacerbating the volatility of revenue flows. The corporate income tax is particularly volatile because in a recession corporate profits decline more rapidly than overall economic growth. Countries that depend heavily on taxation of natural resources such as oil or minerals are especially vulnerable to cyclical swings, with wide swings in commodity prices changing the level of tax revenues. Generally, a country that relies on a balanced set of tax instruments rather than a single revenue source will have lower tax revenue volatility, just as an individual investor can reduce the volatility of her investment portfolio by adopting a diversified investment strategy.

Of course, there is much more to tax policy than revenue and more to measuring its significance than such simple analytical parameters as elasticity. One reason this is true is simply because the economy inevitably extends beyond national borders. For example, a recent official Canadian report argued that '...the goal for Canada should be to make this country the location of choice for the higher-value elements of ... global value chains – whether led by Canadian firms or as part of others' supply chains – as higher-value productive activity translates into higher wages and salaries., more

[6] Calculated from data in Department of Finance (2010). Tax 'elasticity' refers to revenue growth in the absence of any tax policy changes, while tax 'buoyancy' refers to growth including the effects of such changes. In principle, elasticity is a better measure of the growth potential of an existing tax structure; however, buoyancy is both easier to estimate and in some ways more relevant in showing the extent to which countries finance public expenditures through taxes.

occupational choice and a better quality of life for Canadians' (Government of Canada (2007, 6). What this means among other things, as the same panel's final report said, is 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 even in a solely domestic context.

1.3 The Costs of Taxation

1.3.1 Administrative Costs

Taxes are essentially a means of transferring resources from private to public use (or possibly from self-selected private uses to collective private uses as determined and organized through public intervention for which tax policy as a tool). Taxation in principle need not affect the amount of resources available for society's use, whether for public or private purposes. However, few if any taxes come free. Most obviously, taxes cost something to collect. These administrative costs are not excessive in most developed countries – in Canada, for example, they are a bit more than 1 percent of tax revenues[7] – but they are obviously real costs, in the sense that they reduce the revenues available for other public policy purposes.

1.3.2 Compliance Costs

Equally obvious to taxpayers, though not recorded in the government budget, are the compliance costs that taxpayers incur in meeting their tax obligations, over and above the actual payment of tax. Tax administration costs may sometimes be reduced by increasing compliance costs – as when taxpayers are required to provide more information in order to make tax administration easier and less costly. In other instances, however, both compliance costs and administration costs may increase if, for instance, a more sophisticated tax administration requires more information from taxpayers and then undertakes more audits on the basis of this information. Third parties also incur compliance costs. For example, employers withhold income taxes from employees, and banks provide taxing authorities information or may collect and remit taxes to government. Compliance costs include the financial and time costs of complying with the tax law, such as acquiring the knowledge and information needed to do so, setting up required accounting systems, obtaining and transmitting the required data, and payments to professional advisors. Although the measurement of such costs is still in its infancy, Canadian studies suggest that compliance costs are probably at least four to five times larger than direct administrative costs.[8] In particular, the evidence shows that compliance costs are relatively a much greater burden on smaller than on larger firms.

1.3.3 Efficiency Costs of Tax-Induced Decisions

In addition to administrative and compliance costs, taxes generally impose real economic costs (often called *deadweight losses* or *excess burdens*) which reduce the

[7] On average over the 2001-2007 period, the administrative costs of the Canada Revenue Agency were 1.2% of revenue collected (calculated from data in OECD (2009)). Canada's direct administrative costs for taxation tend to be higher than those in the United States largely because a substantial part of Canada's income support system is operated through the tax system (as discussed in Kerr, McKenzie and Mintz 2012).

[8] A recent study estimates that compliance costs in Canada are between 4 and 6 times greater than administrative costs: see Vaillancourt, Clemens, and Palacios (2008).

total resources available for public and private purposes. These 'distortion costs'; arise essentially because most taxes alter the decisions made by businesses and individuals because the imposition of the tax changes the relative prices they confront. There are a few exceptions. Lump-sum taxes, where the tax burden is the same regardless of any behavioural responses by taxpayers, are often used to provide a base-line case in tax analysis although such taxes seldom exist in practice. More practically important is the fact that to the extent that taxes fall on economic 'rents' – payments to factors above those needed to induce them into the activity concerned – they too may not affect economic activity. Well-designed taxes on natural resources and land, for example, may thus to some extent produce revenue without economic distortion. Finally, in certain instances, taxes – again, if properly designed – may actually change economic behaviour in a way that improves well-being, of the person concerned, of the community as a whole, or both. Certain environmental levies, for example, or even crude proxies such as taxes on fuel, may to some extent have such effects.

Such instances of good taxes – those with no bad economic effects – should of course be exploited as fully as possible; similarly, well-designed user charges should be used to the extent possible, given public policy objectives, to finance certain public sector activities that specifically benefit identifiable individuals. In the end, however, most taxes needed to finance government inevitably give rise to changes in behaviour that, it is usually assumed, reduce the efficiency with which resources are used and hence lower the output and potential well-being of the country as a whole. No matter how well the government uses the resources acquired through taxation, everyone loses from the negative consequences of tax-induced changes in behaviour, so one concern in designing tax policy is to limit such efficiency losses.

For example, taxes on wages (personal income taxes, payroll taxes) obviously reduce incentives to work by reducing the amount of income people receive for giving up a certain amount of leisure (non-working) time. Consumption taxes like the value-added tax and retail sales taxes similarly may discourage work by increasing the amount of time one must work to pay for goods and services through the marketplace. Taxes on both wages and consumption thus alter both relative prices (in this case, the net - after-tax - wage) and income. However, people may choose to work more to compensate for lost income. The net effect on work of any tax change reflects both this *income effect* and the effect of the change in relative prices (the *substitution effect*). Although the evidence is not all that strong, on the whole taxes do seem clearly have some effect on work decisions, with the precise strength and nature of the effects depending upon the structure of taxes, the nature of the workforce, and the changing economic context. In particular, the substitution effect (the change in the relative reward for working) creates distortions by causing people to change such work-related decisions as when to enter the labour force, how much education to attain, what career to pursue, how long and hard to work, and when to retire. If those decisions were economically efficient before the tax, the effect of such tax-induced distortions – their efficiency cost -- is to reduce the potential output of the nation.

Taxation may similarly affect other economic decisions. General consumption or sales taxes may discourage the consumption of taxed as opposed to untaxed goods. Excises on fuel, alcohol, and cigarettes can reduce the consumption of these items.[9] Income taxes, because they tax the return to savings, may alter the amount of savings or the

[9] As noted earlier, not all such effects need be bad: for instance, if tobacco consumption is reduced, people may live longer, healthier and more productive lives.

form in which savings are held. For example, failure to tax capital gains until they are realized (when the asset is sold) encourages the holding of assets (a lock-in effect). Taxes may also affect investment, and such effects may be especially important when economies are more open to trade and investment. Foreign investors may choose to locate their activities in a particular country for many reasons such as the relative costs of production, access to markets, and sound infrastructure but taxes too may influence their choice of location. To the extent taxes lower the after-tax return on investments in a country or a region, the level of investment and hence growth may be lower than it would otherwise be. Corporate income taxes may also influence the composition of a firm's capital structure (use of debt or equity financing) or dividend policy. For example, retained earnings are encouraged when dividends are subject to tax at the shareholder level and debt is preferred over equity where interest on debt capital is deductible and dividends paid from equity capital are not.

1.3.4 Tax Effects and Economic Choices

Exactly how important such tax effects are is a matter of considerable debate, but the consensus is that they are much more important than was thought thirty or forty years ago and that the efficiency costs of taxation are a considerable multiple of the administrative and compliance costs mentioned above. About a decade ago, for instance, the Canadian Department of Finance estimated the marginal efficiency cost – the estimated loss in national welfare as a result of increasing taxes by $1 – of the corporate income tax (CIT) as $1.55, compared to only $0.56 for the personal income tax (PIT), $0.27 for payroll taxes (like those financing the public pension plan) and $0.17 for the GST, Canada's national consumption tax.[10] Given the composition of tax revenues in Canada, these figures suggest that the efficiency costs of the existing tax system are much greater than the combined administrative and compliance costs of taxation, with taxes like CIT that affect intertemporal decisions – saving and investment – being particularly costly in these terms.

If one is prepared to assume that the efficiency costs of taxation result from conscious policy decisions (for example, to redistribute income through the fiscal system), the price may be worth paying. Unfortunately, however, it is all too easy to underestimate the damage done by inefficient taxes. Although efficiency losses are definitely real, they are not directly visible. The efficiency cost of taxation arises because something does not happen: some activity did not occur or occurred in some other form. Although achieving a more economically efficient tax system would make Canada as a whole better off, doing so is unlikely to be either a politically popular or readily understandable policy aim since these 'hidden costs' can only be estimated through rather complex and hard-to-understand economic models,. Output that is not produced, however, is still output lost, and since there is no conceivably acceptable rationale for inflicting pain without gain, an important and sensible tax policy objective for tax policy designers always and everywhere is to attempt to minimize the efficiency losses from taxation to the extent other policy considerations permit.

[10] As reported in OECD (1997). More recent detailed analysis generally yields similar rankings (Bibbee 2008).

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.[11] 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, which exclude many services and tax many 'investment' goods (such as 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 -- either 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.[12]

Tax Rates and Rate Induced Distortions

Second, tax rates should be set as low as possible, given revenue needs. The reason is simply because the efficiency cost of taxes arises from their effect on relative prices, and the size of this effect is directly related to the tax rate. The distortionary effect of taxes generally increases proportionally to the square of the tax rate, so that (other things being equal) doubling the rate of a tax implies a fourfold increase in its efficiency costs. From an efficiency perspective, it is thus better to raise revenue by imposing a single rate on a broad base rather than dividing that base into segments and imposing differential rates on each segment. Of course, any efficiency costs arising from differential treatment need to be balanced against the equity arguments noted below for imposing graduated rate schedules.

Location Effects

Third, from an efficiency perspective, it is especially important that careful attention be given to taxes on production. Taxes on production affect the location of businesses, alter the ways in which production takes place, change the forms in which business is conducted, and so forth. This is one of the main reasons that value-added taxes (VATs) are superior to other forms of general consumption tax as well as to import tariffs and most selective excise taxes. This dictum also implies that taxing corporate income is

[11] In theory, in order to minimize efficiency losses different tax rates should be imposed on each commodity, with higher rates imposed on those goods and services where the changes in behaviour are the smallest as well as on those that are complementary to leisure (in order to reduce the negative impact of taxation on work decisions by in effect imposing some taxation on 'non-work' or leisure). To do so, however, requires much more information about how taxes alter behaviour than is available in most countries. Moreover, this approach does not take administrative and equity concerns into account. In general, expert consensus is thus that in practice it is probably generally advisable to impose a uniform tax rate to the extent possible. (For a good discussion of this issue, see Crawford, Keen and Smith 2010.)

[12] As Section 2 below suggests, however, consideration of the 'open economy' nature of many countries casts some doubt on this conclusion.

unlikely to be a good idea. On the other hand, some form of taxation on corporate income is generally considered essential both to prevent tax avoidance by those who own corporations and to collect taxes from foreign-owned firms. The appropriate design of corporate income taxation is thus a particularly difficult task, not least because of the changing reality of the international context we discuss in Section 2 below.

1.4 Equity and Fairness

Fairness or equity is a key issue in designing a tax regime. Indeed, from one perspective, taxes exist primarily to secure equity. National governments do not need taxes to secure funds because they can simply print the money they need. Indeed, the tax system can be seen in essence as a mechanism for taking control of resources away from the private sector in as efficient, equitable, and administratively effective way as possible, in order to redirect them to serve public objectives that would otherwise be unattainable.

1.4.1 Structural Equity

What is considered equitable or fair by one person may differ from the conceptions held by others. Traditionally, as already mentioned, fairness has been understood in the tax context in terms of horizontal and vertical equity. Horizontal equity requires those in similar circumstances to pay the same amount of taxes. Vertical equity requires appropriate differences among taxpayers in different economic circumstances. Equity in both these senses often embraces some notion of ability or capacity to pay. Such concepts have intuitive appeal but are of very limited usefulness when it comes to determining tax policy. These traditional equity concepts do not determine or even provide a useful substantive guide to what good tax policy is; nor do they allow us to characterize decisions that seem to deviate from these concepts to be 'bad' tax policy.[13] At most, they perhaps serve as a point of reference for measuring the effects of choices that in one way or another appear to deviate from these concepts.

1.4.2 Fairness and tax burden

Consider several possible conceptions of fairness. To some, fairness may require everyone to pay the same amount of tax. For example, the tax system might impose a head tax on each individual over the age of 18 years old. Or, more plausibly, one might perhaps require all taxpayers to pay the same rate of tax on their income. To others, however, fairness requires those taxpayers with higher income to pay a higher percentage of their income in tax. Although a progressive rate structure has a rather shaky theoretical foundation, it has been the most common income tax rate structure. Many find assessing progressive taxes on income (as measure of ability to pay) attractive simply on the grounds that the rich are better able to contribute to the financing government.

[13] For example, to make the concept of horizontal equity useful one must determine which differences are important and why these differences justify different tax treatment. Unless people have identical tastes and a single type of ability or income, it is difficult to derive any clear policy implications from this concept. One must also decide whether to focus only on a short time period, such as one year, or take a longer, lifetime perspective. Similarly, it matters whether one takes into account the impact of other taxes and the provision of government services or other benefits. Even more disagreement exists about the usefulness of the concept of vertical equity and about what constitutes appropriate differences in treatment.

1.4.3 Fainess and the choice of tax bases

On the other hand, consumption tax proponents question whether any income tax system can be fair. One approach takes a societal view. Income is what individuals contribute to society; consumption is what they take away from the pot. Therefore, if we want a society that will continue to grow and prosper, we are better off taxing consumption rather than income. A second approach considers consumption as a better measure of a household's ability to pay. Because income varies more than consumption over a person's or household's lifetime, some argue that it may be better to use consumption as the base for taxation rather than income. Finally, since income taxes impose higher taxes on households with higher savings, the income tax penalizes savers over those who consume currently.

On the other hand, income tax proponents claim that a person's net increase in economic wealth is a better measurement of ability to pay than the use of their income. Someone who earns $1 million and spends $10 has a greater ability to pay someone who (in the same time period) earns $10 and spends $10. Under a consumption tax, both would bear the same tax burden while under an income tax the first person would bear a much greater tax burden. Of course, this is only a two-period example, which assumes that a year is the right period in which to assess the relative tax status of different people. If one thinks that most people go out of this world as they come into it – with no worldly goods – by definition their income and consumption are equal from a lifetime perspective. Many issues – such as the regressivity or progressivity of different taxes – may thus look very different depending upon the time period that is considered relevant for purposes of assessing tax fairness.[14]

1.4.4 Fairness and over-riding political, social and economic policy

The previous comments suggest that discussions of fairness in general or of horizontal and vertical equity in particular, are of limited usefulness. Without first specifying a fundamental ethical framework one cannot evaluate the relative fairness of different proposals or different tax regimes. Moreover, even if one sets out such a framework, and is prepared to assert that everyone else should accept it also, it does not follow that they will do so. In the end, it is thus only through its political institutions that any country can really define and implement a view of what is an acceptably fair tax system. One may not like what politicians do, but what they do is what, whether we realize it or not, we have at some fundamental level chosen to do as a society. Of course, policy choices may also be affected by various collateral influences on the need for and effectiveness of government policy, including influences exogenous to the national economy such as those we address under the label of 'globalization' in Sections 2 and 3 below.

In any event, rather than discussing, interminably, such inherently controversial philosophical questions as equity it might be best to focus directly on the expected consequences of different policy choices. Both the intended and the effective impacts of policy are often hard to determine with any certainty. Nonetheless, answers may perhaps be obtained to some factual questions. The same cannot be said about policy debates reflecting different philosophical (or ideological) beliefs – unless one is, as suggested above, prepared to accept whatever emerges from a country's political

[14] For a discussion of how sensitive studies of tax incidence in Canada (as elsewhere) are to assumptions about the relevant time period and many other arguable aspects, see Kesselman and Cheung (2004).

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.

1.4.5 Distributional effects and goals

Like most policy instruments, tax policy can play many tunes. What is critical from an equity perspective is, first, to be as aware as possible of the distributional implications of tax changes not only for income distribution in general but also for the different groups that are evidently of policy concern in most countries -- the old, homeowners, children, the poor, people in depressed regions, etc. -- and, second, to ensure that the actual outcome of such reforms is as consistent as possible with the intended outcome. For instance, although taxes cannot make the poor richer, they may certainly make them even poorer, in both absolute and relative terms. Since it is hard to conceive of any socially desirable reason to adopt increased poverty as a policy goal, heavy taxes on items that constitute major consumption expenditures for poor people should generally be avoided. There are two caveats to this conclusion, however. First, in some instances there may be an overwhelming social argument for even quite regressive taxes, as many think there is with respect to tobacco taxes, for example. Second, if regressive taxes provide a significantly less costly source of revenue, as the data cited earlier on the marginal efficiency costs of different forms of taxation imply, and any undesirable distributional effects of such taxes can be offset by direct expenditures or adjustments elsewhere in the tax system (such as income tax credits), such taxes may have an important role to play in the tax system as a whole.[15]

On the other hand, taxation is one of the few ways short of outright confiscation in which the wealthy may be made less wealthy. Although the evidence seems to be that taxes have had at best only moderate success in reducing income inequality in developed countries and that those countries that have more effective redistributive policies have implemented them mainly through more progressive expenditure policies,[16] some degree of explicitly redistributive taxation might nonetheless be considered to be

[15] As noted earlier, Canada uses the income tax system extensively to provide income support to certain low-income people. While important, the potential use of tax policy as the basis for a more efficient and equitable transfer policy is not discussed further here.

[16] For example, the study of incidence in Canada by Kesselman and Cheung (2004) concludes that, despite the wide variety of outcomes that are conceptually possible within the framework of empirical incidence studies, under most 'reasonable' assumptions taxes are progressive, if at all, only with respect to the top decile of taxpayers, and transfers are much more important in terms of reducing inequality.

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 help, 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 redistributive expenditures, as is generally the case in the 'social welfare' countries of northern Europe.[17]

1.4.6 Incidence – Who Pays?

Turning back to economics, in order to determine the fairness of a tax regime, one must also consider carefully who 'really' pays taxes – what economists call the 'incidence' 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 'burden' or fall on individuals in their roles as consumers, producers and factor (labour, 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 find. 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 any confidence, especially in an open economy such as Canada – and, to some extent, most countries.[18] 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 any conceivable combination of these outcomes. In addition, the immediate impact of a tax in the short

[17] A useful discussion of the role tax policy plays in these countries may be found in Lindert (2004).

[18] Although this point is not strictly relevant to the incidence issue discussed in the text, we should note that, unlike the case in the United States, Canada's corporate income tax is 'integrated' to a considerable extent with the personal income tax for Canadian residents. Nonetheless, 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 economic 'rents' and income accruing to foreign residents, it is worth noting a recent argument that the corporate income tax is an important part of the tax system primarily because it can (and does) serve as a an important regulatory instrument (Avi-Yonath 2011). In this 'one tax-one goal' view, the main objective in designing general consumption taxes is to obtain revenue in the least costly way possible, the main objective with respect to designing personal income taxes is to achieve the socially desired amount of redistribution through the tax system, and the main objective in designing corporate income taxes is to influence large businesses to make decisions in line with public policy objectives.

run may differ substantially from its incidence in different macroeconomic (cyclical) conditions as well as from its long-run incidence after all market adjustments take place. The incidence of a corporate income tax thus depends on such complex matters as the openness of the overall economy in terms of the inflows and outflows of capital investment, the extent to which capital moves between the corporate and unincorporated sectors, the relative capital-intensity of corporations, and the elasticity of demand for goods produced by corporations and other businesses. Such factors and the relations between them are not easy to measure and the outcomes of particular tax policy changes in this area are inherently difficult to understand -- and hence perhaps especially likely to be based on assumptions rather than evidence.

Other considerations add to the difficulty of trying to determine the tax burden of both individuals and groups of individuals in different income classes. For example, the more taxes that there are, the more difficult it becomes to untangle the incidence of any particular tax change from the cumulative and interactive effects of the total group of taxes. Moreover, a complete analysis of incidence requires consideration of all parts of government activities including both government expenditure programs and regulatory policies. For example, a complete analysis of the incidence of payroll taxes levied to finance pensions requires estimates not only of the incidence of the tax but also of the retirement benefits provided. All in all, when it comes to the distributional impact of most tax changes we are generally operating even more in a world of assumption and conjecture than is the case with respect to the efficiency aspects of taxation.

1.5 Administrability

Since the best tax policy in the world is worth little if it cannot be implemented effectively, tax policy design must also take into account the administrative dimension of taxation. What *can* be done may to a considerable extent determine what *is* done. This factor shapes tax policy in particular in the international sphere, as discussed further below. More generally, as already mentioned, the resources used in administering and complying with taxes (or, for that matter, evading them) are real economic costs that diminish the ability of the economy to provide goods and services. Good tax policy requires keeping such costs as low as possible while also achieving such objectives as revenue, growth, and redistribution as effectively as possible. This is no small task.

1.5.1 System design

Three ingredients seem essential to effective tax administration: the political will to administer the tax system effectively, a clear strategy for achieving this goal and adequate resources for the task. It helps, of course, if the tax system is well designed, appropriate for the country, and relatively simple, but even the best designed tax system cannot be properly implemented unless these three conditions are fulfilled. Most attention is often paid to the resource problem - the need to have sufficient trained officials, adequate information technology and so on. However, without a sound implementation strategy, even adequate resources will not ensure success. And without sufficient political support, even the best strategy cannot be effectively implemented.

1.5.2 Collecting information and tax

Effective tax administration requires not only qualified tax officials but also, in largely 'self-enforced' systems like those in Canada and the United States, a good deal of

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 VATs like Canada's GST/HST. Enforcing a tax 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.[19] Consider, for example, the trade-off 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 as 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 trade-off, 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.[20] Of course, this does not in any way imply that

[19] A useful review of the complex tax-growth relationship may be found in Johansson et al. (2008).

[20] The year to year or even decade to decade relationship between growth rates and tax ratios is not particularly strong, but to illustrate the point made in the text consider two extreme cases, the 1960s when

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, tax-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 from investments with the same degree of risk (that is, the risk that they may lose rather than make money for the investor). On the other hand, a good economic case can be made for taxing so-called supra-normal profits as heavily as possible since, by definition, the additional (above average) return on investment is not needed to induce the activity in question.[21] Although it is not easy to distinguish 'normal' from 'excess' profit, a number of business tax schemes intended to achieve this objective have been put forward and even introduced to a limited extent in a few countries, particularly with respect to natural resource industries, in recent years.

On the other hand, even if there is little economic case for taxing 'normal' profits, when a personal income tax is imposed some taxation of such profits is often needed to prevent people from placing assets in a corporation to avoid personal income taxes.[22] In addition, profits taxes may also be seen as way of ensuring that the public sector in countries that host foreign investments receives some share of the profits earned by foreign investors.[23] On the whole, however, high taxes on profits are most unlikely to form part of a growth-oriented tax strategy. At most a reasonably low and stable broad-based profits (or other form of business) tax may be imposed for the reasons just mentioned.

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the average annual rate of real GDP growth was 4.5%, and the years since 2000, when the average annual growth rate was only 1.5%: in the first of these periods, the tax-GDP ratio rose sharply from 23.7% to 30.1%; in the second, however, the tax ratio decreased from 34.6% to 32.8%. (Data on GDP growth from World Development Indicators (http://data.worldbank.org/data-catalog/world-development-indicators); data on tax ratio from Treff and Ort (2010)).

[21] Rather confusingly, economists often call such 'excess' profits (or other returns to particular activities that are not essential to induce people to carry out those activities) 'economic rents': the terminology is confusing because not only are such returns not 'rents' in the ordinary sense of the term but they are also not really 'economic' since, by definition, they are not necessary to induce any economically advantageous action.

[22] 'Integration' – a method of treating corporate taxes (fully or partially) as 'withheld' personal income taxes – was developed in part as a way of reconciling the desire to reduce or eliminate taxes on corporations to achieve growth or other non-fiscal objectives while at the same time sustaining a viable personal income tax.

[23] As discussed earlier, since the economic, social and political context furnishes the framework in which profit-making activity of any kind can take place in a safe and regularized way, it seems both fair and economically efficient for that infrastructure to be financed by those who benefit from it. Non-residents carrying on business in most countries are therefore taxed (on their locally- sourced income) in the same way as residents because their activities depend on and take advantage of the domestic economic, political and social infrastructure in equivalent ways.

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 invested in domestic companies taxed more lightly. The particular form of 'corporate-personal tax integration' found in Canada, for example, seems to be motivated by some 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 and the United States provincial or state access to both income and sales taxes (as well as continued heavy use of the (ancient) real property tax at the local level) may be seen as essential components of the maintenance of a viable and democratic federation. Indeed, the dilemma facing contemporary tax policy designers is essentially how to keep the tax system both compatible with the country's economic needs in the changing international context discussed in Section 2 and sustainable politically within the domestic political context. We return to this issue in Section 3.

1.7 Non-fiscal objectives of taxation

Governments often use the tax system as a device to induce or alter particular economic circumstances and private sector choices and behaviour to achieve various government objectives. This may involve the introduction and propagation of a variety of tax incentives -- for investment, for savings, for exports, for employment, for regional development, and so on. Often, such incentives are redundant and ineffective, giving up revenue and complicating the fiscal system without achieving their stated objectives. Even to the extent that incentives may be effective, for example, in inducing investors to behave differently than they would have done in response to market signals, the result may often be distorting and inefficient, diverting scarce resources into less than optimal uses. Indeed, some argue that selective tax incentives can improve economic performance only if government officials are better able to decide the best types and means of production than are private investors. On the whole, experience suggests that such non-tax factors as a sound macroeconomic policy, good infrastructure and a stable governance system are much more important factors in affecting business decisions than tax benefits.

Nonetheless, most countries have a variety of special tax incentives that attempt to achieve many non-fiscal policy objectives, ranging from improved access to housing and stronger pension financing to encouraging the adoption of particular 'green' or other technologies. Whether or not a good idea in principle, in practice such tax incentives need to be well-designed, properly implemented, and periodically evaluated if they are to do more good than harm.

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 complementary) approach may be to use the tax system as a tool to correct for externalities. A tax on pollution may correct for market failure by requiring polluting firms to bear the cost of pollution. Similarly, as mentioned earlier a rationale for special excise taxes on tobacco, alcohol, and motor vehicle fuel is to impose on users of these products an additional cost that in effect forces them to take into account to some extent the negative externalities resulting for others that arise from their consumption decisions.

Even apart from such market failures, policymakers may use the tax system to encourage or discourage certain activities. Various tax provisions are intended, for example, to encourage such activities as retirement savings, gifts to charities, and home ownership. Such activities could be, and in fact sometimes are also be, subsidized directly though grants and other programs or indirectly through the tax system.

Although the costs in term of forgone revenue of most such 'tax expenditures' are reported regularly in a number of countries,[24] no formal account is taken of such outlays in the normal budgeting process, so the extent to which such reporting ensures adequate accountability is suspect. For example, we know the (estimated) tax revenue forgone by the tax subsidization of private gifts to charity[25] but there is surprisingly little public discussion of whether the public benefits from thus facilitating the partial expropriation by private interests of activities that are largely publicly funded are sufficient to make such incentives on balance socially desirable.

It may sometimes make economic sense to follow the tax expenditure route to achieving a particular policy goal rather than the economically equivalent route of increasing taxes and then spending the revenues in grants to the favoured activities. On the other hand, one reason some tax concessions are introduced may be precisely because more open expenditures on the favoured activities would be politically more difficult to implement and less popular. A serious potential cost of the tax expenditure route is a loss of control over whether and to what extent the targeted objectives are achieved and monitored. Unlike a grant system, tax expenditures leave to those who obtain the direct benefit (reduced taxes) of those expenditures the manner in which 'qualifying' activities are carried out and for whose ultimate benefit. As past experience has shown, unless such expenditures are carefully designed and monitored to anticipate possible abuses or

[24] In Canada, for example, several hundred such 'tax expenditures' are listed in Department of Finance (2011).

[25] Department of Finance (2011) reports that for 2009 the estimated (federal) 'tax expenditure' associated with charities in Canada was about $2.2 billion for individuals, at least another $0.5 billion at the corporate level, and about $1.1 billion in the form of GST rebates and exemptions, or in total almost $4 billion.

leakage to unintended potential claimants, their effects may differ substantially from the stated intention.[26] On the whole, it seems all too likely that in most countries far more tax 'tinkering' than is optimal is done in the name of a wide variety of 'good' things, with the consequence that the tax system as a whole is substantially more costly than necessary and hence a less efficient revenue-raiser than it could be.

1.8 The intergovernmental dimension

Reforming tax policy is always a complex and difficult exercise in any country. It is particularly so countries like Canada in which both federal and provincial governments have important income and consumption taxes. Both the design and implementation of tax policy at one level of government needs to be carried out with full and explicit attention to the possible reactions of the other level. Tax policy decisions are not made in a vacuum. Nor are they made, as seems sometimes to be assumed, by a benevolent government. Rather, they reflect a set of complex social and political interactions between different groups in society in a context established by history and, among other things, by the administrative capacity of the state. Taxation is not simply a means of financing government. It is also one of the most visible parts of the social contract underlying the state. The success of any tax policy thus depends in large part upon how different political groups perceive the reform and how they react. For example, those who will have to pay more must be convinced that they will, so to speak, get something worthwhile for their money. Those who will not pay more must also get behind reform if it is to succeed. The bureaucracy, those who will have to implement reform, must also support it, or at least not actively oppose it.

Some see the inevitable political processes underlying tax reform as inherently 'statist' in the sense that the state can be viewed as an institution in its own right that seeks to maintain and increase its capacity, including its capacity to collect taxes. Others see acceptance of increased tax burdens as inextricably entwined with the expansion of a more democratic polity and a more inclusive society. For citizens to pay more they must get more of what they want. For this process to work as it must -- to be both honest and to be seen to be honest -- the public finances should be both transparent and accountable. For example 'earmarking' revenues to favoured objectives - although a practice usually disliked by budgetary and public finance experts because it is all too likely to distort budgetary decisions - may sometimes prove to be a politically essential component of a successful tax reform.

To take an important example in current Canadian public policy, separating tax and expenditure decisions by levels of government to the extent that Canada does with respect to the health area will perhaps not prove to be sustainable in the long run. The long-term solution may lie either in moving more health expenditure decisions 'up' to the federal level or more revenue decisions 'down' to the provinces in order to re-establish the democratic connection between taxing and spending. In either case, forging a stronger explicit spending-taxation link as well as clearer democratic accountability at both federal and provincial levels may prove to be an essential ingredient in using the tax system in part as one instrument to maintain and sustain federalism and indeed perhaps Canada. As this example suggests, the relevant policy

[26] For example, the 'scientific research and experimental development' tax credit introduced in Canada some years ago spawned a litany of projects of dubious public benefit, and was exploited by various private tax shelter investment schemes to the point where it ended up providing little or no real support to the activities it was supposed to finance.

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 interdependence of national economies has always been a factor in shaping and implementing social, industrial, economic, and tax policy. In part for this reason, the traditional tax policy paradigm discussed in Section 1 has always been far from comprehensive and may no longer work all that well even as an indicative tool. Historically, the limits of tax and economic activity have been understood and defined largely by reference to the physical connections of those activities with observable trade flows of various kinds. In this world, the communities in which production occurred and was consumed were readily evident and suitable adjustments via various forms of trade and tax regulation could be made to establish or protect the fairness of the implicit international bargain. When, however, what a country produces – and hence supports and finances through its tax system and broader economic, social and political infrastructure – flows through cyberspace (the virtual economy) it may all too easily and invisibly be appropriated by others beyond the country's limits. In recent decades, the increased mobility of business inputs, primarily capital, across national borders as well as changes in consumption and production patterns have reduced the significance of national borders. Taxes have become a more important factor in location decisions. There is increased tax competition for direct investment, portfolio investment, qualified labour, financial services, markets, and business headquarters. A country whose tax system differs substantially from other countries with which it has important economic connections, may suffer (benefit) as a result. All countries have to some extent lost some tax sovereignty and the adequacy of some traditional tax policy imperatives and design features has come into question.

Economic Interaction and Incompatible Systems

Globalization has, for example, tightened the constraints on tax policy associated with excessive complexity, tax avoidance and tax arbitrage. Incompatible legal and tax systems increasingly encounter each other in ways not contemplated by traditional tax policy. Tax systems do not mesh easily in practice in a context in which there is no overall international tax design or administration. The increased possibilities for tax minimization either as a self-selected choice by taxpayers or simply as a by-product of the interaction of different legal regimes and tax systems reduce the reachable tax base and hence to some extent put at risk the ability of governments to provide public services. This looming 'race to the bottom' is exacerbated by the extent to which, with increased financial innovation, the labels that now largely determine who taxes what and how much are losing their meanings.

Economic and tax policy choices must be implemented through legal systems that define (and confine) how economic actors organize their activities and enjoy rights and bear obligations in relation to each other. All legal systems adopt fictions and forms to establish the limits of economic and social intercourse such as notions of 'property' and the consequences of dealings through 'contracts'. Since all such terms are invariably

somewhat malleable, they generally permit economic activity through contracts that may connect economic actors in ways that in effect create a private legal regime between them that the general law cannot reasonably have anticipated. Lawyers and investment bankers can now with relative ease convert equity to debt, business profits to royalties, leases to sales, and ordinary income to capital gains - or the other way around. They can also customize the legal characteristics of economic actors, for example, so that they appear to be corporations in one place and partnerships in another in such a way as to minimize taxes. In attempting to cope with such matters, tax policy everywhere has become more complex. Taxation is no longer simply a matter of tapping fairly well-defined pools of economic value (tax bases) that are closely associated with well-defined political jurisdictions in a world in which the underlying legal and other infrastructure is known and constant. In this new fiscal world it is increasingly difficult for tax administrations everywhere to distinguish (presumably bad) 'tax avoidance' from (presumably acceptable) 'tax arbitrage,' equally, and in part for this reason, it has become even more difficult to translate the objectives and principles of tax policy into the desired results.

The Former Context – Interactions with Seams

The traditional tax regime for taxing cross-border transactions in most countries rests on a stylized set of facts: (i) small and evenly-balanced flows of cross border investments; (ii) relatively small numbers of companies engaged in international operations; (iii) heavy reliance on fixed assets for production; (iv) relatively small amounts of cross-border portfolio investments by individuals; and (v) minor concerns with international mobility of tax bases and international tax evasion. These assumptions underlie much of the discussion of two common pillars of international tax policy architecture -- *capital export neutrality* (CEN) and *capital import neutrality* (CIN). These concepts in effect attempt to extend the common criteria of equity, efficiency and administrability discussed in Section 1 explicitly across international borders.

For example, CEN asserts that 'home' and 'away' investments should be treated identically so that capital will flow where it may best – from a world perspective -- be used. In contrast, CIN focuses on whether there are tax-induced biases that would prejudice the use of imported capital in a jurisdiction by exposing it to taxation not faced by competing local enterprises. Neither approach is without problems but in practice CEN – the *residence principle* -- generally rules, at least in principle, with respect to the taxation of *passive (investment) income* (that is, income that is not earned through active exertion by the taxpayer away from the home jurisdiction and that has no necessary geographic or jurisdiction connection other than where the taxpayer is located). On the other hand, CIN – the *source principle* - is more commonly associated with *active (business) income*, the premise being that there is a reliable, necessary, observable connection of the income-earning activity to someplace other than the place where the taxpayer legally resides. In this case, the first claim to tax revenues goes to the location of production (the source) and the home (residence) tax is correspondingly eliminated or reduced. Whether this traditional distinction between residence and source tax policy poles is helpful in defining the kind of taxable connections that now exist between taxpayers and tax systems is debatable (Bird and Wilkie 2000).

In Canada, for example, the Royal Commission on Taxation (1966) developed a logical and consistent domestic tax policy framework essentially on the assumption that Canada was a closed economy and then treated the international dimension as something that

could be 'fixed up' along the lines just sketched once Canada got its domestic tax system 'right.' This approach did not work well then. It certainly does not work now. Given the importance of international developments to Canada and the erosion of technological and physical impediments to cross-border economic flows, the distinctions between home and foreign (or onshore and offshore) established by the traditional paradigm do not provide clear guidelines in dealing with the 'new' international fiscal economy. International concerns can no longer be relegated to a secondary 'add-on' role in formulating tax policy in economies open to extensive trans-border flows.

The New Context – Seamless Interaction

Over the last few decades, many business operations have changed drastically in the direction of dispersing production, with different though nevertheless integrated operations taking place – in reality or at least on paper -- in different countries. The share of total value-added – the ultimate tax base -- arising from services and intangibles has increased and made it more difficult to locate the source of corporate income or taxable activities sufficiently clearly in space (or time) for any country to tax that income with a demonstrably superior relative claim than other countries involved. For similar reasons, although to a considerably lesser degree, it has also become somewhat harder to tax personal income both because it is easier for individuals to earn income outside of their country of residence and because traditional employer-employee relationships have increasingly been evolving into independent contractor status, with more and more 'owner-managers' being able to convert labour income relatively simply into capital income.

At the same time, the challenges posed by electronic commerce and more generally the ability to transfer information, money and even the performance of tasks invisibly without the need for a visibly necessary presence anywhere -- including where the output is consumed -- have made it more difficult for consumption taxes to compensate for the declining reliability of the income tax base. Sellers can increase sales without having a physical presence in a country, and the increased importance of digitized products makes collecting taxes more difficult.

None of these factors – except to some extent with respect to the taxation of international corporate income -- as yet constitutes a proven 'tax killer.' Taken together, however, it seems likely that countries in the 21st century must design and implement tax policy very much in an international context. This section explores some of the ways in which this new international world may affect what countries can do to achieve national policy objectives through tax policy.

2.1 The internationalization of tax policy and administration

National tax systems are confronting each other in unprecedented ways as the economies they support increasingly engage with each other. What has not changed, however, is that each country has its own tax system intended in part to frame, fund and achieve national social, political and economic goals. Good tax policy cannot be divorced from the underlying social, political and economic goals that motivate it. Nations do not necessarily share common goals, and their different choices to some extent manifest themselves in tax system choices. Nonetheless, the interactions of different economies and fiscal systems create a certain degree of unavoidable mutual dependence.

The increasingly pervasive international aspect of tax policy may surface directly in response to other countries' choices: as early as the 1970s, for instance, Canada 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 intra-firm dealings, re-establishing 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 least. 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 self-help 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.

From a tax rather than business perspective, 'internationalization' in various guises may emerge from the adoption of such tax policy norms as 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 taxation, on the grounds that doing so is in the residence country's ultimate economic interest. Both approaches focus on the effective income tax rate and assume, rather optimistically, both that domestic and foreign income measures are 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 more open and 'soft' production inputs (e.g. various manifestations of money or finance and such intangibles as know-how, knowledge, experience and the like) become more important, matters change. The need to accommodate each country's tax system to the different tax systems found elsewhere becomes unavoidable. Tax policy options and tax administration techniques formerly considered unthinkable may have to be reconsidered. For example, reliance on income taxation as the primary revenue source becomes more questionable when it becomes increasingly difficult to define what income is and where it is earned. In such circumstances, more reliance may have to be placed on taxes based on more directly observable and measurable bases such as consumption, payrolls, and property.

As already noted, such problems are most noticeable with respect to international business income. The commonly accepted *arm's length standard* for measuring and allocating among taxing jurisdictions the international income of business enterprises is intended to provide a basis for national taxation of the 'correct' share of such income. To do so, however, this approach applies traditional conventions based on separate entity accounting to multinational and global corporations that consolidate commercial activities organized and operated along functional lines according to centres of business interest. Applying the traditional paradigm assuming economic units that can meaningfully be divided into legally separate components for tax, management accounting or other purposes flies in the face of reality. Multinational enterprises exist precisely to avoid the costs and limitations of dealings between unrelated parties. The 'economic rent' such firms obtain by operating as a single economic entity that avoids these costs and limitations cannot be properly captured and allocated by the prevalent tax approach. National tax administrations need effective institutional ways to tax such enterprises, but characterizing them in a manner that directly contradicts their essence and manner of operation does not seem to be a promising path to sustainable tax policy. Indeed, the effort to make such an approach workable may result in its becoming so reliant on a series of fictional assumptions – conceived initially as practical expedients to adjust for possible profit distortions attributable to common control -- that over time the inherent weakness of this approach becomes magnified and compounded to the point that it becomes unworkable and unadministrable.[27]

One answer to this problem may, as already suggested, be a fundamental reweighting of national tax policy leading to a reduced emphasis on income taxes that to some degree have already become for many enterprises almost discretionary in their impact and unpredictable in terms of revenue. A quite different approach, however, is to focus on the practical regulatory dimension of the emerging new world economic and tax policy order. The seeds of such an international approach to tax regulation may be found in various more or less formal interactions of tax policy and regulatory authorities such as the OECD's Global Tax Forum and various associations of tax administrators such as the Forum on Tax Administration, the Joint International Tax Shelter Information Centre, the OECE's Global Tax Forum and the Leeds Castle Group, as well as in a plethora of new ways of formalizing the exchange of information among tax authorities.[28] Countries have increasingly been sharing financial and tax information, through a plethora of Tax Information Exchange Agreements (TIEAs) in addition to information exchange arrangements contained in bilateral tax treaties. In principle such agreements are intended to limit the possibility that income can be hidden from interested tax authorities; in practice, however, success in this respect remains elusive. One way or another, however, both tax administrators and tax policy makers are

[27] The OECD's Transfer Pricing Guidelines started out as devices to provide valuation guidance in identifying when and to what extent there were distortions in the distribution of 'profit' within a group attributable to the possibilities for manipulation engendered by common control. It is far from clear that the application of these guidelines as transactional accounting standards is or can be adequately matched by the legal concepts and tax system features necessary to give them life.

[28] The OECD (Organisation for Economic Co-operation and Development) is a Paris-based group of (now) 34 countries, most of which are relatively high-income countries: a recent overview of many of the issues discussed here may be found in OECD (2013). The Forum of Tax Administrators (FTA) is a panel of national tax administrators established in 2002 by the OECD's Committee on Fiscal Affairs to promote dialogue between administrations. The Leeds Castle Group is a group of tax administrators from a number of major countries, including some non-OECD countries like China and India, who meet regularly to discuss mutual compliance problems. The Joint International Tax Shelter Center was established by the U.S., U.K., Canada and Australia to develop and share information on abusive tax avoidance.

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

Tax policy has always been to some extent a 'best practices' approach. However, the 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 mix that best achieves the underlying public policy objectives of taxation should change and, if so, how it should change. The balance of this section explores the extent to which the increased internationalization of taxation suggests that it may be necessary to abandon some historically accepted best practices and to adopt new ones.

2.2 Evaluation Criteria: The Framework for Identifying and Measuring Objectives

Even if a country gets the economic analysis of its tax system right, so long as national legal and tax systems do not align fully questions arise about how tax policy can be effectively implemented. Legal infrastructure can be critical in determining policy outcomes in practice. Essentially, four important questions must be decided in order to implement any tax policy: What? Who? How? When? Unless the answers to these questions are clear and appropriate, and both captured by and enforceable within a country's legal system and tax regime, the effectiveness with which even the most intuitively sound and thoroughly conceived tax policy can achieve its intended objectives may be questionable.

2.2.1 What – The Taxable Object

To be captured by the tax system, the tax base – the economic value that is subject to tax -- must be both identifiable and clearly defined either through specific rules or in a relevant general law that supplies the definition and is sufficient within existing legal conventions and practices. This task can be very complicated in an international context. Many legal (and tax) systems treat such definitional issues quite differently. The interaction of national tax systems requires some measure of mutual recognition of these definitions if the results are not to be either ineffective or distortionary. For example, recent OECD attempts to revise the Transfer Pricing Guidelines to deal with such issues as business restructuring and intangibles like 'intellectual property' are critical in order to get at the inherent synergies and efficiencies that are the hallmarks of multinational and global business enterprises. However, there is no common international understanding of what exactly constitutes an 'intangible.' Even the best-defined economic conceptualization does not fit easily within existing national legal and tax systems. This is a much more important challenge to developing a coherent and effective international tax policy than is usually recognized: in the absence of an agreed legal formulation, getting the economics right is like thinking important thoughts without having either the facility of language to express them or the linguistic conventions necessary to translate from one language to another.

2.2.2 Who – The Taxable Object

Even assuming that the object of taxation can be captured satisfactorily by the tax law, that object must then be associated with a particular economic actor whom the tax system recognizes and holds accountable and from whom the tax can be readily collected. Since the norms of public international law generally prohibit extra-territorial enforcement of tax laws, the enforcement by any country of even the most well-designed 'international' tax system inevitably stops at the national border. This is a major

problem in the 'world without (economic) borders' that has to some extent developed in recent decades. One result has been to put pressure on commonly accepted conventions for defining the characteristics of a 'taxable person', particularly with respect to taxing corporations. As noted earlier, a corporation is essentially a legal fiction: although corporations are the focus of much commercial activity and play critical economic and fiscal roles, they have no intrinsic economic 'being' or even legal personality separate from their economic owners other than that bestowed by law. Indeed, as was also mentioned earlier, corporations – even if there were full international agreement on the characteristics of this business form[29] -- as such cannot really pay taxes in the sense of bearing their final incidence. To determine who really pays taxes imposed on corporations one must in effect look through the corporation to the natural persons who gain or lose when taxes are collected at the corporate level, and, as discussed in Section 1, we know very little about the real incidence of the corporate income tax.

Much the same is true with respect to trusts, which are in legal terms simply an obligation undertaken by one person (a *trustee*) to another (a *beneficiary*) at the instance of a former owner of property (a *settlor*) in relation to property and its derivative income (the *trust corpus*) intended to be deployed as originally determined by the settlor but according to the discretion of the trustee in order to serve the material interests of the beneficiary. In other words, a trust is a special form of relationship among persons. Canadian tax law, for instance, gives a trust the legal personality it otherwise lacks separate from its constituent interests, in order to establish a reference point – a taxpayer – and to capture within the tax system changes in the value of and income from the settled property. However, even within a single country, it can be difficult to deal with focus points for value that lack both personality and a clear connection of a person to a place and of both to a property, as Canada's recent experience with 'income trusts' demonstrated.[30]

From one perspective, the enforced integration of the taxation of business income that was achieved through income trusts (where the income earned by the entity was 'flowed through' the trust and taxed only in the hands of its beneficial owners) in effect yielded a simple (and, some might say. efficient) result by treating business income roughly equivalently regardless of the legal construction – corporation, trust or partnership – within which the income is captured and from which it is allocated or distributed to its economic owners. From another perspective, however, real tax avoidance opportunities may arise from imperfect attributions of 'personality' in such arrangements – in this case in terms of establishing precisely who the taxable actor is with respect to the taxable object (the trust property). Tax policy analysis does not stop with the immediate trust actor but must also foresee how the presumed owners of the income are treated in relation to the flowed-through income. For example, to the extent that the income

[29] One of the many challenges when legal and tax systems interact is the incompatibility of notions as fundamental as the definition of the taxable unit. A corporation in one country may be considered a partnership or branch elsewhere; such differences have fundamental implications – for instance that some transactions in one country may not be recognized as such in the other. Tax policy that does not take such matters into account is deficient: for an example, see the Canada-United States Income Tax Convention (Fifth Protocol, Articles IV (6), (7)) which limits relief otherwise provided by the treaty when a 'resident' of one of the treaty partners is disregarded in the other.

[30] For some discussion of this issue, see Mintz and Richardson (2006) as well as a number of other articles on the topic subsequently published in the same journal.

belongs to tax-exempt persons, such as certain deferred income plans, the result may be what from a policy perspective may be considered an intolerable delay in taxing the income despite the theoretical attractiveness, from one perspective, of integrating the income 'earner' and 'owner'.[31] Whether such arrangements constitute tax avoidance and whether such avoidance is to be corrected depends largely on the objective expectations for taxing such value and the rationale for such expectations. It is by no means easy to determine the answer to such fundamental questions even within a purely national context, let alone in the much less well determined international context.

2.2.3 How – The Taxable Transmission of Value

Even when the taxable object is identified as well as a taxable actor to be held accountable the manner in which the value – the object – is manipulated may matter. Typically, the law recognizes a change in the relative interests of actors in a taxable object when there is a disposition (sale or other transfer or letting for use) of the object or the performance of some sort of service. It is this act that gives rise to an identifiable and measurable income or other outcome that in turn occasions tax. In the international arena, however, there is often no common understanding among countries, especially when the taxable object is ill defined or can bear more than one characterization, as to who can be held accountable for its manipulation or even when such an activity takes place.

2.2.4 When – Timing Matters

The best theoretical tax policy construct is not much use if no tax can be collected or if the limits of tax avoidance cannot be determined and addressed in an objectively definable and enforceable way within a reasonable period of time. When is a transmission of value a taxable event, and with what other taxable events should it be associated in order to ensure that the tax base accords with internally consistent tax policy principles formulated and applied with the unique demands of internationalization in mind?

A topical example of this problem that countries are now rethinking relates to the alignment of financing charges (interest) and the income-earning activities that are directly or indirectly financed. This problem, sometimes described as (or associated with) 'debt dumping,' is being addressed by different countries in different ways, most of which are related to the *thin capitalization* rules that exist in many tax systems. These rules are intended to police excessive income transfers arising from debt service that has been arranged to benefit entities beyond the jurisdiction of the country within which a particular entity is located. Although the issue of limiting interest deductibility has sometimes been approached as a domestic tax shelter issue, it is generally driven by a fundamental international question, namely the extent to which a country's tax system is prepared to cede tax base in favour of another country to which the affected tax subject and/or tax object, and related income, has a connection. How much recognition of foreign taxes whether by credit, exclusion of income or otherwise, is justifiable, and why? If financing expenses are recognized in relation to a source of income to which they do not really relate, then foreign income will be overstated. Even if the tax rules of

[31] The collision of these tax policy considerations, in the case mentioned above led Canada to adopt a corporate tax model with two primary features: the introduction of yet another entity concept – the 'specified investment flow-through' ('SIFT') trust – as well as rules to assimilate public investment trusts and partnerships to corporations and the refinement of the dividend tax credit for distributions on corporate shares to ensure better integration of corporate and shareholder taxation.

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 – 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 taxpayers – that 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 hard to discern very clear thinking about the objectives of international tax policy in the way international taxation currently works.

Provisions such as those on controlled foreign corporations and foreign tax credits found in national tax laws, like the many tax treaties that now exist, are perhaps best considered as pragmatic attempts to accommodate the many physical and legal ways in which commercial activities actually take place by adding on particular features to tax laws developed essentially for domestic purposes, without focusing on how the new international aspects interact with and may fundamentally alter the achievement of the various domestic tax policy objectives. This is changing. More fundamental questions are being asked about how tax systems sit atop the legal system that gives them definition – notions of property, contractual dealing, transfer events – and how the changing roles of members of a multinational or global enterprise leads to 'transmission' elsewhere of the economic value thought to originate in a country.

Although agreed answers are hard to find, taxpayers and their various governments have in effect been communicating with each other both through language and through commercial relations. Conceptually, it may even be possible to imply or infer the implicit evolution of a sort of loose confederation of a number of more developed national tax systems perhaps not all that different in some respects from the more formal arrangements that exist within federal countries such as Canada to co-ordinate the contemporaneous application of the federal and provincial tax systems on similar income and consumption bases. We develop this thought further in Section 3 below. Equally, however, what current international tax rules and practices illustrate may be less a principled justification for their continuing acceptance and use than a last ditch rationalization for clinging to outmoded practices and constraints. Time will tell.

In any case, as noted earlier, it seems clear that many productive inputs (including skilled people) are more mobile and less connected to particular countries than ever before. Nations, through their tax systems, are hence increasingly competing for the potential tax base generated by such inputs. In the search for revenues, as borders are

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 as *inter-nation equity* ('fair' international sharing arrangements) have arguably become more important.[32] 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 cross-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 it is simply too complex to expect adequate compliance even from diligent and honest self-enforcers 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 have, to some extent, dynamic influences on each other. Accordingly, to be both sound and sustainable domestic tax policy must attempt to foresee critical developments abroad and accommodate them in its own interest. One aspect of this concern relates to identifying elements of interconnected international policy behaviour that may impair otherwise desirable international economic integration. Importantly, however, another important aspect is to weigh such underlying public policy objectives as preserving the nation and domestic self-interest (national welfare, as the economic literature often calls it) carefully and explicitly in relation to tax policy choices that some may suggest are required in the interests of international tax policy compatibility and more successful integration with the international economy.

Much of the current international tax regime, from the League of Nations in the 1920s to the World Trade Organization in the 1990s, derived from decades of effort to reduce both the distortionary effects of multiple trade taxes and the use of such taxes to shape, colour and subsidize trade – efforts that continue to this day as witnessed by the OECD's continuing efforts to establish a common international basis for taxing digital services. The sorts of questions debated by League of Nations experts in the 1920s, like the language of that debate, are eerily similar to present international tax policy debates. Similar efforts are underway at various international and cross-national levels to grapple with the even more difficult (and considerably broader) problems that arise from the

[32] For a useful recent discussion of inter-nation equity, see Brooks (2009).

increasingly large share of income arising from such 'footloose' factors as intangibles 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 may 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 so intrinsic 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 co-ordinated with the equally shaky systems of other countries. Ideally, the parameters 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 contributions in ways that can be distorted through convenient manipulation or movement of responsibility for activity. If the objective is to capture within the tax base activities that have a measurable and observable connection to a country in such a way that the economic actors held accountable to pay the tax do so within the framework of the parameters of equity, efficiency and administrability discussed in Section 1, then almost certainly the tax system should focus primarily on activities that are clearly economically connected to the country. This focus limits the extent to which either the tax base or the mode of taxation can be manipulated by those outside the domestic economy (and polity) who neither fully benefit from the tax-financed economic, social and political infrastructure nor can be held fully accountable to contribute to it -- non-residents, to use the typical terminology, whose interests and responsibilities are not the same those of 'full tax citizens.'

One strand of recent attempts to cope with the growth of mobile intangible factors has been an international push to homogenize tax systems in part through administrative determinations and guidance exercised by way of a kind of informal international tax administration among major countries. Such efforts may be helpful in terms of aligning tax regulation with the characteristics of the economic actors affected by taxes and the

economic context in which they operate. On the other hand, such moves also imply that countries are silently relinquishing some control over the objectives and characteristics of their tax (and economic) systems. This basic problem is buried in the context of the many specific questions that many countries are now trying to deal with in the international context. For example, although tax discrimination between residents and non-residents is foresworn in tax treaties, countries usually find their way around this prescription through tax expenditures and similar indirect routes as well as by drawing the boundaries of 'discrimination' in treaties so that the use of the tax system to attain policy based fiscal and economic objectives is not forbidden because it is not 'discrimination.' Such considerations suggest that it is perhaps time to think through more explicitly how the international and national dimensions of tax policy design and administration may be better balanced within a broader policy context.

A related issue is the extent to which dominant economic actors may be able to organize or systematize their interactions with national tax systems, through, for example, advanced pricing arrangements/agreements (APAs), which are in effect pre-agreed transfer pricing arrangements. Unless considerable care is used in defining and establishing taxation parameters in such agreements, the achievement of more fundamental tax policy objectives may be imperilled. Clinging to such well-entrenched rules as the arm's length paradigm for measuring the international allocation of multinational income earned through highly integrated activity that increasingly depends on elements not uniquely associated with any particular place presses the limits of self-interested but interdependent national tax policies. As emphasized earlier, multinationals exist essentially because they can increase their returns by obviating the constraints of arm's length dealing; defining their activities for tax purposes by separate entity financial accounting simply cannot capture their integrated and consolidated operations in any sensible way. The more outcomes depend on fictions antithetical to the economic notions and actors to which they apply, the more unreliable, political and disputatious international taxation becomes because there is no reliable reference point to resolve disputes on a predictable basis.

All of these considerations connect to tax administration. What are the norms of acceptable tax compliance? One country's avoidance may be another's fiscal enrichment. In some instances, clever international tax planning may even result in an absolute diminution in the tax base, creating a sort of 'super' private return to those who best play the game of tax planning devices, holding companies, tax-preferred jurisdictions etc. To put the problem another way, what is 'excessive' tax avoidance, that is, when does legal tax planning go beyond the pale by bypassing domestic norms and escaping the limits of the tax system completely?

Although it may seem paradoxical, in some instances it may make policy sense in terms of achieving more important economic and political objectives for a country to relinquish reliance on traditional constraints on avoidance. This is more or less how nations originally approached the issue of international tax policy in the early twentieth century when the League of Nations tried to relieve gratuitous tax-induced impediments to trade by tackling the nature and significance of international taxation. The modern child of these parents is the notion of tax-base sharing through treaties, seen as fiscal and economic bargains between countries each of which is acting in its own national self interest, as well as the less formal emerging international tax administration arrangements mentioned above. In the modern context, however, with the substantially increased 'international' dimension of the tax base, the question becomes whether any

tax policy choices can really be thought of as purely 'domestic' if in the end they must be compatible with different choices made by other countries with which the 'domestic' 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 broad-based 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-based tax through its treatment of both pensions and housing: should the current 'hybrid' income tax system shift even further towards a more explicit consumption-tax base? If it were to be shifted, how should the regressive elements of consumption based taxation be addressed in order to satisfy the fairness concerns discussed in Section 1?

Why should some or all the tax base potentially associated with foreign operations of domestic business be freed from tax? At present, for example, unless repatriated most earnings of Canadian firms operating abroad are not taxed in Canada. If the expectation is that the result of this policy is compounded economic returns for the country that exceed the present value of this tax cost, how can this be tested and measured? Can policy-makers distinguish meaningfully between facilitating international competition in terms of the interests of private parties and doing so for national economic interests? If they cannot do so, then what should they do?

When (political) geography ceases to align with (economic) reality, do current approaches to the international aspects of tax policy design and administration provide an adequate or appropriate way to deal with this issue? Tax systems to some extent have always competed with each other for shares of a shared tax base; they do so today more than ever. When countries' interests collide, historically solutions have been reached either through conflict or, in one form or another, through cooperation. To the extent that consumption and production have less and less attachment to political geography so that the funding of public expenditure depends to a significant extent on factors outside political borders, the integrity and sustainability of the political state is inevitably affected to some extent. Few issues are more important in determining tax policy today than deciding how to cope with the international environment. The relative weights to be attached to the traditional equity, efficiency, and administrative (simplicity, feasibility) aspects of international tax policy need to be reconsidered in this context.

3.2 The limits of government intervention

Standard public finance theory identifies three aspects of government intervention in the economy – stabilization, distribution and allocation. The first two of these objectives are usually associated with central government policy while to a considerable

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 of 'government' in effect becomes little more than a sort of overarching supranational congeries of loose economic and legal arrangements that rely entirely on 'market forces' (including 'political markets') for enforcement purposes. National tax systems to some extent 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 within this paradigm. For this reason, stabilization and redistribution seldom rank high as objectives of subnational tax policy both because such general taxes have effects and purposes that transcend an immediate connection to their payers and because in open subnational economies it is difficult to impose and administer those taxes in an equitable and efficient way. In most countries, the gap between those expenditures that can and should be efficiently carried out at the subnational level and those taxes that can be effectively, efficiently, and equitably administered at that level is closed through government-to-government accommodations akin to the intergovernmental revenue and transfer agreements in federations like Canada and Australia.

In addition to such arrangements, in a closed system like the Canadian federation in which several levels of taxation co-exist, generally within well defined and controllable boundaries, questions about revenue losses and other problems that might arise from imperfect interactions between levels of taxation or as a result of transaction or other manipulations by taxpayers can be addressed. However, none of this is true when as sketched above with respect to the current international scene the central 'authority' to which a country is to some extent subordinated actually exercises no real international tax authority. The result, of course, is that taxpayers are sometimes able to manipulate imperfections in the characteristics and interactions of tax systems in such a way as to reduce the aggregate international tax base.

3.4 National tax policy is not national

While it would clearly be wrong to exaggerate the extent to which national fiscal autonomy has as yet been neutered in this way, it nonetheless seems prudent to consider how more principled tax policy responses to the international pressures sketched in Section 2 might be developed. The traditional tax policy criteria of equity, efficiency, administrability and their derivatives set out in Section 1 may be imperfect and incomplete. Nonetheless, they still provide a useful framework within which to balance

these factors more explicitly even within an open economy framework. The traditional paradigm, such as it is, need not be replaced. In fact, the specific features of tax policy oriented to subnational governments reflect refined applications of the traditional paradigm, and one way to begin the task of rethinking the traditional tax policy paradigm may be to consider more carefully the conventional discussion of the appropriate tax instruments for subnational jurisdictions.

Four criteria may be suggested to guide the design of subnational taxes:[33]

(i) The first, derived clearly from the efficiency criterion, is that subnational taxes should not distort resource allocation (unless, of course, there are clear and significant net gains in terms of non-fiscal policy objectives from doing so).

(ii) The second criterion is accountability in the sense that subnational taxes should be both politically transparent and visible in order to ensure that the governments imposing such taxes are clearly accountable to those for whom they are supposedly acting – their residents. Both these criteria are of course satisfied if taxes are imposed in accordance with the benefit principle so that those who benefit (from the public services financed), those who pay (in terms of the final incidence of the taxes), and those who ultimately 'decide' on taxes are responsible and accountable to the same set of people.

(iii) Thirdly - and even more ideally given the heterogeneous nature of most countries - subnational taxes should be adequate and sufficient to finance expenditure needs (at least of the richest subnational jurisdictions).[34]

(iv) Finally, in order to be effectively implemented, subnational taxes should have relatively immobile bases in the sense that the responsiveness of the tax base to rate changes (its rate elasticity) is low and the tax is visibly based on property and personal interests that are clearly related to, and preferably clearly observable in, the tax jurisdiction in question.

These parameters are not as strict as they may seem at first glance. They do not, for instance, imply that subnational jurisdictions can or should tax only real estate. In fact, as Canadian experience shows, it is possible for provinces – and conceivably even localities – to tax such mobile bases such as employment and consumption provided adequate 'supra-jurisdictional' administrative institutions are developed, as in the extensive federal-provincial tax agreements found in Canada as well as such commonly-agreed federal-provincial rules as those on profit allocation. Nor do the points listed above suggest that it is either impossible or undesirable to attempt to exercise flexible authority over the nature and degree of taxation – for example, to achieve redistribution or targeted incentive effects through taxation. They do suggest, however, that the limits

[33] For a recent review of the relevant literature (in the context of developing countries), see Bird (2011).

[34] Countries may, or may not, choose to 'rebalance' subnational finances by establishing, as Canada and Australia have done but the United States has not, some 'equalization' system of fiscal transfers to those regions with fewer fiscal resources.

on such measures are much tighter at the subnational level and that the likely effectiveness of such measures is more limited.

On the whole the general lesson suggested by considering subnational taxation is that in an open economy the tax system is likely to work best if the demands put on the tax authority for revenue do not exceed its feasible grasp – for instance by trying to extend its authority to sources and persons (non-residents) beyond its reach. Globalization need not result in the dread 'race to the bottom' for the national public sector, just as 'provincialization' has not noticeably hampered the development of the Canadian public sector at either the federal or provincial levels, let alone in total. However, in the international context – which differs sharply from the national context owing to the absence of any overarching fiscal authority -- the result is likely to be that it will become increasingly difficult to resolve policy problems simply by expanding public expenditures (or equivalent 'tax expenditures') and expecting the tax system to be able to keep up.

3.5 Looking forward

In short, the next generation of tax policy changes in countries heavily dependent on international developments will likely have to take more explicitly into account the limitations on national fiscal autonomy imposed by a shrinking economic world. When the traditional closed economy analytical box no longer adequately encompasses the critical marginal (international) component of the tax base tax policy choices will increasingly have to be framed outside that box. In recognition of this fact, Canada and other relatively 'open' countries have in practice begun to delegate more and more elements of national tax authority to such informal internationally-dominated arenas as informal associations of tax administrators and policy makers. This is not a prescription; it is already reality, and likely to become even more so in the future. In the circumstances, perhaps the most important policy concern for those charged with shaping and implementing future tax policy should be to work towards more transparent and balanced *processes* to shape the international tax policy decisions that impact on and to some extent limit national tax policy autonomy.

Getting the right solutions from a domestic policy perspective with respect to such esoteric issues as controlled foreign companies, transfer pricing, thin capitalisation and the like is far too important for the development of coherent, feasible, and necessary domestic tax policy to be left to occasional informal chats in Paris or elsewhere. As with domestic tax policy, the 'right' results from a national perspective are only likely to emerge when the 'right' decision process is in place. It remains to be seen, however, whether that process will eventually lead to some form of 'international tax organization' or whether, as the experience of the European Union – which already faces all the problems discussed here in a particularly clear fashion – suggests, it may perhaps prove to be both more feasible and more probable that countries will not take pre-emptive action to 'get it right' but will instead wait until solutions of some sort finally seem to emerge from increasingly formal 'joint' policy actions and administrative cooperation between national administrations. Whichever route is followed, the formulation and implementation of tax policy in the future seems certain to become even more outward-looking than it already is. All those concerned with improving tax policy and sustaining the critical aspects of the existing public sector in open economies should be thinking more carefully about these matters than perhaps has been the case in the past.

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