International Taxation: The Economic and Legal Interface

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I. CONTOURS OF TAX DESIGN

Principles of Taxation: Efficiency, Equity, Stabilisation

- Tax design should have theoretical underpinnings in the form of principles of taxation comprising efficiency of resource allocation despite taxation’s distortionary effects, its ramifications on inequity, and its potential in economic stabilisation. Some of the well known principles comprise:
  - When economies function well, equity is of less concern. But when an economy is foundering, progressivity in taxation protects the less well-off
  - Progressive tax rates also stabilise the economy from unwanted or unexpected fluctuations
  - Tax design should address efficiency of resource allocation by attempting to minimise tax incentives that distort relative prices across sectors and result in erroneous signals for production—away from consumer preferences

Principles: Buoyancy, Simplicity, Incorruptibility

- Any country authority would be interested in a revenue buoyant tax structure
- Despite good intentions of the tax designers, if the tax law is cumbersome and hard of interpretation, the tax system loses its sharpness and ends in litigation and, the worse is the law, the longer is the litigation process
- Simplicity and the associated ease of taxpayer compliance have increasingly come to be recognised as an important tenet of tax design
- A tax administration's transparency, incorruptibility and impartial application of the law are crucial even as subordinate legislation or administrative rules that override legislative intent are minimised

Does tax reform last

- How often, how far, and across what expanse of geographical reach can tax reform be said to have achieved success? It is an open secret that the predominant opinion of experts is that reform is ephemeral
- Why? First, the term itself is variously, randomly, or even persistently wrongly, used
  - Second, the concept of tax reform itself appears to vary across tax professions
- Even if it is so that those differences are not terribly important, empirical evidence suggests that, after about five years of undertaking tax reform, country authorities face new challenges to the edifice that begins to crack

Tax reform is short-lived

- Those who are adversely affected, even if marginally, begin to lobby, often steadily and strongly, for reinstatement of their privileges, usually for sector specific tax incentives, tax holidays, accelerated depreciation, lowered VAT rates for individual commodity classifications and so on
- In most democracies there is likely to be a change in government in four, five or six years; and the new administration likes to put its own imprint on public policy including, or in particular, on tax policy
- Hence, with the ever longer global reach and internationalisation of taxation, a country’s tax structure gets affected by multilateral movements in international taxation and by changes in political or trading blocs
- Thus the use of the term ‘tax reform’ has become a catch-all for any change carried out by country authorities

Ideal tax structure

i. Why tax expenditure as well as income

- what is the rationale or justification of taxing both the demand and supply side of the same economy?
- Y (L, K, T) or Supply = Demand C + I + G + X - M

ii. Domestic consumption and production taxes

- The internationally accepted premise at present is that the best consumption tax from an efficiency and simplicity point of view is a single or two-rated **value added tax (VAT)** or **goods and services tax (GST)** that allows crediting all input taxes against all output taxes to be paid to the exchequer
- **Environmental taxes** and **user charges** also fall in this broad category

Ideal tax structure contd…

iii. Income and wealth taxes

- The definition of income during a period reflects development of the Schanz-Haig-Simons comprehensive income concept including the
- Integration of dividend income in individual and corporate income tax; and arguably, capital gains as well
- Some other concepts, among others, that have been discussed over the last half century include
- Cash-flow tax
- Presumptive taxes
- Minimum income tax; and, more recently perhaps
- International taxation—increasingly approaching comparable patterns in advanced and emerging economies

II. INCOME TAX

Income and Wealth Taxes

- The definition of income during a period reflects development of the Schanz-Haig-Simons comprehensive income concept.
- It is the sum of the market value of rights exercised in consumption and the change in the value of property rights between the beginning and end of the period in question. Most countries fail to adhere to it.
- In practice, features that determine tax liability include the specification of taxable unit, taxable income or sources of income subject to tax, the tax schedule and tax preferences.
- The number of brackets, the treatment of particular types of income for example the taxability, or not, of second or more real property, allowable deductions, exemptions, tax credit, tax sparing, formulae to mitigate the effects of inflation, further embellish and differ across tax systems.

Design Issues

- While progressivity is generally accepted as a favourable feature to achieve equity, its definition varies.
- Thus, one measure, focusing on the distribution of taxes, could yield high progressivity as long as all taxes fall on a few, say the richest decile of taxpayers, even if the overall tax burden is low, say 1 percent to 1.5 percent of GDP as was common in the 1990’s Latin America.
- Another measure, focusing on after-tax distribution of income, may conclude that the same tax system reflects low progressivity.
- These differences assume great importance in prevalent income distribution patterns as wealth concentration across the globe narrows down on a few individuals.

Integration of Dividend Income in Individual and Corporate Income Tax

- More than a design issue, this is a conceptual area that has not yet been resolved.
- Dividends are a source of income that are taxed at the corporate level prior to distribution and then again after distribution as individual income.
- The case against this “double taxation” is that corporations have no independent ability to pay and are simply a pass-through for incomes to individuals.
- Conceptually this could be perceived in similar fashion to the collection of VAT through different stages of production and distribution; yet it is only the final consumer who ultimately pays the entire tax, while the previous stages become merely collection points.
- In this sense the VAT is equivalent to a retail sales tax.

Presumptive Taxes

- Philosophically, perhaps the concept of presumption is not optimal since it is not exact; nevertheless presumptive taxes are administrative devices that are widely used for practical purposes in particular in developing countries.
- For example, under the VAT, often there is a generally applied presumptive taxation scheme—compounding—in which a threshold is defined below which a taxpayer is given the option not to have to maintain invoices and, instead, to pay tax at a low rate on a turnover base.
- It is not surprising that, usually, a concentration of taxpayers is found just below the threshold.
- A Latin American finance minister once lamented to this author that, "Doctor, in my country, there are many elephants hidden among the mice."
- Under income tax, the MAT is a presumptive concept.

International taxation complexity

- Further complexity emerges with taxation of international incomes.
- The Group of 20 Nations (G20) asked the Organisation of Economic Cooperation and Development (OECD) to suggest comprehensive measures to address tax avoidance by multinational enterprises (MNEs) that tend to structure their business arrangements through a process of tax base erosion by shifting profits (BEPS) among their parent companies, branches and subsidiaries across national boundaries.
- MNEs presumably locate profits in low tax jurisdictions and successfully minimise their total tax contribution in terms of their global profits.
- Though such operations are likely to be legal, advanced country tax administrations began to perceive such practices as unreflective of the intention of the law as the 2008 global financial, turned economic, crisis hit them hard in terms of significantly lower than trend revenue from the corporate income tax (Shome, 2013b).
- The entire BEPS project and its 15 Actions emanated from these concerns.

III. CONSUMPTION TAX

Domestic Consumption and Production Taxes

- The internationally accepted premise at present is that the best consumption tax from an efficiency point of view is a single or two-rated **value added tax (VAT)** or **goods and services tax (GST)** that credits all input taxes against all output taxes to be paid to the exchequer.
- This obviously weeds out any embedding of prior-paid taxes in a product price, thus avoiding cascading or "tax on tax".
- Thus the philosophy of a VAT/GST could be viewed as possessing a positive stance towards a single or few rates that are charged directly at production and distribution points (Shome, 2014, IV).
- Nevertheless, there is a lingering issue with this for, reflecting the theory of "optimal taxation", in order to eliminate economic distortions and "deadweight loss" associated with commodity taxation, the tax rate for each commodity should be ideally distinguished from another, pegging it at the inverse of its elasticity of demand.

Elasticity of Demand and Tax Structure

- To explain simply, an inelastic good whose demand changes little with price movements can suffer a higher tax rate since its demand would not change much with a rate increase in its tax (a price); hence the deadweight loss associated with the tax change would be lower.
- Contrary is the case with an elastic commodity whose tax rate should therefore be lower.
- In the amalgam of “indirect tax” theory, the VAT/GST seems to have won out perhaps reflecting its easier collection mechanism using the debit-credit principle applied using output and input invoices.
- This is despite the fact that there is no country that has only one or two VAT/GST rates; they have many rates that vary according to the type of product or product use.
- Indeed many countries have books full of VAT rates. India’s new GST introduced on July 1, 2017, suffers similarly from a large number of rates.
- At the level of states, it earlier had a VAT that had lower rates for capital goods—presumed inputs—even though the VAT paid on them would be credited out anyway. The same structure continues in the new GST.

VAT/GST over Optimal Taxation

- The VAT/GST base is usually diminished by exemptions (where output is not taxed so that input tax credit is not given); or zero rating (where output is not taxed, nevertheless input tax credit is given), and so on. VAT/GST has also developed complex administration mechanisms such as reverse charge, presumptive taxation such as on cross-border reinsurance services, interpretation between goods and services for composite products such as set-top boxes to name just a few.
- Reflecting this practical experience with the VAT, it is difficult to surmise why the tenets of optimal taxation following the inverse elasticity rule so clearly lost out to the VAT/GST.
  - ✓ One explanation could be that a tax reflecting inverse elasticity of demand could lead to more inequity than the VAT/GST if it were true that the more inelastic goods with higher tax rates are consumed by the less well-off. And that, as we progress towards luxury goods, the elasticity of demand tends to increase, and thus the tax rate would tend to decrease.
  - ✓ However, Atkinson and Stiglitz have shown that it is not impossible to build in an equity component in an optimal tax system. And it is not as though the VAT/GST in general is far more equitable for it is well known that a VAT/GST being a consumption tax that exempts savings is bound to be somewhat inequitable as well.
  - ✓ Thus the resounding victory of the VAT /GST over optimal taxation remains a bit of a mystery.

VAT/GST: Shome Productivity Index

- One thing is clear. Indirect taxes are revenue productive.
- Excises on turnover are obviously revenue productive. They feature in most country annual budgets as discretionary measures for revenue.
- But the VAT/GST too is depended on for revenue. In fact, a measure of the VAT's revenue productivity was observed in Latin America by this author where it has been referred to as the **Shome VAT productivity index** (Modi, 2009).
- If the general VAT rate is X%, then if it is designed well, it should be able to yield ½ X% of GDP in revenue. Chile and New Zealand collected 9% of GDP with an 18% VAT rate. Most countries achieve 1/3X% of GDP and above without touching ½ X%. Countries that linger below 1/3X% comprise examples of poor VAT performance. In the UK, with a 17.5% VAT rate, VAT revenue hovers near 1/3 X% (or 6%) of GDP.
- To achieve high revenue productivity, the VAT/GST has to be structured in such a way that most commodities are at the general rate, there are not too many lower rates, exemptions are few, zero rated items are few, tax compliance is good, and tax administration is reliable.

Country practices in VAT/GST structure

- By convention, since VAT rates are supposed to be few, and given the prevalence of demerit goods, luxuries and non-renewable resources that should bear higher than the general VAT rate, countries usually apply **excises** selectively on the turnover of alcoholic products, yachts and furs, and petroleum products on top of including them in the VAT base.
- This has the advantage of retaining information on their input use and input costs as in the case of all VAT-able products.
- The reality is that most countries have a higher number of commodities on which they impose VAT plus excises.
- The appropriate excise rate structure has moved around somewhat with little economic rationale.
- When they were mainly “specific” rates or taxed by quantity of output, it was felt for decades that they should be taxed on an “ad valorem” basis in order for the value of excise revenue not to suffer from inflation.
- When country after country moved accordingly, tax administrators mainly from multilateral organisations began to push for specific rates with ease of administration as the objective.

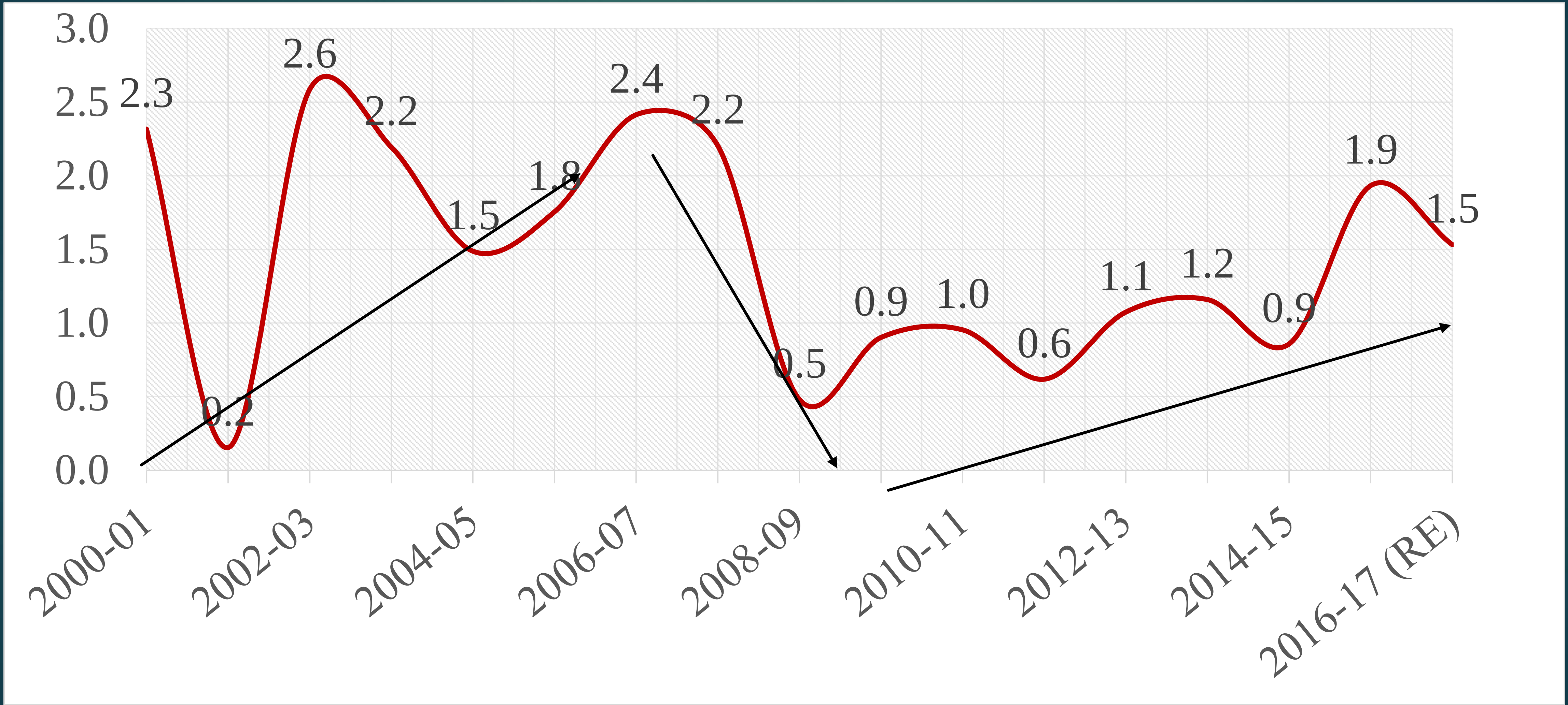
Environment Taxes and User Charges

- The former, termed “Pigouvian taxes”, apply for environmental objectives (Pigou, 1932).
- The idea is to impose a tax that would redress environmental damage, or ‘internalise’ the negative ‘external’ effects of the activity.
- This would rightly bring up the private costs of an economic activity thus helping bring the private cost of the activity to equate the social cost it causes.
- Thus such taxes could be used to reduce pollution by earmarking the revenue for cleaning up the environment.
- The European Union has moved significantly forward in environmental tax design while the United States has walked away from an international agreement on environment termed the Paris Agreement.
- The matter of a global carbon tax has also re-emerged in the context of the G-20’s development agenda though it has not taken hold.

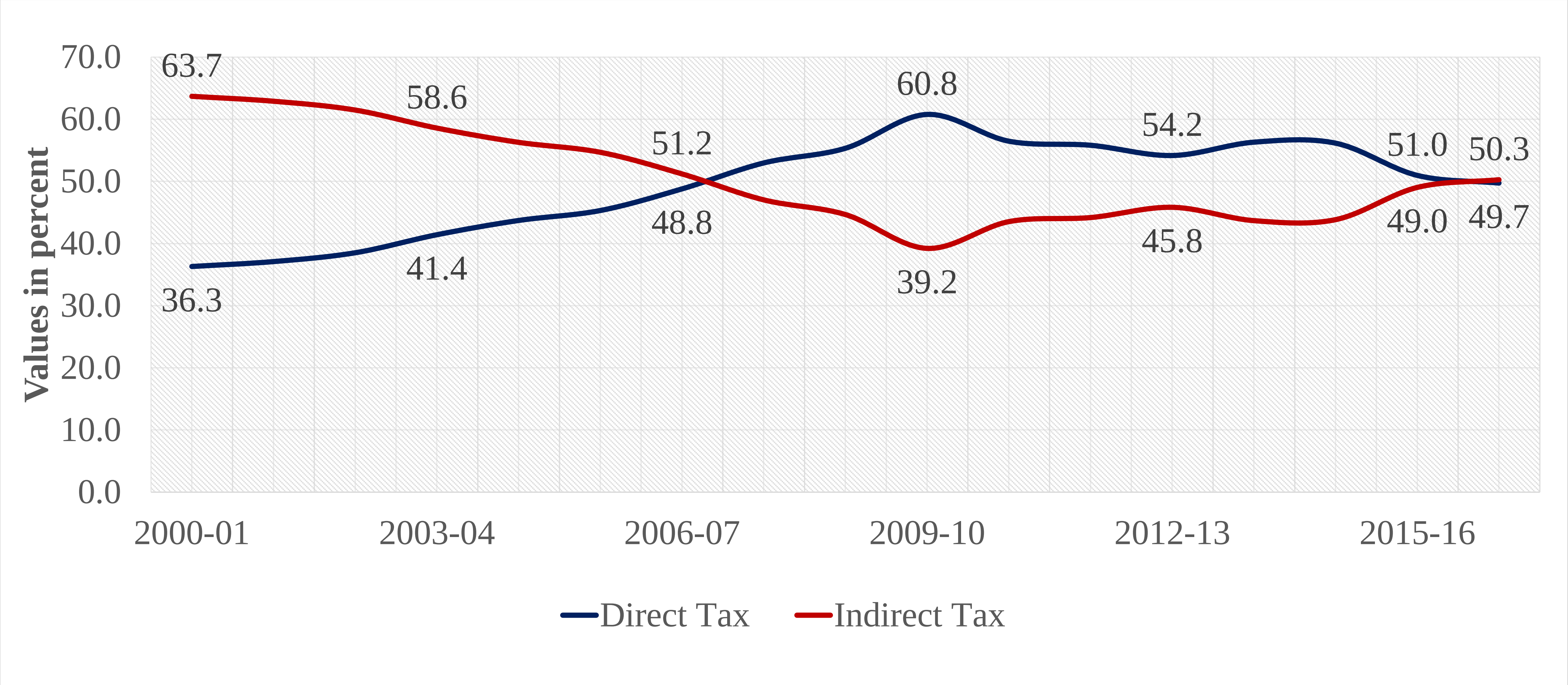
Concluding Remarks

- In conclusion, I would like to emphasise that it is not modernist to replace income tax and related taxes with consumption tax and related taxes.
- What is important is to keep the structure of every tax simple and easy to interpret and comply with. Here is one area where economic and legal approaches differ. Or am I wrong to think so?
- Simplicity should enable ease of tax administration whose arms should reach every potential taxpayer without, however, using punitive measures such as demanding huge amounts of unrelated (to basic audit) information from the taxpayer, or through a search and seizure approach.
- Finally, taxation cannot be a goal in itself of any government. It is, and should remain, a helpful tool for economic growth and development.

Appendix I. India: Buoyancy of Tax Revenue



Appendix II. India: Direct and Indirect Tax as Percent of Tax Revenue



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