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The peculiarity of tax reform

The Direct Tax Code must address eight principles of taxation

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I have recently written on specific aspects of designing the Direct Tax Code. Here I delineate the fundamental underpinnings of tax design.

Principles: When economies function well, *equity* is of less concern. But when the economy is foundering, progressivity in taxation protects the less well-off. Second, progressive tax rates also assist in *stabilisation* of an economy from unwanted or unexpected fluctuations, for example, in crisis and post-crisis periods. Third, tax design should also address matters of *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.

Apart from those three principles, fourth, any country authority would be interested in a buoyant tax structure that has a built-in ability to be revenue productive during both affluent years through the income tax and during deflation through a VAT or GST. Fifth, 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 likely to be. Sixth, simplicity and the associated ease of taxpayer compliance have increasingly come to be recognised as an important tenet of tax design. Seventh, a tax administration's transparency, incorruptibility and impartial application of the law and administrative rules perhaps comprise the bulwark of the system's success. Eighth, a tax structure should not obviate the stability in business decision-making that is essential for production, supply and growth.

Conflicts among principles: These principles could conflict and reform outcomes could become anomalous. An inefficient tax that raises revenue in the short run could impinge on economic growth and thus lead to revenue stagnation in the medium term. Indulgence in taxing capital gains appropriately would lead to inequity across income sources; yet adverse tax treatment of capital income could slow down capital accumulation and economic growth. It is this fear that had led to a long period of accommodation to the taxation of returns to capital of multi-national companies (MNC's) even as tax administrations perceived MNC's as organising tax matters to minimise tax payments globally through complex tax avoidance. A well-worn method to stem both sides of the problem - tax depletion and double taxation - has been the painstakingly slow process for concluding double taxation avoidance agreements (DTAA's). In the extreme case, a tax administration could also attempt to stem it through retrospective taxation.

Illustration by Ajay Mohanty

Peculiarity of tax reform: How often, how far, and across what expanse of geographical reach can tax reform be said to have achieved congruity? Little. First, any survey of the economics or legal literature reveals that the term itself has been variously used by researchers and authors. Economists tend to emphasise the efficiency criterion, disliking a structure that has many tax incentives. Some economists believe that a structure that uses taxation to achieve equity over and above expenditure policies is a poor one. Legal experts tend to focus on the sharpness or clarity of law though, if the law is unclear, they make imaginative interpretation of the law, to be resolved by the judiciary. Yet, a tax administrator's best tax structure is the most revenue productive. It is almost as if there is a glass wall between the tax economist and the legal expert and, again, between the tax economist and the administrator. Differences between a legal expert and a tax administrator in the interpretation of the law also emerge, reflecting fundamental differences in professional perceptions. Bridging these gaps remains a crucial challenge.
Despite such differences, even when "reform" occurs, empirical evidence suggests that, after about five years, country authorities face new challenges to the edifice that begins to crack. First, those who were 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, lowered VAT rates for individual commodity classifications and so on. Thus, those who complain rightly about difficulty in tax compliance, nevertheless seem perennially hungry for tax incentives.

Second, 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 stamp on public policy including, or in particular, tax policy. Relatedly, third, the term "tax reform" probably possesses little clarity in the interpretation of the second word in modern professional usage. Any change is termed reform and successive governments attempt to rapidly change what their predecessors have introduced. Thus, by mere definition and consistency check, these changes can hardly be called reform which should be defined as "change to improve". In some cases, administrations have set up full and comprehensive departments for "change", rendering a rather amusing interpretation that tax policy or tax administration reform may never achieve a stable equilibrium. Fourth, with the increasing global reach and internationalisation of taxation, a country's tax structure gets affected by multilateral movements in international taxation as well as by changes in political or trading blocs. Thus, exogenous shocks from abroad can make the life of a block of domestically initiated tax reform short-lived.

Risk versus uncertainty: I treat the eighth principle — stability in business decisions — separately reflecting its recently emerging importance. An investor invests, or not, reflecting his aversion, neutrality or preference for risk. He calculates the risk in investing based on market environment, existing tax structure and his attitude towards risk. But uncertainty removes this business model. If his investment decision is made in time t, and government changes tax law in time t+2 retrospectively going back to time t-5, the basis of that investment crumbles and uncertainty is created. Yet certain tax jurisdictions have tended to use this legal device to capture revenue already lost. Retrospectivity is, therefore, an unwarranted principle.

Note however, that non-taxation of indirect transfers is not sacrosanct in itself. Safeguarding indirect transfers from taxation is a legal myth and, perhaps, the difficulty or impracticality of taxing them places their non-taxability in the law itself. Ideally, however, indirect transfers should be taxable, though not retrospectively. Any new DTC should embrace this aspect and, in the final analysis, ask, have all eight principles of taxation been addressed?

To be continued