

## **Making and Breaking Tax Systems**

### **Geary Lecture 2012**

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The fiscal history of a people is above all an essential part of its general history. An enormous influence on the fate of nations emanates from the economic bleeding which the needs of the state necessitates, and from the use to which the results are put.

Joseph Schumpeter, “The Crisis of the Tax State”, 1917/18, page 100

#### I INTRODUCTION

The above quote is from an article by Schumpeter which is often thought of as one of the founding articles in the field of fiscal sociology. I am fairly certain that many economists, even those who work in the field of public finance, have not engaged very much with the issues that Schumpeter raises here. It is worth bearing in mind he wrote the words above in an era when it was common for governments of the most prosperous countries to raise around 10 per cent of GDP in taxes. Even then, the question that pre-occupied Schumpeter was whether and how revenues on that scale were sustainable. This requires a proper appreciation of the economic, social and political forces that make tax raising possible.

\* I am grateful to Torsten Persson for many discussions on the topic of this lecture which draws heavily on our joint research. However, he is not to blame for some of the more speculative comments.

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If we fast forward to the end of the century, levels of taxation in the developed world had typically risen four-fold expressed as a share of national income. But this seems to be acknowledged with little comment in mainstream public economics.<sup>1</sup> When I studied public finance as a student a quarter of century ago, it was largely taken for granted. The main focus at the time was how to use tax raising powers in an “optimal way” rather than a concern about what made such taxes feasible in the first place.

Economics is full of unacknowledged assumptions. Another example is how textbooks frequently characterise the ideal of a “laissez faire” market economy where, in fact, governments are needed to play an extensive role in enforcing contracts and property rights. A quick look around the world today and at historical experience reveals that this is a pretty demanding assumption to begin with. As in the case of taxation, understanding it requires exploring both the technical capacity of governments and its motives. In such cases, the risk is that what becomes the focus of economic analysis can look second order compared to the more dramatic variations revealed by history and global comparisons.

In these and other contexts, I am reminded of the well-known quote from Mark Twain:

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.

There are good reasons to think that this quote should be on every policy-maker's door, particularly any policymaker who lived through the recent economic crisis. But there is also no harm in having economists engage in a bit of soul-searching on that basis too.

What is all too comfortable in economics is to focus on small variations in outcomes and experience in the belief that there is a natural state which is pretty good and to which we will return in short order. And, of course, most of the time, events seem to confirm that. But there are two reasons to step out of the comfort zone. The first is historical, realising that many of the things that we study are comparatively recent. So the wider historical experience is frequently dismissed as irrelevant in modern times. The other is that many economists inhabit the hermetically sealed world of functional and well-performing economies, forgetting the experience and lessons from the developing world where poverty is entrenched by social, economic and political forces. Thus, most public finance economists study economies where there is

<sup>1</sup> Although, to be fair, why and how governments grow has been a staple issue in the public choice literature – see, for example, Holsey and Borcharding (1997).

only a small range of variation. The question is how far this could lead them to be making assumptions about things that “just ain’t so”.

Here, I want to unpack some of the unwritten assumptions in discussions about the design of tax systems. These mainly concern social and political forces that underpin such systems. However, it also means giving greater prominence than economists often give to the role of enforcement and compliance. I will begin the paper with a look at some facts which provide a useful backdrop and which are taken from a recent article on taxation and development prepared for the new volume of the *Handbook of Public Economics* written jointly with Torsten Persson (Besley and Persson, 2013).

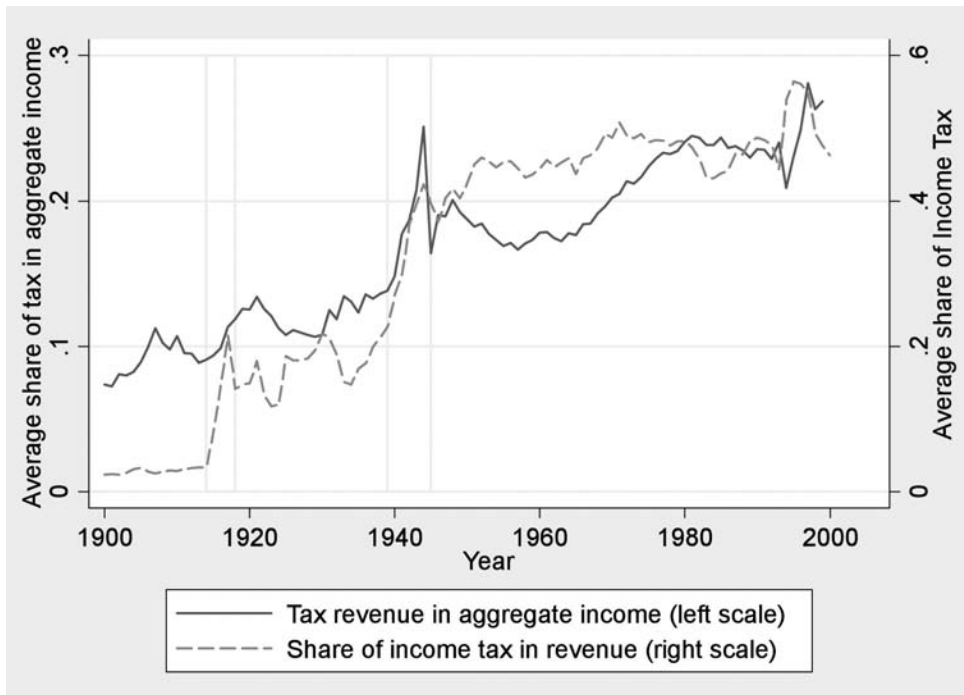
When historians look back at the twentieth century I suspect that a major theme will be the remarkable transformation of the role of the state. The significant increase in public revenues referred to above reflects a broad acceptance that the state needs high levels of resources to support its spending plans. During this period government has gone from a preoccupation with spending on infrastructure and defence towards creating welfare states, building transfer, social insurance, education and health systems.

Figure 1 illustrates this using data for the twentieth century from Mitchell (2007a, b, c). It takes a sample of 18 countries for which we believe that there are broadly comparable tax data for the twentieth century. The countries in this sample are Argentina, Australia, Brazil, Canada, Chile, Colombia, Denmark, Finland, Ireland, Japan, Mexico, Netherlands, New Zealand, Norway, Sweden, Switzerland, United Kingdom, and the United States. The solid line in the figure illustrates how the average tax take has increased over time from around 10 per cent in national income to around 25 per cent in the sample as a whole which combines a range of high and middle income countries.

Equally striking in Figure 1 is the increased reliance on income taxation which is illustrated by the dotted line. Income taxation made up about 5 per cent of revenues in 1900 but about 50 per cent by the end of the last century. There were particularly sharp increases in the income tax share during the two world wars. Moreover, there appears to have been a “ratchet effect” with these shares remaining high even after the conflict ended. This is consistent with a view, developed below, that this development was driven by investments in fiscal capacity that remained in place after conflict ended. A case in point is the introduction and wider use of income tax withholding from the pay packets of employees.

Data like those in Figure 1 provide a natural platform for thinking about the future. The question of how governments raise sufficient revenues to support their spending ambitions is important when governments around the world are raising such significant amounts of debt. While a lot of this stress is

Figure 1: *Evolution of Tax Revenue and Income Tax for a Sample of Eighteen Countries*



due to the post-2008 downturn, it brings into sharp relief some of the longer-term spending challenges which governments face as populations age and as countries compete to attract mobile firms and individuals. And that is assuming that the political and social forces that fostered the creation of the modern fiscal state stay in place.

Another important background issue concerns the prospects for building the European Union as a fiscal state. At present sovereign tax raising power resides with member states and has created challenges in trying to resolve fiscal crises in the Eurozone. Understanding the forces that have shaped the emergence of tax raising power throughout history serves as a useful backdrop to these debates.

The rest of this paper is organised as follows. The next step is to discuss the background facts in a little more detail. I then introduce the idea of investments in fiscal capacity as a means of understanding this drawing on my recent work with Torsten Persson. I will then look at challenges for the future suggested by the approach. Finally, I will offer some concluding comments.

## II MAKING TAX SYSTEMS I: SOME STYLISTED FISCAL FACTS

In this section, I review a few further background facts developed in Besley and Persson (2013) and Besley, Ilzetzki and Persson (2013). I present these in the form of five core fiscal facts illustrated by both time-series and cross-section data. These facts tee up the discussion that follows and provide a framework for thinking about what might be going on behind the scenes.

*Fiscal Fact I: Rich countries collect a much larger share of their income in taxes than do poor countries.*

This is illustrated in Figure 2 where the left panel plots the overall tax take as a share of GDP from Baunsgaard and Keen (2005) against the log of GDP per capita from the Penn World Tables, both measured around the year 2000, and distinguishes observations by income.<sup>2</sup> The right-hand panel looks at the same relationship instead using the time-series data on our sample of 18 countries from Mitchell (2007a, b, c) to plot five-year averages of the tax share over the twentieth century against national income from Maddison's data,<sup>3</sup> and distinguishing observations by time period. The cross-section and time-series patterns look very similar although there is a wide variation in country experiences. Higher-income countries raise more in tax revenue than poorer countries. Furthermore, the tax share in GDP of today's developing countries does not look very different from the tax take 100 years ago in those that are now developed.

Below, I will argue that there are economic, political and social determinants of these profound changes.

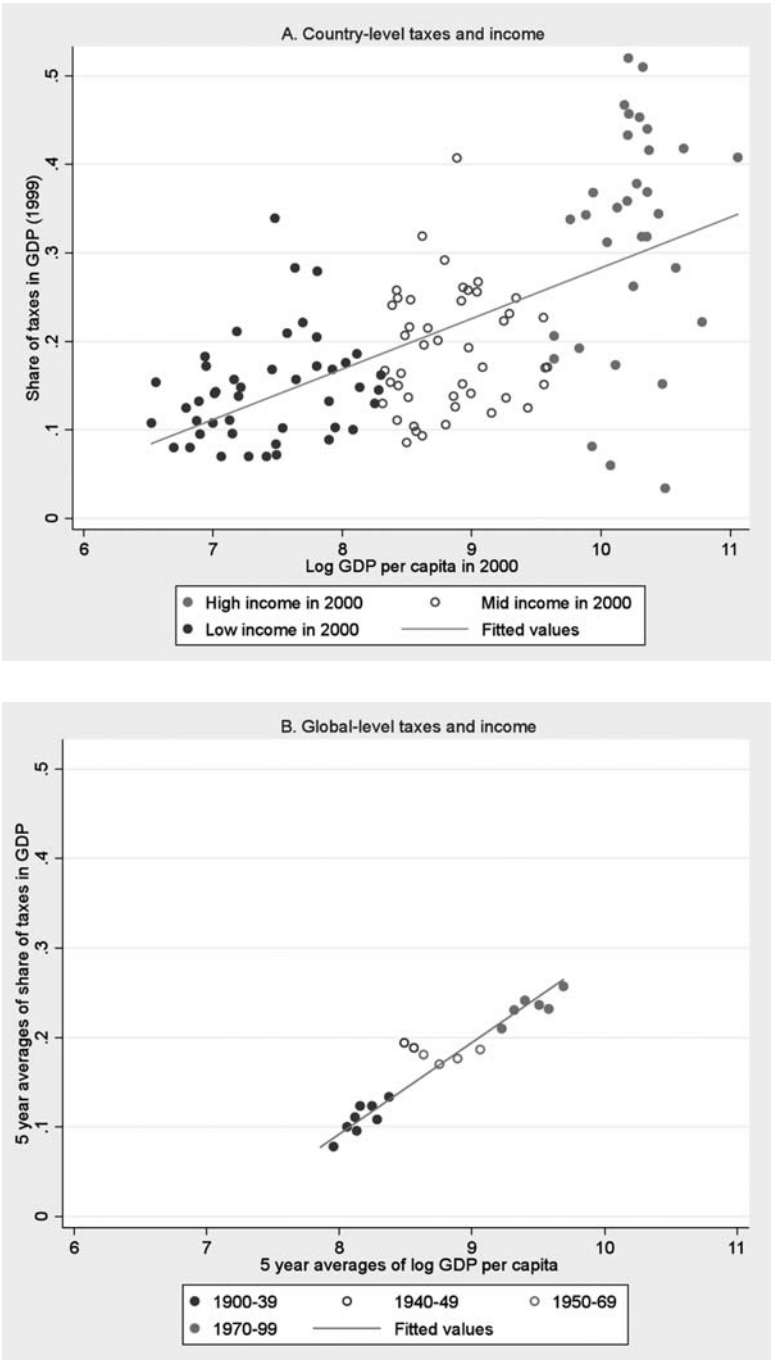
*Fiscal Fact II: Rich countries rely to a much larger extent on income taxes as opposed to trade taxes than do poor countries.*

When it comes to tax administration, trade taxes and income taxes constitute two polar cases. Collecting trade taxes only requires being able to observe trade flows at major shipping ports. Although such taxes may encourage smuggling, detecting and collecting revenue owed is a much easier proposition than collecting income taxes. The latter requires major investments in enforcement and compliance structures throughout the entire economy. One way of looking at the capacity of a tax system is, therefore, to look at the balance of trade and income taxes holding total tax revenue constant.

<sup>2</sup> We divide countries into three equal sized groups based on their GDP per capita in 2000 according to Penn World Tables 6.3.

<sup>3</sup> <http://www.ggd.net/maddison/maddison-project/home.htm>

Figure 2



This is illustrated in Figure 3 which, like the earlier Figure, reports the cross-sectional pattern for the year 2000, based on Baunsgaard and Keen (2005) in addition to the time-series pattern for last 100 years based on historical data for 18 countries from Mitchell (2007a, b, c). The income-tax share is displayed on the vertical axis, and the trade-tax share on the horizontal axis. There is a pronounced negative correlation so that countries that rely more on income seem to rely less on trade taxes. The left panel also illustrates a clear-cut pattern by income with high-income countries depending more on income taxes. In middle-income and, more especially, low-income countries there is greater dependence on trade taxes. The right-hand panel of Figure 3 shows that this move from trade towards income taxes is also seen in the historical development of tax systems as countries develop. The cross-sectional and time-series patterns therefore paint a similar picture.

*Fiscal Fact III: High-tax countries rely to a much larger extent on income taxes compared to low-tax countries.*

We focus on this fact in Figure 4 which plots the relationship between the share of income taxes in total taxes and income per capita, in the current cross sectional data for 2000 as well as the historical time series for our sample of 18 countries. The left-hand panel uses three groups of countries by tax take: countries that raise more than 25 per cent of taxes in GDP, countries that raise 15-25 per cent of taxes in GDP, and countries that raise less than 15 per cent. The countries in the high-tax group look different since they raise a significantly higher portion of their tax revenues in the form of income taxes. The right-hand panel also separates the observations by time period. Once again, this shows that the historical trend in this sample of older nations and the pattern across the world more recently look rather similar.

This fact is interesting as it makes us think about the forces that allow the growth of income taxes in the economy given that income taxes, along with VAT, now do so much of the heavy-lifting in funding government spending.

*Fiscal Fact IV: Differences in tax take are primarily due to the breadth of the tax base and compliance rather than statutory tax rates.*

Another indicator of the government's power to tax can be gauged from the relationship between statutory tax rates and the actual tax take. Governments with a more effective tax machinery will be able to raise higher revenues from a similar tax structure. Figure 5 presents the evidence by plotting the top statutory income tax rates in the 1990s for a sample of 67-countries in Gordon and Lee (2005) against the share of income taxes in

Figure 3

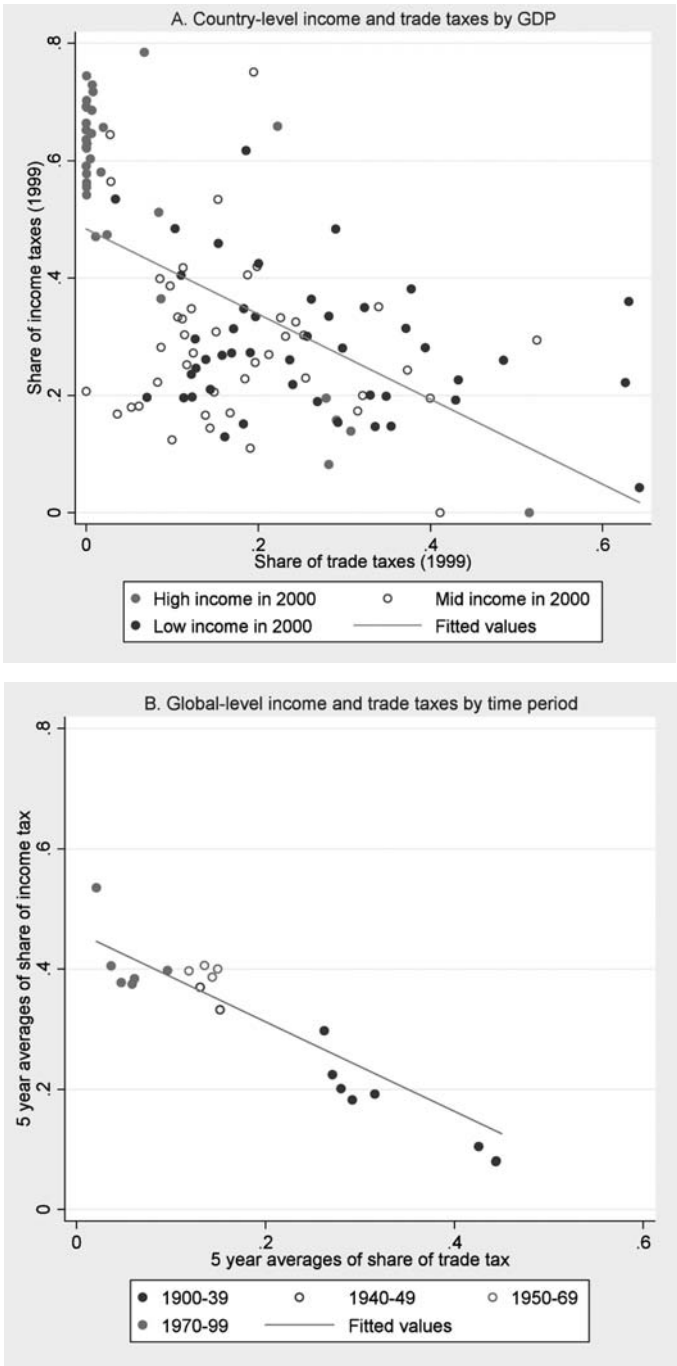
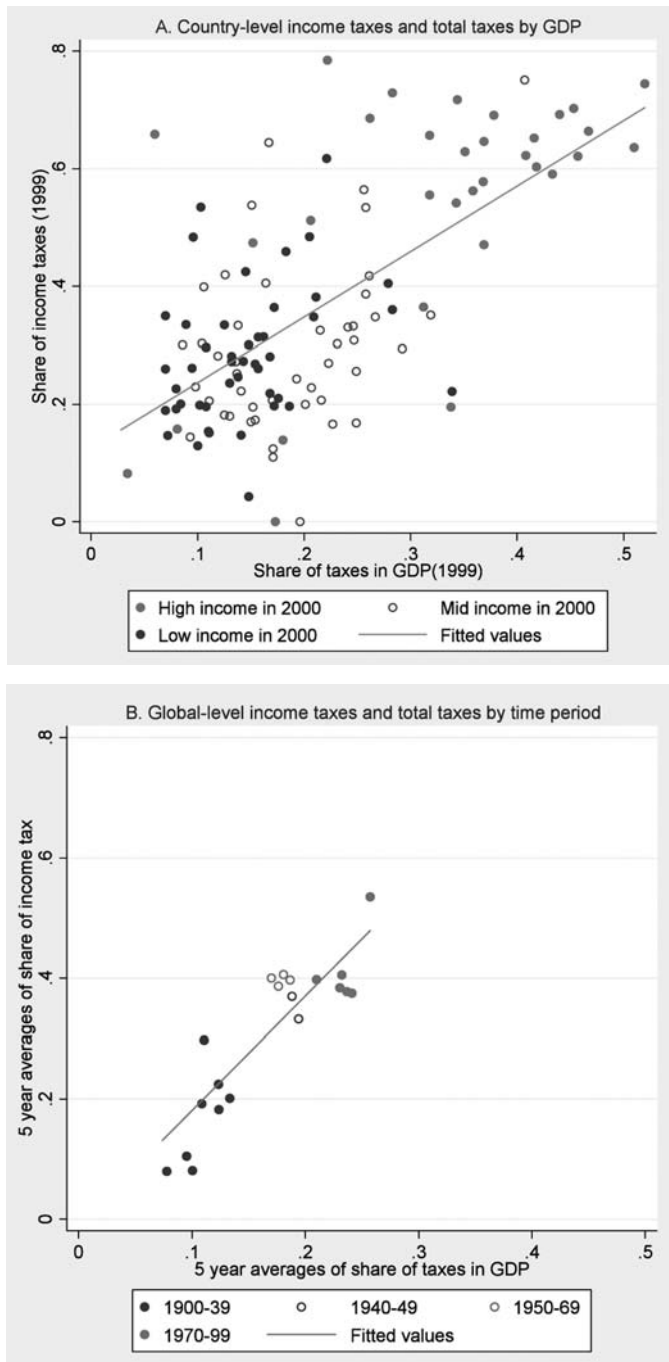


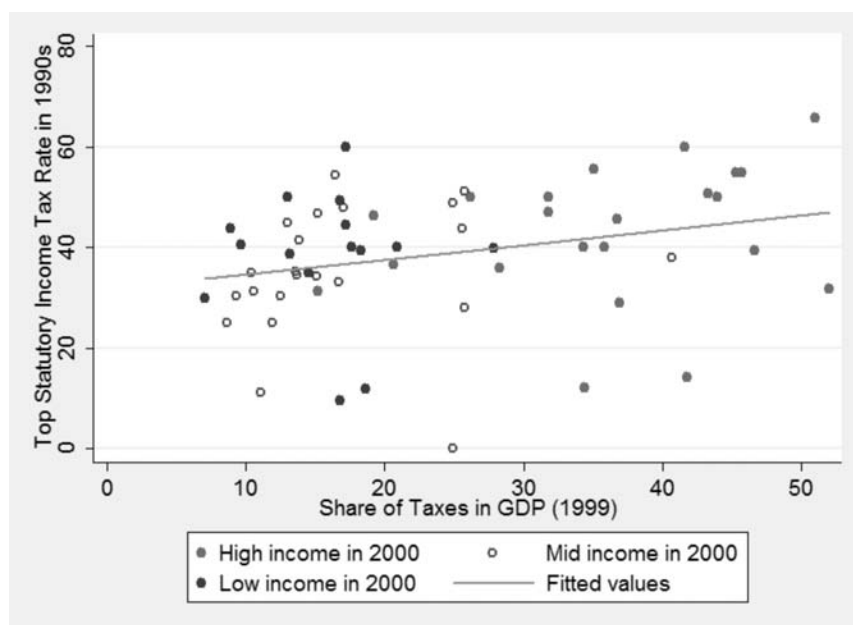


Figure 4



GDP from Baunsgaard and Keen (2005). Figure 5 shows that the distribution of the top statutory rate is about the same amongst high-income and low-income countries. The figure does not directly take coverage and progressivity into account. However, the fact that high-income countries raise much more income-tax revenue than low-income countries suggests that it is the narrowness of the tax base in low-income countries which lies behind this. Thus the growth in the breadth of the base and the compliance measures needed for this is a key focus on understanding changes in the tax system.

Figure 5



*Fiscal Fact V: Countries with strong executive constraints collect higher tax revenues, when income per capita is held constant, than do countries with weak executive constraints.*

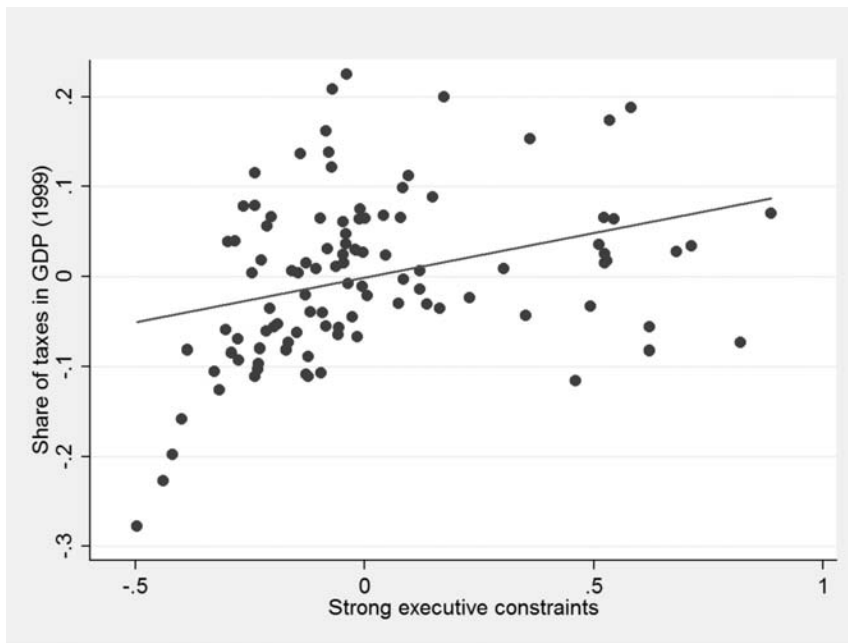
We now turn to politics and its link to tax collection. In particular, we will relate it to the strength of political institutions. The latter is measured by an indicator of the strength of executive constraints from the well-known Polity IV data base.<sup>4</sup> We use the highest value of this variable as coded in the data

<sup>4</sup> See Marshall, Gurr and Jagers (2010).

to measure the proportion of years since independence (or since 1800 if independence is earlier) that a country had strong constraints on the executive.<sup>5</sup> Executive constraints are frequently used as way of capturing how much executive authority requires consent from other institutions such as a legislature.

Figure 6 plots a partial correlation between tax revenues and constraints while controlling for current income and shows a clear positive correlation between this measure of political institutions and fiscal capacity, controlling for the level of economic development.<sup>6</sup> The interpretation of this will be discussed further below when I look at hypotheses for why the size of the tax take grew during the twentieth century.

Figure 6: *Partial Correlation of Executive Constraints and Fiscal Capacity*



<sup>5</sup> We use the variable *xconst* which varies between 1 and 7 with a value of 7 being the highest level of executive constraints.

<sup>6</sup> Specifically, we run a regression of each variable on GDP per capita and then plot the residuals of these two regressions against each other.

### III MAKING TAX SYSTEMS II: UNDERSTANDING STATE CAPACITY

The facts that we have discussed lead naturally to the question of why things changed so dramatically over the twentieth century and across the nations of the world. Of course, there is no simple answer. There is a web of interdependent causality linking an array of factors which are hard to disentangle both theoretically and empirically. There is probably enough here for a lifetime of research rather than a single paper.

My more modest aim in this section is to suggest a framework for thinking about some of these issues. The aim is to strip away a lot of the complexity and to highlight some factors that are likely to be important with a view to providing some building blocks for our thinking. It will be organised around the core concept of investments in fiscal capacity. Besley and Persson (2009, 2011, 2013) use the term “fiscal capacity” to capture the consequences of an array of investments in the state that made such increases on taxation feasible. They argue that many of the trends described above can be thought of as being the result of purposeful investments to increase the ability to raise tax revenues through establishing better record keeping, monitoring and compliance. This is particularly evident, for example, in the case of income taxes.

In what follows, I will offer a stylised account of their framework which emphasises the role of economics, politics and social forces in shaping such investments.

#### 3.1 *Economics*

Many developments in the economy change the ability of the state to tax. The standard economic approach to taxation and economic development focuses on how economic change influences the evolution of the tax system. A central role in this is structural change which lowers the cost of raising taxes and extends the range of taxation. Chief among these is a widening role of the formal market economy. A vast amount of the tax that is transmitted to government in the modern state is from larger formal-sector firms. This would be true, for example, for both the personal income tax and VAT. The problem of informality in developing countries is very similar to the compliance issues that arise with self-employment in developed economies. For the latter, it is notoriously difficult to observe flows of income and expenditures. However, self-employment tends to be relatively less important than formal employment by a firm in modern economies.

Two other related developments in the economy facilitate taxation.<sup>7</sup> The first is the need for businesses to use transparent accounting procedures. This

<sup>7</sup> See Gordon and Li (2009) and Kleven *et al.* (2009).

is often a by-product of raising outside capital where lenders and/or shareholders demand accurate assessments of the financial position of firms. This creates a framework for transparent statement of profits and losses for tax purposes including accurate measurement of the wage bill. Alongside this, the growth of financial transactions through the payment system facilitates greater monitoring compared to cash transactions which are easier to keep outside of the tax net. Both of these suggest that there should be a strong correlation between the power to tax and the development of a modern financial sector. And there is a natural complementarity between the two given that common forms of record-keeping and monitoring are used.

This standard economic approach also studies the influence of the tax system on the economy. Well-designed tax systems can minimise the efficiency losses imposed by taxes and even raise the growth rate in endogenous-growth models. Tax revenues can be spent on market supporting and market augmenting public goods. Moreover, governments may have a stronger interest in building infrastructure when there is a dividend in the form of greater tax revenues.

Economic approaches to the growth of taxation have also dealt with the issues of administration and compliance directly.<sup>8</sup> A greater reliance on trade taxes (and seignorage) compared to income taxes that we noted above is a reflection of this. And governments tend to build more professionalised revenue services which facilitate auditing alongside developments in the economy. Moreover, these need to keep up with developments in evasion and avoidance “technologies” as new ways are found of hiding transactions or building tax “efficient” vehicles to reduce tax liabilities. This game of cat and mouse requires an eternally vigilant revenue service.

Even though revenues tend to rise with economic growth due to higher income and expenditure, the translation of economic growth into higher tax revenues is more than mechanical. Adopting broader tax bases for income and value added taxes, is only feasible if growth is accompanied by investments in compliance. Understanding why this is the case requires a focus on the incentives of government to build tax systems.

### 3.2 *Politics*

The political economy dimension is also important in understanding motives to raise tax revenues. There are large differences in political institutions across countries and there have been important developments over time. To illustrate this, Figure 7 looks at developments in institutions along two dimensions in the Polity IV data base for the sample of 18 countries

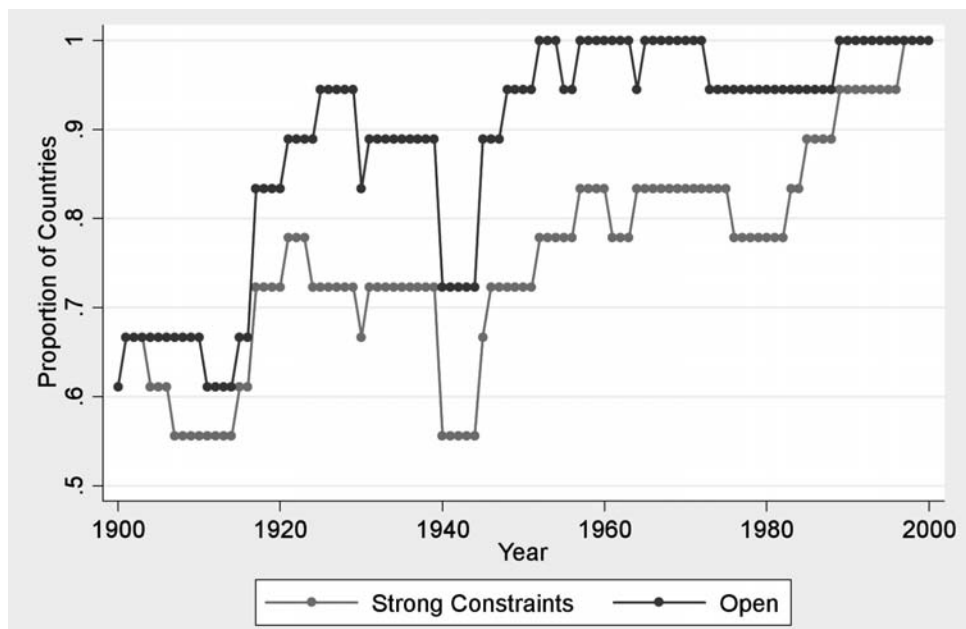
<sup>8</sup> See, for example, Slemrod and Yitzhaki (2002).

for which we have consistent tax data for the twentieth century. The first dimension is strong executive constraints in the data and the other is openness of executive recruitment.<sup>9</sup>

Figure 7 shows that there has been an increase in the fraction of countries that are classified as having open access to power and strong executive constraints over the century, albeit with a reversal during the second world war period. Of course this correlation with increased tax raising over the period is not proof of causation. But it is important to bear in mind that two things are going on side-by-side. Over the whole time period, having strong executive constraints is less prevalent than high openness although by the end of the twentieth century all countries in this sample had strong executive constraints and openness of executive recruitment.

The use of these two measures reflects the fact that political institutions play two key roles. First, they regulate access to power – deciding who governs and on what terms. Our measure of openness of executive recruitment tries to get at this. The growth of electoral democracy creates a greater role for electoral motives which may widen the incentive for politicians to appeal to the mass electorate by offering more public services. Taxation needs to be

Figure 7: *Strong Executive Constraints and Openness*



<sup>9</sup> Specifically, in terms of the Polity IV database, I use xconst=7 to indicate strong executive constraints and xopen=4 to indicate openness.

raised to support these ambitions. Second, political institutions shape how power is used once it is acquired. The growth of executive constraints over time has made it more and more difficult for incumbents to wield power unchecked. This encourages adopting spending programmes which have wide benefits and this complements the electoral motive mentioned above.

So, at least, in theory, there are reasons to expect the process of widening access to and constraining power to lead to greater demands on the state and to encourage an increase in fiscal capacity all else equal (see Besley and Persson, 2009, for a model). This can be seen by thinking of an incumbent government that is contemplating making investments that will have a sustained effect on the fiscal capacity of an economy. Greater constraints on executive power should make it more likely that these future tax revenues will be used for common purposes and Besley and Persson (2009) and Besley, Persson and Ilzetzki (2013) show in different ways that there is a robust positive correlation between executive constraints and the level of taxation in both cross-section and time-series data. Openness is more ambiguous since greater openness could create political instability which can shorten the time horizons of incumbents. The empirical pattern is less clear-cut in respect of this factor.

Although not necessarily measured by Polity IV's notion of executive constraints, a key part of the political economy of taxation and in creating the preconditions for investment in fiscal capacity is improving the scrutiny of how tax proceeds are used. In theory, this should help to increase efficiency by reducing waste as well as reducing corruption. Polities that have strong media and open government should achieve more reassurance that the proceeds of taxation are being well-used and this should provide a further boost to the motives for investing in fiscal capacity.

The political economy approach emphasises that tax compliance is more than a technical issue. It also chimes well with historical accounts of the growth in fiscal capacity such as Brewer (1989); Bonney (1999); Dincecco (2011) and O'Brien (2001). Dincecco (2011) emphasises that a key step towards building fiscal capacity has been by building more centralised fiscal power alongside centralised political power, the history of France being an important example. The history of the US also largely supports an increasing role for federal over more localised forms of fiscal capacity by states and municipalities. And this is what theoretical considerations suggest would give the strongest incentives to build fiscal capacity. One issue is that more decentralised fiscal systems create incentives for the tax base to migrate across jurisdictions. This is combatted by sending fiscal authority to the centre. By and large, we now see developed economies dominated by nation states with centralised tax setting authority.

Political scientists and sociologists sometimes push the role of taxation in development even further, by arguing that taxation can be a catalyst for political and economic change. The old American adage of “no taxation without representation” is a vivid instance of such thinking, whereby demands for transparency and representation are built as part of the need to build a strong fiscal state in a “fiscal contract” between the citizens and the state: see, in particular, Levi (1988). On this account, there would be a feedback from taxation to political reform with countries that have invested in fiscal capacity having a stronger incentive to strengthen political institutions.

### 3.3 *Common Interests*

In the background in this discussion is the question of the interests that citizens have in how the state is used. One question is whether the society is fractured in what it wants government to be used for or is there a strong sense of common interest.

Debates about role of war in supporting the growth of tax systems, such as in Tilly (1990), can be thought of in such terms. The need to fight an enemy becomes a way of recognising a common purpose for which revenue is needed. Throughout much of history, government spending was dominated by servicing military requirements. In more recent times, the role of war has been superseded by the introduction of broad-based programmes in welfare states. To the extent that these are used and valued by the vast majority of the population, they provide a basis for supporting high levels of taxation. This will be facilitated to the extent that there is a common view of priorities. This, of course, is reinforced by having political institutions that reinforce the promotion of these collective interests. But the preconditions need to be there.

Common interests could be fostered by a strong sense of national identity in nation states. Mythologies and realities created around wars and significant historical events can play a role in this as argued, for example, by Anderson (1991). To the extent that people feel bound by common ties, it should be easier to implement social programmes that involve some element of redistribution. Common norms of fairness and distribution may also play a role in supporting greater acceptance of state programmes. Alesina and Glaser (2006) argue that this could explain why the US has not adopted a European-style welfare state.

The flip side of this is the possibility that polarised societies are likely to find it harder to achieve such common purpose. Such polarisation can have its roots in ethnic, religious and/or class differences. Besley and Persson (2011) find consistent evidence that the level of fiscal capacity is negatively correlated with country-level measures of ethnic polarisation in a cross-section



of countries. In addition to making it more difficult to gain acceptance for universal programmes, such societies may also have stronger social capital making it easier to provide public goods via social networks. In such cases, public goods provision through the state will be of lesser interest. Reflecting this, Esping-Andersen (1999) has argued that countries with strong family ties invest less in a welfare state.

### 3.4 *Social Norms*

As well as influencing the way that the state is used social forces can also be important in affecting tax compliance. There is now an extensive literature, reviewed in Torgler (2007), which looks at the economics of “tax morale”, in particular the social and psychological forces that facilitate tax compliance. Early efforts to model compliance looked predominantly at the trade-off that would arise in a game of cat and mouse between tax authorities and citizens based on the probability of being caught for non-compliance. This led to a focus on information flows and detection technologies. However, acts of compliance often look voluntary relative to such detection probabilities.

This literature suggests a role for social norms in creating a culture of compliance. Quite where these come from is, however, open to debate. One view is to consider them strategically as part of a wider social contract. So citizens pay their taxes so long as the state is spending on some pre-agreed set of purposes. Non-compliance becomes a form of protest. One example of this in the UK was the fiscal anarchy unleashed by the Thatcher government when it tried to replace rates with a poll tax as a means of funding local government. An otherwise broadly compliant population undermined the system by refusing to pay in larger numbers. But another interpretation of compliance norms sees them as part of a socialisation process in which paying taxes becomes a reflex as natural as blinking. Such views have to entertain the possibility that preferences are shaped by social forces so that people would rather comply than not, even when they could gamble on not being caught.

Either way, the idea that there is a framework of norms which support tax systems is attractive and maintaining such norms is certainly a challenge for the future of tax systems as I will discuss further below.

### 3.5 *Common Interest States*

Putting this discussion together, we now have a way of thinking about the collection of countries which over the twentieth century grew their fiscal capacities. The approach that I have sketched suggests that this is the product of investments in fiscal capacity which are the combined product of political change, creating universal spending programmes based on common interests, social norms to support compliance and promoting economic development.

This has resulted in levels of fiscal capacity of 40 per cent of national income or even higher. The emergence of these states relies on keeping rent-seeking and corruption at a low enough level and recognising the virtues of universalistic public programmes underpinned by broad-based political coalitions. Taxes that support such spending are typically broad-based and progressive and supported by strong norms of compliance as well as formal monitoring.

Besley and Persson (2011) refer to such states as *common interest states*. Of course, this description is just an “ideal type” and there is considerable variation in the exact organisation of the state and the institutions that support high investment in fiscal capacity. Each country has its own unique history and circumstances that would defy any simple and stylised characterisation and there is variation in the outcomes. For example, the USA has not made a commitment to publicly-funded universal health care nor does it have VAT which makes it rather unusual among developed economies. But on a global scale, it is still a fairly high tax country with a state that performs a wide range of functions.

It is tempting to view common-interest states as the terminal product in an evolutionary process to which the whole world will eventually converge. But it would be bold indeed to make such a claim. There seems at present little pressure for fundamental change among the countries that have trodden this path even though all are grappling with challenges that such states bring. And a country like Greece is displaying particular signs of fragility. However, arguably it was deficient prior to the crisis in developing the norms of tax compliance needed to support a common-interest state and that many of the activities of the state were carried out in pursuit of adding the rather narrow interests of public sector employees.

### 3.6 *Summary*

I have argued that we can explain the fiscal facts that we presented above in terms of a model of incentives to invest in fiscal capacity building. Alongside developments in the economy, this includes changing political institutions and societal change which supports compliance norms and common-interest preferences. Significant events such as the world wars reinforced this pattern and may well have had a “ratchet effect” in fiscal capacity building. These developments explain why the world’s richest economies moved from raising only around 10 per cent of national income in taxes to around 40 per cent over a period of one hundred years. Moreover, other developments in the role of government contributed to the prosperity that accompanied such moves.

It is reasonable to argue that the forces that we have identified are well-entrenched. However, in terms of human history, the developments that I have highlighted are extremely recent – the blink of an eye in human history. For the remainder of the paper, I will highlight some of the contemporary and future challenges that have a bearing on the sustainability of fiscal capacity. The framework that I have discussed so far provides a useful lens through which to view them.

#### IV BREAKING TAX SYSTEMS? CHALLENGES FOR THE FUTURE

The canonical model of the fiscal state and its capacity to tax is based on a closed economy with centralised tax raising power. The first challenge I will discuss arises because of the international context, particularly a world of increasing market integration. Developments in the European Union bring this issue into sharp relief. Both labour and capital are now mobile raising the spectre of increasing erosion of fiscal capacity due to tax competition. Ireland's favourable tax regime for business has long been a sore point among countries in Europe who see it as part of a race to the bottom.<sup>10</sup> But so far most countries are resisting trying to match this policy. The core assumption of traditional tax competition models has been that capital, but not labour, is a mobile factor. But there have been significant increases in labour mobility in recent years. The fact that France went out on a limb in its efforts to tax the very rich further highlights the issues around human capital mobility. The difficulty of integrating VAT tax systems with different bases and rate structures is also a long-standing issue. The goal of market integration in Europe seems to push ever more strongly towards an argument for tax harmonisation.

Issues are also arising with the importance of global businesses many of whose assets are intellectual property, the returns to which can easily be transferred to low tax jurisdictions. Tax havens have facilitated this and make it feasible for many corporations to lower their tax bills significantly compared to what they would pay were they forced to declare their profits in a single jurisdiction. There are those who defend this, not least because it acts as a form of fiscal “fire break” on some kinds of potential misbehaviour by governments. However, there is little doubt that it is also eroding the fiscal capacity of governments.

A second challenge in Europe comes from the experience of monetary integration among a sub-set of the economies in the European Union. This

<sup>10</sup> Ireland is not alone with Luxemburg and the Netherlands also in the mix on this.

Eurozone monetary integration proceeded ahead of any kind of fiscal integration and banking union whose costs have been keenly felt throughout the recent crisis. More and more pressure has been placed on the European Central Bank to solve the fiscal problems of Eurozone members. The growth and stability pact looks in retrospect like a politically expedient device for bringing about monetary union rather than as a credible institution for fiscal restraint. And, of course, the Eurozone has no independent fiscal capacity.

Both of these last two issues are examples of situations where inter-jurisdictional externalities are exacerbated by the absence of tax raising authority and coordination above the level of the nation state. But almost all of the most important political developments in institutions that we highlighted above are national level changes. To create supra-national fiscal authority would require political development at that level. In the US, political integration *preceded* building a federal fiscal state and the Fed was only created once it was clear that economic integration required greater coordination in banking policy. However, the political framework at a federal level existed from the start. By doing this up front, there was no need to create the political institutions once it was clear who the gainers and losers would be from particular policies that would follow from this. There is a potential advantage to ambiguity in this regard. The problem in Europe at the moment is that there are large inequalities across economies and big differences in the fiscal starting points. Policy positions of particular member states are likely to be heavily influenced by this. The natural thought-experiment would be to think what institutions might be created behind some kind of “veil of ignorance”. But that is not likely to be a very good predictive model of how negotiations proceed especially when national politicians are accountable to their domestic constituencies.

To mirror the kinds of development that we saw historically among nation states, there would be a need to build a constitution with direct powers disciplined by strong executive constraints and open competition for executive power. This would have to break the link with national political power. However, at present political authority in the European Union continues to reside almost exclusively with the national governments of member states. To parallel the history of nations would require a very significant change in this trajectory. In the first instance, it would require EU member states to voluntarily grant tax raising powers to the European Union. Past examples of fiscal centralisation such as in early modern France or the United States required a strong centre with legitimacy to override objections from those with local fiscal capacity. There seems little prospect of that happening in the case of the European Union: there would be a number of governments who would strongly resist increasing the fiscal capacity of the European Union.

Another lesson of the framework that I have sketched is that even having the right institutions works better when there is a strong sense of common interest in the relevant jurisdiction. The EU does not have responsibility for any kind of broad-based spending programme. However, the single-market project is arguably a major common-interest undertaking. One policy which the EU has had a lot of influence over is the determination of agricultural subsidies. But this constitutes a narrow redistributive programme which benefits a specific well-defined group of economies and individuals most. It is hardly a good starting point for building a common-interest European state.

So looking at the prospects for creating fiscal capacity at the EU level, the current position is not propitious. Attempting to create a market with free mobility undermines national fiscal capacity without there being any serious institutional basis for centralising revenue authority.

Returning to developments within nation states, there are a number of looming challenges in entitlement programmes, particularly those, such as pension programmes, which have unfunded future liabilities. Pension programmes which promise future benefits find it easy to create a sense of common interest when they are initially introduced because current workers are promised future benefits and those currently old benefit immediately. But an ageing population in mature programmes can create much more of a redistributive tension between the young and the old. This has been brought to the fore in some of the recent discussions about fiscal austerity and the debate about how to contain the cost of pension entitlements. Long-term unemployment and sickness also make some these programmes look less like universalistic insurance programmes and more like transfer programmes. The latter rely less on self-interest and more on altruism for their sustainability. Some of these challenges may make it difficult to grow fiscal capacity further to deal with funding deficits.

Another challenge to maintaining fiscal capacity comes from its reliance on norms of compliance. A hard and fast distinction has been made in economics and law between tax avoidance and tax evasion with only the latter being outside the law. But when it comes to thinking about tax morale and its role in compliance, it is less clear-cut when assessing the harm that each of them does.

The UK has had a series of high profile cases affecting celebrities and corporations where taxes have been avoided using a series of measures that, while legal, raise issues about obligations of tax payers in the jurisdictions in which they reside. When individuals perceive that others are not complying with their taxes, this could encourage them to seek ways to reduce their own liability. And there are political implications to the extent that it calls into

question the fairness of systems of taxation. The options for tax avoidance are open only to a relatively small set of better-off taxpayers who can benefit from professional advice and hence undermine the idea of a common set of rules for taxation. Whether governments are able to get to grips on this is questionable. So far, most progress seems to come from efforts based on direct action by concerned groups of citizens. It certainly presents a challenge to fiscal authorities and poses a particular challenge to governments that wish to raise a larger share of taxes from the rich and/or corporations. One corollary of this may be a move towards even greater taxation of fixed assets like land and property.

Related to these developments, there are some interesting challenges around the possibility of increasing fiscal transparency. Governments often seem to rely on trying to raise taxes where the incidence is least clear – what has been called “stealth taxation” in the UK debate (see IFS (2011) for a discussion of this in a UK context). For example, the Blair government ended some tax reliefs on pensions the consequences of which were extremely hard to understand. On the one hand, it could be argued that efforts to raise taxes in non-transparent ways could make it easier to raise the taxes that are needed to fund government programmes that people want. So the net gain is positive. But one would be uneasy about having to live in a world where the public is permanently (and in some cases deliberately) confused; and there has to be a concern that eventually it will bring the whole tax system into disrepute.

Whether governments should, therefore, try to make it even clearer what taxes people are paying raises interesting policy issues. In an interesting field experiment Chetty *et al.* (2009) showed that whether sales taxes are included in the price or added at the till can affect responses to taxation. Some countries insist that their citizens file a tax return every year to be reminded of their income tax burden while others do not. These are more than administrative issues if they affect perceptions of the tax system and hence political debate and compliance.

Finally, there is the question of how far tax records or individuals and corporations should be private. Some countries have made it rather easy to observe tax records. And there is something attractive about this beyond the bald curiosity that it nourishes. In an interesting social experiment, Norway has been publishing all tax returns in the country on line since 2008. However, being able to observe the tax compliance behaviour of my friends, neighbours or enemies is not obviously conducive to greater compliance. Indeed, the opposite could be true if there is a race to the bottom. More generally, it is clear that modern information technology opens up these possibilities which raise interesting challenges for the future.

## V CONCLUDING COMMENTS

So finally I return to Mark Twain. I hope to have convinced you that it is worthwhile, if only for a few minutes, to think about the unwritten assumptions behind the high levels of taxation that emerged in the twentieth century. There are three core assumptions that modern tax systems are built on:

*Assumption 1:* The nation state will remain central to the creation and maintenance of fiscal capacity.

*Assumption 2:* Nation states will retain a sense of common purpose supporting broad-based tax, transfer and spending programmes. This will continue to be reinforced by cohesive political institutions which encourage wide political coalitions supporting a range of common interests.

*Assumption 3:* Social norms that support high levels of tax compliance will remain in place as citizens regard the system of taxation and spending to be broadly fair.

By making these explicit, I am not trying to convince you that these assumptions need to be questioned. However, we should acknowledge them and realise that making them unconscious when we debate tax policy even when we seem to be debating only second-order reforms and changes. If only some of the unwritten assumptions governing issues in banking and finance had been scrutinised in the early part of the century, there may have been some effort to push back on some developments. And one wonders how far that could have led to greater regulation at a time when this could have made a difference to developments after 2008. The experience of a country, like Canada, which avoided many of the excesses in the banking industry does suggest a role for anticipatory regulation.

In a nutshell, my main argument is that these assumptions are often made implicitly and yet their validity is highly contingent. The kind of tax analysis that economists undertake can help to reinforce their validity. For example, studying the redistributive consequences of tax systems gets to issues of fairness and hence can influence both political debate and norms. Understanding tax incidence and who really pays taxes is important for similar reasons. And promoting tax systems that are more efficient is also an important part of debates that shape the evolution of tax systems.

The key question for fiscal capacity is whether current levels can be sustained (or even expanded) and how this could be achieved. I sometimes wish that I could come back in 100, 500 or 1,000 years to see what kind of state exists then. Only then would it become apparent whether we are indeed

taking too much for granted by assuming that developments in the past century will be sustained. Will nation states see a continued rise in state capacity, a levelling off at current levels, or even perhaps a fall? Or will the current configuration of nation states follow the logic of economic integration in a single market place with increased political integration evolving to reflect this. Looking at the changing maps of Europe in the past 200 years provides an instant reminder of the fluidity and transience of political authority. Is there any reason to think that this will be different in future? Thinking about this requires interpreting previous developments in the forces that shape the creation of state capacity as we have done here.

While responding to much of this is mere conjecture, one thing is clear. The state is now such an important and powerful player in the economy that the fate of our descendants will surely hinge to a significant extent on how well it performs. And, the power to tax stands at the centre of this.

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