Vito Tanzi

Death of an Illusion?

Decline and Fall of High Tax Economies

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Introduction

This paper will consider and identify developments which affected taxation in Western industrial countries over the past century. It will explore the influence of supply and demand on tax levels, and the proportion of revenue raised. What was the interaction with public spending? How far were tax trends affected by the changing political, economic, social and cultural contexts of the time? The trends in, and factors governing, taxation will be considered from a longer-term perspective in four separate periods: before World War One; between World War One and around 1960; the four decades after 1960; and the 21st century. Though the distinction between the periods is not clear-cut and there is overlapping, nonetheless the separation of the periods allows some conclusions to emerge.

The study will also address the forces set to influence the future direction of tax and analyse the pressures both to increase revenue and to curtail or reform taxation. It will speculate on likely future developments, focusing on industrial countries where the current average level of taxation is around 40 per cent of gross domestic product. In particular, it will consider whether the trends to higher revenue and spending over the 20th century, which reflected different priorities, will give way to a different balance in the 21st. What factors might counter increased pressure (e.g., by demographic change) for higher levels of tax and spending? What trends have already emerged which may affect the supply of, and demand for, higher levels of tax in industrial countries?

Such an analysis will help to identify the forces governing levels and types of tax, the pressures for change and the factors most likely to make for future reform.

I

The 20th Century: From Laissez-Faire to Spend and Promise

Before World War One

In the first period, 19th century levels of tax and public spending were anchored in a culture of low taxation, where government's role was limited to fundamental activities such as financing public works and institutions, defence, protection of individuals and property, the financing of basic education and some assistance to the very poor.

This period is often characterised as one of 'laissez-faire' where the role of the state in the economy is limited and where taxation is low-level. The spirit of the time can be captured by the statements about taxation made contemporaneously by those with specialist knowledge of the subject including Paul Leroy-Beaulieu, a public financer and scholar with extensive knowledge of fiscal developments world-wide, whose views of taxation in the late 19th century continue to be of interest to economists. He considered tax levels of 5-6 per cent of national income as 'moderate;' those of 10-12 per cent as 'heavy'; and those above 12 per cent of national incomes as 'exorbitant' and clearly damaging to growth. In the US, economic thinking before the outbreak of the First World War reflected some of the same principles. In 1913, when the US Congress debated the introduction of an income tax that would be applied with a one per cent basic rate and a six per cent marginal rate on the part of income that exceeded half million US dollars at 1913 prices, the then Professor of Public Finance at Harvard University stated, at Congressional hearings, that these rates were 'clearly excessive'. When the US income tax was finally enacted, at one per cent basic rate and at a seven per cent marginal rate on the part of income over a half million dollars, the Chairman of the Ways and Means Committee in the US Congress declared that the tax 'would produce more money than the mind of man would ever conceive to spend' (See Tanzi, 1988, p. 99). The introduction of the income tax in 1913 required an amendment to the US Constitution.

Much of the statistical evidence indicates that in the period before World War One, the tax burdens of major countries were generally around 10-12 per cent of national income. In this period Colbert's[1] famous statement – that the art of taxation consists of so plucking the goose to obtain the largest amount of feathers with the minimum amount of hissing – was clearly a guiding principle. A hundred years ago the main taxes used were foreign trade taxes, property taxes based on cadastral values (that is values determined administratively and based on the physical characteristics of properties), presumptive taxes on some business activities or professions, and, occasionally, local poll taxes.

How could taxes be so low at that time? Didn't governments need more revenue to carry out their essential tasks? The answer is partly found in the roles that the *demand* for tax revenue and the *supply* of tax revenue played.

First, what factors mattered in shaping the demand for tax revenue? In general, governments that focused on the *fundamental* role of the state, as outlined in 1776 by Adam Smith in *The Wealth of Nations,* did not need a lot of money and would not, even today, need much money. The role was limited to the financing of public works and public institutions, the defence of the country, the protection of individuals and property, the financing of basic education and similar activities. These were all activities related to the allocation of resources. The government's role at that time did not include attempts at stabilising the economy or at redistributing income between different categories of individuals, across individuals at different income levels, or across generations. However, it did include some resources for assisting the very poor, a role long recognised by various governments and by Adam Smith. There were almost no 'social transfers' – government expenditures (in cash or in kind) that aimed to protect citizens against particular risks such as illnesses, old age, unemployment, invalidity, illiteracy and poverty. Such transfers did not exist or were very small until the second half of the last century – for welfare, unemployment compensation, pensions, health, housing subsidies and so on. These social transfers acquired some importance only in the 1930s, as Table 1 indicates, partly because of the Great Depression and partly reflecting changing attitudes about what the role of the state in the economy should be. In the period before World War One the main need for *higher* revenue came from occasional wars and (after the wars) from the need to service the public debt that had been accumulated during the wars.

One factor that would lead to demands for higher public spending, and thus higher taxes, was *universal suffrage.* In the United Kingdom, for example, the percentage of household heads who had voting rights rose from 4.2 in 1867 to 74.2 in 1911 and to higher levels later (See Lindert, p.191). As Lindert put it: 'There was so little social spending of any kind before the twentieth century primarily because political voice was so restricted' (Lindert, p.190). The Italian economist, De Viti De Marco, influential a century ago, had already worried that universal suffrage, in societies with uneven income distributions, would lead the poorer majority to demand policies that would exploit the richer few. The masses would legislate for programmes that would benefit them while the cost would be born by the rich (See De Viti De Marco, 1936). The Italian edition of this book was published in the late 19th century. Later this preoccupation led some major exponents of the public choice school of economics, which developed in the 1960s and 1970s, and economists such as James Buchanan, Francesco Forte and others, to advocate constitutional limits to taxation, such as are found in the Swiss Constitution. In Buchanan's view, these limits were needed to constrain populist actions on the part of governments that could damage economic activities and limit individual freedom.[2]

Let us turn now to *supply* considerations and the factors that shaped the supply of revenue. Even if in this pre-World War One environment the demand for public spending had been higher, it might not have led to significantly higher tax revenue because of the difficulties that existed at that time in raising taxes. The difficulties were several: first, the middle class was still small and the taxation of the larger poor classes would have given little revenue while the taxation of the rich would have been politically difficult because they still controlled the political decisions. Second, the structure of the economy imposed strong limitations on tax collection. For example, the share of formal wages and salaries in national income was low; large establishments, capable of withholding taxes at source on incomes paid by them, or on their sales, were still few; the share of agriculture in the economy was high; and informal activities predominated. These characteristics would have made it difficult to raise significantly higher tax levels. Finally, the 'technology of taxation' was still at a rudimentary stage. The major revenue producers of future years (the global income tax, social security contributions, and the value added tax) were still unknown. Instead, import duties, rudimentary taxes on business activities, some taxes on properties, some excise taxes, and some poll taxes predominated. In spite of these limitations the United Kingdom doubled its tax burden during World War One but to levels still sharply lower than today's.

Before the outbreak of World War One, several countries introduced *national* income taxes including the United States, France, and Germany. The UK already had income taxes levied at low rates, but it increased the importance of these taxes in this period. In the United Kingdom the income tax had been introduced more than a century earlier, during the war against Napoleon. For the countries that entered World War One, the conflict provided a political opportunity, a 'cover', for those politicians that wanted to raise the level of taxation permanently. Several governments took advantage of this opportunity.

Table 1
Social Transfers as a Percentage of GDP at Current Prices in Select OECD Counties, 1880 to 1995

Country	1880[a]	1890[a]	1900[a]	1910[a]	1920[a]	1930[a]	1960[b]	1970[b]	1980[c]	1980[c]	1995[c]
Australia	0	0	0	1.12	1.66	2.11	7.39	7.37	12.79	10.90	14.84
Austria	0	0	0	0	0	1.20	15.88	18.90	23.27	23.43	21.39
Belgium	0.17	0.22	0.26	0.43	0.52	0.56	13.14	19.26	30.38	22.45	27.13
Canada	0	0	0	0	0.06	0.31	9.12	11.80	14.96	12.90	18.09
Denmark	0.96	1.11	1.41	1.75	2.71	3.11	12.26	19.13	27.45	26.44	30.86
Finland	0.66	0.76	0.78	0.90	0.85	2.97	8.81	13.56	19.19	18.32	31.65
France	0.46	0.54	0.57	0.81	0.64	1.05	13.42	16.68	22.55	22.95	26.93
Germany	0.50	0.53	0.59			4.82	18.10	19.53	25.66	20.42	24.92
Greece	0	0	0	0	0	0.07	10.44	9.03	11.06	8.67	14.43
Ireland						3.74	8.70	11.89	19.19	16.20	18.30
Italy	0	0	0	0	0	0.08	13.10	16.94	21.24	17.10	23.71
Japan	0.05	0.11	0.17	0.18	0.18	0.21	4.05	5.72	11.94	10.48	12.24
Netherlands	0.29	0.30	0.39	0.39	0.99	1.03	11.70	22.45	28.34	26.94	25.70
New Zealand	0.17	0.39	1.09	1.35	1.84	2.43	10.37	9.22	15.22	16.22	18.64
Norway	1.07	0.95	1.24	1.18	1.09	2.39	7.85	16.13	20.99	18.50	27.50
Sweden	0.72	0.85	0.85	1.03	1.14	2.59	10.83	16.76	25.94	12.97	19.01
Switzerland	…	…	…	…	…	1.17	4.92	8.49	14.33	…	18.87
United Kingdom	0.86	0.83	1.0	1.38	1.39	2.24	10.21	13.20	16.42	11.43	13.67
United States	0.29	0.45	0.55	0.56	0.70	0.56	7.26	10.38	15.03	21.36	22.52

0 = know to be zero Blank = not yet a sovereign state – = known to be positive, but number is not available Source: Lindert (2002); OECD (1985)
[a] Welfare, unemployment, pensions, health, and housing subsidies
[b] OECD old series
[c] OECD new series

From World War One to 1960

Levels of tax increased during, and after, the two world wars, though until 1960 the increase was not dramatic, with the tax to GDP ratio around 30 per cent of GDP in most industrial countries until the 1960s. A number of influences can be detected during this period such as changing views of the role of the state in the economy, the impact of universal suffrage, the impact of two world wars, and the changes to the structure of economies which facilitated tax collection (including the growing share of wages in national income, systems for retaining tax at source, and technological factors).

This period saw a significant increase in the level of taxation especially during World War One followed by a slow growth until World War Two when taxes were increased again to finance the war. However, from the end of World War One until about 1960 there was relatively little increase. Until 1960 taxes remained relatively low compared with the levels that they would reach a couple decades later. Between 1913 and 1960 most of the tax increase came during the wars. Taxes were still only 11 per cent of GDP in 1925-29 in the United States; 20 per cent in France in 1924-25; less than 10 per cent up to 1930, and still below 20 per cent up to 1950, in Sweden. They were about 25 per cent of GDP in 1924-25 and around 30 per cent of GDP in the early 1960s in the United Kingdom. Until the early 1960s, the tax to GDP ratio was under or near 30 per cent of GDP in most industrial countries.

The reasons for the tax increases were several:

(i) Views about the role of the state in the economy changed. Various theoretical concepts developed by economists over the years helped justify the larger spending role of the state and the need for higher taxes (See Tanzi and Schuknecht, 2000).

(ii) By this time universal (or almost universal) suffrage had given voice to a large part of the poorer population, giving some substance to De Viti De Marco's worry that universal suffrage would lead the (poorer) majority to demand policies that would exploit the rich.

(iii) The impact of two world wars had allowed governments to raise tax rates with little political opposition. After the wars some of these increases had been maintained partly to service the large public debts acquired during the wars *(The Growth of Public Expenditure in the United Kingdom,* Peacock and Wiseman, 1961).

(iv) Significant changes in the structure of the economies had facilitated tax collection. Some of these were: (a) growing shares of wages and salaries in national income (these were especially important for income taxes and social securities contributions); (b) growing importance of large firms capable of retaining taxes at source (there is some evidence that until the 1960s the 'administrative costs' of tax collection had declined); (c) significant technological breakthroughs in taxation, such as 'global' income taxes applied with highly progressive rates, and, later, the introduction of value added taxes.

In conclusion, the increase in tax levels derived from higher demands for public spending, coming from a part of the population that had acquired more political power, and a higher supply of taxes due to technological developments in taxation and structural changes in the economies.

The 1960s – 90s

These were the decades where dramatic changes can be identified, where the increase in tax revenue raised the share of taxes as a percentage of GDP for the European countries by about 15 percentage points over the 1965-85 period – with significant tax burdens for some countries by the end of the period. The increased revenue was to come from a variety of sources and was to be facilitated by governments increasingly resorting to income taxes and by pressures on government to spend and promise.

In the first two decades after World War Two, the main role in raising tax levels was played by the (personal) global income tax. This tax was an ideal instrument for the time and came to be seen by many policy-makers and tax experts as a 'dream tax'. In the United States, 90 per cent of taxpayers had considered the income tax as a fair tax during World War Two, according to survey data published by the American Enterprise Institute (2005).

Until the 1970s several countries (including the United States and the United Kingdom) had top, marginal tax rates that at times exceeded 90 per cent. These high tax rates even inspired a Beatles' song, *The Taxman.* The lyrics of the song went: 'I shall tell you how it will be, one for you, nineteen for me, "cause I am the taxman"'. The song was composed in 1966 when the top marginal tax rate in the UK was 95 per cent! In the United States the marginal tax rate had been lowered, from 91 per cent in 1963 to 70 per cent in 1965-67, by the Kennedy Administration. (These rates do not include those imposed by local governments (states and counties)).

The personal income tax, applied with highly progressive rates, was seen to have many virtues: (a) because it was 'income elastic,' it automatically provided a growing share of revenue over the years accompanying the growth of nominal income; (b) it was assumed to reflect the 'ability to pay' of taxpayers because of its progressivity; (c) it could be made as progressive as policy-makers desired; (d) it was an ideal instrument for social engineering, in a world that was seen to be full of 'merit goods,' that is of goods the consumption of which deserved to be subsidised by the government; (e) it could be fitted (or tailor-made) to the specific circumstances of individuals or families.

With the manipulation of income taxes, tax administrations could be made to administer, indirectly, social policies through 'tax expenditures' which complemented, and at times replaced, explicit public expenditures. Authoritatively acknowledged as 'a government spending in the form of a loss or deferment of tax revenue . . .' these tax expenditures can be a direct substitute for direct public spending (See Van den Ende, Leo, Amir Haberham, and Kees den Boogert, 2004). At least 10 OECD countries, including six of the seven G-7 countries, publish tax expenditure budgets that estimate the revenue losses to the governments that are caused by these tax expenditures. Thus tax administrations became almost social ministries. At that time the income tax was seen to have two other important virtues: it had counter-cyclical power, at a time when business cycles were still a major preoccupation of policy makers; and it was considered an efficient tax because most economists dismissed its potential negative effects on work effort and incentives. Few academic articles, if any, dealt with these potential disincentives (See Tanzi, 1988b). Furthermore, though it now seems strange, books on income taxation did not even mention 'tax evasion' or 'the underground economy' as potential problems associated with income taxes (See for examples, Musgrave (1959), Pechman (1971), and Goode (1964)).

By the 1960s there was political and intellectual pressure on governments to increase public spending and to find the tax revenue to finance it (See Tanzi, Politeia 2004). Politically the climate had been changed by the popularity of the Keynesian Revolution and the call for a mixed economy. Economists and politicians convinced the public that government could efficiently improve people's lives. Public spending had become popular and attractive to politicians who could win elections by proposing new government programmes. By 1965, tax revenue as a share of GDP had grown to an average of 28 per cent for 15 countries which are now members of the European Union and 26 per cent for the OECD countries. Several European countries-France, Germany, UK, Austria, Belgium, Finland, Netherlands, and Sweden-had by this time tax levels that exceeded 30 per cent of GDP. The highest tax burden in 1965 was found in Sweden (35 percent of GDP), followed by France (34.5 percent of GDP) and Austria (33.9 percent of GDP). In Sweden, between 1950 and 1965 the share of taxes into GDP had risen by more than 15 percentage points. It would increase even more in the following two decades, thereby changing completely the fiscal and social landscape of Sweden. The period between 1960 and 1985 witnessed the fastest increase in public spending and in tax levels and the establishment of mature welfare states in several countries. The growth in spending often even exceeded the growth in taxes thus leading to increases in public debts that would cause macroeconomic difficulties in later years.

The increases in tax revenue in the period *after* 1965 came from three main sources:

(a) Between 1965 and 1985, the introduction of value-added taxes would contribute about 4 per cent of GDP in *additional* revenue in the 15 European Union countries. (See Table 2 for the year of introduction of VATs and for the current rates.)

(b) The growth in social security 'contributions.' These taxes would contribute, on average, about 6 per cent of GDP in additional revenue in the 1965-85 period. The growth of these taxes would come from the rise in tax rates on the share of wages subject to tax, from the increase in the share of wages subject to taxes, and from the rise in the shares of wages and salaries in national income that was taking place at that time.

(c) The impact on tax revenue that came from increases in real incomes and in *prices*, both of which were growing rapidly until the oil crisis of 1974. This automatic increase in tax revenue was called the 'fiscal drag.' It became important especially during the inflationary years of the 1970s when it provided governments with additional revenue without the need for legislation. Income taxes (on both individuals and enterprises) would contribute about 5 per cent of GDP in *additional* revenues in the 1965-85 period. The 'fiscal drag' would in time generate interest and demands for the indexation of tax brackets for inflation to remove its effect. (See Tanzi, 1980.)

On average the three sources mentioned above raised the share of taxes as a proportion of GDP, for the European countries, by about 15 percentage points over the 1965–85 period. Almost the whole increase in tax levels was accounted for by these three factors. This increase helped finance the increase in social spending taking place in this period.

By the end of this period, two countries, Sweden and Denmark, had tax burdens that exceeded 50 percent of GDP. Sweden's would reach records of 53.3 percent of GDP in 1987 and 53.9 percent of GDP in 2000. These were probably the highest tax burdens ever recorded in the history of the world.

II

Decline and Disillusion: From the 1980s to the New Millennium

1980–2000: Reaction against high taxes

Whereas there had been, in the 1950s and1960s, little intellectual or political opposition to higher taxation and pressure for increased public spending, that began to change in the 1970s. Instead of increases in tax being seen as both necessary and desirable, criticism from both economists and politicians became louder over the decade, prompted by new evidence about the economic consequences of high tax rates and by the increasing reaction against complexity and instability of tax systems.

First, what came to be called 'second generation econometric models' (see, for example, Michael Boskin, 1978) started to find significant negative effects on economic activity caused by high tax rates, effects that had been missed by earlier studies that had used less sophisticated techniques. Some of these new studies found significant disincentive effects on work, on savings, on risk-taking, and on resource allocation in general. Participation in the labour market, especially by married women and secondary workers in families, was seen to be discouraged by high tax rates.

Second, economists and policy-makers woke up to the existence of phenomena that had probably existed before but had been missed, and had become more intense because of the higher tax rates and thus more difficult to miss. Tax evasion and especially underground (or irregular, or black) economic activities started to attract increasing attention. Rather than being fair and efficient, income taxes came to be seen as unfair and growth-retarding.

Third, and especially in the United States, this period witnessed the beginning of what came to be called the 'supply-side revolution,' a revolution in economic thinking that reminded economists of the role of the supply side of the economy in economic growth. This was a reaction to the excessive and almost exclusive attention that had been paid to the demand side as a result of the popularity of Keynesian economics. Many economists started to blame high taxes for the slow growth of economies including Robert Mundell, who went on to win the Nobel prize later and was considered to be the intellectual godfather of the low-tax movement. (See, for example, the two contemporaneous discussions on the negative

Table 2
Value Added Taxes

Countries	Date VAT Introduced	Standard Rate in 2005	Other Positive Rates	VAT Revenue (%) of GDP in 2001
Australia	2000	10.0		
Austria	1973	20.0	10; 16	8.5
Belgium	1971	21.0	6; 12	6.9
Canada	1991	7.0		2.6
Denmark	1967	25.0		9.7
Finland	1994	22.0	8; 17	8.4
France	1948	19.6	2.1; 5.5	7.8
Germany	1968	16.0	7	6.9
Greece	1987	18.0	4.8	7.5
Hungary	1988	25.0	5; 15	8.1
Iceland	1990	24.5	14	9.9
Ireland	1972	21.0	4.3; 13.5	7.2
Italy	1973	20.0	4; 10	5.4
Japan	1989	5.0		2.6
Korea	1997	10.0		4.6
Luxembourg	1970	15.0	3; 6; 12	5.8
Netherlands	1969	19.0	6	6.9
New Zealand	1986	12.5		?
Norway	1970	24.0	12	8.9
Portugal	1986	19.0	5; 12	8.0
Spain	1986	16.0	4; 7	6.2
Sweden	1969	25.0	6; 12	7.2
Switzerland	1995	7.6	2.4; 3.6	3.9
United Kingdom	1973	17.5	5	6.8

(Source: International Bureau of Fiscal Documentation) impact of tax by Jude Wanniski, 1978 and George Gilder, 1981.) Coming in a period when growth rates had fallen, in part as a consequence of the oil crisis and of the inflation that had accompanied it, this was seen as a major flaw in the prevailing tax policies. The so-called 'Laffer curve' added a political and popular dimension to this debate by arguing that high tax rates might even reduce tax revenue. Although some of the claims made by supply-siders may have been exaggerated, their arguments helped change perceptions about the impact of high marginal tax rates.

Finally, the emergence of two articulate and forceful leaders gave a strong political voice to this new view of the role of taxation. Mrs Thatcher and President Reagan felt strongly that the economic liberty of citizens had been much reduced by the high levels of taxation and by the increasing use of 'tax expenditures.' They spoke forcefully in favour of simplification of tax systems and of tax reductions. Margaret Thatcher had a background in tax law while Ronald Reagan was largely driven by his conservative instincts.

Thatcher and Reagan were successful in changing attitudes and had some successes in the UK and the US in reducing *marginal* tax rates and, to a lesser extent, in widening tax bases. This move was imitated by several other countries whose political leaders were influenced by the British and American leaderships. (See Tanzi, 1988a.) Unfortunately, Thatcher and Reagan were not able to reduce the level of public spending permanently. Fiscal deficits widened and the pressure to raise taxes reappeared. The 'starve the beast' approach to reducing public sector activities did not give immediately the desired results. Strong lobbies made it difficult for governments to cut spending. Furthermore, some of the changes in terms of tax simplification, aimed at removing the government from many economic decisions, did not prove durable. They were reversed when new governments came into power. These later governments continued to be pressured by their supporters to provide tax preferences (i.e., 'tax expenditures') for particular groups or activities. Some did not resist these pressures. This clearly occurred during the Clinton administration in the United States during which public spending was contained, but tax expenditures went up sharply. The implications of such policy for the freedom of individuals who experienced sharp reductions in their disposable income provoked taxpayers and led to a series of public criticisms from officials, advisers and politicians across the industrial countries.

Aftermath and change

The growing tax burden, its complexity, instability and inefficiency, and the absence of fiscal coherence, began to prompt popular and official rejection in the early years of the 21st century. The prevailing tax systems reduced the liberty of the citizen not only through the high tax levels (that reduced their disposable, after-tax incomes) but also through the reduction in their freedom to use their after-tax income as they wished. 'Tax expenditures' pushed individuals in the directions desired by the government, but not necessarily wanted by the citizens themselves: their spending choices differed from those they would have made in the absence of the incentives provided by the tax expenditures. For example by 2006 in the United States there were 16 tax breaks (i.e., tax incentives) for education and 26 for energy (See Edwards *loc cit,* 2006).

From around 1980, the annoyance of taxpayers worldwide was directed with increasing intensity not only at the high-tax levels but also at the *complexity* and *instability* of the tax systems. This annoyance became a major factor in the changing attitude of citizens towards taxation registered in many countries in that period. In addition therefore to the level of taxation, such issues as complexity, instability, and fairness of the tax systems became important in many countries as the following examples indicate.

In Britain, instability, inefficiency, and absence of fiscal coherence characterised the tax system: (See Steinmo, 1993, p. 48). 'No one would design such a system on purpose and nobody did. Only a historical explanation of how it came about can be offered as justification. That is not a justification, but a demonstration of how seemingly individually rational decisions can have absurd effects in aggregate' (J.A. Kay and M.A. King, *The British Tax System,* Oxford, 1978, p. 1.). But the British tax system is not alone in its complexity and other countries, even those with low tax levels, also suffer from complexity. It is generally the case that most tax systems have become much more complex in recent decades.

New Zealand, where reform two decades earlier aimed at simplifying the tax system and simplifying the language of laws, provided a model for greater fiscal responsibility and transparency of the government's fiscal policy, had lost its way. The New Zealand Tax Code according to a 2001 report to ministers instilled 'anger, frustration, confusion, alienation' ('flat-tax revolution', *The Economist* (April 16, 2005)).

Italy too has a problematic tax system. Some years ago the President of Italy, Eugenio Scalfaro, stated publicly that the income tax declaration that Italian taxpayers were required to fill could only have been 'designed by lunatics.' Italians take advantage of tax amnesties when they can, not because they have evaded taxes, but because they are never sure whether they have succeeded in complying with all the complex rules and requirements of the Italian laws. By paying a penalty for a violation that they may not have committed, they eliminate the risk and the worries of being audited and penalized at some future date.

The US system, despite being comparatively moderate in the amount of revenue it generates, is also seen complex and confusing. The National Taxpayer Advocate's *Annual Report to Congress 2005* stated (in its IRS News Release) that

> 'Our tax code has grown so complex that it creates opportunities for taxpayers to make inadvertent mistakes as well as to game the system . . . As taxpayers become confused and make mistakes, or deliberately push the envelope, the IRS understandably responds with increased enforcement actions. The exploitation of 'loopholes' leads to calls for new legislation to crack down on abuses, which in turn makes the tax laws more complex. Thus begins an endless cycle-complexity drives inadvertent error and fraud, which drive enforcement or new legislation, which drives additional complexity. In short *complexity begets more complexity.* This cycle can only be broken by true tax simplification, followed by ongoing legislative and administrative discipline to avoid complexity creep'.

The problems have more recently been highlighted by a Report to the President of the United States on tax reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System,* prepared by the President's Advisory Panel on Federal Tax Reform (November 2005). The Report suggests that legislators have lost sight of the fact that the fundamental purpose of the tax system is to finance public spending. Other goals have distracted the system from its fundamental purpose. Second, it suggests that tax preferences replace citizens' choices with government choices and thus reduce economic freedom. Third, it indicates that 'tax preferences complicate the system, create instability, impose large compliance costs and can lead to inefficient use of resources'.

The system discourages saving and investment while leading to huge compliance costs, according to N. Gregory Mankiws writing when Chairman of the Council of Economic Advisers: 'The current tax code is a drag on the economy, discouraging saving and investment, and requiring individuals and businesses to spend billions of dollars and millions of hours each year to comply with the system'. '. . . our tax system is a complicated mess'. . . 'A simpler tax code would lower compliance costs . . . ' (p.1.) An American survey of taxpayers reported that citizens prefer 'root canal surgery' to an audit by the Internal Revenue Service and that 86 per cent consider the tax system very complex (50 per cent) or somewhat complex (36 per cent). The remaining 14 per cent probably do not pay taxes.

The complexity of the system is vividly illustrated by the dramatic expansion of pages of federal tax rules (See Chris Edwards, *loc cit,* of the Cato Institute in Washington). Table 3, adapted from his article, shows that when the US Federal Income Tax was introduced in 1913, there were 400 pages of federal tax rules. By 1939, the pages had increased marginally to 504. By 2006 the number of pages had grown to an extraordinary 66,498. 26,000 pages had been added just *in the past decade!* These are extraordinary figures that perhaps better than anything else show the extent to which taxes have become too complex. The attempts to create tailor-made tax systems have led to this complexity.

Table 3
U.S.A. Number of Pages of Federal Tax Rules, 1913-2006

Year	Number of Pages
1913	400
1939	504
1945	8,200
1954	14,000
1974	19,500
1984	26,300
1995	40,500
2006	66,498

Source: Compiled by Chris Edwards, *loc cit,* from different official sources

One consequence of the increasing complexity is the growth of compliance costs over the past decade even when the level of taxation may have stopped growing. Edwards reports that compliance costs rose from $112 billion in 1995 to $265 billion in 2005 while the number of forms that taxpayers may need to file their tax declaration reached the extraordinary number of 582 in 2006. Americans spent 6.4 billion hours on tax compliance in 2005 and 61 per cent of them used paid tax preparers. H&R Block alone, the major private tax preparer, received $2.2 billion in payments in 2005.

These costs include:
(i) financial costs paid by individuals to tax advisers (accountants, tax lawyers, etc.);
(ii) number of hours spent collecting information, organising it, filling the forms, and so on;
(iii) reporting requirements for businesses, a cost that has been growing a lot in recent years;

(iv) the cost to business enterprises of having on their staff tax lawyers and accountants. This cost is often very high, especially for small enterprises. In many businesses more resources may now go towards 'tax planning' than towards developing new products or reducing the costs of production. The locations where businesses are established are more and more guided by tax considerations rather than by purely economic considerations. In many enterprises tax advisers have become more important than production engineers;

(v) costs related to uncertainty: uncertainty as to whether the requirements imposed by the laws have been fulfilled; and uncertainty about the future course of the tax system. Predicting future tax development is becoming as important as predicting future interest rates;

(vi) finally, the large costs to society when some of its most able individuals choose to become tax lawyers or tax accountants rather than go into more socially productive careers.

The complexity is not limited to industrial countries. For example a recent report on Brazil, published by the International Finance Corporation, *Doing Business in Brazil* (2006), states that 'The Brazilian tax system is among the most complex and burdensome in the world' and that 'Accountants estimate it would take 2600 hours for (a) firm to comply with all tax requirements – the longest in the world' (p. 9). In Brazil constitutional lawyers have become largely tax lawyers because of the frequency with which tax cases end up before the Constitutional Court. The same has been happening in Mexico where more than 90 per cent of all cases that end up in the Constitutional Court are tax cases.

III

What Will Govern Future Taxation?

One of the great issues facing Western economies is the level and type of tax for the future. Despite the picture of growing opposition to high taxes in most countries, nonetheless the levels of taxation and the complexity of the systems continued to grow through the 1990s even though the rate of growth in tax levels was much reduced from earlier decades. Is there any hope that the future will bring lower tax burdens and simpler tax systems? What will be the main influences in future years on tax systems? The two questions will be addressed next in the order in which they have been posed.

Pressures for tax reductions

In the first years of the new century, pressures for tax reduction have become more intense. If 2000 is taken as the starting year, in the next 3-4 years – in 2003 or 2004 – several countries reduced taxes as a share of GDP, some of them significantly. These countries include Canada, the United States, Japan, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, and Sweden. (see Table 4).

Table 4 allows a simple experiment. The highest levels of taxation reached in the recent past for the countries in the table can be averaged as shares of GDP. This is an average of tax levels in *different* years. Comparing this average with the average of the tax levels in 2003, or the preliminary results for 2004, it can be seen that in the most recent year for which data are available (2003 or 2004), the average tax level was 2.2 percent of GDP *below* the average of the highest levels. In some countries the fall in the level of taxation was 3 per cent of GDP or higher (US Japan, Finland and Sweden). In New Zealand and the Netherlands, the fall was 2.9 and 2.4 per cent of GDP respectively. Some reductions in these years are also observed in the taxes on the wages of workers receiving average wages. (See OECD, 2006.) These reductions may represent temporary factors but, because many of these countries were running large fiscal deficits, the fall is likely to represent more permanent forces at work.

While the high levels of taxation begin to be reduced, some other developments, that *in time might lead to tax simplification and further tax reductions,* can be observed.

Table 4
Total Tax Revenue, 1965, 2003-2004

Countries	1965	Highest Level Year reached in brackets	2003[a]	2004[p]
Canada	25.6	36.7 (1998)	33.8	33.0
U.S.A.	24.7	29.9 (2000)	25.6	25.4
Australia	21.7	32.1 (2000)	31.6	n.a. 31.6[a]
Japan	18.2	29.9 (1989)	25.3	n.a. 25.3[a]
New Zealand	24.0	38.3 (1989)	34.9	35.4
Austria	33.9	44.8 (2001)	43.1	42.9
Belgium	31.1	46.2 (2002)	45.4	45.6
Denmark	29.2	50.5 (1999)	48.3	49.6
Finland	30.4	48.0 (2000)	44.8	44.3
France	34.5	45.2 (1999)	43.4	43.7
Germany	31.6	37.4 (1977)	35.5	34.6
Greece	19.9	40.1 (1996)	35.7	n.a 35.7[a]
Ireland	24.9	37.2 (1988)	29.7	30.2
Italy	25.5	43.4 (1993)	43.1	42.2
Luxembourg	27.7	45.6 (1983)	41.3	40.6
Netherlands	32.8	45.8 (1988)	38.8	39.3
Norway	29.6	43.8 (2002)	43.4	44.9
Portugal	15.8	37.1 (2003)	37.1	n.a. 37.1[a]
Spain	14.7	34.9 (2003)	34.9	35.1
Sweden	35.0	53.9 (2000)	50.6	50.7
Switzerland	19.6	30.5 (2000)	29.5	29.4
United Kingdom	30.4	37.6 (1986)	35.6	36.1
Average	26.4	40.4 (1986)	37.8	37.8

[a] 2003 **Source:** OECD, 2005

The first is the beginning of the privatisation of public pensions in several countries. The privatisation of part, or all, of public pensions started in Chile in 1981 and has spread to many countries including Australia, Argentina, Peru, Mexico, Poland, and other European countries. In the industrial countries this process is still in its infancy but, if it acquired speed and depth, it could *in time* reduce the public cost of pensions and the need to raise high taxes to finance them. It should be recalled that rising public expenditure for pensions was one of the most important factors leading to higher tax levels. Only time will tell whether this policy change can compensate for the impact on public expenditure arising from the ageing of the population. Without a significant policy change in this area, the ageing of the population can only lead to pressures for higher public spending and the need for more tax revenue.

Second, attitudes to personal income tax are changing. Over the past two decades we have seen developments that aimed to replace (a) many tax brackets and tax rates with fewer ones, and (b) highly progressive global income taxes with less progressive ones or even with what are called 'dual income taxes'. (For discussions of changes in income taxes over the past couple of decades see: a) Zee, Howell, 2004; b) Tanzi, Vito, 1987; c) OECD, Committee on Fiscal Affairs, 2005). The dual income taxes are essentially a return to the schedular income taxes which existed in several European countries in the first half of the last century. The dual income taxes separate from total income, incomes derived from capital investments (that are mobile) and tax them with *lower, proportional,* and *final* rates (see Sorensen (1994) and Broadway (2005)). This movement represents a major challenge to the concept of the progressive, global income tax that became popular after World War Two. The classic text on the global income tax is *Personal Income Tax* by Henry Simons (1938).

Third, there is a movement towards 'flat-rate taxes', which have become popular in several transition economies (usefully described in *The Economist's* cover story of April 16th – 22nd 2005). So far they have been introduced in Estonia, Georgia, Latvia, Lithuania, Romania, Russia, Slovakia, and Ukraine and are attracting attention in other parts of the world. Some observers have linked these 'flat-rate taxes' to better economic performance. In the above mentioned countries, the rates have ranged from 12 and 13 per cent in Georgia, Ukraine and Russia, to 25, 26, and 33 per cent respectively in Latvia, Estonia and Lithuania. These are all countries without a tradition of income taxation and where the prices of assets (houses etc.) had not incorporated the effects of tax preferences given through the income tax, as has happened in industrial countries.

'Flat-rate' taxation leads to the replacement of multiple rates (and brackets) by essentially two: one zero-rate, for the part of gross income that is exempted, and one positive rate, for the part, above the exemption, that is taxed. Many observers seem to believe that the simplification comes from the reduction in the number of rates. However, this is a misunderstanding because a single rate can co-exist with a lot of special treatments and 'tax expenditures' while multiple rates can co-exist with a simple, comprehensive tax base. In the United States, for example, the reduction in the number of rates and brackets that came with the 1986 Reagan tax reform did not prevent the income tax from becoming much more complex in later years, as was shown earlier.

Another widespread belief is that a single – or flat-rate – tax, by lowering the highest marginal rates, will eliminate requests by pressure groups for special treatment and will somehow reduce the difficulties associated with the definition of the tax base. These are the difficulties that lead to complex tax systems. However, these requests are not likely to disappear when several rates are replaced by one rate especially when that rate can be quite high (as in Estonia). A high flat-rate tax will be needed if public spending remains high and if the exempted (or zero-rated) part of a taxpayer's income is a large proportion of the total. Additionally, a high flat-rate creates a steep step between the part of income taxed at a zero rate and the part taxed at the flat rate. This steep step may encourage tax evasion for many taxpayers who see their income exceeding the exempt part.

Finally, there is a lot of misunderstanding about the virtue of reducing the rates from several to one. Still, if a flat rate is introduced, and if the difference between before tax income and taxable income is reduced only to the level of the basic exemption, this would be a major step towards simplification. By eliminating 'tax expenditures' and high tax rates, the government would reduce its interference in the decisions of the taxpayers. It remains to be seen whether industrial countries will move into that direction. So far interest in flat taxes in these countries has been limited.

A move toward *genuine* flat-rate taxes could eliminate thousands of pages from the tax codes and the regulations that accompany the tax laws. In industrial countries, it would also bring major changes in the prices of some assets and especially in the price of houses which have been affected by the existence of large tax deductions for interest payments on mortgages. Such a move would reduce the need for tax advisers. It is easy to predict that the flat-rate tax will face strong opposition from many groups with powerful political constituencies (tax advisers, real estate agents, property owners, and so on). Some of the same forces that in past years pushed for the expansion of the role of the state in the economy would oppose the reduction of tax rates and the simplification of the tax system. Tax 'expenditures' have created powerful lobbies behind them just as government expenditures have done. In the United States the Report of the President's Advisory Panel on Federal Tax Reform quickly disappeared from the political screen once the lobbies started voicing their opposition to tax simplification that would hurt their interests.

Supply and Demand: The framework for future tax

A number of forces have already emerged to change the balance of tax and determine revenue supply. The influences on levels of taxation in future years will be considered in this section. As in the past, the final outcome in terms of future tax levels will be determined by forces that influence the demand for, and the supply of, tax revenue.

Let us start with the forces that push for more tax revenue. The ageing of the population and the impact of this phenomenon on public spending under current programmes are an obvious force that has received a lot of attention. As is well known, under current policies, demographic changes could lead to large increases in public spending for pensions, public health services, and the care of the very old. The public accounts of many countries are already in a precarious condition even though the full impact of ageing has not yet been felt. Various studies indicate that in some countries the increase in public spending under current policies could be dramatic and could easily exceed the public resources available. More public spending would of course create pressure for more tax revenue.

Over the longer run it may be possible for the government to shift its main role from a spending to a regulatory one. In recent papers, I have argued that a more sophisticated private market with some intelligent regulation and better focused public assistance could provide, for many taxpayers, the required protection against events (old age, illnesses, illiteracy, etc.) that are, to some extent, predictable. Instead of 'buying' this protection from the public sector, through the payment of taxes, the citizens would buy it from the private market against the payment of insurance fees. The lower tax payments would leave in the citizens' pockets more income that could be used for this purpose. (See Tanzi, 2004 and 2005.) If the government could play an efficient regulatory role, and if the market could be made more efficient, many citizens would acquire more economic freedom and the needed services or protection could be provided more efficiently by the market than they are now by the public sector, especially in some countries where public sector expenditure is notoriously inefficient. (See Alonso et al. (2005).) Whether the forces of ageing, with unchanged policies, or the forces of privatisation of protection and public services prevail, will determine whether the demand for public revenue will rise or fall in the future. The result will, to a large extent, depend on who wins the ideological battle about the role of the state in the economy and on whether the government will be able to perform an efficient regulatory role.

What about the forces that determine the supply of revenue? A country may wish to have more tax revenue but be unable to get it, or at least to get it cheaply. A few factors that may have reduced the countries' capacity for, or facility in, raising or even maintaining the current tax levels can be mentioned. (Some of these have been discussed at length in other places. (See Tanzi, 1995 and 2001.)

First, foreign competition, globalisation, and technological developments have created what could be called 'fiscal termites' that have started to damage the foundations of fiscal systems, thus increasing the country's difficulties in raising taxes. Examples of these termites are electronic commerce, transfer prices, off-shore financial centres, complex financial instruments, growing shares of incomes earned abroad, use of electronic money and so on. All these factors will make it increasingly more difficult in the future for countries to collect taxes. (See especially, Tanzi 2001.)

Second, competition from low-tax countries such as China, India, Vietnam and others will make it difficult for high-tax countries to maintain the current levels of taxation that inevitably raise the cost of what they produce. In a world where capital has become very mobile, it will tend to be invested in lower-tax countries. Financial capital will go to places where tax rates on interest incomes, dividends, profits, and so on are lower. Also as time passes, the more able individuals (engineers, scientists, etc.) will be able to move away from countries where their incomes are highly taxed. (See Tanzi, 1995.)

Finally, the structure of economies is likely to change in ways that will make it more difficult to maintain high taxes. For example, many activities will be carried out by establishments that are either too small, or too global, to control. The fact that income distributions are becoming less even will mean that wages (which have been easier to tax) will fall in importance while capital incomes (which are more difficult to tax) will increase. In fact the moves towards dual income taxes or flat-rate taxes will favour capital incomes over wages thus creating a downward bias for tax levels. It is difficult to predict whether the 'technology of taxation' will be able to produce innovations similar to the 'global income tax' or the 'value added tax' that could provide new tax handles for the authorities to use.

IV

A Lower Tax Future?

Against the pattern of rising tax rates and revenue – gradually from the 1900s to the 1960s, with more significant increases during the two world wars, and dramatically in the 1960s and 1970s – certain trends affected change. And, in the 1980s, the pattern changed again as economic, political and popular disillusion prompted reactions against high and complex levels of tax and against public spending and its consequences. These changes in tax rates and tax structures and the proportion of revenue raised have been influenced by the forces of supply and demand and by changing social, cultural, political, economic (and practical) frameworks.

For the future, though the pressures to continue increasing revenue will be strong, especially if current expenditure policies remain unchanged, there may be counter-pressures on the government to change its role and scope, allowing for lower public spending and tax. For instance, government may shift its role from a spending to a regulatory one, especially given the more sophisticated private markets which can provide social goods and services for a price. It can then better focus its support from public sources on those who need it. This would allow citizens to buy protection from the private sector rather than the public sector while maintaining a government role in this area.

Other forces have already emerged to curb tax increases: foreign competition, globalisation and technological developments. These have led to the creation of 'fiscal termites' that create increasing difficulties for tax administrators (e.g. electronic commerce, transfer prices, offshore financial centres, incomes earned abroad, electronic money). In addition, competition from low-tax countries (e.g. China, India, Vietnam and others), will make it difficult for higher-tax countries to keep up present levels of expenditure, let alone increase them. Such competition may also lead to lower levels of simpler taxes in higher tax and spending countries.

This means that there is, for the future, the prospect of a world in which the level of taxation is lower, the taxes are simpler, and the state plays a less intrusive and more efficient role in the economy. Governments should focus their activities more efficiently toward their historical, traditional role (that would include making markets function more efficiently) and markets should be allowed and encouraged to provide social services (in health, education, pensions, etc.) to the citizens. By paying less tax, the citizens would have higher after-tax incomes to purchase these services directly from the market and not through the mediation of the state. The role of the state should be to set the rules and to focus on the small group of citizens who, through no fault of their own, would not be able to buy these basic services directly from the market. This would increase the economic freedom of most individuals and reduce the weight of the state on the economy.

Tax simplification should be pursued as an important objective independently from the objective of reducing the level of taxation. It was argued earlier that tax systems have become extremely complex, burdening taxpayers not only through the tax payments they make but also through the requirements on how to estimate and pay what they owe the state. Governments will rediscover that the objective of taxation is to provide revenues for the state to meet its obligations and not to engage in social engineering through the tax system.

Notes

1 Jean-Baptiste Colbert, Finance Minister of Louis XIV of France.

2 The leaders of the public choice school were James Buchanan and Gordon Tullock in the USA, Alan Peacock in the UK and a few others. The school was indirectly influenced by the Italian Scienza delle Finanze of a century ago. Its first journal was *Public Choice.*

* This study develops the themes introduced during my lecture to Politeia's series *Poverty or Prosperity? What tax is best for a flourishing future?* (Politeia, 2006)

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High levels of tax in industrial countries may not survive. In this pamphlet, *Death of an Illusion? Decline and Fall of High Tax Economies,* Vito Tanzi explains how tax is influenced by supply and demand. In the 20th century, tax and public spending as a share of GDP increased until the 1980s. But then the climate changed. Economists and politicians began to understand the damage high tax caused. Popular and specialist opinion turned against high and complex tax. Several countries reduced tax as a share of GDP with average tax levels falling by 2004. Will the trend continue? Though pressures for spending and higher tax remain strong, they may be countered by powerful global forces: foreign competition, globalization and technological developments.

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