Taxes in a Global Economy:

Efficiency, Fairness and Incentives

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Introduction

The controversy surrounding the current round of tax changes proposed by the Government fails to address a more fundamental and important question: Can the state continue to raise taxes in a manner roughly similar to that it has followed in the recent past, or will it be forced to resort to other instruments of policy to secure its objectives while maintaining the support of Britain's voters?

My thesis is as follows. Globalisation and the increased mobility of all the factors of production have placed limits on the ability of states to impose new taxes; that has led to an attempt to eliminate tax competition. Since it will be difficult for governments to cut either domestic or defence spending, limitations on their ability to raise taxes will result in an attempt to shift the burden of the welfare state from governments to the private sector. They will also find that the desire for an efficient, growth-friendly tax structure often conflicts with voters' notions of equity.[1]

[1] An interesting discussion of the roles of efficiency and equity in policy-making can be found in Ed Balls, Joe Grice and Gus O'Donnell (eds.), *Microeconomic Reform in Britain: Delivering Opportunities for All*, Palgrave Macmillan, 2004, pp.333-340.

I

Globalisation and Tax Policy – Capital, Labour and Land

First, a word about the effect of globalisation – a much abused word, but relevant for our purposes – on tax policy, treating in turn capital, labour, and – surprise – land.

Capital The declining cost of communication, which now has a marginal cost close to zero, has made it possible for capital to move across borders at the touch of button, at times by some teenager posing as a sophisticated trader in currency, shares, bonds, and complicated financial instruments, at other times by long-term investors such as Warren Buffett, a man whose interests are hardly as parochial as his personal habits might suggest. At times, senior management is aware of what is going on; at others, so effortless has it become to shift billions hither and yon, fortunes are made and lost without the sleep of grown-ups being at all disturbed. At times, capital flows into an economy in which prospects seem bright, at times it flows out, often at speeds so blinding as to cause economic upheavals. Needless to say, this capital is constantly shopping for the most benign tax environments available, other things being equal.

Labour The situation in the case of the second factor of production, labour, is more complicated. At the highly skilled end, the market for talent is international in scope, and competition for managers capable of running international enterprises, and for those capable of creating intellectual property, is intense. In response to the intense competition for such talent we witnessed the growth of a mobile class composed of men and women who are almost indifferent to the location at which they ply their various trades – that is a bit of an exaggeration, since man does not live by champagne alone – but still basically correct. The high income these people can command gives them the wherewithal to feather a comfortable nest in almost any place in which an attractive assignment is available, and in which they find the tax climate agreeable – again, other things being equal, the traditional caveat deployed by all economists, and applicable throughout this essay.

At the other end of the labour market are workers far less mobile, but nevertheless involved in international competition, although of a somewhat different and less satisfying sort. They produce goods, and in an increasing number of cases services, that are marketed throughout the world. In effect, therefore, they compete with one another. Unlike those in the top tier of the labour market, where competition for the workers' output drives up the prices they can command, those in the bottom tier face fierce competition for the goods they produce, driving prices steadily down – and with them, wages employers can afford to pay. The entry of over one billion very low-paid Chinese workers into the international market has increased that downward pressure. The products these people produce are internationally mobile, but the producers are not. But the taxing authorities cannot find much revenue among these lowest-earning of these workers.

Unfortunately for the geese in the broad middle – less mobile than the higher earners referred to earlier – they are there for the plucking, with the result that in many countries, including the US and the UK, the tax burden has been shifted from those rich enough to flee, and those too low-paid to pay, to the broad middle class.

But even here, the authorities are running into difficulties. For one thing, increasingly overburdened middle-class taxpayers are becoming increasingly hostile voters, and with good reason: as the pressure of international competition prevents their wages from rising, any increase in their taxes reduces their real disposal income – their standard of living, in non-jargon terms. For another, an increasing number of workers in this middle class are internationally mobile – the famous 'Polish plumber'. They cannot command wages anything like the scarcer executive group, but the declining cost of transportation (Ryanair offers a £65 round-trip fare, Krakow-London) and the increased openness of borders – legal and otherwise – enable them to follow the money, and that means after-tax money. Indeed, it is not stretching a point too far to point out that in some instances even the lowest paid workers, the poor Mexicans who stream across the US border in their millions, for example, are able to seek out the best after-tax incomes on offer. This mobility has an equalising effect on wage rates, holding them down in countries to which they flock[2] – the UK and the US, for example – and driving them up in the countries that at some point need to woo them back or retain them.

Others in this middle group are shielded from the international market, at least for the most part. Think of your dry cleaner, your barber or hairdresser and other purveyors of various services. They need worry only about competition from similarly situated workers in their own countries, although this becomes less true every day: international competition in the provision of medical services is one example of such competition that was unheard of just a few years ago.

The most thoroughly protected are public service workers: their political power, in part a result of their concentration in certain constituencies here, has so far protected them from off-shoring and from the need to increase efficiency in an internationalised labour market that drives other workers to compete. Which is why public-sector compensation (wages, benefits, pensions) is rising faster than

[2] There is considerable controversy concerning the effect of immigration on the wages and job opportunities of the native workforce, and an extensive academic literature on the subject.

private-sector compensation of workers performing similar tasks, despite the lower risk associated with most lifetime-tenured public sector employment.

Land Finally we have the third factor of production: land. It is a completely immobile resource, but increasingly subject to international competition as members of the mobile executive class compare property values around the world when making their location decisions, and manufacturers consider the cost of purchasing land or paying rent when deciding where to locate their businesses. Still, land – and the houses built on land – remains a *relatively* immobile resource, which may account for the rapid rise in property taxes.

In sum, we have a world in which the factors of production are subject to varying degrees of international competition. Top executives move around the globe in search of higher after-tax pay and better lives; some workers in the middle of the income scale also find they can seek greener pastures; lower-paid workers have jobs only so long as their employers do not find greener pastures; and owners of properties find themselves at least somewhat subjected to international competition, especially at the top end of the residential market, and in the market to attract factories; only government workers are shielded – in part by the nature of their work, in part by their political power – from globalised competition. Which might explain the declining productivity in the public sector – but that is another subject.

II

The Limits to Tax?

We should not exaggerate, and claim that these forces completely neuter the taxing authorities. Were that so, Gordon Brown would have been unable to raise taxes steadily over the past decade, to the point where the state now claims about 43 per cent of all the income produced by the private sector. But even he recognised, at least until recently, the limitations imposed by international competition,[3] and resorted to stealth taxes[4] of the sort that are barely noticed in the short run, and do not produce tax flight.

Nor should we fall into the trap of the most devoted of the supply-siders, and assume that any tax increase will reduce the total flow of revenue to the state, or that any tax cut will have the effect of increasing tax receipts. Some tax changes will have such effects, but not all. Thus, we do not yet know whether the proposed increase in the taxes extracted from foreign 'non-doms'[5] will produce the increased revenues that both Labour and the Tories predict, or cause so great an exodus of high earners who now pay taxes on UK incomes, VAT, stamp duty, and other levies, and create taxable jobs, that total receipts will decline, as some in the City expect. Most likely, since other things are never equal, since the impact of most tax changes is difficult to isolate from other factors such as changes in the level of economic activity, and since the impact is rarely felt immediately, we will never know with sufficient certainty to quell the debate on the effect of this (and other) tax changes.

But it is certainly plausible to argue that most governments have exhausted their ability to raise tax rates significantly. There are two reasons. First, governments don't like to lose elections, and although past increases in taxes have been accepted, it is not clear that further rises will not lead to massive voter dissatisfaction. I know that when asked whether they want tax cuts or more public spending, voters often say they favour the latter – lest they seem mean. That is rather like voters not telling pollsters that they plan to vote for the Tories, lest they seem ungenerous to the less well off, or – in the US – replying that they do not know

[3] 'It has certainly entered his [Brown's] soul that if taxes on individuals and companies are raised to relatively high levels by international standards, many will relocate themselves or their wealth to another country where taxes are lower.' So wrote Robert Peston only three years ago. See his *Brown's Britain*, Short Books, London, 2005, p.254. Since then Brown has done some soul-searching and decided that he can risk some exodus of individuals and businesses if he raises taxes.

[4] The purpose of Brown's 'prudence' in the early years of his chancellorship 'was not so different from that of previous Labour governments: it was to invest in public services and augment the income of the poor ... In the first few years he took advantage of a growing economy and a general sense of optimism to raise revenues from new imposts in ways that weren't widely noticed ...'. Peston, *op.cit.*, pp. 248-.

[5] Workers resident in the UK but planning to return to their native countries.

which candidate they will support rather than admit they would never vote for a black. My own impression is that there was indeed a period in which voters felt the public services were under-funded, and they might have been right, but now that their taxes have risen, and spending has increased substantially, they expect improvements to come from better management of the plentiful resources now available – a forlorn hope, since there is no significant incentive on the part of suppliers of those services to improve output. That, too, is a subject for another day.

The second reason to believe that governments are at, or close to, the limits of their ability to raise taxes is the increasing incidence of tax avoidance, the perfectly legal practice of minimising the taxes paid. Tesco's use of the Cayman Islands' low-to-no tax regime to shelter from tax the capital gains it will earn from selling and leasing back £6 billion worth of its stores is but the most recent and widely publicised example. Scores of advisers, accountants and lawyers – some of the best minds in Britain – earn their livings by devising perfectly legal avoidance methods, and by comparison shopping for advantageous tax jurisdictions with a devotion equal to the most dedicated Internet devotee of comparative shopping sites.

So, the competition countries such as Britain now face comes from other taxing jurisdictions, not merely from cheap labour. The local, nation-by-nation monopoly of taxing powers is breaking down. Like other monopolists who find their once-total control under threat from newcomers, high-taxing nation states' first reaction is to form a cartel, sailing under the pleasant-sounding banner 'harmonisation'. The EU wants to stop ruinous tax competition from Eastern Europe countries benefiting from low, and in some cases flat, taxes (Estonia provides the leading example of the sort of country that can benefit from a flat tax); the UK, US, and Germany are particularly upset with Liechtenstein, which offers a legal tax-effective investment climate. So effective has that tiny country (population 35,000) been in attracting capital that it has become one of the most prosperous in the world, at the same time winning approval of the Financial Action Task Force* and America's Internal Revenue Service for its tough line on dirty money. There is nothing a cartel hates more than a cut-price competitor, be it Liechtenstein, or Luxembourg, or Ireland with its 12.5 per cent corporate tax rate, or Monaco, which combines sunshine and low taxes, making it a deadly challenger to the high-tax nations for some important activities. And there is nothing that benefits ordinary taxpayers more, and stimulates economic growth more, than the constraint

* The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money-laundering and terrorist financing.

imposed on greedy chancellors by competition. Carl Mortished put it beautifully in *The Times* (February 27, 2008):

> Without the competing lure of some neighbouring
> fiscal paradise, Europe would certainly be a
> tax hell, a land of disinvestment and unemployment,
> governed by parasitic states and funded
> by an overburdened and shrinking middle class.
> Those with long memories will recollect Britain
> in the 1970s when the top tax rate was close to
> 80 per cent.

III

The Options

All of this leaves government with three alternatives.

Cut spending One way to cope with limitations on the power to tax is to curb spending, not an easy thing to do. In most countries, the US being the principal exception, military spending has been so reduced as to leave little room for further cutbacks. European countries spend so little on their militaries that they cannot move troops without using US-provided transport, or meet their NATO commitments in Afghanistan. British soldiers are already suffering, and in some cases dying, because the Government has failed to provide adequate funds for communications equipment, armour, and other equipment, not to mention adequate housing for families of serving soldiers.

Until now, Europeans have been able to fund their welfare states by short-changing their military establishments. That happy circumstance is about to end. As the American Secretaries of State and Defense have recently made clear in meetings with NATO allies, the US is growing impatient with the free-riding of other countries on American defence expenditures. With the Democrats certain to control both Houses of Congress, and favoured to win the White House, the day when America will pay for the pacification of the Balkans and other areas of more concern to the Europeans is coming to an end. In short, raids on the military budgets are no longer likely to be successful.

Which leaves the various entitlement and other welfare-state programmes as candidates for reduction. I doubt very much whether such cuts are achievable – after all, politicians even regard a slowing of the increase in spending as a reduction. In Britain, both parties are pledged to maintain the existing size of the welfare state, in America the Democrats plan to expand it, and both US parties are unwilling to contain spending on the young, the old, the sick, or the otherwise disadvantaged. Indeed, in most countries the ageing of the population, the marvellous but costly developments in the field of medicine, and rising consumer awareness of the benefits of expensive courses of treatment, will drive pension, health care and related costs inexorably upward.

With the scope for new taxes limited by international competition, and the scope for spending cuts limited by the already-shrunken size of military budgets and political resistance to cuts in welfare spending, governments' next alternative is to turn to the private sector.

Burden the Private Sector I suggested earlier that governments reaching the end of their ability to raise taxes not only seek to stamp out tax competition, but also seek to shift the burden of the welfare state to the private sector. There is no need to raise taxes on pollution when government can require utilities to incur the added costs of producing or buying power from more costly, renewable sources; there is no need to raise taxes to fund programmes to end 'fuel poverty' when the Chancellor can compel energy providers to fund such programmes with a slice of their profits; there is no need to raise taxes when the cost of 'improving workers' work-life balance' can be imposed on private companies by expanding maternity and paternity leave; there is no need to raise taxes to install devices to improve access to the workplace by the disabled when a simple regulation imposes that cost on private companies; and there is no need to raise taxes to pay for more police when a frightened private sector installs and pays for the devices that have reduced car theft in recent years.

In America, when Ronald Reagan's fiscal deficits led us to believe that the liberals (in the American sense) would not be able to enact and fund new welfare programmes that would expand the reach of the state, we found that Congress would simply pass laws forcing private companies to implement new programmes, and bear the costs or pass them on in their prices. Voters get angry with politicians when taxes go up, but with corporations when prices go up.

This tendency to burden the private sector will, of course, in the long run reduce the international competitiveness of any nation's enterprises. But the process will be slow, and less visible to voters. Moreover, a handy way out exists for governments that choose this route – protectionism. Britain and Australia may just turn out to be the last men standing in the ranks of free traders. Certainly, with the honourable exception of John McCain, most politicians in America would prefer to erect trade barriers than to reduce the environmental, employment and other costs imposed by legislation on major corporations. Indeed, the trend is likely to be in the other direction. Barack Obama, who might well be the next President of the United States, provides an example of the trend of populist thinking. He has proposed a Patriot Employer Act that would provide tax breaks for 'patriotic employers'. To join that favoured group a company must pay at least 60 per cent of each employee's health care premiums, not insist on a secret ballot in union recognition elections, increase the number of full-time workers in America relative to those it employs overseas, provide a pension plan, and pay a salary equal to or above the federal poverty level. Watch his lips: no new taxes. But lots of benefits for workers, paid for by private sector companies.

Shift the tax base If governments cannot raise taxes in the conventional way very much, cannot cut military expenditures further, will not reduce the size of their welfare states, and either cannot or will not rein in the size of their welfare states, and recognise that perpetual deficit spending eventually leads to inflation and a devaluation of the currency, they have one other choice: shift to consumption taxes. Tax jobs, and workers and job-creating investors can flee; tax profits, and companies will double their efforts to avoid taxes or find more congenial business environments; tax land, and at least some projects will be located in lower-tax areas.

But tax consumption, and most of these constraints are removed[6]. Yes, at some point consumers will rebel, but they are less likely to do so if taxes on what they buy go up, than if their pay packets are raided. That is why opponents of any tax increases so fear VAT – it is easier to raise than income taxes.

Yes, there will be smuggling across national or, in America, state borders of highly taxed items such as cigarettes and booze. But consumption taxes make it more attractive to save and invest than to spend on current consumption, and certainly have a less discouraging effect on the incentives to work and take risks.[7]

The problem is that consumption taxes can be regressive, since lower-income people spend proportionately more of their incomes than do their better-off counterparts, and certainly spend a higher portion on what we call 'necessities', an extraordinarily vague and elastic concept that it would tax the ingenuity of the tax collector to define. Food is the easiest example, clearly a necessity – until we realise that the shelves of any supermarket display more than what song-writer Terry Gilkyon called 'the simple bare necessities'. Children's clothing is another seemingly simple candidate for exemption from consumption taxes, until we realise that the dividing line between clothing for children and garb for adults is no longer quite as distinct as it once was.

Nevertheless, these problems seem just as soluble as that of defining income, or separating business from personal expenditures. And consumption taxes do not seem to contain the disincentive to work, and the incentives to flee from or avoid the taxman, that are often the consequence of increases in other forms of taxation.

6 Milton Friedman, 'The 'Welfare' Effects of an Income Tax and an Excise Tax,' reprinted in his *Essays in Positive Economics*, University of Chicago Press, Chicago and London, 1953, pp. 100-113.

7 Taxes on interest income, for example, discourage savings whereas if 'all income that is saved would not be taxed until the saving is later spent' people's savings decisions would not be distorted. Individual retirement plans such as the 401(k) programme in America move in the direction of a consumption tax: savings deposited in these accounts escape taxation until the money is withdrawn at retirement.

IV

The Underlying Principles of Taxation

Conflicting goals of tax policy Until now I have emphasised the limitations on tax policy created by competition from lower-tax jurisdictions. Let me conclude by citing one more limitation – perhaps more profound than even the increased mobility of most of the factors of production. I have in mind the pressure created by the three often conflicting goals of tax policy: efficiency, fairness, and the shaping of society, the latter known to its critics as social engineering. And here I draw on a paper I recently prepared for The Smith Institute.

All systems of taxation in democratic societies are designed to accomplish three goals: efficiency, fairness, and the shaping of society. Unfortunately, these goals often pull politicians in opposite directions.

Efficiency dictates avoiding taxes that deter the most talented, hard-working, and risk-tolerant members of society from doing their utmost to add to their own and the nation's wealth. Taxes, taught Adam Smith, should not 'obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes.'[8]

Efficiency also requires that taxes be levied on consumption in instances in which that consumption produces externalities that impose significant costs on others, such as the pollution caused by the consumption of fossil fuels, to take a currently prominent example. Such taxes add to the efficiency with which resources are allocated by forcing consumers to pay prices that reflect the full costs of their consumption choices, and by generating revenue that reduces the need for incentive-reducing taxes on the incomes of workers and risk-taking entrepreneurs.

In short, tax policy should encourage the optimally efficient use of the nation's human and other resources. At least, so economists would argue.

But considerations of fairness often trump economics, not a bad thing in a democracy in which citizens' notions of fairness must be satisfied lest tax evasion become a national sport. Fairness, or equity, is of course, a concept of infinite elasticity. As John Selden[9] long ago noted:

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8 R.H. Campbell & A.S. Skinner, (general editors) W.B. Todd (textual editor), *An Inquiry Into The Nature And Causes Of The Wealth Of Nations*, Clarendon Press, Oxford, 1976, p.826.

9 Samuel Harvey Reynolds (ed.), *The Table Talk of John Selden*, Clarendon Press, Oxford, 1892, p.61.

> Equity is a roguish thing. For Law we have a measure, know what to trust to; equity is according to the conscience of him that is chancellor, and as that is larger or narrower, so is equity. 'Tis all one as if they should make the standard for the measure we call a foot a chancellor's foot. What an uncertain measure would this be! One chancellor has a long foot, another a short foot, a third an indifferent foot; 'Tis the same thing in the Chancellor's conscience.

In practice, the quest for fairness becomes a search for means of making *post-tax* incomes more equal than unfettered market forces make *pre-tax* incomes.[10] Different societies have different tolerance levels for inequality, but most deem it appropriate to impose some form of 'progressive' taxation on incomes – higher rates of tax on high earners than on those lower down on the income scale. They find support in Smith, who argued that those who benefit most from 'the protection of the state', as measured by their earnings, ought to pay a higher proportion of their incomes to the state.[11] Recent experience suggests that such policies at some point clash with the goal of efficiency: they raise marginal tax rates to levels that so discourage work, and/or increase the value of avoidance techniques, that the increases become counter-productive.[12] Unfortunately, we can never know in advance just what that counter-productive rate is.

Which leaves the third objective of tax policy: what has come to be called social engineering. Some policies favour families as traditionally structured, others confer benefits on farmers in the interests of 'food security' or the preservation of the countryside, others encourage home ownership, still others favour certain technologies. The list is rather close to infinite.

With social engineering comes complexity. And with complexity a reduction in efficiency. For one thing, a complex tax code creates uncertainty: it makes investment planning more difficult, as the net after-tax proceeds of any venture will depend importantly on which of the several provisions of the complex tax code applies.

For another, complexity is costly, both to the taxpayer and the tax collector.[13] Smith warned of a tax structure that 'may require a great number of officers, whose

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[10] Milton Friedman, *Capitalism and Freedom*, University of Chicago Press, Chicago and London, 1982, Chapter X, 'The Distribution of Income'.

[11] *Ibid*. p.825.

[12] Robert J. Barro argues that 'a roughly uniform tax on the broad middle class' produces fewer inefficient distortions than does a progressive tax on incomes. *Getting It Right: Markets and Choices in a Free Society*, MIT Press, Cambridge, Mass. and London, 1996, p.126; also pp. 114-115.

[13] See N. Gregory Mankiw, *Principles of Economics*, Thomson South-Western, Mason, Ohio, 2004, p.250.

salaries may eat up the greater part of the produce of the tax'[14] – an extreme example, perhaps, although some taxes are indeed extraordinarily costly to collect, and others to compute.

Unfortunately, both the search for equity and the desire to achieve certain social goals not only create inefficiencies – they fail to achieve their own stated objectives by themselves creating 'all sorts of inequities ... It makes people feel that the tax system is unfair and that they are not getting their fair share of tax breaks.'[15] Encourage home ownership by allowing the deduction of mortgage interest and renters are offended; encourage the traditional family with special tax treatment and single parents are offended. The fate of social engineers often proves to be an unhappy one.

Balancing the conflicting goals of efficiency, fairness, and social engineering is difficult enough when dealing with currently earned incomes, witness the periodic furores over executive compensation, and the heated debates about whether and how tax policy should be used to narrow the income gap between high and low earners. It is even more difficult when we are dealing with wealth. The pursuit of wealth can, and does, drive people to work and take risks; in short, to seek to earn as much as they can. The income they derive from that pursuit is taxed by the state, somehow balancing the often competing demands of efficiency, equity, and social policy. That portion that the state does not seize remains in the hands of the individual – and what is not spent becomes his or her wealth, the accumulation of after-tax income that is not spent on current consumption.

It is therefore arguable that, having once passed through the tax wringer when earned, wealth should be exempt from further taxation. For it seems both unfair to double-tax this wealth, and inefficient in that such a tax might reduce incentives to accumulate wealth by working hard to maximise earnings.

Would that life were so simple. Wealth includes not only the accumulation of the proceeds of work and risk-taking, but windfalls, additions to personal wealth completely unrelated to any contribution to society. Homeowners, for example, have accumulated wealth in many countries merely by 'being there': the availability of cheap credit, constraints on the supply of housing, and other factors unrelated to the skills or effort of homeowners, have enriched them significantly.

This is not the place to resolve all of the issues surrounding taxation of all forms of wealth. That subject, too, deserves separate treatment on another day. And I will

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[14] *Ibid*. p. 826.

[15] Leonard Burman, 'Comment on Tax Policy', in Jeffrey Frankel and Peter Orszag (eds.), *American Economic Policy in the 1990s*, MIT Press, Cambridge, Mass., 2002, p.180.

resist the temptation to repeat my already-too-often repeated defence of inheritance taxes,[16] other than to point out that Anthony Crosland was simply wrong when he wrote that one advantage of taxes on inheritances is that 'They are politically perhaps the least controversial of taxes.'[17] Crosland overlooked what Hayek calls 'the natural instincts of parents to equip the new generation as well as they can'[18], and Tim Hames more recently called 'the powerful psychological appeal to the idea that a little part of us carries on from beyond the grave through what we do with our financial bequest, particularly if it is handed to the children.'[19]

Indeed, the recent proposal by the Conservative Party to exempt large portions of accumulated wealth from inheritance tax proved so popular, even among the 94 per cent of people who are in no present danger of paying inheritance tax, that the Labour Government found itself forced to make a similar proposal lest it face an electoral disaster. The Government then had to find means of making up the resulting revenue deficiency, and decided to tax the very resource Smith warned should not bear a heavy burden – work and risk-taking, in this case by foreigners resident and working in the UK[20], and British entrepreneurs. Clearly, one among many examples of political expediency and a sense of what is fair, or at least politically expedient, trumping economists' notions of what is efficient.

Which is not a bad thing: arguments built on the notion that maximising economic efficiency is the sole goal of policy will not carry the day. Nor should they. Economists are most useful when they explain and, if possible, measure the costs and benefits of any policy proposal, and attempt to force politicians to confront those computations honestly. Democratically elected representatives might reasonably decide that the economic costs are worth bearing – that inheritance taxes, although more efficient than other revenue-raising measures, are abhorrently 'unnatural'; or that the health benefits of cleaner air are worth having even if the costs of scrubbing the air exceed the measured benefits.

This does not mean that economists should shut down their computers and confine themselves to the production of meaningless results from unrealistic models, leaving the policy world to others. Rather, they should accept, even if grudgingly, that their role in policy-making is not decisive. They serve as the polity's resource-bean-counters, the performers of the cost: benefits analyses to which politicians and society should pay heed. And, it is for the duly elected politicians to decide

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16 See my 'From Grave to Cradle: Building a Meritocracy,' London, Social Market Foundation, September 2002, and articles appearing in *The Spectator*, *The Weekly Standard* and other publications.

17 C.A.R. Crosland, *The Future of Socialism*, Jonathan Cape, London, 1956, p.303.

18 F.A. Hayek, *The Constitution of Liberty*, republished Routledge Classics, Abingdon, 2006, p. 80.

19 Tim Hames, 'It's Time for the Last Rites Over Inheritance Tax', *The Times*, October 8, 2007.

20 A mobile group that counts this author among its members.

just who will be taxed, by how much, and, if I might borrow from Colbert, whose bed the feathers plucked from the tax-paying geese should feather.[21]

Here are a few suggestions designed to point them in a direction that balances the economist's desire for efficiency and the politician's desire for a tax system sufficiently fair – or at least seen as sufficiently fair – to enable him to continue in office.

1. Tax competition cannot be ignored, but it must be viewed in context. Low taxes in Darfur will not cause an exodus of hedge-fund managers from London or New York. It is the combination of the tax rate and the efficiency with which taxes are spent on transport, education, cultural amenities, and public safety that affects location decisions. The combination of high taxes and shoddy services is likely to prove lethal.
2. Complexity is as big a deterrent to potential investors as high taxes. Complexity creates compliance costs and the possibility of corruption by collectors who have wide discretion in determining just how much the taxpayer owes. If you doubt that, ask any Russian oligarch – if you can gain access to those now serving time for tax evasion. But keep in mind that most efforts to reduce complexity often increase it, and that investors can probably tolerate a suboptimal tax structure and rules better than changes in the structure and rules. Tinkering is a bad idea. Certainty matters.
3. So how high is high? The international norm for taxes on businesses seems to be settling around 25-30 per cent. 'When rates reach the 25-30 per cent range ... a country is in danger of pricing itself out of business. That is the range the UK finds itself in and has not helped by loading on excessive complexity, uncertainty, and unexpected changes in the tax code.'[22] But beware: the headline rate often bears little relation to the effective rate; credits for research and development, job creation and the like must be considered. Politicians often fail to dig beneath the headline rate to see what it is they are creating; businessmen and investors never fail to do so.
4. It is exceedingly important to make sensible estimates of the effect of proposed tax changes. There are taxes and there are taxes. Some have little effect on behaviour, others can produce changes that reduce the revenue anticipated from tax increases. Eschew both static analysis

[21] Jean Baptiste Colbert, finance minister to Louis XIV was renowned for the relentless manner in which he pursued sources of revenue for the Sun King. It is he who said, or didn't (the record is unclear), 'The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing.'

[22] John Cullinane, 'Tax Competition is More Complex Than Many Thought', *Financial Times*, March 27, 2008.

and the wildest claims of the supply-siders. This might be one place where well-constructed econometric models can prove useful.

5. Taxes should be concentrated on 'bads' not 'goods'. Pollution is a candidate for increased taxation; work and risk-taking should not be. And tax increases aimed at 'bads' such as pollution should be offset by lowering taxes on 'goods', rather than used as an excuse to increase the portion of private-sector wealth claimed by the state.
6. None of the above should reduce concern about the effect of taxes on the main well-spring of improved living standards – economic growth. The resources needed to grow any economy have become increasingly mobile, to varying degrees. That suggests that it is often wise to keep taxes on incomes low, lest the taxpayer flee, and concentrate on taxing consumption, with appropriate exemptions to reduce the regressive nature of some consumption taxes.
7. In the end, there is no simple solution to the problem created for policy-makers by the increased mobility of many of the factors of production and the seemingly ever-increasing demands of the welfare state. One part of any solution must be to keep costs manageable by increasing the productivity of the resources devoted to public service delivery, which means injecting competition and choice into the health care, education and other such industries. Another is to choose that combination of taxes that maximises economic growth, the ultimate source of rising living standards and a steady flow of revenues to the exchequer.

I know that it is a long way from these generalities to a tax code, which must be detailed. But if each detail is tested against these general propositions, the result might – just might – be tax levels and a tax structure that are both efficient and palatable.