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Handbook of Research on Public Finance in Europe and the MENA Region

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Chapter 3
The Difficulties of Achieving Successful Tax Reform

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ABSTRACT

This chapter sets out the issues that should be considered in developing successful tax reform. Economic theory makes an essential contribution to the development of tax reform, incorporating issues of both economic efficiency and equity. However, other theoretical considerations demonstrate that successful tax design may be considerably more difficult than seems to be widely thought. In addition, there are matters of tax administration and compliance that have to be taken into account. The changing socio-economic environment within which tax systems have to operate as well, as the political process of tax reform, are also important. Finally, the chapter shows how to develop a systematic approach which can incorporate the many important issues that should be included in developing successful tax reform.

INTRODUCTION

There is a constant stream of proposals for tax reform in Europe, the MENA Region and elsewhere. Some of the more comprehensive from around the world include the Mirrlees Review (Mirrlees, 2010, 2011) in the UK, the Final Report of the President's Advisory Panel for Federal Tax Reform (2005) in the USA and the Henry Review (2010) in Australia. However achieving successful tax reform is neither a simple nor an easy task. Bird and Oldman (1990) have suggested that the best approach to tax reform is one that takes:

into account taxation theory, empirical evidence, and political and administrative realities and blends them with a good dose of local knowledge and a sound appraisal of the current macroeconomic and international situation to produce a feasible set of proposals sufficiently attractive to be implemented and sufficiently robust to withstand changing times, within reason, and still produce beneficial results (Bird & Oldman, 1990, p. 3).

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Successful tax reform can be a surprisingly complex process (Bird, 2004) even if there appears to be only a simple objective. The economic characteristics of an ideal tax system are well known and such a tax system might be summarised as being economically efficient and equitable. However, tax systems everywhere deviate from such ideal characteristics, often for very good reasons. To begin with, drawing on economic theory, it becomes clear that the theory of taxation does not necessarily imply that the process of tax design is a simple one. Indeed the literature on optimal taxation, the theory of the second best and public choice theory raise many issues that should be considered. For instance, the theory of second best offers the insight that the gains from a proposed reform depend on a much wider range of circumstances than are usually taken into account. Other areas that may not always get the attention they deserve are tax administration and tax compliance risks. Once a proposal has been developed, the process of successful implementation presents a new range of challenges. However, even that is not the end of the story. After a tax reform has been implemented, as Bird and Oldman (1990) suggest, the reform should be capable of withstanding changing times. The whole process of developing tax policy involves taking into account, not only of matters of immediate concern, but also a whole range of relevant factors in the wider context of tax reform. The aspects that should be considered include not just purely economic matters, but also political, social and technological issues. Furthermore, the situation is not a simple case of comparative statics – a comparison between presumed stable equilibria before and after the change, but a dynamic one in which different forces influence the progress of any reform in different ways over time.

It should also be pointed out that taxation is often much more than a powerful method of raising revenue. It is also a major instrument of government policy used to influence the distribution of income as well as discouraging some activities through additional taxation and encouraging others through tax concessions. Such tax concessions are known as 'tax expenditures', a term coined by Stanley S. Surrey in 1967 while Assistant Secretary for Tax Policy in the US Treasury Department. His description was that tax expenditures are those provisions:

containing special exemptions, exclusions, and other tax benefits [which] were really methods of providing governmental financial assistance. These special provisions were not part of the structure required for the income tax itself, but were instead government expenditures made through the tax system (Surrey, 1973, p. vii).

The use by governments of the tax system in a variety of different ways is also something that has to be taken into account in developing tax policy itself.

The purpose of this chapter is therefore to examine the range of issues involved in the nature, context and process of tax reform. It begins by introducing the context of European and MENA countries in general terms. The chapter then examines economic criteria for assessing the merits of a particular tax or tax reform, primarily economic efficiency and equity and goes on to other theoretical contributions to the development of tax reform which are less frequently taken into account, namely optimal tax theory, the theory of the second best, and public choice theory. The chapter then raises significant issues regarding tax administration and compliance. It examines the context of tax reform and the process of tax reform itself which is more complex than may be commonly thought. In order to establish a comprehensive approach to dealing with the entire range of relevant factors, a systematic approach to tax reform is presented. Finally some conclusions are drawn.

TAX REFORM IN EUROPE AND THE MENA REGION

Europe and the MENA Region contain a wide range of approaches to tax reform and circumstances in which they are applied. One of the key factors in Europe is the European Union (EU) though to some extent the tax policy of the EU is developed at the level of Member States rather than for the EU as a whole. In its communication regarding EU Tax Policy Strategy, the European Commission (2014) repeated its belief that Member States are free to choose the tax systems they prefer and there is no need for general harmonisation of European tax systems. Nevertheless, within that general position the main priority of EU tax policy is eliminating tax obstacles to cross-border economic activity and this requirement can clearly limit the ability of each Member State to develop its own tax system in isolation from those in the rest of the EU. Other priorities of EU tax policy are countering harmful tax competition and promoting greater cooperation between tax administrations in terms of control and countering fraud.

There is, of course, no equivalent of such general policies across all MENA countries though, as pointed out in the recommendations of the *MENA-OECD Investment Programme* (OECD, 2005) MENA countries have been reforming their tax systems to improve efficiency, encourage investment and stabilize revenue yield. In a later report, the OECD (2008, p. 245) concluded that MENA countries offer a wide range of fiscal and financial incentives to promote specific policies but that these posed challenges for policy makers in attempts to simplify tax systems as well as ‘eliminate tax distortions, remove unnecessary administrative and compliance costs, increase transparency and improve government’s capacity to generate revenue’. To achieve these aims successfully it is helpful to develop a systematic approach to tax reform which is the purpose of this chapter.

One issue that is sometimes raised is whether there are significant differences regarding taxation in ‘developing countries’ as compared to countries that may be considered more developed in economic terms. Of course, it should be pointed out that descriptions such as less developed or more developed countries have attracted criticism but, in any event, the basic principles of tax reform are widely applicable. Historically, economists have examined the effects of taxation on economic growth and, following the development of Keynesian economics, the role of taxation in promoting economic stability but both of these matters are of general interest. Also, the effects of taxation on economic efficiency and the distribution of income across households and regions are important regardless of a country’s position regarding economic development. Both of these matters are of concern to the EU as well as MENA countries. There are some areas which may be of particular importance in some countries such as political and administrative constraints on tax reform and policies for increasing host-country returns from the exploitation of natural resources but again such the relevance of such matters is not confined to a particular group of countries. Finally, globalisation affects tax design in both European and MENA countries and, as with many other relevant factors, may be included in the process of developing tax reform presented below and the best place to start is by examining the criteria for assessing the advantages and disadvantages of a particular tax or tax reform.

CRITERIA FOR A GOOD TAX OR TAX REFORM

The main criteria involved in the design of a good tax system are efficiency, equity and some macroeconomic aspects. A useful way of examining these issues is using Musgrave’s (1959) framework in his classic Public Finance text. Musgrave summarised the economic justification for the public sector

in a three branch model consisting of the allocation branch, the distribution branch and the stabilisation branch and these deal respectively with the analysis of economic efficiency, the distribution of income and wealth and macroeconomic aspects. The design of a good tax or tax reform should draw on analysis from each of these three branches, together with some important issues of tax administration. They are summarised here and also discussed at greater length by James and Nobes (2014).

The Allocation Branch

The allocation branch is concerned with economic efficiency, essentially allocating resources so that output is maximised and consumers obtain the goods and services they value the most. In economic theory this is analysed in terms of Pareto efficiency - named after the Italian economist Vilfredo Pareto. A Pareto efficient output, sometimes known as a Pareto-optimal output, is where no further efficiency gains can be made that will make one individual better off without making someone else worse off. Inefficiency exists if resources could be re-allocated so that at least one person could be made better off without anyone else being made worse off. The implications for taxation depend on how efficiently particular markets are working. If markets are working efficiently, a good tax in terms of efficiency is one that does not distort choices so that decisions are made for economic reasons rather than tax reasons. If a tax does distort choices, it is said to impose an *excess burden* because, in addition to the tax paid, it becomes an obstacle to individuals consuming the combination of goods and services they value the most. Subject to a number of limitations and exceptions, in an efficient market it might be expected that taxes with a wider base are less likely to be distortionary than taxes with a narrower base.

Another conclusion is that taxes imposed on outputs that are inelastic in supply or demand, in other words the sales of which change relatively little when price changes, are also likely to be less distortionary than taxes on goods and services that are more price elastic in supply or demand. However, if a market economy is not working efficiently, it may be possible to use taxation to improve economic decisions. For example, the consumption of some products such as alcohol and tobacco might involve extra costs that consumers would not take fully into account, but which might be reflected by taxation. This possibility has led to a whole range of 'corrective' taxes being introduced in areas where markets are not considered to be working efficiently. Taxation is not only used to discourage the consumption of some goods but tax concessions may be used where the government wishes to encourage other things. One example is tax relief for saving in a pension scheme to encourage individuals to make provision for their old age.

An important aspect regarding efficiency are possible tax effects on the supply of factors of production, that is the willingness of individuals to work, save and invest and for firms to contribute to the economy in the most appropriate ways. The effects of taxation in these contexts are not always obvious. For instance, in terms of the supply of labour, economic theory suggests there may be a 'substitution effect' which may lead some individuals to substitute other activities or leisure for paid employment which is taxed. However, there may also be an 'income effect' which recognises that taxation reduces individuals' spending power and this may encourage them to work more because they are worse off. The substitution and income effects therefore may work in opposite directions and the final outcome is theoretically uncertain. This has led to a great deal of empirical research on the effects of taxation on the supply of factors of production and generated a number of implications for tax design.

The Distribution Branch

The distribution branch of public finance, as Musgrave (2008, p. 237) describes it, leaves 'the safe haven of Pareto optimality' and moves into the less tangible area of distributive justice. It is concerned with the redistribution of income and wealth towards that which society considers more equitable. What the distribution of income and wealth should actually be and what constitutes a fair tax are, of course, at least partly a matter of opinion. This is the aspect of tax policy that has provoked the most adverse responses in taxpayers – see, for example, James (2014). In terms of the revenue side of public finance, ideas regarding the fairness of taxation have frequently been based on concepts related to ability to pay and there has been much discussion in terms of the sacrifice of taxation and whether fair taxation should be related to equal absolute, equal proportional or equal marginal sacrifice. Another approach has been that taxes should be paid in line with the benefits gained from public expenditure but the nature of government expenditure is that it is often not directly traceable to individual recipients. The benefit approach is also inappropriate with respect to spending on welfare payments of various sorts - which makes up a very large part of modern government expenditure.

The distributional impact of taxes is also important. The study of the 'incidence of taxation' examines how the burden of taxes may be passed on to others through changes in prices and quantities. For example, taxes on goods and services may be formally levied on suppliers but they may be able to pass some of the burden on to their customers through higher prices. It was once thought that taxes such as income tax could not be passed on. However if, say, the supply of labour changes as a result of income tax, part of the burden might be then be passed on to consumers. Similarly if income taxes affect investment decisions then this may also determine how a tax affects other parts of the economy. Sometimes the incidence of taxation may have unexpected effects. For instance, a tax levied on 'luxury goods' in order to increase the tax paid by the rich might also have adverse effects on the employment prospects and incomes of poorer people involved in the production of such goods. More generally, a tax on one good might affect the demand for other goods and services and this could work through to affect the supply and demand of factors of production in different industries. There is also the phenomenon of 'tax capitalisation.' As the capital values of assets are influenced by the income from those assets, when a tax alters the net income from an asset, its capital value is likely to change as well. In considering the distributional aspects in developing tax reform, it is necessary also to consider the impact of a tax change on other parts of the economy.

The Stabilisation Branch

The stabilisation branch is concerned with the effects of taxes on macroeconomic variables which may be relevant to the design of particular taxes. Not all taxes are equally important in this regard and to be useful instruments of stabilisation policy they usually have to be imposed on a relevant variable such as consumption or income and to be sufficiently large to make a significant difference at the macroeconomic level.

Economic cycles have serious disadvantages – not only in economic downturns when, of course, unemployment (of capital as well as labour) may rise but also in boom times when inflation and other problems can emerge. So taxes may be used to try to achieve stable levels of employment and prices but such aims may be hard to achieve. This is because, of course, it is difficult to anticipate macroeconomic changes and the need for a stabilising response. Even after a government has decided it must take ac-

tion, it may still take a significant amount of time to implement a tax change and then even more time for the economy to respond to that change. The result could be that the policy is not only ineffective but may actually increase rather than decrease economic fluctuations. Indeed Ben Slimane and Ben Tahar (2010, p. 50) found strong evidence that, instead of being counter-cyclical, fiscal policy is procyclical in MENA countries, with fiscal policy being expansionary in good rather than bad economic times. There is less evidence for this in European countries though there is still room for improvement. Golinelli and Momigliano (2009) surveyed the recent economic literature relating to the cyclical response of fiscal policies in the euro area. The results of their work are complex but it seemed that introducing budgetary rules limiting discretionary responses by governments might improve the stabilisation role of government and also achieve sounder public finances.

One feature of a tax system that might improve the effectiveness of stabilisation policy are automatic responses to changes in the level of economic activity. Thus when an economy moves into recession, the fall in national income should be partly offset by a fall in tax receipts. The most important example of such 'built-in flexibility' is that a progressive tax system will automatically cause tax receipts to change proportionately more than any original change in national income thus cushioning a recession and dampening a boom.

The Transition from Principles to Policy

The principles of efficiency and equity are major elements for successful tax design. However, there are other important theoretical dimensions which should also be considered if a proposed tax reform is to achieve a more comprehensive approach to the development of policy. Three of these dimensions are optimal taxation, the theory of the second best and the public choice approach and these are examined in turn.

Optimal Taxation

The work on optimal taxation attempts to combine the analysis of tax efficiency with questions of equity in taxation - which is not always a straightforward process. Heady (1993, p. 15) surveyed the optimal taxation literature specifically 'attempting to answer the question of whether, and to what extent, the literature on optimal taxation can provide guidance in the practical determination of tax policy'. It seems clear that the study of optimal taxation has not reached a stage where it can successfully incorporate the range of relevant factors indicated by Bird and Oldman (1990) above. Alm (1996) suggested that existing attempts to formulate an 'optimal tax system' were largely irrelevant to practical tax design because they failed to include many aspects involving fiscal and social institutions. Alm suggested that many of these could be incorporated in an optimal tax framework but acknowledged that it would never be possible to include all the 'incredible complexity' that must be considered in the design and reform of tax systems. In looking at gaps between optimal taxation and policy, Mankiw *et al*. (2009, p. 172) raised the possibility that 'the broader tradition in public finance includes…ideas that are often ignored in modern optimal tax theory'. The lesson from the optimal taxation literature seems to be that the development of successful tax reform is likely to require more than basic economic analysis.

Theory of Second Best

A related development is the theory of the second best. This presents a clear view of the complexity involved in moving from an ideal type of tax which meets the criteria of efficiency and equity as described above, through the range factors described by Bird and Oldman (1990), to a successful tax reform. The theory of the second best was established by Lipsey and Lancaster (1956, p. 12) who demonstrated that it ‘is *not* true that a situation in which more, but not all, of the optimum conditions are fulfilled is necessarily, or is even likely to be, superior to a situation in which fewer are fulfilled’. Furthermore, if one of the Paretian conditions is unachievable then a second best optimum may be reached by departing from all the other optimum conditions. Moreover, there are no general conclusions about the direction or magnitude of the other changes that would be necessary to achieve a second best optimum. This may sound rather complex and counter-intuitive so a simple example may be helpful. Suppose a situation where two economic distortions are cancelling each other out, for example a market where there is only a single supplier (monopoly) selling to a single buyer (monopsony). The first best solution would be to remove both distortions but, if that were not possible and only one were removed, the price might move away from the optimum position. The theory of the second best indicates it might be better to have both distortions rather than only one. Lipsey and Lancaster (1956) actually use a tax illustration where a tax on one good distorts prices between that good and other goods. To achieve a second best optimum, a system of taxes on other goods and services would be needed, some of which would be less than and some more than the original tax and in some cases a subsidy might be needed. The lesson from ‘second best’ theory is that an ‘obvious improvement’ to taxation may not be so when the wider context is taken into account. Lipsey (1997, p. 362) made clear ‘the cautionary warning from second best theory that any policy may have unexpected and undesirable consequences in apparently unrelated parts of the economy that need to be watched for and mitigated where necessary.’

The Public Choice Approach

Public choice has been described as the application of economic methodology to the study of politics. Mueller (2003) comprehensively examines the public choice approach and collective decision-making processes. The public choice literature covers topics such as the behaviour of bureaucracies, interest groups and political parties as well as electoral systems and different constitutional arrangements. Needless to say, this provides additional factors that might influence the success or otherwise of particular tax reforms. However, as Holcombe (1998, p. 359) concluded: despite ‘the insights the public choice perspective offers, most analysis of tax policy does not take public choice considerations into account’. Clearly such important issues should be included in the development of tax policy.

TAX ADMINISTRATION AND TAX COMPLIANCE

In moving to more practical aspects, there are important issues involved in tax administration and compliance: the ‘administrative realities’ as described by Bird and Oldman (1990). Goode (1981, p. 249), points out that this area is properly dominated by insights from the theory and practice of management, together with legal and political considerations. Tradition and expediency may be significant factors as well. There may also be particular aspects that require attention, for example corruption in tax adminis-

tration (Chandler & Wilde, 1992). However, Goode and others have examined economic aspects of tax administration, sometimes in terms of market-orientated solutions to problems and sometimes in terms of the administrative and compliance costs of taxes (see for example Sandford *et al.*, 1989). Nevertheless, equity and other matters have also been taken into account. In this context, as in others, simple reforms may be totally inadequate. Klepper and Nagin (1989, p. 239) suggest that a policy innovation designed, for example, to reduce one form of non-compliance might result in taxpayers transferring their non-compliance activities to take advantage of a now superior alternative opportunity. Simply assessing only the direct impact of that measure might be inadequate and misleading. More generally, a full evaluation of any aspect of compliance policy should take account of its effects on each of the relevant areas.

The literature on tax compliance is considerable – see for example, Andreoni *et al.* (1998), Fischer *et al*. (1992), Jackson and Milliron, (1986), James and Edwards (2010) and Richardson and Sawyer (2001). In the past, work on tax compliance has often been based on the effects of detection and penalties. This approach has to be followed with caution since an over-zealous policy of enforcing the law may produce undesirable and unnecessary side effects. For instance, at one stage the German tax system was reported by both Schmölders (1970) and Strümpel (1969) as being very rigid in its assessment procedures which led to an effective but expensive and confrontational system. The result 'of the relatively coercive tax-enforcement techniques is the high degree of alienation from the state…[which] negatively influences the willingness to co-operate' (Strümpel, 1969, p. 29). There may also be a reluctance to undertake legitimate commercial activities if there is a risk of heavy handed treatment from the tax authorities. The vast majority of the work on compliance has concentrated on taxpayers but the role of the tax authority is also important. Kirchler *et al.* (2006 and 2008) concluded that treating taxpayers reasonably and fairly, explaining rules and decisions and providing reliable information may not only improve how the tax system operates but may also lead to an increasing willingness on the part of taxpayers to comply with the spirit of the law.

More generally, as Posner (2000, p. 1782) suggested, some further explanation for tax compliance behaviour is required because penalties are usually modest for ordinary tax convictions and the chances of detection are low but most individuals still pay their taxes. In recent years tax compliance has increasingly been analysed more comprehensively and account taken of wider considerations. So, for instance, the OECD's (2004, p. 37) *Compliance Risk Management* cites the analysis of James *et al.,* (2001) which identifies the traditional approach to compliance based on penalties but also a behavioural approach which draws on a fuller understanding of individual behaviour with respect to taxation (see, for example, James, 2006). The European Commission's *Risk Management Guide for Tax Administrations* (2006, p. 6) states

Risk analysis also involves the why question: why is the taxpayer behaving in a particular fashion. This is important because it contributes to the assessment and the choice of the most efficient and effective form of treatment.

This approach has led to the development of more sophisticated compliance strategies so that the official response to problems of compliance may depend on the taxpayer's motivation and circumstances. Thus, for example, those who seem determined to evade taxation might be subject to the full force of the law, those who are less committed to tax evasion might be deterred by greater detection and those who are willing to comply but finding it difficult might be offered more and better assistance or the system may be changed to make it easier to comply. In this way action to enforce compliance can be tailored to be forceful where appropriate but supportive when that might achieve better results. An early pioneer in

this approach was the Australian Tax Office but similar features may be seen elsewhere such as the UK where the penalty imposed on taxpayers' mistakes depends on whether the error was 'careless', 'deliberate' or deliberate and concealed' and whether the taxpayer was prompted or not in disclosing the error.

The OECD (2004, p. 8) views compliance risk management as a 'structured process for the systematic identification, assessment, ranking and treatment of tax compliance risks', This, of course, covers risks such as individuals not registering for tax, under-reporting incomes and claiming deductions to which they are not entitled. The OECD summarises how a revenue authority may develop a risk management strategy as follows:

- Identify risks
- Assess and prioritise risks
- Analyse compliance behaviour (causes, options for treatment)
- Determine treatment strategies
- Plan and implement stages.

As the OECD (2004, p. 8) makes clear, such an approach is consistent with management literature more generally and is developed further in section 7 below. The OECD (2009) also states that large businesses increasingly consider tax risk management to be a specific element of corporate governance.

The European Commission's *Risk Management Guide for Tax Administrations* (2006, p. 13) described risk management as 'taking deliberate action to improve the odds' of good outcomes and reducing the odds of bad outcomes. It is not a formula that will always produce the right result but is 'a way of working and thinking that will give better answers to better questions'. Risks consist of the characteristics of 'vulnerability, severity or significance and relative occurrence or frequency'. Finally Silvani and Baer (1997, p. 31) conclude that, while reform is not easy, fundamental reform to improve the effectiveness of tax administration is possible.

THE CONTEXT OF TAX REFORM

In the extract cited at the beginning of the paper, Bird and Oldman (1990) pointed out that reform also should take account of political and administrative realities together with 'a good dose of local knowledge and a sound appraisal of the current macroeconomic and international situation'. All this includes government policy more generally as well as the economic, social and political environment both nationally and, increasingly, internationally (James & Edwards, 2008). An analysis of the environment within which tax systems have to operate indicates trends towards greater complexity which are a major factor in the increasing complexity of tax systems and reforms (James, 1999). Economic variables range from increasing real incomes, which are often drawn from different sources, to an increasing variety of complex financial instruments. Social variables include rising levels of education, which may encourage taxpayers to take a greater and more effective interest in their tax affairs and demographic variables including changing family structure and increasing numbers of older people, who often have complicated financial affairs with a variety of investments and pension income. Political variables include those that result in the expansion of public expenditure in many countries which means taxes have to be ever more carefully designed to be acceptable to taxpayers as the tax burden rises. Technological factors have also presented further considerations in the design of tax reforms, in some ways making things easier, as

with electronic filing, but in other ways, as with some of the implications of electronic commerce, adding further challenges. Globalisation has had an increasing impact on tax policy. It has been defined in various ways and Bhagwati suggested that:

[e]conomic globalisation constitutes integration of national economies into the international economy through trade, direct foreign investment (by corporations and multinationals) short-term capital flows, international flows of workers and humanity generally and flows of technology (2004, p. 3).

This, of course, has major implications for the design of national tax systems. As Sawyer observed:

With the increasing globalisation of business activity, mobility of capital (and to a lesser degree individuals), and the blurring of jurisdictional boundaries, the setting of domestic tax policy has taken on an increasingly international application. As a consequence of this international dimension, tax policy and practice cannot, or at least should not, be developed by a country in isolation of the international implications (2004, p. 8).

Taxation is inevitably affected by increasing economic interdependence and mobility together with the possibility of tax competition by countries attempt to attract resources through favourable tax arrangements (for example, see Hines and Summers, 2009 and Tanzi, 1996).

One possible constraint on tax reform in Europe is tax harmonisation. However, European tax harmonisation has not developed as rapidly as its early proponents hoped. The first significant step towards European tax harmonisation was included in the Messina resolution of 1955 and the Treaty of Rome of 1957 and involved the removal of customs duties between member states. Following that initiative, further moves were very cautious with provisions only for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation was necessary for the operation of the internal market. Since that time there have been many reports and reviews but not much progress - mainly because countries are often reluctant to lose control over their tax systems which form such an important instrument of their social and economic policies.

THE PROCESS OF TAX REFORM

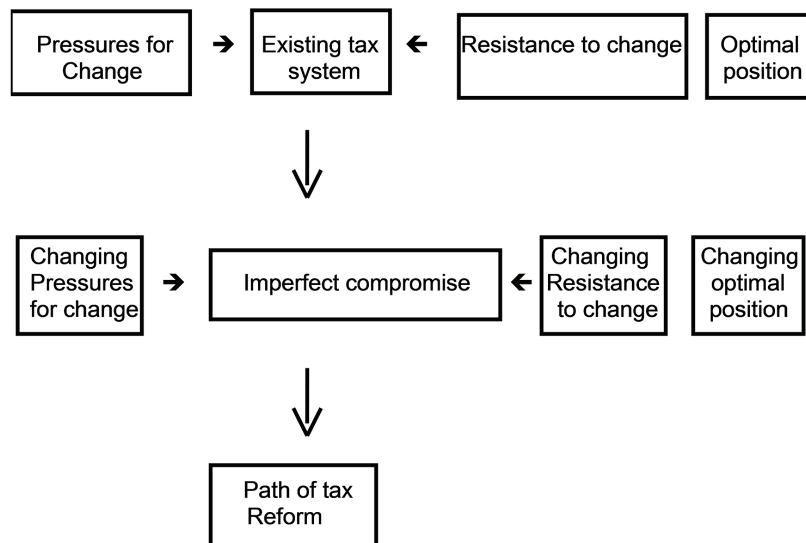
The final part from the Bird and Oldman (1990) extract was that a reform should be ‘sufficiently attractive to be implemented and sufficiently robust to withstand changing times’. One of the difficulties of applying economic theory to tax reform is that the latter is not an exercise in comparative statics – comparing two static positions, one before and one after the proposed change. In reality it is a dynamic process. The study of the progress of proposed tax reforms soon indicates that they will not only be influenced by different factors and interested parties in their development but, as soon as a definite proposal emerges, opposition may develop from those who feel they might be adversely affected. Furthermore inertia is often a factor in the process. As Rose and Karran (1987, p. 5) put it: ‘If keeping out of trouble is a basic law of politics, then not making decisions about taxes is one way to avoid trouble – in the short run at least’. This means, of course, that tax reform is not a smooth process optimally designed to adapt to changing priorities, needs and other circumstances but a jerky process that is the outcome of a variety of forces proposing and opposing change. Nor is the final outcome of this process likely to be an optimal

one. Biases may exist between those favouring and those opposing a change – the disadvantages of a reform may be seen easily by those who will suffer but the gains from change, even if they are potentially greater than the losses, may be less tangible and less likely to arouse public support. Sometimes the opposite might be true. The enthusiasm of those wanting to change things might overcome possibly greater disadvantages that are so diffuse there is no serious opposition. As Break and Pechman put it (1975, p. 13) 'the beauty of tax reform shines more brightly in the eyes of the reformers' than it does in the eyes of the public at large'.

One way of modelling the dynamic process of tax reform is to draw on the forcefield analysis from the work of Lewin (1951) and developed in this context by James and Edwards (2007). This approach allows the incorporation of the complex array of different factors and interests which may influence the development of tax systems and the nature of the political process itself, including the role of inertia. Forcefield analysis reflects the reality that at any time there will be all sorts of different pressures for change developing and a variety of developing forms of resistance to change as illustrated in Figure 1.

Figure 1 indicates that the tax system will be at some position – the status quo – which will almost certainly not be the optimal position. There will be pressures for change, possibly from a range of different interests. However, there may also be considerable resistance to change. Not only would change be likely to make some taxpayers worse off, but changing a tax system will involve both administrative, compliance and perhaps other economic costs. Individuals and businesses may have taken economic decisions in the light of existing tax rules and there may be difficulties in adapting to a new system. The outcome of the interaction through political and administrative process is uncertain but different groups are likely to press their cases with different levels of effort and effectiveness. Compromises may be reached but it is reasonable to assume that the outcome may not be the theoretical optimum. This approach also makes it clear that the whole process is a dynamic one. Both the pressures for change and the resistance to change will themselves be changing over time so reinforcing the point that any tax reform should be 'sufficiently robust to withstand changing times'.

Figure 1. A forcefield interpretation to the process of tax reform



A SYSTEMATIC APPROACH TO TAX REFORM

Given there are considerable difficulties in achieving successful tax reform, the purpose of this section is to outline a systematic process for taking account of the wider range of factors relevant to developing proposed changes to the tax system. As mentioned above, the OECD (2004) has laid out a process for systematically identifying, assessing, ranking and treating of tax compliance risks. More generally the academic literature from the discipline of Management provides guidance on developing strategy which may be applied to tax reform. A key factor, which derives from the discussion so far, is the systematic analysis and understanding of the factors concerned, including not only the matters of immediate interest but also the wider environment in which the activity is being conducted. Furthermore, the process is dynamic. Mintzberg (2004, p. 55) argues that strategy is an interactive process and requires constant feedback from experience. It is not sufficient just to formulate proposals and assume their clear advantages will ensure they are successfully implemented. Once a tax change has been proposed, other forces are likely to come into play. Furthermore, the formulation and implementation of strategy go together (Grant, 2002, p. 25). A proposed tax reform should explicitly incorporate the process of implementation. Finally, it should be clear how the desired outcomes should be measured so that the reform can be refined and possibly reformulated if necessary in the light of experience.

There are certain distinct stages involved in a systematic approach to change. One possible ten stage process of developing tax reform is discussed by James and Edwards (2007) and may be summarised as follows:

1. Identify the aims of the reform.
2. Examine different methods of achieving these aims
3. Analyse in terms of the economic criteria.
4. Specify the administrative constraints.
5. Identify and assess different risks incorporating an analysis of the wider socio-economic context.
6. Analyse behaviour.
7. Establish the relationship(s) of the proposed change with other policies.
8. Develop strategies to achieve the aims of the reform.
9. Plan and implement strategies including intended outcomes.
10. Monitor and evaluate the performance of the strategies against the plan.

Such a systematic approach to tax reform may reduce the chances that important aspects might be given insufficient consideration or even overlooked altogether. Stage one is to identify explicitly the aims of the reform and how they might relate to the objectives of the tax system more generally. The main purpose of taxation is usually to raise revenue for public expenditure but there may also be other aims such as discouraging some activities or encouraging others as mentioned in section 2 above or policy objectives relating to income distribution. The aims of a particular reform may or may not be consistent with other such objectives. The next stage involves an examination of the different methods that might be used to achieve the aims of the reform. Taxation might be the best way but it may not. As Aaron and Galper (1985) argue, using taxation to support worthy causes may be unfair and inefficient in other respects. Although the tax system is often a tempting policy instrument, sometimes a non-tax method might be more appropriate.

The third stage, analysing the reform in the light of economic criteria, draws on the theory in section 2 above. Ideally a tax reform should lead to an improvement in both efficiency and equity. However, sometimes there is a trade-off so that a tax may be efficient but might be considered unfair because it is not related to individuals' circumstances. Alternatively it may take account of individual circumstances but this creates economic distortions and increases administrative and compliance costs. Furthermore, what is regarded as fair may vary from place to place and over time. It can be seen, therefore, that even applying economic criteria is not necessarily a straightforward process.

The next stage is to specify the administrative constraints, which may not be immediately apparent. There may be legal factors to take into account, including possible obligations under international agreements. There may be implications regarding the resources and staff skills available to the tax authority and it may have changing priorities in the use of scarce resources. The tax agency itself may require reform. It is sometimes true, as Devas *et al.* (2001, p. 211) stated, that 'reforms to tax administration are as important as tax policy changes for overall fiscal reform'. Although it is sometimes overlooked, the ability of the tax authority to deliver the proposed reform is an essential part of achieving change successfully.

Identifying and assessing risks forms stage five. As indicated above, the OECD and also other bodies have become aware of the usefulness of assessing risks. It should not be assumed that relevant variables will continue unchanged into the future. Indeed it is clear that the socio-economic-technological environment within which the tax system has to operate is constantly changing and any risks that these may pose should be built into the development of proposed reforms.

Stage six involves analysing behaviour. It was pointed out above that a long standing approach to examining taxpayers' compliance behaviour focuses on rates of detection and levels of penalties. However this has been increasingly supplemented by a more behavioural approach which also examines non-financial motives. Individuals do not always act only in their own immediate self-interest but are often influenced by a wide range of factors. Research in sociology and psychology has indicated that there are many important factors such as attitudes, social norms, social support and a certain background factors such as age, gender and culture. Psychology has developed a branch of 'fiscal psychology' (see, for example, Schmölders, 1959 and Lewis, 1982) which adds many specific insights to the way taxpayers are likely to behave in different circumstances. Allied with developments in behavioural economics with respect to taxpayers, the academic research contribution has moved towards a fuller understanding of behaviour in different circumstances (James, 2006).

Establishing the relationship(s) of the proposed change to other economic and social policies is the next step. The previous discussion in this paper has demonstrated how one change may have implications for other matters that may appear, at least initially, not to be affected. Further investigation might indicate that one or more existing policies may not be entirely compatible with the proposed reform – there may be trade-offs where some compromise should be reached between the advantages of the proposed reform and any disadvantages it may mean for other government objectives.

Step eight involves developing strategies to achieve the stated aims of the reform. As the process is complex, such strategies should be sufficiently comprehensive to deal with wider issues as well as flexible enough to deal with matters of particular concern. They should also, of course, pay particular attention to the issues of the highest priority as well as those where there is the highest chance of success.

The next stage is to plan and implement strategies including intended outcomes. The political context underlines the importance of gaining the support of stakeholders and this can be done in a number of ways such as involving them in the planning stages, consultation exercises and the provision of information and

explanations about the intended strategy. Changes might be more acceptable if they are phased in over a period of time and the OECD (2006) has suggested it might be worth considering some compensation, possibly temporary, for those who are adversely affected. If some of the gains of the reform could be shared with any losers, it might make a significant difference to the possible opposition to the reform, as illustrated in Figure 1, and increase the chances of a more satisfactory outcome.

It is very advantageous that the plan includes intended outcomes and one or more methods for monitoring and evaluating progress. There are advantages if the relevant variables are quantifiable but not everything can be easily measured so provision should also be made for qualitative feedback. This should then complete the systematic development of the proposed reform and the final stage is assessment following implementation.

Step ten involves monitoring and evaluating the performance of the strategies against the plan but this, of course, is not always and easy task. Given the complexity of the whole process, a single indicator may well be insufficient to monitor the whole situation. As well as monitoring the continuing effects of the reform, this should be part of a wider monitoring of the changes with regard to the tax environment and practice, particularly taxpayer behaviour. As time passes different issues may well change in their importance with respect to the overall strategy and new ones may emerge. Finally, the results of the monitoring and evaluation of performance should be fed back into the continuous development of the most appropriate tax strategies.

Such a systematic approach would do much to improve the chances tax reforms being successfully developed and implemented. An example where this has often not been done is tax simplification. The case for tax simplification seems overwhelming when considered in isolation from other aspects of the tax system and the complex socio-economic environment in which taxes have to operate. The advantages of simplification may include savings in compliance and administrative costs, a reduction in uncertainty regarding the tax implications of economic decisions and an improvement in taxpayer compliance. However, attempts at simplifying modern tax systems have often not been very successful since they have not taken proper account of other important factors. There are very sound reasons why tax systems become complex in advanced economies and these must be considered if simplification is to be achieved (see, for example, James, *et al*., forthcoming). A simplification policy that followed a systematic approach, as suggested in this chapter, would become part of general tax policy and appropriate trade-offs between simplicity and other goals could be made and so increase the chances of a successful outcome.

CONCLUSION

Bird and Oldman's (1990) succinct description of the best approach to tax reform covers many important issues. Although, at first sight, the economic theory of tax reform appears relatively straightforward, there are some difficult trade-offs between efficiency and equity. In addition, other theoretical considerations described above give an indication of how complex tax reform can be in practice. Tax administration and compliance are particular areas where a range of difficulties can arise that must be taken into account if tax changes are to be successful. Then there is the context within which such changes must take place – economic, social and technological factors may be significant – together with international considerations arising from globalisation and tax competition. Furthermore, successful tax reform is likely to be a dynamic process rather than a single one-off change. The tax system has to be designed to be sufficiently robust to accommodate continuing change in the socio-economic and political environ-

ment and to be sufficiently flexible to accommodate further adjustments as appropriate. Nevertheless, drawing on the available literature, it is possible to design a systematic process that can take account of the many issues involved in developing tax reform.

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