Chapter 3

The Difficulties of Achieving Successful Tax Reform

Simon James
University of Exeter Business School, UK

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.
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