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Vern Krishna: Tax avoidance debate reaches back two centuries

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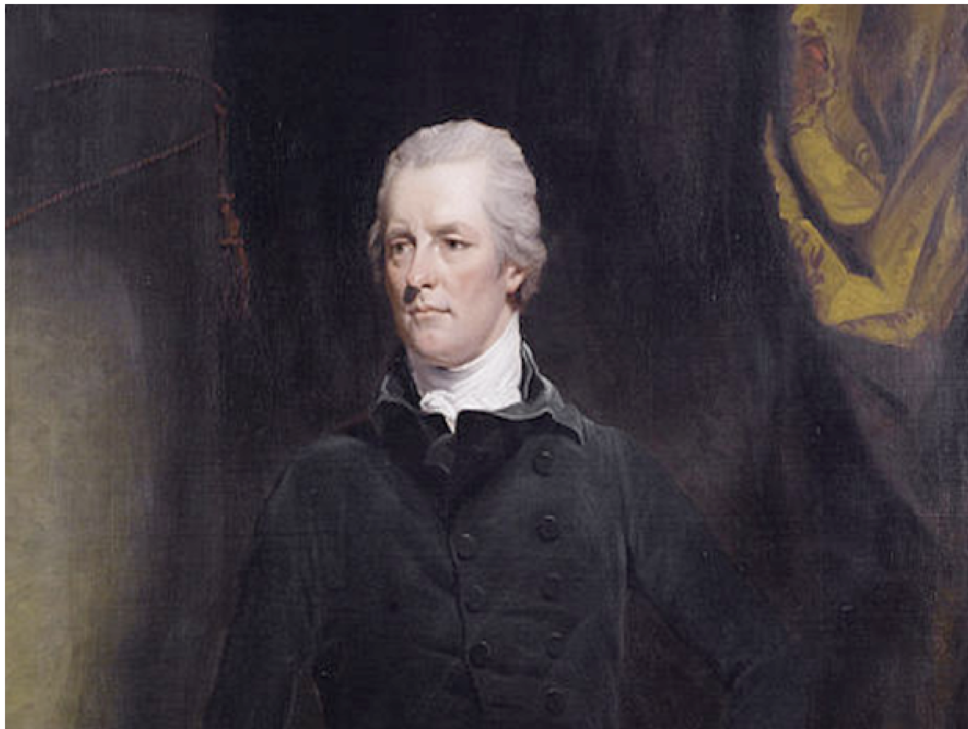

The tax avoidance debate goes back at least to William the Pitt the Younger, the British Prime minister w ho introduced income taxes in 1799 Wikipedia Commons

Tax avoidance debate reaches back two centuries, Vern Krishna writes

Governments of the G20 countries, desperate for tax revenues to support their spending addictions, are at war with taxpayers seeking to maximize returns on their earnings and investments.

This tug of war is not new. William Pitt the Younger (Great Britain's youngest prime minister at 24) introduced the first income tax in 1799, based on the nation's fervour to fight France and Napoleon. He said it was necessary "to repress those evasions [of excise taxes] so disgraceful to the country, so injurious to those who honourably discharge their equal contribution, and, above all, so detrimental to the great advantage which it is intended to promote." No political speechwriter has said anything new about tax avoidance ever since.

A tax system must raise sufficient revenue to finance a government's insatiable appetite for spending. The amount of revenue that a tax system raises is a simple mathematical function: Revenue = Tax Base x Tax Rate.

A system with a broad base is usually simpler than a system with a narrowly constrained base. This is because a broad-based system requires fewer lines of demarcation between classifications of income and expenditures and, hence, fewer avenues for avoidance by shifting types of income. For example, a system that taxes all forms of gains, regardless of their source, requires fewer rules than a system that distinguishes between different sources of economic gains, each with its own rules.

The second variable is the tax rate that one applies to the tax base. It is a fallacy to assume, as governments often do, that the higher

the tax rate, the greater the revenue collected from the tax base. Thus, ignoring behavioral responses to tax rates, a rate of 40% will, in theory, double the revenue than a tax rate of 20%.

However, this assumes that the tax base will not shift to lower tax jurisdictions. Indeed, many economists maintain that a reduction in tax rates stimulates economic growth and enhances revenues, which, in turn, leads to additional tax collections. The debate is about 215 years old.

At least three different rates that affect tax revenues, planning and avoidance: the marginal rate, the average rate and the effective rate. Each rate provides a different perspective, and the effective rate is perhaps the best tool for making international comparisons.

The marginal tax rate is the level of tax that applies on the top dollar of taxable income. For example, a Canadian who earns $30,000 taxable income will pay basic federal tax at 15%; an individual who earns taxable income of $150,000 will pay at a federal marginal rate of 29%. In contrast, the top central government rate in Switzerland is 13.2%. Marginal rates are useful in tax planning because they pinpoint the amount of savings on the top dollar of income.

The average rate reflects the weighted average of all of the marginal tax rates. For example, if Jane earns taxable income of $30,000, her average federal tax rate as an individual is $4,500 or 15%. If Harry earns taxable income of $140,000, his total tax is $30,145, which makes his average rate of tax 22% – that is, 7% lower than his federal marginal rate of 29%. Average rates tell us our overall tax bill.

The effective rate is the most meaningful rate of tax for taxpayers. It is the total tax payable divided by net income before exclusions and exemptions. In the above example, Harry may have earned $60,000 of capital gains in the year. By excluding one-half of his capital gains from taxable income, Harry has, in effect, reduced his effective tax rate on his economic income of $170,000 to only 18%. Effective rates are the most meaningful because they tell us what we are actually paying on all income and the amount of tax leakage for governments.

In making international comparisons, marginal and average rates of tax are not helpful because they do not take into account the differences in calculating the taxable base to which one applies the actual rate. Income exclusions and deductions can substantially reduce the effective rate of tax and provide incentives to move income.

The British supported Pitt's income tax on the basis that it was better to lose some of their property to the government than to lose all of it to Napoleon. The income tax was abolished, at least temporarily, when Napoleon met his Waterloo in 1815.

The Paris-based OECD's latest foray on the subject is the Base Erosion and Profit Shifting or BEPS project. A project report released in May picks up where Pitt left off, saying "that there is a growing perception that governments lose substantial revenue because of profit shifting that erodes the taxable base." Pitt's ghost could have written that speech.