The Economist

Overhaul tax for the 21st century

Today's tax systems are unforgivably cack-handed

IF YOU are a high earner in a rich country and you lack a good accountant, you probably spend about half the year working for the state. If you are an average earner, not even an accountant can spare you taxes on your payroll and spending.

Most of the fuss about taxation is over how much the government takes and how often it is wasted. Too little is about how taxes are raised. Today's tax systems are not only marred by the bewildering complexity and loopholes that have always afflicted taxation; they are also outdated. That makes them less efficient, more unfair and more likely to conflict with a government's priorities. The world needs to remake tax systems so that they are fit for the 21st century.

Let me tell you how it will be

Jean-Baptiste Colbert, the finance minister of Louis XIV of France, famously compared the art of raising tax to "plucking the goose so as to obtain the largest possible amount of feathers with the smallest possible amount of hissing". Tax systems vary from one economy to another—Europe imposes value-added taxes, America does not. Yet in most countries three flaws show how the art of plucking has failed.

One is missed opportunities. Expensive housing, often the result of a shortage of land, has yielded windfall gains to homeowners in big, global cities. House prices there are 34% higher, on average, than five years ago, freezing young people out of home ownership (see article). Windfall gains should be an obvious source of revenue, yet property taxes have stayed roughly constant at 6% of government revenues in rich countries, the same as before the boom.

Another flaw is that tax sometimes works against other priorities. Policymakers in the rich world worry about growing inequality, which is at its highest level in half a century. In the OECD, a group of mostly developed countries, the richest 10% of the population earn, on average, nine times more than the poorest 10%. Yet over this period, most economies (though not America's) have shifted the composition of labour taxation slightly toward regressive payroll and social-security levies and away from progressive income taxes.

Tax systems have also failed to adapt to technological change. The rising importance of intellectual property means that it is almost impossible to pin down where a multinational really makes money. Tech giants like Apple and Amazon stash their intangible capital in havens such as Ireland, and pay too little tax elsewhere. This month it emerged that Amazon's British subsidiary paid £1.7m ($2.2m) in tax last year, on profits of £72m and revenues of £11.4bn. By one recent estimate, close to 40% of multinational profits are shifted to low-tax countries each year.

The "solutions" to such problems often only exacerbate the daunting complexity of today's tax code—and, if lobbies have their way, add extra loopholes too. The European Union wants to determine when firms have a "virtual nexus" in a state, and will then allocate profits across countries using a complicated formula. America's supposedly simplifying recent tax reform included stunningly complex new rules for multinationals. International efforts to co-operate to prevent profit-shifting have made progress. But they are hamstrung by disagreements over how to treat technology firms and competition for investment in a world where capital crosses borders.

Fundamental tax reform can boost growth and make societies fairer—whatever the share of GDP a government takes in tax. Fortunately, the principles according to which rich countries can design a good system are clear: taxes should target rents, preserve incentives and be hard to avoid.

All countries should tax both property and inheritance more. These taxes are unpopular but mostly efficient. In a world where property ownership brings windfalls that persist across generations, such taxes are desirable. A conservative first step would be to roll back recent cuts to inheritance tax. A more radical approach would be to introduce a land-value tax, the most efficient of all property taxes and one with a long liberal heritage (see Briefing).

Economists are sceptical of taxing other forms of capital, for the good reason that it discourages investment. But capital's share of rich-world GDP has risen by four percentage points since 1975, transferring nearly $2trn of annual global income out of paycheques and into investors' pockets. Given that competition is declining in many markets, this suggests that businesses are increasingly able to extract rents from the economy. Taxes on capital can target those rents without disturbing incentives so long as they include carve-outs for investment.

To stop companies shifting profits, governments should switch their focus from firms to investors. Profits ultimately flow to shareholders as dividends and buy-backs. But few people are likely to emigrate to avoid taxes on their investment income—Apple can move its intellectual property to Ireland, but it cannot put its shareholders there. Corporate tax should be a backstop, to ensure that investors who do not pay taxes themselves, such as foreigners and universities, still make some contribution. Full investment expensing should be standard; deductions for debt interest, which incentivise risky leverage for no good reason, should be scrapped.

As the labour market continues to polarise between high earners and everyone else, income taxes should be low or negative for the lowest earners. That means getting rid of regressive payroll taxes which, in

North America, could be replaced with underused taxes on consumption. Though these are also regressive, they are much more efficient.

One for you, nineteen for me

Adam Smith said that taxes should be efficient, certain, convenient and fair. Against that standard, today’s tax policies are unforgivably cack-handed. Politicians rarely consider the purpose and scope of taxation. When they do change tax codes, they clumsily bolt on new levies and snap off old ones, all in a rush for good headlines. Rewriting the codes means winning over sceptical voters and defying rapacious special interests. It is hard work. But the prize is well worth the fight.

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