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On the timeliness of tax reform

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Abstract

This paper analyzes efficient government reactions to unanticipated tax avoidance. Quickly reforming tax laws to reduce the effectiveness of new tax avoidance techniques prevents widespread adoption, but indirectly encourages the rapid development of new avoidance methods if prior users are permitted to retain their tax benefits. Tax reforms that immediately prevent new avoidance mean that innovators need not fear imitation by competitors, and cannot rely on copying the innovations of others. Such an activist reform agenda diverts greater resources into tax avoidance activity, and might thereby lead to a faster rate of tax base erosion, than would a less reactive government strategy. Efficient government policy therefore entails either the retroactive elimination of tax savings, with possible associated costs, or else a deliberate pace of tax reform in response to taxpayer innovation.

JEL classification: H21; H25; K34

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1. Introduction

Countries frequently change their tax laws and regulations, being prompted by budgetary needs, general economic conditions, and the politics of the moment.[1] Laws also change in reaction to unanticipated tax avoidance behavior, as governments attempt to close loopholes, limit arbitrage, and otherwise maintain their tax bases. Since tax reform outcomes seldom satisfy all interested parties, there is continuing pressure to reform tax laws even in the absence of changing needs or economic circumstances. Many voice understandable concern that this process of continual reform may itself undermine tax policy objectives, since the

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[1] For example, the United States introduced 17 separate corporate tax reforms over the 1953–1985 period, as discussed by Auerbach and Hines (1988).

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behavior of taxpayers is likely to be affected by their expectations that the tax environment tomorrow may not resemble the tax environment today. The temptation to correct perceived problems with existing laws is, however, difficult to resist. Interested parties who would otherwise be concerned about the frequency with which tax laws change might nevertheless support just one more reform if it contains the right provisions.

The realization that taxpayers have discovered effective methods of avoiding what might otherwise be their tax obligations serves as a powerful spur to tax reform efforts. Somewhat ironically, this often occurs in response to taxpayer reactions to opportunities created by prior tax reforms, when governments attempt to encourage certain behavior by rewarding it with favorable tax treatment, only to discover subsequently that taxpayers take more advantage of the new provisions than was originally envisioned. It is perfectly natural for governments then to want to correct this state of affairs immediately with new legislation designed to remove some or all of the benefits of any new tax avoidance activity.

The purpose of this paper is to analyze the optimal timeliness of tax reform. Unless governments apply tax reforms retroactively, the efficient policy may not be to eliminate tax avoidance methods as soon as they are identified. The reason is that the eagerness of the government to restrict future tax avoidance indirectly encourages the development and use of new tax avoidance methods. Since it is typically costly to develop such methods, a policy of removing tax avoidance opportunities once they are discovered produces a cycle in which taxpayers are continually expending resources to identify and exploit new tax avoidance opportunities and to replace old methods that are no longer allowed. In such an environment, there can exist situations in which the government's reform efforts actually increase the aggregate level of tax avoidance by encouraging development and early adoption of tax avoidance techniques by taxpayers seeking to obtain benefits prior to any reforms that will render them ineffective or illegal. Retroactive application of tax reform removes the incentive to develop new methods, but does so at the cost of the economic uncertainty associated with possible future use of retroactivity.

Efficient tax reform policy entails considerations other than maximizing tax collections. Since resources devoted to tax avoidance could be profitably deployed elsewhere in the economy, it follows that any welfare analysis of the frequency of tax reform necessarily entails trading off any benefits from reducing tax avoidance with the cost of encouraging taxpayers to devote resources to avoidance activity. To take an extreme example, suppose that taxpayers always are able to reduce their tax burdens by 20% through a judicious use of tax planning opportunities. Government policy can make this tax avoidance easy, perhaps almost costless, or alternatively policy can make it very difficult (by closing off easy-to-find loopholes), in which case obtaining a 20% tax reduction might cost almost as much as the taxes saved. If taxpayers will ultimately obtain their 20% tax reductions (and no more) under either tax policy regime, then an efficient government policy would permit easy access to well-developed tax avoidance methods, since doing so economizes on resources devoted to tax avoidance without affecting aggregate tax collections.

Recent interest in corporate tax sheltering activity brings some of these issues into stark relief. There are well-publicized examples in which financial innovators develop tax avoidance tactics that they then market to taxpayers in return for fees.[2] This

[2] See the examples discussed in Bankman (1999).