

Is Tax Avoidance Harmful?

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Pressures for tax harmonization are mounting in the EU, and tax harmonization means higher taxes: high taxes damage only the country that imposes them, whereas low taxes in one country are perceived as a threat elsewhere. Higher taxes increase the incentive for avoidance, and avoidance is likely to be resisted more strongly in some countries than in others. Thus disharmony can be reintroduced through avoidance.

Two kinds of avoidance must be distinguished – the substantive and the formal. Substantive avoidance alters the pattern of economic activity. If whisky and other spirits, for example, are taxed heavily, consumers may react by reducing consumption; this causes a loss to the fisc and to the economy, because the pattern of consumption is fiscally distorted. Formal avoidance retains the substance of the activity but inserts steps or transactions for the sole purpose of reducing the amount of tax paid. For example, the English whisky drinker may make a trip to France for the sole purpose of buying Scotch taxed at lower rates.

When governments attack tax avoidance in words, their target is always formal avoidance and never substantive avoidance, although the latter is economically more damaging. According to its critics, formal avoidance shifts a burden from the avoiders to other taxpayers, who have to make good the amount of tax avoided. This argument assumes that government expenditure is given and has to be matched in one way or another by taxation. But households and corporations usually match expenditure to income, not the other way round; and governments may react to a shortfall in revenue by reducing expenditure or increasing debt rather than by increasing other taxes. Tax avoidance is an extended process which in practice serves to exert long-term pressure on government spending. The argument about shifting the burden onto other taxpayers also assumes that the rates of tax are below the point of maximum-revenue yield (above which the tax becomes more and more prohibitive). But this may not be so. When Thatcher in the UK and Reagan in the US reduced the very high rates of income tax which they had inherited at the top of the scale, the amount and share of income tax paid by the taxpayers affected did not fall but rise. This suggests that previous avoidance of these very high rates by reducing them to lower rates increased instead of reducing the tax revenue of the fisc. Fortunately there are signs of government beginning to make a more balanced economic assessment of avoidance, recognising positives as well as negatives.

Formal tax avoidance is initially harmful to the fisc below the maximum-revenue rate of tax. Within the economic sector concerned, it is harmful to competitors, like traders selling fully taxed whisky in the south-east of England. It causes like taxpayers to be taxed unequally (horizontal inequity) and poorer taxpayers to be taxed more heavily than richer (vertical inequity). But these are redistributive effects (from fisc to taxpayer, from one taxpayer to another), which are compatible with an increase in the economic product (an increase in whisky consumption towards the amounts consumed in a tax-neutral or no-tax situation). By contrast, substantive avoidance (a shift from whisky to tea or from saving to spending) always reduces the economic product and damages the interests both of the fisc and of taxpayers in aggregate.

Formal avoidance is beneficial to the avoiding taxpayers. It is beneficial to the fisc if the tax rate is above the point of maximum tax revenue. It does good economically by reducing the distortions caused by high rates of tax, by reducing distortions between sectors (by reducing tax on highly taxed whisky or highly taxed saving – income tax, surtax, capital gains tax, stamp duties, inheritance tax etc.). By contrast substantive avoidance is never beneficial: the gains to the avoiding taxpayer are always less than the losses to the rest of the economy.

Thus, formal avoidance, if successful, is always beneficial to the avoiding taxpayer. It is beneficial to the fisc if the tax rate is above the point of maximum tax revenue. It is not harmful to the fisc if it is true that the burden is shifted to other taxpayers, since that argument assumes that the fisc does not lose money. Other taxpayers lose if the burden is shifted and lose from increasing distortion within the sector and gain from decreasing distortion between sectors. The economy is likely or certain to gain from a move towards tax neutrality and a reduction of tax-induced distortion of the pattern of economic activity. Far from avoidance inflicting an overall loss, it is more likely to yield an overall gain, especially if tax rates are high.

Formal avoidance, which is politically contentious, may be economically beneficial. Substantive avoidance, which is tolerated or ignored politically, is always damaging economically. The only way to make both kinds of avoidance less attractive without inflicting further economic damage is to reduce high rates of tax. Recognition of these relationships may serve to constrain the process of increasing taxes through harmonization.