Challenges for the Design of a Sustainable Tax System

Stephen Matthews

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Overview

1. What are the main economic challenges facing OECD countries? What role can/ should tax policy play in addressing them?
2. Tax policy trends
   - Trends over the past 25 years
   - The Great Recession and recent developments
3. Responding to the Challenges: Ensuring Sustainable Tax Regimes

1. The Challenges

Economic Challenges (A selection!)

- Restoring sound public finances and financial systems
- Adapting to /taking advantage of globalisation and technical change
- Returning to sustainable growth of output and employment (and reducing persistent long-term unemployment)
- Maintaining a fair distribution of disposable income in the face of wider pre-tax inequality
- Population ageing
- Addressing environmental damage and climate change

What role for tax policy?

- Taxes are principal means of transferring resources from private to public use
- Tax needs to raise enough revenue to finance public expenditure (and maintain sound public finances), while
  – doing as little harm to the economy as possible;
  – keeping administrative and compliance costs low;
  – maintaining horizontal equity across taxpayers; and
  – providing a means to redistribute income
- Addressing externalities
- Support regulatory frameworks for pension saving, financial institutions, etc

What challenges for tax policy?

1. Globalisation etc making it more difficult to raise enough revenue?

- A given set of tax rates may raise less revenue and/ or be more distortive than previously because of:
  - Increased capital mobility – particularly traded financial assets
  - Labour also more mobile internationally
- Downward pressure on tax rates from tax competition
- Growing importance of Knowledge-Based Capital (e.g. patents): a major source of competitive advantage for MNEs, but also easy to shift IP – and taxable profits - across tax jurisdictions - increased scope for tax avoidance, evasion and fraud

Challenges for tax policy (2)

2. Need for international cooperation

- Cross-border flows of income and of goods/ services: co-operation to avoid double and/ or discriminatory taxation; but also artificially low/ no taxation
- Cross-border pollution: greenhouse gas emissions and climate change

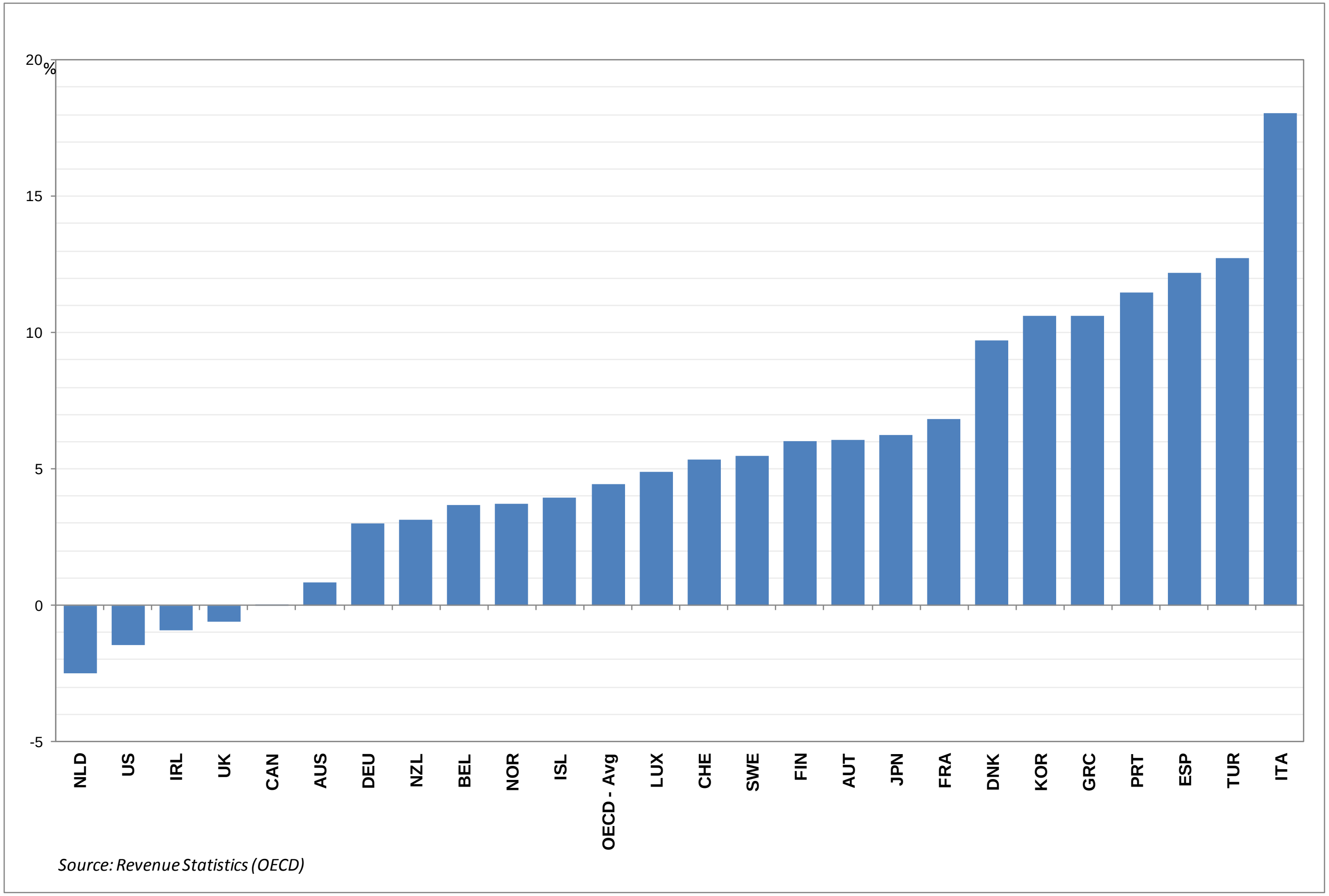
3. Distribution and fairness

- Wider dispersion of pre-tax incomes reduces ‘taxable capacity’ at the bottom and increases it at the top: harder to ensure that tax regime is ‘fair’

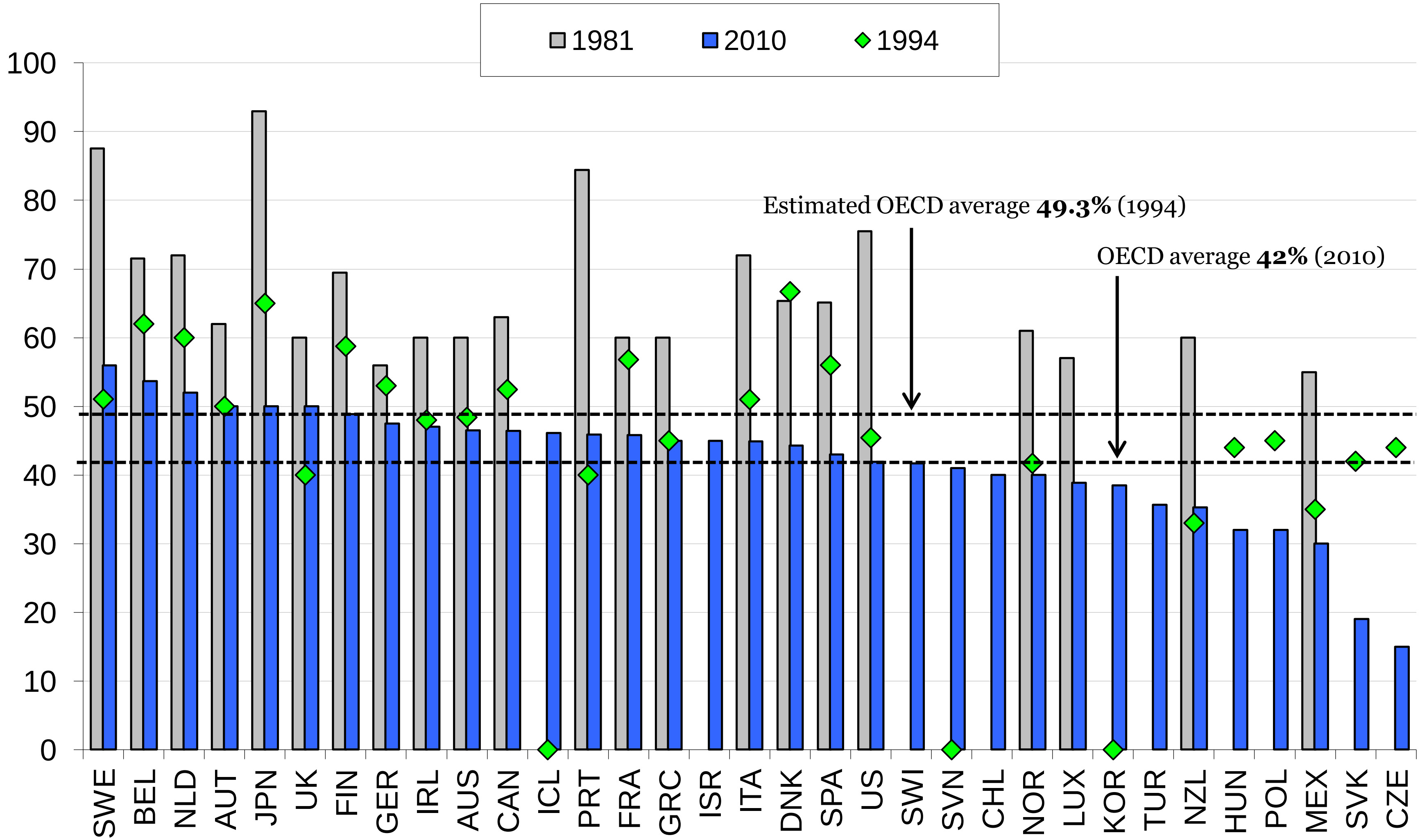
4. Supporting other policy objectives: growth, employment

2. Trends

Change in tax revenues, % of GDP, 1975-2010

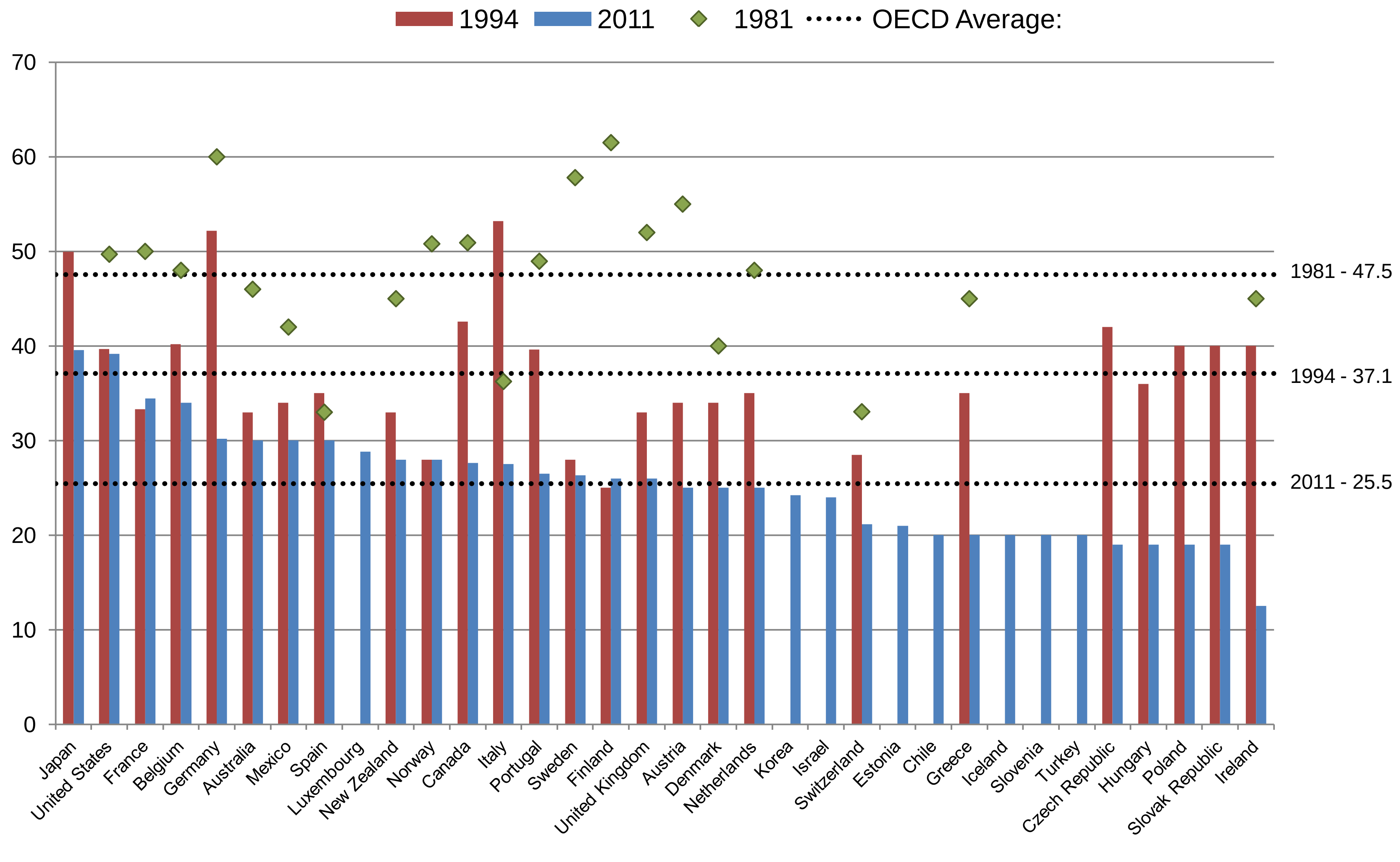


Top statutory personal income tax rates



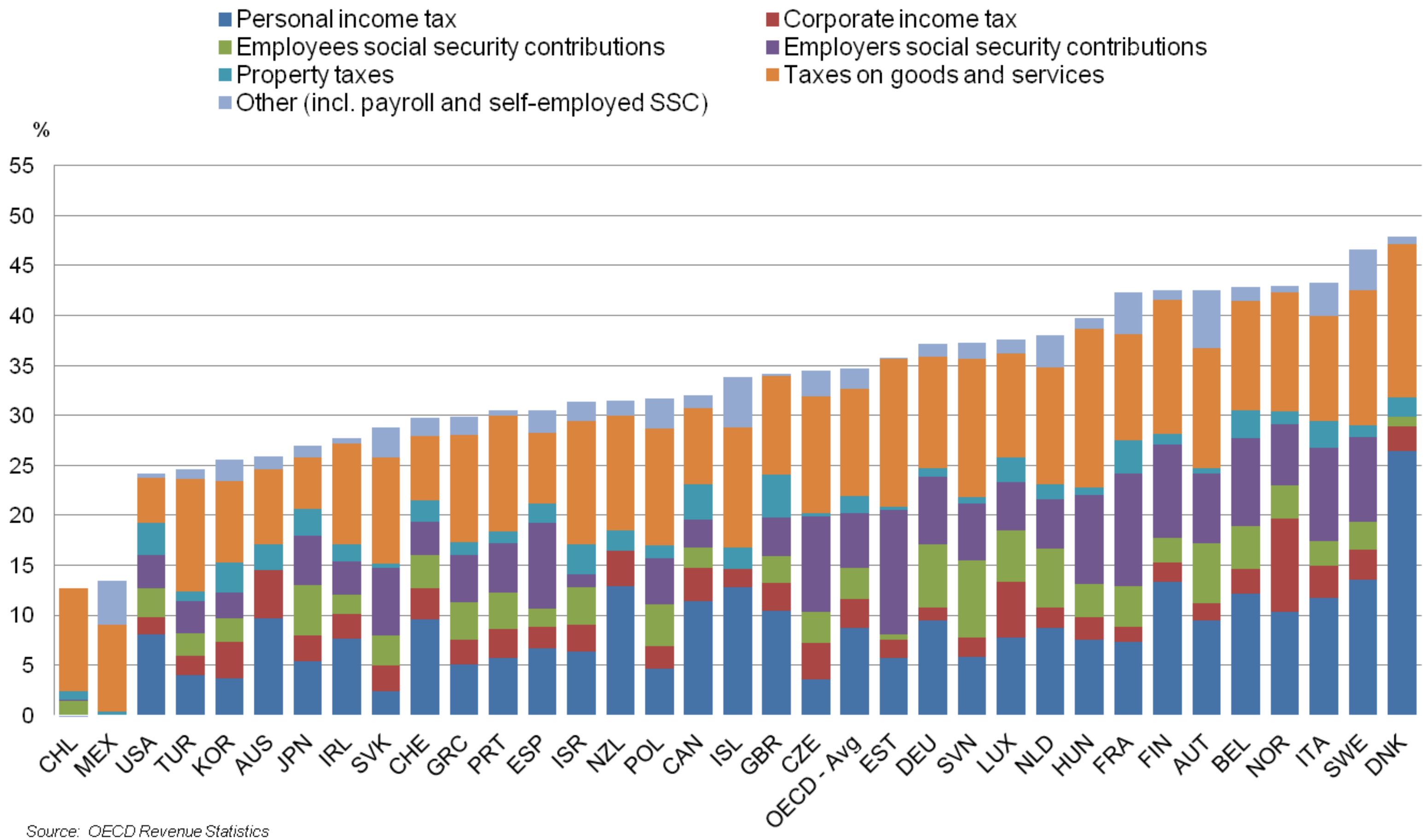
Source: OECD Tax Database

Corporate income tax rates



Source: OECD Tax database

Total Revenues and their Composition

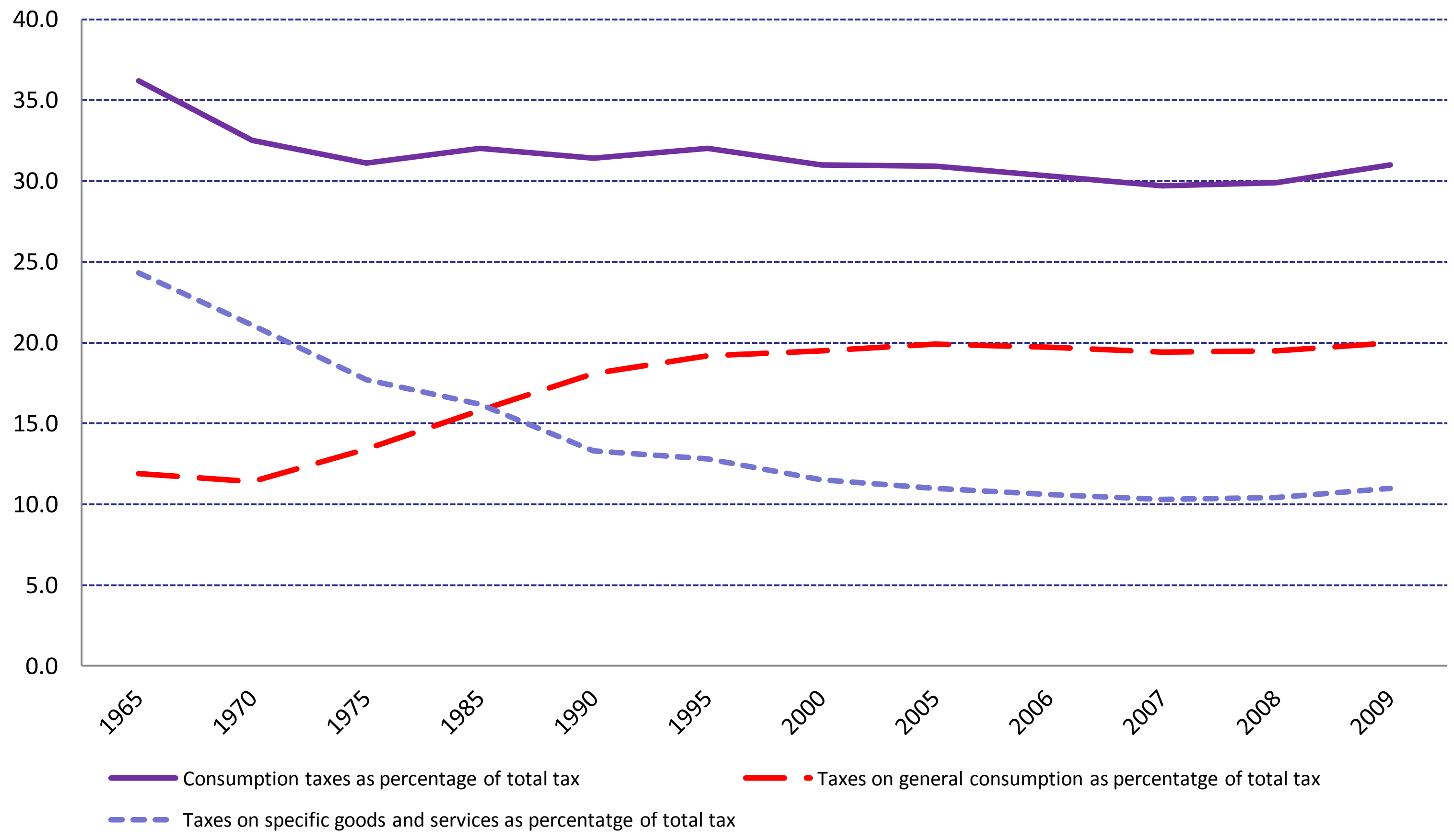


Source: OECD Revenue Statistics

The Rise of VAT

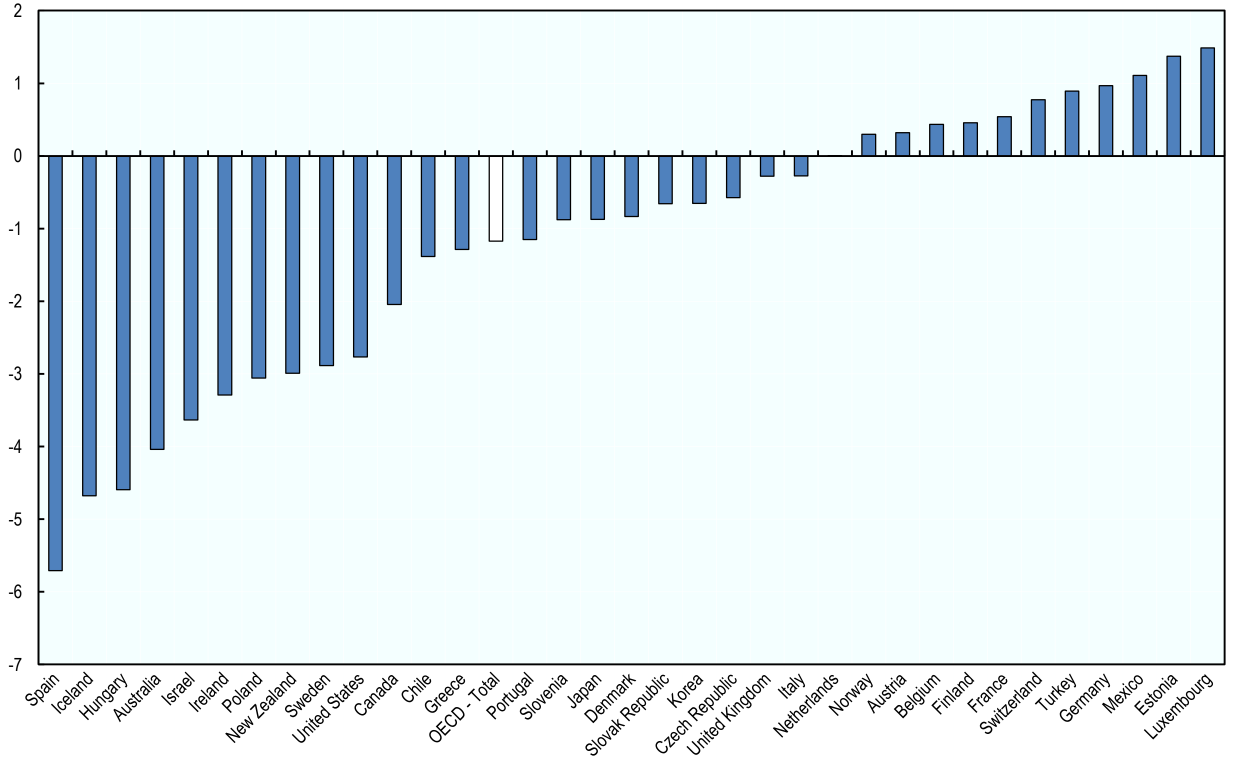
Taxes on specific goods and services (excise & customs duties): from 24,3% of total tax down to 11%

General consumption taxes (mainly VAT): share in total tax up to 20% in 2009 from 11,9% in 1965.



<u>Source</u>: OECD(2011), *Revenue Statistics 2010*

Change in Tax Revenues 2007-2011, % of GDP



Source: OECD Revenue Statistics

Changes in Tax Revenues, 2007-2011, by Category of Tax, % of GDP

	Total	PIT +CIT	SSCs	Property	Consumption
Austria	0.3	-0.4	0.7	-0.1	0.2
France	0.5	-0.4	0.7	0.3	0.1
Germany	1.0	-0.3	1.0	0.0	0.3
Italy	-0.3	-0.8	0.5	0.1	0.4
Spain	-5.7	-3.3	-0.2	-1.1	-1.1
UK	-0.3	-1.2	0.1	-0.4	1.2
US	-2.8	-1.8	-0.8	-0.1	-0.1
OECD	-1.2	-1.2	0.2	-0.1	0.0

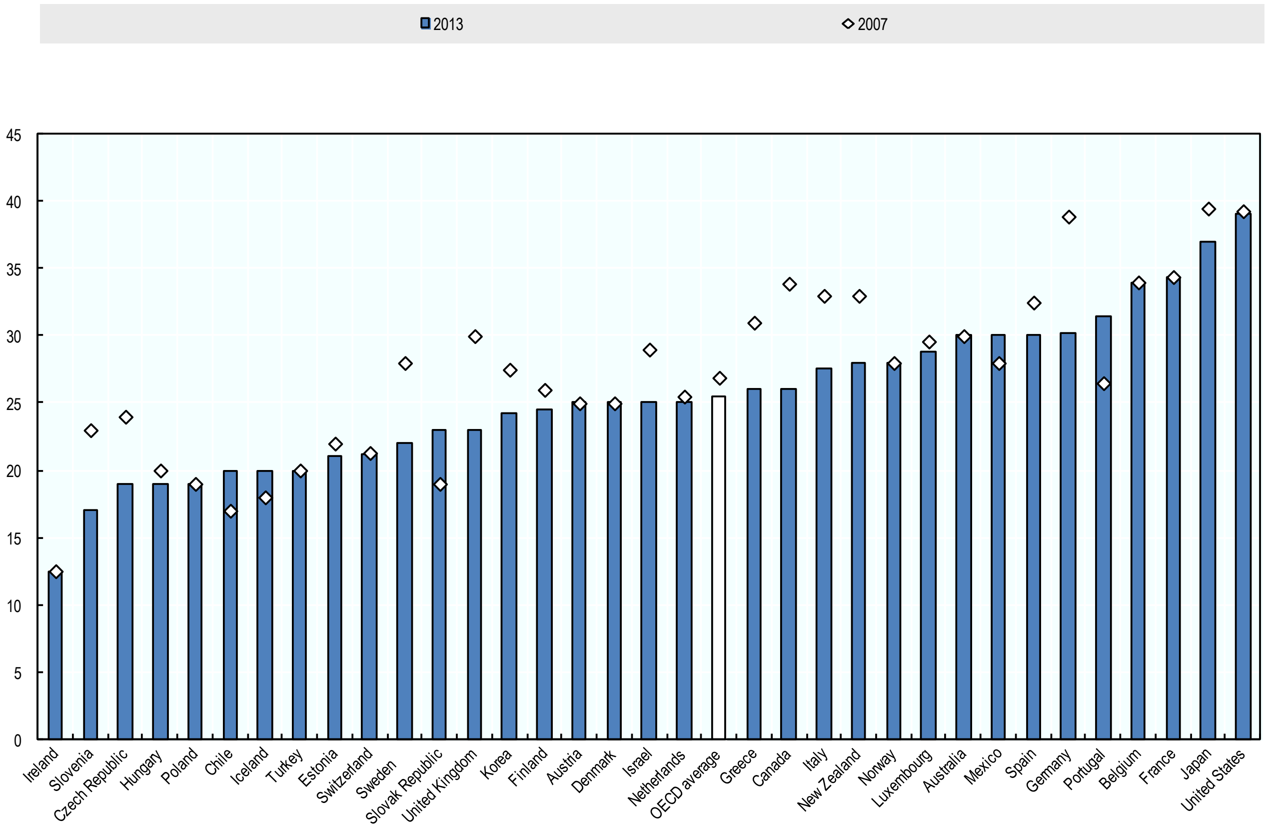
Source: OECD Revenue Statistics

Numbers of OECD countries changing ‘headline’ tax rates, 2007-2014

	Increase	No change	Decrease
PIT top rate	18	9	7
CIT	6	9	19
VAT (standard rate)	18	15	1

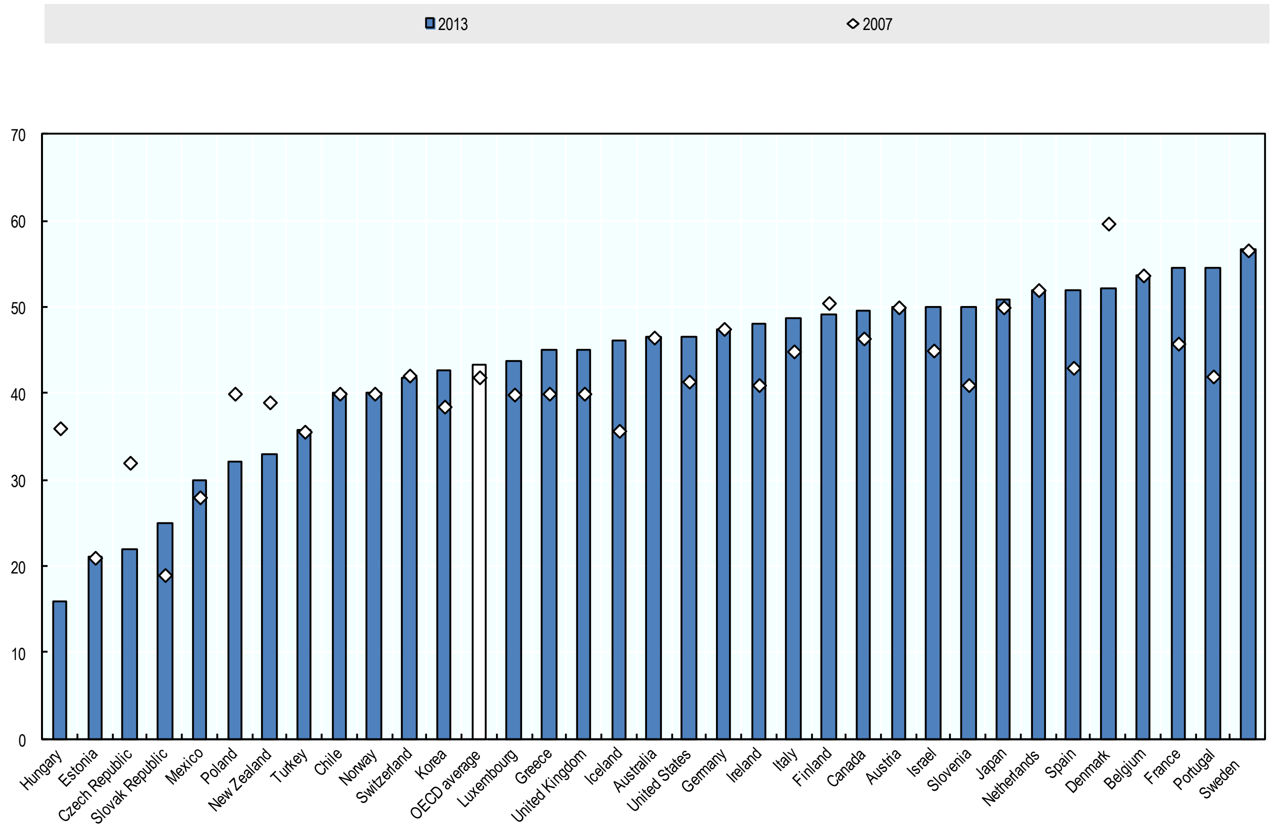
Source: ‘The Tax Policy Landscape Five Years after the Crisis’ OECD Tax Working Paper No. 17

Main Statutory CIT Rate, 2007 and 2013



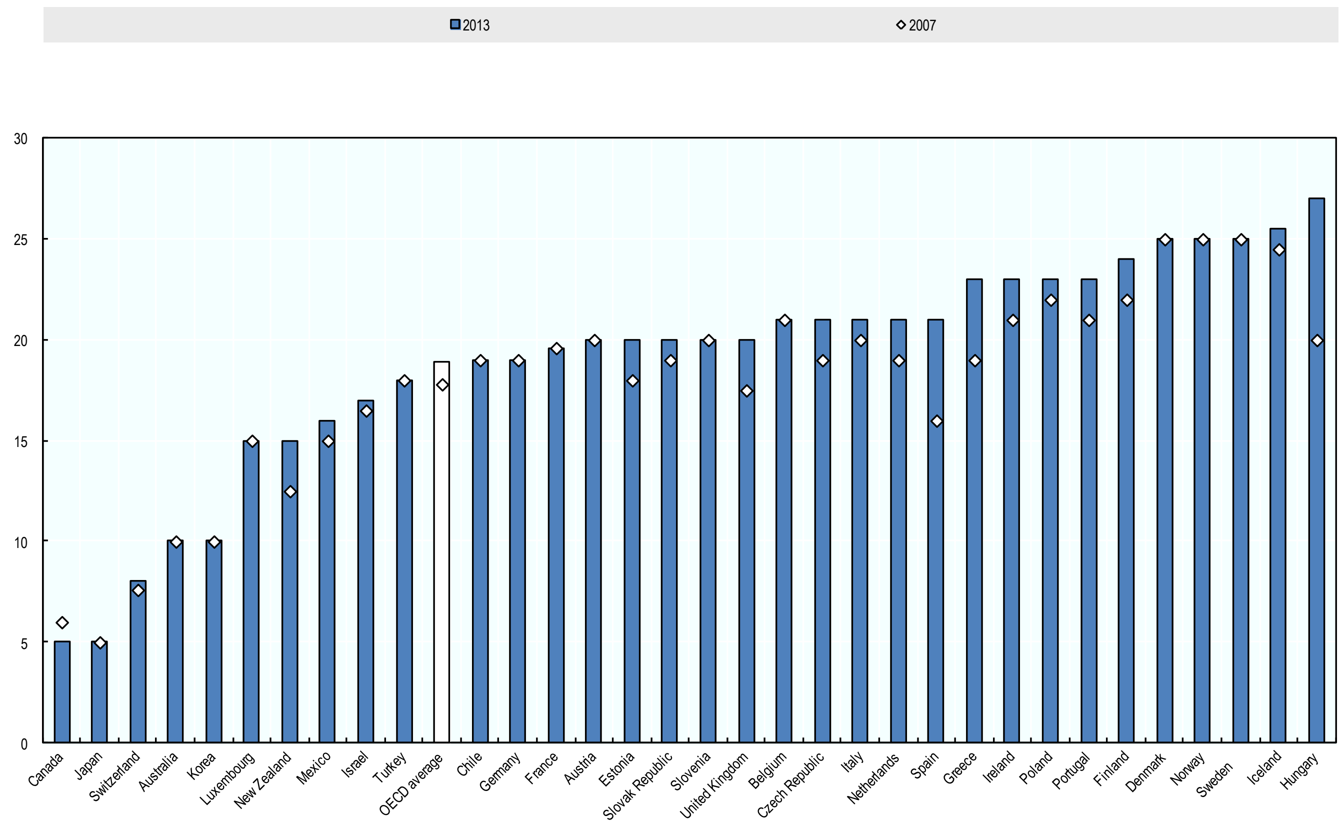
Source: ‘The Tax Policy Landscape Five Years after the Crisis’, OECD Tax Working Paper no. 17

Top PIT Rate, %, 2007 and 2013



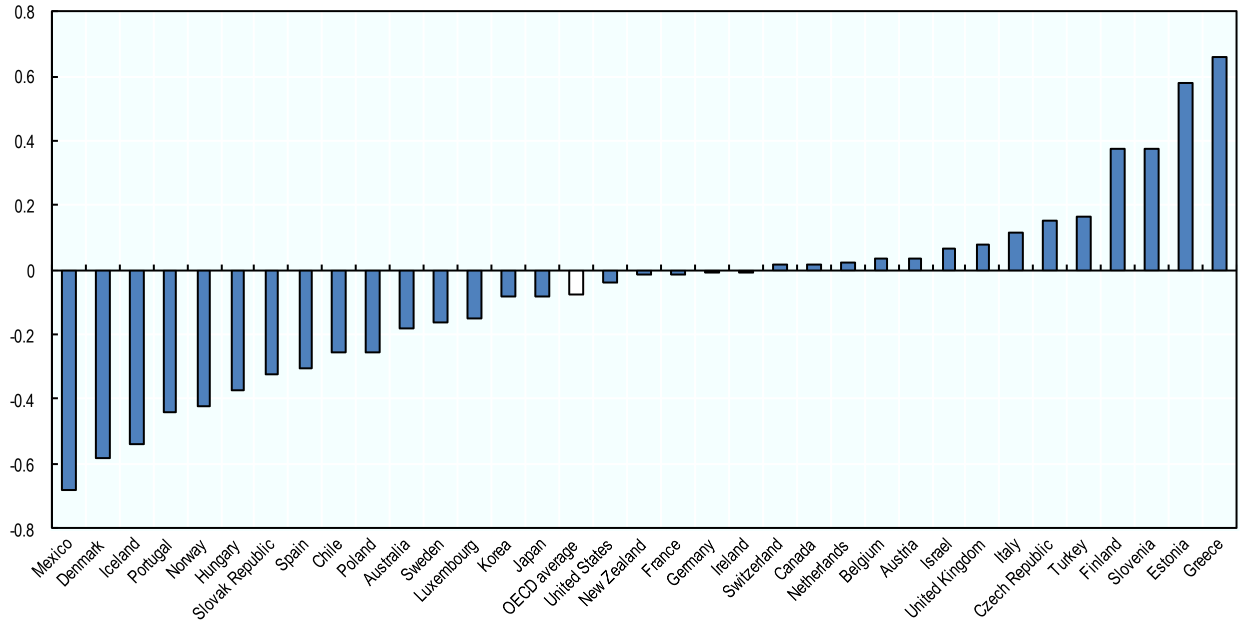
Source: 'The Tax Policy Landscape Five Years after the Crisis', OECD Tax Working Paper no. 17

Standard Rate of VAT, %, 2007 and 2013



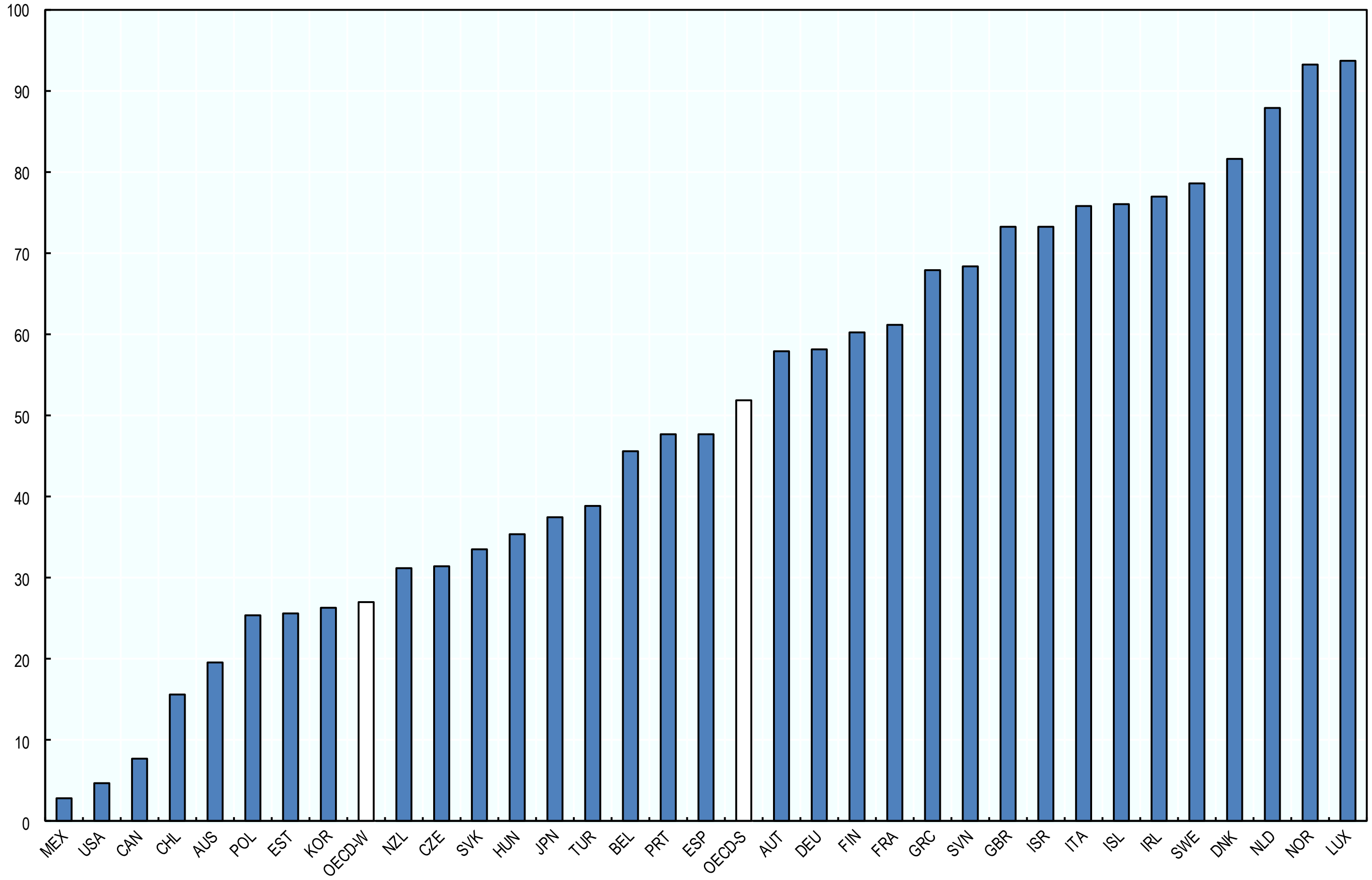
Source: 'The Tax Policy Landscape Five years after the Crisis'. OECD Tax Working Paper no. 17

Changes in Revenues from Environmental Taxes, % of GDP, 2007- 2011



Source: OECD Database of Environmentally-Related Taxes

Average Effective Tax Rates on CO2 Emissions, Euro per tonne



Source: 'Taxing Energy Use'. OECD (2013)

3. Designing a Sustainable Tax Regime

(Combining raising revenue with economic efficiency and fairness)

Tax Structure

- PIT – continues to do heavy lifting of revenue raising and redistribution, but how to reduce disincentives?
- SSC – future role of a second tax on earnings, esp. given demographic challenges?
- CIT – how to design a non-distortionary backstop to PIT and tax on capital income in the face of tax competition?
- VAT – attractions of destination basis and good revenue raiser, but distribution, distortion and fraud concerns
- Property taxes – political economy challenges
- Environmental taxes – no double dividend?

Tax Structure and Economic Growth

- 2008 OECD analysis suggested that a revenue neutral change in composition of tax revenues away from income to consumption taxes could increase growth
- Similar results obtained more recently by IMF, though not for CIT
- But robustness of econometrics remains uncertain
- Need to consider transmission mechanisms – effects of cuts in tax rates and/ or tax breaks on investment, R&D, entrepreneurship, human capital investment, job choice, effort, etc
- Composition of tax revenues is not, in itself, a ‘silver bullet’. Importance of incentives, ‘neutrality’. etc

Tax and Employment

- Challenges for real wages/ employment from globalisation and skill-biased technical change
- Literature suggests
  a. Stronger responses to tax incentives at extensive margin: strengthens rationale for in-work tax credits
  b. Some groups are more responsive than others (non-prime age, second earners, etc): part of rationale for reduced SSC rates for older workers
- But extensive use of income-related benefits/ credits may undermine incentives to up-skill, work harder, save for retirement, etc
- Pros and cons of contributory regimes with more ‘churning’ compared with greater means-testing
- SSCs: employment objectives vs. contributory principle

Tax and Investment

- Desirability in principle of a ‘neutral’ CIT regime: distort investment decisions as little as possible
- ‘Neutrality’ provides rationale for cutting rates and broadening base: but how far should cuts go? CIT a backstop to PIT (by taxing profits on accrual); main tax on capital income
- Debt bias: stability risks of excess leverage
- FDI flows have high tax elasticity: tax competition to attract investment
- But want to tax location specific ‘economic rents’
- An Allowance for Corporate Equity?

Cross-border Profit Shifting

- Extensive base erosion and profit shifting – not associated with actual investment
- Low CIT (and PIT) rates not only attract investment, but also tax base
- Ease of shifting intangible assets between jurisdictions
- Challenges for transfer pricing to establish where profits have been earned due to uniqueness of IP: no arms length price

International Cooperation

- Continually evolving framework of tax treaties, transfer pricing guidelines, etc, primarily to avoid double taxation
- Profile of profit shifting and artificially low ETR increased by cases of Google, Amazon, Starbucks, etc
- G20 approved BEPS Action Plan steps up cooperation: proposals to be developed inter alia on measures
  - to neutralise hybrid mismatch arrangements
  - to prevent treaty abuse
  - to improve transfer pricing for intangibles
- Study on tax issues raised by digital economy
- Development of a global standard for automatic exchange of information for tax purposes

Tax and Equality

- What is measured is managed?
- Tendency to focus on household disposable income BUT other dimensions of well-being also matter, e.g.:
  - Lifetime perspective
  - Equality of opportunity
  - Non-income aspects of inequality, e.g. disability
  - Health, education, engagement in civil society
  - Comparing different household types (equivalisation)
- Tax can have **direct** effect on disposable incomes and also **indirect** effect on future earnings capacity (i.e. Incentives matter and in turn affect future distribution)

Personal Income Tax

- Income tax main instrument available for achieving redistribution from top income recipients
- Taxable income elasticity much studied for such income groups and appears to be quite high
- Close loopholes and reform tax expenditures
- Many tax expenditures are for savings or charities – cap benefit rather than abolish?
- How far to tax capital and business income?
- A modified expenditure tax approach (as Mirrlees)?
- How far does ‘small open economy’ model characterise the real world? More taxation of capital income at a personal level?

Consumption Taxes

- Attractions of destination basis: does not distort trade, but stronger measures needed to combat fraud
- VAT/ GST – efficiency costs least if broad based, but many countries use reduced rates to attenuate regressive distributional effects
- Actual VAT regimes may still be regressive in relation to income but often not in relation to household expenditure
- Reduced rates an inefficient way of achieving distributional objectives
- Studies for the EU, Mirrlees review, etc suggest large efficiency gains from broadening base, with enough extra revenue to achieve more redistribution overall
- But politically difficult

Property Taxation

- No country now taxes full market value of imputed rent from owner occupation, yet mortgage interest relief remains in many countries – tax privilege even compared with expenditure tax treatment
- Taxes on transactions - a highly distortionary and unfair alternative to recurrent taxes on residential property
- Putting a good administrative regime in place to collect recurrent tax is costly, but tax then hard to avoid.
- Visibility = unpopularity? Also many hard cases, esp. among low income and older households.
- Pros and cons of income-related reliefs
- Local tax tied to local spending: hard to assess incidence and progressivity
- Big political economy issues

Environmental Taxes

- Correcting an externality should improve economic efficiency and yield benefits
- Often benefits accrue only partly, if at all, to individual bearing the tax
- Most environmental taxes likely to get passed forward into final consumer prices, implying a fall in real wages and rise in marginal real effective tax rate
- Using revenues from the environmental tax to cut labour taxes could offset, but likely to be competing uses
- Best to assume just a ‘single dividend’: the reduction in environmental harm
- But tax still often better than regulation (revenue raised provides more scope to compensate losers)?

Some Conclusions

- Continuing pressures to increase tax revenues (ageing populations, reduce budget deficits)
- But taxation harms incentives and may reduce growth
- And pressures from globalisation and tax competition
- PIT, SSCs and consumption taxes will remain main revenue raisers
- Greater use could be made of environmental taxes and recurrent taxes on residential property, but significant political obstacles
- Also scope to make most taxes less distortive and fairer
- International coopertaion has never been more important