



## Review of the OECD's Working Paper on Tax Design for Inclusive Economic Growth

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On 20 July 2016 the OECD's Centre for Tax Policy and Administration issued a working paper entitled *Tax Design for Inclusive Economic Growth*, which examines the design features of tax systems and how they can be strengthened to support inclusive economic growth. The paper was discussed at the ministerial-level G20 Tax Symposium on 23 July, just before the meeting of G20 Finance Ministers and Central Bank Governors on 23-24 July 2016.

This latest working paper follows an OECD report in 2008 entitled *Tax and Economic Growth*, which analyzed the impact of taxes on economic growth from an efficiency perspective. The current paper attempts a fresh assessment of the 2008 policy recommendations with a greater emphasis on equity considerations based on developments in academic literature and tax policy over the last several years.

The study examines how the interaction of taxes and other factors influences the efficiency of the taxes and the extent to which outcomes are equitable. The efficiency and equity implications of tax policies can only be assessed by looking at tax systems and benefits as a whole. The implementation of tax policy also needs to be coordinated with international tax mechanisms to prevent tax evasion and tax avoidance.

The OECD working paper notes that tax policy should limit distortions in economic behavior by making the tax system as neutral as possible, limiting discrimination in favor of or against any economic choice. Horizontal equity, requiring that taxpayers in an equal situation pay an equal amount of tax, is also a feature of more efficient tax systems. This may sometimes be achieved at the expense of vertical

equity, which requires taxpayers with a greater ability to pay to bear a relatively higher tax burden.

This report summarizes the OECD analysis of several prominent taxes and other principles discussed in the working paper.

### Property Taxes

The OECD's 2008 report considered recurrent taxes on immovable property to be the least damaging tax to long-run economic growth, finding that recurrent taxes levied on households had less adverse effects than those levied on businesses. The tax base for recurrent taxes on households' immovable property is highly immobile, and therefore there is a limited behavioral response to the tax, especially where the tax is imposed on land. There can also be a strong correlation between the tax paid and public services received, especially where taxes are directly linked to the provision of local public goods, which may also increase the accountability of local governments. These taxes are difficult to evade as immovable property is highly visible.

However, concerns have been expressed about the impact of recurrent property taxes on asset-rich but cash-poor households, requiring concessions targeted at low-income groups. They may also impose an unfair burden on middle-income families, which tend to hold a high proportion of their wealth in immovable property, as compared to high earners who tend to hold a greater proportion of their wealth in more liquid forms. These taxes also often rely on valuations that are outdated and do not reflect current market values.

The latest working paper concludes that a shift toward recurrent taxes on immovable property will normally be a pro-growth reform, but adequate design is required to make the tax shift more inclusive by providing relief to low-income households. The design of such taxes should allow for the updating of property values.

The working paper notes that there is not a strong case for transaction taxes on immovable property because they are highly distortionary and their distributional impacts are uncertain. Though easy to administer, they should be avoided if revenue sources promoting inclusive growth are available. In certain limited cases, well-designed property transaction taxes could help to curb speculative behavior and over-investment in housing.

## Consumption Taxes

Pure consumption taxes do not influence the return on savings or choice between different savings vehicles, although they still have an impact on labor-supply decisions. As exports are generally zero-rated for value added tax (VAT) purposes, the paper notes that a pure VAT does not affect international competitiveness. The design of a VAT system makes it effective for collecting tax and minimizes the opportunity for fraud. If a VAT is broad based, it will not distort consumption choices and will minimize compliance and administrative costs.

There are, however, distributional concerns because VAT is seen as a regressive tax with greater impact on lower income groups, measured as a percentage of current income. However, the OECD working paper notes that studies looking at the VAT burden as a proportion of current expenditure have found VAT systems to be relatively proportional or slightly progressive. The reason for this difference is that the current income studies fail to account for savings behavior. In other words, they do not take into account that income saved this year will still incur VAT when it is eventually consumed. So as higher income households save a greater proportion of their income, the VAT burden measured on the basis of current income tends to be lower, leading to a conclusion that VAT is regressive. The authors suggest that a more accurate picture would be revealed by a multi-period or lifetime analysis.

To counter the perceived regressive nature of VAT, many countries have introduced reduced rates for various items. If these comprise a greater proportion of the expenditure of poorer households, they can be progressive in the sense of offering a larger relative tax reduction to the poor, but the richer households will still gain more in aggregate terms because their aggregate consumption is higher. The paper notes that reduced rates for social, cultural or other non-distributional goals (including reduced rates on restaurant food and hotel accommodation) often have a regressive effect due to the disproportionate benefit to higher income households.

The OECD working paper concludes that there is strong evidence to support a shift in the tax mix toward VAT because it is an efficient source of tax revenue and distributional impacts are less significant than previously thought. However, if an increase in VAT is accompanied by a decrease in personal income tax (which is clearly progressive) the result may have negative distributional effects. Also, many OECD countries have already shifted more toward VAT.

The paper adds that VAT design is important in order to ensure it is a tax on final consumption rather than on business inputs, with full and prompt VAT refunds for business inputs and implementation of international VAT guidelines. Also, it notes that the VAT base should be broadened with removal of reduced VAT rates, in particular those that provide larger savings to upper income groups. Part of the revenue from broadening the VAT base or increasing the standard rate could then be used to compensate lower income groups, as they will be impacted more by a proportionate tax.

## Excise Taxes

Excise taxes on alcohol and tobacco are applied to a relatively inelastic base and are a highly efficient way of collecting tax revenue. They are, however, almost always found to be regressive when measured as a percentage of current income, and generally when measured as a percentage of current expenditure. The working paper concludes that there is a strong case, however, for increasing these taxes on health policy grounds, provided that all substitutes are taxed similarly.

## Environmental Taxes

The main environmental taxes are excise taxes on the purchase/ownership of transport vehicles and on energy products such as transport fuels. These taxes are considered to have a strong environmental impact.

The study finds that often the taxation of transport fuels can raise tax revenue at relatively low efficiency cost and can be compatible with progressivity. However, the study points out that in some countries the taxes are already equal to the social costs of the negative externality, and further increases in this case would be costly for the economy. More precise mechanisms such as congestion charges and distance-based charges could help to control transport externalities and raise revenue, but they are potentially regressive.

Taxes on heating fuels and electricity could be increased as part of a growth-friendly tax policy. Although these taxes are frequently regressive in nature, they are generally charged at low rates that could be increased to yield environmental gains. The working paper notes that this would, however, require some form of compensation for lower income groups to support energy affordability.

## Taxation of Labor Income

The 2008 OECD report ranked the personal income tax, including social security contributions, as the second most harmful tax to economic growth after the corporate income tax. The tax rate bands -- and especially the top rate -- have adverse effects on economic growth. The personal income tax is, however, the main source of progressivity in most tax systems, although the impact of social security contributions varies considerably across countries. Personal income tax reforms should reduce efficiency costs while addressing distributional concerns.

The latest OECD study suggests that the impact of personal income tax and social security contributions on the supply of labor is greater at lower income levels, where there may be low earnings potential and low attachment to the labor market. So high tax rates may have negative consequences for participation in the labor market, hours worked, work effort and wages. At higher income levels, while higher rates are a progressive policy measure, they may have

negative efficiency consequences through increased tax planning or movement of skilled labor abroad.

Horizontal equity in the personal income tax system requires neutrality toward taxpayers regardless of gender, marital status, job security, or occupation. The study notes that this includes improving labor market participation by women through incentives to remain and progress in the workforce. High labor market participation tax rates by second earners can be a result of family-based taxation; family-based benefits; or withdrawal of tax credits or allowances for a second spouse.

If a tax system can reduce market income inequality (unequal income before taxes and transfers), the amount of taxation required to improve distribution of disposable (net after-tax) income is reduced. OECD research also suggests that although a highly progressive income tax can reduce incentives to up-skill, this effect can be compensated by higher subsidies for education. Improvement of market incomes also improves access to skills for all taxpayers.

## Taxation of Income from Capital

The OECD study suggests that, according to recent research, the arguments in favor of reduced capital taxation are not as clear-cut as previously thought. Increased international cooperation via the automatic exchange of information in tax matters could make it possible to raise personal capital income taxes at a lower cost in efficiency. One of the main reasons why countries lowered the tax burden on capital income was to reduce the incentives for tax evasion by using foreign savings accounts and not declaring the income in their residence country. Increased international cooperation and exchange of information will allow countries to better align taxes on capital and labor, and this may allow them to reduce tax at the corporate level while increasing tax at the personal level.

One way to raise taxes on personal capital income could be to return to comprehensive income tax systems that tax both labor and capital income at the personal level. However, the study suggests that, as certain savings vehicles such as pension plans and owner-occupied property might continue to benefit from tax relief, this would increase tax-induced savings distortions.

The study considers that another possibility would be to broaden the capital income tax base and begin taxing capital income under a separate rate schedule at slightly progressive rates (a “Dual Progressive Income Tax”). The total household capital income – to include income from interest, shares, government bonds, and indirect savings vehicles such as life insurance policies below a certain threshold -- could be exempt from tax or taxed at a low rate.

Alternatively, a normal return on savings (e.g., the risk-free rate found by looking at interest on government bonds) could be exempt from capital income taxes at the personal level.

This reform could increase efficiency by encouraging savings and reducing tax-related distortions in savings. At the same time, the tax’s progressive features could be increased, as the top rates for personal income tax on labor and income could be aligned to remove any incentive to shift income from one category to another for tax reasons.

## **Taxation of Income from Capital**

The OECD study identifies broadening of the tax base as one of the principles that supports inclusive economic growth. In practice this means a broad tax base with low tax rates and removing tax allowances (or “relief”) that are not well targeted toward redistributive goals. The social security base should also be broadened.

The paper notes that capital and income from capital should be taxed in an efficient and equitable way, which should include introducing or strengthening progressivity and horizontal equity. The link between taxes paid and benefits received, viewed in the longer term across the lifecycle, should be strengthened. Adequate relief should be targeted toward groups adversely impacted by a pro-growth set of tax reforms.

The study also recommends that tax behaviors and opportunities should be influenced by incentives for agents in the informal economy to become part of the formal economy. The tax system should promote greater equality of market income and opportunity. Tax reform should align private and social costs and returns.

The study concludes that tax policy design should be realistic, and tax administration strengthened to enhance revenue collection; provide tax certainty; deliver high-quality taxpayer services, and increase value for tax receipts. The tax administration should be able to tackle tax avoidance and evasion. Intergenerational and gender equity need to be factored into tax policy design. The quality of tax statistics, data and tax policy indicators should be improved, and better analytical frameworks for assessing tax policy developed.

## **G20 Final Communiqué**

In their final communiqué, the G20 finance ministers and central bank governors also encouraged the notion of inclusiveness, noting that the benefits of economic growth need to be shared more broadly within and among countries. All policy tools including monetary, fiscal and structural tools are to be used individually and collectively to achieve sustainable, balanced and inclusive growth. The objective is for tax policy and public expenditure to be more growth-friendly, with a priority assigned to high-quality investment. The ministers and central bank governors also emphasized the importance of open trade policies and a strong global trading system, and they committed to reducing excessive imbalances to promote inclusive economic growth.