Executive Summary

This tax policy study considers the links between taxes and economic growth and the implications for tax policy. It then discusses the obstacles to fundamental tax reforms that are intended to strengthen economic growth and how they might best be addressed.

A country's rate of economic growth depends on many factors including the rate of economic growth of its main trading partners, the country's innovative capacity, the availability of venture capital, the amount and type of investment, the degree of entrepreneurship, the skills level and the mobility of the workforce, the flexibility of the labour market, the degree to which individuals have an incentive as well as an opportunity to participate in the labour market, the labour costs for employers of hiring workers, the availability of qualified workers, the administrative burden on businesses, product market regulations, the economic infrastructure as well as the legal certainty and the confidence level of consumers and businesses.

The tax system plays a crucial role as it is likely to impinge on many of these factors. The level of the taxes that are raised, the tax mix, the quality of the tax administration, the complexity of the tax rules and the tax compliance costs, the certainty and predictability for households and businesses of the taxes that have to be paid, the network of tax treaties as well as the specific design characteristics of individual taxes including the availability of tax incentives and the broadness of the different tax bases can have an impact on the country's rate of economic growth.

This study focuses on the impact of the tax mix and the design of individual taxes on the drivers of economic growth such as the employment level, the number of hours worked, capital deepening, human capital and the productive use of the factors of production, focusing also on the impact of taxes on entrepreneurship, R&D and innovation and FDI spillovers. This report focuses on tax structures rather than levels as cross-country differences in overall tax levels largely reflect societal choices as to the appropriate level of public spending, an issue that is beyond the scope of tax policy analysis. The report only briefly touches upon tax administration issues.

While there is not necessarily a direct link between economic growth and overall well-being, there are good reasons for OECD countries to try to increase the rate of economic growth. As well as increasing economic opportunity, higher levels of income and output should increase the level of public expenditure that can be regarded as "affordable" and make it easier to keep public debt within sustainable bounds. Many countries have been running large budget deficits as a result of the financial and economic crisis with strongly increased debt levels as a consequence. Reducing debt levels, also in light of ageing societies and the resulting higher pension and health costs, has been – or very likely will be – put high on the political agendas in many countries. Debt-to-GDP levels can be reduced either by reducing spending or increasing taxes but also by increasing the GDP growth rate. Such considerations point to designing the tax system in such a way that it is the least negative for economic growth.

The report brings together the tax policy and economic growth work that has been undertaken by the Centre for Tax Policy and Administration since 2008. The report includes the "Tax and Economic Growth" study that was carried out jointly with the OECD's Economics Department in 2008 (OECD, 2008); this study has been previously published as an *Economics Department Working Paper*, No. 620. It is subsumed within Part I and Annex B of this report.

Chapter 1 of this report investigates how tax structures could best be designed to support GDP per capita growth. The analysis suggests a tax and economic growth ranking order according to which corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable property being the least harmful tax. The explanation for these findings relates to the efficiency characteristics of the different taxes. Taxes that have a smaller negative impact on economic decisions of individuals and firms are less negative for economic growth. In general, income taxes have larger effects on firm and household decisions than (most) other taxes and therefore create larger welfare losses, ceteris paribus. A growth-oriented tax reform would therefore shift part of the tax burden from income to consumption and/or residential property.

Within individual main tax categories – property, consumption, personal and corporate income tax – there seems to be scope for making the design more conducive to economic growth by levying these taxes on a broader base, possibly at a lower rate, rather than providing targeted relief, except where such reliefs can be justified as externality-correcting. This includes moving to a single rate VAT and levying corporate tax on a broader base and with a lower rate. However, some degree of support for research and development through the tax system may help to increase private spending towards the socially desirable innovation level. Other growth-enhancing tax policies can include top marginal personal income tax rates that avoid undue damage to human capital formation and entrepreneurship, well-designed incentives to work at low earnings and externality-correcting specific taxes. A growth-oriented tax reform would therefore improve the design of a tax regime by broadening the tax base and lowering the tax rate and/or improve its externality correcting properties.

In general, a growth-oriented tax system may want to create as little obstacles as possible to the growth of economic activities. This implies also that tax systems may not want to discourage risk-taking, to discourage the possible inflow of high-skilled and other foreign workers and may want to stimulate not only the creation but also the adoption of domestic and foreign created intellectual property. Tax systems can contribute to the creation of an attractive business climate, implying also that the restructuring of business activities for economic purposes should not be discouraged, although governments may want to ensure that they receive their fair share of tax revenues. Growth-oriented tax systems contribute to the creation of a favourable e-business and e-commerce environment. A detailed discussion of these specific growth-oriented tax issues, however, goes beyond the scope of this report.

The tax policy changes that are most likely to increase growth in any particular OECD country will also depend on the starting point, in terms of both the current tax system and the areas of relative economic weakness, such as employment, investment or productivity growth. Also, there may be limits to raising growth by changing tax structures since it is probable that there are diminishing growth returns to adjusting the tax mix.

Chapter 2 analyses trends in the breakdown of tax receipts by type of tax and in tax rates. The level and mix of taxation vary markedly across OECD countries but there have been a number of common trends. Many countries have cut top personal income tax rates as well as corporate tax rates while they have broadened especially the corporate income tax base. Countries have increased social security contributions over time. One-third of the OECD countries have a reduced corporate tax rate for small and medium-sized corporations and many countries provide a generous tax treatment of R&D investment. There has been an increased use of Value-Added Taxes (VAT) and a general trend to higher VAT rates but, on average, there has not been an increase in the use of indirect taxes, mainly as a result of the reduction in the share of excise duties and other taxes on specific goods and services. The share of property taxes has stayed relatively constant over time. There has also been growing interest in the use of environmentally-related taxes, but there has been no general upward trend in their revenues.

Part II of this Report discusses the main obstacles that policymakers can face when designing and implementing fundamental growth-oriented tax reforms and how these obstacles might be tackled. When reforming tax systems, policymakers have to weigh up the different goals that tax systems try to achieve. This often implies that difficult trade-offs will have to be made. For instance, policymakers will balance the efficiency and growth-oriented objectives of tax reform with their distributional impact, both in terms of horizontal and vertical equity. The impact of tax reforms on revenues, tax avoidance and evasion and tax compliance and enforcement costs will also have to be taken into account. Fiscal federalism considerations, the transitional costs of changing tax systems and complex timing issues will also have to be considered.

In addition, policy makers will have to face complex implementation, legal and tax administration issues. The design and implementation of tax reform will be influenced by the institutional context in which the reform occurs. Political economy factors will have an impact on the outcome of the tax reform process as well, for instance because policy makers might use the tax system to favour particular interest groups and increase the probability of being re-elected. Hence, in order to successfully implement growth-oriented tax reforms, policy makers will have to take into account the different administrative, institutional and political environment factors.

Chapter 3 discusses these different tax policy objectives and the most important environment factors that have an influence on the tax reform process, focusing on the circumstances that explain when these objectives and environment factors may become an obstacle to the implementation of growth-oriented tax policies. In addition to the different tax policy objectives from a public economics perspective, Chapter 3 will also focus on tax administration and political economy factors.

Chapter 4 identifies the tax reform strategies that might enable policymakers to reconcile tax policy objectives and successfully carry out growth-oriented reforms. Although the focus of the analysis is on such reforms, many of the tax reform strategies discussed in Chapter 4 are relevant to other fundamental tax reforms.

The chapter argues that the framing of tax reform debates is critical: by considering the tax system as a whole (or even the tax-and-benefit system, when the taxation of labour income is at issue), rather than focusing on isolated elements, policy makers can better communicate the issues involved, as well as address issues of efficiency and equity. This points to the potential for advancing reforms via broad packages that reduce distortions in the system while spreading both benefits and adjustment costs widely. In particular, this will allow policy makers to compensate those who will lose out as a result of the tax reform. Concession to potential losers, however, need not compromise the essentials of the reform. Policy makers may therefore aim at improving the prospects of particular groups that will be affected by tax reform without contradicting its overall aims.

Since tax reform is likely to be a lengthy and complex process, Chapter 4 also argues that articulating broad aspirational goals can help to clarify the meaning of reform for taxpayers and voters, while also making it easier to resist special interest lobbies. Tax reform proposals have to be underpinned by solid research and analysis. An evidence-based and analytically sound case for reform serves both to improve the quality of policy and to enhance prospects for reform adoption. If reform advocates can build a broad consensus on the merits of a reform, they will be in a stronger position when dealing with its opponents. There is often a role for independent bodies charged with assessing the likely impact of proposed reforms on taxpayer behaviour, revenues, equity and ease of administration; the role of the tax administration, in particular, is often critical. Finally, the timing of implementation can be critical. Changes in business taxation, in particular, can have disruptive effects on firms if they are not phased in appropriately; similar problems can also arise in conjunction with changes to recurrent taxes on immovable property or the tax treatment of home ownership.

Part III of the report re-evaluates the "tax and growth recommendations" (from the earlier *Economics Department Working Paper* [OECD, 2008]) and discusses them in light of the need to restore sound public finances in many OECD countries.

Chapter 5 focuses on growth-oriented tax reform design considerations. The discussion provides a nuanced analysis of the pros and cons of some of the specific growth-oriented tax reforms. The recommendation to broaden the different tax bases, for instance, does not necessarily imply that it would be optimal to abolish all tax expenditures. The chapter discusses tax base broadening *versus* the use of tax expenditures, VAT base broadening, recurrent taxes on immovable property and corporate and personal income tax reform strategies respectively. This analysis is not an attempt to undermine the "tax and growth" recommendations. On the contrary, a nuanced analysis of the pros and cons of specific growth-oriented tax reforms might reduce some of the (mainly political) obstacles against these reforms. In addition, the discussion in Chapter 5 presents and discusses also tax-specific strategies that might help overcoming the obstacles against the implementation of the "tax and growth" recommendations.

The "tax and growth" recommendations as well as the strategies to overcome the tax reform obstacles are of special interest in light of the financial and economic crisis. Chapter 6 argues that a crisis might facilitate tax reform. The political economy obstacles against fundamental tax reform might be easier to overcome during a crisis, especially because of the increased pressure to raise more tax revenue in order to restore public finances and because of the pressing need to tackle the economic problems and to put the economy back on a high-growth path. A crisis might make the implementation of tax reform more likely because it undermines the power of vested interest groups and it might imply that opponents of reform may change their perspective because they start to gain of reform as well. A crisis might create a sense of urgency which creates a "window of opportunity" for reform which otherwise would have been blocked. On the other hand, a crisis might make fundamental tax reform even more difficult to implement, especially because large groups of taxpayers are strongly affected by the crisis.

Many OECD countries need simultaneously to restore sound public finances and the growth of potential output. Chapter 6 of this report argues that the "tax and growth" recommendations continue to hold in these circumstances. The chapter does however recognize that the crisis seems to have created additional obstacles that might imply that the immediate implementation of some of the growth-oriented tax recommendations is hampered, at least in the short run. This however does not imply that governments should not start preparing such reforms. In order to increase recurrent taxes on immovable property in an equitable way, for instance, governments need to set up a proper system for the valuation of real property. A broadening of the VAT base by abolishing many of the VAT exemptions and reduced rates requires that the distributional impact of such a reform is analysed carefully; this allows governments to consider accompanying measures that could compensate the losers of the reform such as low-income workers and pensioners.