



# How to implement pro-growth tax reforms ?

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# How to implement pro-growth tax reforms?

- Tax and economic growth: enemies or companions?
- Some evidence from the recent OECD work on Tax and Economic Growth
- How to implement pro-growth tax reforms ?

# Tax and economic growth: companions..?:

- The Wagner's law: the demand for public goods (including redistribution) is increasing with growth and development
- Valid for many developed economies during 60's and 70's
- Still valid ?
  - Marginal increase in demand for public goods could be diminishing when living standards rise
  - Increasing marginal cost of public funds ?
  - Debt financing reduced compared to the 60's-70's
  - Transition economies including those from SEE have a different background and may solve the equity-efficiency tradeoff in a different way compared to « welfare states »

## Tax and Growth: enemies ?

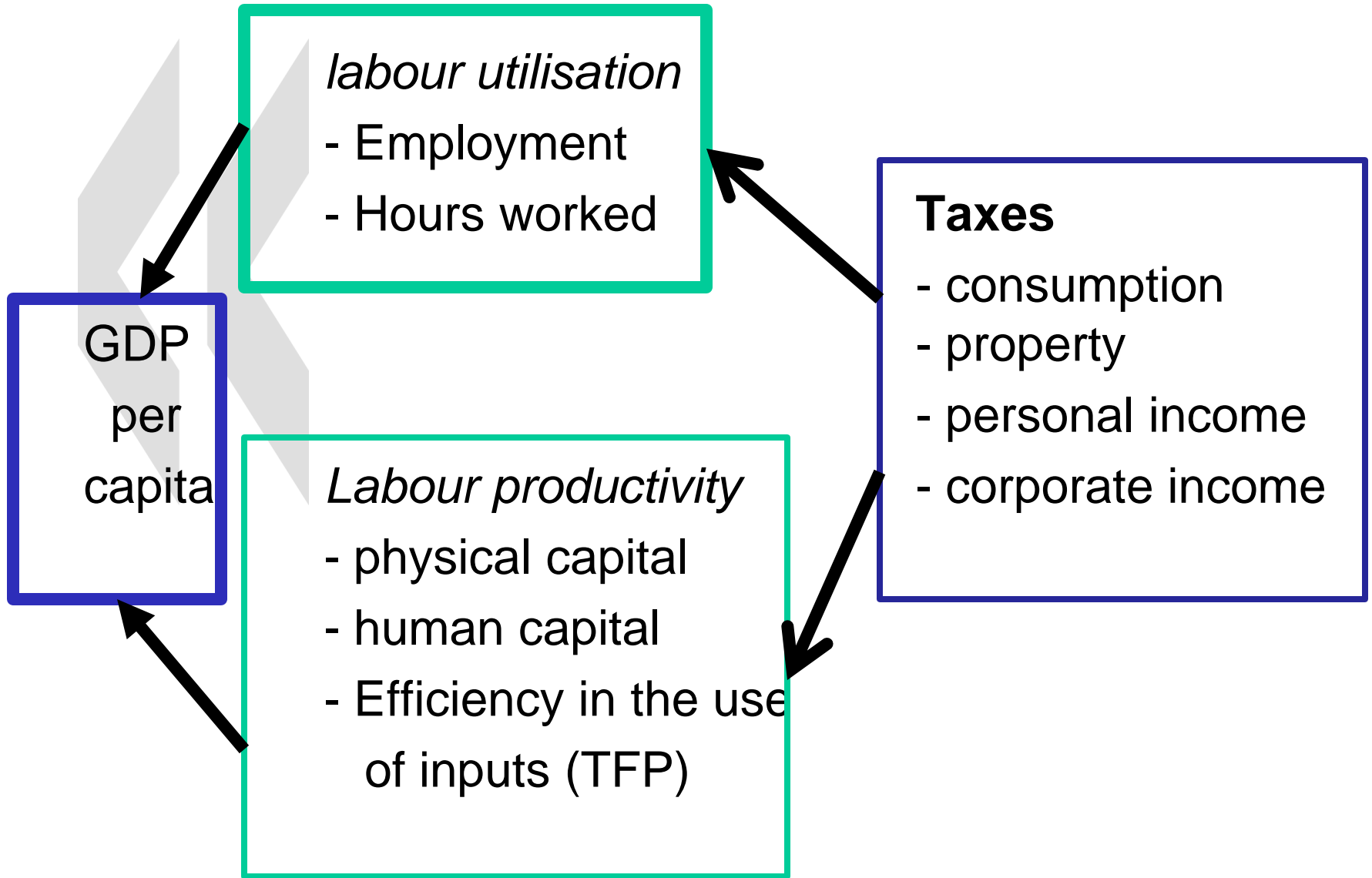
- Lessons from the empirical literature: *growth regressions*
  - « *A decrease of about 1% in the Tax to GDP ratio would imply a 0.5 percentage point increase in GDP per capita level in the long run* » (OECD)
  - « *Like firearms, it is dangerous to leave growth regressions lying around* » (W. Easterly)
  - « *There is a substantial body of literature (...) but the conclusions (and even the methodology) remains contentious* » (G. Myles)

# Main empirical questions in the OECD tax and economic growth project

- Does the tax structure, as opposed to the level of taxes, matter for GDP per capita and its rate of growth?
- To what extent do different tax provisions affect investment, productivity (TFP) and growth?
- Does the industry/firm structure matter for the impact of taxes?

# The recent OECD work on tax and economic growth

- Main linkages between tax and economic growth
- Main empirical questions to be investigated
- Economic growth and...
  - The broad tax structure
  - Corporate taxes
  - R&D tax credits
  - Personal income taxes
- Other important lessons from the literature



## Broad tax structure

- Macro findings suggest a “ranking” of taxes in terms of their negative impact on GDP per capita:
  - ***recurrent taxes on immovable property***
  - **< *consumption taxes***
  - **< *personal income taxes***
  - **< *corporate income taxes***
- Broad tax bases and low rates
- Tax progressivity seems to reduce GDP per capita.

# Corporate taxes I

- Cutting corporate taxes positively affects investment *and* productivity growth, especially for larger and older firms but not for firms that are both small and young.
- Lowering the corporate tax rate will increase the productivity of firms especially in profitable industries.
- Especially dynamic and innovative firms gain from a corporate tax rate reduction.

# Corporate taxes II

- Also the average effective corporate tax rate has a negative impact on the firm's productivity.
- It is possible that product market regulations and large administrative burdens on firms can make investment decisions less responsive to taxes.
- Need to be careful about lowering the corporate rate much below the top personal income tax rate.
- Shift in capital income tax burden from corporate level to personal shareholder level may improve efficiency.

# R&D tax credits I

- *Past studies* have found that R&D tax credits increase R&D spending.
- *Tax and growth study*: R&D tax credits increase productivity and therefore stimulate growth but their impact is relatively modest
- The positive impact of R&D tax credits is larger for industries that are structurally more R&D intensive

## R&D tax credits III

- Are R&D tax credits better for growth than a standard CIT rate reduction?
- The analysis raises the question whether targeting at innovative firms and/or innovative industries would be a good policy option
- But targeting would increase enforcement costs, complexity, etc.

# Personal income taxes

- A reduction in labour taxes can have both a substitution effect and an income effect on participation and hours worked
- Labour taxes also influence firms' cost of labour demand, especially when the tax burden cannot be shifted on to lower net wages (at the lower end of the wage scale)
- *Empirical studies*: hours worked is only modestly responsive to labour taxes (especially for men, there is a response for women/second earners) while the participation decision is much more responsive to labour taxes.

# Personal income taxes and TFP

- High top personal income tax rates have a negative impact not only on labour utilisation but also on labour productivity via ***the entrepreneurship channel*** by affecting risk taking by individuals and through reduced incentives for ***education***.
- Countries with a large share of industries with high rates of enterprise creation (or wishing to move in this direction) may gain from reforming their top marginal tax schedule. However, this could increase inequality.
- Reforming labour taxes and SSC could be more important for productivity in countries with a labour intensive industry structure.

# Personal income taxes and TFP

- The negative impact of top marginal tax rates on TFP is stronger in countries with a high level of the OECD indicator of product market regulation
- The PMR indicator includes, among other things, measures of the administrative burden on firms and regulatory barriers for start-ups.

## Other important lessons from the project and the literature

- Recurrent taxes on immovable property are the least distortionary form of property tax, but they are very unpopular
- Broadening the base of consumption taxes is better for growth than increasing the rate
- There is limited scope to improve growth by using multiple consumption tax rates, and their equity effects are best achieved by other means
- In-work tax credits can promote growth by increasing participation rates, but care is needed to contain costs and minimise adverse effects on hours worked.

# How to implement pro-growth tax reforms (PGTR)?

- Type of reforms
  - Change in the tax mix
  - « Broad bases, low rates »
- Public economics perspective
- Political economy perspective

# Public economics perspective:

## (a) efficiency considerations

- Example: Let's move the tax burden away from labour to consumption...
  - Efficiency gains (from income taxation to cash flow taxation)
  - Efficiency drawbacks: making work pay policies reduce AETRs but may increase METRs if tax cuts targeted to low wage earners
  - Increased VAT rate to finance reduction in the taxation of labour: might be good for growth, but...
    - increased evasion and stimulates informal sector
    - cross border shopping
    - pressures for wage increases

# Public economics perspective:

## (b) distributional considerations

- PGTRs might be seen to benefit high-income groups disproportionately: violation of VE
- Efficiency gains typically do not arise immediately so cannot be used immediately to compensate
- Immediate losers are not necessarily final losers
- On base broadening: abolishing tax privileges is difficult because:
  - taxes and tax provisions are capitalized in the price of assets, the current owners of the tax-privileged assets are not necessarily the beneficiaries of these tax provisions (e.g. owner-occupied housing)
  - Not all taxpayers can still adjust their behaviour in response to the tax reform (e.g. pensioners who already left labour market)

# Public economics perspective:

## (b) distributional considerations

- Corporate income tax:
  - Corporations have to pay their fair share of taxes?
  - But CIT rate reduction will reduce overall tax burden on equity income which might be beneficial to higher income earners
  - Although CIT rate reduction may lead to higher wages and shares are owned by pension funds / large amount of taxpayers

# Public economics perspective:

## (b) distributional considerations

- Personal income tax:
  - Top PIT rate reduction is beneficial to higher income earners
  - Although top PIT rate is levied at different multiples of the AW in different countries
  - But base broadening measures could be linked to a reduction in (top) PIT rates

## Public economics perspective: (b) distributional considerations

- Value-added tax reform
  - Perceived distributional impact of VAT base broadening measures might create obstacles to their implementation
  - But the actual distributional impact of reduced rates is unambiguous as the richer gain more in absolute terms
  - and life-time income should be considered

## Public economics perspective: (b) distributional considerations

- Recurrent taxes on immovable property
  - Taxed at proportional rate violates VE, although richer will pay more because they live in more expensive homes
  - These taxes are not necessarily related to the taxpayer's ability to pay
  - the house provides for basic shelter
  - and the taxes are often levied at regional/local level

# Public economics perspective: tax avoidance/evasion considerations: applied to pro-growth tax recommendations

- These considerations seem not to create strong obstacles because:
  - Base-broadening measures reduce the opportunities for agents to engage in tax-arbitrage behaviour / tax-planning activities
  - Tax rate reductions reduce the gains of tax avoidance/evasion
- Recurrent taxes on immovable property are more difficult to evade
- Increased VAT rate increases incentives to evade consumption taxes

# The political economy perspective: political cycles and the visibility of political decisions I

- Politicians might engage in tax reform in order to attract the “swing voters” who are the more mobile voters that change their vote in case a reform favours them; these reforms are not necessarily in the general interest
- Incremental (>< fundamental) tax reform as a signal that politicians care about taxpayers’ welfare. But by reforming for the sake of reforming, politicians not necessarily take the long-run implications of these reforms into account (on tax revenues, tax complexity, etc.)
- Tax reforms may be blocked and changed during the legislative as well as the administrative stage

# The political economy perspective: political cycles and the visibility of political decisions II

- Politicians face an incentive to enact tax reforms whose reform gains are visible at the time the next election takes place. Politicians might then face obstacles to fundamentally reform the tax system if the next election takes place soon.
- Politicians may prefer tax reforms that are less visible:
  - increase in employer SSC instead of employee SSC and recurrent taxes on immovable property, for instance
  - income taxes and VAT which do not have to be increased each year instead of ad quantum excise duties
  - Bracket creep: incentive for not fully indexing of rates, brackets, allowances and credits

# The political economy perspective: Uncertainty and fragmentation I

- Uncertainty about who will win and lose / about the number of winners and losers and about how much they will win or lose
  - voters may therefore be reluctant to vote for reform
  - Status quo bias;
  - politicians may be reluctant to engage in tax reform
- Uncertainty who will be in power after the elections and whether this government can stop / reverse the reform; this might have an impact on who actually wins/loses
- The larger the uncertainty about the information quality and the larger the divergence between the information obtained through different information channels, the more difficult for politicians to draw conclusions / decide to reform the tax system

# The political economy perspective: Uncertainty and fragmentation II

- Also the diverging impact of tax reform on the different coalition parties might imply an obstacle, especially if one of the coalition parties bears most of the costs.
- The literature suggests that:
  - Countries where the political power is more dispersed change their tax system less often
  - The tax reforms also tend to be compensated more by other reforms/measures in order to be acceptable for all coalition parties
  - So this implies that the more fragmented is the coalition, the more difficult for political parties to engage in fundamental tax reform reform

# The political economy perspective: Vested interests and lobby groups I

- The large group of winners are silent while the minority of losers makes a lot of noise
- Losers can try to influence the policymakers in different ways (direct, through media, through vested interest groups, etc.)
- Special interest groups are especially influential if policymakers depend on them or if they consist of swing voters that have an impact on the outcome of the next election
- Different taxpayers may face different transaction (lobbying) costs; as a result, tax reforms may be biased towards the reforms that are favoured by the influential interest and lobby groups

# The political economy perspective: Vested interests and lobby groups II

- Tax expenditures are a tool to serve swing voters and special interest groups. The benefits from TEs can be targeted while the costs can be spread over all taxpayers.
- Once introduced, it might be difficult to remove tax expenditures as a result of the lobbying for the persistence and further extensions of the special tax provisions. This will result in a less efficient, less fair, more complex and less pro-growth tax system.

# Some preliminary conclusions regarding the obstacles faced by policymakers

- The successful implementation of tax reform has to overcome many obstacles.
- Public finance, tax administration and political economy considerations are linked; political economy tax reform obstacles have to be considered jointly with the public economics and tax administration tax reform obstacles
- It might be easier to overcome obstacles when economic times are good; but it might be easier to overcome obstacles when tax reform is most needed!
- Empirical evidence needed!