Tax Considerations in Responding to the Global Financial Crisis, including main results from the OECD *Tax and Economic Growth* Project

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* The views expressed in these slides should not be attributed to the OECD or any of its Member countries.

Broad categories of tax considerations

- Tax policy as a possible contributing/conditioning factor to the global financial crisis (GFC).
- Tax reform options in addressing possible tax policies contributing to the GFC.
- **Tax policy considerations to boost demand and foster sustained, balanced economic growth**. (focus of slides).
- Other implications of the GFC for tax policy.

Discussion points

- Broad policy framework considerations in formulating tax policy to boost demand and foster sustained, balanced economic growth.
- Insights from the OECD *Tax and Economic Growth* project
  - Alternative taxes ranked in terms of their effect on long-run economic growth.
  - Some specific tax design considerations.
- Guidance on short-run tax stimulus package.

Broad policy framework considerations

1. Need for pro-growth package of fiscal reforms (tax, expenditure programs) that:
   - stimulates short-run demand (consumption, investment, labour),
   - places economy on a sustainable growth path:
     - investment in capital, skills (future factor supply)
     - management of public budget.
   - protects low-income families from severe hardship.

Broad policy framework considerations – mix of fiscal instruments is desirable

2. Stimulus with mix of tax/public expenditures desirable:
   - current expenditure to boost demand immediately; stimulus effects of tax cuts may be realized only after a 1-2 year lag (or longer), depending on their design;
   - uncertainty over timing/strength of PIT cuts (only some fraction of PIT relief will increase consumption; some fraction will result in increased net savings);
   - uncertainty over timing/strength of CIT cuts (only some fraction of relief that will increase investment; some will provide windfall gains to shareholders, only some fraction of which will be spent).

Broad policy framework considerations – complex forecasting environment

3. Forecasts of deficit/accumulated debt need to factor in:
   - pre-crisis deficit calculations and projections.
   - increased public expenditures under automatic stabilizers.
   - expenditure reform
   - tax reform
   - future levels of economic activity (under stimulus)
   - tax loss carryovers

Broad policy framework considerations – inter-actions across governments

4. Co-ordinate central government fiscal reforms (tax, expenditure) alongside reforms at sub-central level:
   - assess need to adjust fiscal equalization scheme.
5. Consider how a proposed fiscal plan interacts with fiscal plans adopted by others; desire to avoid beggar-thy-neighbour policies:
   - tax incentives targeted at FDI;
   - tax incentives for exports;
   - tariffs on imports.

Broad policy framework considerations – scope for fundamental tax reform

6. Consider if exceptional economic conditions provide opportunity for fundamental tax reform - example:
   - Replacement of a CIT with a corporate cash-flow tax -- generally desirable, particularly in current environment:
     - reduces tax distortion towards debt;
     - reduces tax compliance costs (encourage business formation);
     - reduces administration costs (expenditure savings);
     - weakened transitional concerns? (difficult transition under normal conditions - possibly easier to manage under current loss-making environment).

Broad policy framework considerations – fiscal plan that restores confidence

7. Formulate a multi-year fiscal plan that is transparent, flexible, realistic, and credible.
   - required for optimal execution of strategy,
   - required for restoring consumer and business confidence, to maximize instances where tax relief translates into demand,
   - possible reliance on temporary but renewable tax cuts (sunset clauses, reassessments, extensions of tax relief where necessary).

OECD *Tax and Economic Growth* project

- Recent report by OECD Economics Department and Centre for Tax Policy and Administration examining effects of tax on economic growth.
- Econometric study (economy-wide, industry, and firm level analysis).
- Provides ranking of taxes, by broad category, in terms of effects on long-run economic growth.

OECD *Tax and Economic Growth* project – ranking of pro-growth taxes

- Taxes from most to least harmful to long-run economic growth:
  - corporate taxes
  - personal income taxes and social security contributions
  - consumption taxes
  - recurrent taxes on immovable property

OECD *Tax and Economic Growth* project – guidance on tax design

- ↓ top PIT rates - encourage entrepreneurship and skills acquisition.
- ↓ PIT rates on low-wage workers, and ↓ employee social security contributions on low-wage workers -- encourage labour supply.
- ↓ employer social security contributions of low-wage workers -- encourage labour demand (esp. in countries with a high minimum wage).
- VAT at a single rate (minimal exemptions) promotes long-term growth, relative to multiple rate/narrow base system; also minimizes distortions and reduce administration and compliance costs.
- Specific consumption taxes on products that cause environmental damage, discourage unhealthy consumption, discourage labour supply (e.g. luxury goods), enables reduced income tax, promote long-term growth.

Further guidance on CIT design

- General desire to minimize windfall gains to investors, and avoid arbitrage possibilities.
- Permanent reduction in CIT rate may boost investment where headline CIT rate is seen as relatively high, but:
  - Involves windfall gains (↓tax rate on profits on existing capital and new capital), and expensive in terms of foregone revenues compared to incentives tied to new investment;
  - Tax relief is delayed for firms in loss position, contributing to lagged investment response.
  - Encourages tax arbitrage behaviour by creating or widening a gap with the (top) PIT rate (unless (top) PIT rate is reduced as well, to promote entrepreneurship, training).

Further guidance on CIT design (cont'd)

- Temporary reduction in CIT rate may be least effective (tending to provide windfall gains only); provides no immediate cash-flow benefit to loss-making firms, depending on duration of temporary measure, and may involve taxation of post-stimulus profits at the normal rate (possibly with loss carryover).
- Accelerated depreciation tends to avoid windfall gains; (tax relief tied to new investment).
- Non-wastable (refundable) investment tax credits avoid windfall gains and also provide immediate subsidy to investment.
- Incremental investment tax credits may provide fewer windfall gains, but introduce complexity, can create anomalous investment incentives (lumpy investment patterns) in certain cases.

Further guidance on PIT design

- PIT cuts should be targeted to maximize stimulus on current household consumer demand.
- ↓ top PIT rate less likely to boost demand, compared with ↓ PIT rate on low-income (high-income consumers less likely to be credit-constrained, more likely to save most of tax savings resulting from PIT cut).
- ↓ PIT rate (temporarily or permanently) for low-income families can be expected to:
  - stimulate consumption; and
  - stimulate labour supply and thus growth.

Further guidance on PIT design (cont'd)

- Consider reliance on non-wastable PIT credits benefiting households with no taxable income:
  - non-wastable in-work tax credits could be used to both boost employment and boost consumption.
- Countries with high private savings rates may consider temporarily limiting PIT deductions for contributions to registered savings, to boost current consumption.*

* This suggestion is a personal view, and does not arise out of the OECD *Tax and Economic Growth* study.

Tax and Economic Growth project – guidance on post-crisis tax mix

- OECD project – finds support for recurrent taxes on immovable property and general consumption taxes to underpin sustainable long-run growth.
- Significant reliance on property taxes:
  - heightens need for accurate valuations and provisions to ease the burden for low-wealth individuals.
  - plans for increased reliance should involve current enactment of programs to enable accurate valuations in the future.
- Significant reliance on VAT:
  - aim for a broad base.
  - revenues from a broad base may help finance PIT assistance to low-income households hard hit by broad base.

Questions and comments welcome