

V. CHALLENGES FOR TAX POLICY IN OECD COUNTRIES

Modern OECD economies have fundamental economic and social objectives that require public spending. This in turn must be financed mainly through taxation. However, because taxation inevitably impinges on most aspects of economic activity, careful consideration must be given to its design – in addition to its level and hence the level of related expenditure. Three features of taxation are especially important. *First*, so long as taxation affects incentives it may alter economic behaviour of consumers, producers or workers in ways that reduce economic efficiency. These effects should be taken into account when the costs and benefits of public expenditure to be funded are being assessed. *Second*, the distribution of taxation's impact across the population raises issues of equity, or fairness, which must be given substantial weight even if it entails costs in terms of economic efficiency. *Third*, the practical enforceability of tax rules and the costs arising from compliance are important considerations, the more so since these are both affected by, and have implications for, the efficiency and public perceptions of the fairness of tax systems. As elaborated in more detail in Box V.1, the key challenge for tax policy is to strike the best possible balance among these issues.

Tax design needs to balance considerations of economic efficiency, equity and enforceability

In the past two years, the OECD has reviewed the tax systems of a number of Member countries – twelve in total – in *Economic Surveys*, using a common analytical framework.¹ While the challenges facing tax policy in these countries are very diverse, the policy recommendations and their underlying rationale may provide some useful lessons for other OECD countries.² This chapter pulls the main lessons together. It starts with a brief overview of major trends in tax receipts. The subsequent sections identify the scope for improving tax systems by:

Useful lessons may be drawn from countries' experiences

- Reducing the distortions in economic behaviour stemming from taxation of saving and business activity.
- Striking a better balance between efficiency and equity in the taxation of labour and of consumption.
- Enhancing the effectiveness of tax collection and enforcement and better matching the assignment of autonomous taxing power with the responsibility for public provision at lower levels of government.

1. These are (in chronological order): Mexico, Switzerland, Japan, Poland, Spain, the Czech Republic, Norway, Korea, Greece, New Zealand, Iceland and Portugal. See the various issues of the OECD *Economic Surveys* (tax reviews in this series are forthcoming for the United States and Finland). In addition, earlier *ad hoc* tax reviews in the *Economic Surveys* of Canada (1997), Austria (1998) and Sweden (1999) were taken into consideration. A synthesis of the findings is reported in Van den Noord and Heady (2001).

2. To enhance the country coverage of the analysis, an in-depth review of tax policies in the European Union countries was prepared, see Joumard (2001). It focuses in particular on countries not listed above, and highlights a number of tax issues that are specific for the European Union.

Box V.1. General principles guiding tax policy

Tax design is shaped by the need to raise revenues and by considerations of efficiency, equity and enforceability. If the only concern were to minimise efficiency losses associated with taxation, taxes generally should be designed so as to leave economic behaviour unaffected. Specifically, taxes should be lump sums or relate to tax bases that cannot be influenced by taxpayers, such as natural resources and undeveloped land. While such a tax system would avoid distortions in economic behaviour, it would be highly unlikely to yield sufficient revenues to fund socially useful expenditure without producing substantial inequity. A more useful guideline is that the tax system should be as neutral a possible, *i.e.* minimise discrimination in favour of or against any particular economic choices. In practice, this points to building tax systems substantially around broad income and expenditure bases and minimising differences in tax rates that can be applied. As a rule of thumb, in the absence of compelling considerations to the contrary (see below), improvements in efficiency can be achieved by: *i)* broadening tax bases by eliminating exemptions and special regimes; *ii)* flattening rate structures; and *iii)* integrating or aligning different tax rate structures to avoid arbitrage opportunities.

However, neutrality need not be an overriding consideration; other factors that can usefully be taken into account are:

- Governments may find scope for leveraging the revenue-raising potential of tax systems by taxing some items more heavily than others. For example, under some circumstances it can be efficient to tax most heavily those items that are comparatively price-inelastic.¹

- It may be desirable to use the tax system to enhance welfare by correcting market failure. This may involve taxing “bads”, such as alcohol, tobacco and polluting substances such as fossil fuels. Where demand for such goods is inelastic there may be revenue benefits which allow distorting taxes elsewhere to be lowered.² While market failures could also justify tax reliefs for activities whose social return is high (*e.g.* R&D and training), the advantages need to be weighed against the need for higher distorting taxes elsewhere.
- Allowing taxes to differ across local jurisdictions permits the supply of local public goods and services to be aligned with the particular, but differing, preferences and circumstances of their constituents – although there are different views across countries as to which taxes could usefully be decentralised.³
- Tax systems influence income distribution and may have a role to play in the pursuit of equity goals. The resulting loss in neutrality, *e.g.* due to progressive taxation, may involve efficiency losses but may also contribute to the perceived fairness of the system.⁴
- The cost of compliance with the tax code needs to be kept low, requiring tax rules to be clear and avoid unnecessary complexity. While the neutrality principle is often consistent with simplicity, there are cases where departures from the neutrality principle enhance simplicity, for example by exempting income that is difficult to assess such as fringe benefits or imputed rentals.

1. The principle known in the literature as “Ramsey’s rule” states that the efficiency loss or “excess burden” is minimised if the product of tax rates and price elasticities is equalised across all items.
2. Provided these revenues have not been earmarked for (environmental) expenditure programmes, see Chapter VI, “Encouraging environmentally sustainable growth: experience in OECD countries”.
3. See for an elaboration Atkinson and Van den Noord (2001).
4. Equity is subjective but perceptions about it are important. Greater neutrality in tax systems is usually consistent with better “horizontal” equity; *i.e.* ensuring that persons in the same economic position pay the same amount of tax. However, governments are often faced with trade-offs between neutrality and “vertical equity”, *i.e.* requiring that people on higher incomes pay a higher proportion of their income in tax.

Trends in tax receipts and structure

How to measure the tax burden?

The measurement of tax burdens is subject to controversy. The most commonly used gauge, the ratio of taxes to GDP, is only a rough indicator, for a variety of reasons:³

- Institutional set-ups differ across countries in ways that significantly affect the reported tax-to-GDP ratio without having much impact on the burdens

3. See OECD (2000a).

imposed by taxation. For example, there are differences across countries, and over time, in the taxation of transfer income, the size of tax payments by the public sector itself and the mix of subsidies and tax expenditures (targeted exemptions, allowances and credits).⁴

- Some taxes may have a stronger impact on economic behaviour – *i.e.* act more as a “burden” – than others, and it is therefore useful to examine the breakdown of tax revenues by tax base. Different forms of taxation may also interact to result in pronounced differences in the marginal effective tax rates faced by particular groups, thus heavily affecting their economic choices. Such marginal tax rates have been calculated by the OECD and used to assess tax systems.⁵
- The tax burden needs to be assessed in a wider context, including the “burden” stemming from regulation that mandates the private sector to provide social protection or public goods and services in the government’s place.

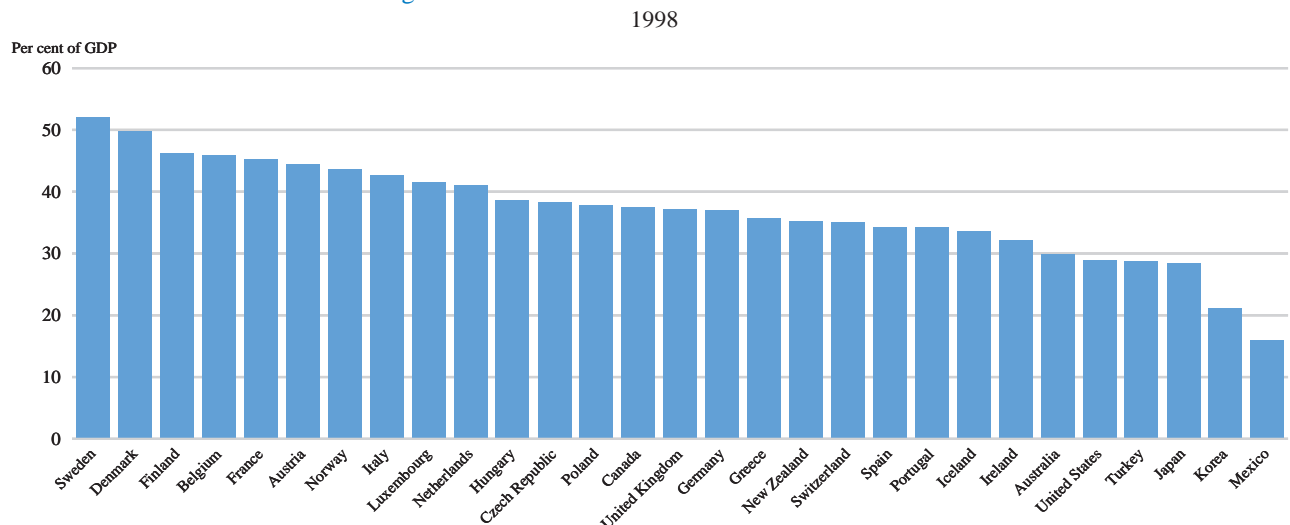
Even so, bearing these caveats in mind, the ratio of tax revenues to GDP is useful as a “scaling factor”: to the extent tax systems matter for economic efficiency, their costs are likely to rise as economic decision makers’ exposure to taxation increases.

The evolution of tax revenue as a percentage of GDP in OECD countries since 1965 is reported in Table V.1. Figure V.1 presents an overview of the situation in 1998. The stylised facts are the following:

The tax-to-GDP ratio has trended up until recently...

- There has been a persistent and largely unbroken upward trend in the ratio of tax to GDP since 1965 across most of the OECD area, though recent developments suggest the trend increase may be ending.

Figure V.1. Total tax revenue in OECD countries



Source: OECD, *Revenue Statistics, 1965-1999*. In the case of Greece, the figure is based on a submission by the national authorities.

4. See for example Adema (2000).

5. See for example OECD (1991, 1994, 1999a and 1999b).

Table V.1. Total tax revenue as percentage of GDP

	1965	1970	1975	1980	1985	1990	1995	1998	1999 ^a
Australia	22.4	22.9	26.6	27.4	29.1	29.3	29.4	29.9	..
Austria	33.9	34.9	37.7	39.5	41.6	40.2	41.5	44.4	44.3
Belgium	31.1	35.7	41.6	43.1	46.3	43.1	44.8	45.9	45.4
Canada	25.9	31.2	33.1	32.0	33.1	36.1	35.7	37.4	..
Czech Republic	..	..	..	..	..	..	40.1	38.3	37.5
Denmark	29.9	40.4	41.4	44.0	47.4	47.1	49.4	49.8	50.6
Finland	30.3	32.5	37.7	36.2	40.0	44.7	45.0	46.2	46.5
France	34.5	35.1	36.9	40.6	43.8	43.0	44.0	45.2	46.0
Germany ^b	31.6	32.9	36.0	33.1	32.9	32.6	38.2	37.0	37.7
Greece ^c	18.2	20.9	21.0	24.0	28.6	29.4	31.7	35.7	37.1
Hungary	..	..	..	..	..	..	42.4	38.7	37.0
Iceland	26.2	27.0	29.6	29.2	28.4	31.4	31.2	33.6	35.4
Ireland	24.9	29.9	30.2	31.5	35.1	33.6	33.1	32.3	31.9
Italy	25.5	26.1	26.2	30.3	34.4	38.9	41.2	42.7	43.0
Japan	18.3	19.7	20.9	25.4	27.6	30.9	28.4	28.4	27.7
Korea	..	..	15.2	17.7	16.9	19.1	20.5	21.1	23.8
Luxembourg	27.7	28.9	39.6	40.8	45.3	40.8	41.9	41.5	42.1
Mexico	..	..	..	16.2	17.0	17.3	16.6	16.0	16.5
Netherlands	32.8	37.1	43.0	43.4	42.4	42.8	42.0	41.0	40.3
New Zealand	24.7	27.4	31.1	33.0	33.6	38.1	37.6	35.2	..
Norway	29.6	34.9	39.9	42.7	43.3	41.8	41.5	43.6	41.8
Poland	..	..	..	..	..	..	39.9	37.9	..
Portugal	15.8	19.8	21.3	24.6	27.1	29.6	32.7	34.2	34.5
Spain	14.7	16.9	19.5	22.9	27.6	33.0	32.8	34.2	35.1
Sweden	35.0	39.8	43.4	47.1	48.3	53.7	47.6	52.0	52.1
Switzerland	19.6	22.5	27.9	28.9	30.6	30.9	33.5	35.1	35.1
Turkey	10.6	12.5	16.0	17.9	15.4	20.0	22.6	28.6	31.8
United Kingdom	30.4	37.0	35.4	35.4	37.7	36.0	35.2	37.2	36.6
United States	24.7	27.7	26.9	27.0	26.1	26.7	27.6	28.9	..
Total OECD									
Unweighted average	25.8	28.9	31.1	32.1	33.8	35.0	36.1	37.0	37.3
Weighted average ^d	23.1	25.4	26.7	28.3	29.1	30.3	31.9	32.8	33.0
European Union									
Unweighted average	27.8	31.2	34.1	35.8	38.6	39.2	40.1	41.7	42.1
Weighted average ^d	29.1	31.6	33.4	34.6	36.8	37.7	39.4	40.3	40.7

a) Figures for 1999 are estimates.

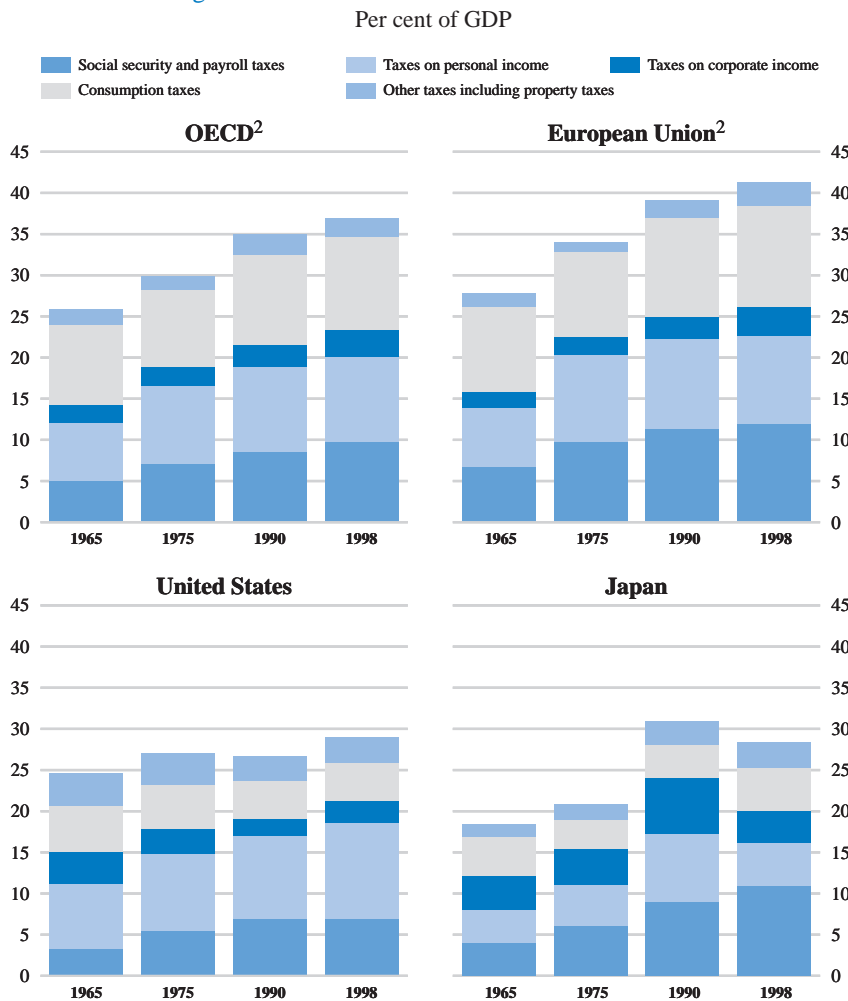
b) Unified Germany beginning in 1991.

c) Figures for 1998 and 1999 are based on a submission by the national authorities.

d) Using 1995 GDP at purchasing power parities as weights. In 1998 and 1999 the average is based on the latest year for which data are available.

Source: OECD, *Revenue Statistics*, 1965-1999.

- Very few countries have consistently resisted this long-term trend. Only in the Netherlands are tax ratios currently below their 1975 level, and in only three other countries, *i.e.* Mexico, the United Kingdom and the United States, have tax receipts developed broadly in line with GDP over a long period.
- A few more, including Ireland, Japan, New Zealand and Sweden, have succeeded in reducing the tax ratio from peak levels of 1985 or 1990, but not by large amounts. Only rather recent data available for transition countries suggest that these countries are recording falling tax revenues relative to GDP as well, although this may reflect in part “erosion” of their tax bases while they are grappling with the transition process.
- Tax ratios in the European Union, averaging more than 40 per cent of GDP, generally exceed those elsewhere. Outside Europe, only Canada and New Zealand have tax ratios above 30 per cent of GDP.

Figure V.2. Evolution of the tax mix over time¹

1. The breakdown of income tax into personal and corporate income tax is not fully comparable across countries. A cautious interpretation of the numbers in Figure V.2 is called for. The split between personal and corporate income tax can be misleading for two reasons. First, many OECD countries have some form of integration between corporate and personal income taxes, so that a portion of corporate taxes are refunded to the shareholders as a reduction in personal income tax. This is reflected in the statistics as a reduction in the revenue from personal income taxes, but it could be just as well regarded as a reduction in corporate tax revenue. Second, OECD countries vary in the extent to which businesses are incorporated. For example, German firms are much less likely to be incorporated than firms in the United States. This means that Germany reports a much lower share of tax revenue coming from corporate income tax, even though the taxes on business income have been higher overall.

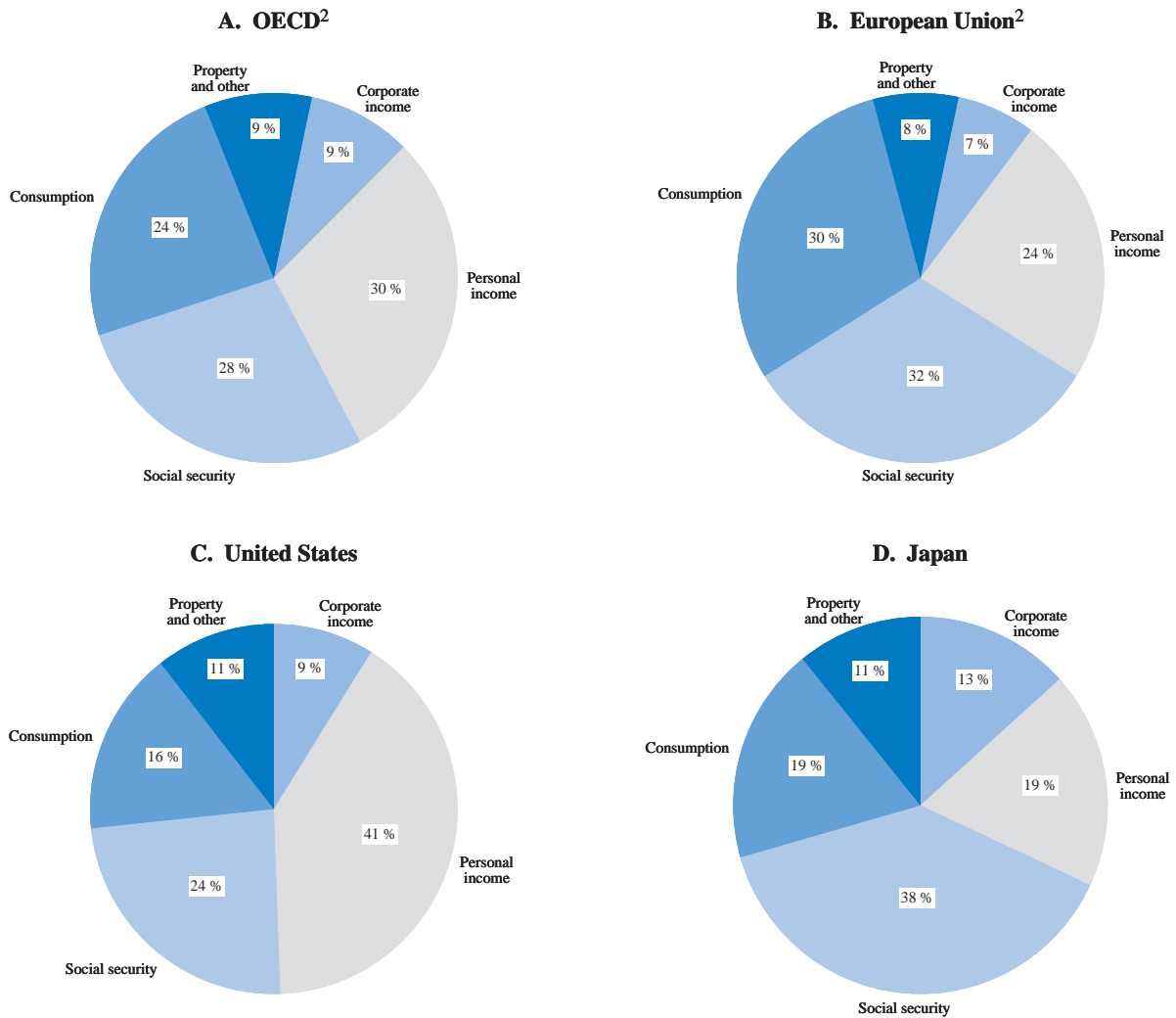
2. Unweighted average.

Source: OECD, *Revenue Statistics*, 1965-1999.

Declining tax ratios are currently being reported more widely across countries. This largely reflects public expenditure trends,⁶ although fiscal consolidation efforts during the 1990s have implied that the success a number of countries have had in reducing expenditure ratios has not yet been reflected in tax ratios that are actually falling. Moreover, a favourable cyclical position has buoyed the tax take as a percentage of GDP notwithstanding tax cuts implemented in a large number of countries.

6. See Atkinson and Van den Noord (2001).

Figure V.3. Tax mix by source¹
Per cent share of total tax revenue, 1998



1. The breakdown of income tax into personal and corporate tax is not fully comparable across countries; see footnote 1 Figure V.2.

2. Weighted average.

Source: OECD, *Revenue Statistics*, 1965-1999.

... with social security contributions having borne the brunt of rising revenue needs

As tax GDP to ratios have drifted up over the longer haul, the largest part of the increases has taken the form of higher social security contributions (Figure V.2). This has reflected the expansion of social insurance systems substantially financed by such contributions, notably in Europe. Higher personal income taxes have also played a significant role, although most of the rise in these had taken place by 1975. Taxes on corporate income and wealth, more constrained by the potential geographical mobility of their bases than social security contributions, and taxes on goods and services have risen more modestly.

The vast bulk of tax revenue, *i.e.* more than 80 per cent, currently stems from three main sources of roughly equal size: personal income tax, taxes on goods and services and social security tax. However, countries vary considerably in the relative importance of different tax revenue sources (Figure V.3). Overall, the European Union (EU) relies more on consumption taxes and social security contributions and less on personal income tax than the OECD average. In contrast, the United States collects more in personal income tax and property tax but less in consumption taxes and social security contributions. Japan is similar to the United States in its low share of consumption taxes but collects much less in personal income tax, offsetting this with higher levels of corporate tax and social security contributions.

Taxation of saving and business activity

Mobilising saving and allocating it effectively to areas where it yields a high return is key to maintaining high rates of productivity and economic growth over the medium to longer term. There is little evidence that taxation has a significant impact on aggregate saving or investment. However, tax systems clearly discriminate between specific forms of saving and investment. This influences comparisons of rates of return across savings and investment vehicles, and may result in sub-optimal saving and investment patterns and efficiency losses. Moreover, globalisation and the associated growth in international financial transactions, while enhancing the growth potential of economies and associated tax bases, risks heightening such distorting effects as new possibilities for international tax evasion and avoidance emerge.⁷

Tax incentives change the composition, more than the overall levels, of saving and investment

One longstanding issue is that double taxation of distributed profits, first at the corporate level and subsequently at the shareholders' level, can produce a high combined tax rate on equity. With interest on debt deductible against the corporate tax this can create an incentive to finance investment through debt (bank credit and the issuance of bonds) rather than the issuance of shares.⁸ This may make companies more prone to insolvency and discriminate against small companies and start-ups, which have reduced access and less favourable terms on debt financing and thus depend more on equity. This points to the desirability of removing the bias against equity financing. One way that this has been done is by granting a tax credit to dividend recipients corresponding to the corporate tax on distributed profits. This is known as the imputation system (applied in Australia, Finland, France, Mexico, New Zealand and Norway),⁹ as opposed to the so-called classical system without such credits. However, the concerns caused by the classical system have eased over time because a major source of debt bias – inflation – has been practically removed. Moreover, in many countries reductions in corporate tax rates have

While tax-induced indebtedness of corporations has become less of a concern,...

7. Moreover, there is recent evidence that international differences in taxation are having a significant effect on foreign direct investment flows. See Altshuler *et al.* (1998).

8. Retained earnings are another possible source of finance, but are often in limited supply for new and fast-growing companies. They are usually treated more favourably than new equity financing given that capital gains on shares are often not fully taxed at the individual level beyond a certain holding period.

9. Moreover, several countries apply partial imputation credits, corresponding to some fixed share of imputed corporate profits, notably Canada, Denmark, Ireland, Italy, Korea, Portugal, Spain, Turkey and the United Kingdom.

reduced the “tax value” of interest deductions.¹⁰ At the same time, double taxation relief is often provided indirectly, by adopting low flat tax rates on personal dividend income.¹¹

... globalisation has compromised traditional ways of dealing with it

Meanwhile, tax designers in many countries have been moving towards the view that in a world with free cross-border capital flows, imputation credits are unlikely to be effective in reducing the bias towards debt financing of corporations. Indeed, if the pre-tax required rate of return for shareholders is determined in world capital markets and capital is flowing freely across borders, unilateral changes in personal income taxation are thought to be unlikely to change the demand for and supply of equity capital. Moreover, in the absence of a substantial network of accommodating bilateral tax treaties, imputation credits may discriminate against foreign companies and shareholders. As a result, some countries have chosen to maintain (or revert to) a classical system.

Tax systems favour certain industries, locations and business forms in complex ways...

In most countries the tax code contains special tax reliefs to favour certain activities and locations, such as accelerated depreciation allowances for investment in intangible assets (such as training) and tax reliefs for job creation, deprived areas or foreign direct investment. Typically these are intended to target market failure, or to contribute to social policy or equity objectives. But effective targeting is often undermined by arbitrage opportunities which erode the tax base and lead to unintended distortions in the allocation of resources. For example, special tax regimes designed to lower the taxes paid by certain companies alone (*i.e.* “ring-fencing”) can lead to a serious distortion of competition. Non-tax measures that lower the overall cost of doing business in a certain region, such as infrastructure development, or the provision of training facilities, are more transparent and may create more durable positive effects. Where tax reliefs are used to complement these measures, they need to be designed very carefully.

In addition to special regimes and allowances, several countries maintain a progressive corporate tax rate structure or grant simplified tax filing to small business (Mexico, Canada, France, Japan, Korea, Netherlands, Portugal, Spain, Switzerland, the United Kingdom and the United States). These measures are designed to offset the disadvantages of new, or small, enterprises in financing their investment projects and the disproportionate costs stemming from administrative complexities, including tax compliance.¹² There is also a case for favouring small corporate business to the extent it is prone to market failure, for example due to imperfections in patent systems penalising start-ups, high cost of compliance with regulations due to diseconomies of scale and reduced access of smaller firms to venture capital. Unfortunately, however, progressive or simplified corporate taxation may give rise to abuse with larger companies splitting up into smaller units for tax purposes, but strict anti-fragmentation rules can help to prevent this occurring.

10. One country, Italy, introduced a corporate tax rebate for investment financed through new equity or retained earnings.

11. Many countries tax dividends at a lower (flat) rate under the personal income tax code (Austria, Belgium, the Czech Republic, Denmark, Hungary, Iceland, Italy, Japan, Korea, Poland and Sweden). Meanwhile, Germany has recently introduced a “half rate” system whereby only half the dividends received from German corporations enter the personal income tax base. One country, Greece, exempts dividends from personal income tax all together.

12. A progressive rate structure of corporate taxation is motivated in some countries also by equity objectives, but will only be effective to the extent that there is a correlation between the size of corporations and the relative wealth position of their shareholders.

Favourable tax treatment of pension plans, both voluntary and mandatory, is widespread, with Australia, Denmark, Luxembourg, New Zealand and Sweden being notable exceptions. The main purpose of these provisions is to avoid “moral hazard” of workers, who may otherwise be tempted to consume too much of their earnings during working life and “free ride” on the social safety net once they retire. Moreover, countries with a severe ageing problem may find such tax privileges a useful way to smooth the transition from pay-as-you-go financing to pre-funding, by providing some offset for the “double burden” hitting current workers who are required to finance both current and future pension payments. However, these advantages need to be weighed carefully against the risks of poor targeting, as the tax relief may benefit groups who are not affected by moral hazard and whose prospective pension income, with reasonable saving, is well above the social safety net. Moreover, systems that provide tax breaks to pension vehicles often give particular providers a favoured status, something that the design of such systems should avoid.

... while distortions also stem from tax reliefs for pension-saving vehicles...

Another area often favoured by tax systems is home ownership. According to the neutrality principle, the rental income stemming from home ownership should be imputed for tax purposes, while capital gains should be taxable and mortgage interest payments deductible. However, in most countries little or no rental income is imputed for tax purposes and/or capital gains of owner-occupiers are not taxed – even if property taxes may offset this form of tax relief to some extent. Moreover, mortgage interest payments often result in tax deductions against the highest marginal income tax rate. This implies favourable treatment compared to the taxation of most forms of return on personal saving, which in several countries is taxed at low flat rates, and interest on consumer credit, which is usually not tax-advantaged. It also risks favouring higher income groups, who face a comparatively high marginal income tax rate and can afford the investment to qualify for the tax subsidy. Tax relief for house ownership may, finally, result in a bias against the development of commercial property and other business investment, where interest payments are normally deductible against the (typically lower) corporate tax rate.

... and home ownership

There are only few options available to move away from such unfavourable features. Some countries have capped mortgage interest deductions or eliminated them altogether while removing imputed rental income from the personal tax base. While enhancing the simplicity of the tax code and facilitating tax compliance, this type of measure still involves an asymmetry between the taxation of net capital income from housing and other forms of capital income. An alternative approach – more neutral but also more complex – is to impute a rental value and tax both it and any capital gains (net of mortgage interest payments) together with other forms of personal capital income at a uniform flat rate, akin to the dual income tax system adopted by the Nordic countries (see below). However, the experience in the Nordic countries has shown that the transition costs associated with the introduction of such a system, in terms of abrupt declines in house prices and associated solvency problems, may be high. Indeed, whatever change in tax regime is adopted for owner-occupiers, it would need to be phased in gradually.

Taxation of net wealth is applied in a number of OECD Member countries (Finland, France, Germany, Iceland, Luxembourg, the Netherlands, Norway, Spain, Sweden and Switzerland), although several have been considering its abolition. Net wealth tax, which taxes financial and real assets of individuals or corporations after deduction of financial liabilities, is motivated *inter alia* by income redistribution objectives, but its redistribution properties are undermined by the tax planning of higher income groups because of the availability of tax shelters. In particular, net wealth tax

Countries should reassess the merits of net wealth taxes...

generates incentives for taxpayers to inflate their liabilities, *i.e.* take out loans in order to invest in tax-favoured or underassessed assets such as real estate. An alternative to this tax is an increase in the taxation of real property, which would also remove the heavy cost of tax assessment. Some countries find that the information collected in the assessment of net wealth taxes provides a useful check on the accuracy of income tax returns, as a person's wealth accumulation can be compared with his/her income, but there may be other ways of collecting this information. All considered, countries using this tax could usefully reassess the merits of continuing to apply them.

... and are encouraged to continue their co-operation on taxation of savings invested abroad

The pattern of saving flows between countries is influenced by the greater possibilities of tax evasion when savings move across borders. A divergence in source country (withholding) and residence country (income) tax rates can create incentives to shelter income from home country tax by having that income accrue abroad if it can be hidden from the home tax authorities. At the same time, investors may seek securities subject to no, or low, withholding tax at source to minimise the overall tax bill. Abstracting from evasion and avoidance, residence taxation should not affect the choice of whether to invest at home or abroad. In practice, however, evasion and avoidance are problems that need to be addressed through exchange of information between source and residence countries.

Faced with these difficulties, governments have responded in a number of ways. One response, observed a decade ago in a number of Nordic countries, has been to separate the taxation of (geographically mobile) capital and (geographically immobile) labour, by adopting the dual income approach noted above. The essential feature of a dual income tax system is the taxation of capital income at a relatively low flat rate, while earned income and transfers are taxed according to a high (and progressive) rate schedule. Many other countries have since adopted separate capital income tax regimes to move in this direction. Meanwhile, the exchange of information has become common among many OECD countries and has been agreed in principle within the EU recently.

Taxation and the performance of labour and product markets

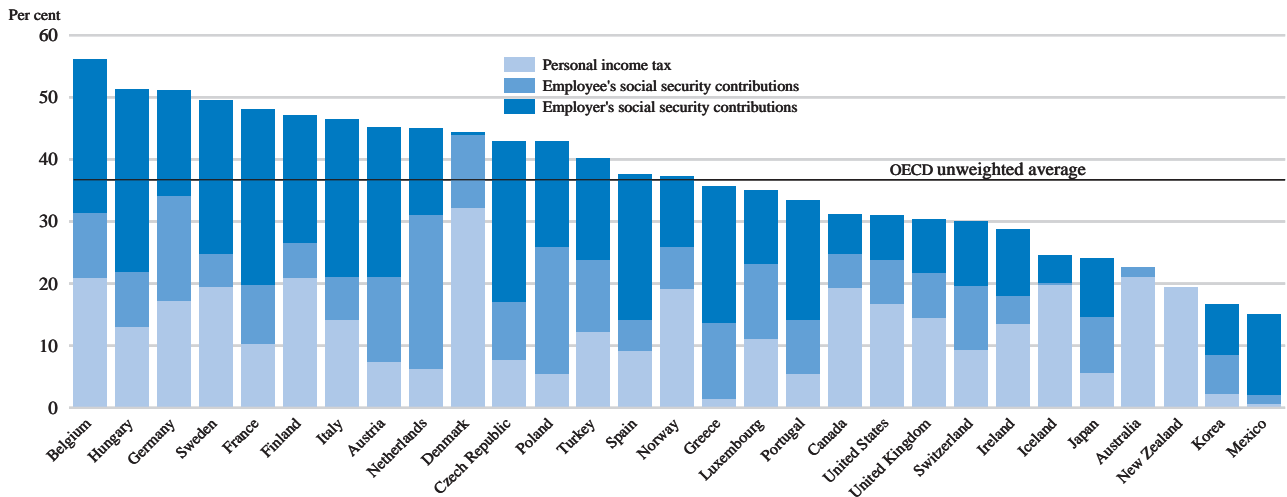
Heavy taxation of wage earnings discourages employment, notably in Europe,...

As has been extensively analysed in the framework of the OECD *Jobs Strategy*, the heavy taxation of wage earnings which is typical for countries that maintain high levels of public expenditure, drives a large wedge between the real labour compensation as paid by employers and real take-home pay per worker.¹³ This phenomenon is particularly pronounced in many countries of the European Union, but the European transition countries are confronted with this problem as well (Figure V.4).¹⁴ To the extent that industrial relations, regulatory constraints or transfer schemes prevent the burden of this wedge from being borne by the workers, firms will be induced to cut back on their use of labour. This may take the form of substitution of (typically

13. See for example OECD (1999c).

14. The tax wedges shown in Figure V.4 refer to income and social security taxes only, abstracting from consumption taxes. The cross-country spread in tax wedges would be even larger if account were taken of the taxation of consumption from wage earnings, with countries in the European Union featuring not only the highest labour taxes but also the highest consumption taxes.

Figure V.4. Tax wedges on labour, 2000¹
As a percentage of gross labour costs²



1. For a single individual at the income level of the average production worker. Data for 2000 are based on estimated wage levels of the average production worker.

2. Gross wage plus employers' contributions.

Source: OECD, *Taxing Wages*, 1999-2000.

low-skill) labour with other production factors, downsizing of activity or relocation of activity to countries that offer lower labour costs for a given level of skills and competencies. At the same time, where tax and social security contributions are shifted back into wages they may generate disincentives to seek work or raise work effort. If tax enforcement is weak, firms and workers may also drift into the “informal” economy.

Concerns about excessive labour costs have prompted initiatives in several EU countries (Belgium, France, Greece, the Netherlands, Spain and the United Kingdom) to cut social security contributions at the bottom end of the pay scale.¹⁵ Such measures have generally been found to be effective in terms of creating job opportunities for low-skilled workers. Several countries, including some in the European Union, have also introduced earned-income tax credits to strengthen incentives for participation in work at low levels of wage earnings, following the example of the United States (Canada, Finland, France, Greece, Ireland, New Zealand and the United Kingdom). This is found to be particularly effective in encouraging labour supply if combined with a minimum wage at a reasonable level, as this limits the extent to which the incidence of the tax credit might be transferred from the worker to their employer. A drawback is that incentives for additional work effort at income levels in the abatement range are reduced (the credit is phased out as earnings approach a statutory threshold). Careful design can help avoid this, but much depends on the shape of the earnings distribution – if this is narrow, the phase-out problem is markedly more difficult to deal with – as well as the overall level of taxation – if this is high, marginal effective tax rates in the phase-out range may become prohibitive.¹⁶

... and efforts to ease this problem have proved beneficial

15. See for details Joumard (2001), *op. cit.*

16. See: Bassanini *et al.* (1999) and Pearson and Scarpetta (2000).

*Progressive income taxation
faces difficult trade-offs
between efficiency and equity*

Progressive income taxation is aimed at enhancing the fairness of income tax systems but also strengthens incentives for tax minimisation to the extent that high-income taxpayers are able to benefit from tax reliefs, via the purchase of pension annuities, housing or other tax-favoured assets (see above). Moreover, although not a large-scale problem yet, top income earners may become more prone to labour mobility *vis-à-vis* other countries where income taxation at the top end of the income distribution is lower. Maintaining strongly progressive tax rates under such conditions frustrates economic efficiency without gaining much in terms of equity. There is scope for governments to continue their ongoing efforts to reduce marginal tax rates at the top end while broadening the base by limiting tax reliefs, especially in countries where the pre-tax income distribution is narrow. Indeed, as opportunities for economic and social mobility of individuals increase, horizontal equity (ensuring that people in the same economic position pay the same amount of tax) may gradually take precedence over vertical equity (requiring that people on higher incomes pay a higher proportion of their income in tax) as a means to promote fairness.

*Rate differentiation in indirect
taxation often removes
neutrality and is not well-suited
for income redistribution
purposes*

All but one OECD country have introduced a value-added tax (VAT). This may have simplified the tax rate structure, but rate differentiation and exemptions still imply a lack of neutrality in most countries. This reflects the fact that these structures have not been dictated purely by tax considerations but also by other, often complex, social and historical factors. They may also be motivated by industrial policy objectives (*e.g.* to favour the tourism industry), but, since they usually favour specific producer interests, lobbying activity can influence the assessment of their merits. VAT exemptions for small companies are intended to facilitate compliance, but recent experience in some countries (*e.g.* Italy) has shown that requiring small (non-incorporated) companies to register for VAT may be a more effective way to encourage overall compliance with the tax code. Low or zero indirect tax rates and exemptions may also be motivated by concerns over indirect taxation hitting disadvantaged groups heavily. However, these policies are rarely successful in alleviating such concerns because consumption patterns of basic goods and services (to which lower rates mostly apply) vary rather little across income groups.¹⁷ Targeted help, for example cash payments (including child benefits) or vouchers for basic staples, could be a more cost-effective way to assist people on low incomes, although there is a need to take account of possible problems: low take up, increased effective marginal tax rates and high administrative costs.

*Taxing electronic commerce in
a neutral way is an emerging
challenge*

Electronic commerce continues to grow rapidly,¹⁸ but this new way of doing business also presents certain challenges to established tax policy principles and to effective tax collection, particularly in terms of ensuring a similar tax treatment of electronic traders as compared to more traditional businesses. Specific problems arise in connection with supplies to final consumers and businesses that are not registered for VAT, where there is little incentive for suppliers to fulfil their VAT obligations in relation to such sales. It is important that taxation rules continue to apply fairly and consistently, and with predictable outcomes internationally, so as to avoid distortions. OECD countries are working, in partnership with the international business community and with many non-member economies, to implement the core principles set out in the Ottawa Taxation Framework Conditions.¹⁹ They point, in short,

17. See for example Figure VI.3 in Chapter VI, "Encouraging environmentally sustainable growth: experience in OECD countries", which broadly confirms this in the case of household energy consumption.

18. See OECD (2000b).

19. OECD (2001).

to the application of existing taxation principles and norms to e-commerce, albeit with some clarification and development of those norms in selected areas.

Tax compliance, enforcement and decentralisation

The self-employed in many countries face low effective income-tax rates, as they usually have more scope for deductions and credits regarding expenses that qualify as necessary for carrying out their business, contribute relatively little to social security, or underreport income due to weak auditing. This raises concerns not only in terms of tax-revenue loss, but also produces inequities between self-employed and other workers and jeopardises the efficiency of industrial organisation. Strengthening the taxation of self-employment income is imperative in countries where tax compliance is reportedly a key problem. These countries might benefit from the recent experience in Italy, which introduced a system of assessing self-employment income through auditing based on regional benchmarking.²⁰ A specific problem associated with the dual income tax systems applied in some countries (see above) results from the splitting of self-employment income into labour and capital components, each taxed at its own level. Since the statutory tax rate on labour income is high and relatively progressive, incentives to convert labour income into capital income (dividends) and/or to incorporate may be strong for individuals with high earnings. This may force these countries to reduce the differential between capital and labour income tax, at the risk of undermining the rationale behind the dual income tax system.

The taxation of the self-employed is often the Achilles heel of the tax system

Strengthening the enforcement of tax laws can potentially enhance the perceived fairness of the system and thus compliance. Meanwhile, raising the cost-effectiveness of tax administrations would free-up resources for more beneficial uses, such as combating tax evasion. Current reform strategies that may yield benefits in this regard include:

Clear tax codes and effective tax enforcement enhance tax acceptance and compliance

- Simplifying tax codes and reinforcing voluntary compliance by providing tailored assistance, advice and support to taxpayers; harnessing new information technology to provide improved taxpayer services electronically.
- Improving cost-effectiveness of tax collection by reduction of overlap between various tax (and social security) administrations with regard to collection and processing and the introduction or extension of modern information technology.²¹
- Widening the coverage of tax assessment. This could be achieved by introducing a single tax identification number (TIN) to discourage underreporting of income, up-to-date land registers to allow a proper assessment of real estate, and abolishing lump-sum tax settlements for self-employed while assessing their income based on proper accounting rules.

20. The so-called *studi di settore*; see for a discussion the 2000 issue of the *OECD Economic Survey* of Italy.

21. Recent progress in, for example, electronic filing of tax returns over the Internet has been rapid in several countries, and in some has had quite striking results both in terms of the number of taxpayers using this facility and the cost of collection and compliance.

- Combating cross-border tax abuse, including failure of taxpayers to declare income from cross-border investment of savings, the use of tax havens to hide companies' profits from their country of residence, and abuse of cross-border sales tax or VAT regimes. These problems are currently being addressed within the framework of the OECD and the EU, mainly on the basis of improving exchange of information between tax authorities.

There is no unique role model for decentralised taxation...

Countries differ in prevailing fiscal arrangements between the central and sub-central levels of government. The combined share of sub-central governments in total tax revenues has been relatively stable in past decades, but shows a wide variation across countries (see Table V.2). Where federal constitutions apply, the sub-central share is higher on average than in unitary countries (27 and 13 per cent,

Table V.2. Attribution of tax revenues to sub-sectors of general government

Percentage of total tax revenue

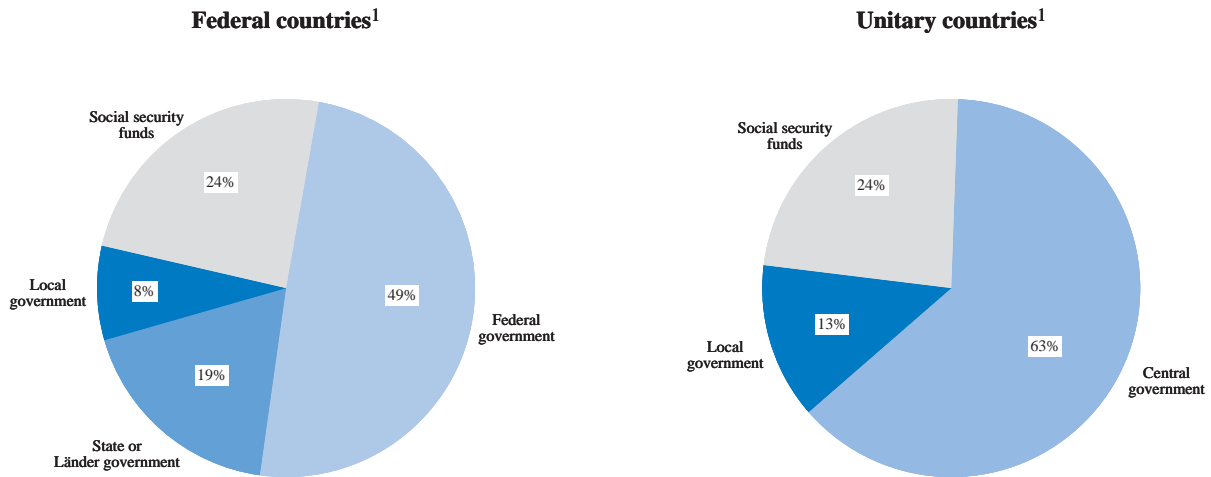
	Federal or central government			State or Länder government			Local government			Social security funds		
	1975	1985	1998	1975	1985	1998	1975	1985	1998	1975	1985	1998
<i>Federal countries</i>												
Australia	80.1	81.4	78.4	15.7	14.9	18.0	4.2	3.7	3.5	–	–	–
Austria	51.7	48.9	52.7	10.6	13.1	9.3	12.4	10.7	10.2	25.3	27.2	27.8
Belgium	64.3	62.6	36.7			23.3	4.8	5.1	4.9	30.9	32.2	35.1
Canada	47.6	41.2	41.0	32.5	36.0	36.3	9.9	9.3	8.9	10.0	13.5	13.7
Germany	33.9	31.9	29.4	22.6	22.2	22.0	9.1	9.0	8.0	34.4	36.9	40.6
Mexico		87.7	82.0		0.4			0.6			11.3	18.0
Switzerland	27.4	28.9	30.1	24.2	22.7	19.5	19.6	16.8	14.8	28.9	31.6	35.7
United States	45.4	42.1	45.1	19.5	20.2	19.2	14.7	12.6	12.0	20.5	25.2	23.7
Unweighted average	50.1	53.1	49.4	17.9	16.2	18.5	10.7	8.5	7.8	21.4	22.2	24.3
<i>Unitary countries</i>												
Czech Republic			43.9						11.9			44.1
Denmark	68.8	68.9	64.9				29.9	28.6	32.0	1.2	2.5	3.1
Finland	56.6	55.8	52.6				23.6	22.4	22.2	19.8	21.8	25.2
France	51.5	47.5	43.6				7.6	8.8	10.6	40.8	43.8	45.8
Greece ^a	67.1	63.1	68.8				3.4	1.3	1.1	29.5	35.6	30.1
Hungary			62.5						4.5			33.0
Iceland	81.3	81.4	77.1				18.7	18.6	22.9	–	–	–
Ireland	79.1	83.8	86.8				7.5	2.3	2.0	13.4	13.9	11.2
Italy	53.2	62.7	58.8				0.9	2.3	11.7	45.9	34.9	29.5
Japan	45.4	43.7	36.2				25.6	26.0	25.4	29.0	30.3	38.4
Korea	89.0		71.4				10.1		17.6	0.9		11.1
Luxembourg	64.3	67.0	68.1				6.6	6.6	6.3	29.1	26.4	25.6
Netherlands	59.8	52.6	56.5				1.2	2.4	3.0	39.0	44.9	40.5
New Zealand	92.3	93.5	94.2				7.7	6.5	5.8	–	–	–
Norway	50.6	59.7	59.4				22.4	17.7	18.3	27.0	22.7	22.2
Poland			58.8						9.0			32.3
Portugal	65.4	70.6	67.0				0.0	3.5	6.1	34.6	25.9	26.9
Spain	48.2	47.8	48.0				4.3	11.2	17.0	47.5	41.0	35.0
Sweden	51.3	54.1	58.1				29.2	30.4	30.8	19.5	15.6	11.1
Turkey		75.5	69.1					10.2	16.6		14.3	14.3
United Kingdom	71.1	71.1	78.2				11.2	10.6	3.9	17.7	18.3	17.9
Unweighted average	64.4	64.6	63.0				12.3	12.3	13.3	23.2	23.1	23.7

a) Figures for 1998 are based on a submission by the national authorities.

Source: OECD, Revenue Statistics, 1965-1999.

Figure V.5. Attribution of tax revenues to sub-sectors of general government

Per cent share of total tax revenue, 1998



1. Unweighted average.

Source: OECD, *Revenue Statistics*, 1965-1999.

respectively, in 1998 – see Figure V.5), but variation within these categories is also wide. For example, among the unitary countries, the Nordic countries report local tax shares in the range of 20 to 30 per cent, as compared to *e.g.* 2 per cent in Ireland. However, the true fiscal autonomy for sub-central governments depends on their degree of discretion or control in adjusting their local tax revenue to the costs of the local public provision. A recent study²² found that in several countries a substantial proportion of tax revenue of sub-central governments comes from sources over which they have no formal control. Moreover, in most countries, the tax revenues allocated to sub-central levels are redistributed across jurisdictions through tax sharing arrangements, often combined with some equalisation of differences in tax yields across jurisdictions.

Fiscal devolution may yield welfare gains, as local, rather than national, governments are best able to meet many local needs and preferences for public services. Letting local needs for services be tested by the willingness of local residents to pay is often the most efficient way to determine the size and nature of publicly funded programs. To achieve this, local governments could be allowed to exercise more flexibility in modifying public provision levels at the margin according to local preferences, as long as this is matched by local taxes to reveal the cost to local taxpayers. On the other hand, a risk associated with devolution is that local governments are unable to implement tax and spending policies with a view to serving national objectives. While recognising that the vertical assignment of taxing power in many

... but careful devolution of taxing power may yield some welfare gains

22. OECD (1999d).

countries is rooted in a Constitution and therefore difficult to change, considerations that may help to optimise benefits of devolution of taxation and minimising disadvantages include:

- Many specific forms of taxation are unsuitable for local use;²³ sub-central governments can most effectively use resident-based tax (such as property tax) and non-tax revenues (*i.e.* user fees) levied on economic units to let them pay for the benefits they receive from the local public services. For some countries with significant devolution of expenditure powers, this is insufficient and other tax bases are used, sometimes on a shared basis with the central government. To the extent tax bases are shared by various government layers in this way, the definition of the tax base, the rate structure and the administration should be co-ordinated in order to minimise compliance and collection costs.
- Equalisation transfers of nationally collected tax across local jurisdictions could be used to ensure that some minimum or standard level of public provision is achieved no matter how strong or weak the taxing capacity of the local jurisdiction. These can take either of two forms: the direct allocation of a share in nationally collected taxes on a formula basis or direct grants from higher levels of government. However, the equalisation rule should reflect an objective assessment of the strength of the local tax base, considering *e.g.* demographic and geographic features, rather than actual taxes collected.

23. Local governments should minimise the use of: mobile tax bases, redistributive taxes, unevenly distributed tax bases, taxes subject to economies of scale and taxes subject to sharp cyclical fluctuations.

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