

Tax Policy Reform and Economic Growth

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In the wake of the recent financial and economic crisis, OECD countries face the challenge of restoring public finances without jeopardising economic growth. This report investigates how tax structures can best be designed to support GDP per capita growth. It suggests shifting part of the tax burden from income to consumption and residential property and a greater role for environmental taxes and fees. But implementing these growth-oriented tax reforms may not be easy. This report therefore identifies those tax reform strategies that will allow policymakers to overcome obstacles and to make tax reform happen.

Growth-oriented tax systems seek not only to minimise the distortions of market signals by the tax system, but also to create as few obstacles as possible to investment, innovation, entrepreneurship and other drivers of economic growth. The empirical analysis in this report suggests a “tax and economic growth” ranking order according to which corporate income 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. This reflects the different distortionary effects of different taxes. A growth-oriented tax reform would, therefore, shift part of the tax burden from income to consumption and/or residential property.

“...a growth-oriented tax reform would shift part of the tax burden from income to consumption and residential property and would broaden the tax base...”

Within individual main tax categories – property, consumption, personal and corporate income tax – there is 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 addressing market failures. 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 level of innovation. Other growth-enhancing tax policies include the reduction in top marginal personal income tax rates if they have a strong negative impact on human capital formation and entrepreneurship, well-designed incentives to work at low earnings and specific taxes to correct externalities.

When reforming tax systems, policymakers have to weigh up the different goals that tax systems try to achieve. Policymakers will have to balance the efficiency and growth-oriented objectives of tax reform with their distributional impact. The impact of tax reforms on revenues, tax avoidance and evasion and tax compliance and enforcement costs will have to be taken into account. The impact on sub-central levels of government, the transitional costs of changing tax systems and complex timing issues will also have to be considered as well as the different administrative, institutional and political environment factors.

“...Policymakers face many challenges when trying to make tax reform happen...”

By considering the tax system as a whole rather than focusing on isolated elements, policy makers can better communicate the issues

involved in improving the efficiency and equity of tax regimes. This points to the potential for advancing reforms via broad reform packages that reduce distortions in the system while spreading reform benefits widely. In particular, this will allow policy makers to compensate those who will lose out as a result of the tax reform. Concessions for 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, articulating broad aspirational goals can also 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 the adoption of reform. 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 crucial.

“...The economic crisis has created a window of opportunity for tax reform, but made tax reform more difficult to implement at the same time...”

The timing of implementation is critical as well. 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. And politicians will want to implement reform such that the reform benefits are visible at the time the next election takes place.

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 economic problems and to put the economy back on a high-growth path. A crisis that undermines the influence of vested interests may make reform more likely. It may mean that opponents of reform change their perspective because they start to benefit from reform as well. A crisis might create a sense of urgency and a “window of opportunity” for reform which otherwise would have been blocked.

Unfortunately, a crisis might also make fundamental tax reform more difficult to implement, especially because large groups of taxpayers are strongly affected by the crisis. These additional obstacles 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, 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.

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