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.
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.
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).
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.
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).
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).
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.
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.
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