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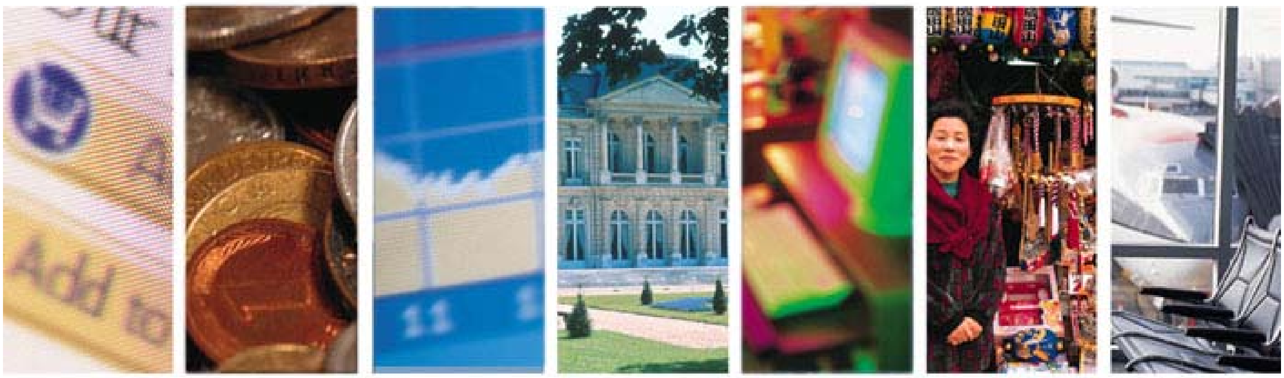

Tax Policy Conclusions

CENTRE FOR TAX POLICY AND ADMINISTRATION

5. TAX POLICY CONCLUSIONS

This section evaluates the tax reform in Denmark, Italy, Slovak Republic and Turkey in terms of the principles of sound tax policy: efficiency, equity, simplicity, tax compliance and tax revenue. These principles will be briefly reviewed in section 5.1. On the basis of the country information that was presented during meetings of the OECD Working Party No. 2 on Tax Policy Analysis and Tax Statistics under the Committee on Fiscal Affairs, section 5.2 then summarizes and analyses the tax reforms in each country.

5.1 Tax principles

Tax revenue

OECD governments find themselves squeezed by pressures to maintain or to increase their expenditures on the one hand and the need to make their tax systems more competitive on the other hand. The ageing of the population, high levels of unemployment, the need to replace physical infrastructures and the remaining government debt all increase the pressure on government expenditures. However by reducing rates, OECD countries might attempt to reduce, for instance, the obstacles to job creation, people's willingness to work, and the amount of (domestic and foreign) investment. As such, governments protect their tax revenue indirectly by reducing expenditures (unemployment benefits, etc.) and increasing tax revenues. As tax revenues decline as a result of tax exemptions, tax allowances and tax credits and as a result of tax-arbitrage behaviour, defining a broad tax base – a broad base minimizes the opportunities for tax-arbitrage behaviour – has a direct positive impact on tax revenue. In order to avoid abuse of the tax rules and provisions, taxpayers' behaviour has to be strictly monitored. As these monitoring costs are increasing in the number of tax exemptions, tax allowances and tax credits and in the number of tax-arbitrage opportunities, defining a broad tax base raises tax revenue indirectly as well. Yet at the same time, increased international mobility has increased tax-competition and put a downward pressure on the rates. Corporate income, personal capital income and labour income of especially high-skilled employees are examples of tax bases that become increasingly geographically mobile. Recent proposals for tax reform in OECD countries can be seen as a response to these challenges.

Efficiency

Many tax reforms in OECD countries since the mid-1980s have been based on the principle of broadening tax bases and lowering tax rates. An important objective of such reforms has been to reduce tax distortions which may be an important impediment to economic growth. In practice, tax systems should be as neutral as possible. The tax system should minimize discrimination in favour of or against any particular economic choices, which in practice means building tax systems substantially around broad income and expenditure bases and minimizing differences in tax rates that can be applied to different bases. The focus in tax reforms on base broadening may in part be explained by the need to compensate for the revenue loss due to reductions in tax rates. However, base broadening may also help to reduce tax distortions and enhance efficiency as tax systems often discriminate between specific activities.

Equity

All OECD countries have progressive income tax systems, implying that income redistribution through the tax system is a policy objective. When analyzing the effects of taxation on income distribution, there are two main types of equity that are relevant: horizontal and vertical equity. Horizontal equity from a tax perspective implies that taxpayers in an equal situation should be taxed in an equal manner as they have the same ability to bear the tax burden. Horizontal equity then implies that the tax on a given level of total income should be the same regardless of how this income is composed (e.g. wage and pension income, fringe benefits or any form of capital income including imputed income from owner-occupied housing and capital gains on an accruals basis). The tax policy objective of vertical equity prescribes that taxpayers with better circumstances should bear a larger part of the tax burden as a proportion of their income. Vertical equity then implies that the distribution of after-tax income should be narrower than the distribution of before-tax income, or that the average tax rate should be increasing in income. This can be achieved by having a basic allowance and/or by having a progressive rate schedule (marginal tax rates that are increasing with income).

Policy makers will have to choose between using the tax system for income redistribution (vertical equity) and minimizing the negative effects of tax distortions (efficiency). As such negative effects of taxation increase with the tax rate, using progressive rates to promote income redistribution is accompanied by weaker incentives and higher distortionary costs. Certain types of tax allowances and tax credits favour low-income households, e.g. the earned income tax credit. However, especially high-income taxpayers are often able to benefit from other tax reliefs. Maintaining strongly progressive tax rates might frustrate economic efficiency without gaining much in terms of equity. Reducing 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, becomes then an interesting policy objective.

Simplicity and tax compliance

Another significant part of the political debate on personal income tax reform in many OECD countries is the need for significant simplification of the existing tax systems. There is a growing understanding of the detrimental effects of complexity. Tax exemptions, tax allowances and tax credits have given rise to complicated rules and imply that authorities have to levy high tax rates, which creates further pressure for new exemptions, allowances and credits

There are costs involved in raising a given amount of revenue both for the taxpayers and for the tax administration. Generally speaking, such costs increase with the complexity of the tax system. Costs for taxpayers increase because they have to use more resources on understanding how to declare and to minimise their taxes within the framework of the tax law, which may include having to use accountants or tax lawyers. Authorities must make extra efforts to implement the complex tax rules and to ensure that taxpayers understand their obligations.

Complexity inevitably puts compliance at risk as some proportion of taxpayers will not fully understand their obligations and make errors while others will simply ignore what is expected from them. In addition, the possibilities to avoid or evade taxes normally also increase with the complexity of the tax system – which may encourage taxpayers to spend even more resources on reducing their tax bill and which increases the amount of resources needed in the tax administration to prevent and detect tax fraud. In reducing the complexity of the tax system by broadening tax bases through the reduction in the number of tax exemptions and allowances, authorities might reduce the opportunities for taxpayers to make filing errors and to avoid and evade taxes. Less complexity then leads to an increase in tax compliance.

5.2 Tax policy experiences and trends

Reduced distortions

Since 2001, the Danish government has committed itself to not increasing taxes. In real terms, this tax commitment implies that the tax burden – and therefore the distortions that are created – slowly decrease over time. However, there are concerns that the distortions that are caused by the Danish tax system might be solved more efficiently by reforming the tax system in a more fundamental way. The personal income tax reform of 2003 – it increased the threshold of the medium tax bracket and introduced a tax allowance scheme – aimed at reducing the distortions in the labour market and at improving incentives to work. The changes in the corporate tax rules concerning the joint taxation of parent companies with domestic and foreign subsidiaries have decreased corporate tax distortions as well. Moreover, corporations have no longer an incentive to “collect losses” from around the world, while leaving their profits in foreign low-tax jurisdictions.

The reform of the personal income tax in Italy (in 2003 and 2005) mainly aimed at reducing distortions by reducing the personal income tax rates and by flattening the rate structure. Distortions were also reduced because the tax credit system was replaced by a less complicated tax allowance scheme. Also the corporate income tax causes fewer distortions because of, for instance, the reduction in the corporate tax rate, the replacement of the full imputation system with a partial inclusion system, the introduction of a participation-exemption regime and the introduction of thin capitalization rules.

Fewer tax-induced distortions might be expected in the Slovak Republic as well. The personal income tax system and the corporate income tax system were replaced with the flat tax system as from January 2004. However, the strong incentives for unemployed people to enter the labour market were not caused by the flat tax reform but by the reduction in social assistance benefits and some other reforms that have made working more beneficial in relation to the unemployment benefits that can be received.

Both the IMF and the World Bank have signalled concern about the complexity of the Turkish tax system. Both different nominal tax rates and investment incentives across financial instruments have distorted the effective tax rates across both financial and real investments. The harmonization of the system for investment incentives and tax rates on income from investment has reduced distortions recently.

Lower tax rates

In Denmark, personal income taxes have decreased over time. For instance, the top personal income tax rate was 73 per cent in 1986 and is 63 per cent in 2005. However, the rates continue to be rather high. The corporate tax rate has declined as well. It currently has at a rate equal to 28 per cent (coming down from 50 per cent at the beginning of the 1990s). Indirect taxes have been decreasing over time as a response to cross-border shopping and as a response to the EU’s indirect tax harmonization rules.

The Italian government has reduced its corporate tax rate from 36 per cent in 2002 to 33 per cent in 2004. Also the personal income tax rates have decreased. The top personal income tax rate has decreased from 45.5 per cent in 2000 to 43 per cent in 2005. Moreover, the new tax allowance scheme has reduced the personal income tax burden for low-income families and for many middle-income families. The Italian corporate tax reform has slightly increased the corporate tax burden. However, the corporate tax burden has decreased for firms belonging to a group that has chosen for tax consolidation.

Personal income tax rates were reduced in the Slovak Republic. The five income brackets – rates varying from 10 per cent to 38 per cent – were replaced by a single rate of 19 per cent. The corporate tax rate of 25 per cent was reduced to 19 per cent as well. Dividends are no longer taxed at the household level. Moreover, the general VAT rate was reduced from 20 to 19 per cent. The low VAT rate of 14 per cent, however, was abolished.

In Turkey, both corporate and personal income tax rates are around the OECD-average level. The recent reform has abolished the surcharge on the corporate tax. The introduction of the new partial inclusion system implies a significant reduction in the total tax burden on corporate profits gradually from 65 to 44 per cent in 2005.

Tax-base broadening

In Denmark, the personal income tax base has been broadened over time. Even though the corporate income tax rate has been reduced considerably, corporate tax revenues in Denmark have been increasing as a result of corporate base broadening measures (for instance, because of the new joint-taxation corporate tax rules).

The introduction of the flat tax in the Slovak Republic was combined with a significant elimination of tax relief measures, which led to a considerable broadening of the personal income tax base. Also the corporate income tax base has been broadened, for instance by abolishing the exemptions for newly established firms.

The Turkish tax reform has simplified and reduced the investment tax allowance. Several other tax incentives and exemptions have been rationalized. This has contributed to a broader tax base, and has resulted in a simpler and more transparent tax system.

Tax-base shifting

Many OECD countries have been shifting their tax base towards consumption and environmental taxes, using the proceeds to lower the taxes on labour and capital income.

This trend has been observed in Denmark in the 1990s but seems to have stopped. In recent years, Denmark has not further shifted its tax base towards consumption and environmental taxes. Due to the high indirect taxes on consumption goods and the high environmental taxes – they even exceed the externalities – that were already in place. There seem to be little scope for further base shifting. In fact, tax harmonization inside of the EU forced Denmark to even lower its excise duties.

No additional tax base shifting has occurred in Italy. On the contrary, the ‘specific’ consumption taxes have raised less revenue, while tax revenue from ‘general’ consumption taxes has been fairly constant since the beginning of the 1990s. The reduced revenue of income and profits taxes has mainly been compensated by an increase in property taxes and by a new regional tax, as described in section 2.3.2.

The government of the Slovak Republic partly financed its flat tax reform by shifting the tax burden from direct to indirect taxation. In fact, the decline in personal income and corporate income tax revenues is almost entirely compensated by an increase in VAT revenues and excise revenues.

Turkey relies heavily on taxation of goods and services. Indirect taxes yield about half of the total tax revenue. This reflects a significant shift of the tax base in recent years from direct to indirect taxation as described in section 4.3.2.

Reduced tax complexity

The change in the corporate tax rules concerning the joint taxation of parent companies with domestic and foreign subsidiaries has simplified the tax system in Denmark considerably. It reduces the available tax-avoidance (tax-planning) strategies and it avoids the necessity of complex anti-avoidance rules. The Danish government has reformed its tax administration. Moreover, it aims at reducing the administrative burden imposed on businesses considerably. In order to reach this goal, the compliance costs are calculated for different elements of the tax legislation.

The Italian government has taken several measures to simplify their tax system. Until 2003, the Italian personal income tax system provided tax credits that differed according income, the number of family members and types of dependents. The complex system even implied that families were not able to take full advantage of the system. The tax credit scheme was therefore replaced by a simpler tax allowance scheme. Also the reduction in the number of tax brackets (from 5 in 2000 to 4 in 2005) might be considered as a tax simplification measure.

The Slovak Republic has simplified its tax system considerably through its flat tax reform. With the introduction of a single rate on a broad tax base with few tax exemptions and allowances/credits, the Slovak Republic has a rather unique tax system in the OECD area.

Both the abolishment of the Investment Tax Allowance and rationalization of tax incentives and exemptions have contributed to reduced tax complexity. The introduction of the Special Consumption Tax (SCT) making it possible to abolish several other taxes has reduced tax complexity regarding consumption taxes. The VAT is also simplified but it still has three rates (18, 8 and 1 per cent).

Tax revenue trends

In Denmark, the "tax freeze" means that taxes cannot be increased since 2001. It applies to both direct and indirect taxes. This tax freeze is the cornerstone in the Danish strategy to control public spending and is driven by the desire to make fiscal policy sustainable in the long-run. We pointed out that the corporate tax revenue has been increasing over time. On the other hand, tax revenue from indirect taxes has been decreasing over time (due to increased cross-border shopping and decreased tax rates).

Tax revenue has been increasing in Italy until 1997 in order to fulfil the Maastricht Treaty requirements. However, tax revenue has been relatively stable since then.

The fundamental tax reform in the Slovak Republic did not have a strong impact on tax revenues. In fact, total tax revenue as a per cent of GDP decreased from 31.3 per cent in 2003 (before the tax reform) to 30.8 per cent in 2004 (after the tax reform). This result can partly be explained by the fact that the decrease in tax revenues from personal and corporate income taxation has been compensated by an increase in VAT revenue and by the fact that the Slovak Republic continues to levy high social security contributions.

The earlier increase in the tax burden in Turkey (as seen by table 4.1) seems to have stopped and the tax revenue as a per cent of GDP has been stable in recent years. The tax burden is still below the OECD-average. The recent tax base shift from direct to indirect taxation, resulting in half of the tax revenue coming from taxation of goods and services, has probably limited the scope for further increase in revenue from indirect taxes.