TAX POLICY REFORM and FISCAL CONSOLIDATION

Introduction

Few people like to pay tax and even fewer like to see their existing tax burdens rise further. Many governments have thus found that the most propitious time for tax reform is when the state of the public finances allows an overall reduction in taxes or, failing this, a revenue-neutral reform that allows some compensating cuts for politically sensitive groups of taxpayers. At present, many countries are not in such a fortunate position. The need to undertake fiscal consolidation strategies over the medium term leaves little room for manoeuvre to finance any tax reductions. In many cases, countries’ assessment of the appropriate balance between cutting public expenditure and raising taxes means that tax revenues will need to be increased.

In deciding on the scale, speed and means of fiscal consolidation, governments have to strike a balance between different drivers. What, for instance, would be a sustainable and prudent public sector debt ratio? How far are budget deficits likely to be self-correcting with renewed growth of output and incomes? How quickly should discretionary fiscal measures be phased in, given for instance the economic outlook for the domestic and world economies? What should be the balance between tax and spending measures? How far should this balance shift over time, given the desired pace of fiscal consolidation and any differences in the short-run impact on aggregate demand? This brief does not attempt to address these questions. Its focus is rather on what is perhaps the next question in this series: if discretionary tax increases are needed, how should such additional revenues best be raised?

This policy brief, which draws upon the extensive work done by the OECD on tax reforms, considers how countries can best raise taxes in these circumstances. It argues that the aim should be to reduce distortions in current tax regimes and to raise additional revenues from the taxes that do the least damage to prospects for economic growth. This points, in particular, to a rigorous scrutiny of tax expenditures and to scaling them back or abolishing them where the benefits do not justify the costs.

Ensuring that tax reforms are perceived by electorates to be fair is critical. Implementing reforms as part of a package of measures in which some of the additional revenues raised are recycled, for instance, to poorer households can be helpful. It is in any case best to look at the overall distributional impact of reform packages rather than at the impact of individual measures, since fairness is most appropriately assessed in the context of the tax (and benefit) regime as a whole. For instance, by itself, a rise in indirect taxes may tend to be regressive, but it could be part of a wider package of measures that directs better targeted support toward poorer households. Even so, countries may have to weigh the potential trade-offs between the immediate distributional impacts of tax changes and a strengthening of future growth prospects.

Given its focus on tax reform, this policy brief looks not only at what changes might be made to raise additional tax revenues, but also at whether there are broader reform packages involving increases in some taxes, but reductions in others that could improve the overall design of tax regimes and generate a net increase in revenues.  

1. OECD Economic Outlook 87 has more discussion of such questions.

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Overall, tax burdens (i.e., all taxes and compulsory social security contributions paid to all levels of government) vary widely in the OECD area, ranging from a low of 21% of GDP in Mexico to a high of 48% in Denmark in 2008. On average, the overall OECD tax burden was 35% of GDP in 2008 (see Chart 1).

Economic growth (provided, of course, that it is not brought about by expansionary fiscal policy) not only reduces budget deficits (by boosting tax revenues and reducing outlays on unemployment benefits), but also helps to bring debt ratios under control. It is thus particularly desirable in the present economic climate that tax policies should do as little damage as possible to incentives to work, save and invest and to other drivers of output and employment growth. It is similarly desirable that a tax regime generate adequate revenues in the long run.

In addition, the distribution of the tax burden has to be politically and socially acceptable. Ensuring that tax burdens are broadly related to the ability to pay is a major tax policy objective. The tax regime, in conjunction with public expenditure, plays a crucial role in bringing about an acceptable distribution of income.

In considering the distributional effects of taxation, the effective as well as formal incidence of the tax needs to be taken into account. That is to say that the business or individual that is responsible for remitting tax receipts to the authorities may not actually bear the burden of the tax. This is particularly important in respect of taxes on corporate and other capital income. Economic analysis suggests that, especially in a small open economy, the much greater mobility of capital than labour will mean that a significant part of such taxes is in fact borne by labour.
What taxes to raise?

A country’s choice about what taxes to raise, if necessary, as part of a programme of fiscal consolidation naturally depends on the structure of its existing regime; i.e., on such factors as the composition of revenues by type of tax, how tax bases are defined, tax rates, on its economic stature and political preferences, etc. Tax regimes that raise revenues equivalent to some 35% of GDP on average across the OECD inevitably blunt incentives and distort decisions to work, invest and innovate, thereby reducing GDP. Table 1 shows the composition of tax revenues by major tax category and how tax structures have on average changed over the past two decades. While there has been some increase in the importance of the value added tax (VAT), income taxes and social security contributions continue to make up over 60% of the overall tax burden.
Table 1
Tax Structures, 1990-2008
(Percentage share of major tax categories in total tax revenue)

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>2000</th>
<th>2008</th>
</tr>
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<tbody>
<tr>
<td>Personal income tax</td>
<td>30</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>8</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Social security contributions and payroll taxes</td>
<td>23</td>
<td>25</td>
<td>26</td>
</tr>
<tr>
<td>VAT/GST</td>
<td>16</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Other consumption taxes</td>
<td>15</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Recurrent taxes on immovable property</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Other taxes</td>
<td>5</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: OECD Revenue Statistics.

OECD analysis\(^2\) suggests that some taxes are more distortive than others and may also harm economic growth to a greater degree. This is partly a function of the time period considered. Behavioural responses are likely to be greater in the long run than in the short term. Capital, in particular, may be fixed and immobile in the short term but can move to alternative uses given more time. The increased international mobility of capital, the growing importance of cross border services and the growth of multinational enterprises have further increased the extent to which the location of business investment and innovation have become more sensitive to the taxation of corporate and capital income. Moreover, it has become easier to shift the location of taxable profits between different jurisdictions.

This points to the difficulty of raising corporate income tax (CIT) rates to raise revenues, as behavioural responses are likely to reduce the amount of additional receipts and reduce investment. As already noted, the effective incidence of CIT is likely to fall partly on labour. For some countries the question may be whether to continue to follow the downward trend in statutory CIT rates that has taken place across the OECD area over the past two decades. The OECD average fell from around 41% in 1990 to around 28% in 2010, with the United States being the only significant exception to the downward trend.

However, CIT rates that are lower than personal tax rates (including social security contributions) create an incentive for businesses to incorporate to reduce their tax bills. Increased taxation of dividends and capital gains at the personal level could discourage such incorporation, but there is then a risk that large companies will enjoy a more favourable regime than smaller ones; for instance, because they may have greater scope to exploit international tax planning opportunities. And if the effective tax rate from the combined effects of CIT and dividend taxes exceeds the personal tax rates on business income, firms will want to remain unincorporated. This explains why in some countries (e.g., the United States) there has been a rapid growth in unincorporated enterprises.

\(^2\) Tax Policy Reform and Economic Growth, OECD Tax Policy Study, No. 20
Personal and corporate income tax regimes are thus closely interconnected. Personal income tax (PIT) rates will thus affect not only work incentives, but also incentives to set up and develop businesses (as well as the choice of business form). Given that PIT and social security contributions (SSCs) account for about half of tax revenues among OECD countries, raising significant additional revenues without raising these taxes will be challenging.

Most OECD countries have, in fact, reduced their top marginal PIT rates significantly in recent decades, with the average on the OECD area falling by some seven percentage points between 1994 and 2009. Overall tax burdens have also fallen slightly since 2000 (see Table 2). European countries with the highest burdens are doing the most to reduce them.

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Tax burden at average wage (single person without children)</th>
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<tbody>
<tr>
<td></td>
<td>2000</td>
</tr>
<tr>
<td>OECD</td>
<td>37.8</td>
</tr>
<tr>
<td>EU - 19</td>
<td>43.8</td>
</tr>
</tbody>
</table>

Source: OECD Taxing Wages.

Taxes on consumption (such as VAT), especially if they are broad-based, do not distort business decisions about production techniques and are thus likely to be less damaging to growth. While an increase in VAT is likely to raise the price level, with present margins of unused capacity in many countries, this seems unlikely to have a continuing effect on inflation rates. However, higher prices would reduce the real incomes of individuals with fixed incomes and savers whose accumulated savings would now buy a smaller volume of goods and services. In practice, most OECD countries have kept their standard VAT rates constant for long periods of time, and the OECD average has remained at just under 18% for over a decade. More recently, though, this stability disguises the use of VAT reductions by some countries as a counter-cyclical measure in response to the economic crisis and increases in VAT rates by others as revenue-raising measures.

Recurrent taxes on residential property are also likely to have little impact on a country’s attractiveness as a location for business investment and to avoid distortion of investment decisions in a way that risks being detrimental to economic growth. However, if the return on housing is only lightly taxed, such investment may be favoured over business investment.

Tax disincentives and distortions are driven by marginal tax rates. Moreover, the deadweight costs (of lost output and consumption) from taxes rises more than proportionately with the tax rate. Tax regimes with a broad base enable marginal tax rates to be lower and, therefore, should be less distortionary and detrimental to growth. In practice, though, many countries have extensive ‘tax
expenditures’ through which tax reliefs are provided for distributional and other social policy objectives such as encouraging the consumption of merit goods, or supporting activities like charitable giving or pension saving. Tax expenditures may also encourage particular types of investment or support certain industrial sectors.  

In a period of fiscal consolidation where public expenditure programmes are under close scrutiny to identify the scope for savings, it is also important to review tax expenditures with a similar degree of rigour. Some tax expenditures may not be a very cost-effective way of achieving distributional objectives. For instance, reduced rates of VAT for food provide a greater benefit in absolute terms for high income than for low income households. If governments wish to address the regressivity of the VATs, it would be less costly to make transfers directly to low income households. Applying the standard rate of VAT across the board would raise significant additional revenues, only a fraction of which would be needed to compensate low income households.

Tax breaks within the personal and corporate income tax regimes were often originally intended to provide increased incentives to undertake activities that the government judged to be socially desirable. However, such good intentions may often be subverted. Investment plans may be sold to clients on the basis of the tax saving rather than the underlying prospective yield and risk, thus distorting market signals.

Countries should review whether the original reasons for establishing a tax break continue to be valid. For instance, is tax support for the production and/or consumption of fossil fuels that was enacted in the past still justified, given the greater present concern about the effects of climate change? Even if the rationale for government support remains valid, consideration could be given to whether a tax expenditure is the most cost-effective way of achieving these objectives. Such an assessment should take into account not only the estimated revenue cost of the tax expenditure and the expected behavioural costs of scaling it back or removing it, but also the additional costs of resources engaged in tax planning and tax administration.

While tax expenditures have tended to grow on average across the OECD in the past couple of decades, suggesting significant political support for such tax breaks, there have been some exceptions. For instance, some countries have taken advantage of housing booms to scale back or abolish mortgage interest relief. While the current state of the housing market in some countries may make emulation of such cuts untimely, the exceptionally low levels of interest rates will automatically have reduced the advantage from tax relief and may provide an opportunity to reconsider mortgage interest relief.

How can compliance be improved?

While non-compliance with the tax code provides a benefit to the taxpayer concerned (including perhaps a lower marginal tax rate), for the population as a whole, tax rates may have to be higher to make up for revenue shortfalls. Thus, non-compliance is likely to add to tax distortions, as well as to be unfair in that taxpayers with similar incomes pay different amounts of tax.

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3. For further discussion see Choosing a Broad Base – Low Rate Approach to Taxation, OECD Tax Policy Study No. 19.
Developing a tax administration regime that makes it easy for taxpayers to comply and, at the same time, makes extensive use of third party information and tax audits to reduce the risk of under-declaration of income or overstatement of deductions is thus likely to be an important part of a tax policy strategy that seeks to be both fair and growth-oriented. Over time, such a strategy should help secure the tax base, generate sustainable revenues and produce a fairer tax system.

Tax policy can, however, support the tax administration to improve compliance by strengthening the overall coherence of a tax regime. This might involve closer alignment or integration of personal and corporate income tax regimes so that incentives to reduce tax bills by changing business form are reduced. Similarly, taxing different types of income at similar rates where possible (and putting regulatory obstacles in the way where not) could reduce revenue losses from, for instance, ordinary income being converted into capital gains, or, more generally, from exploiting asymmetries in tax rates between different taxpayers, types of income, gains and losses, etc.

The case for using tax policy to help achieve environmental objectives and, in particular, to ensure that social costs and benefits (externalities) are reflected in market prices has a long history. It provides an important part of the rationale for existing environmentally-related taxes. They may be growing in importance, given the twin challenges of fiscal consolidation and achieving the ambitious targets for reductions in emissions of greenhouse gases that countries have announced or are considering. In particular, the magnitude of the climate challenge in relation to current mitigation efforts points to setting much higher “prices” for greenhouse gas emissions to provide incentives not only to economise on energy use but also to innovate to reduce consumption of fossil fuels. Achieving this either through taxes or a cap-and-trade regime could potentially generate significant additional revenues.

Experience suggests, however, that raising net additional receipts from environmental taxes is often more difficult in practice than in theory. There are often pressures to restrict the coverage or to phase in the introduction of taxes or the auctioning of tradable permits, especially where they affect sectors that are exposed to competition from countries that do not have comparable tax or permit regimes. This may not only undermine their environmental efficacy and the amount of revenue raised, but also have unwelcome distributional effects. Polluters are, for instance, often able to pass at least some of the market price of permits on to domestic consumers, thereby allowing recipients of free permits to make windfall profits, as has been seen in the electricity generation sector in Europe. This suggests that significantly increased international co-operation is likely to be needed (e.g., to overcome the perceived needs to exempt certain sectors or issue free permits) in order both to improve the effectiveness of policy and to raise more revenues.

Another potential concern with environmentally-related taxes is that they may be regressive. Low income households may, for instance, spend a higher proportion of their income on domestic fuel and power than high income households. However, as with reduced rates of VAT, the use of low rates of (indirect) tax is not a cost-effective tool for addressing distributional concerns.
It is preferable to ensure that all households face a market price that includes the cost of the externality associated with fossil fuel consumption and provide income transfers directly to poorer households (e.g., through higher income-related benefits). Moreover, where countries are committed to achieving a given reduction in emissions of greenhouse gases, under-pricing such emissions in one area, in principle, implies higher prices and/or tighter regulations elsewhere. This in turn means greater economic distortions, lower output and probably slower growth than would otherwise be achievable.

Thus, while it may not be realistic to expect significant additional receipts from environmentally-related taxes (and/or the auctioning of emissions permits under a cap-and-trade regime for greenhouse gas emissions) as a source of funds to reduce budget deficits over the short to medium term, the scale of the climate challenge raises the possibility of seeking higher taxes (and revenues) in this area. In the slightly longer term, if they are well-designed, auctioned emissions permits and carbon taxes could raise significant additional receipts. It is also worth noting that the prospective need for fiscal consolidation increases the presumption that environmental objectives like reducing greenhouse gas emissions should be addressed through measures that raise revenues rather than tax reliefs and other subsidies (which would increase budget deficits), although a case could be made to use tax incentives to stimulate environmentally-friendly innovation. Where environmental costs are appropriately “priced” through the tax system, this can help reinforce tax reliefs that are intended to address other externalities, such as those associated with R&D, making a potentially powerful combination.1

The extent to which revenues increase automatically with economic activity tends to vary from country to country; but, in most cases, personal income tax regimes generate a certain amount of fiscal drag. That is to say that the amount of income tax receipts rises more than proportionately with income if tax allowances and thresholds are left unchanged. A gradual rise in the overall tax burden can thus be achieved by taking no overt policy steps and may thus be a tempting source of additional revenues in a period of fiscal consolidation. The disadvantage, though, is that some individuals will see a rise in their marginal tax rates and associated work disincentives from being brought into the tax system or by crossing a threshold from a lower to a higher rate of tax. It may also be less attractive for someone on income-related benefits to take a job. While not adjusting tax allowances and thresholds may mean that a relatively small number of people will see a substantial rise in their marginal tax rate, compared with the much larger number of people facing a small rise in their marginal tax rate if rates are raised, the low income workers who could make up a significant part of the former group are often the individuals who are most responsive to work disincentives. The responsiveness of labour supply in different parts of the earnings distribution may vary from country to country, but such behavioural effects (and the associated impact on employment), in principle, ought to inform choices between not raising allowances and thresholds and raising tax rates.

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1. See for example Tax, Innovation and the Environment, OECD, October 2010
Whatever the political attractions of raising taxes by allowing ‘fiscal drag’ to raise tax revenues, the scale of the challenge of restoring sound public finances in many countries is likely to require discretionary tax increases. Using this challenge as an opportunity for tax reform will not be easy. Successful tax reform involves weighing different tax policy objectives and setting a clear direction for change. The rationale and evidence base for the chosen reform strategy has to be communicated effectively to interest groups and influential commentators, as well as to the electorate more generally. Enacting tax reforms may be difficult unless reforms are seen to be both necessary and fair. This is likely to apply as much to environmentally-related taxation (e.g., to reduce emissions of greenhouse gases) as other taxes, especially as they may imply significant changes to existing lifestyles.

Conclusions

This policy brief has reviewed a range of ways of raising additional revenues and altering the tax structure. While there may be a role for allowing fiscal drag to raise revenues and for strengthening compliance efforts, in many countries discretionary tax policy measures are likely to be needed. The policy brief has argued that the focus should be on raising revenues in the least distortionary and most growth-oriented way. It recommends that countries consider raising additional revenues through broad-based taxes on consumption and recurrent taxes on residential property and better tax compliance. Countries may also consider taking this opportunity to scale back or abolish distortionary tax expenditures as part of a reform package that, where necessary, includes tax and benefit changes targeted to help low income households to ensure that the package is seen as not only essential but also fair. In the longer term countries could also consider raising revenues from taxes or emissions-trading programs related to greenhouse gas emissions.

5. Further discussion of these issues is contained in the two OECD Tax Policy Studies referred to in footnotes 2 and 3.
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