Responding to the global financial and economic crisis: the tax dimension

2nd Meeting of the
SEE Working Group on Tax Policy Analysis
16-19 June 2009, Dubrovnik

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Broad tax policy considerations in relation to the crisis

I. Tax policies as possible exacerbating factors to the crisis, and potential need for reform.

II. Policy environment / context:

- Fiscal projections and policy interactions.
- Political economy considerations.

III. Tax policy and tax administration options to:

- Stimulate current demand,
- Support economic growth and fiscal balance.

Focus of presentation

1. Main contributing factors behind crisis.
2. Tax policies as exacerbating factors.
3. Tax policy environment.
4. OECD *Tax and Economic Growth* project.
5. Desired characteristics of SR tax stimulus.
6. Potential tax channels to stimulate SR demand.

Principal focus of presentation

7. Implementing pro-growth, sustainable tax policy.

   - Core features of pro-growth, sustainable tax policy.
   - Reliance on / modifications to main taxes.
   - Limiting cross-border tax arbitrage.
   - Review of tax expenditures.
   - Encouraging tax compliance.
   - Tax transprency and exchange of information.

1. Main contributing factors behind the crisis

Main contributing factors – non-tax

- Main contributing factors behind the crisis:
  - Increasing use of debt by businesses and households.
  - Bank assets concentrated in residential mortgages.
  - Incentives for investment in high-risk assets.
  - Lack of transparency (derivatives market).
  - Inadequate regulation.
  - Inadequate governance.
- Tax not a root cause of the crisis, but may have exacerbated the influence of a number of factors.

2. Tax policies as exacerbating factors

2. Tax-based exacerbating factors – Favourable tax treatment of debt

- Tax arbitrage linked to tax treatment of debt.
- Tax bias to household debt (housing).
  - Deduction for mortgage interest expense; exemption for rental income on owner-occupied housing.
- Tax bias to corporate debt finance.
  - Deduction for interest expense (not equity).
  - Lack of ‘matching’ of interest expense and taxable income:
    - Exemption/deferral of tax on foreign profits.
    - Conversion of interest income into tax-exempt profit.
      – Tax haven affiliates (conduits), lack of transparency
      – Hybrid instruments.

Tax-based exacerbating factors – Favourable tax treatment of capital gains

- Tax bias encouraging growth of bank profits (over asset protection / management):
  - Favourable capital gains tax treatment of stock options, corporate tax deduction on exercise of stock options.
- Tax bias encouraging investment by equity funds in capital-gains producing assets (relatively high risk);
  - Capital gains tax treatment of carried interest of private equity/hedge fund managers.

3. Tax policy environment

Tax policy environment
– Broad demands on policy makers

- 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.
    - Equitable distribution of tax burden, protection of low-income families from severe hardship.

Tax policy environment
– Mix of fiscal instruments may be desirable

- Stimulus by tax & public expenditures may be desirable:
  - Public expenditures may boost demand immediately; effects of tax cuts realized with lag, depending on type.
  - Uncertainty over timing and strength of PIT cuts:
    - Only some fraction of relief will increase consumption; some fraction will result in increased net savings;
  - Uncertainty over timing and strength of CIT cuts:
    - Only some fraction of relief will increase investment; some fraction will give windfall gains to shareholders, only some fraction of which will be invested in capital.

Tax policy environment – Accounting for government inter-actions

- Need to co-ordinate central government reforms (tax, expenditure) alongside reforms at sub-central level:
  - Assess need to adjust fiscal equalization scheme.
- Consider how 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.

Tax policy environment
– Potential scope for fundamental tax reform

- Consider if exceptional economic conditions provide opportunity for fundamental tax reform - example:
  - Replacement of a CIT with a corporate cash-flow tax.
  - Introduction of an ACE (allowance for corporate equity) system, as in Belgium.
  - Restrictions on debt finance:
    - Overall (e.g. based on % profit).
    - Targeted (e.g. interest allocation rules)
      - Possibly part of broader tax reform that tightens system of taxing income on foreign direct investment.

Tax policy environment
– Need for fiscal plan that restores confidence

- Desirable to formulate multi-year fiscal plan that is transparent, flexible and credible.
  - For optimal execution of strategy.
  - For restoring consumer and business confidence, to increase likelihood of intended outcomes (e.g. increased demand accompanying tax relief).
- Possible reliance on temporary, renewable tax cuts:
  - Use of sunset clauses to enable policy reversal, or continuation, depending on policy assessment.

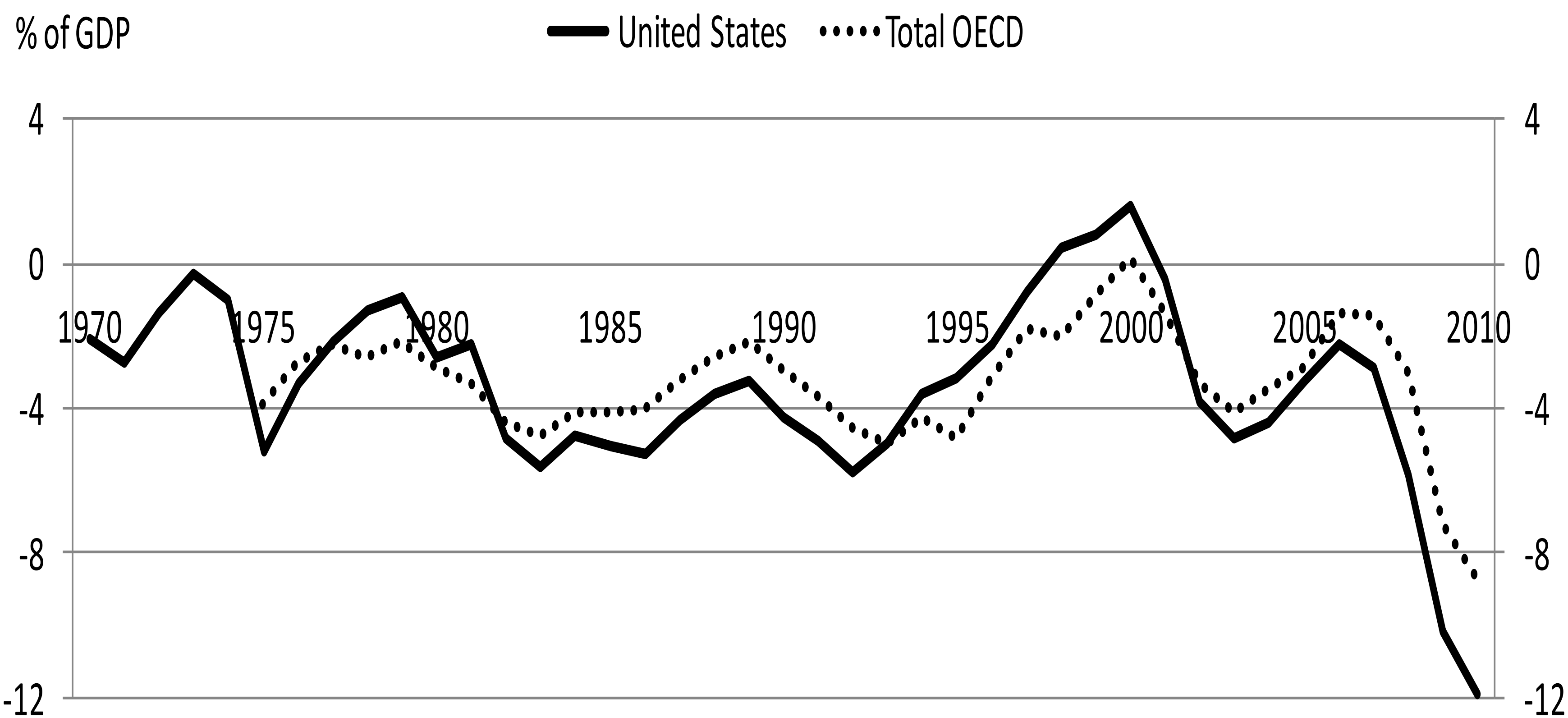
Tax policy environment – Complex forecasting environment

- 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.

Tax policy environment – Fiscal deficit implications of the crisis

- Large current fiscal deficits resulting from the crisis:
  - Automatic stabilizers
  - Discretionary measures
  - Reduced taxpayer compliance.
- Key driver of future tax policy: need to reduce deficits through public expenditure cuts and tax increases (automatic stabilizers will not be enough).
- Challenge to find pro-growth, sustainable tax regime (↑GDP growth rate, maintain/increase (tax/GDP)).
- Need for review of tax mix, domestic and international tax policies, tax expenditures.

Net lending of general government



4. OECD report on *Taxation and Economic Growth* (CTPA, ECO)

OECD *Tax and Economic Growth* – main findings of project

- Recent report by OECD (CTPA, ECO) examining effects of tax on economic growth.
- Econometric study (economy, industry, 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 LR economic growth:
  - Corporate taxes
  - Personal income taxes and social security contributions
  - Consumption taxes
  - Recurrent taxes on immovable property

5. Desired characteristics of short-run stimulus tax measures

SR tax stimulus - desired characteristics

- Efficient in stimulating demand:
  - Reaches primarily taxpayers most likely to increase demand.
  - Increases primarily demand for domestic goods (no explicit targeting).
  - Avoids leakages ('windfall gains'), avoids creation or widening of tax arbitrage (tax planning) opportunities.
- Benefits primarily low-income households hard hit by recession.
- Can be quickly implemented, minimal tax administration/compliance cost.
- Consistent with long-run pro-growth sustainable tax policy:
  - Encourages investment and labour utilisation.
  - Encourages growth in total factor productivity (innovation, training).
  - Raises tax revenue (or does not significantly worsen public debt/GDP).

6. Potential tax channels to stimulate short-run demand

Potential tax channels to stimulate current consumption demand

- Reduce tax on current consumption *(revenue losing)*:
  - Reduce VAT rate (distribution and efficiency concerns).
  - Narrow VAT base (efficiency concerns).
  - Reduce specific excise tax rates (efficiency concerns).
- Increase tax on future consumption *(revenue raising)*:
  - Announce future increase in VAT rate (or introduction of VAT).
  - Announce future increase in specific excise taxes.
- Increase effective tax rate on current savings *(revenue raising)*:
  - Increase general tax rate on investment income (interest, dividends, gains).
  - Increase targeted tax rate on return on specific assets (e.g. rental income).
  - Temporarily reduce deduction for registered retirement savings.

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Potential tax channels to stimulate current consumption demand

- Reduce tax on wage income:
  - Reduce SSC^{er} on low-income households (increase labour demand).
  - Reduce PIT/SSC^{ee} on low-income households (increase labour supply).
- Streamlined processing of tax refunds:
  - Payment of non-wastable (refundable) tax credits.
  - Payment of VAT input tax credits (self-employed).
  - Post-refund audit for lower-risk claims.
- Delayed payment of tax liabilities:
  - Delay monthly payments of PIT on wage income
  - Delay monthly payments of SSC^{ee}/SSC^{er} on wage income.
  - Delay monthly payments of PIT/SSC^{se} on self-employed income.

Potential tax channels to stimulate current investment demand

- Reduce effective tax rate on current investment *(revenue losing):*
  - Current or phased-in reduction in CIT rate (permanent).
  - Accelerate tax depreciation rates (permanent).
  - Increase investment tax credit rates (permanent/temporary).
  - Reduce/eliminate capital taxes, sales taxes on investment.
- Increase effective tax rate on future investment *(revenue raising):*
  - Announce future lowering of depreciation allowances (for new investment).
  - Announce future reduction in general/targeted investment tax credit rate.
- Increase effective tax rate on foreign investment *(revenue raising):*
  - Restrict deductions for interest and other overhead expenses incurred to undertake FDI (until foreign earnings are repatriated).
  - Limit tax deferral/exemption to active business income.

7. Implementing pro-growth, sustainable tax policy

Steps in implementing pro-growth, sustainable tax policy

- Identify core features of pro-growth, sustainable tax system.
- Consider possible adjustments to tax mix, tax design.
- Identify scope for further revenue and efficiency gains:
  - Consider changes to limit cross-border tax arbitrage, as part of reforms to avoid future crisis.
  - Review system of tax expenditures.
  - Encourage tax compliance.
  - Tax transparency and exchange of information.

Core features of pro-growth, sustainable tax policy

- Core features of pro-growth, sustainable tax policy:
  - Not impeding to sources of economic growth:
    - Increased domestic investment (plant, M&E)
    - Increased labour utilisation (participation, work effort)
    - Increased total factor productivity (technology upgrading through R&D/acquisition; skills upgrading).
  - Generates tax revenues to meet fiscal balance targets
    - Support desired public expenditure.
  - Equitable/balanced distribution of the tax burden
    - Political (public) support.

Reliance on and potential reforms to Property and Consumption taxes

- *Tax and Economic Growth* report - taxes on immovable property and consumption are least impeding to growth – favourable to growth and revenue increasing.
- Tax on immovable property.
  - Pro-growth, ownership relatively insensitive to tax rate.
  - Regressive (possible to address through PIT).
  - Requires accurate valuations.
- Tax on domestic consumption (VAT, excises).
  - Pro-growth, consumption of necessities (VAT), alcohol and tobacco (excises) relatively insensitive to tax rates.
  - Regressive (possible to address through PIT).

Reliance on and potential reforms to PIT and SSC on high-skilled labour income

- PIT/SSC on high-skilled labour income.
  - Highly progressive rates discouraging to employment location, work effort, entrepreneurship, skills upgrading.
  - Address by lowering progressivity of PIT (e.g. ↓ top PIT rate).
  - Address through upper threshold for wage/business income subject to SSC^{ee}/SSC^{er}/SSC^{se}, possibly strengthen actuarial link between SSC and benefits.
- Policy adjustments noted to lessen negative impact on growth are <u>favourable to growth</u> but <u>revenue reducing</u>.

Reliance on and potential reforms to PIT and SSC on low-skilled labour income

- PIT/SSC on low-skilled labour income.
  - High SSC rates, high first-tier PIT rate, low basic allowance, discouraging to labour market participation (interaction with benefit program).
  - Address by increasing basic allowance, lowering first-tier PIT rate, increasing first-tier threshold, increasing lower threshold for wage/business income subject to $SSC^{ee}/SSC^{er}/SSC^{se}$, possibly strengthen actuarial link between SSC and benefits.
  - Address possibly through earned (in-work) income tax credits.
- Policy adjustments to lessen negative impact on growth are <u>favourable to growth</u> but <u>revenue reducing</u>.

Reliance on and potential reforms to CIT on corporate profits

- CIT on profits derived from domestic tangible capital.
  - Impeding to growth (capital mobility), in general.
  - But sensitivity of domestic investment to CIT rate depends on:
    - Market size/other factors (can tax location dependent profit).
    - Type of business activity (agriculture, manufacturing, trade, non-financial services, financial services).
    - CIT rate on profit on FDI (substitute for domestic investment).
  - Address by reducing effective tax rate on domestic investment (favourable to growth but revenue reducing).
  - Address by increasing effective tax rate on FDI
    - Restrict interest deductions on FDI (revenue increasing).
    - Limit tax deferral/exemption (revenue increasing).

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Limiting cross-border tax arbitrage

- Some degree of tax arbitrage and tax planning inevitable where countries apply different tax rates – but tax relief on cross-border investment extends well beyond:
  - Use of hybrid entities (regarded as branch by tax authorities in one country, subsidiary to another)
  - Use of hybrid securities (bond to one country, equity share to another).
  - Lack of matching principle (deduction of interest on funds financing FDI generating little/no home country tax – a tax subsidy for FDI).
- Potential revenue gains, efficiency gains, improved fairness, SME competitiveness, from limiting degrees of freedom for tax arbitrage and tax planning.
- Ability to tax location-dependent profits of MNEs.

Review of tax expenditures

- Large fiscal deficits call for line-by-line review of public expenditures, including tax expenditures.
- Assessment of desired level of tax expenditures should factor in costs and benefits.
- Example: tax relief targeted at R&D expenditures should be assessed alongside measurement of effective tax rate on returns on R&D.
- Other examples:
  - Tax-preferred savings accounts, pension savings
  - Energy-savings incentives.

Encouraging tax compliance

- Fiscal situation calls for review of factors influencing tax compliance, possible adjustments.
- Reassess high-risk compliance groups, adjust audit and enforcement strategies accordingly:
  - Assess taxpayers most affected by the crisis.
  - Assess taxpayers made better off / worse off (in absolute and relative terms) from SR tax stimulus and structural measures.
- Encourage tax compliance through communications strategy (explaining taxpayer obligations, main tax changes, rationale).

Tax transparency and exchange of information

- Tax havens and the shadow banking system may have accentuated the crisis.
- G20 agreed action against non-cooperative jurisdictions, including tax havens.
- OECD published list of countries assessed by Global Forum against international standard for exchange of tax information.
- All 84 countries surveyed by the Global Forum have not endorsed the standard.

Thank you.