COMMENTS ON SESSION IV: TAX REFORMS

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As the last discussant of this workshop, let me on behalf of all participants thank our hosts for the excellent organisation of this event and for the lavish supply of food – both for the stomach and for thought. The variety of insights presented and the breadth of items discussed have provided an intellectually enriching atmosphere for all of us. Thus, many thanks to the Banca d'Italia for hosting this meeting.

For two and a half days we have been discussing a very old topic: taxes have, after all, been around virtually as long as organised governments have been in place. Even in the Bible it says that the tithe (one tenth) of the crops be set aside and that the tithe be used for purposes of redistribution and to support the priesthood. However, it is not clear what the enforcement mechanism was, and the extent of tax evasion was not an issue in the Bible, either.

We have been talking about a policy area that is concerned with the design of tax systems which are capable of financing the necessary/preferred level of public spending in the most efficient and equitable way.

Being the final discussant, I would like to recall briefly what we have heard in this forum and then share my impressions with a view to wrapping up the discussions that have evolved over the past few days. In other words, the purpose of my contribution is to round off this workshop with some concluding comments.

1. A retrospective glance – what were the debates about?

The first three sessions focused on the challenges advanced economies typically face. Challenges related, above all, to efficiency and growth considerations, but also challenges regarding equity aspects of tax systems, as discussed, in particular, in the first session. The taxation of production factors, such as labour taxation and its potential effects on labour supply and labour demand, and capital taxation and its potential effects on investment and saving decisions were at the centre stage; at the sidelines, distributional aspects of indirect and direct taxation were touched upon.

Another session focussed on the macro impact of taxation – taxation and its relevance for stabilising the economy or for dampening the deviations of economic activity from its trend path. Given the long and uncertain lags with which discretionary policy measures – especially specific tax measures – work, and given problems of irreversibility, there is a wide consensus that fiscal stabilisation should

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be primarily carried out via automatic stabilisers. However, efficiency-enhancing income tax reforms might affect the effectiveness of automatic stabilisers.

Current tax debates, be it in Germany or in Austria, centre on the question whether tax reforms designed to increase the disposable income of households are indeed capable of stimulating the economy – amid growing uncertainty about the long-run sustainability of public finances, notably doubts about the fiscal sustainability of public pay-as-you-go pension systems. There is no consensus among economists and policy-makers about this issue.

The third session dealt with taxation issues in open and integrating economies and reminded us that in designing tax reforms it has to be taken into account that (intended or unintended) spillover effects tend to be important, and that tax policy can be used as a substitute for the classical beggar-thy-neighbour policies. This session revolved around the analysis of tax competition issues and the issue in how far such harmonisation is indeed necessary. In particular in the field of capital taxation, competitive aspects are increasingly coming to the fore. Concerns about the effects of high tax levels and high tax rates on competitiveness are the driving forces behind corporate tax reform proposals.

In an open economy, the problem of levying taxes on a mobile tax base in general hinges on the possibility of an induced tax base flight (positive externality to other countries) or a tax induced tax base import (negative externality to other countries). The latter implies the strategic use of tax policy measures designed to attract tax bases, such as financial capital, by offering foreign investors favourable tax treatment of capital income. As a case in point, the "necessity" of cutting corporate income taxes to retain Austria's attractiveness as a business location is being discussed as our neighbours towards the east (Hungary, Slovakia) announced their decision to reduce their corporate income tax rates significantly. However, the empirical findings about tax-induced location decision of FDI are rather mixed.

The ongoing integration process has an impact not only in terms of creating scope for proactive measures in global location competition. This process evidently restricts the room for tax increases on mobile tax bases.

1. Tax reform challenges in advanced economies

In the final session, Gabriella Briotti tried to find out – based on different tax indicators – whether the tax reforms undertaken in recent decades, notably in the field of corporate taxation, were mainly driven by tax competition reasons. The last decades saw major reforms in the area of income taxation, especially capital taxation, *i.e.* corporate and capital income taxation. Even though not mentioned explicitly, most of the reforms were driven by the intention to reduce non-neutralities *vis-à-vis* saving, investment and financing decisions, as well as to enhance growth by cutting marginal tax rates, flattening the rate structures, broadening the tax bases (by eliminating tax exemptions, special regimes, tax deductions and tax allowances) and by integrating or aligning different tax rate

structures to avoid arbitrage opportunities. Base broadening alongside tax rate cuts explains why the average effective tax rate was growing over the last decade of the 20th century.

Undoubtedly, globalisation and the free movement of production factors had an impact on tax reforms, as they tended to lower top marginal rates in particular on the more mobile tax bases (and hence, on those bases with more elastic responses to taxation) and to raise them on less mobile tax bases. In this sense, the reforms corresponded to a standard principle for the design of tax systems – that tax distortions are minimised if the burden is focussed on tax bases that respond relatively weakly to taxation. At the same time, though, these shifts in the tax mix gives rise to fairly serious concerns for distribution and tax equity.

However, Gabriella Briotti concluded that, based on the information examined in her paper, no strong conclusion can be drawn regarding countries' practise in the area of tax competition, although corporate tax rates, statutory and effective, have converged over the last decade, particularly in the euro area. What can be said is that statutory rates have fallen dramatically and that they continue to fall, but that depreciation allowances (which pay only when tax rates are high) have become less generous. However, there has not been an obvious decreasing trend in corporate tax revenues. What comes immediately to my mind is that the reduction in statutory rates may indeed have been a measure of governments to combat income shifting strategies, *i.e.* tax planning activities of trans- or multinational companies.

If I discussed current taxation options from the Austrian point of view, I would put the finger on problem areas quite similar to the ones of other European countries:

- the high tax burden (including social contribution) on labour,
- the negative effect on labour demand and for low skilled labour in particular, but also on labour supply;
- the implications of high marginal income tax rates on human capital accumulation,
- the relationship between tax planning efforts and tax avoidance activities of highly skilled people with high marginal tax rates,
- the danger of revenue losses with respect to mobile tax bases, such as capital, and, finally,
- the attempt to reinforce the internalisation of negative externalities through environmental taxes.

In my opinion, future tax reform debates in Europe are likely to revolve around the following issues, most of which were touched upon in the three sessions:

- the reduction of the tax burden and the restructuring of the tax systems with a view to increasing employment and enhance the long-term growth potential,

- the international coordination and/or harmonisation of tax policies with a view to reducing tax-induced allocation distortions and to prevent competitive tax cuts of mobile bases,
- the timing of tax reforms and their role in stabilisation in general, against the background of the European fiscal rules in particular,
- the intra- and intergenerational tax equity – shifting the burden from wage taxes to consumption and property taxes, in consideration of societies characterized by an increasingly ageing population;
- fostering environmental objectives via taxation.

2. Tax reforms and tax policy challenges in transition countries and Latin America

The last session was devoted to tax policy issues and problems in reforming tax structures of a set of extremely heterogenous countries. While Gabriella Briotti discussed the problems that advanced European countries typically face, Ivan Matalík analysed tax policy problems from the perspective of a more advanced acceding country that will join the EU soon, namely the Czech Republic. The paper by Luca Barbone and Luís-Alvaro Sánchez about the political economy of taxation policy in CIS countries highlighted in particular the problems of weak institutions or the lack of proper functioning institutions, rules and so on. Finally, our attention was turned to Latin America peculiarities.

These last papers of the final session gave a broad overview of problems often neglected in discussions about taxation issues, since we tend to start under the assumption of functioning market economies with more or less functioning democratic rules, as is the case in advanced OECD countries. The necessary and sufficient conditions, or rather “pre-conditions” for the working of a modern tax system are usually assumed as given. What becomes obvious immediately is that CIS countries as well as Latin American countries suffer from problems related to the so-called governance structure: the challenge they face is the need to introduce or implement appropriate institutional structures, to institutionalise functioning tax administrations,[1] to reduce the influence of specific interest groups, to reduce corruption, to build up functioning or efficient budgeting processes and so on.

In other words, from the point of view of both transition and Latin American countries, providing and securing these pre-conditions is what counts in the first place. What good does it do to take over and install modern Western-type tax systems if the underlying political culture, the institutional framework and widespread popular support and understanding are missing and if the effective tax systems are distorted by the arbitrariness of policy-makers or those who have economic power? With respect to these countries, questions about the proper

[1] Otherwise, “tax administration in fact becomes tax policy” (Bird *et al*., 1992, quoted in Shome, 1999).

framework conditions for efficient tax systems are relevant, whereby "proper" relates to a governance structure able to achieve stable and sufficient revenues, raised with some degree of fairness and at minimal efficiency costs.

In all the countries considered, a tax system should of course raise enough revenue to finance essential expenditure without recourse to excessive public sector borrowing. However, in CIS countries – but also in most of Latin American countries – the establishment of effective, efficient and equitable tax systems is clearly also challenged by characteristics other than insufficient/inappropriate governance, such as the scarcity and the poor quality of basic data (Tanzi *et al.*, 2000) and the structure of the economies itself: large informal sector activities and occupations, agriculture accounting for a large share of the total output and employment, many small establishments, a small share of consumer spending made in large, modern establishments etc.: all that *per se* reduces the possibility of relying on certain modern taxes such as personal income taxes and maybe even the possibility of achieving high tax levels.

Another, and very well known, problem is the uneven income distribution (not to speak of the distribution of wealth). In order to generate higher income tax revenues, the top deciles of the income distribution would perhaps have to be taxed significantly more, proportionally to the low deciles. As long as the economic and the political power is concentrated in the top deciles, richer and wealthier taxpayers are able to prevent tax reforms with a strong re-distributional intention that would affect them negatively. This at least can be seen as one explanation why personal income taxes and property taxes have been very little exploited;[2] in general, total taxes on incomes generate less than 5 per cent of GDP and much less than that in some countries. In a few countries, such as Mexico, property taxes have remained negligible in terms of GDP.

Of utmost importance for all the discussed countries is the need to effectively tackle tax avoidance and tax evasion. This has become a problem in advanced countries, too, reinforced by the free movement of production factors – but it is much more dangerous in developing countries and emerging markets, since they already suffer from a high informal sector and therefore from small tax bases. The result may be a vicious circle – small tax bases and high tax rates may be accompanied by a growing informal sector, followed by a further reduction of the tax bases, as mentioned by Ivan Matalík for the Czech Republic. These problems are fuelled by complex income tax provisions with a web of exceptions (numerous tax allowances, exemptions and deductions, tax holidays) and multiple rate systems in the area of indirect taxation as administrative difficulties grow exponentially with the increase in the number of rates.

Moreover, some Latin American countries are heavily dependent on raw materials – such as oil, copper and gold – for their revenues, revenues that are

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[2] As Bird (1992, quoted in Mahon, 1997) stated for Latin American countries, "major explicit tax changes are almost invariably political dynamite."

volatile, as they depend on the development of world market prices for these goods. Given these peculiarities, it seems extremely challenging to generate adequate and, above all, stable tax revenues.

However, raising stable and sufficient revenues in an efficient way so as to achieve more sound fiscal policies is of particular importance exactly for those countries, as they do not generate the appropriate private savings for the investments needed. Hence, they have to rely on external finance. As long as they do not manage to have stable fiscal policies, there is the danger that savings will be diverted from badly needed private sector investments, thus increasing the risk of a financial crisis. What we see in Latin American countries is that, during the good times, these countries have easy access to external financing. During the bad times, however, access to international markets becomes harder and more expensive, forcing these countries to adjust their fiscal accounts (*i.e.* cut their expenditures). Worse, inadequate fiscal policies may be penalised by the flight of capital – a disciplinary measure of international financial markets. Latin American countries have tended to cut capital spending in the wake of such crises, which – in part – contributed to the reduction of the rate of medium term growth prospects for the upcoming decades (Tanzi, 2000).

In last year's Perugia workshop, we talked about the implications that fiscal policy may have for long-term growth. It was mentioned that one of the clearest and most direct conceptual links between fiscal policy and growth is associated with tax policy. However, with respect to growth considerations, not only the financing but also the spending side is important. Even though empirical studies provided some evidence that in Europe any reduction of distortionary taxation could boost long-run growth, at least in the case of Latin American countries it is reasonable to assume that the opposite is true. As mentioned by Mateos-Hanel for the Mexican case, there are *imperative* future expenditures for their development which have to be financed by an increase in taxation.

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