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POLICY BRIEF

Tax Policy in the 21st Century: New Concepts for Old Problems

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Highlights

Over the last three decades the environment in which tax systems operate changed dramatically. The globalisation and digitalisation of the economy has substantially increased the geographic mobility of the tax base and Multinational Enterprises (MNEs) play an increasingly important role in international trade.

In responding to these pressures governments have pursued profound reforms of their tax systems. Structural reforms have been implemented in almost all of the OECD and most of the BRIICS countries (Brazil, Russian Federation, India, Indonesia, China and South Africa). These reforms have reduced rates, broadened the base and increased reliance on consumption taxes. Tax administrations have reacted to potential base erosion and profit shifting by reinforcing their access to information, strengthening their anti-abuse provisions and moving from cooperation to coordination.

In addition to a changed environment, the actors in the tax debate have changed. The aftermath of the global financial crisis and a rising awareness of steadily growing wealth and income inequality has increased the public awareness of the social consequences of tax design. A perception of justice is fundamental for social cohesion which in turn

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enables structural reforms to be carried out. These concerns for equal opportunity and fairness will take the centre stage in global tax policy, alongside the objectives of efficiency, to put the economic recovery on a sustainable growth path.

The fundamental goal of national governments is to advance their own national interests and the global financial crisis has reinforced this. Tax competition, like any other form of competition, can be conducive to growth by incentivising the establishment of efficient tax systems. However, to achieve the full benefits of tax competition, the international community needs to agree on certain "rules of the game". Aggressive tax planning by MNEs and aggressive tax competition by jurisdictions has to be addressed if a "race to the bottom" is to be prevented, where zero taxation of corporations depicts the lower bound. In open economies, considerations on how tax policy can stimulate national growth and prosperity cannot be viewed in isolation from the impact on other countries.

Introduction

Tax Policy issues have moved up the global political agenda. Governments and citizens are increasingly concerned that Multinational Enterprises (MNEs) and High Net Worth Individuals are not paying their fair share of taxes. MNEs are increasingly concerned that the OECD projects on Base Erosion and Profit Shifting will result in new tax barriers being erected to cross border trade. At the same time many governments around the world are looking for higher tax revenues as part of their efforts to reduce budget deficits, but to do this in ways which reduce the complexity of tax systems and reduce the growing inequalities in income and wealth. The international tax community is facing the challenge of how to adapt tax systems which were developed in a "bricks and mortar" economy, where there were significant barriers to international trade, to a truly global economy where individuals and companies can use modern communication technologies to exploit the new opportunities opened up in this borderless world and where the wealth of companies lie very much in what they know rather than in the physical products they produce.

This is the context in which the Global Governance Programme of the European University Institute and the Institute for Austrian and International Tax Law, WU (Vienna University of Economics and Business) created a joint project on taxation and governance. As part of this project a High-Level Policy Seminar was organised in Florence on 11 July 2013. The seminar, which was held under the Chatham House rule, brought together politicians, senior officials, business representatives and academics to discuss "Tax Policy in 21st Century: New Concepts for Old Problems".

Background

Up to the 1970s, tax policy was largely viewed as an instrument to achieve broader policy goals, above all, redistribution of income. Top marginal personal income tax (PIT) rates in excess of 65% were the rule; top statutory corporate income tax (CIT) rates rarely fell below 45% and tax codes, having multiple schedules, multiple rates and multiple exemptions, tended towards complexity.

A rethinking of global tax policy was initiated by the perception that over-complex tax codes and regimes distort economic incentives of private actors, are difficult to administer and provide wide opportunities for avoidance and evasion. Accordingly, countries responded by broadening the tax bases and lowering tax rates, both to enhance the efficiency of their tax regime and to adjust to the increasing mobility of capital. By 2012, the OECD average top marginal PIT rate was 42.5% and corporations faced an average CIT rate of 25.5%. Revenue losses associated with the fall in PIT rates were tempered to some degree by the introduction or increase in social security contributions.

The on-going global financial crisis stresses the need for structural reforms and for policy makers to look at links between tax, growth and equity. A recent OECD study[2] suggests that many countries will face a long period of adjustment to absorb the aftermath of the crisis, in particular, high unemployment, excess capacity and large fiscal imbalances. While income from work and capital fell considerably since 2007 for almost all OECD countries, the burden of the crisis was not evenly shared. Income inequality surged since the onset of the crisis.[3] Tax

2. OECD (2012): Looking to 2060: Long-Term Global Growth Prospects, http://www.oecd.org/eco/outlook/lookingto2060.htm
3. OECD (2011): Divided We Stand: Why Inequality Keeps Rising, http://www.oecd.org/els/soc/dividedwestandwhyinequalitykeepsrising.htm

policy, in conjunction with other instruments, must be implemented in a systemic approach to address these issues.

Fiscal devaluation, that is, shifting taxation from social security contributions to consumption taxes in a revenue-neutral way, has been considered one possible instrument to boost competitiveness. By lowering unit labour costs and changing the relative price of imports - since VAT bears on domestic consumption - the idea is to foster exports and thus to improve the trade balance. As part of a broader package of reforms involving labour, product and financial markets, a shift towards consumption taxes might be helpful to enhance the flexibility of prices and wages. However, empirical estimates suggest that permanent effects of fiscal devaluation alone will be small.[4] And, importantly, the redistributive consequences may not be feasible politically nor desirable economically, particularly in times of crisis and increasing inequality.

Key Issues

What Constitutes a Competitive Tax Environment?

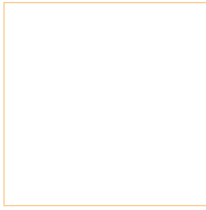
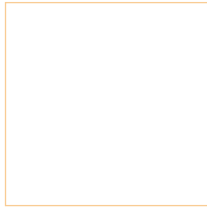
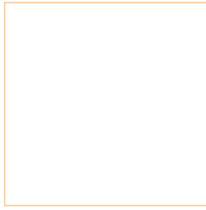
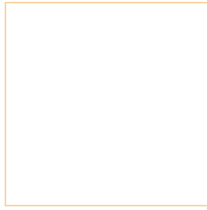
Countries are increasingly competing as a location for foreign direct investment (FDI), to attract skilled labour, jobs, R&D, or simply the tax base. As a result, corporate income tax rates have been driven down, tax incentives are used heavily in spite of their disputed effectiveness, and countries are reconsidering how to tax income earned offshore. Aggressive tax competition over an increasingly mobile tax base can be harmful to growth, equity, and prosperity.

However, as any other form of competition, tax competition does have positive effects. It may incentivise the establishment of an environment that provides clarity, certainty and predictability to firms. A competitive environment in turn induces an increase in productivity which translates into growth. But to get the full benefits of tax competition, the international community needs to coordinate and to commit to certain "rules of the game", just as it does in the case of free trade.

Clearly, the corporate income tax is just one of many taxes which influence competitiveness and investment decision. This is particularly important in the area of research and development where countries are designing special targeted low tax regimes to attract these activities (e.g. I P Boxes). This potentially new form of harmful tax competition needs to be addressed. Business location decisions are also influenced by the way in which a tax system is administered. The relationship between taxpayers, their advisors, and revenue authorities needs to be characterised by mutual understanding that is based on commercial awareness, impartiality, proportionality, openness, and responsiveness, in order to encourage voluntary compliance and an efficient collection of revenues. An internationally accepted set of rules must be agreed on what is fair and unfair in terms of administrative competition.

Raising tax revenues in a way that is broadly accepted as fair enhances the perception that individuals, firms, and governments interact in a sound and equitable legal and administrative framework. Such an environment is more likely to achieve high levels of voluntary compliance. Clear rules, consistent implementation of tax law and elimination of corruption make the tax regime predictable and thus reduce the extent to which investment might be discouraged. Tax policymaking that is evidence-based and transparent, including the publication of forgone revenue and periodic reviews of cost-effectiveness,

4. IMF Working Paper (2012), Ruud de Mooij and Michael Keen Fiscal Devaluation and Fiscal Consolidation: The VAT in Troubled Times, http://www.imf.org/external/pubs/ft/wp/2012/wp1285.pdf

encourages a broader public debate and thus broader acceptance.

Protecting the Tax Base in a Borderless World

The globalisation and digitalisation of the economy has increased the mobility of capital and facilitated ways to engage in aggressive tax planning for MNEs. Using intra-group transaction, the financial structure of the group, or the location of intangible assets, MNEs can minimise their tax obligations by shifting profits from high to low tax jurisdictions. Importantly, the increasing role of knowledge-based assets and global value chains change the way the production process is structured. This complicates the question of where production value is added and taxation of MNEs, which, in turn, increasingly requires international cooperation.

Countries have responded to these challenges by lowering CIT rates and by reconsidering how they should tax income and profits earned offshore. However, governments need to take a systemic view of the tax regime and, in particular, how they want to tax capital income. Forgone revenues have to be made up through higher taxes on the rest of the economy and a tax regime‘s competitiveness, as discussed above, is not determined by tax rates on a corporation‘s income alone. Moreover, corporate income taxes potentially fulfil a number of valuable functions such as taxing profits on an accrual basis, so that corporations cannot be used as a tax shelter, redistributing income and conveying the perception of fairness.

Above all, unilateral actions to address base erosion, profit shifting and the general competitiveness of a tax regime are of limited efficacy. Not only may such an approach impose the risk of double, and possibly multiple, taxation of cross-border investment and thereby dampen growth. But, uncoordinated competition can also further fuel a race in tax concessions where zero taxation of corporations might not be a lower bound. The aggressiveness of both countries and MNEs needs to be addressed by the international community and a set of voluntary guidelines needs to be agreed on. In order to implement a coordinated policy which is aimed at mitigating profit shifting and base erosion, building capacity, particularly in developing economies, will be of crucial importance.

The Role of Taxation in Reducing Inequalities in Income and Wealth

The interaction of governments and society has changed over time. Civil unrest due to a steady growth in income and wealth inequality has become a global political concern and the perception of unfair taxation and the misuse of tax revenue must be ascribed a central role in explaining these developments. The perception of transparency, fairness and a link between taxing and spending is key for a renewal of the social contract which may be the outcome of current developments.

Excessive inequality undermines social cohesion, impedes structural reforms and thus dampens economic growth. One way to encourage equality of opportunity and to reconcile redistribution with growth is to foster education. Tax regimes need to be designed to take account of various market imperfections and spill overs that often arise in higher education. Moreover, society must be informed about linkages between taxing and spending to increase the perception of fairness and compliance. Taxation of property may be another promising way to achieve a more equitable society while doing little harm to long-run growth.[5]

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5. IMF Working Paper, John Noorregaard (2013): Taxing Immovable Property - Revenue Potential and Implementation, http://www.imf.org/external/pubs/ft/wp/2013/wp13129.pdf

Tax policy will, again, become more instrumental in reducing inequalities. Societies, particularly in the emerging world, are pushing for public service and governments which achieve a fairer distribution of income and wealth.

Taxing the Financial Sector: Getting the Right Balance

High profits and compensations reflect the assumption of high risk. In the context of the global crisis this assumption materialised and urged economists to rethink how the financial sector should be organised and regulated. Besides being fair and substantial, taxation must be directed to accomplish specific goals. The international community has to be clear about the economic reasons for taxing the financial sector. Only then is evaluation of the available instruments possible.

Excessive risk and the non-applicability of current VAT regimes for financial institutions have been identified as major problems that should be part of the reassessment of tax instruments for the financial sector.[6] Moreover, for most actors, a reduction in tax rates over the last three decades was accompanied by a broadening of the base. The financial sector, however, has largely been exempted from the latter development.

While financial transaction taxes (FTT) have been promoted in the wake of the financial crisis and future returns from this measure have been anticipated in some countries' consolidation plans, their ability to curb excessive leverage and risk is highly disputed. In order to ensure that financial institutions bear the fiscal costs that future crisis or failures will impose, the IMF proposed the introduction of a financial activity tax (FAT) which could take the role of a VAT for the financial sector.

6. IMF (2010): Financial Sector Taxation - The IMF's Report to the G-20 and Background Material

Policy Recommendations

1. Developing a Global Response to Harmful Tax Competition

Just as governments have put in rules to get the full benefits of free trade so they now need to develop rules to get the full benefits of tax competition. This will require an agreement on what constitutes acceptable tax competition and what constitutes unacceptable competition. The OECD should reinvigorate its work launched in 1998, seeing this as an integrated part of its response to base erosion and profit shifting.

The OECD's definition on harmful tax competition which put the emphasis on the need for tax transparency and to avoid "ring fencing" (i.e. where governments limit the benefits of low tax regimes to non-residents) should be extended to include regimes which are targeted at activities that are highly mobile and which provide a significant lower effective tax rate than the "normal" regime.

- Non-OECD countries should engage in the debate on how to reformulate these rules and to put in place a mechanism for monitoring their implementation, similar to that used by the Global Forum on Tax Transparency.
- The G20, OECD, World Bank and IMF should develop a set of guidelines to improve the transparency and accountability of tax incentives. These should specify that all tax incentives should be an integrated part of the tax legislation approved by national parliaments, be administered by ministries of finance and that each year there should be a report to the parliaments on the revenue forgone for each set of incentives and an estimate of how much new investment was generated, both of which should be public. Such Guidelines would

encourage a broader debate on the net benefits derived from giving tax incentives.

- One of the tests for this new approach to tax competition is how they would deal with the spread of shipping regimes (tonnage regimes) and intellectual property (IP) regimes which have spread rapidly over the last 10 years. The EU should be a strong supporter of this work since it would help it to take forward the mandate of its Code of Conduct Group and avoid that EU Member States are placed at a competitive disadvantage vis a vis third countries.

2. *Counteracting Base Erosion and Profit Shifting (BEPS)*

In September 2013, the OECD submitted an ambitious 15 point action plan to the G20 leaders which will require an unprecedented level of co-operation between OECD and G20 countries, as well as an engagement of developing countries.

To resolve BEPS governments should:

- Reassess the role of tax treaties and, in particular, the way in which the existing roles divide up the tax base between source and residence countries.
- Amend the OECD's Transfer Pricing guidelines particularly as they apply to intangibles which, in turn, may require using agreed formulae in the context of profit split methods.
- Re-examine the ways in which VAT and corporate tax systems apply to the digital economy.
- Reinforce existing anti-abuse measures (e.g. controlled foreign corporation legislation) and consider introducing a general anti avoidance provision.
- Changing the nature of the dialogue between tax administrations and taxpayers, moving it beyond one characterised by mistrust and a lack of transparency, to one where there is mutual respect and openness: what the Forum on Tax Administration has called "co-operative compliance" whereby MNEs comply with the spirit and letter of the law and compliance is seen as part of a company's good governance agenda.

The overall aim of these measures should be to ensure that the tax paid in a country reflects the level of economic activity carried out in that country and that opportunities for aggressive tax planning are reduced.

3. *Tax and the Financial Sector*

Since the beginning of the financial crisis in 2007 there has been an on-going and at time heated debate on questions such as whether banks are paying their fair share of taxes, if existing tax provisions encourage excessive leverage and debt financing and how can the tax system be used to discourage bonuses which bear little relationship to the undying profitability of an institution.

To address these issues governments should:

- Reassess the ways in which corporate taxes apply to the financial sector.
- Re-examine the treatment of financial instruments under VAT moving away from the current approach of exemption to one where VAT is applied, or consider the IMF's recent proposal for a financial activity tax.
- Ensure that by moving forward on the financial transaction tax they do not put their financial sector at a competitive disadvantage.

4. *The Role of Taxation in Reducing Inequalities in Income and Wealth*

Growing inequalities in income and wealth undermine social cohesion in a society which in turn

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makes it more difficult to achieve a political consensus to undertake the structural reforms required to achieve sustainable growth paths.

To address growing inequalities, governments should:

- Recognise that tax can only be one part of the response. The main burden to reduce these inequalities must come from the regulatory and benefit side of government. Empirical evidence shows that minimum wages and social programs directed at low income groups can make a significant difference.
- Improve tax compliance, especially in the offshore sector, by directing more resources to implement the new exchange of information agreements that have been put in place as a result of the G20 initiatives.
- Reassess the merits of inheritance taxes.
- Review their taxation of land and buildings to see how these property taxes can contribute to reducing inequalities and at the same time proving a valuable source of financing for lower levels of government.
- Re-examine specific sales taxes on products and services which are primarily consumed by the rich (e.g. private planes, luxury hotels etc.).

Taken together this new approach to taxation can go some way to reduce the growing inequalities in income and wealth.

In the context of the EUI/Vienna University of Economics and Business joint program on taxation and governance all of the issues referred to above will continue to be explored.

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