TAX POLICY FOR CONSOLIDATION AND GROWTH

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CONTEXT
Revenue-side challenge is to find tax instruments that:

- Play their part in restoring fiscal sustainability, while...
- Are as supportive as possible of long-term output/welfare
- Do least to depress current activity, and....
- Respect equity concerns

A tough balance between current actions and credible medium-term commitments
Fiscal Adjustment by Revenue and Expenditure Components, 2010-12

- Direct taxes
- Indirect taxes
- Other
- Capital expenditure
- Compensation of employees
- General transfers

Percent of GDP

- Advanced countries under market pressure
- Other advanced countries
In the EU, 2011-12:H1

<table>
<thead>
<tr>
<th></th>
<th>Personal Income Tax</th>
<th>Corporate Income Tax</th>
<th>Social Security Contribution</th>
<th>Value Added Tax</th>
<th>Excise Duties</th>
<th>Taxation of Property</th>
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</thead>
<tbody>
<tr>
<td><strong>Increase</strong></td>
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<td><strong>Decrease</strong></td>
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<tr>
<td><strong>Statutory rates</strong></td>
<td>11</td>
<td>2</td>
<td>10</td>
<td>14</td>
<td>25</td>
<td>6</td>
</tr>
<tr>
<td><strong>Base or special regimes</strong></td>
<td>14</td>
<td>6</td>
<td>2</td>
<td>12</td>
<td>4</td>
<td>-</td>
</tr>
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NEAR TERM
How big are tax-specific multipliers?

• Size of multipliers again a hot topic
  – Recent work suggesting larger in recessions, and perhaps larger than often thought

• But almost no work on size by type of tax
  – Empirical literature has focused on long-run effects
  – Models give no unambiguous ranking

• First principles suggest (very broadly):
  – Larger for taxes that reduce aggregate demand components conditional on output by more
Incidence may differ in short and long runs

...with effects though quantities if price adjustment sluggish

• E.g., distinction employers’ and employees’ social contributions (SCs)
  – likely immaterial in long run
  – but can be important in short if net of employers’ SC wage rigid (e.g., minimum wage)

• Strong case to avoid increasing gross labor costs
Temporary versus permanent changes

• Widely recognized these can have different effects
  – E.g., temporary vs. permanent CIT cut

• But is there scope to exploit this?
  E.g., commitment to future VAT increase may increase consumption (and revenue) now
  – Evidence this can bring consumption forward, but strategy little used except
    • U.K.: 2.5 point cut, with some predicting a 1.25 percent increase in spending
    • Japan: raising from 5 to 10 percent by 2015
MEDIUM / LONG TERM
Faced with an increased need for revenue, what are the best instruments to achieve it?

- If system initially optimal, so MCPF equalized across instruments
  - For small revenue need: Doesn’t matter
  - For big revenue need: Heavier use of whichever has MCPF that increases less rapidly
    - But that depends on elasticities of elasticities

- If tax system not initially optimal: Whichever has lower MCPF
  - But do we know enough to rank instruments by MCPF?
A hierarchy of taxes?
OECD empirical work (Arnold et al., 2012) points to a hierarchy:

1. **Property taxes**—especially recurrent taxes on personal residences

2. **Consumption taxes**

3. **Personal income tax**

4. **Corporate income tax**

For instance, shifting 1 percent of tax revenue from income to consumption taxes—increasing standard VAT rate in order of 1 pp—increases long run per capita GDP by 0.25-1 percent.
Convenient and fits priors—but should ask:

- **Empirically**: How robust?
  - Allowing more heterogeneity in response, difference PIT and CIT vanishes (Xing, 2012)
  - Endogeneity issue: Coefficient on CIT remains significant, but more than halves, and no longer significantly different from PIT
• Conceptually:
  – Where do the differences (e.g., PIT and VAT) come from, given equivalencies (e.g., VAT and wage tax)?
    • Taxing return to savings
    • Progressivity
    • Consumption value of benefits

But then recommendations much more nuanced

– Not all VATs/PITs/CITs are the same:
  • Would we expect rent tax form of CIT to have same growth effects as traditional CIT?
With limited knowledge of MCPFs, broad division into:

- **Corrective (or distortion-reducing) taxes**
- **Rent taxes**
- **Distorting taxes** (very selective)
Corrective (distortion-reducing) taxes
• **Carbon pricing**, rising over time
  – In EU, movement to full auctioning; scope for extension to non-ETS sources
  – In U.S., proposals (with full auctioning) could have raised around 0.5 percent of GDP

• **Other environmental taxes**
  – Fuel taxes in some countries
  – Congestion pricing
  – Main issue in many cases is restructuring energy taxes
• Financial sector
  – More purposive use of ‘bank’ taxes to address externalities from financial failures?
  – FTT, though perhaps not clear what externality being addressed

• Addressing corporate-level debt bias—later

• Harmful tax expenditures
  – Not all tax expenditures are bad (and “low rate broad base not right if base is wrong!” But important to assess/review
    • E.g., mortgage interest deductibility in U.S.
Rent taxes
• **Natural resources**
  – Several G20 continue to be reliant more on distorting royalties than rent taxes
  – Norway: the example of what better taxation can do

• **Corporate taxation**—later

• **Financial sector rents**, including from TBTF
  – Is there a case to capture these, e.g., through a variant of the Financial Activities Tax? Or sector-specific ACE?
Distorting taxes—(very) selective
Value Added Tax

• VAT extensively used already: between 2009 and 2011, 13 MS raised standard rate; only one cut

• Clear potential where low or non-existent:
  – Japan, now committed to reform
  – U.S., but issues related to state/local sales taxes

• Where it exists, standard rate often high
Scope to increase VAT revenue by moving closer to uniform broad base suggested by

\[
C - \text{efficiency} = \frac{\text{VAT revenue}}{\tau_5 \times \text{Consumption}}
\]

(a.k.a VAT Revenue Ratio....) often much less than 100 percent

Average in OECD only 60 percent (and lowest 35)
To diagnose, decompose C-efficiency (IMF, 2010):

\[ C\text{-efficiency} = (1 - \text{Compliance gap}) \times (1 - \text{Rate differentiation}) \times (1 - \text{Exemptions}) \]
Distributional concerns mean raising reduced rates may call for compensation, reducing revenue gain

![Graph showing distributional concerns and average tax gains/losses.](image-url)
An Aside: Fiscal Devaluation

• With fixed exchange rate, tax changes can mimic (largely) a devaluation: as Keynes noted long ago for import tariff + export subsidy

• ‘FD’ proposals for troubled euro countries are to shift from employer SC toward VAT:
  – With nominal wage fixed, this
    • Reduces foreign currency price of exports
    • Raises domestic consumer/producer price of imports

But these effects are expected to be temporary
What do the data say?

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<tr>
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<th>Non-euro</th>
<th>Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lag net exports</td>
<td>-0.21* (0.12)</td>
<td>-0.10** (0.05)</td>
</tr>
<tr>
<td>ΔSCR</td>
<td>-2.84** (1.30)</td>
<td>-3.42*** (1.26)</td>
</tr>
<tr>
<td>SCR\textsubscript{\text{-1}}</td>
<td>-0.06 (0.11)</td>
<td>-0.13 (0.10)</td>
</tr>
<tr>
<td>ΔVAT</td>
<td>-0.05 (0.94)</td>
<td>0.56 (1.00)</td>
</tr>
<tr>
<td>VAT\textsubscript{\text{-1}}</td>
<td>-0.03 (0.17)</td>
<td>0.05 (0.17)</td>
</tr>
<tr>
<td>Short-run FD</td>
<td>2.80* (1.58)</td>
<td>3.98*** (1.55)</td>
</tr>
<tr>
<td>Long-run FD</td>
<td>0.18 (1.11)</td>
<td>1.92 (2.05)</td>
</tr>
<tr>
<td>N</td>
<td>369</td>
<td></td>
</tr>
</tbody>
</table>

Robust system GMM, tax rates as external instruments added, lag limits (2,3), robust s.e. between brackets; *, **, *** denotes 10, 5, or 1 percent significance.
Limitations

• Effect likely to be temporary (as nominal wages increase in face of increased VAT)

• Distributional aspects:
  – reduction in real value of out-of-work benefits may amplify effects, but have unacceptable distributional consequences; and compensation will reduce impact

• What if everyone does it?
Personal income tax

• Optimal degree of progressivity—and treatment of capital income—again (more than ever) a key issue

• Little evidence that current top marginal rates above revenue-maximizing

• Flat tax experience: Large cut in top PIT in Russia associated with large increase in PIT revenue
  – But difference-in-difference analysis suggests responses did not account for increase in revenue
  – Though are signs of improved compliance
Corporate Income Tax

• Potential Laffer effects?
  – Clausing (2007) puts revenue-maximizing rate at 33 percent (presumably higher with cooperation)

• Structural reform, to eliminate debt bias?
  – Remove/limit interest deductibility (as several have); becomes a rent tax if immediately expense investment
    • What about personal level tax?
    • And what about financial sector?
  – Allowance for Corporate Equity/Capital?
    • Base narrowing, but revenue loss more limited when interest rates low and allowance only for post-adoption equity
Closer international cooperation

• E.g., Structural solutions to VAT fraud related to absence internal frontiers in EU

• International aviation and maritime fuels

• Progress on information exchange—but ultimately more likely required

• Scope, e.g., for action on avoidance schemes relying on mismatches of legal definition (hybrid entities)

• Include in checklist for assessing tax reforms the impact abroad
  – E.g., potentially significant effects from a move to territorial taxation in the U.S.
CONCLUDING
• Why such reliance on SCs for consolidation?

• Overcoming obstacles to VAT base broadening
  – Earmarking?

• Other instruments?
  – Revival of wealth taxation (Ireland, Spain)

• Rebuilding/strengthening automatic stabilizers

• Role of administration