TAX POLICY FOR CONSOLIDATION AND GROWTH

Michael Keen
International Monetary Fund

ECFIN Workshop

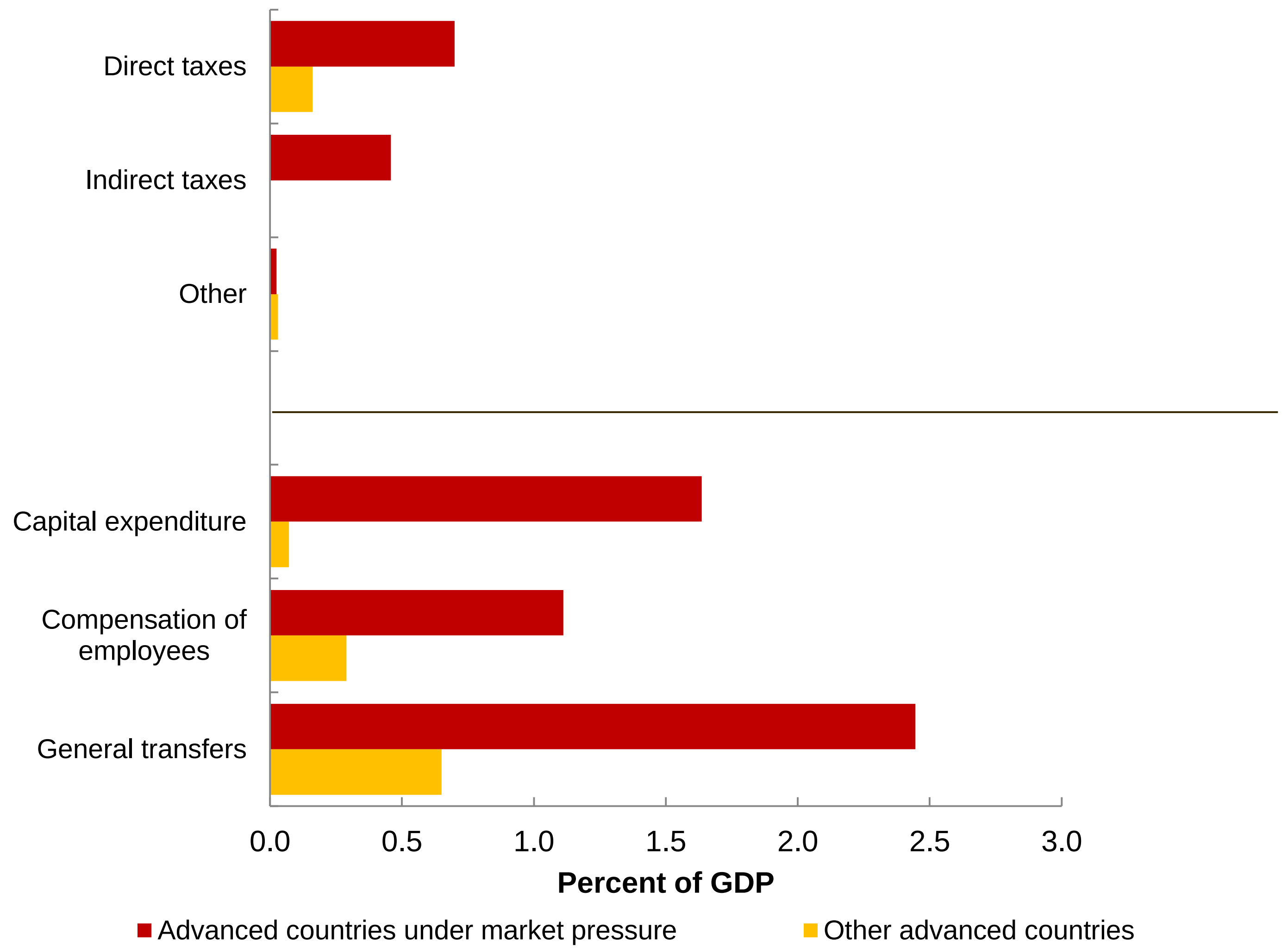
"The Role of Tax Policy in Times of Fiscal Consolidation"

October 18, 2012

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



In the EU, 2011-12:H1

		Statutory rates	Base or special regimes
Personal Income Tax	Increase	11	14
	Decrease	4	13
Corporate Income Tax	Increase	2	6
	Decrease	5	6
Social Security Contribution	Increase	10	2
	Decrease	2	1
Value Added Tax	Increase	14	12
	Decrease	-	6
Excise Duties	Increase	25	4
	Decrease	1	-
Taxation of Property	Increase	6	4
	Decrease	1	-

Source: European Commission (2012), *Tax Reforms in EU Member States* (Working Paper N.34-2012).

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

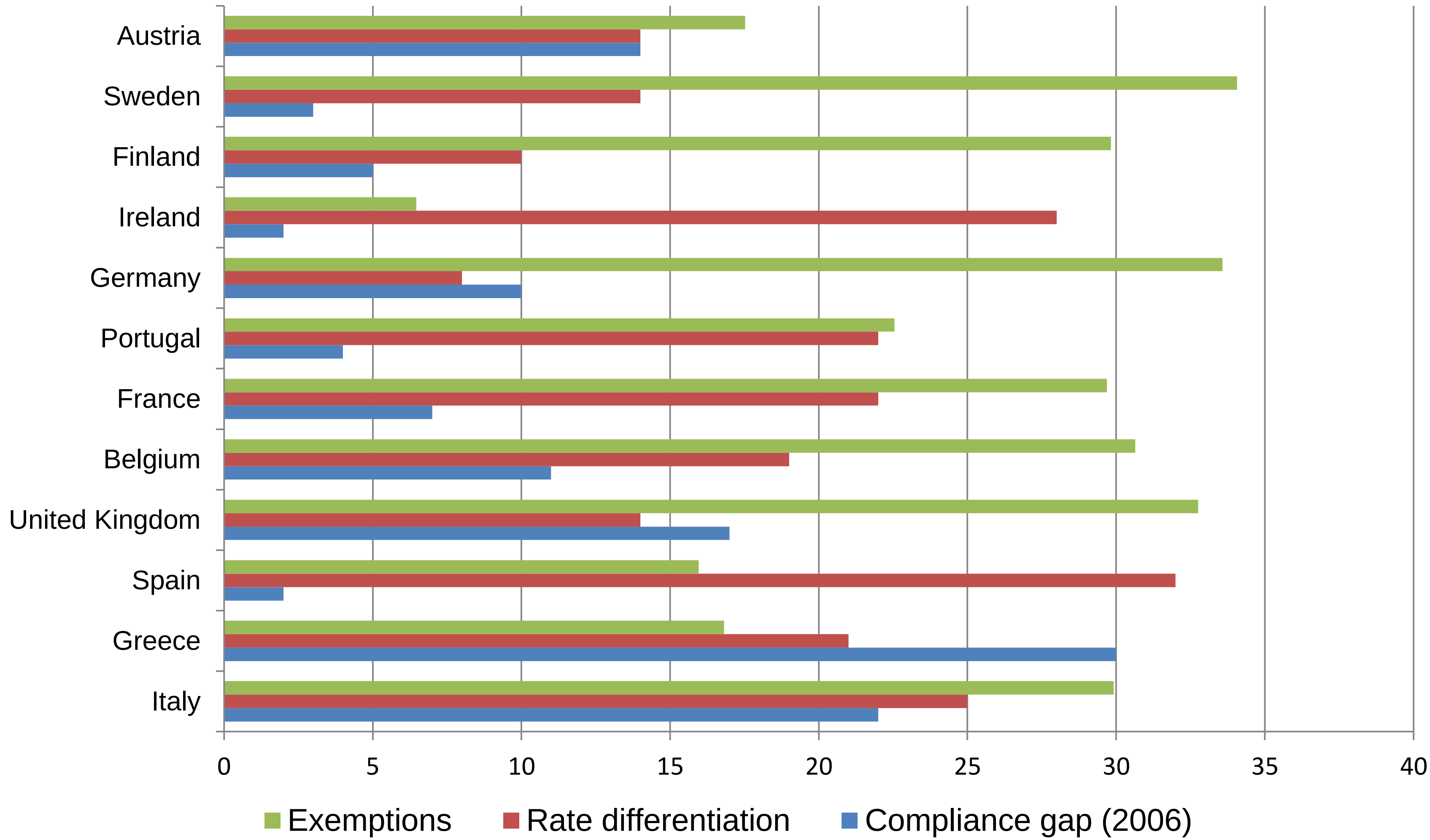
$$C-efficiency = \frac{VAT\ revenue}{\tau_S \times Consumption}$$

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

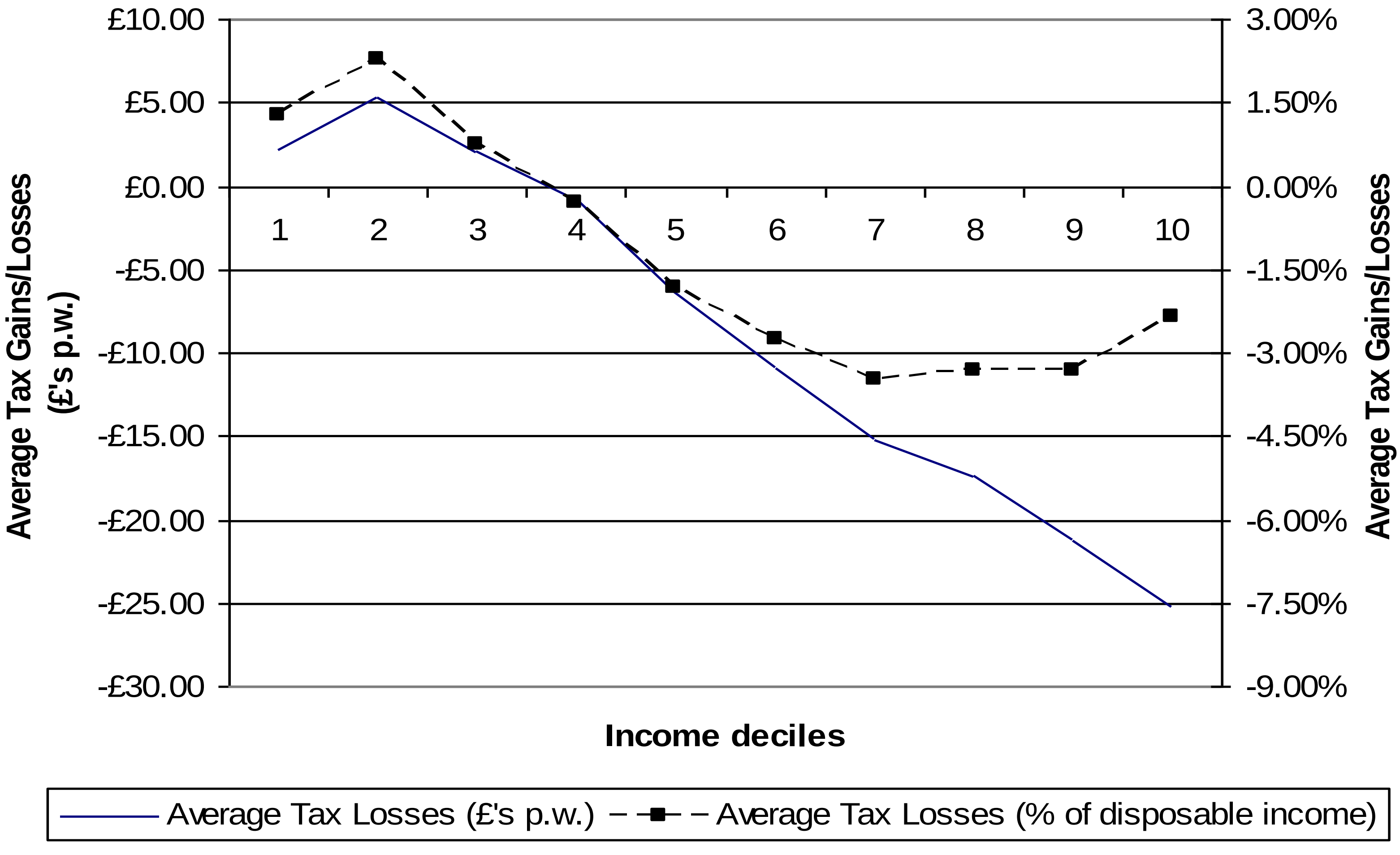
Average in OECD only 60 percent (and lowest 35)

To diagnose, decompose C-efficiency (IMF, 2010):

C-efficiency = (1- *Compliance gap*)×(1 – *Rate differentiation*)×(1 - *Exemptions*)



Distributional concerns mean raising reduced rates may call for compensation, reducing revenue gain



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?

	Non-euro	Euro
Lag net exports	-0.21* (0.12)	-0.10** (0.05)
ΔSCR	-2.84** (1.30)	-3.42*** (1.26)
SCR_{-1}	-0.06 (0.11)	-0.13 (0.10)
ΔVAT	-0.05 (0.94)	0.56 (1.00)
VAT_{-1}	-0.03 (0.17)	0.05 (0.17)
Short-run FD	2.80* (1.58)	3.98*** (1.55)
Long-run FD	0.18 (1.11)	1.92 (2.05)
N	369	
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