



MAKING FUNDAMENTAL TAX REFORMS HAPPEN

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Outline of the presentation

- **Obstacles & challenges to tax reform:**
 - Tax policy design obstacles and challenges
 - The political economy perspective
- **Strategies for making tax reforms happen:**
 - Political economy strategies
 - Strengthening tax policy design and analysis



Tax Policy Design: Obstacles & Challenges to Tax Reform (I)

- **Distributional considerations** are important
 - Taxes paid as a percentage of income or expenditure?
 - Life-time income versus year-by-year assessment.
 - Who are the individuals/ households within each decile?
- **Efficiency and pro-growth** tax policy design challenges
 - Balancing efficiency and distributional considerations, wherever possible, will allow countries to implement « Inclusive Growth »
- Raising sufficient **tax revenues** to balance budgets
- **Tax avoidance and tax evasion** considerations are complex but need to be taken into account
- **Tax incidence and tax capitalisation** issues make reform complex:
 - Taxes and tax provisions are capitalised in the price of assets. The current owners of tax-privileged assets are not necessarily the beneficiaries of these tax provisions.
 - Not all taxpayers can still adjust their behaviour in response to tax reform (e.g. pensioners who already left the labour market).



Tax Policy Design: Obstacles & Challenges to Tax Reform (II)

- **Transitional tax reform** considerations need to be taken into account.
- **Fiscal federalism** issues matter and complicate reform.
- **Timing matters!** When to implement reform?
- The mere **announcement** of reform can result in costs but also benefits.
- **Who wins and who loses** from tax reform?
 - Today, tomorrow and in the future?
 - Immediate losers are not necessarily final losers.
- **Can we, do we want to and how to compensate losers?**
 - Efficiency gains typically do not arise immediately so cannot be used immediately to compensate losers of tax reform.
- How to **administer the tax?** The tax administration plays a key role.
- The **international tax** environment creates constraints but also opportunities.



The political economy perspective: political cycles and the visibility of political decisions (I)

- Politicians might engage in tax reform in order to **attract the “swing voters”** who are the more mobile voters that change their vote in case a reform favours them; these reforms are not necessarily in the general interest.
- Incremental (>< fundamental) tax reform as a signal that politicians care about taxpayers’ welfare. But by **reforming for the sake of reforming**, politicians not necessarily take the long-run implications of these reforms into account (on tax revenues, tax complexity, etc.).
- **Tax reforms may be blocked and changed** during the legislative as well as the administrative stage; e.g. if politicians anticipate that good reform proposals will turn into poor reforms, they may not want to push for reform at all.



The political economy perspective: political cycles and the visibility of political decisions (II)

- Politicians face an incentive to enact tax reforms whose **reform gains are visible** at the time the next election takes place. Politicians might then face obstacles to reform the tax system if the next election takes place soon.
- Politicians may prefer tax reforms that are **less visible**:
 - increase in employer SSC instead of employee SSC and recurrent taxes on immovable property, for instance.
 - income taxes and VAT which do not have to be increased each year instead of ad quantum excise duties.
 - Bracket creep: incentive for not fully indexing of rates, brackets, allowances and credits.
-and prefer tax reductions (Taxes) which are **highly visible** to the beneficiaries (while the costs are less visible and borne by all).
- Pareto improving tax reforms may never get implemented because a political party expects to be able to **get a better deal next time**.



The political economy perspective: Uncertainty and fragmentation (I)

- **Uncertainty about who will win and lose** / about the number of winners and losers and about how much they will win or lose
 - voters may therefore be reluctant to vote for reform
 - Status quo bias (because risk-averse swing-voters does not know whether he/ she will win or loose ex-ante);
 - politicians may be reluctant to engage in tax reform
- **Uncertainty who will be in power** after the elections and whether this government can stop / reverse the reform; tax policy annulations/reversals/ changes might have an impact on who actually wins/loses.
- **The larger the uncertainty about the information quality** and the larger the divergence between the information obtained through different information channels, the more difficult for politicians to draw conclusions / decide to reform the tax system



The political economy perspective: Uncertainty and fragmentation (II)

- Also the diverging impact of tax reform on the different coalition parties might imply an obstacle, especially if one of the coalition parties bears most of the costs.
- The literature suggests that:
 - Countries where the political power is more dispersed change their tax system less often.
 - The tax reforms also tend to be compensated more by other reforms/measures in order to be acceptable for all coalition parties.
 - So this implies that the more fragmented is the coalition, the more difficult for political parties to engage in fundamental tax reform.



The political economy perspective: Vested interests and lobby groups (I)

- The large group of **winners are silent** while the minority of **losers makes a lot of noise**.
- Losers can try to influence the policymakers in different ways (direct, through media, through vested interest groups, etc.).
- Special interest groups are especially influential if policymakers depend on them or if they consist of swing voters that have an impact on the outcome of the next election.
- **Different taxpayers may face different transaction (lobbying) costs**; as a result, tax reforms may be biased towards the reforms that are favoured by the influential interest and lobby groups.



The political economy perspective: Vested interests and lobby groups (II)

- Tax expenditures are a tool to serve swing voters and special interest groups. The benefits from TEs can be targeted while the costs can be spread over all taxpayers.
- Once introduced, it might be difficult to remove tax expenditures as a result of the lobbying for the persistence and further extensions of the special tax provisions. This will result in a less efficient, less fair, more complex and less pro-growth tax system.



Political Economy Strategies for Making Tax Reform Happen (I)

Formulate/ communicate clear strategic vision and tax reform objectives

- Allow implementing reforms with long time horizon
- Creates incentives to continue and not to deviate/ reverse the reform.

Framing tax policy debates

- It is essential to see **the tax system as a system rather than to consider its different tax elements in isolation!** Framing of the tax policy debate on single taxes makes it difficult to implement tax reforms!
- Lobby groups might have an interest to frame particular tax policy reforms in isolation, but this approach is unlikely to be in the interest of the general public.

Advancing reforms through introduction of ex-ante constraints:

- Might imply that some Pareto improving tax reforms are not considered because they are not in accordance with one of these constraints.
- But might sometimes make tax reform feasible.



Political Economy Strategies for Making Tax Reform Happen (II)

« Bundling of reforms» (comprehensive reforms; big bang tax reforms)

- Policymakers should treat the tax system as a system rather than to consider each tax in isolation. Disconnected tax debates may be counterproductive.
- Comprehensive tax reform may allow finding sufficient political support.
- Big bang approach may also be preferred if the full tax reform package is necessary to realize the long run tax reform benefits.
- It might allow to spread costs and benefits over population at large, and allow to mitigate the costs of reforms for groups that might otherwise be hard hit by the reform.
- Comprehensive reform may allow to compensate losers.
- Comprehensive tax reform might prevent the formation of lobby groups – or not!
- And incremental reform runs the risk of losing focus and to degenerate in ad hoc tax policy measures that do not fundamentally reform the tax system.



Political Economy Strategies for Making Tax Reform Happen (III)

« Incremental approaches » may sometimes work best

- But the incremental tax reform approach puts less demand on scarce policymaking and tax administrative resources
- Comprehensive reform might take longer than 4 years to be implemented / before benefits are visible
- Might help to overcome the status quo bias: unbundle reforms that do not harm the same voters.
- Might be efficient if the tax reform outcome is uncertain – it allows to minimise tax reform « reversal costs »
- Comprehensive reform might require incremental reform: fine-tuning
- Do NOT give away the carrot to soon!

Transparency of reform process

- Requires proper dialogue (with social partners, broader public) and communication
- Increased government accountability
- But too much transparency might make reform difficult.



Political Economy Strategies for Making Tax Reform Happen (IV)

- Implement grandfathering rules which allow the old tax rules to continue to apply to some existing situations while the new tax rules apply to all future situations:

Beneficial if agents have no longer opportunity to change behaviour, but will reduce the tax reform gains, and will increase complexity of the tax code. Although the old rules can be phased out over time: proper length?

- **Temporary tax measures might help as well, but they have the tendency to become permanent; sunset clauses.**
- **Strong coordination across levels of government**
- Engage in an international tax dialogue
- Important role for **tax analysis departments**
- **Role for independent bodies** to calculate the effects of tax reform proposals on behaviour, tax revenues, distributional impact, etc. and tax policy reform committees and commissions.



Strengthening Tax Policy Design and Analysis in order to « Make Tax Reform Happen »

- Strengthen tax policy analysis & toolbox:
 - Improve monitoring of winners and losers from reform
 - Monitoring not only of the income but also wealth distribution
- Not only ex-ante but also ex-post country tax reform evaluation & reporting
- Regular member country tax policy reviews by international organisations
- Build on success of « Tax Expenditure Reporting » to move towards « Value for Tax Money » reporting
- OECD work on « Tax Design for Inclusive Economic Growth » discusses tax reform strategies that allow reconciling efficiency and equity considerations.



THANK YOU FOR YOUR ATTENTION

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