Tax Policy Reform and Economic Growth
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PART III

Chapter 5

Tax Design Considerations

Chapter 5 discusses in more detail to which degree it is optimal to implement the "tax and growth" recommendations discussed in the first chapter of this report. The chapter mainly focuses on the implementation of tax-cut-cum base broadening reforms with respect to property, consumption, personal and corporate income taxes. The discussion in this chapter clarifies that the "tax and growth" recommendation to broaden the different tax bases does not necessarily imply that it would be optimal to abolish all tax expenditures. The growth-oriented VAT base broadening recommendation, for instance, does not exclude that some goods and services receive a different tax treatment, either by taxing them at reduced rates or by not including them in the tax base. Note, however, that this analysis is not an attempt to undermine the "tax and growth" recommendations. On the contrary, a nuanced analysis of the pros and cons of specific growth-oriented tax reforms might reduce some of the (mainly political) obstacles against these reforms. In addition, the analysis will present and discuss also tax-specific strategies that might help overcoming the obstacles against the implementation of the "tax and growth" recommendations.

Section 5.1 discusses the rationale for base broadening and points out that, in some circumstances, there are indeed good reasons to implement tax expenditures. Section 5.2 discusses the reasons and scope for VAT base broadening, focusing also on whether it is desirable to include financial services and immovable property in the VAT base. Section 5.3 discusses when and how countries could increase the recurrent taxes on immovable property. Section 5.4 briefly discusses additional corporate and personal income growth-oriented tax reform strategies.

5.1. Tax base broadening *versus* the use of tax expenditures

There are four main efficiency and cost-related arguments in favour of broad tax bases as a growth-oriented tax strategy:

- *increased allocative efficiency:* implementing a broad base minimises the distortions and resulting dead weight losses that arise if different tax rules apply to similar types of taxpayers or types of activity;
- *reduction in administrative, enforcement and compliance costs:* broadening the tax base will simplify the tax system and will result in lower tax administration, enforcement and compliance costs for taxpayers;
- *increased tax compliance:* a broadening of the tax base might lead to higher rates of tax compliance, mainly because the opportunities for tax-arbitrage behaviour are reduced;
- *lower tax rates:* a broadening of the tax base increases tax revenues which can finance tax rate reductions, leading to further efficiency gains and reductions in tax avoidance and evasion incentives.

A broadening of the tax base will also strengthen the fairness of the tax system. Tax base broadening will improve not only the horizontal equity – similar taxpayer no longer are taxed in a different way – but possibly also the vertical equity of the tax system. In general, richer households seem to benefit more from, for instance, the personal income

tax expenditures not only because many of them are expense related but also because their value often increases with the household's marginal personal income tax rate. A tax reform package that broadens the personal income tax base and reduces all but especially the top PIT rates might therefore even be redistributional neutral.

As pointed out, base broadening measures are often implemented as a way to finance tax rate reductions. This seems especially true for the corporate tax rate. However, rate reductions will also reduce the obstacles against the broadening of the tax base. A reduction in the statutory corporate income tax rate, for instance, reduces the value of the interest payments deductibility and will therefore reduce the obstacles against measures that treat debt and equity more equally at the corporate level. Rate reductions might therefore also increase the tax base broadening opportunities.

Moreover, tax expenditures are often badly targeted and their objectives can more efficiently be obtained through alternative measures. An obvious example is the case of richer households which consume more than poorer households and therefore benefit more from the reduced VAT rates. Governments can support poorer families more efficiently through direct benefits and targeted personal income tax credits, for instance.

However, base broadening measures are not necessarily always growth-oriented tax measures. A restriction of the interest deductibility in the corporate income tax, for instance, would not necessarily be "pro-growth" especially because of the enormous transitionary problems that would arise from such a fundamental change in the corporate income tax system. Moreover, CIT and PIT base broadening measures would increase the share of these taxes in the tax mix; this will be a growth-oriented strategy (only) if the increased tax revenues are used to lower the CIT and PIT rates. Moreover, R&D tax provisions are "pro-growth" but imply that the CIT base becomes narrower.

Rationale for tax expenditures

In some cases there might indeed be good reasons for implementing tax expenditures. First, the tax administration costs of broadening the base might exceed the corresponding efficiency gains. This argument is often used for not including financial services in the VAT base (see further below). Second, the tax provisions might have the same purposes as social benefits. This is for instance the case of tax allowances or credits for dependent children. The removal of these tax provisions would typically require their replacement by ordinary expenditure programmes and would therefore not result in an opportunity to lower the tax rates. However, the natural question to ask is then why these tax provisions are not delivered as ordinary expenditure programmes. Leaving aside the possible political advantages of a lower recorded tax-to-GDP ratio and reduced legislative oversight, the two most obvious reasons are: *i)* these tax provisions reflect ability to pay, and *ii)* it is administratively more efficient to provide them through the tax system, as discussed in the following paragraphs.

An equitable tax system implies that the value of the tax expenditures depends on the taxpayer's ability to pay. Taxpayers should therefore be able to claim a deduction from their taxable income that depends on the actual costs that they bear and to the extent that these costs constitute a burden for them. However, because of the progressive PIT rates in most countries, the financial benefit of the tax expenditures is greatest for those taxpayers that face the highest marginal tax rates. These are also the taxpayers that are best able to meet these costs. Many countries have therefore replaced tax allowances with refundable (non-wastable) tax credits. In that case, the tax provisions become then almost equivalent to a direct expenditure programme.

The administrative argument is that delivery of assistance through the tax system is more efficient than through an ordinary expenditure programme. In some countries, this appears to be because the tax administration is seen as more efficient than the social welfare administration, but this can be expected to vary between countries and could be tackled by improving the efficiency of the welfare systems directly. A more convincing argument in favour of using the tax system for delivery of assistance is two-fold. First, to the extent that there is any income targeting in the assistance, the tax authority already collects this information. Moreover, it allows the interaction of these assistance measures with other tax provisions in the personal income tax system. It also avoids that social welfare departments would have to perform complicated calculations in order to derive the precise value of the benefits that have to be provided. Second, many tax authorities use a system of taxpayer self-assessment combined with rather infrequent audits, which is less costly than the more detailed controls that social welfare departments typically use. Note also that in case of make-work-pay policies, for instance, taxpayers might associate the provided assistance more closely with work. The benefits can also be reflected directly in the taxpayer's monthly take-home pay, although some countries make these payments after the end of the tax year. On the other hand, the use of the tax administration to deliver social benefits would require that more resources are made available for dealing with low-income households, who frequently have very different problems from the higher-income households with whom the tax administration is more familiar. It might also require detailed information that is not directly available for tax auditors and can therefore be handled more efficiently through other channels.

A third rationale for the implementation of tax expenditures is that they might operate as tax incentives that correct for market failures or provide incentives to internalize positive external effects. Examples of such tax provisions are tax incentives for R&D and deductions for healthcare expenses.

Hettich and Winer (1999) offer a fourth argument in favour of tax expenditures. They argue that the enforced closing of special tax provisions may well lead to lower levels of tax revenue in the medium run rather than higher levels as is often implicitly assumed. According to their political economy argument, abolishing tax expenditures implies that government will be less able to discriminate among heterogeneous taxpayers and voters, which will lead to an increased overall opposition to taxation. Despite the increase of tax revenues in the short run, reducing tax expenditures may then lead to lower levels of taxation in the medium and longer run.

Tax expenditure reporting

This and the following sections will show that, in many cases, base broadening is a growth-oriented tax reform strategy. However, in some cases, there are indeed good reasons to implement a narrow tax base, for instance through the use of tax expenditures. However, in order to ensure that tax expenditures are rather the exception than the standard rule, governments might assess the need for tax expenditures on a regular basis. Governments could design a set of criteria which have to be met before they actually decide to introduce a particular tax expenditure. These rules should aim at demonstrating that tax expenditures constitute good tax policy and that they are a better way forward than standard tax-cut-cum base broadening measures.

Another strategy would be to commit to proper tax expenditure reporting. In order to reduce the amount of tax expenditures, countries might publicly report the costs of the tax

expenditures on a yearly basis. Political ideas that are presented before or at the time of elections might also be evaluated in terms of their tax revenue foregone and their redistributional impact either by the government's administration or by independent research institutes, as for instance is the case in the Netherlands.

5.2. VAT base broadening

Governments might consider broadening the VAT base by abolishing the zero and reduced rates. VAT rate differentiation, which is implemented in most OECD countries, distorts individual's spending decisions by creating tax-induced incentives to choose goods and services that are relatively lightly taxed and by favouring some sectors over others.

Countries implement reduced VAT rates on necessities such as basic food and clothing in order to reduce indirectly the tax burden on low-income households. Other reasons for reduced VAT rates is that governments want to stimulate consumption of goods with positive externalities (*e.g.* energy saving appliances) and do not want to tax merit goods[1] – medicine and health services, housing, education, music and cultural events, books, and newspapers – at high rates.

The OECD (2008) *Consumption Tax Trends* publication lists the lower rates applied across OECD countries. Whilst there are some reduced VAT rates that are common across many countries and which seem to be targeted at the poor and merit goods, other reduced rates seem less targeted. Amongst these are admissions to cultural events, including circuses and cinemas, hotel accommodation and cut flowers. The reasons for these reduced rates might be rooted in a country's socio-economic history, but their validity may be questionable within a general tax on domestic consumption of goods and services.

Reduced VAT rates on necessities such as food and clothing are available to all consumers. Thus a richer person will benefit from a reduced rate. In fact, the richer gain more from the reduced rate on food as they spend more on food and clothing than poorer people do. As a result the wealthy gain most in absolute terms from a reduced rate. Poorer people do, of course, derive considerable benefit in that their expenditure on food and other goods that are taxed at a lower VAT rate represents a much higher proportion of their income. However, using VAT to allocate benefits is a particularly blunt instrument and it would be preferable to target such benefits at those who are genuinely in need of them.

This argument against reduced rates is even stronger for (most of the) merit goods. Reduced rates on, for instance, cultural events might have the unintended effect of subsidizing the consumption of these goods by high-income households who tend to consume more merit goods rather than leading to an effective increase in consumption by lower-income households. This might lead to or strengthen a so-called "Mattheus effect" according to which social distribution flows from lower-income households to higher-income households.

It is sometimes argued that correcting externalities might justify VAT rate differentiation; for example, higher rates on goods that generate pollution or reduced rates on energy-saving appliances. In these cases, rate differentiation may improve efficiency if it means that private marginal costs of an activity are brought more into line with society's marginal costs. However, VAT is a rather blunt instrument for correcting environmental externalities, as it may be hard to target the actual source of pollution. For example, reduced rates on energy-saving appliances, by reducing the private marginal cost of these goods may boost demand for them and, therefore, stimulate consumption of these goods.

However, the overall effect on CO_2 emissions is ambiguous. The reduced VAT rate may give incentives to shift from more to less energy consuming items (consumers might replace their old fridge with a new one, for instance), but at the same time may also lead to an increase in the purchase of energy-intensive products (*i.e.* consumers may replace their old fridge with two or more new fridges) (Copenhagen Economics, 2007). In fact, governments may levy higher rates to correct for negative externalities rather than lower rates on goods with positive externalities. For instance, a higher VAT rate on high energy-consuming appliances will be good for the environment but may also have the advantage of raising tax revenue which could be used to reduce rates of other distortionary taxes, leading to further efficiency improvements.

An effective redistribution policy is not implemented through each tax in isolation but should be implemented by considering the entire tax system as well as the benefit system. Because the redistributional impact of the reduced VAT rates is ambiguous, the income distribution goals could better be achieved through means of targeted PIT relief and/or targeted benefits. Deaton and Stern (1986) for instance show that direct lump-sum payments to households depending only on their socio-economic characteristics are better for both equity and efficiency. Ebrill *et al.* (2001) argue that direct targeted transfers to low-income households are more effective in enhancing equity than VAT exemptions, zero and reduced rates.

Moreover, much low income observed at a point in time is temporary and need not reflect low lifetime living standards. While it is true that some people are persistently poor, many have volatile earnings. Over a lifetime, income and expenditure must be equal – apart from inheritances, which are generally small – and indeed annual expenditure is arguably better than annual income as a guide to lifetime living standards. If we were to look at the effect of taxes on lifetime income inequality, the contrast between "progressive" direct taxes and "regressive" indirect taxes would be much smaller. However, it would still be the case that personal income taxes are more progressive than consumption taxes.

An argument in favour of different VAT rates on different goods and services is that governments can increase efficiency if they impose a lower rate on work-related items such as commuting costs and a higher rate on leisure-related ones in order to offset the overall disincentive to work created by taxation. However, the IFS (2009) review suggests that even in this case, it is not sure that the potential efficiency gains from differentiating VAT rates in this way would outweigh the costs of greater complexity and the advantage of a single rate in making it easier to resist political pressures to provide favourable treatment to particular sectors or items (IFS, 2009: Mirrlees Review).

Abolishing a wide range of reduced rates prevents the "me too" syndrome. By granting a reduced rate to one sector, other sectors will inevitably lobby hard for inclusion. This can even become an international issue with lobbyists quoting a reduced rate in country A as a means of pressing the government in country B to follow suit. The recent extension of reduced rates to labour-intensive services within the EU provides a good example with sectors, such as restaurants, lobbying hard for inclusion.

A uniform VAT rate avoids also significant administrative costs of having to define and monitor for each and every good and service which rate has to be applied. These costs seem to be particularly large for the food sector due to its multitude of products and the grey zone between sale of basic food and prepared food, for instance.

VAT base broadening and simplification will reduce the compliance costs especially for smaller businesses. As an indirect tax, business has to collect VAT and remit it to authorities on behalf of their customers. Especially for smaller businesses this can create significant compliance burdens and costs; since compliance costs are largely independent of the amount of tax payable, they fall more heavily on smaller traders. VAT is often a complex tax with an array of different rates, exemptions, special schemes as well as requiring comprehensive reporting arrangements. Tax base broadening as part of a tax simplification strategy and increasing the threshold for registration might then reduce the tax compliance costs.

A high VAT rate will also encourage certain easily hidden activities to move into the underground economy and will increase the self-supply rather than the purchase of these services on the market (mainly home improvement and repair services, gardening, services of hairdressers, etc.). Some countries have taken the view that the way to deal with this is to apply a lower rate of tax to the goods and services these activities produce. However, it is difficult to exactly identify the goods and services that fall into this category. Also, it should be noted that even the underground economy pays a non-zero rate of VAT as it is unable to reclaim the VAT paid on its inputs. VAT then offers an effective way to tax the informal sector but at the same time creates a barrier to the growth of small businesses (IFS, 2009). In these circumstances it may be administratively easier to counter the incentive to enter the underground economy by a combination of avoiding excessively high rates of tax – which also avoids a too high tax burden on services that households can perform themselves – having a fairly high VAT threshold and a well-targeted audit programme than by a multi-rate VAT system (Heady *et al.*, 2009).

Some countries also extend reduced VAT rates to sectors employing many low-skilled workers such as, for example, hotels, bars and restaurants. While the theoretical and political motivation for these reduced rates is to increase low-skilled labour demand by stimulating the demand for such services, other policy instruments such as labour market reforms could be more efficient on achieving this objective.

It is also important to consider the international dimension when assessing the advantages and disadvantages of a shift towards a broader VAT base and especially a higher statutory VAT rate and excise duties. Higher consumption taxes in one country may induce individuals to consume in other countries with lower taxes, though cross-border shopping is relatively small-scale except in cases where large population centers are close to a border or the tax differences are very large (which happens most commonly for excise duties on tobacco and alcohol[2]) (Heady *et al.*, 2009).

Financial services

Financial (banking and insurance) services are generally exempt from VAT mainly because of technical difficulties in determining the VAT tax base. Ideally, the VAT would only be levied on the intermediation charge, which reflects the actual value added created by the financial institution and not on the interest rate, premium or return that has to be paid by the financial institution's customers. However, in practice, this distinction is not easily made, especially for tax administrations. Although it would improve efficiency, a VAT on financial services might also lead to high tax compliance, administration and enforcement costs. It therefore is unclear whether broadening the VAT base by including the services provided by the financial sector could be considered as a growth-oriented tax policy reform.

The exemption of financial services from VAT creates a number of distortions with respect to both consumer and business decisions. Exemptions cause a break in the VAT chain, meaning that financial institutions incur significant amounts of (unrecoverable) VAT paid on their inputs but which they cannot recover as they cannot charge VAT on their sale of services. This provides financial institutions with a tax-induced incentive to self-supply services to avoid that they have to pay unrecoverable VAT, which would be the case if they would obtain these services from other firms. Banks might therefore provide in-house legal, accounting and tax advice services. The tax system then provides an incentive for vertical integration. This break in the VAT chain also distorts the international competition between financial institutions as the (unrecoverable) VAT rate, which differs across countries, will affect the rates that will have to be charged to customers. Business and private consumers might also face an incentive to excessively consume financial services compared to other goods and services because no VAT is explicitly levied, although the unrecoverable VAT might be included in prices. In fact, the VAT payments might be embedded in the charges that financial institutions make to their business customers, in the services that final (personal) consumers pay and it might lead to lower wages for their employees or lower profits for the bank itself (and therefore for its capital owners). The actual tax incidence of the unrecoverable VAT has to be analysed empirically.

If the tax would be fully embedded in the charges that banks make to their business customers, the VAT will be carried through to final prices for domestic consumption, resulting in a "tax on tax" that (very likely) will be paid by final consumers. As most financial services are business-to-business, it seems likely that this will be the case, at least to some extent. To correct for this cascading effect would mean either "zero-rating" business-to-business financial transactions or charging VAT (assuming that the base is readily determined) and allowing input tax credit in the normal way. This might be a significant cost in terms of revenue foregone, especially in countries with major financial service sectors. However, this reform could be qualified as being good tax policy as it would reduce the tax-induced distortions and would bring the VAT closer to a "pure" tax on final consumption.

A similar conclusion holds in case the unrecoverable VAT would be (directly) borne by final consumers. Note that also in this case, including financial services in the VAT base might not strongly increase VAT revenues. It might neither lead to strong changes in the after-tax prices of financial services for personal consumers. Including financial services in the VAT base would however increase tax compliance, administration and enforcement costs. In fact, if the unrecoverable VAT is borne by the final consumers, one might argue that there is no need to bring the financial sector into the reach of the VAT because the consumers pay the tax anyway. In this case, the VAT is just prepaid by the financial sector – as banks and other financial firms do not receive input tax credits for the VAT they have paid – instead of being paid directly by final consumers. However this argument is not entirely correct because the value added created by the financial sector would not be taxed, implying that there still would be a reason to tax financial services under the VAT. Note also that not all financial services might bear the unrecoverable VAT in the same degree. It might well be the case that financial services that are offered in a highly competitive market pay less than other services. In addition to the under-taxation of financial services compared to other goods and services, not including financial services in the VAT would then also distort the consumers' choice for financial services.

Finally, if the irrecoverable VAT would lead to lower profits of the financial sector – so without affecting the prices of business and consumer services and wages – it can be

considered to be a tax on the financial sector. Given the huge losses that many of these firms have realized over the last years, it may well imply that this additional tax will be the only tax that firms in the financial sector will pay in the years to come. In that case, an increase in the statutory VAT rate could also be considered as an additional tax on the financial sector.

Note that not only the inclusion but also the exemption from VAT creates additional administration and compliance burdens. This is especially the case when input VAT has to be assigned to taxable and exempt outputs for producers selling both types of outputs, where a credit for the VAT paid on the inputs is available for the former but not for the latter transactions.

Immovable property

The VAT treatment of immovable property differs across countries. In general, construction, alteration and maintenance of immovable property are taxed under the VAT. The tax treatment of sale and rental of immovable property distinguishes between residential and non-residential property. Most countries levy VAT on sales and rental of non-residential property. In contrast, exemption and zero-rating is a common practice for sales and rental of residential property.

If the house would be considered as a consumption good, the consumption value of housing services would be yearly taxed under the VAT. The main practical problem – in addition to the strong political resistance – is the high administrative and compliance costs of obtaining a good and fair estimate of the consumption value of housing services for owner-occupied housing. Most countries do therefore not include these services in the VAT base. As a result, the residential rents are not included in the VAT base either. However, some countries such as Belgium and France levy VAT on the first sale of residential properties on the basis that the price reflects the present value of the stream of services that housing is expected to yield. In fact, this approach is also applied to other durable goods such as refrigerators or televisions. Because of the upfront taxation, the yearly consumption services should not be included in the tax base. The sale/purchase of the property does not lead to new value added and should therefore not be taxed in the VAT base either. Also residential rents should then not be included in the VAT base as the VAT has been prepaid and the rents reflect these total costs (implying that the rents implicitly include a part of the VAT that has been paid on the original construction price of the property).

The main problems regarding the introduction of a VAT levied on the construction price of new property relate to the increase in the price of newly constructed buildings. As no VAT is and has been levied on existing buildings, the price of these buildings would then be lower than the price of newly constructed buildings merely because of the different VAT treatment. The resulting increased demand for this existing property would then lead to price increases and therefore windfall gains for existing property owners. Moreover, households that enter the housing market would have to pay VAT on household services in contrast to households that entered the market before the VAT was levied on the construction price. This would clearly undermine the equity of the tax system. A partial solution to this market distortion would be to tax the VAT on all property when it comes on the market (but to tax it only once). This, in turn, would then imply that the tax system will discourage people to sell and purchase a new property which is, for instance, situated closer to their workplace or is more convenient given their family situation (more children, etc.). This is because a change in the residence implies that consumption taxes on housing

services would have to be paid (up-front) from that moment onwards. This distortion would be avoided if housing consumption services would be taxed on a yearly basis for the properties for which no VAT has been paid yet. This, however, would require that government has to determine the consumption value of housing services for many buildings. As this value is (possibly) linked to the market value of the property, levying the VAT on housing services might be possible if government would have these values at its disposal. This, however, seems more likely if government considers the real property as an investment good rather than as a consumption good. The valuation of all property would be a very expensive operation, especially because these values would no longer be used to calculate the yearly consumption value of housing services once the property would have been sold (and VAT would have been levied up-front).

Note that if the house is treated as a consumption good, there is no strong rationale for the deduction of mortgage interest payments from the personal income tax base, which might be considered when countries aim at broadening the personal income tax base. This is especially the case if no similar tax subsidy is given for the consumption of other durable goods. It however also implies that there is no rationale for levying income taxes, recurrent taxes on immovable property or a transaction tax when the property is bought, perhaps with the exception of the value of the land on which the house is build. The land value might then be taxed under a property tax or, if the value of the land and the house cannot easily be separated, a certain percentage of the total value of the property could be taxed with a recurrent tax on real property.

VAT base broadening and "double growth dividends"

In summary, broadening VAT bases by bringing exempt activities into VAT and by increasing zero and reduced rates would be an attractive option except in a number of specific cases. However, the present rate structure reflects perceptions about fairness and strongly entrenched views about "merit goods", although many countries have zero or reduced rates that are more difficult to justify. VAT base broadening might therefore have to be accompanied with other reforms that offset the distributional impact of the VAT reforms. For instance, VAT base broadening measures that go along with the introduction or extension of current make-work-pay policies that stimulate labour participation might then lead, if these policies are designed efficiently, to a double growth dividend.

5.3. Recurrent taxes on immovable property

Before discussing some of the strategies that might overcome the obstacles to an increase in recurrent taxes on immovable property, this section starts by pointing out that recurrent taxes on immovable property are only part of a second-best solution. A growth-oriented tax reform would increase taxes on immovable property, especially because houses are currently taxed at lower effective rates than other investment opportunities. This however not necessarily implies that countries have to levy recurrent taxes on immovable property, as will be discussed below.

Residential property can be considered not only as a consumption good, as discussed above, but also as an investment good for which services flow to the homeowner in the form of actual rental payments or imputed income in the case of owner-occupied housing. In this last case, the net imputed return on housing will have to be included in the tax base. The net imputed return is defined as the imputed rent, which could be calculated by imputing a return on the value of the property or by using the rental payments that would have to be

paid if a similar property would be rented on the market, net of depreciation allowances and mortgage interest payments. Ideally, the distortion between housing and other investments should be removed by taxing housing income in the same way as other capital income. An efficient tax system would therefore equalize the overall tax burden on (either debt or equity-financed) investment in housing and other investment opportunities (taking into account the tax burden at the corporate and personal level). This implies that the imputed income, net of depreciation allowances and mortgage interest payments, has to be taxed under the (progressive) personal income tax or the capital income tax that is levied at the personal level (for instance in case of dual income tax systems). Capital gains and losses would then respectively be taxed or deductible in case the country would also levy a capital gains tax that provides a full loss offset on other investments. Note also that countries might consider ring-fencing rules to limit the deduction of mortgage interest payments such that they can only be off-set against income from the corresponding real property.

Note that the up-front taxation with VAT of the building and renovation costs is not necessarily against the investment good perspective. The return on all other investment goods is usually taxed first at the corporate and personal level and afterwards with the VAT when this return is consumed. In case of housing, the VAT is taxed up-front and the return on investment is taxed afterwards.

In most countries, owner-occupied housing receives a favourable tax treatment compared to other forms of investment. Many countries do not tax the imputed rental income because of problems to measure it accurately while countries that do often underestimate the rental value or only tax it partially. Capital gains are often tax-exempt as well but mortgage interest payments are often deductible from personal income at high rates. In such circumstances, the denial of mortgage interest relief and the use of property taxes – instead of taxing the imputed return under the (personal or capital) income tax – can provide a "second best" approach (Heady *et al.*, 2009).

Note that governments might levy recurrent taxes on immovable property at mildly progressive rates. Progressivity can also be achieved by having a basic tax-free allowance corresponding to the basic-shelter quality of the owner-occupied house. A lot of progressivity can be created by having a basic tax-free allowance, as was demonstrated in OECD (2006b) for the flat personal income tax. This allowance could be made dependent on particular family characteristics as the number of dependents or children that live in the owner-occupied house. Moreover, it is the overall progressivity of the tax system that matters and not the progressivity of each individual tax.

Messere (1993) points out that, when the amount of the property tax payable for a year exceeds a stated percentage of an owner-occupier's income, then in some countries legislation or administrative discretion enables local authorities to waive or rebate part of the excess. Higher levels of government usually reimburse local governments for lost revenue. Messere points out that this measure may be available to all who meet a well-defined income requirement or only to those above a certain age or having a certain family status in addition to meeting the specific income requirement.

Instead of waving the property tax, countries might also implement systems that defer the payment of the tax. Messere (1993) notes that such systems may also be used as a means of providing personalised taxpayer relief. The unpaid tax liability may remain a lien on the property – the deferred taxes might also increase with an appropriate interest rate – and may not be allowed to exceed more than a certain percentage of the capital value

of the property after deducting existing mortgage loans secured by the property. Deferred payment may be available only to those who qualify on the basis of low income, age, or some other financial disability (Messere, 1993).

Perhaps governments could also consider making recurrent taxes on property dependent on the energy-efficiency of the real property. In that case, the tax-free basic allowance might have to be designed such that the poorer households who likely live in houses that are less insulated do not pay a too high share of the tax. The combination of energy-dependent recurrent taxes on immovable property with housing renovation premiums or tax credits might then be considered.

Finally, note also that especially developing economies might not want to levy recurrent taxes on immovable property – or any other tax on real property – in case of an under-supply of houses with an appropriate quality. Providing a tax-favoured treatment for investment in real property will then reduce the property price, it will stimulate investment and solve the under-supply and might make the price of real property affordable for many households.

Valuation of real property values

A proper valuation of real properties is crucial in developing a fair and efficient property tax system. However, many OECD countries use out-dated property values because they do not regularly revalue the real property in their country. There are however exceptions as, for instance, is the case in the Netherlands and Denmark. One of the main reasons is that the revaluation of real property is very costly in terms of administrative resources and tax compliance costs. Moreover, once the values are no longer accurate and underestimate the real market value, the political costs of revaluation become very high, therefore possibly leading to even less accurate values over time. The market value of real property is not following a stable trend over time, as the recent housing bubble and corresponding collapse in prices have demonstrated in many countries. This creates an additional difficulty in using the market value of real property as a taxable base. Alternatively, the tax administration could use its own set of property valuation rules that is not directly (or only partly) linked to the market value. Moreover, government might decide to tax only a certain percentage of the official property value; also this strategy will reduce the number of taxpayer appeals.

Possible strategies that might help minimizing the valuation costs are: 1) value the property on the basis of a number of key characteristics. A very detailed evaluation will take very long, lead to a very large amount of tax payer appeals and will not significantly increase tax revenues; 2) create a real property valuation department that acquires expertise and is able to perform the tasks at minimum costs; 3) use the value of the property for different tax purposes, including tax compliance (one might expect that taxpayers that earn very little taxable are not able to acquire expensive real property; in case they do, a tax audit seems appropriate), and in different tax bases (recurrent taxes on immovable property, income tax, transaction tax, inheritance tax, etc.). Government might even decide to sell the property values to external parties as, for instance, insurance companies.

5.4. Corporate income tax reform strategies

Corporate income tax rate reductions and CIT base broadening are growth-oriented tax reform strategies, as discussed in Chapter 1. Corporate tax base broadening measures have been successful in financing the corporate tax rate reductions in the past to a large

extent, especially through reductions in the generosity of tax depreciation allowances. However, continuing this base broadening strategy seems not to be possible without having to lower the tax depreciation rates below the economic depreciation of the assets in many countries, which would be inefficient. Other CIT base broadening measures might however be implemented.

First, countries might gradually shift part of the tax burden from the corporate to the personal bondholder and shareholder level. This process might be strengthened by the recent process of increased exchange of information which tackles international tax evasion.

Second, the OECD's tax and growth empirical study (see Annex B) showed that the reduced CIT rate targeted at SMEs is not very effective in creating growth. This result then implies that abolishing the reduced CIT rate for SMEs while using the revenue to lower the statutory CIT rate will very likely increase economic growth. Increasing the reduced CIT rate for SMEs might however be difficult to implement from a political economy perspective.

Third, limiting the interest deductibility is a strategy that might be considered in order to broaden the CIT base. Entirely abolishing the interest payment deductibility seems not to be good tax policy as it will entail such large transitionary costs which will outweigh the future efficiency gains of such a fundamental tax reform. Also moving towards a Comprehensive Business Income tax (CBIT) – allowing for CBIT entities and non-CBIT entities – seems a strategy that can only be implemented on a world-wide basis. However, countries could limit the deduction of interest on debt to finance participations, especially if the return on these participations will not lead to taxable income in the country that provides the interest deductibility. Moreover, countries could limit the interest deductibility by linking the deductibility to the level of profits as recently implemented in Germany and Italy. Note that these kind of interest deductions are not only a response to domestic distortions but could also be seen as a response to international tax trends, as for instance the plans that are studied in the Netherlands to introduce a mandatory group interest box (see below).

As of 1 January 2008, both Italy and Germany continue to allow full interest deductibility from received taxable interest payments. However, any excess interest payments is deductible up to a maximum of 30 per cent of gross operating income, which are the earnings out of the core business of the company before deduction of interest, taxes, depreciation and amortization (EBITDA). Any excess interest payments that cannot be deducted may be carried forward indefinitely. In Germany, this interest barrier is only applicable to companies belonging to a group of related companies[3] while in Italy the interest limitation applies to all companies including holding companies, but not banks, insurance and finance companies.

The economic impact of limiting interest payments depending on the profitability of the firm implies that the debt/equity ratio of firms is decreasing in the interest rate that has to be paid on debt and is increasing in the profitability of the firm, implying that very profitable firms will continue to find it attractive to finance a large part of their investment with debt. In the absence of economic rents – implying that the average return on all investment equals the interest rate – the debt/equity ratio will be 3/7. It also implies that in economic downturns, firms that face a strong decrease in profits can deduct less interest payments from taxable corporate profits. Linking the interest deductibility to the firm's profits might also create a competitive disadvantage for start-ups.

However, countries are not only implementing base broadening measures but CIT base narrowing tax reforms can be observed as well, as for instance the implementation of R&D tax credits. The tax and growth empirical study (see Annex B) concluded that R&D tax provisions are good for economic growth, although their effects appear relatively small outside R&D intensive industries. The positive effect of R&D tax credits obviously nuances the CIT base broadening recommendations discussed in this report. Recent OECD work (Palazzi, 2010) however argues that R&D tax credits provide incentives for the creation of intangibles without ensuring that this newly created intellectual property (IP) will actually be adopted to its full potential and without ensuring that the new IP increases taxable income within the same country, for instance because multinationals find ways to locate their IP in a low-tax country. Firms might also try to re-qualify ordinary costs as R&D costs in order to benefit from the R&D tax provisions. There are also high tax administration costs of implementing and monitoring the proper use of the R&D tax provisions and high compliance costs for businesses. Moreover, they are often targeted at the manufacturing sector and not at the increasingly important service sectors. Moreover, if tax provisions that attract R&D activities of multinationals in one country are matched by similar benefits offered by other countries, the overall loss in tax revenue may exceed the benefits to be obtained locally from R&D externalities or knowledge spillovers. The question then rises whether R&D tax credits are actually more "pro-growth" than a statutory CIT rate reduction? The use of R&D tax credit allocation rules might link the provision of R&D tax credits with the actual increase in taxable profits as a result of the provided tax incentives to undertake R&D activities; the implementation of R&D tax credit allocation rules would then imply a broadening of the CIT base.

Some countries like Belgium, Ireland and the Netherlands tax royalty income at a reduced rate instead of providing very generous R&D tax credits (see also Palazzi, 2010). Belgium exempts 80 per cent of royalty income from corporate taxes, thereby reducing the effective tax rate on royalty income from the statutory CIT rate of 33.99 per cent to 6.8 per cent. The Netherlands taxes royalties and the profits realized when patents are sold at a reduced 10 per cent CIT rate in the patent box. Moreover, the profits earned by using the patent are also included in the patent box if the patent contributes at least 30 per cent to the creation of these profits. Ireland exempts the patent income from CIT if the research has been carried out in the EU, limited to EUR 5 million per year.

The actual impact of reduced CIT rates on royalty income on economic growth has not yet been assessed. There are however some strong arguments that a reduced CIT rate on IP income might increase economic growth (above the impact of a general CIT rate reduction) by stimulating the adoption of IP into newly developed products and services that are sold on the market and at the same time providing incentives to create new IP. It is for instance often argued that countries should not only be concerned of where MNEs carry out their research and development, but also whether MNEs use the new IP in the production of goods and services within that country. Both stages of the innovation process (research and development activities and the following adoption/incorporation of the R&D output in the production) lead to an increase in investment and economic growth. The research and development phase may attract high skilled workers and investment in physical capital while the adoption of the intangible into the production process increases employment and induces the creation of other surrounding economic activities that will have a positive impact on economic growth.

Providing a reduced CIT rate on IP income (royalties or remuneration embedded in the sales of patented products/services) would then nuance the base broadening recommendations of the tax and growth report as this provision effectively narrows the statutory CIT base. However, one might also argue that these CIT rate reductions are implemented for tax competitiveness reasons and are mainly implemented in order to attract IP holding companies. Reduced CIT rates on IP income will then not necessarily lead to an increase in total R&D and IP across countries but would, instead of leading to more overall economic growth, attract only other country's taxable base.

The broad base and low CIT rate recommendation might also have to be nuanced when focusing on the allowance for corporate equity tax system, as implemented in Belgium. The allowance for corporate equity provides a deductible allowance for corporate equity in computing taxable profits. This allowance equals the product of shareholders' funds, which generally equals the company's total equity capital including taxable profits net of corporate tax and other reserves and an appropriate interest rate. Belgium also does not provide the ACE on assets that do not generate a return that is fully or largely taxed in Belgium as, for instance, shares that belong to a participation and jewellery. The allowance therefore approximates the corporation's normal profits. The corporate tax is thus confined to economic rents because corporate profits in excess of the ACE remain subject to corporate tax.

The ACE is considered to be very favourable as it exempts the normal return on investment from tax at the corporate level. However, the Belgian experience shows that the revenue costs can be quite large, also because of the many tax-planning opportunities that have arisen. Belgian banks, for instance, sold their shares that did not qualify for the ACE to foreign fully-owned subs as the cash that was received in return did qualify for the ACE. Tax-planning opportunities have also arisen in a pure domestic setting. Instead of borrowing directly from a bank, Belgian companies face a tax-induced incentive to have a fully-owned Belgian sub borrow (first dip). The funds are then used to buy shares of the parent which then uses these funds to finance the investment. This implies a double dip as the parent can benefit from the ACE. More work needs to be done to analyse whether the tax-planning opportunities under the ACE in Belgium arise because of the specific design characteristics of the Belgian ACE or whether the problem is more fundamentally linked with the ACE itself.

Finally, it is not entirely clear whether the mandatory group interest box proposal in the Netherlands would narrow or broaden the CIT base (and would therefore fit within the tax and growth recommendations). This box has not yet been implemented but the Netherlands obtained recently the approval of the European Commission (July 2009) for its implementation; the box is no longer considered as providing state aid. In this box, the balance between group interest received and group interest paid would be taxed at a rate of 5 per cent rather than at the statutory CIT rate of 25.5 per cent. The interest paid that exceeds the group interest received would be deductible at a rate of 5 per cent (only). A reduced 5 per cent rate would also apply to interest income from short-term deposits, which are subsequently used to acquire participations of at least 5 per cent in other companies. Firms that are externally financed still can deduct interest payments at the rate of 25.5 per cent.

The purpose of the mandatory group interest box is twofold. First it reduces the incentives for foreign parents to finance their Dutch subsidiaries excessively with debt. Second, the box is aimed to attract finance and holding companies and headquarters of

MNEs, including the headquarters of firms that previously had left the Netherlands. The proposal implies that companies that on balance use loans not externally financed face an 80 per cent interest non-deductibility. These groups face a tax-induced incentive to locate their finance company in the Netherlands, such that the interest payments that the finance company receives are also taxed at the reduced rate of 5 per cent. The interest payments that are paid from countries outside the Netherlands would however be deductible at higher rates in the source country (except in countries like Germany and Italy, depending on the profitability of these subsidiaries, as a result of their interest limit barrier). The Netherlands would therefore become an attractive location for finance companies of MNEs. Note that this proposal does not entirely solve the earnings stripping in the Netherlands as a result of excessive debt financing because firms, under the current proposals, would still be able to borrow debt from an external source, deduct the interest payments at the top statutory CIT rate and use the funds to finance domestic and foreign participations.

This scheme will broaden the CIT base in the Netherlands. The proposal reduces the tax rate on received interest payments but also reduces the rate at which interest can be deducted. Strong tax revenue gains might however be expected if the Netherlands would attract many group finance companies as a result of the reform and because Dutch subsidiaries that are financed with debt provided by the foreign parent will no longer be able to deduct the interest at the high CIT rate; the interest paid by Dutch subsidiaries to foreign parents would very likely be taxed at higher rates in the parent country's of residence. This therefore implies that the mandatory group interest box broadens the CIT base in the Netherlands but, if MNEs would relocate their finance companies, would narrow the CIT base in other countries.

5.5. Personal income tax reform strategies

Another main conclusion of the tax and growth empirical study (see Annex B) is that a reduction in the top personal income tax rate is a growth-oriented tax reform mainly because it will stimulate entrepreneurship. However, further reductions in the top PIT rate faces strong obstacles, which are even enforced because of the global economic crisis. In fact, many countries are considering increasing their top PIT rate. A second-best solution to stimulate entrepreneurship and economic growth that tackles the growth-oriented tax reform obstacles might then be the implementation of more generous loss-offset provisions. In fact, an increase in the top PIT rate that is accompanied by a full-loss offset might increase risk-taking by risk-averse entrepreneurs.

The combined personal income tax and social security burden on labour income is high in many countries. In addition to a reduction in the top PIT rates, the use of in-work tax benefits and the broadening of the PIT base, countries might also strengthen the link between social security contributions and the corresponding benefits. This could be done by making social security contributions less of a tax but more like fully requited payments. The high tax burden on labour income might then create fewer distortions if taxpayers understand that social security contributions are a kind of compulsory savings which entitles the beneficiaries to a fair return on the savings made.

Taxpayers at lower income levels face high marginal personal income tax rates in many countries, thereby reducing incentives to participate in the labour market, to follow training and to look for better paid jobs. Governments also face pressures to reduce the tax

burden on high-skilled and high-income taxpayers which are increasingly becoming mobile, thereby reducing the innovative capacities of the country and putting tax revenues further under pressure. Both problems at the low-end and the top-end of the income distribution might be tackled by reducing the total tax burden on labour income at all income levels instead of introducing more targeted tax relief measures. An overall rate reduction might be financed by personal income tax base broadening measures – for more information on provisions for retirement savings, for instance, see OECD, 2010b – especially because in many countries PIT (as well as VAT) base broadening measures have not been part of the tax policy agenda.

Notes

1. Richard Musgrave's concept of "merit goods" refers to goods which are judged that an individual or society should have on the basis of some concept of need, rather than ability and willingness to pay.
2. Note that the automatic indexing of excise duties will increase indirect tax revenues without government having to raise the tax rates.
3. In Germany, the interest barrier does not apply if the debt/equity ratio of the company is not higher than the debt/equity ratio for the group. However, regardless of this escape clause, the interest barrier does apply if more than 10 per cent of the interest expenses are on related-party debts.

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