Tax Policy Reform and Economic Growth
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PART III

Chapter 6

Taxation, Economic Growth and Sustainable Tax Revenues

The tax and growth recommendations as well as the strategies to overcome the growth-oriented tax reform obstacles are of special interest because of the global financial and economic crisis. On the one hand, it is sometimes argued that the crisis might facilitate tax reform. The political economy obstacles against fundamental tax reform might be easier to overcome during a crisis, especially because of the increased pressure to raise more tax revenue in order to restore public finances and because of the pressing need to tackle the economic problems and to put the economy back on a high-growth path.

Olofsgard (2003) argues that a crisis might make the implementation of tax reform more likely because it undermines the power of vested interest groups and it might imply that opponents of reform may change their perspective because they start to gain of reform as well. He argues that a crisis might create a sense of urgency which creates a "window of opportunity" for reform which otherwise would have been blocked. Harberger (1993) argues that a severe crisis may be necessary in order to convince policy makers that their view of what is "good" tax policy may not be entirely correct, that there are other alternative tax systems available and that growth-oriented tax reforms are necessary. On the other hand, the crisis might make fundamental tax reform even more difficult to implement, especially because large groups of taxpayers have and will be strongly affected by the crisis.

6.1. Implemented tax reforms during and after the crisis

Many countries have implemented tax measures and reforms in order to alleviate the impact of the financial and economic crisis and subsequent sharp downturns in demand and economic activity. There are of course many country-specific differences in the tax measures that have been implemented during the crisis, but also a number of common themes, including:

- **Measures to support private sector liquidity.** One effect of the financial crisis has been a reduction in the availability of credit to businesses (as banks sought to deleverage, reduce their balance sheets and cut their risk exposure). A number of countries have sought to alleviate cash flow/liquidity of business by giving them longer to pay over tax, paying refunds more quickly, allowing greater carry back of losses, etc. Such effects should have just a "one-off" effect on the public finances.
- **Temporary measures to stimulate spending.** Outlays on capital goods and consumer durables fell most sharply in the downturn of 2008 Q4 and 2009 Q1. Many countries have introduced temporary accelerated tax depreciation provisions for capital investment, reliefs for housing investment, cuts in VAT, schemes to boost purchases of new cars, etc. If these measures really are temporary their effects on tax receipts should (broadly speaking) be reversed when they end.
- **Cuts in personal income tax.** Many countries have cut personal income tax by more than they would otherwise have done to stimulate household spending. Many countries have increased personal allowances in real terms and some have made cuts in rates,

particularly countries that were developing/implementing personal income tax reforms before the crisis broke. Many countries have also increased support for children and poorer families.

- **Cuts in tax on capital/business income.** Countries that already had plans to cut their main rate of corporation tax have implemented such changes. Other measures have tended to focus on lowering the tax burden on SMEs and increasing the tax credits available for R&D.
- **Other reforms.** A few countries have made cuts in social security contributions, especially for younger and older workers.

Some of these measures have been in line, while others have gone against the tax and growth recommendations. The latter may not be particularly significant, given that the main aim of these tax measures was to boost aggregate demand. The main determinants of choice of measures were thus short-term economic impact and how easy measures would be to reverse when the stimulus was no longer needed. More recently, some countries have started to consider tax base broadening measures in order to increase tax receipts without having to increase tax rates, especially because countries are very careful not to negatively influence the first signs of recovery.

6.2. The tax and growth recommendations are unchanged

Countries have now multiple reform agenda's. Tax revenues have strongly declined, business profits and investment levels have decreased while costs of capital have increased as a result of higher risk premiums despite the current low interest rates, innovation activities have decreased and unemployment rates continue to increase. Confidence is only slowly returning to normal levels and the financial sector is not yet entirely stabilized. At the same time, problems of ageing societies are becoming more pressing and environmental measures are urgently needed.

The question then rises whether the tax and growth recommendations, which have been derived from analysing OECD economies before the crisis, are still valid and whether the tax and growth recommendations offer a direction that policy makers could follow in order to strengthen their economies. This section will argue that this is indeed the case. In fact, the discussion will demonstrate that the tax and growth recommendations are even more valid than before the tax reform, although in the short run, implementing some of the measures might be counterproductive.

First, countries have a genuine interest in stimulating economic growth in order to increase tax revenues, to reduce their deficits and to ensure their debt levels are sustainable. Clearly, the higher is the growth rate relative to the effective interest rate on government debt, the easier it will be to bring debt ratios under control again (as the size of the required primary budget surplus is smaller).

The crisis has weakened the credit-driven economic growth which many countries experienced before the crisis. The higher capital requirements of banks and other financial institutions imply that it will be very unlikely that the same borrowing patterns will be observed again in the near future, either because less credit will be available or higher interest rates will be asked. However, these high levels of borrowing, both by businesses and households, have led to high growth rates in the past. Moreover, many financial institutions, businesses and households are still deleveraging. Economic growth might therefore have to come from increased business investment, innovation and entrepreneurship, which can be

best supported by lowering the top PIT rate and especially the CIT rate. This strengthens the arguments for implementing the tax and growth recommendations, as these recommendations have been a source of growth in the past.

Countries are facing high unemployment rates which continue to increase. Tax policies will therefore have to be redesigned in order to have more labour intensive growth. This clearly implies a shift away from direct taxation by lowering PIT rates and social security contributions, as recommended by this report.

The implementation of the tax and growth recommendations is also desirable because it will help put countries on a higher long-run growth path. This is necessary as the growth potential has been affected by the crisis – for instance because many innovative firms went bankrupt because of a lack of venture capital, implying that the crisis has not only a short-run impact but also a medium and long-run impact.

The tax and growth empirical work (see Annex B) did not strongly emphasise the role of environmental taxes. Given the objectives to improve the environment, governments might consider increasing environmental taxes – which could also be considered to be an increase in the indirect tax burden, especially because environmental taxes are not (necessarily) bad for growth. This is especially the case if they are designed such that they provide a green growth stimulus while they increase taxes on environmentally bad goods.

The tax and growth study focused on a revenue neutral world, while countries now need more tax revenues. This observation, however, does not undermine the tax and growth recommendations but strengthens the role for these recommendations that were tax revenue raisers as, for instance, the base broadening measures. Corporate income tax rate reductions might be considered in order to increase investment levels and stimulate innovation but broadening the CIT base is important as well.

However, in the short run, the crisis seems to have created new obstacles that might imply that the immediate implementation of some of the recommendations is hampered. The increase in recurrent taxes on immovable property at a time when house prices have decreased a lot must be handled carefully, especially because it will put house prices further under pressure, thereby possibly triggering further economic problems. The same argument holds for increases in VAT rates, which might reduce consumption, and an increase in the reduced CIT rate for SMEs as many of them might be credit constrained.

This however does not imply that governments should not start preparing the implementation of the tax and growth recommendations that are difficult to implement in the short run, especially because some of the reforms seem to require preparatory time before they can be implemented. In order to increase recurrent taxes on immovable property in an equitable way, for instance, governments need to set up a proper system for the valuation of real property. A broadening of the VAT base by abolishing many of the VAT exemptions and reduced rates requires that the distributional impact of such a reform is determined; this allows governments to consider accompanying measures that could compensate the losers of the reform such as low-income workers and pensioners.

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