Trends in global Tax Reform

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I. Introduction

Taxes are the core source of state financing. They are an inevitable means to enable governments to meet the commitments for which they were elected. At least to some extent, the tax burden must reflect the scope and quality of functions the given state performs, although this is not a rule in practice.[1]

There is no doubt that the right to decide on the tax legislation is an essential feature of a state's sovereignty. The globalization and boom in international trade, however, have meant a turnabout in the tax policy of the majority of economies worldwide. Their tax systems step by step have become exposed to events happening across the border and consequently, their tax sovereignty has become constrained. The spread of information technologies and unprecedented dynamics in information flows have made the national tax systems subject to international comparison. Since taxation is one of the determinative factors for the attraction of Foreign Direct Investment (FDI) it became a popular competition tool for the national economy. At the same time, national tax systems have become more vulnerable to changes in tax legislations abroad and national policymakers were forced to react swiftly on possible spill-overs.

Gradually, the above-mentioned interconnectedness of the economy has resulted in a serious challenge for governments. Ideally, taxes have to be designed in a way that they do not distort decisions of the economic operators. Indeed, this is not only the goal in a purely domestic situation, but also with respect to the taxpayer's cross-border activity. However, what one can observe in practice are tax benefits from mismatches of the tax systems being the only driver for the businesses to invest abroad. Simultaneously, the correlation between an increase in FDI and tax revenues has vanished. Current businesses are built on intangibles and knowledge. As a result, it is not only FDI but the tax base which is currently being lured by the jurisdictions.[2] Such a tax environment nourishes the perception of tax injustice among taxpayers and undermines their trust in the government.

In the light of the global financial crisis and the consequent slump in tax revenues, the effectiveness of tax policy has become even more pressing. This paper sets out to provide an overview of those actions which have already been imprinted in the tax systems of jurisdictions worldwide. The second section deals with the major trends in national tax reforms which were undertaken more or less unilaterally or with limited international cooperation. Subsequently, the third section depicts the most recent trends on the international level which require an internationally coordinated approach.

1 See Chapter: Taxation, State Building and Governance in Developing Countries.

2 Stephen Matthews, What is a "Competitive" Tax System?, Taxation Working Papers, No. 2 (OECD, 2011), p. 7 p. 7.

II. Taxation Trends on the National Level

A. Low Rate – Broad Base Policy

It is generally accepted that elimination of exemptions and preferential regimes makes the tax system simpler, easier to comply with and thus reduces costs for both tax administration and taxpayers. A broad-base approach is considered to enhance market efficiency by avoiding distortion of economic decisions.[3] Not only does it lure taxpayers away from undesirable tax planning, but by increasing the equity among them it may even stimulate their willingness to comply. This is true across the entire spectrum of taxes.

From a long-term perspective, the most evident shift towards a low rate – broad base policy has taken place in the field of corporate taxation. In the last three decades the average OECD corporate tax rate fell by more than 20%.[4] This cut was compensated, for instance, by reductions in depreciation allowances or elimination of preferential regimes,[5] which allowed the ratio of revenues from corporate income tax to GDP maintain its upward tendency.

However, the above trend was more visible in the advanced economies. In contrast, some developing countries, especially in Africa, reported lowering their tax rates accompanied by narrowing the tax base, thus leading to effective rates approaching nil. This was due to the introduction of special tax regimes such as tax holidays or special zones targeted at FDI inflow.[6]

Especially as a response to the economic crisis, broadening the tax base with a simultaneous lowering of the tax rate was widely recommended as an effective growth-oriented way of raising revenues in all fields of taxation.[7] Countries, particularly in Europe, were alarmed by the sharp decline of business investment. This triggered further cuts of corporate income tax rates (the OECD average rate declined by 1.5% in the period 2007-2013)[8], but also led to targeted measures to boost the economy, especially for research and development. For instance, in 2012 and 2013, one third of the EU Member States simplified or enlarged the scope of their R&D tax schemes.[9]

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3 Stephen Matthews, What is a "Competitive" Tax System?, OECD Taxation Working Paper No. 2 (OECD, 2011), p. 5.

4 OECD, Choosing a Broad Base – Low Rate Approach to Taxation, OECD Tax Policy Studies No. 19 (OECD, 2010), p. 66.

5 Bert Brys, Stephen Matthews, Jeffrey Owens, Tax Reform Trends in OECD Countries, OECD Taxation Working Paper No. 1 (OECD, 2011), p. 9.

6 IMF, A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies, Working Paper WP/12/28 (IMF, 2012), p. 8.

7 See for instance OECD, Tax Policy Reform and Economic Growth, OECD Tax Policy Studies No. 20 (OECD, 2010), p. 84, or European Commission, Communication from the Commission, Annual Growth Survey 2012, COM(2011) 815 final, p. 5.

8 Pierre LeBlanc, Stephen Matthews, Kirsti Mellbye, The Tax Policy Landscape Five Years after the Crisis, OECD Taxation Working Paper No. 17 (OECD, 2013), p. 24.

9 European Commission, Recent Reforms of Tax Systems in the EU: Good and Bad News, Working paper N. 39 (Luxembourg: Office for Official Publications of the European Communities, 2013), p. 19.

However, only a little progress was made in broadening the tax base in the recent years. Within the EU, the few implemented measures mainly focused on a limitation of loss relief and interest deductibility.[10] Actually, comparing the composition of their corporate tax base today and two decades ago, the most developed countries might have already reached the point when further broadening of the base is hard to achieve.[11] Consequently, as part of their fiscal consolidation efforts, they at least became much more prudent in narrowing their tax base by conducting a prior in-depth analysis of each new tax expenditure.[12]

B. Shift towards Consumption Taxation

In the last three decades, there has been a global move towards introduction of consumption taxation. In 2012, more than 150 countries worldwide had some kind of value added tax.[13] This figure also includes China, which launched a pilot project beginning 2012 meant to replace business tax by VAT and extended this project nationwide in 2013.[14] Focused on the developed countries, the US remained the last OECD country still hesitating to employ this source of revenue, although it has already been under recurrent debate for some decades.[15] In the period from 1985 to 2009, the share of VAT on global tax revenues rose from 11% to 19%, making this tax on average the third most important source of tax revenue, just after social security contributions and personal income tax.[16]

This trend is characteristic for both the developed as well as less developed part of the world. In the sub-Saharan region, for instance, around 80% of the countries implemented a kind of VAT and benefited from an increase of tax revenues by one third. Obviously, this policy shift was driven by the high capacity of con-

10 European Commission, Tax Reforms of EU Member States 2013, Working paper N. 38 (Luxembourg: Office for Official Publications of the European Communities, 2013), p. 22.

11 The Australian Government the Treasury, Risks to the Sustainability of Australia's Corporate Tax Base, Scoping Paper (Commonwealth of Australia 2013), p. 11, visited on 20 February 2014, available at http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability.

12 E.g. decision framework and sunset clause for new provisions on tax expenditure in the Netherlands, see European Commission, Recent Reforms of Tax Systems in the EU: Good and Bad News, Working paper N. 39 (Luxembourg: Office for Official Publications of the European Communities, 2013), p. 17.

13 OECD, Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues (OECD, 2012), p. 11.

14 China to Expand VAT Reform Nationwide Starting August 1, 2013, China Briefing, posted on 11 April 2013, visited on 22 February 2014, available at http://www.china-briefing.com/news/2013/04/11/china-to-expand-vat-reform-nationwide-starting-august-1-2013.html.

15 Kathryn James, An Examination of Convergence and Resistance in Global Tax Reform Trends, Research Paper No 2010/59 of Faculty of Law, Monash University, 2010, p. 483, visited on 22 February 2014, available at http://ssrn.com/abstract=1960272.

16 OECD, Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues (OECD, 2012), p. 44.

sumption taxes to raise tax revenues. Apart from that, similarly to property taxes as discussed further on, their advantage lies in targeting a less-mobile tax base and thus leaving no or little room for cross-border tax planning. When disregarding the broadly used reduced rates and exemptions, VAT also seems to be neutral to economic decisions of both households and businesses.[17] Last but not least, less developed countries were further driven by the belief that the adoption of a VAT system based on self-assessment may in parallel enhance tax compliance of taxpayers in the area of direct taxation.[18]

According to a wide spectrum of tax analysts, unlike income taxes consumption taxes are considered to have a pro-growth effect, especially when designed in a broad-base manner. In spite of particularly strong economic arguments for the unification of tax rates and minimization of exemptions[19], there has only been a little evidence of this approach in practice. Some states indeed managed to extend the scope of the standard rate; the long-term increase in VAT revenues was, however, achieved by higher tax rates.[20]

Bearing the above in mind, VAT was a key instrument when countries restructured their tax mix in the framework of the fiscal consolidation after the global financial crisis. In the period 2007 to 2013, the average standard rate in the OECD countries was raised by 1.1%,[21] and in the EU by almost 2%.[22] In this regard, it was repeatedly recommended by the European Commission to EU Member States that the additional tax revenue be used for easing labor taxation.[23] As follows from one of its surveys, a shift from social security contributions towards VAT might in particular be effective in decreasing the youth unemployment[24] which in 2013 reached 24% in the EU[25].

17 OECD, Tax Policy Reform and Economic Growth, OECD Tax Policy Studies No. 20 (OECD, 2010), p. 22.
18 IMF, Taxation and Development – Again, Working Paper WP/12/220 (IMF, 2012), p. 11.
19 OECD, Choosing a Broad Base – Low Rate Approach to Taxation, OECD Tax Policy Studies No. 19 (OECD, 2010), pp. 15-19.
20 Pierre LeBlanc, Stephen Matthews, Kirsti Mellbye, The Tax Policy Landscape Five Years after the Crisis, OECD Taxation Working Paper No. 17 (OECD, 2013), p. 30.
21 Pierre LeBlanc, Stephen Matthews, Kirsti Mellbye, The Tax Policy Landscape Five Years after the Crisis, OECD Taxation Working Paper No. 17 (OECD, 2013), pp. 30-31.
22 European Commission, Recent Reforms of Tax Systems in the EU: Good and Bad News, Working paper N. 39 (Luxembourg: Office for Official Publications of the European Communities, 2013), p. 7.
23 European Commission, Communication from the Commission: Annual Growth Survey 2013, COM(2012) 750 final, p. 5 and European Commission, Communication from the Commission, Annual Growth Survey 2012, COM(2011) 815 final, p. 5.
24 European Commission, Tax Reforms of EU Member States 2013, Working paper N. 38 (Luxembourg: Office for Official Publications of the European Communities 2013), p. 108.
25 European Commission, Employment and Social Developments in Europe 2013 (European Union, 2014), p. 45.

C. Addressing Social Policy Concerns by Personal Income Tax

As follows from its features, VAT can hardly take account of the personal circumstances of the taxpayer. A shift towards consumption taxation might thus make the already worrisome pre-tax income inequality even more serious.[26] Consequently, a number of developed countries combined increases in consumption taxes with a simultaneous reduction of tax wedge, predominantly targeting at low-income earners.[27]

Generally, the developments in the personal income taxation in the last few years suggest it is a key policy tool in the redistribution of income. Its design (along with social security contributions) significantly affects willingness of the unemployed population to work as well as decisions of the employed labor force on further education or increased activity. It also influences the occurrence of informal employment and tax evasion by high-income individuals. Looking back at the post-crisis years, developed countries mainly targeted the alarming upward trend in unemployment, increased inequality in society and the imprudent incentivizing of debt-financed housing. Chapter

chapter Firstly, the attention of policymakers was driven towards make-work-pay measures. This was due to the sharp turnaround of 2008 in the preceding trend of declining unemployment. In the EU, for instance, the unemployment rate increased by 3.5% until 2012.[28] In the light of the fact that the tax wedge counts for more than 50% of total tax revenues in the OECD countries,[29] a corresponding tax burden placed on labor presents a significant disincentive to work. Countries targeted mainly those groups of the population which are most responsive to tax barriers. These are predominantly second-earners in the family, older people, and low-skilled workers.[30] Their labor market participation was mostly encouraged by a reduction of the employers´ part of social security contributions, introduction of in-work credits, or enlargement of first tax rate brackets.[31]

Secondly, a number of developed or transition economies focused on mitigation of the rising social inequality.[32] For instance, the data referring to the OECD

26 OECD, Tax Policy Reform and Economic Growth, OECD Tax Policy Studies No. 20 (OECD, 2010), p. 20.
27 Thomas Alastair, Fidel Picos-Sánchez, Shifting from Social Security Contributions to Consumption Taxes: The Impact on Low-Income Earner Work Incentives, OECD Taxation Working Papers, No. 11 (OECD, 2012), p. 3.
28 Derived from the World Bank database at www.data.worldbank.org.
29 Bert Brys, Wage Income Tax Reforms and Changes in Tax Burdens: 2000-2009, OECD Taxation Working Paper No. 10 (OECD, 2011), p. 3.
30 Jeffrey Owens, 'Taxation and Employment: Current Trends and Policy Options', Bulletin for International Taxation, Volume 66, No 2 (IBFD, 2012) p. 122.
31 Pierre LeBlanc, Stephen Matthews, Kirsti Mellbye, The Tax Policy Landscape Five Years after the Crisis, OECD Taxation Working Paper No. 17 (OECD, 2013), p. 27.
32 UNCTAD, Trade and Development Report 2012(UNCTAD, 2012), p. 57.

countries suggest increases in taxation of capital income, partially balancing the long-lasting downward pressure on corporate income tax rates. Furthermore, temporary surcharges or further brackets for the highest-income earners were introduced. This reversed the pronounced trend of cutting the top statutory personal income tax rates present until the mid-2000s. Consequently, concerns emerged that these measures might dampen work effort and investments in education of those affected high-skilled individuals, and potentially lure them either to incorporate or to move abroad. A number of countries thus preferred less apparent alternatives and shifted the tax burden to high-income individuals, for instance, by ceilings on deduction of contributions to pension schemes.[33]

Last but not least, in order to stabilize the housing market, many EU Member States reduced or eliminated incentives for debt-financing of personal dwellings.[34] Empirical evidence shows that these measures often failed to boost the housing market; on the contrary, they were often reflected in increased prices. Interestingly, though intensively discussed, this incentive is still present in the United States where it has already earned the label of the "sacred cow" of the tax code.[35]

The above-listed trends also help to illustrate diversities between the developed and developing countries. Generally, the importance of personal income tax in the revenue mix of developing countries is far beyond of that of developed ones. While in the OECD countries the personal income tax amounts to almost one fourth of the overall tax revenues,[36] in the low-income developing countries it makes up only around 10%.[37] For the time being, there is not an evident converging. Developing countries still face serious challenges – redesigning towards a broad-base system covering balanced taxation of all sorts of capital income, enlarging the scope of the tax to cover small entrepreneurs and professionals as well as increasing tax compliance by strengthening the tax administration, mitigating tax evasion and combating corruption.[38] It is not a coincidence that almost the entire receipts from personal income tax in developing countries are collected in the public sector and large companies by means of withholding.[39] All in all, this source of budget revenue has not yet proved to be a success story in developing countries.

33 Pierre LeBlanc, Stephen Matthews, Kirsti Mellbye, The Tax Policy Landscape Five Years after the Crisis, OECD Taxation Working Paper No. 17 (OECD, 2013), pp. 25–29.
34 European Commission, Recent Reforms of Tax Systems in the EU: Good and Bad News, Working paper N. 39 (Luxembourg: Office for Official Publications of the European Communities, 2013), p. 25.
35 Bruce Bartlett, 'The Sacrosanct Mortgage Interest Deduction', *The New York Times*, posted on 6 August 2013, visited on 8 February 2014, available at http://economix.blogs.nytimes.com/2013/08/06/the-sacrosanct-mortgage-interest-deduction/?_php=true&_type=blogs&_r=0.
36 OECD average in 2011 according to OECD Statistics available at http://stats.oecd.org/.
37 IMF, Revenue Mobilization in Developing Countries (IMF, 2011), pp. 14 and 16.
38 IMF, Revenue Mobilization in Developing Countries (IMF, 2011), pp. 5, 10–11.
39 IMF, Revenue Mobilization in Developing Countries (IMF, 2011), p. 31.