

BACKGROUND PAPER

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Fundamental Tax Reform: The Experience of OECD Countries

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Trends in OECD Tax Systems

1 Introduction

Since the mid-1980s all OECD countries have engaged in fundamental reforms of their tax systems. These reforms have been driven by the need to provide a more competitive fiscal environment: one which encourages investment, risk-taking and entrepreneurship, and which provides increased work incentives. At the same time, governments are aware of the need to maintain taxpayers' faith in the integrity of their tax systems. Fairness and simplicity have become the bywords of reformers. Fairness requires that taxpayers in similar circumstances pay similar amounts of tax. Simplicity requires that paying your taxes becomes as painless as possible (not something easily achieved in modern societies) and that the administrative and compliance costs of collecting taxes are kept at a minimum.

Almost all the tax reforms of the last two decades can be characterized as rate reducing and base broadening reforms, following the lead given by the United Kingdom in 1984 and the United States in 1986. In the mid-1980s, most OECD countries had top marginal income tax rates in excess of 65 per cent. Today it is rare to find top rates above 50 per cent and most OECD countries find themselves around or below 40 per cent. Similarly, top statutory corporate income tax

rates were rarely less than 45 per cent, while today most are below 35 per cent and an increasing number fall below 25 per cent.

These reforms, however, did not, until recently, lead to a fall in the overall tax burden (measured by the tax-to-GDP ratio). From 1975 to 2000, most OECD countries experienced an increase in this ratio. Some, like Finland and France, saw the tax burden increase by almost a third. A small number of countries — notably the United Kingdom and the United States — experienced a stable tax burden. It does appear, however, that this long-term upward trend peaked in 2000 and the latest figures available to the OECD suggest that most countries are now below the peak 2000 level.

This paper provides a brief summary of major tax reforms, both in policy and administration, in OECD countries, with particular emphasis on changes since the year 2000. Section 2 documents the general trend of reductions in both tax revenues and rates. Section 3 examines the diversity in tax policies across OECD countries, reflecting the diversity in both economic circumstances and policy objectives. Section 4 deals with developments in tax administration. Finally, section 5 looks at some of the challenges for

The views expressed in this paper do not necessarily reflect the views of the OECD Member countries, although the reports upon which the paper is based have been approved by all 30 OECD countries. This paper has been prepared in collaboration with the Staff of the CTPA and has benefited from comments by colleagues in other parts of the OECD.

Table 1**Tax-to-GDP Ratios in the OECD-area
1975–2002**

| | 1975 | 1985 | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 |
|--------|-------|-------|-------|-------|-------|-------|-------|-------|
| US | 25.6% | 25.6% | 27.3% | 27.9% | 29.9% | 28.9% | 26.4% | 25.4% |
| OECD | 30.3 | 33.6 | 34.8 | 35.9 | 37.2 | 36.8 | 36.3 | n.a. |
| EU15 | 33.2 | 38.8 | 39.4 | 40.3 | 41.8 | 41.2 | 40.6 | n.a. |
| Japan | 20.8 | 27.4 | 30.2 | 27.8 | 27.1 | 27.4 | 25.8 | n.a. |
| Canada | 31.9 | 32.5 | 35.9 | 35.6 | 35.6 | 35.0 | 33.9 | 33.9 |

Source: OECD Revenue Statistics 1965–2003.

Table 2**Total Tax Revenue as a Percentage of GDP
Selected Years 1975–2003**

| | 1975 | 1985 | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 |
|--------------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| Canada | 31.9% | 32.5% | 35.9% | 35.6% | 35.6% | 35.0% | 33.9% | 33.9% |
| Mexico | — | 17.0 | 17.3 | 16.7 | 18.5 | 18.8 | 18.1 | 19.5 |
| United States | 25.6 | 25.6 | 27.3 | 27.9 | 29.9 | 28.9 | 26.4 | 25.4 |
| Australia | 26.5% | 29.1% | 29.3% | 29.6% | 31.8% | 30.4% | 31.5% | n.a. |
| Japan | 20.8 | 27.4 | 30.2 | 27.8 | 27.1 | 27.4 | 25.8 | n.a. |
| Korea | 14.5 | 16.0 | 18.1 | 19.4 | 23.6 | 24.1 | 24.4 | 25.5% |
| New Zealand | 28.5 | 31.3 | 37.7 | 37.0 | 33.4 | 33.3 | 34.9 | 34.8 |
| Austria | 37.4% | 41.9% | 40.4% | 41.6% | 43.4% | 45.2% | 44.0% | 43.0% |
| Belgium | 40.6 | 45.6 | 43.2 | 44.8 | 45.7 | 45.9 | 46.4 | 45.8 |
| Czech Republic | — | — | — | 39.8 | 39.0 | 38.5 | 39.3 | 39.9 |
| Denmark | 40.0 | 47.4 | 47.1 | 49.4 | 49.6 | 49.9 | 48.9 | 49.0 |
| Finland | 36.8 | 40.2 | 44.3 | 46.0 | 48.0 | 46.0 | 45.9 | 44.9 |
| France | 35.9% | 43.8% | 43.0% | 43.9% | 45.2% | 44.9% | 44.0% | 44.2% |
| Germany ¹ | 35.3 | 37.2 | 35.7 | 38.2 | 37.8 | 36.8 | 36.0 | 36.2 |
| Greece | 21.8 | 28.6 | 29.3 | 32.4 | 38.2 | 36.6 | 35.9 | n.a. |
| Hungary | — | — | — | 42.4 | 39.0 | 39.0 | 38.3 | n.a. |
| Iceland | 29.7 | 28.5 | 31.5 | 31.8 | 39.4 | 38.1 | 38.1 | 40.3 |
| Ireland | 29.1% | 35.0% | 33.5% | 32.8% | 32.2% | 30.1% | 28.4% | 30.0% |
| Italy | 26.1 | 34.4 | 38.9 | 41.2 | 43.2 | 43.0 | 42.6 | 43.4 |
| Luxembourg | 37.5 | 45.1 | 40.8 | 42.3 | 40.2 | 40.7 | 41.8 | 41.6 |
| Netherlands | 41.3 | 42.8 | 42.9 | 41.9 | 41.2 | 39.8 | 39.2 | 38.8 |
| Norway | 39.3 | 43.1 | 41.5 | 41.1 | 43.2 | 43.4 | 43.5 | 43.9 |
| Poland | — | — | — | 37.0% | 32.5% | 31.9% | 32.6% | n.a. |
| Portugal | 20.8% | 26.6% | 29.2% | 33.6 | 36.4 | 35.6 | 33.9 | n.a. |
| Slovak Republic | — | — | — | — | 34.0 | 31.6 | 33.1 | n.a. |
| Spain | 18.8 | 27.8 | 33.2 | 32.8 | 35.2 | 35.0 | 35.6 | 35.8% |
| Sweden | 42.0 | 48.2 | 53.2 | 48.5 | 53.8 | 51.9 | 50.2 | 50.8 |
| Switzerland ² | 27.0% | 25.8% | 26.0% | 27.8% | 30.5% | 30.0% | 30.3% | 29.8% |
| Turkey | 16.0 | 15.4 | 20.0 | 22.6 | 32.3 | 35.1 | 31.1 | 32.9 |
| United Kingdom | 35.3 | 37.7 | 36.5 | 35.0 | 37.4 | 37.2 | 35.8 | 35.3 |
| Unweighted average: | | | | | | | | |
| OECD Total | 30.3% | 33.6% | 34.8% | 35.9% | 37.2% | 36.8% | 36.3% | — |
| OECD America | 28.8 | 25.0 | 26.8 | 26.7 | 28.0 | 27.6 | 26.1 | 26.2% |
| OECD Pacific | 22.6 | 26.0 | 28.8 | 28.5 | 29.0 | 28.8 | 29.1 | — |
| OECD Europe | 32.1 | 36.6 | 37.4 | 38.5 | 39.9 | 39.4 | 38.9 | — |
| EU15 | 33.2 | 38.8 | 39.4 | 40.3 | 41.8 | 41.2 | 40.6 | — |

1) Unified Germany beginning in 1991. Starting in 2001, Germany has revised its treatment of non-wastable tax credits in the reporting of revenues to bring it into line with the OECD guidelines.

2) The source for the 1975 figure is Swiss authorities, due to a change in the methodology which is only implemented in OECD Revenue Statistics from 1985 onwards.

Source: Revenue Statistics 1965–2003 and Swiss authorities.

tax policymakers and administrators that are likely to arise over the next few years and sketches possible alternative approaches to solving them.

This paper draws heavily on three annual statistical outputs of the OECD's Centre for Tax Policy and Administration: the Revenue Statistics, Taxing Wages and the OECD Tax Database. It also draws on a recent OECD monograph, *Recent Tax Policy Trends and Reforms in OECD Countries*,¹ which is based on exchanges at the OECD of tax policy experiences and on *Tax Administration in OECD Countries: Comparative Information Series*.

2 The Recent Downward Trend in Tax Revenues and Rates

2.1 Tax Revenues

The evolution of tax revenue as a percentage of GDP in OECD countries since 1975 is shown in Table 1. Until 2000, there had been a persistent and largely unbroken upward trend in the ratio of tax to GDP since 1975 across most of the OECD area. However, the unweighted OECD average peaked at 37.2 per cent in 2000 and then fell to 36.8 per cent in 2001 and 36.3 per cent in 2002. No overall OECD ratio is yet available for 2003 as a number of countries still have to report, but provisional figures suggest a break in this downward trend, possibly in part reflecting stronger economic growth.

Despite this possible break in the trend, a number of countries experienced large reductions in tax-to-GDP ratios between 2000 and 2003, as illustrated in Table 2. The United States, for example, saw a reduction of 4.5 percentage points in its tax-to-GDP ratio, from 29.9 per cent to 25.4 per cent. Substantial reductions were also experienced in Finland (3.1 percentage points), Sweden (3.0 percentage points), the Netherlands (2.4 percentage points), Ireland (2.2 percentage points) and the United Kingdom (2.1 percentage points). No countries experienced increases in their tax-to-GDP ratios of more than 1.5 percentage points over the same period.

2.2 Personal and Corporate Income Tax Rates

One of the main factors behind the reductions in tax revenues since 2000 has been reductions in the rates of personal and corporate income tax. Indeed, all of the countries with falls of more than two percentage points in their tax-to-GDP ratios

1 These documents may be found at <http://www.oecd.org/publications/>.

have significantly cut income taxes, particularly personal income taxes.

Table 3 shows that the marginal statutory personal income tax rates for individuals with high wage income were eased between 2000 and 2003. The unweighted OECD-average was reduced by about 2.2 percentage points, while this rate was reduced by 2.9 percentage points in the EU15. The rates were reduced by more than 1 percentage point in 16 countries, and Sweden was the only country where this rate was slightly increased. The rate was reduced by 5 percentage points or more in Belgium, France, Greece, Luxembourg, Mexico, Netherlands and the United States.

A similar picture emerges when comparing the “all-in” effective marginal tax rates, i.e. including both income taxes and employee social security contributions and taking account of standard tax credits, tax allowances and ceilings for social security contributions. On average, the top all-in tax rates were reduced by 2.2 percentage points in OECD and by 2.3 percentage points in the EU15.

The general trend towards reduced tax rates is even more pronounced in respect of corporate income tax rates. Table 4 shows that the statutory corporate income tax rates in the OECD Member countries dropped on average by 2.8 percentage points between 2000 and 2003, from 33.6 per cent to 30.8 per cent. This trend seems to be widespread, as rates have been reduced in 18 countries and in none of the OECD countries was the rate increased. In the EU15 countries, the unweighted average corporate tax rate dropped by an average of 3.4 percentage points, from 35.1 per cent to 31.7 per cent.

The trend towards reduced rates started in the mid-1980s in most countries, and even earlier in some countries. In the late 1970s it was not uncommon to find top marginal personal income tax rates between 70 and 80 per cent, while it is now well below 50 per cent in a majority of OECD countries. Similarly, the trend towards a reduction of corporate income tax rates started when several countries introduced tax reforms with base-broadening and rate cuts following the tax reforms in the United Kingdom and the United States in the mid-1980s. The more recent cuts in corporate tax rates have been partly financed by base-broadening in many countries, although trying to attract foreign direct investment is another important reason for such rate

cuts. In the OECD area, the average corporate tax rate has dropped by almost 7 percentage points since 1997.

2.3 Taxation of Labor

The total tax wedge on labor, or the difference between what employers have to pay in wages and social security charges and what employees take home after tax and social security deductions plus

Table 3

Marginal Tax Rates for High-Income Employees^{1,2} 2000 and 2003

| | 2000 | | | 2003 | | |
|---------------------------|---------------------|-----------------------------------------------------|----------------------------------------------|---------------------|-----------------------------------------------------|----------------------------------------------|
| | All in ³ | Statutory Rate for Personal Income Tax ⁴ | Statutory Rate for Employee SSC ⁵ | All in ³ | Statutory Rate for Personal Income Tax ⁴ | Statutory Rate for Employee SSC ⁵ |
| Australia | 48.50% | 48.50% | 0.00% | 48.50% | 48.50% | 0.00% |
| Austria | 42.71 | 50.00 | 0.00 | 42.71 | 50.00 | 0.00 |
| Belgium | 65.66 | 60.50 | 13.07 | 59.58 | 53.50 | 13.07 |
| Canada | 47.86 | 47.86 | 0.00 | 46.41 | 46.41 | 0.00 |
| Czech Republic | 40.50 | 32.00 | 12.50 | 40.50 | 32.00 | 12.50 |
| Denmark | 63.33% | 59.70% | 9.00% | 62.33% | 59.70% | 8.00% |
| Finland | 59.14 | 55.17 | 7.20 | 56.71 | 53.03 | 6.30 |
| France | 48.11 | 61.25 | 0.85 | 45.34 | 56.09 | 0.85 |
| Germany | 53.80 | 53.80 | 0.00 | 51.17 | 51.17 | 0.00 |
| Greece | 45.00 | 45.00 | 0.00 | 49.54 | 40.00 | 15.90 |
| Hungary | 41.50% | 40.00% | 1.50% | 44.00% | 40.00% | 4.00% |
| Iceland | 43.07 | 45.37 | 0.00 | 37.00 | 43.55 | 0.00 |
| Ireland | 46.00 | 44.00 | 2.00 | 44.00 | 42.00 | 2.00 |
| Italy | 51.86 | 46.40 | 10.19 | 45.90 | 45.90 | 0.00 |
| Japan | 47.70 | 50.00 | 0.40 | 47.85 | 50.00 | 0.70 |
| Korea | 50.70% | 44.00% | 6.70% | 41.06% | 39.60% | 2.42% |
| Luxembourg | 47.15 | 47.15 | 0.00 | 39.95 | 38.95 | 1.00 |
| Mexico | 42.93 | 40.00 | 2.93 | 36.45 | 34.00 | 2.45 |
| Netherlands | 60.00 | 60.00 | 0.00 | 52.00 | 52.00 | 0.00 |
| New Zealand | 39.00 | 39.00 | 0.00 | 39.00 | 39.00 | 0.00 |
| Norway | 55.30% | 47.50% | 7.80% | 55.30% | 47.50% | 7.80% |
| Poland | 51.23 | 40.00 | 25.01 | 51.23 | 40.00 | 25.01 |
| Portugal | 46.60 | 40.00 | 11.00 | 46.60 | 40.00 | 11.00 |
| Slovak Republic | 49.42 | 42.00 | 12.80 | 45.94 | 38.00 | 12.80 |
| Spain | 48.00 | 48.00 | 0.00 | 45.00 | 45.00 | 0.00 |
| Sweden | 55.38% | 55.38% | 0.00% | 56.17% | 56.17% | 0.00% |
| Switzerland | 49.40 | 43.75 | 10.05 | 47.88 | 42.06 | 10.05 |
| Turkey | 40.60 | 40.60 | 0.00 | 40.60 | 40.60 | 0.00 |
| United Kingdom | 40.00 | 40.00 | 0.00 | 41.00 | 40.00 | 1.00 |
| United States | 47.96 | 46.51 | 1.45 | 42.87 | 41.42 | 1.45 |
| OECD-average ⁶ | 48.95% | 47.11% | 4.48% | 46.75% | 44.87% | 4.61% |
| EU15-average ⁶ | 51.52 | 51.09 | 3.55 | 49.20 | 48.23 | 3.94 |

1) Tax rates calculated at an income level of 10 APW earnings in 2003 and 12 APW earnings in 2000.

2) These are the rates that apply for income earned in the year in question, although the actual tax payments in certain countries are fully or partly postponed until the following year.

3) The all-in rate is calculated as the net increase in personal income tax plus employee social security contributions resulting from a marginal increase in gross wage earnings, including the effect of all tax credits and deductibility of social security contributions in personal income tax.

4) The statutory personal income tax rates includes all compulsory surcharges, and includes the effects of one income tax being deductible against other income tax rates.

5) These are the statutory employee social security contribution rates that apply to high-income earners at the margin, taking account of ceilings.

6) Unweighted averages.

Source: Taxing Wages calculations and national authorities.

2 See www.oecd.org/document/60/0,2340,en_2649_37427_1942460_119656_1_1_37427,00.html.

any cash benefits for which they may be eligible, can be a disincentive to work. Social security contributions have increased in a number of countries, but reductions in personal income taxes have meant that there has been a gradual reduction in the wedge for the average OECD country, and a faster reduction amongst the EU15 countries.

Table 5 shows that the total tax wedge (income tax plus employee and employer social security contributions) for a single worker at average earnings of a production worker has on average decreased by 0.8 percentage points since

1996. The reduction in the unweighted EU15 average and the United States during the same period was 2.4 percentage points and 1.7 percentage points respectively, while the tax wedge increased by 7.6 percentage points in Japan and remained fairly stable in Canada. Although the largest reduction was in the EU15 area, the average rate in 2003 was still 4.4 percentage points higher than the OECD average and substantially above the levels in the United States, Canada and Japan.

The trend is similar for single individuals at 67 per cent and 167 per cent of average earnings. At 67 per cent of average earnings, the tax wedge was reduced by 2.8 percentage points in the EU15 and by 2.1 percentage points in the United States. The overall average was reduced by 0.9 percentage points, while the tax wedge was reduced by 0.4 percentage points in Canada and increased by 7.7 percentage points in Japan. At 167 per cent of average earnings, the tax wedge was reduced by 2.1 percentage points in the EU15 and the United States and by 3.2 percentage points in Canada, as compared to an average reduction in the OECD of 0.4 percentage points and an increase in Japan by 8.2 percentage points. However, the tax wedge in the EU15 is still substantially higher than that in the United States, Canada and Japan at these income levels.

The tax calculations also take account of standard cash benefits and tax credits for families and for children, and will thereby pick up the effects of the increasing use of the tax system as a vehicle to deliver social benefits in many countries. Table 6 illustrates the development in the tax wedge, including income tax plus employee and employer social security contributions and less cash benefits, for a married couple with one earner at average earnings and two children. The wedge fell on average by 1.1 percentage points between 1996 and 2003, from a level of 28 per cent. Although the reduction of the unweighted EU15 average was substantially larger than that of the OECD (3.8 percentage points), the tax wedge in 2003 was still 2.6 percentage points above the OECD average. For this family type, the tax wedge was substantially reduced in the United States (by 8.4 percentage points), while it increased by 0.6 percentage points in Canada and by 8.1 percentage points in Japan.

Table 7 shows the similar development for a single parent with two children, earning 67 per cent of average earnings. The tax wedge for this family type dropped on average by 1.8 percentage points, from 19.3 per cent in 1996 to 17.5 per cent in 2003, within the OECD area. The

Table 4

**Corporate Income Tax Rates¹
2000 to 2003**

| | 2000 | 2001 | 2002 | 2003 |
|---------------------------|-------|-------|-------|-------|
| Australia | 34.0% | 30.0% | 30.0% | 30.0% |
| Austria | 34.0 | 34.0 | 34.0 | 34.0 |
| Belgium | 40.2 | 40.2 | 40.2 | 34.0 |
| Canada | 44.6 | 42.1 | 38.6 | 36.6 |
| Czech Republic | 31.0 | 31.0 | 31.0 | 31.0 |
| Denmark | 32.0% | 30.0% | 30.0% | 30.0% |
| Finland | 29.0 | 29.0 | 29.0 | 29.0 |
| France ² | 37.8 | 36.4 | 35.4 | 35.4 |
| Germany ³ | 52.0 | 38.9 | 38.9 | 40.2 |
| Greece | 40.0 | 37.5 | 35.0 | 35.0 |
| Hungary | 18.0% | 18.0% | 18.0% | 18.0% |
| Iceland | 30.0 | 30.0 | 18.0 | 18.0 |
| Ireland | 24.0 | 20.0 | 16.0 | 12.5 |
| Italy ⁴ | 37.0 | 36.0 | 36.0 | 34.0 |
| Japan | 40.9 | 40.9 | 40.9 | 40.9 |
| Korea | 30.8% | 30.8% | 29.7% | 29.7% |
| Luxembourg | 37.5 | 37.5 | 30.4 | 30.4 |
| Mexico | 35.0 | 35.0 | 35.0 | 34.0 |
| Netherlands | 35.0 | 35.0 | 34.5 | 34.5 |
| New Zealand | 33.0 | 33.0 | 33.0 | 33.0 |
| Norway | 28.0% | 28.0% | 28.0% | 28.0% |
| Poland ⁵ | 30.0 | 28.0 | 28.0 | 27.0 |
| Portugal | 35.2 | 35.2 | 33.0 | 33.0 |
| Slovak Republic | 29.0 | 29.0 | 25.0 | 25.0 |
| Spain | 35.0 | 35.0 | 35.0 | 35.0 |
| Sweden | 28.0% | 28.0% | 28.0% | 28.0% |
| Switzerland | 24.9 | 24.7 | 24.4 | 24.1 |
| Turkey | 33.0 | 33.0 | 33.0 | 33.0 |
| United Kingdom | 30.0 | 30.0 | 30.0 | 30.0 |
| United States | 39.4 | 39.3 | 39.3 | 39.4 |
| OECD-average ⁶ | 33.6% | 32.5% | 31.2% | 30.8% |
| EU15-average ⁶ | 35.1 | 33.5 | 32.4 | 31.7 |

1) Combined central and sub-central statutory tax rates. In federal countries, the sub-central rate in the most populated city is used. Where sub-central income tax is deductible against central government tax, this is reflected in the net rate.

2) Including the CSB (Contribution Sociale sur les Bénéfices), which is only payable for companies with a taxable profit of more than €2,289,000 and liable tax payments of at least €763,000. For companies that do not pay the CSB, the top rate is 1.1 percentage point lower than these rates.

3) Including the regional trade tax (Gewerbesteuer) and the surcharge.

4) This is the corporate income tax rate (IRPEG) excluding the regional tax (IRAP). The base of IRAP is broader than, but includes, corporate income. The general rate for the IRAP is 4.25 per cent, but regions may increase or decrease this rate by 1 percentage point.

5) Source: KPMG's Corporate Tax Rate Survey.

6) Unweighted average.

Source: OECD Tax Database and KPMG's Corporate Tax Rate Survey.

reduction was particularly large in the United States, where the tax wedge dropped from 11.8 to 3.4 per cent mainly due to the Earned Income Tax Credit, and in Canada where it dropped from 10.6 to 1.4 per cent. The tax wedge for this family type dropped significantly in the EU15 as well, to a level that was just above the unweighted OECD average in 2003. In Japan, the tax wedge increased by 8.2 percentage points, to a level well above the OECD average.

2.4 Taxation of Dividends

The rate of taxation on dividends has been of particular interest in recent years, given policy interest in reconsidering the relevant advantages, disadvantages and methods of integrating corporate and personal level taxation of distributed income. Table 8 reports the marginal tax rates on distributions of domestic source profits to a resident individual shareholder, taking account of the fact that profits are usually taxed both at the corporate level and again when they are distributed as dividends (although double taxation may be reduced by introducing imputation systems, tax credits or reduced tax rates on dividends). The table shows that on average, the top marginal tax rate on dividends in the OECD-countries was reduced by 3.7 percentage points between 2000 and 2003, from 50.1 per cent to 46.4 per cent. In the EU15, the unweighted average tax rate fell by 3.8 percentage points, from 51.7 per cent to 47.9 per cent. The reduction of the effective tax rate was 8 percentage points in the United States, due to the introduction of a reduced tax rate on dividends at the personal level.

The reductions in the effective tax rate on dividends reflect the reduction of corporate income tax rates, personal income tax rates on dividends or both. As discussed in Section 3.3 below, a recent trend is the move away from full imputation systems in many European countries to systems where dividends are taxed at a lower rate at the personal level. Germany introduced the so-called half-income system in 2002, whereby 50 per cent of dividends are taxed as personal income. Several other countries have or are in the process of introducing a similar system, e.g. France, Italy and Finland.

2.5 Other Aspects of Personal Income Taxation

Table 3 illustrated the personal income tax rate for high wage earners. For a majority of OECD countries this is also the top marginal personal income tax rate on capital income. However, most OECD countries apply lower rates for certain

types of capital income, in particular income from dividends and capital gains, than the general income tax rate. In addition, some other countries apply a lower general personal income tax rate on capital income than on wage income (see below for a brief description of the dual income tax system in Finland, Norway and Sweden and the Box system in the Netherlands, but several other European countries also apply a flat tax rate on capital income which is lower than the top rate on wage income). Table 3 can therefore not be used to compare the taxation of capital income at the personal level between countries.

Table 9 illustrates yet another feature of personal income tax systems where countries differ substantially, namely the number of brackets in the taxation of wage income. The number of brackets in the personal income tax system varies from just 2 in Ireland to 17 in Luxembourg. Most

*Table 5
Tax Wedge for Single Individual at Average Earnings¹
1996–2003*

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---------------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| Australia | 24.4% | 24.8% | 25.4% | 25.9% | 22.8% | 23.3% | 28.3% | 28.3% |
| Austria | 41.5 | 45.6 | 45.8 | 45.9 | 44.9 | 44.5 | 44.7 | 45.0 |
| Belgium | 56.4 | 56.6 | 56.8 | 56.9 | 56.2 | 55.6 | 55.1 | 54.5 |
| Canada ³ | 32.1 | 32.3 | 31.7 | 31.1 | 31.3 | 30.4 | 32.2 | 32.4 |
| Czech Republic | 42.6 | 42.9 | 42.8 | 42.7 | 43.1 | 43.1 | 43.5 | 43.8 |
| Denmark | 44.8% | 45.1% | 43.7% | 44.5% | 44.4% | 43.6% | 42.7% | 42.7% |
| Finland | 50.3 | 48.9 | 48.8 | 47.4 | 47.3 | 45.9 | 45.2 | 44.5 |
| France | 49.7 | 48.7 | 47.6 | 48.1 | 48.2 | 48.3 | 48.2 | 48.3 |
| Germany | 51.2 | 52.3 | 52.2 | 51.9 | 51.8 | 50.8 | 51.1 | 52.0 |
| Greece | 35.8 | 35.8 | 36.1 | 35.7 | 36.0 | 35.7 | 34.6 | 34.3 |
| Hungary | 52.0% | 52.0% | 51.6% | 50.7% | 49.6% | 49.0% | 49.0% | 45.7% |
| Iceland | 24.5 | 24.4 | 25.9 | 26.0 | 26.7 | 27.5 | 28.8 | 29.3 |
| Ireland | 36.1 | 33.9 | 33.0 | 32.4 | 28.9 | 25.8 | 24.5 | 24.5 |
| Italy | 50.8 | 51.5 | 47.5 | 47.2 | 46.7 | 46.1 | 46.0 | 45.3 |
| Japan | 19.4 | 20.7 | 19.6 | 24.0 | 24.1 | 24.2 | 29.8 | 27.0 |
| Korea | 6.3% | 12.4% | 14.7% | 16.1% | 16.5% | 16.6% | 14.1% | 14.1% |
| Luxembourg | 34.5 | 35.2 | 33.8 | 34.6 | 35.5 | 33.9 | 31.3 | 31.7 |
| Mexico | 25.0 | 20.8 | 21.9 | 14.1 | 15.4 | 14.4 | 16.1 | 17.3 |
| Netherlands | 43.8 | 43.6 | 43.5 | 44.3 | 45.1 | 42.3 | 42.5 | 43.0 |
| New Zealand | 22.3 | 21.6 | 20.0 | 19.4 | 19.5 | 19.5 | 20.1 | 20.6 |
| Norway | 37.6% | 37.4% | 37.5% | 37.3% | 37.2% | 36.9% | 36.9% | 36.8% |
| Poland | 44.7 | 43.9 | 43.2 | 43.0 | 43.0 | 42.7 | 42.8 | 42.9 |
| Portugal | 33.8 | 33.9 | 33.8 | 33.4 | 33.5 | 32.5 | 32.6 | 32.6 |
| Slovak Republic | n.a. | n.a. | n.a. | n.a. | 41.2 | 41.7 | 41.1 | 41.4 |
| Spain | 38.8 | 39.0 | 39.0 | 37.5 | 37.6 | 37.9 | 38.2 | 37.6 |
| Sweden | 50.2% | 50.7% | 50.7% | 50.5% | 49.5% | 48.5% | 47.6% | 46.6% |
| Switzerland | 30.4 | 30.0 | 30.0 | 29.8 | 29.5 | 29.5 | 29.6 | 29.2 |
| Turkey | 38.3 | 40.7 | 39.8 | 30.3 | 40.4 | 43.6 | 42.4 | 42.3 |
| United Kingdom | 32.6 | 32.0 | 32.0 | 30.8 | 30.1 | 29.5 | 29.5 | 31.1 |
| United States | 31.1 | 31.1 | 31.0 | 31.1 | 30.8 | 29.8 | 29.7 | 29.4 |
| OECD-average ³ | 37.3% | 37.5% | 37.2% | 36.6% | 36.9% | 36.4% | 36.6% | 36.5% |
| EU15-average ³ | 43.4 | 43.5 | 43.0 | 42.7 | 42.4 | 41.4 | 40.9 | 40.9 |

n.a. indicates that data is not available

- 1) The tax wedge is the sum of income tax plus employee and employer social security contributions as a percentage of total labor costs (gross wage plus employer social security contributions).
- 2) The increase from 2001 to 2002 is due to a change in the method used to calculate the average tax rate, which allowed the inclusion of Ontario employer social security contributions, and not a change in the tax system itself.
- 3) Unweighted average.

Source: Taxing Wages 2002–2003.

Table 6**Tax Wedge for One-earner Family with Two Children at Average Earnings¹ 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---------------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| Australia | 15.0% | 14.5% | 15.5% | 16.1% | 13.5% | 14.2% | 20.4% | 20.4% |
| Austria | 28.0 | 32.2 | 32.7 | 31.6 | 29.5 | 29.0 | 29.5 | 29.5 |
| Belgium | 40.4 | 40.8 | 41.1 | 41.2 | 40.5 | 40.3 | 39.7 | 39.0 |
| Canada ² | 22.7 | 23.4 | 22.9 | 21.2 | 21.4 | 20.4 | 23.1 | 23.3 |
| Czech Republic | 31.4 | 31.2 | 23.4 | 24.4 | 25.2 | 28.2 | 28.7 | 30.6 |
| Denmark | 31.1% | 31.3% | 30.1% | 31.1% | 31.0% | 30.7% | 30.1% | 30.1% |
| Finland | 42.0 | 40.8 | 40.7 | 39.6 | 39.9 | 38.8 | 38.3 | 37.8 |
| France | 40.7 | 39.5 | 38.5 | 38.9 | 39.8 | 39.4 | 39.5 | 40.0 |
| Germany | 35.0 | 35.6 | 35.9 | 34.4 | 33.3 | 32.7 | 32.2 | 33.5 |
| Greece | 35.9 | 36.2 | 36.5 | 35.8 | 36.1 | 35.9 | 35.0 | 34.3 |
| Hungary | 40.4% | 40.8% | 40.3% | 35.9% | 35.0% | 32.8% | 33.9% | 30.5% |
| Iceland | -6.6 | -2.8 | 3.1 | 5.8 | 7.6 | 7.8 | 8.0 | 8.9 |
| Ireland | 25.6 | 23.8 | 22.5 | 20.1 | 15.5 | 12.8 | 9.1 | 7.4 |
| Italy | 43.8 | 43.3 | 37.5 | 37.0 | 36.5 | 35.4 | 35.9 | 35.5 |
| Japan | 15.1 | 15.6 | 14.0 | 19.8 | 20.2 | 20.4 | 26.2 | 23.2 |
| Korea | 5.3% | 11.6% | 13.9% | 15.4% | 15.8% | 15.9% | 13.6% | 13.6% |
| Luxembourg | 12.9 | 13.0 | 12.0 | 10.7 | 11.4 | 11.5 | 9.2 | 9.6 |
| Mexico | 25.0 | 20.8 | 21.9 | 14.1 | 15.4 | 14.4 | 16.1 | 17.3 |
| Netherlands | 33.5 | 33.0 | 33.2 | 34.1 | 35.5 | 33.0 | 33.1 | 33.7 |
| New Zealand | 18.8 | 16.2 | 14.8 | 14.1 | 15.5 | 16.7 | 18.8 | 20.4 |
| Norway | 25.0% | 24.9% | 25.6% | 26.2% | 26.9% | 26.9% | 27.2% | 27.6% |
| Poland | 39.5 | 38.9 | 37.4 | 38.1 | 38.2 | 37.8 | 41.2 | 41.3 |
| Portugal | 26.9 | 26.8 | 26.5 | 26.0 | 26.2 | 24.1 | 23.6 | 23.7 |
| Slovak Republic | n.a. | n.a. | n.a. | n.a. | 25.2 | 28.5 | 28.2 | 32.3 |
| Spain | 33.5 | 33.7 | 33.3 | 30.4 | 30.6 | 31.1 | 31.5 | 30.9 |
| Sweden | 44.6% | 45.2% | 44.4% | 44.4% | 42.6% | 41.1% | 40.3% | 39.5% |
| Switzerland | 18.6 | 17.7 | 17.8 | 17.8 | 17.7 | 17.9 | 18.1 | 17.8 |
| Turkey | 38.3 | 40.7 | 39.8 | 30.3 | 40.4 | 43.6 | 42.4 | 42.3 |
| United Kingdom | 25.3 | 24.8 | 24.9 | 23.3 | 21.4 | 18.2 | 17.3 | 18.3 |
| United States | 23.9 | 24.1 | 23.7 | 21.1 | 21.3 | 18.3 | 17.8 | 15.5 |
| OECD-average ³ | 28.0% | 28.2% | 27.7% | 26.9% | 27.0% | 26.6% | 26.9% | 26.9% |
| EU15-average ³ | 33.3 | 33.3 | 32.7 | 31.9 | 31.3 | 30.3 | 29.6 | 29.5 |

n.a. indicates that data is not available

- 1) The tax wedge is the sum of income tax plus employee and employer social security contributions less cash benefits as a percentage of total labor costs (gross wage plus employer social security contributions).
- 2) The increase from 2001 to 2002 is due to a change in the method used to calculate the average tax rate, which allowed the inclusion of Ontario employer social security contributions, and not a change in the tax system itself.
- 3) Unweighted average.

Source: Taxing Wages 2002–2003.

Table 7**Tax Wedge for Single Parent with Two Children at 67 percent of Average Earnings¹ 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|--------|-------|-------|-------|------|------|------|------|------|
| US | 11.8% | 12.2% | 11.6% | 8.5% | 8.6% | 5.0% | 5.2% | 3.4% |
| OECD | 19.3 | 19.5 | 18.7 | 18.0 | 17.5 | 17.0 | 17.0 | 17.5 |
| EU15 | 24.6 | 24.5 | 23.3 | 22.8 | 21.6 | 20.3 | 19.0 | 18.9 |
| Japan | 15.1 | 15.6 | 14.1 | 19.7 | 20.3 | 20.4 | 26.3 | 23.3 |
| Canada | 10.6 | 10.3 | 8.4 | 5.1 | 4.0 | 3.9 | 1.2 | 1.4 |

- 1) The tax wedge is the sum of income tax plus employee and employer social security contributions less cash benefits as a percentage of total labor costs (gross wage plus employer social security contributions).

Source: Taxing Wages 2002–2003.

countries apply a piecewise linear system, with Germany being the only country that has a formula-based system where the marginal tax rate increases continuously with income between a minimum and a maximum rate. Seven countries (Belgium, Finland, Greece, Luxembourg, Mexico, Slovak Republic and Spain) reduced the number of tax brackets between 2000 and 2003, while the number of income brackets was increased in Canada, Portugal and the United States. The Slovak Republic is the first OECD country to introduce a single tax rate on all personal (and corporate) income above a basic threshold beginning in 2004.³

2.6 Value Added Taxes

Table 10 shows that after Australia introduced its goods and services tax in 2000, all OECD countries except the United States, had value added type taxation. There has been a clear trend to move to general consumption taxes combined with a reduction in tax revenues from excise taxes. The overall share of total tax revenue from general consumption taxes has remained fairly stable over the past few years, although it has increased when compared with the situation in the mid-1970s.

The general VAT/GST rate has remained fairly stable since 1998 in most countries. The unweighted average rate among those countries that have a VAT/GST system was just below 18 per cent in 2003, ranging from 5 per cent in Japan to 25 per cent in Denmark, Hungary and Sweden. The average VAT rate among the EU15 countries was 19.6 per cent in 2003.

However, most countries apply reduced rates or exemptions for certain goods and services. Seventeen of the countries have a zero rate on certain domestic sales and 22 countries have reduced rates for certain goods and services, while 7 countries apply special rates within specific regions in the country. Certain goods or services are also exempt from the VAT/GST system in most countries.

3 Diversity in Tax Policies

While the previous section concentrated on broad trends in the OECD, it is important to recognize the substantial differences among OECD countries in the tax policies that they follow. Indeed, this is illustrated in the tables from the previous

3 Iceland also applies a flat income tax rate above a threshold (the rate was 38.55 per cent in 2003). However, they have an additional surtax of 5 per cent that is levied on income above a threshold level that is equal to about 150 per cent of average earnings.

section. There are wide differences in tax-to-GDP ratios and in tax rates, in tax structures and in the design features of particular taxes. This section looks at some of the differences in more detail, and at two current policy approaches to reducing inefficiencies in tax systems. These are policies to 'make work pay' by the use of in-work tax credits and policies to reform corporate taxation.

3.1 Differences in Tax Revenues and Rates

The United States has top personal income tax rates that are just below the OECD average (Table 3), while the corporate tax rate (Table 4) and the top marginal tax rate on dividend income (Table 8) are well above both the unweighted OECD average and that of the EU15. Similarly, most

other OECD countries have chosen to have fewer brackets in the personal income tax system than the United States. Even so, when comparing tax-to-GDP ratios it is evident that the total tax burden in the United States is among the lowest in the OECD area and it was almost 15 percentage points lower in 2002 than the average in the EU15. Furthermore, the tax-to-GDP ratio has fallen by 4.5 percentage points between 2000 and 2003 to a level which is the same as it was in 1975. This can be compared to a reduction of only 1.2 percentage points in the EU 15 between 2000 and 2002, and where the tax-to-GDP ratio in 2002 was more than 7 percentage points higher than in 1975.

Such differences can be partly explained by the distribution of tax revenue among major taxes.

Table 8

*Top marginal tax rates on dividend income¹
2000 to 2003*

| | 2000 | 2001 | 2002 | 2003 |
|---------------------------|-------|-------|-------|-------|
| Australia | 48.5% | 48.5% | 48.5% | 48.5% |
| Austria | 50.5 | 50.5 | 50.5 | 50.5 |
| Belgium | 49.1 | 49.1 | 49.2 | 43.9 |
| Canada | 62.5 | 60.2 | 57.9 | 56.5 |
| Czech Republic | 41.4 | 41.4 | 41.4 | 41.4 |
| Denmark | 59.2% | 60.1% | 60.1% | 60.1% |
| Finland | 29.0 | 29.0 | 29.0 | 29.0 |
| France | 63.2 | 61.9 | 58.4 | 57.0 |
| Germany | 53.8 | 51.2 | 54.5 | 55.5 |
| Greece | 40.0 | 37.5 | 35.0 | 35.0 |
| Hungary | 55.7% | 55.7% | 55.7% | 55.7% |
| Iceland | 37.0 | 37.0 | 26.2 | 26.2 |
| Ireland | 57.4 | 53.6 | 51.3 | 49.3 |
| Italy | 45.9 | 45.9 | 46.1 | 46.1 |
| Japan | 66.7 | 66.7 | 66.7 | 66.7 |
| Korea | 44.6% | 53.9% | 49.5% | 49.5% |
| Luxembourg | 52.3 | 50.9 | 44.0 | 44.0 |
| Mexico | 40.0 | 40.0 | 35.0 | 34.0 |
| Netherlands | 74.0 | 54.5 | 54.2 | 54.2 |
| New Zealand | 39.0 | 39.0 | 39.0 | 39.0 |
| Norway | 28.0% | 35.9% | 28.0% | 28.0% |
| Poland ² | 44.0 | 38.8 | 38.8 | 38.0 |
| Portugal | 51.4 | 51.4 | 46.4 | 46.4 |
| Slovak Republic | 39.7 | 39.7 | 36.3 | 36.3 |
| Spain | 52.7 | 52.7 | 52.7 | 50.0 |
| Sweden | 49.6% | 49.6% | 49.6% | 49.6% |
| Switzerland | 56.5 | 56.0 | 55.4 | 55.2 |
| Turkey | 65.0 | 65.0 | 65.0 | 46.5 |
| UK | 47.5 | 47.5 | 47.5 | 47.5 |
| USA | 59.3 | 59.2 | 58.8 | 51.3 |
| OECD-average ³ | 50.1% | 49.4% | 47.7% | 46.4% |
| EU15-average ³ | 51.7 | 49.7 | 48.6 | 47.9 |

1) This table reports the overall (corporate plus personal) top marginal tax rates on distributions of domestic source profits to a resident individual shareholder, taking account of imputation systems, dividend tax credits etc.

2) The figures are based on KPMG's Corporate Tax Rate Survey and the European Tax Handbook.

3) Unweighted average.

Source: OECD Tax Database.

Table 9

*The Number of Brackets
in the Taxation of Wage
Income
2003*

| | 2000 | 2003 |
|-----|------|------|
| IRE | 2 | 2 |
| DEN | 3 | 3 |
| HUN | 3 | 3 |
| ICE | 3 | 3 |
| NOR | 3 | 3 |
| NZ | 3 | 3 |
| POL | 3 | 3 |
| SWE | 3 | 3 |
| UK | 3 | 3 |
| CAN | 3 | 4 |
| CZ | 4 | 4 |
| GRE | 6 | 4 |
| JAP | 4 | 4 |
| KOR | 4 | 4 |
| NL | 4 | 4 |
| AS | 5 | 5 |
| AUS | 5 | 5 |
| BEL | 7 | 5 |
| ITA | 5 | 5 |
| SLO | 7 | 5 |
| SPA | 6 | 5 |
| FIN | 7 | 6 |
| POR | 5 | 6 |
| TUR | 6 | 6 |
| US | 5 | 6 |
| FRA | 7 | 7 |
| MEX | 10 | 7 |
| SWI | 11 | 11 |
| LUX | 18 | 17 |
| GER | — | — |

Source: OECD Taxing Wages 2002–2003.

This distribution for OECD countries in 2002 is reported in Table 11.⁴ The OECD average shows that the vast bulk of tax revenue, i.e. over 90 per cent, comes from three main sources: income taxes, taxes on goods and services, and social security contributions (other payroll taxes are zero or very small in most countries). However, countries vary considerably in the relative importance of these three main revenue sources.

Overall, the European Union relies relatively more on social security contributions. In contrast,

the United States collects more in personal income tax and property tax but less in consumption taxes. Japan is similar to the United States in its low share of consumption taxes, but collects much less in personal income tax, offsetting this with higher levels of corporate tax and social security contributions. There are also substantial differences across countries in the share of taxes on property, which are generally lower in continental Europe than elsewhere. Such differences between countries are in part due to changes in tax policy, e.g. reflecting an increased reliance on social security contributions and/or consumption taxes, over income taxes in many countries. It partly also reflects fundamental income tax reforms in many countries, where tax bases have been broadened along with cuts in statutory tax rates. In addition, such changes reflect in part broader changes in the economy, e.g. business cycles and the rate of inflation.

Table 12 illustrates the difference between OECD countries in their reliance on income tax and social security contributions in the taxation of labor. The figure illustrates that there are great differences between countries in the level of personal income taxes for someone at average earnings, ranging from below 5 per cent in four countries to above 30 per cent in Denmark. Countries also differ on the reliance on social security contributions, from New Zealand which does not levy any such contributions to several countries where the main part of the tax wedge on labor is social security contributions.

Another possible explanation of the differences can be found by comparing Table 3 with Table 5 in Section 2. The latter figure compares the average taxation of labor income in the United States with that of the overall OECD average, the EU15 and Japan, while the first provides information on the top marginal rates. It is evident from these figures that even if the top marginal rate in the United States is close to the OECD average, the average rates are much lower than the overall average in the OECD. This indicates that the tax base is more narrowly defined in the United States than in many other OECD countries, probably mainly as a result of a more extensive use of tax allowances and special tax privileges. This is

Table 10
Standard Rates of VAT/GST in OECD Countries
Selected Years 1994–2003

| | 1994 | 1998 | 2000 | 2003 |
|---------------------|-------|-------|-------|-------|
| Australia | — | — | 10.0% | 10.0% |
| Austria | 20.0% | 20.0% | 20.0 | 20.0 |
| Belgium | 20.5 | 21.0 | 21.0 | 21.0 |
| Canada ¹ | 7.0 | 7.0 | 7.0 | 7.0 |
| Czech Republic | 23.0 | 22.0 | 22.0 | 22.0 |
| Denmark | 25.0% | 25.0% | 25.0% | 25.0% |
| Finland | 22.0 | 22.0 | 22.0 | 22.0 |
| France | 18.6 | 20.6 | 20.6 | 19.6 |
| Germany | 15.0 | 16.0 | 16.0 | 16.0 |
| Greece | 18.0 | 18.0 | 18.0 | 18.0 |
| Hungary | n.a. | 25.0% | 25.0% | 25.0% |
| Iceland | 24.5% | 24.5 | 24.5 | 24.5 |
| Ireland | 21.0 | 21.0 | 21.0 | 21.0 |
| Italy | 19.0 | 20.0 | 20.0 | 20.0 |
| Japan | 3.0 | 5.0 | 5.0 | 5.0 |
| Korea | 10.0% | 10.0% | 10.0% | 10.0% |
| Luxembourg | 15.0 | 15.0 | 15.0 | 15.0 |
| Mexico | 10.0 | 15.0 | 15.0 | 15.0 |
| Netherlands | 17.5 | 17.5 | 17.5 | 19.0 |
| New Zealand | 12.5 | 12.5 | 12.5 | 12.5 |
| Norway | 22.0% | 23.0% | 23.0% | 24.0% |
| Poland | 22.0 | 22.0 | 22.0 | 22.0 |
| Portugal | 16.0 | 17.0 | 17.0 | 19.0 |
| Slovak Republic | 25.0 | 23.0 | 23.0 | 20.0 |
| Spain | 15.0 | 16.0 | 16.0 | 16.0 |
| Sweden | 25.0% | 25.0% | 25.0% | 25.0% |
| Switzerland | 6.5 | 6.5 | 7.5 | 7.6 |
| Turkey | 15.0 | 15.0 | 17.0 | 18.0 |
| United Kingdom | 17.5 | 17.5 | 17.5 | 17.5 |
| United States | — | — | — | — |

'n.a.' indicates that data is not available, '-' indicates that there was no VAT.

1) This represents the rate of the federal Goods and Services Tax (GST) and does not reflect provincial consumption taxes. The provinces of Newfoundland and Labrador, New Brunswick, and Nova Scotia have harmonised their provincial sales taxes with the GST to form the Harmonised Sales Tax, which is levied at 15 per cent. Quebec levies a tax similar to the GST at a rate of 7.5 per cent on prices that include the GST. The other Canadian provinces, with the exception of Alberta, apply a provincial retail sales tax to certain goods and services.

Source: OECD Tax Database.

⁴ A cautious interpretation of the first two columns of numbers in this table is called for. The split between personal and corporate income tax can be seriously misleading for two reasons. First, many OECD countries have some form of integration between corporate and personal income taxes, so that a portion of corporate taxes are refunded to the shareholders as a reduction in personal income tax. This is reflected in the statistics as a reduction in the revenue from personal income taxes, but it could be just as well regarded as a reduction in corporate tax revenue. Second, OECD countries vary in the extent to which businesses are incorporated. For example, German firms are much less likely to be incorporated than firms in Japan and the United States. This means that Germany reports a much lower share of tax revenue coming from corporate income tax.

probably also the main explanation for the relatively low revenue share from corporate income in the United States in Table 11, even though the statutory corporate tax rates in Table 4 are above the OECD average.

3.2 Making Work Pay Policies

Following the example of the United States with its Earned Income Tax Credit (EITC), a number of OECD countries have recently introduced in-work tax credits to help ‘make work pay’ for the low-skilled. The main objectives of such making work pay (MWP) policies are:

- To increase employment. This is done by reducing the costs of hiring disadvantaged workers, or by increasing the incomes of those who accept low-paid work.
- To increase incomes of disadvantaged groups. Linking an increase in transfers to those with

low incomes to their employment status appears sometimes to be politically more acceptable than achieving this end via a general increase in social transfers or reduction in taxes to all those with no income from work.

The appeal of MWP policies spans political divides, and governments of both the right and left have introduced or extended such policies in recent years. The political attraction is that such policies appear to achieve both employment and distributional objectives at the same time, unlike some other alternative policies. Nonetheless, most OECD countries have not introduced these policies or they have followed alternative approaches, such as cuts in employers’ social security contributions.

Table 13 summarizes some of the main in-work credits and benefits that are used in OECD countries. The following design features are worth noting:

Dual Income Tax – the Nordic Example

A policy objective of reducing tax distortions, in particular in the taxation of corporate and capital income, combined with an objective of continued income redistributions through the income tax system were the main driving forces behind the introduction of dual income tax systems in Finland, Norway and Sweden in the early 1990s. The main guiding principle of the dual income tax (DIT) is to combine a progressive taxation of labor income with a flat tax on corporate and capital income with a broad tax base and a fairly low tax rate.

Norway introduced the purest form of dual income tax, and will therefore be used as an example. The main characteristics of the Norwegian system are:

- A flat personal income tax rate of 28 per cent on net income. Net income includes wage, pension and capital income less tax deductions, and the same rate was introduced for corporate income. This implied
 - a symmetrical treatment of all capital income, e.g. with no double taxation of dividends and capital gains on shares and full deductibility of all interest expenditures
 - a reduction of the number and the value of tax allowances, as all remaining allowances are only deductible against the flat 28 per cent rate

- A progressive taxation of wage and pension income in addition to the flat rate, by introducing a surtax on gross income from wages and pensions above a certain threshold level. The highest surtax rate on wages and pensions was 13 per cent when the tax reform was implemented in 1992, but it was increased to 19.5 per cent in 2000. Social security contributions are also only levied on wage and pension income.
- To ensure an equal tax treatment of all labor income, income from self-employment and persons working in their own companies is split into a labor and a capital income component by use of the so-called split model. The part considered as labor income is then taxed according to the progressive rate schedule, while the part considered as capital income is taxed at the flat rate.

Sweden introduced a personal income tax rate of 30 per cent and a corporate income tax rate of 28 per cent, and also dropped the principle of full integration of corporate and personal taxation of dividend income and capital gains. Finland introduced a full imputation system for dividend income at a rate of 28 per cent, but with double taxation of capital gains and a simplified version of the taxation of income from self-employment.

- In-work credits paid to the individual are generally lower in value than in-work credits paid to the family. This presumably reflects the distributional objective: by targeting a credit on families (usually families with children) with low income, rather than individuals with low earnings, the potential clientele and cost of any given credit is much reduced.
- All countries have to tackle the issue of how to ensure that those with minimal hours of work do not benefit disproportionately from the policy. There are two main ways in which this is done. The first is to phase in the credit, so that, in effect, marginal tax rates are negative over a range of earnings. Hence, those with very low earnings do not get the maximum value of the credit, but face strong incentives to increase hours of work in order to take full advantage of the money on offer. The alternative approach is to make payments conditional on hours worked. This enables the credit to be targeted on those with a significant degree of participation in work, but requires additional information — and hence administrative costs — in determining eligibility.
- Many countries make their tax credits non-wastable, e.g. that a cash payment is made by the revenue authorities to the individual or

family if tax liabilities before the credit are lower than the value of the credit. Hence, even low income households benefit fully from the credit. The alternative — of using a traditional wastable tax credit — means that those with very low incomes cannot get the full value of the benefit and will therefore have their incentive to seek employment reduced. However, this does reduce the cost of the policy.

- Most countries phase out the benefit (with the Netherlands as an exception). This is a way of reducing the budgetary costs of the credits. However, the result is that there is a range of earnings where an increase in work effort, be it hours or wage rates, results in a loss of MWP benefits. When added to taxes, social contributions, and (in some countries) other income-tested benefits such as housing or family benefits, the result can be high marginal effective tax rates (METR) on increases in work effort over certain earnings ranges.

Effects on Employment

There is evidence that the Earned Income Tax Credit (EITC) in the United States, which subsidizes those workers who accept employment but who have low family incomes, promotes

The Box System in the Netherlands

This system was introduced as a result of the 2001 tax reform, where the objectives were to reduce tax rates and broaden the tax base, to replace tax allowances by tax credits and to replace the wealth tax and the taxation of personal capital income with taxation of an imputed income from capital. One of the main arguments for introducing taxation of an imputed income from capital is to ensure that all forms for personal capital income are taxed equally, and to prevent taxpayers from avoiding the taxation of capital income by realizing capital income as e.g. capital gains (which was not taxed prior to the reform). The main features of the system are:

- Box 1 includes wage income, income from self-employment, social security payments, pensions and imputed income from owner-occupied houses, less allowable deductions (e.g. personal allowance, deduction of childcare expenses and certain other deductions). The net income is taxed at progressive rates, ranging from about 30 per cent (including social security contributions

levied on net income) to a top rate of 52 per cent.

- Box 2 includes taxable income from a substantial business interest. This is defined as income from dividends and capital gains where the shareholder controls (directly or indirectly) at least 5 per cent of the shares in a private or public limited company. The net income from such activities is taxed at a flat rate of 25 per cent.
- Box 3 is the taxation of capital income, including income from non-substantial business interests. Instead of a tax on the actual capital income, a 30 per cent flat tax rate is applied on a notional return of 4 per cent on the net value of the assets owned by the shareholder (average of net assets 1 January and 31 December). In practice, this is equivalent to a tax on net wealth of 1.2 per cent (30 per cent tax rate times 4 per cent return). In order to insert a progressive element in the system, there is a basic tax-free allowance.

employment.⁵ Meyer and Rosenbaum (1999)⁶ calculate that 63 per cent of the increase in labor force participation rates of lone-parent families (the main group of beneficiaries) between 1984 and 1996 was due to the EITC. Eissa and Liebman (1996)⁷ estimate that the 1986 expansion of the EITC increased labor force participation of lone parents by 2.8 percentage points, rising to 6 percentage points for those lone parents who had the lowest level of education. Ellwood (2001)⁸ estimates that welfare reform accounts for half of the increase in employment of female-headed households over recent years, the EITC another 30 per cent, with the remainder being due to improved labor market conditions.

Simulations suggest that the expansion of the programme, when the United Kingdom moved from the Family Credit to the WFTC in the late 1990s, promoted employment, with estimates of the net increase in employment ranging from between 10,000 to 100,000 people.⁹ However, the net effects are limited because women married to low-earning men face reduced incentives to participate in the labor market - because if they stopped work, the husband would become eligible for the credit, so the net loss in family income from her giving up her earnings would be limited. Hence, Blundell and Meghir (2002)¹⁰ estimate a reduction in the number of households where no-one worked of 57,000 due to the move to the WFTC. However, as around 20,000 married women and 10,000 married men would drop out of the labor force, the net increase in employment would be below 30,000. This is a consequence of linking credits to household income, and is less likely to occur in countries that base their credits on individual income. However, such linking of tax credits to household income might increase their effectiveness in reducing poverty.

The evidence presented above refers to the aggregate level of employment. However, there are three other dimensions which are potentially of

importance in evaluating the effects of MWP policies on the labor market.

First is the effect of MWP policies on hours of work. As noted above, most countries withdraw their tax credits or benefits from those with higher

Table 11
Tax Revenue of Major Taxes as a Percentage of Total Tax Revenue 2002¹

| | Personal income ² | Corporate income ² | Social Security and Other Payroll | Property | Goods and services | Of which : General consumption |
|-----------------------|------------------------------|-------------------------------|-----------------------------------|----------|--------------------|--------------------------------|
| Australia | 38.5% | 16.8% | 5.4% | 9.0% | 30.3% | 13.5% |
| Austria | 22.8 | 5.1 | 39.5 | 1.3 | 28.2 | 18.7 |
| Belgium | 31.7 | 7.6 | 31.6 | 3.1 | 24.6 | 15.7 |
| Canada | 35.0 | 10.1 | 17.2 | 9.8 | 26.3 | 15.3 |
| Czech Republic | 12.8 | 11.8 | 44.1 | 1.5 | 29.7 | 17.3 |
| Denmark | 53.2% | 5.8% | 3.9% | 3.5% | 33.1% | 19.9% |
| Finland | 31.2 | 9.3 | 26.6 | 2.4 | 30.2 | 18.2 |
| France | 17.3 | 6.6 | 39.5 | 7.5 | 25.4 | 16.7 |
| Germany | 25.1 | 2.9 | 40.3 | 2.3 | 29.2 | 18.0 |
| Greece | 14.0 | 10.4 | 32.8 | 4.7 | 37.3 | 23.5 |
| Hungary | 20.3% | 6.2% | 33.5% | 1.9% | 37.4% | 24.3% |
| Iceland | 38.6 | 3.0 | 8.1 | 7.4 | 40.3 | 27.6 |
| Ireland | 26.2 | 13.1 | 15.6 | 5.3 | 39.5 | 25.0 |
| Italy | 25.5 | 7.6 | 29.4 | 5.1 | 26.9 | 15.0 |
| Japan | 18.4 | 12.2 | 38.3 | 10.8 | 20.1 | 9.5 |
| Korea | 12.8% | 12.8% | 19.1% | 12.7% | 38.8% | 18.9% |
| Luxembourg | 16.2 | 20.5 | 26.9 | 8.0 | 27.9 | 15.5 |
| Mexico ³ | — | — | 19.4 | 1.7 | 49.0 | 19.3 |
| Netherlands | 18.3 | 8.8 | 35.5 | 5.3 | 30.8 | 19.2 |
| New Zealand | 42.3 | 12.1 | 0.8 | 5.0 | 35.2 | 25.3 |
| Norway | 24.8% | 18.9% | 22.7% | 2.3% | 31.2% | 19.2% |
| Poland | 22.9 | 6.3 | 29.6 | 4.3 | 36.9 | 22.6 |
| Portugal ⁴ | 17.9 | 10.8 | 27.0 | 3.1 | 40.0 | 24.0 |
| Slovak Republic | 10.2 | 8.2 | 43.3 | 1.6 | 34.1 | 22.7 |
| Spain | 19.4 | 9.1 | 35.3 | 6.6 | 28.6 | 16.6 |
| Sweden | 30.4% | 4.8% | 34.8% | 3.2% | 26.4% | 18.4% |
| Switzerland | 34.4 | 8.8 | 25.6 | 8.6 | 22.6 | 13.0 |
| Turkey | 17.6 | 7.1 | 19.8 | 2.9 | 46.8 | 26.1 |
| United Kingdom | 29.8 | 8.1 | 17.0 | 12.0 | 32.7 | 19.4 |
| United States | 37.7 | 6.7 | 26.1 | 11.9 | 17.6 | 8.2 |
| OECD Total | | | | | | |
| Unweighted | 25.7% | 9.4% | 26.3% | 5.5% | 31.9% | 18.9% |
| EU15 | | | | | | |
| Unweighted | 25.3 | 8.7 | 29.0 | 4.9 | 30.7 | 18.9 |

1) Rows do not add to 100 because some minor taxes are omitted and general consumption taxes (mainly VAT) are a sub-category of taxes on goods and services.

2) The breakdown of income tax into personal and corporate tax is not comparable across countries.

3) Data for personal income tax and corporate income tax do not exist.

4) Data from 2001.

Source: Revenue Statistics 1965-2003.

5 Hotz, V. and J. Scholz (2000): Not Perfect, but Still Pretty Good: the EITC and other Policies to Support the US Low-wage Labour Market. *OECD Economic Studies*, No 31. Paris.

6 Meyer, B. and D. Rosenbaum (1999): Welfare, the EITC, and the Labor Supply of Single Mothers. *NBER Working Paper*, No 7363.

7 Elissa, N. and J. Liebman (1996): Labor Supply Response to the Earned Income Tax Credit. *Quarterly Journal of Economics*, Vol 111.

8 Ellwood, D. (2001): The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage and Living Arrangements. *National Tax Journal*, Vol. 53.

9 Dilnot, A. and J. McCrae (2000): The Family Credit System and the Working Families Tax Credit in the United Kingdom. *OECD Economic Studies*, No. 31. Paris.

10 Blundell, R. and C. Meghir (2002): Active Labour Market Policy vs. Employment Tax Credits: Lessons from Recent UK Reforms. *IFAU Working Paper*, 2002/1.

Table 12
Income Tax and Social Security
Contributions in OECD Countries^{1,2}
2003

| | Income Tax | Income Tax+ Employee SSC | Tax Wedge |
|-----|------------|--------------------------|-----------|
| AUS | 22.6% | 22.6% | 28.3% |
| AS | 8.4 | 22.3 | 45.0 |
| BEL | 20.4 | 31.1 | 54.5 |
| CAN | 16.3 | 22.1 | 32.4 |
| CZ | 8.6 | 17.8 | 43.8 |
| DEN | 31.6% | 42.1% | 42.7% |
| FIN | 20.2 | 25.1 | 44.5 |
| FRA | 9.4 | 19.0 | 48.3 |
| GER | 17.2 | 34.6 | 52.0 |
| GRE | 0.0 | 12.4 | 34.3 |
| HUN | 9.5% | 18.6% | 45.7% |
| ICE | 23.7 | 23.9 | 29.3 |
| IRE | 10.3 | 14.8 | 24.5 |
| ITA | 13.5 | 20.4 | 45.3 |
| JAP | 5.2 | 15.4 | 27.0 |
| KOR | 2.1% | 6.2% | 14.1% |
| LUX | 7.7 | 19.8 | 31.7 |
| MEX | 2.5 | 3.8 | 17.3 |
| NL | 7.4 | 29.3 | 43.0 |
| NZ | 20.6 | 20.6 | 20.6 |
| NOR | 18.6% | 25.5% | 36.8% |
| POL | 5.1 | 25.9 | 42.9 |
| POR | 4.5 | 13.4 | 32.6 |
| SLO | 4.5 | 13.8 | 41.4 |
| SPA | 9.3 | 14.2 | 37.6 |
| SWE | 17.9% | 23.2% | 47.9% |
| SWI | 8.9 | 19.0 | 29.2 |
| TUR | 12.1 | 24.4 | 42.1 |
| UK | 14.4 | 22.1 | 31.1 |
| US | 15.2 | 22.3 | 29.4 |

- 1) Single individual at average earnings of a production worker.
 2) The tax rates are measured as a percentage of total labor costs (gross wage plus employer social security contributions).

Source: OECD Taxing Wages 2002–2003.

incomes or earnings. Because people with earnings in this range face both higher marginal effective tax rates (METRs) and have greater incomes (from the tax credit), their incentives to work additional hours are unambiguously reduced. As a result, it is to be expected that some people will reduce their earnings.

High METRs are closely related to a second potential problem with MWP policies — that they reduce the incentive for individuals to increase their human capital through training, as any increase in wage rates is offset in part by a reduction in benefit payments. This is an area, however, where there are no empirical studies which can guide policy.

Third, MWP policies may have an impact on wage levels. In part, this will reflect the effects of

such policies on human capital accumulation. In addition, because a cut in wage rates will be partly offset by an increase in MWP payments, there may be downward pressure on wages. Potentially, this could create a situation where public funds designed to support low-wage workers are instead passed through to employers in the form of reductions in wage rates and without inducing them to hire more labor. Again, evidence on how big an effect there may be is absent.

Income Distribution

The other main objective of MWP policies is to redistribute income towards low-income individuals or households. The degree of targeting of the tax credits/benefits is therefore a key factor in determining whether the policy is successful or not.

Evidence suggests that the MWP policies of the United States and the United Kingdom significantly increase the income of poor households. For example, United States data suggest that 40 per cent of EITC payments are made to taxpayers in the bottom quarter of the earnings distribution (earning below \$6.25 per hour) and 80 percent go to those below median earnings.¹¹ Relatively little goes to high-income households. Of course, the very poorest in society do not usually have any earnings and so do not benefit from the policy unless and until they find work. The group which benefits most from existing schemes is lone-parent households, for whom the rewards to working have been low in the past and who form a significant subset of those in poverty. In Belgium, the work tax credit for low-wage earners has reduced the tax burden for employees earning less than 2/3 of the APW-level. For people at 1/3 of APW-earnings, the tax reduction constituted more than 4 per cent of gross pay. However, the system also implies that the effective marginal tax rate increased by more than 10 percentage points for someone earning 2/3 of the APW-level. Similarly, the prime pour l'emploi in France implies a steep increase in marginal tax rates for low-income workers, while at the same time providing them with a significant increase in disposable income.

However, the focus of in-work payments on household income is inefficient to the extent that it does not distinguish between those who have low income because of low effort in the labor market and those with low skills. In the United Kingdom, beneficiaries have to work a minimum

11 Hotz, V., C. Mullin and J. Scholz (2002): The Earned Income Tax Credit and Labor Market Participation of Families on Welfare. *JCPR Newsletter*, Vol. 5.

of 16 hours per week in order to qualify for the tax credit, but this still leaves the possibility of those who have higher wage rates but who choose to work less receiving a greater tax credit than those with lower skills and wage rates who put in greater work effort.

What Determines Whether MWP Policies Achieve Their Objectives?

Prior analysis of these policies by the OECD¹² led to the conclusion that ‘framework conditions’ are of great importance in determining the viability of MWP policies. These include the level of taxation, and in particular the marginal tax rates — because if tax rates are already high, the additional increase at the margin as MWP payments are phased out may raise the resulting METRs to unacceptably high levels. Similarly, the earnings and/or income distribution needs to be fairly wide. If it is narrow, it is very difficult to pay an amount sufficient to make a real impact on labor market incentives, and to withdraw the benefit from those with higher earnings, without having an unacceptable number of people in the ‘phase-out’ zone where, both the income and substitution effects act in the same direction to reduce labor supply. Third, there appears to be a case for having a minimum wage when using MWP policies — even if they are targeted at employees, not employers. This would limit any possibility of wages being reduced in response to the presence of a subsidy for those with low wages. However, the minimum wage must be carefully set so as to avoid pushing-up the costs of employing low productivity workers to an extent that employment is damaged. A delicate balancing act is required.

Countries perhaps fall into three camps. In those with a low tax–low benefit environment and relatively low minimum wages, the essential problem is to encourage labor supply and to provide higher incomes for those in poorly paid jobs. In these circumstances, it seems preferable to place greater stress on in-work payments to workers. By contrast, in countries with high levels of taxes and benefits and relatively high wage floors, MWP schemes are likely to have high fiscal costs and risk reinforcing disincentive effects related to higher METRs. As a result, policy interventions in the second group of countries generally focus on wage subsidies to employers, or

reductions in employer social security contributions, as the essential problem is one of increasing labor demand for the low-skilled or inexperienced workers. Finally, in some countries earnings distributions are so narrow, or initial tax rates so high, or other framework conditions are such that MWP policies cannot be introduced without having overall adverse effects (Bassanini et al. (1999)¹³ find this to be the case for Germany in their simulations using a computable general equilibrium model, for example).

Table 13
In-Work Credits in 2001

| | Target group | Non-wastable | Approximate Maximum Income Increase (Euros/dollars) | Phase in | Phase out | Hours criterion |
|------------------------------|--------------|--------------|-----------------------------------------------------|----------|-----------|-----------------|
| Belgium ¹ | Individual | Yes | 440 | Yes | Yes | No |
| Canada (Quebec) ² | Families | Yes | 3,150 | Yes | Yes | No |
| Finland | Individual | No | 290 | Yes | Yes | No |
| France ³ | Individual | Yes | 230 | Yes | Yes | No |
| Ireland ⁴ | Families | Yes | 2,260 or more | No | Yes | Yes |
| Netherlands | Individual | No | 920 | Yes | No | No |
| New Zealand ^{5a} | Families | Yes | 7,800 | No | Yes | Yes |
| New Zealand ^{5b} | Families | Yes | 780 per child | No | Yes | Yes |
| United Kingdom ⁶ | Families | Yes | 6,150 or more | No | Yes | Yes |
| United States ⁷ | Families | Yes | 4,000 | Yes | Yes | No |

1) Introduced in 2002.

2) Most Canadian provinces have a scheme similar to this. There are no Federal MWP programmes.

3) PPE is an individual tax credit which increases when gross income rises from 30 per cent to 100 per cent of the SMIC (minimum wage).

4) FIS equals 60 per cent of the difference between net family income and an earnings limit. For a family with one child the weekly earnings limit is around £170. Figures given here reflect an assumption of hourly earnings of £5.33 and a 40 hour week; with lower earnings and hours, the maximum receipt could be higher.

5a) Family Tax Credit. The child minder must work at least 20 hours per week (lone parent) or 30 hours per week (combined hours for a couple with children). The maximum payment equates to the net income subsidy for a lone parent working 20 hours per week at the minimum wage, needed to reach the guaranteed minimum net income of NZD 15 080 p.a. in 2001

5b) Child Tax Credit. The entitlement abates with family income after full abatement of the non work-tested Family Support, and is therefore available to a number of middle to higher income working families as well as to all low income working families.

6) WFTC (replaced in 2003) was calculated by adding credits for adults and children and then deleting 55 per cent of the difference between net income and GBP 92.90 per week. The family is here assumed to have gross earnings of £5.33 per hour and a 40 hour week; with lower earnings and hours, the maximum receipt could be higher. Child-care supplements are ignored.

7) Earned Income Tax Credit. For taxpayers with two or more children, the credit is 40 per cent of up to \$10 020 of earned income in 2001. EITC reaches its maximum amount of \$4 008. The credit starts to reduce in value when income exceeds \$13 090 (at a rate of 21.06 per cent) and phases out when it reaches \$32 121.

Source: OECD Benefits and Wages database.

12 E.g., OECD (1997): *Making Work Pay* and Pearson, M. and S. Scarpetta (2000): *An Overview: What do we know about Policies to Make Work Pay?* *OECD Economic Studies*, No 31.

13 Bassanini, A., J.H. Rasmussen and S. Scarpetta (1999): *The Economic Effects of Employment-Conditional Income Support Schemes for the Low-Paid: An Illustration from a CGE Model Applies to Four OECD Countries.* *OECD Economics Department Working Paper*, No. 224. Paris.

3.3 Corporate Tax Reforms

Recent tax reforms in the corporate tax field can be seen as a continuation of efforts to improve efficiency in the allocation of real capital and to strengthen the competitive position of firms, while at the same time protecting domestic tax revenues and aiming for an equitable sharing of the tax burden between capital and labor income. Statutory corporate income tax rates have been reduced in many countries, sometimes significantly, and corporate tax bases have been broadened with special corporate tax preferences unwound or scaled back, enabling a (partial) financing of a reduction in statutory rates.

Such reductions in statutory corporate tax rates are generally viewed as attractive by investors, while also assisting tax administration efforts by reducing tax-planning pressure on the tax base. Alternative strategies have been adopted in other OECD countries to further improve the competitiveness of firms — for example, strategies providing direct support for investment in information technology to enhance productivity and tax incentives for R&D. While certain similarities may be observed, the examples cited below reflect diversity across OECD countries in tax systems, fiscal environments and corporate tax policy strategies.

Recent reforms of the corporate income tax rate based on the principle of reducing tax rates and broadening the tax base may be seen as a continuation of the reforms in the United Kingdom in 1984 and the United States in 1986, which was followed by similar reforms in many countries in the early 1990s (e.g. in the Nordic countries and New Zealand). However, in addition to the objective of reducing tax distortions caused by high rates on a narrow tax base, the recent cuts in corporate tax rates are also partly driven by an objective to attract foreign direct investment in an increasingly fierce competition between countries.

Reducing Corporate Tax Rates

The corporate tax reform announced in Belgium in October 2001, with effect from 2003, involved an enlargement of the corporate tax base, enabling a significant reduction in the statutory corporate tax rate, with the net budgetary impact expected to be nil. The reduction in the statutory rate would see the basic nominal rate falling from 39 to 33 per cent (excluding the crises surcharge), and a lowering of the reduced rate for small and medium-sized enterprises.

Significant corporate tax rate reductions are also on stream in Canada, made possible largely as

a result of strong economic growth and following significant base broadening in recent years. In 2000, the general federal corporate income tax rate in Canada was 29.12 per cent, inclusive of surtax, and provincial rates averaged 14 per cent. The corporate tax rate was relatively high compared to other countries (particularly when Canada's capital taxes were factored in — see below), and moreover, other countries had reduced or announced reductions in their statutory corporate tax rates. A key principle of the tax reduction plan announced in 2000 was that the business tax system must be internationally competitive, with high corporate tax rates viewed as impacting negatively on economic growth, productivity, employment, wages and income.

The tax rate reduction drive in Canada is targeted at high-taxed sectors, or more specifically, at income that had been subject to the basic (general) rate. Prior to the general rate reduction, small business income and manufacturing and processing (M&P) income were already subject to a relatively low effective tax rate (owing to a special small business deduction, and a M&P profits deduction). In its 2000 budget, the federal government announced that the federal statutory corporate tax rate applicable to high-tax sectors would be reduced within 5 years from 28 to 21 per cent, beginning in 2001 with a 1 percentage point reduction. Later in the year, following strong revenue growth, the federal government announced an accelerated timetable for phased-in reductions in the basic rate, to 25 per cent in 2002, 23 per cent in 2003, and 21 per cent in 2004. In addition there is a surtax of 1.12 per cent. Taking the federal lead, many of the provinces announced reductions in their general corporate income tax rates as well. These combine to give a reduction in the average provincial general rate from roughly 14 per cent in 2000, to about 12.5 per cent in 2004.

In September 2003 the government in Finland agreed upon a corporate tax reform, which will be introduced in 2005. The most important measures of the reform are the lowering of the statutory corporate tax rate from 29 to 26 per cent and the personal capital income tax rate from 29 to 28 per cent. The dividend imputation system will be abolished and replaced by a partial inclusion system that includes a certain percentage of dividends in the personal income tax base (more on this below). In addition, the wealth tax thresholds will be increased and the tax rate lowered. With corporate tax rates having been reduced in many countries, a main goal behind these tax reform measures is to improve the

international competitive position of the Finnish tax system. In particular, the reform is aimed to spur entrepreneurship and promote corporate investment, growth and capacity to generate employment.

While corporate tax rates were effectively increased in France during the mid-1990s, the tax rate applied to corporate profits was decreased from 42 per cent in 1998 to 35.4 in 2002.¹⁴ These rate cuts have been financed by base broadening measures, in particular by reducing depreciation rates and modifying the system for taxation of dividends distributed between companies. The tax cuts for small and medium-sized businesses were larger, and the reform of the corporate income tax rate was supplemented by a reform of the local business tax (*taxe professionnelle*).

Fundamental tax reform has also been underway in Germany, beginning in 2001, aimed at improving the international competitiveness of the German economy. As from 2001, the statutory federal corporate tax rate was cut to a uniform 25 per cent. Under the previous split-rate regime, the rate was dependent on whether profits were distributed (30 per cent) or retained (40 per cent). These changes were accompanied by a fundamental change in the way in which corporate and personal income taxes are integrated (see below).

Significant cuts in personal income taxes in Germany are also providing a competitive boost to unincorporated businesses, a particularly important component of the German economy. These cuts follow an increase, in three steps, in the basic personal allowance from approximately 12,300 DM in 1998, to 15,000 DM in 2005. Over the same period, the basic rate of tax is being reduced from 25.9 per cent to 15 per cent, with the top rate cut to 42 per cent. As of 2005, the top rate is to be applied to taxable income in excess of DM 102,000.¹⁵

To maintain a low rate, broad base system, the main corporate income tax rate in the United Kingdom was cut from 33 to 31 per cent in 1997

and further to 30 per cent in 1999. Rate cutting was accompanied by several base broadening measures, including the abolition of the Advanced Corporation Tax and the system where certain tax-exempt shareholders (pension funds etc.) could get the value of the dividend tax credit paid out in cash. As in many other countries, the tax cuts were larger for small and medium-sized companies, where the small companies' rate was reduced to 19 per cent in 2002 with a starting rate of zero.

Significant statutory corporate rate reductions have also been witnessed in the Czech Republic and Slovak Republic. In 1990, corporate income tax was introduced in the Czech Republic with rates ranging from 20 to 65 per cent, depending on the nature of the taxpayer and the amount of tax base.¹⁶ At the time of the creation in 1992 of two new independent states, the Czech Republic and the Slovak Republic, the corporate tax rate was 45 per cent.¹⁷ Since then, both countries have been reducing their statutory corporate tax rate. By 2002, the rate had fallen to 31 per cent in the Czech Republic, and to 25 per cent in the Slovak Republic. It is noteworthy that, despite the rate reductions, corporate tax revenues as a percentage of GDP increased steadily in the Czech Republic between 1998 and 2002 while remaining fairly stable in the Slovak Republic. The Czech Republic slashed its corporate tax rate further to 28 per cent in 2004. Also in 2004 the Slovak Republic reduced the tax rate to 19 per cent, when a flat tax on personal and corporate income was introduced.

Iceland is among the other OECD countries that have cut their corporate income tax rates in recent years; their rate was cut from 30 per cent to 18 per cent in 2002. Ireland, while reducing its general corporate income tax rate from 31 per cent in 1998 to 12.5 per cent in 2003, had to increase the 10 per cent special tax rate for manufacturing to 12.5 per cent in order to comply with the EU Code of Conduct on Business Taxation.

14 The statutory rate is 33.33 per cent when excluding the remaining part of the 1995-surtax (3 per cent) and the 3.3 per cent *Contribution sociale sur les bénéfices* levied on firms with a turnover and profit above €7.6 million and a profit above €763,000.

15 Additionally, sole traders or entrepreneurs deriving income from trade or business and liable to local trade taxes (*Gewerbesteuer*) are afforded relief with the crediting of the trade tax against income tax liability. As a result, the majority of SMEs are given full relief from trade tax. Furthermore, the restructuring of unincorporated companies by way of a tax-neutral transfer of reserves is facilitated by reintroducing the so-called "Co-partner tax remission". This provision makes the transfer of a company easier and helps SMEs cope with inter-generational succession.

16 Under the communist regime, profit tax rates varied widely and were subject to yearly negotiation, and set with reference to firm profitability and national policy objectives. With the fall of the communist regime in November 1989, reforms of the tax system began immediately.

17 Also, in 1992, the final withholding tax rate on dividends and interest was 25 per cent. This withholding tax rate was reduced to 15 per cent in 1994 in the Slovak Republic, and in 2000 in the Czech Republic.

Also, 2004 witnessed very significant corporate income tax rate reductions in a number of OECD countries. In addition to the rate cuts noted above for Belgium, Canada, Finland, Germany, the Czech Republic and the Slovak Republic, Hungary reduced its statutory corporate rate by two percentage points to 16 per cent, while Mexico took one percentage point off to lower its rate to 33 per cent. Portugal cut its corporate tax rate by over 5 percentage points, to 27.5 per cent, while Poland cut its rate by a staggering 8 percentage points, to just 19 per cent. In addition, Austria has decided to reduce its corporate income tax rate from 34 per cent to 25 per cent from 2005.

Base Broadening

As noted above, the reduction in the statutory corporate tax rate in Belgium from 39 to 33 per cent in 2003, and the lowering of the small and medium-sized enterprise tax rate, was made possible by significant base broadening, with the net budgetary impact expected to be nil.¹⁸ A number of measures were introduced to expand the tax base and realize the revenue neutral result. The main measures include non-deductibility of regional taxes; reinforcement of measures to avoid under-capitalization; and increased control over the taking of exemptions.

These changes build on earlier phases of tax reform in Belgium that have concentrated on doing away with or limiting tax expenditures and misuse of existing provisions. This includes efforts to refocus measures to eliminate double taxation, steps taken to ensure that exemptions were granted only if the income in question had in fact already been taxed, and the replacement of standard tax credits for foreign withholding taxes notionally paid with credits for tax actually withheld. These changes led to a rise in the (effective or implicit) corporate tax rate; a reduction in tax expenditures;¹⁹ and a more moderate trend in deductions to eliminate double taxation, with the exception of capital gains on shares.

Overall, these earlier reform measures have increased the effective corporate tax rate in Belgium, whether one uses an implicit tax rate or other corporate tax burden indicator. When computed on the basis of tax statistics, the differential in relation to the nominal tax rate

narrowed from 15.2 to 3.6 percentage points, between 1990 and 1998. The same trend emerges whether indicators are based on macroeconomic, accounting or tax data: the corporate tax burden in Belgium is approaching the nominal tax rate.

The corporate tax rate reductions noted above for Germany are being financed, for the most part, through base broadening. In particular, among the measures adopted to finance tax reform, principal emphasis was being placed on restricting tax depreciation arrangements to reflect what are believed to be more realistic useful life periods. Under the revised depreciation schedules, the declining-balance depreciation rate for movable assets was lowered from 30 to 20 per cent, while the depreciation rate for company buildings fell from 4 to 3 per cent.

Other Measures to Improve the Business Environment

While reductions in statutory corporate tax rates may attract the greatest amount of public attention, adjustments aimed at addressing unintended effects and costs on business are equally noteworthy developments. Indeed, much if not most corporate tax policy making involves reviewing tax systems with an eye to ensuring that not just the main tax parameters but also the more detailed rules are enabling to business and supportive of policy goals.

In contrast to other countries which have largely relied on statutory corporate rate reductions as a means to encourage investment, Japan has recently embarked on an alternative strategy to bolster the competitiveness of Japanese firms. In October 2002, Japan announced that it would initiate a tax reduction in 2003 which would exceed one trillion yen under a multi-year reform bill, with a focus on stimulating the competitiveness of corporations in high-growth potential industries.

Under the reform environment in Japan in 2002, with many corporations not making sizable taxable profits, the effectiveness of a reduction in the general statutory corporate tax rate was doubtful to policy-makers. Moreover, it was recognized that general tax rate cuts would benefit corporations making profits mainly through dividends and other income from overseas — profits arising from investments made overseas

18 The inclusion of a 'supplementary contribution' brings the basic rate (33 per cent) to 33.99 per cent.

19 A continued profit exemption applies for profits of Belgian Co-ordination Centers, the only remaining major tax expenditure. Other preferential schemes (e.g. for "redeployment companies") were frozen in the early 1990s, and the capital investment deduction was limited to investment by SMEs and to investments that generate positive spillovers (e.g. R&D, environmental benefits).

and in the past. Such tax relief would have no direct effect on creating jobs and increasing consumption in Japan. Also, personal income tax rates had been lowered just prior to this period, in part to stimulate household demand, and little scope was seen to reduce personal tax rates further.

In contrast, targeted corporate tax incentives aimed at R&D and information technology were viewed as providing more focused tax relief to promote investment in fixed capital and intangibles. The pre-reform system gave incremental R&D tax credits (as opposed to volume-based credits), with progressive tax credit rates on the level of incremental R&D investment. However, corporations that had already made a large investment in R&D were expected to be generally insensitive to an incremental credit. Furthermore, the 2002 economic environment was not conducive to an increase in R&D investment by corporations. Thus, replacing the incremental credit with a volume-based proportional R&D tax credit was tabled for consideration as part of 2003 tax reform. The measures ultimately included in the 2003 reform were expected to result in tax reductions of approximately 1.8 trillion yen (U.S. \$14.9 billion) in the fiscal year 2003.

Several other countries have introduced special tax incentives for R&D investment. For example, the United Kingdom has introduced a tax relief on R&D expenditure at a rate of 125 per cent for large companies and 150 per cent for small and medium-sized companies.

In a move to further improve the competitiveness of firms in Canada, the federal government announced that it would also review its Large Corporations Tax (LCT), set at 0.225 per cent on taxable capital employed in Canada in excess of \$10 million, and reduced by the corporate income surtax.²⁰ While corporations are able to credit corporate surtax against LCT (a form of minimum tax), concerns had been expressed that the tax on capital employed in Canada, being profit-insensitive, put Canadian firms (particularly early-stage firms and those subject to cyclical effects) at a competitive disadvantage. A review at the federal level led to the announcement in Canada's 2003 budget of a phase-out of the LCT.

By temporarily increasing the amount of investment small business can write-off immedi-

ately and by allowing all businesses to write-off immediately one-half of qualified investment, the United States has enacted substantial short-term tax relief for businesses. These provisions are intended in part as a short-term stimulus to aggregate demand. If made permanent, however, they would represent a substantial step towards cash flow taxation.

Corporate and Personal Tax Integration

In order to reduce the double taxation of corporate profits, in 2003 the United States reduced the maximum statutory federal tax rate on dividends and capital gains to 15 per cent. This tax cut is expected to help to remove taxes from decisions concerning where to invest, whether to finance with debt or equity, and whether to pay out profits as dividends or instead repurchase shares or retain the income within the corporation. The tax cut also is expected to help stimulate the economy in the short run by boosting investment and the value of the stock market.

The integration of corporate and personal income tax systems has long been a hallmark of many European tax systems. Thus it is interesting to observe that at roughly the same time as the United States has moved to integrate its corporate and personal tax systems, many European countries are moving in the opposite direction towards classical tax treatment. The differences in policy approaches reflect different policy environments, underscoring the dependence of tax system design on the policy environment, including market characteristics.²¹

Where the marginal source of finance for domestic investment is domestic equity capital, then integration relief provided to domestic shareholders can be expected to lower the cost of capital for firms, spurring investment. While this effect may be broadly observed in the United States, it may not be in a number of European countries. In the small open economy context where large multinationals rely on foreign capital raised in international capital markets, the cost of finance is exogenously determined, independent of the degree of integration of domestic corporate and personal tax systems. In such cases, integration relief may serve to boost domestic savings, but may not lower the cost of capital to firms. A

20 A separate capital tax is levied on financial institutions.

21 In deciding the relative merits of reducing/eliminating imputation credits to shareholders, one consideration for European countries is the view of the European Court of Justice (ECJ) that dividends received from foreign companies must be taxed in the same way as dividends received from domestic companies (i.e. if imputation credits are provided to shareholders, they must be provided for both domestic and foreign-source dividend income).

number of European countries have chosen to reduce the degree of integration relief offered, while in certain cases targeting such relief to small and medium-sized firms that may have limited access to international capital markets.

In Sweden, relief from double taxation is limited to equity interests in small- and medium-sized companies that generally have limited access to international capital markets. Individual shareholders of unlisted Swedish companies are exempt from tax on dividends received up to a threshold amount (equal to 70 per cent of a 'normal' return on equity, determined by applying a specified interest rate on government debt to the acquisition value of shares).

As of 2002, the full imputation system in Germany was replaced by the so-called half-income system, under which only one-half of distributed profit is exempted from the shareholder personal income tax base. With the half-income system replacing the imputation credit approach, corporate income tax is no longer fully offset at the shareholder level.

As noted above, Finland has recently decided to replace its full imputation system by a partial inclusion system from 2005, similar to the German half-income system. Under the previous system, full relief was provided at the shareholder level for corporate tax paid on distributed income. In the new system, 70 per cent of dividends from listed companies will be taxed as personal capital income at a rate of 28 per cent (that is, a 30 per cent exclusion is provided). For unlisted companies, the same treatment will apply for dividends exceeding €90,000 per person dividends. However, dividends paid by unlisted companies will remain tax-free at the shareholder level if the shareholder interest is not larger than 9 per cent of the net value of the company. Dividends exceeding the 9 per cent limit will be taxed as earned income.

Portugal also replaced its imputation system in 2002 with a partial inclusion system that includes half of dividends received in taxable income. Similarly, France will adopt a half-income inclusion approach beginning 1 January 2005. Turkey has also decided to introduce a half-income system. In Italy, the former imputation system was replaced in 2004 with a modified classical system that includes 40 per cent of dividends received, 10 percentage points less than under the half-income inclusion approach applied in Portugal, France and Germany, while restricting

the relief to shareholders owing at least 5 per cent of the share capital (25 per cent in unlisted companies).

It may also be noted that the United Kingdom has reduced the degree of integration provided. In particular, the dividend (imputation) tax credit attached to domestic dividends has been reduced to one-ninth (and is non-wastable).

4 Tax Administration

The borderline between tax policy and tax administration is never clear. Policy reforms are, in part, driven by what is administratively feasible. Also, in practice the tax administration will be engaged in day-to-day reform of the tax system. It is, therefore, of interest when looking at tax reform to also examine recent trends in the conduct of tax administration in OECD countries. This section draws on work of the CFA's Forum on Tax Administration, including a number of publicly-released documents: "Tax Administration in OECD Countries: Comparative Information Series (2004)" and "Managing and Improving Tax Compliance."²²

Institutional Arrangements for Revenue Administration

Governments in OECD countries have established a variety of institutional arrangements for the administration of tax laws. These include the creation of unified and semi-autonomous bodies (in 15 OECD countries) with a broad range of powers that are responsible for the administration of most, if not all federal/national taxes; single directorates with little autonomy within the formal structure of the ministry of finance (in 6 countries); and multiple directorates with little autonomy within the formal structure of the Ministry of Finance (in 9 OECD countries). To a large extent, these varied institutional arrangements reflect underlying differences in the political structures and systems of public sector administration in countries, as well as longstanding historical practice. In 11 countries, the tax body is also responsible for the collection and enforcement of social contributions, while in 17 countries the collection and enforcement of these has been entrusted to a separate body. In six OECD countries, there is a unified body responsible for both tax and customs administration operations, but there does not appear to be any trend in this direction. There is, however, a clear trend to allocate other tasks of a non-taxation

²² These documents may be found at <http://www.oecd.org/publications/>.

nature to the national revenue body. Such tasks include government valuation tasks, the payment of various social welfare benefits, the collection of non-tax government debts (e.g. child support, student loans), and the maintenance of population registers.

Organization of Tax Administration Operations

A revenue body's organizational structure can have significant implications for overall operational efficiency and effectiveness in delivering its primary mandate. Particularly over the last 10-15 years, there has been a clear trend in the way the organizational structures of national revenue bodies have evolved.

The earliest organizational model employed by tax administrators was based principally on "type of tax" criterion. This entailed the operation of separate multi-functional departments for each tax that were largely self-sufficient and independent of each other. While this model served its purpose, it was eventually seen to have numerous shortcomings, including: (1) an inherent duplication of functions; (2) inconvenience for taxpayers with multiple tax dealings; (3) complicated compliance management implications; (4) a propensity for uneven and inconsistent treatment of taxpayers across taxes; and (5) under-utilization of staff. To address these sorts of problems, tax administrators have resorted to organizing their operations largely on a 'functional' basis.

Under the functional basis, staff are organized principally by functional groupings (e.g. registration, accounting, information processing, audit, collection, appeals, etc.) and generally work across taxes. This approach to organizing tax work was introduced to enable greater standardization of work processes across taxes, to simplify computerization and arrangements for taxpayers, and to generally improve efficiency. Today, over two-thirds of OECD countries have adopted the functional model as the primary method for structuring tax administration operations.

A more recent trend among a number of OECD countries has been to organize operations principally around 'taxpayer segments' (e.g. large businesses, small/medium businesses, wage earners, etc.). The rationale for organizing operations around taxpayer segments is that each group of taxpayers has different characteristics and tax compliance behaviors and, as a result, presents different risks to the revenue. This is the model that was adopted for the US Internal Revenue Service, as part of the 1998 Restructuring Act. Proponents of the 'taxpayer segment' type of

structure contend that grouping key functional activities within a unified and dedicated management structure increases the prospects of improving overall compliance levels. While application of the 'taxpayer segment' model is still in its early stages of use, many countries have partially applied this approach by establishing large taxpayer units to fully administer the affairs of their largest taxpayers.

Managing Taxpayers' Compliance

The fundamental goal of all revenue bodies is to improve the overall level of compliance with the tax laws. This is by no means a straightforward task given, among other things, the complexities of many taxpayers' affairs, the population of taxpayers to be administered with available resources, and the many and varied forms of non-compliance behavior to be addressed (e.g. unreported income, over-claimed deductions, fraudulent VAT refunds, non-payment of debts, and non-filing of returns).

In order to address tax compliance risks more effectively, there has been a trend in recent years in more advanced OECD countries to adopt a more strategic approach to managing these risks, applying modern risk management techniques. This development has been in line with the adoption of modern corporate governance practices, gives recognition to the fact that the more serious tax compliance risks require a range of treatment strategies and has been found to be a useful way of communicating to staff of what the revenue body is trying to do and what is expected of them.

In practical terms, the application of this more strategic approach has led to better targeting of compliance improvement efforts, more effective matching of compliance improvement strategies with the underlying behavior to be addressed and, for some countries, demonstrated improvements in specific areas of taxpayers' compliance.

Tax Return Filing and Payment Regimes

The administrative workloads of revenue bodies are to a large extent influenced by the nature of the systems in place for collecting and paying taxes, and the filing of associated tax returns, and the optimal use of modern technology.

Personal income tax: Concerning tax payment, withholding systems are the cornerstone of personal income tax collection in respect of salary and wage income in all but two OECD countries (France and Switzerland). Withholding mechanisms are also applied in the majority of OECD countries in respect of dividend and interest

income paid to resident taxpayers. For income that is not subject to withholding, virtually all countries rely on a system of advance payments requiring the progressive (i.e. generally monthly or quarterly) payment of tax commencing within the year of income.

Concerning return filing obligations for employee taxpayers, a variety of arrangements have evolved across OECD countries, each with significantly different compliance burdens for taxpayers and employers, and administrative costs for tax bodies. These arrangements fall into four distinct categories: 1) cumulative withholding systems administered by employers that generally obviate the need for employees to file annual tax returns (operating in 15 OECD countries); 2) cumulative withholding systems administered by employers coupled with the preparation and issue of pre-populated returns by the tax body to taxpayers, the majority of which in practice do not require further adjustment by taxpayers (operating in 4 Nordic OECD countries, and being tested elsewhere); 3) non-cumulative withholding systems requiring the annual preparation and filing of tax returns by taxpayers (operating in 9 countries); and 4) no withholding, with taxpayers required to make advance payments (2 countries).

Advances in technology in recent years in many countries have significantly facilitated employers' administration of withholding regimes (both cumulative and non-cumulative type arrangements), while at the same time enabling taxpayers and tax professionals in many countries to prepare and file their returns electronically (see later comments).

Corporate tax: All OECD member countries rely on a system of advance payments requiring the progressive payment of tax, although these systems vary substantially in terms of the number of payments to be made, the basis of their computation, and the precise timing of individual payments. OECD countries are roughly evenly split in their use of administrative assessment vis-à-vis self assessment arrangements.

VAT: As noted in Section 2.6, systems of value added taxation operate in all but one OECD country (i.e. the United States) and represent a significant part of the revenue base of most OECD countries.

Across OECD countries, VAT payment and filing requirements (and associated administrative workloads) are characterized by monthly payment and return filing obligations for the largest taxpayers and less frequent (i.e. quarterly, six

monthly, or annual) obligations for smaller taxpayers. Businesses required to charge VAT are largely identified on the basis of an annual turnover threshold, the precise levels of which vary substantially across OECD countries, with direct implications for administrative workloads and taxpayers' compliance burden.

A significant feature of VAT systems in general, and particularly in OECD countries, is the incidence of VAT that must be refunded to taxpayers, in particular, exporting businesses (resulting from the so-called "zero-rating" of exports) and other businesses with excess input credits. It is not uncommon for revenue bodies in some OECD countries to have to refund the equivalent of 30-40 per cent of gross annual VAT receipts. This is one of the less attractive features of VAT systems as it presents unscrupulous registrants with opportunities for fraud and accordingly brings added pressure to revenue bodies to employ effective risk-based checks, with significant resource implications, to detect and deal with fraudulent refund claims.

Delivery of Services and Use of Technology

An effective program of taxpayer services is a critical objective of all revenue authorities. The general complexity of tax laws coupled with the population of taxpayers to be administered mean that, fundamentally, all revenue authorities must rely substantially on taxpayers' voluntary compliance to achieve the outcomes expected of them. It is axiomatic that to achieve high levels of voluntary compliance, taxpayers and their representatives must have a good standard of services to help them determine their obligations under the laws and to complete the steps required to acquit those obligations.

Particularly over the last decade or so, the goal of improving voluntary compliance has led many revenue authorities to adopt a more strategic approach to the provision of services to taxpayers. This has manifested itself in the following sorts of ways:

- Differentiating service delivery actions/activities across the various segments/groupings of taxpayers, recognizing that taxpayer populations are not homogeneous but are comprised of varying segments/groupings of taxpayers, each with their own characteristics, attitudes, expectations, and behaviors.
- Treating taxpayers as persons/bodies with rights that are codified in the form of charters, etc., and publicized; treating taxpayers as clients or customers.

- Recognizing that it is often more cost effective to leverage service actions through taxpayers' representatives (e.g. tax professionals, industry/business groups, other third parties).
- Consulting widely with taxpayers and/or their representatives prior to the implementation of changes; designing products more from a 'whole of taxpayer/client' perspective.
- Taking advantage of modern technology offerings.
- Establishing and monitoring service delivery performance according to prescribed service performance standards.
- Measuring client satisfaction with the level and quality of services offered.
- Demonstrating accountability by publicizing the levels of performance achieved against the service standards set.
- Ensuring that there is an appropriate balancing of resources between service and enforcement activities to achieve the outcomes being sought.
- Systematically identifying weaknesses in service delivery and developing organizational action plans (including many of the strategies identified above) to address those weaknesses.

Evidence of this more strategic approach to service delivery is seen today in many OECD countries, particularly within those that might be regarded as at a more advanced stage of development.

A particular feature of efforts to improve the delivery of services to taxpayers over the last 5-10 years has been the harnessing of new technologies to improve taxpayers' access to the information required by them, and the delivery of associated services. Recent OECD survey work to gauge the extent of developments in this area has revealed some findings of considerable interest:

- There has been substantial progress over the last four years in the scope and nature of electronic services offered to taxpayers and their agents by virtually all national revenue bodies in OECD countries; notwithstanding this progress, considerable potential exists for many national revenue bodies to substantially increase the take-up rates for the various services offered, especially by businesses.
- Substantial progress has been made in the use of electronic filing by taxpayers and their agents for personal income tax administration purposes; indicative of this progress is the fact that in 2003, the take-up rate for these services exceeded 50 per cent in five OECD member countries, with four achieving 80 per cent or

more (3 without requirements); progress in other areas (e.g. VAT, corporate income tax), largely covering businesses, is considerably less advanced, although a small number of countries have demonstrated that very high overall take-up rates (i.e. over 50 per cent) can be achieved.

- The Internet has become a significant tool for the delivery of services to taxpayers; generally speaking, revenue bodies have substantially increased the information content, functionality, and "user-friendliness" of their websites over recent years; over half of the revenue authorities in OECD member countries offered transaction services via their Internet sites in 2004.
- There has been considerable growth in the provision of electronic payment facilities; notwithstanding this development, the take-up

Table 14
Comparison of Staff-related Measures

| Country | STAFF-RELATED MEASURES | | | Unusual/Abnormal Factors likely/known to Influence Reported Ratio |
|--------------------------|---------------------------------------------------|-------------------------------|----------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| | Aggregate Staff Usage (FTEs) of National Tax Body | Citizens/ One Full-time Staff | Labor Force/ One Full-time Staff | |
| Australia | 19,177 | 1,016 | 512 | |
| Austria | 8,750 | 929 | 450 | Does not administer collection of social contributions. |
| Belgium | 21,489 | 476 | 207 | Includes real property, motor vehicle taxes/fees |
| Canada | 38,381 | 810 | 425 | |
| Czech Rep. | 14,720 | 700 | 351 | Includes real property, motor vehicle taxes/fees |
| Denmark ¹ | 8,226 | 651 | 348 | Includes real property, motor vehicle taxes/fees |
| Finland | 6,323 | 820 | 415 | Includes real property, motor vehicle taxes/fees |
| France ¹ | 75,046 | 788 | 358 | Includes real property, motor vehicle taxes/fees |
| Germany | 122,278 | 665 | 324 | Includes real property, motor vehicle taxes/fees |
| Greece | 14,000 | 752 | 311 | |
| Hungary | 13,258 | 768 | 309 | |
| Iceland | 486 | 586 | 335 | Includes motor vehicle taxes/fees |
| Ireland | 6,364 | 625 | 282 | Includes customs component |
| Italy | 47,575 | 1,202 | 510 | |
| Japan | 56,315 | 2,260 | 1,199 | Most employees are not required to file tax returns; high VAT threshold and low frequency of tax payments; NTA does not administer collection of social contributions. |
| Korea | 16,845 | 2,804 | 1,359 | Most employees are not required to file tax returns; tax body does not administer collection of social contributions |
| Luxembourg | 628 | 706 | 450 | |
| Mexico | 28,292 | 3,536 | 1,384 | Substantial final withholding |
| Netherlands ¹ | 25,400 | 629 | 320 | Includes motor vehicle taxes/fees |
| New Zealand | 4,547 | 853 | 425 | Includes social welfare-related work |
| Norway | 6,305 | 716 | 374 | |
| Poland | 51,435 | 751 | 339 | Includes real property, motor vehicle taxes/fees |
| Portugal | 13,238 | 778 | 402 | Includes real property, motor vehicle taxes/fees |
| Slovak Rep. | 5,791 | 929 | 458 | Includes motor vehicle taxes/fees |
| Spain | 23,961 | 1,680 | 745 | |
| Sweden | 9,030 | 985 | 494 | Includes real property, motor vehicle taxes/fees |
| Switzerland | — | — | — | |
| Turkey | 41,880 | 1,797 | 541 | Includes real property, motor vehicle taxes/fees |
| United Kingdom | | | | |
| —IR/C&E ¹ | 81,859 | 730 | 360 | Includes all staff of national contributions agency |
| United States | 100,229 | 2,261 | 1,445 | No national VAT |

1) These countries have all recently announced their intention to make reductions in the staffing of their revenue bodies.

Sources: Country survey responses, annual reports of revenue bodies.

of these services has been slow, most likely due to taxpayers' concerns around security and fears of fraud.

- There is a clear trend of revenue authorities in most member countries devoting an increasing share of their administrative budgets to IT investments.
- Call centre phone operations, supported by modern phone technology, are becoming an increasingly significant element of the service delivery strategy of many revenue authorities in OECD countries, reflecting drives for increased efficiency and accessibility for taxpayers to the information they require to meet their tax obligations.

Resources for Tax Administration Bodies

Generally speaking, revenue bodies are large consumers of public sector resources and there is, accordingly, considerable interest in ensuring that these resources are used efficiently and effectively.

Given the similarity in the major taxes collected by national revenue bodies in most OECD countries, observations are made from time to time on the comparability of their respective administrative budgets. As salary expenditure constitutes the major share of these budgets in all countries, comparisons are frequently made on the staffing levels of the respective bodies to gain some insights as to their relative funding level/efficiency. Comparisons of this kind, however, need to be made with considerable care given differences in the responsibilities of the respective revenue bodies.

A summary of the staffing levels of national revenue bodies is set out in Table 14. To the extent possible, account has been taken of some non-taxation related roles performed by some revenue bodies. In order to reflect a degree of relativity, aggregate staff levels have been compared with overall official country population and labor force data. To assist readers, known abnormal factors influencing the reported ratios have been identified.

As will be evident, the greatest level of consistency occurs in relation to the measure based on country labor forces — 11 countries have a ratio in the range 301–400 and 11 in the range 401–550. However, there are four significant outliers (Japan, Korea, Mexico and the United States) about which brief reference should be made.

In the case of Japan, staffing levels of the NTA have remained in the region of 50,000 to 56,000 for the last 50 years, reflecting decisions both to keep resources roughly constant and, no doubt, to minimize workloads. Concerning the latter, the administrative workload is much less than in many other OECD countries due to the design of tax collection systems and administrative practices. For example, until recently²³, there was an abnormally high threshold for VAT registration (i.e. equivalent to around €300,000) and bi-annual payment and filing requirements for VAT. In addition, there are biannual return filing and payment obligations in respect of corporate tax, withholding of tax at source on dividend and interest income and certain payments for independent services, while a final wage withholding system applies for most employee taxpayers. Also relevant is the collection of social security contributions by a separate agency. Korea also imposes withholding at source for dividend and interest income and certain payments for independent services, makes substantial use of final withholding systems for the bulk of employee taxpayers (with minimal recording of taxpayer registrations), and applies bi-annual reporting and payment arrangements for VAT liabilities. With annual tax collections equivalent to around 19 per cent of GDP, Mexico's tax system is of a much smaller scale than other OECD countries. Its tax system arrangements are characterized by substantial use of final withholding system arrangements for employee taxpayers (with quite limited registration of personal taxpayers (equivalent to around to 21 per cent of the official labor force)), and a relatively small population of registered business taxpayers. In the case of the United States, a comparison of relative staffing levels with other OECD countries is significantly complicated by the absence of a national VAT (or a similar tax) administered at the national level, as in all other OECD countries. A further complication is that, unlike most other OECD countries, there are income taxes and retail sales taxes levied at the state level in the United States that are administered separately, not by the national revenue body.

5 Tax Policy Challenges for the Future

The reductions in tax revenues and tax rates discussed in section 2 of this paper result largely from a recognition of the improvements in

23 From 2004, registration, return filing, and payment obligations have been brought more into line with the requirements seen in most OECD countries.

economic efficiency that lowered taxes can bring, while the two policy areas discussed in section 3 illustrate in detail how countries try both to reduce the harmful distortions that taxes can generate and to promote a competitive environment.

The evidence of a break in tax revenue reductions in 2003 suggests that the future may not just be a continuation of the recent past, with continued tax cuts and improved economic efficiency. The main part of this break was probably caused by a recovery of economic growth.

But this is not the only problem. Population aging in almost all OECD countries suggests that the demands for government finance for pensions and healthcare will grow significantly over the next fifty years. At first sight, this appears to give governments a very difficult choice — between raising taxes substantially, cutting entitlements to core expenditure programmes, imposing higher user charges and/or improving the efficiency of the public sector. Many OECD countries mainly finance pensions and healthcare from social security contributions and other payroll taxes. Increasing these taxes would result in increasing the tax wedge on labor — something that many countries have been fighting hard to reduce. The increased tax wedge could reduce labor force participation and working hours, leading to a reduction of the tax base, making it even harder to raise the desired revenues.

At the same time, governments are facing difficulties in maintaining their existing tax bases. The tax base associated with capital income and high wealth individuals is becoming increasingly geographically mobile. A growing proportion of the consumption tax base — particularly that associated with digital products (e.g. music, software) — is also already highly mobile. Attitudes towards tax compliance are shifting, with more taxpayers being prepared to engage in aggressive tax planning, often involving the use of tax havens. In Europe, the tax base is also threatened by a spate of recent decisions by the European Council of Justice which has ruled a number of anti-abuse provisions (e.g. thin capitalization rules) to be inconsistent with the EU Treaty of Rome.

Governments find themselves squeezed by pressures to increase their expenditures and the need to make their tax systems more competitive. On the expenditure side this has led some governments to look at how health and pension provisions could in part be met by the private

sector. On the revenue side governments are likely to pursue the types of reforms described in this note, although we could expect that there will be a new willingness to explore more fundamental tax reforms.

As each country pursues its tax reforms they will be guided by specific circumstances. Nonetheless, recent experience of OECD countries suggests that there are some general principles of good tax design which could contribute to individual solutions that each country will need to develop:

- *Simplification.* Many countries have attempted to simplify their tax systems but more can be done in most countries. Simple tax systems, characterized by low rates applied to a very broad tax base, generally lead to fewer economic distortions, greater certainty for the taxpayer, as well as lower administrative and compliance costs. If politicians are serious about reducing the complexity of the tax code, however, they first need to review the policies that the code is trying to implement.
- It is possible to identify two aspects of fairness: vertical equity and horizontal equity. While countries differ widely in their views on using the tax system to promote vertical equity, there is more general support of the concept of horizontal equity — that people in similar situations should pay similar amounts of tax. The special tax exemptions, reliefs and regimes that abound in OECD countries often violate the principle of horizontal equity, while achieving little of real value. The elimination of these, or their replacement with policies that achieve their objectives more efficiently, would produce a gain in revenue while improving economic efficiency. Similarly, these lower rates applied to a broader base should be vigorously enforced. This will require that as governments pursue their tax reform agenda, they also examine the operation of their tax administrations. Good tax compliance, which is an essential element of fairness, requires that governments get the right balance between taxpayer service and tax enforcement. Those taxpayers who want to pay the right amount of tax have the right to expect that the tax administrations make this task as easy and painless as possible. Honest taxpayers also have the right to expect that those who cheat on their taxes will be identified and reprimanded. Only if we get this balance right will we maintain taxpayers' faith in the system.

-
- *Removal of tax obstacles to growth.* Complexity and special tax exemptions can also create serious obstacles to growth, creating uncertainty and giving companies greater financial returns from distorting their decisions to take advantage of special tax provisions than from simply improving efficiency and meeting consumer needs.
 - *Move to more efficient tax bases.* Countries could consider altering the balance between different tax bases. The efficiency of many tax systems has been improved by using a broad-based VAT to replace a patchwork of individual excise duties and sales taxes. Could countries that finance pensions and healthcare from taxes on labor diversify their funding to less

distortionary taxes, e.g. by increasing the share of revenue from consumption and property taxes? Consumption-based tax systems would also reduce or remove the negative effects on pension savings and other forms of savings imbedded in an income tax system, if the increased revenue from consumption taxes is used to reduce income tax rates. Furthermore, such a tax shift could increase participation of women and older people in the workforce — allowing incomes, consumption and therefore the tax base to grow. This is a far better alternative to raising taxes on labor and capital and seeing these tax bases diminish further.



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